

WIFO

ÖSTERREICHISCHES INSTITUT
FÜR WIRTSCHAFTSFORSCHUNG

 **WORKING PAPERS**

This Can Still Be Europe's Century

Karl Aiginger

522/2016



This Can Still Be Europe's Century

Karl Aiginger

WIFO Working Papers, No. 522

August 2016

Abstract

We live in a world of black and white, with referenda in the yes/no style, politics in 100-second video clips and headline chasing. All of this leads to over-simplification and, in the end, to a seeming reduction of options. We see this all too well in the case of the European Union: one is either for or against it. In this cacophony of dichotomous beliefs and one-sided or even false information we tend to oversee the most important question: do we really want to leave behind what we have achieved in seven decades of a great European project? We still have a narrow window of opportunity to introduce reforms, but time is running out. With Euro-scepticism on the rise it becomes harder each day to tell a convincing and impassioned European story.

E-mail address: Karl.Aiginger@wifo.ac.at
2016/236/W/0

© 2016 Österreichisches Institut für Wirtschaftsforschung
Medieninhaber (Verleger), Hersteller: Österreichisches Institut für Wirtschaftsforschung • 1030 Wien, Arsenal, Objekt 20 •
Tel. (43 1) 798 26 01-0 • Fax (43 1) 798 93 86 • <http://www.wifo.ac.at/> • Verlags- und Herstellungsort: Wien
Die Working Papers geben nicht notwendigerweise die Meinung des WIFO wieder
Kostenloser Download: <http://www.wifo.ac.at/www/pubid/58984>

Karl Aiginger

This can still be Europe's century*

The European narrative is in a predicament

What is the European narrative?

Europe is the only large economic area in history created by neither military force nor expansion to uninhabited territories. Instead, European integration is based on the voluntary decision of (at this time) 28 independent countries with their own histories, cultures, traditions and governance systems (Arrow, 2016).

What began as a peace project became a long-run success story, leading to a single market of 28 countries and a currency union for 330 million Europeans, with more countries applying for membership or close relations with the EU 28. Although European integration has never been a smooth process, Europe is a "convergence machine", not least due to the historically unprecedented pace of former communist countries catching up with Western Europe in per capita GDP (Gill – Raiser, 2012).

And Europe is a peace project, which was awarded the Nobel Peace Prize in 2012. This is no small achievement. After centuries of war among European nations, no military conflict has occurred between any member countries since the start of the integration process.

This development has born fruit. To name only three developments: Europe has high life expectancy and low child mortality, and Europe can be proud of its environmental achievements (Sachs, 2008).

Quality of life has highest priority in the range of values among European citizens and the European Union is about bringing high quality of life to not only a few but the vast majority of the European citizens. This is what sets Europe apart from the other large economic and cultural regions of the world.

What has gone wrong?

However, this narrative has gone awry. "No one falls in love with a common market" – this statement attributed to Jacques Delors contains much truth, and the problem nowadays is that a growing number of people are about to completely fall out of love with the European Union. According to the Eurobarometer the number of EU citizens who are completely positive about the EU is decreasing. Furthermore, trust in European institutions is waning fast – before the Financial Crisis about half of EU citizens tended to trust the institutions of the European Union, while nowadays it is less than one third.

* This working paper was prepared for the McKinsey Global Institute "Opportunity for Europe" Essay Prize.

What has happened to get us into this situation?

It is evident that Europe "is not in a good state" (Juncker, 2015) and European policy makers do not seem to have a clear idea of how they can actually change this situation. Indeed, economic growth has been slow since 2000 and only regained pre-crisis output in 2015; unemployment is about 10% and the rate is twice as high among young people. Mobility and positive spillovers are too low for an economic union, much less for a monetary union. The European policy response is slow and passive. The reaction to the crisis, in particular, lacked a proactive component, neglecting distributional issues and young people, ignoring chances for new firms and new technologies, and completely failing to connect with citizens.

The European neighbourhood, which could have the potential to surround Europe with a ring of high-growth countries, is suffering from political problems of its own. Migration to Europe is increasing - pushed by problems in countries of origin, rather than pulled by the needs of European countries.

