

THE ROLE OF THE STATE IN ECONOMIC GROWTH

PARIS

Stimulating Growth

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October 2014

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There is considerable political consensus that the best short-run solution to the longer term debt problem is to stimulate the private sector to grow to help tax revenues recover and the budgetary (and human) costs of unemployment fall. To be precise, the current Eurozone crisis is one of low growth, persistent high unemployment and worryingly high public debts, which must be addressed without precipitating any sharp loss of confidence in financing that debt. The future credibility of public finances is therefore a constraint of action, and a sustainable debt is an objective for the medium to longer term. This note sets out how that debt constraint may be alleviated, where best to stimulate private investment that is consistent with that constraint, and how the European Commission can work with Member State Governments to increase the overall rate of investment and hence stimulate growth.

Accounting for and managing the public debt

A sustainable public finance posture requires that the cost of financing the public debt is compatible with the long-run rate of growth of the economy; and the willingness of lenders to hold public debt at acceptable rates of interest, not just under favourable financial circumstances but under adverse conditions, as at present in the Eurozone financial crisis. Lenders

must be assured that the country is and will be credit-worthy.

The task of convincing financial markets of the sustainable level of public debt would be eased if the public sector published and adopted a proper balance sheet, allowing productive public investments to be financed by additional borrowing without prejudicing ability to pay. The present debt : GDP ratio fails to take account of the asset side of the balance sheet and to distinguish between economic stimuli which increase consumption and debt liabilities and those that increase productive investment that adds productive assets to balance the liabilities issued.

This task of adjusting to a sustainable fiscal stance is further complicated by pressures (demographic and political) to increase public expenditures on health, education and pensions. If their provision is not reformed, their share of GDP will likely continue to increase. Steps taken during a financial crisis, such as at present, should ideally provide credible longer-run commitments to a suitable fiscal and expenditure pattern without prejudicing shorter-term objectives of supporting a growth strategy. A commitment to link the retirement age to life expectancy (perhaps with some initial catch-up) starting at some future date, has obvious attractions, as does tax and expenditure reforms that reduce distortions and ensure that public expenditure is justified in social cost benefit terms (Mirrlees et

¹ Paper arising from the conference "The Role of the State in Economic Growth in Europe" held at Sciences Po, Paris, Oct 6, 2014, and drawing on submissions to the LSE Growth Commission (2013).

al, 2011).

Stimulating private sector activity and investment

If the argument above is accepted then the public sector should ensure that it increases public investment in projects which have a high benefit-cost ratio (BCR) in recessions. One defining characteristic of a global financial crisis or a Depression is that the recovery period is considerably longer than a “normal” recession – perhaps of the order of 7-10 years instead of 3-5 years (Reinhart and Rogoff, 2008). That means there is more need to commit to investments even if they have a delay before expenditure can be fully committed, while still concentrating on more “shovel-ready” projects that have already been appraised and passed the BCR test.

The projects which seem most likely to stimulate private sector activity are those that relax bottlenecks impeding private sector activity, that have a high labour content, and are domestic resource intensive. Road improvements that reduce congestion black spots score highly on all counts, and should also be closer to “shovel ready”. In general, as Eddington (2006) demonstrated, transport projects generate additional spill-over benefits to private productive activity, and have remarkably high BCRs. Only the public sector can commission such projects, so a failure to undertake them is doubly damaging, as road and rail projects are unlikely

to be provided by other agents, although airports can be financed by the private sector provided they are given planning permission. Although the time-scale for that investment is likely considerably longer, given the likely length of the recession, an early start would still mean that considerable investment expenditure should contribute to stimulating the economy well before it reaches full employment again. The fact that many countries have cut such investments is all the more reason for reversing such policies as quickly as possible, and certainly where there is excess capacity in the economy.

Investment in low-carbon electricity

There is substantial EU agreement on the importance of decarbonising electricity. Low-carbon generation has high capital costs, and much of it is non-commercial at the current and expected carbon prices emerging from the flawed Emissions Trading System (ETS). Seeking private finance is problematic when there are any doubts about the credibility of the institutional support structure – whether they be long term feed-in tariffs (FiTs), Contracts for Differences, or premium FiTs. The apparent cost of capital for many of these investments is nearer to 10% real than the weighted average cost of capital that UK regulated utilities can earn (closer to 3-4% real). A coordinated investment programme in renewable and other low-carbon investment (nuclear power where acceptable, Carbon Capture and

Storage elsewhere) combined with more cross-border transmission links, funded either by State Banks or with underwriting from the state, would support an accelerated level of needed investment.

The role of the European Commission in energy and climate change policy

If the EU is to deliver on its 2050 vision, very substantial investments will be needed in the near future, and could go some way to raising the rate of investment and hence, if done well, productivity and growth in the EU. The European Commission (EC) can help by clarifying the role of State Aids and public underwriting and finance of low-carbon options, ensuring that just because low interest rates are offered to such projects of common interest they are not ruled out on that account. Here it is worth noting that the discount rate at which the costs of climate change appear worryingly large are low, and it would be inconsistent to value the benefits of decarbonisation at a lower discount rate than is used to finance them. Put another way, there is co-insurance benefits of the state acting on behalf of future generations in offering funds at low real interest rates to such projects.

