

EUROPE NEEDS REFORMS FOR INCLUSIVE GROWTH. DO EUROPEANS AGREE?

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Productivity decline and increasing fragmentation

The debate about the economic governance of the European Union and of the Eurozone is concentrated on issues related to EMU reform, Banking Union and Capital Market Union. This reflects the fact that the crisis has highlighted the incomplete nature of institutions supporting the Economic and Monetary Union.

Such a policy agenda is obviously very relevant but it is incomplete. It must be complemented by a parallel agenda targeted at strengthening the growth potential of the European economy. Such a growth potential should be rich in jobs and inclusive, i.e. such as to maximize the diffusion of the benefits of growth so as to generate, in addition to economic efficiency, social cohesion and support to its implementation.

This is particularly relevant given that the great recession has further deepened the slowdown in productivity in the European Union. A fall which had been going on for a decade. More recently productivity growth has recovered slightly but has not inverted its downward trend. (See OECD 2018).

A related phenomenon is the increase in fragmentation and heterogeneity in several dimensions: a) an increase in inequality, especially within countries, b) an increase in dispersion in regional income per capita, c) a widening gap between companies on the technological frontier and laggard companies, d) increasing symptoms of a digital divide. The above may be seen as different aspects of one single phenomenon: laggard firms grow less than frontier firms and laggard regions grow less than frontier regions. Inequality in income and wealth distribution may follow. Frontier companies are usually concentrated in richer regions and frontier regions grow faster also because they make a better use of intangible capital including from digital technologies. And, as Haskel and Westlake (2018) show, growth in intangible capital is likely to bring more, not less, inequality. Fragmentation tends to increase at times of crisis as richer companies and regions cope with crisis situations better,

also because of better institutions and richer intangible capital. In sum, divergence increases because of the crisis but also because of technological progress and a move towards more intangible rich economic systems.

The two phenomena interact with each other. Lower growth and higher unemployment increase inequality, Higher inequality depresses aggregate growth and so does per capita income divergence. Larger gaps between frontier and laggard companies indicate that innovation and productivity growth are increasingly concentrated in some firms and regions, and that innovation diffusion is limited or nonexistent, further depressing growth. Last but not least, the way in which new technologies penetrate the economy is highly unequal across countries, sectors, and companies (see e.g. Guerrieri and Bentivegna 2011). Lower growth, in turn, contributes to widening gaps and increases fragmentation in what could develop into a vicious circle. Such a circle takes place in a framework of very fast technological transformation, with the economy and society becoming increasingly penetrated by intangible capital. As mentioned, to some extent at least a wider role of intangible capital increases inequality and concentration.

The European countries need to address both the causes of productivity decline and the drivers of fragmentation. This imperative has an economic rationale as the aggregate aspect is related to the increasing divide between frontier and laggard firms and regions. Indeed, as frontier companies are able to grow thanks to faster introduction of new technologies the gap between frontier and laggards increases and it is likely to affect negatively aggregate productivity growth. So, technological and income gaps may grow in parallel. This has also a political and social imperative as one likely consequence is increasing inequality, both income inequality and opportunities inequality. And increasing inequality and low growth enhance social frustration and conflict. Dealing with inequality therefore is not only a matter of redistribution. It is a matter of establishing conditions for self-sustained growth. And it is about supporting inclusive growth.

The politics of reform

Dealing with such issues, i.e. implementing policies so that productivity growth and employment are put back on a sustainable trajectory, requires reshaping and adjusting economic and political priorities. The challenges to be addressed are of a structural nature and require a structural response, a structural reform strategy addressing both obstacles to aggregate growth and lack of efficient convergence mechanisms. This is where the political challenge comes in. Structural reforms require significant political capital to be implemented and such a political capital, in Europe, seems to be in short supply, indeed decreasing. Both reform fatigue and discontent with the prevailing economic system are on the rise in Europe (OECD 2018). Political support, and the related political capital the seems to be attracted by “new” options (such as populism and “sovereign nationalism”). Dismantling reforms rather than strengthening the reform agenda, favoring state led rather than market-based policy recipes, and focusing on national rather than European solutions seems to be the winning political bet.

