

A very hesitant economic recovery: the EU needs a real boost

Introduction

The European Commission's Annual Growth Survey 2015, published in November 2014, predicts a hesitant recovery in EU economies. GDP growth is set to reach 1.3% in 2015, with 0.8% in the euro area. There will be a slight further acceleration in 2016. This will ensure that economic levels in most EU member states are above their 2008 levels, but it hardly represents a return to sustained growth. It will leave Europe lagging behind other parts of the world that have left the economic and financial crisis behind them.

Some of the European Commission's analyses seem soundly based. They identify low demand as a constraint but fiscal policies across the EU continue to be deflationary. Mechanisms exist to force countries to restrict spending in line with eurozone rules, but not to ensure that those able to spend more do so. The Commission argues for a 'coordinated boost to investment', but the proposed investment plan remains a weak and unconvincing response to the depth of the problem.

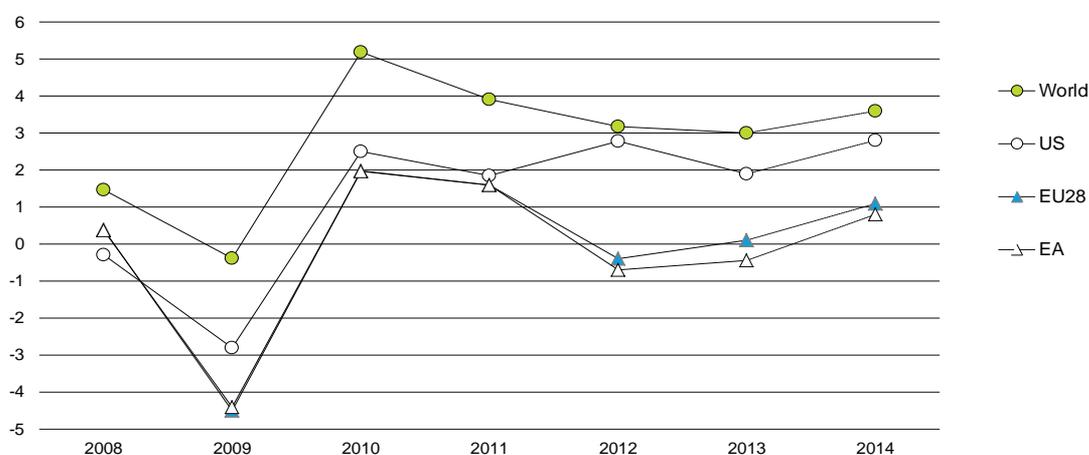
The continuing emphasis on 'fiscal responsibility' has meant adherence to rules that hold back growth and that limit resources for research and development and transformation of energy production. A commitment to 'structural reforms' is said to be essential, but the agenda set out under this heading is peripheral to the needs for restoring growth. Important measures, such as preventing the competitive downward spiral in corporate tax rates, remain to be implemented.

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Economic developments: very slow recovery

Figure 1.1. Real GDP growth (at 2005 market prices), EU28, EA, US, World, 2008-2014.



Source: Own calculations using IMF and Eurostat data. Note: 2014 are forecasts.

Lowered growth forecasts

Figure 1.1 shows the growth rates for the EU and eurozone compared with the USA and the world as a whole over the period from 2008, when the financial crisis spread beyond the banking sector in the USA, to 2014. Much of the world weathered the crisis with only a slight drop in growth rates. The EU too showed 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 was slow and uncertain, leaving GDP as predicted by the IMF in real terms just 0.6% above its 2007 level in 2014. The eurozone has performed slightly worse than the EU as a whole, but the difference is small.

The European Commission did not foresee the second downturn, confidently asserting in its 2010 autumn forecast that 'the economic recovery ... is making progress' (European Commission 2010: 9) and foreseeing a growth rate of 2.0% in 2012. The reality was to be -0.3% for the EU as a whole and -0.6% for the eurozone. This reflected a failure to predict the effects of austerity policies applied with particular vigour to Greece and the

other so-called 'programme countries'. Indeed, Greece was expected to recover in 2012 after a GDP decline of 7%. In reality, GDP had fallen by 20.5% by 2012 and continued to decline. The inaccurate forecast followed from an inability to predict exports, which did not grow in response to wage reductions, and the inability to predict the full effects of cuts in public spending which led to lower GDP with no significant compensating recovery from the private sector. As the following sections indicate, Greece was an extreme case, but the roots of forecasting errors were similar across countries.

Forecasts became more cautious after the predicted post-2010 recovery turned into a double-dip recession. However, the autumn forecast of 2013 reported that 'recovery is expected to continue and gather speed' (European Commission 2013: 11), foreseeing 1.4% growth in 2014, a figure progressively revised downwards to 1.1% during the year. A year later it was accepted that recovery 'began to slow again' and not much acceleration was foreseen for 2015. The prediction was rather of 'slow recovery with very low inflation' (European Commission 2014b: 11).

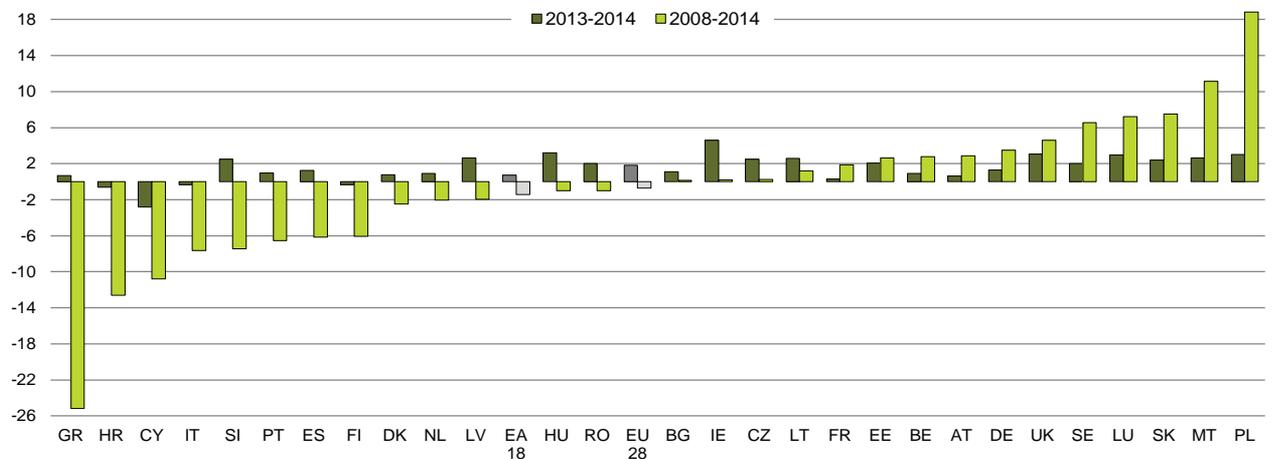
The reasons behind this near stagnation are clear. Austerity policies have been applied across the EU with a number of countries running balanced budgets and very substantial balance-of-payments surpluses (see below). This

depresses demand both in those countries themselves and across the EU. Stagnation has thus ceased to be an issue only for the countries in the greatest difficulty but has spread also to previously more secure parts of the EU.

The longer-term future remains uncertain. The principal barrier to faster growth is the absence of demand, as confirmed directly or indirectly by surveys of business. This lies behind low employment and low investment. Evidence also suggests that it is a major factor blocking a recovery in bank lending, a problem particularly for countries that have been most severely affected by recession, with banks citing the perceived macroeconomic situation and prospects for individual branches as reasons for caution on lending (ECB 2014). The seriousness of the situation has been recognized by Jean-Claude Juncker with his warnings of the existential threat to the EU if economies do not recover. His remedy in the form of an increase in investment is discussed in a later section.

Economic developments: very slow recovery

Figure 1.2. Change in real GDP, 2008 to 2014



Source: Calculated from AMECO database, GDP at market prices and GDP price deflators. Note: 2014 figures are estimates.

Slowdown spreading across Europe

Differing rates of decline and growth after 2008 led to widening divergences across the EU. The richer countries tended to do better. This was becoming less clear in 2014 when a number of high-income countries – notably Germany, Austria and Finland – performed badly while some lower-income countries were emerging from the depths of their depressions.