Despite some reforms, the European governance structure is still dominated by the European Council and the partial interests of its members, whose priority is their success as national leaders. The agenda of the European Commission is not adequately controlled by European Parliament. Governance does not address the complexity of 28 countries, while at the same time heterogeneity and polarisation are increasing. It is therefore almost impossible to find common responses to issues such as trade and investment agreements or the refugee crisis.

To summarize: The European success model is in the throes of a severe midlife crisis. It has lost economic momentum and its emotionally adhesive power is fading.

We have to revive and reframe the narrative again

The message of this essay is that this, however, does not have to be the end of the story. On the contrary: Europe has all of the resources and potential required to face the challenges of the future. But it has to make full use of these resources. If (and only if) Europe once again becomes more dynamic, can the migration problem, anti-European populism, and the upcoming opposition to free trade and globalisation be resolved. Success breeds success, and economic performance is the key to putting acute political problems into the right perspective. Europe is not a "failed" project, rather one that has to be revived and reframed.

Such a reframed narrative has to be about developing the best socio-ecological model for a rich but heterogeneous region. The problems currently dominating the political discussion, such as Brexit, TTIP and the refugee crisis, have to be solved. This should be done, first, by increasing economic dynamics, second, by connecting European policy with individual and societal needs and, third, by giving citizens greater leverage to co-determine reforms and control their delivery.

A vision for Europe 2050 based on well-being

A vision should be demanding, but realistic and feasible. It has to be built on existing strengths and preferences, and define a common project that takes precedence over short-run individual idiosyncrasies.

The following vision was agreed upon by 34 research organisations in the course of the WWWforEurope project, which also provides the scientific basis for this essay (Aiginger, 2016).

"By 2050, Europe will be a region with high and increasing well-being, including ambitious social and environmental standards. It will be a dynamic, open and pluralistic economic area. Unemployment will be low, inclusion high and income differences limited. Emissions and resource use will have declined absolutely to a level compatible with environmental resilience, biodiversity protection and mitigating climate change. Europe will learn from other regions and offer its improved model to neighbouring regions and the world at large."

This vision demands important changes in policies and mind-sets:

First of all, the overall economic performance benchmark has to be changed from GDP and its rate of growth to "high and increasing well-being". This concept is well elaborated and underpinned by data sets in the "Beyond GDP" literature (Stiglitz – Sen – Fitoussi, 2009). It connects economic policy with individual needs (like income, health, employment opportunities and upward mobility), which together establish well-being. Switching from GDP to well-being as the overarching benchmark of success does not imply "de-growth" – rather, it stresses the desire for mobility and a good life built on capabilities, personal efforts and gainful employment. This requires rising income for a large share of European citizens.

Well-being is derived from three strategic goals: economic dynamics, social inclusiveness and ecological sustainability.

Economic dynamics on the one hand imply rising incomes, with the priority placed on the lower segments and the poorer regions and on the other hand structural change and mobility. Income differences have to be addressed.

Social inclusiveness calls for a reduction of unemployment, specifically youth unemployment, but also for the employability of elder persons. Life chances should be distributed more equally, while income differences should decrease and be based on merit.

Finally, environmental sustainability addresses the containment of climate change and respecting other planetary boundaries. Emissions need to decrease absolutely and strongly in line with the targets of COP 21 (Paris 2015), both due to a historical responsibility and as the base for a European technology leadership.

Changing the game: Reforms in seven core fields

Restarting dynamics under the common overall goal of well-being requires fundamental reforms.

Game changer 1: Boosting and redirecting innovation

Innovation is the crucial link that can turn negative trade-offs between economic dynamics, social inclusiveness and environmental sustainability into synergies. Boosting innovation is vital for closing the technology gap to the USA as the frontier economy and for sustaining the competitive advantage of Europe relative to emerging countries.

However, innovation should also be redirected. Today, the focus of innovative activity is primarily to save labour, which can aggravate social problems in a phase of already-high unemployment. Instead, Europe should focus on increasing total factor productivity, mainly by improving energy and material productivity. This can be done through carbon pricing or taxation, specific R&D incentives and public procurement.

