

# Faltering recovery under threat again

## Introduction

The European Commission's autumn forecast from November 2016 (European Commission 2016a) predicts GDP growth slowing to 1.5% in 2017, with employment increasing by only 0.9%. These modest forecasts reflect concerns over possible economic uncertainties elsewhere in the world and over the UK's preparations to leave the EU. The European Commission has been worried enough to argue for the benefits of a slightly expansionary fiscal policy across the euro area countries, albeit with no means to ensure its implementation. This, it hopes, will supplement the effects of its investment plan and the 'structural reforms' implemented in recent years in a number of countries. Unfortunately, these measures will bring very few benefits.

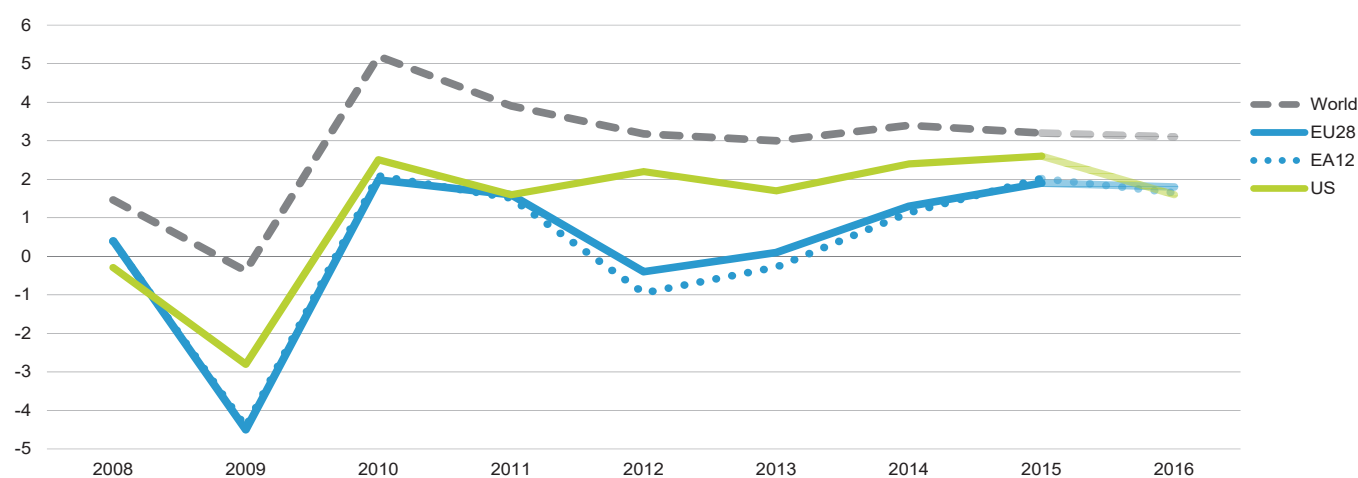
The key to sustained recovery should be fiscal policy, both to stimulate internal demand and to create the basis for a more serious investment plan. There is plenty of scope for this approach, as indicated by the comfortable budgetary positions of some countries and the minimal rates of interest at which they can borrow. The need is also there: in the failure of current policies to reduce cleavages across the EU, in the shortfall in research and development spending, in the weakness of the European infrastructure, and in the lack of a vigorous approach to energy conversion. However, the limited flexibility allowed in existing euro area rules means that little is likely to change. In a year's time, the European Commission is likely to report another year of slow growth, possibly once again somewhat below its already modest forecasts.

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## Economic developments: recovery remains modest

Figure 1.1. Real GDP growth (EU28, EA12, US, World) (2008-2016)



Source: own calculations using IMF, OECD and Eurostat data.

Note: 2016 are forecasts.

### Recovery slowest in the euro area

Figure 1.1 shows the growth rates for the EU and euro area compared with both the USA and the whole world over the period 2008-2016. A large part of the world weathered the crisis with just a slight drop in growth rates and a secular deceleration in subsequent years. The EU also showed signs of recovery after 2009 but, as Figure 1.1 shows, it diverged from the USA and the rest of the world from 2010, falling back into depression. Recovery from that second dip remains slow, leaving GDP in real terms in 2016 5.2% above its 2007 level. The euro area (when measured as the twelve pre-2007 members) performed worse, with 3.0% growth over 2007, while GDP in the remaining EU members grew by 11.3%.

The European Commission (EC) had confidently asserted in its 2010 autumn forecast that 'the economic recovery ... is making progress' (European Commission 2010: 9), only to see two years of negative growth. Forecasts for 2016 (European Commission 2015a) were still slightly over-optimistic at 2.0%; the reality turned out to be 1.8%. The policies of austerity that were implemented from 2010, and subsequently

only partially relaxed, also contributed to a shift in economic orientation. Domestic demand increased between 2008 and 2016 by only 2.2% in the EU (no change for the euro area), while exports increased by 24.3% (24.4% for the euro area). Thus exports relative to GDP increased from 38.6% to 45.8% between 2008 and 2016 (from 39.0% to 47.3% for the euro area); the EU has become more dependent on economic developments elsewhere in the world.

The EC foresees a slowing of growth in exports, due to probable slower growth in China and a number of other developing countries. This may be counterbalanced by rising commodity prices, especially of oil and gas, which would increase demand in exporting countries but also tend to depress EU growth by reducing real spending power of populations. Exports to the UK from other Member States may also fall.

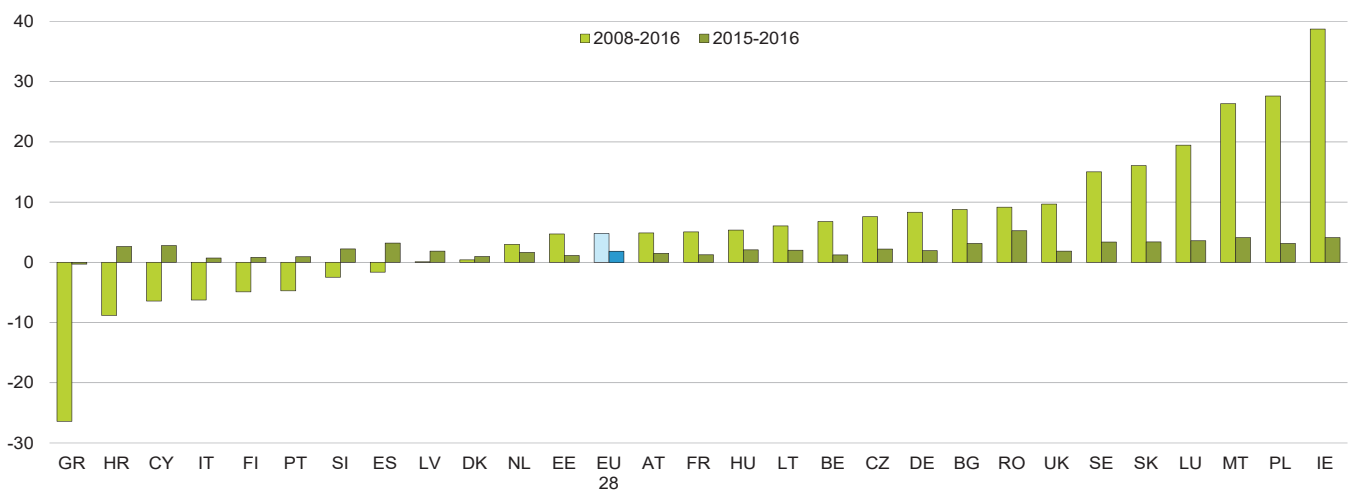
Prospects would be better with a stronger orientation towards domestic markets. In fact, total domestic demand is predicted to grow more slowly than total GDP, which will continue to depend on export growth. Private consumption is slowing down, as is public spending (although temporarily increased in some countries due to spending associated with refugees and asylum seekers). Investment, it is forecast, will grow more rapidly than GDP, as it did in 2016, but, as indicated below (see page 16), hopes of

a stimulus from the EU's investment plan are proving unrealistic.

There is likely to be some growth thanks to higher external demand and a gradual recovery in internal demand. The European Central Bank (ECB) policies discussed below (see page 13) are expected to contribute very little. The investment plan also adds nothing to credit levels already being granted by the European Investment Bank (EIB). Hopes of a very small fiscal stimulus within the euro area (see page 14), should they materialise, will help counter negative pressures, but not provide a basis for renewed sustainable growth. The European Commission (2016a: 1) is predicting GDP growth of 1.5% for 2017 and 1.7% for 2018; by no means impressive figures when set against pre-2008 performance or that of other parts of the world. This is furthermore at the upper end of what can be expected.

## Economic developments: recovery remains modest

Figure 1.2. Change in real GDP (2008 to 2016)



Source: calculated from AMECO database; GDP at 2010 constant prices.

Note: 2016 figures are estimates.

### Low growth leaving some behind

Figure 1.2 shows differing GDP growth performances across countries. All countries, apart from Greece which had negative growth, had returned to some degree of growth by 2016. However, ten countries had still not reached their pre-crisis peak GDP level, and among these were four with growth rates below 1% (Denmark, which reached its peak in 2007, Italy, Portugal and Finland).

There is no easy division between east and west, between north and south, between the euro area and the rest of the EU or even between higher and lower income countries. There have been good and bad performances within all of these categories. Some lower income countries have moved up the scale. Between 2007 and 2016, IMF data show Poland moving from per capita GDP levels (measured by purchasing power parity) of 55% to 70% of the EU average. Portugal and Greece, however, declined in the same period from 78% and 94%, respectively, to 73% and 68% of the EU average. Bulgaria remained the lowest, with per capita GDP increasing from 44% to 47% of the

EU average, at which rate it will catch up with the average in about 166 years (<https://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weoselgr.aspx>).

