EEAG

Report on the European Economy

2018
Vol. 17

What Now, With Whom, Where To – The Future of the EU

Macroeconomic Conditions and Outlook

Building Trust between Suspicious Minds

All Together Now:
The European Union and the Country Clubs

It's OK to Be Different:
Policy Coordination and Economic Convergence

EEAG European Economic Advisory Group @ CESifo

EUROPE econPOL

The European Economic Advisory Group (EEAG) analyses key economic policy issues of common European concern. It aims to offer the public and policymakers research-based insights. Taking into account the variety of perspectives within Europe, the group fosters bridge-building between research and policy as well as across European countries.

EEAG Report on the European Economy
ISSN 1865-4568 (print version)

A yearly journal on European economic issues
Publisher and distributor: CESifo Group Munich, Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 89 9224-0, Telefax +49 89 9224-1409, Email ifo@ifo.de
Editor: Lisa Giani Contini (giani-contini@ifo.de)
Reproduction permitted only if source is stated and copy is sent to the publisher.

Suggested citation
EEAG (2018), EEAG Report on the European Economy, CESifo, Munich

www.cesifo-group.de

Foreword

On the 55th anniversary of the Élysée Treaty, signed in January 1963 to mark France and Germany's post-war reconciliation, German Chancellor Angela Merkel and French President Emmanuel Macron drew a picture of a "prosperous and competitive Europe, more sovereign, united, and democratic". But a decade of economic and migration crises and Britain's decision to leave the European Union represent major stumbling blocks on the path towards ever closer ties and continuous enlargement of the European Union. This year's report by the European Economic Advisory Group (EEAG) at CESifo focuses on the causes and symptoms of, and possible cures to the current integration malaise.

The fundamental question arises what factors are holding societies together. As **Chapter 2** explains, interaction within and between nation-states is strongly shaped by trust. Trust enables economic, social, and political interactions both within countries and internationally. It is also instrumental in forging common social identities. It is strengthened when there is contractual security in a relationship; but it is also created by the simple existence of repeated and continuing interactions between people. The chapter discusses the historical origins of nation-states and their functionality, before analysing trust in the European context.

A founding principle of the European Union is that all member states and citizens should participate equally in a single process of ever closer integration. Exceptions have been made in the past, however, and more flexible structures have been proposed. The euro crisis, Brexit, and global geo-political trends now make it interesting to revisit the issue of whether European states should be able to subscribe to only some of the rights and obligations of membership, with policy-specific country groupings moving at variable speeds. This would solve some problems, but would also raise new issues of transparency and accountability of decision-making, free-riding, and heterogeneity of rights depending on residence. **Chapter 3** reviews these and other issues in the light of experience and of the theoretical insights and practical analogies afforded by viewing the European Union, and possible sub-entities within it, as 'clubs' of countries.

Economic convergence is an important political objective of the European Union, but there is a widespread view that the last decade has brought divergence. **Chapter 4** shows that income and employment have converged for some groups of member states and during certain periods. Both before and after the global financial and euro area debt crises, however, there has also been significant divergence in both economic outcomes like income levels and inputs, such as institutional quality. Inequality has also increased within some countries, eroding trust in the ability of national governments to provide social protection. The perceived distributional impact of economic integration also tends to undermine trust in European institutions.

As always, **Chapter 1** of the report contains an in-depth analysis of the economic situation of the European Union and other countries around the world, together with a forecast for the year ahead. Attention is also devoted to some of the major policy changes that have already been transposed into law, like the US tax reform, or that are taking shape, like a gradual normalisation of monetary policy.

The European Economic Advisory Group at CESifo, which is collectively responsible for all parts of the report, consists of seven economists from six countries. This year the Group is chaired by Giuseppe Bertola (University of Turin). The other members are Torben M. Andersen (Aarhus University), John Driffill (Yale-NUS College), Harold James (Princeton University), Jan-Egbert Sturm (KOF Swiss

Economic Institute, ETH Zurich), Branko Urošević (University of Belgrade), and myself (ifo Institute and University of Munich).

I would like to express my gratitude for the valuable assistance provided by the scholars and staff at CES and ifo who helped to prepare the report. This year's participants were Felix Hugger and Daniel Stöhlker (assistants to the group), Christian Grimme (economic forecast), Lisa Giani Contini (editing), Inge Kunz, Annika Lorenz, Christiane Nowack (graphics), Katharina Pichler and Elisabeth Will (typesetting), and Ines Gross (cover). I also wish to extend my warmest thanks to Swiss Re for hosting our September meeting in Zurich.

Clemens Fuest
President, CESifo Group
Professor of Economics and Public Finance
Ludwig Maximilian University Munich

Munich, 26 February 2018

CONTENTS

RECOMMENDATIONS FOR EUROPE 6

EXECUTIVE SUMMARY 7

CHAPTER 1 MACROECONOMIC CONDITIONS AND OUTLOOK 10

The global economy has moved from recovery mode to a pronounced upturn. Output gaps in the euro area and the United States are expected to close soon, if they have not done so already. East and Southeast Asia are also making strong contributions. The Chinese and the Japanese economies expanded strongly in 2017, both fuelled by economic stimuli. In Latin America, the recovery was dampened by slow economic development in Brazil and the aftermath of the devastating earthquakes in Mexico. India's economy is regaining its footing. The global upturn is likely to continue for a while, before gradually slowing down as factors of production become increasingly over-utilised, particularly in North America and in Europe.

CHAPTER 2 BUILDING TRUST BETWEEN SUSPICIOUS MINDS 35

Trust is crucial to hold societies together. As for nation-states, trust in the European Union can be strengthened by contractual security, as well as by repeated and continuing interactions between people. In the absence of sufficiently high levels of trust, pooling resources across national boundaries may be perceived as painful and can erode, rather than build up a common identity. This chapter discusses the importance and development of trust both between people and in national and European institutions.

CHAPTER 3 ALL TOGETHER NOW: THE EUROPEAN UNION AND THE COUNTRY CLUBS 47

A founding principle of the European Union is that all member states and citizens should participate equally in a single process of ever closer integration. The euro crisis, Brexit and global geo-political trends make it interesting to revisit the issue of whether more flexible structures might be more promising. By comparing supranational groupings to country clubs, this chapter examines the pros and cons of a potential reconfiguration of the euro area, the Schengen Agreement, and the European Union. This chapter argues that while a multi-speed and variable geometry approach would solve some problems, it would also raise new issues of transparency and accountability of decision-making, free-riding, and the heterogeneity of rights depending on residence.

CHAPTER 4 IT'S OK TO BE DIFFERENT: POLICY COORDINATION AND ECONOMIC CONVERGENCE 64

Convergence has long since been one of the key goals of the European Union. As this chapter shows, however, convergence has not yet been achieved in many areas, most evidently in the case of income and employment levels, as well as for policies and institutional quality, undermining trust in European institutions. At the same time, diversity is natural and valuable, and policies need to be targeted to country-specific circumstances. Policy coordination at the European level can pave the way for necessary reform by providing information and encouraging dialogue, but within the existing institutional setup, economic convergence mainly hinges on the policies adopted by the member states.

Authors: The Members of the European Economic Advisory Group at CESifo

The views expressed in this report are those of the authors and do not necessarily reflect those of the institutions they are affiliated with.

TABLE OF CONTENTS

RECOMMENDATIONS FOR EUROPE 6

EXECUTIVE SUMMARY 7

1. MACROECONOMIC CONDITIONS AND OUTLOOK 10
- 1.1 Introduction 10
- 1.2 Current Situation 10
  - 1.2.1 Global Economy 10
  - 1.2.2 United States 12
  - 1.2.3 Asia 14
  - 1.2.4 Latin America and Russia 14
  - 1.2.5 Europe 15
- 1.3 Fiscal and Monetary Policy 18
  - 1.3.1 Fiscal Policy 18
  - 1.3.2 Monetary Conditions and Financial Markets 20
- 1.4 Macroeconomic Outlook 25
  - 1.4.1 Assumptions, Risks, and Uncertainties 25
  - 1.4.2 Global Economy 26
  - 1.4.3 United States 27
  - 1.4.4 Asia 28
  - 1.4.5 Latin America and Russia 28
  - 1.4.6 Europe 29

Appendix 1.A: Forecasting Tables 33

2. BUILDING TRUST BETWEEN SUSPICIOUS MINDS 35
- 2.1 Introduction 35
- 2.2 History 35
- 2.3 Reform Initiatives and International Order 37
- 2.4 Trust among Europeans 38
  - 2.4.1 The Impact of Trust on International Trade and Economic Integration 40
  - 2.4.2 Trust in Relationships between States 40
- 2.5 Coordination 42
- 2.6 Attitudes towards a Multi-levelled European Political Entity 43
- 2.7 The Enlargement Process 45

3. ALL TOGETHER NOW: THE EUROPEAN UNION AND THE COUNTRY CLUBS 47
- 3.1 Introduction 47
- 3.2 Governments and Clubs 48
  - 3.2.1 What Governments Do and Where 48
  - 3.2.2 Club Goods 48
  - 3.2.3 Good and Bad Clubs 49
- 3.3 Countries and Clubs 50
  - 3.3.1 Clubs within States 50
  - 3.3.2 Country Clubs in Europe 51
  - 3.3.3 The European Union as a Club 51

3.4 Speeds of Europe 52
3.4.1 Opt-outs 53
3.4.2 Enhanced Cooperation and PESCO 53
3.5 Geometry Variation in the Past 53
3.5.1 The Currency Club 53
3.5.2 The Borderless Club 58
3.6 Paths Forward 59
3.6.1 Integration Needs and Ways 60
3.6.2 Smaller Clubs 60
3.6.3 Defence Anybody? 61
3.6.4 A Better and maybe Smaller Club 61

4. IT'S OK TO BE DIFFERENT: POLICY COORDINATION AND ECONOMIC CONVERGENCE 64
4.1 Introduction 64
4.2 What is Convergence? 65
4.3 Outcome Convergence in the European Union 65
4.3.1 Convergence of per Capita Incomes across EU Member States 65
4.3.2 Labour Market Convergence 66
4.3.3 Inequality 69
4.4 Convergence in Policies and Institutions 70
4.4.1 Convergence in Public Sector Size and Tax Structures 71
4.4.2 Convergence in Institutional Quality 72
4.5 Economic Convergence in the European Union: Where Do We Stand? 74
4.6 What Does the European Union Do to Support Economic Convergence? 74
4.6.1 The EU Budget 75
4.6.2 How Successful is the EU's Cohesion Policy? 75
4.6.3 The European Semester 76
4.6.4 The European Social Pillar 77
4.7 Conclusions and Policy Recommendations 80

LIST OF FIGURES, TABLES, AND BOXES 83

THE MEMBERS OF THE EUROPEAN ECONOMIC ADVISORY GROUP 85

PREVIOUS REPORTS 89

RECOMMENDATIONS FOR EUROPE

- Low levels of trust are both a cause and a consequence of institutional weakness and opportunistic behaviour. Trust is fostered by reliable information and shared expectations of long-lasting repeated interactions. Such tools have been deployed by European nation-states in the past and should continue to be implemented in the European Union.

- Results that fall short of excessively optimistic promises undermine trust. Trust can and should be rationally supported by a realistic narrative that convincingly highlights the advantages of a future together and the perils of alternative arrangements.

- To reinforce trust, international policy integration should define rights and responsibilities clearly, which can be easier when it is focused on specific areas such as defence. It should also ensure cooperative behaviour, which is easier in a comprehensive policy framework with limited opt-outs. Commitment and cooperation can be self-enforcing when members are in a position to trade-off advantages and disadvantages. Short-sighted opportunistic behaviour would be difficult to control in fragmented and unstable 'Europe à la carte' institutional structure.

- While the heterogeneity of policy preferences is stronger in a larger group of countries, it can be dealt with more effectively when a broader set of policies is negotiated. A clear case can be made for deeper integration in public good policy areas like customs administration, border controls, common immigration visa, and defence. Extending supranational competences to the harmonisation of social policy could, however, weaken trust in an integration process that cannot realistically deliver results in such areas.

- Economic integration does not automatically imply income and policy convergence, but its politico-economic sustainability is threatened by a lack of convergence. To prevent resentment against integration, it should be recognized that, in the current institutional setting, the EU's policy toolbox cannot foster cohesion: convergence depends mostly on the policies of the member states.

- Economic integration offers valuable opportunities for development, but requires policy adjustments that can be difficult for countries to implement. Policy coordination at the European level can pave the way for necessary reform by providing information and encouraging dialogue. It should focus on areas where the effects of national policies spill over country boundaries, and involve national institutions to improve the quality of information and ensure that recommendations get a favourable public reception.

EXECUTIVE SUMMARY

The report begins with its usual review of the economic conditions and outlook in Europe and the world. Both are benign at present, but a decade of economic and migration crises and Britain's decision to exit pose a strong challenge to the previous path of ever closer union and bold enlargement in Europe. The other three chapters of this year's EEAG report focus on the symptoms and possible cures of the current integration malaise in Europe. One chapter highlights the role of trust in allowing not only national and supranational organisations, but all human societies to function, and analyses the sources of the current lack of trust in international dialogue. The next chapter reviews the role of admission criteria and governance rules in the operation of clubs that supply services to their members within states, and of the club-like groups of states that supply various public policies within Europe. The final chapter considers economic convergences across EU countries and discusses which public policies are indeed suitably organised at the EU level, and whether and how those policies may reduce, or be hindered by, the member countries' heterogeneity.

CHAPTER 1
Macroeconomic Conditions and Outlook

The global economy has moved from recovery mode to a strong upturn. The robust development of private consumption and a considerable increase in investment in advanced economies has made a major contribution to current global economic expansion. Output gaps in the euro area and the United States are expected to close soon or are already fully closed, while strong contributions are also coming from East and Southeast Asia. The Chinese economy and the Japanese economy expanded strongly, both fuelled by economic stimulus. In Latin America, the recovery was dampened by the sluggish economic recovery in Brazil and the aftermath of the devastating earthquakes in Mexico. In India, the economy is regaining footing after a banknote demonetisation and a reform of the VAT system.

In recent years, the low interest rate environment has promoted financial leverage and stimulated investors to go into riskier assets in search of higher yields. Stock market valuations in some European countries and in the United States are at historic highs and yields on speculative-grade bonds are extremely low. While the Japanese central bank continues to stick to its ultra-expansionary monetary policy, the European Central Bank has halved its bond purchases and is expected to increase the interest rate in 2019 and the US Federal Reserve is already on the path to normalisation.

The gradual flattening of the yield curve in the United States is a sign of financial market concern about future developments. Flat yield curves have been reliable empirical predictors of imminent economic downturns in the past. Interest rates increases can trigger excessive loan defaults and major distortions in financial markets if implemented too hastily. However, the size of assets at risk of default is nowhere near as high as it was prior to the last financial crisis in 2007, and the financial system has become much more resilient. This decreases both the likelihood and the impact of future crises.

The global upturn is likely to continue for a while and gradually slow down as factors of production become increasingly over-utilised in North America and in European countries that have been experiencing relatively strong growth after the crisis. In the latest ifo World Economic Survey both the assessment of the current situation and the expectations for the upcoming six months regarding economic developments are postive and still rising in the advanced economies. Whereas some developing and emerging countries assess the current situation negatively, most of these look optimistically into the future, as they are likely to benefit from a revival in world trade and the recovery in commodity prices.

CHAPTER 2
Building Trust between Suspicious Minds

Trust is one of the most important elements that hold societies together. It enables economic, social, and political interactions both within countries and internationally. It is strengthened when there is contractual security in a relationship, but also by repeated and continuing interactions between people. Sovereign nation-states historically relied on strong levels of trust within their boundaries. But their policies and economic success or failure clearly impacts conditions beyond those boundaries. Those spill-overs call for coordination between nation-states, which requires trust, and is not necessarily compatible with the philosophy of the nation-state and with choices made by citizens in the national context.

As in nation-states, a common legal infra-structure and common symbols (such as flags, coins,

or banknotes) aim to strengthen a sense of identity in the European Union that was also built in nation-states by pooling resources through social welfare schemes. The globalisation of economic activity has over time made states that were the right size for social protection too small to contain and regulate markets that increasingly involve complex value chains rather than just trade in goods. In the absence of a sufficiently high level of trust, pooling resources across national boundaries may be perceived as painful and destructive extraction, and could erode rather than build common identity.

The extent to which Europe can be integrated into a functional community of nations is greatly influenced by how different nations view themselves and each other, as well as by trust or distrust in national and European institutions. Empirical measures of trust vary greatly within and across European countries in ways that can be explained not only by ethnic and linguistic factors, but also by the quality and prestige of institutions, and especially by familiarity: countries that are long-standing members of the European Union are trusted more than recent members and non-members. From this perspective, the rapid enlargement of the European Union is a double-edged sword. It can increase familiarity, reduce negative stereotyping, and dismantle the hidden barriers that a lack of trust implies for economic cooperation. Increasing diversity, however, can strengthen suspicion and reduce trust. The next two chapters examine whether trust might be built up by plural arrangements ('clubs') that ease issues coordination among heterogeneous states, or by convergence processes that reduce heterogeneity over time.

CHAPTER 3
All Together Now: The European Union and the Country Clubs

A founding principle of the European Union is that all member states and citizens should participate equally in a single process of ever closer integration. Exceptions have been made, however, and more flexible structures were proposed after the fall of the Berlin Wall and in the run-up to the introduction of the euro single currency. The euro crisis, Brexit, and global geo-political trends now make it interesting to revisit the issue of whether European states might subscribe to only some of the rights and obligations of membership.

Supranational groupings of countries are in many ways like the clubs that within states provide facilities to their members and exclude non-members. In both cases, member selection and internal governance should be consistent with each other and with functional goals. Inspection of the euro area, the Schengen Agreement, and the European Union itself suggests that the mixed performance of those 'country clubs' is better explained by governance problems than by misguided membership criteria.

The lessons from those experiences can be brought to bear on how international clubs may be improved and possibly extended to other policy areas. One might envision policy-specific country groupings that move at variable speeds towards one final steady state, or crystallise into a multiple club geometry. That structure could be more flexible and focused than the European Union. Clearly defining and enforcing effectively the rights and obligations of members, however, can be difficult for small single-purpose clubs. Heterogeneous members may disagree strongly on a single issue. This may very well prove more problematic in smaller clubs: one formed by just France and Germany, for example, would in some key respects be most heterogeneous. Hence, a single-policy club cannot do much without implementing compensatory transfers, or enforcing decisions that will make minorities unhappy and eager to leave.

