Key factors affecting the **future growth of Europe**

An economic basis for political action

January 2015

STUDY

European Economic and Social Committee

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Study on the key factors affecting the future growth of Europe

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CONTRACT No.21152 Relations with Organised Civil Society and Forward Studies/04/2014

DOCUMENT INFORMATION

CLIENT	European Economic and Social Committee (EESC)
CONTRACT NUMBER	No.21152 Relations with Organised Civil Society and Forward Studies/04/2014
REPORT TITLE	Study on the Key factors affecting the future growth of Europe
REPORT SUB-TITLE	An economic basis for political action
PROJECT TEAM	Lighthouse Europe
PROJECT OFFICERS	Dr David Sears, EESC Group I Secretariat, EESC
DATE	January 2015
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DISCLAIMER	This study was carried out by Lighthouse Europe following a call for tenders launched by the European Economic and Social Committee. The information and views set out in this study are those of the authors and do not necessarily reflect the official opinion of the European Economic and Social Committee. The European Economic and Social Committee does not guarantee the accuracy of the data included in this study. Neither the European Economic and Social Committee nor any person acting on the Committee's behalf may be held responsible for the use which may be made of the information contained therein.

Please cite this publication as:
Lighthouse Europe (2015), *Study on the key factors affecting the future growth of Europe* prepared for EESC

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LIST OF ABBREVIATIONS

BRICS	Brazil, Russia, India, China, South Africa
CCCTB	Common Consolidated Corporate Tax Base
CMU	Capital Markets Union
CO_2	Carbon dioxide
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
ECB	European Central Bank
ESM	European Stability Mechanism
ETS	Emissions Trading System
GDP	Gross Domestic Product
ICT	Information and Communication Technologies
IPR	Intellectual Property Rights
MIP	Macroeconomic Imbalances Procedure
OECD	Organisation for Economic Co-operation and Development
QE	Quantitative Easing
R&D	Research and Development
SGP	Stability and Growth Pact
SWOT	Strengths, Weaknesses, Opportunities, Threats
ULCs	Unit Labour Costs
UP	Unitary Patent
YoY	Year-on-Year change

LIST OF COUNTRIES

AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EA	Euro Area
EE	Estonia
EL	Greece
ES	Spain
EU	European Union
FI	Finland
FR	France
HR	Croatia
HU	Hungary
IE	Ireland
IT	Italy
JP	Japan
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
US	United States

ABSTRACT

Achieving sustainable growth in a competitive world is challenging. The challenge is even greater for the European Union, as the Old Continent faces a severe competitiveness deficit.

Without entering into a health review, that could be delivered at a further stage, of each of the 28 Member States, **the ambition of this study is to draw-up a comprehensive picture of EU economic growth**. This will lead to specific recommendations on the conditions to restore EU competitiveness and a scoreboard of the current state of reforms among Member States. **The reader will have a clearer appreciation of the tools that could be usefully mobilised on both economic and political levels to tackle the growth issue and seize the most realistic opportunities to restore growth within the EU.**

We analyse step by step the main reasons for the EU's lack of competitiveness paving the way for a comprehensive analysis of the conditions necessary to stimulate EU competitiveness. There follows a review of the current state of reforms. The conclusions are summarized in a SWOT analysis chart for the EU.

EXECUTIVE SUMMARY

Achieving sustainable growth in a competitive world is challenging. The challenge is even greater for the European Union, as the Old Continent faces a severe competitiveness deficit. In practical terms, economic growth results from competitiveness, i.e., from the ability to produce high-quality products at a relatively low price for sale on the world market. However, EU competitiveness is weakened by both internal and external factors.[1]

Regarding internal weaknesses, the European economy has evolved into a high-cost business environment with an ageing and relatively expensive labour force limited, in many cases, by low productivity. Innovation is weakened by the incomplete achievement of the Single Market and the weak application of intellectual property rights and trademarks. High debt levels in both public and private sectors throughout the Euro Area are further challenges for European competitiveness while EU governance and Single Market integration remain fragile in the aftermath of the 2007 and Euro Crises.

Regarding external threats on competitiveness, the European financial system is not able to attract enough investment to stimulate innovation while insufficient access to resources weighs on production costs. Moreover, pessimistic global economic perspectives exaggerate these negative trends.

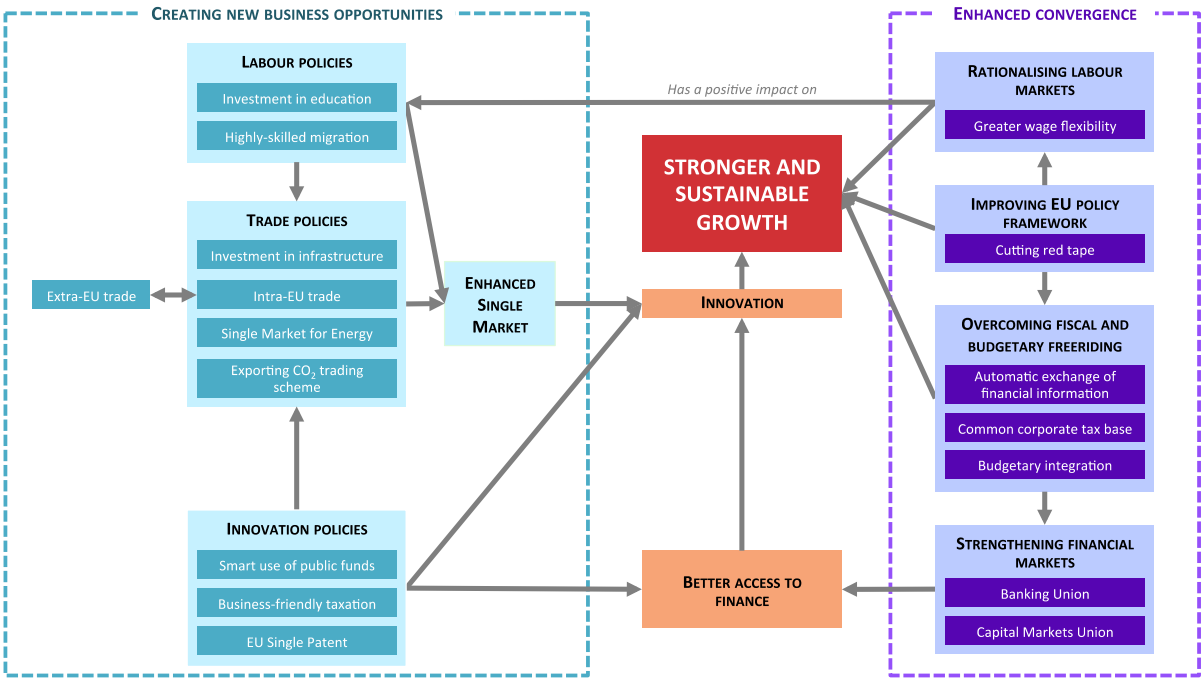
Still, the European Union has the potential for growth but needs to initiate the right reforms to boost its competitiveness. In a context of budgetary discipline, these reforms should aim at making the Single Market a truly integrated level playing field, which will enable firms to compete and innovate in a favourable business environment.

Creating new business opportunities would allow firms to invest more, increasing their competitiveness and fostering growth. Achieving a more integrated Single Market should therefore be a priority. To this end, reforms should focus on increasing investment in education, enhancing the movement of highly skilled workers within the Single Market, increasing investment in network industries and stimulating intra- and extra-EU trade. To reap the benefits of a more integrated Single Market, the European Union should also create the conditions for higher private and public investment by encouraging more business friendly taxation and promoting a smarter use of national and European public funds.

Achieving enhanced convergence should enlarge the European level playing field and restore EU-competitive forces. Reforms should therefore aim at improving the general framework of EU policy, overcoming fiscal and budgetary free-riding, rationalising labour markets and strengthening financial markets.

[1] This study aims at highlighting the general trends in the European Union as a whole and relies on macroeconomic analysis of the notion of growth. Its ambition is to present tendencies based on hypotheses regarding aggregated economic data and political feasibility of the suggested measures without, at this stage, reverting to a country-based approach.

Figure: *Boosting EU competitiveness*



Source: Lighthouse Europe

The economic crisis and the political willingness to implement structural reforms have revealed disparities among EU countries in their approach to integrate these key reforms in their economic policies. Three groups of countries can be differentiated:

- *Member States acting by anticipation* dominated by Northern European countries with a better position in terms of competitiveness and political acceptance of further reforms (e.g., Germany),
- *Member States implementing structural changes under economic pressure*, 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 (e.g., Greece),
- *Member States in often very rapid economic catch-up* which have in common their low level of public debt, lower wages and positive attitude towards policy reforms. It is a key element regarding their growth potential (e.g., Poland).

These three groups highlight the discrepancies between Member States as regards to a successful implementation of growth-enhancing reforms. Fiscal discipline and the implementation of growth-and-competitiveness-orientated policies have proven to be efficient whereas a *laisser-faire* approach and the lack of structural reforms have created an uncomfortable economic and political situation in the concerned countries.

The European Union still has economic and political latitude to implement growth-efficient policies. Its scope for action is however gradually reducing and urgent reforms are now required.

INTRODUCTION

At the end of the 1990's, Jacques Delors defined the keys to the economic success of the European Union in the following words:

"Competition that stimulates, cooperation that strengthens, and solidarity that unites."

The optimistic thinking of this sentence is now often denounced as irrelevant and even naïve in the light of the contemporary reality of the European Union: economic imbalances, enhanced global competition, free-riding policies, stagnation, looming deflation and, last but not least, citizens' impatience and disapproval. Two provocative questions emerge from this:

Does the European Union still have a purpose in an unstable and fragile environment?
Are the "European" criteria still relevant to compare widely differing economies such as Greece and Germany?

The European paradox lies in the confrontation between a common understanding of the required structural reforms to restore growth and their feasibility from a political standpoint. As a general fact, populism and extremism within the European population is gaining ground against an out-dated consensus prompted by the European founding fathers in a post-war context. It is therefore legitimate to challenge the feasibility of the proposed economic cure to restore growth on a political basis.

Economic difficulties often give way to irrational reasoning or statements, either over-optimistic or unduly pessimistic. These hyperbolic appreciations of the issue justify **the need for an objective and scientific appreciation of the key factors affecting the future growth of Europe** (*Part II*). An **economic analysis** of the economic growth is therefore crucial to understand the real weaknesses of the European Union and the disparities of the European countries (*Part III*).

The ambition of this study is not to complete a health review for each Member State that could be delivered at a further stage. **Its objective is to draw-up the common tendencies of the European economy in the light of their economic growth criteria**. This will lead to specific recommendations on the conditions necessary to restore EU competitiveness and a scoreboard of the current state of reforms among Member States. **This appreciation will give a clearer view of the tools that could be usefully mobilised to tackle the growth issue and seize the realistic opportunities to restore growth within the EU, taking into account the political feasibility of the proposed measures.**

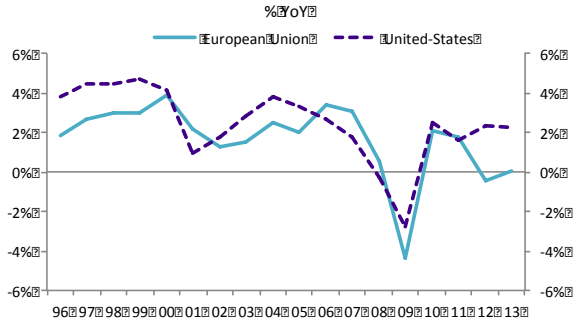
The main reasons for EU's lack of competitiveness will therefore be analysed step by step (*Part IV.1*), paving the way for a comprehensive analysis of the conditions to stimulate EU competitiveness (*Part IV.2*). This will lead ultimately to a review of the current state of reforms from a political standpoint (*Part IV.3*). The relevant conclusions will be summarized in a SWOT analysis chart for the EU (*Part IV.4*).

Conducted by Elise Cachin, graduate of Paris Dauphine University and the College of Europe, under the supervision of Lighthouse Europe, **this study emphasizes a pedagogical approach aiming at explaining a complex reality in simple though hopefully not simplified terms**.

OBJECTIVE AND GROUNDS FOR THE STUDY

The 2007 and Euro Crises have dramatically weakened the economic growth of the European Union (***Figure 1***).

Figure 1: *GDP Growth in the EU and the US*



Source: Eurostat

With low medium-to-long-term growth and low inflation expectations, the European Union is currently confronted by **a risk of a long-lasting recession**[2]:

- *Consumption* is weakened by **high unemployment** and **massive wealth destruction**, fostering a loss of consumer confidence and consequent **risk of Japan-like deflation**[3].
- *Investment* suffers from **weak innovation** compared to the rest of the world, **weak patent protection** across the EU, **poor access to finance and heavy labour costs**,
- *Budgetary consolidation* of already highly indebted Member States **limits public spending**,
- The ECB cannot lower **interest rates** to stimulate *export* growth.

As a result, **the position of the EU as a global commercial power weakens**, reducing its influence, economic leadership and world stature.

Why does growth matter? Economic growth improves standards of living and extends life expectancy. It also helps reducing inequalities and creates jobs. Low growth rates have a very strong impact in the long run: if a 2% annual growth rate doubles GDP per capita in 35 years, a 1 % rate stretches the doubling process out to 70 years. In more practical terms, **the lower the growth rate, the greater the challenges for future generations**.

In summary, **economic growth** is the growth of output over time, i.e., the growth of the quantity of goods and services produced by an economy during a year. It **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 and therefore stimulates growth.

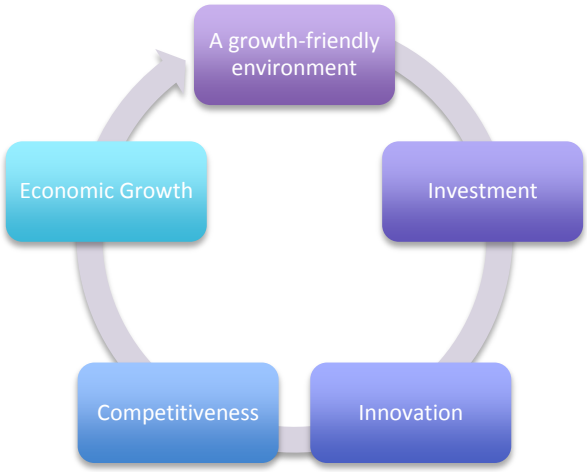
Strong economic growth requires enhanced competitiveness over time.

How to achieve enhanced competitiveness over time? A growth-friendly environment fosters the conditions for enhanced investment. Investment in turn leads to innovation, from which derives competitiveness and growth. A virtuous circle consequently appears (***Figure 2***). **As growth derives from competitiveness, this study focuses on the factors impacting EU competitiveness to understand the reasons for the currently weak growth rate in Europe and to find new drivers for growth.**

[2] A recession is a significant decline in activity across the economy, lasting longer than a few months.

[3] The opposite of inflation, deflation is a general decline in prices. Deflation discourages both investment and expenditure – as firms and households expect it will be cheaper in the near future – and consequently undermines growth.

Figure 2: *The virtuous Growth-Competitiveness circle*



Source: Lighthouse Europe

METHODOLOGY

Approach

This study uses theory and qualified examples of economic policies at both Member States and EU levels to put into perspective the key factors affecting the future growth of Europe. It focuses on the risks and the relevant economic levers.

The current outcomes of the implementation of the suggested measures will be mentioned in light of their compliance with the above-mentioned recommendations.

The outcome of the study is analysed and summarised in a SWOT chart. This, leads to conclusive remarks on the tools the EU can use as a remedy to its low growth potential.

