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Holding Together what Belongs Together:

A Strategy to Counteract Economic Polarisation in Europe

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A Strategy to Counteract Economic Polarisation in Europe

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Abstract

The 2017-2018 economic upswing in the EU only masked the underlying economic polarisation in the bloc, which will again become more evident as the economy continues to cool.

What could a European strategy look like that counteracts the existing structural polarisation and thereby strengthens the cohesion of Europe? Based on a new study, this policy brief provides a sketch of policy suggestions on which the European Commission or leaders of EU member countries could take the lead, including:

› Coordinated industrial policy programmes

› Measures against rising income (and wealth) inequality

› Institutional reforms of the eurozone

› Further reforms of the financial sector

› Efforts to harmonise social and ecological regulation in the EU towards higher common standards

› Wage and fiscal policies geared towards reducing excessive current account surpluses

› Measures to counteract tax avoidance by international corporations.

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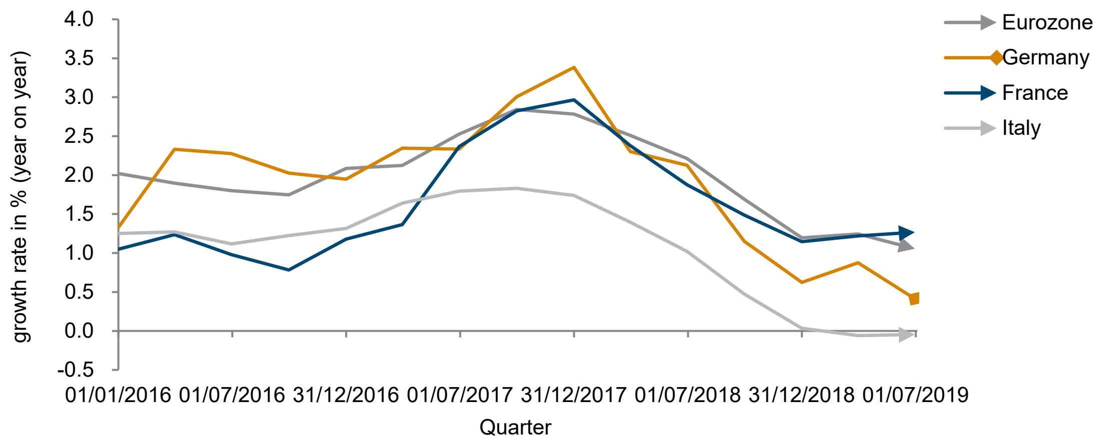
INTRODUCTION

The cyclical upswing in the EU in recent years led to widespread optimism. After years of recession, several European countries were finally able to record stronger economic growth and declining unemployment rates. Unfortunately, this temporary improvement in business cycle conditions has already come to an end, and a downswing has recently been gaining force (see Figure 1). Our study argues that it is therefore to be expected that the underlying economic polarisation within the EU will again become more visible.

Figure 1 / Quarterly real GDP growth, percentage change year on year



Data: OECD.

Our study argues that the southern EU countries have experienced a lost decade. Over the time period 2009-2018, the strongest real GDP growth actually took place in Eastern European catch-up countries, as well as in relatively small countries such as Malta, Luxembourg and Ireland. The latter countries, however, have a special role in the European 'race for the best location', as they operate as financial centres and low-corporate-tax destinations. The southern eurozone countries, meanwhile, are all to be found in the bottom third of the growth ranking – far behind the growth performance of high-income countries, such as Germany and Austria. While unemployment in Germany has recently recorded historical lows, the labour market in large parts of Southern Europe still performs worse than in pre-crisis times. In short, the last ten years have been characterised by a persistent drifting-apart in terms of living standards of large parts of Europe. In our study, we show that this process started in pre-crisis times, but was fostered by the outbreak of the financial crisis in 2007/2008.

Divergences within the EU are also manifest at the level of migration movements: in particular, Eastern European countries with low income levels and Southern European countries with weak or negative growth dynamics are experiencing a corresponding decline in population. In the long term, the net migration movements will also cause a widening of existing performance gaps and potentials between the European economies, since it is primarily people of working age and with higher education who prove to be internationally mobile.

