Factors for Growth

Priorities for Competitiveness, Convergence and Cohesion in the European Union

STUDY

European Economic and Social Committee

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List of abbreviations

ASEAN	Association of South-East Asian Nations
BRICS	Brazil, Russia, India, China, South Africa
CEO	Chief Executive Officer
CEPS	Centre for European Policy Studies
CMU	Capital Market Union
CSR	Country Specific Recommendations
EaSI	EU Programme for Employment & Social Innovation
ECB	European Central Bank
ECU	European Currency Unit
EDP	Excessive Deficit Procedure
EES	European Employment Strategy
EFSF	European Financial Stability Facility
EFSI	European Fund for Strategic Investment
EFSM	European Financial Stabilisation Mechanism
EIAH	European Investment Advisory Hub
EIB	European Investment Bank
EIPP	European Investment Project Portal
EMS	European Monetary System
EMU	Economic and Monetary Union
EPC	European Policy Centre
ESF	European Social Fund
ESM	European Stability Mechanism
ETS	Emission Trading System
EU	European Union
FDI	Foreign Direct Investment
FET	Further Education and Training
G20	Group of 20
GDP	Gross Domestic Product
GERB	Citizens for European Development of Bulgaria
ICT	Information and Communication Technologies
IMF	International Monetary Fund
MB	Megabyte
NIP	National Infrastructure Plan
OECD	Organisation for Economic Co-operation and Development
OFGEM	Office of Gas and Electricity Markets
PS	Parti Socialiste
QE	Quantitative Easing
R&D	Research and Development
SGP	Stability and Growth Pact
SME	Small and Medium-sized Enterprises
SWOT	Strengths, Weaknesses, Opportunities and Threats
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union
TPP	Trans-Pacific Partnership Free Trade Agreement
TTIP	Transatlantic Trade Investment Partnership
UEAPME	European Association of Craft, Small and Medium-sized Enterprises
UKIP	United Kingdom Independence Party
ULC	Unit Labour Costs
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNICEF	United Nations International Children's Emergency Fund
YoY	Year-on-Year

List of countries

EU	European Union
EA	Euro Area
AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EE	Estonia
EL	Greece
ES	Spain
FI	Finland
FR	France
HR	Croatia
HU	Hungary
IE	Ireland
IT	Italy
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
PL	Poland
PT	Portugal
RO	Romania
SE	Sweden
SI	Slovenia
SK	Slovakia
UK	United Kingdom
CN	China
IN	India
JP	Japan
KR	South Korea
US	United States

Abstract

Abstract

This Study brings light to the economic factors that contribute to sustainable growth in the European Union (EU) and investigates the political feasibility of economic reforms enhancing such factors. It also explores the aspects influencing competitiveness and fostering convergence and cohesion at EU and Member States levels.

Based on an analysis of economic performance in the EU since 2000, Member States are classified in three groups according to their competitiveness pattern – Leading, Following or Catching-up. Structured interviews with representatives of EU and national institutions, and think tanks, conducted on a group of targeted countries, identify the impact of the political environment on the success and failure of reform implementation to draw up best practices for each of these groups. A review of international experience in reform implementation completes the analysis. The conclusions are presented in the form of economic and political recommendations at both Member State and EU level. They include a proposed timeframe for implementation according to the nature of the Member States' competitiveness.

Executive Summary

Executive Summary

The weight of the European Union in the world economy is decreasing and its role as an international leader is diminishing in comparison to global competitors. The lack of convergence across the European Union and an aggravation of the divergences existing among its Member States contribute to worsening the situation.

The inefficiency of the convergence policies conducted so far has contributed to growing divergences between Member States. The latter have both political and economic roots:

- *Political feasibility of reform implementation* varies considerably across Member States. From a political standpoint, the implementation of such reforms depends on the efficiency of the political system and the leadership capacity of national governments in each Member State.
- *Economic factors* also influence EU growth potential. Policies impacting factors such as education, labour costs, Euro Area membership, trade or energy vary in each Member State and help to accentuate divergences.
- EU policies originally based on a Single Market among converging economies do not sufficiently take into account this new reality: *one size regulation does not fit all*.

Three different competitiveness patterns arise in the EU. Member States can be classified according to their competitiveness patterns into three different profiles with a diverse ability to reform and restore growth:

- ***Member States Leading in competitiveness***, dominated by Northern European countries with a better position in terms of competitiveness and political acceptance of further reforms.
- ***Member States Following in competitiveness***, with difficulties in implementing structural reforms other than to resolve short-term adverse economic pressures and reluctant to implement longer term policy changes.
- ***Member States Catching up in competitiveness***, which have in common their low levels of public debt, lower wages and positive attitude towards policy reforms. This is a key element regarding their growth potential.

This new paradigm of growing divergences between Member States needs to be taken into account by EU policies. Their efficiency and subsequent legitimacy could be found in their ability to *benchmark best practices at national level* in each competitiveness category and to widespread them across Member States. The EU could also *act as a coordinating actor* to support reform implementation at national level (i.e., European semester approach) and review on-going processes. The enhancement of diverging profiles across Member States should be tackled by *the use of project-based existing tools* mentioned in the Treaties such as enhanced cooperation and the use of EU-funded programs as promoted in the Juncker plan. *An adequate use of the subsidiarity principle,* which implies the use of targeted action at the most appropriate level, will also contribute to the identification of the relevant growth enhancing reforms and projects to be implemented at EU level.

The Study further draws best practices from analysis of the political feasibility of reform implementation in nine selected Member States and three third countries:

- *Germany, the United Kingdom, and Ireland* for Member States Leading in competitiveness,
- *France, Spain, and Greece* for Member States Following in competitiveness,
- *Poland, Latvia, and Bulgaria* for Member States Catching up in competitiveness,
- *The United States, Japan, and South Korea* for third country models.

Best practices for Member States Leading in competitiveness

- The stimulation of flexibility in the British labour market is a good example of fostering competitiveness.
- Germany and the UK provide positive models for market deregulation and increased competition.
- The development of apprenticeships implemented in Germany is a useful basis for well-targeted education to tackle the mismatch between supply and demand of work.
- The implementation of a High Tech Research and Innovation Strategy in Germany provides a positive model for the promotion of R&D.
- Germany and Ireland are good examples of compliance beneath the 3% deficit threshold.
- Germany, the UK and Ireland provide positive models for the sustainability of pensions with the postponement of legal age of retirement.
- Ireland provides an overall attractive business environment for trade policies combining low taxation, high education, and innovation.
- Member States in this category exhibit on average high reform implementation rates, although attention must be paid to ensure effective implementation in the near future as populations often fail to see the need for further reforms in times of economic prosperity.

Best practices for Member States Following in competitiveness

- France leads the way in the improvement of the functioning of product markets with the launching of the Macron Laws.
- As regards investment policies, the leverage effect of the French investment bank is a successful experience to be promoted to a wider extent. *France provides a positive example for the promotion of investment policies with the leverage effect created by the French investment bank.*
- The success of the pension system reform in Spain to help to contain long-term expenditure could be helpful for other countries to ensure the sustainability of their pension schemes in the future.

Best practices for Member States Catching up in competitiveness

- Poland provides a positive model of efficient investment in key sectors with a clear return on its investments policy for the allocation of EU structural funds.
- *Latvia constitutes a positive example of efficient use of EU funds to strengthen energy*

security and launch energy efficient programmes.

- Poland provides a positive model for the sustainability of pensions with the increase of the age of retirement and limitation on early retirements.
- Poland leads the way in implementing reforms with an overall good performance.

Implementation subject to the economic and political environment

- *Member States Leading in competitiveness* are currently experiencing a good economic environment, which makes populations less familiar with the need for reform. This calls for more awareness-raising on the 'return on investment' of the suggested reforms in order to ensure sustainable growth in the future.
- *Member States Following in competitiveness* have experienced the depletion of their economies, and populations are not receptive to further reform. Implementation could therefore focus on improving employment and achieving growth in the short run to restore confidence in the economy, to undergo through tougher reforms as a second step.
- *Member States Catching up in competitiveness* are on a good trend but efforts are still needed to reach the same development levels as the two previous groups. In particular, the quality of institutions must be improved to ensure the proper implementation of reforms.

Objective and Grounds for the Study

Objective and Grounds for the Study

The European Union has been undergoing a weak economic recovery due to a succession of economic and financial shocks since 2007 which have hampered its competitiveness and growth potential. While global competitors have implemented the necessary reforms to address shortcomings in specific policy areas and particularly the United States, some EU Member States lag behind and have lacked the political will to enforce the necessary reforms to assure their future economic growth.

Contrasting competitiveness patterns within the European Union reveals economic and political divergences across European Member States and demonstrates divergences within the EU. EU legislation has contributed to deepening this growing divergence, since it has so far been unable to successfully address this issue.

The present Study complements the preliminary study on *Key factors affecting the future growth of Europe*[1], which portrayed the position of the EU as a global player, presented growth and income divergence among EU countries, and outlined internal reasons for the EU's lack of competitiveness.

The current Study now demonstrates the EU's lack of competitiveness and assesses how the EU's legislative approach has contributed to the sluggish growth. By identifying the factors negatively affecting growth and noting the growing divergences between Member States, it also proposes best practices that can be drawn from the experience of certain countries to foster growth and avoid shortfalls for other Member States.

The current Study classifies into three groups EU Member States which share similar economic and political traits, according to their competitiveness patterns. It further examines three Members States in each group by expounding supplementary and detailed analysis for specific policy areas. The latter include education, investment, social policies, trade, labour and energy costs and demographic shifts for the selected Member States. The Study also relies on international experience from other countries to investigate the competitiveness of the European Union in comparison with its main competitors at a global level.

[1] See Lighthouse Europe, *Key Factors Affecting the Future Growth of Europe*, prepared for EESC, 2015 for further details.

Methodology

Methodology

Despite economic rationale, reform implementation is often contradicted by the political context. This Study identifies the gap between the necessary economic reforms to foster growth and the political feasibility of adopting corresponding policies at EU and Member State levels. It also brings to light the factors fostering competitiveness, convergence and cohesion within the European Union.

In a first step, the Study provides an analysis of EU Member States' economic performance since 2000. It examines specific internal and external factors affecting economic growth and competitiveness in the EU. The latter includes education, social policies, labour costs and productivity, demographic change and drifts in population, Euro Area membership, the quality of its national institutions, trade, Foreign Direct Investment (FDI), and energy costs. After this investigation, the Member States are classified into three groups according to their competitiveness pattern: Leading, Following or Catching-up.

In a second step, the Study explains the quest for economic growth and explores the economic factors influencing the EU's competitiveness. It analyses internal and external factors affecting competitiveness at a European level, **and completes the findings with a SWOT analysis**[2] focused on the European Union.

In a third step, the Study puts forward the role of the European Union as a single political actor and coordinating authority. It explains the prerogatives of the European Union and points out growth-enhancing policies at a European level. **The Study also analyses the political approach to competitiveness and growth.** It examines existing policy recommendations formulated by various entities – such as international and business organisations and think tanks – and investigates the 'political feasibility' criterion.

In a fourth step, the Study evaluates the political feasibility of reform implementation in the above-mentioned fields for three selected Member States per group:

- *Germany, the United Kingdom, and Ireland* for Member States Leading in competitiveness,
- *France, Spain, and Greece* for Member States Following in competitiveness,
- *Poland, Latvia, and Bulgaria* for Member States Catching up in competitiveness.

Best practices drawn from EU Member States, as well as international experience in third countries, complete the findings.

[2] A SWOT analysis identifies the Strengths, Weaknesses, Opportunities and Threats of an organisation.

The outcome of this Study is illustrated by graphs and is summarised in a final section. Policy recommendations are listed for each group of Member States and for the European Commission as a coordinator and facilitator of economic policy.

This Study relies on existing literature – published before February 2016 – to map out which economic reforms are politically viable in these Member States. The different sources taken into account include economic analyses and forecasts, policy briefs by international organisations and business organisations, academic reports from think tanks and universities and publications from corporate stakeholders.

While the academic literature on the factors of economic growth is abundant, **the policy-oriented nature of this study required primary research in certain areas – for instance political feasibility – for which existing literature does not provide a fully satisfying account**. To fill this knowledge gap, structured interviews[3] were conducted with EU officials and academic stakeholders from the EU Commission, Member States' Permanent Representations, and Brussels-based think tanks. The interviews were conducted between September and December 2015, in both English and French. Sections 5 and 6 present and analysis based on the minutes of these meetings; the original extracts from the transcripts are provided in Section 7.

[3] Most interviewees requested anonymity; a number of others approached declined to contribute. *See 7.1.1.* Questions posed to interviewees for more details.

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1. Introduction

1. Introduction

The EU has been facing a slow economic recovery since the 2007 and ensuing Euro crises, while third countries – such as the United States, China or India – **experience more significant growth levels.** The political wrangling over necessary reforms to be introduced explains, to a great extent, this outcome in the EU.

From a political standpoint, the succession of recent economic and political shocks (i.e., financial crisis, the risks of Grexit or Brexit, migration and terrorist crisis) **calls into question the decision-making capacity of the European Union compared to its global competitors**. The decision-making capacity remains mostly the prerogative of Member States, resulting in asymmetry and increasing divergence among the latter. This state of play questions the governability of the European Union as a homogeneous entity and the ability of some Member States to take decisions in favour of growth. Two questions can therefore be raised:

- *Which economic reforms are necessary to boost EU Member States' competitiveness?*
- *Are the identified reforms achievable from a political acceptability and leadership standpoint?*

The present Study aims to provide a set of differentiated policy measures and structural reforms recommended for Member States that share similar economic and political traits. It complements a report provided for the EESC Employers' Group in 2015 that drew up a comprehensive picture of EU economic growth. The Study also presents policy recommendations at EU and Member State levels to coordinate policy efforts, spur growth, increase economic convergence, and foster cohesion.

The different competitiveness patterns across the European Union evince economic and political divergences from one Member State to another and point out the heterogeneity amongst the EU. Differences concerning both economic and political dimensions show disparities between EU countries as regards the willingness to implement economic reforms oriented to foster growth. Nonetheless, similar developments in competitiveness can be highlighted with three groups of Member States with either Leading, Following or Catching up competitiveness patterns.

The objective of the Study is to give a more accurate view of what could be accomplished at both EU and Member States levels to realistically restore growth in Europe, notably to achieve a more stable macroeconomic environment, enhance innovation and entrepreneurship, complete the Single Market, boost competitiveness and foster convergence and cohesion in the EU.

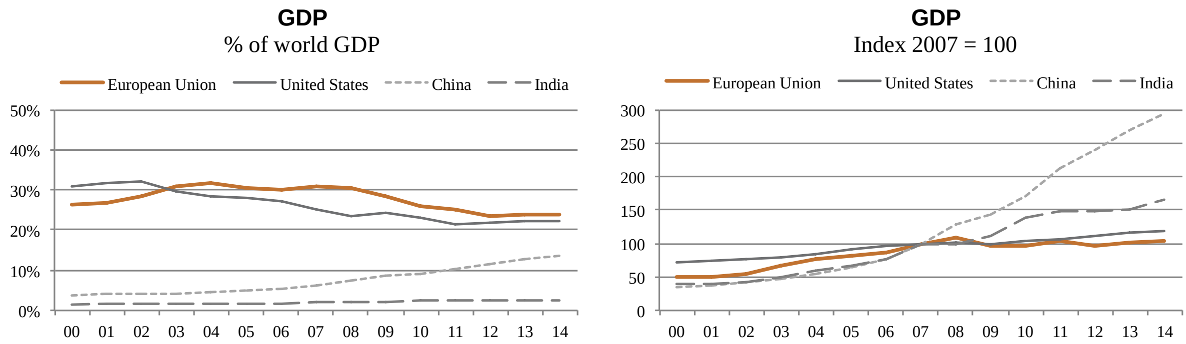
The analysis of the causes of the EU's loss of economic leadership in the world since 2007 (**Section 2**) helps to demonstrate the economic factors affecting the EU's competitiveness (**Section 3**). This paves the way to put forward the role of the European Union as a single political and coordinating actor, to analyse the political approach to structural reforms supporting growth, and to examine existing policy recommendations formulated by various entities (**Section 4**). The identification of best practices for each group of Member States and insights on international experience shed light over possible reform paths to restore growth in the EU (**Section 5**). Finally, in a concluding section, recommendations at both EU and Member State levels take into account the greater heterogeneity of the EU economies and the complexity of the European decision-making to enhance competitiveness and growth in the EU (**Section 6**).

2. The European Union losing ground as a global actor

2.1. The place of the European Union in the world since 2007

The influence of the European Union as a global economic power has declined since the 2007 and ensuing financial and Euro crises, as highlighted by the stagnation of its GDP over the last years, whereas two of the BRICS[4] countries – China and India – and the United States experienced more significant growth (**Figure 1**).

Figure 1: *The contribution of the EU to world GDP*

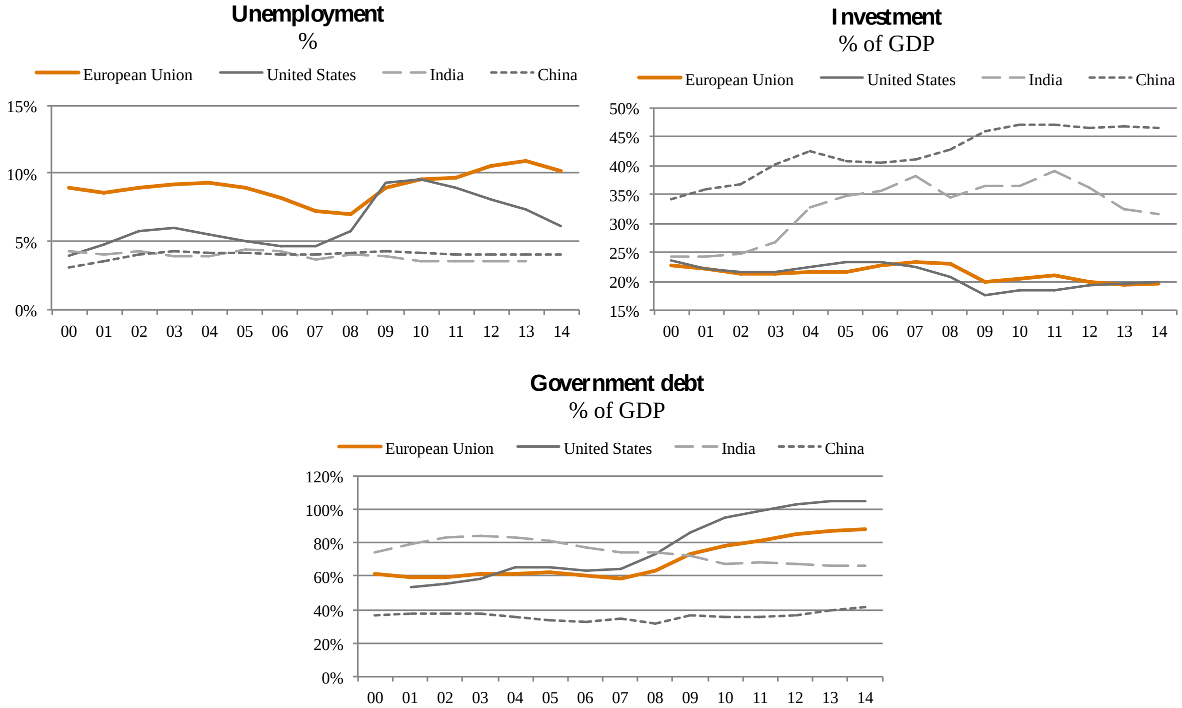


Source: International Monetary Fund

Weaker growth in the EU translated into high unemployment rates since 2007 – especially compared to the United States – **and low investment levels** – EU investment reaching only 19.5% of GDP in 2014, while China invested up to 46.4% of its GDP the same year (**Figure 2**). Public finances worsened as the EU and its Member States attempted to mitigate the effects of the crises on the economy. The United States also heavily relied on public spending to foster economic recovery, but the central role of US dollar in the world economy has reduced financial pressures faced by the country.

[4] Brazil, Russia, India, China, South Africa.

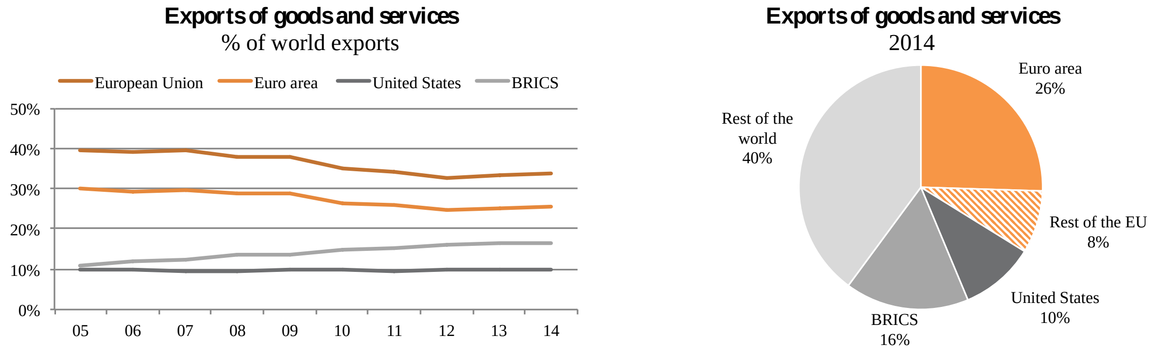
Figure 2: Unemployment, investment, and government debt in the EU, US, China, and India

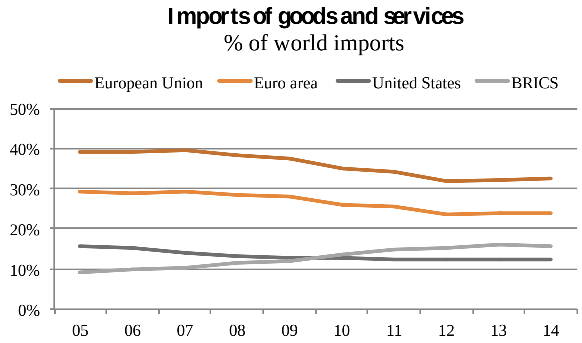


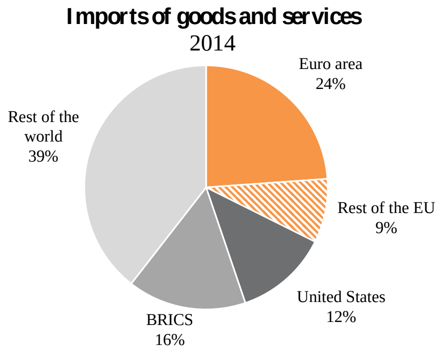
Source: International Monetary Fund

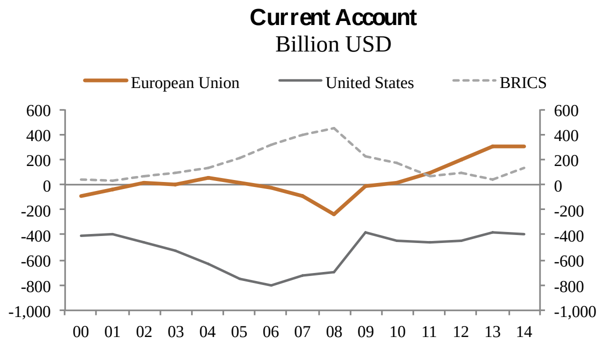
In face of new emergent economic powers, the position of the European Union in world trade has weakened (**Figure 3**). EU exports of goods and services have strongly declined since 2007, while the United States exhibits a steady performance throughout the crisis. The European Union, however, exhibits a sharper fall in imports of goods and services, restoring its current account balance.

Figure 3: The contribution of the EU to world trade





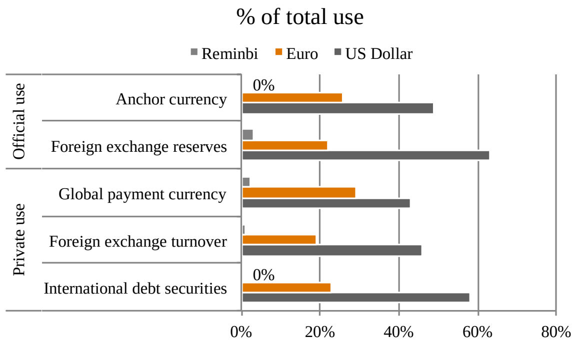




Source: United Nations Conference on Trade and Development, International Monetary Fund[5]

Nonetheless, the Euro has gained a central role in international exchanges over the years (**Figure 4**). The currency has been increasingly used in international debt markets for the issuance of both government and corporate debt. It is the second most actively traded currency in foreign exchange markets and is widely used as a reserve currency.

Figure 4: *The role of the Euro in world financial markets*



Source: European Central Bank

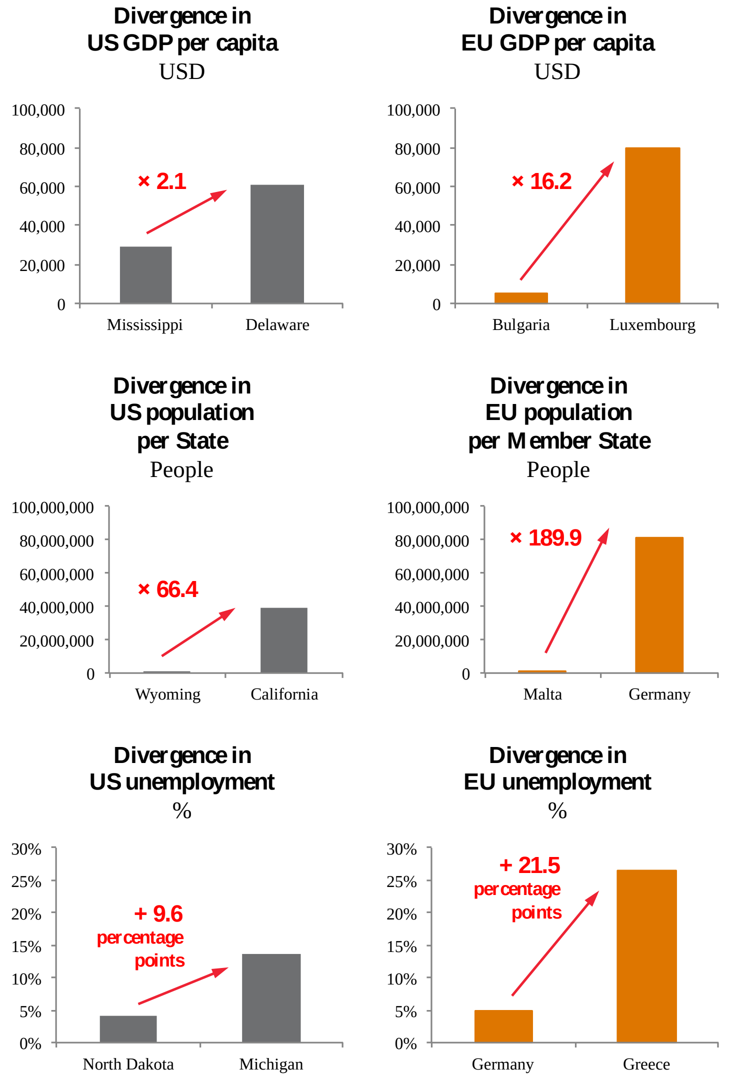
2.2. Gap analysis between the EU and the US

Finding an external role model for the EU is not easy. However, the United States provides some indicators on the degree of convergence required to achieve both stable governance and sustainable economic performance (**Figure 5**). The chronologically more mature economy of the United States shows much less divergence between individual US States than between the Member States of the EU

[5] According to international standards, *"billion"* means a thousand million and *"trillion"* a thousand billion.

concerning key indicators such as GDP per capita, population and unemployment levels. The difference between the worst and best performing Member States either at US and EU level gives a clear indication of the greater divergences at European level.

Figure 5: *Divergence in and between the US and the EU in 2013*



Sources: StatsAmerica, International Monetary Fund, Eurostat

2.3. Growing divergences in the EU and the end of the spillover effect

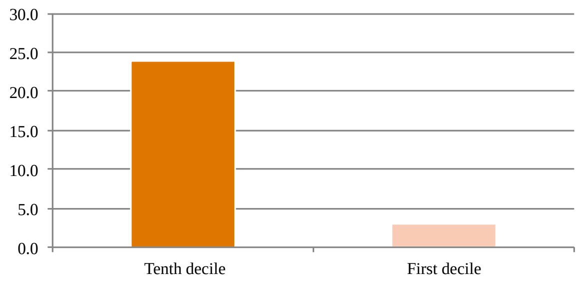
The Treaty of Rome of 1957 defined the European project as the simultaneous pursuit of economic prosperity, cohesion and social progress, both within and across Member States, thanks to upward convergence across the EU. Consequently, the European Union engaged in social policies to address poverty and inequality, inadequate housing, and unemployment alongside economic and industrial policy across the EU.

However, the 2007 and ensuing financial and Euro crises strongly affected the European Union, leading to high unemployment and increased inequality (**Figure 6**). Despite a slight improvement between 2000 and 2007, unemployment worsened in the aftermath of the financial crises. The high youth employment figures since 2000 – 10.7 percentage points higher than total unemployment on average between 2000 and 2014 – and their unfavourable developments since 2007 are particularly worrying. Long-term unemployment leads to skill depletion, which fuels inequality. As a consequence, the richest 10% of the EU population still earned more than 23% of EU income in 2012, while the 10% poorest earned 3% of EU income. This failure to achieve cohesion and social progress contributes to popular discontent within and towards the European Union.

