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STUDIES ON
GROWTH WITH EQUITY

**AN
EMPLOYMENT-
ORIENTED
INVESTMENT
STRATEGY
FOR EUROPE**



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INTERNATIONAL LABOUR ORGANIZATION
RESEARCH DEPARTMENT

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KEY POLICY OPTIONS AND CONSIDERATIONS

Against a backdrop of sluggish economic conditions and continued weak job creation, the Investment Plan proposed by the European Commission President Jean-Claude Juncker would provide a rapid economic stimulus that would foster Europe's competitiveness at the same time as boosting much-needed employment creation. The main finding of this ILO report is that, if careful consideration is given to the design of the programme and its allocation, over 2.1 million net new jobs would be created by mid-2018.

A call for action

- *Stimulating investment is a step in the right direction to boost job creation.* Since the height of the crisis, investment in the EU-28 remains well below pre-crisis levels and is too low to make a significant dent on unemployment and under-employment. The unemployment rate, at 9.7 per cent in the third quarter of 2014, is close to 3 percentage points above the level reached in the same quarter of 2007. Moreover, half of those unemployed have been without a job for more than a year. By comparison, in the United States of America, for example, investment has recovered by more than 2 percentage points and the unemployment rate has fallen by more than 3 percentage points since 2009.
- *The Investment Plan comes at a time when the growth outlook is deteriorating.* Between the Spring and Autumn 2014 European Commission projections, GDP growth was revised downwards for 2015 in 22 of the 28 economies. In the EU-28 this translates into a downward revision of 0.5 percentage points from 2.0 to 1.5 per cent, with the outlook weakening significantly in some of the larger EU-28 economies, such as France and Germany. Higher investment is essential to reverse that trend, improve competitiveness and create more and better jobs.

Employment impact of the Investment Plan will rely on key design features and distribution criteria

- *Employment impacts will be significantly enhanced through private sector investment.* 1.8 million direct and indirect jobs (0.8 per cent of total employment) can be created if the Investment Plan succeeds as planned in leveraging private sector investment that would raise the total funds invested in the economy to €315 billion. This means that public investment projects should be selected on the basis of the extent to which they do not “crowd out” private investments. Ensuring that small enterprises benefit (directly from the projects and indirectly through credit guarantee schemes and improved access to credit in general) is also crucial to its success.
- *Allocating funds with consideration to unemployment levels yields the best and most equitable job gains.* Under a scenario where part of the funds are distributed by Member States’ level of unemployment, total employment gains would approach 2.0 million. Moreover, not only would overall employment be higher by nearly 10 per cent (compared to the 1.8 million scenario), but those countries in greatest need would observe the highest increases in employment and thus narrow the labour market disparity across the European Union.
- *Complementary support to skill development will lead to additional net positive gains.* Within the current financing structure, if less than 5 per cent were reallocated towards measures to support improvement in skills, the job gains from such a redistribution would be in the order of 4.3 per cent or 0.1 million (compared to an allocation solely focused on investment), bringing the total gain of an employment-friendly approach to 2.1 million jobs.

Need to lay the groundwork for a balanced and sustained strategy

- Any measures need to form the basis of a medium-term employment strategy that aims at quality job creation and avoids a race to the bottom in terms of wages and working conditions. In that respect, consideration should be given to monitoring the employment impacts of the Investment Plan in the broader context of an employment-centred policy agenda. Finally, balanced, sustainable and credible solutions are best achieved in a tripartite setting, and coordination and dialogue both within countries and at the EU level would leverage a stronger economic impact.

INTRODUCTION

Economic growth in the 28 European Union Member States (EU-28), at 1.3 per cent in the second quarter of 2014, remains well below the pre-crisis growth rate of 2.7 per cent (average between 2000 and 2007). Moreover, the outlook is deteriorating, with the European Commission now forecasting growth in gross domestic product (GDP) for 2014 to come in at 1.1 per cent (compared to 1.4 per cent forecast in 2013).¹ Economic activity is expected to recover somewhat in 2015 at 1.5 per cent, but this too is revised downwards from 2.0 per cent. Accordingly, labour market conditions remain weak: in the third quarter of 2014 the unemployment rate stood at 9.7 per cent, close to 3 percentage points higher than the same period in 2007.

It is therefore increasingly evident that a different strategy to create jobs is urgently needed. To date, the initial efforts to rein in government expenses have not led to sufficient gains in investment and growth. Moreover, debt levels remain high and have increased in a number of instances, raising concerns about the feasibility of additional fiscal stimulus. Finally, the effectiveness of monetary policy (at the level of the Eurozone) in a low (or negative) inflation–low growth paradigm is limited.

Against this background, a comprehensive Investment Plan has been put forward by the European Commission President Jean-Claude Juncker. The current approach has the Investment Plan being steered by the European Investment Bank (EIB) and backed by a dedicated Investment Committee. And although – as of early January – questions related to the nature of the funding remain, the opportunity to place greater emphasis on long-term strategic investments is a welcome development. Such an approach – if carefully designed – would help create jobs and place the European economy on a more sustainable growth path.

The purpose of this study is first to highlight the gravity of the current economic and labour market situation, and importance of the investment shortfall in this context (section A). Section B then examines the employment effects under various funding scenarios. This includes a simulation that

¹ The International Monetary Fund (IMF) also revised downwards its projections for EU-28 economic growth for 2014 to 1.4 per cent, the latest in a series of downward revisions since 2011.

encompasses active labour market policies into the spending mix. Finally, section C discusses the importance of developing a framework and plan of action so that the Investment Plan is successful in terms of creating jobs and that efforts undertaken in the short term lay the groundwork for more employment-rich and inclusive growth.

A GROWTH, INVESTMENT AND EMPLOYMENT NEXUS IN THE EU: RATIONALE FOR ACTION

1 GROWTH AND EMPLOYMENT IN THE EU

*Limited growth in the EU has
yet to translate into gains in employment ...*

The economic recovery experienced so far in some European countries has not yet been translated into improved labour market performances. During the initial (and steep) fall in GDP in 2009, employment fared comparably well due in part to a series of job-friendly measures introduced at the time (ILO, 2009b). Moreover, after a sharp fall in the first phases of the recession, GDP levels for the entire EU-28 have improved, nearly attaining pre-crisis levels in 2014. However, employment growth has been rather stagnant, remaining 2 per cent below pre-crisis levels, with only a modest upturn in recent quarters (figure 1, panel A).

The employment content of growth has occurred with some considerable country heterogeneity. For instance, in some cases (for example Poland and Slovakia) GDP growth has far outpaced job gains,² whereas in the odd EU country employment growth has surpassed GDP growth (for example in Germany between the beginning of 2008 and the second quarter of 2014, employment and GDP growth were equal to 1.0 and 0.8 per cent, respectively).³ Other countries have experienced a fall in employment more pronounced than the contraction in GDP (for example Ireland and Spain), while others have seen a relatively more pronounced fall in GDP than employment (for example Greece).

² Poland's GDP increased at an average rate of 3.1 per cent between the first quarter of 2008 and the second quarter of 2014, while employment growth was equal to only 0.5 per cent during the same period. Similarly, in Slovakia GDP increased by 1.9 per cent during the same period, but employment fell at an average of 0.1 per cent.

³ Similarly, in the United Kingdom during the same period GDP growth was on average equal to 0.2 per cent and employment growth to 0.6 per cent.

... and the recovery is losing momentum.

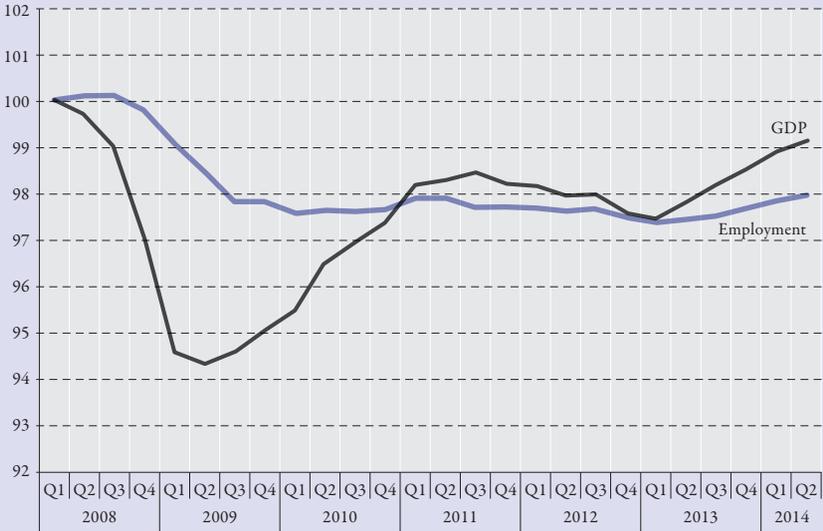
Of considerable concern is the fact that the European economic outlook has recently deteriorated, with growing macroeconomic and geopolitical risks posing new challenges to the pace and strength of the recovery, which had barely gained momentum in the second half of 2013. As a result, the main international organizations have revised downwards their economic forecasts for the majority of EU countries. In particular, between the Spring and Autumn 2014 European Commission projections, GDP growth was revised downwards for 2015 in 22 of the 28 economies (figure 1, panel B).⁴ In the EU-28 this translates into a downward revision of 0.5 percentage points from 2.0 to 1.5 per cent. The 2015 outlook has deteriorated most in terms of percentage points in some of the eastern European economies but has also been considerably weakened in some of the larger EU-28 economies. For example, the outlook in both France and Germany was cut by half (or nearly in the case of Germany, falling from 2.0 to 1.1 per cent).⁵ A decline in 2014 growth is also expected compared to what was forecast one year ago (1.1 per cent for the EU-28 compared to the 1.4 per cent forecast in 2013).

