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End of previous Forum article

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A Strategy Change for Europe: Old Myths Versus New Roads

The European Union is a successful model in a midlife crisis. Restarting growth should not follow the old trajectory, nor should it be built on old myths. It should start from a new vision with a much stronger emphasis on social and ecological investment.

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Europe in 2016

Europe faces unprecedented social, economic and environmental challenges. Internal growth dynamics are low, unemployment and income disparity have increased, and new social risks are arising. Climate change continues un-

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abated, and ageing is not being addressed strategically. Secular stagnation could hit Europe relatively heavily, and pessimism about jobs for European youth and the future of "our grandchildren" is rising. Some of the challenges are more specific to Europe, such as unemployment, a lack of consumer demand and the decline of investment. Other challenges need global solutions, for example, tax compliance, profit shifting and decarbonisation.

At the same time, European governance seems no longer appropriate for a union with 28 members (and seven more countries applying for membership). Internal diversity is growing, and power shifts are occurring at the global level. The long-lasting repercussions of the financial crisis and political turmoil in neighbouring countries, including mass immigration from war-torn countries of the Middle East and the mishandling of the Greek crisis, have raised calls on one side for a re-nationalisation of policies and on the other for a more prominent role for European institutions.

A successful model in a midlife crisis

Despite the substantial economic and political problems currently, it is important to recall that European integration, and the EU, has by and large been a success model. A common market has been created, and subsidies and non-tariff barriers have been abolished. The EU has become the region with the highest share in world output. The EU's negotiating position has become much stronger relative to the US, Russia and China than any large European country could ever achieve alone. Within its current borders, the EU has safeguarded peace on a continent formerly characterised by recurrent and disruptive wars. Its role as a peacekeeper was acknowledged with the Nobel Peace Prize in 2012.

The major achievement of the EU has been to cut national subsidies and state aid. Former highly regulated monopolistic markets (postal service, telecom, electricity) have been liberalised and are generally open for firms and individuals.Economic integration has culminated in a common currency for 330 million people, to which 59 countries and territories around the world have pegged their currencies. Furthermore, political integration and the economic catching-up of the former communist countries have been achieved at an unprecedented pace. The European Union has not only been able to prevent military conflicts within its borders, but, by means of its pre-accession processes, it supports solving or mitigating conflicts, fighting corruption and strengthening the rule of law in prospective member countries.

However, structural change necessitated by globalisation, an unwillingness to reform the public sector and bubbles in non-tradables created a conundrum of economic problems in the years preceding the financial crisis. The crisis – whose root causes originated in the US – quickly spread to Europe and intensified already existing problems. It seems that European institutions and regulations are unable to successfully manage and overcome the crisis. Low growth dynamics and high unemployment are persistent in many countries.

Seven myths

Most of the policy recommendations for restarting growth in Europe exhibit severe shortcomings with respect to their effectiveness and their failure to address the new challenges.

1. Growth will solve the unemployment problem

Many policy statements and econometric models implicitly assume that the financial crisis has finally been overcome and economic growth will become strong enough in the medium term to reduce unemployment to "normal" levels.

There are four arguments which make this unlikely, even if policy measures exist and should be used to increase growth dynamics. First, historical evidence on the aftermath of financial crises shows that the return to past rates of growth and employment may take a very long time. Second, literature on secular stagnation identifies several reasons – such as saturation of demand or lack of new radical innovations – for lower long-run growth, particularly in industrialised countries.[1] Third, history shows that periods of economic growth higher than 1.5 per cent per year are exceptions.[2] Fourth, planetary limits are shown to be stressed by the current output level, and radical changes in technology, policy and behaviour have to occur if the growth levels of industrialised countries are to be similar to those in the past while at the same time compatible with environmental goals such as limiting global warming to two degrees.

Therefore, the effectiveness of policies may be enhanced by thinking about alternative policies to tackle unemployment, to finance welfare and to repay debt if growth should indeed fail to "return to normal".

