Policies for an investment and equality-led sustainable development strategy in Ireland and Europe

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1. Introduction

Austerity policies coupled with rising inequality in Ireland and elsewhere in Europe have resulted in a prolonged stagnation. In the aftermath of the Great Recession, the lack of a full recovery in wage income continues to be a drag on household confidence and demand, which in turn discourages business investment in the absence of a healthy growth in domestic demand. In the past, countries such as Ireland, the UK in or Spain relied on household debt to maintain consumption levels in the absence of a healthy growth in their wages and salaries. The mirror image of this debt-driven growth model was the export-led growth model of Germany or Austria, where countries tried to export their way out of the problem of deficiency of domestic demand faced with a declining wage share. After the crisis, Europe's economic model is still based on the same shaky grounds of this dual model, and we are far from correcting the European imbalances.

The way to end this vicious circle of chronically low demand, slow down in investment and productivity, and economic, social and political instability requires a coordinated action mobilising fiscal and incomes policies in Ireland along with all the EU Member States.

2. The impact of a coordinated mix of public investment and incomes policies on growth, private investment and budget balance

Recent research by Obst, Onaran and Nikolaidi (2017) presents the impact of a coordinated policy mix of increased public investment together with more progressive taxation and labour market policies to improve income distribution in Europe. Based on an econometric model for 15 individual EU Member states, we simulate a policy scenario of a simultaneous increase in public investment by 1% of GDP along with more progressive taxation (increasing effective tax rate on capital by 1% and decreasing tax rate on labour by 1%) and an increase in the wage share by 1% of GDP in each country. The result is 6.72% higher GDP in the EU and 2.91% higher GDP in Ireland (Obst, Onaran and Nikolaidi, 2017). GDP increases by more than 2% in all countries.

As a result of this policy mix, private investment as a ratio to GDP increases as well by 2.3% (on average in Europe) and by 1.4% in Ireland; i.e. overall public spending does not crowd out but rather crowds in private investment despite a rise in tax rates on profits (Obst, Onaran and Nikolaidi, 2017).

Despite the rise in public spending, the budget balance in Europe improves (by 0.86% as a ratio to GDP) because the beneficial fiscal effects of higher economic growth and higher tax rates on capital prevail (Obst, Onaran and Nikolaidi, 2017). In Ireland this policy mix does improve the budget balance slightly by 0.05%. Hence, expansionary fiscal policy is sustainable when wage and public spending policies are combined with progressive tax policy also in Ireland; the impact is stronger when these policies are implemented in a coordinated fashion across Europe due to strong positive spill over effects on demand.

The concerns regarding the inflationary effects of wage increases are also not supported by empirical evidence. This policy mix leads to only a modest 1.5 % increase in the price level in Europe on average and 0.9% in Ireland (Obst, Onaran and Nikolaidi, 2017). In fact, a wage stimulus would help to keep the European economy away from deflation.

The policy mix would still be effective if implemented alone in isolation in one country, e.g. Ireland, although the impact would be much more modest. The coordination of this policy mix across Europe, along with a properly designed industrial policy enhances the impact substantially and can ensure genuine regional convergence and social cohesion in Europe.

3. The missing link between private investments and profits and financialization of the economy

Despite increasing profits private investment remained weak in Ireland as well as other European countries as firms directed their profits to financial speculation. Recent research by Tori and Onaran (2017) show that one of the most important reasons behind this missing link between profits and investment is financialization, in addition to the deficiency of demand, evidenced by Obst, Onaran and Nikolaidi (2017).

Based on the balance sheet data of publicly listed non-financial corporations (NFCs) in Europe, Tori and Onaran (2017) show that financialization has led to an increasing orientation towards external financing and shareholder value orientation as well as the substitution of fixed investment by financial activity.

In Europe as a whole, during 1995-2015 the NFCs' rate of accumulation (I/K) has been stagnant around an average value of 24% (see Figure 1 below based on Tori and Onaran, 2017). At the same time, NFCs' financial payments (dividends plus interests as a ratio to fixed assets) have been increasing significantly. There is also a sharp increase in the level of non-operating incomes (as a ratio to fixed assets) before the crisis (173%). The 2007-8 crisis has led to a reversal in the NFCs' financial incomes, although they are slowly recovering towards the levels of the early 2000s (Tori and Onaran, 2017).

<Figure 1 here>

In Ireland, the rate of accumulation of the NFCs has been overall stagnant, declining to 16% in 2013 and recovering slightly during 2014-15 (see Figure 2 below based on Tori and Onaran, 2017). The ratio of financial payments to total fixed assets increased considerably reaching 45% in 2015, whilst financial profits have been characterized by a volatile cycle in the first half of the period and stabilized at lower values after the crisis (Tori and Onaran, 2017).