⁴ EU Commission economic forecasts, Spring 2014 and Autumn 2014 editions.

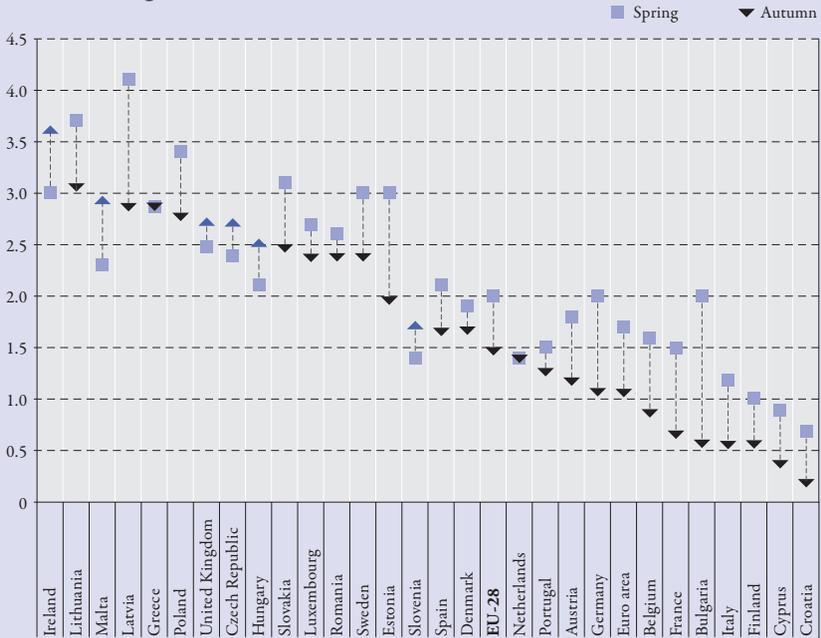
⁵ The European Central Bank economic forecasts released in December 2014 predict even lower growth in the euro area for 2015, equal to 1 per cent.

Figure 1 Economic and employment in the EU: Forecasts and performances

Panel A. Employment and GDP in the EU-28, Q1 2008=100

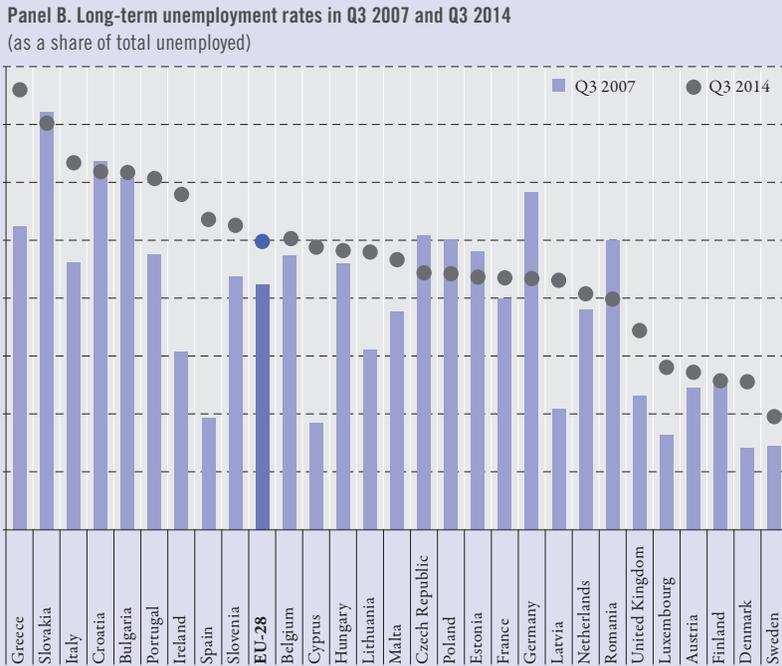
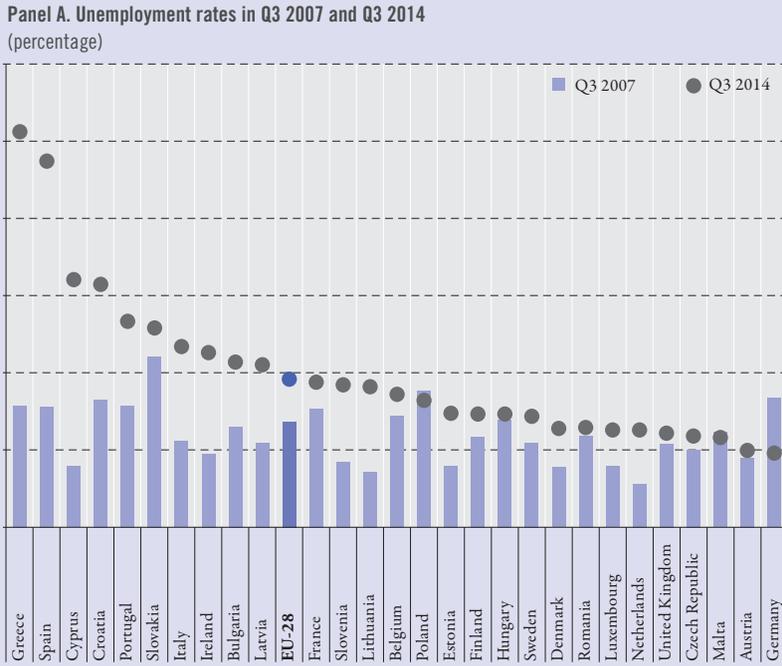


Panel B. GDP growth forecasts in the EU-28 for 2015



Source: ILO Research Department based on OECD (Panel A) and EU Commission Economic Forecasts, different editions (Panel B).

Figure 2 Unemployment and long-term unemployment in EU-28



Notes: Long-term unemployment rate refers to the number of unemployed persons out of work for 12 months or more as a share of the total number of unemployed.
Source: ILO Research Department based on Eurostat.

2 LABOUR MARKET CHALLENGES PERSIST

Poor labour market conditions are hampering prospects for sustainable and inclusive growth ...

Weighing on the growth performance of the EU-28 is a lacklustre labour market. In the EU-28 the unemployment rate stood at 9.7 per cent in the third quarter of 2014, close to 3 percentage points above the rate reached in the same quarter of 2007 when the global crisis erupted. Despite some encouraging signs of recovery that emerged in 2011, only three European countries (Germany, Malta and Poland) have observed unemployment rates below pre-crisis levels (figure 2, panel A). In some instances, unemployment rates have increased by more than 5 percentage points in the last three years alone, notably in Cyprus and Greece.

This translates to over 23 million Europeans unemployed in the third quarter of 2014, of which close to 12 million have been looking for a job for one year or more. The increase in the incidence of long-term unemployment has been particularly acute in some countries, such as Cyprus, Ireland and Spain, where the long-term unemployment rate increased by more than 25 percentage points between the thirds quarters of 2007 and 2014 (figure 2, panel B).

These developments – unless addressed – could result in huge economic and social costs. For instance, those individuals who have been in unemployment for long periods of time are more likely to become discouraged and leave the labour market altogether. As a result, skills erode, productive capacity declines and their employability deteriorates – making it increasingly difficult to find a new job when the labour market begins to recover. The ones who do find jobs are often associated with future lower earnings, diminished career prospects and a growing risk of being stigmatized.

3 UNDERLYING SLOW GROWTH IN JOBS IS A SHORTFALL IN INVESTMENT

Persistent weakness of investment is one of the main causes of the sluggish labour market recovery ...

With current nominal investment levels in the EU lower than 2007 by nearly €380 billion – or approximately 15 per cent – the EU is confronted with a considerable investment shortfall.⁶ Moreover, empirical evidence shows a strong correlation between unemployment and investment (figure 3, panel A).⁷ Indeed, improving investment activity is crucial for three main reasons. First, investment feeds into aggregate demand and higher investment activity leads therefore to greater demand and, in turn, higher economic activity and overall employment. Second, improving investment activity is also crucial to renewing and transforming economies' real capital stock, thus enabling firms to take advantage of new opportunities, expand and hire new employees. Finally, investment is crucial for restoring competitiveness imbalances.

The global financial crisis had a significant negative impact on global investment, with most advanced economies experiencing a decline in investment as a percentage of GDP that was accompanied by a proportional increase in unemployment rates. For instance, in the EU-28 and the United States, where the fall in investment between 2007 and 2013 was more pronounced (a decline of 4.5 and 3 percentage points, respectively), unemployment rates in 2013 were 3.6 and 2.7 percentage points, respectively, above levels of six years previously. Likewise, among comparably good crisis performers such as Japan or Australia, where unemployment rates increased by 0.1 and 1.3 percentage points, respectively, investment as a share of GDP performed relatively better, falling only by 2 and 1 percentage points, respectively.

⁶ It is important to note that the investment shortfall varies depending on the unit measure selected. Thus, a €380 billion deficit is observed if investment is considered in current prices. However, when investment is expressed in constant prices, this shortfall swings from €383 billion at 2000 exchange rates to €413 billion at 2005 exchange rates. By contrast, the investment deficit decreases to €347 billion when the variable is expressed at prices of the previous year.