Figure 1.2 shows differing GDP growth performances across countries. There is no easy division between East and West, between North and South, or between the eurozone and the rest of the EU. The crisis of 2008 hit hardest those countries that had become dependent on inflows of credit from abroad. The collapse of construction booms in Ireland, Spain and the Baltic Republics cut out significant parts of GDP. Countries exporting manufactured goods were hit in 2009, but recovery was fairly rapid in 2010. The downturn after 2010 was most marked in countries pushed into the severest austerity measures after facing sovereign debt problems, either directly or following crises in private finance. The

worst affected was Greece (GDP down by 25% from 2008 to 2014) while Cyprus, Italy, Spain and Portugal all experienced post-2010 decline leading to GDP levels still significantly below those of 2008.

The rest of the EU had broadly restored the 2008 GDP level by 2013, but very few member state economies had grown much above that level. Poland was something of an exception with GDP having increased by 19%. It was not severely hit by the banking crisis of 2008 – it had not been dependent on credits from outside – nor was it severely affected by declining export demand in other countries and it continued with planned public investment projects while others were cutting back.

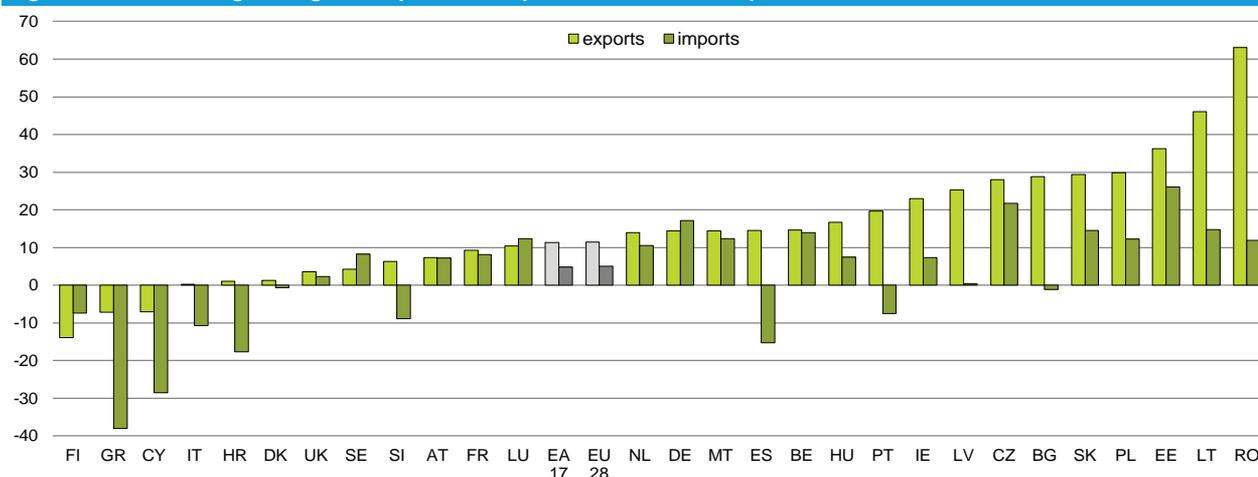
A number of other countries appeared to be recovering in 2014. The UK, having pursued less vigorous austerity policies than eurozone members and continuing to run a budget deficit that would not be allowed within the latter's rules, showed significant growth in GDP and employment in 2014. However, it was heavily dependent on an increase in low-income self-employment and accompanied by a persistent current account deficit. The three Baltic Republics, having experienced exceptionally deep initial depressions, showed reasonably strong recoveries which slowed down in 2013 and 2014. These countries were significantly helped by public investment, financed to a great extent from EU sources.

A remarkable feature of 2014 was the slow recovery in core eurozone countries. Germany's post-2008 growth had depended heavily on higher exports rather than domestic demand. Continued determination to achieve a budget surplus inevitably depressed domestic demand, overwhelmingly the most important element in total demand, and hence GDP. France's experience was slightly different, with exports doing worse than domestic demand. Finland also demonstrates the combined effects of austerity with export failure. The latter was particularly important, as explained below, while attempts to remain true to the austerity doctrine that Finland had advocated for other countries led both to a worsening of fiscal indicators and to the depressive effects of declining domestic demand (European Commission 2014b: 121).

The differing performances of individual countries demonstrate the continuing importance of the impact of the 2008 crisis, the varying severities of austerity policies, and the diverse export performances that are discussed in a subsequent section.

Eliminating current account deficits

Figure 1.3. Percentage changes in exports and imports, 2008-2014, 2010 prices



Source: calculated from AMECO database.

Diverging export results

Figure 1.3 shows the growth in exports and imports of goods and services from 2008 to 2014. Exports, which had grown by 11.4% for the EU as a whole, were well in excess of imports, turning the EU into an area in net current account surplus with the rest of the world: a deficit equivalent to 0.2% of GDP in 2004-8 (0.3% surplus for the eurozone) had become a surplus equivalent to 1.4% of GDP (2.5% for the eurozone) in 2014. This major change was accompanied by depressed internal demand, and some reduction in demand for countries elsewhere in the world.

Variation between countries is enormous. Exports grew very rapidly in the Baltic Republics, Poland, Romania and Slovakia, but declined in Greece, Cyprus and Finland while barely increasing in Italy, Denmark and Croatia. The variations cannot be explained by differences in policies pursued at the time. They depended on countries having products to export and on developments in their export markets. Thus Greece, the worst performer in exports, suffered from an absence of high-value export-oriented activities, a weakness that could not be overcome by the policies it was

required to pursue. On the other hand, changes in imports relate more clearly to policy choices, with the sharpest falls where the most severe austerity policies were imposed, notably in Greece, Spain and Portugal.

This was the principal effect of the policy of so-called 'internal devaluation', favoured by the European Commission for eurozone countries in the greatest difficulty. The argument was that, unable – within the common currency – to devalue, they should achieve the same reduction in export prices by cutting wage costs. In fact, wage reductions were predominantly in non-tradable and public sector activities and did very little to improve export competitiveness. Exports increased primarily for more advanced products for which quality is more important than price. For Spain major contributors to higher exports were nuclear reactors and aircraft, while pay in manufacturing as a whole was increasing. For Ireland the increase was strongest in computer services, an activity with high and increasing pay levels.

The importance of improved quality in export increases is indicated by an increased price of exports, particularly in a number of countries with large increases in export volumes. For Ireland export prices increased by 7.6% against a 2% drop in the domestic price level. For Latvia the respective figures were 14.8% and 1.1%. On the other hand, average export

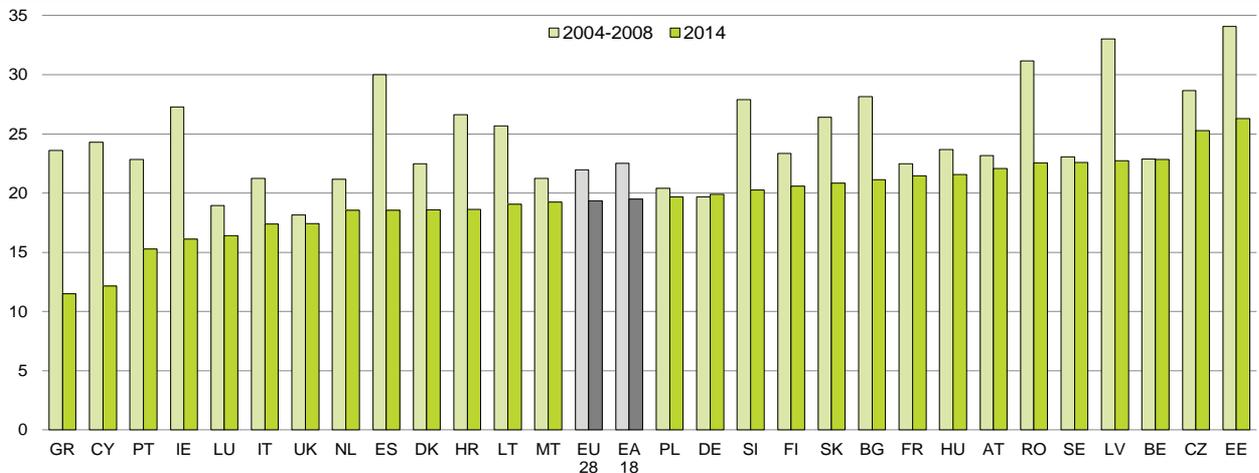
prices for Finland, one of few countries with declining exports, increased by only 1.7% against a growth in domestic prices of 11.7%.