The developments sketched so far run counter to the political promise of economic convergence. This promise was based on the hypothesis that the European Economic and Monetary Union would trigger a process of catching-up convergence for its Member States – i.e. those countries that were less rich at the time of entry would relatively quickly approach the higher levels of material living standards in the richest EU countries. However, the crisis and the subsequent economic experiences have shown that the convergence trend of the pre-crisis years was largely a façade, because economic growth – driven by rising private indebtedness, especially in the southern eurozone countries – came to a juddering halt with the outbreak of the crisis. Our study shows in more detail that there were certainly important differences across Southern European countries when debt-led growth reached its climax in pre-crisis years; for example, Spain experienced a major boom-bust cycle in housing, which was not the case in other southern countries. However, prior to the crisis of 2007/2008 the Southern European countries had all embarked upon a distinct path of debt-led growth and accumulated current account deficits; and when the financial crisis and the subsequent eurozone crisis hit, the fragility of the imbalances built up in pre-crisis times laid bare the underlying reality of macroeconomic divergence.

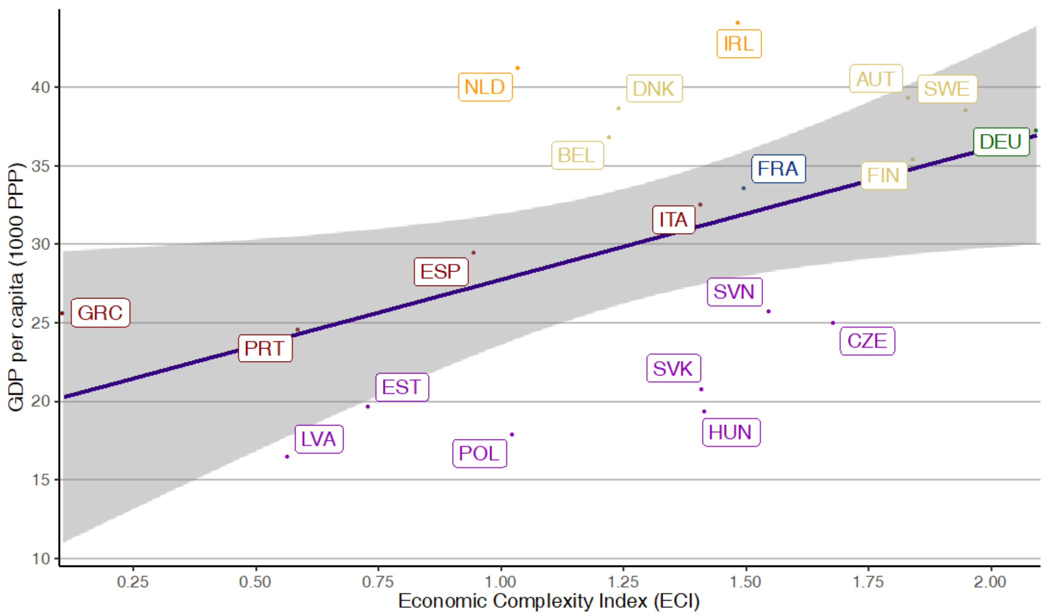
Unequal distribution of technological capabilities leads to structural polarisation

Our study argues that essential factors for explaining the long-term divergence of EU countries are to be found in the unequal regulatory conditions in the context of the European 'race for the best location' (for example, in the areas of the labour market, tax and corporate law, or financial market regulation), as well as in the different technological capabilities across EU countries. Our argument is based on the concept that firms with a technological leadership position benefit from current circumstances (e.g. through additional export opportunities to Asian countries wishing to acquire new technologies and capital goods), while firms with less technological specialisation face new challenges (particularly from Asian countries). Significantly more firms in core countries (compared to periphery countries) operate in medium- to high-tech industries. For example, while Germany has become stronger and more productive in high-tech manufacturing over the past two decades, Southern European countries have increasingly been locked into lower-tech and non-tradable activities. As a consequence, German firms often do not directly compete with Spanish, Portuguese, Greek or even most Italian firms; rather, they are price-setters due to their strong market standing, which is generated by a high degree of technological sophistication. In contrast, firms located on the periphery (e.g. Greece and Portugal) are more often confined to the role of price-takers, as they compete with low-cost Asian producers. Most European firms with a strong technological position typically operate from their home-base in rich countries, such as Germany and Austria – although there are certainly exceptions, e.g. in the industrial north of Italy and Spain. Nevertheless, many firms in the southern eurozone are relative technological laggards, and these underlying differences in technological capabilities are a highly important driving factor for the macroeconomic divergence within the EU.