2. Cutting public deficits at any price must be a priority

Policy analyses stress that public debt and deficits are high. It is asserted that a precondition for returning to

1 C. Teulings, R. Baldwin: Secular Stagnation: Facts, Causes and Cures, London 2014, CEPR Press.

2 G. Tichy: European integration as an underestimated success programme, WWWforEurope Working Paper No. 109, October 2015.

growth would be to eliminate current deficits quickly and to reduce debt-to-GDP ratios. Some stipulate that this should be done at any price and for all countries, if necessary across-the-board.

However, the success of fiscal consolidation strategies is known to be highly dependent on their priorities, timing and on the economic dynamics in adjacent regions. Public support for fundamental reforms in general, and consolidation programmes in particular, depends on perceived fairness, communication, trust in government and on their embeddedness in a long-run vision. Fiscal consolidation in a specific country, if neighbours consolidate at the same time, is extremely difficult.

The reduction of long-run debt is indeed an important goal, particularly if long-run growth prospects are limited. The danger of a possible rise in interest rates and of a new crisis (requiring further fiscal and monetary stimuli) cannot be excluded. Existing public deficits have to be spent on future activities with high private or public returns and not for past priorities, bureaucracy and clientelism. Aiginger et al. stress that EU-wide instruments to finance debt should be used to reduce the interest burden of debt and create leeway for investment in social, technological and environmental innovations.[3]

3. There is a lack of public funds for European goals

The mid-term evaluation of the EU 2020 strategy clearly reveals that many policy goals (e.g. that of increasing R&D) will not be reached.[4] Other analyses show that the switch to renewable energies is being limited by insufficient investment in European grids and that strategies to cut unemployment are being put on hold. Policy makers ascribe this to a general lack of public funds.

Considering the following facts, it becomes obvious that a shift in priorities may well free up public funds to finance future-oriented policies. First, Europe currently grants large subsidies to fossil-based energy sources. In many countries, subsidies for fossil fuels are higher than for renewables.[5] In general, but even more so in times of low oil prices, subsidies for coal, petrol and diesel could be curbed. Second, Europe spends the largest single part of the EU budget subsidising large agricultural units (the first pillar of the Common Agricultural Policy), with a prioritisation of conventional instead of organic agriculture (the second pillar). Third, Europe allows firms to transfer their profits and evade taxation, and it fails to impose an adequate tax on financial speculation. Fourth, Europe spends more on its 28 different military systems than Russia and China together.[6] These uncoordinated military systems are inadequate for any new challenge within and outside the Union, be it border protection, pre-empting conflicts, supervision of migration or the provision of humanitarian aid.

The Annual Growth Report of the European Commission should be used to propose shifts from counterproductive subsidies (e.g. for fossil fuels) and inefficient expenditures (e.g. large agricultural units) to priorities in line with Europe 2020.

4. A lack of profits prevents economic recovery

Private investment has been sluggish ever since the outbreak of the financial crisis and has not since recovered to its pre-crisis level.

This is often attributed to low profits or credit constraints. Contrary to mainstream perceptions, the reason for this is not a credit and liquidity squeeze but rather low demand for corporate credit. Profits have recovered, wage income shares are, if anything, lower than in the past, and loans are cheap (even if conditions have been tightened). Firms are using their profits to rebuy their own assets or to deleverage. The total non-financial business sector has given up its usual net debtor position and is now a net creditor. The main reason for sluggish investment is pessimism about the dynamics of markets and low medium-term growth expectations.

If private business investment does not recover due to pessimism and unused capabilities, public investments (mainly for intangibles) should be increased (e.g. by the European Fund for Strategic Investment). A consistent strategy is needed – based on a European vision – to bring back optimism.

5. Increasing labour productivity is a top priority

Even where recovery has finally started, the increase in labour productivity is lower than in past cyclical upturns. Increasing labour productivity has been assigned a central priority in many policy recommendations.

3 K. Aiginger, O. Cramme, S. Ederer, R. Liddle, R. Thillaye: Reconciling the short and the long run: governance reforms to solve the crisis and beyond, Policy Brief No. 1, September 2012.

4 K. Aiginger: The Europe 2020 strategy at midterm: Disappointing assessment calls for an urgent change driven by long run priorities, WWWforEurope Policy Paper No. 17, October 2014.