A comprehensive and stable policy-making framework allows advantages and disadvantages to balance out across policy areas as well as over time, and the resulting give-and-take opportunities make it more stable and effective than a plethora of single-policy clubs. Effective governance is better supported by giving states a voice in well-informed discussions among members of a large and permanent Union than by the possibility of exit (or expulsion) from more flexible clubs. Not all countries need join a single convoy of European states, but there were, and still are, good reasons for one such convoy to be formed.

CHAPTER 4
It's OK to Be Different: Policy Coordination and Economic Convergence

The fact that trust plays a crucial role in ensuring stability and effectiveness of policy-making institutions means that they should, in turn, be structured and operate in ways that rationalise and strengthen trust. Some of the EU's current woes may be traced back to the trust-eroding effects of misleading information and unrealistic promises.

The European Union is officially supposed to "aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions." Income and employment have converged for some groups of member states and during certain periods. Both before and after the global financial and euro area debt crises, however, there was significant divergence in those dimensions and in policies and indicators of institutional quality. Inequality has also increased within countries, eroding trust in the ability of national governments to provide social protection, and the distributional impact of economic integration tends to undermine trust in European institutions too.

Neither economic theory nor historical experience suggest that economic integration automatically implies convergence of economic outcomes, or of

institutional and policy inputs: diversity is natural and valuable, and policies should be adapted to specific circumstances.

The European Union does aim to support economic convergence with regional and structural funds, which, however, have a limited impact on the economic development of the receiving regions. It may be possible to improve their effectiveness, but increasing regional transfers is unlikely to spur convergence. History shows that even countries with strong national institutions and considerable fiscal redistribution across regions have often been unable to bring about economic convergence between rich and poor regions. In the existing institutional setup, economic convergence depends mostly on the policies of the member states. The European Semester policy coordination process aims to raise awareness of the cross-border European implications of national policies. Implementation of the resulting recommendations, however, is politically difficult at the national level where public debate and democratic control currently takes place.

Giving the European Union additional competences in areas where national economic policies generate large spill overs can be helpful, but may blur responsibilities and allow national politicians to blame Europe for poor results primarily caused by the shortcomings of national policies. The European Union can easily undermine trust in its own effectiveness if its cohesion and coordination initiatives are not equipped with the instruments needed to deliver results, and its policy recommendations lack political ownership and legitimacy at the national level.

Macroeconomic Conditions and Outlook

1.1 INTRODUCTION

The global economy has moved from recovery mode into a strong upturn. Supported by the robust development of private consumption and a marked increase in investment, in particular advanced economies made a major contribution to the current wave of global economic expansion. Output gaps in the euro area and the United States are expected to close soon or have already done so. Strong contributions are also coming from East and Southeast Asia. The Chinese economy and the Japanese economy expanded strongly, both fuelled by economic stimuli. In Latin America, the recovery was dampened by the sluggish economic recovery in Brazil and the aftermath of the devastating earthquakes in Mexico. In India, the economy is regaining its footing after a banknote demonetisation and a VAT system reform.

Monetary divergence between the major economic regions continues. While the Japanese central bank continues to stick to its ultra-expansionary monetary policy, the US Federal Reserve is already on the path to normalisation. At the start of the year, the European Central Bank (ECB) halved its bond purchases and a first interest rate hike is expected in 2019. This slow pace is driven by experiences of past economic crises. These have shown that a hasty increase in interest rates can lead to excessive loan defaults and, as a result, to major distortions in financial markets. On the other hand, the low interest rate environment of recent years has promoted financial leverage and encouraged investors to go into riskier assets in search of higher yields. From a historical perspective, stock markets in some European countries and in the United States appear overvalued. Yields on highly speculative bonds are also extremely low at present. The gradual flattening of the yield curve in the United States indicates that there are concerns in financial markets about future developments. In the past, flat yield curves were reliable indicators of an imminent economic downturn. However, the size of default risk assets is nowhere near as high as it was prior to the last financial crisis in 2007. In addition, the financial system has become much more resilient, which decreases both the likelihood and the impact of financial market crises. Moreover, given the experience of the Great Recession and the European debt crisis, central banks have a greater willingness to respond quickly in the event of financial turbulence.

The global upturn is likely to continue for a while, and will gradually slow down. The expansion in Europe and North America will also weaken over the forecast horizon, as the factors of production in these regions will be increasingly over-utilised. This view is also supported by the results of the latest ifo World Economic Survey. In the advanced economies both the assessment of the current situation as well as the expectations for the upcoming six months regarding economic developments have continued to rise in recent quarters. Whereas some developing and emerging countries still assess their current situation negatively, they also look optimistically into the future. They are likely to benefit from a revival in world trade and the recovery in commodity prices.

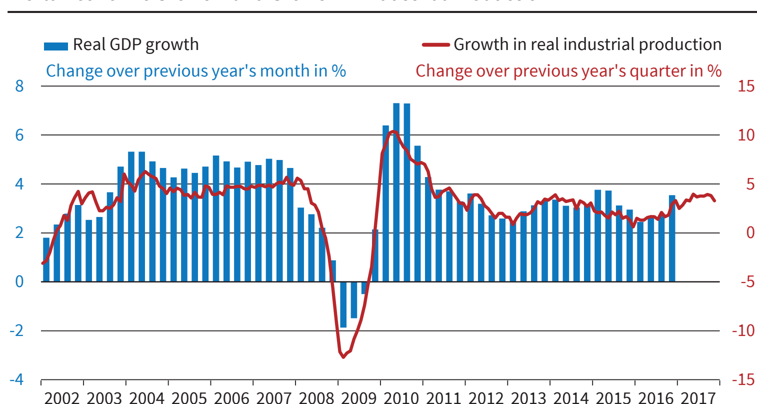
1.2 CURRENT SITUATION

1.2.1 Global Economy

After the Great Recession and a swift initial recovery in 2010, the global economy remained in moderate growth mode until last year. Whereas in 2012/13 the euro crisis and in 2016 lower than expected growth in the United States and recessionary trends in commodity-exporting emerging economies like Russia and Brazil kept the world economy from growing faster, last year all major regions benefited from a global economic upswing. The pace of expansion increased

Figure 1.1

World Economic Growth[a] and Growth in Industrial Production



[a] Purchasing Power Parity (PPP) weighted aggregate year-over-year real GDP growth rate.
Source: IMF International Financial Statistics; CPB Netherlands Bureau for Economic Policy Analysis; last accessed on 27 January 2018.

© CESifo

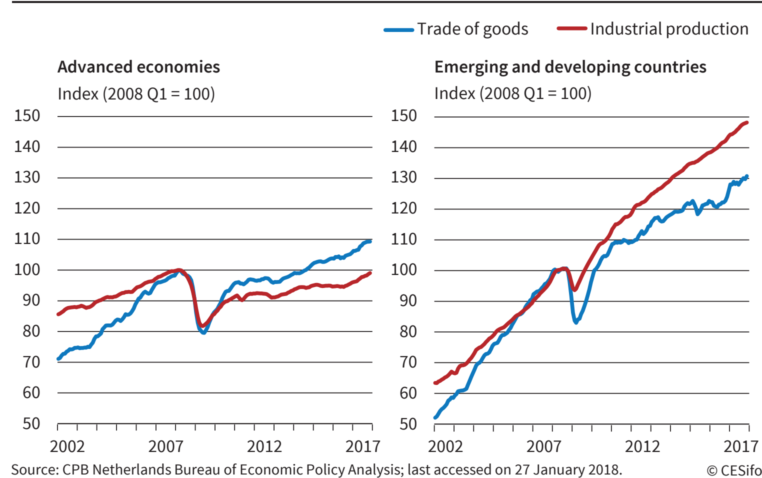
EEAG (2018), "Macroeconomic Conditions and Outlook"
EEAG Report on the European Economy, CESifo, Munich, pp.10–34.

markedly during 2017 and real GDP increased in the second half of 2017 at an annualised change of about 3.5%, compared to a rate of just above 3% in the first half of the year. A main driver of the upturn is industrial production in both advanced economies and emerging economies (see Figure 1.1). After a pronounced period of weakness in 2015 and 2016, it accelerated significantly until early summer 2017, and has since expanded at largely unchanged high growth rates.

Global commodity trading gained momentum too. Although emerging markets were the main drivers of this recovery, the international exchange of goods also accelerated in the advanced economies. Despite a strong upturn at the end of 2016, trade growth has been well below industrial production growth in emerging and developing countries since 2011 (see Figure 1.2). This remarkable change as compared to the pre-crisis period and relative to the advanced economies, where an increase in industrial production goes hand in hand with a disproportionate increase in commodity trading, is most probably related to China: As it moves up in the global value chain, the foreign content of China's exports is diminishing. World trade and world GDP are expected to have increased by 4.4 and 3.2% respectively last year (see Table 1.A.1). Both figures imply a substantial increase as compared to 2016 (1.4 and 2.5%). This acceleration is almost equally due to emerging and advanced economies.

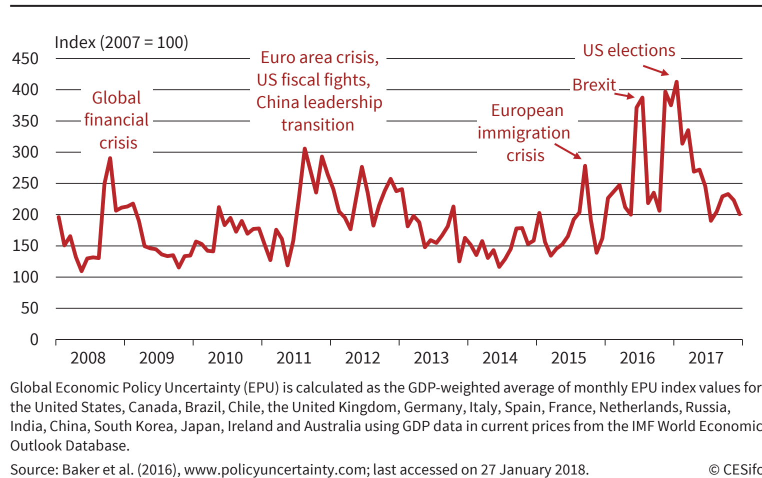
Economic growth has largely accelerated due to the waning importance of a large number of risks over the course of last year (see Figure 1.3). The long-feared slump in China, for example, has still not materialised, mainly because domestic demand has proven robust. The implementation of far-reaching economic policy measures in the United States has also failed to date for various reasons. Although the Brexit vote slowed economic development in the United Kingdom, there has not yet been any slide back into a recession or any clear negative feedback from major British trading partners. In the parliamentary elections in the Netherlands, France, and Germany, Eurosceptic parties won fewer votes than feared, meaning that the European Union did not suffer any further losses in political stability.

Figure 1.2
Trade and Industrial Production in Advanced and Emerging Economies



Source: CPB Netherlands Bureau of Economic Policy Analysis; last accessed on 27 January 2018. © CESifo

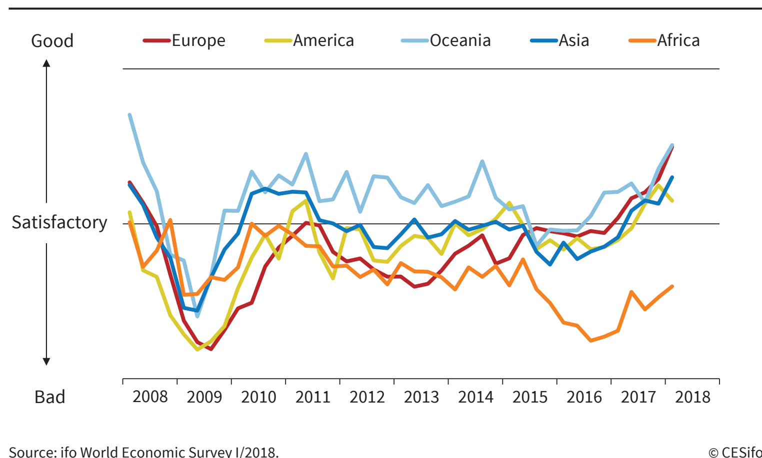
Figure 1.3
Global Economic Policy Uncertainty Index



Global Economic Policy Uncertainty (EPU) is calculated as the GDP-weighted average of monthly EPU index values for the United States, Canada, Brazil, Chile, the United Kingdom, Germany, Italy, Spain, France, Netherlands, Russia, India, China, South Korea, Japan, Ireland and Australia using GDP data in current prices from the IMF World Economic Outlook Database.

Source: Baker et al. (2016), www.policyuncertainty.com; last accessed on 27 January 2018. © CESifo

Figure 1.4
ifo World Economic Survey
Economic situation



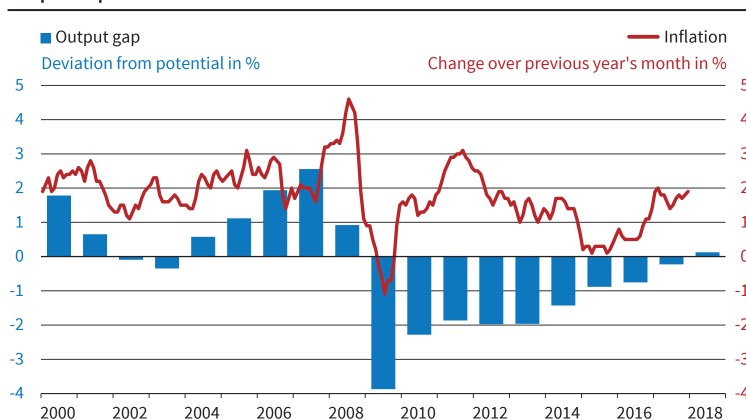
Source: ifo World Economic Survey I/2018. © CESifo

Against this background, companies and households' expectations have brightened more than originally anticipated and the global economic momentum has consolidated. By and large economic sentiment in most parts of the world improved clearly over the course of last year. With the exception of Africa, all continents are now clearly performing well above average indicating the excellent economic conditions that are prevailing in most parts of the world. Although the economic situation in Africa has improved, it is still at a historically low level (see Figure 1.4).

Inflation rates, albeit still moderate, picked up compared to the two preceding years. After falling into a trough in 2015, inflation rates in most parts of the world have increased steadily since. This is particularly true for the advanced economies. The recovery in inflation rates was mainly due to an increase in crude oil prices (see Figure 1.5), which was due to both restrictions imposed by OPEC countries on the supply side, and the global economic recovery on the demand side.

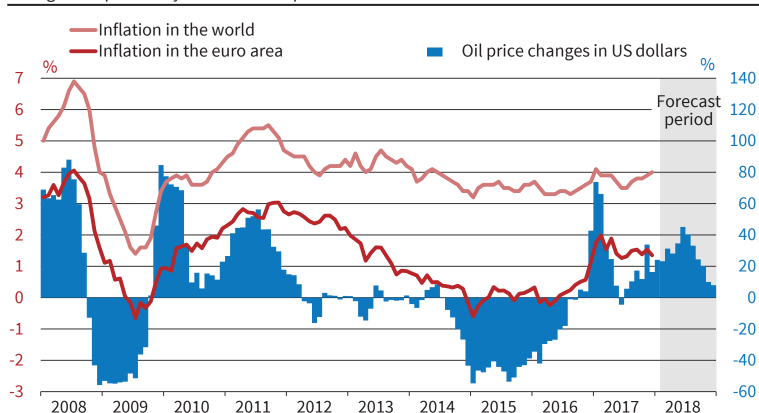
By contrast, core inflation rates, which measure the increase in consumer prices without taking the volatile energy and food price components into account, have more or less moved laterally in most advanced economies. There is a considerable amount of slack in inflation after the protracted period of capacity underutilization following the Great Recession. The closure of output gaps in advanced economies last year has not yet put pressure on prices (see Figure 1.6).

Figure 1.5
Output Gap and Inflation in Advanced Economies



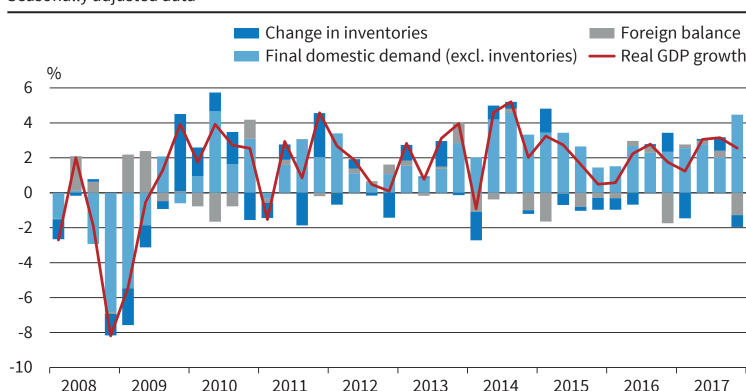
Source: IMF World Economic Outlook, IMF International Financial Statistics; last accessed on 27 January 2018. © CESifo

Figure 1.6
Inflation in the World and Oil Price Movements
Change over previous year's month in percent



Note: Forecast for 2018 based on the assumption that oil prices remain steady from January 2018 onwards.
Source: IMF International Financial Statistics; last accessed on 27 January 2018. © CESifo

Figure 1.7
Contributions to GDP Growth[a] in the United States
Seasonally adjusted data



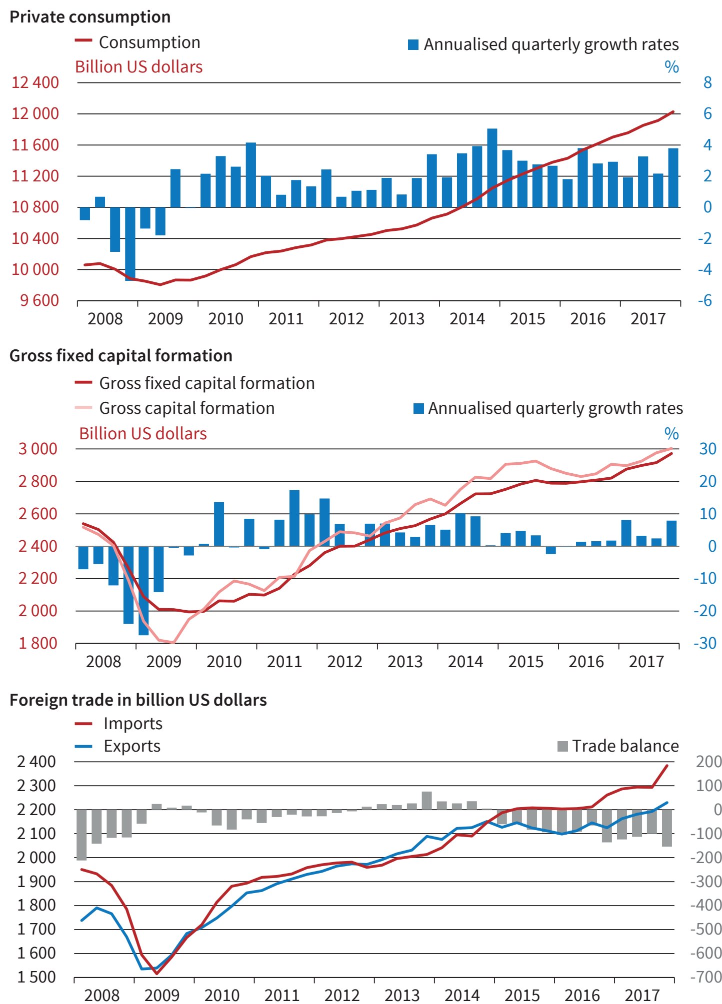
[a] Annualised quarterly growth.
Source: US Bureau of Economic Analysis; last accessed on 27 January 2018; EEAG calculations. © CESifo

1.2.2 United States

After weak growth during the winter 2016/17, the United States experienced a strong upturn during the summer half of 2017 with GDP growth rates of above 3% (see Figure 1.7). Although private consumption and investment activity were dampened in the third quarter by the impact of hurricanes in Texas and Florida, businesses steadily stocked up. In addition, the public sector intervened on a supporting basis. As a result, the output gap estimated by the Congressional Budget Office has closed and the US economy has entered a boom, reaching an overall growth rate of 2.3% in 2017.

