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The future of EU-wide coordinated policies in the post-crisis era: policy note

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The future of EU-wide coordinated policies in the post-crisis era: policy note[1]

Abstract

The current policy note argues that the above socio-economic challenges are a logical outcome of the asymmetrical integration (Reinert & Kattel 2013) within the European Union that has brought together 28 member states with vastly different levels of competitiveness. Furthermore, the EU economic development policy framework, including co-ordinated and cohesion policies, fell, in our view, short on two key aspects that are crucial to securing longer term socio-economic cohesion in the European Union in 2000s.

Content

[1] The current policy note builds and summarises on Kalman & Tiits 2014, which presents an in-depth analysis of the issues that are summarised in the current policy note briefly.

Introduction

Ten years have passed since the historic enlargement of the European Union in 2004, which involved a larger and socio-economically more diverse group of countries than any earlier enlargement of the European Union. We have experienced a full economic cycle that involved a period of economic boom and a major crisis in the last decade. This is a good time to analyse the role of the Lisbon Strategy, open method of co-ordination, and cohesion policies in building a more competitive and socially more cohesive European Union.

Cohesion has been a process with mixed results in the European Union in the last decades. Some cohesion countries, often the poorest, have been catching up fast in GDP per capita terms. While this has been the case, a number of other countries have not experienced meaningful growth for a decade or even longer in the European Union. Social situation, which improved prior to the global financial and economic crisis in 2008-2009, has worsened significantly thereafter. Why is this so?

The current policy note argues that the above socio-economic challenges are a logical outcome of the asymmetrical integration (Reinert & Kattel 2013) within the European Union that has brought together 28 member states with vastly different levels of competitiveness. Furthermore, the EU economic development policy framework, including co-ordinated and cohesion policies, fell, in our view, short on two key aspects that are crucial to securing longer term socio-economic cohesion in the European Union in 2000s.

First, it was not able to limit the build-up of excessive imbalances in trade and financial flows between the different member states. This, in turn, led as the result of the global financial crisis to a severe economic crisis in the most vulnerable member states.

Second, the combined efforts of the EU and member states policies have not been able to induce a powerful wave of structural change toward more knowledge intensive economic specialisation throughout Europe and in cohesion economies in particular. This has foremost to do with the weakness of the strategic management of the co-ordinated and cohesion policies both at the EU and member states levels.

Recommendations

The current policy note concludes with the following policy recommendations:

- First, the European Union, and the euro area in particular, needs a much better co-ordination of its macro- and microeconomic policies. The co-ordination of production and employment levels should be central to it as far the stability of euro, and socio-economic cohesion are concerned.

- Second, Europe 2020 strategy needs a more stringent and actionable vision of its future economic strengths. Identification and creation of European lead markets for emerging science and technology intensive industries is where the reinforcement of the EU 2020 strategy should start.

- Third, Europe can and should do more for upgrading its exporting industry, with a strong focus on European cohesion economies in particular. For one, the European Investment Bank and the European Investment Fund could play a much more stronger role in fostering industrial upgrading in Europe.

- Fourth, setting the incentives right is crucial with several levels of stakeholders and thus diverging interests. Soft policy co-ordination, such as the Lisbon strategy and open method of co-ordination, applied prior to the crisis have proven insufficient and Cohesion policy has been criticized for ineffective implementation. More systematic strategic management of the co-ordinated and cohesion policies both at the EU and member states levels is needed, including a stronger focus on evaluation of the impact of the public investment as compared to its originally intended objectives. Also, stronger enforcement of the conditionalities for the receipt of EU funds is necessary.

- Finally, further efforts continue to be needed on regulatory, administrative and institutional capacity building in Cohesion countries, so that such institutional obstacles do not hinder the success of both EU2020 and Cohesion policy, thus a smarter, yet inclusive boost to the growth of Europe.

Background

Lisbon Strategy of the European Union, which was launched in 2000, aimed at making the enlarged European Union 'the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion' by 2010.

The historic enlargement brought 10 new member states to the European Union in 2004; two more countries joined in 2007 and a further one in 2013. At the first glance, the enlargement has worked well. Some cohesion countries, often the poorest, seemed to catch up fast in GDP per capita terms. Yet, their average wage growth was often even faster than productivity growth in exporting industry in 2000s. Rapid increase of unit labour cost along with consumption rather than export led growth led to the erosion of competitiveness in such economies. While this has been the case, a number of other countries have not experienced meaningful growth for a decade or even longer in the European Union. Social situation, including employment level and social inclusion, which improved prior to the global financial and economic crisis, worsened significantly thereafter. (Eurostat 2014)

One could argue that the last global crisis was an unforeseeable external event, which the European Union had little to do with. We do not share this view. The crisis in Europe was, similarly to the global crisis, largely the result of major imbalances, which had been built up earlier. While trade of goods and services was in surplus in majority of the more advanced member states, the cohesion countries have maintained trade deficit throughout 2000s. Trade disparities reached record levels prior to crisis in 2007-2008, when the imbalance in trade of goods and services peaked at -22% of GDP in Latvia, -21% of GDP in Bulgaria, -14% of GDP in Greece and Romania, -13% of GDP in Lithuania, -11% of GDP of Cyprus, -10% of GDP in Estonia and Portugal. (Eurostat 2014)

