Policy Brief: The macro-economic conditions for social investment

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This Policy Brief summarises a Re-InVEST report (Leaman, 2019) on the macro-economic, fiscal and ethical implications of the EU's Social Investment Package (SIP). A major gap in the SIP was the absence of a credible fiscal strategy to collect the necessary funds for a powerful EU-wide Social Investment policy. The SIP seemed to accept budgetary austerity as unavoidable and therefore suggested to substitute private profit-seeking capital for tax-based funding. However, this privatisation of social policies would involve a dangerous shift in their ethical foundations. Leaman argues, on the contrary, that 'upward fiscal convergence' is the only viable way of achieving the objectives of the SIP.

The EU's 'Social Investment Paradox'

The European Commission's *Social Investment Package* acknowledged the importance of the social dimension of human existence for economic development, and proposed an ambitious pan-European multi-dimensional programme of co-ordinated policies by EU member states. This was informed by its own extensive evidence of economic and social imbalances in the region, particularly in the wake of the Great Crisis after 2008. This Policy Brief, however, notes that the rhetoric of a Social Investment-driven process of economic and social cohesion remains rooted in a narrative that ignores the specific ethical foundations of state intervention and continues to prioritise fiscal consolidation, deficit- and debt-reduction and the privatisation of public services. Accordingly, as in the parallel European Investment Plan, the Commission places a strong emphasis on the mobilisation of private capital for investment into and delivery of public goods.

Analysing four decades of supply-sidism theoretically and empirically questions the logic of 'crowding in' private investment: declining rates of investment, weaker rates of economic growth, high levels of inequality, destructive levels of financialisation and short-termism, growing levels of private monopolisation, and a dysfunctional response to the Great Crisis are the outcomes of this policy. Furthermore, the economic trajectory implied by private sector participation in Social Investment can be seen to reinforce the trend of financialisation and weaker real investment. Europe's political economies need, rather, to reduce levels of monopolistic rent-seeking and promote programmes of economic and social innovation which deliver real benefits for human welfare. The time-horizons and the comprehensive nature of social investment make collective, public responsibility for such programmes inescapable; equally, the need to underpin the public delivery of public goods democratically is urgent for the realisation of long-term social and cultural cohesion.

In the EU's scheme of "fiscal governance" a revenue dimension is virtually absent and the official concept of "fiscal sustainability" relies on essentially monetarist assumptions. Our concept of "fiscal viability" is therefore counterposed to that of "sustainability", in particular because of the longer-term, inter-generational ambitions of Social Investment. Fiscal viability requires the assurance that longer-term, transformative reforms are adequately resourced and not subject to arbitrary cutbacks. This in turn means both the harmonisation and upward convergence of taxation systems within the European Union, and the preparedness to use debt securities to maintain the essential continuity of support for agreed programmes of Social Investment.

The need for upward fiscal convergence

An exposition of the extreme asymmetries of taxation systems and tax culture within the EU underscores the need for a thorough-going reform of the region's revenue-generation: reintroducing and/or enhancing the scale of progressivity in income-taxation, thus eliminating flat tax regimes from several Central-Eastern European Countries (CEECs), reducing the increasing dependence on regressive indirect taxation, raising national tax ratios to levels sufficient for both long-term structural expenditure and short-term crisis-management. Without such reforms, the EU will become increasingly powerless to combat the destructive processes of inter-state tax-competition and to resist the tax and regulatory arbitrage activities of global corporations. The need for convergence is inescapable.

Our research sets Social Investment in the context of a new paradigm of long-term "patient capital" as the foundation for a transformative programme by an active democratic state committed to the enhancement of human capabilities and of social capital and the protection and improvement of natural capital. The nature of secular economic and technological developments and of democratically underpinned human rights, demand a considerably more active role for the state as economic and social actor, in line with Wagner's Law[1]. This has to be reflected in a radical reform of economic and, most relevantly here, fiscal governance. The point of departure of this survey of fiscal issues is the strong recommendation of macroeconomic coordination of monetary and fiscal policy and a reform of the institutional arrangements of the European System of Central Banks; this would include the abandonment of the single mandate of inflation-management and of discredited thresholds for state debt and deficit ratios.