Game changer 2: Technological leadership in renewables and energy efficiency

Absolute reductions in the use of energy and material resources are necessary in order to limit climate change. While domestic resource use has stopped increasing or even declined in most European countries since the early 1970s (Fischer-Kowalski, 2011; Schaffartzik et al., 2014), global CO₂ emissions have risen significantly in the past two decades. In 2014 the International Energy Agency (IEA) for the first time reported a stabilisation of greenhouse gas emissions in a year of a fast-growing global economy.

As a very first step, distorting subsidies for fossil fuels should be phased out. As a second step, incentives for boosting energy efficiency and standards for housing, offices and transport should be continuously raised. Combined with green innovation and a higher share of renewables, this game changer would involve Europe taking the technology lead in new energy and energy efficiency (Aiginger, 2013; Antal – van den Bergh, 2013).

Game changer 3: New dynamics through a reduction of inequality, uncertainty and pessimism

Europe is suffering from insufficient demand. Consumption is low, since wage shares have been falling. To counteract real wages increasing in line with labour productivity should be the rule. Decreasing the spread between high and low incomes could boost consumption. Increasing low wages can be achieved by reducing taxes on labour in the short run and upgrading skills in the long run.

Private investment can be stimulated by investment into low carbon infrastructure, and by reducing bureaucracy for new and fast-growing firms. Re-establishing a growth agenda in general while decreasing taxes and regulation would improve the business climate and encourage firms to invest out of the available cash flow.

Game changer 4: Shift from physical to intangible investment

Investment is important for economic dynamics and employment. However, the type of investment changes with the income level of economies. Today, Europe should focus much

more on intangible rather than physical investment, ranging from preschool education to top universities, from broadband to innovation. These kinds of investments should be exempted from the upper spending limits in the fiscal pact (Aiginger, 2014) and prioritised in the European Fund for Strategic Investments (EFSI).

Game changer 5: The public sector as an engine of reforms and new dynamics

Almost one half of the output of Europe's economies is re-allocated through the public sector. This power should be used to promote well-being with a better structure of taxes and expenditures.

The current tax system functions in a completely wrong direction, when assessed in light of employment, equity and sustainability. Instead of being boosted, employment is heavily taxed (20% of Europe's GDP arises from this source). Taxes on property and inheritances are low, thereby perpetuating differences in wealth and life chances. Taxes on emissions are low, and subsidies for fossil energy persist, thus decelerating decarbonisation.

A major game changer would be to halve taxes on labour (from 20% of GDP to 10%) and substitute the revenue loss through the following four sources (Aiginger, 2016): (i) increasing environmental taxes; introducing a carbon tax, and ending subsidies for fossil energy; (ii) tax increases on property, inheritance and financial transactions; (iii) taxes on alcohol and tobacco; (iv) increasing tax compliance, and preventing revenues flowing to off shores.

Models indicate that this tax shift could boost employment by approximately 10% in the long run and reduce greenhouse gases by 65% (Kratena - Sommer, 2014). If the "rest of the world" does not shift taxes at all, there is a marginally negative effect on European GDP growth. If non-European countries increase taxes on energy or emissions as well, at least to some extent, or if some part of the efficiency gains by the tax shift is spent on innovation, European GDP will rise as compared to the no-change scenario. This yields a win-win-win situation, with higher growth, lower unemployment and emissions.

Expenditure structures should also be shifted at the EU level as well as on the national level towards social or environmental innovations. Procurement policy can reduce the path dependency of technologies.

Game changer 6: Switching from ex post protection to ex ante investment

Although welfare costs are higher in Europe than in any other part of the world, new challenges stemming from family disruption, mobility-driven non-insurance and longer time of care due to longevity are still not covered. One answer is to shift the focus from ex post protection to ex ante investment (Leoni, 2015, Hemerijck – Vandenbroucke, 2012): Investment in early education, school and training systems can enhance the ability to adapt to change. These measures have the highest individual and societal "rate of return". Preventing unemployment or health problems instead of curing them is cheaper and increases well-being.

Game changer 7: A social contract on symmetric flexibility

Europe definitely does not have a quantitative shortage of labour due to ageing over the next 10 to 20 years, but it does have a double matching problem: First, Europe has an oversupply of low-skilled people and a shortage of highly qualified ones. Second, many workers would prefer to work longer hours, while others would prefer shorter hours.