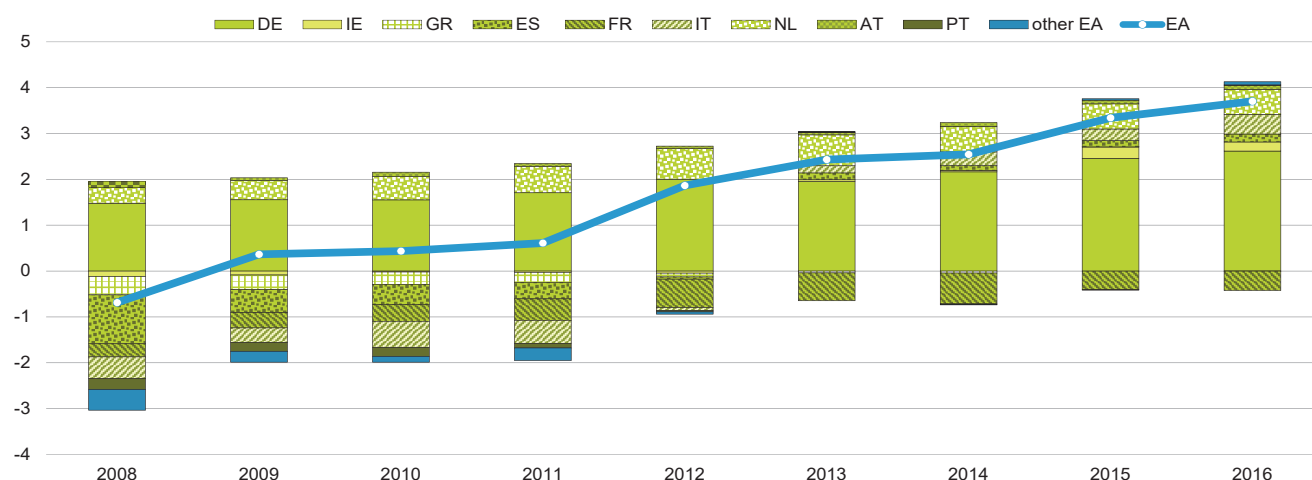
Differences between countries' performances reflected the extent of exposure to the effects of the 2008 financial crisis, the scope for increasing exports, and the policies chosen by, or imposed upon, the country in question. The crisis of 2008 hit hardest those countries that had become dependent on credit to finance construction booms, notably Ireland, Spain and the Baltic states. The downturn after 2010 was most marked in countries that had been pushed into imposing the severest austerity measures after facing sovereign debt problems, mostly following crises in private banking. This applied to several euro area members: Ireland, Portugal, Spain, Italy, Cyprus and Greece, with the latter particularly suffering from the effects of policies that were implemented to meet conditions for maintaining repayments on a level of public debt that continued to escalate. Denmark, not a euro area member, suffered from a collapsed housing boom that resulted in world record levels of private household debt relative to income. The resulting banking crisis was weathered without experiencing the same escalating public debt and extreme austerity measures seen in crisis-hit euro area members, but Danish growth was held back by stagnating private household consumption.

Ireland's quite exceptional recorded GDP growth was mostly the result of a revision of 2015 figures to include profits of multinational companies declared in Ireland, where the tax regime was very favourable. This added about 20% to recorded GDP in one year. Poland, meanwhile, having avoided the effects of the 2008 banking crisis, was something of a star, with GDP that increased by 27.6% between 2008 and 2016.

The German economy, accounting for 21% of EU and 28% of euro area GDP, is currently growing in line with the EU average. Its post-2008 growth had depended heavily on higher exports. Domestic demand played more of a role in both 2015 and 2016, thanks to slightly higher pay levels and some public spending related to refugees, although the budget surplus remained at 0.8% and 0.6% of GDP respectively. These effects seem to be petering out, leaving German growth once again dependent on exports, which are growing more slowly now. In view of its budget and balance of payments positions, which are discussed in the next section, it could do much more to stimulate demand across the EU.

## Economic developments: current account balance

Figure 1.3. Current account balance of the euro area with the rest of the world and contributions of selected Member States (% of EA GDP at current prices) (2008-2016)



Source: AMECO UBCA, UVGD series, own calculations.

### Weak domestic demand and a current account surplus

In 2016, the euro area saw a further expansion of its current account surplus with the rest of the world to 3.7% of GDP, compared to 3.3% in 2015 (see Figure 1.3).

This growing surplus from a more or less balanced external position in 2008-9 indicates that consumed and invested resources in the euro area as a whole are lower than those produced; or, put more simply, that domestic demand is too low compared to supply.

Figures on domestic demand corroborate this suggestion. According to data from the EC's annual macroeconomic database (AMECO), the value of domestic demand (in 2010 prices, including stocks) in the euro area was in 2016 still below its 2008 level. According to the European Commission's autumn 2016 economic forecasts, euro area domestic demand is only expected to surpass its 2008 level (in constant 2010 prices) in 2018, with the forecast being subject to downside risks.

The same AMECO data series suggests that the level of domestic demand was lower in 2016 than it was in 2008 in more than half of the euro area member countries (ten altogether).

In this section we illustrate the various sources of this domestic demand weakness. As far as current account balances are concerned, Figure 1.3 above shows that the significant divergence in current account balances among Member States with which the EU, but in particular the euro area, entered the crisis in 2008 has been reversed, primarily thanks to the efforts of Member States which had current account deficits. Sudden halts in the financing of these deficits resulted in several cases of sovereign debt and banking crises. Seeking financial support from the EU and the IMF, Member States had to undergo economic adjustment programmes which had fiscal austerity and internal devaluation as their main pillars, with a particular focus on labour cost adjustment.

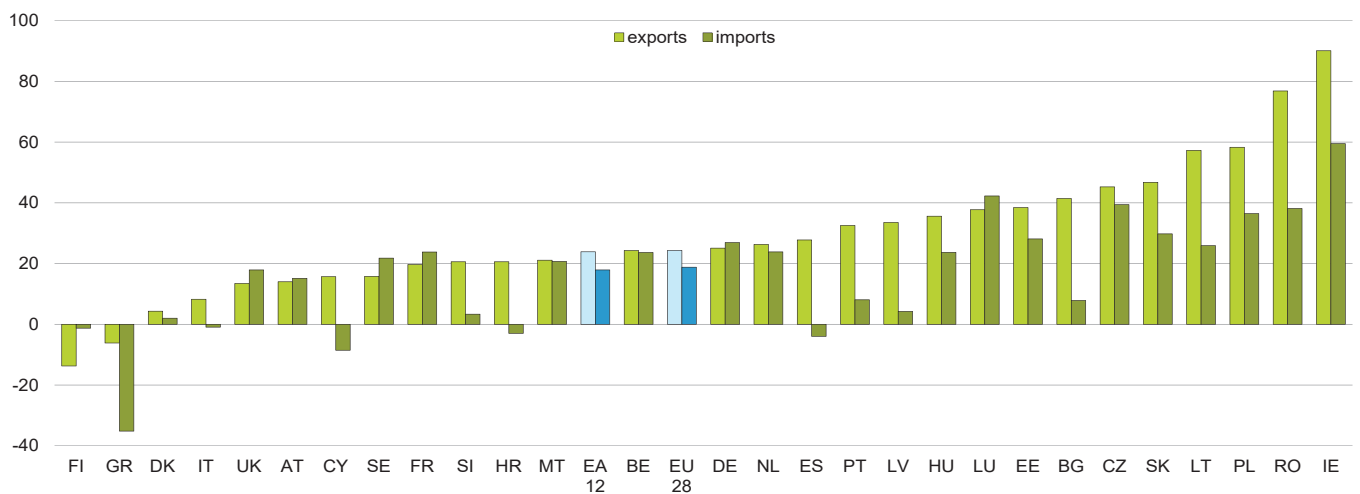
However, as Figure 1.3 suggests, this rebalancing of the current account deficits in some Member States (Greece, Portugal and Spain) through policies that impinged on their domestic demand was not matched by a similar rebalancing in such countries as Germany and the Netherlands with current account surpluses that since 2008 have risen even further, to reach, respectively, 9% and 8.5% of GDP.

While in general there is considered to be a smaller risk of current account surpluses unwinding suddenly and abruptly (as happened in 2008), there are reasons to be concerned about the sustainability of the picture above. A current account surplus is likely to put pressure on the euro to appreciate, especially when the ECB decides to abandon its current expansionary policy stance and make euro area exports to the rest of the world more expensive. With domestic demand as weak as it is now, a slowdown in net exports would risk undermining the current, fragile recovery. Moreover, once the weak domestic demand in Member States that underwent adjustment picks up again, there is a risk that current account imbalances will grow again in the euro area.

The economic governance tools that are currently in place – that is, the EU fiscal rules and the Macroeconomic Imbalances Procedure – do not provide much leverage to enforce measures in national fiscal policies that would deliver the necessary stimulus in aggregate demand. The Macroeconomic Imbalances Procedure tends to treat current account surpluses less strictly than current account deficits, thus placing a greater onus onto deficit countries to adjust.

## Economic developments: varied export performances

Figure 1.4. Percentage changes in exports and imports (2008-2016) (at 2010 prices)



Source: calculated from AMECO database.