Exploratory field

The reader will be provided with an objective and comprehensive understanding of the issue thanks to different sources (***see Bibliography in appendixes***):

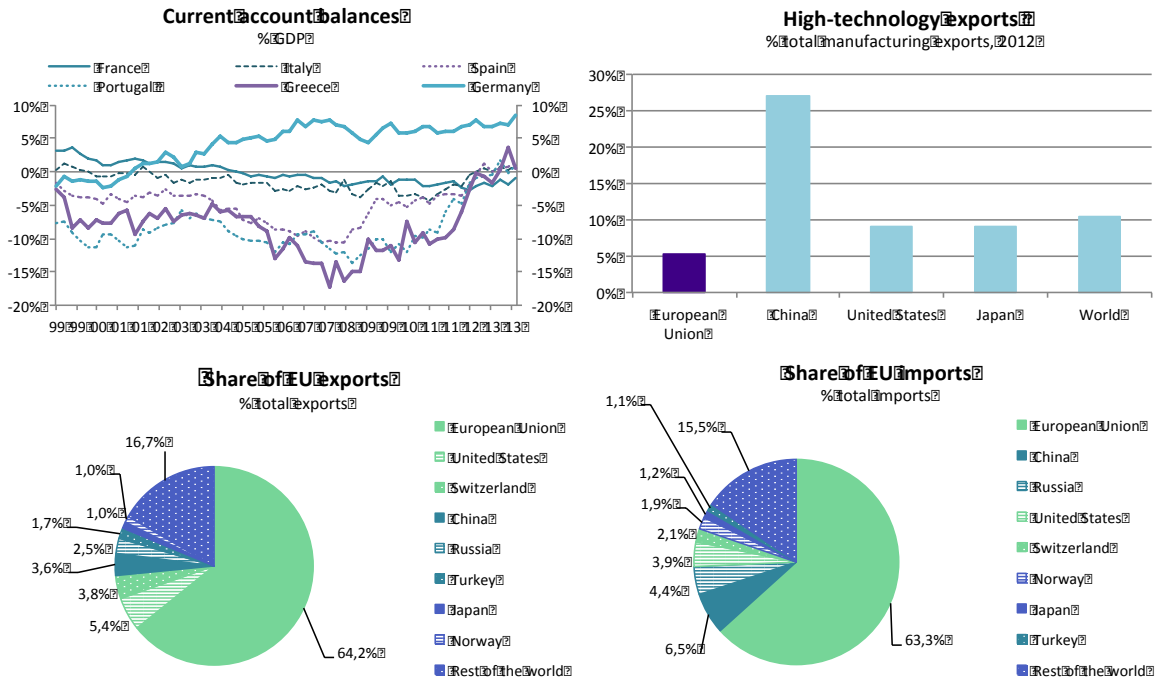
- Academic reports from Think tanks and Universities,
- Analyses and forecasts at EU and Member States levels,
- Reviews from International organisations,
- Publications from consultancies and corporate stakeholders,
- Rating agencies briefs.

CASE STUDY

Chapter I: The reasons for the EU's lack of competitiveness

The position of the European Union as the largest exporter in the world market has decreased over the decade: it imports more than it exports[4] (***Figure 3***). Even though part of this evolution can be explained by the emergence of the BRICS countries[5] in world trade, the recent deceleration of EU economies threatens EU growth in the long run. The 2008 financial crisis has forced EU Member States to initiate deep structural reforms but challenges remain.

Figure 3: *EU's deteriorating competitiveness*



Source: OECD, Eurostat, European Commission, World Bank

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

I.1. Internal factors

I.1.1. A high-cost environment

Competitiveness is also a question of costs. A product is deemed competitive when it enjoys a higher quality-price ratio compared to other similar products available on the world market. In the framework of a country or

[4] The current account of a country measures the difference between its exports and its imports of goods and services with the rest of the world.
[5] Brazil, Russia, India, China, South Africa.

a region such as the EU, **an economy is competitive if it has the ability to produce high-quality products at a lower cost than its competitors**.

In this context, **its labour force is a cornerstone of competitiveness**. According to its quality (i.e., skill level) and its price (i.e., wages), the labour force may be able to achieve the following quality-price trade-off:

- A highly skilled labour force can produce efficiently high-quality products that will be sold at a low (or at least, acceptable) price on the world market.
- Still, the higher the skill level, the more expensive the labour force; its cost then weighs on production costs, pushing up the price of the products on the world market.

Innovation is an important driver. By making production processes more efficient, it fosters competitiveness. By creating new products, it provides a competitive edge, as its beneficiary becomes the only manufacturer for a limited period of time.

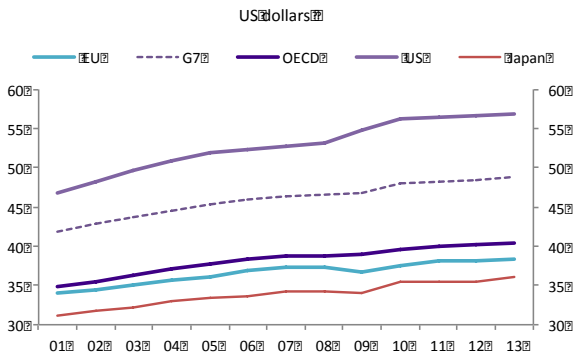
The two components of Europe's competitiveness are therefore its labour force and the state of innovation.

I.1.1.1. An expensive and ageing labour force experiencing growing inequalities

Two indicators can measure labour quality and costs: **productivity**[6] (expressed in GDP per hour worked) and **the average labour** cost **per unit of output produced** expressed by the Unit Labour Costs (ULCs).

EU competitiveness is weakened by the overall low productivity of its labour force compared to its major competitors with only $43.7 produced per hour worked in 2013 against $57.5 in the United States (***Figure 4***) despite some improvements since 2000. These results may be partly explained by **the low education level in the EU**: on average, 26.7% of 25-64 year-olds have reached tertiary education in the EU against 43.5% for the US.[7, 8]

Figure 4: *GDP per hour worked*

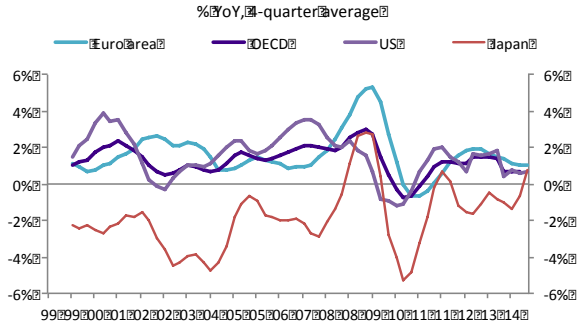


Source: OECD

The rise in EU labour costs also weights on Europe's competitiveness. Unit Labour Costs (ULCs) have strongly increased since 2000, even though the recent financial crisis has curbed the trend. This outcome results from the extensive use of redistribution policies in case of negative shocks in the EU while countries like the US rely more on wage flexibility (***Figure 5***).

[6] Productivity expresses how efficiently output is produced.
[7] Source Eurostat and OECD.
[8] The OECD is used as a proxy for EU average. EU Member States in the OECD are: Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.
Non-EU OECD members include Australia, Canada, Chile, Iceland, Israel, Japan, Korea, Mexico, New Zealand, Norway, Switzerland, Turkey and the United States.

Figure 5: *Evolution of Unit Labour Costs in the EU and selected countries*



Source: OECD

The weakness of EU competitiveness has been exacerbated by high and lasting unemployment to which in turn contributes – creating a vicious circle (***Figure 6***)**.** Unemployment fosters skills depletion[9], which is particularly problematic in case of high youth unemployment as currently experienced by the EU. Firstly, lasting unemployment implies for young graduates a lower probability of future employment and lower wages. Secondly, youth unemployment is a missed opportunity for competitiveness: fresh graduates hold up-to-date knowledge that could improve EU competitiveness by injecting innovative ideas into companies. Thirdly, high levels of youth unemployment erode social cohesion and institutions, fostering crime.

Figure 6: *Unemployment in the European Union*

	European Union	United States
Unemployment rate (%)	**10.5**	**7.4**
Youth (%)	23	16
Long-term unemployed (%)	4.7	2.7

Source: OECD

High unemployment rates imply lower income for households. Households consequently lower their consumption and save more to create a safety net. For firms, lower consumption means less profit and fewer opportunities to invest in more efficient production processes.

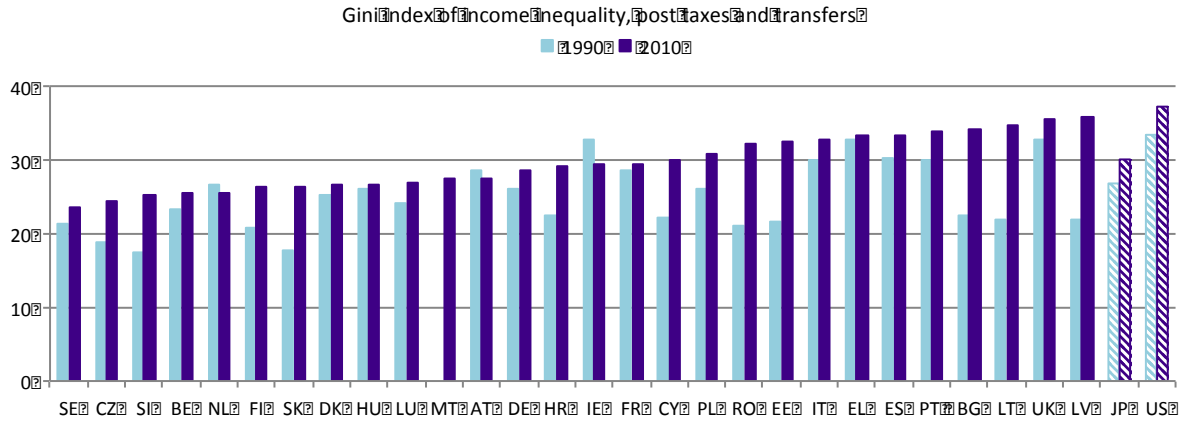
Furthermore, the 2007 and Euro Crises have increased the social imbalances within and between EU Members States, in particular youth unemployment, actual poverty, income inequality and social protection (***Figure 7***)[10], which have a negative impact on EU growth:

- EU institutions struggle to adopt appropriate policy responses in case of EU-wide economic and financial shocks such as the 2009-2011 Eurozone debt crisis.
- Such imbalances undermine the growth potential of Europe's economies by limiting growth opportunities (e.g., reduced consumption and innovation).
- They threaten the sustainability of public debt by simultaneously calling for more social spending and lower tax receipts.

[9] Skill depletion accounts to the loss of skills due to inactivity. Consequently to its inactivity, the skills of an unemployed person deteriorate; the longer the inactivity, the greater the skill loss, i.e., the greater the skill depletion.

[10] The Gini index measures income inequality. It ranges between 0 in the case of perfect equality and 100 in the case of perfect (i.e., very serious) inequality (The World Bank definition).

Figure 7: *Growing inequalities in the EU*

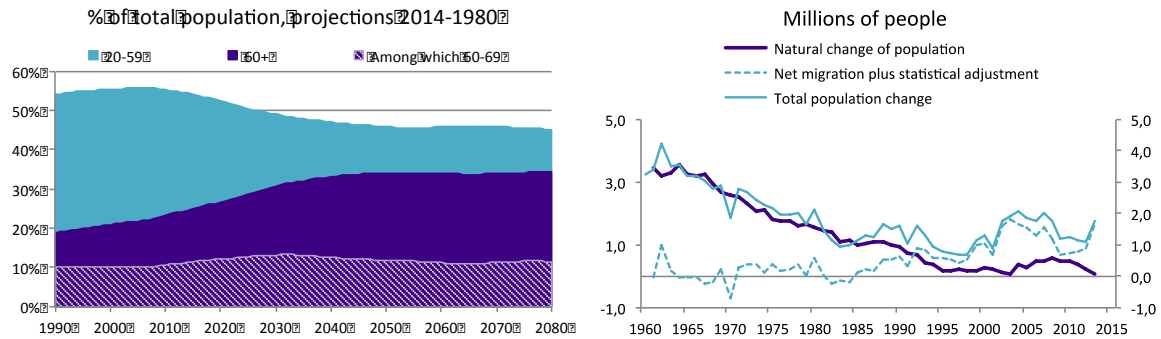


Source: Standardized World Income Inequality Database, Bruegel

The ageing labour force threatens competitiveness in the longer run (***Figure 8***)**.** Firstly, an ageing population implies more seniors within the European economy. It has a negative impact on social security systems that face higher health and pension expenditure while lowering tax revenue for the government, which threatens public debt sustainability. As more people prepare to retire, investments in pension funds expand, reducing the amount of savings available for more productive investment and thereby lower economic growth.

Secondly, an ageing population implies fewer workers on the market. As the labour force shrinks, wage inflation occurs and weakens competitiveness. To compensate for the loss of tax income with the elderly leaving the job market, the workers remaining on the market might face higher taxes, which creates disincentives to work and discourages firms to invest. Overall, these developments lead to a fall in competitiveness and growth.

Figure 8: *The ageing of the EU labour force*



Source: European Commission, Eurostat

Migration could reverse the trend but Europe is experiencing a fall in immigration[11] – aggravated by a sharp fall in highly skilled immigration – **and a brain drain**. The positive impact of migration is further restrained by a low employment rate of third country nationals (10% below the overall employment rate[12]) due to discrimination and a failure to recognise their existing qualifications.

[11] Source OECD.
[12] Source European Commission (2012).

I.1.1.2. Decelerating innovation

Innovation shapes competitiveness by creating the conditions for more efficient production at any quality level considered. Innovation can be considered as the transformation of investments in research and development into marketable products, i.e., the capacity to create new products. A high innovation rate fosters competitiveness by improving the quality of labour, i.e., the level of qualification.

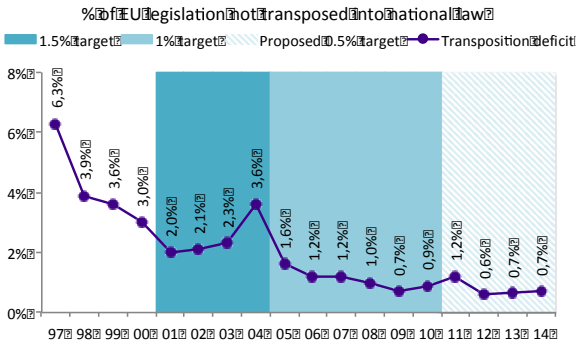
Many factors influence innovation:

- *The level of integration of the Single Market*, i.e., the rationale for innovation,
- *Intellectual property rights and trademarks*, i.e., the tools ensuring innovation is profitable to investors,
- *Spending in research and development*, i.e., what is actually invested in innovation.

Regarding the Single Market, its current level of integration fails to stimulate innovation due to lacking and inadequate transposition of EU law into national law (***Figure 9***). Despite a strong improvement over the last decade, the Single Market has not reached its critical step to encourage more extensive innovation:

- A more integrated Single Market would stimulate competition between firms, which would force companies to improve their production processes, i.e., to innovate, to be able to compete and survive on the market.
- With a larger market, firms would be able to spread the cost of investment over a larger pool of consumers, creating incentives to invest.

Figure 9: *The transposition deficit*



Source: European Commission

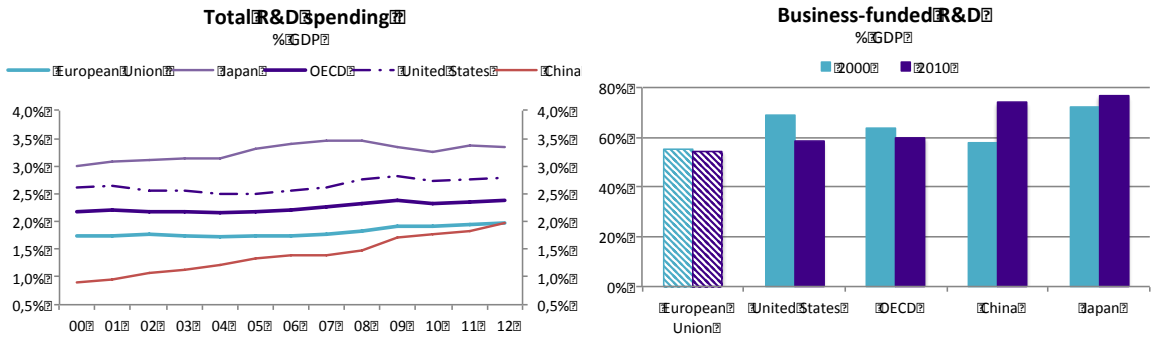
Regarding Intellectual property rights (IPR) and trademarks, Europe is still lagging behind its main competitors. The functioning and costs of the European patent system greatly explain this trend: a patent must be validated, translated, monitored and enforced in every national patent office. In 2008, it was 9 times more expensive to issue a patent in Europe than in the US and 7 times more costly than in Japan.[13]

Weak enforcement and high costs for IPR and trademarks are highly detrimental to innovation as IPR allow innovators to privatise the profits of their innovation over a given period of time: they create incentives to innovate by securing profits. The current development of a Unitary Patent (UP) at EU level should solve some of these shortcomings. However, translation costs will remain high and only two Member States have ratified the UP regulations.

This lack of integration and weak IPR and trademarks explains the low levels of investment in Research and Development (R&D) in the EU, especially from firms, which inevitably weigh on EU competitiveness (***Figure 10***). The economic and financial crisis has exacerbated this trend.