European austerity politics have been criticised for their negative multiplier effects , and their inadvertent but dangerous 'stunting' and 'scarring' of human development, which was evident both before and after the Great Crisis. By contrast, the positive multiplier effects of a courageous, active state can be postulated, with particular reference to the need for an effective and equitable fiscal transmission process. This is linked to the earlier discussion of fiscal viability and fiscal subsidiarity and is supported by a comparison of contrasting models of fiscal distribution and equalisation among Europe's member states. Notwithstanding the heterogeneity of Europe's states and statelets, a best case paradigm of fiscal governance would be characterised by the fiscal federalism and refined scheme of fiscal equalisation of Germany (but without the new constitutional straitjacket of the "debt brake") on the one hand, and the embedded fiscal norms of the Scandinavian cluster of states.

Without a reversal of the current set of ideological and political preferences at the level of the EU and its major member states, the laudable ambitions of a socially inclusive, solidaristic Europe will evaporate. Without the intensified involvement of the public sector, in particular at sub-national levels, and the guarantee of appropriate, adequate and predictable revenue-streams, the disillusionment of increasing sections of European societies in political and economic elites will grow, undermining the viability of the Union itself.

[1] Wagner's law holds that the advent of modern industrial society will result in increasing political pressure for social progress and increased allowance for social consideration by industry.

The essential objectives of the Re-InVEST conception of Social Investment are to remove the current obstacles to reform of economic and social policy and to enhance societal well-being. This requires above all structural macro-economic reforms with an accompanying new and positive narrative of the role of the state and social stakeholders, in particular in relation to fiscal affairs. Such 'structural reforms' will be explicitly distinct from the frequent iterations of supply-side mantras of deregulation, privatisation and 'crowding-in' private investment. Rather, the structural reforms will be to the foundations of fiscal viability, creating a fiscal framework which is appropriate "to the investment objective pursued" (OECD 2014). In simple terms this means equipping the state at all levels with the resources to do its job. An under-resourced, reactive, defensive and unimaginative state cannot be expected to "do its job" and is more likely to remain captured by sectional and economically dysfunctional interests.

Recommendations

The focus on *fiscal viability* demands in turn a radical modification of the EU's concept of fiscal sustainability qua *fiscal rules.* European society cannot afford to preside over economic and social disintegration. It must therefore devise effective fiscal governance mechanisms to realise its policy goals, above all those of *convergence* and *cohesion.*

1. The 28 states of the EU region must set appropriate allocatory priorities on the basis of shared commitments, common fiscal standards and equity. This indispensable foundation of cross-national, EU-wide social investment is still barely discernible in 2019. In particular, critical elements of **fiscal viability** and **multilateral fiscal responsibility** are absent. The wide **disparity** between the tax ratios of the fiscally weak EU states (Baltic and Balkan groups) and the major economies of the old EU15 (Austria, Belgium, Denmark, Finland, France, Germany, Netherlands, Sweden, UK) **needs to be narrowed**; indeed the flattening of the curves of progression in those EU states with progressive systems of income taxation has to be reversed and the fiscal resources of the weaker states have to be boosted by appropriate changes to their tax systems and tax cultures. Failure to achieve this leaves ALL member states vulnerable to tax arbitrage by mobile corporations.
2. Consequently, those CEECs with systems of flat taxes have to be incentivized to **introduce or reintroduce progressive systems of income tax** with curves of progression similar (if not identical) to those obtaining in the old EU15; a harmonisation of tax systems, involving a convergence of marginal rates at both the lower and higher ends of the income scale and a closer alignment of tax allowances for both households and businesses would be an important first step in a – for certain CEECs – radical transformation of the state's ability to raise revenues and to deploy those revenues effectively; because of the GDP per capita divergences, EU member states – via ECOFIN[2] – would have to agree to *slightly lower levels of capital and income taxation in CEECs to ease the transition to a state of fiscal viability*; a process of promoting the modernisation of fiscally weaker member states should be accompanied by a closer harmonisation of tax cultures across the whole Union, firstly to prevent destructive tax competition between member states and to reduce the contradictions between top marginal rates for Personal Income Tax and the much lower rates of Corporation Tax; this in turn would remove the incentive for SMEs to "incorporate";