5 International Energy Agency: World Energy Outlook Special Report 2015: Energy and Climate Change, 15 June 2015.

6 Stockholm International Peace Research Institute Military Expenditure Database.

Increasing (total) productivity is indeed an important goal, since it allows goods and welfare to be provided with lower inputs. Furthermore, it increases the potential to export. But total productivity can be boosted alternatively by increasing energy and material productivity instead of labour productivity. Historically, labour productivity has increased faster than energy and resource productivity, leading to the close correlation between output dynamics and emissions and to the need for economic growth to be over a certain threshold if unemployment is to decrease.

Particularly in a scenario in which growth will be subdued in industrialised countries – and this cannot be changed by policy – an increase in labour productivity at a rate faster than that of output will increase unemployment and make it persistent. Increasing resource productivity would both provide major scope for cost reductions (the share of materials plus energy input is higher than the share of wages) and limit emissions. As a side effect, it may raise labour productivity, too, but less so than if a labour productivity increase is the top-priority objective.

6. Growth is restricted by a labour shortage due to population ageing

The European workforce is ageing, and the share of young people is decreasing. This leads to the general presumption that Europe is doomed to suffer from an impending labour shortage.

Actually, it is very unlikely that there will be a quantitative shortage, at least in the medium term. Unemployment today is around ten per cent, and underemployment adds approximately five per cent to labour reserve capacities. There are a number of additional sources of labour supply which could be tapped if needed, such as part-time workers who would like to work longer, young people in marginal jobs and older people who are forced into too early retirement after losing a job. Moreover, the retirement age should be raised in line with rising life expectancy, and the retirement age of women should be raised in those countries where it is still lower than that of men. Lowering the barriers to intra-European mobility and encouraging migration from neighbouring European countries would further increase the labour supply.

The potential to increase the labour force or its utilisation should not be confused with the important mismatch problem in European labour markets: often the supply and demand of qualifications and experience do not match (a so-called skill gap). This is a qualitative problem which requires other policies than those called for by a quantitative shortage.

Böheim et al. suggest that there will be no quantitative shortage of labour through 2030.[7] Intra-EU migration can be used to solve eventual shortages in individual regions. Reducing the mismatch in qualification is the real problem.

7. Cutting labour costs and environmental and social ambitions will restart growth

Europe has higher costs for social expenditure and environmental standards, as well as a lower spread between high and low incomes, than its competitors. However, there are no signs that cost competitiveness has been generally lost in Europe. There are some countries with high absolute labour costs and overregulated inflexible labour markets and, at the same time, large trade deficits and slow growth. But since labour costs can be compensated by higher productivity, unit labour costs are the benchmark for cost competitiveness. Several leading European countries combine high labour costs with high levels of productivity and high social and ecological rankings. Economic analyses by Porter[8] and Stern[9] emphasise the beneficial consequences of sophisticated consumers and of a first-mover advantage (leading to lower costs and higher export potential) if climate change is combated early.

Elements of a new approach

Only "high road" competitiveness is feasible for Europe

Europe's chance is to actively pursue a "high road to competitiveness".[10] A low road approach, consisting of depressing wages, reducing other costs, including social and environmental standards, and opening a second labour market, is not feasible for a high-wage region surrounded by neighbours with low wages and abundant work forces. The only feasible way for Europe is a strategy based on quality, structural change, education, innovation, and social and ecological ambitions.

Aiginger et al. define five "capabilities" as drivers of success: education, innovation, institutions, activating social policy and ecological ambition.[11] And the outcome performance of an economy should not be measured by the

7 M. Böheim, A. Strauss, T. Weiss: Moving towards a new growth model. Policy options, WWWforEurope Second Feedback Conference Report, 2015.

8 M.E. Porter: America's Green Strategy, in: Scientific American, Vol. 264, No. 4, 1991, p. 168.

9 N.H. Stern: The economics of climate change: the Stern review, Cambridge 2007, Cambridge University Press.

10 K. Aiginger, S. Bärenthaler-Sieber, J. Vogel: Competitiveness under New Perspectives, WWWforEurope Working Paper No. 44, October 2013.