The answer to the first mismatch is to upgrade skills. The second mismatch calls for new bargains between firms and employees based on "symmetric flexibility" (Aiginger, 2016; Leoni, 2015). Firms should be given the ability to adapt labour input to demand more flexibly by varying working time cyclically. In exchange, employees should be given the right to temporarily or permanently change their working time based on work-life balance and individual preferences.

A new social contract could combine these two types of flexibility. If the "exchange" is symmetrical, it increases profits for firms as well as well-being for employees. In the aggregate this will support economic growth, but also reduce total hours worked – which is necessary if growth is not high enough to absorb the labour supply. This reduction is superior to any enforced general working time reduction, because it fits preferences and prevents poverty (which rises as a result of a general reduction without income compensation).

Three principles for making reforms effective

So now we know what to do, but the next question is how to do it. To realise these game-changing reforms, the following three principles have to be observed: simultaneity, high-road ambitions and two-stage implementation.

Simultaneity: If strategic goals like dynamics, inclusion and sustainability are addressed separately, policies become inefficient. Let us take the example of a tax-induced increase in energy prices: Trade unions will oppose it because of its regressive effect on low-incomes. Manufacturing will oppose it based on fear of reduced price competitiveness. However, if simultaneously net income rises relatively to gross income (specifically for low incomes), trade unions will favour such a tax shift. If the manufacturing sector simultaneously gets better-trained people and additional funding for R&D, it can invest in drivers of growth and improve its technology lead. In the aggregate, the positive effects outweigh the costs, as inefficiencies are eliminated (e.g. parallel subsidies for fossils and renewables).

High-road ambitions: Focussing on cost issues may be necessary in situations where cost competitiveness has been temporarily lost. In general, however, a high-road strategy focussing on quality over cost, structural change, improved skills and boosted innovation will more effectively support economic dynamics and quality of life.

Two-stage implementation: Restarting dynamics in a period of low growth of consumption and investment requires new stimuli: consumption could be increased by boosting low incomes and investment by incentivising a low carbon infrastructure. Individual working hour choices could reduce the labour hours supplied, which is essential today given the high

unemployment rate, and this applies all the more for a future second stage in which growth rates in industrialised countries are expected to be low (secular stagnation theory). Unemployment could thus be prevented in the second stage, even if growth rates are low.

Reconnecting with the Citizens

Economic reforms are necessary but not sufficient for regaining support for the European project. European institutions have to transport the new narrative into their actions and they have to reconnect with the citizens,

Regaining stability after the crisis

After the financial crisis, governance reforms focussed on regaining stability. This has to a certain extent been achieved by the European Stability Mechanism (ESM), the European Fund for Strategic Investments (EFSI) and the Banking Union, which is by and large on track. However, there is a need for further improvement: A debt redemption fund involving temporary and bounded mutualisation of debt could reduce costs for highly indebted countries. The EFSI and the Youth Employment Initiative should be implemented more quickly, and investment into decarbonisation should be followed more decisively to gain a first-mover advantage. It is all important to restart growth quickly, with first results up to 2020.

Connecting reforms to individual needs and values

Instead of overemphasising fiscal balances, the European Semester and its "country-specific recommendations" should be better aligned with goals valued directly by citizens, such as employment, fairness and equity, enabling the pursuit of different life scripts, or higher energy efficiency. The Annual Growth Survey of the European Commission should be converted into a report on growth and well-being, monitoring on the founding of firms, social and environmental innovations, but also addressing problems like migration or individual fear of status loss. The social dialogue has to be revived, addressing unemployment, the quest for work-life balance and old age security, as well as the need for flexibility and highest-qualified human capital for firms.

Strengthening democratic support and pluralism

It has to be determined which problems should be solved at the European level and which are to be left at the national or even regional level. According to *Summers (2016)*, "responsible nationalism" means people wish to feel that national governments shape the societies in which they live. This may, however, at the same time call for more international cooperation, for example, by reducing taxes on labour by a "trillion dollars or more" if capital income is identified worldwide, preventing a race to the bottom. The same holds for financial regulations and environmental standards, which the national interests of each country call for international rules.

Both the European Council and the European Commission should be subject to stronger control by the European Parliament. It should communicate more directly with national parliaments and stakeholders. Members of the European Commission should report to citizens on work done and future plans at least every two years and be open to their feedback. The nexus between the different policy levels has to be strengthened – for example, Commissioners could become non-voting members of their own national parliament or members of national parliaments could become non-voting members of European Parliament.