Finland's experience demonstrates in a different way the importance of innovation and product quality. The biggest element in declining exports was the failure of Nokia to compete with Apple and Google. Prices were not the issue in this market and attempts to maintain budget discipline failed to help, ultimately proving unsuccessful as tax revenues declined. Nokia had at one time provided about a fifth of Finland's exports and 4% of the country's GDP (Ali-Yrkkö 2010: 18); its decline led to greater dependence on less sophisticated products and hence to the falling average export price.

These changes in exports and imports led to the elimination of, or massive reduction in, current account deficits in those countries where they had been especially high. Latvia had been the record case, with, in 2003-8, a deficit equivalent to over 15% of GDP that, by 2014, had been reduced to 2.1%. A number of other countries had previously been strongly in surplus and roughly matching growth in exports and imports left that position unchanged. Notable among these were Germany (7.1% of GDP), Sweden (5.7%) and the Netherlands (7.8%) which stand out as countries that could comfortably afford higher domestic spending to boost demand both at home and in other countries.

Means for renewed growth

Figure 1.4. Gross fixed investment as % of GDP, 2004-2008 and 2014



Source: calculated from AMECO database.

Hopes and doubts from investment

Figure 1.4 shows that investment fell dramatically in the aftermath of the crisis. Its 2014 level was 15% below the peak of 2007, using 2010 prices. Total fixed investment fell from 22.0% of GDP in the 2004-8 boom period to 19.4% in 2014. In some countries – notably Germany, Austria and Sweden – there was little net change over this period. For some, by way of contrast, the drop was enormous: Cyprus, Ireland, Greece, Latvia and Spain all saw falls in investment equivalent to over 10% of their GDPs. Most of the decline was in private investment, including housing construction and industry, but public fixed investment also fell by more than 50% in Ireland, Spain and Greece.

While some past investment was no doubt misdirected, it would be wrong to consider investment levels in the years up to 2008 as harmful aberrations. All countries have demonstrable needs for investment to cope with the challenges of the future in transport and communications, education and research, climate change, energy, environment, and ageing of populations. Faster growing countries typically have considerably higher

investment rates, reaching almost 50% of GDP in China. Figure 1.4 shows that levels are extraordinarily low in a number of EU countries, leaving large numbers of unemployed and much unused capacity.

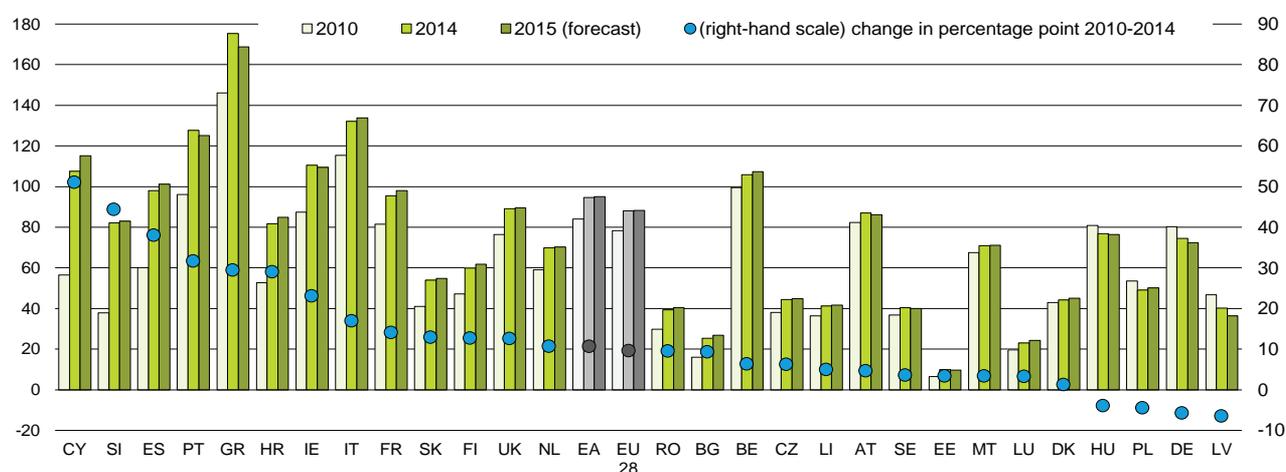
A revival in investment activity would provide an immediate stimulus to demand, increasing GDP by somewhat more than the increase in investment, thanks to multiplier effects. It is also essential for long-term growth and for overcoming growing divergences and inequality within the EU. In 2013 the ETUC 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. It could be financed by member states contributing to an increased capitalisation of the EIB on the basis of which long-term loans could be raised, taking advantage of the abundance of finance-seeking safe investment opportunities. The increases in GDP that could be expected would be much more than adequate to repay the debts incurred. Major barriers to such a programme include the eurozone rules on debt and budget deficits, both of which would need to be relaxed to some degree.

A more modest plan from European Commission President Jean-Claude Juncker proposed the investment of 2.4% of EU GDP over three years. The public commitment was also less clear, with the EU contributing a small guarantee and member states encouraged, but not

obliged, to contribute in exchange for a small degree of temporary leniency on budget rules (European Commission 2015). The plan suffered from two further weaknesses. The first was that the level of investment was to be maximised by allowing private lenders to choose which projects they would invest in, supporting a strong bias towards investing in the highest-income countries that had the least need of an EU programme. The second was that the plan was set to be combined with measures to satisfy business demands for easier conditions, for example by labour market deregulation. Private business was said to be holding back from investing due to a lack of 'confidence'. In fact, regular surveys leave little doubt that business confidence is influenced primarily by the state of order books, in other words demand (see the Economic Sentiment Indicators, at http://ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm), pointing clearly to the benefits to be derived from a public investment programme for restoring business confidence.

Economic developments

Figure 1.5. Gross public debt/GDP ratios, 2010-2015 in the EU



Source: own calculations using AMECO data (UDGG).

The legacy of fiscal austerity: high debt/GDP ratios

The public finances of 15 out of 28 individual countries, as measured by the gross-debt-to-GDP ratio, deteriorated between 2010 and 2014 in spite of the fiscal austerity adopted throughout this period. This deterioration was not, however, evenly distributed. Member states that saw the biggest increases in their gross-debt-to-GDP ratios are also those which saw the greatest relative reductions in their real output over the same period, most notably Greece, Ireland, Portugal, Spain, Cyprus, Slovenia and Croatia. This group of most affected countries includes all the member states that have faced sovereign-debt and/or balance-of-payments crises in the markets since 2010 and which, along with Latvia, pursued, in response, the toughest austerity programmes as a condition for receiving financial help from the EU and the IMF. Of these, Greece alone had a debt/GDP ratio that was, in 2010, already relatively high, well above 100 per cent.

The evolution of debt-to-GDP ratios, especially in the member states that received bail-outs, testifies to the failure