To answer the question of how the technological capabilities of the EU Member States relate to their current level of prosperity, we use the data on 'economic complexity' provided by a research group at Harvard University (Atlas of Economic Complexity). The Economic Complexity Index (ECI) measures the extent of technological capabilities accumulated within a country. The ECI has excellent predictive power for the future long-term path development of an economy, as in the long run 'countries tend to approach the levels of income that correspond to their measured complexity'.

Indeed, we find a significantly positive relationship between the level of technological capabilities and the GDP per capita of EU countries: countries with a higher level of economic complexity tend to record higher levels of economic prosperity (and vice versa). Figure 2 shows that Germany is in a leading technological position. The lowest levels of technological capabilities are to be found in the Southern European countries of Greece, Portugal and Spain, as well as the Baltic countries of Latvia and Estonia. Notably, some other Eastern European countries perform better, as one can verify by looking at the Visegrád countries (Poland, Czech Republic, Slovakia and Hungary). These countries benefit from geographical proximity to Germany and Europe's industrial core, and their relatively low wage levels have enabled them to become important 'industrial workbenches'. Therefore, patterns of divergence are also visible within the group of Eastern European countries, as these countries currently play a different role in the European 'race for the best location'.

Figure 2 / Complexity and per-capita income (average 1999-2016)



Data: Eurostat; *Atlas of Economic Complexity*; own calculations. 7 EU countries are not included due to missing observations.

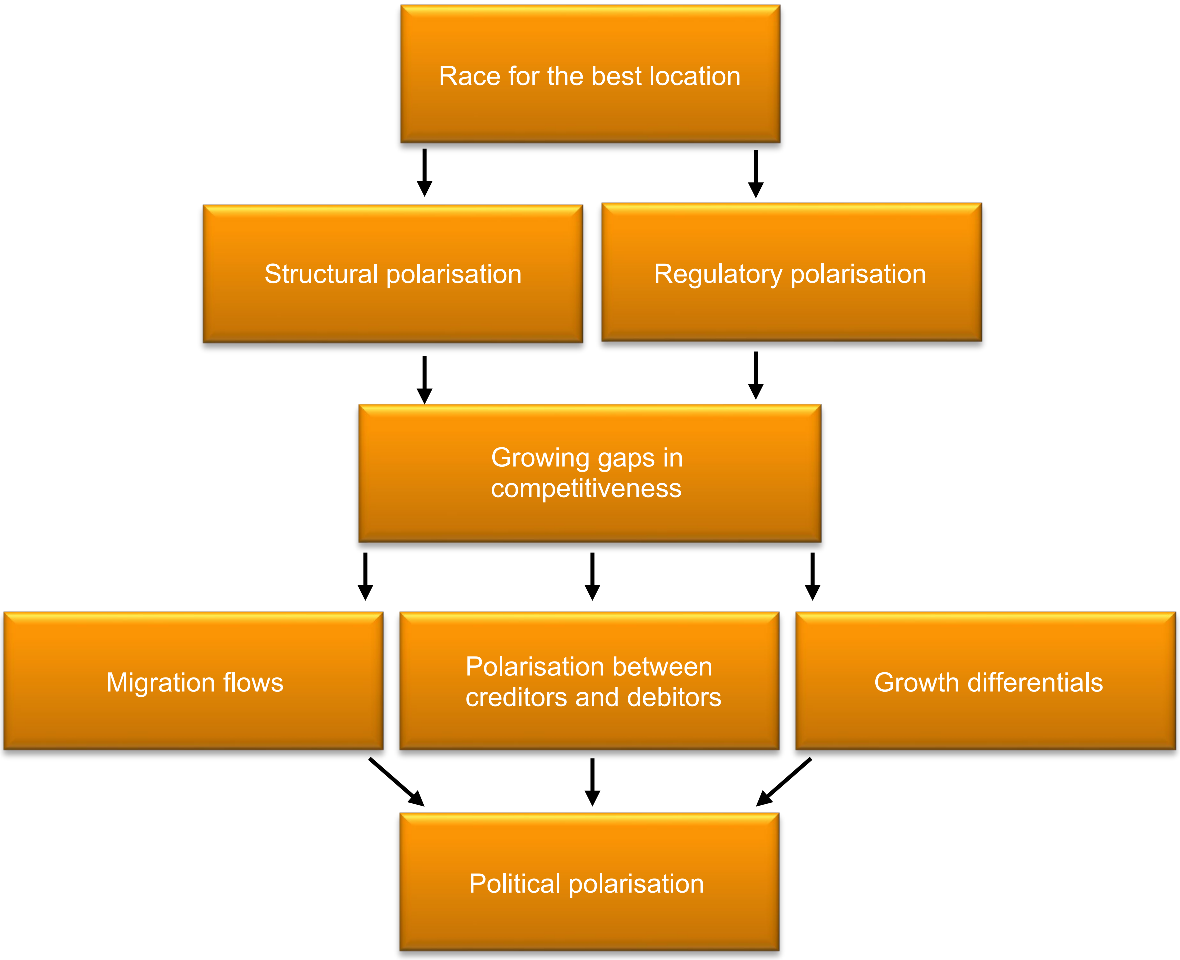
From a historical perspective, most developed European economies had a wage-driven growth model after the Second World War, i.e. the most important growth component was wage growth, which resulted in increasing household consumption and high productivity growth. However, a combination of different but related factors – the institutionalisation of strict monetary policy, economic globalisation and capital market liberalisation, the advent of shareholder value orientation and the diminishing strength of trade unions' organisational power – brought about a crisis in the wage-driven growth regime from the 1970s onwards. This crisis in turn led numerous European countries to search for alternative growth models, in which real wage growth would no longer be the driving force of the growth model. The experience of European countries that are relatively poor in terms of technological capabilities (compared to other highly developed countries) is that they tend to develop fragile growth models that are based on increasing (private) debt. In those countries where a large proportion of the firms that are subject to global competition are not able to produce and export complex products, the path of export-led growth is essentially blocked. While firms in technologically very competitive countries (e.g. Germany) can compensate for downward pressure on consumption spending resulting from rising income inequality by expanding their exports, this is not possible in large parts of the technologically lagging European countries. Particularly for larger countries such as Italy and Spain, whose economic growth depends more on domestic demand than is the case in smaller economies such as Ireland, wage deflation, which leads to improvements in price competitiveness, does not promise a long-run improvement in living standards. Instead, there is a need for a set of policy measures that allow firms in those countries to be supported in accumulating technological capabilities.