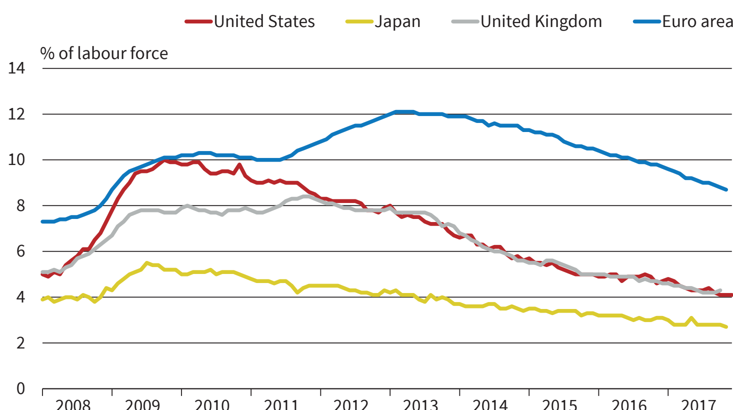
Despite some volatility during the year, mainly due to the weather-related fall in demand in August

Figure 1.8
Business Cycle Developments in the United States
In constant prices, seasonally adjusted and work-day adjusted



Source: US Bureau of Economic Analysis; last accessed on 27 January 2018. © CESifo

Figure 1.9
Unemployment Rates



Source: OECD; last accessed on 27 January 2018. © CESifo

and subsequent greater demand for motor vehicles and spare parts, private consumption contributed strongly to overall growth last year. Public spending, on the other hand, basically stagnated throughout 2017. A strong uplift in national defence and disaster relief expenditure during the second half of the year and moderate increases in state and local government expenditure did not compensate for the austerity measures initiated by the Trump administration at the federal level.

Throughout the year, gross fixed capital formation increased by around 3%. However, clear differences emerged between its construction and equipment components. While equipment investment continued to perform strongly throughout the year, growth in both residential and commercial construction remained weak. Inventory investment increased during the second half of the year, mainly due to a strong build-up of inventories in wholesale trade. Although exports benefited from the weakening of the US dollar in spring, the strong domestic economy circumvented the trade balance from significantly improving during the course of the year (see Figure 1.8).

Despite natural disasters, the US labour market continued to tighten throughout the year. Unemployment rates fell from 4.8% at the beginning of 2017 to 4.1% at the end of the year, reaching the lowest level since the turn of the millennium (see Figure 1.9). Decreasing slack in the labour market is also visible in a stable labour force participation ratio, which occurs in spite of the demographic changes associated with an ageing and a slower-growing population. The high utilisation of the production factor labour is however still barely noticeable in wage dynamics.

Consumer prices have recovered from a short setback in the summer of 2017 during which inflation rates fell well below 2%. Although inflation rates measured by both the CPI and the personal consumption expenditure deflator have subsequently recovered, this is not yet the case for the respective versions that exclude energy and food prices.

1.2.3 Asia

The *Chinese* economy overall continued to grow with rates hovering close, but below, 7% last year. The production side picture has remained stable: the manufacturing and transport sectors increased significantly. Both benefited from the fiscal stimulus initiated in the second half of 2016. By contrast, construction activity remained relatively weak as a result of more restrictive monetary policy and tighter housing market regulations, including those on the acquisition of second homes. Economic momentum in China only slowed slightly during the second half of the year. The manufacturing sector expanded somewhat more weakly than before, as did the transport sector, with fiscal stimulus lessening somewhat over time. However, this slowdown was offset by higher growth in other service sectors, notably in the financial sector.

With the expiry of stimulus measures adopted during the Great Recession, producer prices in the industrial sector turned clearly negative. The deflationary trend that started back in 2012 reflects both the ongoing productivity gains in some areas of the Chinese economy, as well as substantial overcapacities in many state-owned operations like the steel, coal, and cement industries. These falling producer prices helped keep consumer prices relatively low for emerging market standards. The renewed fiscal stimulus in 2016 not only resulted in a revival of the real economy, it also fuelled producer prices. Not least because of lower food prices at the beginning of 2017, which have temporarily slowed consumer price inflation noticeably, while the latter have only been affected slightly to date. Core inflation rose from around 1.5% in the first half of 2016 to 2.2% in December. Overall inflation lagged somewhat behind the core rate at 1.8% at the end of last year. For the year 2017 as a whole, the inflation rate turned out to be 1.5%.

The *Japanese* economy is also benefiting from the world economic upswing. Since the beginning of 2016 its GDP has been growing at an annualised average rate of 1.9%, resulting in an estimated GDP growth rate of 1.8% for 2017. Although public investment did play a part, private economic activity, both residential and non-residential investment activities, and strong export growth, were the main drivers behind this upswing. Private and public consumption remained subdued in this respect. Despite the strong economy, price pressure as measured by both the GDP deflator and consumer prices remained low. Core inflation even fell back to 0% early last year, before recovering slightly again during the second half of 2017.

During most of last year, the *Indian* economy was held back by special economic effects. A cash reform towards the end of 2016 led to liquidity bottlenecks in the heavily cash-based small business sector. The introduction of a nationwide Goods and Service Tax (GST) system last June also hampered economic activity. Although the new GST system remains relatively complicated, both reforms are nevertheless likely to increase medium- to long-term growth potential. The massive monsoon rains in some regions put pressure on the economy in the form of crop failures and food price spikes during the second half of last year. All in all, this resulted in a below potential growth rate of 6.2% for 2017. Not only the relatively weak economy, but also a one-off drop in food prices in summer, lowered the annual inflation rate from 4.9% in 2016 to 3.3% last year.

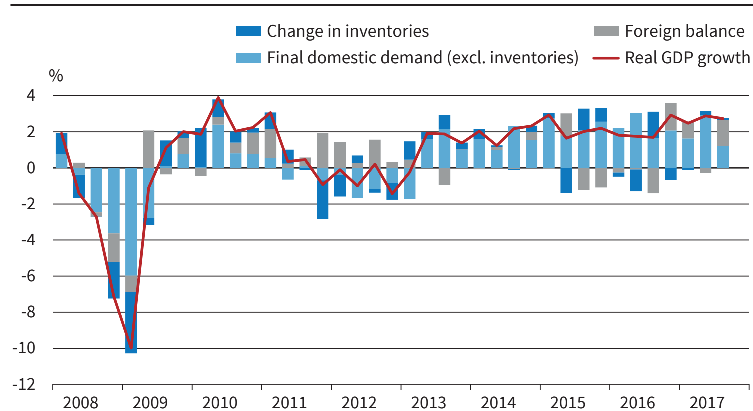
GDP growth in the remaining East and Southeast Asian economies (*Hong Kong, South Korea, Taiwan, Indonesia, Malaysia, Philippines, Singapore,* and *Thailand*) has been strong since the end of 2016. While consumption rose sharply at the end of last year, investments are gradually flattening out. In Taiwan investment even fell for two quarters in a row last year. Exports, which had delivered high levels of expansion until the winter of 2016/17, remained weak or even declined significantly in the case of Indonesia. With the structural weakening seen in the Chinese economy since 2012, massive export growth appears to have become a thing of the past for this region.

1.2.4 Latin America and Russia

In Latin America, the upswing was dampened by the sluggish economic recovery in Brazil and the aftermath of the devastating earthquakes in Mexico. The regional economy nevertheless gained momentum and the recovery started to become more broadly based. Whereas the business situation and consumer confidence in *Mexico* were able to quickly recover from the setback following the US presidential election and the significant appreciation of the Mexican peso, two major earthquakes in September caused a negative growth rate for the third quarter of 2017. The increased inflation dynamics forced the Banco de Mexico, the central bank of Mexico, to increase its overnight interbank rate in five steps from 5.75% at the beginning of 2017 to 7.25% by the end of the year. The inflation rate nonetheless more than doubled from 2.8% in 2016 to 6% last year. The economies of *Colombia, Ecuador, Peru, Bolivia,* and *Chile* regained some momentum following a weak beginning to the year. The continued subdued development of prices for industrial metals and agricultural goods has held these countries back in their expansion. *Brazil* finally came out of a two-year recession in spring of last year. The recovery is largely due to foreign trade and consumer spending, which benefited from a slight improvement in the labour market and stronger consumer sentiment. The recovery, however, is still shaky. Any renewed allegations of corruption against the government could raise political uncertainty, curbing consumer confidence and deterring foreign investors. GDP growth is expected to have been 1.1% last year.

At the end of 2016, the *Russian* economy moved out of recession and gained momentum until mid-2017. During the second half of the year, the economic recovery decelerated. This slowdown was mainly due to developments in the health sector, social services and the construction sector, as well as the manufacturing industry. Nevertheless, after two years of negative growth rates, the Russian economy is likely to have expanded again at a growth rate of 1.9% last year.

Figure 1.10
Contributions to GDP Growth[a] in the European Union
Seasonally adjusted data



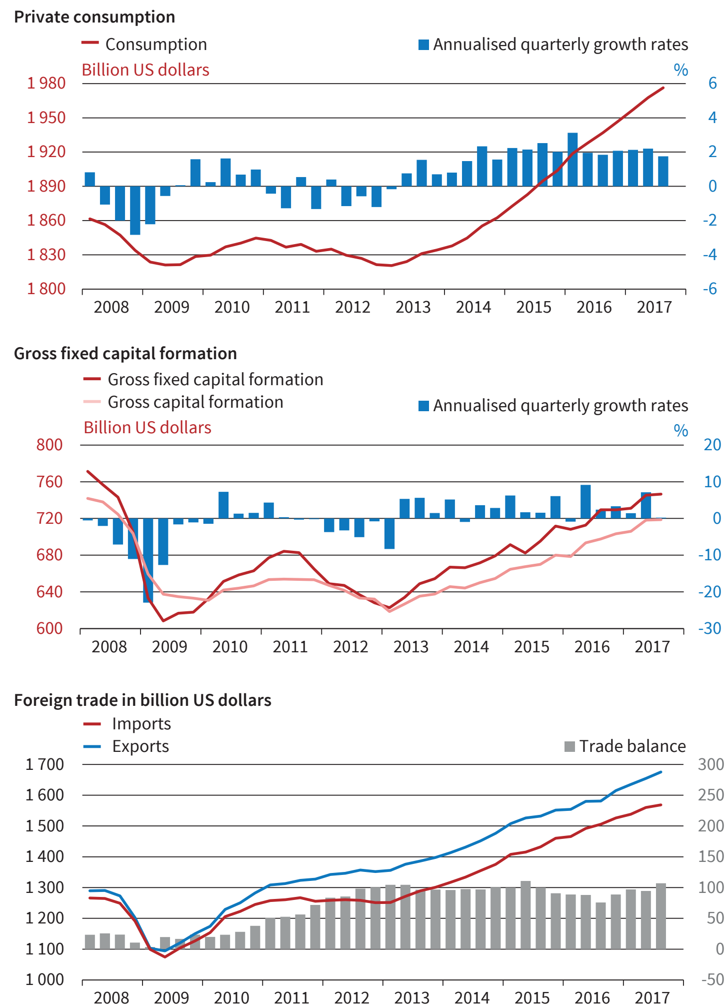
[a] Annualised quarterly growth.
Source: Eurostat; last accessed on 31 January 2018; EEAG calculations. © CESifo

1.2.5 Europe

Cyclical Situation

As of the fourth quarter of 2016, the European economy shifted into a higher gear. Up until then, annualised GDP growth rates averaged less than 2% since the end of the recession in the second quarter of 2013. Looking at the last four quarters, this average increased to 2.6%. Hence, the European economy moved from recovery into a strong upswing mode (see Figure 1.10). Although domestic demand's contribution to growth increased, the turnaround in external trade was largely responsible for this acceleration. While import growth on average surpassed export growth between 2013 and 2016, indicating a largely domestically-driven recovery, this has changed in recent quarters. Both the booming world economy and the low valuation of its currencies have created an environment in which foreign trade is contributing positively to economic growth in the European Union.

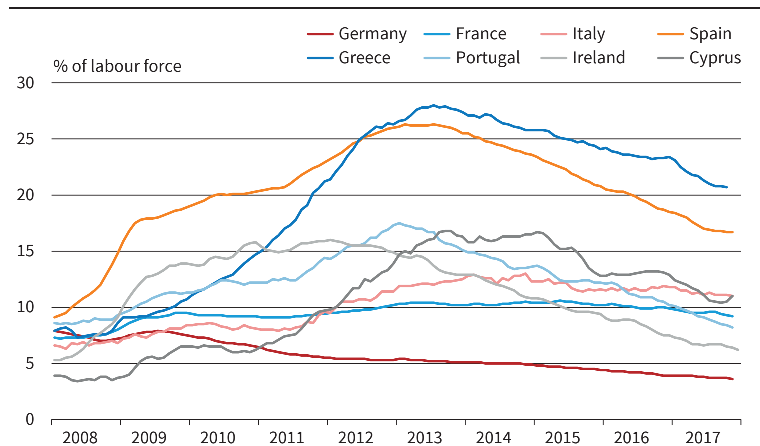
Figure 1.11
Business Cycle Developments in the European Union
In constant prices, seasonally adjusted and work-day adjusted



Source: Eurostat; last accessed on 29 January 2018. © CESifo

In addition to foreign demand, the economic upswing continues to be fuelled by private consumption and especially investment (see Figure 1.11). Slow progress with reforms of the European Union and member state specific labour and product markets, the only gradually improving budgetary situation of EU governments, as well as concerns about Brexit, migration flows, and populist movements all no longer appear to be having a strong negative impact on business confidence in Europe. Almost full use of production potential and a bright economic outlook within a still very low interest rate environment is now sparking a willingness

Figure 1.12
Unemployment Rates in Selected Euro Area Countries



Source: Eurostat; last accessed on 27 January 2018. © CESifo

among firms to invest. Although public consumption continued to contribute positively, its growth rates have moderated slightly in recent quarters.

The gradual downward trend in European unemployment continued throughout 2017. The unemployment rate in the euro area and the European Union stood at 8.7 and 7.3% respectively in November 2017, and was thereby about one percentage point lower than a year before. During the first half of 2017 in particular, employment levels increased substantially with annualised growth rates of around 2%. In the euro area employment developments have been very similar. Here too, employment levels have now clearly surpassed their pre-crisis levels. Although the unemployment rates fell in all member states, there are still major differences in levels. In Spain, 16.7% of the employment force was registered as unemployed in November, while the rates in Germany (3.6%) and the Netherlands (4.4%) were much lower. Italy and France were in the midfield, with rates of 11.1 and 9.4% (see Figure 1.12).

With the start of last year, inflation, as measured by the harmonised index of consumer prices, jumped to values of just over 1.5% on average (see Figure 1.13). Initially this development was mainly due to energy price effects. After hovering between 0.5 and 1% between the end of 2013 and early 2017, euro area core inflation that excludes volatile energy and food prices, however, also rebounded to above 1% for prolonged periods in 2017. At the same time, wage development also continues to be subdued. For over four years now, the annualised increase in unit labour costs has on average in the euro area hovered around 1%.

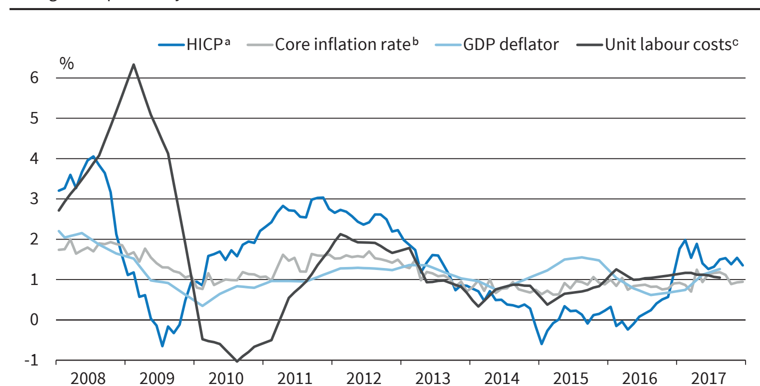
Price developments across European countries, however, vary considerably. Whereas wages have clearly increased since 2014 in Germany to the extent that they have reduced competitiveness as measured by relative unit labour costs there, the opposite is the case for most other European countries (with the exception of Slovakia and Estonia, see Table 1.1). The stronger economic momentum in Germany compared to most other European countries is behind this, which in itself can be seen as a natural adjustment process. In both Italy and France, for instance, inflation has been comparatively moderate in recent years.