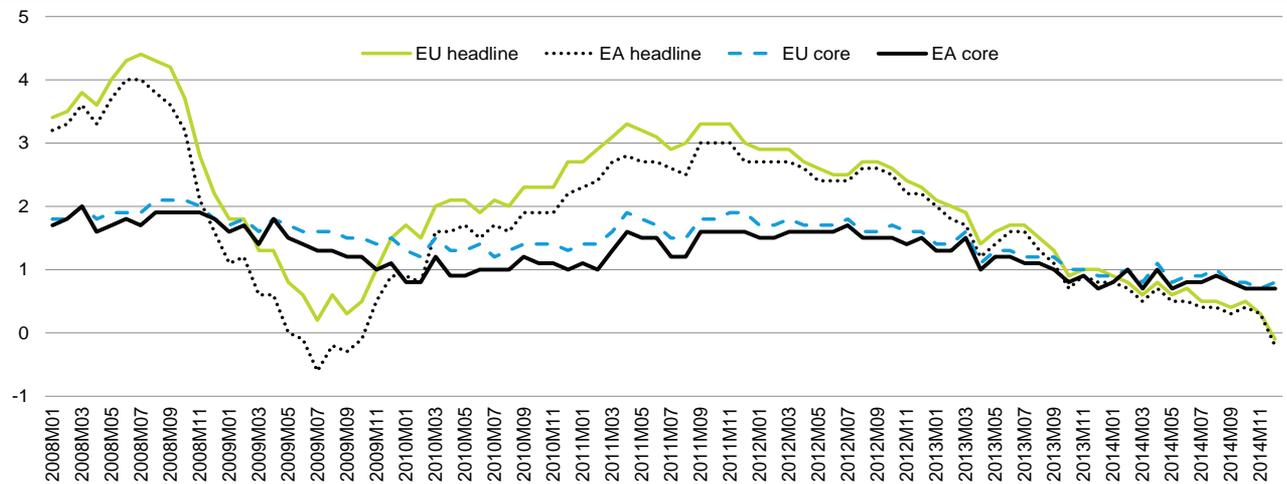
of financial support programmes which, by imposing deep fiscal austerity in the face of contracting economies, resulted in aggravating one of the symptoms they were meant to resolve, namely high public indebtedness. The results of fiscal austerity on output growth and, thereby, public debt/GDP ratios have been known since 2012 (IMF 2012), and yet there has been no essential change in policy course. In the bailed-out economies, this omission was directly related to the political unwillingness to finance the gaps that would emerge should fiscal consolidation take longer. More generally, however, the pursuit of austerity instead of growth as the main weapon for tackling high public/GDP ratios has been based on the threat that governments might lose access to the financial markets, in the way the peripheral euro-area members did. Again, this notion conveniently ignored the fact that the sovereign debt crisis in the euro area in fact subsided and financing costs decelerated once the ECB pledged to play its role as a lender of last resort in July 2012 by declaring that it would do 'whatever it takes' to preserve the integrity of the eurozone, including buying government bonds in the secondary markets through its Outright Monetary Transactions (OMT) programme.

The average debt-to-GDP ratios for both the EU and the euro area are forecasted to remain at the high levels they have reached, in the majority of

countries, in 2015. Even in those cases where a decline is forecasted, it is expected to be small and is conditional on whether positive output growth forecasts will also turn out to be correct. Rather than boosting confidence in the sustainability of public debt, austerity policies and their adverse effects on real output growth have undermined it, leading to persistently higher debt-to-GDP ratios.

Economic developments

Figure 1.6. Headline and core inflation rates, EU and euro area, 2008 MO1-2014 MO12



Source: Eurostat (prc_hicp_manr).

On the brink of a deflation trap

Following years of stagnant or negative output growth since the crisis began, in 2014 average inflation rates in the EU and particularly in the euro area decelerated further, well below the 2 per cent target of the ECB and dangerously approaching zero. Several member states, most notably Greece, Bulgaria, Cyprus and Spain, have been experiencing deflation, that is, negative inflation rates for several months. The average headline inflation rate (i.e. the one reflecting the entire basket of goods and services used for its calculation) was in December 2014 negative in more than half of the EU member states and virtually zero in a handful of others. The declining price of oil has been related to this as the core inflation (that is, the inflation rate excluding food and fuel) was negative in only four member states (Bulgaria, Greece, Cyprus and Spain). Even core inflation, however, was in December 2014 below one per cent in the majority of member states.

Inflation rates that are too close to or below zero are a worrying development as they suggest that, alongside very weak demand, economies are on the brink of a deflation trap. An economy

falls into a deflation trap when it suffers from deflation while nominal interest rates have also reached very close to zero. Under these circumstances, conventional monetary policy loses much of its potency: lowering nominal interest rates, the most conventional monetary policy tool for stimulating demand, is limited by the zero bound, while a negative inflation rate means that even with zero nominal interest rates, real interest rates, which really matter for investment and demand, become too high. In the case of the euro area, where fiscal policy is constrained by the stability and growth pact rules, having monetary policy losing its effectiveness to stimulate the economy exacerbates the difficulties.

Equally importantly, deflation or declining inflation increases the burden of servicing debt, whether in the public or the private sector. This happens because debts are denominated in nominal terms and paid off according to nominally fixed pay instalments. The fact that the debt remains constant whereas wages, prices and tax revenues fall, in the context of deflation, means that servicing the debt becomes harder, thus squeezing demand further and fuelling the spiral.

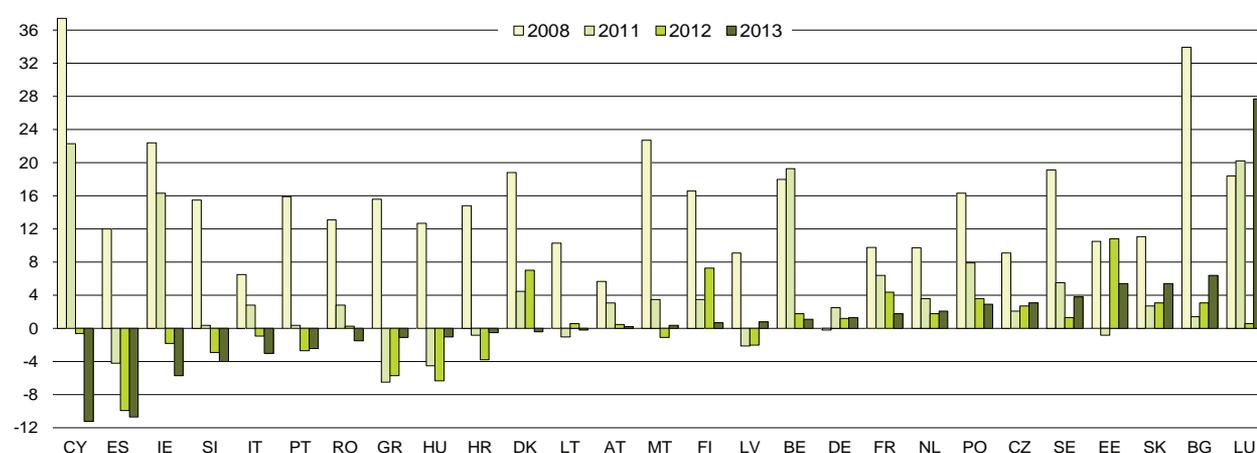
Last but not least, deflation makes the adjustment of relative wages more difficult. This is especially important for the eurozone where a process of relative price adjustment has been taking place since 2010 when the diverging current

account positions started unravelling. Practically, deflation means that the process of internal devaluation is becoming even more difficult and painful.

Deflation, once it becomes entrenched in wage and price expectations, comes to constitute a challenge for central banks, as wage- and price-setters pull each other, in the presence of falling demand, into a downward spiral of ever decreasing prices and nominal wages. As the example of Japan has shown, it is particularly difficult to draw an economy out of a deflation trap and sustained efforts from fiscal and monetary policies are essential (Koo 2009). In the context of the euro area, it is also hard to see how deflationary expectations could be avoided or uprooted without the support of coordinated collective wage bargaining.

Economic developments

Figure 1.7. Private sector (corporations and households) credit flows as % of GDP, 2008, 2011-2013



Source: Eurostat tipspc20.

Private sector: credit constrained where credit most needed

A factor of the weak demand in the EU and especially the euro area has been the meagre growth in private sector credit flows as a share of GDP. These declined substantially after 2008 in the vast majority of member states and have been negative or minimal for almost half of member states since 2011. The most affected have been mostly those worst hit by the crisis, where deleveraging has been taking place since 2010-11 with negative credit flows representing the reversal of the large credit growth in the run-up to the crisis.