Continued inflow of foreign financing fuelled domestic demand led growth and real estate boom in the cohesion economies, but led often also to significant current account deficits. It is often argued that the trade and current account deficits and perfectly normal for successful catching up countries, which need to import capital and novel technologies. External deficits cannot be, however, sustained forever. A large current account deficit, exceeding 5% of GDP, and foreign denominated debt are major economics risk when it comes to external financial shocks (Furman and Stiglitz 1998). We argue in the following that the realisation of such risk is exactly what we witnessed in the European Union in the course of the global financial and economic crisis that started in 2008-2009.

Unemployment rate is now higher in many member states than in 2000 in the European Union. High youth unemployment is especially problematic in the context of the European aging population. EU28 average youth unemployment, which bottomed at 15% in 2007-2008, has increased in since then to more than 23% in 2013. Moreover, these cohesion economies, which suffered from the implosion of their economies the heaviest, suffered also from a wave of emigration of their working age population. Working age population (15-64 year olds) declined by drastic 18% in Latvia, 9% in Lithuania and 6% in Bulgaria between 2008 and 2013. (Eurostat 2014)

Relatively less knowledge intensive industrial specialisation in the cohesion economies continues to be perhaps the most fundamental factor that inhibits rapid convergence of living standards within the European Union. Establishment of more knowledge intensive businesses in the cohesion economies assumes, in turn, for the emergence of a new generation of highly skilled workers. This poses a significant challenge to a number of cohesion economies, where the share of population with tertiary education remains quite low. The number of PhD graduates continues to be insufficient for setting the basis for a new generation of R&D personnel and meeting the 3% R&D intensity target in the most of the cohesion economies. (Eurostat 2014, Tiits et al 2014).

As the result of the above, Lisbon Strategy proved largely a failure, as its objectives were unlikely to have been met even without the global financial and economic crisis.

Analysis

The various macroeconomic conditions, including global financial flows proved extremely powerful in fuelling the unsustainable domestic consumption led growth in a number of cohesion countries in the European Union. These market forces out powered the achievements of the combined efforts of co-ordinated policies (Lisbon and EU2020 strategies) and cohesion policies in improving competitiveness of the cohesion economies in the 2000s. We have identified, in connection to this, a number of blind spots in the EU economic policy mix, which allowed this to happen.

First of all, there is, crucially to the stability of the European common currency and to building a more cohesive Europe, still no effective policy mechanism for co-ordination of production and employment levels in the different parts of the European Union. Neither co-ordinated policies, such as Lisbon strategy or Europe 2020 strategy, nor euro convergence criteria or the Stability and Growth Pact for the co-ordination of national fiscal policies in the European Union has fulfilled this role.

Moreover, we find that some elements of the EU economic policy framework, such as foreign trade policy, monetary policy or even R&D and innovation policy, continue to face major challenges in meeting the realities and needs of the 28 member states with very different levels of competitiveness. Some countries, such as Germany, would like to continue to benefit from strong euro, but less competitive cohesion economies would clearly benefit from weaker currency. European R&DI policy, which puts scientific excellence first, tends to benefit the largest and strongest labs in Europe foremost, leaving the weaker research labs and companies to lag behind. This leaves both structural and cyclical imbalances, which do not get sufficient attention from other policy domains, for the EU cohesion policy to be resolved, and leads the euro area in particular to the situation where more competitive economies export their manufactured goods and less competitive economies export their unemployed working age population.

Fundamentally, we witness an asymmetric integration (Reinert & Kattel 2013) in the European Union, which has brought together 28 member states with very different levels of competitiveness of their exporting industry. We find that both the labour productivity gap in the exporting industry and structural challenges in industrial specialisation are larger than often anticipated in the European public policy. More competitive member states in core Europe specialise in increasing returns high-income activities, such knowledge intensive services, medium and high technology manufacturing. Cohesion economies, which are mostly located on the EU periphery, specialise, however, in low-income non-knowledge intensive services, low and medium technology manufacturing. This is the fundamental reason why the productivity and cohesion gap persists in the European Union. So far, combined national efforts, EU policy co-ordination and cohesion funds have been ineffective in fostering the emergence of a 'flying geese' development pattern that would be similar to the ones witnessed after the British Industrial Revolution in 18-19th centuries in Western Europe and in 20th century East Asia (Akamatsu 1935, Pollard 1973, Pollard 1981).

Lisbon Strategy of the European Union expected the increase the R&D intensity of the economy to 3% of GDP, and a healthy 70% employment level, which were to indicate a competitive and inclusive economy. Unfortunately, the objectives of the Lisbon Strategy were not met; and they were unlikely to have been met even without global financial and economic crisis (Reinfeldt 2009). Sadly, the Europe 2020 strategy shares a number of the weaknesses of the earlier Lisbon Strategy. The headline objectives of the Europe 2020 strategy, such as the intended R&D intensity or employment level, reiterate some of the headline objectives of earlier Lisbon strategy. These targets are, however, of a very high level of abstraction, and the strategy itself is not clear enough on what it actually takes to achieve these targets. For example, 3% R&D intensity target calls implicitly for major structural change in the European economy; 75% employment level is an indication of well performing economy, but these targets alone do not indicate how Europe actually seeks to become successful.

