Karl Aiginger[*]

A strategy change for Europe is needed

Ten hypotheses

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1. *Europe is a success model in midlife crisis.*

Success can be demonstrated by the number of member countries of the European Union (and those with the intention to join or to cooperate more closely in the future) or by Europe´s size in world trade (larger and more stable than that of the US) and its trade surplus. The Euro has become a widely accepted currency, its future is no longer questioned despite of predictions of many US economists from the beginning that it will never work. The value of the Euro (relative to the US Dollar) is as high as at the start (it had been too strong for several years but this did not lead to current account deficits of the EU. Europe has achieved the pacification of a formerly belligerent continent (within the current borders of EU28). But also many countries outside have reformed institutions and reluctantly started a dialogue with neighbours with whom conflicts have a high probability before.

Indicators for a critical phase of the European development today are the low dynamics (GDP is practically not higher than 2008), the youth unemployment rate of 20%, inadequate European governance (with national priorities and preferences still overriding community goals), decreasing political support, and inroads of left wing as well as right wing parties - often cooperating with each other, both looking for alternatives to the European project.

Europe has not yet the institutions to influence political conflicts, be it in North Africa or in the Black Sea area, cannot provide information about border crossing military troops and not deliver human help efficiently as shown in the Ukraine conflict. This ineffectiveness holds despite of expenditures for the 28 military systems larger than that of Russia and China combined.

Europe is reluctant to build on its own strengths and to stick to set targets, and last, but not least to close the gap in innovation and entrepreneurship for the majority of countries and shift resources from the past to the future in general.

2. *Large and inefficient public sector, and lack of will*

The public sector is quantitatively large and surprisingly inefficient. Close to 50% of GDP is absorbed on average (of the member countries) by three to four layers of government (from

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local to European) without eliminating differences in gender, parental position and income on education or the distribution of life chances. The innovation effort is low in most countries and below national as well as EU targets. The direction of the technical progress is unfavourable (it is labour saving instead of resource saving). This tendency is shared with other countries - but it did not change since the EU roadmap had defined the goal of reducing emissions to 10% or 20% of its current level up to 2050 and as youth unemployment had doubled. Quality of education is mediocre in many parts of Europe (even in large countries like Germany, France, Italy and Spain), support for entrepreneurship, mobility, social innovation, enhancing life chances is inadequate.

Lack of finance is less important than lack of political will. On the national as well as on the European level it is often argued that there is a lack of finance. This is not really the case, first since finance offered to investors with a joint European guarantee is cheap; it is not true even for current fiscal balances.

- Europe currently spends on subsidies for fossil energy probably more than for renewables. Specifically in times of low oil price, the subsidies for coal and oil could be curbed without social costs.
- Europe spends more on 28 military systems (inadequate for any challenge outside Europe) than Russia and China together (with very high expenditures particularly in high deficit countries like France and Greece).
- Europe spends the largest single part of the EU budget for subsidising big agricultural units (specifically on that pillar which does not prioritize to bio agriculture).
- Europe allows tax evasion for firms and forfeits an adequate tax on financial speculation.

Taking these four sources of money together - depending on time horizon and ambition - 100 - 200 bn. funds can become available. They can be used for reducing distorting taxes, on reducing budget deficits or for increased spending on future competitiveness.

3. *Taxing the wrong activities and "forgetting" the own targets*

The tax system makes positive activities expensive like employment and the creation of jobs. European countries are unable or unwilling to tax public bads like emissions, resource uses, fossil energy, tobacco, polluting traffic. The ability to tax wealth and inherited income is very low due to insufficient transparency of capital flows, profit shifting, and tax exceptions favouring mobile capital. If banks are regulated it is easy to switch money to non banks or to off shores. Tax evasion and tax fraud seems to be an accepted activity of successful firms, managers, innovators in a system with big government, bureaucracy and over taxation (a tendency which is currently changing slightly). Labour is taxed, financial speculation not (if anything a stamp duty on new shares looks to be realistic ten years after the start of the Financial Crisis, which would be a new burden on the real economy).