11 Ibid.

export surplus but by the attainment of a set of economic, social and ecological goals. This radically changes the meaning of the term "competitiveness" from price (or cost) competitiveness to the ability of a region to provide beyond-GDP goals. This redefinition may at first appear to be of academic interest only, but in fact, a well-defined concept of high road competitiveness is a game changer from an inadequate, backwards-looking strategy to a future-oriented one. A complement to this game-changing definition is to define a new systemic industrial policy as a policy supporting high road competitiveness.[12]

A bravo – with a proviso – for the European Fund for Strategic Investments

In the current EU situation – with a deficit in aggregate demand that cannot be easily solved by higher private consumption or higher private investment and with a need for budgets to be consolidated – a European investment fund attracting international capital is an excellent idea. There are, however, various problems to be addressed. The most important proviso is that the projects in which the money is to be invested must be carefully selected. The first list of projects submitted by member countries was primarily a patchwork of projects that had been rightly rejected due to lack of demand or insufficient future prospects (or both) in the past. Highways that did not get priority in the Trans-European Networks, atomic energy plants which could not work profitably without subsidies, and airports too near to other airports were resubmitted.

The core of the projects finally approved by the new fund should be those in which the long-run growth effects are largest and the short-run demand effects on employment are also high. These criteria imply a shift from the old paradigm of material investment to a new one in which economic growth in rich countries depends more on intangible investments – and Europe has a specific deficit in intangibles (innovation, high quality education, broadband internet).

Towards a "silver bullet" strategy

A necessary complement for the European Fund for Strategic Investments is therefore exemptions from the Fiscal Compact. Countries should be encouraged to spend more than allowed by the Fiscal Compact if they invest in five to ten pre-determined expenditure categories. Aiginger proposes, for example, the following categories:[13] research and education, early childhood education, requalification, infrastructure maintenance and upgrading, refurbishment of homes and offices, improvements of energy efficiency, closing bottlenecks in energy and broadband grids, renewable energies, business parks, and incubation centres. Independent agencies should monitor the content and adherence to the criteria, reporting to the European Parliament. This proposal is more restrictive than golden rule proposals which would qualify all investments, and specifically highways and other material investment. Exceptions should be possible for a maximum period of three years.

Wider Europe versus a shrinking Europe

Some economists advocate the concept of a core Europe going it alone. A core Europe, consisting of Germany, France and a few other countries, would currently supply ten per cent of world output, but this share would decrease to five or six per cent by 2050. Core Europe would be a low-growth area, with annual growth between one and 1.5 per cent. A wider Europe that included its neighbours (in Western Asia and Northern Africa) would still produce about 30 per cent of world output in 2050, and growth would be at least as dynamic as in the US.[14] A regionally defined Europe plus neighbours need not include only EU members, and certainly not all neighbours can become euro countries. Wider Europe should be a region in which economic, political and cultural relations are closer than those with more distant regions and continents.

But it is not the economic issue alone that is relevant: if Europe does not cooperate with its eastern neighbours (the Black Sea region, the former Soviet Union), with Arab countries and North Africa, these countries will look for new partners. Populist parties, be they from the right or the left, from Greece and Serbia to Hungary and France, openly show sympathy for autocratic systems (and are happy to cooperate with each other). Conflicts in the European neighbourhood, including some in countries in the current EU, will be economically and politically destabilising. The so-called "refugee crisis" is an outcome of conflicts in the neighbourhood that were long ignored.

The strategy has to be based on a long-run vision

This is a decisive phase for the European project in six dimensions:

12 For definitions for a new industrial policy see P. Aghion, J. Boulanger, E. Cohen: Rethinking Industrial Policy, Bruegel Policy Brief 2011/04, 2011; D. Rodrik: Green Industrial Policy, in: Oxford Review of Economic Policy, Vol. 30, No. 3, 2014, pp. 469-491; and K. Aiginger: Industrial Policy for a Sustainable Growth Path, in: D. Bailey, K. Cowling, P. Tomlinson: New Perspectives on Industrial Policy, Oxford 2015, Oxford University Press, pp. 365-39.