### Explaining diverging export performances

Figure 1.4 shows the growth in exports and imports of goods and services from 2008 to 2016 that lies behind the current account changes discussed above (see page 10). Exports increased by 24.3% for the EU as a whole, while imports grew by 19.2%. The European Commission had wanted to see improved current account positions in a number of Member States, so this would seem to be a good result. However, it was only the drop in imports that was a direct result of policy choices. Rising exports had quite different causes and the resulting surplus was linked to depressed demand within the EU.

A key argument was that exports could be increased by holding down labour costs, which resulted in unit labour costs across the whole economy being targeted as a key indicator for judging countries' performances. However, this is of little relevance to international competitiveness, partly because it includes non-traded sectors: labour costs are reduced by cuts in public sector pay which have no direct bearing on export prices. Furthermore, competition is much more a

matter of product quality, which is not adequately taken into account in the unit labour cost measure (as discussed with country examples in Myant *et al.* 2016). In fact, changes in this measure clearly explain very little of the export performances shown in Figure 1.4.

Variation between countries is enormous. Among the fastest growing countries were the relatively new Member States from central and eastern Europe (CEE), benefiting from integration into western European value chains. Unit labour costs increased in some of these countries from 2008 to 2015 (by 5% in Estonia and Slovakia) with no visible effect on export performance. Lower unit labour costs in Greece (down 14%), meanwhile, did not prevent falling exports.

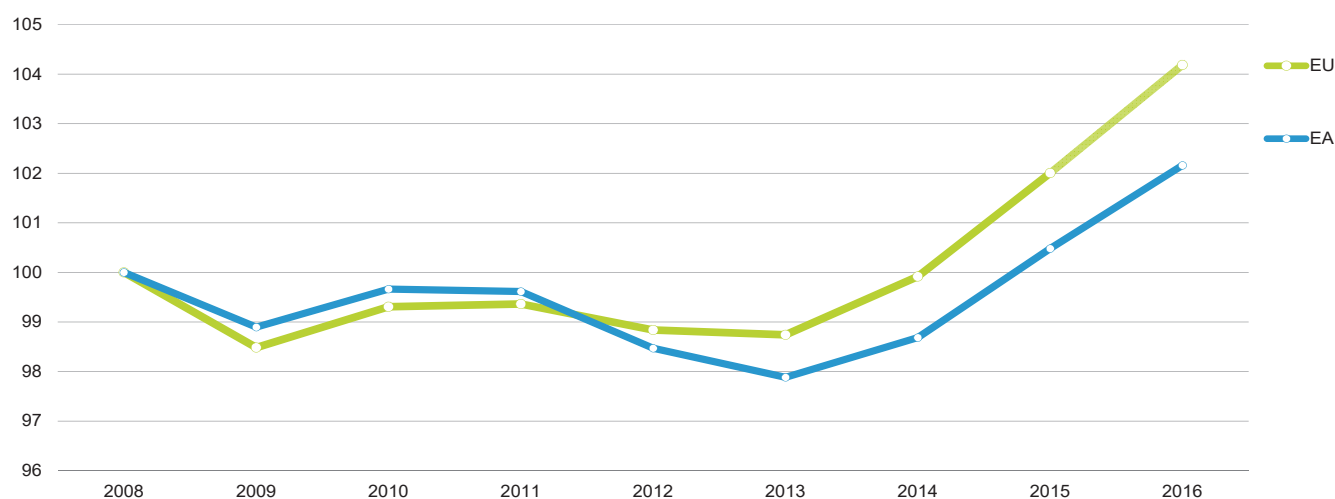
Export prices should be a better guide to export performance, but again there is no relationship. They increased by 11% in Ireland, a country with a 28% fall in unit labour costs which reflected generally lower public sector pay. Export success instead came from higher quality products and supported higher wages. Export prices fell in Greece by 1% and in Finland by 3%, both countries with falling exports. Both lacked the necessary base of modern, export-oriented industries. Exports from Finland peaked in 2013 and then suffered from the failure of Nokia. Reducing wages and imposing economic austerity did nothing to restore

the previous foundation in high-tech exports but instead deepened the depression across the Finnish economy.

Imports followed a more consistent pattern across countries; those undergoing the severest austerity measures suffered lower domestic demand and hence big import reductions. The biggest deficit by 2016, at 5.6% of GDP, was found in the UK, a country which had seen little change in either exports or imports compared with pre-crisis levels. Not being a member of the euro area, the UK had not been required to implement the most vigorous austerity policies which would presumably have restored external balance by cutting domestic demand and therefore imports.

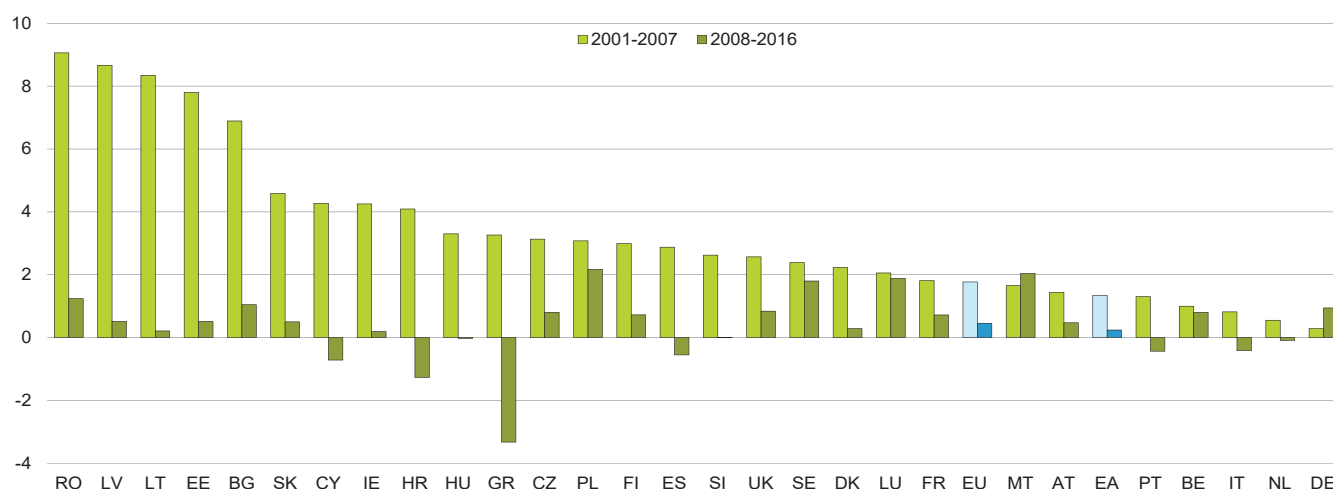
## Economic developments: slow recovery in private demand

Figure 1.5. Private final consumption expenditure at 2010 prices (2008=100) in the EU and the euro area (2008-2016)



Source: AMECO OCPH series, own calculations.

Figure 1.6. Average annual growth (%) in private final consumption expenditure (at 2010 prices) (EU28 Member States)



Source: AMECO OCPH series, own calculations.

### Subdued private consumption demand

Figure 1.5 above shows the evolution of private final consumption expenditure at 2010 prices. Final consumption includes expenditure for consumption, investment and exports by households and

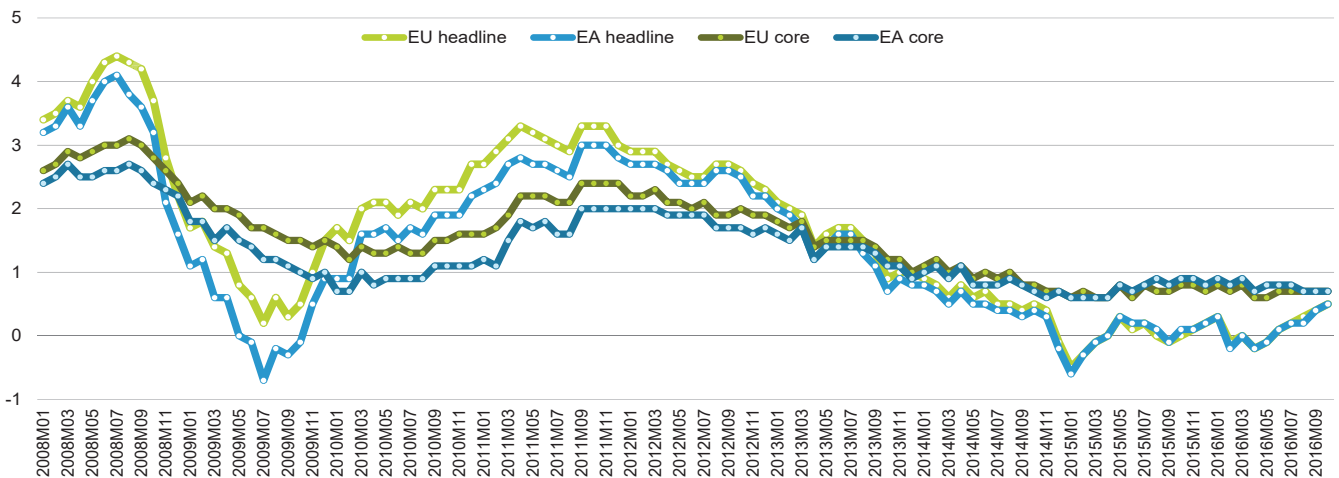
firms. The graph illustrates the weakness of private final consumption after 2008. Notably, real expenditure for private final demand only surpassed its 2008 level in both the EU and the euro area in 2015. What is also remarkable is the contrast between the average annual growth rate in private final consumption expenditure in constant 2010 prices during the 2001-2007 and the 2008-2016 periods. Figure 1.6 illustrates how this collapsed in all but a handful of Member States, most notably Poland, Sweden (both outside the euro area), Belgium and Luxembourg,

while it increased in Malta and Germany, in the latter after having remained at virtually zero (0.3% per annum) during the earlier period. Member States in the southern periphery, as well as Croatia and the Netherlands, experienced average negative annual growth rates in their real private final consumption expenditure. Insofar as private final consumption expenditure is a major driver of demand, its collapse is also remarkable in the newer CEE Member States, where it had grown very fast in the 2001-2007 period.