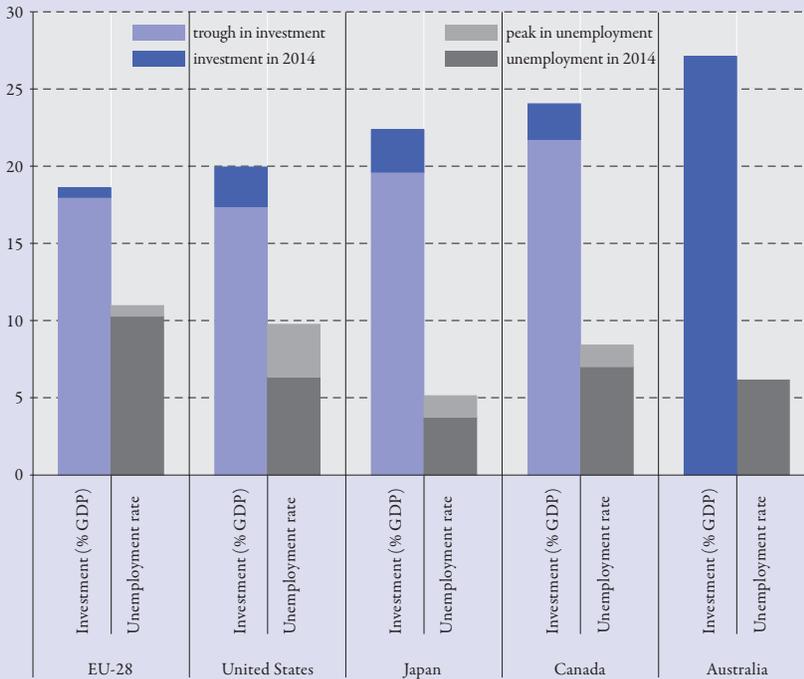
⁷ Of course, the relationship between investment and employment is highly dynamic, with causality flowing in both directions (ILO, 2012). A number of factors, notably pre-existing macroeconomic imbalances and initial starting positions, are important determinants of employment outcomes and investment patterns. For more detail, see Appendix I.

Figure 3 Investment and employment relationship

Panel A. Investment as percentage of GDP and unemployment rates in EU-28, 1995-2013



Panel B. Change in investment as a percentage of GDP and unemployment rates from trough/peak to 2014



Source: ILO estimates based on IMF, Eurostat and KILM.

During the recovery process, in many advanced economies the gap between the trough and current levels of investment is strongly associated with the difference between the peak and actual levels of unemployment. In particular, investment as a percentage of GDP in EU-28 increased by 0.3 percentage points from its trough, while the unemployment rate decreased only 0.7 percentage points from its peak. Whereas, in the United States the decrease in the unemployment rate of 3.4 percentage points since it reached its peak in 2010 has been accompanied by an increase in investment – of 2.2 percentage points since 2009 (figure 3, panel B).

... so the Investment Plan proposed is a step in the right direction.

The recent announcement by the President of the European Commission, Jean-Claude Juncker, of an Investment Plan worth €315 billion is a clear recognition of the immediate need to stimulate the EU economy. Moreover, Mr Juncker made clear in his speech in the European Parliament plenary session presenting the Investment Plan that it aimed to boost much-needed job creation, putting jobs at the same level of growth and investment in a three-component approach (European Commission, 2014b). Moreover, with objectives focusing on human capital and productive capacity (box 1), it gives hope that the strategies used to implement the Investment Plan will simultaneously recognize the quality of jobs created.

A particularly welcome aspect of the Investment Plan is the means to replace the current focus on short-term financial gains with longer-term committed financing of projects. Indeed, increasing financialization of the business sector has resulted in a falling wage share of growth, prompting a widening of inequality and the unequal distribution of economic gains (ILO, 2014a). However, long-term financing under these terms would ensure that jobs created will be of a sustainable nature, allowing for prolonged economic and societal gains – all without contributing to long-term debt. Indeed, the European Commission estimates the plan could add 1 percentage point to economic growth each year from 2015 to 2017 and create up to 1.3 million additional jobs (European Commission, 2014a).

Main objectives

1. Reverse downward investment trends and help boost job creation and economic recovery, without weighing on public finances or creating new debt;
2. Take a decisive step towards meeting the long-term needs of the economy and increasing competitiveness;
3. Strengthen the European dimension of human capital, productive capacity, knowledge and physical infrastructure, with a special focus on the interconnections vital to the Single Market.

Steps

The first step is to raise and leverage capital. The Investment Plan, as outlined in the plenary address, aims to mobilize €315 billion over three years. The funds would be held by a new financial entity, the European Fund for Strategic Investments (EFSI), and would be initiated with €16 billion provided by the European Commission from the EU budget plus an additional €5 billion from the EIB's reserves. This €21 billion reserve will allow EIB to make loans of €63 billion. These €63 billion will be used to finance the riskier components of investment projects, leaving the remaining €252 billion to be put forth by the private sector. Moreover, it is hoped that this will be a minimum, with EU Member States making additional contributions.

Second, ensuring that the funds reach the real economy will be determined by needs identified and validated by the EIB and a dedicated Investment Committee within EFSI. Accordingly, project validation will be assessed according to growth generation, commercial and societal impact, and value added to the EU. With this in mind, new sources of long-term funding will include steps towards a Capital Markets Union, with the eventual aim of reducing fragmentation of EU financial market regulation, as well as diversifying finance for small and medium-sized enterprises (SMEs). Elsewhere, the focus on the Single Market element will include the European Energy Union; transport infrastructure and systems; the Digital Single Market; service and product markets, particularly through deregulation; and research and innovation.

Timeframe

The Investment Plan is intended as a three-year initiative (2015–2017). With collaboration and commitment by EU Member States, it is hoped that fast-tracked legislation will have EFSI operational by June 2015. In mid-2016 there will be a progress review, to coincide with a midterm review of the Multiannual Financial Framework.

The purpose is to encourage strategic investments that promote innovative, sustainable and job-rich growth. Accordingly, the EIB is well placed for such strategic investments, particularly with an Investment Committee of experts providing additional technical and strategic oversight.

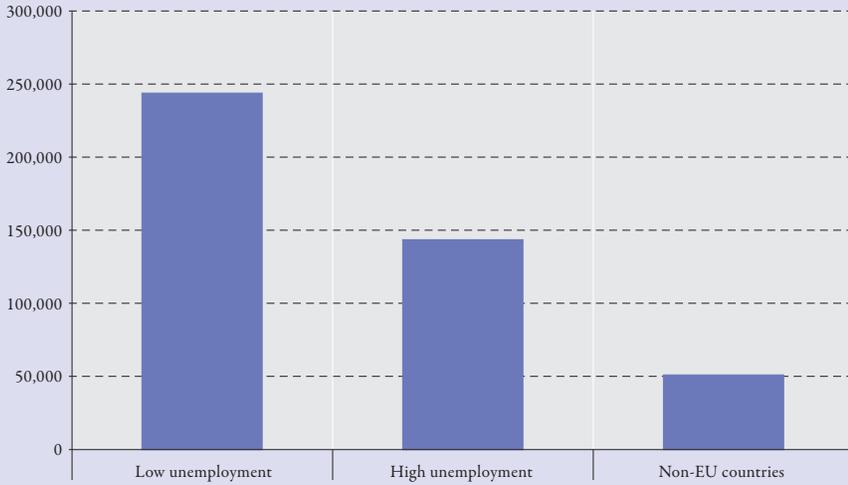
But must avoid “business as usual” in terms of funding allocation

The impact of the Investment Plan on jobs – and thus its success as measured by people – will depend very much on its design, including how the funding is allocated and distributed. The challenge is to ensure that policy-makers at the EU level avoid a “business as usual” scenario that would result in funds being diverted away from countries and sectors that are most in need.

For instance, an analysis of the geographical destination of EIB funding reveals a high degree of concentration across EU Member States, with France, Germany, Italy and the United Kingdom receiving more than 45 per cent of all funding (figure 4). In that regard, it is important to note that in recent years the disproportionate rise in unemployment levels occurring in some countries has not been followed by a parallel increase in financing from the EIB. For instance, Greece currently receives only 2.3 per cent of total EIB funding going to EU Member States, while it hosts 5.1 per cent of EU unemployed (in 2007 these percentages were equal to 1.8 and 2.4 per cent, respectively). Similarly, Spain receives 16.6 per cent of total EIB funding within the EU, but it hosts 23.1 per cent of total unemployed in the EU (in 2007 the relation was reversed and these shares were equal to 17.3 and 10.8 per cent, respectively).

Of course, employment is not a funding criterion of the EIB per se, and it is important to recognize that EIB funding entails involvement of private investors, which may be weak in crisis-hit countries. But ironically, the issue has gained increasing importance in the EU during the crisis, as in some countries the combined effect of fiscal consolidation measures and tight credit conditions – characterizing the current approach to the crisis – has considerably reduced the resources available for private and public invest-

Figure 4 Distribution of EIB funding in the EU-28, 2007–2013
(millions of Euros)



Note: "Low unemployment" refers to EU countries whose unemployment rates over the period 2007-2013 were below the EU-28 average. Conversely, "High unemployment" refers to EU countries with above the average unemployment rates in the period 2007-2013. "Non-EU countries" refers to EIB partner countries outside the European Union.

Source: ILO Research Department based on European Investment Bank.

ment and the ability to leverage sources of financing such as the EIB, further contributing to the deterioration of macroeconomic and labour market performances.⁸ Careful consideration therefore must be given to how the Investment Plan is implemented and the potential employment impact of various allocation scenarios – issues taken up in section B.