Differences across Europe

Albeit to different degrees, all member states contributed to the strong expansion. Among the five largest economies, Spain and Germany recorded the highest growth rates last year with 3.1 and 2.6% respectively, followed by France (1.8%), Italy (1.6%), and the United Kingdom (1.6%). Although the former smaller crisis countries Greece and Portugal also benefited from the general upswing, their growth performance still lagged behind that of the rest of Europe. Cyprus and Ireland, on the other hand, again posted above-average growth rates in 2017.

The upturn in *Germany's* economy that started in 2013 accelerated markedly last year. Aggregate output is expanding almost twice as fast as current estimates of the potential rate suggest. Accordingly, the over-utilisation of the German economy has increased significantly, and the construction industry in particular seems to have reached its capacity limits. As compared to other sectors, the German industry expanded at above-average rates last year, and thereby significantly contributed to the overall acceleration. It

Figure 1.13
Price Developments in the Euro Area
Change over previous year's month



[a] Harmonised Index of Consumer Prices (HICP). [b] HICP excluding energy, food, alcohol and tobacco.
[c] Nominal compensation of employees per unit of real GDP.
Source: Eurostat; last accessed on 27 January 2018. © CESifo

Table 1.1

Labour Costs[a]

	Compensation per employee[b]		Real compensation		Labour productivity		Unit labour costs		Relative unit labour costs[d]		Export performance[e]		
	1999–2013	2014–2017	1999–2013	2014–2017	1999–2013	2014–2017	1999–2013	2014–2017	1999–2013	2014–2017	1999–2013	2014–2017	2017
Germany	1.3	2.5	0.4	0.8	0.6	0.8	0.8	1.9	−1.2	0.7	0.5	0.3	0.0
France	2.4	1.3	1.0	0.5	0.7	0.6	1.7	0.6	0.0	−0.7	−1.5	−0.6	−1.5
Italy	1.8	0.6	−0.1	−0.1	−0.3	0.1	2.3	1.1	0.5	−0.1	−2.8	0.1	0.2
Spain	2.4	0.6	0.2	0.3	0.6	0.6	2.1	0.4	0.4	−0.8	−0.6	0.8	1.2
Netherlands	2.6	1.1	0.7	0.5	0.7	1.2	1.8	−0.1	0.1	−1.3	−0.2	1.0	1.1
Belgium	2.5	0.7	0.9	−0.7	0.8	0.5	1.9	0.1	0.2	−1.1	−1.0	1.1	0.6
Austria	2.0	2.1	0.5	0.3	0.7	0.5	1.4	1.8	−0.3	0.4	−0.5	−0.3	0.6
Finland	2.8	1.0	1.2	−0.4	0.8	1.0	2.0	0.1	−0.3	−0.5	−1.4	−1.0	2.8
Greece	2.6	−0.8	0.7	0.1	0.7	−0.6	2.7	0.1	0.6	−0.7	−1.0	0.3	1.1
Ireland	3.3	2.2	1.6	0.2	2.0	7.8	1.5	−4.8	0.1	−6.4	2.0	10.1	−0.6
Portugal	2.5	0.5	0.3	−0.9	1.0	−0.1	1.8	1.1	0.0	0.0	−0.2	1.5	3.2
Slovakia	6.1	2.7	3.1	2.7	3.3	1.3	2.3	1.9	1.9	0.7	4.3	0.3	−1.3
Slovenia	5.3	2.1	1.9	0.9	1.8	1.7	3.4	0.6	−0.1	−0.6	0.9	2.8	4.1
Estonia		5.3		3.2	3.6	1.4	4.7	3.6	2.1	3.2	1.1	−0.2	−2.0
United Kingdom	3.4	1.9	1.5	0.3	1.0	0.5	2.3	1.1	−1.0	−0.9	−1.5	−1.6	1.1
Sweden	3.4	2.5	1.9	0.6	1.3	1.6	2.2	1.2	0.4	−2.4	−0.7	0.9	−0.5
Denmark	2.9	1.5	0.9	0.6	0.9	0.4	2.1	1.2	0.2	0.3	−0.5	−0.8	0.2
Poland	4.9	3.0	1.9	2.2	3.2	2.1	2.0	1.4	−0.5	0.0	2.3	3.1	0.3
Czech Republic	4.5	4.2	2.8	2.8	2.3	2.5	2.0	1.8	2.4	0.3	3.4	2.4	2.1
Hungary	6.4	2.7	1.5	0.2	2.0	0.6	4.9	2.3	1.7	0.0	3.5	3.4	3.2
Switzerland	1.4	−0.3	0.7	0.0	0.6	0.0	1.0	0.0	1.0	1.2	−0.1	−2.9	−4.0
Norway	4.5	2.4	−0.1	2.5	0.5	1.1	4.1	1.3	2.9	−4.0	−3.4	−2.2	−1.9
Iceland	6.1	6.5	1.4	3.8	1.5	1.7	4.9	4.1	−1.4	11.2	0.7	3.4	2.6
United States	3.1	2.1	1.1	0.6	1.5	0.6	1.6	1.6	−1.6	4.8	−1.4	−1.1	−1.3
China									3.8	2.4	9.4	0.1	3.2
Japan	−0.7	0.7	0.3	−0.2	0.9	0.2	−1.2	0.9	−2.5	−1.0	−2.7	1.1	0.6

[a] Growth rates for the total economy; [b] Compensation per employee in the private sector; [c] Compensation per employee in the private sector deflated by the GDP deflator; [d] Competitiveness: weighted relative unit labour costs; [e] Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares.

Source: OECD Economic Outlook, November 2017.

was thereby able to provide a broader basis for the upswing. While domestic demand components, with the exception of public consumption, also increased faster, impulses from abroad intensified. This benefited export-oriented German companies, which recruited more staff and expanded their capital stock. Despite growing tensions in the labour market, real wages have remained in line with productivity to date. The extraordinary increase in wages and prices, which one could expect in a boom phase, has therefore failed to materialise to date. Wage agreements still seem to have been driven by low inflation rates in previous years and/or continued low inflation expectations. After a period of collective wage moderation and the gradual introduction of labour market reforms adopted in 2002, unemployment in Germany declined from 2005 onwards. The Great Recession only briefly interrupted this downward trend in 2008 and 2009.

In contrast to the German economy, the expansion in *France* was largely internally driven and marginally supported by gradual labour market and tax reforms implemented under the Hollande government. Despite increased export growth, even stronger imports led to a negative growth contribution from external trade. The labour market is continuing to recover and private employment rose sharply last year. This supports private consumption and investment, which also grew strongly due to exceptionally low interest rates.

Although production growth accelerated somewhat during the second half of last year, in general the economy of the *United Kingdom* is moving slowly, compared to the world economic upswing. A key driver of slightly higher growth in the second half of the year was a stronger expansion of private consumption due to a rebound effect following the introduction of a car tax in April. However, this effect is only temporary and current car sales figures do not indicate a rapid recovery in private consumption. In addition, price increases due to the depreciation of the pound probably led to lower consumption dynamics. Both effects also explain the stagnation of investment in transport in the second half of the year. As far as other investments are concerned, non-residential construction also declined, while only residential construction continued to grow. Overall, foreign trade had a negative impact on production, particularly due to the poor demand for British goods from non-EU countries. The weak pound has not been reflected in stronger export figures to date. Despite the slightly accelerated pace of growth in the second half of the year, the figures paint a rather weak picture of the UK economy. GDP growth eased to 1.6% in 2017. This was made even clearer by the recent revision of official statistics. The economy appears to have been hit harder by the Brexit decision than initial figures suggested back in 2016. From today's perspective, machinery and equipment investment declined significantly one year ago, while muted business sentiment and the uncertainty triggered by the referendum is now showing more clearly than previously. On the other hand, the unimpressed attitude of private households is also more clearly reflected in the rise of residential investment, which has been sharply revised upwards.

The *Italian* economy was able to build on the positive developments abroad and expanded by 1.6%

last year. Although foreign trade generated stronger momentum in the past year than in 2016, growth was mainly supported by domestic demand. The recovery in Italy is still hampered by its ailing financial sector and weak lending. Italian banks are lagging behind in the process of reducing their debt. While loans at risk of default have been removed from bank balance sheets in many former crisis countries, their share of total lending in Italy has tripled since 2007. As a result of the sheer size of the Italian financial sector, this means that around one third of euro area non-performing loans now lie in Italy. Weak capitalisation, as measured by core capital relative to risk-weighted assets, could pose a problem if the ECB were to raise interest rates unexpectedly. Another risk factor is the large amount of Italian government bonds in domestic bank balance sheets. At around 10%, this share is more than twice as high as the euro area average. If a renewed public budget imbalance leads to a decline in the value of Italian government bonds, the financial system will inevitably be damaged. In the meantime, the labour market is showing only modest improvements despite the economic recovery. Given its high starting level, and compared to other European countries, the decline in the unemployment rate from an average of 11.7% in 2016 to 11.5% last year is only modest. Due to comparatively low capacity utilisation, at an annual rate of 1.3%, inflation hardly accelerated last year.

Economic growth in *Spain* remains strong and robust. Overall, the political crisis in Catalonia did not have a significant negative impact on economic activity. At a growth rate of 3.1% last year, Spain outperformed most other EU countries for the third consecutive year. Both domestic and external demand contributed to growth, underlining a more balanced growth pattern than in the run-up to the Great Recession. Strong job growth supported household income and consumer spending. Business investment, supported by stronger confidence and improved profit margins, continued to rise. Construction investment has increased, reflecting improved labour market and favourable financing conditions for households and non-financial corporations. Strong demand from trading partners and structural reforms have helped to improve competitiveness and support export growth.

Of the smaller former crisis economies, Cyprus, Portugal, and Ireland fared well. All three have been back on a steady growth path since at least early 2015. With an annual growth rate of 1.1% last year, only Greece is having problems finding its way back to persistent growth. Despite low growth, Greece has also seen a noticeable turnaround in its labour market. Unemployment has been steadily falling in all four economies since at least 2015 (see Figure 1.11).

The recovery in the *Central and Eastern European* member states of the European Union continued and gathered pace again. This was mainly due to stronger external demand, including that from the euro area. Domestic demand was robust almost everywhere. Real household income increased, not least because inflation remained low (although higher than the year before). Equipment investment also made an overall positive contribution to the increase in GDP in the region. Its expansion was facilitated by interest rates, which remained low throughout the year. All of this led to a further noticeable improvement in the labour market situation everywhere, which was accompanied by a significant drop in unemployment rates in all countries.

Increasingly driven by favourable overall economic conditions in the world, the gaps between these Central and Eastern European countries started to close. While Croatia was the only country reporting a growth rate of slightly below 3%, Estonia, Latvia, Slovenia, and in particular Romania reported growth rates of well above 4%. The Baltic states in particular benefited from the recovery of the Russian economy.

1.3 FISCAL AND MONETARY POLICY

1.3.1 Fiscal Policy

Except for the *United States*, fiscal policy is unlikely to play an important role for the economic developments in most advanced economies in 2018. There, however, the recently approved tax reform will not only generate some economic impulses for this year, it will also lead to a further increase in the already high US fiscal deficit (see Box 1.1).

In *Japan*, government debt surpassed 240% of GDP last year (see Table 1.2). The Bank of Japan now owns over 40% of the outstanding public debt stock. Historically low interest rates are currently still limiting the debt burden. It nevertheless poses a serious risk. The stimulus measures launched at the beginning of last year supported output growth, but also kept the deficit-to-GDP ratio above the 4% mark last year at the same time. Fiscal consolidation is set to gradually resume this year; another supplementary budget adopted in December 2017 was not the same size as previous supplementary budgets. However, achieving fiscal sustainability in a low growth environment in the face of a further ageing society is certainly a challenging task.

After the consolidation phase of the years 2011 to 2015, the fiscal stance as measured by the change in the cyclically adjusted deficit has turned more or less neutral in the *euro area*. Although the overall deficit in the euro area continued to decline for the eighth consecutive year in a row, the latest improvements have only materialised through increased revenues triggered by higher economic growth and lower interest payments due to historically low interest rates. Coming from a much higher level, the structural deficit of the *United Kingdom* has been substantially reduced further last year (see Figure 1.14).

Box 1.1

On the Effects of the Tax Reform in the United States

A key element of the US tax reform signed into law on 22 December last year is an income tax cut. The highest income tax rate will go down from 39.6% to 37%. The top rate will be levied on income of over 500,000 US dollars raised from the long-held level of 427,000 US dollars. The standard deduction is almost doubled (while personal exemptions are eliminated) and the tax rate is flattened overall. High income earners stand to benefit the most. Whereas those in the lowest-earning fifth of the population will, according to the Tax Policy Center, see their after tax income increase by 0.4%, the biggest increase of 2.9% will go to those in the top-earning fifth – the highest 1% of incomes are even estimated to gain 4.5%. These figures exclude any growth effects of the reform, as well as the consequences of future spending cuts or future tax increases that could be required to cover any tax revenue losses.

The maximum corporate tax rate will be reduced from 35 to 21% and there will be an immediate write-off of capital goods. The profits earned by American companies abroad are exempt from US taxation. To date, these profits were taxable if they were transferred to the United States. Although taxes paid abroad were credited against domestic tax liability, the high US tax rate made it worthwhile to let the money remain abroad. By the end of 2016, US companies had hoarded 1,300 billion euros abroad. In addition, a growing number of US companies have relocated abroad to avoid US taxation altogether. As part of the tax reform, profits hoarded abroad are to be subjected to one-off taxation, regardless of whether or not they are transferred to the United States. Future foreign profits are to be exempt from taxation in the United States. The United States is thus following a global trend (see Chapter 4 of this report). In the United Kingdom, for example, the taxation of foreign profits was abolished in 2009, in Germany and in most other OECD countries these profits are exempt from domestic taxation. However, the reform not only provides relief, but also tightening. Above all, the deductibility of interest rates is restricted in order to prevent tax avoidance through debt financing.

Three aspects of this corporate tax reform should be highlighted. Firstly, the US government has abandoned its original plans to introduce country-by-country corporate taxation. That would have marked a radical change of system in which company taxation is similar to VAT. The effort of conversion and the uncertainty associated with the system change were apparently too large. Secondly, with this reform, the US government is following the internationally established trend towards lower tax rates, the exemption of foreign profits, and unilateral measures against profit shifting for tax avoidance. Thirdly, this reform will dramatically increase international tax competition. The combination of massive tax cuts and improved tax depreciation creates significant incentives to relocate US investment. Other industrial locations will have to react in order to remain attractive. In addition, tax havens are being pressured to concede that they did incentivise US companies to avoid high profit taxes at home.

As a result of the US tax reform, real GDP is likely to be, at least temporarily, stimulated through growing investment, rising consumer spending and increased labour supply. The sum of these effects is controversial. The US Senate expects somewhat restrained effects (see Joint Committee on Taxation, 2017). According to the report, real GDP is expected to be 0.8% higher in the next ten years on average than would be achievable without the reform. Another study concludes that GDP will increase by 0.7 and 0.6% in 2018 and 2019 respectively, and by 0.4 to 0.5% in the years until 2025 (see Tax Policy Center, 2017). A study by the US Tax Foundation is more optimistic and expects a long-term increase in US gross domestic product of 3.7% (see Tax Foundation, 2017). The difference to the first two estimates can mainly be explained by the fact that this study expects stronger investment effects and a slower rise in interest rates.

The expected tax revenue losses largely depend on the projected growth effects of the tax reform. The US Senate estimates that only around one sixth of the tax cut will be offset by growth effects. The bottom line is an increase in the government deficit of about 1.1 percentage points of 2016 GDP by 2020. The Tax Policy Center expects this figure to be in the same ballpark at 1.25 percentage points. By contrast, with the far more optimistic growth spurt expected by the US Tax Foundation, the reform would be self-financing in the long term after some initial, but temporary, revenue losses.

In the short term, the positive economic stimulus will probably boost exports to the United States and thus the global economy. This will also benefit Europe's economy. At the same time, Europe is likely to respond to increased tax competition and further reduce corporate taxes. The United States is currently in an upswing. In this environment, large-scale tax cuts are leading to increased upward pressure on prices, forcing the US Federal Reserve to tighten its monetary policy sooner than expected and raise rates more quickly. This would remove part of the positive effects of the tax reform. At the same time, the spread between the United States and the rest of the world would increase. To the extent that this is not due to a higher risk premium, this could lead to increased capital shifts to the United States and force central banks around the world to raise interest rates earlier than expected to date.

Table 1.2

Public Finance

	Gross debt[a]				Fiscal balance[a]			
	1999–2007	2008/2009	2010–2016	2017	1999–2007	2008/2009	2010–2016	2017
Germany	62.3	68.9	75.8	64.8	−2.3	−1.7	−0.5	0.9
France	62.5	73.5	90.9	96.9	−2.5	−5.2	−4.5	−2.9
Italy	102.9	107.5	125.7	132.1	−2.9	−4.0	−3.1	−2.1
Spain	48.2	46.1	87.1	98.4	0.2	−7.7	−7.5	−3.1
Netherlands	49.3	55.8	64.2	57.7	−0.5	−2.6	−2.8	0.7
Belgium	100.7	96.0	104.4	103.8	−0.5	−3.2	−3.4	−1.5
Austria	66.1	74.0	82.7	78.6	−2.2	−3.4	−2.4	−1.0
Finland	40.6	37.2	56.1	62.7	3.8	0.8	−2.3	−1.4
Greece	103.8	118.1	170.3	179.6	−6.3	−12.7	−7.5	−1.2
Portugal	59.6	77.6	121.8	126.4	−4.3	−6.8	−6.1	−1.4
Ireland	30.9	52.0	98.5	69.9	1.6	−10.4	−9.3	−0.4
Slovakia	40.6	32.4	49.9	50.6	−5.2	−5.1	−3.8	−1.6
Slovenia	25.7	28.2	64.4	76.4	−2.2	−3.6	−5.9	−0.8
Luxembourg	7.1	15.3	21.4	23.7	2.5	1.3	0.8	0.5
Lithuania	20.1	21.3	39.3	41.5	−1.7	−6.1	−3.2	0.1
Latvia	12.0	27.0	41.2	39.0	−1.6	−6.7	−2.5	−0.9
Cyprus	58.7	49.4	89.5	103.0	−2.4	−2.3	−4.4	1.1
Estonia	5.0	5.8	8.9	9.2	0.9	−2.4	0.2	−0.2
Malta	65.5	65.1	65.1	54.9	−4.9	−3.7	−1.8	0.9
Euro area	**67.8**	**73.5**	**90.5**	**89.3**	**−1.9**	**−4.2**	**−3.3**	**−1.1**
United Kingdom	38.1	57.0	84.4	86.6	−1.6	−7.6	−6.2	−2.1
Sweden	49.6	39.6	41.0	39.0	1.2	0.6	−0.4	0.9
Denmark	43.8	36.7	42.7	36.1	2.3	0.2	−1.5	−1.0
Poland	42.6	47.9	53.2	53.2	−3.9	−5.4	−4.1	−1.7
Czech Republic	24.5	30.9	40.8	34.6	−3.7	−3.7	−2.0	1.2
Romania	19.5	18.2	36.3	37.9	−2.5	−7.5	−3.3	−3.0
Hungary	58.3	74.1	76.7	72.6	−6.3	−4.1	−3.1	−2.1
Croatia[b]	38.5	44.3	75.7	80.3	−3.6	−4.4	−4.9	−0.9
Bulgaria	45.3	13.4	20.9	25.7	0.5	−1.2	−1.8	0.0
European Union	**64.8**	**68.4**	**84.5**	**83.5**	**−1.7**	**−4.3**	**−3.6**	**−1.2**
United States[b]	61.0	80.3	103.1	108.1	−3.1	−9.9	−6.4	−4.3
Japan	162.9	199.9	234.7	240.3	−5.7	−6.9	−6.8	−4.1
Switzerland	54.9	46.0	44.3	42.8	−0.4	1.2	0.5	−0.1
Japan	−0.7	0.7	0.3	−0.2	0.9	0.2	−1.2	0.9

[a] As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States, Japan and Switzerland, definitions are according to the IMF; [b] Data on Croatia and the United States are only available from 2001 onwards.