## Macroeconomic developments and policies: low inflation and monetary policy

Figure 1.7. Monthly headline and core inflation: annual change (%) in the EU and euro area (2008M1-2016M12)



Source: Eurostat prc\_hicp\_manr series.

Note: headline inflation: Harmonised Index at Consumer Prices - all items; core inflation: HICP - excluding energy and seasonal food.

### The perils of low inflation

The headline inflation in the EU and in the euro area again took negative values in early 2016, although they accelerated during the second semester of the year, as Figure 1.7 shows. Both the headline and the average core inflation rates – the overall price index excluding energy and unprocessed food, whose prices tend to be more volatile, and thus reflecting the underlying long-run inflation trend – remained firmly below 1% and therefore well below the 2% target of the European Central Bank and other central banks in the area (for example, the Bank of England). In only a handful of Member States was core inflation near the ECB target, namely Belgium and the Baltic states, while in Austria it edged just above 1%.

These developments suggest that the objective of stable price increases at around 2% per year is not being met for the biggest part of the EU and the euro area. This confirms a weakness in demand. Moreover, low inflation (close to or below zero) leads to a higher real (public and private) debt burden and makes relative price adjustments in the euro area more difficult. Negative inflation may require even more negative

nominal interest rates in order to achieve real interest rates that support growth, which may not be possible without leading to savers holding their savings in cash rather than in bank deposits. Given that high debt places constraints on economic recovery, as both governments and the private sector try to reduce it rather than undertaking expansionary action, low inflation is a problem of high urgency.

In March 2016, the ECB reduced the interest rate on its main refinancing operations to 0%, while it set the interest rate on its deposit facility (that is, the interest rate that banks in the euro area receive for depositing money with the ECB) at -0.4%. The latter meant in practice that banks would have to pay a penalty for keeping reserves with the central bank.

Turning to so-called ‘unconventional’ monetary policy tools, in December 2016 the ECB announced the extension of its quantitative easing programme (which began in March 2015 and was originally due to last until March 2017) to the end of 2017. The amount of bonds the ECB buys every month is due to fall as of March 2017 from €80bn to €60bn, following on from the bank’s predictions that the risk of deflation has been eliminated in the euro area.

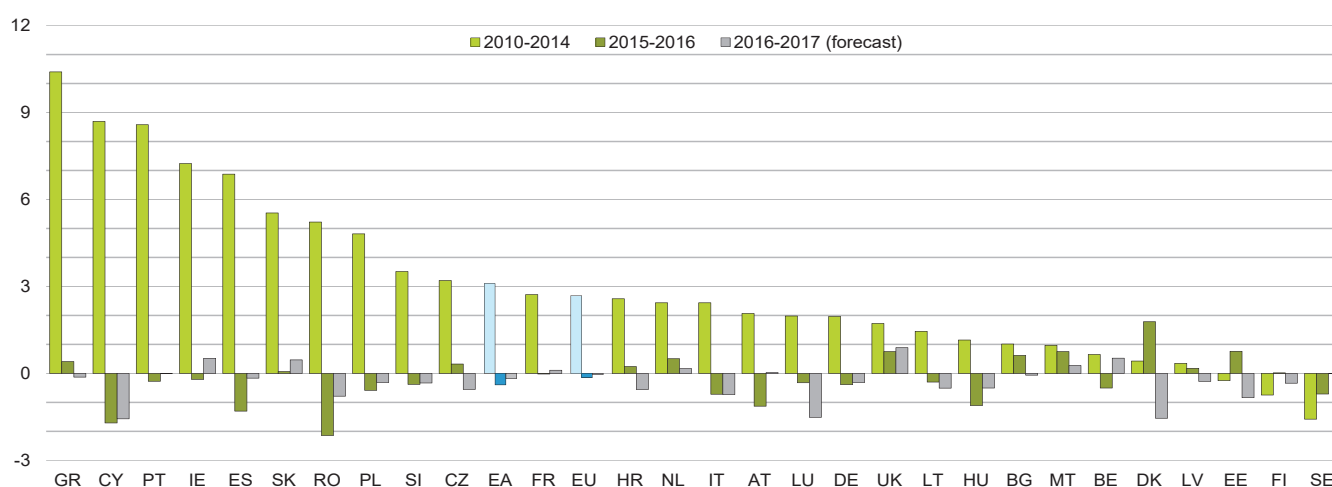
The debate over whether monetary policy in the euro area is on the right track has been a controversial one. One question is whether it works, as recovery

remains weak and investment below par, and another is whether it creates too high risks. According to a recent counterfactual analysis, the investment rate in the euro area in 2015 would have been 5.5 p.p. of GDP lower without the ECB interventions undertaken since 2008 (OFCE *et al.* 2016). The same report found that the risks of financial asset bubbles from the ECB’s quantitative easing programme have been overstated.

The main problem, however, is whether reliance on monetary policy alone is sufficient for relaunching growth in an environment where demand, especially for investment, remains very weak.

## Macro economic developments and policies: fiscal policy

Figure 1.8. Cumulative change in the primary structural fiscal government balance (p.p. of potential GDP) in the EU28



Source: AMECO UBLGPBPS, own calculations.

### A positive fiscal stance in the euro area?

Figure 1.8 shows the evolution of the aggregate (EU and euro area) fiscal policy stance as well as those of the Member States. This is calculated as the change in the government budget balance (in percentage points of potential GDP) once the effects of automatic stabilisers and interest payments are excluded. In simple words, it shows the balance between expenditure and revenues that are at the discretion of a government. A positive change is equivalent to contraction (that is, revenues exceeding expenditure) whereas a negative change signals an expansion (that is, expenditure being greater than revenues).

Following a period of fiscal austerity in 2010-2014, the fiscal stance turned more neutral in 2015-2016 in most Member States, with a few exceptions: notably Denmark, Estonia, the Netherlands, the UK, the Czech Republic and Greece. Expansionary stances were seen in Cyprus, Spain, Romania, Poland, Slovenia, Austria, Germany, Belgium, Italy, Hungary and Sweden.

In its latest economic policy recommendations for the euro area (European

Commission 2016h: 2), the European Commission proposed a 'positive' fiscal stance for the area as a whole; 'positive' referring both to the fact that is expansionary (to the tune of 0.5% of GDP, or a fiscal stimulus equivalent to around €50bn) and to the distribution of adjustments between different types of expenditures and taxes. According to the Commission, the motivation behind this long overdue recommendation has been the weakness of the recovery, the persistently high number of jobless people (for more on which see Chapter 2) and the continuously very low inflation; but it is also because the implementation of last year's country-specific recommendations would lead to a neutral fiscal stance in aggregate.

Whether this recommendation will influence the country-specific recommendations and the actual policy stance of the Member States, however, is rather doubtful. The Eurogroup of 5-6 December did not endorse it, stating that only Germany, the Netherlands and Luxembourg had the 'fiscal space' needed to increase expenditure while sticking to the Stability and Growth Pact rules. These rules cannot force Member States' governments to expand their fiscal policy stance.

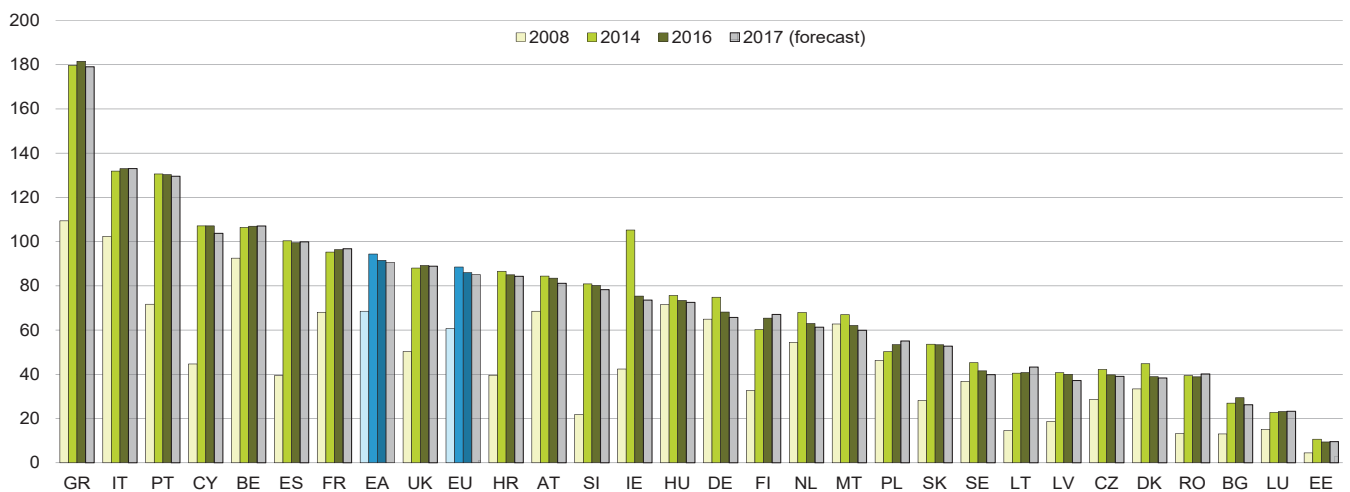
It is of paramount importance, however, that fiscal policies in the euro area, and the EU more broadly, are expansionary (especially in those Member States hardest hit by the crisis) so

that together with the expansionary policies of central banks they create a policy mix that restarts growth.