⁸ See for instance ILO, 2014b, and ILO, 2014c, for the cases of Greece and Spain, respectively.

B MAXIMIZING THE EMPLOYMENT IMPACTS OF THE INVESTMENT PLAN

The potential employment impacts of the Investment Plan will depend on a number of factors, most notably the extent to which private sector funds can or will be leveraged.⁹ In the first instance, and in light of similar EU initiatives in recent years, an important element of the Investment Plan is the timely release of funding. The Youth Guarantee scheme, for example, was a welcome initiative but has been confronted with some delays in operationalizing the plan, with negative consequences for those young jobseekers in need of immediate support (ILO, 2014c). Clearly, the success of the Investment Plan over the three-year span of 2015–2018 will hinge on the timing of implementation.¹⁰ From that perspective, the decision to fast-track the legislative process so that implementation can start as early as mid-2015 appears appropriate.

Success will also depend critically on how the funding is distributed and allocated both across and within countries, and whether any consideration is given to introducing complementary measures such as training or other active labour market policies. With that in mind, this section will attempt to estimate the employment impacts under various scenarios.

1 SCENARIO 1: IMPORTANCE OF LEVERAGING PRIVATE SECTOR INVESTMENT: €63 BILLION VS €315 BILLION

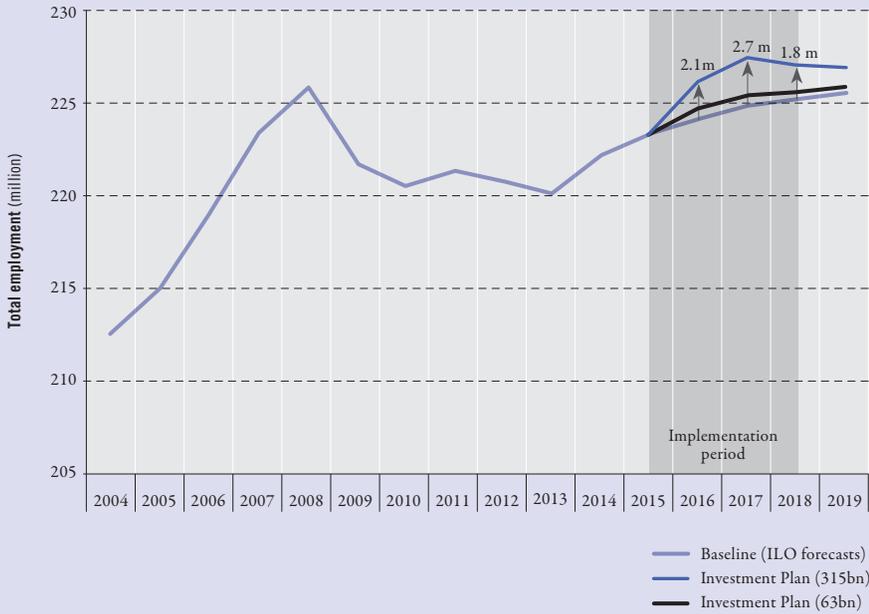
To begin, a baseline scenario is developed that assumes there is no Investment Plan and that future employment creation will be a function of current growth forecasts. Based on this, it is estimated that for the region, employment would grow by only 0.6 per cent.¹¹ Then, scenario 1 – using

⁹ There is also some considerable debate as to whether the funding is new or simply a reallocation of existing funds. This includes whether the initial funds from the EU budget and the EIB will be directed away from other projects. However, for the purpose of estimating the employment impacts under various scenarios, it is necessary to assume that the funding will represent an injection of capital into the real economy. The leveraging of initial funds will, after all, be derived from the private sector and attracted by circumstances of reduced risk.

¹⁰ ILO, 2009a, for instance, discusses the different impacts derived from immediate or delayed interventions. However, the models presented in this section have been calibrated to reflect a staggered timeframe for raising and leveraging capital.

¹¹ Based on the ILO, Trends Econometric Models, October 2014.

Figure 5 Potential employment impact of the Investment Plan versus ILO forecasts



Source: ILO Research Department.

the Global Economic Linkages Model calibrated to reflect current prevailing conditions in the EU-28¹² – highlights the employment effects of €63 billion, assuming that the plan is unable to leverage any private sector investment.¹³ It assumes that the investment expenditure (in infrastructure alone) is distributed in proportion to the size of each country’s GDP¹⁴ and is implemented over a three-year period starting in mid-2015. The impact, however, is limited, as it results in only an additional 430,000 jobs compared to the baseline of no additional investment (figure 5 and 6).

In comparison, if the plan succeeds in encouraging the private sector to invest to the full extent – as discussed in section A – total investment would

¹² Namely, an economy characterized by low levels of inflation with GDP growth approaching a steady state. Moreover, it assumes the economy is demand constrained, implying (a) prices are less affected by aggregate demand, (b) prices do not affect the monetary policy stance.

¹³ The lower bound estimate of €63 billion refers to the loans related to the EIB (see box 1).

¹⁴ Based on current prices.

rise to approximately €315 billion.¹⁵ Assuming the same funding allocation as in the €63 billion scenario, but distributing the funds between infrastructure and SME financing (€240 billion and €75 billion, respectively), the estimated employment impact rises to 1.8 million (0.8 per cent).¹⁶ This impact reflects direct effects from spending, namely a direct increase in employment associated with the investment projects, as well as any indirect spillovers deriving from knock-on spending in the wider economy.¹⁷

2 SCENARIO 2: FUNDING ALLOCATION TAKING INTO ACCOUNT UNEMPLOYMENT LEVELS

The current approach to funding allocation is likely to be such that funds are distributed according to strategic investment decisions; that is, they will be assessed by their potential for innovation and growth-enhancing impacts, as well as the likelihood of private sector engagement. This latter point is particularly salient given that countries characterized by labour market distress are often those where the private sector is facing considerable challenges (ILO, 2014b, 2014c), leading to a result probably not so dissimilar to that of the current EIB allocations discussed in section A. This may only exacerbate the economic and employment disparity that currently prevails across Europe, with the difference between the highest and lowest unemployment rates in the group of countries at more than 20 percentage points in 2014.

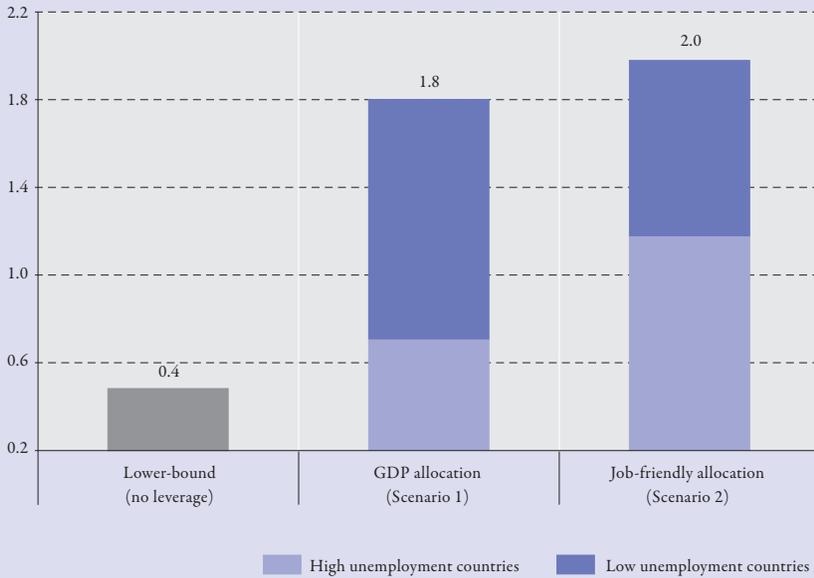
Therefore, in an effort to address – or partially redress – the labour market situation, the second scenario proposed here seeks to show the employment-enhancing outcomes achievable by taking into account the current levels of unemployment in the allocation decisions. In particular, this scenario – using country-specific elasticities (Appendix II) – allocates one-third of

¹⁵ This is treated as an injection of “new money” rather than redistributed existing funds. See also footnote 9.

¹⁶ It assumes investment spending reaches a peak after the second year and winds down into the third. However, due to the long-term nature of the investments, it assumes that spending does not completely cease after the third year, instead winding down significantly over the following years. As such, the simulated impacts on GDP and employment bear this in mind.

¹⁷ A productivity-enhancing component is also included in the model and reflected in the employment gain presented here.

Figure 6 Employment outcomes under different Investment Plan allocations
(millions)



Source: ILO Research Department.

the €315 billion by relative size of the economy (that is, weighted by GDP) and the remaining two-thirds by levels of unemployment. Under such an allocation, total employment gains are enhanced by 9.4 per cent.¹⁸ In other words, total employment gains after three years could approach 2.0 million (see figure 6). Moreover, not only would total employment be higher than under scenario 1, but those countries in greatest need would observe the highest increases in employment. This is consistent with the fact that job creation is a core feature of the Investment Plan. Targeting investments to sectors with high employment elasticities could also help to leverage further employment creation.

¹⁸ The magnitude of the employment gains estimated in percentage terms – that is, 9.4 per cent – using country-level investment–employment elasticities is applied to scenario 1 to illustrate the employment gains in millions to ensure consistency across scenarios in terms of job levels.

