ZEI Insights

Is the Juncker plan an appropriate answer to the European investment gap? - A Literature Review

No. 25 June 2015

By Tobias Buchmann

In March 2015, the European Council adopted the implementation of the Juncker Plan. The plan is based on a November 2014 communication of the European Commission (EC) proposing "An investment Plan for Europe" (European Commission 2014). It starts with an analysis of the status quo of public and private investment levels. The Commission states that due to the enduring economic and financial crisis, investments dropped overall significantly from the peak in 2007 by about 15% and by much larger amounts in member states that were particularly hit by the crisis such as Italy, Spain or Greece. Moreover, investments fell clearly below the historical trend. This decline, it is concluded, decreases the potential for employment, growth recovery and international competitiveness. To increase investments in Europe the Commission suggests a three pillar strategy. First, the provision of an additional amount of 315 billion euro of public and private investments over three years through the establishment of a European Fund for Strategic Investment (EFSI). The EFSI is expected to start operations by the end of this summer after approval by the European Parliament in June 2015. Second, the development of investment opportunities by selecting economically viable projects to channel the funds into the real economy. Third, initiatives for better regulation and for the completion of common markets to increase the attractiveness of investments. Member states are expected to contribute to the EU funds to reach altogether a leveraged amount of half a trillion euro of additional investments. While most previous initiatives targeted the structural rigidities in Europe, that is, mostly supply problems, the Juncker Plan focuses on the demand side of the economy with pillar one and two complemented by the supply oriented pillar three (Schneider 2015).

An important aspect of the initiative is that the EU is not willing to actually spend the envisaged 315 billion euro as such, rather its role is taking over part of the risks of private investments. Thereby, it is expected, that investments yield higher rates of expected returns which will attract private investors. Only an amount of 21 billion euro will directly be public money which is expected to be leveraged by a factor of 15. The European Fund for Strategic Investments (EFSI) will support investments in fields that yield high social returns such as infrastructure, education, innovation and renewable energy. Absorbing parts of investment risks is a promising approach. In innovative projects, investors are not only faced with a high level or risk but with true uncertainty (Knight 1921) meaning that they are not able to attribute a failure or success rate to projects. This leads to a situation where investments fall below the socially optimal level. Claeys, Sapir and Wolff (2014) stress that the EFSI should hence focus on very risky projects for which guarantees increase the propensity to invest and that are most probably not carried out without guarantees. Support for such projects may also decrease the risk of crowding out of private investments by public money. On the other hand, authors such as Diermeier and Hüther (2015) raise concerns over this reasoning. Investors' reluctance might simply reflect market risks but does not necessarily indicate the existence of market failure.

Critical points

While some authors are in favor of the general line of argumentation and the conclusions drawn by the EC, others doubt the necessity and effectiveness of the plan. Even those which are generally in favor of public investment support raised critical questions. Claeys, Sapir and Wolff (2014) doubt that the EC is able to quantify the exact shortfall of investments which could be much larger than 100 billion euro per year. On the other hand, Gros (2014) questions the existence or at least the relevance of an investment gap since, it is argued, an ageing society and decreasing populations require less infrastructure. Also, investment in 2007 which is the benchmark of the EC's analysis were driven by construction activities which created an investment bubble (Diermeier and Hüther 2015).

In the second pillar, an EU Task Force on Investment has been implemented to identify projects that fulfill certain criteria and to address potential barriers to investment. Member states have been asked to present project ideas. By December 2014 already 2000 projects worth 1.3 trillion euro have been identified. The question is, which regions will receive most of the funds. From an investors perspective factors such as political stability will be taken into account. This will favor countries that are performing comparatively better and hence have less need for support. It is explicitly stipulated that "there should be no thematic or geographic pre-allocations, in order to guarantee that projects are chosen on their merits and maximize the added value of the Fund". Countries that face the strongest fiscal constraints might not be able to invest in additional projects due to strict economic governance rules, while those that have the freedom to invest more are not willing to spend more (Schneider 2015). Even worse, countries which have the strongest need for additional investments are the ones which are often the least efficient in implementing projects (Diermeier and Hüther 2015).