## Macroeconomic developments and policies: public debt

Figure 1.9. General government consolidated gross debt (% of GDP) in the EU28



Source: AMECO UDGG series, own calculations.

### The public debt overhang

Figure 1.9 shows the evolution of the gross public debt/GDP ratio since 2008 when the economic crisis began. No Member State escaped an increase in their public debt/GDP ratio. In 2016 the EU average stood at 85%, whereas in the euro area it was 95%; both well above the 60% of GDP stipulated by the EU's fiscal rules. The graph also shows that the reversal of increases in the public debt-to-GDP ratio has been in most cases very slow, especially in those countries (with the exception of Ireland) that saw the most dramatic increases. The fact that recovery has been weak in most Member States explains to a significant extent this sluggish reversal.

High public debt/GDP ratios may reduce the space for governments to deal with future crises by borrowing money (for example, should a bank need to be recapitalised, a pension fund supported to continue paying benefits to recipients, or the victims of a national disaster compensated) (cf. Obstfeld 2013). The environment of economic stagnation (with its effects on the balance sheets of banks) and historically low interest rates, together with an ageing population,

suggest that there is a real risk of such crises occurring in the not so distant future. Also, insofar as high public debt/GDP ratios imply a relatively greater need to 'roll over' debt (that is, borrow to replace government bonds that expire), any sudden increase in interest rates in the financial markets may increase the interest payment burden of a highly indebted government or even result in a liquidity crisis. Still, and unlike what is often considered as popular wisdom (cf. Reinhart and Rogoff 2010), there is no robust evidence of any negative effect of a specific public debt/GDP ratio on output growth (see Panizza and Presbitero 2013 for a review). Instead there seems to be quite a lot of evidence on the adverse effects that pursuing fiscal austerity has on growth, especially when an economy is already weak.

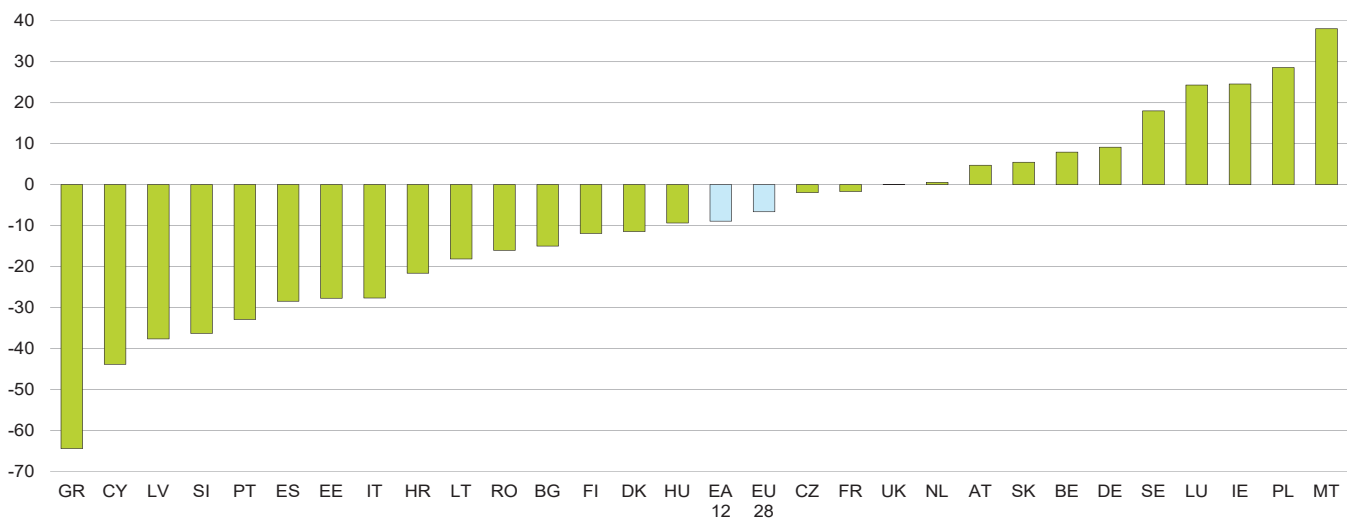
Recent research on the ways in which public debt/GDP ratios were reversed over the period from 1800 to 2014 suggests that economic growth is the most benign way of doing so and was used in just over half of the episodes they studied (Reinhart *et al.* 2015). Therefore, under the current circumstances of prolonged stagnation in many parts of Europe and weak recovery of a by now chronically deficient public investment rate, a route of promoting debt consolidation by fiscal expansion rather than austerity is likely to be more effective. Moreover, global interest rates have been

falling for a long time and this trend is likely to prevail, thus reducing the risk of sudden increases in the interest payment burden.

The same research suggested that in 21% of the episodes of debt reversal studied since 1800, debt restructuring was used during peacetime, highlighting the fact that debt forgiveness has not historically been as extraordinary an option as is often presented nowadays in Europe. Of course, such a restructuring measure in the case of the euro area would require careful reforms in economic governance to ensure that the management of public finances could benefit and support growth in the future.

## Reducing cleavages through investment?

Figure 1.10. Gross fixed capital formation (2007-2016) (percentage change, 2010 prices)



Source: calculated from AMECO database.

### An investment plan that does not increase investment

Figure 1.10 shows the dramatic fall in investment in the aftermath of the crisis. Using the broad measure of gross capital formation, its 2016 level was 6.6% below the peak of 2007, in 2010 prices. This included a decline of 8.9% in the twelve pre-2007 euro area countries and no net change in the remainder of the EU. Nine countries experienced falls of over 20%, including a fall of over 60% in Greece. All of these countries had in 2016 per capita GDP levels below the EU average. Only a few countries experienced significant growth in investment, including Malta, Poland and Ireland.

A revival of investment, targeting the continuing and growing divergences across the EU, would seem essential to economic revival. All countries have demonstrable needs for investment in order to cope with the challenges of the future in transport and communications, education and research, climate change, energy, environment, and the ageing of populations.

In 2013 the ETUC presented a proposal for an investment plan (ETUC 2013) that would increase investment by the equivalent of 2% of GDP every year over a ten-year period. A more modest plan from European Commission President Jean-Claude Juncker proposed an investment of 2.4% of EU GDP over three years, now likely to be extended for a further three years. The crucial element in the investment plan was a commitment to contribute to a guarantee of €21bn through the so-called European Fund for Strategic Investment (EFSI), billed as enabling the EIB to raise finance on commercial markets and increase lending to support a total investment of €315bn.

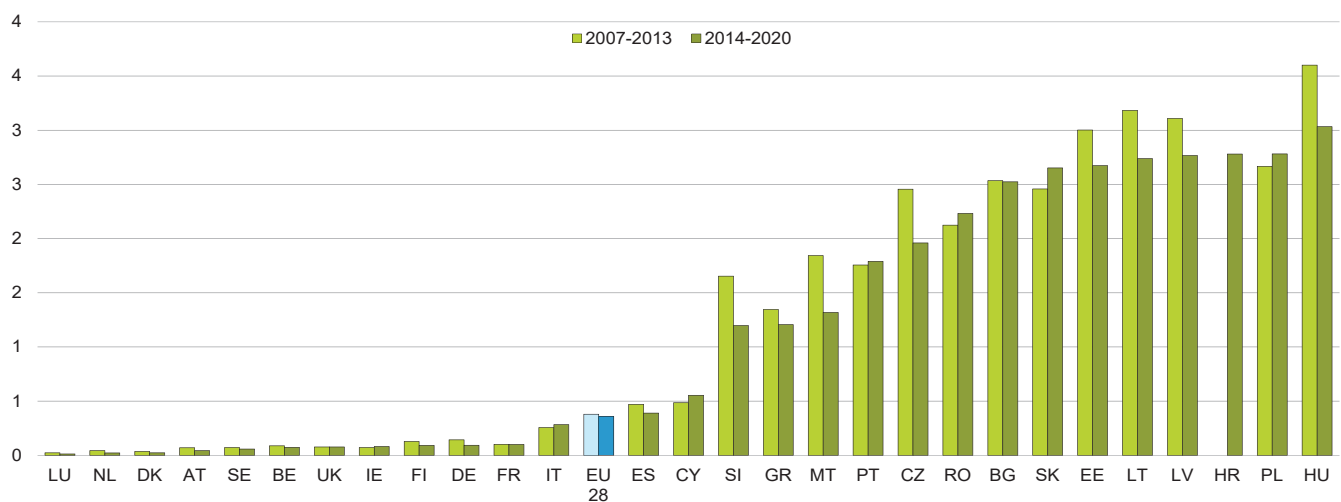
The new investment was intended to be targeted towards riskier projects but, due to the governance structures in place, there is limited transparency regarding the rationale behind decisions. In fact, guarantees have been given to projects that had previously been approved without one, to projects that would have taken place anyway, although maybe on a smaller scale, and to projects previously backed by a Member State government (EIB 2016a; Rubio *et al.* 2016). There is also a bias towards higher income countries. The UK, with 12.8% of the EU population, accounted for 17.3% of EFSI funding in projects signed by the end of 2016. Romania accounted for 0.2% of funding, despite representing 3.9% of the EU population (calculated from data

taken from <http://www.eib.org/efsi/>). Reasons for this bias include the accumulated experience in higher income countries and their greater familiarity with EIB practices, plus the likely perceived risk in lower income countries.