[13] Bruegel, Europe's R&D, Missing the wrong targets?

Figure 10: *R&D spending in the European Union*



Source: OECD and Bruegel

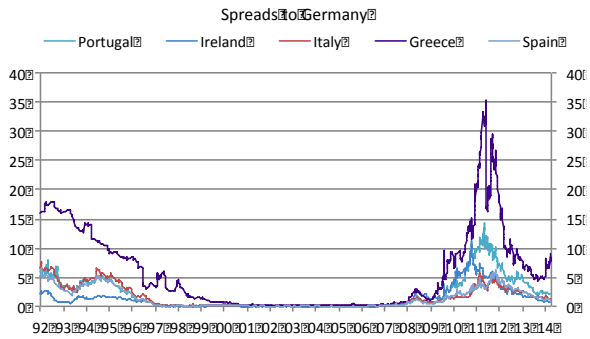
I.1.2. The debt issue in the Euro Area

The debt issue[14] in the European Union – and especially in the Euro Area – is a two-sided problem which applies both to Member States and to the private sector (i.e., households and corporations).

What is the logic behind public debt? Countries engage in debt for two reasons. Firstly, solid economies such as Germany have the possibility to borrow at a very low interest rate[15]. It becomes more interesting for them to borrow than to invest their own funds. Secondly, when a country is in recession, the government can decide to help the economy by reducing the tax burden or by increasing public spending. The government will then borrow money to earn more tax revenue in the future, thus restoring its finances. In both case, borrowing is profitable because it is assumed to be a temporary behaviour that will allow the borrower to reimburse its loan in the near (over even distant) future.

The Eurozone crisis can be understood as a shift in Member States' borrowing behaviours. The introduction of the Euro fuelled financial markets with the reasonable belief that the European currency was uniform in value and would last forever. Interest rates consequently converged to the low levels experienced by Germany before the introduction of the Euro. Each Euro Area Member State experienced a similar level of interest rate when borrowing, despite their differences (***Figure 11***). By taking advantage of unusually low interest rates, some countries like Greece and Portugal borrowed excessively, pushing their sovereign, corporate and personal debts to unsustainable levels.

Figure 11: *The risk premium on peripheral Eurozone countries*



Source: Gavekal

[14] The deficit is the amount by which expenses exceed income or costs outstrip revenues. The debt is the amount borrowed by one party from another.
[15] The interest rate is the price of borrowing.

Once financial markets and credit agencies realised the severity of the situation, financial market understood for the first time that the eternal existence of the Euro was not guaranteed – and that the credit worthiness of the users was not the same, i.e., there was a real possibility of a default by a European country**.** The exchange rate of the Euro might be too strong for the most indebted Member States, which would have to leave the current currency. The reintroduction of their national currency with a lower exchange rate compared to the Euro would then enable these Member States to pay back their debt.

As a consequence, financial market modulated interest rates of the Euro Area Member States according to this redenomination risk. Countries such as Greece, Ireland and Portugal were unable to finance themselves at an acceptable price and became effectively insolvent (***Figure 11***).

The negative dynamics were aggravated by what economists call the *doom loop between bank and sovereign insolvency*. On the one hand, national banks tend to buy more public debt of their own sovereign government, e.g., the Spanish Santander holds mainly titles of Spanish public debt. When the government declares bankruptcy, the public debt hold by national banks therefore loses its value and these banks become themselves insolvent. The solvency of the banking system therefore depends on the solvency of the Member States

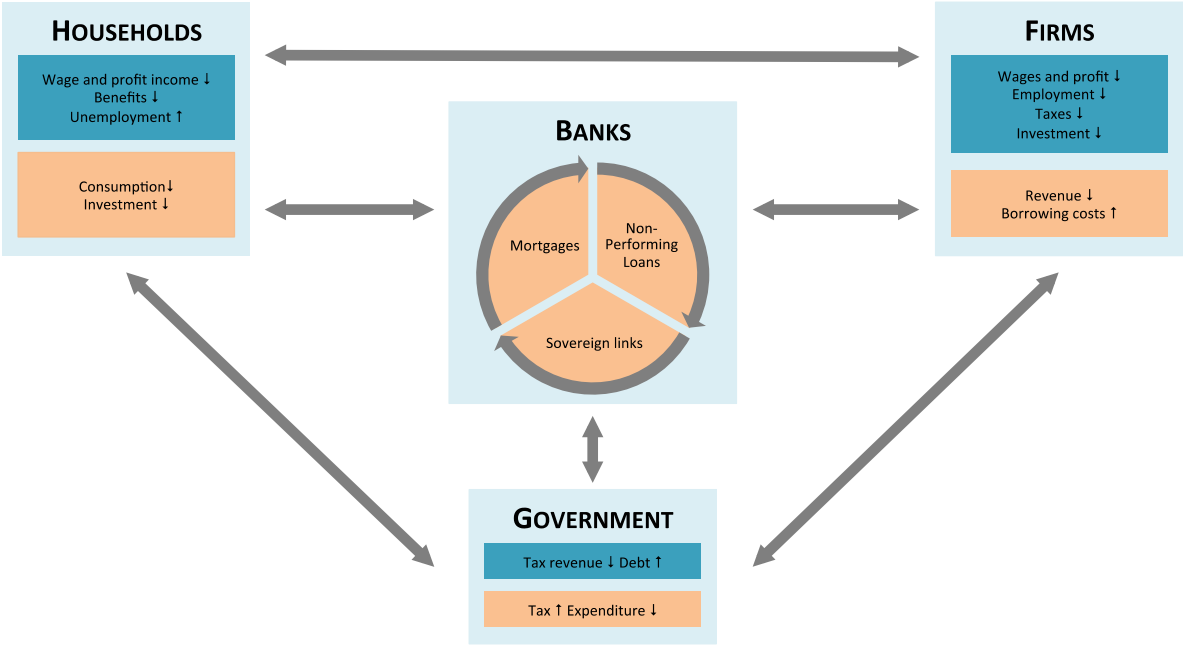
On the other hand, European economy mainly relies on bank loans for funding[16]. A given Member State – for instance Cyprus or Slovenia – could not afford the collapse of its banks since the private sector would lose its access to financing, pushing the real economy[17] into crisis. In case of trouble, governments must therefore massively invest in the banking sector to save the system, deepening their deficits. The knowledge of this principle led some banks to lend money excessively, relying on the idea that they were too big for the State to let them fail. Consequently, the solvency of Member States also relied on the financial health of their banks due to the so-called *too-big-to-fail* logic.

The *too big to fail* logic was particularly strong in countries facing housing bubbles. The low interest rates faced by Member States following the introduction of the Euro translated into low interest rates for the private sector. Spanish and Irish households heavily invested in real estate, creating an artificial increase in housing prices. The rise in prices provided more valuable collateral, allowing banks to give more mortgage loans, feeding a real estate bubble. When the bubble burst, banks that had excessively lent to the private sector were in a very difficult position, calling for public spending to help them overcome the crisis (***Figure 12***).

[16] On the contrary, countries like the US tend to rely more on market-based financing, i.e., firms issue debt titles such as bonds and shares to finance themselves.

[17] The real economy relates to the part of the economic activities actually producing goods and services, as opposed to the part of the economy that is concerned with buying and selling on financial markets.

Figure 12: *The Euro Crisis in a nutshell*



Source: Schindler, Berger, Bakker and Spilimbergo

The Sovereign Debt Crisis has significantly changed the governance landscape. A Banking Union has been introduced and budgetary rules reinforced. **However, public debt still remains at very high levels in the EU**, reaching over 85% of GDP on average[18]. Highly indebted countries devote more and more of their resources to debt servicing[19]. In more practical terms, these Member States cannot invest in research and development, nor can they help households to consume more by reducing taxes. In period of slack growth – such as the current recovery, the public sector is therefore unable to stimulate economic growth. These dynamics are reinforced by the limited flexibility allowed by the European Treaties regarding deficit rules. Although such safeguards ensure smoother budgetary management, they prevent growth stimulus through enhanced public spending.

Private sector deleveraging also weighs on growth and competitiveness: firms are not able to invest in R&D, limiting their competitiveness, while households limit their consumption, lowering opportunities for growth.

I.1.3. EU policy-making in question

Governance impacts growth by shaping the conditions for competitiveness. The European Union has two major challenges to overcome on the matter: fostering a growth-friendly environment and ensuring policy certainty.

The quality of the economic environment has improved since the Euro Crisis. The creation of a Banking Union provides the EU with financial backstops while new mechanisms have been created to avoid macroeconomic imbalances (e.g., excessive public debt, current account disequilibria, excessive increase in ULCs, excessive development in housing process, excessive unemployment, and so on).

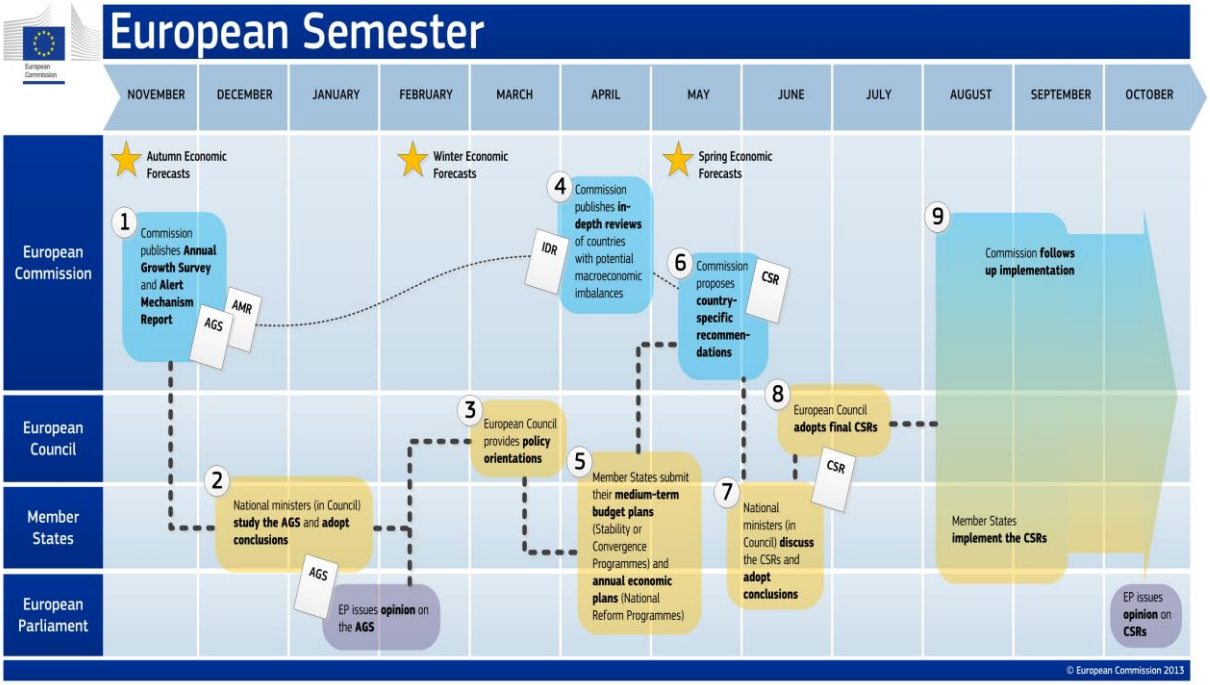
[18] Source Eurostat.
[19] Reimbursement of contracted loans.

More precisely, the Banking Union provides for early intervention to ensure an orderly wind-down of troubled banks, thus limiting the burden for taxpayers in case of an eventual bail-out[20]. It relies on three complementary arms:

- *A Single Rulebook* to regulate, supervise and govern the financial sector. It implements stricter banking regulations regarding capital requirements[21], supervises the Deposit Guarantee Schemes and provides for a Direct Bank Recapitalisation Mechanism to resolve and restructure funds[22] of failing banks at the national level.
- *A Single Supervisory Mechanism* under which the European Central Bank (ECB) controls significant banks while national authorities supervise smaller establishments.
- *A Single Resolution Mechanism* which ensures that where a bank facing difficulties, there are resolved in an orderly manner at European level.

Regarding macroeconomic imbalances, the Macroeconomic Imbalance Procedure (MIP)[23] imposes thresholds to reveal imbalances that might threaten growth in the short and the long term. Moreover, the European Semester integrates the prior surveillance of budgets and other macroeconomic and structural developments in an annual framework (***Figure 13***).

Figure 13: *The European Semester*



Source: European Commission

[20] A bail-out 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). With a bail-in, the regulator imposes losses on the business's creditors (e.g., on the richest savers).

[21] The Capital Requirement Directive and Regulation (CRD IV, CRR). They are complemented by the international Basel III regulations.

[22] Pre-financed by financial institutions.

[23] Introduced by the Six-Pack legislative measures that aimed at reforming the Stability and Growth Pact to introduce greater macroeconomic surveillance.

In particular, budgetary imbalances have benefited from a significant reform. The Euro Crisis has generated economic and financial turmoil, which has highlighted the weak monitoring of budgetary imbalances at EU level; this has lead the European Union to adopt three new treaties[24, 25].

A voluntary scheme has been developed to restore trust in the Member States' fiscal stance: the European Stability Mechanism (ESM). It provides participating Member States with stability support loans, precautionary financial assistance (i.e., a "credit line" on which ESM Member States can draw upon if required) and a Market Support Facility (i.e., the ESM is allowed to purchase sovereign bonds on the market).

Despite all these improvements, the new European governance faces some important limits. Firstly, detractors of the Banking Union have pointed out the lack of ambition behind the Single Resolution Mechanism and the questionable role of the ECB that is responsible for monetary policy and prudential supervision (i.e., the ECB is judge and jury at the same time).

Secondly, the multiplication of optional treaties – such as the Treaty on Stability, Coordination and Governance for which ratification is required to join the ESM – creates a two-speed European Union. This divergence is particularly strong between Euro and non-Euro Member States.

Thirdly, some mechanisms are skewed to accommodate specific Member States. For instance, the MIP is often criticized as being favourable to Germany: the criteria for current account imbalances only cover excess imports and leave aside excessive exports.

In the particular case of Economic and Monetary Union (EMU), i.e., of the Euro Area, critics underline the lack of economic integration beyond the mere monetary union embodied by the Eurozone. By joining the Euro , Member States renounce their national currency to adopt a foreign (common) currency, the Euro . The given States therefore lose their main tool to address economic shocks: their exchange rate. Consequently, for the Euro to be viable in the long run, the Monetary Union should be completed by mechanisms addressing country-specific shocks that would normally be dealt with a change in (national) exchange rates[26], namely:

- *A budgetary and fiscal union* that would allow the transfer of public spending from a Member State in a good position to a Member State experiencing difficulties.
- *An enhanced capital and labour mobility*, a high degree of economic openness to ease unemployment in fragile States and equilibrate price differentials.
- *Economic convergence* among diversified Member States' economies to minimise the need for adjustments between Member States.

Despite recent improvements, the EMU still does not satisfy most of these criteria, endangering the long-term viability of the Euro .

Beyond fostering a growth-friendly environment, governance must ensure policy to stimulate investment. With unclear and cumbersome decision-making processes and excessive red tape, the European Union discourages businesses from developing their activities across the Single Market and reduces the appeal of the Old Continent to foreign investors. Combined with a seeming lack of anticipation, the EU is subject to panic movements on financial markets while having difficulty in overcoming threats of deflation.

[24] The Two-Pack and Six-Pack are regulations reforming the Stability and Growth Pact (SGP) to respectively introduce greater macroeconomic surveillance across the EU and monitor more closely struggling Eurozone Member States. The Treaty on Stability, Coordination and Governance is a new stricter version of the SGP signed by all EU Member States to the exception of Croatia, the Czech Republic and the United Kingdom.

[25] According to the Stability and Growth Pact, the government deficit should remain under 3% of GDP while the public debt should be limited to 30% of GDP.

[26] According to the Optimal Currency Area theory developed by Mundell and Kenen.