Sources: European Commission, Autumn 2017; IMF World Economic Outlook, October 2017.

According to OECD estimates, the fiscal impulse as measured by the change in the cyclically adjusted primary deficit was 0.25 percentage points of GDP in the euro area last year. Italy (0.5 percentage points), Germany (0.4 percentage points) and Spain (0.4 percentage points) were the main drivers. By contrast, the cyclically adjusted primary surplus in the United Kingdom improved by 1.1 percentage points last year. Fiscal policy measured in this way was also slightly restrictive in France and Ireland.

This year, the fiscal stance is likely to remain fairly loose in the euro area. The upswing is therefore not being used to comply with the rules of the European fiscal compact. In most countries the debt-to-GDP ratio is still (well) above the 60% mark, and countries like France, Italy, Spain, Belgium, Finland, Ireland, and Portugal are also unlikely to meet the lower limit of a structural deficit of 0.5% of GDP this year. With the exception of Ireland, fiscal policy in all of these countries is thereby likely to be pro-cyclical. Apparently, these fiscal rules are still not having a strong disciplinary effect. Against the background of an expected normalisation in monetary policy and the associated increase in capital market rates, some countries could come under pressure again.

1.3.2 Monetary Conditions and Financial Markets

Monetary Conditions

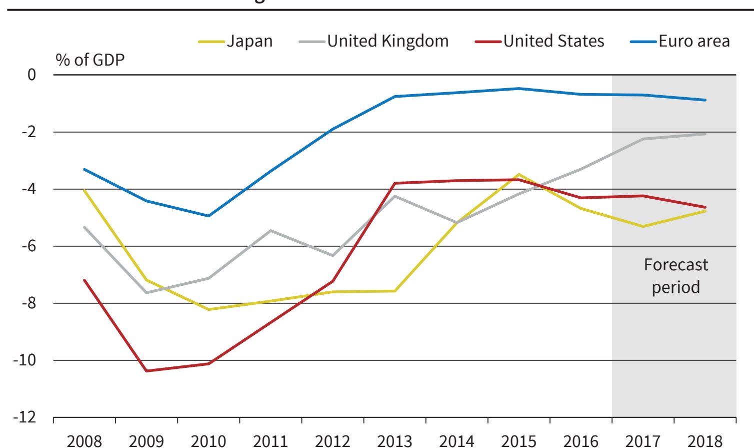
Although a number of mainly smaller countries like Mexico, South Korea, the Czech Republic, and Canada increased central bank policy rates in 2017, global monetary policy is still expansionary on the whole. Even the policy of the US Federal Reserve can – after five interest rate hikes since the end of 2015 – still be considered as accommodative.

The new governor of the Fed, Jerome Powell, is going to continue with the stepwise normalisation of monetary policy. Three additional 25 basis point hikes of the main refinancing rate are likely to be implemented over the course of this year. Furthermore, slow reductions in the strongly expanded Federal Reserve's balance sheet initiated last October will continue throughout the year. This balance sheet amounted to around 4.4 trillion US dollar by the end of 2017, and there are plans to it reduce it by about 400 billion US dollars by the end of this year through lower reinvestment of maturing bonds (see Figure 1.16).

At its meeting in October 2017, the ECB decided to further develop its extended Asset Purchase Program (APP). Bond purchases amounting to 60 billion euros

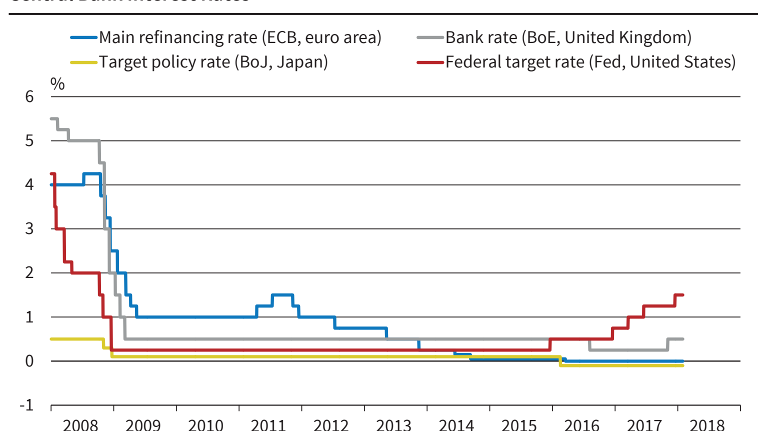
Figure 1.14

Government Structural Budget Balances



Source: OECD Economic Outlook, November 2017; 2017 and 2018: EEAG forecast. © CESifo

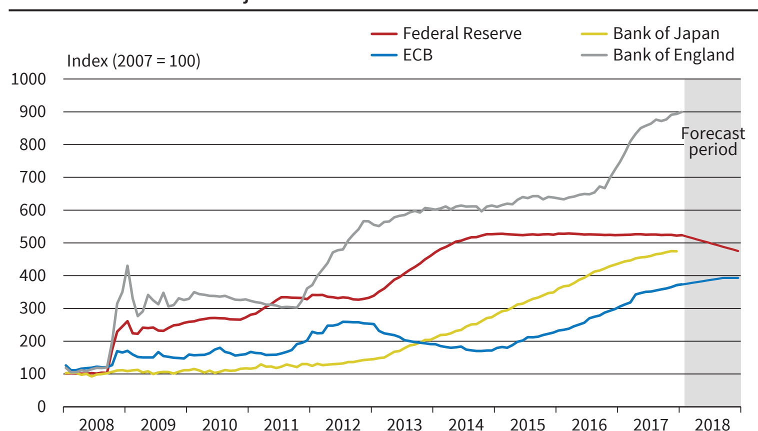
Figure 1.15
Central Bank Interest Rates



Source: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan; last accessed on 27 January 2018.

© CESifo

Figure 1.16
Balance Sheets Sizes of Major Central Banks



Source: Federal Reserve; Bank of Japan; European Central Bank; Bank of England; Swiss National Bank; last accessed on 27 January 2018; EEAG calculations and forecast.

© CESifo

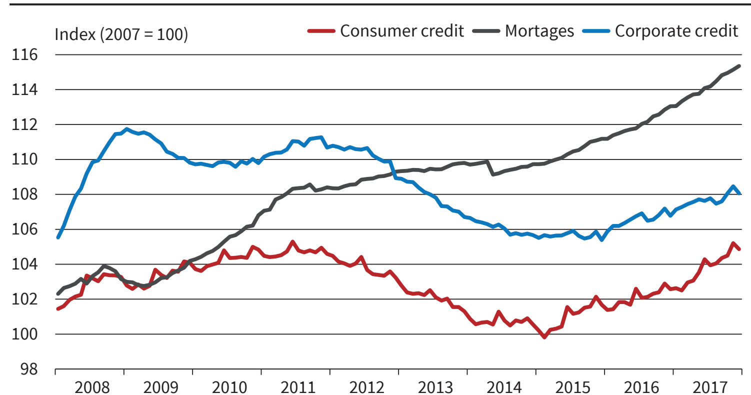
per month by the end of last year will continue this year at a monthly volume of 30 billion euros until at least the end of September 2018. By December last year, the ECB's holdings of securities for monetary policy purposes amounted to 2,364 billion euros. For the period after September 2018, a further reduction in bond purchases by the ECB is expected, before they are reduced to zero by the beginning of 2019 at the latest.

Since March 2016, the ECB has kept its main refinancing rate at 0%, the marginal lending rate at 1.25% and the deposit rate at – 0.4%. With the continued excess liquidity of the banking system, money market rates for overnight money (EONIA) and three-month money (EURIBOR) remained below – 0.3% and thus close to the deposit rate. The key policy rates are likely to remain at their current level until mid-2019.

Overall, the ECB is thus continuing its strongly expansionary monetary policy course. Although the volume of planned loan purchases was cut in half, it was extended far into 2018 at the same time. This also gives the 'forward guidance' that policy rates will remain at a low level for a longer period of time, well beyond the end of the APP, additional credibility. Interest rates are not expected to rise before mid-2019. Continuing refinancing via full allotment gives banks medium-term planning security with regard to the costs of their liquidity management. Reinvesting matured securities, even after the (still undefined) end date of the APP, implies a medium to long-term central bank balance sheet that may also impact long-term interest rates through the euro system's portfolio of securities. At the same time, increased liquidity in the banking system as a result of the APP and the targeted longer-term refinancing operations (TLTROs) should keep money market rates near the (negative) deposit rate (– 0.4%) in the medium term. For the time being, the ECB's hesitant exit from unconventional measures is avoiding distortions in bond markets of the kind that arose when the Federal Reserve started communicating its tapering process in 2013. Back then the Fed's announcement that its bond purchases programme was due in January 2014 sparked a shock wave in global financial markets. US Treasury yields rose sharply and prices tumbled in some emerging markets. Against this background, ECB President Mario Draghi has repeatedly emphasized that there is no fixed end date for the unconventional policy that the ECB is currently carrying out.

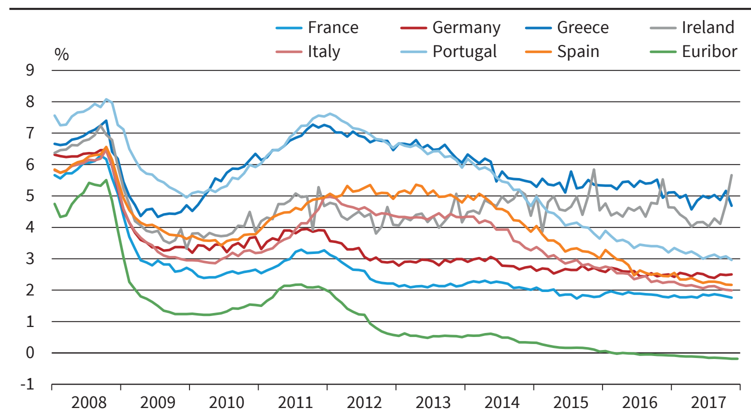
From a monetary perspective, the massive monetary expansion of the ECB since 2014 should have led to an increase in inflation. Inflation developments, however, appear more compatible with a (New) Keynesian view, whereby inflation depends on capacity utilisation rates in the economy. In the wake of both the Great Recession and the euro crisis, the economies of the euro area were clearly under-utilised up until recently. Furthermore, the ECB was worried that energy prices, which had plummeted in the period from 2014 to 2016, would manifest themselves in core inflation or inflation expectations through second-round effects; and thus generate permanently lower inflation. Indeed, according to the ECB Survey of Professional Forecasters that polls experts affiliated with financial or non-financial institutions based within the European Union, the probability assigned to having an inflation rate below 1.5% in five years' time increased from just above 20% in 2011 and 2012 to between 30 and 35% as of the second half of 2014. This probability only fell for

Figure 1.17
Credit Developments in the Euro Area[a]



[a] These indices of adjusted outstanding amounts are calculated according to $I_t = I_{t-1}(1+F_t/L_{t-1})$, where L stands for the outstanding nominal amount of credit and F the amount of transactions (credit granted). The transactions F are calculated from differences in outstanding amounts adjusted for reclassifications, other revaluations, exchange rate variations and other changes which do not arise from transactions (see European Central Bank, 2010, for details).

Figure 1.18
Interest Rates on Loans to Businesses in Selected Countries of the Euro Area[a]



[a] New loans to non-financial corporates up to one million euros using floating rates or up to 1 year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year.
Source: European Central Bank; last accessed on 27 January 2018.
© CESifo

the first time again just below the 30% mark in the most recent survey (October 2017).

Although credit growth has picked up in the euro area since 2015, the pace at which this is happening is still to be considered modest in the light of historically low interest rates and the huge amount of liquidity that the ECB is injecting into the system. Mortgage loans have been steadily increasing for years now and increased by 1.9% in 2017. Consumer credit growth turned positive again in 2015 and registered 1.6% growth in 2017. As of 2016, loans to the corporate sector also started growing again, reaching a growth rate of just above 1% in 2017 (see Figure 1.17). By comparison, while M1 grew by around 9%, M3 increased by approximately 4.7% last year.

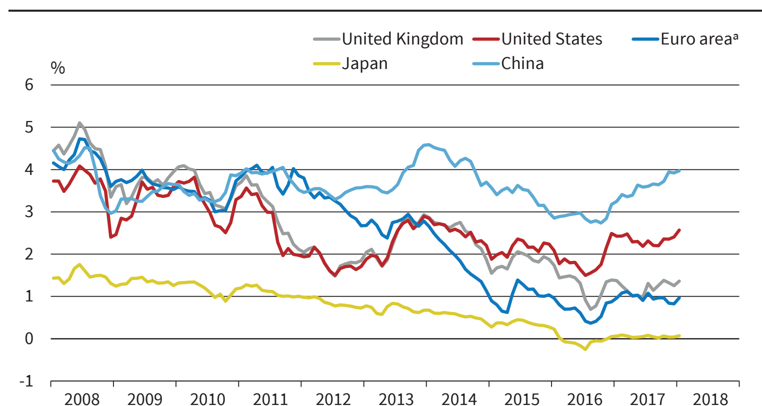
One explanation for this subdued recovery in banking credit are the still relatively high lending rates that apply to non-financial corporations (see Figure 1.18). While the overall funding costs of the banking sector continued to fall even further into negative territory last year, bank lending rates were, in contrast to the preceding years, left behind in many cases.

Bonds, Stocks, and Foreign Exchange Markets

Except for China, long-term government bond yields largely moved laterally in all major economies during 2017 (see Figure 1.19). Given the mostly clear increases that occurred at the end of 2016, this implies that the US and euro area long-term rates did, on average, turn out to be, respectively 45 and 30 basis points higher than in 2016. In China, these government bond yields continued to increase throughout the year, increasing the year-on-year difference to 70 basis points. Japan and the United Kingdom were the only countries in which no significant changes in these averages occurred.

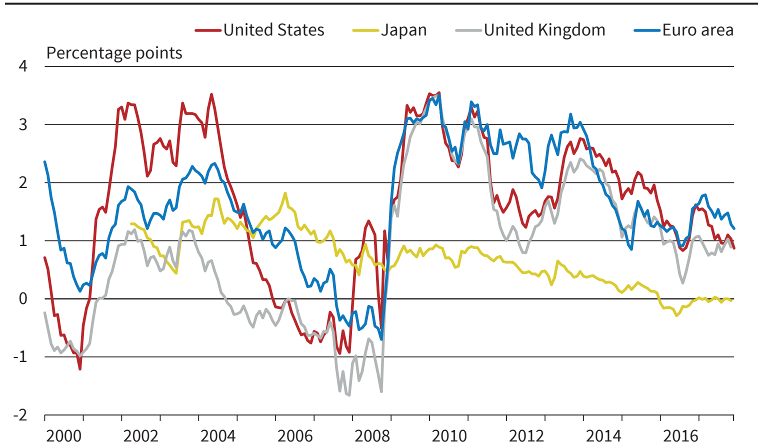
The lateral movement of long-term government bond yields together with the policy rate hikes implemented by the Federal Reserve implies that the yield curve in the United States clearly flattened. A comparison of short-term interbank rates with returns on long-term government bonds shows that their differences also declined during 2017 for the euro area (see Figure 1.20). This neither holds for the United Kingdom, nor Japan. In

Figure 1.19
10-Year Government Bond Yields



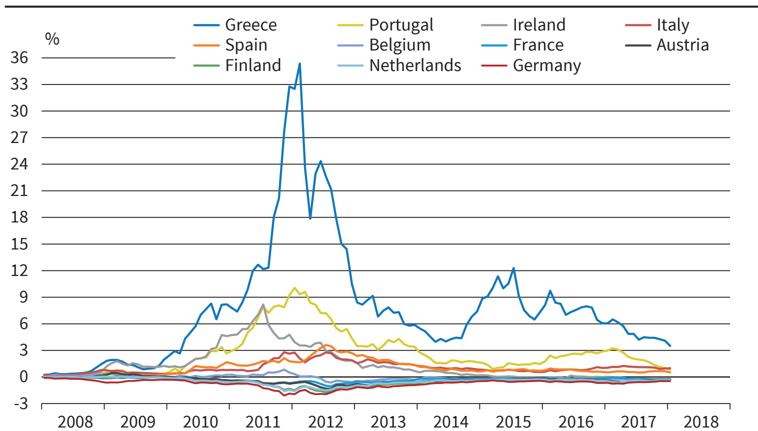
[a] The synthetic euro area benchmark bond refers to the weighted average yield of the benchmark bond series from each Economic and Monetary Union member.
Source: Datastream; last accessed on 27 January 2018.
© CESifo

Figure 1.20
Differences between 10-Year Government Bond Yields and 3-Month Interbank Rates



Source: OECD; last accessed on 27 January 2018. © CESifo

Figure 1.21
Regional Disparties in Government Bond Yields in the Euro Area
Differences between 10-year national and synthetic euro area benchmark bond yields



Source: Datastream; last accessed on 27 January 2018. © CESifo

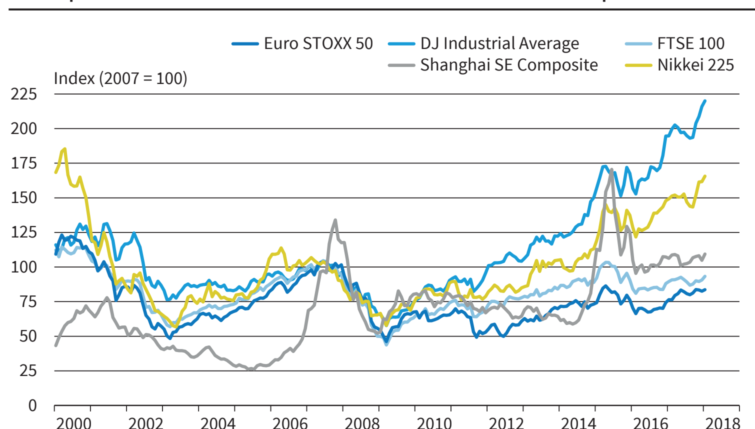
the latter case, this reflects the clearly communicated targets of the Bank of Japan of maintaining its short-term interest rate at – 0.1% and the target for the 10-year government bond yield at 0%.