Figure 6: *Inequalities in the EU*

Distribution of income

(share of national income, EU15, 2012)



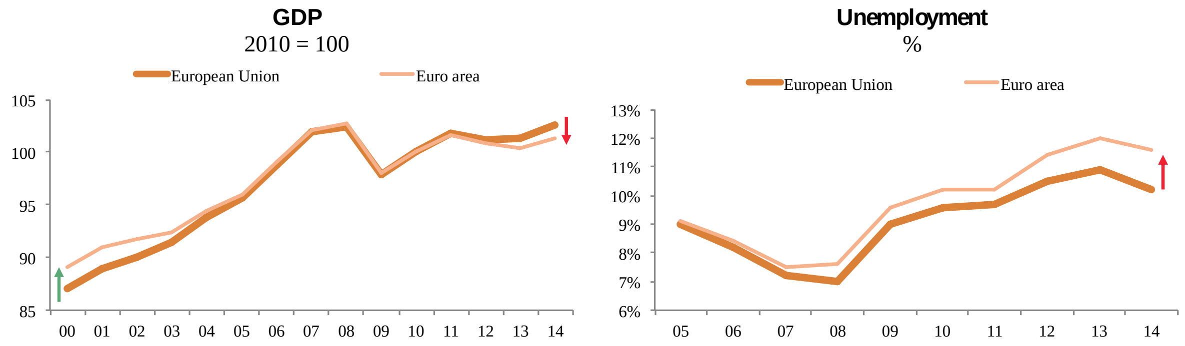
Source: Eurostat

Inequality actually increased in the EU since 2000, but not evenly across EU Member States, as highlighted by growing divergences:

- *Between the Euro Area and other Member States*, the former being more severely hit by the financial crises than the latter. While GDP growth was stronger in the Euro Area than in the EU as whole between 2000 and 2007, the former lost ground in the aftermath of the financial crisis; similarly, the Euro Area faced a stronger deterioration in employment than the EU on average since 2007 (**Figure 7**).
- *Within the Euro Area*, since unusually low interest rates have led to excessive borrowing and inefficient economic specialisation[6] in some countries, such as Greece and Portugal. The introduction of the Euro fuelled financial markets with the reasonable belief that the European currency was uniform in value. Consequently, national interest rates converged to the low levels experienced by Germany before 1999, despite diverging economic fundamentals across the Euro Area. Overall, the Euro Area suffers from the absence of convergence among its Members in the areas of inflation, competitiveness, and external position.[7]
- *Between core Member States* that are more developed and better equipped to face financial turmoil, *and peripheral Member States* that face higher unemployment and public debt levels.

[6] Euro Area countries specialised in fields that would benefit from such unusually low interest rates, with no regard for their economic fundamentals, i.e., they specialised in sectors in which they would be unable to compete on the world market once the interest rates would have gone back to their usual rate.
[7] auf dem Brinke, A., Enderlein, H., and Fritz-Vannahme, J., *What kind of convergence does the euro area need?*, Bertelsmann Stiftung und Jacques Delors Institut Berlin, 2015.

Figure 7: *Growing divergence in the EU*



Source: European Commission

The recent financial crises also highlighted a lack of political willingness to implement the necessary reforms to ensure convergence across the EU. Nine Member States[8] were unable to meet the terms of the Stability and Growth Pact introduced to foster convergence among EU Member States and are currently, in 2015, under the Excessive Deficit Procedure (EDP).[9] More worryingly, large Member States such as the United Kingdom did not take effective action to correct their excessive public deficit, leading to the publication of new Commission recommendations in June 2015. As a whole, the European Commission's Directorate General for Economic and Financial Affairs stresses that only around 40% of the 2012 and 2013 EU recommendations for growth were implemented at Member State level.[10]

As a result, inequality across and within Member States has worsened over the past decade. Disparities in GDP per capita are visible among Member States, with a 16.2:1 ratio between Luxembourg and Bulgaria and 9.7:1 ratio between Denmark and Bulgaria in 2013. In Germany, the income of the richest 20% of the population was 4.6 times higher than the income of the poorest 20%, against a 3.5:1 ratio in 2000.[11]

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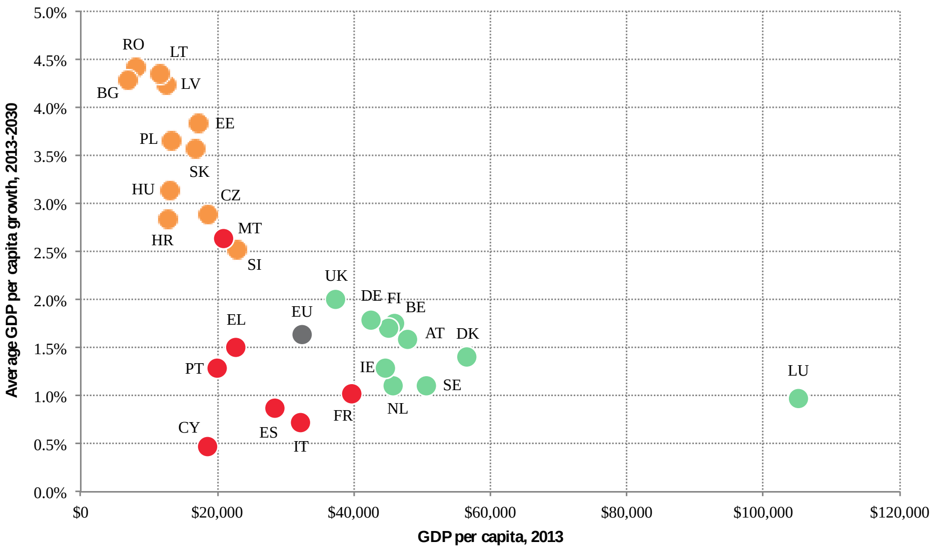
[8] Croatia, Cyprus, France, Greece, Ireland, Portugal, Slovenia, Spain, United Kingdom.
[9] The EDP addresses excessive public deficit and debt levels.
[10] See *4.3.* Divergence in reform implementation for further details.
[11] Source Eurostat.

2.4. A Member State classification

Since the outbreak of the Euro crisis, a number of business and academic studies have sought to classify the Member States of the EU into 3, 4, 5 or 6 coherent but different economic, political or geographic groups. Within each group, leaders and laggards arise at any certain time – and actual performance can be deeply affected by changes of government and economic and social policy. The group may reinforce the behaviour of its members – for good or bad – thus making change more difficult in some cases. When such groupings are valid, a targeted set of recommendations could address such shortcomings to foster convergence across the EU.

This Study further recognises the importance of a State's international competitiveness as a key indicator of its ability to build wealth, and notes that this is dependent upon its ability to enact structural reforms. Particularities, such as Euro Zone membership, must be taken into account to account for and understand their influence on competitiveness, structural reform, and economic growth. The Study therefore builds on and extends an analysis first conducted by the Centre for European Policy Studies (CEPS)[12] and mentioned in an earlier study for the EESC[13] (**Figure 8**).

Figure 8: *Divergence within the EU*



Source: CEPS

An analysis of three key indicators – GDP, GDP per capita, and Public Debt-to-GDP – over the 2000-2014 period highlights **three groups of Member States in the European Union following three distinctive competitiveness patterns**:

- *Member States Leading in competitiveness*, dominated by Northern European countries with a better position in terms of competitiveness and political acceptance of further reforms.
- ***Member States Following in competitiveness***, characterised by their difficulties in implementing structural reforms, the need for adverse economic pressure to initiate the changes needed, and their reluctance to implement additional policy changes.

[12] Gros, D. and Alcidi, C., *The Global Economy in 2030: Trends and Strategies for Europe*, CEPS Paperbacks, April 2sd 2014.
[13] Lighthouse Europe, *Key Factors Affecting the Future Growth of Europe*, prepared for EESC, 2015.

- ***Member States Catching up in competitiveness***, which have in common their low level of public debt, lower wages and positive attitude towards policy reforms. This is a key element regarding their growth potential.

Within each group, Member States are listed in the order in which they are ranked for competitiveness in the 2015-2016 Report from the World Economic Forum (WEF) (**Figure 9**). For reference, the USA as a whole ranks as the 3rd best performing country in the world, just behind Switzerland (1st) and Singapore (2nd). A total of 140 countries are ranked, with the 28 Member States of the EU dominating the most competitive and richest upper half. Three Member States from each of the three groups have been explored in greater depth, as highlighted in the table below.

Figure 9: *A classification of EU Member States*

Member States Leading in Competitiveness	Member States Following in Competitiveness	Member States Catching up in Competitiveness
• **Germany** (4)	• **France** (22)	• Estonia (30)
• Netherlands (5)	• **Spain** (33)	• Czech Republic (31)
• Finland (8)	• Portugal (38)	• Lithuania (36)
• Sweden (9)	• Italy (43)	• Slovenia (39)
• **United Kingdom** (10)	• Malta (48)	• **Poland** (41)
• Denmark (12)	• Cyprus (65)	• **Latvia** (45)
• Belgium (19)	• **Greece** (81)	• Romania (53)
• Luxembourg (20)		• **Bulgaria** (54)
• Austria (23)		• Hungary (63)
• **Ireland** (24)		• Slovakia (67)
		• Croatia (77)

World Economic Forum's Competitiveness Rankings for 2015-2016 are shown in brackets.

Member States **Leading** in competitiveness ranked among the most developed in the European Union, with a GDP per capita of €35,650 on average in 2014 against a €20,782 EU average in the same year.[14] They proved relatively resilient to the 2007 and ensuing crises, as shown by a contained fall in GDP per capita over the 2007-2013 period; GDP per capita even grew in Germany, Austria, and Sweden (**Figure 10**). As do their counterparts Following in competitiveness, they exhibit high Debt-to-GDP ratios, with six out of ten Member States Leading in competitiveness above the 60% threshold introduced by the Stability and Growth Pact. Nonetheless, they contained public spending better during the 2007-2014 period (**Figure 11**). Ireland is an important outlier; particularly affected by the financial crisis, the country managed to recover quickly. Its GDP grew by 6.1% between 2013 and 2014[15] while its Debt-to-GDP ratio fell by 13.5 percentage point over the same period[16].

On average, Member States **Following** in competitiveness experience a similar level of economic development to Member States Leading in competitiveness. However, the former showed lower growth rates in GDP per capita over the 2000-2007 period than the latter (**Figure 10**). Furthermore, the impact of the recent financial crises was greater for Member States Following in competitiveness.

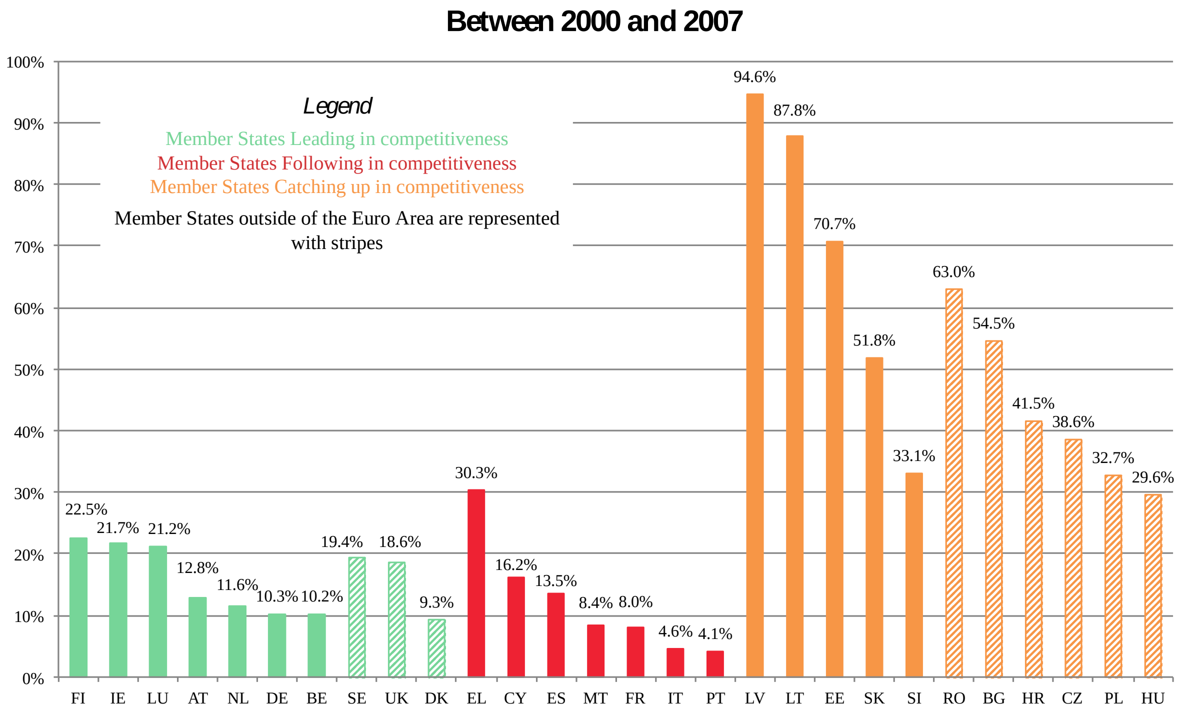
[14] Source Eurostat.
[15] Source Eurostat.
[16] Source Eurostat.

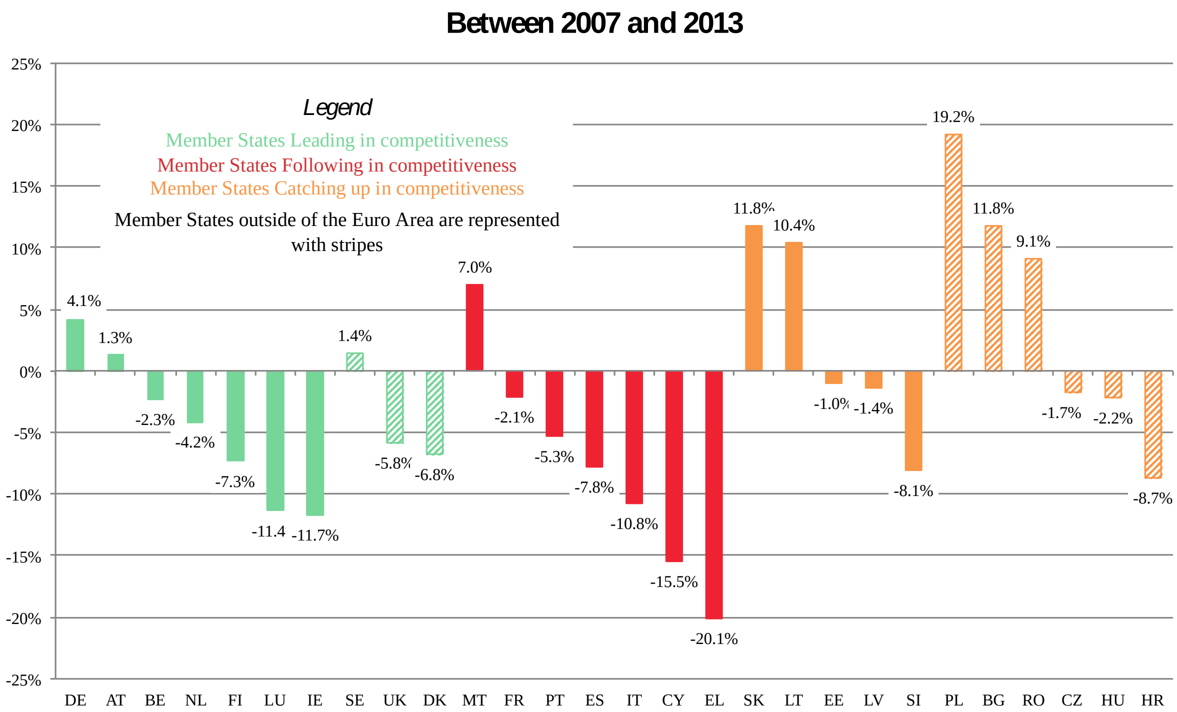
They underwent the sharpest fall in GDP per capita over the 2007-2013 period (**Figure 10**) and the strongest increase in Debt-to-GDP between 2007 and 2013 (**Figure 11**). Every Member of this category except Italy is currently under the Excessive Deficit Procedure (EDP) and they all experienced in 2014 Debt-to-GDP ratios over the 60% threshold introduced by the Stability and Growth Pact – Portugal, Italy, and Greece even doubled this threshold (**Figure 11**). It is worth noting that all the Member States in this group belong to the Euro Area – and that this may have, for good or bad, reduced the impact of external forces which would otherwise have driven internal change.

All Member States **Catching up** in competitiveness joined the European Union in the 2000s and five of them[17] adopted the Euro between 2008 and 2015. In terms of GDP per capita, these Member States exhibit a pattern of rapid economic catch up. GDP per capita grew on average by 52.1% over the 2000-2007 period, against a 15.7% average for the two other groups (**Figure 10**). Among this category, four out of the five Member States belonging to the Euro Area benefited from much stronger growth rates than the other Member States of the category, highlighting the potential for the positive impact of the Euro (**Figure 10**). Variations in GDP per capita over the 2007-2013 period point out to a better resilience to the 2007 and ensuing Euro crises (**Figure 10**), thanks to lower levels of public debt (**Figure 11**) and dynamic economies.

[17] Estonia, Latvia, Lithuania, Malta, Slovakia.

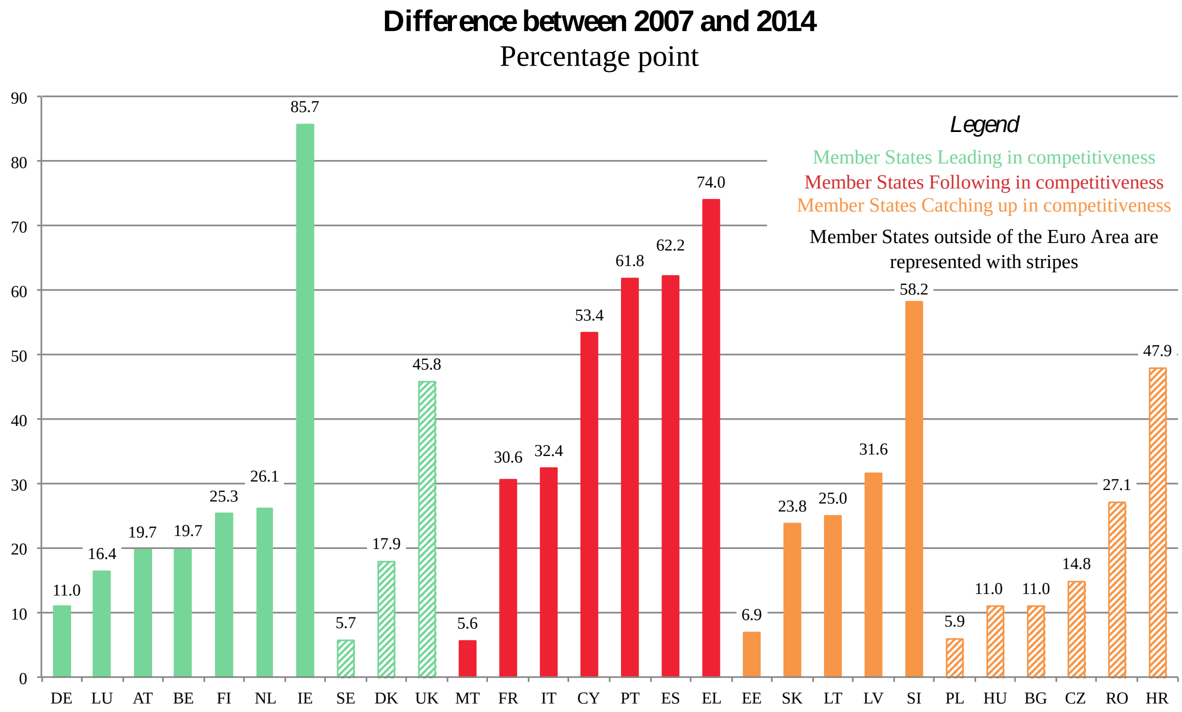
Figure 10: Variation of GDP per capita over the 2000-2007 and 2007-2013 periods

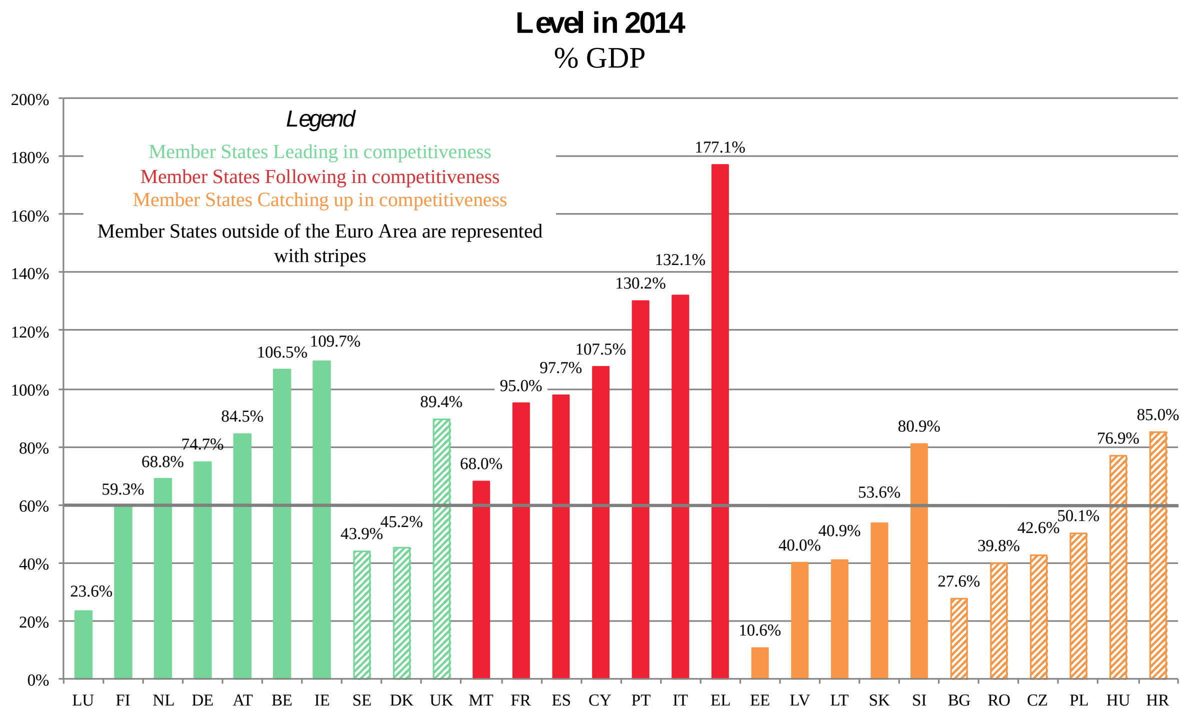




Source: Eurostat

__Figure 11:__ Difference in Debt-to-GDP ratio between 2007 and 2014





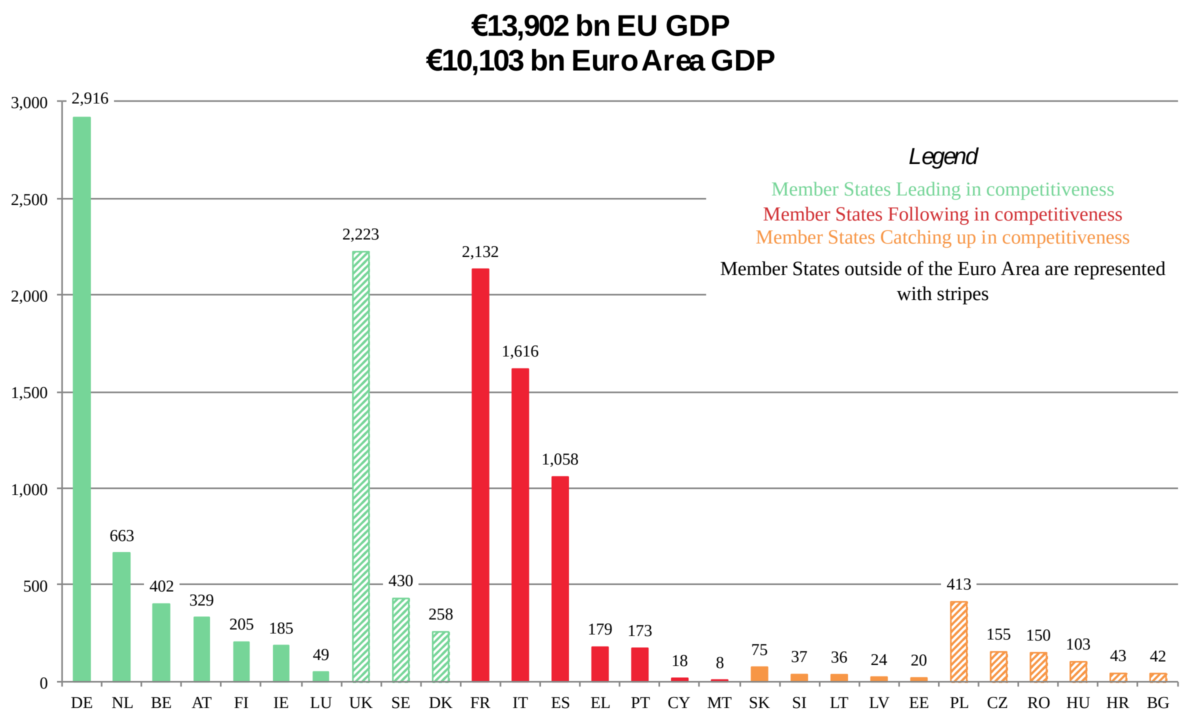
Source: European Commission

Membership in the Euro Area impacts economic performance in every group. Member States belonging to the Euro Area experienced stronger growth rates in GDP per capita over the 2000-2007 period than their counterparts (**Figure 10**). However, they were more severely hit by the recent financial crises, leading to sharper falls in GDP per capita between 2007 and 2013 (**Figure 10**).

Financial turmoil often forced these Member States to engage in bailout plans[18], which worsened their public debt ratio (**Figure 11**). Furthermore, only 6 out of the 19 Member States that adopted the Euro respect the 60% threshold introduced by the Stability and Growth Pact to ensure convergence within the Euro Area (**Figure 11**).

The breakdown of EU GDP per Member States provides further insight on the three competitiveness patterns previously presented (**Figure 12**). In 2014, Member States Leading in competitiveness accounted for 53.1% of EU GDP, Member States Following in competitiveness produced 37.4% of EU GDP, while Member States Catching up in competitiveness are responsible for only 7.7% of EU GDP. Member States belonging to the Euro Area are accountable for 72.6% of EU GDP in 2014.[19] Furthermore, the critically important third, fourth and fifth largest EU economies all exhibit Following competitiveness patterns.

Figure 12: *GDP Breakdown per EU Member States in 2014*



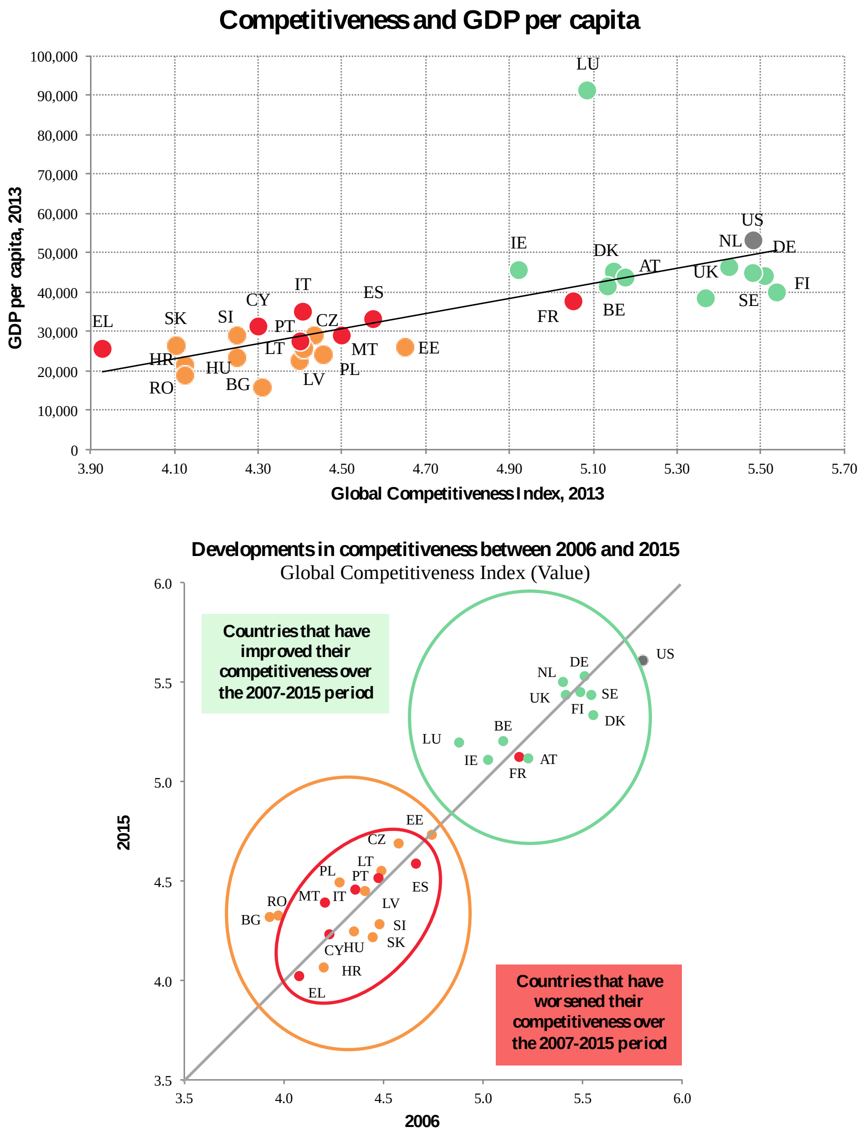
Source: Eurostat

Competitiveness is essential to increase wealth and improve welfare across Europe, as highlighted by the broadly linear relationship between GDP per capita and the World Economic Forum's Global Competitiveness Index (**Figure 13**). Greater wealth and higher levels of wellbeing in turn foster the necessary environment to improve competitiveness. Among Member States **Leading** in competitiveness, Luxembourg is a clear outlier, as its competitiveness mainly relies on its extensive specialisation towards financial services. Member States **Following** in competitiveness appear to have fallen to levels of competitiveness similar to those of Member States **Catching-up** in competitiveness,

[18] A bailout occurs when a third party offers money to a failing business in order to prevent the consequences that arise from that business's downfall (e.g., a State rescuing a bank to save savers from suffering important losses).
[19] Source Eurostat.

despite exhibiting higher levels of GDP per capita. Nonetheless, France remains more competitive than others in its group but struggles politically to make essential reforms; overall, the country clearly has the potential to join and play a major role in the **Leading** group.