If one asks where lies the comparative advantage of EU-level energy and climate change policy, the obvious place to look is where there are either significant externalities between Member States, public good problems

and/or coordination failures. The three pillars of EU climate change policy illustrate this well, as they all address either the public good of climate change mitigation or the spill-overs from knowledge creation. The ETS was introduced to correct the market failure of the lack of a proper price for the pollutant, CO₂. It was intended to deliver a carbon price enabling mature low-carbon technologies to compete efficiently in the market place with fossil energy. The 20-20-20 Renewables Directive was intended to solve the club-good problem of jointly financing the deployment of not-yet commercially viable renewable energy, justified by the learning spill-overs that cannot be captured by any one developer or nation. The Strategic Energy Technology (SET) Plan was intended to more than double the amount of R&D on immature low carbon technologies, making up for the catastrophic collapse in R&D attending the liberalisation of the energy industries. Had these policies been as successful as hoped, they would have provided much of the supporting environment for a substantial increase in investment, which would certainly have helped stimulate the economy if carefully designed and delivered.

Success has been at best mixed, and there are clear steps that are needed to improve outcomes and hence make a positive contribution to growth and productivity. Perhaps the most disappointing in terms of outcomes is the ETS, which is failing in its central

purpose of delivering an adequate, credible and durable carbon price signal. While it was a signal success to reach EU-wide agreement on the ETS in the first instance, it should have been underwritten by mechanisms to keep the price within acceptable limits, and certainly above some credible supported price trajectory. Clearly with current concerns over EU competitiveness, there is little political appetite for a substantial tightening of quotas or moves to higher support prices. That may change with the next round of climate change negotiations, where ideally if the major emitters (China and the US) continue to put in place carbon pricing mechanisms there may be a route to a trade agreement with a common external border tax adjustments on trade from countries without such mechanisms, addressing some of concerns over competitiveness and carbon leakage. But there are steps that Member States should be taking in any case to address competitiveness, for many of the climate change policies, which deliver public goods, are being financed by highly distortive taxes or charges that fall on energy consuming industries. Sound principles of public economics argue for such public goods to be funded from general taxation, and a further principle is that such taxes should avoid distorting production decisions (Value Added Taxes are a good example of such).

The 20-20-20 Renewables Directive has successfully solved the club-good problem of jointly financing the

deployment of not-yet commercially viable renewable energy, by setting targets for each Member State and leaving them to determine how to finance their obligation. Its weakness is that it failed to find a satisfactory mechanism to deliver the results at least total cost, as these renewables are hard to trade across borders. However, it holds lessons for the SET Plan, which lacks any form of collective finance to deliver its public good of new knowledge. One logical solution would be to interpret the renewable energy targets in terms of financial obligations on Member States to fund R&D, demonstration projects and deployment support from a common fund. To count against the agreed commitments, MSs would invite competitive tenders or hold auctions for projects or renewables support, which could be located in any MS.

In terms of its role in coordination, the EC already has a variety of plans to support Trans European cross-border networks. The financing of economically beneficial cross-border transmission links (electricity and gas) is often stymied by a failure to align payment with benefits. Although EC funding can help allay that, one problem is that existing cross-border tariffication models that may represent a politically feasible solution for existing networks, are not well-suited to new investments. The principle of beneficiary pays for new investment is likely to be a better starting point.

The principles of the Guidelines on State Aid for Environmental Protection are sound, but their implementation leaves much to be desired, as they appear to argue for transferring all marketing and balancing risk to the renewable developers. It would be helpful if it were clarified that the natural manager of such risk is the System Operator, who should be charged to offer long-term contracts that reflect the value of the renewables to the system while removing as much risk as possible, obviously with a margin to cover such costs as balancing. Again, better contract design and risk allocation (including through state guarantees to final users) can facilitate private investment.

Conclusions

The major route to growth is investment in socially productive assets, for which sound cost benefit analysis is needed for public investments, and efficient market signals for private investment. The State can play an important role in ensuring that publically provided infrastructure is properly funded and carefully selected. That will require better accounting and funding practices in the public sector, as well as better project management. It may benefit from new institutions, matching the regulated utilities set up in telecoms, water, and energy. One of the major areas where the state can better assist the private sector is addressing the various market, regulatory and policy failures in the

energy sector, where investment requirements are large, as is the need for low cost finance, but where price signals are distorted and policy inevitably unstable and therefore risky and costly for private finance. State funds, state development and/or Green investment banks, long-term sensibly incentivised contracts, and intelligent risk allocation could all help unleash a substantial, sustainable and socially beneficial investment programme.

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