In the United States in particular financial market analysts have started worrying about the underlying flattening of the yield curve and discussing whether this may be a sign that the next recession is imminent. Although an inverted yield curve has indeed often preceded a recessionary period in the past, the differences between long- and short-term yields are still not comparable to those seen in 1989, 2000, or 2006/7, for example. Current spreads are more in line with levels seen during the entire second half of the 1990s. Furthermore, this time around, the environment is largely determined by ongoing quantitative easing programmes in Japan and the euro area in particular. With interest rates on safe assets of different maturities in these parts of the world still be near or at their effective lower bounds, US treasuries can still be considered relatively attractive. Of course, the Federal Reserve's forthcoming policy hikes will tend to reduce these spreads even further. On the other hand, the reduction of the Fed's balance sheet and US tax cuts are going to put upward pressure on longer-term yields.

Within the euro area, the risk premiums on both Greek and Portuguese government bonds clearly declined last year (see Figure 1.21). The economic outlook for these countries has started to improve. Although the economies of Italy, and especially Spain, are benefiting from the overall boom too, the difference between their government bond yields and a synthetic euro area average has hardly moved throughout the year. As a result of the reduction of yields on Portuguese and Greek bonds, nearly all other euro area country yields have moved towards the synthetic average.

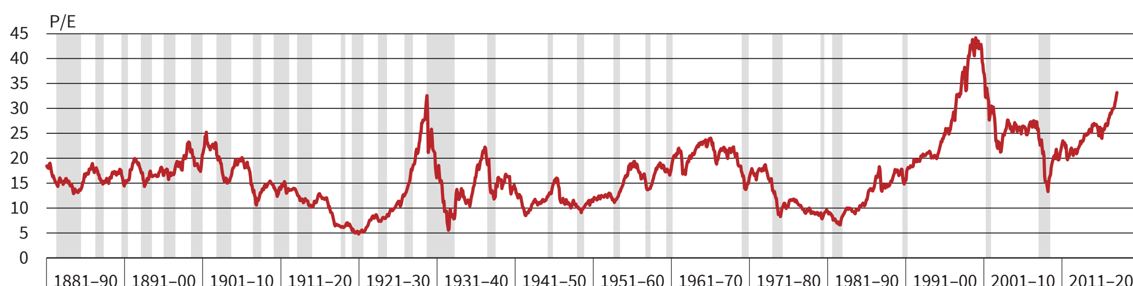
In contrast to the development of interest rates relevant to the private sector, and despite a dip during the summer, stock markets in general developed strongly last year (see Figure 1.22). From a euro area perspective, both the Euro STOXX 50 and the Dow Jones Industrial were about 11% higher last December compared to the previous

Figure 1.22
Developments in International Stock Markets from a Euro Area Perspective[a]



[a]Stock market indices outside the euro area are first converted into euros.
Source: Datastream; last accessed on 27 January 2018. © CESifo

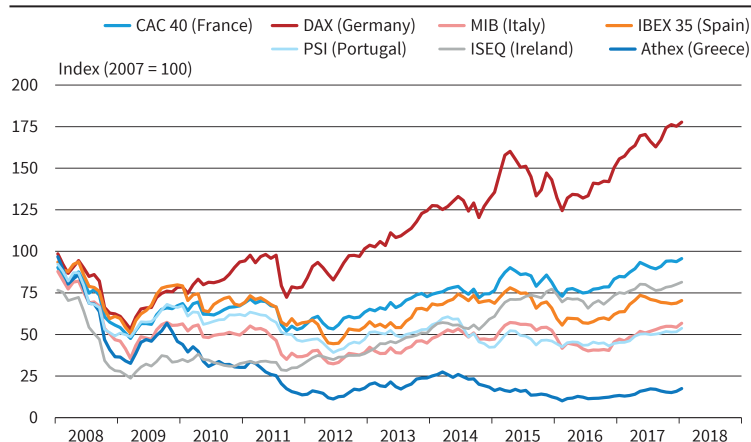
Figure 1.23
Shiller Price Earnings Ratio



Note: Grey areas indicate recession periods according to the NBER classification.
Source: Datastream; http://www.econ.yale.edu/~shiller/data.htm; last accessed on 27 January 2018.

© CESifo

Figure 1.24
Developments of Selected Stock Markets within the Euro Area



Source: Datastream; last accessed on 27 January 2018.

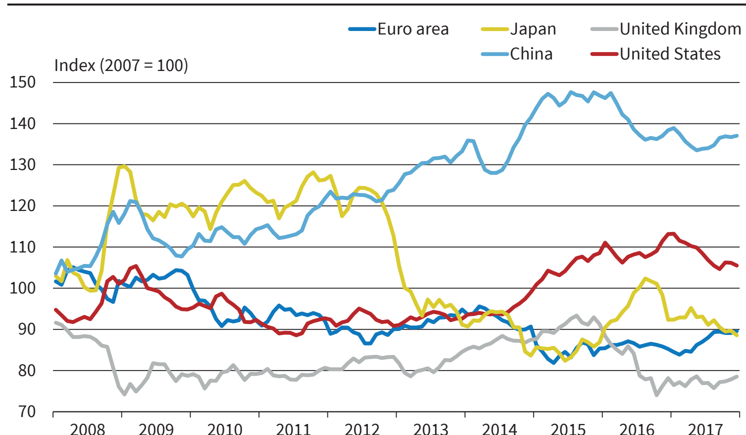
© CESifo

year. When measured in US dollars, the latter even showed an increase of almost 25%. The difference is explained by the clear appreciation of the euro over this time period. By contrast, for the Shanghai Stock Exchange Composite, the increase was a mere 4.4% when measured in local currency. Taking the depreciation of the Chinese renminbi into account, this even implied a decline of 2.3% from a euro area perspective.

From a longer-term perspective, US stock markets have also reached historically high levels. The real Shiller Price/Earnings ratio for the Standard & Poor's 500, which is based on average inflation-adjusted earnings from the previous 10 years, has reached a level that is again very close to that seen shortly before the outbreak of the Great Depression in 1929 (see Figure 1.23). It thereby stands substantially above the levels reached before the start of the Great Recession in 2008. That said, the monetary environment is also still exceptional at the moment. We have never had this much liquidity being placed in the financial systems of major economic regions and interest rates that remained persistently at such low levels. A clear consequence of loose monetary policy in recent years is that investors are moving into stock markets. The intention is that, through both the so-called Tobin's q and balance sheet channels, the private economy is increasing its demand for durable goods and services in particular. A strong and very swift change in the monetary policy environment could trigger a bursting of these asset market bubbles. On the other hand, the longer central banks wait, the larger the potential bubble will turn out to be. The next few years will be marked by this balancing act on the monetary policy side.

Whereas US stock markets have reached historically high levels, the same cannot necessarily be said of those in Europe. Of the larger economies, only the German DAX has already surpassed pre-crisis levels (see Figure 1.24) since 2013. All of the

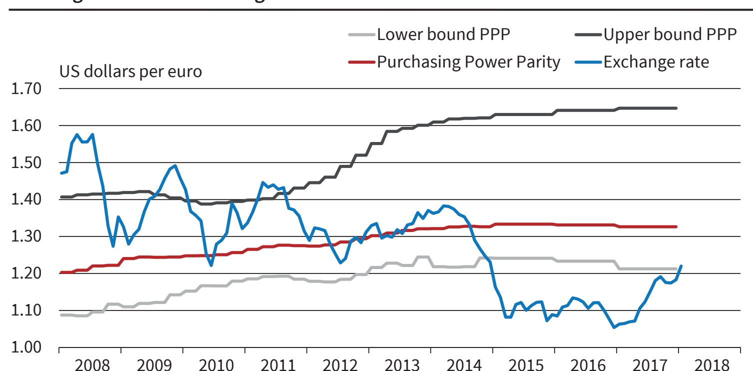
Figure 1.25
Real Effective Exchange Rates around the World



Source: Bank for International Settlements; last accessed on 27 January 2018.

© CESifo

Figure 1.26
Exchange Rate of the Euro against the US Dollar and PPP[a]



[a] The nominal exchange rate is based on monthly data, while the exchange rate based on purchasing power parity (PPP) is given at a quarterly frequency. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar. The PPP upper bound represents the 90th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 10th percentile. In calculating these bounds the 11 euro area member countries with the largest GDP weights are used.

other stock markets are, despite their improvements in recent years, still below their respective 2007 levels.

Although the ECB is in the process of tapering its asset-buying programme and long-term interest rates are likely to rise, financing conditions for the private sector will remain favourable for some time to come. The situation in the banking sector and the demand for corporate credit are likely to continue to improve.

After a strong reduction in its real value following the Brexit decision, the British pound has stabilised at a lower level. Over the course of 2017, the real effective value of the euro increased by 5% (see Figure 1.25). This appreciation was both driven by a much stronger economy than expected and the start of the tapering of the ECB's quantitative easing programme. All other major currencies have weakened somewhat.

Taking a purchasing power parity perspective, the undervaluation of the euro relative to the US dollar largely disappeared during 2017 (see Figure 1.26).

1.4 MACROECONOMIC OUTLOOK

1.4.1 Assumptions, Risks, and Uncertainties

The forecast is based on the assumption that a barrel of Brent crude oil will, on average, cost around 67 US dollars this year. The exchange rate between the euro and the US dollar is assumed to be 1.20.

The risks to global economic developments are largely balanced. It is assumed that the Brexit negotiations between the United Kingdom and the European Union will not fail and a 'hard Brexit' will be avoided. The latter would have significantly negative economic effects, especially for the United Kingdom, but also for the European Union (see Felbermayr et al., 2017). Should trade between these two regions in the future be carried out on the basis of WTO rules, GDP per capita for the United Kingdom would be 1.4% lower, while that of the European Union would fall by 0.25% in the long run.

Financial fragilities in *China* pose another risk to the world economy, as corporate debt increased massively in recent years and is now at a very high level by international comparison. This increases the risk of financial instability. As a result, a faster than currently expected normalisation of US monetary policy could, despite the existence of capital controls, trigger increased capital outflows from China placing the Chinese financial system at risk.

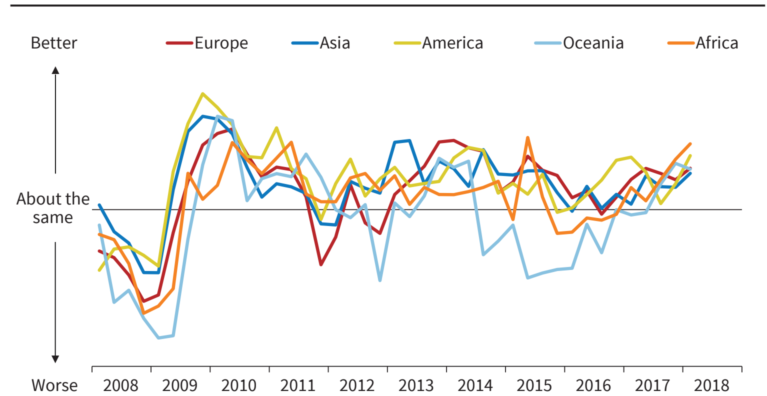
The tax plans of the US government, negotiated between the Senate and the House of Representatives at the end of last year, could trigger a faster lifting of key interest rates in the *United States*. The tax reform represents a significant upside risk for the US economy, which could – in the short term at least – be significantly stimulated by the planned tax cuts. At the same time, however, government debt in the United States is likely to increase sharply, which in itself should lead to an increase in global capital demand and hence capital market interest rates (see Box 1.1).

The risks that could cause the economic forecast for the *euro area* to deviate upwards or downwards are largely balanced. The consistently positive assessments by companies, households, and financial markets of the current economic situation and the outlook for the forthcoming quarters may lead the euro area economy to expand significantly faster, especially in the short term, than assumed in this forecast. The successful implementation of further structural reforms in its member states could also improve the labour market situation even more swiftly and generate higher inflationary momentum.

However, the Brexit negotiations, the fragile situation in the banking sector in some member states, and rising long-term interest rates pose downside risks to the outlook. Albeit to a lesser extent than a year ago, problems in the European, and particularly in the Italian banking sector, persist. In the meantime, some Italian banks have been successfully recapitalised or liquidated. The share of non-performing loans fell by almost 5 percentage points as a result. The current share of just under 12% is nevertheless still fairly high and continues to pose a risk to financial stability. Finally, abrupt changes in monetary policy are a risk for countries with high public debt shares. This is demonstrated by debt sustainability in Italy, where, due to the political constellation, no further structural reforms can be expected in the medium term and the debt-to-GDP ratio averaged 132% last year (see Table 1.2).

A further increase in key interest rates by 1 percentage point in both 2018 and 2019 would make it even more difficult to reduce public debt in Italy. The public debt to GDP ratio would continue to rise to just under 134%, instead of falling to 130%. This limits monetary policy's scope for manoeuvre and could lead to a resurgence of the confidence crisis in the euro area.

Figure 1.28
ifo World Economic Survey
Economic expectations for the next 6 months



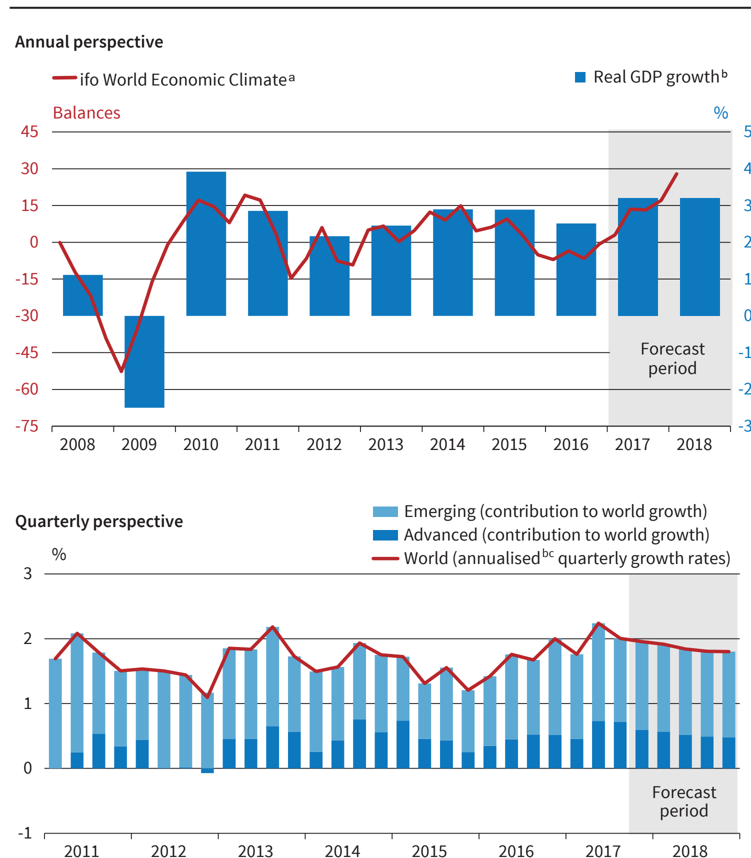
Source: ifo World Economic Survey I/2018. © CESifo

1.4.2 Global Economy

Following up on the strong summer of 2017, the world economy is likely to continue on an expansion path at above-average growth rates in the winter months of 2017/18. After some moderate improvements in the ifo World Economic Climate during the second half of last year, another boost was registered in the most recent survey (see Figure 1.27). Both the underlying assessments of the situation as well as the expectations for the upcoming six months are still improving in many parts of the world (see Figure 1.28).

In line with other indicators, the general expectation is that across continents economic conditions are going to improve further in the months ahead. A major exception to this rule amongst the more advanced economies is the United Kingdom. A lack of confidence in the government's economic policy, and particularly in the outcome of the Brexit negotiations, remains a drag on growth.

Figure 1.27
World Economic Growth and the ifo World Economic Climate



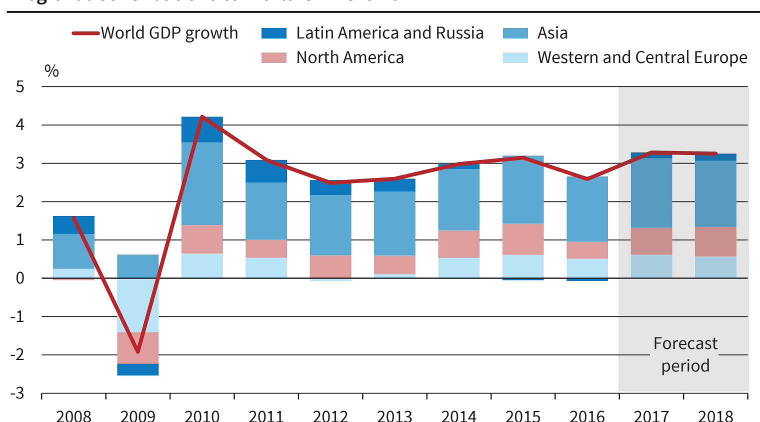
[a] Arithmetic mean of judgements of the present and expected economic situation; [b] Countries are weighted according to previous year's nominal GDP in US dollars; [c] Growth contributions of advanced and emerging economies thereof.