Figure 13: *Competitiveness patterns in the EU*



Source: World Economic Forum, World Bank

These results raise questions regarding the ability of the European Union and its Member States to implement the required economic reforms. EU governance has of course greatly improved since 2007, thanks to the European Semester, which created a framework for EU support to Member States in reform implementation. Every year, the Annual Growth Surveys and Country-Specific Recommendations of the European Commission provide Member States with guidelines for growth-enhancing reforms. The College of Commissioners adopted in October 2015 a package of measures, which aimed among other topics to revise the approach of the European Semester.[20] As a result, the latter will highlight the employment and social aspects and increase the role played by social partners in the deepening of the EMU.

However, if certain Member States implement such recommendations, others fail to so do. To understand the reason for such disparities in reform implementation, this Study investigates the 'political feasibility' criterion and analyses the political environment in three Member States from each group:

- *Germany, the United Kingdom, and Ireland* for Member States Leading in competitiveness,
- *France, Spain, and Greece* for Member States Following in competitiveness,
- *Poland, Latvia, and Bulgaria* for Member States Catching up in competitiveness.

[20] European Commission, *Communication from the Commission to the European Parliament, the Council and the European Central Bank on steps towards Completing Economic and Monetary Union*, 21 October 2015, COM(2015) 600 final.

3. The challenges ahead for EU growth

3. The challenges ahead for EU growth

3.1. The rationale for the quest of economic growth

Economic growth, i.e., the growth of output over time[21], **is sought to improve the overall wellbeing of a given society.** Achieving high levels of economic growth has a positive impact on standards of living and life expectancy, creates wealth that reduces inequality when equitably distributed, and fosters jobs and incentives to invest and innovate. As the European Union grows and its Member States converge towards one another, the EU becomes more socially cohesive and easier to govern. These positive dynamics expand to next generations who build on a more growth-friendly environment. This virtuous circle, the backbone of so much political, economic and social progress in Europe, is however now under threat and the safe assumptions of many decades need to be re-tested.

Economic growth is derived from competitiveness, i.e., from the ability to produce high-quality products for sale at a relatively low price on the world market or at a higher price, sustained by enhanced quality and reliability. When competitiveness is high, the European economy becomes a net exporter, which stimulates growth. Strong competitiveness requires a growth-friendly environment that fosters the conditions for enhanced investment.[22] Achieving high levels of competitiveness requires engaging in appropriate structural reforms to address potential weaknesses in a timely manner.

Rising heterogeneity across Member States challenges the ability of the European Union to govern and promote EU-wide growth-enhancing policies: the effect of public investment differs across Member States, regions, and sectors. In particular, divergence within a Monetary Union such as the Euro can trigger severe economic and financial crises that spread to the EU economy as whole, through increasingly interdependent trade and financial relationships.

This Study identifies the economic factors affecting the competitiveness profile of the European Union to highlight its growth potential in a SWOT analysis[23]. Particular attention will be paid to heterogeneity concerns.

3.2. Economic factors affecting the EU's competitiveness

Two types of factors influence European competitiveness – and therefore its ability to fuel growth: internal factors that emerge from EU characteristics and governance, and external factors on which the EU has little influence.

[21] In practice, economic growth is measured by the growth of the quantity of goods and services produced by an economy during a year.
[22] See Lighthouse Europe, *Key Factors Affecting the Future Growth of Europe*, prepared for EESC, 2015 for further details.
[23] A SWOT analysis identifies the Strengths, Weaknesses, Opportunities and Threats of an organisation.

3.2.1. Internal factors

Internal factors impacting EU competitiveness are very diverse, ranging from labour costs and demography, to intellectual property rights and debt levels.[24] Education, social policies, labour costs, and especially demographic change strongly impact productivity, i.e., how efficiently output is produced. Euro Area membership and the quality of national institutions[25] influence the overall economic environment and its ability to foster long-run growth.

3.2.1.1. Education

Education is essential to economic growth as it improves the skill and productivity levels of the labour force – and notably of managers – in any manufacturing or service organisation. The more educated, experienced and engaged individuals are, the more able they are to innovate and to make the best use of existing technologies, thereby increasing competitiveness. With increasing life expectancy, life-long learning becomes ever more essential.

These positive dynamics are correlated to the quality of education systems and the levels of school and higher attainment (quantity of education):

- Technological innovation, in particular in the manufacturing sector, often requires a large pool of researchers holding at least a master's degree or a PhD, while sustainable growth relies on achieving basic education throughout the population. Innovation in services and software development is increasingly following this same path.
- However, not every diploma achieves an equal level of qualification and equal access to labour markets, as proven by the large number of students who choose to pursue their studies in universities recognised to be more prestigious and available only in certain countries.
- As in other areas, there is a reinforcing circle where the most renowned universities, business schools and colleges attract the best staff and students and so continue to improve – to the detriment of others which are less well regarded. Worldwide rankings reinforce this process.

The data highlight the degree of divergence in the performance of education systems across Member States (**Figure 14**). According to the 2014 edition of the Education and Training Monitor, 17.8% of EU students exhibited a level of reading skills inferior to Lower Secondary Education[26] in 2014. The same year, the best performing EU Member State accounted only 9.1% of its students falling in this category, while 39.4% of the students living in the worst performing Member State had a poor reading level. In the long run, these divergences in student aptitude translate into major divergences in adult skills.

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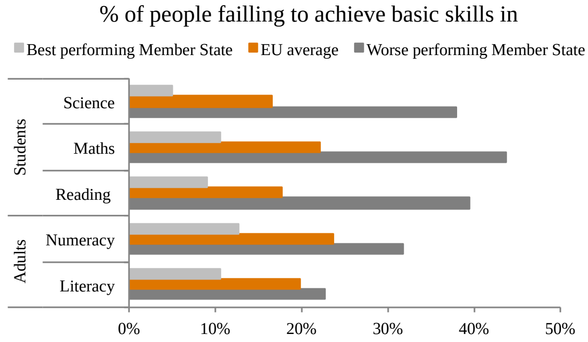
[24] See Lighthouse Europe, *Key Factors Affecting the Future Growth of Europe*, prepared for EESC, 2015 for further details.
[25] According to economic theory, 'institutions' as mentioned here are the economic, political, and social constraints that human beings impose on themselves.
[26] The International Standard Classification of Education's Level 2.

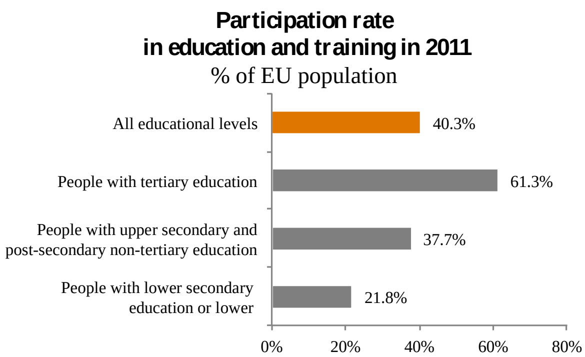
Figure 14: Low achievements in basic competences in 2014



Source: European Commission

Lifelong education and training is also essential for upgrading the skill sets of the labour force, notably to benefit from the latest technologies. It also improves the adaptability of the labour force, which is essential to overcome economic and financial crises. Lifelong education also exhibits diverging patterns across the EU: on average 40.3% of the European population took part in adult learning at least once per year in 2011, reaching 61.3% for adults with tertiary education against 21.8% for adults below upper secondary education (**Figure 15**).[27]

Figure 15: Divergence in lifelong learning



Source: Eurostat

Education improves living conditions and influences voting behaviours: adults with a higher level of education are more likely to live a longer, more satisfactory life, and show higher levels of civic engagement. Regarding voting behaviour, the gap in voting rates between adults (25-64 year olds) with tertiary degrees and those without an upper-secondary education reached 14.2% in the EU in 2012.[28] Sadly, the least well educated and least engaged also tend to be the most affected by economic downturns – and most critical of their own governments and of the EU. If alternative parties emerge, often with nationalist overtones and promises to end ‘austerity’, the above voting pattern can change. Sudden consequential changes of government and policies make the EU seem very fragile and potentially easily fragmented.

[27] Source Eurostat.
[28] OECD, *Education at a Glance 2014: Highlights*, 11 September 2015, OECD Publishing.

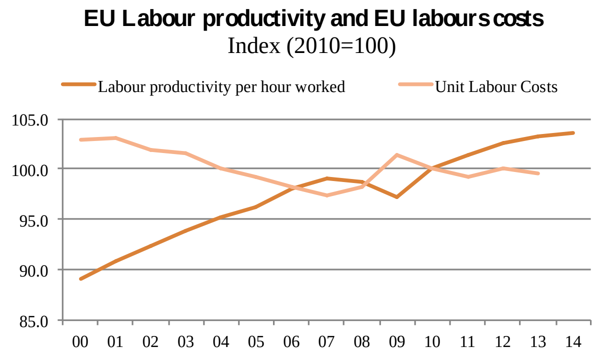
3.2.1.2. Labour Costs and Productivity

Labour costs typically represent a large share of production costs, reaching up to 72% of total costs in Austria and France in 2014.[29] In addition, up to 63% of CEOs in the world are concerned about the availability of key skills.[30] Their impact on competitiveness and growth is linked to productivity developments, i.e., to how efficiently output is produced.

- Positive dynamics occur when higher labour costs are a consequence of high productivity levels, translating into higher income for households and stronger consumption. In turn, stronger consumption stimulates production and fosters growth.
- On the other hand, higher labour costs associated with low productivity levels weigh on production costs, increasing the price of products on the world market, thereby reducing competitiveness.

The 2007 financial and ensuing Euro crises triggered some long-needed adjustment in labour costs developments: labour productivity generally increased more rapidly than labour costs since 2009. However, policies aimed at reducing labour costs are widely unpopular, as they generally translate into wage and job cuts (**Figure 16**). However, if some Member States such as Germany could achieve such reforms beforehand, the introduction of the Euro created the political room to adjust labour policies in more reluctant Member States.

***Figure 16:** Labour Costs and Productivity*



Source: Eurostat

Without a common currency, a given country can compensate for the loss of competitiveness induced by high labour costs through an adjustment in its exchange rate, i.e., a devaluation that would lower the price of its exports on the world market. A common currency such as the Euro prevents any such adjustment, as exchange rates are pegged to a common value between its Members. The only available tool to regain competitiveness is real adjustment, achieved through various channels, such as stimulating innovation or using machinery-based production processes. However, most of those channels only have a significant impact on competitiveness on a long-term basis. Lowering wages and labour costs become imperative to achieve short-term competitiveness.

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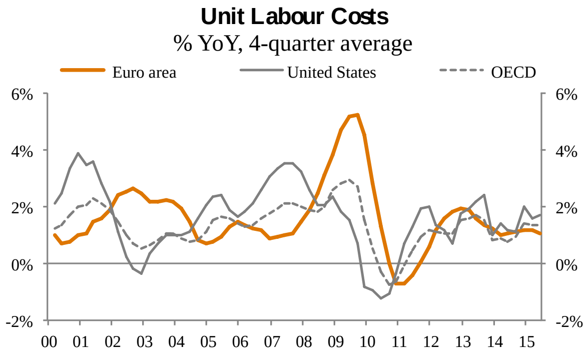
[29] Source OECD.
[30] Source LinkedIn Corporation. LinkedIn is a professional social network that covers roughly half of the world's knowledge workers through 3.5 million company profiles and 24,000 university pages.

Despite recent improvements, the European Union remains less competitive than its major competitors: labour costs are growing at a faster rate in the European Union than in other developed economies, such as the United States or Japan (**Figure 17**).

Figure 17: Labour Costs

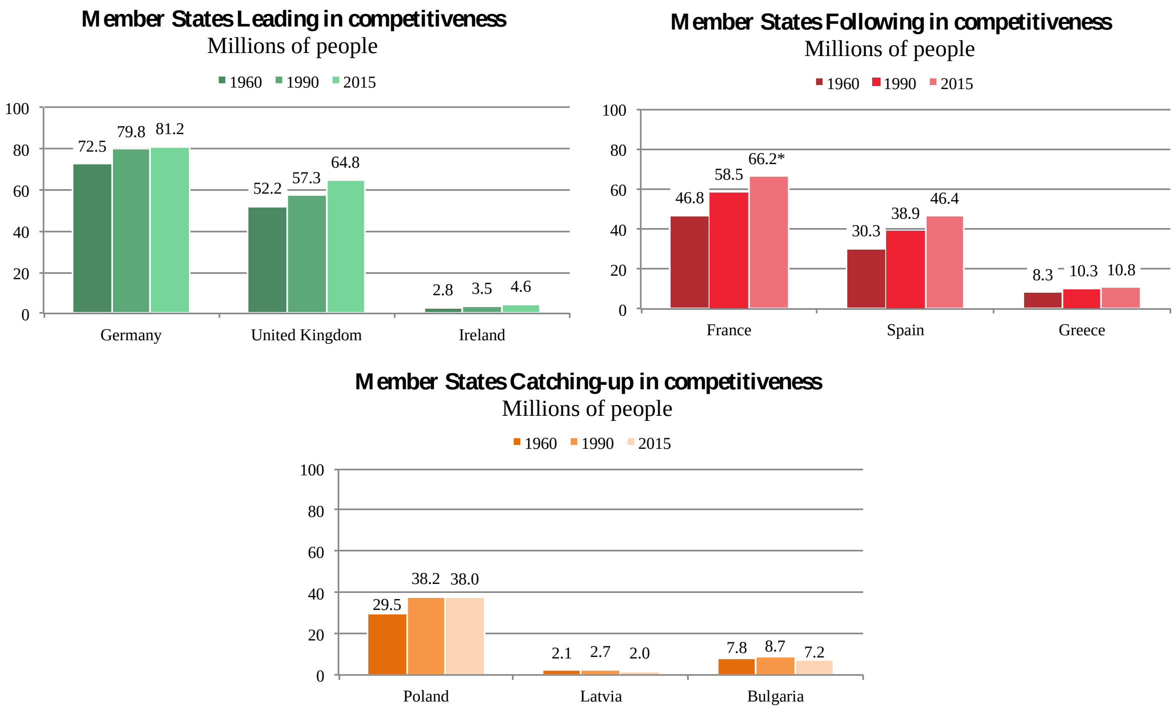


Source: Eurostat

3.2.1.3. Demographic Change and Drifts in population

The European labour force is ageing: life expectancy at birth has increased from 77.7 years in 2002 to 80.6 years in 2013[31], while EU fertility rate remains at 1.5 in 2013[32] – well below the generation renewal line of 2.1 (**Figure 18**). Some Member States have static or even declining populations.

Figure 18: Evolution of population in selected Member States



* Data for France is only available until 2014, based on the World Bank dataset.

Source: Eurostat, World Bank

[31] Source Eurostat.
[32] Source Eurostat.

If a population is allowed to age unchecked, this can threaten competitiveness in the longer run. It increases costs associated with health and pension systems, threatening public debt sustainability.

- Private investment is diverted towards pension funds, which reduces the amount of savings available for riskier and more productive investment; risk aversion itself becomes a problem.
- Retirement waves shrink the size of labour force and alter its skill composition, as elderly workers are characterised by extensive knowledge, experience and professional networks. Skill shortages stimulate wage inflation and reduce productivity.
- The remaining workers face higher taxation levels to compensate for the loss of tax income, which creates disincentives to work and discourages investment.

An ageing population can nonetheless create new business opportunities via the so-called Silver Economy. The Silver Economy can be driven both by the emergence of new consumer markets, as an ageing population includes a wide range of seniors willing to consume more as they get older, and the parallel need to improve the sustainability of public expenditure for their health care. This does however depend on their accumulated wealth and on the general state of the economy. When the economy declines, the elderly tend to suffer more than others.

The immigration of highly skilled workers could address unfavourable demographic dynamics. The skill composition of immigrants could compensate for skill shortages, and expanding the labour force would increase tax receipts and support public finances. However, the positive impact of immigration is restrained in many Member States by:

- *A low employment rate of third country nationals* (10% below the overall employment rate[33]) due to discrimination and a failure to identify or recognise their existing qualifications.
- *A brain drain affecting Europe*. On average in 2014, European migrants were relatively young, mid-level professionals with 7.8 years of experience, and most came from the United Kingdom, Spain, France, and Germany. The Single Market supported intra-EU migration, with Germany increasing its workforce by 0.4%, while other Member States such as Spain, the United Kingdom, France, Italy and Ireland suffered from a loss of talented labour force (**Figure 19**).[34] Despite being one of the first to open its borders to new arrivals to the EU and benefitting accordingly, the United Kingdom in particular remains limited by a lack of skills at all levels – but public and political pressure are building against further immigration. Governments face similar inconsistencies in other Member States as they struggle to deal with the current influx of refugees from war zones around the globe.

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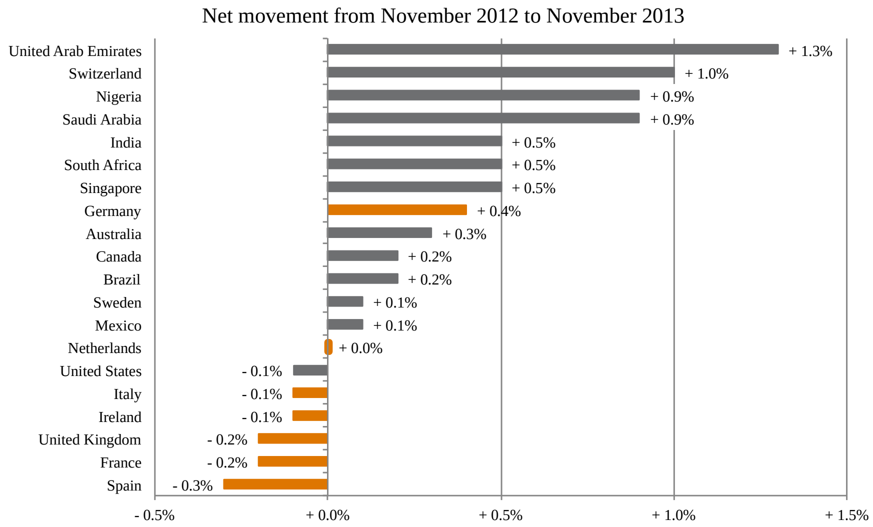
[33] Source European Commission.
[34] Source LinkedIn Corporation.

Figure 19: Countries gaining and losing from relocation



Source: LinkedIn Corporation

Geopolitics and the on-going refugee crisis could shift the skill composition of immigration as wars and unstable political systems negatively impact all aspects of life, including education systems. Nonetheless, according to the Organisation for Economic Co-operation and Development (OECD), low-educated immigrants have a better fiscal position[35] than their native-born peers. Furthermore, low skilled immigrants fill labour needs by taking up jobs regarded as unattractive or lacking career prospects by domestic workers. As a whole, the cumulative waves of migration over the last fifty years in OECD countries had a neutral impact on the fiscal balance of the hosting countries.[36]

Among other things, the European Union addresses ageing through its European Innovation Partnership on Active and Healthy Ageing, which supports best practices in the management of ageing populations across the EU. Three priorities have been highlighted: (i) prevention, screening and early diagnosis of ill health, (ii) care and cure for those who are sick, and (iii) active ageing and independent living for as long as possible.

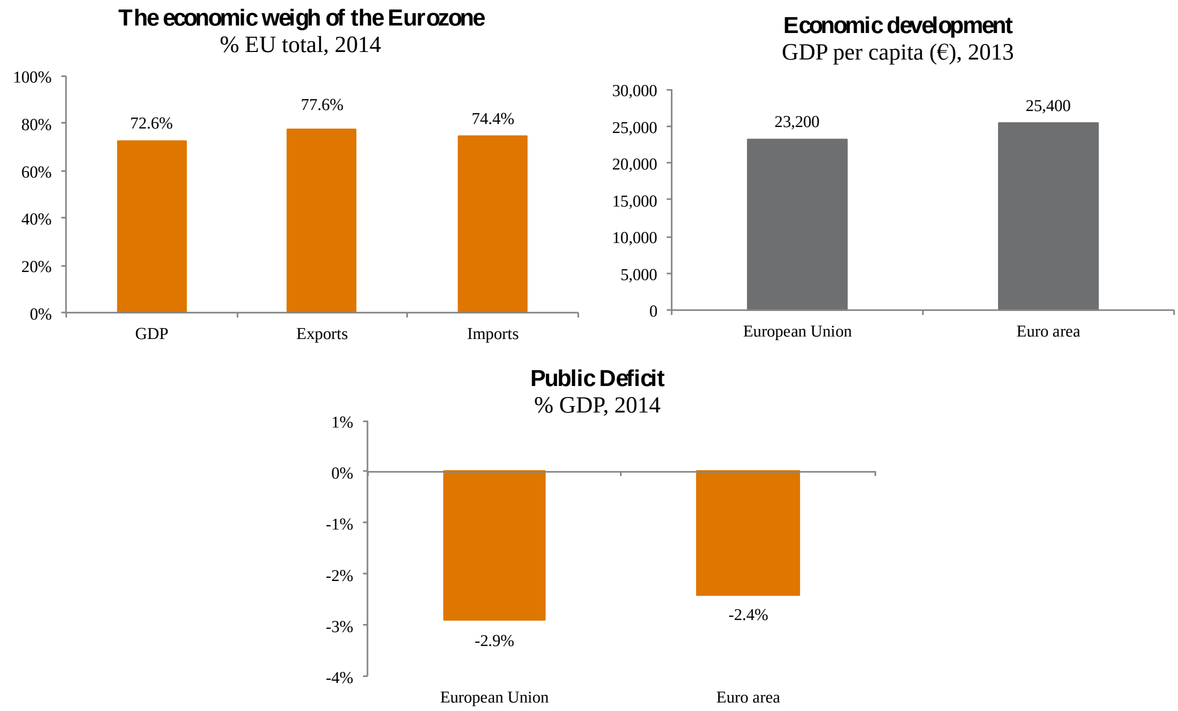
3.2.1.4. Euro Area Membership

Euro Area membership impacts the growth potential of its Members as a common currency facilitates trades but is also subject to financial turmoil. The Euro was created in 1999 and came into full use in 2002. It accounted for up to 72.6% of EU GDP in 2014 (**Figure 20**).[37] Currently used in 19 Member States[38], the Common Currency should be adopted by every European Member State that fulfils the required convergence criteria; Denmark and the United Kingdom have negotiated 'opt-out' clauses that exempt them from this obligation. These convergence criteria, also known as the

[35] The difference between their contributions and the benefits individuals receive.
[36] OECD, 'Is migration good for the economy?', *Migration Policy Debates*, May 2014, OECD.
[37] Source Eurostat.
[38] Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovenia, Slovakia, Spain.

Maastricht criteria, are intended to foster convergence among Member States by mitigating public debt, and achieving price and exchange rate stability.

***Figure 20:** The Euro Area in the European Union*



Source: Eurostat, International Monetary Fund

A Single Currency positively impacts the economies of its Members through different channels:

- It facilitates trade as transaction costs and exchange rate risks are drastically reduced and price transparency across countries improves.
- It stimulates the mobility of financial assets and frees financial resources formerly devoted to exchange rate transactions.
- A Single Currency adopted by many important economic players, such as the Euro, can be used as an international currency, boosting local financial markets.

However, a Single Currency also comes at a cost. As exchange rates are pegged between the Members of the currency area, Member countries lose an essential tool to address country-specific shocks: the exchange rate.[39] As it becomes impossible to influence prices, i.e., exchange rates, country-specific shocks must be addressed through real adjustments, also known as structural reforms. Even though necessary, structural reforms are usually widely unpopular – as are labour reforms – and their positive impact on growth often arises only in the medium run. **To avoid such costs, a Currency Area must only include countries that are sufficiently similar, in order to mitigate the risks of country-specific shocks.[40]**

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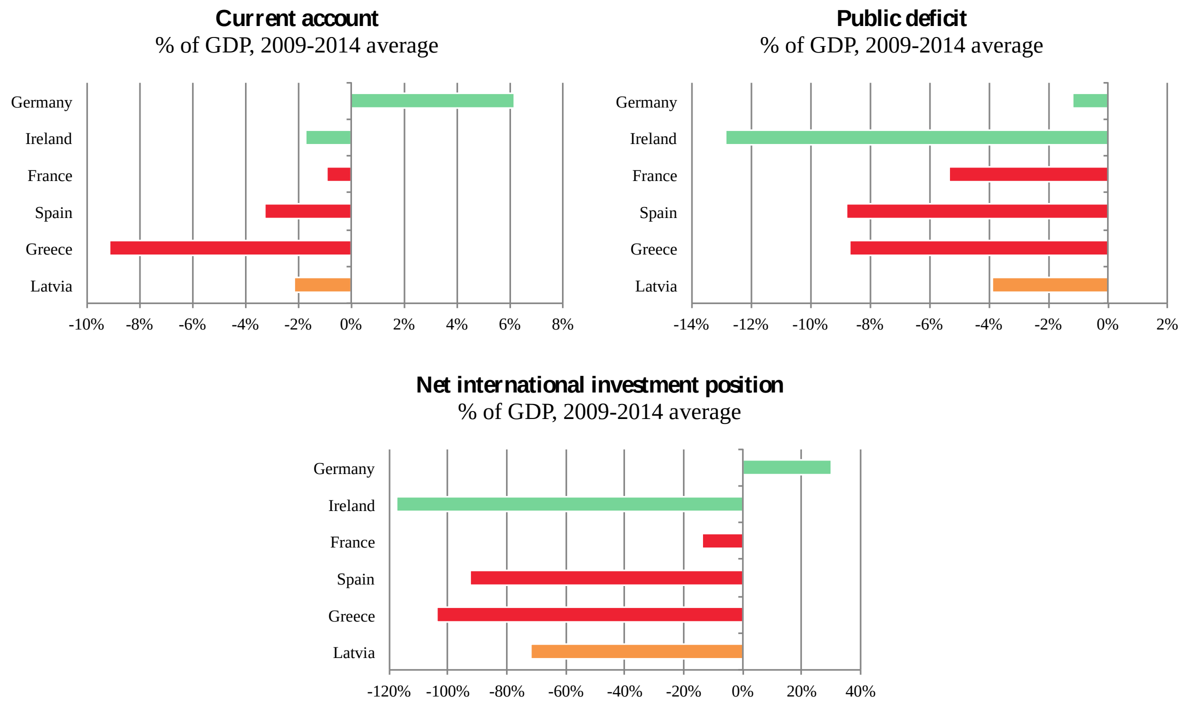
[39] See *3.2.1.2.* Labour Costs and Productivity for more details.
[40] Geeroms, H., Ide, S. and Naert, F., *The European Union and the Euro: How to Deal with a Currency Built on Dreams*, 2014, Intersentia.

The 2007 financial and ensuing Euro crises highlighted severe macroeconomic imbalances across the Euro Area (e.g., excessive public debt, current account disequilibria, excessive increase in ULCs, excessive unemployment, and so on), **which threatened the sustainability of the Euro** (**Figure 21**). Seven out of the nine Member States currently under the Excessive Deficit Procedure (EDP) belong to the Euro Area[41]; the EDP addresses excessive public deficit and debt levels to foster convergence among EU Member States. Such imbalances arise partly from non-compliance to the Maastricht criteria, notably in 2003 when France and Germany's public deficit exceeded the 3% of GDP threshold foreseen in these criteria.

Figure 21: *Macroeconomic imbalances in selected States of the Euro Area*



Sources: Eurostat

Despite the recent financial and economic crisis, the Euro remains attractive to the newest European Member States, as proven by the Latvian and Lithuanian examples; the two countries decided to join the Single currency respectively in 2014 and 2015. Indeed, the 19 Member States of the Euro Area benefited from the positive impact of the Single Currency on their economy, producing 72.6% of EU GDP, 77.6% of EU exports and 74.4% of EU imports in 2014 (**Figure 20**).

3.2.1.5. Quality of institutions

According to economic theory, 'institutions' as mentioned here are the economic, political, and social constraints that human beings impose on themselves. In particular, they define the business environment, i.e. the rules within which business is conducted and growth fostered, from regulatory frameworks and legal protection to political stability. High quality institutions allow for better management of ethnic diversity and conflicts, and more efficient economic and social policies.

[41] Cyprus, France, Greece, Ireland, Portugal, Slovenia, Spain.

Political stability and efficient policymaking create the necessary conditions for good education systems, adequate infrastructure, and political stability – that in return attract investment and stimulate long-term economic growth. The quality of institutions can be determined through different indicators, such as the risk of expropriation, the degree of corruption, the quality of administration, the security of property rights, or the strength of the rule of law.

As a whole, the European Union exhibits high institutional quality but these findings vary considerably across Member States, which questions their ability to generate growth in the long run (**Figure 22**). A report from the Dutch Rabobank analyses institutional quality in Europe over the 2010-2013 period.[42] The report focuses on the overall institutional strength of the Member States – including governance and ease of doing business, the level of legal protection, and the presence of corruption. The document highlights strong divergence in institutional quality across the European Union, calling for a more differentiated approach in governance. Please note that these five groups correlate very closely with the three groups described earlier as the basis for this Study. The detailed assessments are, as elsewhere, taken directly from the report cited. Similar results underpin the World Economic Forum estimations of global competitiveness.