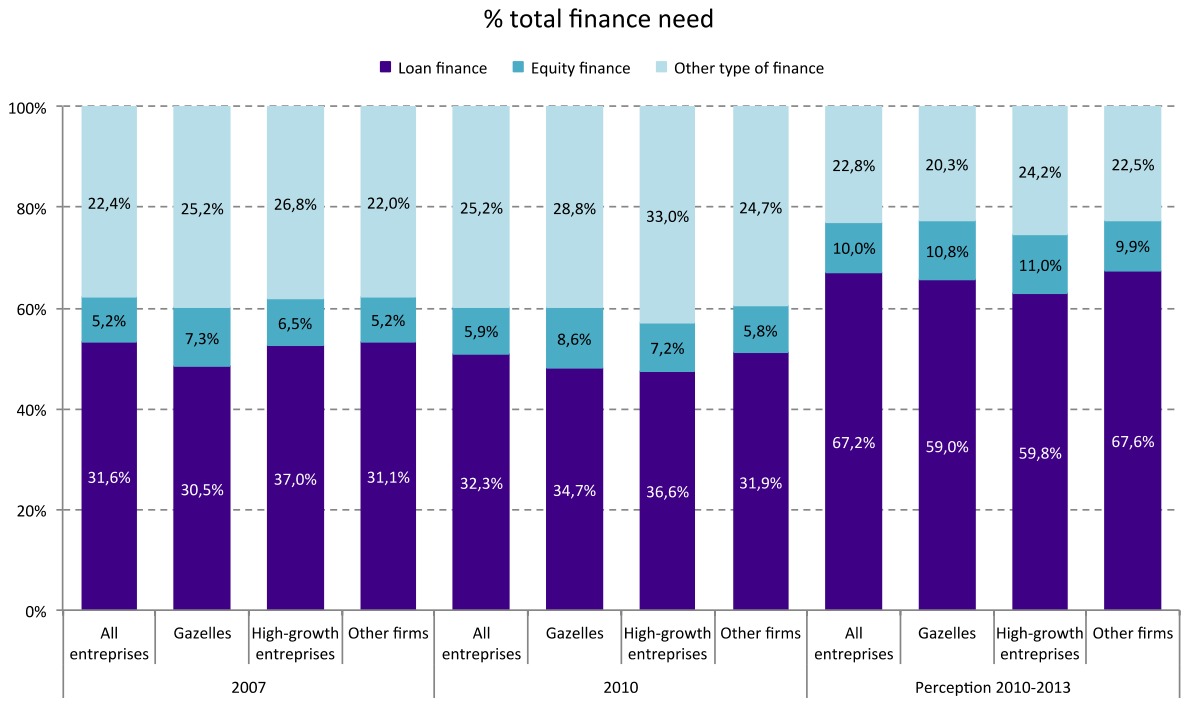
I.2. External factors

I.2.1. Capital shortages

To ensure competitiveness in the EU, firms must have easy access to external financing to invest, innovate and grow. Two main channels are available for companies: bank loans and financial markets. The willingness of creditors to offer funding will depend on requirements for collateral, debtors' debt levels, and the ability for the bank to finance itself. A funding gap burdens growth when viable projects cannot be financed.

The European financial system is weakly diversified with 67% of corporate financing occurring through bank loans between 2010 and 2013[27] (***Figure 14***). This bias towards bank-based financing **prevents any reallocation of financing in case of adverse shocks affecting the banking system**. As demonstrated by the Euro Crisis, a doom loop between bank and sovereign insolvency emerges in the absence of alternative source of financing, threatening public finances and therefore growth. Bank dependence also weakens recovery processes, as businesses cannot overcome credit restrictions.

Figure 14: *Types of finance sought*



The gazelles are young enterprises with high-growth potential.

Source: Eurostat

The European financial system has been relatively well integrated since the Maastricht Treaty. It prohibits restrictions on capital movements and payments between EU Member States, and EU Member States and third countries. **Freedom of capital is however not unconditional**, as Member States are allowed to restrict financial movements under strict conditions.

The Euro Crisis has stressed the shortcomings of EU financial integration and has even led to defragmentation. The emergence of a redenomination risk for Euro Area Member States has created a two-speed EU financial market. On the one hand, countries deemed solvent such as Germany or France enjoy

[27] Source Eurostat.

excessively low interest rates while countries like Ireland and Greece had to leave the market for a certain time due to (too) high interest rates. This divergence in rate has created fragmentation: capital would leave Southern Europe to reach Northern Member States, creating so-called sudden-stops[28].

Even though the current recovery and new economic and financial governance of the EU has restored to some extent financial integration, **the Single Market for capital has not yet returned to its pre-crisis integration levels**. This limited financial integration coupled with policy uncertainty regarding the solvency of Euro Area Member States makes **the EU unattractive for foreign investors, reducing investment potential and therefore limiting growth**.

I.2.2. Insufficient access to resources

In a world of finite resources, physical and economically sustainable access to raw materials is central to ensure smooth economic activity. The EU is dependent on imports of phosphates, for example to sustain agriculture, and faces strong shortcomings regarding energy and metals. The need for raw materials for manufactured goods greatly depends on EU governance and its capacity to stimulate ecodesign and recycling, i.e., on its ability to create products using low levels of natural resources during their fabrication and use.

I.2.2.1. Excessive energy dependence

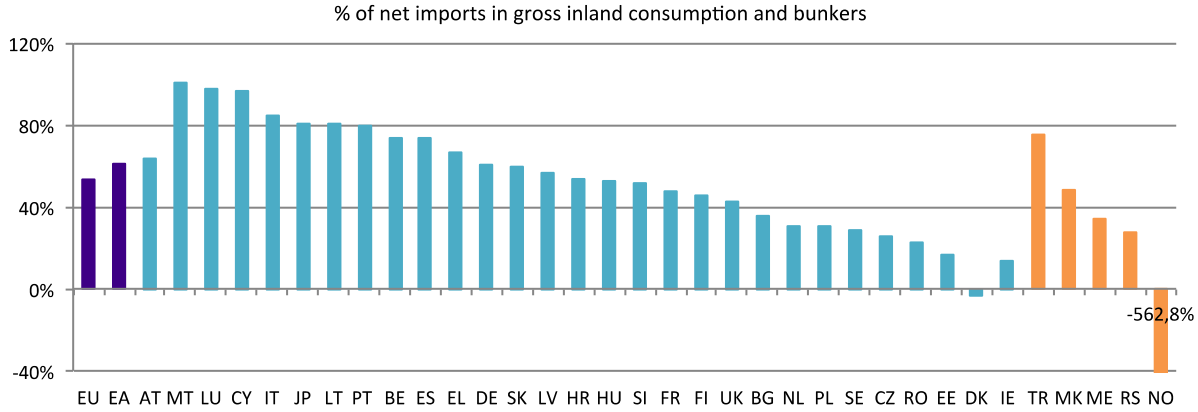
Energy is a key factor for growth and competitiveness. For businesses, it is a major component of production costs. For households, it is a significant item of expenditure that diverts consumption and deepens income inequality. Due to its few and generally declining existing resources in gas and oil, **the European Union is strongly energy import dependent**: it has to import a large share of its consumption, making its Member States vulnerable to energy price fluctuations (***Figure 15***).

Beyond energy dependence, energy prices greatly impact EU economy and competitiveness. Higher prices in commodities threaten growth in non-energy-producing countries, as they increase production costs and reduce the share of income devoted to non-energy-related consumption, i.e., to manufactured goods. Reciprocally, lower energy prices benefit firms and households but may threaten the sustainability of public finances for both energy-producing and non-energy-producing countries, as energy production and consumption is heavily taxed. At the current time of rapidly falling world prices for energy, high fixed tax levels on energy in the EU reduce the perceived benefits for consumers – thus penalising users in, say, Germany, v. those in the US where tax rates are lower.

Often exacerbated by volatility in exchange rates, these imbalances burden EU growth potential by reducing its competitiveness abroad and limiting internal growth drivers.

[28] A sudden-stop is an abrupt reduction in capital flows entering an economy. It creates a financial imbalance between this economy and the rest of the world that would usually require an adjustment of the exchange rate. Sudden-stops occurring in only some countries sharing a common currency – as it was the case during the Euro Crisis – can eventually force these countries to leave the common currency to restore their economy.

Figure 15: *Energy dependency rate*



Source: Eurostat

I.2.2.2. The vulnerability on raw material supplies

Regarding raw resources, the 2010 Raw Material Initiative established a list of critical raw materials[29], i.e., materials of high economic importance facing a high supply risk (***Figure 16***). China, Russia, the Democratic Republic of Congo, South Africa, Brazil and South East Asian countries are important suppliers of most of these commodities. As for energy, dependency on these materials threatens growth in the long run and Europe's industrial performance on the world market.

Figure 16: *EU import dependency on raw materials*

Raw material	Import Dependency
Natural rubber	100%
High-tech metals	96%
Iron ore	85%
Critical raw materials	77%

Raw material	Import Dependency
Bulk metals	57%
Industrial metals	46%
Wood	15%
Paper	9%

Source: European Commission

I.2.2.3. Vulnerability to international conflicts

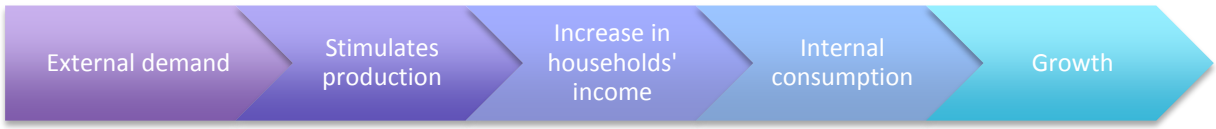
Because of these energy and raw materials dependences, the European Union is particularly vulnerable to international conflicts. The recent disagreements between the EU and Russia have for instance influenced the supply in national gas. International developments therefore influence policy debates, notably on the exploitation of shale gas or nuclear electricity.

[29] Antimony, Beryllium, Borates, Chromium, Cobalt, Coking Coal, Fluorspar, Gallium, Germanium, Indium, Magnesite, Magnesium, Natural Graphite, Niobium, PGMs, Phosphate Rock, Heavy and light rare Earth elements, Silicon Metal and Tungsten.

I.2.3. Weak external demand leading to more competition at the global scale

In a gloomy economic context, external demand plays a crucial role in stimulating production. By substituting for internal demand, the demand for exports helps a given economy to overcome a crisis. External demand therefore triggers an adjustment process that stimulates production that in turns increases households' income and stimulates internal consumption (***Figure 17***).

Figure 17: *From external demand to internal sources of growth*



Source: Lighthouse Europe

In a more globalised world, external demand has a lesser impact on growth due to intensified international competition. As the number of competitors increases, the share of world demand for European exports reduces, reinforcing competition on the world market. The European Union therefore needs to stimulate its competitiveness not only to grow but also to achieve higher levels of competitiveness at a global scale. If the EU fails to do so, a vicious circle would settle in: the weaker the EU competitiveness, the lower the economic growth and the fewer the opportunities to reverse the trend.

Chapter II: Boosting EU competitiveness

The European Union needs to free its growth potential to overcome the risk of secular stagnation[30]. There is more latitude than one might expect because the EU has enormous potential for catch-up growth[31] as its living standards are only expected to reach 60% of US levels by 2020[32]. Catching-up adjustment should also occur within the EU: the European Commission estimates that if Member States could close half the gap with the three best-performing EU Member States, EU GDP growth rates could be boosted by 0.5 percentage points each year, over a 10-year period[33].

Two options are available: demand-side and supply-side reforms, i.e., stimulate consumption to trigger production or stimulate production to trigger higher revenues for households and enhanced consumption. Arbitrating between these two options is a 'chicken-and-egg' dilemma. Still, in a context of budget discipline, **supply-side reforms should offer a new driver for growth with a limited impact on public deficits**.

[30] The notion of *secular stagnation* was first introduced by former US Treasury Secretary Larry Summers to describe a situation of persistent negligible or null economic growth.
[31] Catching-up growth refers to Solow's economic theory on growth. The higher the living standards of a country, measured by its GDP per capita, the harder for that country to grow at the high rate. In more practical terms, the EU should have a stronger potential for high growth level than the US since its living standards are lower than the ones enjoyed in the US. The period during which the EU would reach the US standings is called catching-up.
[32] Source McMorrow and Roeger.
[33] *Ibid.*

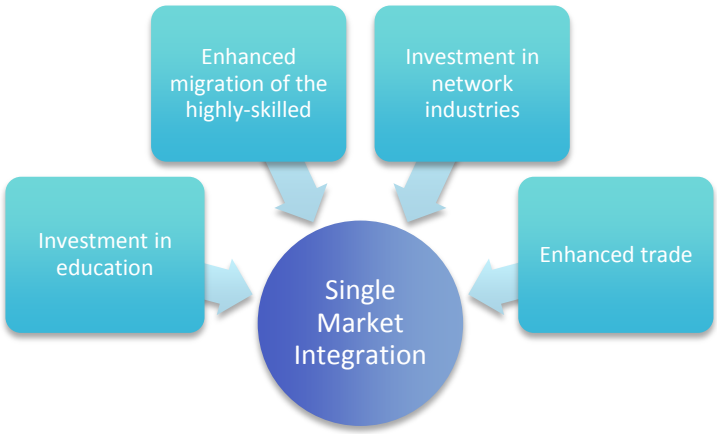
II.1. Creating new business opportunities

Fostering new business opportunities within the EU would allow companies to invest more, as investment costs would be spread over a larger pool of consumers. Thanks to enhanced investment, innovation would foster competitiveness and growth throughout the European Union. A more integrated Single Market would create such possibilities while policy support to investment would enable firms to reap the benefits from these new opportunities.

II.1.1. Achieving a more integrated Single Market

Achieving a more integrated Single Market should be a priority (***Figure 18***)**.** In more practical terms, integration should be stimulated through different channels: investment in education, enhanced migration of highly skilled workers, investment in network industries and enhanced trade.

Figure 18: *Achieving a more integrated Single Market*



Source: Lighthouse Europe

II.1.1.1. Investment in education

Investment in education could reduce productivity gaps between Member States while providing more flexibility for EU labour force. Long-term exchange programmes between Member States (e.g., Erasmus) should be promoted to develop language skills and encourage cultural diversity.

Investment in education should be promoted in the very short term, as positive returns to investment only occur in the very long term. This necessity is highlighted by the various league tables of the top 100 ranking universities and MBA schools that exhibit a strong predominance in the United States, followed by the United Kingdom – that hosts half of all top EU institutes. The issue is especially worrying as other European Member States struggle to increase the quality of their learning institutions. Barriers to internal movements would exacerbate the problem.

II.1.1.2. Enhanced movement of highly skilled-workers

Exchanges between highly skilled workers would spread good practices over the Single Market, stimulating competitiveness while closing the skill gap. If programmes such as Erasmus for Young Entrepreneurs already

exist, their scope should be extended beyond mentoring of young entrepreneurs by experienced workers. Mutual recognition[34] of qualifications should also be enhanced to create incentives for workers' movement.

Stimulating workers migration would also be an efficient tool to answer asymmetric economic shocks, i.e., shocks impacting only some Member States as opposed to EU-wide shocks (e.g., excessive public debt in Southern States versus the 2008 financial crisis). Such mechanisms would ease economic activity over time, allowing for a more consistent growth rate over time.

II.1.1.3. Investment in network industries

Network industries are central to firms' competitiveness (***Figure 19***)**.** They provide key services that enable businesses to produce more efficiently (i.e., efficient communication systems, reliable transport services for workers and products, affordable and secure energy supply).

Investment in infrastructure would increase firms' efficiency by reinforcing network interoperability between Member States (notably for rail systems) and developing new more reliable and more cost-effective technologies (e.g., 4G in telecoms). The capacity of transport, digital and energy networks must furthermore be adapted to Europe's future needs through initiatives such as the Single Digital Market.

Figure 19: *Investing in network industries to strengthen the EU's position as a global player*

Source: Lighthouse Europe

II.1.1.3.1. Energy industries as a strengthened drivers of growth

Energy has a significant impact the competitiveness of most manufacturing companies competitiveness since their production costs are highly dependent on energy costs. Completing the Single Market for Energy would

[34] The mutual recognition principle guarantees free movement of goods and services without the need to harmonise Member States' national legislation. Goods and services lawfully produced in one Member State cannot be banned from sale on the territory of another Member State, even if they are produced to technical or quality specifications different from those applied to its own products. Any exceptions are strictly overseen and can only override general interest such as health, consumption or environment.

therefore have notably positive impacts on growth, as increased competition and connectivity between Member States' networks would help stabilise energy prices.

However, the European gas and electricity markets remain fragmented at both European national level, limiting more efficient EU-wide investments. **Going beyond the logic of national interests should therefore create synergies that would benefit growth.** Energy regulation should not be used for domestic industrial and social policy purposes (e.g., identical electricity prices in North and South Germany despite a lack of interconnection) and should only aim at expressing preferences against certain technologies (e.g., no shale gas exploration in France).