Source: IMF World Economic Outlook, October 2016; GDP 2017 and 2018: EEAG forecast; ifo World Economic Survey I/2018. © CESifo

Despite a slight loss of impetus, the current upswing is likely to continue during the rest of the year. Output gaps will close in all major economies as a result, while capacity increases in many advanced economies will give a further boost to global investment activity. No further stimulus is to be expected from China. Its economy is likely to expand at a similar pace as last year, while facing more restrictive monetary policy, lower fiscal impulses, and high corporate sector debt restricting further debt-financed growth. This contrasts with the invigorating economic recovery processes in India and increasingly in Brazil too.

Overall, the total economic output of the world is forecast to grow by 3.2% this year. The current upswing in the world economy will thereby be the longest in the post-war period. This upturn, however, also followed its strongest fall and has been relatively weak until recently.

Figure 1.29
Regional Contributions to World GDP Growth[a]



[a] Based on market weights.
Source: IMF World Economic Outlook, October 2017; EEAG calculations and forecast.
© CESifo

The world inflation rate is expected to be 2.2% this year. Like last year, some of this is a result of the rise in energy prices. Assuming that oil prices remain more or less stable during the remainder of the forecasting horizon, these positive impulses for consumer prices are likely to fade out during the second half of this year. The dynamically expanding world economy will lead to an increasing capacity utilisation, gradually creating upward pressure on prices too.

The strong dynamics seen in world trade by the middle of last year will weaken. This is indicated by the decline in in leading indicators of international goods traffic. The RWI/ISL Container Throughput Index and the World Trade Expectations of the ifo World Economic Survey, for example, recently declined somewhat after several at times steep increases during 2017. However, world merchandise trade will continue to be an important driver of the international economy. Overall, world trade is expected to expand by 4.2% after 4.4% last year. World trade is thereby growing more than twice as fast as during the years 2012 to 2016.

The stronger momentum of world trade is not only directly due to the recovery in the global economy, but also reflects an increase in the elasticity of world trade, defined as the ratio of world trade to world production. Whereas this elasticity has been lower than usual during the post-financial crisis period, the pick-up in global investment activity is likely to normalise this elasticity. Investment goods are generally rather trade-intensive, with higher import content than consumer goods (see Bussière et al., 2013).

The major regions will develop more homogenously than in the past years. The US economy will nevertheless grow more strongly than that of the euro area and Japan. In the United States, the output gap is closed and real GDP will grow at trend levels, or slightly above them, in the quarters ahead. The euro area economy has recently seen a closing of its output gap. It is nevertheless still characterised by structural differences across its member countries, as indicated by, for example, the still large volume of non-performing loans on bank balance sheets in Greece, Italy, and Portugal, as well as the lack of competitiveness of the French and Italian economies. The recovery has, however, gained pace, supported by the ECB's extremely accommodating monetary policy. As monetary policy is highly expansionary and fiscal policy will remain supportive, the Japanese economy will continue to expand. The stimulus from monetary and fiscal policy, and in particular a buoyant world economy, is partly offset by a shrinking labour force, a rising old-age dependency ratio and tight immigration controls.

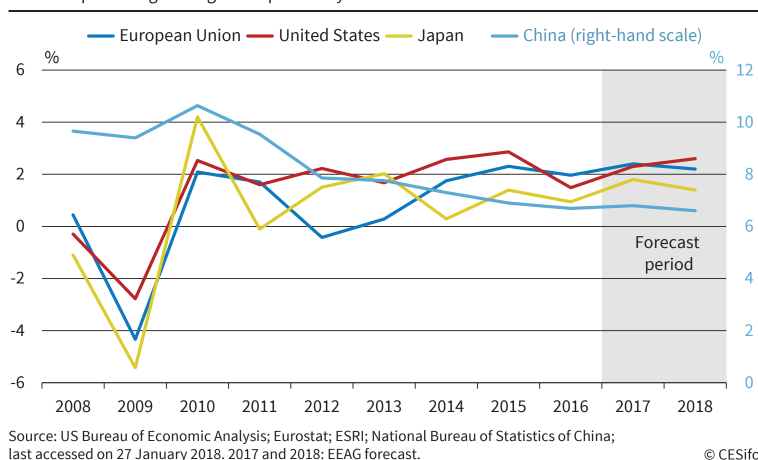
The pace of expansion in emerging markets will hardly change over the forecast period. In view of higher oil prices and the slight recovery in the prices of other raw materials, Brazil and Russia will continue along their recovery path. India is likely to expand rapidly. However, these positive impulses are offset by a slowdown in Eastern European countries. China's economy will continue to grow at a similar pace as last year. To achieve this, the Chinese economy will need to perform a balancing act between expansionary and contractionary measures. It is probable that those sectors in which a cooling emerges will be supported, while those sectors that risk overheating will be exposed to contractionary economic policy interventions. Finally, rising interest rates in the United States are likely to negatively impact financing conditions in emerging economies. Growth in emerging markets is nevertheless still twice as high as that in advanced economies.

1.4.3 United States

Supported by the tax reform, the short- to medium-term outlook for the US economy looks good. Consumer confidence, as measured by the Conference Board's sentiment surveys, is at its highest level since the beginning of the new millennium, indicating continued strong consumer momentum. Investment activity, which has recovered from its weakness in 2016, is expected to provide a high level of expansion for some time to come. However, stagnating house prices and a declining number of building permits indicate that there will be no impetus from residential construction. For the current year, GDP is expected to expand by 2.6% (see Figure 1.30).

Last year's change in consumer prices amounted to 2.1%. With core inflation picking up, but the contribution from energy and food prices abating, this year's inflation rate is also expected to end up being

Figure 1.30
Economic Growth by Region
Real GDP percentage change from previous year



Source: US Bureau of Economic Analysis; Eurostat; ESRI; National Bureau of Statistics of China; last accessed on 27 January 2018. 2017 and 2018: EEAG forecast.

© CESifo

2.1%. Jerome Powell, who took over the chairmanship of the US Federal Reserve at the beginning of this year, will continue along the path of a gradual normalisation of monetary policy. Accordingly, the Fed is likely to raise its Federal Funds rate target range three times this year to achieve a federal funds target rate of 2.25% by the end of the year. The reduction in the balance sheet of the Fed, which began in October last year, should also exert some upward pressure on long-term interest rates.

1.4.4 Asia

While for *China* the Markit Purchasing Managers' Index (PMI) is still in the expansion zone, it fell to its lowest level in five months in November. On the other hand, the less appreciated PMI of the Chinese Bureau of Statistics and the leading indicator of the OECD for China paint a somewhat more optimistic picture for the winter half of 2017/18. Given the boost in consumer confidence, the Chinese economy will also be able to keep its current momentum for the time being. For this year, GDP growth is forecast to be 6.8%. At the Party Congress of the Chinese Communist Party, the position of party and state leader Xi Jinping was strengthened. In the past, Xi favoured a state- and stability-oriented economic policy over a market-oriented policy. The Chinese leadership will therefore continue to strive to maintain economic momentum through state intervention if necessary. This, however, delays the reduction of imbalances in the Chinese economy, which in turn increases the risk of a sudden economic collapse. The already materialised increase in producer price inflation will also increasingly be reflected in consumer prices. After 1.5% in 2017, an inflation rate of 2.1% is expected for this year.

This year, the *Japanese* economy is likely to weaken somewhat. Firstly, fiscal stimulus, which has recently stimulated domestic demand, will gradually diminish. Secondly, demand from abroad is likely to slow somewhat. GDP growth is likely to fall to a still well-above potential rate of 1.4%. Although the economy is running above potential, the output gap is on the verge of being closed (IMF) or has already closed (Japanese Cabinet Office) and companies are finding it increasingly difficult to fill vacancies. Against this background a tightening of ultra-expansive monetary policy is not to be expected given the still stubbornly low inflation rate. The good economic situation, however, will allow the inflation rate to pick up and reach 1.0% this year.

After a weak year for *India*, triggered by different structural reforms and one-off events, a gradual increase in its growth rate is expected. In the medium term, the current implementation of several structural reforms will help to push growth above the 8%-mark. For 2018, an overall growth rate of 7.6% is expected.

For the remaining East and Southeast Asian region (*South Korea, Indonesia, Taiwan, Thailand, Hong Kong, Malaysia, Singapore,* and the *Philippines*) current growth dynamics will remain steady. In the medium run, the slowdown of growth in China will have a dampening effect on the entire Asian region. In the short run, however, stronger international trade will also benefit this region. Although remaining favourable overall, the economic climate in many of these countries has deteriorated in recent months. All in all, real GDP is expected to grow by 3.7% in these East Asian countries this year.

For the largest economy of this region, South Korea, stronger fiscal support should also keep GDP growth at around 3% this year. At the same time, construction investment will slow down following the tightening of regulations in residential construction and mortgage lending. Weak employment growth is also dampening private consumption. In the light of the first step towards tightening monetary policy taken at the end of November last year, inflation is also expected to stay at just under 2% this year, and thereby below the regional average.

1.4.5 Latin America and Russia

Although in the commodity-exporting countries of Brazil, Russia, and Mexico, assessments of the current situation are still negative, expectations are turning increasingly positive. The fundamentals for the *Mexican* economy are looking favourable, although the two major earthquakes in September last year will hold back the overall growth rate for this year. In *Brazil*, the now historically low interest rates set by its central bank, together with an overall flourishing world economy, will support the country's economic recovery. With a

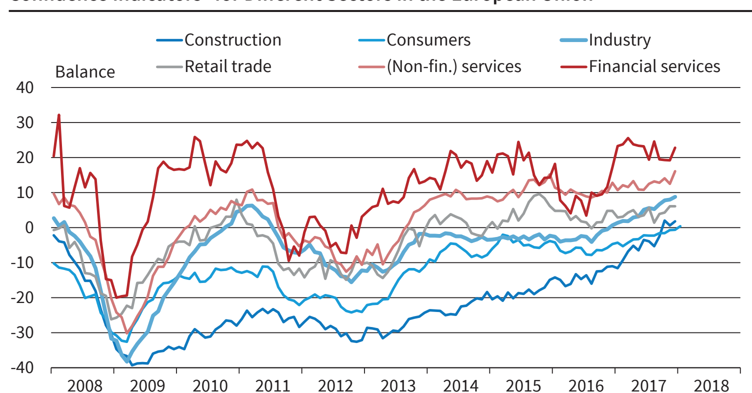
growth rate of 1.9%, a moderate upswing is about to set in.

The prospects for *Argentina* are good. Following a deep recession caused by radical market-oriented structural reforms in recent years, its economy returned to strong growth in 2017. Whether the abolition of foreign exchange controls and the reduction of trade barriers will suffice to lead the country to sustainable growth after years of economic stagnation remains to be seen. In order to attract more foreign investors, Argentina will need to reduce its high tax burden on companies and reduce its excessive state budget deficit. It is important to bring its high inflation rates under control, which have 'skyrocketed' as a result of the massive devaluation of the Argentinian peso and the elimination of subsidies for electricity and gas.

Macroeconomic imbalances, unorthodox policies, rising inflation and lack of investment are keeping *Venezuela* in a serious economic crisis. A default on government foreign debt could cause creditors to confiscate foreign assets and thereby pose a huge risk to the already paralysed economy. The currency traded in the parallel market is crashing from one record low to the next. Its drastic slump came after the announcement in December that the country was trying to restructure its foreign debt, without clarifying how. Successful restructuring is critical as over 9 billion US dollars in debt will mature this year.

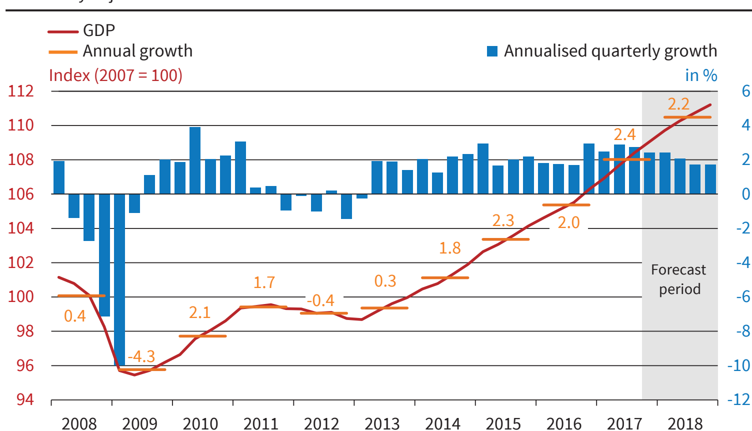
In *Russia*, the overall robust growth observed last year has the potential to be sustained in the quarters ahead. In particular, improving consumer demand, lower inflation and looser monetary policy together with improved oil prices will lay the foundation for a prolonged recovery. On the downside, the potential of an expansion of Western sanctions remains a key downside risk to economic growth. Growth is forecast to be 2.0% this year.

Figure 1.31
Confidence Indicators[a] for Different Sectors in the European Union



[a] Arithmetic means of selected (seasonally adjusted) balances on business and consumer tendency survey questions. Balances are constructed as the difference between the percentages of respondents giving positive and negative replies.
Source: European Commission; last accessed on 27 January 2018. © CESifo

Figure 1.32
Real GDP in the European Union
Seasonally adjusted data



Source: Eurostat; last accessed on 27 January 2018; EEAG calculations and forecast. © CESifo

1.4.6 Europe

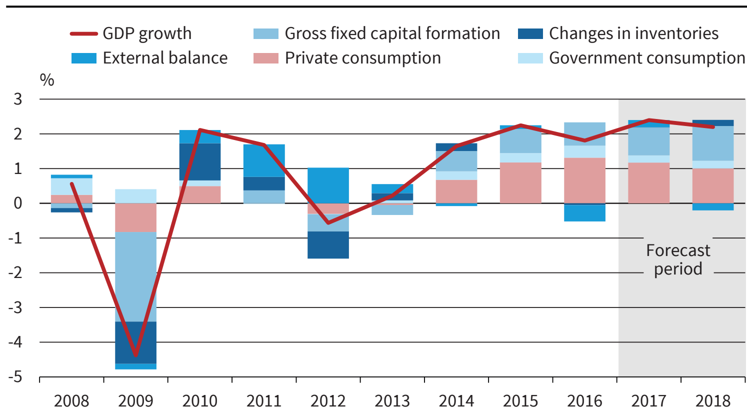
Cyclical Situation

Fuelled by low macroeconomic and political uncertainties, the business confidence indicators for the European Union all report positive balances for the first time since 2007 (see Figure 1.31). Even the consumer confidence indicator published by the European Commission has basically reached zero, which historically happened in early 2001 for the last time. Other leading economic indicators also remain consistently positive for the European Union and the euro area in particular, and point to a continuation of the upturn this year.

In line with last year's growth performance, GDP expansion rates are likely to remain near or slightly above an annualised 2%. After an overall growth rate of 2.4% last year, real GDP is forecast to grow by 2.2% this year (see Figure 1.32). With the output gap closed by the end of last year and growth still above potential, the former is going to open up over the course of the year.

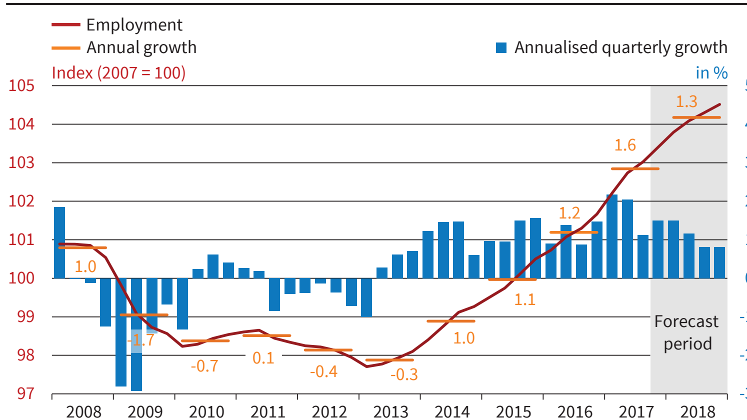
Improvements in the labour market and favourable lending conditions are likely to further stimulate domestic demand, while the positive outlook for the global economy will boost export demand. However, since imports into Europe are also expected to grow somewhat more strongly, the growth contribution of net exports will remain modest and significantly short of the figures in previous recoveries (see Figure 1.33).

Figure 1.33
Demand Contributions to GDP Growth in the European Union[a]



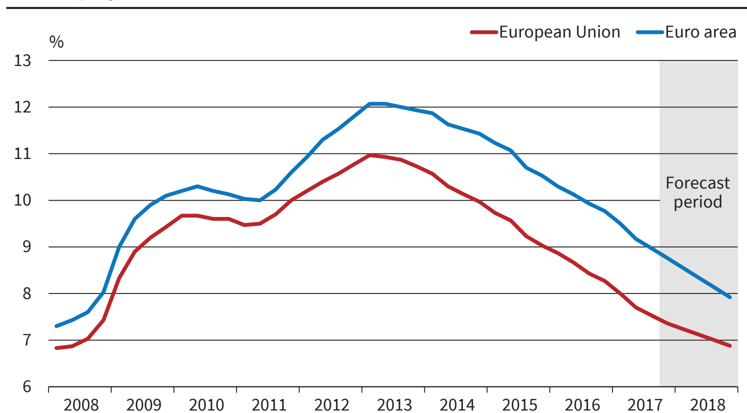
[a] Gross domestic product at market prices (prices of the previous year). Annual percentage change.
Source: Eurostat; last accessed on 27 January 2018; EEAG calculations and forecast. © CESifo

Figure 1.34
Employment in the European Union
Seasonally and work-day adjusted data



Source: Eurostat; last accessed on 27 January 2018; EEAG calculations and forecast. © CESifo

Figure 1.35
Unemployment Rates in the Euro Area and the European Union
Seasonally adjusted data



Source: Eurostat; last accessed on 27 January 2018; EEAG calculations and forecast. © CESifo

Whereas in previous years, private consumption was in the driver's seat of the economic recovery, lower gains in purchasing power will result in consumption growth rates this year being somewhat lower than last year. More in line with previous upswings, gross fixed capital investment has become an important driver. Favourable financing conditions, less uncertainty and increases in capacity utilisation are encouraging firms to ramp up their investment.

In this upward spiral, the recovery will allow for the further creation of additional jobs (see Figure 1.34). Although employment growth of 1.3% will not reach the rate seen for last year (1.6%), it will still be sufficient to further reduce the overall unemployment rate in both the European Union and the euro area.