Figure 22: *Institutional quality in the EU*

Nordic Member States
- Finland, Denmark, Sweden
- Ranked among the best worldwide

Western Member States
- The Netherlands, Luxembourg, Austria, Germany, the United Kingdom, Ireland, Belgium, France
- Achieve the second-highest level of institutional quality in Europe

Southern Member States
- Portugal, Cyprus, Spain, Italy, Greece, Malta
- Perform relatively strongly in terms of government effectiveness, but exhibit weak regulatory quality and an unstable political landscape

Central Eastern and Baltic Member States
- Estonia, Lithuania, Slovenia, Poland, Czech Republic, Latvia, Slovakia, Hungary
- Average performance in institutional quality, perform relatively well in political stability and ease of doing business, but corruption is high and regulatory quality mediocre

South Eastern Member States
- Croatia, Bulgaria, Romania
- Low levels of institutional quality due to weak legal protection and rule of law, poor control of corruption, low government effectiveness, and persistent political instability, but above world average performance in regulatory quality and ease of doing business

Source: Rabobank

The Euro crisis aggravated these disparities and led to an institutional deterioration between 2010 and 2013, triggered by higher corruption, weaker rule of law, and poor regulatory quality.

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[42] Briegel, F. and Bruinshoofd, A., *Institutional quality in Europe: diverging trends in challenging economic times*, Economic Report, 7 May 2015, Rabobank.

As highlighted in the report from the Dutch Rabobank, even Denmark and Sweden have exhibited a slight increase in corruption indices (albeit from a very low base). Austria, France, and Ireland suffered from an overall deteriorating institutional quality, despite the fact that indicators of legal protection and absence of corruption remained consistent after 2008. A slight deterioration in regulatory quality and rule of law occurred in Spain and Cyprus. Italy and Greece continue to suffer from widespread corruption, weak rule of law, and low government effectiveness, exacerbated by political instability. In contrast, Spain and Portugal have improved government effectiveness.

3.2.2. External factors

In a globalised world, the European Union, despite best efforts, cannot fully control every aspect of the economic environment in which it evolves. Such external factors impacting economic growth include – among others – trade, Foreign Direct Investment (FDI) and energy costs.

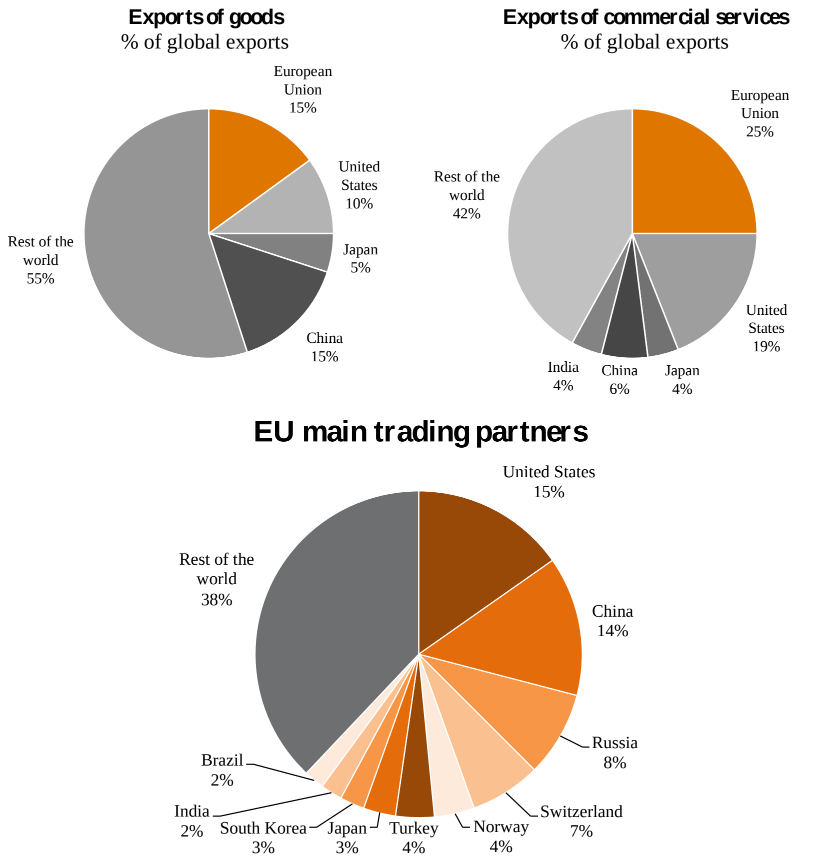
3.2.2.1. Trade

In a world of limited human, financial and natural resources, trade fosters an efficient allocation of assets across countries, i.e., specialisation. As countries specialise, they pool their limited resources to produce what they are more productive at and trade the products they want to consume. Efficiency gains translate into higher competitiveness for firms and higher incomes for workers, which fuel consumption and enhance growth.

Trade plays a central role in the European economy. Created in 1993, the Single Market guarantees the free movement of people, goods, services and capital between all 28 EU Member States. The rationale behind the Single Market was to promote intra-European trade, boost competition and competitiveness, make the EU more attractive for foreign investment, and create jobs. More than twenty years after its implementation, the Single Market accounted for a 2 to 3% increase in EU GDP since its creation[43] while intra-EU trade accounted for 65.5% of EU exports and 64.0% of EU imports in 2014.[44] The Single Market provided European companies with a larger market that allowed for economies of scale, which increase cost-efficiency across the European Union. The EU thus became the largest world trading power, producing 15% of exports of goods worldwide and 25% of global exports of commercial services in 2013 (**Figure 23**). Nonetheless, the creation of the Single Market entailed some costs: overregulation and an inefficient bureaucracy.

[43] Vetter, S., *The Single European Market 20 years on – Achievements, unfulfilled expectations & further potential*, EU Monitor European integration, 31 October 2013, DB Research.
[44] Source International Monetary Fund.

***Figure 23:** The major world trading powers in 2013*

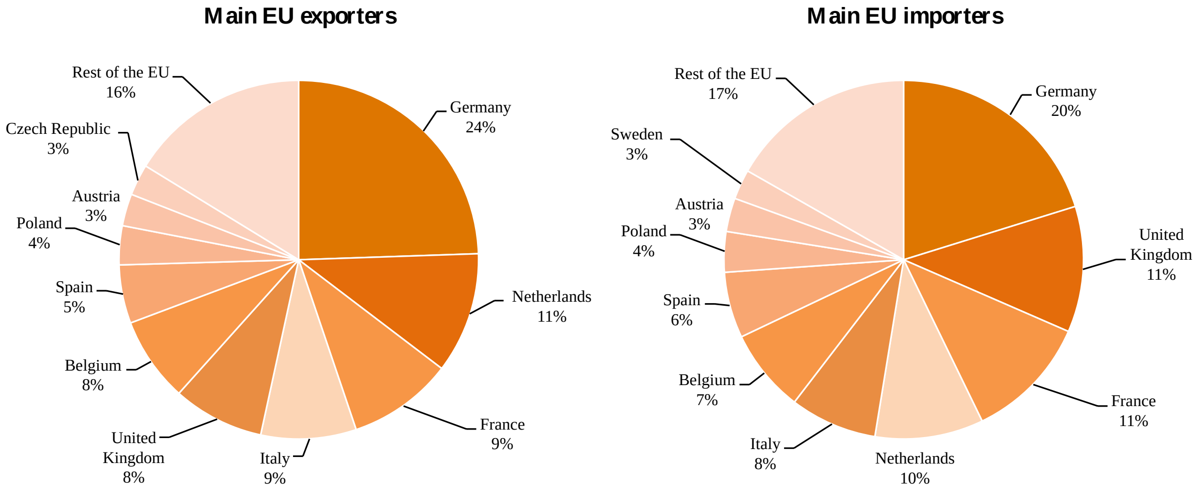


Source: European Commission

Extra-EU trade is an essential growth driver in the European Union that is stimulated by trade agreements. Trade agreements open new markets for goods and services, increase protection and opportunities for investment, reduce tariff and trade barriers, and create greater certainty for intellectual property rights, competition and public procurement. By 2012, the European Union had 28 Free Trade Agreements in force, accounting for two thirds of EU trade.[45] The European Commission is currently negotiating new agreements with – among others – India, the United States, Japan, the MERCOSUR[46], and the Association of South-East Asian Nations (ASEAN)[47]. The European Commission is also exploring new opportunities, notably with New Zealand.

[45] Source European Union.
[46] Argentina, Bolivia, Brazil, Paraguay, Uruguay, Venezuela.
[47] Indonesia, Malaysia, Philippines, Singapore, Thailand, Brunei, Cambodia, Laos, Myanmar (Burma), Vietnam.

***Figure 24:** Trade performance by Member States in 2014*



Source: Eurostat, European Commission

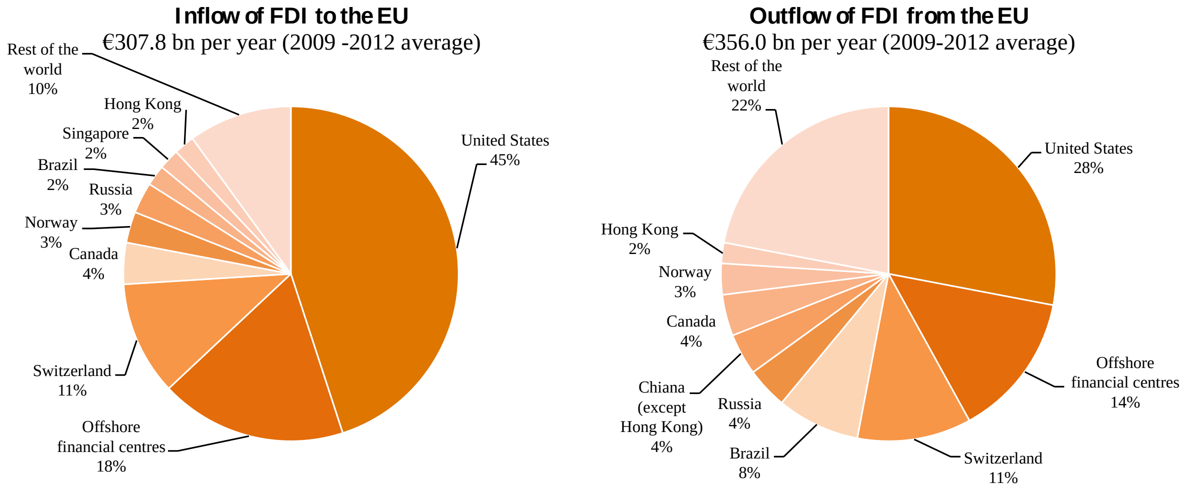
3.2.2.2. Foreign Direct Investment

Investment finances drivers of long-term growth – such as research and innovation, education, machinery and technologies – that fuel efficiency and competitiveness. Foreign Direct Investment (FDI)[48] compensates for weak local investment, in particularly in times of crisis. Incoming FDI injects the necessary liquidity to finance local projects while outbound FDI allows for the appropriation of new technologies. The ability to attract FDI is highly dependent on the ease of doing business in the destination country, the size of the destination market, the available resources – raw materials, technologies, know-how, and access to specific suppliers. Geographical proximity to a country with a large potential for FDI investment also plays a role.

The European Union has clearly lost its leading position as the world's most important recipient of FDI, accounting for less than 20% of global FDI inflows in the 2010s against 50% in the early 2000s while the BRICS countries[49] have more than doubled their global shares since 2007. [50] Overall, in 2012, FDI to the EU reached €3,905 billion, while €5,130 billion were secured in EU outbound FDI. [51] The geographical distribution of FDI flows to and from the EU confirm the strong commercial relationships with the United States and Switzerland, and highlights the challenge raised by fiscal optimisation practices, as offshore financial centres[52] gather 18% of FDI inflows to and 14% of FDI outflows from the EU (**Figure 25**).

[48] FDIs are business investments aiming at long-term relationship where a company based in one country invests into an entity based in another country. In practice, the investing firm sets up a subsidiary or an associate company in the foreign country by means of greenfield investments (i.e., the establishment of an entirely new firm in a foreign country), shares acquisition of an overseas company, or mergers and joint ventures.
[49] Brazil, Russia, India, China, South Africa.
[50] Source Deutsch Bank.
[51] Source Eurostat.
[52] Such as Andorra, the Bahamas, or Liechtenstein.

Figure 25: Geographical origin and destination of EU FDI

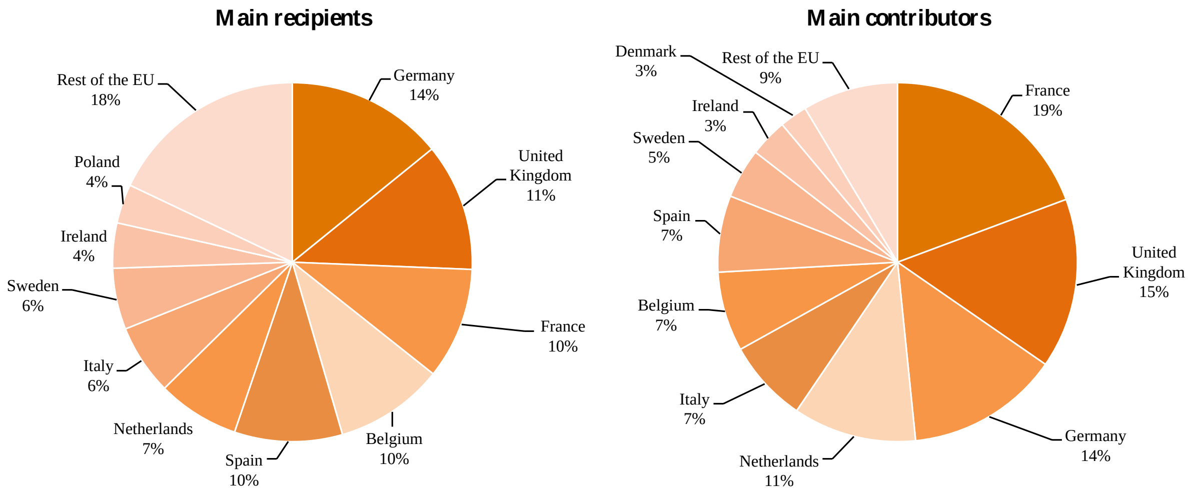


Offshore financial centres offer little or no government interference in legitimate business and financial activities. They often offer very low or zero tax rates, and provide excellent communications facilities.

Source: European Commission, Eurostat

The creation of the Single Market has strongly supported intra-EU FDI, which accounted for 61.3% of total FDI inflow to the European Union in 2012 and €303.6 bn per year on average between 2009 and 2012.[53] Main recipients include Germany, the United Kingdom, Belgium, and Spain (**Figure 26**). These findings highlight strong dynamics for EU integration, but limited input of alternative sources of financing in a gloomy economic recovery. The interdependency of the EU and the US in this and in other areas is obvious.

Figure 26: Main recipients and contributors of intra-EU FDI in 2011



Source: Eurostat

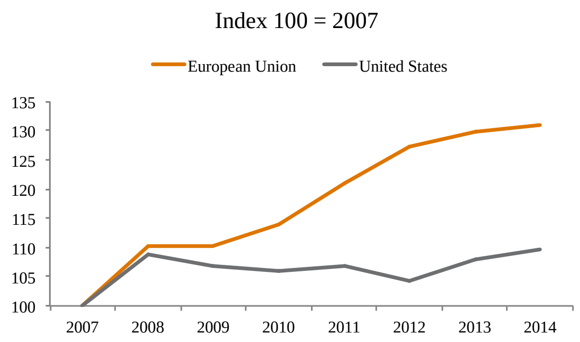
[53] Source Eurostat.

Measures taken at EU level to attract FDI include the upcoming completion of the Banking Union and the creation of a Capital Markets Union, the Juncker Investment Plan that aims to restore growth in the European Union, and social policies to address high unemployment.

3.2.2.3. Energy

Energy is an input factor to nearly all manufactured goods and services in the economy, making reliable access to affordable energy sources essential for growth. In the United States, the discovery of shale gas has led to a 10% reduction in the cost of electricity, translating into a 1.1% increase in GDP in 2013.[54] However, the European Union suffers from high energy costs compared to its main competitors (**Figure 27**): wholesale electricity prices were 30% higher in Europe than in the United States in 2014, reaching up to 100% higher for wholesale gas prices.[55] Furthermore, the EU needs to invest over €1 trillion in the energy sector by 2020 to address infrastructure shortcomings.[56]

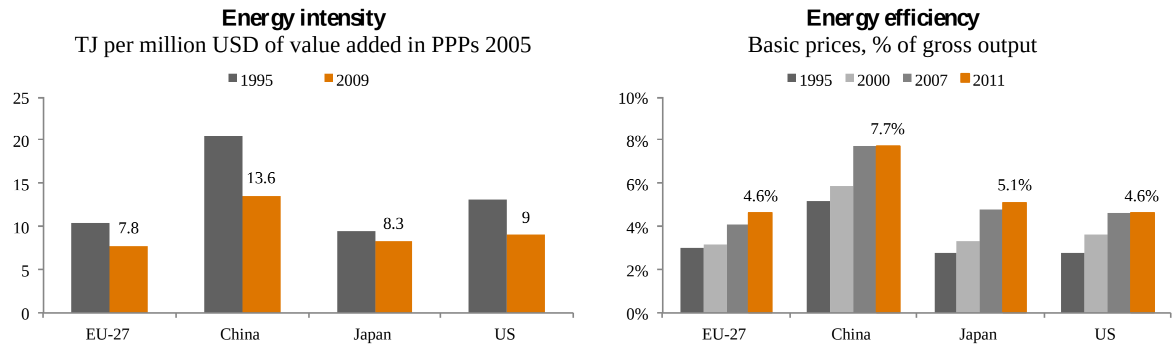
***Figure 27:** Evolution of energy prices for industrial consumers in the EU and the US*



Source: [Eurostat](), [US Energy Information Administration]()

To mitigate the negative impact of energy prices on growth, EU industry adapted its production processes to consume less energy. Consequently, EU industry is less intensive in energy than its counterparts worldwide (**Figure 28**). Similarly, EU service industry exhibits higher levels of energy efficiency.

***Figure 28:** Energy intensity and energy efficiency in the EU*



Source: European Commission

[54] Source World Economic Forum.
[55] Source European Commission.
[56] Source European Commission.

3.2.3. Expanded SWOT analysis of the European Union

Figure 29: *SWOT analysis of the European Union*

STRENGTHS

- An integrated Single Market, stimulating trade and intra-EU Foreign Direct Investment (FDI)
- The euro as an international reserve currency
- High overall institutional quality
- High GDP per capita allowing high competitiveness to be maintained
- The world largest trading power
- More than 500 million consumers
- Energy efficient economy

WEAKNESSES

- Diverging quality in education systems and lack of lifelong learning across Member States
- Brain drain and skill mismatches
- Inability to deal with the incoming refugees issue
- Inadequate management processes and national commitment to the euro
- Increasing inequality within and among Member States
- Inconsistent and generally weak response to Russia and opportunistic military aggression

OPPORTUNITIES

- The Silver Economy
- The migration crisis
- Political will to address the shortcomings of Euro governance
- Increasing role of the Euro in international exchanges
- New free trade agreements under negotiations
- Energy efficiency and renewable energies

THREATS

- Increasing divergence across Member States
- Weak competitiveness in the world market
- Ageing population
- Popular mistrust in the European political, economic and social model
- Potential separation by Member States (Grexit/Brexit) or by smaller countries or regions (Scotland, Catalonia)

4. Reform implementation in the European Union

4. Reform implementation in the European Union

Structural reforms are key to addressing threats to growth in the European Union. However, the ability to implement structural changes varies across Member States, which gives legitimacy to the European Union to act as a single political actor and a coordinating authority.

4.1. The European Union as a single political actor and coordinating authority

4.1.1. The prerogatives of the European Union

In a period such as this one of economic and financial turmoil, the European Union can act as a political actor and coordinating authority to implement growth-enhancing reforms across Member States. The ability of the EU to do so is, as ever, ruled by the European Treaties.

- *The Treaty on the European Union* establishes in its Article 5 that the exercise of Union competences is subject to the three main principles of conferral, subsidiarity and proportionality.[57, 58]
- *The Treaty on the Functioning of the European Union* defines the division of competences between the European Union and the Member States (**Table 1**).[59] The Treaty distinguishes three types of competences of the European Union: exclusive, shared and supporting competences.

Table 1: *Competences of the European Union*

Competence	Main fields	Ability of the EU to easily introduce changes
Exclusive	▸ Common Commercial Policy ▸ Competition Rules ▸ Customs Union	✓ The EU is able to legislate alone and adopt binding acts for these specific fields
Shared	▸ Area of freedom, security and justice ▸ Economic, Social and Territorial cohesion ▸ Energy ▸ Environment ▸ Internal Market ▸ Trans-European networks ▸ Transports	× Both the EU and the Member States can adopt binding acts × The EU needs a Qualified Majority Voting to introduce changes for these specific fields
Supporting	▸ Administrative cooperation ▸ Education ▸ Vocational training ▸ Youth	× The EU only supplements, supports, or coordinates the actions taken by the Member States

[57] The *principle of conferral* provides that the competences not conferred to the European Union in EU Treaties remain with the Member States.
The *principle of subsidiarity* provides that in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action could be better achieved at Union level rather than at regional or national level.
The *principle of proportionality* provides that the exercise of EU competences may not exceed what is necessary to achieve the objectives of the Treaties.
[58] European Union, Treaty on the European Union, 30 March 2010.
[59] European Union, Treaty on the Functioning of the European Union, 30 March 2010.

The European legislative process and its voting system heavily influence the ability of the European Union to act as a coordinating authority. The EU faces a complex voting system – in which decisions are adopted through simple majority, qualified majority, or unanimity[60] – which deters fast adjustments at EU level to address economic and political challenges. Such shortcomings raise the question of possible solutions to address this dysfunction (**Table 2**).

Table 2: *Possible alternatives to improve EU legislative processes*

Alternative	Implications	Decision making
Existing framework	‣ Use existing provisions of the EU treaties	• Qualified Majority Voting
Enhanced cooperation	‣ Deepen cooperation between some Member States while leaving the door open to others ‣ Member States to join them at a later stage	• At least 9 Member States are required for the procedure • Qualified Majority Voting
Modification of the Treaties	‣ Increase or decrease EU competences (ordinary revision procedure) ‣ Only for internal policies and action of the EU (simplified revision procedure)	• Unanimity
Passerelle clause	‣ Change from special legislative procedure to ordinary legislative procedure ‣ Change from voting by unanimity to voting by qualified majority	• Unanimity

The Euro and Migration Crises shed light on the limits of the existing EU legislative framework. The former highlighted the weak monitoring of budgetary imbalances at EU level, which generated economic and financial turmoil throughout the EU, while the Macroeconomic Imbalance Procedure proved to be an overly complex mechanism. The latter contributed to the difficulties of coordinating Member States' actions to adopt timely and satisfactory solutions to the challenges posed by the vast wave of migrants wanting access to the EU. The failure to resolve these two problems has led to a decline in public and political support for the EU – and hence a further decline in its ability to bring about mutually acceptable solutions.

Qualified majority voting has proven to be barely adequate to address such challenges, calling for other alternatives that might improve the adaptability of the legislative process at EU level:

- *The enhanced cooperation mechanism* aims to strengthen the integration progress within the EU and to overcome political vetoes by Member States; the procedure has notably been used to create a unitary patent system and to facilitate divorce processes for transnational couples. Nonetheless, this procedure cannot constitute a temporary solution to speed up EU response to sudden events, as it can neither affect EU exclusive competences, nor the Member States that decided not to participate in it, and requires qualified majority voting to enter into force.
- *The modification of the existing Treaties* allows for major revisions of EU and Member States competences through the ordinary revision procedure or the simplified revision procedure.[61] However, the introduction of possible modifications to the Treaties is deterred

[60] The *simple majority rule* is only used for non-legislative votes, such as procedural matters or to request the Commission to undertake studies or to submit proposals.
The *qualified majority rule* is reached if two conditions are met: at least 55% of the Member States vote in favour and they at least represent 65% of the total EU population.
The *unanimity rule* is used for the matters considered as sensitive by the Member States.
[61] *The ordinary revision procedure* serves either to increase or to reduce the competences conferred to the EU.

by the need for unanimity between all the Member States, since it can affect national prerogatives.

- *The passerelle clause* hastens the legislative process by simplifying the decision-making process.[62] However, the use of this procedure requires unanimous approval by Member States to be activated, which in the end deters possible fast decision-making.

The European Union needs to take into account these struggles to quickly address political and economic challenges in the coming years. The implementation of alternative solutions – such as the promotion of non-legislative tools that are less constrained by law-making requirements – should therefore become a priority. Focusing on the needs of specific Member States, or ideally of groups of states as indicated in this Study, could become a more useful approach than 'one-size-fits-all' on all topics affecting economic growth and social cohesion.

This new principle of differentiation could constitute a useful basis for the European Union since it would act as a facilitator to promote best practices with a differentiated approach depending on the different competitiveness patterns by Member States.

4.1.2. Growth-enhancing policies in the European Union

Despite the above limitations, the European Union has used its prerogatives throughout the recent crises to try to put a halt to economic turmoil and sluggish growth. It has identified priorities for policy action and key policy areas to restore growth. Unfortunately, these initiatives are barely reported outside Brussels, and it is unclear to what extent national governments (or opposition parties seeking power) are aware of the resources available to them, or the external obligations already incurred, through these processes.

4.1.2.1. Priorities for policy action

The Euro crisis[63] triggered a political will to improve the governance of the European Union as a whole, as well as of the Euro Area, leading to the creation of the European Semester. The European Semester is an annual cycle of non-binding economic policy guidance and prior surveillance of macroeconomic developments to coordinate policy reforms across Member States.[64] It ensures greater consistency throughout the EU to achieve a balanced economic recovery, in which positive spillovers are maximised and negative ones minimised.

The Annual Growth Survey (AGS) **is the starting point of this annual governance cycle**, in which the European Commission defines a series of economic and social recommendations. In its 2016 edition, the Commission stressed that the EU economy experienced in 2015 the first benefits of the

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The simplified revision procedure cannot increase the competences conferred to the EU. It could only affect Part Three of the TFEU, i.e., the internal policies and action of the EU.
Both procedures need the ratification of all Member States according to their national ratification procedures.

[62] The Passerelle clause provides for the derogation of the legislative procedures initially provided for by the Treaties under certain circumstances. It allows switching from special legislative procedure to ordinary legislative procedure, and from voting by unanimity to voting by qualified majority.

[63] See Lighthouse Europe, *Key Factors Affecting the Future Growth of Europe*, prepared for EESC, 2015 for further details.

[64] During the year, the European Commission publishes Annual Growth Surveys, Alert Mechanisms Reports, In-Depth Reviews of countries with potential macroeconomic imbalances, and Country-Specific Recommendations.

reforms implemented over previous years.[65] However, it acknowledged that *"even though convergence has restarted, the performance of Member States varies significantly in some areas that are crucial for productivity and convergence"*.[66] The policy priorities set by the 2016 AGS reflected this concern:

- *Re-launching of investment*,
- *Pursuance of structural reforms* to modernise the economies of the Member States,
- *Conduct responsible fiscal policies*,
- *Stimulation of employment and social cohesion*,
- *Exchange of best practices across policy areas* to provide common standards to ensure convergence.

As regards the Euro, the 5 Presidents' Report[67] pointed out how Euro Area countries are dependent on each other to achieve growth. Published in June 2015, the document presents a three-step roadmap to complete European Economic and Monetary Union (EMU). Stage 1 should be completed by 30 June 2017 to boost competitiveness and structural convergence within the European Union. Stage 2 would formalise the convergence process and provide a legal set of common agreed standards, making the process more binding for Member States. The final Stage – to take place by 2024 at the latest – should put in place *"a deep and genuine EMU"*.

4.1.2.2. The Juncker Plan

The European Union has adopted a number of horizontal measures to reactivate growth within the EU, under the general heading of the 'Juncker Plan'. This 'Investment Plan for Europe'[68] addresses investment gaps that threaten long-term growth in the EU. The European Union thereby acts as a financial leverage actor assisting the development of specific strategic actions. The Juncker Plan aims to mobilise at least €315 billion in additional financing.

The Investment Plan for Europe targets three priority areas:

- *The mobilisation of public and private financial resources* through the creation of a European Fund for Strategic Investments (EFSI) to provide the necessary funding for strategic investments in energy, transport, broadband, education, and research and innovation. The EFSI also targets SMEs and Midcap companies.
- *The provision of technical assistance to viable projects* through the European Investment Advisory Hub (EIAH) and the European Investment Project Portal (EIPP). The EIAH provides access to advisory and technical assistance to address the main financial and non-financial obstacles deterring investment. The EIPP connects investors with investment projects.[69]
- *The removal of barriers* deterring investment to foster innovation and R&D. These actions go in line with the development of a Digital Single Market, an Energy Union and a Capital Markets Union.

[65] European Commission, *Annual Growth Survey, Strengthening the recovery and fostering convergence,* 26 November 2015, COM(2015) 690 final.
[66] *Ibid.*
[67] European Commission, *Completing Europe's Economic and Monetary Union*, 22 June 2015.
[68] The investment plan for Europe, also known as 'Juncker Plan' was launched in November 2014 by the European Commission.
[69] As of January 2016, the EIPP was in a pre-launch phase.

4.1.2.3. Individual policy areas

Alongside defining general economic and social priorities, the European Union adopts specific plans for individual policy areas.

Concerning Labour Markets, the European Union only acts as a coordinating authority, the responsibility for employment and social policies lying primarily with the Member States. Nonetheless, the European Union provides funds to complement such policies. It also has the power to adopt laws regulating workers' rights, and the coordination of social national security and inclusion schemes.

- *The European Platform against poverty and social exclusion* completes the scheme and lies between the seven flagship initiatives of the Europe 2020 Strategy; it was conceived to help EU countries reach the headline target of pulling 20 million people out of poverty and social exclusion. However, since the introduction in 2010 of the Europe 2020 Strategy, the number of people at risk of poverty or social exclusion has grown by 3.59%, representing 122,253 people in 2014 compared to 118,008 in 2010.[70]
- *The 2015 Joint Employment Report* (JER) *also includes recommendations that go in line with the employment guidelines for 2015 published by the Council of the EU*, which seek to enhance the functioning of the European labour markets.