These improvements could be strengthened by coordination at EU level. Ensuring better connectivity of the energy network and diversifying sources of energy imports could reduce energy dependence. Promoting the development of green technologies would enable the European Union to control its energy bill. Promoting ecodesign for products and buildings could reduce energy consumption. Support for innovation in renewable energies should enable the EU to respect its international environmental commitments while stimulating its exports.

Because of the important role played by energy in production processes, **the challenges of climate change and global warming also represent an opportunity for the European Union to strengthen its position as a global player in green policies**.

Firstly, **the development and exportation of cutting-edge green technologies** would enable the EU to set international standards and become the reference point in environment-friendly business.

Secondly, in a context where most pollution will be produced outside the European Union in emerging countries, **the EU could lead by example with initiatives such as its CO_2 Emissions Trading System** (ETS). Despite some shortcomings[35], aggravated by the recent collapse of oil and gas prices, experts have deemed the ETS robust and favoured its exportation to developing and emerging countries. Expanding the ETS to other countries would restore EU competitiveness by imposing identical environmental constraints to Europe's competitors. Even if convincing these countries of the importance of the ecological challenge might be a demanding task, the recent Chino-American agreement on climate raises hope for the future.

II.1.1.4. Enhanced trade

Stimulating trade within the EU is essential for every Member State, as the European Union is their larger trade partner. For instance, the United Kingdom sent 45.8% of its exports to other EU Member States[36]. **Enhanced trade within the EU would therefore benefit growth by enlarging the consumer pool that firms benefit from.** If tariffs have been dramatically reduced, non-tangible barriers to trade still exist (e.g., subsidies proving national producers with an unfair competitive advantage, conception requirements, etc.). The adoption of common standards within and outside the European Union and enhanced mutual recognition could overcome some of these shortcomings while the implementation and enforcement of harmonized legislation at EU level could reduce firms' production costs in intra-EU exports.

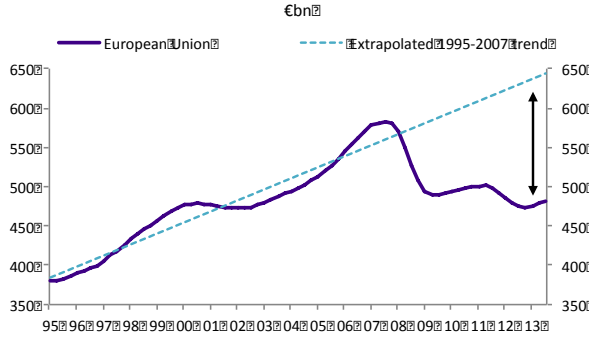
Vis-à-vis trade opportunities, looking beyond the European Union as such could also be useful. Namely, trade agreements such as the Transatlantic Trade and Investment Partnership or the Trade in Services Agreement could further expend business opportunities, extending the positive impact of intra-EU trade to a larger scale.

[35] The ETS is often criticized due to carbon leakage, i.e., situations where production is transferred to countries with laxer constraints on greenhouse gas emissions. Increasing the number of ETS participants should in theory reduce carbon leakage.
[36] Source International Monetary Fund.

II.1.2. Stimulating investment to reap the benefits of a more integrated Single Market

An enhanced Single Market has positive impacts on growth, as it enables firms to innovate by enlarging their consumer pool and thereby enables them to better spread innovation costs. Still, to take full advantage of the EU Single market, **wider access to private and public financing is required to truly foster stronger innovation** (***Figure 20***)**.**

Figure 20: *Investment gap in the Eurozone*



Source: Eurostat, Natixis

With regards to private funding, a more business friendly taxation regime would free funds that could be reassigned to research and development. The new schemes could rely on successful experiences at national levels such as the French *Crédit d'impôt recherche* [37] that includes R&D spending into a tax deduction scheme. Ensuring a rapid implementation of the Single European Patent would also prove very efficient by triggering new incentives for innovation.

As for public funding, a smarter use of national and European public funds should be implemented, especially in innovation-lagging and fiscally weak Member States that have cut their R&D spending during the crisis. In practical terms, smarter innovation implies targeting sectors with the highest growth potential and greatest need of funding, i.e., advanced technologies. Maximising opportunities in advanced technologies would build on the comparative advantage of the EU. The development of new technologies in food production, computer-based design and manufacture, climate change avoidance and mitigation, and the creative industries, for example, would ensure the European Union's position as a worldwide innovation leader. The EU would thereby attract more foreign investment and resources generally, creating positive dynamics for growth.

In this context, the €315 billion Juncker Investment plan for Europe is particularly adapted to EU needs, as it targets key sectors: (i) infrastructure in transport, broadband and energy, (ii) resource efficiency and renewable energy, and (iii) long-term investment funds, education and training, research and innovation. The main recipients are intended to be small and medium enterprises, i.e., businesses that face the most difficulties in accessing financing, and R&D projects.

Even so, this Investment plan relies predominantly on the leverage principle. The European Union and its Member States only provide limited funding (€63 billion) that would be used to borrow extra funds to be invested in specific projects (€252 billion) to reach the target of €315 billion for the 2015-2017 period, i.e., a total leverage of 15. Even though such a high leverage ratio seems too optimistic, the Juncker Investment plan should provide the EU with new growth drivers. The recent offer of €1 trillion in Quantitative Easing to and via Central Banks over the coming months will also help. The proposal, long awaited and in some eyes, long overdue, is still to be examined in detail.

[37] Research tax credit.

II.2. Achieving a EU level playing field through enhanced convergence

The Euro Crisis has highlighted the need for a European level playing field. The European Union is a collection of Member States with different economic characteristics. If the economic diversity of the EU is to be preserved, enhanced convergence between Member States is needed to restore EU-wide competitive forces and allow firms to truly compete within the Single Market. Greater convergence would also improve the European Union's ability to address asymmetric shocks[38] efficiently. Overall, businesses and investors' trust in EU economic potential would be restored and would again create the conditions for investment and growth.

A European level playing field could emerge from a four-pillar strategy for convergence and growth focusing on (i) improving the general framework of EU policy, (ii) overcoming fiscal and budgetary free-riding, (iii) rationalising labour markets and (iv) strengthening the financial markets.

II.2.1. Improving EU policy framework

The European Union is often criticised for its creation of red tape, which refers to excessive, sometimes obsolete, redundant, rigid and bureaucratic regulation. **Rationalising EU legislation would increase the efficiency of firms** by limiting their administrative burden, especially for small and medium sized enterprises. It would also **restore trust in EU policy making by generating consistency and predictability**. As highlighted by ***Figure 2***, rationalising EU legislation would create a more growth-friendly environment, which is the key to trigger a growth-competitiveness virtuous circle.

To this end, the 2002 Smart Regulation[39] initiative should be strengthened. The Better Regulation principles aim at cutting EU red tape and improving the quality of regulation by: (i) analysing impacts, (ii) communicating and taking account of the views of citizens and companies, (iii) reducing paperwork, (iv) simplifying legislation, and (v) looking at alternatives such as self-regulation. The Juncker Commission has already taken steps in that direction with the appointment of a First Vice-President in charge of Better Regulation. Moreover, **coupling these initiatives with proper implementation and enforcement of EU law should drastically improve the image of the EU as a business-and-investment-friendly area**.

II.2.2. Overcoming fiscal and budgetary free-riding

Fiscal and budgetary policies are a competence belonging to Member States. The recent Luxembourg Leaks scandal[40] has nonetheless highlighted the main issue as **the lack of fiscal and budgetary convergence between Member States**: it **creates room for unfair tax free-riding that distorts competition**.

Multinationals avoiding taxation through complex financial engineering – known generally as 'fiscal optimisation' – negatively impact growth on two grounds. Firstly, firms not relying on such schemes (i) pay relatively more taxes that the ones using them and (ii) usually suffer higher tax rates than without fiscal optimisation; as a result, they become less competitive on the market. Secondly, fiscal optimisation diverts tax revenue from certain Member States, weakening their budgetary position. Unfair taxation finally reflects a bad image for the European Union.

Achieving greater fiscal and budgetary convergence would limit fiscal and budgetary free-riding and restore competitive forces across the Single Market. Several policy tools are available to achieve such convergence,

[38] Shocks suffered only by some Member States.
[39] Also "Better Regulation".
[40] The Luxembourg Leaks scandal refers to the disclosure of confidential tax agreements passed between Luxembourg and multinationals.

from the less to the most interventionist: (i) introducing the automatic exchange of financial information, (ii) developing a common corporate tax base, and (iii) partial pooling of European public debt.

II.2.2.1. Introducing the automatic exchange of financial information

Fiscal optimisation relies on the lack of financial dialogue between Member States. It is for instance very difficult for the Polish government to determine which assets are kept abroad by its citizens. It therefore cannot retrieve tax revenues on these assets. The automatic exchange of financial information would increase administrative efficiency in tax collection and create a level playing field across the EU while limiting public interventionism.

The European Union has already adopted a Directive in 2011[41] to introduce an automatic exchange of financial information. The Directive provides for the exchange of information, that is, of any information with *"foreseeable relevance"* to the administration and the enforcement of Member States' tax laws. The text covers all taxes[42] and six categories of income and capital: (i) income from employment, (ii) director's fees, (iii) life insurance products not covered by other Directives, (iv) pensions, (v) ownership of income from immovable property and (vi) dividends, capital gains, any other income[43].

The automatic exchange of financial information will be implemented in January 2015, although there are still questions about its efficiency in practice. Attention should be paid to enforcement and conflict resolution. The adoption by the G20 of a similar scheme leaves nonetheless hope for better and more efficient fiscal coordination.

II.2.2.2. Developing a common corporate tax base

A second and more interventionist tool to achieve fiscal and budgetary convergence would be the introduction of a Common Consolidated Corporate Tax Base (CCCTB). In practice, the CCCTB would take the form of a single set of rules that companies operating within the EU could use to calculate their taxable profits. For firms, this fiscal instrument would provide businesses with simplicity, clarity and predictability regarding fiscal matters, improve their ability to bear losses and reduce compliance costs, allowing them to invest more. For Member States, a CCCTB would promote more efficient revenue collection.

Although this idea of a Common Consolidated Corporate Tax Base was initiated at EU level in the early 2000s, the project has been frozen for a few years. However, the recent Luxembourg Leaks scandal has changed the context. More particularly, Jean-Claude Juncker, President of the European Commission and Pierre Moscovici, Commissioner for Economic and Financial Affairs, Taxation and Customs have reaffirmed their commitment to this project. If the current political climate is conducive for the introduction of the CCCTB, European citizens must remain cautious to give, if needed, the European Union the necessary encouragement.

[41] Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC

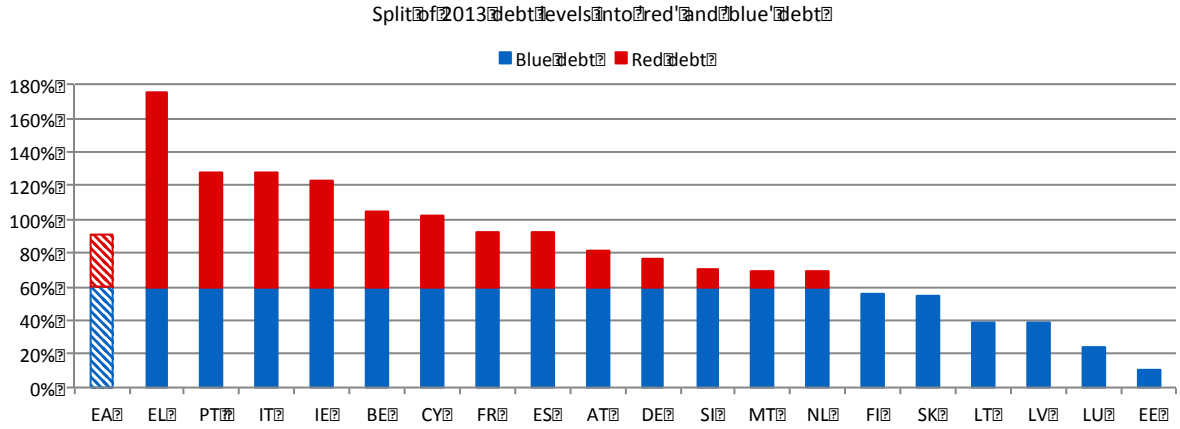
[42] With the exception of VAT, customs duties excise duties and compulsory social contributions that are covered by dedicated directives.

[43] Council Directive 2014/107/EU amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation

II.2.2.3. Partial pooling of European public debt

A third and most interventionist option would be to institute partial pooling of European public debt. What does it mean in practice? Member States would have the possibility to issue Euro bonds, i.e., common government debt securities that would benefit from joint and several liability[44]. These Euro bonds would only cover the amount of debt allowed in the treaties, i.e., up to 60% of GDP as defined by the Maastricht criteria (***Figure 21***). Over that level, Member States would issue national sovereign debt, i.e., they will have the exclusive responsibility of their repayment.

Figure 21: *Interaction between Euro bonds and national bonds*



Source: Eurostat, Bruegel

Debt issued as Euro bonds would enjoy a lower interest rate in the market, i.e., would be cheaper, thanks to the large number of countries responsible for its repayment. On the contrary, the debt above 60% of GDP should face a higher interest rate. Because of the interest rate differential between Euro bonds and national debt, Member States would not have incentives to have debt levels over the 60% of GDP suggested by the Treaties.

To what extend would the partial pooling of European public debt create a EU level playing field then? Such a scheme should limit the possibilities for fiscal optimisation by discouraging governments from engaging in beneficial tax rulings[45]. It would also restore financial markets' trust in sovereign debt, which in turn would ease access to funding.

The introduction of Euro bonds would indeed provide credible incentives for Member States not to engage in tax rulings (as above)**, as they would bear the costs of lower tax revenues in other Member States.** Each Member State favouring fiscal optimisation does it at the expense of other Member States, i.e., it increases its tax revenues by lowering the one of its partners. The latter would thus face lower tax revenues that would weaken their budget position, generating risks of default. In light of this default risk, financial markets would charge a higher interest rate to the partners' public debt, on both titles of national debt and Euro bonds. As Euro bonds enjoy joint and several liability, the Member State favouring fiscal optimisation would also bear higher interest rates and therefore bear the cost of detrimental fiscal optimisation.

The partial pooling of European public debt would also create a climate of trust on the sovereign debt market. Thanks to the joint and several liability attached to Euro bonds, the risk of default in case of economic turmoil in one or few Member States would be reduced since other (healthy) Member States could pitch in to help their weak partners to settle their debt. The mere existence of such a mechanism should prevent spikes in

[44] Each Member State would become responsible for the repayment of the full amount of the Euro bonds.
[45] A tax ruling is a decision or ruling issued by the fiscal administration of a country to a taxpayer with regard to a taxation matter.

interest rates, lowering the impact of turmoil on interest rates. Firms would benefit from easier access to funding during the crisis, which would smooth the recovery process while fostering the conditions for growth.

II.2.3. Rationalising labour markets

In addition to red tape and fiscal and budgetary free-riding, European firms must overcome inefficient labour markets to become more competitive and foster growth. Workers are not mobile enough across the Single Market while great wage gaps create inequalities within and between Member States. **In this context, the EU could be a very efficient growth engine for convergence among EU labour markets.**

Stimulating wage flexibility at EU level should be an efficient way to rationalise the European labour market in the short run. To be competitive, a country must pay its workers the right price, i.e., wages must be in line with productivity. Wage flexibility also ensures higher level of employment, especially in times of crisis, as firms are able to lower wages to maintain the employment level. This approach seems to have been used to good effect in the UK, with unemployment falling and wages at last increasing towards their former levels. Ensuring high levels of employment limits skill depletion and is therefore crucial for a quick return to growth.

As suggested by the European Commission in its 2015 Annual Growth Survey, **collective agreements should provide a certain degree of flexibility for differentiated wage increases across and within sectors** to mirror different productivity developments. Attention must also be paid to income inequality. Challenges remain ahead: the European Central Bank has proven that labour market adjustment mechanisms in the EU are traditionally slow, especially in times of downturns and low-inflation periods. It worth notifying that wage bargaining is a national competence, and the European Commission is only able to encourage national reforms through recommendations and cannot impose solutions to Member States.

II.2.4. Strengthening of financial markets

A true level playing field could not be achieved within the European Union without strong and open financial markets. As previously stressed, secure and affordable access to financing is crucial for investment, competitiveness and growth. EU policy should therefore focus on two aspects: consolidating the Banking Union to foster growth-friendly financial markets and developing a Capital Market Union to efficiently diversify the European financial system.