3 **SCENARIO 3: THE CASE FOR MAKING COMPLEMENTARY EFFORTS TO INVEST IN PEOPLE**

Finally, a number of studies focusing on developed countries have found that active labour market policies (ALMPs), such as training and job search assistance, matter at the aggregate level, and that there are positive net effects on the labour market of spending in ALMPs. Moreover, in the context of an investment strategy, it will be central to ensure that the projects are able to leverage people with the right skill set in order to ensure successful project implementation. Accordingly, scenario 3 directs part of the total investment funds – €15 billion – towards ALMPs.^{19,20} Figure 7 highlights that the gains from such a redistribution would yield net positive job gains in the order of 4.3 per cent after three years, above and beyond the gains of the scenario 2 model.

In particular, by the end of the first year of the Investment Plan, “ALMP redistribution” provides an additional 46,000 jobs above and beyond scenario 2 (without ALMPs), climbing to around 126,000 jobs by the end of the third year of the Investment Plan. And while modest, it is important to bear in mind that these gains are a net addition that could be achieved simply by reallocating funding within an existing envelope and would thus bring the total employment gains of a job-friendly approach to 2.1 million.

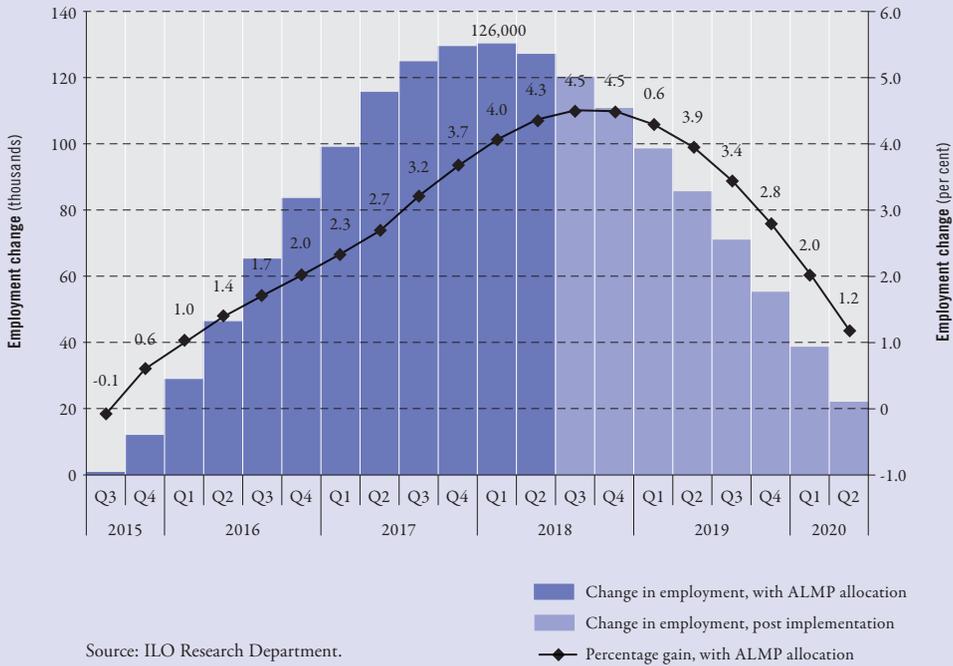
4 **EFFECT ON PUBLIC FINANCES: DEBT-TO-GDP REDUCTION OF APPROXIMATELY 1.9 PER CENT**

An important consideration in the context of the Investment Plan is, of course, the effects on public finances. In light of this, it is key to bear in mind that one of the most effective means of improving public revenues is through job creation (ILO, 2012). Indeed, there are two channels by which the impact on debt-to-GDP can be evaluated, namely the budgetary impact and the GDP impact, as well as the related spillover effects.

¹⁹ This equates to approximately 0.1 percentage point of GDP increase in ALMP spending. It is assumed that this degree of increased spending would avoid saturation.

²⁰ Consideration could also be given to how, and in what manner, European structural funds could be leveraged as a complement to financing additional support to ALMPs in the context of the investment projects.

Figure 7 Net employment gains of directing funds towards ALMPs



Source: ILO Research Department.

First, the net fiscal impact includes both revenues gained from increased tax revenues deriving from additional employed persons in the labour force, and reduced expenditures on unemployment benefits and related financial support. For context, an estimated 50.8 per cent of all unemployed in the EU-28 had access to benefits in 2012, equivalent to around 14.4 million people and with an average cost of approximately €787 per person per month.²¹ As a result, it suggests there are potentially significant savings from reduced unemployment benefit expenditure as jobs are created. In addition, the creation of 1.8 million jobs – as per scenario 1 in this section – would create significant direct and indirect tax revenues. Consequently, an estimate of these effects in the baseline scenario anticipates a 1 percentage point reduction in debt by the third year compared to the baseline scenario.

²¹ European system of integrated social protection statistics (ESSPROS).

Second, it is estimated that over the three years the cumulative GDP gain would be approximately 2.3 percentage points. This includes increased consumption of the additional employed resulting in higher incomes. This would yield in year 3 a 0.9 per cent increase in GDP. Taken together, the impact on public finances and the improvement in GDP would result in a reduction of 1.9 per cent in the debt-to-GDP ratio.

Finally, consideration needs to be given to potential spillover effects as a consequence of the amelioration of the fiscal position. For instance, a reduction in the debt-to-GDP ratio would also translate into improved financial market confidence in countries' stability and in turn into lower future payments for interest rates on public debt; in addition, the reduced debt-to-GDP ratio would allow increased fiscal space for alternative expenditure allocations. The projected impact on the debt-to-GDP ratio is therefore likely to underestimate the full effect.

C A STRATEGY TO ENSURE SUCCESS

Section C proposes a number of key complementary policy measures or initiatives to ensure that investment works for both enterprises and employees. First, as section B highlighted, the success of the Investment Plan will rely on (a) the capacity of the private sector and the extent to which it is leveraged; and (b) short-term complementary ALMPs to ensure individuals have the right skills to take up the jobs created. Second, for the Investment Plan to be sustainable and bring forth lasting gains, the initiatives – rather than being a “one-off” – need to form the basis of a more medium-term strategy that is developed through social dialogue in a tripartite setting, and that would build on leveraging the private sector as employment creators and work towards mitigating any structural consequences of the prolonged labour market recession. The purpose of this section is to discuss these issues in greater detail.

1 SUPPORTING THE PRIVATE SECTOR, ESPECIALLY SMES, TO CROWD IN PRIVATE INVESTMENT

The capacity of EFSI to sustain investment and create jobs critically depends on the degree to which the private sector matches publicly allocated resources to finance investments. The involvement of private enterprises is thus an essential component that will determine the success of EFSI in sustaining investments and promoting employment creation in the EU. This is particularly true in a context in which fiscal consolidation measures are affecting the investment capacities of many EU governments, notably those most in need.

The EU Investment Plan needs therefore to be adequately designed in order to maximize the incentives of private investors to participate. At the same time, the design of EFSI will need to avoid a situation whereby the fund will finance investment projects that would have taken place anyway. Otherwise, EFSI risks providing a gain to private and public investors

already willing to undertake a project – in the form of reduced interest rates and reduced public spending, respectively (European Commission and EIB, 2014).

EFSI aims to attract private investors by taking more risk on the public part of investment and using public money as a buffer against potential losses of some projects (European Commission and EIB, 2014). Central issues include how much risk EFSI will be willing to take, how the risk sharing between the fund and public and private investors will take place, and what institutions will be at the centre of EFSI:

- *Promote the financing of risky projects.* One measure that could be taken to ensure that the investments that are financed through EFSI are indeed additional to those that would have already taken place is to prioritize projects with a relatively high risk profile. Indeed, low-risk projects could be financed by governments, especially in Member States that have a good fiscal stance, or by private enterprises, also profiting from the current low interest rates.²² In countries where there is limited availability of public resources due to fiscal constraints or limited access to credit to the private sector, more adequately targeted measures to tackle these specific issues – rather than an EU-wide guarantee for public and private investments – should be implemented. By contrast, EFSI could finance risky projects that (according to available evidence) are currently not financed by the private sector in the EU, and for which a public guarantee would have the larger effect (Claeys, Sapir and Wolff, 2014).
- *Provide up-front cash for investments.* The second aspect refers to how EFSI will contribute to the reduction of risk taking by investors. In this respect, priority should be given to the possibility that EFSI provides up-front cash for investments and increases the willingness of public and private investors to crowd in. For instance, in Spain in 2013 the first public fund (FOND-ICO) was launched with the objective of attracting additional resources by co-financing projects with private investors, which would need to provide between 30 and 70 per cent of the resources needed (Münchau, 2014).

²² Importantly, despite overall low interest rates, a number of EU Member States are confronted with issues related to access to credit, notably for SMEs. See for instance ILO, 2014b, and ILO, 2014c, for the cases of Greece and Spain, respectively.

-
- *Involve national development banks to channel credit to SMEs.* Despite not being directly linked to the risk-sharing design of EFSI, the issue of the institutions that will be involved in the implementation of the plan is essential for its success. This is especially the case if the fund aims at reaching also SMEs and mid-cap enterprises that are generally beyond the target of the EIB. Indeed, the loans of the EIB have an average size above €70 million. For this reason, the EIB generally provides credit to private commercial banks, which independently select the SMEs that will receive the financing – benefiting from a reduction in interest rates. In this case, there is a risk that commercial banks will provide credit to their favourite customers, who would have received it even in the absence of EFSI (Gros, 2014). In order to overcome this risk, it might be considered to channel credit to SMEs through national development banks. Indeed, these institutions already have the capacity to operate large-scale programmes, thus increasing the efficiency of EFSI. A number of other policy measures that could be enacted quickly could also be considered in an effort to get credit flowing to SMEs (box 2). In particular, credit guarantees, improved credit mediation and earmarked liquidity can help restore credit to SMEs.