<Figure 2 here>

Estimations by Tori and Onaran (2017) for the European NFCs show that both aspects of financialization had a fundamental role in suppressing investment in the NFCs. On the one hand, the increase in financial payments (both interest and dividend payments) have a negative effect on investment. On the other hand, the rise in financial activities in search for short term financial profits crowd out investment in physical machinery and equipment. Perversely financial activities do not provide more funds for productive activity. According to estimations by Tori and Onaran (2017), the rate of investment by the NFCs in Europe would have been 27% higher without the rise in interest and dividend payments, and 10% higher without the crowding-out effect of increasing financial incomes.

Country specific estimations also support this evidence (Tori and Onaran, 2017): The negative crowding-out effect of both financial incomes and financial payments is a robust significant finding in most countries including Ireland.

The growth of the financial markets and intermediaries delinked from the financing requirements of NFCs is incentivizing firms to heavily engage in non-operating (non-core) activities, ultimately leading to stagnant levels of investment. Financial incomes have a positive

effect on investment only for the small companies in countries with low levels of financial development, but a significant negative effect in the large as well as small companies in countries with high levels of financial development (Tori and Onaran, 2017). In Ireland[1] in large NFCs, investment rate would have been 14% higher without the rise in financial payments; in Ireland there is a positive impact of financial incomes only on the small NFCs (Tori and Onaran, 2017). It has to be noted that larger companies create the vast majority of capital, and the crowding-out of physical investment of these companies by financial activity is a substantial drag on the investment performance and productivity of the European countries. The crowding-out effect of financialization has not been addressed carefully by policy makers so far, in particular because of the strength of the conventional idea that 'every additional fund is good for investment' (Tori and Onaran, 2017).

4. Conclusion

Combining egalitarian labour market and tax policies with public spending policies are important not only for achieving higher growth, investment and sustainable debt levels but also for other important social targets, such as lowering carbon emissions via green investments or improving gender equality via public spending in social infrastructure (Onaran, Nikolaidi and Obst, 2017). Similarly, public investment policies are key to achieving structural change, higher productivity in tradable sectors and keeping trade balance under control while still managing an egalitarian economic model. To reinstate the missing link between private investment and profits, Europe needs directed public investment policies accompanied by a properly designed industrial policy, along with higher equality and stimulated demand, and regulation of finance and corporate governance (Onaran, Nikolaidi and Obst, 2017).

A wage-led development strategy requires the use of both pre-distributive as well as re-distributive policies. Pre-distributive policies can aim at improving the market distribution of income by a variety of policies to build institutions and re-regulate the labour market, improve the union legislation, increase the coverage of collective bargaining, and enforce equal pay legislation more effectively.[2]

Coordination of wage policies at the European level is crucial to ensure that wages increase in line with historical increases in productivity to stabilise effective demand, avoid counter-productive beggar thy neighbour policies, and prevent a race to the bottom. In the Euro area, this implies that wage policy has to take into account current account surpluses as much as deficits and coordination must aim at avoiding a deflationary adjustment with substantially higher wage growth in the surplus countries, while also aiming at convergence in productivity through active investment policies (Onaran and Stockhammer, 2016).

[1] Ireland is classified as a country with a relatively low level of financial development in Europe compared to countries such as the UK or Germany. The classification is based on the Financial Development index, which is a combination of standardized measures of five components, namely market capitalization as a ratio to GDP, total value traded as a ratio to GDP, total value traded as a ratio to market capitalization, ratio of liquid liabilities to GDP, and credit to the private sector as a ratio to GDP, based on the Global Financial Development Database (GFDD) of the World Bank (Tori and Onaran, 2017).

[2] Guschanski and Onaran (2016) estimates that a rise in minimum wages, or changes in labour market and trade union and collective bargaining legislation to increase the bargaining power of unions are very effective policies to offset the negative impact of technological change or globalisation on the wage share in Europe. The results are robust, if the wage share excluding the income of the top 1% of the waged and salaried people are used as the dependent variable.

With respect to corporate governance, a process of de-financialization of the non-financial sector is a pre-condition for a stable and vigorous investment performance (Tori and Onaran, 2017). This would require an extended regulation of companies' non-operating financial activities along with financial regulation.

Managers' short-termist behaviour and decisions exclusively aimed at maximizing dividends distributed to the shareholders should be disincentivized (Tori and Onaran, 2017). What is needed is the provision of an institutional setting for the NFCs that encourage management orientation towards long term growth and, more generally, 'stakeholder value'. This should be addressed in particular in the case of larger corporations.

The focus of corporate governance should be on the destination of the funds (Tori and Onaran, 2017). Policies should aim at favouring a productive destination of NFCs' internal funds, e.g. higher rate of taxation on profits which are not invested.

Last but not least, a wider and renewed fiscal policy can be effective in reconstructing the link between investment and profits. Alongside the re-regulation of the financial sphere of our economies (both at the macro and at the corporate levels), the reform of a financialised system needs coordinated public investments (Tori and Onaran, 2017). In fact, the public sector can act as the catalyst and driver of a new phase in which NFCs' objectives are essentially brought back to productive and stable capital accumulation. The evidence speaks in favour of a vast program of public investment that can provide a consistent and sustainable 'direction' to the private initiative (Tori and Onaran, 2017). Under the guidance of a macroeconomic policy framework focused on full employment and equality, which helps to define and improve the vector of choices of firms, shareholders themselves could see the long-term stability of the corporation as their main goal once again (Tori and Onaran, 2017).