There are two main reasons why this is the case. One is that the traditional “structural reform cycle” is long and difficult to complete, thus generating reform fatigue. Another one is that increasing

reform fatigue is associated with decreasing support for Europe and the European project. So, apparently while Europe badly needs more reforms Europeans reject the idea.

Structural reforms require a complex and long cycle to be completed and this implies that they carry a very high cost in terms of political capital. Reforms have to be introduced by the government and approved by parliament; they have to be translated into administrative procedures, which have to be implemented, often by several government institutions, both national and local; they have to deliver visible outcomes, and such outcomes have to be perceived by citizens (and voters) as generated by the reform process. This may require quite a substantial communication effort by the government. In addition, while outcomes of reforms are typically widespread and delayed, costs of reforms are usually upfront and concentrated in smaller (and more vocal) groups. Finally, evidence suggests that benefits of reforms are stronger and more visible when the macroeconomic cycle is on the upswing. Two implications, among the many, follow. First, governments introducing reforms should, in general, be prepared to wait several years to see some returns for the investment of their political capital. And this may run against political “short termism” in governments. Second, governments may want to activate compensation mechanism for the losers to broaden their consensus base. In such a case the reforms may bear (additional) budget costs for the government.

Structural reforms can be implemented at the national and the EU level. Political support is needed both for national reform policies and for EU level policies. One example is the interaction between product market liberalization at the national level and at the EU level (single market). There are political economy implications in this case too. In some cases EU policies can be more attractive for citizens insofar as they are perceived as dealing with inequality (examples include competition policy as a way of confronting monopoly power of big internet giants, tax policy as an instrument for redistribution). In other cases EU level policies are seen as mechanism that weaken national sovereignty, and hence they tend to be resisted. A possible misalignment between economic and political reforms priorities may emerge as economically crucial reforms may be much harder to introduce.

Some reforms, both national and EU level have a direct impact on convergence. National policies include labor and product market reforms, and also human capital accumulation (i.e. education policies). Such national level policies can be targeted to securing convergence. Convergence, however, can be supported by EU level instruments (e.g. structural funds), so that the two levels of policy can support each other. One would expect, therefore that political capital for national reforms can be made available by EU level action, so that action at the national and EU level add up in providing the political capital for reforms. This has been the case for some time. More recently however EU level policies are seen as limiting the national political agenda and perceived as “foreign interference” thus making it more difficult to implement national reform policies. To this issue we now turn.

Building consensus for reforms

The points above suggest that, as reform fatigue increases, the incentives governments face for a reforms strategy are likely to get weaker. Thus, a political economy vicious cycle may materialize. Widespread discontent in many European countries following the financial crisis is related to slow

or weak growth and employment and the cause of such poor a performance is identified with a “wrong” European policy response based on structural reform and fiscal austerity. It follows that, insofar as lifting growth and employment requires a structural effort, there is little or no political capital available to implement it. This dilemma is compounded by the pressure for political capital needed to complete the “macroeconomic pillar” of European integration; Monetary Union and Banking Union. We will return to this point later.

So the EU needs a structural agenda but the EU reform agenda needs to be revamped and adjusted to win the political support needed for its implementation. The more so as we approach a round of European elections which promises to be crucial for the future of Europe. The rise in populism and “sovereign nationalism” in several EU member states is flying on the wings of euro skepticism. This makes it unlikely, among other things, that a EU policy for productivity growth, based on intangible capital driven growth, which requires action at two levels, both EU and national, would win sufficient support. We will argue, however, that a strategy to win support for reforms can be designed and implemented by leveraging the multidimension characteristics of European integration. Before we do that, however, let’s consider a different case.

One consequence of rising populism/sovereign nationalism is that a new political drive can emerge if reform fatigue and euro skepticism are transformed in “national reforms enthusiasm” as a way to confront Europe. I.e. national interest considerations may be a way to raise “fresh” political capital. The narrative underlying this approach would sound “We are happy to introduce reform at the national level because this is a way to affirm our national interest and resist EU impositions”. Of course reforms in a nationalistic environment are quite different from open market/liberal reforms and they often imply the dismantling of previously introduced reforms. It goes without saying that “nationalistic” reforms would imply resistance against further integration. And often such reforms de facto amount to “resistance” to EU norms or regulations. In other cases however they are norms that “fill a gap” if EU level regulations are absent. One area where this could be the case is tax policy.