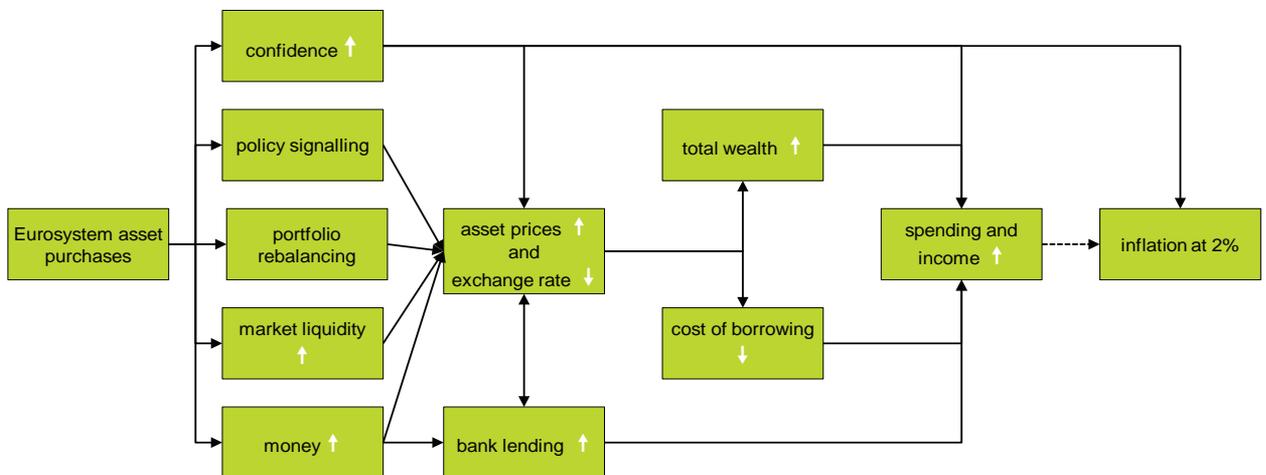
Low or negative credit flows to the private sector can be largely explained by the credit crunch conditions that have emerged in several member states due to the sovereign debt crisis and the subsequent prolonged recession, following the policies of adjustment. National banking systems, especially in those member states experiencing protracted financial distress, have also suffered from the double exposure to weak domestic economies

and financially distressed governments. Both these factors have been weakening their balance sheets.

To address the problem of the so-called 'lethal loop' between banking stability and sovereign debt, the euro-area members, in an effort to complete a banking union in the area, took steps such as the appointment of a Single Supervisory Mechanism for the 'systemically relevant' financial institutions and the establishment of a Single Resolution Mechanism (that is, a common pot of funds to help recapitalise and resolve troubled banks). While the steps have been in the right direction, the fact that the ECB has limited funds at its disposal in the resolution mechanism means that it may not always be as strict as necessary in identifying problematic institutions. A case in point is the stress tests that it conducted in 2014 ahead of taking over the supervision of the biggest banks. While the exercise was of unprecedented rigour, it emerged soon afterwards that the banks had not been stress-tested against deflation scenarios, which at the moment seem more plausible than ever. Several large banks marginally passed the tests.

Monetary policy

Figure 1.8. Quantitative easing



Source: Adapted from Joyce *et al.* (2011).

ECB becoming more activist

In 2014, the ECB reduced its main refinancing operations rate twice, in June and in September, bringing it down from 0.25 to 0.05%. Arguably, the interest rate cuts came with some delay, as the headline inflation in the euro area had by then fallen well below the two-per-cent target while economic activity in this area has been stagnant. The shift to a more activist ECB stance was signalled in a – now considered landmark – speech by Mario Draghi at Jackson Hole in August 2014, where, acknowledging the gravity of the unemployment situation in the euro area, he called for more active coordination of fiscal and monetary policies, at the same time urging governments to continue the pursuit of structural reforms.

On 22 January 2015 the ECB announced the launch of its quantitative easing (QE) policy whereby it will extend its asset purchase programme to securities issued by euro-area governments and European institutions to the tune of 60bn euros per month for at least 18 months and until there is evidence that the euro-area inflation rate is on the path to reaching its target of under but close to 2 per cent. The monthly amount of

purchases will be distributed according to the contribution of member states to the ECB’s capital (that is, according to their relative GDP). In a move that signalled that there has been strong opposition to QE by Germany, the default risk of any government will remain largely with its national Central Bank.

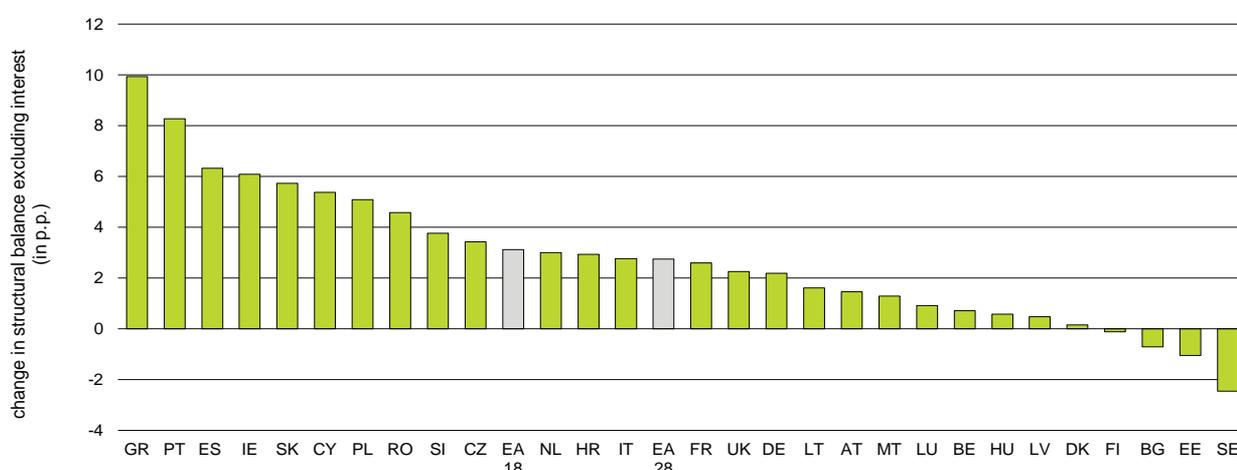
Quantitative easing is an unconventional policy whereby the central bank directly purchases private and public sector financial assets held by financial institutions. Conventional monetary policy, by a lowering of interest rates, increases demand for investment and other determinants of demand that are sensitive to interest rate movements, as well as fuelling exports (insofar as the lowering of interest rates can also lead to an exchange rate depreciation). QE is meant to work to stimulate an economy through a number of channels, namely, by improving the public’s expectations about the economy (confidence); by signalling the central bank’s commitment to raise the inflation rate (policy signalling); by reducing the interest rate on corporate bonds and thereby facilitating borrowing for companies which would presumably borrow to invest (portfolio rebalancing); by stimulating market activity for certain financial assets (market liquidity); and last but not least, by providing banks directly with extra cash which they can lend to households and firms (money) (Carlin and Soskice 2015: 479). Faced

with conditions of recession and very low nominal interest rates, the FED and the Bank of England used quantitative easing much earlier than the ECB. There is some limited evidence that it can be successful.

Given that quantitative easing involves central bank purchases of government bonds, there have been objections in the euro area to its pursuit by the ECB. For one thing, the effectiveness of the policy is still not well established, while it does create winners and losers among owners of financial assets; for another thing, there have been fears that, should a euro-area government default on its debt, then the ECB would have to take the losses and effectively make unauthorised fiscal transfers across member states’ taxpayers. The uncertainty about the effectiveness of QE notwithstanding, it has been argued that these fears are largely irrelevant (De Grauwe and Ji 2013). In any case, as Mario Draghi also suggested, its potential effectiveness is not sufficient to pull the euro area out of the crisis. A more supportive fiscal stance is simultaneously required, as well as, in our view, structural reforms of the type that do not exacerbate wage deflation and demand in the short run.

Fiscal policy

Figure 1.9. Fiscal policy stance in the EU, 2010-2014



Source: own calculations using AMECO data (UBLGBPS).

Contractionary stance continues

One of the three pillars of the Annual Growth Survey for 2015 has been 'fiscal responsibility' (European Commission 2014a), meaning the lack of any deviation from adherence to the EU's fiscal rules. Various key EU policymakers, from Commissioners Katainen and Dombrovskis to Mario Draghi, have been emphasising the need to keep fiscal policy within the rules. This insistence has been flying in the face of what basic Keynesian macroeconomics would suggest: that in a context of recession, deflation and nominal interest rates virtually at zero, fiscal policy should step in to stimulate demand as the effectiveness of monetary policy to do so becomes severely constrained. The EU fiscal rules were set out under circumstances where excessive inflation, and not deflation, was the concern. Yet the fear of losing credibility by changing the rules to fit the current exceptional and not previously foreseen circumstances has been dominating policy considerations.