[2] ECOFIN: the EU Council of Ministers of Economic and Financial Affairs

3. The strengthening of progressivity would, of itself, increase the revenue share of direct taxes; however, member states should be encouraged to **reduce the regressive effect of a still excessive dependence of indirect taxation**, for example through a stronger differentiation of taxable goods and services, favouring basic commodities and services with socially and environmentally progressive functions (children's clothing, housing, education, health, renewable energy, decontamination, bio-diversity);
4. Narrowing the divergence of tax and revenue cultures would, in the medium term, still leave weaker jurisdictions less well placed to promote both overall development and, above all, social investment. There is a strong case for **strengthening/ deepening the fiscal arrangements of both the Eurozone and the wider EU**, to increase markedly the resources available through the Cohesion Funds. The allocation of enhanced funding for poorer states/regions, for example, could reasonably be conditional on the implementation of progressive social investment programmes; these in turn could be subject to compliance procedures with at least as much leverage/ compulsion as the rules governing state deficit and debt ceilings.
5. There is an urgent need to **promote a strong and sustainable convergence of levels of fiscal viability** via both arrangements of vertical and horizontal fiscal equalization within the EU28, and collective liability for short-term public deficits and long-term state debts, qua Eurobonds. Again, the issuance of Eurobonds could be made conditional on the targeted use of funds for the provision of vital public goods, including economic and social infrastructure and social investment.
6. **Harmonisation and cooperation in tax affairs** is most obviously needed in the field of tax avoidance and tax evasion. The scale of revenue loss is eye-wateringly high; 2013 estimates cited annual levels of €1 trillion, or six times the 2018 EU Budget. Recovering revenue of this magnitude would certainly present difficulties, given the globally permissive environment for tax-evasion, profit-shifting and tax-avoidance. However, the prize of European cooperation in closing loopholes and stopping intra-European profit-shifting through the application of the OECD's Base Erosion and Profit Shifting guidelines would be considerable. Progress on combatting tax avoidance/ evasion at both EU and national level has been disappointingly slow, despite the strength of public opinion polls and cross-party proposals in the European Parliament; there is therefore a real danger that the failure to rectify the perceived injustice of tax-cheating and the associated wide disparities in the distribution of income and wealth will fuel growing populist resentment against established political 'elites'.
7. Given the high level of mobility for financial capital and the improbability of the imposition of effective exchange controls within the global political economy, the case for an **annual wealth tax** has become more popular and more promising. Thomas Piketty's proposal for a progressive wealth tax of 1 percent on fortunes between 1 and 5 million euros, and 2 percent above 5 million "would affect about 2.5 percent of the population and bring in revenues equivalent to 2 percent of Europe's GDP". The essential feature of such a tax would be unanimity and harmonised standards among EU member states and the automatic sharing of bank information within the EU and with third countries.
8. The more recent initiatives to **tax the global 'big tech' corporations** need to be pursued with greater urgency. Notwithstanding the difficulty for tax authorities to identify the location of big tech profits, revenues and associated abuse, tolerating the

emergence of untouchable, untaxable financial assets is highly corrosive of democratic cultures and the principles of tax justice. Isolated, national initiatives are arguably doomed. Bold, multilateral approaches are essential, if EU states wish to escape from their current vulnerability as real or potential victims of tax and regulatory arbitrage.

Reference:

Leaman, J. (2019). *The macro-economics of social investment. The fiscal dimension*. Loughborough University.