II.2.4.1. Consolidating the Banking Union

The Banking Union is a great improvement in EU economic and financial governance. **However, experts have highlighted weaknesses in its conception**, implementation is lengthy and threats of a two-speed EU remain.[46]

[46] See section *I.1.3. EU policy-making in question* for a brief description of the current state of the Banking Union.

A CMU would benefit growth in many ways. In the short term, it would increase the resistance of financial markets to economic shocks and thus stimulate recovery by easing financing conditions. Enhanced financing would also be achieved through increased financial competition between banks-based funding and other forms of financing on the one hand, and between these alternative sources of funding on the other.

In the longer run, a Capital Market Union would diversify EU financing of the real economy, ensure greater efficiency of monetary policy and foster financial innovation. The Capital Market Union would also benefit public finances by creating a level playing field for the taxation of financial flows. **Overall, a Capital Market Union would increase the attractiveness of the European financial system, enabling banks to bridge the current funding gap.**

The regulatory framework for the CMU should nonetheless be developed with caution:

- *CMU policy should not freeze market structures in their current underdeveloped forms but allow for financial innovation with safeguards* against doom loops and other *too big to fail* dilemmas. Still, the regulation should be broad enough to limit the risks associated with shadow banking[49] and therefore overcome the traditional European suspicion regarding financial markets.
- *Particular attention should be paid to financial transparency, accounting and auditing* to allow consistent financial supervision and champion trust in the EU financial framework.
- *EU growth would also benefit from extending the CMU agenda to insolvency and debt restructuring frameworks.* As for the Banking Union, such provisions would reduce the negative impact of financial turmoil on public finances while increasing trust in EU financial markets.

Pursuing the Capital Market Union agenda should prove very efficient, as the CMU should embrace the entire European Union, it would include the United Kingdom, in contrast to the Banking Union that has opt-out clauses. However, challenges remain ahead: achieving a truly integrated Capital Market Union would require strong political consensus, long and complex legislative processes, and patience.

II.2.4.3. The role of Quantitative Easing

The European Central Bank (ECB) has played a central role in smoothing economic activity since 2007. As any central bank, the ECB is a lender of last resort, i.e., it provides the economy with funds when commercial banks cannot cover a supply shortage, thereby preventing the banking system from failing. In practice, the ECB has eased financing conditions since the beginning of the Financial Crisis through drastically lowered interest rates and increased duration of loans[50]. The ECB has also massively purchased public and private debt securities on the secondary market[51, 52].

In early January 2015, the European Central Bank announced a €1 trillion Quantitative Easing (QE) programme to stimulate inflation. Widely used in the United States and the United Kingdom in the aftermath of the 2007 financial crisis, QE is an unconventional monetary policy[53] upon which a central bank – the ECB – purchases public or private securities from the primary market in order to lower interest rates. Lower interest rates thereby ease financing conditions and stimulates inflation. Proven very efficient when short-term interest

[49] Shadow banking refers to financial activities (fully or partially) outside the regular banking system (e.g., hedge funds' operations).
[50] The so-called 'Long-Term Refinancing Operations'.
[51] The so-called 'Securities Market Programme' and 'Outright Monetary Transactions'.
[52] 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.
[53] To influence interest rates and prices, a central bank has at its disposal both conventional and unconventional tools. Conventional instruments include, among others, acting on reference rate and setting up minimum reserve requirements. In case of economic turmoil, unconventional tools can be used, such as Quantitative Easing or lowering the required quality of collateral to access funding.

rates approaching zero, this policy is nonetheless very controversial as it could result in unintended and non-transparent monetary financing of the receiving governments.

The large amount of funds dedicated to QE and its duration (until at least September 2016 and extendable until the inflation rate settles below but close to 2% over the medium term) **should have a positive impact on inflation and overcome deflation threats.** Higher inflation should stimulate consumption and investment to achieve higher growth level in the EU in the short term.

Chapter III: From economic urgency to political feasibility

As previously described, many policy reforms are available to restore EU's growth potential. **Still, the economic potential of these options will be limited by their political feasibility.** While enhancing investment in education, for instance, is broadly supported, some Member States are opposed to the creation of a common corporate tax base due to the political context in which they operate. Political feasibility must therefore be taken into consideration to evaluate the likely efficiency of any proposed economic policy.

III.1. The political challenge

Economic urgency and political feasibility do not always tally, as proven by the increasing number of opponents to budgetary austerity since the beginning of the crisis. Many factors impact the political feasibility of reforms[54]:

- *Time*, as economic and political actors engage in reform when it becomes too expensive for them to wait-and-see.
- *Crises* can trigger reforms, as they are very costly. Reforms limiting such costs become consequently easier to achieve on political grounds.
- *The nature of political institutions*. Reforms are more likely to be delayed in political systems with a poor leadership or weak executive power (e.g., when other political actors hold a veto).
- *Political schedule*. Reforms are more likely to occur in the aftermath of elections rather than before. Major changes in government may nonetheless result in lost opportunities for action as the inevitable steep learning curve is followed by the new administration.
- *External factors* also impact reforms, such as lending facilities.

Overall, reforms are implemented faster by governments that (i) enjoy an electoral mandate for reforms, (ii) implement an effective communication programme to gain support from voters and stakeholders, (iv) found their decisions on solid research and analysis, (v) avoid haste in policy making, (vi) enjoy unity and leadership regarding the reform, (vii) present revision clauses in the reforms, and (ix) display persistence.[55]

Political feasibility is a determinant factor of success of economic reform. The more concentrated the costs or the benefits, the more organised the stakeholders supporting or opposing them. In more practical terms, reforms that have diffuse benefits but concentrated costs such as partial pooling of public debt are more likely to face stronger political resistance than reforms with diffuse costs and concentrated benefits (e.g., implementing an automatic exchange of financial information).

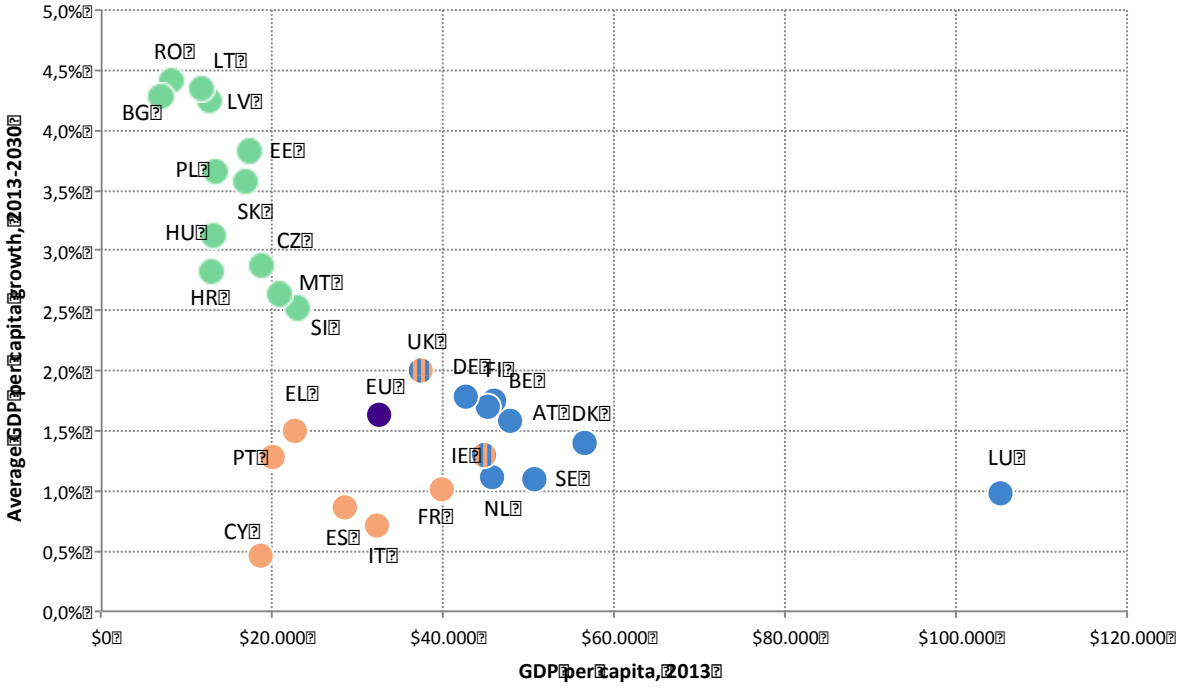
[54] Alesina, A., Ardagna, S. and Trebbi, F., "Who Adjusts and When? The Political Economy of Reforms", *IMF Staff Papers*, Vol. 53, International Monetary Fund, 2006.
[55] Tompson, W., *The Political Economy of Reform: Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries*, OECD Publishing, 2009.

III.2. The current state of reforms in the EU

Political willingness and feasibility at EU and national levels remain mitigating factors that threaten the ability of the European Union to take full advantage of its growth potential. At EU level, the European Commission, Parliament and Council face strong veto powers and discordance regarding political reforms that they may wish to conduct. At national levels, economical late-comer countries such as Greece or Cyprus are under strong external pressure from the Troika[56] that may or may not weaken their willingness to implement austerity reform, while rising extremist movements reduce room for Europe-driven reforms.

Europe as a whole therefore consists of very heterogeneous countries regarding both economic and political dimensions. If we use the GDP per capita index as a reference, the economic crisis has revealed disparities between EU countries in their approach and willingness to integrate key growth-orientated reforms in their economic policies. Still, similarities can be highlighted to rank Member States into three groups (***Figure 22***).

Figure 22: *The current state of reforms in the EU*



Source: CEPS, ERS

- *Member States acting by anticipation* (in blue): **this leading group is dominated by Northern European countries** with a better position in terms of competitiveness. These countries benefited from a favourable political context and conducted structural reforms before and during the crisis, which improved the resistance of their economies. The health review of the Northern countries remains positive in the aftermath of the crisis with a less degraded public balance and a trade balance still positive, moderate increase in wages, and increased labour productivity. Their political environment remains open to new reforms due to the successful implementation so far. These criteria are met by Austria, Belgium, Denmark, Finland, Germany, Luxembourg, the Netherlands and Sweden.

[56] The term *Troika* describes the European Commission, International Monetary Fund and European Central Bank, which consist in a group of international lenders during the Euro Crisis.

- *Member States implementing structural changes under economic pressure* (in orange): **this group is characterised by a struggling political environment translating into difficulties to implement structural reforms, and the need for adverse economic pressure to initiate the changes needed**. Falling in this category are Cyprus, France, Greece, Italy, Portugal and Spain. The absence of fundamental reforms has produced a growing and dangerous economic instability: the large increase in wages is not compensated for by a similar increase in labour productivity. These countries have thus lost competitiveness and seen deterioration in their external balance. Their high level of consumption compared to their level of innovation is detrimental to their external account. The debt burden and unemployment are therefore increasing. As latecomers delay policy implementation, reforms have strongly impacted their population that become in turn hostile to further policy changes, making it challenging for governments to pursue the necessary reforms.

- *Member States in economic catch-up* (in green): compared to the latter, **these countries have in common their low level of public debt and lower wages, which is a key element regarding their growth potential**. The sustained production rate could however be altered by a declining labour force and an ageing population. In this context, innovation could be a key factor. Traditionally more open to liberal reforms in the aftermath of the Cold War, these countries usually welcomed the post-crisis reforms and now call for further policy change. Falling in this category are: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia.

Two countries – Ireland and the United-Kingdom – overlap these categories. Ireland had to reform drastically under strong economic pressure but restored its economy quite quickly and attracts inward investment again while the United-Kingdom has a significant debt burden but remains attractive for investors. Reduced energy costs have reduced inflation and wages are returning to pre-crisis levels. Left wing parties have failed to capitalise on the situation. Populist anger focuses on immigration rather than austerity. ***Figure 23*** summaries the differences between these groups.

Figure 23: *Scoreboard on the economic outcome and political feasibility of the proposed reforms*

Proposed reforms	Economic		Political feasibility		
	Impact (+/++/+++)	Urgency (-/+/++)	Acting by anticipation	Implementing reforms under pressure	In economic catch-up
CREATING NEW BUSINESS OPPORTUNITIES					
Labour policies					
Investment in education	++	+++			
Highly-skilled migration	++	++			
Trade policies					
Investment in infrastructure	+++	++			
Intra-EU trade	+++	+			
Extra-EU trade	+++	+++			
Single Market for Energy	+++	+++			
Exporting emission trading scheme	+	-			
Innovation policies					
Smarter use of public funds	+++	+++			
Business-friendly taxation	+++	+++			
EU single Patent	+++	++			
ENHANCED CONVERGENCE					
Rationalising labour markets					
Greater wage flexibility	++	++			
Improving EU policy framework					
Cutting red tape	++	+			
Overcoming fiscal and budgetary freeriding					
Automatic exchange of financial information	++	+			
Common corporate tax base	+++	++			
Pooling of European public debt	+++	++			
Strenghtening financial markets					
Banking Union	+++	+++			
Capital Markets Union	+++	+++			

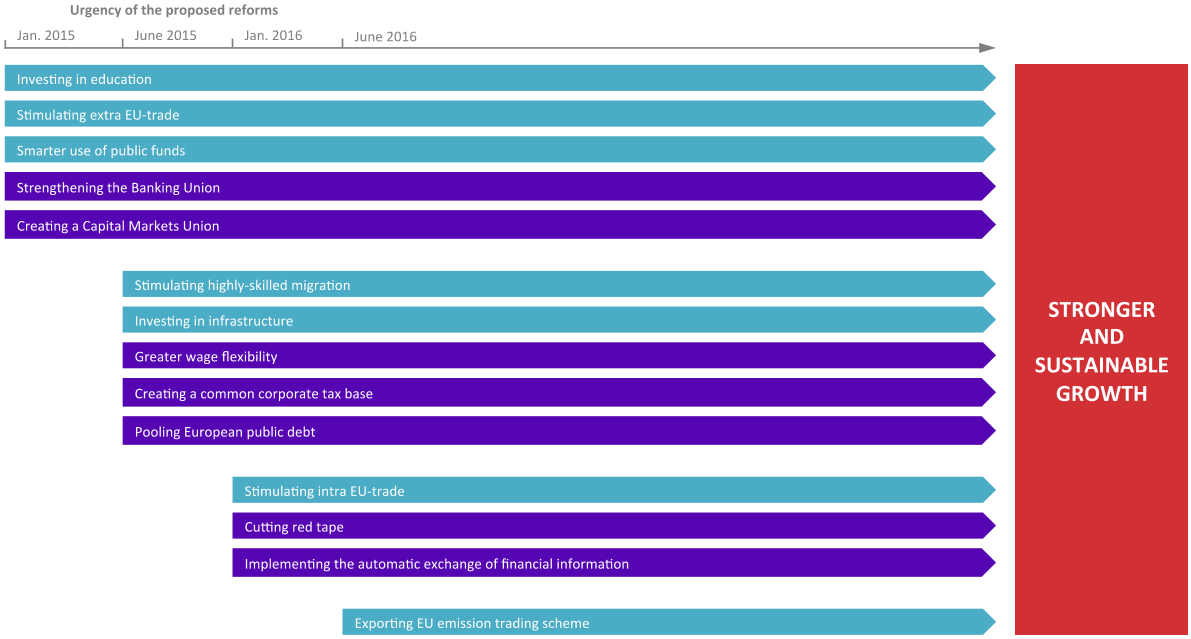
Stripped boxes represent mixed opinions.
These views rely on aggregated hypotheses reflecting the political context in the three relevent groups of countries.
A complementary study could provide in-depth analysis of the political acceptability of the proposed measures.