2 ENSURING WORKERS HAVE THE SKILLS AND SUPPORT TO TAKE UP THE JOBS ON OFFER

The extent to which the Investment Plan succeeds in creating jobs will very much depend not only on the extent to which private sector funds are leveraged, but also on the manner in which the funds are disbursed, across and within countries. As shown in section B, ALMPs – notably improving skills and labour market matching – will be central to any investment strategy that seeks to improve labour market outcomes. In particular, analyses suggest that job search assistance and training are among the most effective ALMPs, with the effectiveness of job search assistance higher than that of training in the short term, while the positive effects of training increase over time (Card, Kluve and Weber, 2010; Hotz, Imbens and Klerman, 2006). However, support to these programmes has been declining (box 3). It is

Measures to restore credit flows to SMEs

Credit guarantees. Credit guarantee schemes help reduce the risk premium associated with SMEs, thus enhancing lender confidence, and are usually in the form of public, corporate or mutual schemes. The most common of these, mutual schemes, leverage public resources to guarantee all or part of loans provided to viable SMEs by financial institutions. Studies have found that this type of programme has proved particularly useful because it merges government funding and management capacities with credit risk assessments and financial expertise of banks (Beck, Klapper and Mendoza, 2010). For example, the Canada Small Business Financing Programme is a joint programme in which Industry Canada pays up to 85 per cent of a bank's net losses in case of default.

Credit mediation. Mediation mechanisms should be in place to ensure that refusal of a financial institution to finance a small or medium-sized enterprise – either fully or partially – is for reasons related to the viability of the business.

Direct financial support. Small enterprises can be eligible for direct grants in the form of loans and partial equity positions. For example, Ireland established the Microfinance Loan Fund in early 2012 as part of the Action Plan for Jobs, providing unsecured loans of up to €25,000 to SMEs.

Earmarked liquidity. Efforts to target financial resources for SMEs may be merited as central bank operations to increase liquidity, but do not always lead to the desired results. For instance, in the United States, the 22 largest recipients of government bailout money actually decreased lending to small businesses between 2009 and 2010.

Sources: Beck, Klapper and Mendoza, 2010; ILO, 2013b.

therefore crucial to complement the European Commission Investment Plan with the right set of tools and support and to include employers in the design of such measures, especially as regards training. The following could be considered:

- *Training programmes that match the skills in demand.* Training programmes are essential to the recovery process and to the right functioning of the European Commission's investment package. In particular, measures to address the specific needs of unskilled and long-term unemployed are of the utmost importance, as this is the pool of available labour (table 1). As such, training programmes need to be accompanied by a customized

provision of services that match the skills of the unemployed to the needs of the sectors that will benefit from the investment injections. Moreover, the direct involvement of employers, either as providers of on-the-job training or as providers of work experience to those receiving classroom-based training, leads to better outcomes than purely classroom-based training options. This approach is also important to equip workers with the skills needed in emerging sectors. In this respect, efforts to leverage better public-private partnerships could help to improve the overall effectiveness of training delivery.

- *Reinforcing public employment services.* Findings from a number of Organisation for Economic Co-operation and Development (OECD) countries show consistently positive outcomes from investing towards well-resourced public employment services (PES) (Martin and Grubb, 2001). In fact, evidence shows that increasing the available ALMP resources to PES strengthens the favourable effects of activation measures on the labour market (Escudero, 2014). In addition, a more direct PES staff-client relationship has been proven to yield positive outcomes (Tergeist and Grubb, 2006), especially as individualized counselling improves the probability of most vulnerable populations finding a job.
- *Keeping funds and support flowing to newly created enterprises.* Interestingly, start-up incentives have been found to be cost-effective in reducing unemployment. The new waves of investment that will be injected in the EU-28 economies will probably produce some sort of structural transformation that will have to pass at least partially through newly created enterprises. In order for such policies to have their maximum impact, it is important that enterprises receive the support necessary to be ready to expand and create more jobs. As such, providing an additional support mechanism that enables entrepreneurs to acquire the operational managerial skills required to run and expand a business would be a welcome strategy. Likewise, additional business services to start-ups – as well as ongoing support – would be a way to improve outcomes for self-employed individuals and to promote competitive sectors in line with the European Commission investment package.

Table 1 Examples of measures aimed to support skills and job creation

Training programmes that match the skills in demand	In 2013 the Canadian Government announced the implementation of the Canada Job Grant, which enables participants to receive the vocational training necessary for available jobs by putting training decisions in the hands of employers. The Government contributes up to C\$10,000, while employers are required to contribute one-third of the total costs. Grants are for short-duration training provided via eligible third parties, such as community colleges or private trainers.
Keeping funds and support flowing to newly created enterprises	<p>In 2008, the Republic of Korea launched several start-up initiatives aimed at fostering entrepreneurship and overcoming a cultural aversion to risk-taking through the Korean Institute of Start-up and Entrepreneurship Development (KISED). This public agency is leading the effort to implement programmes through which prospective entrepreneurs can participate in mentorships and receive advice on management and technology at the weekends. In addition, in February 2010 KISED launched an online start-up system that simplifies the procedure of starting a business.</p> <p>In Argentina, <i>Programa de Financiamiento Productivo del Bicentenario</i>, launched in 2010, grants subsidized loans to firms. The loans may be used to acquire land, put towards working capital or used to refinance debt. Loans are primarily granted to ventures that generate employment and result in domestic production. Such measures are expected to encourage more people to create their own self-employment opportunities.</p>

Source: ILO (2014a, 2013b).

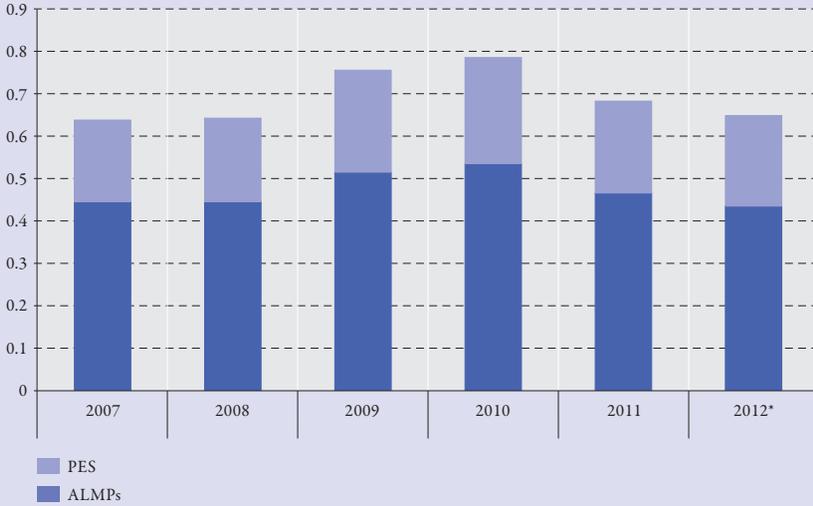
Box 3 Resources for ALMPs

Total expenditure on active labour market policies (ALMPs) has been falling in the EU-28 since 2010. After an increase of 0.15 percentage points following the financial and economic crisis, expenditure on ALMPs (including labour market services – PES) peaked in 2010 at 0.79 per cent of GDP (figure 8, panel A). Since then, spending on ALMPs and PES has been decreasing, despite the severity of the labour market challenge discussed in section A. In 2011, the region spent close to €7 billion less on ALMPs alone than in 2010, and another €3.4 billion less in labour market services.

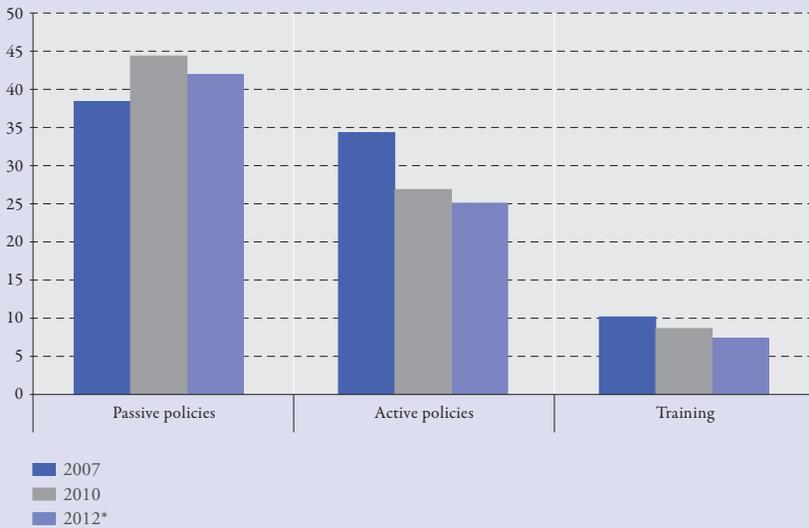
Moreover, activation support by participants fell between 2007 and 2012 (figure 8, panel B) by close to 10 percentage points, from 34.7 participants for every 100 people wanting to work in 2007 to 25.2 in 2012. In fact, the activation support analysis shows that even when ALMP spending was increasing during the crisis (2007–2010), the boost was not commensurate with the labour market needs generated by the turmoil.