Ten policy options for ensuring economic prosperity in Europe

Our study shows that there is a lack of convergence in the field of technological capabilities. Although some parts of Eastern Europe (in particular, the Visegrád countries) have experienced some catching-up, other EU countries (such as some Baltic states or the Southern European countries) do not display patterns of convergence. This finding should sound alarm bells for policy-makers, because technological capabilities have excellent predictive power for long-run economic development. A continued drifting-apart is dangerous. After all, it has become clear over the past ten years that major economic disparities between the European countries also lead to conflicts that have the potential to contribute to a political failure of the EU (see Figure 3). Since the development dynamics of technological capabilities are path-dependent processes that would be reinforced by the ‘free play of market forces’, economic policy interventions aimed at convergence are needed. The problem is that the emergence of a structural competitive advantage in terms of technological capabilities (e.g. in Germany’s case) rests on increasing returns to production; success breeds success, which suggests that countries with a more favourable starting point in terms of technological capabilities gain further structural advantages over time, while relative laggards tend to lose even more technological ground.

Against this background, our study discusses several policy options geared towards formulating a common European strategy that not only addresses existing problems and makes possible the often-promised upward convergence between EU countries, but that also provides a potential basis for dealing with key future challenges (such as digitisation, ageing society, climate change or global trade) on the basis of common European objectives.

Figure 3 / Dimensions of polarisation in Europe



Source: own illustration.

1. The EU needs coordinated industrial policy measures that allow for a technological catching-up by lagging European countries. Relevant industrial policy programmes and measures that contribute to a more even distribution of technological capabilities within Europe are needed to enable a fair distribution of economic prosperity.

2. Those countries that benefit most from the current constellation should contribute to a stronger European domestic economy by promoting a) high wages and social standards, b) public investment programmes in relevant infrastructure sectors and c) greater intra-European solidarity.

3. An alternative catalogue of economic policy objectives is needed that goes beyond the vision of being the 'most competitive economic area in the world', as stated in the EU's Lisbon Strategy. In contrast, it is necessary to define attractive economic policy objectives aside from export surpluses and high growth rates. The latter is anyway a requirement of the times in an environment that is increasingly faced with qualitatively new economic policy challenges – such as digitisation, which leads to greater inequality, especially in the labour market, or climate change, which brings new restrictions on political and economic processes into play.