Concerning productivity, the World Economic Forum highlighted the existing productivity gap between the European Union and the United States.[71] The crisis contributed to widening this gap, which led to 20% lower productivity in Europe than in the United States in 2014. The Report mentions as factors conducive to increasing this gap the existence of a more cumbersome regulation, lower investments in communication technologies, or other intangible factors, such as human capital and R&D.

The European Commission also pointed out in 2010[72] **the productivity gap faced by the EU** compared to its main trading partners, due to a less business-friendly business environment.

- *The Europe 2020 Strategy* consequently identified five targets to turn the EU into a smart, competitive playing field delivering higher productivity levels.
- The flagship initiatives of *the "Agenda for new skills and jobs"* further promoted a healthier ageing population to allow higher productivity levels at all ages.
- The various initiatives taken by the European Commission – such as the launch of the Juncker Plan and its commitment to limiting excessive regulation – should ease the overall business environment in Europe, but further effort will be required from Member States

The European Union aims to develop well-functioning product markets that enable higher economic growth and better quality jobs, as highlighted by the European Commission's Directorate

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[70] Source Eurostat.
[71] World Economic Forum, The Europe 2020 Competitiveness Report, Building a More Competitive Europe, 2014, WEF.
[72] European Commission, *Communication from the Commission – Europe 2020 – A strategy for smart, sustainable and inclusive growth,* 3 March 2010, COM(2010) 2020 final.

General for Economic and Financial Affairs in June 2014.[73] Structural reforms targeting product markets reduce regulatory requirements, which in turn supports a better and more efficient allocation of resources within and across sectors. They also enable a higher degree of competition, as well as decreasing the costs borne by the consumers.

As regards investment, the 2007 and ensuing Euro crises called for better governance of financial markets to attract investment and avoid deflation[74]. The European Union focused its actions on the creation of a Banking Union and a Capital Market Union, as well as easing financial conditions.

- *The Banking Union should provide the EU banking sector with further financial backstops.* It relies on three complementary arms: (i) a Single Rulebook to regulate, supervise and govern the financial sector, (ii) a Single Supervisory Mechanism to control significant banks while national authorities supervise smaller establishments, and (ii) a Single Resolution Mechanism, which ensures an orderly wind-down of troubled banks at European level. The creation of a Banking Union is a step in the right direction if fully implemented, which still remains a challenge.
- Presented in September 2015, the *'Action Plan on building a Capital Market Union (CMU)'* aims to achieve a truly integrated Single Market for capital. A CMU would harmonise rules across Member States to further integrate capital markets[75] and expand non-banking financial markets in an adequate regulatory framework. The road to the completion of the CMU remains long, but this scheme should offer proper mechanisms to offset the excessive reliance on the banking sector for financing in Europe.
- *The European Central Bank (ECB) has eased financing conditions since the beginning of the financial crisis to stimulate investment* through drastically lowered interest rates, increased duration of loans[76], and massive purchases of public and private debt securities on the secondary market in times of financial distress.[77] [78] It also launched a €1.1 trillion Quantitative Easing (QE) programme[79] to stimulate inflation in Euro Area Member States with sound economic fundamentals in January 2015.

To address the shortcomings of its energy policy, the European Commission launched in February 2015 its Energy Union Strategy. The Energy Union is intended to (i) ensure energy supply security, (ii) achieve a fully-integrated Internal Energy Market, (iii) improve energy efficiency, (iv) encourage the reduction of greenhouse emissions, and (v) support research and innovation in low-carbon technologies. The effective completion of the Energy Union should benefit EU competitiveness, but strong political leadership will be required to achieve this project.

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[73] European Commission, *The Role of Structural Reform for Adjustment and Growth*, June 2014, ECFIN Economic Briefs Issue 34.
[74] Deflation is a general decline in prices, which can create a vicious spiral of reduced consumption and investment – and eventually lowers growth rates.
[75] Capital markets gather all financial markets that are not about bank intermediation (e.g., bonds markets, sovereign debt markets).
[76] The so-called 'Longer-Term Refinancing Operations' (LTRO), 'Very Longer-Term Refinancing Operations' (VLTRO) and 'Targeted Longer-Term Refinancing Operations' (TLTRO).
[77] The so-called 'Securities Market Programme' (SMP) and 'Outright Monetary Transactions' (OMT).
[78] Debt securities are traded in two types of market: the primary market where the buyer directly buys the securities from the issuer, and the secondary market where buyers exchange privately securities. The ECB has for a long time limited its purchase operations to the secondary market to avoid direct financing of public debt.
[79] The 'Public Sector Purchase Programme' (PSPP).

Concerning education, the European Union only has the competence to supplement, support, or coordinate the actions taken by the Member States. The EU adopted in 2009 its Strategic Framework on Education & Training 2020 (ET 2020) for cooperation in education policies, which includes exchanges of best practices, mutual learning, and support for policy reforms. This Strategy has been updated in September 2015[80] to focus on six new priorities:

- Relevant and high-quality *skills and competences*,
- *Inclusive education*, equality, non-discrimination, civic competences,
- *Open and innovative* education and training,
- Strong support for *educators*,
- *Transparency and recognition* of skills and qualifications,
- *Sustainable investment*, performance and efficiency of education and training systems.

Preliminary data suggest a positive impact of the ET2020, with the share of early school leavers falling from 13.9% in 2010 to 11.2% in 2014[81] and tertiary education attainment improving from 33.8% in 2010 to 37.9% in 2014[82].

Regarding R&D, the European Union launched in 2010 the Innovation Union to boost the EU's research and innovation performance. The Innovation Union is one of the seven flagship initiatives of Europe 2020 that aims to invest 3% of the EU's GDP in R&D by 2020.

- It included, among other principal proposals, the introduction of a *European Innovation Partnership* to bring together actors at EU, national, and regional levels and to combine supply and demand-side tools for innovation.
- The Innovation Union also put in place a *strategic use of public procurement budgets* to finance innovation, a comprehensive *Innovation Scoreboard* using 25 indicators, and a *European knowledge market for patents and licensing*.
- However, gross expenditure on R&D remained at the level of 2.03% of EU GDP in 2014[83], below the 3% target, which calls into question the efficiency of EU policies on the matter.

EU economic governance includes the avoidance of excessive public deficit, as mentioned in Article 126 of the Treaty on the Functioning of the European Union (TFEU).

- *The Stability and Growth Pact* further defines thresholds for headline deficit and public debt to respectively 3% and 60% of GDP. If a Member State were to breach either the deficit or the debt criterion, the European Commission would have the ability to launch an Excessive Deficit Procedure (EDP) which subjects the given Member State to extra monitoring and sets up a deadline to address such excessive public debt. Nine Member States[84] are currently, in 2015, under the Excessive Deficit Procedure (EDP).[85]
- *The Fiscal Compact – also named as Treaty on Stability, Cooperation and Governance (TSCG)* – further committed Euro Area and other Member States[86] to balanced public budgets by triggering automatically the correction mechanism of the Stability and Growth

[80] European Commission, *2015 Joint Report of the Council and the Commission on the implementation of the strategic framework for European cooperation in education and training (ET 2020), New priorities for European cooperation in education and training*, 12 December 2015, 2015/C 417/04.
[81] Source Eurostat.
[82] Source Eurostat.
[83] Source Eurostat.
[84] Croatia, Cyprus, France, Greece, Ireland, Portugal, Slovenia, Spain, United Kingdom.
[85] Further details on the matter for the nine selected Member States are provided in Sections 5 and 7.
[86] Only Croatia, Czech Republic, and the United Kingdom did not sign the TSCG.

Pact when structural deficit exceed 0.5% of GDP.[87] An observed deviation from this adjustment path triggers automatically a correction mechanism that includes the obligation to adopt the necessary measures to correct this deviation over a given period of time.

As regard pensions, the European Institutions are aware of the issue of long-term sustainability, as underlined by the 5 Presidents' Report, the European Commission's White Paper on Pensions[88] and the Growth Annual Survey for 2016. Recommendations include the alignment of retirement age with life expectancy and adapting social protection models to demographic changes.

The European Union has a very active role with regard to the trade policy area, as enforcement of trade policy is a part of the common commercial policy for which the EU holds an exclusive competence. The European Commission negotiates on behalf of the Member States – notably in the framework of the World Trade Organisation – and is the only body able to conclude bilateral trade agreements with non-EU partners. The Institution presented in October 2015 its new strategy 'Trade for All' to adapt EU trade policy to the new realities that the European Union has to embrace.[89] The document advocates enhanced transparency for trade agreements through the publication of key negotiations, and the safeguard of high standard levels of regulatory protection. These efforts should prove efficient to support EU exports, but will require long negotiation processes to be effective.

Finally, for reform implementation, the Juncker European Commission took strong steps to improve institutional quality, making Better Regulation one of its priorities. Adopted in May 2015, the Better Regulation Agenda aims to improve policy design in the EU through (i) enhanced transparency when preparing, implementing, and reviewing policy, (ii) reliance on data and evidence, and (iii) the early involvement of stakeholders. Thereby, the Juncker Commission pledged to improve the efficiency and effectiveness of EU policies by identifying and removing red tape both at European and national levels. Although the aim is good, actual performance will need to be closely observed, as deregulation at either EU or national level tends to be weak or non-existent in practice. It also still retains the notions that the fundamental role of civil servants anywhere is to regulate, not to educate, prepare or facilitate, and that, in regulatory terms, one size fits all.

4.2. Review of existing policy recommendations

Various entities – such as international and business organisations and think tanks – **regularly analyse economic and political development at national and regional levels to elaborate targeted policy recommendations to foster sustainable growth** (**Table 3**). Section 4.2 explores such recommendations by focusing on most recent suggestions formulated by:

- *The European institutions,*
- *The Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF),* amongst the most prominent international organisations that provide policy recommendations.

[87] Flexibility up to a structural deficit of 1% of GDP is allowed for Member States with a public debt ratio is well below 60% of GDP.
[88] European Commission, *White Paper on an Agenda for Adequate, Safe and Sustainable Pensions*, 16 February 2012, SWD(2012) 7 and 8 final.
[89] European Commission, *Trade for All, Towards a more responsible trade and investment policy*, October 2015, Directorate-General for Trade.

Table 3: Recommended policy action by International Organisations

Policy Field	European institutions	International organisations	
		OECD	*IMF*
Structural reforms	- Labour market (job creation) - Productivity - Product markets	- Labour market - Productivity - Product markets (Competition)	- Labour market - Productivity - Product markets
Investment	- Energy, Transport, Digital infrastructure - Education - Innovation and R&D	- Education and training - Innovation policies	- Infrastructure
Fiscal consolidation	- Improving Public Finances - Reforming Pension Systems	- Tax reforms - Unemployment benefits reforms - Social protection reform	- To be growth friendly - To take a neutral stance allowing for recovery and long-term growth (balanced deficit)
Trade	-	- Trade	-
Monetary and Financial	- Accommodative Monetary Stance - Banking Union and Capital Market Union	-	- Accommodative Monetary Stance

Policy Field	Business organisations		
	Business Europe	*EuroChambers*	*AmCham EU*
Structural reforms	- Labour market - Strengthening flexicurity - Strengthening productivity	- Labour market (employment)	-
Investment	- Energy, Transport, Digital infrastructure - Education and training - Build a culture of innovation	- Energy infrastructure - Education and Training - Innovation	- Energy, Transport, Digital infrastructure
Fiscal consolidation	- To be growth friendly - To take a neutral stance allowing for recovery and long-term growth (balanced deficit)	- To be growth friendly - To take a neutral stance allowing for recovery and long-term growth (balanced deficit)	- Improving public finances - Reforming pension and benefit systems
Trade	- International markets (Transatlantic Trade and Investment Partnership, TTIP) - Fully implementing Single Market - Improve access to finance	- Correctly implementing the Single Market - Including a SME chapters in Free Trade Agreements - Improve access to finance	-
Monetary and Financial	- Banking Union - Balanced prudential regulation - Smooth functioning of the EMU (deficit reduction)	-	- Reform of financial markets and products - EMU Reform and Banking Union - Transatlantic Convergence and Extraterritoriality of Financial Services Regulation

Policy Field	Think tanks		
	Bruegel	*CEPS*	*EPC*
Structural reforms	- Labour market (unemployment) - Social policies	-	- Labour market (unemployment) - Productivity-enhancing structural reforms in weaker Member States
Investment	- Public in infrastructure investment if fiscal space	- Increasing infrastructure investment in specific Member States, but not applicable to entire EU	- Energy, Transport, Digital infrastructure - Education - Innovation and R&D
Fiscal consolidation	- Improving Public Finances - Reforming Pension Systems - Fair burden sharing between rich and poor	-	- Strengthen public finances - Creating fiscal capacity (for investment) - Stronger conditionality to establish trust between Member States
Trade	-	- Stimulate capital markets and improve access to finance for companies	- Demand stimulus and export surplus - Completing internal market - IPR and bringing innovation to market
Monetary and Financial	-	- Implementing Banking Union - Improve Banking Supervision - Continued global regulatory coordination	-

Sources: European Commission, OECD, IMF, Business Europe, EuroChambers, AmCham EU, Bruegel, CEPS, ECP

- *Business Europe, EuroChambres, EuroCommerce, and UEAPME*[90], the four main European business organisations.
- *The Centre for European Policy Studies (CEPS), Bruegel, and the European Policy Centre (EPC)*, think tanks that provide further highlights on growth-enhancing reforms.

The content of such recommendations of course overlaps to some extent in terms of scope and depth. Nonetheless, repeated emphasis and occasional controversy on recommended policy action, spurs the political and public debate. While policy-makers remain free to choose whose advice to take on board, the opinions and recommendations by these organisations should clearly serve as a basis for new policy direction and eventual action.

4.2.1. European institutions

Following the economic crisis, the European Council decided in 2010 to establish the European Semester to help reform the EU's economic governance. Within this framework, the European Commission uses an Annual Growth Survey (AGS) that sets out general economic priorities for the EU and analyses the EU's advancement in achieving its strategic priorities. Furthermore, the European Commission assesses the implementation of economic reforms at Member State level, and presents proposals for Country-Specific Recommendations (CSRs) to be adopted by the EU Council, with regard to relevant resolutions of the European Parliament.

In particular, **the European Commission recommends these simultaneous actions** to restore growth across Europe in its 2015 AGS[91]:

- *Increase investment* to address the 15% fall in investment compared to its peak before the crisis in 2007. The Investment Plan for Europe presented by Commission President Jean-Claude Juncker is expected to mobilise €315 billion in public and private investment over the period 2015-2017.
- *Implement structural reforms* at both the EU and national levels focusing on sectors such as services, energy, telecommunications, and the digital economy. The Institution argues that the Single Market needs to be completed and that reforms of national product, services and labour markets are necessary.
- *Improve fiscal responsibility* so that Member States secure long-term control over their debt levels and pursue differentiated policies according to their national needs. Member States with fiscal space are encouraged to support investment and domestic demand.
- *Strengthen coordination efforts between Member States* to promote jobs, growth and investment by reinforcing the European Semester.

[90] Business Europe represents businesses across the EU. EuroChambres gathers national associations of chambers of commerce and industry. EuroCommerce protects the interests of retail, wholesale, and other trading companies. UEAPME advocates for European Small and Medium Enterprises.
[91] European Commission, *Annual Growth Survey 2015*, 28 November 2014, COM(2014) 902 final.

4.2.2. International organisations

The Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF) are among the most prominent international organisations that provide policy recommendations.

4.2.2.1. Organisation for Economic Co-operation and Development

The Organisation for Economic Co-operation and Development (OECD) **identifies adequate investment, structural reforms and fiscal policy as key to boosting competitiveness and growth in Europe.**[92] Additionally, it also highlights the importance of revitalising trade and using an effective monetary policy.

- *Regarding investment*, the emphasis is on removing unnecessary restrictions on investment flows, notably through the creation of a European Capital Market and supporting investment in green infrastructure. Public investment should focus on projects with high impact and returns, notably infrastructure, while structural reforms should stimulate private investment.
- *Quantitative Easing is considered as an option* when sustained low interest rates have not had the desired effect.
- *The Organisation also advocates the use of a tax-shift* to relieve low-wage workers while imposing more indirect taxes to boost activity and employment.
- *Trade should be enhanced* by fostering competition and facilitating technology transfer, liberalising the service sectors, increasing the harmonisation of regulation, improving access to finance, and reviewing bankruptcy laws to encourage entrepreneurship.

The OECD expects these reforms to increase GDP by 2.5 to 5% in major European economies over a period of five years.

4.2.2.2. International Monetary Fund

The International Monetary Fund (IMF) **recommends that the European Union should simplify its fiscal governance system** to bring about automatic enforcement procedures, more credible sanctions, and improved coordination of fiscal policy.[93] The IMF also advises advanced economies to maintain their supportive policies, including investment in infrastructure and growth friendly fiscal policies.[94]

Structural reform is seen as key to raise potential output. According to the IMF, labour participation, the removal of obstacles to employment, and an improved functioning of product markets, need to be promoted in Euro Area countries.

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[92] OECD, *Escaping the Stagnation Trap: Policy Options for the Euro Area and Japan*, January 2015, OECD Publishing.
OECD, *Structural reforms in Europe Achievements and Homework*, April 2015, OECD Publishing.
[93] Andrle M., et. al., *Reforming Fiscal Governance in the European Union*, IMF Staff Discussion Note, May 2015, IMF Publishing.
[94] IMF, *Global Prospects and Policy Challenges - G-20 Finance Ministers and Central Bank Governors Meeting*, 9–10 February 2015, Istanbul, Turkey. Prepared by Staff of the IMF.

As inflation might continue to decline in the Euro Area, **the IMF advocates sustained monetary accommodation** and welcomes the European Central Bank's (ECB) asset purchasing programme (Quantitative Easing).

4.2.3. Business Organisations

The four main European business organisations – Business Europe, EuroChambres, EuroCommerce, UEAPME[95] – published a common position paper in September 2014 that called for action to improve competitiveness, which is key to jobs and growth.[96] They identified eight important elements:

- *Structural reforms* following a market-based approach, including monitoring mechanisms to observe policy implementation and effectiveness.
- *Better regulation*, including the creation of an impact assessment body that would provide reliable information about the effectiveness and cost-benefit advantages of policy proposals.
- *Private investment*, notably in education and vocational training, as the only solution to ensure growth.
- *Skills and modernisation of labour markets*, with a greater variety of contractual work arrangements, greater autonomy in wage setting mechanisms, and reformed employment protection.
- *Deepening the Single Market* to fully implement regulation and remove remaining obstacles.
- *Access to affordable energy and resources*.
- *Access to finance* through the provision of financial support and efficient financial regulation.
- *Enhancing extra-EU trade* through reduced tariff and non-tariff barriers, notably for services, trade agreements with third countries, and fair trading practices with third countries.

4.2.3.1. Business Europe

In addition to the recommendations above, Business Europe also advocates **the promotion of cooperation for innovation to facilitate the commercialisation of innovation, and expanding trans-European infrastructure** by removing regulatory and technical barriers.

4.2.3.2. EuroChambres

EuroChambres further highlights the need for targeted initiatives to help more European businesses to be present and active outside the EU. The organisation advocates the introduction of special clauses and considerations for Small and Medium-sized Enterprises (SMEs) in key trade agreements.

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[95] Business Europe represents businesses across the EU. EuroChambres gathers national associations of chambers of commerce and industry. EuroCommerce protects the interests of retail, wholesale, and other trading companies. UEAPME advocates for European Small and Medium Enterprises.

[96] Business Europe, EuroChambres, EuroCommerce, UEAPME, *Competitiveness First*, 26 September 2014.

Overall, **EuroChambres calls on the Juncker Commission to pursue five main issues**: employment and skills, economy and finance, Enterprise and innovation, (international) market access, and energy and environment.[97]

4.2.3.3. American Chamber of Commerce EU

The American Chamber of Commerce EU (AmCham EU)[98] identifies investment in energy, transport, and digital infrastructure, in more and better connections with the EU's partner countries. [99] Additionally, the organisation advocates enhancing trade by conducting increased transatlantic convergence with regards to financial services. Reforming financial markets, as well as products markets, in the EU are also seen as important factors.[100]

4.2.4. Think tanks

The Centre for European Policy Studies (CEPS), Bruegel, and the European Policy Centre (EPC) provide further highlights on growth-enhancing reforms.

4.2.4.1. Centre for European Policy Studies

The primary concern of the Centre for European Policy Studies (CEPS) is to ensure that **investment policy must be balanced and effective**. Excessive investment – at the peak level in 2007 – leads to severe financial and economic crises and discourages consumption, which is essential to trigger growth, as highlighted by recovery experiences in the US and the UK. Nonetheless, CEPS advocates investment in infrastructure subject to the fiscal health and anticipated high return rates of the Member States, and calls for continued investment in research and development.[101]

Additionally, the think tank supports the full implementation of the Banking Union with a functioning and effective banking supervision to ensure stability and growth, and the strengthening of global financial regulatory coordination at the Group of 20 (G20)[102] level. The implementation of the Capital Markets Union is seen as essential to ensure that companies can access different sources of finance.[103]

4.2.4.2. Bruegel

Bruegel highlights that structural reforms require time before taking effect and therefore experience much opposition by citizens when they are not accompanied by investment and growth. Pension reforms would increase debt sustainability and allow for gradual fiscal

[97] Eurochambres, *A Growth and Jobs Agenda for 2014-2019*, February 2015.
[98] AmCham EU represents American companies trading to Europe.
[99] American Chamber of Commerce, *AmCham EU's position on the European Fund for Strategic Investments*, 22 June 2015.
[100] American Chamber of Commerce, *Letter to Rt. Lord Hill, Commissioner responsible for Financial Stability, Financial Services and Capital Markets Union*, 12 November 2014.
[101] Gros, D., *Investment as the key to recovery in the euro area?*, CEPS Policy Brief, No. 326, 18 November 2014.
[102] Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.
[103] Lannoo, K., 'A Financial Markets Policy for the next 5 years', *CEPS Commentary*, 1 October 2014.

consolidation, while a review of the financial system and the setting up of a Banking Union are perceived as the most pressing priority in order to spur growth.[104]

According to Bruegel contributors Zolt Darvas and Guntram B. Wolff, **addressing the unemployment issue should be a priority**. Labour market and fiscal reforms should be implemented to accommodate the needs of the unemployed, while the benefits system between generations and between social classes should be reformed.[105]

4.2.4.3. European Policy Centre

The European Policy Centre (EPC) **points out that a balanced approach between fiscal discipline, both public and private investment, and growth orientated policies needs to be put in place to recover from the crisis.** Stronger conditionality and increased trust are also perceived as key to achieving economic governance reforms that allow for increased fiscal capacity. This, in turn, would provide the necessary funding for productive public investment, even during times of economic downturn.[106]

4.3. Divergence in reform implementation

The analysis of policy recommendations formulated by European public institutions and relevant stakeholders highlights key reforms to support growth. **However, experience on the ground shows that such recommendations are not always implemented.** According to the European Commission's Directorate General for Economic and Financial Affairs, Member States implemented only around 40% of the 2012 and 2013 recommendations included in the Country Specific Recommendations (CSRs)[107], despite substantial benefits expected in enhanced economic growth and job creation. Three fundamental trends have arisen since 2011:

- *The implementation rate has decreased over time*, *depending on the stage of the electoral cycle the Member State finds itself in*, and is more likely to be implemented where market pressure requires swift policy action, as in the financial sector. The decreasing implementation rate over time is, of course, also due to the fact that Member States start with the simplest reforms and are left with more difficult ones, which are accordingly more difficult to implement.
- *The average implementation rate of the recommendations was higher in countries when the adoption of the CSRs did not take place within 12 months before or after an election.* The area of tax reform presents the lowest implementation rate, which is considered a very sensitive issue for national governments. Similarly, education, competition in services, and public administration have also experienced poor implementation levels, due to very high levels of vested interests.

[104] Darvas, Z., 'Europe's Growth Problem (and what to do about it)', *Bruegel Policy Brief*, Issue 2013/03, April 2013.
[105] Darvas, Z. and Wolff, G. B., 'Europe's Social Problem and its Implications for Economic Growth', *Bruegel Policy Brief*, Issue 2014/03, April 2014.
[106] Schneider, J. D., 'Growth for Europe – Is the Juncker Plan the answer?', *EPC Discussion Paper*, 20 March 2015, European Policy Centre.
[107] Produced in the framework of the European Semester, the CSRs are tailored advice provided to Member States on how to boost growth and jobs, while maintaining sound public finances. They are formulated by the European Commission and endorsed by EU Heads of State.

- *The Nordic countries (Denmark, Finland, and Sweden) have a stronger record of implementing Country Specific Recommendations* on average than other EU Member States. However, Finland still faces some implementation issues.

More often than not, implementing austerity measures leads to a fragmentation of the governing parties in the face of 'anti-austerity' parties. In most cases, the anti-austerity parties are also strongly anti-EU, which fuels further resistance to reform implementation. National elections can therefore lead to major changes in approach and willingness to undertake much needed reforms, as highlighted by the arrival to power of Syriza in Greece and the recent support for UKIP in the United Kingdom, which has destabilised the opposition rather than the government.

The willingness to follow and implement Country Specific Recommendations thus differs between Member States, and could arguably be traced back to differing cultural approaches, with Northern Member States feeling more inclined to follow suggestions from the European Institutions. Nonetheless, it must be remembered that EU Member States have different reform needs, varying priorities, and a dissimilar urgency to implement changes. These divergences need to be kept into account when making direct comparisons. Many Northern Member States have fared better throughout the crisis years than their southern counterparts, which is why the present reform needs for the latter are more encompassing and more urgent.

4.4. The political feasibility of structural change

At this stage of the Study, economic statistics allowed us to distinguish three categories based on their growth potential – Member States Leading, Following and Catching-up in competitiveness – while experience on the ground highlighted divergence in reform implementation across the EU. **These distinctions can be combined and refined in a key political criterion: political feasibility.**

According to a recent Bruegel Working Paper[108], **the political feasibility of reform implementation differences varies with the political system**:

- *The nature of the constitutional rules* (parliamentary versus presidential) has a significant weight on the leadership ability of the country to conduct economic reform. Presidential systems with governments are more likely to impose losses on depositors, while both single-party and multi-party governments in presidential systems are associated with lower fiscal costs of crisis management.
- *The electoral rules* (single party versus coalition government) determines the extent to which the executive power influences policy-making, as these rule shape the number of parties, government formation, and hence policy choices.

Another interesting element comes from the leadership factor highlighted during the 2015 World Economic Forum. In a definition borrowed from Warren G. Bennis, leadership is *"the capacity to translate vision into reality"*, i.e., recommendations put forward by economists and institutions require strong leadership to be achieved in the various Member States. However, governments might lack such leadership capability, especially in times of crisis.

[108] O'Keeffe, M. and Terzi, A., *The Political Economy of Financial Crisis Policy*, Bruegel Working Paper, June 2015.

Overall, as highlighted by a recent Working Paper of CESifo[109]**, financial crises exert pressure on democracy.** Financial turmoil causes the disruption of Government majorities, raises the share of votes for far-right parties, and tends to increase the fragmentation of Parliaments. As a consequence, the resulting political uncertainty hampers the possibility to solve crises and, as the authors note, *"these developments likely hinder crisis resolution and contribute to political gridlock"*.

[109] Funke, M., Schularick, M. and Trebesch, C., *Going to Extremes: Politics after Financial Crisis, 1870-2014*, CESifo Working Paper, October 2015.

5. Selected National Case Studies

5. Selected National Case Studies

The analysis of recommendations from the European Institutions, international and business organisations, and European think tanks highlighted ten priority policy areas: labour market, productivity, product markets, investments, education, R&D, public deficit, pensions, trade, and reform implementation.

The ability of the European Union and its Member States to implement essential economic reform is highly dependent on the political feasibility of reforms in such policy areas. Various factors impact this criterion, including economic rationale, cultural habits, and political systems. These National Case Studies provide insights into the 'political feasibility' criterion through the analysis of the role played by the EU as a single political actor and coordinating authority. They also examine the political environment in nine selected Member States and relevant third countries.

In particular, as discussed in Section 2.4**, EU Member States can be classified as having three diverging competitiveness profiles – Leading, Following and Catching-up –** with varying ability to restore economic growth. Addressing these disparities is essential to achieving sustainable growth in the European Union. To understand the reason for such divergence, the National Case Studies analyse the political environment in three Member States selected from each of the three groups:

- *Germany, the United Kingdom and Ireland* for Member States Leading in competitiveness,
- *France, Spain and Greece* for Member States Following in competitiveness,
- *Poland, Latvia and Bulgaria* for Member States Catching up in competitiveness.

These Member States were selected to show a range of different political approaches across the spectrum of EU geography and cultural diversity. The analysis is based upon the information collected with structured interviews with representatives of the European Commission, national Permanent Representations to the EU, and relevant think tanks. The Section 7.1 presents the findings more extensively.

5.1. Member States Leading in competitiveness

5.1.1. Overview

Member States Leading in competitiveness exhibit a better position in terms of competitiveness and political acceptance of further reforms. They include Austria, Belgium, Denmark, Finland, Germany, Ireland, Luxembourg, the Netherlands, Sweden, and the United Kingdom.

Germany, the UK and Ireland were selected for further study. Germany is the largest European economy and has fared well throughout the recent financial crises, Ireland had its own property bubble which magnified the effects of the financial crisis that greatly hit the country in 2007, but has since experienced a strong recovery, while the United Kingdom, outside the Euro Zone, is at present showing steady growth. All three enjoy stable government and broad public support for on-going reforms. The UK will hold a referendum on its position in the EU by the end of 2016.

5.1.2. Best practices and areas requiring improvement in Member States Leading in competitiveness

The perceived strengths and weaknesses of these three Member States are described in greater detail in Section 7, following a series of discussions with Commission officials and other interested parties. **This Section seeks to identify best practices for others to follow – and notes other areas where further action is required** to maintain their position as leading in competitiveness.