The discussion about austerity is attracting too much attention; the real problem of Europe is overspending for past priorities and for particular interests, implying a shortage of funds for investing into the future, into new firms and jobs. A corollary of this is the inability to stick to strategic goals, whether this is the EU 2020 strategy or the energy roadmap 2050. The EU 2020 midterm review has shown that employment goals, R&D targets and poverty goals were widely missed and environmental goals which had been set without ambition (e.g. in relation to the energy roadmap 2050) had been attained only due to stagnant respectively declining GDP. And nobody cared about missing the strategy goals. If many European countries still face high fiscal deficits or if debt has even increased relative to GDP, this is more the consequence of low growth, wrong taxation and three to four layers of inefficient bureaucracies, than of radical public austerity.

4. *Lack of private demand and asymmetric application of structural reforms*

The quest for so called "structural reforms" is adequate in principle, but the term has been hijacked by a specific conservative agenda. Structural reforms which activate labour supply, which remove particular interests or entry barriers for new firms are fine, but in practice the call for structural reforms is always used to exert downward pressure on labour costs, specifically in the segment of already low wages. The discrepancies between high and low incomes thus increased since the financial crisis, the wages which are already lagging productivity are further dampened. Wage increases are criticized in the European semester, wages below the productivity increase are overlooked. These tendencies additionally reduce consumption in a time in which firms were reluctant to invest their profits and business had become a net saver. It is well known that the benefits of structural reforms on the labour market occur in the long run and will materialize in good times (like the benefits of German´s Hartz 4, ten years after creating a low wage sector on Germany labelled as "dead man of Europe"). Asymmetric calls for structural reforms (forgetting those leading to high incomes and super normal profits in regulated businesses) reduce aggregate demand and employment in bad times.

The question which component of aggregate demand should rise after the Financial Crisis was constantly ignored; austerity as defined by low public deficits is the minor part of demand inefficiency (and difficult to tackle if good times did not deliver budget surpluses and government share approaches already 50% of GDP). If consumption decreases due to low wage increases (and decreasing real wage after tax and inflation), and if large firms do not use their profits for investment but become net creditors, and small and young firms are credit squeezed since the financial sectors wants to reduce risk, private demand will not rise. Firms and investors will become pessimistic about future growth. Investment incentives, reducing product market incentives, and producing incentives for business starts and innovation including those in renewable energy and energy efficiency by higher standards could help.

Therefore Europe faces "private austerity" in the sense of lacking potential or willingness to increase private consumption and private investment. To match it by increasing export (surpluses) is limited for extra-European exports (increasing intra-European exports is infeasible as national strategy for all members). To compensate lack of private demand by the traditional strategy of increasing public deficits and size of the public sector is the wrong way since government is already large and its increase would furthermore boost inefficiencies, lead to higher taxes and lower investment and consumption (without radical structural policies, very different ones than those known from the past).

5. *Only "high road" competitiveness is feasible for Europe*

Europe's chance is to go intentionally for a "high road to competitiveness" (*Aiginger – Bärenthaler-Sieber – Vogel*, 2013). A low road approach, consisting of depressing wages, reducing other costs incl. social and environmental standards and opening a second labour market is not feasible for a high wage region, surrounded by neighbours with low wages, abundant work force and own efforts to catch up with richer countries via an export led strategy. The only feasible way for Europe is a "high road strategy" based on quality, structural change, education, innovation and social and ecological ambitions.

Aiginger – Bärenthaler-Sieber – Vogel define five "capabilities" as drivers of success: education, innovation, institutions, activating social policy, and ecological ambition. And outcome or performance of an economy is measured not by the export surplus but by the attainment of a set of economic, social and ecological goals. This radically changes the content of the term "competitiveness" from price (or cost) competitiveness to the **"ability of a region to provide Beyond GDP goals"**. This redefinition may look of academic interest first, but in fact a well defined concept of high road competitiveness is a game changer from an inadequate past looking strategy to a future oriented one. A compliment of this game changing definition is to define a new systemic Industrial policy as a policy supporting high road competitiveness (for definitions for a new industrial policy see *Aghion – Boulanger – Cohen, 2011; Rodrik*, 2013; *Aiginger*, 2015).