The principal governance mechanism for the Lisbon Agenda was the voluntary Open Method of Coordination (OMC), which proved to be beneficial as a soft policy diffusion mechanism across EU countries, however failed in achieving an overall EU-wide policy focus on competitiveness and employment levels. This was in part due to the overly complex and large pool of Lisbon goals and unclear development paths, the lack of clarity of the linked cohesion goals *per se* as well as the lack of political commitment to Europe 2020 targets and related performance reporting at the member states level.

Apart from efforts on coordinating strategic planning and monitoring in the EU Semester, the primary tool for 'promoting Lisbon through Cohesion' was the thematic allocation of cohesion funding to Lisbon priorities via earmarking. The earmarking instrument itself has been criticized for being too top-down, administratively demanding and contributing to the emphasis on spending instead of outcomes. Yet it was a precedent for top-down governance, when European Union could set parameters in allocation decisions of Member States – a tendency strengthened for the new 2014-2020 period with more specific spending categories for both ERDF and ESF.

Proper operationalisation of the headline targets of the Europe 2020 strategy into meaningful policies remains thus a major challenge for the member states. So far, institutional weaknesses tend to allow for rent-seeking, distortions and waste of resources in the cohesion economies. It is, therefore, not surprising to see that earlier studies have brought out several shortcomings with regard to implementation of EU Cohesion Policy, such as a deficit of strategic planning and policy concept; lack of focus on priorities; failure to focus on results - problems with the indicators used; too strong focus on absorption, lack of real policy debate. (See, e.g., Barca 2009)

Conclusion

We conclude the analysis with the following conclusions and policy recommendations:

- First, the European Union, and the euro area in particular, needs a much better co-ordination of its macro- and microeconomic policies. The co-ordination of production and employment levels should be central to it as far the stability of euro, and socio-economic cohesion are concerned. This is a hugely challenging proposal, as we are discussing an international multi-level governance system with several principals and multiple agents with vastly different resources.

- Soft policy co-ordination, such as the Lisbon strategy and open method of co-ordination, applied prior to the crisis have proven insufficient. It is yet to be seen whether new and more stringent methods – macro and initial conditionalities, EU semester taken more seriously – introduced for 2014-2020 EU financial period will work or need further reinforcement.

- Second, Europe 2020 strategy needs a more stringent and actionable vision of its future economic strengths. Identification and creation of European lead markets for emerging science and technology intensive industries is where the reinforcement of the EU 2020 strategy should start. A stronger vision of Europe's technological and industrial future beyond 2020 would open both for more and less advanced economies in European a more clear vision of the direction European Union seeks to take. This, in turn, allows for better re-alignment of research, education and labour market policies, etc.

- 'Green growth', which emphasises energy efficiency and environmentally friendly development, is already part of Europe 2020, and may very well emerge as central element of next techno-economic paradigm that will last for the most of the 21st century. However, it may very well be that biotechnology, nanotechnology or some other technology will emerge over the next decade as the next paradigm leading technology. In any case, Europe needs to co-ordinate better its efforts. Therefore, development of a more specific strategy of industrial revival is crucial.

- Third, Europe can and should do more for upgrading its exporting industry, with a strong focus on European cohesion economies in particular. For one, the European Investment Bank and the European Investment Fund could play a much more stronger role in fostering industrial upgrading in Europe by establishing specialised investment funds that support early stage growth in new high-tech firms, and restructuring of the existing major industries across Europe. Such investment funds should seek co-investment from major private venture capital firms and commercial banks, channelling this way also private capital into industrial revival in Europe. This is where the 315 billion euro investment plan (Juncker 2014) of the new European Commission could play an important role.

- Finally, setting the incentives right is crucial. Lisbon Strategy was originally a strategy without any financial resources the European Union itself could potentially commit for the achievement of its strategic objectives. 'Lisbonisation' of cohesion policy that has taken place from the mid-2000s has helped somewhat, but this has been too little and too late. The adoption of cohesion funds has, however, a history of focussing too much on the absorption of resources while paying too little attention to the impact achieved. More systematic strategic management, including evaluation of the impact of the public investment as compared to originally intended results is a must. Recent reform of cohesion policy, and the introduction of the element of performance contracts to the partnership agreements for the 2014-2020 period will hopefully improve the situation with this respect.

- Further efforts continue to be nonetheless needed on building regulatory, administrative and institutional capacities as well as emphasis on greater involvement of regional agencies in strategic planning. This would involve setting context-specific local goals for an inclusive growth strategy, and monitoring of the implementation of the EU2020 strategy and cohesion policy. Along with this, both the definition of the specific policy actions and the selection of performance indicators need to be improved considerably.

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