The fiscal stance in the vast majority of member states between 2010 and 2014 has been contractionary. Governments have been managing the part of spending and revenues that is at their

discretion – broadly everything apart from interest payments on debt – in a way such that revenues have been higher than spending. This can be seen in Figure 1.9 (above) which shows by how many percentage points the balance between discretionary public revenues and spending – i.e. the primary structural balance excluding interest – changed between 2010 and 2014. A positive change means that revenues increased relative to discretionary expenditure. In practice, this means that the vast majority of governments have not been using discretionary fiscal policy in order to stimulate demand in their economies in the face of recession or low demand, but have instead been contributing negatively to low demand in order to reduce their total government budget deficits.

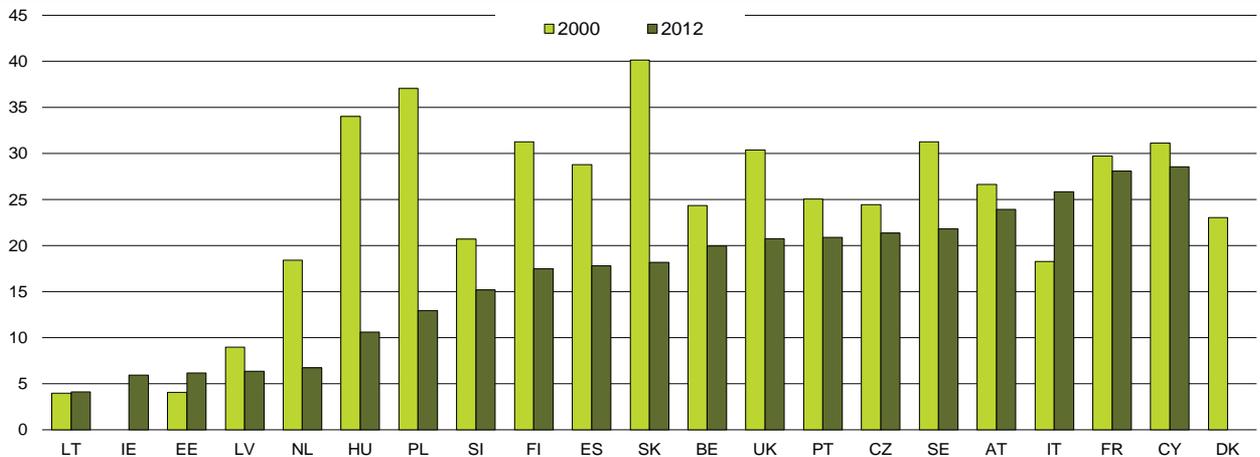
The largest consolidation took place in Greece, Portugal, Spain and Ireland, i.e. the four member states that received financial support from the EU, with Cyprus following only behind Slovakia. The graph underrepresents the fiscal effort made in Hungary and Latvia, countries that faced financial crises and had to pursue fiscal austerity earlier than the eurozone, and whose fiscal stance between 2007/2008 and 2012 tightened by 5 and 6 p.p. respectively.

What is most worrying in the Figure above is that the fiscal stance in the euro area and the EU28 as whole has been contractionary. Only a handful of

member states have faced sovereign debt crisis and of those only Spain is a large economy. Therefore, the above euro-area and EU28 averages have been driven by developments in member states which, in principle, would have the space to use expansionary fiscal policies, for example Germany. The EU fiscal rules do not impose fiscal expansion under any circumstances, so it is up to the individual governments with available fiscal space to decide whether they are going to expand their policies in order to support the aggregate stance in the eurozone. So far, such calls have been falling on deaf ears, even though the financing costs (long-term real interest rates) in countries such as Germany have been at or below zero since 2012.

Company tax victim of a tax race

Figure 1.10. Implicit tax rates, % of corporate income, 2000 and 2012



Source: Implicit tax rates: DG Taxation and Customs Union and Eurostat (online data code: gov_a_tax_itr).

Government policies allow tax avoidance by multinationals

Taxes on corporations account for a small share of tax revenue in the EU with substantial variation between member states. In 2012, after a period of declining tax rates over two decades, the EU average was 6.5%. High levels were recorded in Malta (18.7%), Cyprus (17.8%) and Luxembourg (13.4%). The lowest levels were in Slovenia (3.4%) and Greece (3.3%). The simple average top statutory tax on corporate income rates in EU28 fell from 35% in 1995 to 22.9% in 2014, albeit still leaving substantial variation between countries. The trend continued in 2014 with four member states cutting their statutory rates: Finland (from 24.5% to 20%), followed by the United Kingdom (23% to 21%), Slovakia (23% to 22%), and Denmark (25% to 24.5%). Against this trend, France's statutory top rate for large companies was raised in 2014 through the change in the exceptional surcharge.

Implicit tax rates (ITRs) on corporate income in 2000 and 2012 in

individual EU countries are shown in Figure 1.10. These measure actual tax revenue as a percentage of potential tax revenue, thereby taking account of deductions and exemptions. Unfortunately, data are not available for all EU countries. However, Figure 1.10 shows some massive reductions in a number of EU countries, notably Hungary, Poland, Slovakia, Spain, Finland and the UK. The only increases were in Italy, Latvia and Estonia, the last two from exceptionally low initial levels.

The downward trend can be attributed, to some extent, to the differences in tax rates. These differences put pressure on individual countries to cut their effective rates of business taxation. As capital enjoys considerable mobility in the EU, states find themselves competing to keep, or attract, investment and to discourage companies from recording profits from their home activities in foreign jurisdictions.

Many multinational companies, however, record much lower rates of taxation on profits from their European operations than suggested by respective implicit or average tax rates. Various loopholes sustained by tax policies pursued by some member states, most notably Ireland, Luxembourg, and the Netherlands, have allowed multinational companies to enjoy tax reductions as high as 95%. The Irish government is to close down by 2020 the notorious Double-Irish-Dutch

Sandwich, a mechanism allowing companies to reduce their tax burdens, but current regulations allow a number of other tax avoidance schemes, such as that based on intra-company lending through Swiss-based branches.

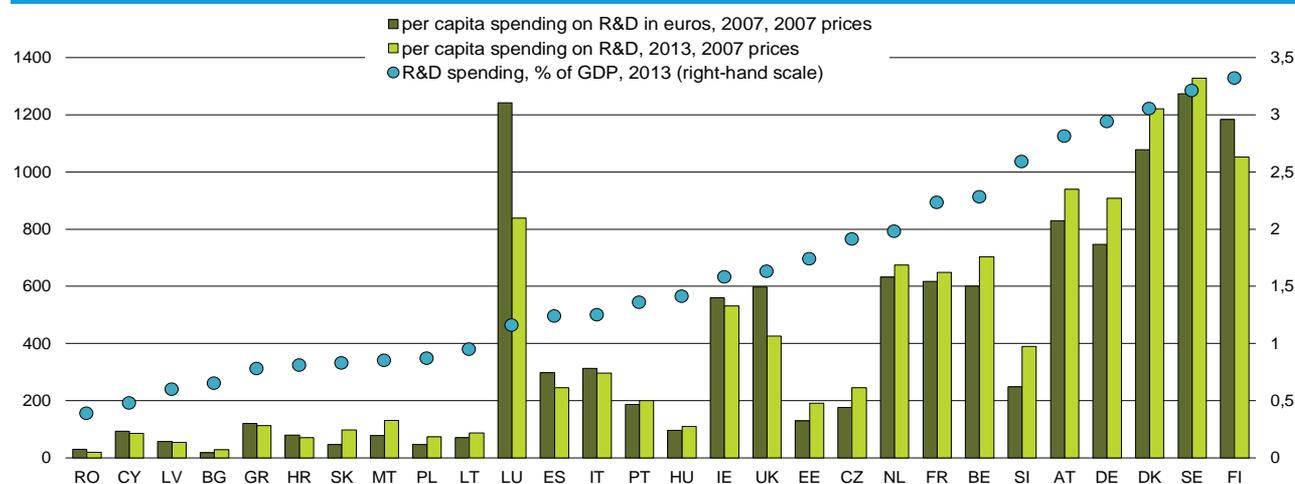
State capacity to collect taxes from business is also undermined by undeclared economic activities. The shadow economy is estimated at around 18-19% of GDP in Europe, but estimates vary between 8% in Austria and 32% in Bulgaria.¹ Tax evasion through undeclared activities is particularly rife in the New Member states (including Malta and Cyprus) and in southern Europe (i.e. Greece, Italy, and Portugal).