Going for a "high road" holds with a slightly different perspective and specific reform needs for Southern and Eastern Europe. Of course countries with large deficits in current accounts have to bring costs down. But the real problem are "costs per unit of output" and these can be corrected by productivity increase, technology transfer, fostering new firms at least as easily as by a cumulative downward strategy of lowering labour costs.

It was essentially the problem leading to the crisis, that Southern European countries remained in a competitive position adequate for the pre-globalisation area. Southern Europe should have climbed up the quality ladder to a medium income position, defendable if new low cost competitors came up. High energy costs (of Europe relative to the US) can be compensated by increasing energy efficiency (with existing differences of 3:1 across industrialised countries) and renewables substituting coal, oil and gas imports can help to balance current accounts.

6. A bravo- with a proviso- for the New Strategic Investment Fund

In the current European situation - with a deficit in aggregate demand not easy to be solved by higher private consumption or higher private investment and budgets needed to be consolidated - a European Investment Fund attracting international capital is an excellent idea. There are however different problems to be addressed. The most important proviso is that the projects in which the money should be invested should be carefully selected. The list of projects submitted by member countries up to now is the sum of those projects which were rightly rejected due to lack of demand in the past or insufficient future prospects (or both). Highways that did not get priority in the Trans European Nets (TEN), atomic energy plants which could not work profitable without subsidy, airports too near to other airports were resubmitted.

The core of the projects finally approved by the New Fund should be where (i) the long-run growth effects are largest and (ii) the short-run demand effects on employment are high too. These criteria imply a shift from the old paradigm of material investment to the new one that economic growth in rich countries depends more on intangible investments and Europe has a specific deficit in intangibles (innovation, high quality education, ICT).

A second problem of the Strategic Investment Fund is that project selection, financing and project implementation will need that much time that the economic impact of the fund will become relevant for demand in late 2016 (and for supply about 2020).

7. A bottom complement is needed: a "silver bullet strategy"

A necessary complement for the Strategic Investment Fund are therefore exemptions from the fiscal pact along a "silver bullet strategy". Countries should be encouraged to spend more than allowed by the fiscal pact if they invest in 5-10 pre-determined expenditure categories. *Aiginger* (2014) proposes for example the following categories: research and education, early childhood investment, 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, incubation centers. Preconditions for this extra spending (relative to the Fiscal Pact limits) are that these are additional investments and they are complemented by symmetric structural reforms (symmetric respective to the distributional effects). Independent agencies should monitor the content and the adherence to the criteria to the European parliament. This proposal (*Aiginger*, 2014) is more restrictive than golden rule proposals which would qualify all investments and specifically highways and other material investment of old style Keynesianism for permanent deficit spending; it is compatible with the rules of the fiscal pact, and the exceptions should be possible for a maximum period of 3 years. This is better than to postpone targets indefinitely and not dependent on clear criteria and eternal monitoring as it is done today.

8. *It has to be a "Europe including the neighbours" or a shrinking Europe*

Some economists advocate a small "Core Europe". A "Core Europe" consisting of Germany, France and some other countries would currently supply 10% of world output and this share will decrease to 5% or 6% up to 2050. Core Europe would be a low growth area with annual growth between 1% or 1 ½%. A Europe including neighbours (in Western Asia and Northern Africa) 2050 would still produce about 30% of world output, and growth will be at least as dynamic as in the US. A regionally defined Europe plus neighbours needs not include only EU-members and by far 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 which is relevant: if Europe does not cooperate with its eastern neighbours (Black Sea, former Soviet Union), with Arab countries and North Africa, these countries will look for new partners. Populist parties be it from the right or the left from Greece to Serbia, and Hungary and France openly show sympathy for autocratic systems (and are happy to cooperate with each other). And European neighbourhood including some countries in the current EU will be destabilized economically and politically by conflicts in the European neighbourhood.