Figure 8 Evolution of ALMPs and PES in the EU

Panel A. Expenditures in ALMPs and PES
(% of GDP)



Panel B. Participants in labour market policies per 100 persons wanting to work
(percentages)



*Estimates.

Source: ILO Research Department, based on Eurostat

3 TOWARDS A COHERENT, BALANCED AND INCLUSIVE GROWTH STRATEGY

*Immediate measures need to be embedded
in a broad approach that first creates an enabling business environment ...*

For longer-term results, it will be important to build on the short-term measures presented above in support of more inclusive growth. Indeed, while it is crucial in the present context and with a view to making the most of the proposed investment package to help firms crowd in investment, in the longer term robust action is needed to ensure an enabling environment for enterprises as the creators of jobs. Therefore, improving the design and implementation of EFSI – as discussed in section C.1 – should not be the unique objective of a comprehensive policy approach to sustain investments in the EU. Indeed, the EU investment gap not only reflects concern about high-risk projects that are not currently attractive to private investors (such as large innovative projects or high-risk SMEs), but also concern about strategic investments that are not undertaken by private investors due to challenges with the business environment. In particular, investments in many areas of intervention – from education to infrastructure – are unlikely to see a sizeable improvement arising from the implementation of EFSI if reforms at the national and EU levels are not implemented.

Consequently, governments and EU institutions can encourage private investments by setting up a supportive regulatory framework and promoting the convergence of product market regulation within the EU – an issue that is especially relevant for cross-border investment projects. This would also guarantee that viable investments are undertaken by private and public investors independently from EFSI.

Possible policy initiatives to enhance the functioning of the business environment cover different areas, and the right policy mix will largely depend on country-specific circumstances. In all cases, however, measures should aim at facilitating firms' ability to operate in national and international markets. In particular, policy interventions should include (a) confronting barriers to starting up and running a business; (b) providing advice

and assistance that enables entrepreneurs to acquire the operational and managerial skills required to run and expand a business (currently support tends to be front-loaded); (c) increasing product market competition in key economic sectors that provide intermediate inputs to other industries by removing entry obstacles; and (d) promoting the convergence of national product market regulation across countries in the single market by aligning administrative requirements and regulatory barriers for key sectors that present economies of scale within the single market (for example the energy sector).

... second, favours ALMPs that support worker attachment to the labour market through a combination of active and passive policies ...

As the economic recovery is still in its nascent phase in several EU countries, it is critical to ensure that the European Commission investment package – as discussed above – includes immediate measures to help improve workers’ skills, but this should serve to complement efforts to help workers remain attached to the labour market and retain (and where necessary improve) their skills. Indeed, as the share of long-term unemployed increases, there is a growing risk of skills erosion and social exclusion, which in turn will further reduce the probability of the long-term unemployed re-entering the labour market. This requires improvements in the design of ALMPs, including better targeting and more frequent contacts with PES and the provision of adequate income support to all jobseekers. But it also requires a substantive reinforcement of ALMPs and PES so these measures can attain higher levels of efficiency and can reach at least a majority of those in need of this type of support. Such an approach would provide critical support during periods of structural transformation.

One targeting method that has proven successful in the past is intensification of activation measures as the unemployment situation worsens. Additional research efforts could also be directed towards identifying and providing intensified support to other at-risk groups at early stages. This can lead to improved resource allocation as support is targeted to those most in need of assistance. This could, for example, be achieved through more efficient use of new technologies for both the PES and their clients.

... third, promotes balanced reforms of labour market institutions ...

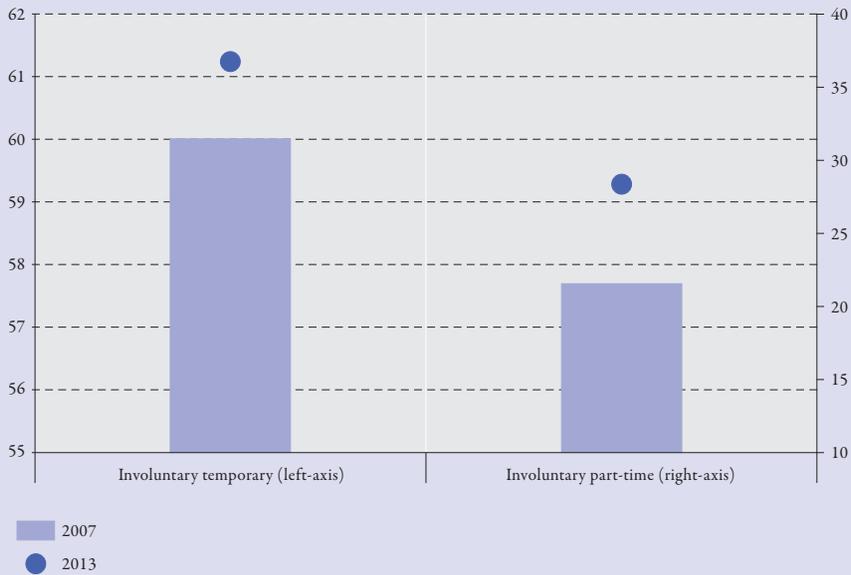
Along with supply- and demand-side support, different labour market institutions would benefit from a more comprehensive analysis to find solutions with optimal results in a particular context. Institutions such as collective bargaining systems and employment protection legislation went through important reforms in different EU countries during the crisis period. The hope was that these and other reforms together with fiscal consolidation measures – while associated with some short-term costs – would help to cut government deficits, arrest the trend increases in government debt and boost business confidence, leading to greater investment and job creation. However, these expectations have not been met, and certainly have not (as yet) yielded the expected outcomes in terms of job creation.

Moving forward, it will be important to monitor these changes, notably as regards employment outcomes. For instance, while decentralization of collective bargaining can help improve firm flexibility, there are a number of risks, including the reduction of worker coverage and fragmentation of collective bargaining, giving rise to a lack of transparency in working conditions and regulations, leading to less predictability for investors. In addition, polarization in the labour market has increased, with non-standard employment often leading workers out of the labour market rather than providing a stepping stone towards more stable employment.

Further, a growing share of individuals is engaged involuntarily in part-time and temporary employment, a situation that has worsened during the crisis (figure 9) (ILO, 2014b, 2014c, 2013a). For instance, in the EU-27, involuntary temporary employment as a share of temporary employment increased from 60.0 per cent in 2008 to 61.2 per cent in 2013 (and from 53.7 per cent in 2000). Similarly, involuntary part-time employment increased more than 6 percentage points on average between 2007 and 2013, reaching 28.0 per cent.

It is therefore important to move towards balanced labour market reforms to avoid further polarization in labour markets. Reforms will need to strike an optimal balance between promoting firms' adjustment to business cycles alongside the provision of employment and income security for employees,

Figure 9 Involuntary temporary and part-time employment, 2007 and 2013
(percentages)



Source: ILO Research Department based on Eurostat.

in a context that brings workers and employers closer together to make informed decisions.

In this sense, promoting a more coherent use of temporary employment is needed, through the use of temporary workers to respond to temporary demands rather than to carry out the regular operations of a company. Further, job mobility and transition towards more stable employment should be promoted, considering that a low transition rate between temporary and permanent employment is a problem common to many EU countries. For instance, initiatives could be considered to improve mobility and transition by enabling accumulation of severance pay uninterrupted throughout a worker's career, for example through establishing a severance payment fund applicable to all employees. In this way, the gap in severance payments between temporary and permanent workers could be reduced, thus making it less attractive to hire temporary rather than permanent workers.

In the area of collective bargaining, this means searching for appropriate solutions in each country context through a joint tripartite process, and putting emphasis on the autonomy of bargaining parties to decide on bargaining levels and coordination of issues. Indeed, for improved transparency in the labour market and thereby stability for investors, it will be important to find ways to improve the coverage of workers through collective bargaining agreements at appropriate levels. In this sense, social partners together with governments could consider finding innovative models for collective bargaining agreements whereby, for example, minimum higher-level protection in some areas would be combined with enterprise-level adaptation in other areas. In addition, while it is important to allow for the possibility to opt out of certain collective bargaining agreement clauses as a temporary measure in situations of severe economic distress, attention needs to be paid to derogation practices and definition of control mechanisms so as to avoid their widespread use. In view of the trend towards decentralization, it will also be necessary to ensure appropriate worker and employer representation structures at the local levels.

... and finally, supports an inclusive and coordinated approach to policy-making.

Finally, balanced, sustainable and credible solutions are best achieved through tripartite dialogue, supported by evidence-based analysis from research institutions. Countries worst hit by the crisis in the EU provide important lessons about the manner in which tripartite engagement in the reform process can build legitimacy and facilitate successful implementation (ILO 2014b, 2014c, 2013a).

In the context of the EU, coordination and dialogue are necessary, both within and across countries, given the heterogeneity and breadth of the challenges facing European countries. Increased coordination of policies related to investment and employment (as well as income, taxes, etc.) will help to restore and improve competitiveness while enhancing labour market and social outcomes.

What is clear is that the proposed Investment Plan has the potential to create job-rich and inclusive growth in the European Union. As section A of this report highlights, though wide disparities in labour market conditions exist across Europe, suitably allocated funds could narrow these gaps and benefit those most in need. Accordingly, section B of the report advocates a distribution of funds that takes into account unemployment and the important role of complementary labour market policies.