There needs also to be a much more ambitious approach to tax coordination on the EU level. An ETUC draft resolution on taxation includes a mandatory common consolidated corporate tax rate base and a minimum tax rate of 25%. An EU-wide tax rate would be an important step towards addressing the problem of tax-related capital mobility.

1. http://ec.europa.eu/taxation_customs/resources/documents/common/publications/com_reports/taxation/com%282012%29351_en.pdf

Missing the targets

Figure 1.11. Research and Development spending per capita, 2007 and 2013, and as % of GDP, 2013



Source: Eurostat.

Mixed progress on research and development

Figure 1.11 shows spending on Research and Development in member states using two measures. The measure of total spending as a percentage of GDP relates to the target set in the Europe 2020 agenda of reaching a level of 3% of GDP. That benchmark had been passed by only a very small number of countries by 2014.

R&D therefore remains an area of great and persistent inequality across the EU. The extent of the differences is shown even more clearly by figures for R&D per capita. Lower-income countries spend much less on research. In some cases, the per capita level even fell between 2007 and 2013. There were particularly large declines in Romania, by 34%, and Spain, by 17%, and reductions also in Greece, Italy, Finland and the UK. Elsewhere, including in a number of lower-income countries, there were substantial increases.

Research is important as a key input to innovation and to production of high-quality goods and services, these being the main determinants of international competitiveness. Its concentration also follows from differences in income

levels, as research workers are generally highly mobile and can move to the country where pay is best. Public spending and support for research and higher education institutions are also crucial and the weakness or absence of this infrastructure places lower-income countries at a massive disadvantage.

Overcoming these obstacles depends on action at the EU level. Structural Funds and EIB investment were essential in practically all public sector development of research infrastructure in central and eastern Europe in the 2007-14 period and hence in improving – sometimes very significantly – the position of a number of those countries.

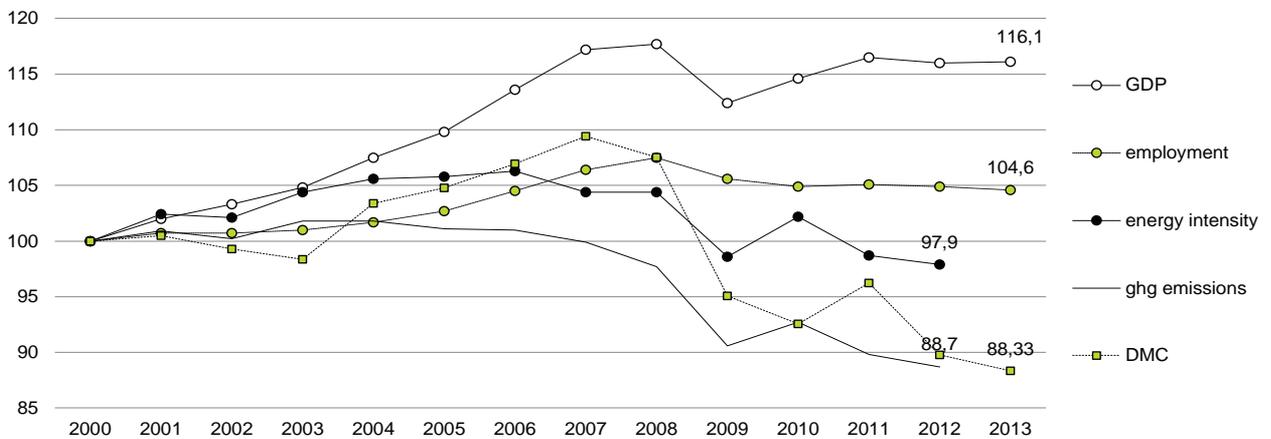
The investment programme proposed by the European Commission for the 2015-8 period could make a significant further contribution. However, that depends on the criteria set for judging investment. Research and higher education have been major areas for EIB investment in higher-income countries, notably the UK where university incomes are guaranteed by high levels of fees for domestic and overseas students. Allowing lenders to select the projects they will finance is likely to mean a continuing bias away from investing in similar facilities in lower-income countries. The successful development of research across the EU would depend on making investment resources available and also on making current spending available to attract and

retain educators and researchers. Such developments are obstructed by strict application of budget rules, leading to the declining levels of research spending in a number of countries, as shown in Figure 1.11.

Research spending alone does not guarantee economic competitiveness, as illustrated by the problems for Finland where innovation was heavily concentrated within one firm. The results of research need to be convertible, and also converted, into activities, and that depends on complex relationships within so-called innovation systems. Private- and public-sector users of research results need to have contacts, knowledge, incentives and sources of finance. The distribution of these factors accentuates the inequalities between countries, encouraging a continued concentration of innovation. A wider strategy for improving competitiveness across the EU therefore needs to include means to bring expertise and capital to those who can develop innovative ideas in all countries. The Juncker investment plan has included references to helping countries find appropriate and viable projects. Encouragement of more substantial changes, including an infrastructure of investment banks and public advisory services, will be necessary if innovative and knowledge-based economies are to develop beyond the established core of the EU.

Decoupling economic growth from material and energy use

Figure 1.12. Development of GDP, employment, energy intensity, ghg emissions and domestic material consumption for the EU28 (index, 2000=100)



Source: Eurostat, 2015. Note: DMC is domestic material consumption.

Most greening is due to the recession

There is a broad consensus that in the current economic environment the viable way of setting our production and consumption model on a sustainable basis is to decouple economic growth from pollution and resource use (energy and material). Economic growth, and in particular employment growth, is still seen as essential for wellbeing, for full employment and for social justice. There is also a widespread expectation that the green transformation process will create jobs, the overall aim being to create more wealth while exerting less impact on the environment and the planet. Climate-change policies for developed countries (under the Kyoto Protocol) set the target of an 85% reduction for greenhouse gas (GHG) emissions by 2050 compared to 1990 levels (assuming that economic growth will continue). A Factor Five, or 80 per cent, reduction of environmental impacts per unit of economic output is necessary and achievable (UNEP 2011). At this point we will take a look at Europe's performance according to the main indicators.

By 2012 total GHG emissions in the EU28 had decreased by 19.2% since 1990, while EU15 emissions were 15.1% below the base year under the Kyoto Protocol. Accordingly, the 2020 target had almost been reached in 2012. As EU28 GDP in this period had grown by 45%, the 19% GHG reduction (EEA 2014) meant not only an early fulfilment of the EU 2020 target but also provided evidence of a considerable decoupling from GDP growth.

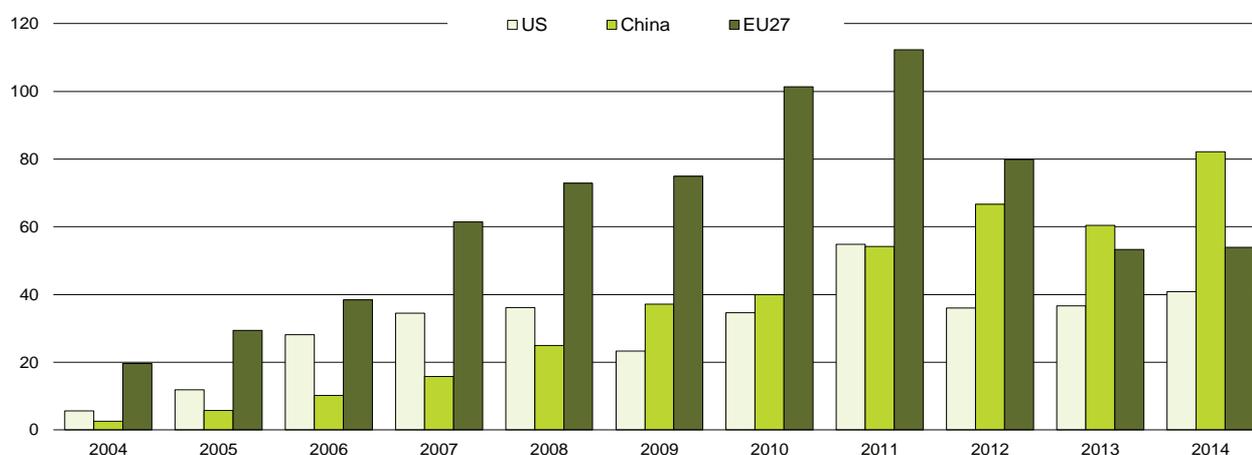
So everything is fine, we could say? Not entirely. Figure 1.12 provides an overview of major sustainable development indicators as they developed in the period 2000-2013 in the EU28 (this is the period for which all these data are available, encompassing times of both boom and crisis). GDP over this period showed a 16.1% increase (with a peak of 17.7% in 2008), signifying a meagre yearly average of 1.23%. Employment performance was even weaker – a mere 4.6% increase in 13 years (with a peak of 7.5% in 2008), corresponding to a yearly increase of 0.35%.