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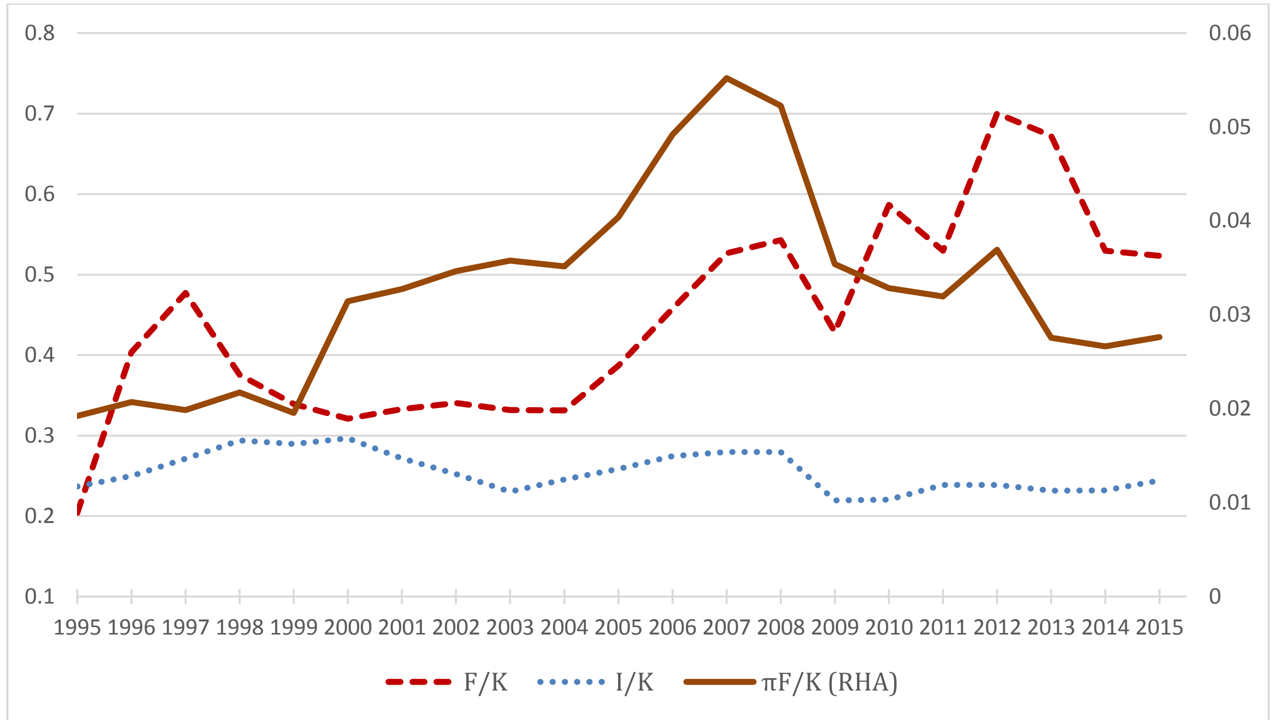
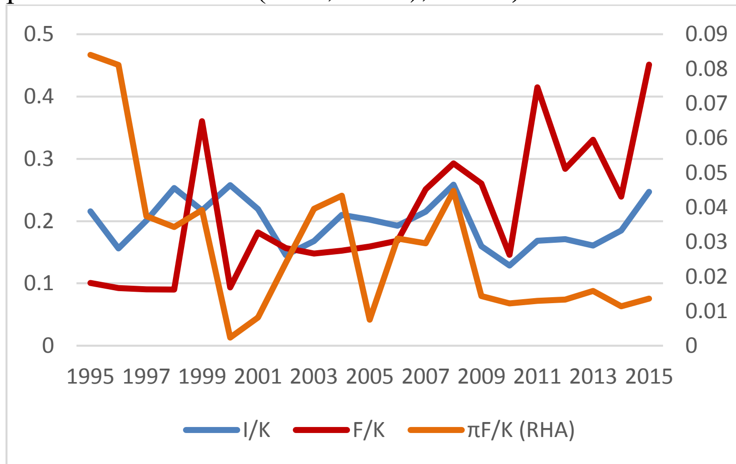
Figure 1. Investment/Fixed Assets (I/K), total financial payments/fixed assets (F/K), and total financial profits/fixed assets (πF/K, RHA), NFCs, Europe, 1995-2015



Source: Tori and Onaran (2017)

Figure 2 Investment/Fixed Assets (I/K), total payments/fixed assets (F/K), and total financial profits/fixed assets (π_F/K, RHA), NFCs**,** Ireland



Source: Tori and Onaran (2017)