Source: Lighthouse Europe

III.3. The way forward

Given the political feasibility of the proposed reforms and Europe's limited financial resources, implementation should take into consideration time management. For instance, returns on investment in education only occur in the long run, which calls for immediate implementation, while exporting EU emission trading scheme can be delayed due to its more limited impact on growth. ***Figure 24*** provides the reader with an indicative timeline for the implementation of the proposed reforms. **Nonetheless, one must bear in mind that the strong divergences among Member States exhibited by the recent crises call for a comprehensive reform strategy.**

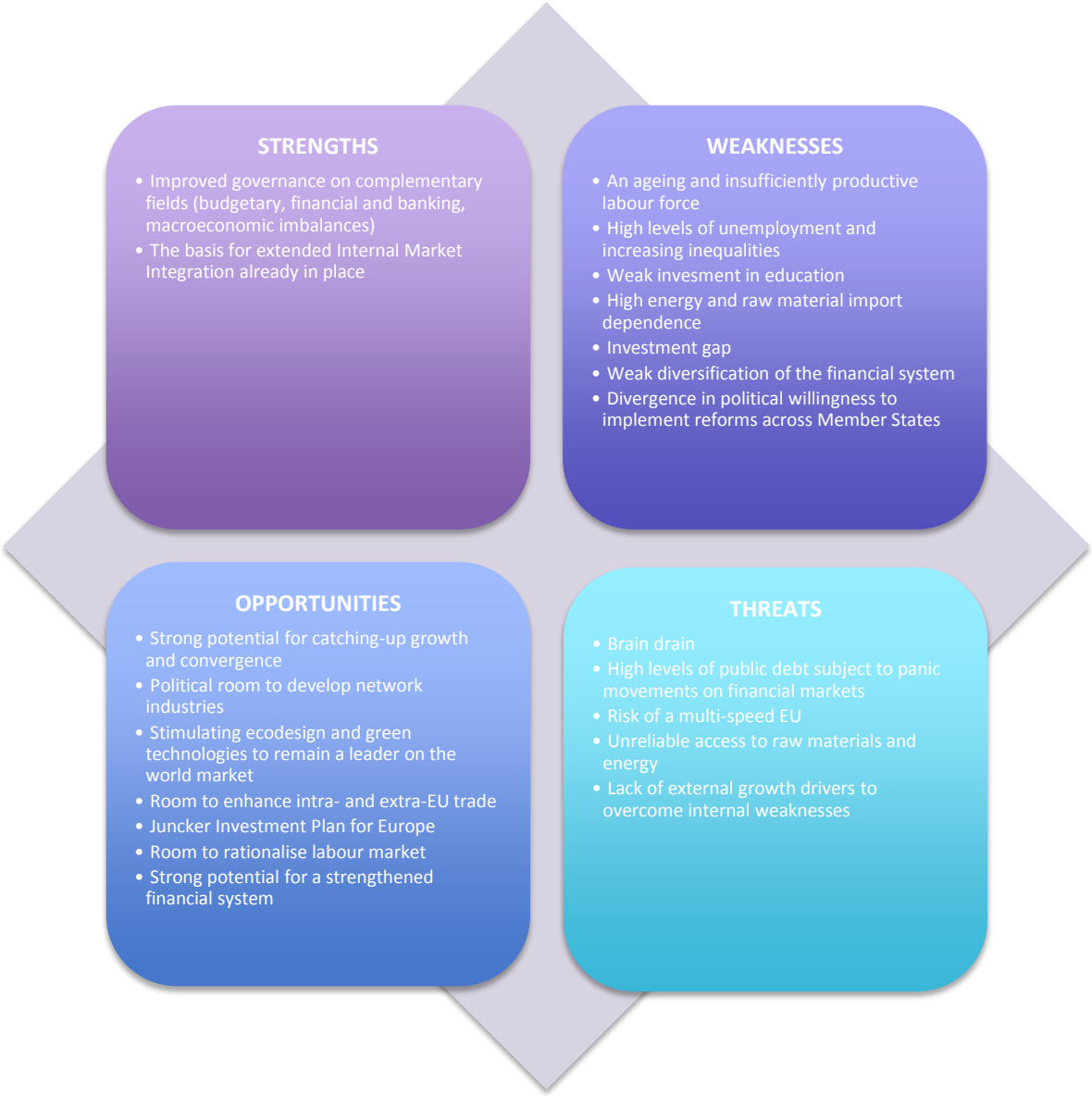
Figure 24: *Timing of implementation*



Source: Lighthouse Europe

Chapter IV: SWOT analysis

Figure 25: *SWOT analysis of the European Union*



Source: Lighthouse Europe

CONCLUSION: OPPORTUNITIES

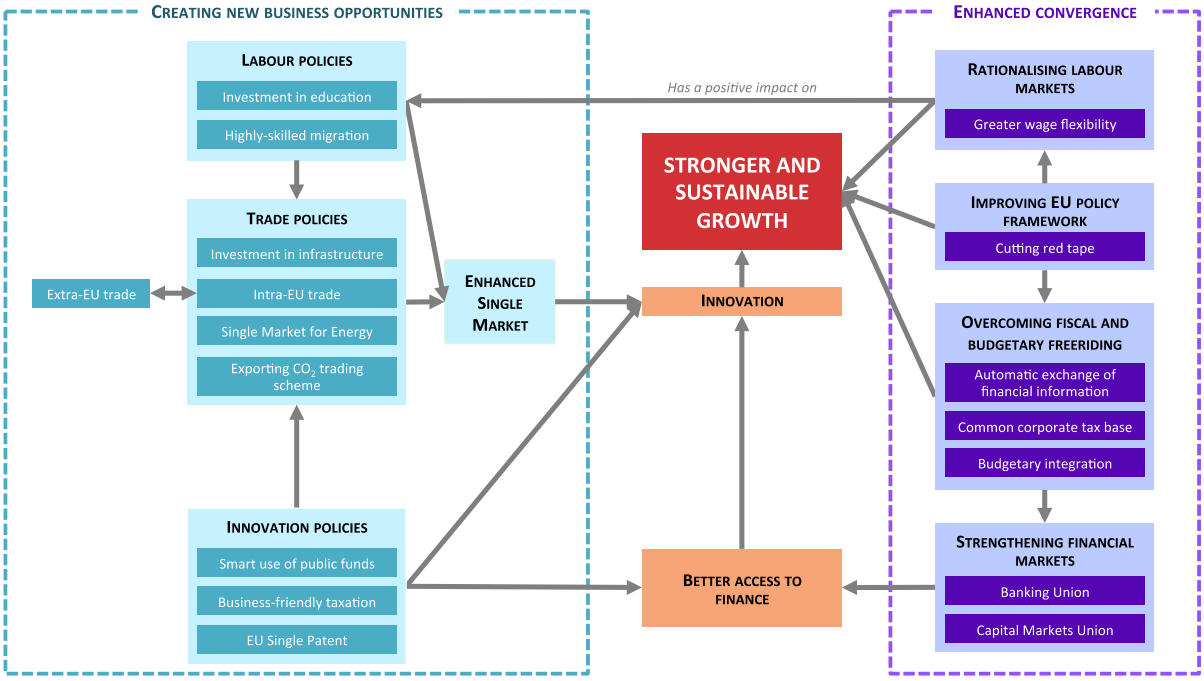
Achieving economic growth is necessary to provide future generations with the same or higher living standards. The European Union must therefore restore its competitiveness to enhance its growth potential. However, EU competitiveness is limited by internal and external factors.

The European Union faces internal weaknesses. Its Single Market is a high-cost environment with an ageing and expensive labour force that experiences low productivity while incomplete integration and weak intellectual property rights and trademarks undermine innovation. High public debt and private levels in the Euro Area limit investment, and EU governance and Single Market integration remain fragile in the aftermath of the crisis.

The EU cannot rely on external factors to overcome its internal shortcomings. Its financial system does not attract enough investments to stimulate innovation while unreliable access to energy and raw materials production costs. As a result, the gloomy global economic perspective exacerbates these negative trends.

Still, the European Union has potential for growth and must adopt adequate reforms to boost its competitiveness. In a context of budgetary discipline, these policies should aim at making the Single Market a truly integrated level playing field where firms could compete and innovate (***Figure 26***).

Figure 26: *Boosting EU competitiveness*



Source: Lighthouse Europe

Enhancing Single Market integration will create new business opportunities that companies could capitalise on and invest more, thereby increasing their competitiveness and fostering growth. To this end, reforms should focus on increasing investment in education, enhancing the movement of highly skilled workers, deepening investment in network industries and stimulating intra- and extra-EU trade. In this context, energy industries represent a unique opportunity for the EU to restore its world influence by exporting advanced technologies and policy models. Adopting a more business friendly taxation and promoting a smarter use of national and European public funds could further strengthen public and private investment.

Greater convergence will lead to a European level playing field for companies operating in Europe and restore EU-competitive forces. Cutting red tape would harmonise and improve the general framework of EU

policy. Overcoming fiscal and budgetary free-riding could improve the fiscal environment in which companies evolve while improving their access to funding by reducing public debt burden. To this end, many policy tools are available: the implementation of an automatic exchange of financial information, the introduction of a common corporate tax base, and the promotion of the partial pooling of European public debt. Rationalising labour markets through enhanced wage flexibility should also positively impact EU competitiveness. Finally, strengthening financial markets by completing the Banking Union and creating a Capital Markets Union would help to bridge the European investment gap.

If the strong divergences among Member States revealed by the recent crises call for a more comprehensive reform strategy, the EU should nonetheless focus on the highest growth potential reforms.

EU countries have adopted different approaches to integrate these key reforms in their economic policies. Three broad groups of countries have been previously listed, with some overlaps with time or internal governance:

- *Initiators acting by anticipation* enjoying a better position in terms of competitiveness and political attitude towards policy reforms (e.g., Germany),
- *Latecomers implementing structural changes under economic pressure* that require adverse economic pressure to initiate the changes needed, translating into a painful experience with policy changes (e.g., Greece),
- *Eastern European countries in economic catch-up* that enjoy low level of public debt, lower wages and a positive attitude towards reforms but still need to overcome an ageing population (e.g., Poland).

As highlighted by this classification, Member States' public opinions exhibit divergent levels of tolerance to structural reforms. In this context, countries with a good economic health review have proven to be more resistant to shocks whereas countries with difficulties put in question the implementation of the needed reform.

As a whole, EU growth potential stems from the ability of its Member States to implement relevant growth-enhancing policies. Especially, the upcoming political events, such as the UK elections or evolutions of the Russian external policy, will influence strongly the economic impact and political feasibility of the proposed reforms. In order to estimate the future growth landscape of Europe, different hypothesis on whether structural reforms will be successful and restore growth in Europe can be formulated:

- *Scenario 1:* Initiators, Latecomers and Eastern European countries are able to efficiently implement the required reforms and can overcome political reluctance to change.
- *Scenario 2:* Latecomers struggle in the face of the economic and political challenges ahead, leading to a two-speed EU.
- *Scenario 3:* Reforms have been implemented but have a weaker impact on EU competitiveness that expected, questioning the ability of the European Union to compete in a globalised world.
- *Scenario 4:* Political consensus cannot be achieved, leaving the European Union in an economically declining and increasingly destabilised *status quo*.

This confrontation between the economic analysis of the needed adjustments and their feasibility from a political stand point must be evaluated further to truly apprehend the remaining action possibilities from one group of countries to the other. This could be developed in a more comprehensive work.

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STATISTICAL ANNEX

GROWTH

GDP growth (% YoY)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	3,9%	2,2%	1,3%	1,5%	2,5%	2,0%	3,4%	3,1%	0,5%	-4,4%	2,1%	1,7%	-0,4%	0,0%
Euro area	3,8%	4,5%	0,9%	0,6%	2,2%	1,6%	3,2%	3,4%	0,7%	-3,8%	2,0%	1,8%	-0,7%	-0,5%
Germany	3,0%	1,7%	0,0%	-0,7%	1,2%	0,7%	3,7%	3,3%	1,1%	-5,6%	4,1%	3,6%	0,4%	0,1%
Greece	4,0%	3,7%	3,2%	6,6%	5,0%	0,9%	5,8%	3,5%	-0,4%	-4,4%	-5,4%	-8,9%	-6,6%	-3,9%
Spain	5,3%	4,0%	2,9%	3,2%	3,2%	3,7%	4,2%	3,8%	1,1%	-3,6%	0,0%	-0,6%	-2,1%	-1,2%
France	3,9%	2,0%	1,1%	0,8%	2,8%	1,6%	2,4%	2,4%	0,2%	-2,9%	2,0%	2,1%	0,3%	0,3%
Poland	4,6%	1,2%	2,0%	3,6%	5,1%	3,5%	6,2%	7,2%	3,9%	2,6%	3,7%	4,8%	1,8%	1,7%
United-Kingdom	3,8%	2,7%	2,5%	4,3%	2,5%	2,8%	3,0%	2,6%	-0,3%	-4,3%	1,9%	1,6%	0,7%	1,7%

Source: Eurostat

GDP (€ billion)

	AT	BE	BG	CY	CZ	DE	DK	EE	EL	ES	FI	FR	HR	HU
2000	208,5	252,5	14,0	9,9	63,8	2.047,5	173,6	6,2	137,9	629,9	132,2	1.439,6	23,3	50,3
2013	313,1	382,7	39,9	16,5	149,5	2.737,6	249,0	18,6	182,1	1.023,0	193,4	2.059,9	43,1	97,9
	IE	**IT**	**LT**	**LU**	**LV**	**MT**	**NL**	**PL**	**PT**	**RO**	**SE**	**SI**	**SK**	**UK**
2000	105,6	1.198,3	12,4	22,0	8,4	4,4	418,0	185,7	127,3	40,7	268,3	21,5	22,0	1.619,6
2013	164,0	1.560,0	34,6	45,5	23,4	7,3	602,7	389,7	165,7	142,2	420,8	35,3	72,1	1.899,1

Source: Eurostat

GDP per capita (€ per inhabitant)

	AT	BE	BG	CY	CZ	DE	DK	EE	EL	ES	FI	FR	HR	HU
2000	26.000	24.600	1.700	14.300	6.200	24.900	32.500	4.500	12.600	15.600	25.500	23.700	5.300	4.900
2013	37.000	34.500	5.500	19.000	14.200	33.300	44.400	13.900	17.400	22.300	35.600	31.300	10.100	9.900
	IE	**IT**	**LT**	**LU**	**LV**	**MT**	**NL**	**PL**	**PT**	**RO**	**SE**	**SI**	**SK**	**UK**
2000	27.800	21.000	3.600	50.300	3.600	11.200	26.300	4.900	12.500	1.800	30.200	10.800	4.100	27.500
2013	35.600	25.600	11.700	83.400	11.600	17.200	35.900	10.100	15.800	7.100	43.800	17.100	13.300	29.600

Source: Eurostat

COMPETITIVITY

Current account (% GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Euro area	-1,5%	-0,4%	0,6%	0,3%	0,7%	0,1%	-0,2%	0,0%	-1,5%	-0,2%	0,1%	0,1%	1,4%	2,3%
Germany	-1,8%	0,0%	1,9%	1,8%	4,4%	4,8%	6,0%	7,2%	6,0%	5,7%	6,0%	6,6%	7,3%	7,4%
Greece	-7,3%	-6,8%	-6,7%	-6,5%	-5,4%	-7,3%	-10,9%	-14,0%	-14,4%	-10,8%	-9,4%	-10,0%	-2,6%	1,2%
Spain	-3,9%	-3,9%	-3,2%	-3,4%	-5,1%	-7,2%	-8,8%	-9,7%	-9,4%	-4,7%	-4,3%	-3,6%	-1,2%	0,8%
France	1,4%	1,7%	1,2%	0,8%	0,5%	-0,5%	-0,6%	-1,0%	-1,7%	-1,3%	-1,3%	-1,7%	-2,1%	-1,3%
Poland	-	-	-2,8%	-2,5%	-5,3%	-2,4%	-3,8%	-6,2%	-6,5%	-3,9%	-5,0%	-4,9%	-3,7%	-1,4%
United-Kingdom	-2,8%	-2,2%	-2,0%	-1,6%	-1,9%	-1,8%	-2,7%	-2,1%	-0,9%	-1,4%	-2,6%	-1,4%	-3,6%	-4,2%

Source: OECD

High-technology exports (% total goods exports)

European Union	11,0%	10,2%	9,4%	8,7%	8,7%	9,0%	9,1%	6,9%	6,2%	6,2%	6,1%	5,5%	5,3%	-
Euro area	10,2%	9,4%	8,3%	8,1%	8,2%	8,2%	7,8%	6,5%	5,7%	5,4%	5,3%	4,9%	4,8%	-
Germany	8,4%	8,2%	7,9%	7,4%	7,9%	7,9%	7,4%	5,9%	5,1%	4,9%	5,1%	4,6%	4,4%	-
Greece	4,3%	3,4%	3,1%	2,8%	3,4%	2,8%	3,0%	2,4%	2,6%	2,5%	2,5%	2,0%	1,7%	-
Spain	4,7%	4,5%	4,0%	4,1%	3,8%	3,7%	3,4%	2,6%	2,4%	2,2%	2,2%	1,5%	1,3%	-
France	10,8%	9,1%	7,7%	6,5%	6,5%	6,3%	6,6%	4,8%	4,3%	4,3%	4,4%	4,3%	4,1%	-
Poland	4,1%	4,5%	4,9%	4,4%	3,8%	4,0%	5,0%	5,7%	7,0%	9,4%	9,6%	7,0%	7,0%	-
United-Kingdom	17,8%	17,6%	16,7%	12,1%	10,8%	14,0%	19,1%	6,7%	6,1%	6,7%	6,0%	5,0%	4,2%	-

Source: World Bank

Firstly, attention should be paid to the governance of the Banking Union to avoid counter-positive layering of national and European authorities and ensure efficient enforcement.