The scenarios presented here are meant to be illustrative in nature. They do highlight, however, that taking into account the labour market challenges in addressing the investment shortage could yield better outcomes. Exactly how this would be determined concretely is of course a matter for the European Commission and the tripartite constituents in each country. Importantly, addressing the current labour market and social challenges should not end with the Investment Plan. These efforts need to form the basis of a medium-term employment strategy that both mobilizes the private sector and supports working conditions and job quality. In this regard, it will be important to monitor the employment impacts of the Investment Plan in the broader context of a employment-centred policy agenda.

APPENDIX I

MACROECONOMIC CONTEXT DETERMINES INVESTMENT-EMPLOYMENT RELATIONSHIP

Investment is a key driver of employment and productivity growth, and consequently, the lack thereof can hamper job creation. However, a country's domestic conditions, current account, public finances and overall economic growth each have their own implications. As such, a cross-country analysis can shed light on macroeconomic similarities exhibited by countries sharing labour market characteristics.

Accordingly, such an analysis is provided in table 2. It provides average indicators for select macroeconomic variables, according to two categories of labour market performance: those with unemployment rate increases below the 50th percentile, categorized as “good” crisis performers, and those with increases above the 50th percentile, categorized as “weak” performers. Interestingly, the table shows how the relative economic performance during the crisis hinged on the interplay of several factors and imbalances pre-existing the crisis, and sheds light on the importance of initial starting positions for employment and investment outcomes.

Indeed, table 2 supports the notion that certain cross-country variations in terms of employment developments are, at least partially, conditioned by the macro situation. Moreover, this is consistent with wider empirical evidence and research detailing the role of the composition of demand in explaining cross-country differences in labour market responses to the crisis (Berkmen et al., 2009; Rose and Spiegel, 2010).

Beginning with investment, it is apparent that significant imbalances in competitiveness had accrued during the period of crisis. Although the “weak” performers had, on average, levels of investment as a share of GDP above the “good” performers prior to the crisis – 24.7 and 20.1 per cent of GDP in 2007, respectively – there were sizeable gaps in investment performance during the crisis. In fact, among the “weak” performers, investment as a percentage of GDP fell close to 8 percentage points, compared

Table 2 Assessment and indicators of macroeconomic performance

Indicator	Period	Good crisis performers	Weak crisis performers
Real GDP growth	2007	3.5	3.3
	Change 2007–2013	-2.7	-4.5
Public debt (% of GDP)	2007	55.1	63.3
	Change 2007–2013	23.5	40.5
Current account balance (% of GDP)	2007	1.0	-4.6
	Change 2007–2013	0.1	7.2
Total investment (% of GDP)	2007	20.1	24.7
	Change 2007–2013	-2.3	-7.9
Unemployment rate	2007	7.4	6.4
	Change 2007–2013	0.2	9.4
ALMP + service delivery spending	2007	0.6	0.6
	Change 2007–2012	3.6	1.7
ALMP spending	2007	0.4	0.5
	Change 2007–2012	-7.4	2.5

Notes: “Good” (“weak”) crisis performers are defined as those with unemployment rates increase between 2008–2013 below (above) the 50th percentile. Figures for 2007 are expressed in percentages. Figures that correspond to the change between 2007 and 2013 are expressed in percentage points (except for ALMPs spending and ALMPs plus service delivery spending, which are expressed in percentages).

Source: ILO Research Department based on IMF Statistics and Eurostat.

to just over 2 percentage points among “good” performers. Initially, this suggests that labour market performance and investment trends declined hand in hand with the onset of the crisis; however, it does not, in itself, provide any causal inference.

Given the interrelation between investment and labour market trends, the wider macroeconomic impact on the labour market is also channelled via impact on investment. For instance, insufficient aggregate demand dampens business confidence and reduces investment, resulting in a laggard investment recovery. This enters a cycle in which low aggregate demand is compounded by ongoing economic uncertainty, prompting an increase in cash holdings by firms. Investment is withheld as cash holdings increase, until financial sector confidence rises, which in turn depend on fiscal conditions, economic outlook and reforms. Consequently, job creation is reduced not only directly by the wider macroeconomic conditions, but also via the shortfall in investment.

As such, current account balances are also significant: “good” performers had, on average, a current account surplus of around 1 per cent of GDP in 2007, while the “weak” performers had, on average, a current account deficit of around 4.6 per cent of GDP. While the balances have little reflection on trade competitiveness, such large deficits can be problematic as they entail large build-ups of net foreign debt that has to be repaid, which becomes difficult in times of crisis. This holds true regardless of whether the debt has been built up by the private (Ireland, Spain) or public (Greece) sector. At a country level, current account deficits of more than 10 per cent of GDP existed in 2007 in Cyprus, Greece, Portugal and Spain, while high surpluses were shown by such “good” performance countries as Germany, Luxembourg and Sweden.

Nonetheless, “weak” performers showed a higher improvement in current account balances during the crisis. While this could reflect the results of policies aimed to promote exports implemented over this period, it is more likely to reflect changing conditions in the deteriorating economic context. For instance, as capital flows stalled, the current account will have naturally narrowed; also, as domestic demand decreased and imports dropped, the current account will have contracted further, suggesting the contribution of higher exports to the current account improvement was probably limited on average.

Finally, there is an observed negative correlation between performance in the crisis and public debt levels. Thus, many European countries with “good” performances during the crisis enjoyed low levels of public debt prior to the crisis, allowing them the room to pursue countercyclical spending, as in the cases of Austria, Malta and Sweden. A solid fiscal position during expansionary periods is interpreted by financial markets as a sign of prudent policy, leading to low interest rates for government loans, and improving the economic capacity to respond to the crisis (Berkmen et al., 2009). It suggests that a country’s labour market outcomes in response to a crisis rest on the state of macroeconomic variables at the time of onset.

APPENDIX II

ESTIMATING THE EMPLOYMENT–INVESTMENT ELASTICITY: A CROSS-COUNTRY AND SECTOR ANALYSIS

The elasticity of employment with respect to investment may serve as a valuable tool to assess the employment effect of an increase in investment and in turn inform the design of the investment package with a view to maximizing the related employment gains. In its most basic formulation, the employment elasticity to investment change is a numerical measure showing the percentage variation in employment associated with a certain percentage change in investment. For the purpose of this report, the employment elasticity is computed by OLS estimation of a log-linear regression model over a panel of 22 EU countries for the period 1992–2012. For the remaining six countries, notably Croatia, Estonia, Ireland, Latvia, Romania and Sweden, due to the lack of detailed sectoral information, an elasticity was computed for the entire economy using the same methodology and data.²³

The model specification is the following:

$$\ln Empl_{i,t} = \alpha + \beta_1 \ln GFCF_{i,t} + \beta_2 (\ln GFCF_{i,t} * D_i) + \gamma D_i + \varepsilon_{i,t} \quad (1)$$

Where $\ln Empl_{i,t}$ and $\ln GFCF_{i,t}$ are the natural logarithm of the employment level and real gross fixed capital formation respectively in country i and year t . D_i are country dummies, while $(\ln GFCF_{i,t} * D_i)$ is the interaction between these dummies and the associated level of investment; α is a constant and $\varepsilon_{i,t}$ is the error term. In order to control for differences in the employment–investment elasticity across sectors of the economy, countries’ sector-specific employment–investment elasticities are generated by estimating Equation (Eq.)(1) for 36 sectors with available data. Data on employment and investments by sector were collected from Eurostat – National accounts, Detailed Breakdown, NACE 38 sectors Rev.2.

²³ A robustness check was undertaken using aggregate data from IMF (GDP) and ILO (employment) and yielded results for the EU-28 comparable to the sectoral elasticity approach discussed in this appendix.

Given the model in Eq. (1), the country-specific employment–investment elasticity for a certain country is given by $(\beta_1 + \beta_2)$. This indicator therefore shows the change in employment in a specific sector associated with a change in gross fixed capital formation in the same sector in the same country. Such an estimation strategy allows controlling for both cross-country and cross-sectoral heterogeneity in employment responsiveness to investment. As employment–investment elasticity may greatly vary according to sectors’ capital (labour) intensity as well as countries’ time-invariant institutional characteristics, this represents an important strength compared to employment elasticity measures computed at a higher level of data aggregation. However, some limitations to the estimated employment elasticities may apply. First, the simple model in Eq. (1) does not take into account other variables that may affect the employment–investment linkage and in turn the estimated elasticity. Second, Eq. (1), by modelling a contemporaneous employment–investment relationship, may not capture the potential delayed effect of investment on employment. Although the results obtained here are robust to the use of lagged values of $\ln GFCF_{i,t}$, concerns related to the timing of the employment–investment relationship may persist.

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AN EMPLOYMENT-ORIENTED INVESTMENT STRATEGY FOR EUROPE

The employment situation remains a major source of concern in the majority of countries in the European Union. Half of the region's unemployed have been without work for more than a year, and unless the policy approach changes, the prospects are for a sluggish employment recovery.

The Investment Plan proposed by the European Commission is thus a welcome initiative that recognizes the immediate need for stimulating growth, fostering Europe's competitiveness and tackling the employment crisis.

This report finds that for the Investment Plan to make a significant dent in unemployment, the design of the programme is crucial. Taking into account the magnitude and diversity of the labour market challenges, placing greater emphasis on complementary labour market policies and ensuring that small enterprises have access to credit will lead to better outcomes. In addition, any measures developed as part of the Investment Plan need to form the basis of a medium-term employment strategy that aims at quality job creation and avoids a "race to the bottom" in terms of wages and working conditions.

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