Greenhouse gas emission reductions showed a very mixed performance over the period. While there is an 11.3% drop over twelve years (the latest data available are for 2012), the two sides of the economic cycle show entirely different results. During the period of economic boom GHG emissions were not decreasing (the decrease in 2007 compared to 2000 was 0.01%). The difficulty of decoupling economic growth (while

it existed) from pollution, resource and energy use is apparent from the performance in domestic material consumption and primary energy consumption. Between 2000 and 2007 domestic material consumption grew by 9.4% (more than employment), while primary energy consumption grew by 4.4%. It is primarily the economic recession that brought a reduction in both domestic material consumption and final energy use. Although we see some degree of decoupling for the period taken as a whole, as with the 16.1% overall GDP increase we have an 11.7% decrease in domestic material consumption and a 12.1% decrease in final energy consumption (based, in the latter case, on data from 2000 to 2012). These developments fail to provide convincing evidence that a policy-driven transformation process towards a more sustainable economy is underway and even less indication that the more ambitious 2050 targets are likely to be reached. Moreover, the objective was to decouple economic growth from resource and energy use and not from employment. The disappointing employment performance is also undermining confidence that a greening of the economy will deliver jobs – for, after all the talk of green jobs, where are they? Unless massive investment is forthcoming, we simply will not get there.

Clean energy investment in the EU, US and China

Figure 1.13. New investments in renewable energy (USD bn)



Source: Mills (2015).

Europe falls behind both the US and China

Europe is losing momentum in greening its economy, and its former leadership in the world is eroding rapidly. The case of clean energy investment is the most glaring example in this respect.

As Figure 1.13 shows, in the period 2004-2011 the EU had been the unquestionable leader in this field with a spectacular increase in its investment levels. In that period clean energy investment in Europe increased six-fold compared to the base value in 2004, with the EU outperforming China and the US combined.

A spectacular collapse followed: in 2013 clean energy investment in Europe had fallen by 53% compared to the investment peak in 2011 (Figure 1.13). Data for the first three quarters of 2014 (not shown here) reveal that the falling trend for Europe continued unabated: in the third quarter of 2014 clean energy investment in Europe tumbled to USD 9.2 billion, the lowest level in more than eight years, as spending under this heading fell in the UK, Italy and Germany (Mills 2014).

It was only the 2014 fourth quarter investment value of USD 17.8 billion

that saved Europe from another year of diminishing clean energy investment. Although the USD 54bn total investment value in 2014 is slightly higher than the 53.3 billion in 2013, it falls very far short of China (USD 82.2 bn).

This happened in a year when 310 billion USD was spent globally on renewable energy projects (a 16% increase over 2013) and when China's solar investment hit a historic record. In 2014 Europe provided 17% of the global investment, its share back in 2010 having been still as high as 37%. It thus took only three years for Europe to change from global fore-runner to global laggard in terms of clean energy investment.

As Europe's performance in most sustainable development indicators – shown in Figure 1.13 - illustrates, its recent greening trajectory is based more on a recessionary environment than on investment or the implementation of policy targets. In order to turn around this unfavourable and unsustainable trend more investment, particularly into clean energy, is necessary.

Conclusions

Austerity and growth do not mix

The European economy has gone through two recessions since 2008. The first policy reactions to the crisis in 2008 suggested that the EU was on the right track. The fall in private sector activity was to be countered by a stimulus from the public sector. The second recession, after 2010, followed after the reversal of that early approach. The European Commission predicted at the time a fairly quick recovery. Instead, the small subsequent recovery has been uneven, slow and insecure. By 2014 the European Commission was prudently predicting only modest growth for the next few years.

The dominant rhetoric and the accompanying policy measures have pointed in two opposing directions. On the one hand there has been a verbal recognition that past policies had failed and that a big change is needed if GDP and employment growth are to be restored. However, this coexists with an insistence that there can be no substantial change to the central principles governing past policies, most notably the adherence to the recently tightened fiscal rules. As a consequence, austerity must continue. However, unless there is a major change in policy thinking, as well as general rhetoric, the EU economies face the prospect of an agonisingly slow recovery with dampened prospects in several 'core' as well as 'periphery' countries.

It should not be difficult to find a better way forward for the European Union, but the new measures in EU policymaking will make only a small contribution to this. Two are important here. The first is the investment plan proposed by European Commission President Jean-Claude Juncker. It will not restore investment to its pre-crisis level and minimal concessions on budget rules mean that it will be concentrated towards countries in the least need of an EU programme. It is far short of what Europe could afford and also far short of what Europe needs.

The second important new element is the European Central Bank's policy of quantitative easing announced in January 2015. The ECB will extend its asset purchase programme to securities issued by euro-area governments and institutions for at least 18 months or until there are indications that inflation rate is on track to returning to its target. This follows similar programmes in the UK and USA, albeit with some controversy over their precise effects. The ECB programme reflects political compromises: most of the risk of buying government bonds will not be shared but will instead remain with national central banks

Despite these new elements, much of policy thinking remains unchanged. The emphasis continues to be on 'fiscal responsibility' which has meant too tight a fiscal stance across the Eurozone, as well as the EU, as a whole. The measure of the budget balance that shows the discretionary fiscal policy of governments, that is, the structural balance excluding unavoidable interest payments on debt, has increased since 2008 across the EU by almost 3 percentage points of GDP, with the figure touching 10 percentage points for Greece. Even within existing eurozone rules, a number of countries could comfortably and substantially increase spending to provide a stimulus to demand. However, the fiscal rules only impose actions following too high deficits, not too small ones or too high surpluses. At a time of prolonged recession, 'responsibility' should mean pursuing policies that can restore recovery, but the only effective insistence from EU level has been on the continuation of adherence to the fiscal rules in countries that are already pursuing severely contractionary policies, for fear of otherwise losing credibility with the financial markets.

Continuing in this policy direction does not offer a solution to the problem of high levels of public debt as share of GDP. Indeed, these have grown as a result of contractionary policies. With the exception of Greece, they were not the trigger of the crises that certain member states faced and will not decline as a proportion of GDP as long as growth remains subdued. This is an absolutely basic proposition in macroeconomic theory

and is confirmed by Europe's post-2008 experience. Gross debt as a proportion of GDP has increased across the EU and, with only a couple of exceptions, in every country and every year since 2008. Reversing that trend requires renewed growth, providing the growth in tax revenues which can reduce budget deficits.

Continuing austerity has also brought the increasingly real danger of deflation, meaning a continuously falling price level that, unless tackled, risks becoming self-perpetuating. Combined with nominal interest rates virtually at zero, this renders monetary policy even less effective than it has been so far. It would also make it more difficult to reduce both public and private debt levels, thus adding to the difficulties of banks to lend. The ECB policy of quantitative easing is intended to counter deflation, but its effectiveness is greatly restricted by the absence of an accompanying fiscal expansion.

Continuing tight fiscal policies also greatly limits the effectiveness of Juncker's investment plan. This is under-financed because no new public resources are available within existing rules. Its effectiveness is limited because member states have limited means to afford necessary co-financing, to cope with needs for current spending to make use of the results of investment, and to repay credits.

Other policy areas essential for long-term growth are also hit by fiscal rules. Target levels of R&D spending will not be met, with very significant reductions in some countries where the level was already low. Targets for reducing carbon emissions are threatened by cuts in public spending such that much of the apparent recent progress in this area has come as a result of economic depression.

It is not difficult to find alternative policies for Europe that could restore growth and employment. Europe, after all, has been performing exceptionally badly in comparison with the rest of the world. The modest ideas currently proposed for restoring growth are inadequate to counter the deflationary effects of continuing contractionary fiscal policies.