If nationalism prevails one may well face a situation of increasing fragmentation between countries and, possibly but not necessarily, increasing cohesion within countries. It is not *prima facie* clear if this would provide a boost to productivity and, support for reforms. In any case we should be prepared to face a post-election scenario where a “sovereign/national approach” to economic policy prevails in Europe. The consequences might well in the end be destructive for European integration. The issue is to what extent such an approach would find sufficient and sustained political support. This point is not new in the policy debate. See for instance the discussion in Albert Breton, et al. 1995.

Let us go back to the interaction between EU and country level reform processes. There is a major difference on how consensus for reforms has to be mobilized when reforms must be introduced at the two levels. At the national level consensus must be raised by governments facing national electorates. At the EU level consensus must be raised vis a vis other governments. These two processes are interconnected as famously described by Robert Putnam (1988) in his “two level games” framework (See also Paolo. Guerrieri, Pier Carlo Padoan, (1989). The interconnection runs both ways. Governments may be interested in negotiating binding agreements at the international level so as to force consensus domestically on relevant policies. At the same time they may be

interested in leveraging a strong domestic political mandate so as to extract more concessions when they bargain internationally.

The “populist/sovereign approach” to EU policies would favor the second component, while the “EU approach” would favor the first component. In reality both elements play a role, possibly with different relative weights in different countries and at different times. This is an element of flexibility which may turn out to be very useful to find a solution to the bargain. When and if a solution emerges, there will be a “win set” of policies which satisfy both levels of bargaining and a cooperative rather than a nationalist framework will merge.

A second element is useful to describe the consensus building process in Europe: the fact that governments have several elements in their reforms agenda developing in parallel and, therefore, they have several bargaining tables open at the international level. Such a situation, unsurprisingly, has been identified as a “parallel games” framework. See James Alt and Barry Eichengreen, (1989). Typically bargains are struck simultaneously on more than one table, so as to exploit mutual concessions, i.e. establishing “issue linkages” across tables.

The European policy agenda is characterized by both “two level” and “parallel” games. Parallel games are present insofar as the reform agenda includes both “growth” elements (as we have described) and “money” issues related to eurozone reform. It can be argued that by exploiting both two level and parallel games elements Europe is more likely to work through a successful reform drive and possibly overcome reform fatigue. The intuition is that progress in one area (growth) is conditional upon making progress in the other area (money) and vice versa. At the same time progress in one area may foster progress in the other.

“Growth” reforms and “money” reforms

Cooperation at the macroeconomic (money) level requires building appropriate institutions, including those associated with the establishment of a banking union. This requires agreement on risk sharing and risk reduction. Both elements are needed to make progress. The two dimensions reinforce each other as progress in risk reduction across countries reinforces mutual trust and raises incentives for collective action needed to enhance risk sharing. Conversely, more risk sharing and the consequent strengthening of EU level institutions and instruments reinforces incentives for risk reduction at the national level. How does this impact on agreement and reform in other (growth) areas? The issue is rather complex but an example may help describe the point.

We have argued above that slowdown in growth and productivity is a Europe wide phenomenon partly related to the financial crisis, and that productivity decline is also associated with increasing fragmentation. One way to invert productivity decline and spur growth is to arrest fragmentation and support integration. Integration could be supported if, among other things, appropriate macroeconomic instruments were available at the European level for this purpose. The recent proposal to establish a convergence instrument in the EU budget goes in this direction. The idea of an EU wide unemployment insurance mechanism also does.

Conversely, if growth is strengthened macroeconomic and financial stability are also strengthened and so is risk sharing as benefits from European integration are perceived as more compelling. In

terms of consensus building if growth is strong and also inclusive one can expect support for reforms to be stronger. Presumably support would be extended beyond the inclusive growth agenda as the monetary union agenda would be seen as instrumental in achieving inclusive growth.