A *decentralised* approach with regions, cities and Member States as actors in the reform process has definite advantages in terms of mutual learning and enhancing innovation. Given the existing heterogeneity of Europe, a *pluralistic* approach can turn this heterogeneity into an advantage. Young people and new actors should be invited to elaborate ideas and participate more than they do today.

A neighbourhood policy turning problems into chances

Europe as it is today (including the United Kingdom) is the largest economic area in the world, with a share of output of more than 20%. However, as a low-growth area it will soon be overtaken in output by the US and China. And Europe may lose a geopolitical partner if the US "pivots" eastwards (Lamy, 2016). The only way to strengthen its geopolitical position and to expand European ideas and values is for Europe to cooperate with its neighbours. Europe is surrounded by countries with low per capita income yet high growth potential, due to large energy and human resources. The Western Balkans, the Black Sea countries, North Africa, and the post-Soviet countries are all eager to catch up. The geopolitical area of a "Wider Europe" amounts to about 30% of world output. And this Wider Europe could grow faster than the US plus their neighbours in the North and South, thus reducing unemployment in the EU, providing investment opportunities and limiting migration.

This perspective of restarting dynamics through growth in unison with neighbourhood countries may seem improbable today, given the political and military conflicts, autocratic policy regimes and differing value systems. But these blockers could be turned into enablers through a new approach of "openness and cooperation". The proposal is that Europe should first invest massively in its neighbourhood; second, it should initiate a political and cultural dialogue. A growth-enhancing and politically stabilising policy would require investment programs of the scope of the US European Recovery Program after World War II: The costs of this are still lower than that of a military build-up, of conflicts, and reversing European integration.

From preventing migration by fences to active investment

An investment program in the neighbourhood countries is not only an economic opportunity of an otherwise low-growing Europe; it is also a chance to stabilise these countries politically and reduce migration flows.

Stabilising the neighbourhood countries will not be easy and quick. Special zones, charter cities (Romer, 2015) or UN-supervised zones in areas of relative peace in or near conflict-ridden countries could all raise production and income, provide laboratories for new governance and participation of citizens, limit migration and make a restart easier when a conflict ends.

Without an economic perspective, more people from conflict-ridden and poor areas will come to Europe. As we are witnessing, Europe's political system and society are not prepared for this. Resorting to military force, border controls and fences is not the solution, as this comes at the cost of dismantling the benefits of freedom of trade, travel migration and work. Destabilised economies and societies will be the result – the end of the dream of an ever closer union (European Commission, 2015).

This can still be Europe's century

Europe will only overcome its midlife crisis if it reframes its narrative towards a socially cohesive, environmentally sustainable and economically dynamic economy. If Europe restarts growth and lowers unemployment, economic success will put the currently overriding political issues into perspective.

What has to be done? We have defined game changers such as redirecting innovation, going for the technological lead in decarbonisation, lowering income spreads, switching from ex post protection to ex ante social investment and "symmetric" flexibility, with the linchpin of reforms radically to shift taxes from labour to emissions, property and speculation.

How it can be done? This strategy can only be successful if both policy makers and European citizens believe in it. It is therefore of utmost importance that the overarching performance benchmark be shifted from GDP and GDP growth to well-being, and that the "macro goals" of dynamics, inclusiveness and sustainability be more closely related to individual interests and needs, such as consumption, employment, housing, health and equity.

The goals of the strategy have to be addressed simultaneously, rather than with "silo strategies". It should be a high-road strategy that does not depend on low wages. Dynamics should be restarted quickly, since unemployment, debt and income spreads are high and endanger public support for the European project. However, the restart should not be business as usual; it should instead make use of investment in decarbonisation and lower income spreads as growth drivers.

These policies have to be followed against the background of an intensive and participative discussion on the scope of goals and the position of Europe in the long run, as well as the development of an inspiring narrative of a genuinely European model.

Changes in governance are required, as well as democratic control of the European Council and the European Commission by the European Parliament. The ability of Europe to play a decisive role in a globalised world has to be communicated and based on the participation

of new actors and young people. Europe has to invest in and communicate with its lively and potentially fast-growing neighbourhood.