The British **labour market** is a good example of a properly functioning labour market**.** The unemployment rate has fallen steadily since 2012, despite an equally steady increase in the working age population, and is expected to reach levels closer to 5.4% for 2016 and 2017. On the contrary, shortages of skilled labour force in Germany and structural unemployment in Ireland highlight the current shortcomings of these countries' labour markets.

Productivity performance in these states, however, remains weak and limits competitiveness. A rebalancing process for wage developments in Germany and across the public sector in Ireland was implemented to increase productivity. Weak productivity developments have not gone in line with employment growth in the UK since there was a lack of any matching increase in value added.

The United Kingdom benefits from competitive product markets thanks to the privatisation process which started in the 1990s. Even though German's tradable sector is a benchmark in the EU, the country needs to deregulate professional services since their restrictiveness causes uncompetitive behaviour. Ireland also faces high legal proceedings costs due to its delay in the implementation of the advised product markets' reforms.

Investment performance, in contrast, remains weak, and the situation is particularly compounded for Germany and the United Kingdom who face an underspending on essential infrastructure projects. In an effort to reduce current account deficits, or to avoid inflationary pressures, the three Member States now suffer from low public investment in sectors that could otherwise help to increase growth levels.

Performance in the education field is weaker than it should be. In Germany, public underinvestment in education has contributed to perpetuating the dependence of educational success on socioeconomic background. An unusually high proportion of young people in the United Kingdom suffer from a lack of numeracy and literacy skills. In Ireland, the educational system was seen as being ineffective in delivering the necessary skills that the Irish economy needed.

R&D is a policy field in which more contrasts can be observed among the selected Member States Leading in competitiveness. The German R&D system represents a good example of a well-functioning R&D system, despite its complexity. The High Tech Strategy adopted in September 2014 contributed to improvements in the R&D environment. On the contrary, the UK has been suffering from a continuous decrease in R&D spending. The economic contraction in Ireland caused a decrease in R&D intensity, although the 2015 Budget introduced measures focused on the development of incentives in this field.

Germany and Ireland have performed well in respecting appropriate public deficit levels. Neither is in a deficit situation. Although the United Kingdom is in this situation, it introduced fiscal consolidation efforts in 2010 that were intended to reduce the country's deficit. The latter is projected to reach levels closer to 3% of the GDP for 2016.

These Member States need to continue to devote attention to their pension systems due to their ageing populations. Containment of public expenditure will be necessary to ensure the long-term sustainability of the pension schemes in these countries.

Major differences can be observed in trade performance. The export oriented manufacturing sector in Germany contributing to the country's trade surplus is not accompanied by strong domestic demand. A decreasing net investment income since 2010 in the United Kingdom helped to deepen the current account deficit. The rebalancing process between the tradable and non-tradable sectors in Ireland contributed to the country's trade good performance.

The implementation of reforms appeared to be suitable for the Member States Leading in competitiveness, despite a necessary additional effort**.** Germany made some progress in implementing the reforms covered in the CSRs, but the country still needs to continue on the reform implementation trend. Reforms were launched after the crisis in Ireland and the current government continued its own reform programme, although the upcoming 2016 general elections have slowed down the implementation process. The United Kingdom did not need to implement major reforms but only to make some adjustments.

Experience in Germany, Ireland and the United Kingdom highlights best practices for fostering growth (as well as shortfalls to avoid) in the other countries that are categorised as Leading in competitiveness and in leading members of the groups that are shown as Following or Catching up. This comparative policy analysis can be summarised in the following chart **Figure 30**.

Figure 30: Best practices for Member States Leading in competitiveness

Country	Labour Market	Productivity	Product Markets	Investment	Education	R&D	Public Deficit	Pensions	Trade	Reform Implement.
Germany	🟡	🟡	🟡	🔴	🟡	✓	✓	🟡	🟡	*✓
United Kingdom	✓	🟡	✓	🔴	🟡	🔴	🟡	🟡	🟡	✓
Ireland	🟡	🟡	🔴	🟡	🟡	🟡	✓	🟡	✓	*✓

Legend

✓	*✓	🟡	🔴
Good performance	Good performance subject to additional effort	Average performance	Low performance

As a whole, the experience of the proper functioning of the British labour markets could constitute a useful basis for the improvement of the German and Irish labour markets. On the other hand, the respect of public deficit thresholds in Germany and Ireland could be helpful for the United Kingdom on the path of continuous deficit reduction.

5.2. Member States Following in competitiveness

5.2.1. Overview

Member States Following in competitiveness are characterised by their difficulties in implementing structural reforms, the need for adverse economic pressure to initiate the changes needed, and their reluctance to implement additional policy changes. The group includes Cyprus, France, Greece, Italy, Malta, Portugal, and Spain. All belong to the Euro Area.

France, Spain and Greece were selected for further study. France is the third largest European economy and, despite difficulties in making reforms, is still the most competitive of this group, although is currently facing a strong rise of Euroscepticism. Greece was particularly hard hit by the recent financial crises and is confronted by a strong popular opposition to reform implementation, while Spain still exhibits difficulties to reform, but has greatly improved its economic situation in recent years.

5.2.1. Best practices and areas requiring improvement in Member States Following in competitiveness

The perceived strengths and weaknesses of these three Member States are described in greater detail in Section 7 following a series of discussions with Commission officials and other interested parties. **This section seeks to identify best practices for others to follow – and notes areas where further action is required** to increase their ability to compete, increase wealth, and achieve greater political, economic and social stability.

Performance of these three Member States concerning labour markets is generally weak. France faces gender inequalities and many vested interests hamper possible changes and the reduction of the market's duality. Spain also suffers from labour market duality[110], which is worsened by high long-term unemployment and youth unemployment levels. In Greece, undeclared work and cumbersome labour legislation contribute to the high unemployment rate.

Productivity is a policy field in which differences can be identified. On the one hand, France has faced a continued total factor productivity[111] slowdown, although the country benefits from fairly good productivity levels due to a good educational system. Spanish productivity is really dependent on the performance of its labour market; scale effects and productivity developments are restrained by the small size of Spanish manufacturing companies. The recent reallocation of sectors in Greece contributed to developing a better realignment of productivity with wage developments, although productivity decreased in the short-term.

France benefits from **competitive product markets** thanks to the efficient implementation of the Macron Law, which aimed to reform uncompetitive sectors. France further benefits from strong brand

[110] The International Labour Organisation defines labour market duality or segmentation as the division of the labour market into separate submarkets or segments, distinguished by different characteristics and behavioural rules. The latter generally refer to permanent versus temporary employment.
[111] The total factor productivity measures effects in total output not caused by primary inputs in the production process (labour and capital).

management, notably in the luxury goods sector. On the contrary, different and varying legislation across Spain due to regionalism adds an extra burden for businesses. Excessive regulation and the existence of barriers continue to deter competition and a proper functioning of Greek product markets.

Investment is a policy field in which more contrasts can be observed. France profits from an overall and dynamic investment level. Spain benefits from an appropriate investment level in transport but exhibits low levels of productive investment, particularly to stimulate competition in the energy markets. An excessively large public sector in network industries is deterring investment in Greece.

Education performance appears to be weak and the situation is particularly compounded for Spain and Greece. The attainment level of the educational system in France is fairly good and the recent vocational education reform should encourage apprenticeship contracts. However, the country suffers from an increasing number of low achievers. Spain suffers from a skills mismatch for university studies and labour market needs and scores low results for PISA studies. Greece suffers from a large ineffective public education sector.

R&D performance also appears to be weak. R&D is therefore a policy field to which these Member States should devote greater attention. The system regulating innovation in France is cumbersome and blocks the ability of entrepreneurs to innovate. The Entrepreneurship Law in Spain facilitated access for SMEs to finance innovation, yet the country lacks a rationalisation of the division of powers for R&D competences among regions. The Research and Innovation Strategies for Smart Specialisations[112] in Greece, adopted in 2013, should help to address ineffective public debt management, which hampers funding.

Public deficit requires stronger long-term management. The three Member States are in a situation of excessive deficit, despite having implemented actions to control it. France introduced the High Council of Finance to monitor commitments to respect the deficit criteria. Spain has strengthened its fiscal framework since 2012, but the European Commission warned in November 2015 that the deficit would breach five tenths of the forecast GDP for this year. Greece finally enacted better budgetary management measures, but will need growth in the future to make its debt sustainable again.

Reform of the pension system in Spain in 2013 proved to be successful since it will contribute to contain long-term expenditure and help to adopt a sustainability factor. After the recent December 2015 elections, one of the priorities for the new resulting government will be to ensure the sustainability of the pensions in the medium to long term. For France, the long-term sustainability of the pension system may pose practical problems due to a high expenditure level that will run a projected deficit still in 2040. The reforms implemented in 2012 in Greece addressing the unsustainability of the system will need to be complemented in the future with other measures to reinforce the pension scheme.

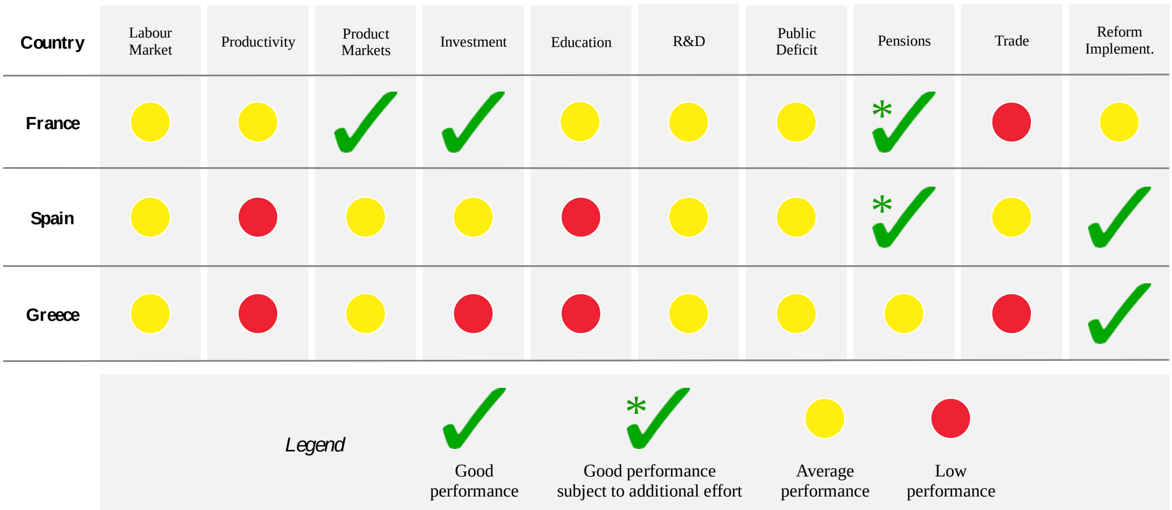
[112] National/Regional Research and Innovation Strategies for Smart Specialisation (RIS3 strategies) are integrated, place-based economic transformation agendas. They are designed in entrepreneurial discovery process, so that the European Structural Investment Funds (ESIF) can be used more efficiently.

Trade performance proved to be weak, and the situation is particularly compounded for France and Greece. French exports suffer from strong competitive forces on the world market, as the positive impacts of tax reductions are offset by the inefficient wage control mechanism. Exports in Spain have grown since the beginning of this century, although the economy is still dependent on imports. The small size of the Greek economy contributes to the weak relevance of the country's export sector.

The recent performance of Spain and Greece regarding reform implementation is now seen as satisfactory in the eyes of EU officials, although Greece will need to continue implementing more reforms to improve the consolidation of its fiscal situation. On the contrary, France has made limited progress in implementing reforms. The country seems unable to adopt more than one major reform per year in a given policy area.

The experience in France, Spain and Greece highlights best practices to foster growth – as well as shortfalls that must be overcome – in the other countries that are categorised as Leading or Catching up in competitiveness. This comparative policy analysis can be summarised in the following chart (**Figure 31**).

Figure 31: *Best practices for Member States Following in competitiveness*



As a whole, the experience of the proper functioning of the French product markets, thanks to the Macron Laws, could constitute a useful basis for the improvement of the Spanish and Greek product markets. The success of pension system reform in Spain to contain long-term expenditure could be helpful for France and Greece to ensure the sustainability of their pension schemes in the future.

5.3. Member States Catching up in competitiveness

5.3.1. Overview

Member States Catching up in competitiveness have in common a low level of public debt, lower wages and a positive attitude towards policy reforms. This is a key element regarding their growth potential. They include Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, and Slovakia.

In this group, Poland, Latvia and Bulgaria were selected for further study. Bulgaria is the least developed Member State, Latvia, one of the smallest economies in this group, joined the Euro in 2014, and Poland, by far the largest, exhibits the best economic performance of the Central and Eastern European Member States that acceded to the European Union in the 2004 and 2007 enlargement rounds.

5.3.2. Best practices and areas requiring improvement in Member States Catching up in competitiveness

The perceived strengths and weaknesses of these three Member States are described in greater detail in Section 7 following a series of discussions with Commission officials and other interested parties. **This section seeks to identify best practices for others to follow – and notes other areas where further action is required** to ensure that they speed up the process of Catching up in competitiveness.

Labour market performance for these Member States appears to be weak. Despite the progress made in Poland to balance the need for flexibility with worker protection, there are insufficient incentives to enter the labour market, and segmentation remains a main concern. Latvia faces a shrinking labour force and a weak social security system that together deter possible developments. Bulgaria suffers from a severely shrinking population and work force, skills mismatches that hamper a weak labour market with high unemployment rates, and low employment generally.

Productivity performance appears to be weak. Poland will benefit from the deregulation of professional services but needs to remove disincentives to expand scales of activities and complete a further reallocation from agriculture to other sectors. An ageing population and the emigration of skilled workers hamper developments for Latvia's productivity. Bulgaria suffers from the same shortcomings as Latvia, though worsened by a weak administrative capacity.

Product markets also appear to be weak, and the situation is particularly compounded for Latvia and Bulgaria. Poland should pursue recently adopted initiatives to reform its public procurement rules and adopt measures to face weak competition in the energy sector. Following its application to join the OECD in 2013, Latvia has developed an independent and business-oriented recruitment system, but faces some elements of corruption that hamper the business environment. Bulgaria suffers from complex regulations and an unsupportive business environment that hampers well-functioning product markets.

The absorption of FDI inflows and EU funds has contributed to improving investment levels in the economy in these three Member States. Nonetheless, these countries still face several shortcomings that cause weak performance. Poland suffers from low investment in the railway sector and needs to clarify the longer-term strategy for the energy market due to an ageing infrastructure still severely dependent on coal. Investment levels in Latvia are still low in the transport and energy sectors. The absorption rate of EU funds in Bulgaria remains low due to administrative constraints and uncertainty in the business environment leading to weak private investment.

Performance in the education field also appears to be weak. Both Latvia and Poland have improved their education systems with the recent reforms, but the issue of an outdated vocational education which is not aligned with market needs remains a problem. Bulgaria suffers from a low quality of access to the general education and vocational education systems. This has caused a **skill mismatch problem**, worsened by the ageing population and high levels of emigration of skilled workers.

R&D performance is also weak and the situation is particularly compounded for Latvia and Bulgaria. Poland has promoted measures to create an innovation-friendly business environment, yet the country still needs to improve its business innovation. The Latvian R&D system is substantially dependent on EU funds and the country invests only 0.6% of its GDP on R&D, a rather low level by European standards. Inefficient governance structures and weak cooperation between science and business means that Bulgaria had a weak R&D intensity of 0.65% of its GDP for 2013.

These Member States have however performed relatively well in keeping public deficit levels below the 3% threshold. However, this is due to medium-high growth levels that conceal issues with taxation and tax collection. Poland lacks an efficient tax administration and effective tax collection. The Latvian economy also suffers from a tax collection issue. Moreover, the Latvian budget for 2016 included increased military expenditure due to the ongoing tensions with Russia, causing an increased deficit. Bulgaria faces the same issue as Poland and Latvia regarding tax collection and the situation is worsened by a shadow economy that hinders its overall economy.

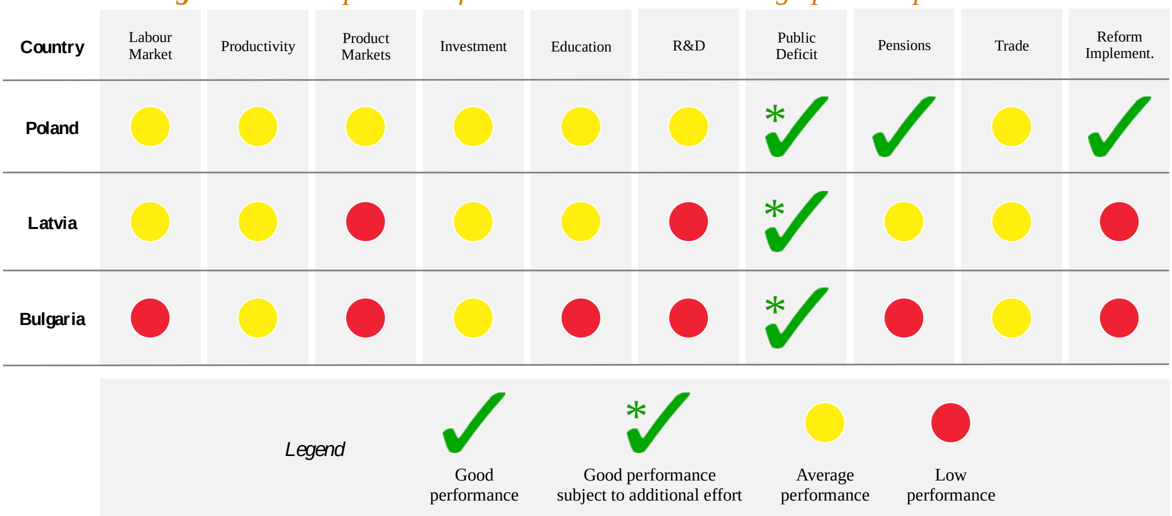
Reform of the pension system in Poland in 2013 proved to be successful according to EU officials, since it increased the retirement age and imposed limits on early retirement. However, the special pension scheme for miners that are exempted from the contribution system still needs to be addressed. The ongoing reform of the pension system in Latvia to move social contributions towards private insurance schemes was less ambitious than expected and the sustainability of future pensions is seen as an issue by EU officials. An ageing population and the emigration of workers led EU officials to consider that a structural reform for the Bulgarian pension system is necessary to ensure fiscal sustainability in the long term.

The substantial dependence of these Member States on trade with Russia remains a problem. Polish exporters managed to compensate for losses in the export markets by turning to the EU and other new markets. On the contrary, the ongoing Russian crisis and sanctions have shown the difficulty in re-orientating the export market in Latvia, especially for those companies that did not look for diversification and are now suffering under the sanctions. Bulgaria imports around 95 % of its energy products from Russia, which puts the country in a situation of strong dependence on good relations with Russia.

The overall performance of Poland regarding reform implementation was noted as being particularly successful by EU officials. In contrast, there has been slow progress in reform implementation for Bulgaria and Latvia.

The experience in Poland, Latvia and the Bulgaria highlights some best practices to foster growth – as well as the many shortfalls to avoid – that could be applied in other Member States Catching up in competitiveness. This comparative policy analysis can be summarised in the following chart (**Figure 32**).

Figure 32: *Best practices for Member States Catching up in competitiveness*



As examples of best practices among the Member States Catching up in competitiveness, the experience of the successful pension system reform in Poland to increase age retirement and limit early retirements could constitute a useful basis for Latvia and Bulgaria to ensure the fiscal sustainability of their pension schemes. Moreover, the overall good performance of Poland while implementing reforms could be helpful in encouraging Latvia and Bulgaria to implement the necessary reforms in order to improve their economies.

5.4. International experiences in carrying out reforms

Experience in third countries provides useful insights for the European Union and its Member States on reform implementation: the economy of the United States shows similarities with Europe's; Japan provides useful insights into the main pitfalls to be avoided, while the South Korean example is of relevance for R&D and education policies.

5.4.1. United States

The 2007 global financial crisis started in the United States with the bursting of the housing bubble and the problems of subprime mortgages. American investment banks were the first to be affected and the bankruptcy of the American Lehman Brothers was a critical turning point in the unfolding of the crisis. Nonetheless, the US economy is currently healthier than Europe's. From 2010 to 2014, US GDP grew by an average of 2.2 %.[113] The unemployment rate, which reached 9.7% in 2010, has been declining since then.[114]

As for investment, the US approved the American Recovery and Reinvestment Act in 2009, through which the State boosted its public expenditure by $840 billion to balance the decrease of private spending, thus preserving employment and preventing further recession.[115] Moreover, the Obama administration first reiterated and then made permanent the tax cuts introduced by the Bush administration through Tax Relief Acts in 2010 and 2012.[116]

The Federal Reserve also supported the economy with a programme of Quantitative Easing from November 2008 onwards. The European Central Bank did not apply quantitative easing until 2015, and for much smaller amounts than the Federal Reserve. This is partly explained by the wider statutory objectives of the Federal Reserve – which include economic growth – compared to the European Central Bank.[117]

Judging that the crisis also rose from a lack of regulation, the US Government reformed the financial regulatory system with the 2010 Dodd-Frank Act and its Volcker rule[118], which prevents commercial banks from engaging in certain kinds of speculative investments.[119] The European Union relied on the 2012 Liikanen Report that supported subsidiarisation (i.e., the separation of higher-risk trading activities in a separate legal entity from the core credit institution). This Report served as a basis for the January 2014 Proposal for a Regulation to improve the resilience of EU credit institutions.[120]

If the quick recovery of the US economy called into question the severe austerity measures advocated in the European Union, **structural differences between the two regions are worth noting**:

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[113] Source World Bank Data.
[114] Source World Bank Data.
[115] Source US Government.
[116] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. American Taxpayer Relief Act of 2012.
[117] Source Federal Reserve.
[118] Dodd–Frank Wall Street Reform and Consumer Protection Act.
[119] Source US Commodity Futures Trading Commission.
[120] Council of the European Union, *Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions*, 19 June 2015, Interinstitutional File: 2014/0020 (COD)

- The US public debt was proportionally smaller than that of many EU Member States, providing the US Government with more room for manoeuvre than its European counterparts.
- The United States enjoys a unique position in the public debt market, which allows the country to finance itself at a lower cost than most countries, mitigating the consequences of the financial crisis.

With regard to energy, the increasing exploitation of shale gas sediments from 2000 onwards was a major stepping-stone for the US energy sector. American manufacturing, chemical and steel industries have been greatly benefitting from affordable gas [121] while the development of shale resources accounted for 600,000 new jobs in 2010.[122] Seven European Member States[123] possess shale gas reserves, yet no extraction activity is scheduled to date due to strong pressure from environmental organisations.

The Information, Communications and Technology sector has been one of the primary engines of US growth over the past two decades, leading to innovation and productivity boost. The European digital economy has yet to realise its full potential. Achieving the Digital Single Market will also require harmonising national legislation on sensitive issues such as copyright or privacy.

The economic crisis heightened attention to trade as a method to spur economic growth in the United States. In 2015, the US signed with 11 Pacific-rim countries the Trans-Pacific Partnership Free Trade Agreement (TPP)[124], while it is still negotiating with the EU the Transatlantic Trade Investment Partnership (TTIP). The TTIP aims to lower trade barriers such as tariffs, harmonise intellectual property, establish standards for labour and environmental law, and create an investor-state dispute settlement mechanism. The European Union has also engaged in trade negotiations with a number of countries, but achieving a consensus, including on TTIP, has proven more difficult.

Concerning Foreign Direct Investment (FDI)**, the United States exhibits the largest stock of FDI and is one of the first FDI recipient worldwide over the past decade.**[125] To improve the country's attractiveness, the Obama administration launched in 2011 SelectUSA[126], a Government programme acting as a single point of contact for investors. Despite being larger in size, the EU Single Market remains less attractive for foreign investors as many EU countries are still struggling to recover from the crisis, and national divergences in regulations, practices and languages remain of importance.

5.4.2. Japan

Japan, the world's third largest economy[127]**, has experienced deflation and sluggish growth since the early 1990s.** In 2012, upon entering into office, Japanese Prime Minister Shinzō Abe announced a new economic policy to reverse this trend and reflate Japanese growth. His economic

[121] Zhaokui, F., *The Impact of the Changing Global Energy Map on Geopolitics of the World*, 24 January 2013, China-US Focus.
[122] Fetzer, T., *Fracking Growth*, 28 March 2014.
[123] Bulgaria, France, Germany, Poland, Romania, Spain, the United Kingdom. Source Shale Gas Explained, Shale Gas Europe.
[124] Australia, Brunei Darussalam, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam and Japan. Office of the United States Trade Representative, *Overview of TPP*.
[125] Organization for International Investment, *Foreign Direct Investment in the United States, 2014 Report*, October 2014.
[126] White House, *FACT SHEET: President Obama to announce New Steps to Attract Foreign investors and Create Jobs through the Continued Expansion of the SelectUSA Initiative*, 23 March 2015.
[127] Source World Bank.

recipe, dubbed Abenomics, consisted of three elements: (i) fiscal stimulus and (ii) monetary easing to provide economic relief in the short run, and (iii) structural reforms intended to boost growth in the long term. [128]

In the first weeks of his mandate, Abe approved a $210 billion stimulus bill, including $116 billion in direct Government spending. The Bank of Japan simultaneously committed to a Quantitative Easing programme including acquisition for ¥60-to-70 trillion in bonds per year, increased to ¥80 trillion per year in October 2014. The injection of liquidity into the economy raised inflation and devalued the Yen, which made Japanese exports more competitive.[129] The effects on GDP growth, however, fell short of the mark; economists attribute responsibility to the consumption tax hike, from 5% to 8%, implemented by Abe in April 2014 to counterbalance his expansive fiscal policies.[130]

Structural reforms were designed to address the several distortions preventing the Japanese economy from achieving its full potential. These include a rigid labour market, practices that hinder foreign competition, strong agricultural protectionism, and inefficient services in some sectors. So far, the Abe Government has reformed the corporate sector and increased female employment. Experts generally agree that it is a step in the right direction, yet judge such steps insufficient and consider that the tempo of the reforms has been too slow.[131]

Developments in Japan should be closely monitored in the EU. The similarities between the two economies pave the way for comparison, and some problems that Japan is currently facing, such as the ageing of the population and deflation, are likely to become major problems for most EU Member States in the coming years.

5.4.3. South Korea

South Korea represents an interesting case for the European Union. It is a developed country with a well-diversified economy and a strong industrial base. Like several EU Member States, it is a member of the OECD and the G20.[132] South Korea is the 8th most important trade partner for the European Union, representing 2.3% of the total imports and 2.5% of the total exports in EU trade during 2014.[133]

South Korea has experienced remarkable economic development over the past fifty years. From being a poor country with a smaller GDP than Bolivia and Mozambique in the 1960s[134], South Korea has become the world's thirteenth largest economy in 2013.[135] Growth was led by exports of

[128] Nishizaki, K., Sekine, T. and Ueno, Y., 'Chronic Deflation in Japan', *Asian Economic Policy Review*, Vol. 9, Issue 1, pp. 20-39, January 2014.

[129] Uchida, M., 'Towards the end of deflation in Japan? Monetary policy under Abenomics and the role of the central bank', *Revue de l'OFCE*, N° 135, Issue 4, pp. 243-268, 2014, Les éditions du Net.
[130] Dadush, U., *The Truth About Japan's Economic Decline*, 25 April 2014, Carnegie.
[131] Jakobsen, J. J., *Three Arrows Cannot Be Broken! A study of Abenomics' third stage of structural reforms*, 3 March 2014, Roskilde University.
[132] Source Global Edge.
[133] European Commission, *European Union, Trade in Goods with South Korea*, 20 October 2015, Directorate-General for Trade.
[134] Noland, M., 'Six Markets to Watch: South Korea', *Foreign Affairs*, January-February 2014.
[135] Source World Bank.

industrial products, a remarkable fact considering that South Korea has almost no natural resources. The country became a leader in key industrial sectors, such as consumer electronics (Samsung, LG), automobiles (Hyundai Kia group), steel, and shipbuilding.

South Korea's economic development has been supported by extensive spending in R&D, accounting for 3.7% of its GDP in 2011. Korea's Ministry of Science and Technology strongly supported investments in telecommunication infrastructure and the adoption of new technology.[136]

Regarding education, South Korea exhibits one of the world's highest university enrolment rate, and schoolchildren consistently score in the top five in almost all international tests.[137] The South Korean educational system is characterised by the imposition of a hard-working discipline for students, with intense timetables and extensive involvement of teachers and parents.[138] External monitoring groups evaluate Korean schools annually, focusing on student needs, curriculum, teaching and learning practices. Furthermore, the Ministry of Education gives performance awards consisting in bonuses for the top performing schools, while schools that do not perform well are granted extra administrative support.[139]

EU Member States suffer from weak investment levels in Research and Innovation and in Education, and would greatly benefit from greater spending in these sectors, as is the case in South Korea. As proven by the South Korean example, such investments could help compensate for scarce natural resources.

[136] Kharas, C., Penalva, J. and Uribe, A., *South Korea: Reviving the Miracle on the Han River*, 3 April 2014,Global Economy – NYU Stern School of Business.
[137] Chang, H.-J., 'South Korea's economic reforms – a recipe for unhappiness', *The Guardian*, 1 April 2012.
[138] Jones, R. S., *Education Reform in Korea*, OECD Economics Department Working Papers, No. 1067, 27 June 2013, OECD Publishing.
[139] Kharas, C., Penalva, J. and Uribe, A., *South Korea: Reviving the Miracle on the Han River*, 3 April 2014,Global Economy – NYU Stern School of Business.