13 K. Aiginger: A silver bullet for restarting growth in Europe, euractiv.com, 17 December 2014.

14 K. Aiginger, C. Glocker: Restarting Growth in Europe, in: Applied Economics Quarterly, Vol. 60, No. 3, 2014, pp. 179-214.

- *Economy*. If the EU does not take part in the coming business cycle, a lost decade will be completed.
- *Internal disequilibria*. Southern Europe, including France and Italy, need a stronger productive base and new industries for exports.
- *Social acceptance*. Youth unemployment and income inequality have to be reduced.
- *Peace in the neighbourhood*. From Ukraine to North Africa, political destabilisation and economic problems reinforce each other.
- *Technology*. Europe has to close the technological lead of the US, from ICT to biotechnology.
- *Climate*. Europe has one last chance to extend its first-mover advantage in renewables, energy efficiency, new car engines and other industries needed to limit climate warming to two degrees Celsius.

If Europe attempts to solve these problems in an isolated way, there will be not enough money to tackle them (given the unwillingness to make all the changes to the public budgets delineated above), and there will be no chance of agreeing on measures across Europe. However, if problems are addressed by a strategy which starts from a vision and develops synergies, different goals can be attained simultaneously.

Such a strategy is currently developed in the project "A new growth path for Europe" by 33 European research institutions under the lead of the Austrian Institute of Economic Research (WIFO).[15] Its constituent strategy lines are:

- stronger dynamics based on innovation and skills, measured by beyond-GDP goals
- lower income differences, higher employment
- Europe's world leadership in environmental technology and renewables
- stable financial sector, financial transaction tax, reduced taxes on labour
- making the most of the advantages of globalisation and heterogeneity, closer cooperation with neighbours.

This vision starts with goals, not with problems. The consolidation of budgets and the resulting lower debt is a long-run necessary side condition. The goal, however, is *balanced economic dynamics*, with increasing consumption and investment, but also with respect for the limits of the planet and the equalisation of life chances across regions.

Taxing financial transactions and public bads, zero tolerance for tax evasion, and much lower taxes on labour are integral parts of the strategy, as is acknowledging that income distribution matters for growth and stability. Equality of opportunities and life chances, capabilities, institutions, dialogue and democratic discourse, as well as tolerance for heterogeneity and working to transform it into a productive force are parts of the strategy. An absolute decoupling of energy consumption and resource use is necessary. This implies a reduction in CO_2 emissions of 80 to 90 per cent and requires a doubling of energy efficiency, a 50 per cent share of renewable energy sources, and a redirecting of technological progress from labour-saving to energy and resource-saving.

Europe will succeed only if it improves its own model

Europe will overcome its midlife crisis if the public sector is streamlined and reoriented towards the future, and if taxes and incentives are used to support employment and growth. Moreover, Europe needs to invest in its own model of social cohesion and an ecologically sustainable economy instead of mimicking the US or the Asian models. Europe needs to lead and learn from its neighbours so as to achieve a decisive role in the globalised economy of 2050.

Aiming for ecological excellence and reducing youth unemployment as well as the inequalities of income and wealth are not blockers of growth but – if embedded in a strategy – can be drivers of change, innovation and new growth dynamics. This holds specifically for Europe, since these societal goals fit the European model. The goal of becoming the global leader in renewable technologies is part of the programme of the new Commission but has been ignored in most decisions (e.g. the latest reforms in the European Semester). The current low oil prices should be used for a substantial reduction of subsidies for fossil fuels and for rebuilding the emissions trading system. The pending trade agreements, inter alia between Europe and the US (TTIP) should be used to coordinate the efforts to limit global emissions, to build up a new cleaner industry (industry 4.0), to tax kerosene while reducing taxes on labour, and to develop an industrial policy favouring societal goals. The technology policy should improve resource and energy productivity (not labour productivity, as is presently the case).[16] The feasibility and costs of reducing emissions to ten per cent of the current level in Europe, as planned in the Energy Roadmap 2050, will be determined by the infrastructure, car engines and traffic systems Europe builds and develops today.

15 See www.foreurope.eu.

16 "Biasing" technological progress towards increasing resource and energy productivity faster than labour productivity should be easy given the strong government interference in innovation policy and high taxes in Europe in particular.