- *Interactions between the European Central Bank, the European Banking Authority and national banking regulators* should be clearly defined to avoid overlaps and strengthen the ECB's credibility as a supervisory body.
- *Regarding the supervision of banks,* a level playing field must be maintained between banks under national supervisions and those falling under the ECB's authority (e.g., equivalent obligations and stress tests).
- *Proliferation of rulemaking should be limited*, especially under the scope of the Single Rulebook. Options are available: regulation calibration to take into account the diversity of the national banking systems under consideration, harmonisation of the discretion options available to national authorities, etc.

Secondly, the creation of Banking Union calls for the creation of a common fiscal backstop to legitimise the system, i.e., the creation of a mechanism that will protect the budgetary position of Member States experiencing a banking crisis. If a Banking Union dramatically reduces the need for bailouts, public authorities might have to inject liquidities into the financial system in case of severe economic turmoil[47]. Combined with reduced tax revenues due to the degradation of the economy, budgetary positions might dangerously weaken. A fiscal backstop would address these fiscal risks while facilitating the orderly resolution of cross-border banks, which would in turn foster a level playing field and stimulating competition between banks.

What form should such a fiscal backstop take? **This mechanism should be structured as to avoid any moral hazard problems**: it should remove any incentives for Member States not to regulate their banking system properly. A first option would be to rely on existing institutions, namely the European Stabilisation Mechanism (ESM). If the ESM is already operational, its budget and framework is not adapted to address large adverse economic shocks; it should therefore remain an (efficient) tool for the short term. A more sustainable option is the implementation of a Single Resolution Fund (SRF) financed by banks. The Council has already agreed in December 2014 on a SRF covering at least 1% of the amount of covered deposits to be effective by 2023. If these policy developments are very encouraging, quick implementation remains the key for an effective level playing field within the Banking Union.

Thirdly, the threats of a two-speed EU must be addressed. Steps in that direction have already been taken, as the Banking Union includes provisions for extending the scheme to non-Euro Area Member States. Still, the exclusion of Europe's major financial hub, the United-Kingdom, remains problematic. Stronger incentives for British participation in the Banking Union should be implemented, as the British political landscape could move towards a more open stance.

II.2.4.2. Developing a Capital Market Union

Overcoming Europe's excess reliance on banks would provide room for cheaper and more secure financing of growth and reduce fragmentation of EU financial markets. In this regard, the European Commission has put forward an ambitious programme, the creation of a Capital Market Union (CMU), to complete its Banking Union. The CMU would harmonise rules across Member States in order to eliminate the barriers preventing the integration of capital markets[48]. While the Banking Union aims at centralising banking policy to check its existing development with an adequate supervisory mechanism, the Capital Market Union would therefore expand non-banking financial markets in an adequate regulatory framework.

[47] Due to the *too big to fail* principle.

[48] Capital markets gather all financial markets that are not about bank intermediation (e.g., bonds markets, sovereign debt markets).

PRODUCTIVITY

GDP per hour (US dollar)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	33,4	33,9	34,5	35,1	35,7	36,1	36,9	37,4	37,3	36,7	37,6	38,1	38,2	38,4
Euro area	38,9	39,4	39,8	40,0	40,5	40,9	41,8	42,3	42,2	41,7	42,6	43,1	43,4	43,7
Germany	44,5	45,6	46,2	46,6	47,0	47,8	48,7	49,4	49,5	48,2	49,4	50,4	50,7	50,9
Greece	25,4	26,3	26,6	28,0	28,8	28,1	29,4	30,2	29,7	28,9	29,0	26,9	28,2	28,3
Spain	35,2	35,2	35,3	35,4	35,5	35,6	35,8	36,3	36,4	37,3	38,2	38,8	39,7	40,4
France	44,9	45,4	46,8	47,3	47,6	48,3	49,6	49,6	49,2	48,9	49,7	50,3	50,6	50,9
Poland	15,1	15,6	16,3	17,1	17,7	18,0	18,5	19,1	19,1	19,7	21,1	22,0	22,4	22,9
United-Kingdom	38,6	39,4	40,4	42,0	43,0	43,2	44,2	45,0	45,0	43,9	44,6	45,1	44,5	44,5

Source: OECD

R&D spending (% GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	1,7%	1,8%	1,8%	1,8%	1,7%	1,7%	1,8%	1,8%	1,8%	1,9%	1,9%	1,9%	2,0%	-
Germany	2,5%	2,5%	2,5%	2,5%	2,5%	2,5%	2,5%	2,5%	2,7%	2,8%	2,8%	2,9%	3,0%	-
Greece	0,0%	0,6%	0,0%	0,6%	0,6%	0,6%	0,6%	0,6%	0,0%	0,0%	0,0%	0,7%	0,7%	-
Spain	0,9%	0,9%	1,0%	1,0%	1,1%	1,1%	1,2%	1,3%	1,4%	1,4%	1,4%	1,4%	1,3%	-
France	2,2%	2,2%	2,2%	2,2%	2,2%	2,1%	2,1%	2,1%	2,1%	2,3%	2,2%	2,2%	2,3%	-
Poland	0,6%	0,6%	0,6%	0,5%	0,6%	0,6%	0,6%	0,6%	0,6%	0,7%	0,7%	0,8%	0,9%	-
United-Kingdom	1,8%	1,8%	1,8%	1,7%	1,7%	1,7%	1,7%	1,8%	1,8%	1,8%	1,8%	1,8%	1,7%	

Source: OECD

Business-funded R&D (% total R&D)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	55,3%	55,0%	53,8%	53,2%	53,6%	53,7%	54,6%	54,5%	54,3%	53,4%	53,2%	54,3%	-	-
Germany	66,0%	65,7%	65,5%	66,3%	66,6%	67,6%	68,3%	68,1%	67,3%	66,1%	65,6%	65,6%	-	-
Spain	49,7%	47,2%	48,9%	48,4%	48,0%	46,3%	47,1%	45,5%	45,0%	43,4%	43,0%	44,3%	-	-
France	52,5%	54,2%	52,1%	50,8%	50,7%	51,9%	52,3%	52,3%	50,8%	52,3%	53,5%	55,0%	-	-
Poland	29,5%	30,8%	30,1%	30,3%	30,5%	33,4%	33,1%	34,3%	30,5%	27,1%	24,4%	28,1%	32,3%	-
United-Kingdom	48,3%	45,6%	43,5%	42,2%	44,1%	42,1%	45,2%	46,0%	45,4%	44,5%	44,1%	45,9%	45,6%	-

Source: OECD

Energy dependence (% net imports in gross inland consumption and bunkers)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	47,4%	47,5%	48,8%	50,1%	52,2%	53,6%	52,9%	54,7%	53,7%	52,7%	53,9%	53,4%	-	-
Euro area	63,3%	64,0%	64,2%	64,1%	65,2%	65,5%	63,9%	64,9%	63,8%	62,1%	62,2%	61,0%	-	-
Germany	60,9%	60,1%	60,5%	60,9%	60,4%	60,8%	58,4%	60,8%	61,0%	60,0%	61,5%	61,1%	-	-
Greece	68,9%	71,5%	67,5%	72,7%	68,6%	71,9%	71,2%	73,3%	67,6%	69,1%	65,0%	66,6%	-	-
Spain	74,7%	78,5%	76,7%	77,6%	81,4%	81,2%	79,6%	81,3%	79,1%	76,8%	76,4%	73,3%	-	-
France	50,8%	51,1%	50,6%	50,8%	51,7%	51,5%	50,4%	50,8%	51,0%	49,1%	48,7%	48,1%	-	-
Poland	9,8%	10,6%	13,2%	14,4%	17,2%	19,5%	25,4%	30,3%	31,5%	31,2%	33,4%	30,7%	-	-
United-Kingdom	-9,3%	-12,5%	-6,6%	4,5%	13,4%	21,2%	20,5%	26,2%	26,3%	28,3%	36,2%	42,2%	-	-

Source: Eurostat

Types of finance sought (% total finance need)

	2007				2010				Perception 2010-2013			
	All firms	**Gazelles**	**High-growth firms**	**Other firms**	**All firms**	**Gazelles**	**High-growth firms**	**Other firms**	**All firms**	**Gazelles**	**High-growth firms**	**Other firms**
Loan finance	31,6%	30,5%	37,0%	31,1%	32,3%	34,7%	36,6%	31,9%	67,2%	59,0%	59,8%	67,6%
Equity finance	5,2%	7,3%	6,5%	5,2%	5,9%	8,6%	7,2%	5,8%	10,0%	10,8%	11,0%	9,9%
Other type	22,4%	25,2%	26,8%	22,0%	25,2%	28,8%	33,0%	24,7%	22,8%	20,3%	24,2%	22,5%

Gazelles are young enterprises with high-growth potential.

Source: Eurostat

LABOUR

Unit labour costs (% YoY)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	-	2,2%	1,9%	-0,3%	1,1%	1,3%	1,0%	1,7%	1,0%	2,0%	0,8%	0,5%	3,1%	0,4%
Euro area	1,5%	2,0%	2,3%	2,0%	0,6%	1,3%	0,5%	1,3%	3,4%	4,7%	-0,7%	0,7%	1,8%	1,2%
Germany	0,6%	-0,3%	0,6%	1,2%	-0,5%	-0,4%	-2,4%	-0,8%	2,5%	6,9%	-1,5%	0,5%	3,1%	2,2%
Greece	0,7%	1,9%	9,8%	1,0%	1,8%	6,4%	-1,1%	1,6%	5,1%	7,0%	1,8%	-2,7%	0,3%	-7,0%
Spain	2,4%	3,0%	3,0%	3,0%	2,9%	3,4%	3,4%	4,2%	5,9%	1,6%	-1,6%	-1,0%	-2,9%	-0,3%
France	1,4%	2,1%	2,7%	2,1%	0,7%	2,0%	1,9%	1,5%	2,7%	3,5%	0,9%	0,8%	1,8%	1,2%
Poland	4,8%	6,5%	-1,9%	-2,7%	-2,4%	0,6%	-0,6%	2,3%	8,8%	1,0%	1,8%	1,3%	2,1%	0,9%
United-Kingdom	3,0%	3,7%	1,0%	1,4%	3,1%	1,8%	3,6%	3,4%	2,2%	4,6%	1,8%	-0,3%	2,2%	1,6%

Source: OECD

Unemployment (%, total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	8,9%	8,6%	9,0%	9,1%	9,2%	9,0%	8,2%	7,2%	7,0%	8,9%	9,6%	9,6%	10,5%	10,8%
Euro area	8,8%	8,2%	8,5%	9,0%	9,2%	9,1%	8,3%	7,5%	7,5%	9,6%	10,2%	10,1%	11,3%	12,0%
Germany	7,9%	7,8%	8,6%	9,7%	10,4%	11,2%	10,1%	8,5%	7,4%	7,6%	7,0%	5,8%	5,4%	5,2%
Greece	11,2%	10,7%	10,3%	9,7%	10,6%	10,0%	9,0%	8,4%	7,8%	9,6%	12,7%	17,9%	24,5%	27,5%
Spain	11,9%	10,6%	11,5%	11,5%	11,0%	9,2%	8,5%	8,2%	11,3%	17,9%	19,9%	21,4%	24,8%	26,1%
France	8,6%	7,8%	7,9%	8,6%	8,9%	8,9%	8,8%	8,0%	7,4%	9,1%	9,3%	9,2%	9,8%	10,3%
Poland	16,1%	18,3%	20,0%	19,8%	19,1%	17,9%	13,9%	9,6%	7,1%	8,1%	9,7%	9,7%	10,1%	10,3%
United-Kingdom	5,4%	5,0%	5,1%	5,0%	4,7%	4,8%	5,4%	5,3%	5,6%	7,5%	7,8%	8,1%	7,9%	7,6%

Source: Eurostat

Youth unemployment (%, less than 25 years)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	19,2%	18,9%	19,5%	18,6%	19,0%	18,9%	17,6%	15,7%	15,8%	20,1%	21,2%	21,6%	23,1%	23,6%
Euro area	19,5%	18,0%	18,7%	17,4%	18,2%	18,2%	16,9%	15,4%	15,9%	20,4%	21,2%	21,1%	23,3%	24,1%
Germany	8,7%	8,3%	9,8%	11,5%	13,7%	15,4%	13,6%	11,8%	10,4%	11,1%	9,8%	8,5%	8,0%	7,8%
Greece	29,1%	28,0%	26,8%	26,8%	26,5%	25,8%	25,0%	22,7%	21,9%	25,7%	33,0%	44,7%	55,3%	58,3%
Spain	23,2%	21,1%	22,2%	22,7%	22,0%	19,6%	17,9%	18,1%	24,5%	37,7%	41,5%	46,2%	52,9%	55,5%
France	31,5%	29,1%	30,5%	18,9%	20,5%	21,0%	22,0%	19,5%	19,0%	23,6%	23,3%	22,6%	24,4%	24,8%
Poland	35,1%	39,5%	42,5%	41,9%	39,6%	36,9%	29,8%	21,6%	17,2%	20,6%	23,7%	25,8%	26,5%	27,3%
United-Kingdom	12,2%	11,7%	12,0%	12,2%	12,0%	12,8%	13,9%	14,3%	15,0%	19,1%	19,8%	21,3%	21,2%	20,7%

Source: Eurostat

GOVERNANCE

Transposition deficit (% EU legislation not yet transposed into national law)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
European Union	3,0%	2,0%	2,1%	2,3%	3,6%	1,6%	1,2%	1,2%	1,0%	0,7%	0,9%	1,2%	0,6%	0,7%

Source: European Union

LIVING CONDITIONS

Population by age group (% total population)

	1990	1995	2000	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050	2055
20-59 years	54,3%	55,0%	55,3%	55,8%	55,3%	54,1%	52,5%	50,6%	49,1%	47,9%	47,1%	46,4%	45,9%	45,7%
60+ years	19,0%	19,9%	20,9%	21,8%	23,3%	25,0%	26,8%	28,8%	30,7%	32,2%	33,1%	33,8%	34,1%	34,2%
am. 60-69 years	10,0%	10,0%	10,1%	10,1%	10,6%	11,5%	12,1%	12,8%	13,2%	13,1%	12,6%	12,2%	11,9%	11,6%
	2060	**2065**	**2070**	**2075**	**2080**	-	-	-	-	-	-	-	-	-
20-59 years	45,8%	46,0%	45,9%	45,6%	45,3%	-	-	-	-	-	-	-	-	-
60+ years	33,9%	33,8%	33,9%	34,2%	34,5%	-	-	-	-	-	-	-	-	-
am. 60-69 years	11,2%	11,0%	11,3%	11,6%	11,5%	-	-	-	-	-	-	-	-	-

Source: Eurostat

Inequality (Gini index, 0-100 scale)

	AT	BE	BG	CY	CZ	DE	DK	EE	EL	ES	FI	FR	HR	HU
1990	28,7	23,4	22,5	22,1	18,8	26,2	25,3	21,7	32,7	30,2	20,8	28,7	22,4	26,2
2010	27,7	25,4	34,2	30,0	24,5	28,6	26,7	32,5	33,3	33,3	26,3	29,4	29,3	26,7
	IE	**IT**	**LT**	**LU**	**LV**	**MT**	**NL**	**PL**	**PT**	**RO**	**SE**	**SI**	**SK**	**UK**
1990	32,7	30,1	21,9	24,1	22,0	-	26,6	26,0	30,0	21,1	21,3	17,5	17,6	32,8
2010	29,4	32,7	34,8	26,9	35,8	27,4	25,7	31,0	33,8	32,2	23,6	25,2	26,3	35,7

Source: Harvard

January 2015

(updated on 23rd March 2015)

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Published by: "Visits and Publications" Unit
EESC-2015-49-EN
www.eesc.europa.eu

QE-04-15-393-EN-N
ISBN 978-92-830-2781-2
doi:10.2864/756821

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