It is quite possible that the investment plan will reach its target in terms of support for investment. However, the EIB has made clear in its Corporate Operational Plan (EIB 2016b: 8) that this will enable it only to maintain the granting of credits at €71bn per annum, slightly below its 2014 and 2015 levels. There will be no increase, but almost 30% of new credits will be classified as risky. The plan will therefore enable the European Commission to claim, with substantial publicity, to be promoting investment while actually only supporting a continuation of existing levels.

## Reducing cleavages through investment?

Figure 1.11. ESIF spending as % of GDP



Source: calculated from AMECO database and [http://ec.europa.eu/regional\\_policy/en/funding/available-budget/](http://ec.europa.eu/regional_policy/en/funding/available-budget/).

### Financial transfers to support public investment

The European Structural and Investment Funds (ESIF) are the main EU instrument for reducing regional disparities and promoting economic, social and territorial cohesion. The spending planned for 2014-2020 will account for about one third of the EU budget, or almost 0.36% of likely total GDP over that period, compared to 0.38% in the 2007-13 period. Co-financing from domestic, mostly public sources, will on average be equivalent to almost 30% of total expenditure. The most important parts, constituting 62% of the total, are the European Regional Development Fund (ERDF) and the European Social Fund (ESF), with the best terms for regions with per capita GDP below 75% of the EU27 average. This applies to the Baltic states and southern Italy, most of Portugal and of the new CEE Member States, much of Greece, and some peripheral parts of Spain and the UK. Less advantageous terms are offered to regions with per capita GDP below 90% of the EU average. Only Sweden, Finland, Ireland and the Netherlands have no region that qualifies.

A recent ex-post evaluation of the ERDF and the related Cohesion Funds (European Commission 2016e) concluded that they had brought benefits to all countries, either through higher investment or through higher demand for exports to support that investment, equivalent in some countries to up to 5% of GDP. This may be optimistic, but the ESIF clearly led to a transfer of funds, as indicated in Figure 1.11, which shows the planned spending relative to GDP for the periods of 2007-2013 and 2014-2020. These show some reduction for most countries, making way for new member Croatia. Declines were most significant in the higher income countries. Unlike the EU's investment plan, the bias towards lower income countries is clear and deliberate, with the largest stimulus likely in Croatia, Hungary and Poland. Romania and Bulgaria, the two lowest income countries, continue to receive slightly less (relative to GDP) than the above-mentioned countries.

The European Commission's evaluation concluded that national and regional divergences decreased up to 2009, but there has been little change since then (European Commission 2016e: 19). Nevertheless, the ESIF presumably countered tendencies, generated by austerity policies, towards widening divergences in the post-crisis period. They have been crucial for supporting continued investment in transport (covering

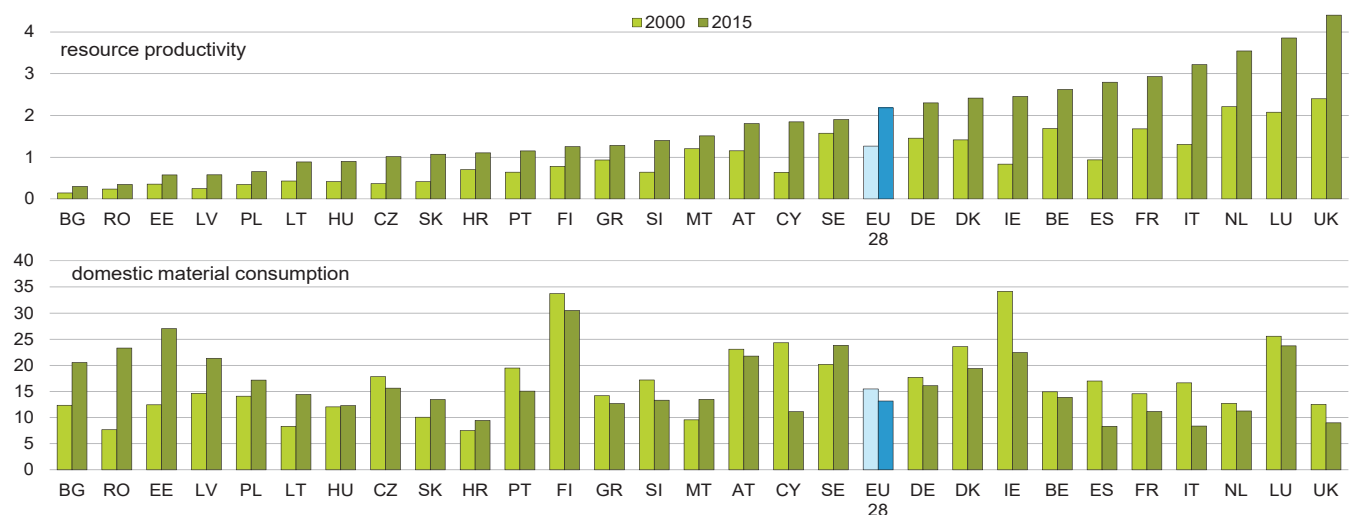
40% of public capital expenditure in the twelve new Member States) and supporting more than half of total government capital investment in Hungary, Lithuania, Slovakia and Latvia (European Commission 2016e: 18).

Evaluations have pointed to weaknesses in lower income countries in terms of proposing good projects or bringing together diverse actors, ensuring implementation and in the poor utilisation of available financial resources. Italy and Romania had still been able to use only 80% of their allocations from the 2007-2013 period by March 2016. As a result, projects tend to be directed from above and justified by spending money rather than achieving changes in business behaviour. Research spending has meant constructing research facilities rather than undertaking research or disseminating innovations.

For the 2014-2020 period, new rules will require a greater emphasis on research and innovation, access to ICT, competitiveness of SMEs, and the low carbon economy. It remains to be seen whether countries will be able to make better use of the resources made available and help to re-establish the tendency towards economic convergence.

# Greening the economy: progress in diversity

Figure 1.12. Resource productivity (EUR/kg) and domestic material consumption per person (tons per capita) in the EU



Source: Eurostat.

## The different shades of green across Member States

By the usual measures the EU appears to have achieved an absolute decoupling of economic growth from resource use and greenhouse gas (GHG) emissions. At the same time, there are marked differences between the experiences of different Member States.

Figure 1.12 illustrates this diversity with data on domestic material consumption (DMC) and resource productivity. The latter, defined as DMC per unit of GDP, is a lead EU indicator for greening, although without a specific EU target. According to the European Energy Agency (EEA 2016), between 2000 and 2014 resource productivity in the EU28 increased by 34% as GDP grew by 18%, while DMC fell by 12%. Figure 1.12 shows resource productivity and its change between 2000 and 2015 in Member States, highlighting the huge differences. Two main trends can be identified: new Member States (NMS) have significantly lower resource productivity than the EU15 (by achieving €4.4 GDP with 1kg material input in 2015, the

UK had 15 times higher resource productivity than Romania). At the same time, resource-intensive NMS economies were achieving significant improvements in resource productivity between 2000 and 2015 that can be seen as a sign of some convergence. For resource productivity gains there is another factor that also played an important role: the highest increases were recorded in the countries where the crisis had a huge negative impact on the material-intensive construction sector, as in Spain and Ireland, where resource productivity increased threefold between 2000 and 2015.

Domestic material consumption per capita and its change between 2000 and 2015 tells a different but related story. Richer countries consume more, and even with their higher resource productivity, their per capita material use is generally higher than that of their poorer counterparts. With improving resource productivity, EU28 per capita material use between 2000 and 2015 shrank from 15.4 tonnes to 13.1 tonnes. Richer countries saw their per capita material use shrinking (for the UK from 12.5 to 8.9 tonnes), even if their GDP grew. For poorer NMSs, resource productivity gains could not compensate for their growing consumption levels, and their per capita material use grew significantly (for Romania from 7.6 to 23.3 tonnes).