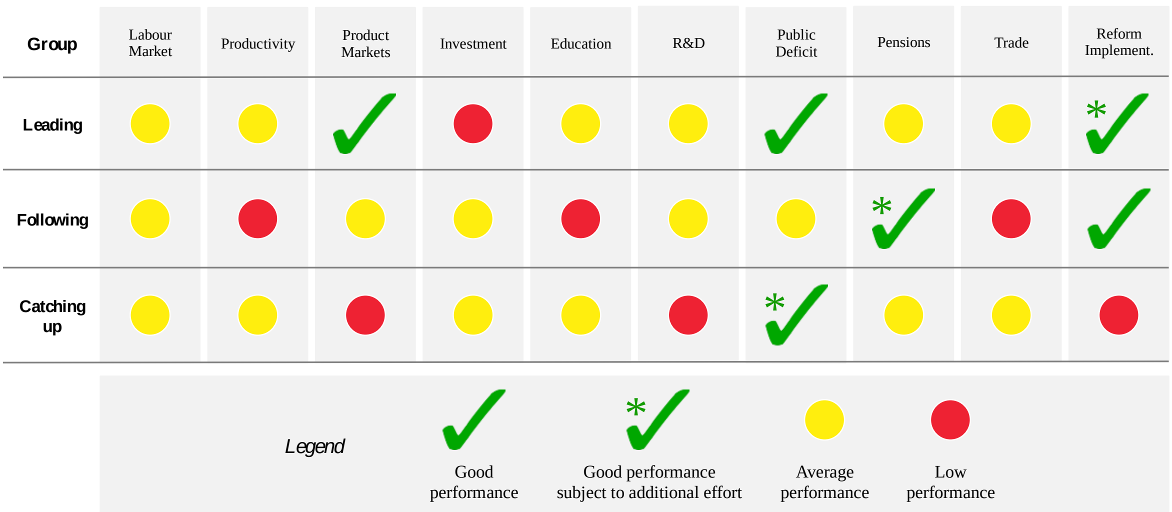
6. Recommendations for Greater Competitiveness

6. Recommendations for Greater Competitiveness

6.1. Recommendations per competitiveness pattern

The Selected National Case Studies highlighted best practices in the implementation of growth-enhancing reforms put in place by the various EU countries examined as well as by relevant third countries (**Figure 33**). Such practices are of relevance for Member States but also for the European Union, as they point out the need for greater coordination in economic policy across the EU. Furthermore, the analysis showed that Member States facing greater economic challenges provide useful experience on reform implementation in specific fields. This benchmark has been completed by Best practices from comparable third countries to enhance the relevance of the recommendations.

Figure 33: Benchmark of performance per group of Member States



Best practices for Member States Leading in competitiveness

- The stimulation of flexibility in the British labour market is a good example to foster competitiveness.
- Germany and the United Kingdom provide positive models for market deregulation and increased competition.
- The development of apprenticeships implemented in Germany is a useful basis for well-targeted education to tackle the mismatch between supply and demand of work.
- The implementation of a High Tech Research and Innovation Strategy in Germany provides a positive model for the promotion of R&D.
- Germany and Ireland are good examples of compliance beneath the 3% deficit threshold.
- Germany, the UK, and Ireland provide positive models for the sustainability of pensions with the postponement of the legal age of retirement.

- Ireland provides an overall attractive business environment for trade policies combining low taxation, high education, and innovation.
- Member States in this category exhibit on average high reform implementation rates, although attention must be paid to ensure effective implementation in the near future as populations often fail to see the need for further reforms in times of economic prosperity.

Best practices for Member States Following in competitiveness

- France leads the way in the improvement of the functioning of product markets with the launching of the Macron Laws.
- In terms of investment policies, the leverage effect of the French investment bank is a successful example to be promoted on a broader level. *France provides a positive example for the promotion of investment policies with the leverage effect created by the French investment bank.*
- The success of the pension system reform in Spain to help to contain long-term expenditure could be helpful for other countries to ensure the sustainability of their pension schemes in the future.

Best practices for Member States Catching up in competitiveness

- Poland provides a positive model of efficient investment in key sectors with a clear return on investments policy for the allocation of EU structural funds.
- *Latvia constitutes a positive example of efficient use of EU funds to strengthen energy security and launch energy efficient programmes.*
- Poland provides a positive model for the sustainability of pensions with the increase of age retirement and limitation on early retirements.
- Poland leads the way in implementing reforms with an overall good performance.

6.2. Implementation subject to the economic and political environment

The classification between the Leading, Following and Catching up Member States shows key differences between the political and economic environment of each typology. **These divergences must be taken into account when implementing reforms**, i.e., the implementation intensity and the political urgency must vary across each category (**Figure 34**).

Figure 34: *Priorities in reform implementation per group of Member States*

Group	Short term	Medium term	Long term
Leading	**Investment** Education **Product Markets** R&D	Public Deficit Labour Market Productivity **Pensions** Trade	Improving reform implementation
Following	**Education** Productivity **Public Deficit** R&D **Trade**	Improving reform implementation Product Markets **Labour Market** Pensions **Investment**	-
Catching up	**Product Markets** Education **R&D** **Improving reform implementation**	Labour Market Pensions Investment **Productivity** Trade	Public Deficit

Legend		
	Priorities for reforms	Need for high intensity in political action
	Priorities for reforms	Need for lower intensity in political action

Members States Leading in competitiveness are currently experiencing a good economic environment and a greater acceptability of the reforms thanks to thoughtful political leadership and communication. Awareness raising on the 'return on investment' of the suggested reforms to maintain growth in the long run are key elements to justify that further reforms are needed today as their impact will take time to materialise.

Member States Following in competitiveness have experienced the depletion of their economies and populations are not receptive to further reforms. Implementation could therefore focus on improving employment and achieving growth in the short run to restore confidence in the economy and the trust of the people, which are essential to undertaking tougher reforms.

Member States Catching up in competitiveness are on a good trend but efforts are still needed to reach the same development levels as the two previous groups. In particular, the quality of institutions must be improved to ensure a proper implementation of the reforms.

6.3. Conclusions

This Study highlights the necessary reforms to implement at both European and Member State levels to restore competitiveness and growth while taking into account the political feasibility criterion. Political feasibility varies from one Member State to another – and needs to be kept in mind to ensure the effective implementation of structural reforms in Europe.

The European Union's deteriorating competitiveness has weakened its ability to act as an influential global economic actor since 2007. The 2007 and ensuing Euro crises highlighted growing divergences within the EU, which a weak economic recovery has exacerbated. This new paradigm calls into question the spillover effect thesis promoted from 1958 to the end of the 1990s, according to which EU integration would improve economic and social conditions for all.

This Study notes that Member States in the European Union can be classified according to their competitiveness patterns into three different groups. Each group exhibits varying ability to reform and restore growth. Selected National Case Studies provide insights on the political feasibility of structural reforms in each group:

- Member States **Leading** in competitiveness: Germany, the United Kingdom, and Ireland,
- Member States **Following** in competitiveness: France, Spain, and Greece,
- Member States **Catching up** in competitiveness: Poland, Latvia, and Bulgaria.

On a broader level, this Study argues that the link between competitiveness, convergence and cohesion must be re-established. Competitiveness depends on essential structural reforms; convergence is fostered by trade and economic growth; cohesion requires the creation of wealth and its effective distribution, preferably through value-adding employment. Governments and other regulators do not create wealth but can provide the necessary framework to achieve such cohesion.

This Study also argues that such convergence becomes possible in developed data-rich societies if policies are built on facts, if processes are transparent and are seen as necessary and just, and if the desired outcomes are measured and communicated. To this end, this Study uses data from many sources to demonstrate that the economies of EU Member States, both in and outside the Euro Area, are diverging rather than converging and that effective governance, as well as social and political cohesion are increasingly at risk. To identify causes and possible solutions, it analyses the competitiveness and reform capabilities of the 28 Member States, divided into the three mentioned groups.

Examination of their economic and financial performance before, during and after a series of crises suggests that the groupings are valid – and therefore one set of solutions may not work for others. It also raises the concern that the differences may be deeply embedded and therefore harder to resolve. Overall the data make clear that 'one size fits all' regulation is no longer sufficient or even appropriate – if it ever was.

The quantitative data and qualitative assessments identifying the proposed groups are of course already available at EU level. The Country Specific Reports, as their name suggests, are indeed country specific, and clearly set out the different stages of political and economic development and needs of each Member State. The current regulatory process, however, fails to recognise either the deeply embedded structural differences or the likely timescales for convergence – or, critically, that this approach may actually be responsible for the divergence now evident across the EU. These concerns are now routinely highlighted in external studies but rarely within the Institutions of the EU itself.

This Study also notes that transfers of funds– inside the EU or as part of international aid, **however well-meaning, does not systematically lead to convergence or cohesion** unless they are focused on increasing competitiveness and the ability to add value and generate fairly-distributed wealth through trade. This process, too, needs re-thinking. **Popular dissatisfaction with the organisation and**

operation of the EU is not merely a result of poor communication – and the redistribution of funds is insufficient to buy the support of the beneficiaries.

The Study gathers data and stakeholder views on ten components of competitiveness – the structure of labour markets, productivity, product markets, investment, education, R&D, public deficit, pensions, trade, and the process of reform implementation. Other analyses are included where appropriate. The feasibility of making the required reforms is discussed and timetables and priorities proposed.

Initiatives recently proposed by the European Commission under some, but not all, of these headings should, if fully enacted, eventually lead to improvements in the overall competitiveness of the EU. **However the need to focus on all the factors affecting competitiveness as a first step towards both convergence and cohesion has not yet been accepted or made central to all policies, on any area of concern.**

Although academic in approach, this is not merely an academic exercise. Unless cohesion between the peoples of Europe and their leaders is regained, the EU itself as an economic and political entity is at risk. This will not happen until the citizens of Europe see the institutions of the EU as part of the solution, not the cause of their problems. **This in turn requires a change of approach from regulation to facilitation**, to finding local or regional solutions and monitoring their outcomes, to seeking for and sharing best practices from in or outside the EU, to sharing and developing the intellectual and physical resources that do exist, in the best interests of all.

This Study also confirms that treating the EU as a single entity is no longer possible – and that the division into 2, the Euro Area and others, is insufficient to ensure growth and to bring convergence and social cohesion. Whether a division into 3 groups – or 4, 5, or 6, as others propose – proves helpful will depend on the issues at hand and the instincts, objectives, and political and social capabilities of the Member States and electorates concerned.

Many of these ideas have either been suggested by others or even implemented, to some extent, at EU level. **However, it is clear that they have not been fully communicated to, within or between governments and their electorates.** Joint ownership and responsibility has not been acknowledged or seen as essential or as a benefit. These are now required if the EU is to regain cohesion; competitiveness and convergence provide the route.

The European Union owes much to the six founding members who, recognising that they shared similar economic and social problems, developed and shared a common view of the way forward. **The situation today is just as urgent and needs a similar approach.** It is hoped that this Study will help this process.

7. Appendices

7. Appendices

7.1. Summaries for selected Member States

7.1.1. Questions posed to interviewees

General Questions

- Bearing in mind the economic situation in your country, what successful reforms are currently being conducted to stimulate growth?
- What additional realistic reforms should be achieved to boost competitiveness in your country?
- What is the degree of acceptability of the population as regards these reforms?
- What could be done to obtain political and popular backing for such measures?
- To what extent do the upcoming national elections (and the recent EU elections) have an impact on the introduction of reforms?

Policy Specific Questions

- What kind of labour market reforms are being, or should be, introduced?
- How can your country's productivity be boosted?
- How should product markets be reformed?
- How could investment in energy, transport, and digital infrastructure be optimised?
- How could your country reform its education and training policies to achieve sustainable growth?
- How could your country create a favourable environment for innovation and R&D?
- What measures could be taken to tackle the countries' deficit and debt issue?
- What has your country achieved so far to reform its pension system?
- What is and what should be done to boost trade?
- How well has your country advanced in implementing these reforms?
- How could the EESC be of help? What should the EESC focus on?

Additional questions where applicable

- To what extent has the new European Commission (Juncker Commission, DG Growth) had an impact on introducing and managing necessary reforms?
- Are there any best-practices amongst EU Member States as regards managing reforms?
- How well has reform management been in the EU compared to third countries?
- How could the EESC be of help? What should the EESC focus on?

7.1.2. Member States Leading in competitiveness

7.1.2.1. Germany

***Table 4:** Views of European stakeholders on Germany*

GERMANY	
Labour Market	***Context:*** *Shortages of skilled labour and an ageing population* → Better integration of migrants in the local labour market → Addressing regional disparities in unemployment and disincentives to take up full time work → Improving employability
Productivity	***Context:*** *On-going rebalancing of wage developments in line with productivity* → Addressing sheltered sectors (such as professional services)
Product Market	***Context:*** *Competitive tradable sector* → Deregulating professional services to address un-competitive pricing
Investment	***Context:*** *Weak public investment* → Reforming the tax system to be more investment friendly → Addressing the financing gap for infrastructure
Education	***Context:*** *Increased spending on education to address low levels of investment* → Stimulating public and private investment in education and R&D
R&D	***Context:*** *Well-functioning but complex R&D system, and adoption of a new High Tech Strategy in September 2014* → Stimulating public and private investment in R&D → Developing venture capital as an alternative source of financing
Public Deficit	***Context:*** *No deficit issue* → Implementing debt break at regional level (*Länders*)
Pensions	***Context:*** *Major reforms conducted between 2001 and 2003 setting up a three pillar system* → Need for higher expenditure on pensions to address an increasing risk of old age poverty
Trade	***Context:*** *Weak domestic demand and weak demand for imports* → Boosting domestic demand, notably through higher wages
Reform Implementation	***Context:*** *Limited progress on implementing reforms* → Need for EU authorities to engage with the national political level

Source: Interviews with representatives of the European Commission, national Permanent Representations to the EU and Think tanks[140]

Accounting for 20.9% of EU GDP and 15.9% of EU population in 2014[141], **Germany is the largest European economy and has become one of the most influential actors in the European Union**. Germany has fared well throughout the recent financial crises, outperforming most Euro Area economies, based on a strong labour market and an innovative manufacturing sector.[142] The German economy is expected to increase by 1.5% in 2015 and 1.6% in 2016, according to the International Monetary Fund (IMF).[143]

The German Federal Parliamentary Republic is characterised by its stability over the recent years. The latest Parliamentary elections resulted in the best results for the Christian Democratic Union since the reunification of Germany. Euroscepticism is marginal; its most notable expression is characterised by the anti-Euro Alternative for Germany Party.

Chancellor Angela Merkel has been in office since 2005 and is currently serving her third mandate in a Government of coalition between her party, the centre-right Christian Democratic Union, and the centre-left Social Democrats; the next parliamentary elections are expected in 2017. Chancellor Merkel benefits from popular backing that may be challenged by the current Migration Crisis.

[140] Each summary table in the following sections is based on structured interviews with representatives of the European Commission, national Permanent Representations to the EU and think tanks.
[141] Source Eurostat and Eurostat.
[142] OECD, *Economic Surveys Germany*, May 2014, OECD Publishing.
[143] IMF, *Adjusting to Lower Commodity Prices*, World Economy Outlook, October 2015, IMF Publication Services.

Since the beginning of the 21st century, Germany enacted two major reforms which targeted specifically the labour market and the pension system. The 'Laws for Reform of the Job Market', also known as Hartz reforms, were implemented between 2003 and 2005 to address high unemployment and to reduce incentives to stay out of employment.[144] A minimum wage setting of €8.50 per hour in all branches of activities was introduced in January 2015 to address wage inequality between men and women.[145] Nonetheless, Germany still encounters vulnerable social groups, in particular low-skilled workers.[146] As a whole, EU officials have underlined a need to adjust labour policies to improve their employability.

As regards productivity, Germany still has room for improvement. Data from EU officials show that higher levels of public and private investment could enhance German growth.

EU officials consider German product markets as a benchmark for the European Union. Nonetheless, they remain sceptical about the proper functioning of these markets in the long run due to some indications of uncompetitive pricing.

Additionally, the current lack of skilled labour added to **weak public investment has entailed a financing gap for infrastructure.** EU officials underline the need for a more investment-friendly tax system to address low levels of private investment.

Regarding education and training policies, the 2013 childcare reforms have proven to be successful; these reforms promote a right-based approach entitling children between 1 and 3 years old to childhood support in a day care centre to support women in work. EU officials believe more public and private investment is needed in education.

EU officials believe the **High Tech Strategy** adopted in 2014 to have been generally efficient and the **R&D system** to be functioning well, despite its complexity.[147] However, EU officials stressed that the under-development of venture capital should be tackled.

Concerning public deficit, data from EU Institutions reflect the sustainable position of Germany's public finances; the country has even become the strongest advocate of austerity measures for the highly indebted Euro Area countries. EU officials have underlined the need to implement a debt break for the *Länders* to correct possible budgetary deviations.

As regards pensions, Germany conducted the Riester Pension Reforms between 2001 and 2003 to ensure long-term sustainability and stability of the pension system, and to promote a wider use of supplementary private pension savings.[148] EU officials deem the system efficient, but high expectations remain regarding its ability to tackle the increasing risk of old age poverty.

EU officials are aware of the country's large trade surplus and have underlined the weak domestic demand. Boosting domestic demand consequently appears essential to trigger higher levels of investment and improve productivity.

Finally, EU officials are sceptical about **the extent of reform implementation** in the country. A stronger engagement by the European authorities with the national level might be advisable.

[144] These reforms bundled long-term unemployment benefits and social welfare benefits into one package.
[145] EurActiv, *Merkel cabinet agrees on €8.50 minimum wage*, 4 April 2014.
[146] IMF, *Adjusting to Lower Commodity Prices*, World Economy Outlook, October 2015, IMF Publication Services.
[147] The High Tech Strategy establishes priorities in Research and innovation – including the digital economy, green growth, and intelligent mobility –, supports innovation at industry level, and improves the environment for R&D.
[148] The Riester Pension Reforms set up a three-pillar system that relies on (i) mandatory State Pension Insurance (basic social security system), (ii) a voluntary Occupational Pension Insurance, and (iii) private insurance.

7.1.2.2. United Kingdom

Table 5: *Views of European stakeholders on the United Kingdom*

UNITED KINGDOM	
Labour Market	***Context:*** *Good performance* → Encouraging more women in the Labour Market → Correcting skill mismatches
Productivity	***Context:*** *Weak productivity developments* → Stimulating investment in high-quality infrastructure → Improving access to finance to boost private and public investment
Product Market	***Context:*** *Extensive privatisation in the 1990s* → Clarifying the governance of regulatory agencies to avoid inefficiencies
Investment	***Context:*** *Insufficient levels of public investment* → Targeting high-quality infrastructure investment → Reforming the tax system to be more investment friendly
Education	***Context:*** *Measures taken to promote youth employability* → Addressing the lack of basic skills among young people → Simplifying the vocational qualification system
R&D	***Context:*** *Continued fall in R&D public spending* → Increasing R&D public spending to reach levels similar to the EU average and the US
Public Deficit	***Context:*** *Some progress in prioritising capital expenditure* → Exiting the excessive deficit situation
Pensions	***Context:*** *Reform of the private pension schemes currently being held* → Completing the switch to a 3-pillar system
Trade	***Context:*** *Trade deficit* → Improving skills of the labour force to foster a spillover effect to the export sector
Reform Implementation	***Context:*** *No need for extensive reforms but for adjustments to be done* → Need to tackle the insufficient housing supply

The United Kingdom joined the European Union in 1973 and represents the second largest economy of the European Union, accounting for 20.9% of EU GDP and 12.7% of EU population in 2014.[149] The country achieved a good economic performance during the crisis and should soon recover according to the IMF: its economy is predicted to increase by 2.5% in 2015 and 2.2% in 2016.[150]

The United Kingdom is very influential within the European political sphere, in spite of not belonging to the Euro Area. Euroscepticism represents an important element in the country's parliamentary monarchy system. It gained momentum during the 2014 European Parliament elections as the two issues of EU membership and migration control became linked, with the Eurosceptic United Kingdom Independence Party (UKIP) obtaining 26.8% of votes.[151] In light of these political developments, the British Prime Minister, David Cameron, promised to hold a referendum on EU membership by 2017. Conditions for Britain remaining in the EU include limitations on EU migrants' welfare, opt-out clauses from the EU's aim to achieve an "*ever-closer Union*", and incremental powers for the UK's Parliament.[152]

The British labour market performs very well, with unemployment projected to decline to 5.4% in 2015[153]. There is room for improvement concerning female employment, skills mismatches, and low levels of wage mobility. In particular, the vocational qualifications system needs to be improved.

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[149] Source Eurostat and Eurostat.
[150] IMF, *Adjusting to Lower Commodity Prices*, World Economy Outlook, October 2015, IMF Publication Services.
[151] Source European Parliament.
[152] Mr Cameron revealed renegotiation demands on 10 November 2015. Proposals for reform include economic governance, competitiveness, sovereignty, and immigration.
[153] Source: European Commission.

Productivity developments in the United Kingdom have raised concerns. The under-spending in high-quality infrastructure and the underperforming credit sector could be improved.

The overall good functioning of the British product markets is enabled by a relatively deregulated economy since the 1980s. Nonetheless, market regulators should focus exclusively on their sectors to avoid market malfunctioning.

With regard to investment, the Government set out policy initiatives in its National Infrastructure Plan (NIP) to attract new private investment and to address the current under-spending in new and existing infrastructure.[154] According to EU officials, the promotion of high-quality infrastructure investment and reforming the tax system should render the system more investment friendly.

Regarding education and training policies, the United Kingdom has adopted measures to encourage youth employability through the strengthening of vocational education and apprenticeships. Some progress in reducing the number of people with low basic skills has also been achieved. However, large proportions of the adult population suffer from comparatively low levels of numeracy, literacy, and digital skills, which could weigh on UK competitiveness in the near future.

Regarding R&D, the United Kingdom has been facing a continued fall in the level of investment. The country devoted 1.28% of its government expenditure to R&D in 2014, compared to 1.38% on average in the EU. The 2016-2021 Investment Plan for Research Infrastructure does not provide clarity on the rest of the science and innovation budget. The country should increase its R&D public spending to reach levels closer to EU and US averages.

Concerning public deficit, the on-going fiscal consolidation has supported more efficient public spending toward investment. Expenditure cuts represented 80% of the consolidation measures in 2014, resulting in an estimated fall of 5.5 percentage point in the budget deficit between 2009 and 2014. Nonetheless, the country is still facing a situation of excessive deficit that should be addressed.

Regarding pensions, EU officials encourage further progress under the 2014 Pensions Act to move towards a three-pillar system.[155] Nonetheless, containing age-related expenditure would be necessary to assure long-term fiscal sustainability.

The United Kingdom faces a trade deficit.[156] Nonetheless, the on-going deterioration in the current-account deficit since 2010 has been driven by net investment income rather than a sharp deterioration in the trade balance. These results suggest that encouragement of the labour force skills should develop a spillover effect to the export sector, resulting in a gain in competitiveness.

Finally, the United Kingdom did not need to implement major reforms during the crisis, but minor adjustments had to be made. The United Kingdom has made substantial progress in improving the availability of bank and non-bank financing to SMEs. Additionally, the country has made some progress in implementing the CSRs, reinforcing its budgetary strategy, increasing the housing supply, improving youth employability and providing clarity on funding commitments. However, limited progress has been observed to reduce child poverty for low-income households.

[154] HM Treasury, *National Infrastructure Plan 2014*, December 2014.
[155] The 2014 Pensions Act 2014 introduced a single-tier state pension at a flat rate set above the level of means-tested support, brought forward by eight years the state pension age to 67, and set a framework for raising it in line with life expectancy. It also included a regular review of the pension age to ensure its link with longevity.
[156] A trade deficit occurs when an economy imports more goods than it imports.

7.1.2.3. Ireland

***Table 6:** Views of European stakeholders on Ireland*

IRELAND	
Labour Market	***Context:** Lack of labour mobility across sectors* → Addressing structural unemployment and long-term unemployment
Productivity	***Context:** Rebalancing of labour markets with structural increase in productivity across the public sector* → Allowing for wage increases in line with productivity development → Addressing skill mismatches
Product Market	***Context:** Weak implementation of the legal services reform* → Addressing enactment delays and reducing the cost of legal proceeding
Investment	***Context:** Recovering private investment, low public investment levels* → Stimulating public investment in key infrastructure
Education	***Context:** Minor reforms since the financial crisis* → Support to the ongoing reform of the Further Education and Training (FET) system
R&D	***Context:** Measures focused on developing incentives for R&D* → Higher tax incentives for R&D and the creation of intangibles (e.g., patents, trademarks)
Public Deficit	***Context:** Plan to reduce the headline deficit to 2.3 % of GDP in 2015* → Arbitrating between expenditure cuts or taxes increases to assure growth
Pensions	***Context:** Pension reforms expected to be financially sustainable in the long-term* → Building a pension scheme based on compulsory contributions
Trade	***Context:** Rebalancing process between the tradable and non-tradable sectors* → Completing the rebalancing process → Relying on strong trade relations with the more dynamic US and UK markets
Reform Implementation	***Context:** Multiple reforms being implemented simultaneously* → Enacting the legal services reform → Delays in implementation to be expected due to upcoming elections

After joining the Union in 1973, Ireland experienced a period of rapid economic growth fuelled by foreign direct investment, which led economists to refer to the country as the Celtic Tiger[157]. Nonetheless, the 2008 financial crisis plunged the Irish economy into recession and Ireland had to enter a bailout programme that involved tough austerity measures.

Irish authorities officially requested EU financial assistance on 21 and 28 November 2010; a technical agreement was rapidly reached and encompassed a comprehensive policy package for the period 2010-2013 for a total approved financial support package of €85 billion.[158] The Irish Government engaged in deep reforms following the provision of financial assistance. Priorities were to address macroeconomic imbalances thanks to public debt adjustment, labour market reforms, and education and training policies.

Ireland exited the bailout programme on 13 December 2013.[159] Preliminary data from the IMF even predicts a *"stronger-than-expected growth"* in Ireland for 2015 and 2016, forecasting the Irish GDP to increase by respectively 4.8% and 3.8%.[160]

Taoiseach[161] **Enda Kenny and his Fine Gael** (Liberal-Conservative) **and Labour coalition have led Ireland's parliamentary democracy since 2011.** The country benefited from strong political stability, notably during the financial crisis. Furthermore, Ireland represents an exception to the EU-wide trends of Euroscepticism, rising populism, and fragmentation of national parliaments. The

[157] The denomination derives from the similarities of the Irish economy with the East Asian Tigers (Hong Kong, Singapore, South Korea, and Taiwan) during their periods of rapid growth between the early 1960s and the late 1990s.
[158] Council of the European Union, *Council Implementing Decision of on granting Union financial assistance to Ireland*, 7 December 2010, 17211/1/10 REV 1.
[159] Martin, A., *Ireland exits bailout in better shape*, 13 December 2013, BBC News.
[160] IMF, *Adjusting to Lower Commodity Prices*, World Economy Outlook, October 2015, IMF Publication Services.
[161] Prime Minister of Ireland.

absence of migration pressures contributed to continuing support from the Irish population for the European project.

Regarding the labour market, the consensus to reduce salaries appeared as an essential tool for quick structural adjustments. EU officials remain sceptical about the developments of the labour market as structural unemployment, and particularly youth unemployment, stands at much higher levels than during the pre-crisis period (11.3% in 2014 against 4.7% in 2007[162]).

With regard to productivity, EU officials welcome the rebalancing of resources from the non-tradable to the tradable sector. If lower wages have been considered as efficient to increase productivity, wage increases would be welcomed if they appear to be in line with productivity development. Skills mismatches need to be further addressed.

Concerning product markets, data reveals a delay of implementation of the legal service reform. Legal services were included as one of the conditions for EU financial assistance in the 2010 reforms programme; yet, the reforming Bill has been stuck in Parliament since 2011. EU officials consider it necessary to address this implementation delay to enable the reduction of legal proceedings.

As regards investment, cuts in capital spending occurred since the beginning of the 2008 crisis, partly as a result of the reduction of public expenditure. A promotion of public investment would be advisable, especially focused on developing key infrastructures.

EU officials are sceptical about the proper functioning of the Further Education and Training (FET)[163] **Strategy for 2014-2019** that did not provide the necessary skills to smooth the rebalancing of the Irish economy. Ireland consequently enacted further reforms, which effects are yet to be visible.

Ireland is rapidly advancing towards its R&D investment target of 2.0 % of GDP in 2020. Nevertheless, EU officials encourage the country to implement higher tax incentives for R&D.

Concerning the public deficit, Ireland outperformed its 3% target for 2014. However, sustainable growth would require a clearer arbitration between expenditure cuts or tax increases.

As regards pensions, EU officials question the non-implementation of their recommendation to develop a pension scheme based on compulsory contributions. These results are to a great extent due to the upcoming 2016 national elections.

Ireland is currently rebalancing its trade policy from the non-tradable to the tradable sector. EU officials encourage the completion of this process and stress the strong trade relations with the more dynamic UK and US markets as a competitive edge for the country.

Regarding the reform implementation, EU officials believe that the enacted post-crisis reforms exhibit satisfactory results but more issues need to be addressed. It is unlikely that such reforms would be initiated before the upcoming national elections.

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[162] Source Eurostat.

[163] The term 'Further Education and Training' refers to education and training received after secondary school distinct from the higher education offered in universities. It encompasses any level above compulsory secondary education, from basic skills training to higher vocational qualifications.

7.1.3. Member States Following in Competitiveness

7.1.3.1. France

Table 7: *Views of European stakeholders on France*

FRANCE	
Labour Market	***Context:*** *Enhanced social dialogue and firms' empowerment* → Improving labour protection legislation to address inequalities → Reforming the labour law to provide more incentives for employers to hire
Productivity	***Context:*** *Productivity slowdown* → Boosting productivity by training low skilled workers
Product Market	***Context:*** *Implementation of the Macron law aiming to address uncompetitive behaviour* → Boosting competitiveness to increase firms' profitability and presence in export markets
Investment	***Context:*** *Appropriate overall level of investment but lack of investment in transport infrastructure* → Improving transport interconnections and housing offer
Education	***Context:*** *Good education system* → Implementing measures to prevent early school leaving
R&D	***Context:*** *Cumbersome innovation rules* → Simplifying rules to foster SME's ability to innovate
Public Deficit	***Context:*** *Introduction of the High Council of Finance* → Enacting structural reforms to correct excessive deficit
Pensions	***Context:*** *High expenditure level* → Implementing complementary pension schemes
Trade	***Context:*** *Taxes reduction* → Setting wage control to achieve full gain of tax reduction
Reform Implementation	***Context:*** *Limited progress on the CSRs* → Covering all the reform agenda → Adopting a more holistic approach to reforms

France is a founding member of the European Union and its third largest economy, accounting for 15.3% of EU GDP in 2015.[164] The French Republic has been a leading architect of EU integration together with Germany, but has witnessed a strong rise of Euroscepticism in the past decade, led by the right-wing Front National of Marine Le Pen.