All of these proposals are based on a sound scientific foundation due to the interdisciplinary work of 34 research institutions in a four-year project. We therefore know that the recommendations may be radical, but are feasible and effective. Econometric projections show that they can generate win-win situations and synergies, if followed consistently and simultaneously. A substantial part of the proposals can be implemented quickly, so as to deliver first results by 2020.

The good news is that Europe has the best socio-ecological model for a high-income economy. With higher income the interests of individuals become more heterogeneous, the marginal utility of income decreases, and other elements of well-being become more important. Reduced poverty and lower income spreads result in higher support from citizens. Ecological concerns increase with rising incomes, while at the same time technologies to decouple emissions from output become available. This offers the potential for Europe for a technology lead in energy efficiency and decarbonisation. The higher priority of non-economic goals, as represented in the "Beyond GDP approach", is already a constituent part of the European model – more so than in any other model, whether in Asia or the US. Thus, Europe can offer a model that, despite its bumpy start into the new millennium, could make the 21st century the "European Century".

References

- Aiginger, K., New Dynamics for Europe: Reaping the Benefits of Socio-ecological Transition. Part I: Synthesis, WWFforEurope Synthesis Report, Vienna, Brussels, 2016, EU 7th Framework Programme.
- Aiginger, K., A silver bullet for restarting growth in Europe, EurActiv, December 18th 2014.
- Aiginger, K., The "greening" of industrial policy, headwinds and a possible symbiosis, WWFforEurope Policy Paper No. 3, May 2013.
- Antal, M., van den Bergh, J., "Macroeconomics, Financial Crisis and the Environment: Strategies for a Sustainability Transition", Environmental Innovation and Societal Transitions, 2013, 6, pp. 47-66.
- Arrow, K., Welcoming Address at WWFforEurope Final Conference, February 25th, 2016, Brussels, http://www.foreurope.eu/fileadmin/events/Final_Conference/Welcoming_Address_Arrow.pdf
- Fischer-Kowalski, M., "Analyzing sustainability transitions as a shift between soci-metabolic regimes", Environmental Innovation and Societal Transitions, 2011, 1(1), pp. 152-159.
- Gill, I., Raiser, M., Golden Growth: Restoring the Lustre of the European Economic Model, The World Bank, 2012. <http://www.worldbank.org/en/region/eca/publication/golden-growth>
- Hemerijck A. C., Vandenbroucke, F., "Social Investment and the Euro Crisis: The Necessity of a Unifying Social Policy Concept", Intereconomics, 2012(4), pp. 200-229.
- Juncker, J.-C., Speech - State of the Union 2015: Time for Honesty, Unity and Solidarity, Strasbourg, 9 September 2015, http://europa.eu/rapid/press-release_SPEECH-15-5614_en.htm
- Kratena, K., Sommer, M., "Policy implications of resource constraints on the European economy", WWFforEurope Policy Briefs, 2014, (6).
- Lamy, P., What Future for the EU in the Global Trading System?, Intereconomics, 2016(1), pp. 34-36.
- Leoni, T., Welfare state adjustment to new social risks in the post-crisis scenario. A review with focus on the social investment perspective, WWFforEurope Working Paper, 2015, (89).
- Romer, P., Interview on Urbanization, Charter Cities and Growth Theory, 2015. <https://paulromer.net/interview-on-urbanization-charter-cities-and-growth-theory/>
- Sachs, J.D., Financial Times, August 19, 2008.
- Schaffartzik, A., Mayer, A., Gingrich, S., Eisenmenger, N., Loy, C., Krausmann, F., "The global metabolic transition: Regional patterns and trends of global material flows, 1950-2010", Global Environmental Change, Mai 2014, 26, pp. 87-97.
- Stiglitz, J., Sen, A., Fitoussi, J.-P., Report by the Commission on the Measurement of Economic Performance and Social Progress, Commission on the Measurement of Economic Performance and Social Progress, European Commission, Paris, 2009.
- Summers, L., Financial Times, July 11, 2016. <http://www.ft.com/cms/s/2/15598db8-4456-11e6-9b66-0712b3873ae1.html#axzz4EkQDGUqw>