4. Europe's strong role as a big internal market should be exploited to a greater extent: in the case of ethically relevant concerns related to companies exporting to Europe, these companies should be gradually persuaded to comply with higher standards by threatening possible import restrictions. This would not only reduce the competitive pressure on European living standards in the long term, but would also add a global perspective to the efforts to harmonise social and ecological regulation within Europe. For an effective implementation of such a project, it would also be advisable to fundamentally question the internal competition between EU members in the 'race for the best location', especially in the area of tax policy.

5. The increase in income (and wealth) inequality since the 1980s jeopardises the EU countries' internal social cohesion. It reduces their political capacity to act, and thus ultimately also negatively affects the process of European integration. There are a number of policy proposals and historical models for creating a more even distribution of income (and wealth), including, for example, an increase in top marginal tax rates to curb income concentration at the upper end of the income distribution (as undertaken in the United States in the 1930s) or the introduction of higher minimum wages to strengthen the relative position of lower-income groups (as in several European countries after the Second World War).

6. The institutional architecture of the European Economic and Monetary Union should be completed. This includes: an expansion of the European Central Bank's mandate in terms of strengthening the role of labour market developments relative to the inflation target; the institutionalisation of measures to counteract speculative activities or to stabilise financial markets; the creation of a common 'safe asset' to stabilise the bond markets in the euro area; and the development of financing capacities for public projects in association with, or in a similar way to, the European Investment Bank (EIB).

7. Further reforms of the financial sector should be implemented – such as the introduction of a financial transaction tax to weaken the propensity to speculate, the re-regulation of international capital flows, the fight against tax havens, or the containment of the shadow banking sector. Such reforms have so far not been pursued with sufficient consistency. Not only would the European Union benefit from tighter financial market regulation (because it would result in greater economic stability and a forced stronger focus on the real economy), but the European institutional level is actually the authority that is best placed to effectively address the underlying questions and problems in connection with a strongly growing and powerful international financial sector.

8. Reducing (or even putting an end to) the intra-European race to the bottom in regulatory standards appears to be a central prerequisite for a unified European political approach in the field of economic and geopolitical policy. Those countries that attract multinational companies or foreign capital through particularly favourable regulatory conditions (e.g. Ireland, Malta, Luxembourg) create incentives (mostly through very low tax rates) for companies or particularly wealthy persons to relocate their business and financial assets to their territory. However, the additional tax revenues and jobs generated in the countries operating as financial hubs as a result of this targeted undercutting of regulatory standards cause considerable damage to the remaining countries in the medium and long term. In order to lead the EU into a prosperous future, a determined fight against tax avoidance is needed. The EU is losing an estimated EUR 60 billion in tax revenue each year because international corporations move their profits to tax havens. Germany alone suffers a

revenue loss of about EUR 17 billion. On the one hand, EU countries should join forces to exert pressure on tax havens to raise tax standards that are far too low and to impose harsher penalties on companies and countries that make tax avoidance possible – or even encourage it. On the other hand, EU countries should raise transparency standards on financial assets in a coordinated manner, in order to prevent the possibility of tax avoidance and to facilitate the investigation of such activities.

9. Excessive current account surpluses (especially in Germany) are a threat to financial stability and must be reduced. The countries concerned would not have to export less (hardly a viable course of action, given the advantage in terms of non-price competitiveness of countries such as Germany); rather, measures to stimulate import demand would make much more sense. Higher wage increases for middle and lower earners could not only address the problem of income inequality, but would also reduce dependence on export-based growth by strengthening domestic demand. An expansion of public investment would support this process and could at the same time address key long-term challenges for the future, for example through targeted investments in education, health, social affairs and ecological transport infrastructure.

10. Regardless of the fundamentally undisputed historical and current relevance of economic growth for a prosperous society, there is a need for multi-dimensional target systems, especially in view of the diversity of socio-economic challenges, in order to grasp the different dimensions of individual well-being, social progress and ecological sustainability, and to bring these various important dimensions into the focus of the public debate.

To sum up, our study argues in favour of a reform of the relevant European institutions in connection with a fundamental economic policy change. Far-reaching reforms are needed to achieve convergence and sustainable development. The extent and direction of a reform of European economic and monetary policy is very much a question of political courage to ask the right questions and to take the answers – arrived at on an analytical basis – politically seriously. The European Commission, as well as political leaders in EU countries, should take the lead on these issues.

In any case, the persistent economic polarisation within Europe should trigger a broad public debate about sensible institutional and policy changes in the EU in general, and in the eurozone in particular.

IMPRESSUM

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