9. *Towards a coherent strategy based on a long-run vision*

This is a decisive phase for the European project in six dimensions: (i) economically; if Europe will not take part in this upcoming business cycle a lost decade will be completed, (ii) for coping with internal disequilibria: Southern Europe including France and Italy need a stronger productive base and new industries for exports; (iii) social acceptance; youth unemployment, and income spread have to be reduced, (iv) peace in neighbourhood: from Ukraine to North Africa, political destabilization and economic problems enforce each other, (v) technologically; Europe has to close the technological lead of the US, from ICT to biotechnology; (vi) Europe has the last chance to extend its first mover advantage in renewables, energy efficiency, new car engines and other industries needed to limit climate warming to 2 degrees.

If Europe solves these problems isolated, there will be not enough money to tackle them (given the unwillingness to make all the changes in the public budgets delineated above). And there is no chance to agree on measures across Europe. 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; see www.foreurope.eu). Its constituent strategy lines are:

- Stronger dynamics based on innovation and skills, measured by Beyond GDP goals
- Less differences in incomes, higher employment

- Europe becomes world leader in environmental technology and renewables
- Stable financial sector, regulated, financial transaction tax, reduced taxes on labour
- Open area, enjoying globalisation/heterogeneity, inviting neighbours

This vision starts from goals, not from problems. The consolidation of budgets and lower debt are a long-run necessary side condition. The goal however is a **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 and persons.

Taxing financial transactions and public bads, zero tolerance tax evasion, much lower taxes on labour are integral parts of the strategy, acknowledging that income distribution matters for growth and stability. Equality of opportunities and life chances, capabilities, institutions, dialogue and democratic discourse, the tolerance for heterogeneity and transforming it into a productive force is part of the strategy. A deep absolute decoupling of energy consumption on resource use is necessary (this implies – 80% to 90% CO_2, doubling energy efficiency, 50% share of renewable redirecting technical progress from labour saving, to energy and resource saving).

10. Europe will overcome its midlife crisis if it improves its own model

Europe will overcome its midlife crisis if the public sector is streamlined, reoriented towards the future, if taxes and incentives are used to support employment and growth. And if Europe invests into its own model of a social cohesive and ecological sustainable economy instead of mimicking the US or the Asian model; Europe needs leading and learning from its neighbours as to achieve a decisive role in the globalized economy of 2050.

Going for ecological excellence and reducing youth unemployment as well as the spread of income and wealth are not blockers of dynamics but are - if embedded in a strategy - drivers of change, innovation and dynamics. This holds specifically for Europe, since these societal goals fit to the European model better than to alternatives. The goal of becoming world leader in renewable technologies is part of the program of the New Commission. The current low oil prices should be used for a substantial reduction of subsidies for fossil energy and for rebuilding emission trading. The pending trade agreements inter alia between Europe and the US (TTIP) and the upcoming climate conferences 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), to develop an industrial policy favouring societal goals. The technology policy should improve resource and energy productivity (not that much labour productivity as done today[1]). Europe currently builds the new infrastructure for 2050 and develops traffic systems and car engines for 2050. The infrastructure built today decides about feasibility and costs to reduce emission to 10% of the current level in Europe as planned in the Energy Roadmap 2050.

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[1] "Biasing" technological progress towards increasing resource and energy productivity faster than labour productivity should be easy given the strong government inference in innovation policy and high taxes in Europe in specific.

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Annex: a primer for strategy change

- Business as usual is no longer possible for Europe
- Unemployment and stagnation threaten EU-project and peace
- Globalisation offers chances; needs complementary policy
- Radical, absolute decoupling (energy, material) urgent but a demanding task
- Distribution (opportunities, income, wealth) lies at the core of a strategy change
- Reforms need a vision, ambition, institutions, allowing for heterogeneity
- Reform resistance to be tackled by communication, democratic discourse
- EU should no longer ignore neighbours: culture, schools, ERP-initiative
- Neither US' nor China's strategy is based on "Beyond GDP goals"
- Europe can become a role model: dynamics, inclusion, sustainability