The opposite is also true. An effective national reform agenda would significantly strengthen the EU wide macroeconomic process. Consider, as an example, the impact of reforms on current account imbalances. The point is made repeatedly that a number of countries have been systematically running current account surpluses thus subtracting aggregate demand vis a vis the rest of the EU. These countries have also resisted the pressure to expand domestic demand through fiscal policy. To overcome political resistance and provide more effective solutions to the challenge of persistent imbalances the issue can be approached in a partially different way recalling that current account surpluses reflect excess savings (over investment). So a policy that would raise investment would, both, support growth in surplus countries and smooth imbalances within the EU. Structural reforms, especially those improving the business environment, and liberalizing product and labor markets, would raise investment and contribute to narrowing payment imbalances. As a consequence, the macroeconomic environment would be strengthened benefiting from higher growth and smaller imbalances. Some conclusions follow: a) the structural reform agenda would spill over, positively, on the macro agenda, and, conversely, the reform (growth) agenda would be strengthened by the macroeconomic (money) agenda; b) all countries, not only low growth or lagging countries, would benefit from a reform agenda; c) international cooperation would benefit from establishing both two level and parallel games; d) risk sharing would increase.

A non-cooperative (“sovereign nationalistic”) scenario, on the other hand, would impact both the growth and the money agenda. Failure to agree on risk sharing options would imply that fewer resources are made available to support convergence thus a failure in the money agenda would reverberate on the growth agenda. And support would fail to materialize for both agendas. A weaker growth agenda would imply a weaker money agenda. In short, the whole range of European policies would lack support. Ultimately, this vicious circle could significantly weaken the very foundations of monetary union.

Another example of interconnectedness between levels is tax policy. Again, an example is useful. Consider the case for a digital tax. Taxing digital companies is appropriate both for efficiency and for fairness reasons. Taxing internet giants, however, is extremely difficult given their very high mobility and the large role intangible capital plays in their activity. In addition, the very low tax revenues that are extracted from such companies are also seen as highly unfair from a social distribution point of view given the very high income and wealth levels these companies enjoy. Such features make it desirable to introduce a digital tax. However, its practical implementation is quite difficult for at least two reasons. First, it is not clear what to tax (revenues, equalization levy, bit tax, fat fee, etc), Second, the tax should be implemented on a global basis or, at least, on a European basis to minimize tax competition and free riding. Hence cooperation is needed. As mentioned, one can expect political support at the domestic level given the fairness component of such a tax, but more confrontation at the international level given the resistance to adjusting national tax systems to an international or European standard. Stronger collective action would address the issue and support for such a tax at the national level would encourage governments to find an agreement at the international level. Possibly, in such a case political capital at the country level could leverage political capital at the EU level needed to introduce reforms.

Where do we stand?

The short concluding answer to this question is that EU badly needs a comprehensive reform agenda to deal with significant risks of further productivity decline and increasing fragility and fragmentation. The more so as the global economic environment appears to be getting weaker and more exposed to negative shocks.

However, Europe lacks the political capital needed to implement the ongoing reform agenda (the “money agenda”) and introducing the, necessary, “growth” agenda. The situation is made more difficult by the fact that the growing populist/sovereign nationalist rhetoric identifies reforms with the “policy imposition” from Brussels. Hence resisting Europe and resisting reforms are equivalent. At the same time, however, a sovereign nationalistic agenda would further depress growth, increase fragmentation and weaken, if not destroy, incentives for both risk reduction, as this would be seen as imposition from Brussels, and risk sharing as this would imply enhancing the cooperative (hence European) dimension.

I have argued that a “renewed” European agenda for inclusive growth can raise sufficient political capital to support the needed reforms by leveraging both the interaction between national and international bargaining processes (the two-level game dimension) and the interaction between different agendas (the parallel game dimension). Is this perspective realistic? I am hopeful, as one can see some positive indications in the (very few) steps forward introduced by the recent political dialogue. One example among the few is the proposal to adopt a convergence, (but not a stabilization) instrument in the EU budget. But I am afraid that little progress, if any, can be expected before the upcoming European elections. And, after the elections, it may be too late if a different political climate emerges.

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