A further challenge relates to the selection of projects that will receive funding. It refers to Hayek's "pretence of knowledge" argument claiming that governmental intervention can make things worse. Member states may try to lobby to channel funds into their own economy which may lead to suboptimal investment. Moreover, the regions most severely hit may not receive enough funds due to institutional deficiencies (Zuleeg 2014) even though (neoclassical) theory suggests that such regions which have a relatively low capital endowment are most attractive for capital investment which yields a high rate of return, triggering a convergence process. Related is the question to what extent EU money and guarantees generates additional investments and to what extent private investment is replaced by public money, that is to what extent can we expect crowding-out effects. The answer to this question depends on whether firms or regions treat additional public funding as a complement or as a substitute to their own funds (David, Hall and Toole 2000). It is foreseen that the EFSI acts to complement existing policies such as Horizion 2020 for research, development and innovation. It is expected that member states may propose projects for funding that would not have received national funding. However, some of the EFSI's money comes from reshuffling EU money planned to be invested in other projects for growth and development, it is therefore not additional (Zuleeg 2014). Diermeier and Hüther (2015) question to what extent market forces do not work properly which would legitimize an intervention. Schneider (2015) argues that public investment will not crowd out private investments as compared to increased government spending. On the contrary, it can encourage private investments having a crowding-in effect. Moreover, since nominal interest rates set by the ECB are close to zero, the stimulating characteristic of monetary policy is very limited. This situation is also known as a liquidity trap where stimulating fiscal policy measures will not raise interest rates, thus not causing private investments to fall. An Investment Committee, which will consist of independent experts and which is accountable to the Steering Board, will be in charge of the actual project selection. This Committee must ensure that public support does not crowd out private investments and that projects are selected which support structural changes in Europe. The Committee must moreover be capable of selecting projects that would not have been started without the Commission's plan.

The third pillar is better regulation and structural reforms, which has strong potential for long term recovery if applied in a coherent way. Planned measures encompass an Energy Union and the Digital Single Market. So far, it is open to what extent concrete policies in this field will be implemented.

Conclusions

Investments are an easy target for politicians looking for possibilities to cut budgets since such measures do not harm any strong interest groups (Schneider 2015). As many EU countries are bound by strong fiscal constraints, it seems to be a good idea to provide public guarantees to attract private investments (Zuleeg 2014). Private investors are easily willing to invest in infrastructure projects which generate safe returns. This requires setting-up attractive framework and regulatory conditions (Claeys, Sapir and Wolff 2014). Diermeier and Hüther (2015) doubt that the reason for low investments levels is increased risk aversion, arguing that market actors expressed a rather optimistic outlook. They state that political uncertainty plays a much greater role for investment hesitation which is not market failure. Consequently, political stability must be restored and favorable institutions that create trust need to be established. Fiscal rules should be flexible enough to allow critical investments in infrastructure, education research and development. In a monetary union, fiscal policy has a strong role for buffering asymmetric shocks. However, financing infrastructure with public good character is a genuine task of the national and regional governments and should hence not be the target of a singular investment plan. Claeys, Sapir and Wolff (2014) suggest using more credits for public investments since infrastructure will either create own revenue streams or will significantly increase growth potential in the future.

The projects to be selected should strengthen European infrastructure networks, clusters, research and innovation. The internal market should be strengthened to allow for knowledge exchange and European research projects. Addressing the public and private investment gap should therefore be seen as one component of fostering growth rather than being the only policy response. Since investment conditions might be more attractive in countries less hit by the crisis due to more stable political situation, regulatory framework, access to qualified labor and the economic outlook, investments in such countries or regions might even increase the gaps between economies leading to a polarization of economic activities.

The European Commission has set itself a high benchmark. The Investment Committee needs to be able to identify projects that yield high social returns also compared to other initiatives. It is therefore important that experienced EIB experts are involved rather than politicians (Schneider 2015). Eventually, it will be difficult to evaluate to what extent the Juncker plan will actually have been able to trigger additional projects that would not have been started without the plan.

***Tobias Buchmann** is a ZEI MES Alumni "Class of 2008" he is currently a Post-doctoral researcher at the chair for Innovation Economics, University of Hohenheim*

Literature

Claeys, G., Sapir, A. & Wolff, G.B. (2014). Juncker's investment plan: No risk – no return. Available: http://www.bruegel.org/nc/blog/detail/article/1491-junckers-investment-plan-no-risk-no-return/#republishing [31.5.2015].

David, P.A., Hall, B.H. and Toole, A.A. (2000). Is public R&D a complement or substitute for private R&D? A review of the econometric evidence, Research Policy, 29 (4), pp. 497-529.

Diermeier, M. and Hüther, M. (2015). Mit dem großen Hebel für mehr Investitionen: ökonomische Bewertung des Juncker-Plans, Wirtschaftsdienst, 95, pp. 334-341.

European Commission (2014). Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank - An Investment Plan for Europe, COM(2014) 903.

Gros, D. (2014). Investment as the key to recovery in the euro area? CEPS Policy Briefs (326).

Knight, F.H. (1921). Risk, uncertainty and profit, Boston: Hart, Schaffner & Marx.

Schneider, J.D. (2015). Growth for Europe–Is the Juncker Plan the answer? EPC Discussion Paper, 20 March 2015 .

Zuleeg, F. (2014). Juncker's Investment Plan: a New Deal for the EU?. Available: http://www.epc.eu/pub_details.php?pub_id=5112 [31.5.2015].