The 2012 French presidential elections resulted in a victory for the Socialist candidate François Hollande. The French President started a box-ticking exercise in order to pass the necessary legislation to deliver on electoral promises. However, the currently low popularity levels of the French Government limit reform implementation, which are likely to be further delayed by the 2017 presidential elections.

France introduced balanced short-term-gains labour reforms to create more employment under fixed-term contracts, supported by extended social dialogue. Nonetheless, France faces gender inequalities in its labour market, with women's employment rate only reaching 65.6% in 2013 compared to 73.7% for men. In addition, the labour unions are not very large in size but retain a large influence.

Productivity developments exhibit a slight slowdown, despite a fairly good overall productivity level. Labour hoarding, especially in the manufacturing sector, has contributed to an increase in the under-use of the labour force. EU officials underline the need to train low skilled workers to address this downturn.

The Macron Law, which aimed to reform uncompetitive sectors and to improve French product markets, has been considered efficient. However, this Law was adopted under tough conditions, as

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[164] Source Eurostat.

the French Prime Minister had to 'engage the responsibility of the Government'[165] before the National Assembly passed the text. Nonetheless, France should foster competitiveness to increase its firms' profitability and presence in export markets.

France presents an appropriate overall investment level. Nevertheless, data shows a specific investment shortfall for the manufacturing sector, leading, amongst other things, to a lack of robotised equipment compared to other EU Member States.

The French educational system performs well, supported by the recent vocational training reform that encourages apprenticeship contracts. However, France faces an increasing number of low achievers, with poor educational attainments. The country should implement measures to train low skilled workers and to fight early school leaving.

Data reflects a good R&D level compared to the size of the country's manufacturing base. The attractiveness of high-quality public research fosters the emergence of new innovative companies. However, the country still faces a cumbersome system of rules and low levels of private R&D funding.

France's public deficit increased during the crisis in line with the traditional French approach based on enhanced public spending in times of economic turmoil. EU officials have pointed out the need to enact structural reforms to further correct the deficit, which is forecasted to decrease to 3.8% of GDP in 2016.[166]

The French pension system is among the most expensive in the EU, due to the high expenditure and an ageing population, raising questions about its sustainability in light of a forecasted deficit of 0.5% of GDP in 2040[167]. The under-performing complementary pension schemes and the forecasted exhaustion of its financial reserves by 2023 further stress the need for decisive action.[168]

As far as trade is concerned, the French Government attempted to restore the country's competitiveness by reducing labour taxation. However, this policy translated into higher wages that lower the competitiveness of French exports. Costly professional services further worsen these dynamics. Consequently, EU officials called for the set-up of a wage control mechanism.

EU officials pointed out limited progress on implementing the CSRs, questioning the ability of the country to pass more than one major reform per year in a given policy area. Commentators further stressed that the Government is pursuing the right reform objectives that vested interests watered down, as it is the case in the current debate on notary reform. According to one observer, it would be more beneficial for the country to concentrate on fewer issues at a time and ensuring that these are extensively transformed.

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[165] Article 49-3 of the French Constitution allows the Government – in specific situations – to commit its responsibility to push through a bill without a vote in the Parliament.
[166] European Commission, *European Economic Forecast Autumn 2015*, Institutional Paper, November 2015.
[167] European Commission, *Country Report France 2015 Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*, 26 February 2015, COM (2015) 85 final.
[168] *Ibid*.

7.1.3.2. Spain

Table 8: Views of European stakeholders on Spain

SPAIN	
Labour Market	***Context:*** *Rationalisation of labour markets after the 2012 reform* → Reducing differences in contract modalities → Possible need for centralised wage setting mechanisms[169]
Productivity	***Context:*** *Excessive reliance on the banking sector and weak investment in physical capital* → Addressing the high unemployment rate to boost productivity → Increasing investment in machinery
Product Market	***Context:*** *Strong regional disparities in regulation* → Promoting stronger competition among professional services → Reducing the regulatory burden
Investment	***Context:*** *Appropriate investment level in transport but lack in energy infrastructure* → Promoting energy interconnection with France
Education	***Context:*** *Reform of the higher education system to address the skills mismatch* → Addressing the low results in PISA scores and the disparities among regions → Improving the cooperation between public and private sector, notably in academic research
R&D	***Context:*** *Entrepreneurship Law facilitating SME financing for innovation* → Rationalising R&D management between regions → Creating a specialisation strategy to reduce overlaps
Public Deficit	***Context:*** *Strengthened fiscal framework since 2012* → Consolidating and achieving deficit targets
Pensions	***Context:*** *Reforms changing the contribution period and the retirement age* → Stabilising public debt to maintain pensions
Trade	***Context:*** *Current account surpluses* → Improving the quality of medium-to-low quality high-tech products
Reform Implementation	***Context:*** *Good overall performance* → Maintaining the momentum for reforms created by the crisis

Spain joined the European Union in 1986 and is its fifth largest economy, accounting for 7.5% of EU GDP in 2014.[170] The bursting of a large housing bubble in 2008 particularly affected Spain and produced the highest unemployment rate in the European Union. On June 2012, Spain requested financial assistance from the European Financial Stability Facility. From the total approved financial support package of up to €100 billion, the Spanish Government only drew €41.3 billion. The 18-month assistance program ended in January 2014.[171]

The latest economic developments have shown signs of improvement for Spain, which has reaped the benefits of reforms implemented by the Conservative People's Party of Mariano Rajoy's Government. Policy action focused on the adoption of a new fiscal and financial framework and labour market reforms.[172] However, Spain faces strong anti-austerity sentiment, as highlighted by the anti-austerity '15 May movement', though no Eurosceptic movement was formed. The IMF forecasts Spanish GDP to increase by 3.1% in 2015 and 2.5% in 2016.[173]

The legislative elections held on 20 December 2015 triggered important changes in the Spanish parliament monarchy, with the arrival of the left-wing party Podemos – born from the '15 May' movement – and the Catalan liberal party Ciudadanos. This new landscape should bring further political instability in the near future.

[169] The need for centralising wage setting mechanism has been pointed out by EU officials in line with the CSRs for Spain that suggest to foster real wage developments steady with the ultimate objective to create jobs.
[170] Source Eurostat.
[171] IMF, *Spain: Financial Sector Reform—Final Progress Report*, IMF Country Report No. 14/59, February 2014, IMF Publication Services.
[172] Interviewee 6, European Institutions.
[173] IMF, *Adjusting to Lower Commodity Prices*, World Economy Outlook, October 2015, IMF Publication Services.

The Spanish labour market is characterised by strong market duality that has a detrimental effect on productivity. The 2012 labour market reform has proven efficient but the need to centralise wage-setting mechanisms and to improve non-cost competitiveness remains. High long-term unemployment and youth unemployment rates of 22% and 48%, respectively, continue to aggravate the situation. According to EU officials, there is an overuse of temporary contracts, which brings additional difficulties to productivity growth due to poor companies' investment levels in terms of the training of their employees.

Productivity developments are hindered by high long-term unemployment and high segmentation. The small size of many Spanish manufacturing companies results in low productivity levels since they cannot benefit from scale effects. The re-skilling of workers towards dynamic sectors and encouraging non-banking finance should address unemployment and boost productivity.

Product markets suffer from strong regional disparities, as businesses face red tape and barriers to opening establishments in several regions. Uncompetitive pricing contributes to hamper the situation. The development of policies oriented towards the reduction of costs to open a business and facilitating market operations should help to address this situation.

Spain benefits from an appropriate investment level in transport but exhibits low levels of productive investment, notably in the interconnection of energy infrastructures with France. Addressing the situation might prove difficult in light of weak capital formation in the aftermath of the 2007 financial crisis.

The Spanish economy suffers from a mismatch between university studies, graduates' skills and labour market needs, aggravated by inter-regional disparities in education. This observation calls for the development of a higher degree of cooperation between public and business sector. Specific regional programmes have further proven efficient to mitigate early school leaving.

Spain should address its inefficient allocation of R&D tasks across regions, which has fostered duplication of work. The 2013 Entrepreneurship Law could be a strong basis for such change; this law aimed to facilitate access to R&D for smaller companies. Furthermore, the enhancement of R&D intensity for the Spanish manufacturing sector can help to develop its technology and to reduce the dependence towards imports.

EU institutions fear a possible budgetary deviation in Spain due to the overly optimistic GDP forecast formulated by the Spanish Government. As a consequence, EU officials have underlined the need to consolidate and achieve deficit targets.

The satisfactory implementation of the 2013 pension reforms should restrain long-term expenditure; these reforms modified the contribution period and extended the retirement age by two years. Nevertheless, a stabilisation of the public debt has been pointed out as essential to ensure the long-term sustainability of the new pension system.

Spain runs a current trade surplus, but exhibits weak exports penetration levels to other Member States. Strong import dependence on high quality technological products, calls for education, R&D, and investment policies moving the country up the global value chain.

EU officials consider there has been an adequate overall performance regarding reform implementation. For this reason, they encourage Spain to maintain the momentum for reforms that the crisis has created. However, the reform of professional services has been highlighted as an area where Spain has not done any progress. The reform on these services could improve the Spanish product markets and increase the competition within the sector.

7.1.3.3. Greece

Table 9: Views of European stakeholders on Greece

GREECE	
Labour Market	***Context:*** *Reforms in 2012 led to a more flexible market* → Need to fight undeclared work and simplify labour legislation
Productivity	***Context:*** *Reallocation of production sectors to restore competitiveness* → Creating opportunities for investment to innovate
Product Market	***Context:*** *Excessive regulation* → Pursuing professional services liberalisation
Investment	***Context:*** *Privatisation already conducted for transport infrastructure* → Addressing the excessive size of the public sector regarding other network industries
Education	***Context:*** *Weak public education system* → Launching a review of education policy to strengthen public and private partnership
R&D	***Context:*** *Absorption of EU funds increasing R&D expenditure* → Fostering stronger synergies with universities → Adapting financial conditions to support SMEs involvement in R&D → Improving public debt management to trigger easier funding
Public Deficit	***Context:*** *Fiscal adjustment over the last 5 years* → Improving budgetary management → Shifting tax property from labour to indirect taxation
Pensions	***Context:*** *Reform in 2012 to ensure financial sustainability of the new pension scheme* → Suppressing grandfathering on early retirement → Integration of the various pension systems into one fund → Strengthening the pension funds system
Trade	***Context:*** *Weak export sector for the economic size of the country* → Simplifying regulatory constraints on exports to open the country to internal trade
Reform Implementation	***Context:*** *Improvement over the 3 last years* → Need to further address difficulties in implementation highlighted by the European Commission

Greece joined the European Union in 1981 and its economy accounted for 1.3% of EU GDP in 2014.[174] The country was hit the hardest by the 2007 and ensuing Euro crises, with six consecutive years of recession and increasingly severe cuts in public spending. In January 2015, an anti-austerity coalition led by the far left party Syriza won the legislative elections with the promise of renegotiating the EU-IMF bailouts. The negotiations for a third bailout marked a peak of political tension within the EU and led to a further round of elections.

In the 20 September 2015 elections, the governing party Syriza won the largest number of seats but lost the outright majority. As a consequence, Syriza formed a coalition with the right-wing Independent Greeks party,[175] fostering an unstable political and social environment.

The majority of the Greek population supports Euro Area membership in light of the potentially devastating consequences of exiting the Single Currency. While an agreement on the bailout was eventually reached, the political instability has led the Greek population towards low degree levels of acceptance of reforms since the Government has not been able to counter the need for adjustment. The faith of the Greeks in the European project is at its lowest, and the reforms agreed upon by the Government lack public support. The political poses a serious threat to the implementation of reforms.

Greece enacted efficient reforms of the labour market in 2012 that have created a more flexible market for contractual relationship. Nonetheless, undeclared work and cumbersome labour legislation should be addressed to tackle the excessive unemployment rate of the country.

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[174] Source Eurostat.
[175] Teffer, P., *'Vindicated' Tsipras wins Greek elections*, 21 September 2015, EUobserver.

The recent reallocation of sectors has contributed to developing a better realignment of productivity with wage developments. The promotion of a higher interdependence between research and the business sector should foster innovation for business and boost productivity.[176]

The proper functioning of Greek product markets is constrained by excessive regulation. The existence of barriers also deters competition. EU officials have highlighted the need to pursue the liberalisation of professional services to address this issue.[177]

An excessively large public sector in network industries has deterred investment in Greece. The recently enacted labour and product market reforms and the privatisation of motorways should improve the overall business environment and reverse the trend.[178]

The quality of the public education system for primary and secondary levels concerns EU officials, as organisational rigidities have hampered its efficiency. The enacted rationalisation of the school system and the upcoming launch of a review of education policy aiming to strengthen public and private partnership should improve its efficiency.

The absorption of EU funds has contributed to increase R&D expenditure. Greece benefited from higher co-financing rate since 2010 due to its status as a country under financial assistance. Nonetheless, the Research and Innovation Strategies for Smart Specialisations (RIS3 strategies)[179] should be oriented towards the development of a national framework for R&D and innovation, supported by the promotion of stronger synergies with universities and the creation of tax incentives.

Concerning public deficit, EU officials are aware of the fiscal adjustments that have taken place in Greece over the last five years and note the improvements in the budget overall. Nonetheless, Greek public debt must be sustainable again to ensure long-term growth.

The 2012 pension reforms address the unsustainability of the Greek pension system but further reforms remain necessary, including the suppression of grandfathering on early retirement, as well as the integration and reinforcement of the pension funds systems into a common framework.

A weak export sector and the existence of regulatory constraints hamper the Greek trade openness. The simplification of the regulation should address the issue.

Greece is the EU Member State that has implemented the most reforms since the 2007 financial crisis but further reforms are still needed to restore long-term growth. EU officials point out that the presence of vested interests fosters a high risk of non-implementation of policy recommendations. The first Greek programme targeted primarily the improvement of accountability and left aside growth enhancing reforms, which fostered popular resistance to austerity and put a hold on further reform implementation that could address weak economic growth.[180] Hence, better communication from the Greek Government, with a stronger emphasis on the need for change and the positive impact of such change on growth in the medium term, is required to obtain stronger popular backing for further reform implementation.

[176] European Commission, The Second Economic Adjustment Programme for Greece Fourth Review – April 2014, Occasional Papers 192, April 2014.
[177] *Ibid.*
[178] *Ibid.*
[179] National/Regional Research and Innovation Strategies for Smart Specialisation (RIS3 strategies) are integrated, place-based economic transformation agendas. They are designed in entrepreneurial discovery process, so that the European Structural Investment Funds (ESIF) can be used more efficiently.
[180] Alessio Terzi, *Reform momentum and its impact on Greek Growth*, 29 July 2015, Bruegel Policy Contribution, Issue 2015/12.

7.1.4. Member States Catching up in Competitiveness

7.1.4.1. Poland

***Table 10:** Views of European stakeholders on Poland*

POLAND	
Labour Market	***Context:** Progress to balance the need for flexibility and worker protection* → Closing the gap in associated social contributions and in flexibility of contracts → Providing incentives to access the labour market by decreasing the tax wedge on low wages
Productivity	***Context:** Deregulation of the Polish professional services* → Reallocation of resources from agriculture to other sectors → Removing disincentives to expand scales of activities and simplifying the taxation scheme for small companies
Product Market	***Context:** Initiatives to reform public procurement rules* → Increasing competition in the energy industry
Investment	***Context:** Progress in transport investment thanks to EU Funds* → Clarifying the longer-term strategy to follow for the energy market
Education	***Context:** Important reforms in education and training* → Updating and correcting the outdated vocational education scheme → Encouraging companies to invest in human capital
R&D	***Context:** Measures promoting an innovation-friendly business environment* → Improving the quality and effectiveness of R&D policy → Strengthening business innovation
Public Deficit	***Context:** No debt issue* → Reaching the medium-term objective of a structural deficit of 1% of GDP
Pensions	***Context:** Reform of the pension system in 2013* → Assuring the well-functioning of the pension system in the long run
Trade	***Context:** The Russian embargo strongly impacted Polish exporters in the past* → Avoiding duplications in public money spending concerning the support for exporters
Reform Implementation	***Context:** Good performance* → Parliamentary elections at the end of 2015

Poland exhibits the strongest economic performance amongst the Central and Eastern European Member States which acceded to the European Union in the 2004 and 2007 enlargement rounds. Its GDP doubled in the 10 years following its accession[181], a growth – a unique case in the EU – which was not stalled by the 2007-2008 global economic crisis. Preliminary IMF data forecast a 3.5% increase in Polish GDP in 2015 and 2016.[182]

Member of the Conservative and Eurosceptic Law and Justice Party (PIS - Prawo i Sprawiedliwość) **Andrzej Duda was elected President on 24 May 2015**. The Law and Justice Party achieved outright majority after the October 2015 parliamentary elections. Election pledges included undoing the pension reform introduced by the former government that increased the retirement age for men and women.[183]

The Polish labour market suffers from extensive segmentation as Poland exhibits the highest share of temporary contracts in the EU, accounting for 26.8% of total labour contracts in 2013.[184] According to EU officials, the duality of labour could be addressed by reducing the gap in flexibility

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[181] Source Eurostat.
[182] IMF, *Adjusting to Lower Commodity Prices*, World Economy Outlook, October 2015, IMF Publication Services.
[183] Easton, A. *Poland returns to conservative roots with Law and Justice win*, 26 October 2015, BBC.
[184] European Commission, Commission Staff Working Document Country Report Poland 2015, February 2015, SWD(2015) 40 final.

and social contributions between fixed-term and long-term contracts. Decreasing the tax wedge[185] on low wages should provide further incentives to enter the labour market.

The recent deregulation of the professional services in Poland should ease the business environment and **contribute to increasing productivity.** Reallocation of resources from agriculture to other sectors should also support productivity developments. The removal of disincentives to expand scales of activities and the simplification of the taxation scheme for small companies should also foster productivity gains.

Concerning product markets, the recent initiatives taken to reform Polish public procurement rules are perceived as positive and should be further pursued. Addressing weak competitive forces at play in the energy sector could further improve productivity.

As regards investment, recent data show better absorption of EU investments, notably in the transport sector. A clear long-term energy strategy should support investment in energy infrastructure.

Regarding education and training policies, recent education reforms are perceived as efficient. Nonetheless, EU officials consider the Polish vocational system to be out-dated, and therefore advise the country to encourage companies to promote investment in human capital.

With regard to R&D, EU officials welcomed the measures promoting an innovation-friendly business environment. Poland should further improve the quality and effectiveness of its R&D policy and strengthen business innovation.

There is no public deficit issue in Poland. The country should therefore focus on achieving its medium-term objective of a structural deficit of 1% of GDP.

Poland reformed its pension system in 2013. Particular attention should be paid to ensure the smooth functioning of the reformed pension system in the long run.

As far as trade is concerned, the Russian embargo strongly impacted Polish exporters. Ineffective public spending and duplications in export support should be addressed.

EU officials stress the need to continue to implement the required reforms, despite the unsettling outcome of the October 2015 parliamentary elections.

[185] OECD defines tax wedge as the ratio between the amount of taxes paid by an average single worker (a single person at 100% of average earnings) without children and the corresponding total labour cost for the employer.

7.1.4.2. Latvia

***Table 11:** Views of European stakeholders on Latvia*

LATVIA	
Labour Market	***Context:*** *Improvement of labour market policies* → Correcting the weak coverage of active labour market policies
Productivity	***Context:*** *Ageing population and emigration of skilled workers* → Fostering policies for the return of migrants to bring back expertise and skills → Improving the supply of adequate skill-sets
Product Market	***Context:*** *Elements of corruption that hamper improvement of the product markets* → Implementation of an independent and business-oriented recruitment system since OECD accession → Conducting gas market liberalisation
Investment	***Context:*** *EU investment funds impacting positively on economic activity* → Addressing the lack of innovation → Fostering private investment
Education	***Context:*** *Recent progress to reform education* → Addressing inadequate public funding for higher education → Improving the attractiveness of vocational education and apprenticeships
R&D	***Context:*** *Weak R&D intensity* → Consolidation of research institutes → Increasing cooperation between businesses and academia
Public Deficit	***Context:*** *No public deficit issue* → Addressing insufficient resources attributed to the public sector due to low taxes → Limiting the impact of defence spending on other sectors
Pensions	***Context:*** *Rebalancing towards private insurance schemes* → Correcting a possible insufficient amount of pensions for retirement
Trade	***Context:*** *Modernisation of local infrastructure to reduce the trade deficit* → Diversifying strategies to benefit from the European market and become less dependent on the Russian market
Reform Implementation	***Context:*** *Slow progress* → Benefiting from EU funds to provide a stimulus to the Latvian economy → Having a balanced discussion between selected and broader issues

A member of the European Union since 2004, Latvia experienced strong economic growth until 2008. The country faced the deepest economic recession in the EU, exhibiting a 22.9% fall in GDP between 2008 and 2009.[186] EU institutions officially granted Latvia €7.5 billion in financial assistance on 20 January 2009.[187] Latvia initiated stringent fiscal consolidation[188] and achieved considerable wage cuts in both the private and public sectors.[189] The country showed revived growth in 2011, and has experienced resilient economic growth since them; the IMF predicts the Latvian economy to grow by 2.2% in 2015 and 3.3% in 2016.[190]

The Government coalition led by centre-right Unity, centrist Green/Farmers Union, and right-wing National Alliance was re-elected on 4 October 2014. The coalition has, however, faced internal opposition among its members since the elections, which has slowed reform implementation. Nevertheless, Euroscepticism represents a marginal issue in the Latvian political debate. While criticism of some EU policies occurs, no main party questions the benefits of EU integration.

[186] Source Eurostat.
[187] Council of the European Union, *Council Decision granting mutual assistance for Latvia*, 20 January 2009, OJ L 79/37.
[188] Fiscal consolidation is a reduction of Government deficit and debt accumulation.
[189] Council of the European Union, *Council Decision providing Community medium-term financial assistance for Latvia,* 20 January 2009, OJ L 79/39.
[190] IMF, *Adjusting to Lower Commodity Prices*, World Economy Outlook, October 2015, IMF Publication Services.

Latvia still faces a weak social security system, a shrinking labour force, and high levels of youth unemployment. Improving the quality of vocational and higher education systems and career guidance services, as well as developing more considerate austerity measures, should prove useful. EU officials further recommend improving the financing and coverage of active labour market policies.

The emigration of skilled Latvian workers and its ageing population hamper productivity developments, as Latvia's productivity level ranges at around 60% of EU average.[191] The country should improve the supply of skill-sets and promote the return of skilled workers to bring expertise back within its borders. Reforming the education and innovation system is also deemed necessary to boost productivity.

Product markets would greatly benefit from a more transparent business environment, notably regarding corruption. The OECD accession enabled the Latvian Government to implement an independent and business-oriented recruitment system. Latvia should conduct the liberalisation of the gas market and the separation of the network to improve the functioning of the Baltic gas market.

The absorption of EU funds has positively impacted investment in the country. Nonetheless, investment levels remain weak in Latvia, particularly in transport and energy infrastructure. Fostering innovation and stimulating private investment should help to address these issues.

Latvia has initiated the reform of its education system. The country should still address the inadequate public funding for higher education, and improve the attractiveness of its vocational education and apprenticeship programmes, notably in technology and engineering.

Latvia's R&D levels are particularly weak and hinder the development of a knowledge-driven economy.[192] A more important allocation of funds to R&D and a stronger cooperation between business and academia would be advisable.

Adjustments following the 2007 financial crisis tackled Latvia's public deficit issue. Defence appears as a priority due to the on-going tensions with Russia. Nonetheless, attention should be paid to the insufficient resources attributed to public administrations and other key sectors such as health, education, and social expenditure.

Latvia has rebalanced its public pension scheme towards a privately managed system. EU officials remain unsure about the proper future functioning of this on-going rebalancing, as pension adequacy is unlikely to be achieved in the medium-term.

Latvia's trade deficit includes a relatively strong exposure towards the Russian economy. The on-going Russian crisis and sanctions have shown the difficulty to re-orientate the export market. Latvia should encourage companies to diversify their trade strategies to benefit from the European market while becoming less dependent on Russia.

Latvia shows slow progress in reform implementation. A proper use of EU funds could contribute to stimulating Latvian economy while allowing for a more balanced approach in the allocation of public resources.

[191] European Commission, Commission Staff Working Document Country Report Latvia 2015, 26 February 2015, SWD(2015) 33 final.
[192] *Ibid.*

7.1.4.3. Bulgaria

Table 12: *Views of European stakeholders on Bulgaria*

BULGARIA	
Labour Market	***Context:*** *Weak labour market* → Developing an integrated approach for unemployed older workers and young people → Addressing skill mismatches
Productivity	***Context:*** *Restructuring of businesses since 2008* → Correcting the weak administrative capacity → Reducing burdensome regulation and high compliance costs for businesses
Product Market	***Context:*** *Decreasing costs to start a business* → Addressing the remaining challenges to ease doing business
Investment	***Context:*** *Rebalancing of FDI inflows* → Correcting the continuous decline in private investment → Addressing the persistent corruption problem
Education	***Context:*** *Late adaptation of the vocational education and training legislation* → Improving young people's employability → Addressing the skills mismatches worsened by ageing population and high levels of emigration
R&D	***Context:*** *Insufficient levels of investment* → Promoting innovation activities of undertakings
Public Deficit	***Context:*** *Plan to reduce public deficit to 2,8 % of GDP in 2015* → Addressing the shadow economy → Improving tax collection
Pensions	***Context:*** *Bulgarian healthcare system facing several major challenges* → Increasing the retirement age and limiting early retirement
Trade	***Context:*** *Restructuring of businesses since 2008* → Cutting red tape to reduce the administrative burden for businesses
Reform Implementation	***Context:*** *Political instability and limited progress in addressing the CSRs* → Promoting an active dialogue with stakeholders to build a broad public consensus

Bulgaria joined the European Union in 2007 as its least developed Member State with a GDP per capita of €3,200 against a €23,200 EU average in 2013.[193] Low fertility, stagnant life expectancy, high emigration, subdued domestic demand and strong dependence on the Russian market hamper growth prospects. The IMF nonetheless predicts the Bulgarian economy to increase by 1.7% in 2015 and 1.9% in 2016.[194]

The 2014 financial crisis coincided with a period of political uncertainty, marked by the resignation of Prime Ministers Boyko Borisov (GERB, right-wing party) in February 2013 and Plamen Oresharki (Socialist Party) in July 2014. GERB won the parliamentary elections held on 5 October 2014 but did not obtain an absolute majority and therefore engaged in a coalition to form a government.[195]

Bulgaria remains largely pro-EU, despite its membership of the Schengen Area being delayed by the presence of organised crime, persistent corruption and weak rule of law. The country is not a member of the Eurozone, though its Government stated its intention to consider further steps towards the Single Currency only once it has stabilised.

Structural long-term unemployment has worsened the country's weak labour market. The misalignment between the supply and demand of skills, fuelled by an ageing population and extensive

193 Source Eurostat.
194 IMF, *Adjusting to Lower Commodity Prices*, World Economy Outlook, October 2015, IMF Publication Services.
195 BBC, *Centre-right GERB party ahead after Bulgaria election*, 5 October 2014.

emigration, poses a mismatch problem. The development of an integrated approach for jobless older workers and young people should help to address this issue.

Cumbersome regulation with high compliance costs for business, a weak administrative capacity, and high corruption levels hamper Bulgarian productivity. Business restructuring taking place since 2008 should help address these issues.

Difficulty in conducting business implies an improper functioning of Bulgarian product markets. Already achieved progress to decrease the costs of starting a business, together with on-going guidance, should contribute to improving the overall business environment.

EU membership gave Bulgaria access to various European Funds, but the absorption rate of such financing remains one of the lowest in the EU due to Government constraints. Some improvements occurred in recent years, which have improved growth prospects and export performance. Nonetheless, private investment remains weak. Improving the reliability of the Bulgarian banking sector and improving the ease of doing business should help addressing the issue.

The low quality of education and training systems hampers the supply of necessary and adequate labour to the market. [196] Bulgaria should therefore enact policies to improve youth employability, promote flexible pathways between vocational and general education, and improve the management of universities, and to provide widespread lifelong learning.

With regard to R&D, data from EU officials indicates a poor investment level in the country. Public policies in R&D suffer from inefficient governance structures and weak long-term financial commitment. The adopted Innovation Strategy for Smart Specialisation should improve the competitiveness of the country.

The Bulgarian public deficit is below the 3% threshold and complies with the SGP criteria. EU officials have underlined the need to address the shadow economy and to improve tax collection to avoid a structural deterioration of public finances.

The adequacy and sustainability of the pension system depend on reforms that incentivise and support a longer and less interrupted working life. Data from EU officials reveals that the Bulgarian healthcare system faces several major challenges. Bulgaria should increase its retirement age and limit early retirement.

An excessive administrative burden for businesses and red tape deter Bulgaria's trade performance. Furthermore, the country is heavily dependent on Russia energy imports, while services exports to Russia are significant. Reforms to improve the overall business environment and the diversification of trade strategies towards intra-EU trade should improve the country's overall trade performance.

Reform implementation levels remain weak due to extensive corruption problem that deter possible changes. The EU Institutions should follow and assist the Bulgarian Government during the implementation of the recommended reforms. The country should build an active dialogue with stakeholders to enhance cooperation.

[196] European Commission, *European Economy Macroeconomic imbalances Country Report – Bulgaria 2015*, June 2015.

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