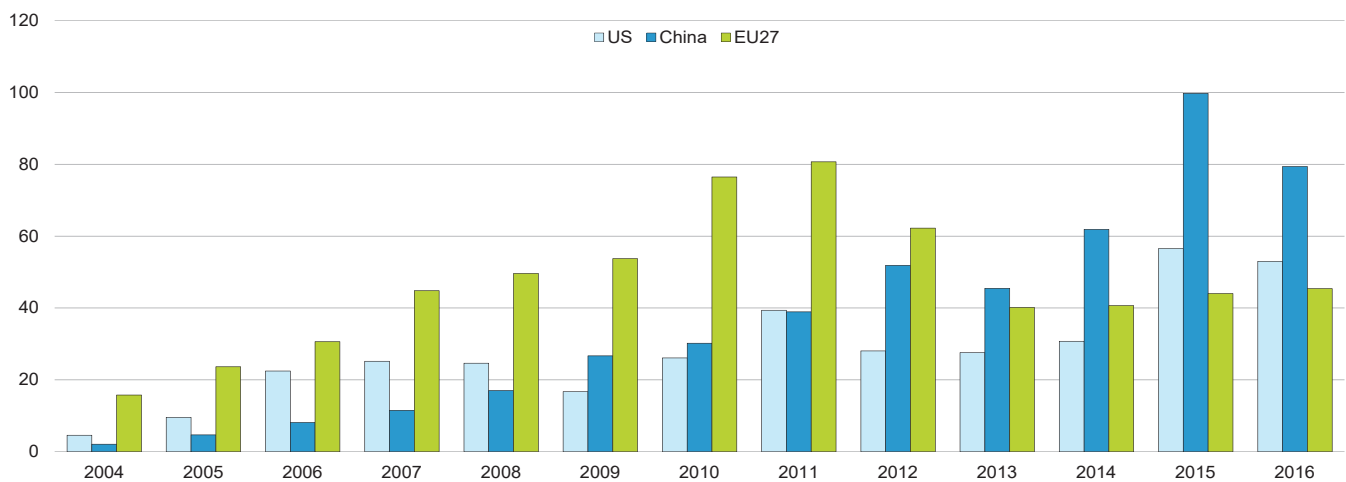
Improved resource productivity has been accompanied by reduced GHG

emissions which declined in the EU28 by 22.9% between 1990 and 2015, surpassing the EU 2020 target of a 20% reduction and making the 40% reduction target by 2030 a realistic prospect (Eurostat 2016). This overall success again masks huge differences between Member States. Lithuania cut its GHG emissions by 59.3%, while in Malta GHG emissions increased by 48.7% (Carbon Brief 2016).

The high diversity in the degrees of greening between Member States was driven mostly by factors other than green policies, notably changes in the economic structures of these countries (the reduced weight for material-intensive activities) and the effects of the crisis. Material use was still growing until 2007 and only in the wake of the crisis did it fall by 20%, leading to a 12% reduction for the period 2000-2014. It is clear that green policies need to be strengthened if 2050 targets are to be achieved.

## Clean energy investment in Europe

Figure 1.13. New investments in renewable energy in the US, China and the EU (2004-2016) (EUR bn)



Source: BNEF (2017).

Note: USD figures were converted at ECB yearly reference rates.

### The EU, the global laggard in renewables investment

2015 was a record year in global investments into renewable energy generation, reaching €315bn (BNEF 2016). In 2016 the world reached a turning point and is now creating more capacity for clean energy than for coal and natural gas combined (Bloomberg 2016).

For Europe, however, 2015 was just another year of falling investment, with its €44bn investment value making up just over half of what the continent had in its own record year in 2011. Figure 1.13 shows investments in renewables made by the US, China and the EU27 between 2004 and 2016. China has been taking the lead since 2013 and with its €99.7bn in 2015 it invested as much into clean energy as Europe and the US put together.

It is even more disturbing for the EU that almost half of its poor investment activity in 2015 came from (its still yet member) the UK, which invested €20bn in clean energy that year (UNEP 2016). In Germany (€7.7bn, its lowest

level in twelve years) and France (€1.8bn, 52% less than in 2014) low levels of clean energy investment in 2015 were mostly related to the uncertainty brought about by the overhaul of the incentive system. In Italy and Spain collapsing investments into renewable energy were the consequence of austerity policies, as in Italy such investments in 2015 (€840mn) were just 4% of its peak in 2011, while in Spain the €520mn investment in 2015 was in sharp contrast to its €16bn record in 2008.

Preliminary data for 2016 (BNEF 2017) show no significant change in this European trend. As Figure 1.13 also shows, clean energy investments in Europe have increased slightly to €45.3bn, still behind the US and miles behind China.

It is no exaggeration to talk about a paralysed clean energy investment landscape in Europe, with investment frozen at around €45bn for the fourth consecutive year. This performance is even more disappointing than the sluggish recovery of total investments that we saw in the last couple of years (see Figure 1.11 and the corresponding section).

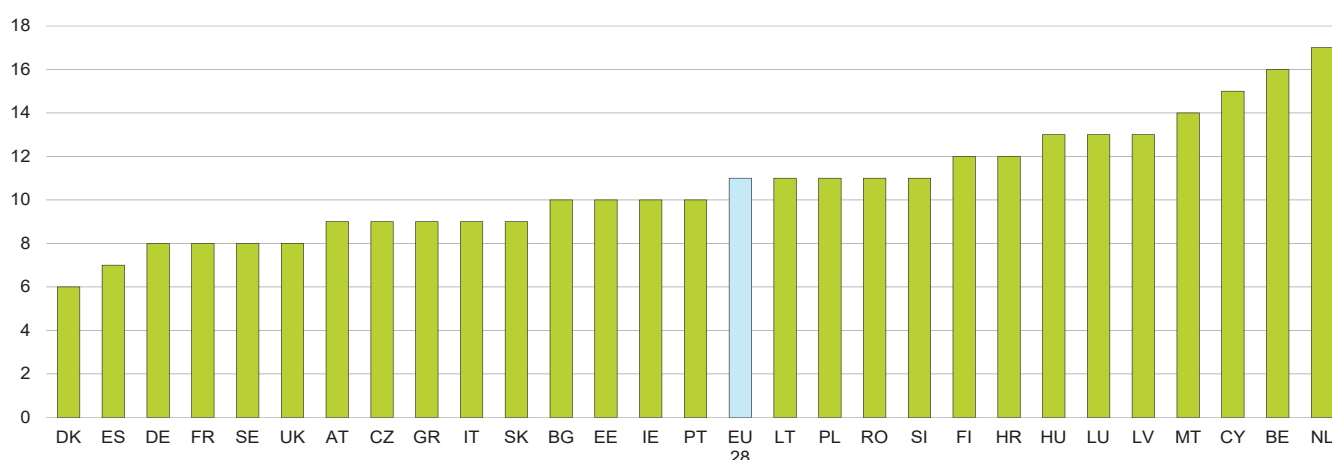
The Investment Plan for Europe currently promises very little (see page 16). According to a factsheet by the European Commission (2016b), 5% of EFSI transactions approved by the EIB by mid-2016 had an environment and resource efficiency objective and 23%

were dedicated to the energy sector. However, a coalition of NGOs claims that 15% of the projects approved by the EFSI for the energy sector support fossil fuel investments (CAN 2016). According to their statement, all energy efficiency investments will be concentrated in three countries only (the UK, France and Finland) and more than half of clean energy investments take place in two sole countries (the UK and Belgium).

The ETUC action programme 2015-2019 (ETUC 2015) stresses the key role of EU-led public investment for developing a green and decarbonised European economy by putting resources into renewable energy and energy efficiency. Strengthening the investment plan and its green priorities is a necessary step towards achieving these ambitions.

## Evading corporation tax

Figure 1.14. Number of aggressive tax planning structures



Source: Ramboll Management Consulting and Corit Advisory (2016).

## Can the EU deliver good structural reform?

The ability to raise taxes is key to sustaining public services and the systems of social protection. Yet EU countries have long faced constraints in collecting taxes from corporations. Taxes on corporate income account for a small share of tax revenue in the EU, averaging 6.3% of all receipts in the EU28 in 2015 (2.5% of GDP) (Eurostat gov\_10a\_taxag). The (implicit) tax rates on corporation profits fell, on average, by 6.3 percentage points in the EU28 between 2000 and 2015 (European Commission 2016g; ETUC and ETUI 2015).

The limited ability to collect revenue through company tax has been highlighted by a number of scandals revealing deals that allowed multinational corporations to pay little tax on profits by declaring the latter in tax havens. Figure 1.14 identifies the EU countries with the largest number of aggressive tax planning structures (meaning legal provisions that can be used by corporations to avoid paying taxes in other EU Member States). The so-called 'LuxLeaks scandal' has exposed how advance pricing

agreements (APAs) relating to the treatment of transfer pricing were used in Luxembourg to give multinationals deals that in some cases involved paying tax rates well below 1%.

The use of APAs has been growing rapidly. The total number in the EU28 grew from 547 in 2013 to 1,444 in 2015, an increase of 78%. In 2015, the highest number of APAs was in Luxembourg (519), Belgium (411) and the Netherlands (236) (European Commission 2014; 2015c; 2016f). In 2016, the European Commission challenged some of these deals as illegal state aid (most notably Apple in Ireland, Starbucks in the Netherlands, Fiat in Luxembourg, and a number of companies in Belgium).

Moreover, as capital enjoys considerable mobility in the EU, states find themselves competing to keep, or attract, investment, and have therefore reduced headline tax rates and introduced various exemptions. There are so-called 'patent boxes' in twelve EU countries. These do not represent an effective way of stimulating research or innovation (European Commission 2015d), but they do give companies generous tax exemptions (amounting to 7.6% of total corporate income receipts in the Netherlands in 2016).

Efforts to combat tax evasion had been blocked by those EU Member States which enable such practices and benefit from them. In 2015, the highest corporate

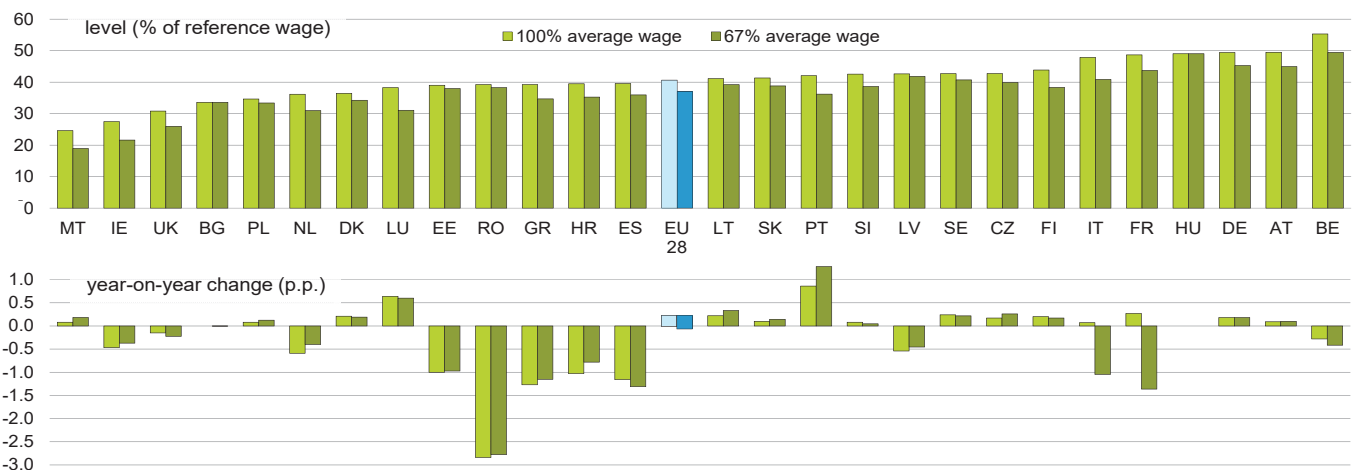
income tax receipts were recorded in Malta (6.7% of GDP), Cyprus (5.9%), and Luxembourg (4.5%), notorious tax-evasion enablers. Another cleavage that characterises the EU is thus that between the countries that engage in tax competition in various ways and countries, such as Denmark, France and Italy, that have to face its negative consequences.

Following a number of high-profile scandals, the European Commission put forward a new proposal for a Common Consolidate Corporate Tax Base (CCCTB) in October 2016. This would prevent the arbitrary declaration of profits made in other countries to favourable jurisdictions by allocating the taxable value based on three equally weighted factors: assets, labour and sales. However, a complete solution to restoring the ability to tax corporations would require a common EU tax rate. Unfortunately, the resistance of countries that benefit from tax competition makes this unlikely.



## The tax shift

Figure 1.15. Tax wedge on labour (level in 2015 and change over 2014/2015)



Source: Tax and benefits database, OECD and European Commission.

Note: data are for single earner households (no children). Tax wedge is defined as the ratio between the amount of taxes paid by an average single worker (a single person at 67% or 100% of average earnings) without children and the corresponding total labour cost for the employer.

## Are 'structural reforms' just a distraction?

In the absence of a stronger fiscal stimulus, 'structural reforms' remain the main instrument through which Member States are expected to pursue economic growth. The European Commission includes 'structural reforms' among the drivers of future growth and actively promotes them through the European Semester. The shift of taxes away from labour represents a major measure that is recommended by the European Commission to boost growth and increase employment. The tax wedge on labour varies significantly across the EU (see Figure 1.15).

Lowering labour costs through lower taxes can increase the demand for workers. Moreover, high labour taxation makes any additional income from employment too low to be an incentive for the unemployed and inactive to take up work. Referring to these two reasons, the European Commission has long advocated a shift in taxation away from labour and towards the 'least distortionary taxes', including taxes on consumption, housing and other property, as well

as environmental taxes (European Commission 2015d: 24).

Such thinking relies on empirical modelling by the OECD, which, however, failed to find any strong evidence of the benefits of labour tax wedge cuts (Bouis *et al.* 2012: 29). The original model (OECD 2010) even cast doubt over the rationale for the tax shift, as it showed that consumption taxes affect employment and hours of work in the same way as income taxation. Recently, the IMF also called for a tax shift, but its model found strong evidence of positive effects of expansionary labour tax cuts, with smaller impact when tax wedge cuts were budget neutral (IMF 2016: 118).

It is difficult to empirically separate the effect of taxes from that of other elements of the policy mix in individual countries. A comparison of employment and tax levels in the EU shows no relationship between the two, as many countries with very high employment levels impose steep labour taxes (ETUC and ETUI 2016).

In any case, the European Commission's recommendations for 2017 start from the assumption that the tax burden on labour in the euro area is 'very high' and represents a 'particular concern' (European Commission 2016d: 11). The Eurogroup has also committed to reducing the tax burden on labour. It adopted the EC's methodology that finds there is a need for countries to reduce taxation

on labour if the levels are above the EU average (European Commission 2015d). The arbitrariness of such a benchmark is striking and it would imply the need for change in many countries. In fact, the EC calls rather for a 'country-specific approach' (European Commission 2016c), which in practice means seeing a high labour tax as a problem only in countries with high unemployment and not in those where good employment outcomes seem perfectly compatible with a high tax burden.

To add insult to injury, the documents supporting the 2017 recommendations include neither reference to studies about the impact of labour taxation, nor information on how their positive examples of reforms impact on employment. In the absence of any evidence, the EC's 2017 recommendations claim that the euro area countries that have shifted taxation away from labour 'are more resilient and demonstrate better employment and social performance' (European Commission 2016c: 5). In particular, the Commission refers to tax shifts in France and Italy (see Figure 1.15); but as discussed in Chapter 2, these countries reported only average employment performance and even below-average youth employment performance.

## Conclusions

### A desperate need for new policies

The European economy has been slowly and hesitantly pulling out of recession. The peak pre-crisis GDP level that the EU as a whole reached in 2008 was surpassed by 4.8% in 2016. This has largely been a result of export growth, meaning a reorientation of the EU economy towards external demand. Private consumption remains barely above its pre-crisis level while the investment level is significantly lower. This leaves the EU more vulnerable to political and economic developments in an increasingly unpredictable world, particularly in the aftermath of the UK's decision to leave the EU and in the face of the USA's possible turn towards protectionism.

Prior to 2008 there had been a prominent trend towards reduced divergences in per capita GDP between Member States, which had incidentally been a major factor ensuring political support for the EU. There has, however, been no restoration of this trend, despite the modest recovery in economic growth. Measures to reduce cleavages, notably the European Structural and Investment Funds, are still given significant funding but are inadequate to counter the negative effects of austerity and other policies. Nor, as will be argued below, do new initiatives promise a return of the trend towards convergence.

The European Commission's rhetoric and accompanying policy measures reflect neither the depth of the problems nor the extent of policy change required to tackle them. There has been a verbal recognition that past policies have failed and that a big change is needed if GDP and employment growth are to be restored and maintained, but this has led only to half-hearted and uncoordinated responses. The key to supporting sustained growth is a switch to expansionary policies, raising demand through higher public spending and higher pay levels. The key obstacles remain continued adherence to the EU's fiscal rules and

mistaken views on the direction that the 'structural reforms' should be taking.

There has, however, been a little movement in the right direction. Somewhat more flexibility has been allowed in the Growth and Stability Pact. Moreover, the European Commission, worried by the failure of past policies to bring about adequate recovery, has cautiously argued for a mildly positive fiscal stance across the euro area. However, it faces strong opposition from powerful Member States still wedded to the belief that budget surpluses will lead to lower public debt and subsequently to recovery. In fact, existing policies are doing little to prevent continually increasing public debt levels relative to GDP. Gross debt as a proportion of GDP increased across the EU and, with few exceptions, in every country and every year from 2008 to 2014, after which time it fell from 88.5% of GDP to 86.0% in 2016. That is less than the growth in GDP and would suggest the need for another ten uncertain and painful years to reach the 60% level required by euro area rules. Past experience around the world suggests that reducing debt levels is usually the result of renewed growth which provides higher tax revenues.

Against this background, new elements in EU economic policy came from two directions. The first is the investment plan proposed by European Commission President Jean-Claude Juncker. Set to run for three years from 2015, it was slow in starting and has so far had no visible economic impact. The second new element is the European Central Bank's policy of quantitative easing which injected into the euro area economy the equivalent of 9% of GDP during 2016. Evidence of any impact is sparse.

Quantitative easing has not reversed the trend towards deflation which threatens to become another factor hampering economic recovery. Deflation (meaning a falling price level such as has already occurred in several Member States) would make it more difficult to reduce both public and private debt levels, thus adding to banks' difficulties in lending. Indeed, evidence on private debt levels points to continuing disincentives both for consumers to borrow and for banks to lend, contributing to, and

in a number of countries exacerbated by, increasing proportions of debt that are not being repaid.

These two areas of cautious policy change can make little difference when the key issue, namely fiscal policy and the constraints imposed by euro area rules, has not been addressed. Ongoing tight fiscal policies greatly reduce the already limited effectiveness of Juncker's investment plan. This is under-financed because no new public resources can be made available within existing rules. Member States also have limited means for the necessary co-financing of projects, for current spending to make use of the results of investment, and for repaying credits. This has resulted in a strong bias in the accepted projects towards higher income and safer countries, pointing to a future widening of divergences across the EU. Even more seriously, the investment plan offers only a continuation of past EIBa credit levels and not their expansion. Thus, rather than a means to restore growth across the EU, it has become a vehicle for the European Commission to claim to be taking action, while actually changing nothing.

Other policy areas essential for long-term growth are also hit by fiscal rules. Targets for reducing carbon emissions should be tougher if the aims of the Paris climate change conference of 2015 are to be met. However, recent figures on investment in renewable energy suggest that the EU is becoming a global laggard rather than a leader.

There is a clear need for a shift towards expansion and investment. Resources are available and even more could be found with a more vigorous approach to combating the destructive competition between Member States to minimise company tax rates. Unfortunately, the modest ideas currently being proposed by the European Commission are inadequate to counter the effects of continued cautious fiscal policies and the threatened fall in demand in external markets.