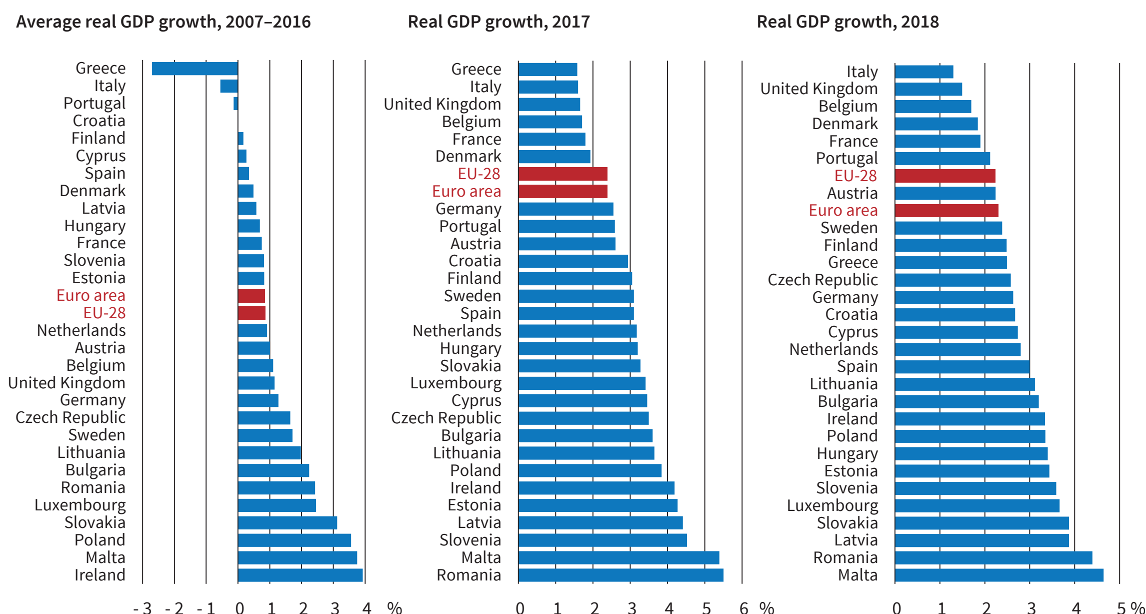
For this year, an average 7.1% of the working population in the European Union will be registered as unemployed. By the end of the year, the unemployment rate for the European Union will have returned to its pre-crisis levels (see Figure 1.35). Although the reduction in the euro area will be similar, it will still be about 1 percentage point above that seen before the start of the Great Recession by the end of the year.

The inflation rate is likely to pick up this year as a result of the closed output gap, the improved labour market situation and stronger wage growth. This is also indicated by the growing share of companies reporting plans to increase their prices in the months ahead in business tendency surveys performed by the European Commission. The initial rise in consumer prices is also being driven by higher energy prices. Under the assumption of relatively stable oil prices, this effect, however, will abate over the course of the year. In the euro area as a whole, inflation will therefore remain at 1.5% this year.

Differences across Europe

The economic recovery has reached all member states, reducing differences in GDP growth rates (see Figure 1.36). The expansion rates of Germany and France are estimated to be 2.6 and 1.9% in 2018. Among the five largest economies, Spain has the best growth prospects (3.0%). Both Italy's and the United Kingdom's growth rates will remain, at 1.3 and 1.4% respectively, well below the euro area

Figure 1.36
Economic Growth in EU Member Countries



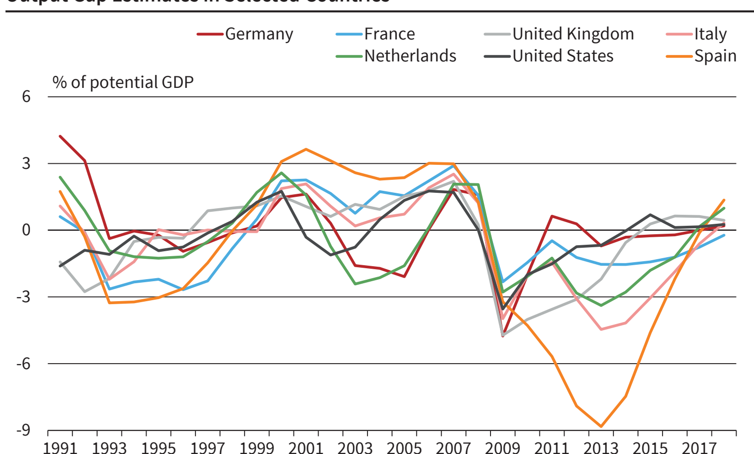
Source: Eurostat; last accessed on 27 January 2018; 2017 and 2018: EEAG forecast.

© CESifo

average of 2.5%. Hence, although Spain is back on a convergence path, the same cannot be said for Italy. With well-above average growth rates overall, the eastern parts of Europe are continuing to catch up with their western counterparts.

The differences in price developments remain significant across the euro area countries. They reflect the different rates of economic recovery and heterogeneous labour market conditions. According to estimates by the European Commission, this further improved environment will allow most European countries to experience a closed output gap this year (see Figure 1.37). Germany, the Netherlands, and Spain will face the highest inflation rates (1.9, 1.5, and 1.5%, respectively); in France and Italy, these rates will be significantly lower (0.9 and 1.2%, respectively, see Table 1.A.2).

Figure 1.37
Output Gap Estimates in Selected Countries



Source: Eurostat; last accessed on 27 January 2018.

© CESifo

Prospects for the labour market are likely to improve further and unemployment rates across the European Union should continue to decline. While the unemployment rate is likely to fall in each of the five largest economies, it will do so from very different levels. This year, the unemployment rate in Germany is likely to fall to 3.6%, while in Spain, Italy, and France, it will only drop to 15.2, 11.,2 and 9.4%. In Spain, the labour market is expected to develop most dynamically. The opposite holds for the United Kingdom where the unemployment rate is likely to more or less remain at its already low level.

Although GDP growth in *Germany* has likely remained above potential this winter, some slowdown in dynamics seems likely. This is supported by a current business situation that has not really improved further and less dynamic developments in industrial production. Nevertheless, all of the signs still indicate a booming economy. The upswing in Germany will continue in 2018 as a result, boosted by domestic demand and exports. Private consumption will expand strongly, driven by rising effective wages, increasing transfer income, and rising employment. Like last year, public consumption remains significantly weaker than in 2015/16; which reflects markedly reduced migration inflows. As capacity utilisation increases further, business investment will continue to expand strongly. Growth in both commercial and residential

construction, however, will gradually slow down. This is indicated by the decline in building permits. Even though growth will remain considerably high in view of the strong global economic momentum, exports are unlikely to rise quite as strongly as in 2017. All in all, German GDP is expected to increase by an average of 2.6% this year. As a result, the output gap, which has been positive since 2016, will grow noticeably. Overall, job market prospects remain good, but the currently strong growth in employment will gradually slow down. In light of the continued buoyant economy, consumer prices are expected to increase by 1.9% this year. The shortages in employment supply will lead to higher labour market tensions. Earnings per employee are expected to rise by 3.4% this year.

Economic growth in *France* will remain robust at an annual pace of 1.9% this year. Strong external demand, a rebound in tourism, robust business confidence, job creation, and the initiated labour market reforms will all support the upswing. Last year's labour market reform facilitates enterprise-level negotiations, especially for small businesses, and simplifies the complex management of employee representation. The reform is likely to make the French economy more competitive and to stimulate investment and growth, especially for small and innovative companies. The government also plans to invest heavily in training, to simplify the overly complex education system and strengthen apprenticeship training. All this will help to improve the labour market outcomes of less skilled workers. A ceiling on compensation to be set by courts to compensate workers for dismissals should encourage the use of permanent contracts. Implementing the plan to increase social contributions for companies that rely excessively on short-term contracts is likely to have a similar effect. All and all, these reforms have the potential to improve access to more secure jobs and lead to more training for many workers.

In the *United Kingdom*, uncertainty for companies and households remains high. Uncertainty regarding the outcome of the Brexit negotiations means that UK GDP is set to grow only slowly this year. Overall, 1.4% growth is expected for 2018. Both private consumption, investment, and foreign trade should contribute positively to the overall economic expansion. As both private consumption and investment activity slow down, foreign trade will become the main economic driver. However, this pace of growth will not be sufficient to warrant a further decline in the unemployment rate. Inflation remains at 2.6% this year, well above the inflation target of the Bank of England. This outlook triggered an interest rate hike of 25 basis points in November last year. Given the economic situation, the Bank of England will probably not initiate a further interest rate step this year. Further steps may only follow when the economic effects of the negotiations with the European Union will become more apparent.

According to the available leading indicators, the economic momentum in *Italy* is expected to gradually level off in the quarters ahead. Domestic demand will continue to expand. The expected flattening of private consumption will be compensated for by increased investment activity. For the current year, the Italian economy is forecast to expand at an overall rate of 1.3%. A downside risk to the forecast stems from the parliamentary elections in Italy, which will be held on 4 March 2018. Opinion polls indicate a significant shift to the right. The populist and immigration-critical 5-star movement is on a par with the Democratic Party, which is currently in government. Difficult government formation would lead to higher risk premiums on Italian government bonds, which, in turn, would negatively impact the financial sector and the economy.

As growth in domestic demand slows somewhat, GDP growth in *Spain* will drop slightly to 3% this year. The expansionary effect of corporate and household spending on pent-up demand and temporary supportive factors like low oil prices and lower taxes is expected to gradually decline. However, continued job creation and favourable financing conditions will continue to support private consumption and business investment. The contribution of net exports to growth will gradually decline. The unemployment rate should fall to 15.2% this year, which is still well above the European average. Inflation will remain at a similar level to last year at 1.5%.

After Ireland, Portugal, and Cyprus, *Greece* will also finally pull out of its GDP trough and continue to grow on a stable path. The Greek economy is forecast to grow by 2.5% and is thus starting to recover at a rate comparable with the economies of Portugal, Cyprus and Ireland. Their growth rates are forecast to be 2.1, 2.7, and 3.3% respectively.

The economies in the *Central and Eastern European* region will continue to grow, albeit at a pace that is somewhat lower than last year in almost all of these countries. Some stimuli in foreign trade are to be expected from the ongoing recovery in the euro area and Russia. As the decline in unemployment is not going to be as strong as last year, the positive impulses from domestic demand are expected to decline somewhat. Historically low interest and inflation rates will continue to support investment dynamics in the region.

REFERENCES

Bussière, M., G. Callegari, F. Ghironi, G. Sestieri, and N. Yamano (2013), "Estimating Trade Elasticities: Demand Composition and the Trade Collapse of 2008-2009", American Economic Journal: Macroeconomics 5(3), 119–151.

Felbermayr, G., C. Fuest, J. Gröschl, and D. Stöhlker (2017), "Economic Effects of Brexit on the European Economy", EconPol Policy Report 1(4).

Joint Committee on Taxation (2017), "Macroeconomic Analysis of the Tax Cut and Jobs Act as Ordered Reported by the Senate Committee on Finance on November 16, 2017", (JCX-61-17), 30 November 2017.

Tax Foundation (2017), "Preliminary Details and Analysis of the Senate's 2017 Tax Cuts and Jobs Act", Special Report Nr. 240.

Tax Policy Center (2017), "Macroeconomic Analysis of the Tax Cuts and Jobs Act as Passed by the Senate Finance Committee", 1 December 2017.

APPENDIX 1.A
Forecasting Tables

Table 1.A.1

GDP Growth, Inflation, and Unemployment in Various Countries

	Share of total GDP in %	GDP growth			CPI inflation			Unemployment rate[a]		
		in %								
		2016	2017	2018	2016	2017	2018	2016	2017	2018
Industrialised countries:										
EU-28	24.9	2.0	2.4	2.2	0.3	1.7	1.7	8.3	7.6	7.1
Euro area	18.1	1.8	2.4	2.3	0.3	1.5	1.5	10.0	9.2	8.6
Switzerland	1.0	1.4	1.0	2.3	−0.4	0.5	0.5	4.9	4.8	4.6
Norway	0.6	1.1	2.1	1.8	3.6	2.0	1.8	4.7	4.1	3.9
Western and Central Europe	26.5	0.5	0.6	0.6	0.1	0.4	0.4	8.2	7.5	7.0
US	28.2	1.5	2.3	2.6	1.3	2.1	2.1	4.9	4.4	4.0
Canada	2.3	1.5	2.9	2.1	1.4	1.6	1.9	7.0	6.4	6.2
Japan	7.5	1.0	1.8	1.4	−0.1	0.4	1.0	3.1	2.9	2.8
Industrialised countries (total)	**64.5**	**1.0**	**1.5**	**1.5**	**0.5**	**1.1**	**1.1**	**6.7**	**6.1**	**5.7**
Newly industrialised countries:										
China	17.0	6.7	6.8	6.6	2.0	1.5	2.1	.	.	.
India	3.4	7.1	6.2	7.6	4.9	3.3	4.7	.	.	.
Russia	1.9	−0.2	1.9	2.0	7.0	3.0	3.5	.	.	.
East Asia[b]	6.8	3.4	3.8	3.7	1.6	2.3	2.3	.	.	.
Latin America[c]	6.3	−2.0	0.8	1.6	21.1	43.9	138.8	.	.	.
Newly industrialised countries (total)	**35.5**	**1.5**	**1.7**	**1.8**	**2.1**	**3.3**	**9.5**	.	.	.
Total[d]	**100.0**	**2.5**	**3.2**	**3.2**	**2.6**	**4.4**	**10.6**	.	.	.
World trade growth in %[e]		**1.4**	**4.4**	**4.2**				.	.	.

[a] Standardized unemployment rate; [b] Weighted average of Indonesia, Korea, Malaysia, Tawain, Thailand, Philippines, Singapore, and Hong Kong. Weighted with the 2016 levels of GDP in US dollars; [c] Weighted average of Brasil, Mexico, Argentina, Venezuela, Colombia, and Chile. Weighted with the 2016 level of GDP in US dollars; [d] Weighted average of the listed groups of countries; [e] Trade of goods.

Source: EU; OECD; IMF; ILO; National Statistical Offices; CPB. 2017 and 2018: EEAG forecast.

Table 1.A.2

GDP Growth, Inflation, and Unemployment in EU Countries

	Share of total GDP in %	GDP growth			Inflation[a]			Unemployment rate[b]		
		in %								
		2016	2017	2018	2016	2017	2018	2016	2017	2018
Germany	21.1	1.9	2.5	2.6	0.4	1.8	1.9	4.1	3.8	3.6
France	15.0	1.2	1.9	1.9	0.3	1.1	0.9	10.1	9.7	9.4
Italy	11.3	0.9	1.6	1.3	−0.1	1.3	1.2	11.7	11.5	11.2
Spain	7.5	3.3	3.1	3.0	−0.3	1.7	1.5	19.6	17.2	15.2
Netherlands	4.7	2.2	3.2	2.8	0.1	1.3	1.5	6.0	4.9	4.5
Belgium	2.8	1.5	1.7	1.7	1.8	2.2	1.5	7.8	7.3	7.0
Austria	2.4	1.5	2.6	2.2	1.0	1.9	1.9	6.0	5.5	5.3
Finland	1.4	1.9	3.0	2.5	0.4	0.9	1.4	8.8	8.7	8.3
Portugal	1.2	−0.2	1.6	2.5	0.0	1.2	1.0	23.6	21.9	20.5
Greece	1.2	1.5	2.6	2.1	0.6	1.5	1.5	11.2	9.4	8.5
Ireland	1.8	5.1	4.2	3.3	−0.2	0.3	1.2	8.4	6.3	5.8
Slovakia	0.5	3.3	3.3	3.9	−0.5	1.3	1.7	9.7	8.2	7.5
Luxembourg	0.3	3.1	4.5	3.6	−0.2	1.6	1.6	8.0	6.8	6.0
Slovenia	0.4	3.1	3.4	3.7	0.0	1.8	1.7	6.3	6.0	5.7
Lithuania	0.3	2.3	3.6	3.1	0.7	3.7	2.6	7.9	7.2	6.6
Latvia	0.2	2.1	4.4	3.9	0.1	2.9	2.9	9.6	8.7	8.3
Estonia	0.1	3.0	3.5	2.7	−1.2	0.9	0.9	13.0	11.4	10.3
Cyprus	0.1	2.1	4.3	3.4	0.8	3.7	3.2	6.8	7.4	8.1
Malta	0.1	5.5	5.4	4.6	0.9	1.3	1.6	4.7	4.3	4.3
Euro area[c]	**72.4**	**1.8**	**2.4**	**2.3**	**0.3**	**1.5**	**1.5**	**10.0**	**9.2**	**8.6**
United Kingdom	16.1	1.9	1.7	1.5	0.6	2.6	2.6	4.8	4.4	4.4
Sweden	3.1	3.2	3.1	2.4	1.1	1.6	1.6	6.9	6.6	6.3
Denmark	1.9	2.0	1.9	1.8	0.0	1.0	1.4	6.2	5.8	5.8
EU-22[c]	**93.4**	**1.9**	**2.3**	**2.2**	**0.3**	**1.7**	**1.7**	**9.0**	**8.3**	**7.8**
Poland	2.9	2.9	3.8	3.3	−0.2	1.9	2.3	6.2	4.8	4.0
Czech Republic	1.2	2.6	3.5	2.6	0.6	2.3	1.8	4.0	2.8	3.0
Romania	1.1	4.8	5.5	4.4	−1.1	1.1	3.3	5.9	5.3	5.2
Hungary	0.8	2.2	3.2	3.4	0.4	2.5	3.2	5.1	4.4	4.3
Bulgaria	0.3	3.2	2.9	2.7	−0.6	1.1	1.2	13.4	13.9	13.5
Croatia	0.3	3.9	3.6	3.2	−1.3	1.1	1.4	7.6	6.6	6.4
New Members[d]	**8.0**	**3.1**	**3.9**	**3.4**	**−0.2**	**1.9**	**2.3**	**6.1**	**5.1**	**4.8**
EU-28[c]	**100.0**	**2.0**	**2.4**	**2.2**	**0.3**	**1.7**	**1.7**	**8.3**	**7.6**	**7.1**

[a] Harmonised consumer price index (HICP); [b] Standardised unemployment rate; [c] Weighted average of the listed countries; [d] Weighted average over Slovakia, Slovenia, Lithuania, Latvia, Estonia, Poland, the Czech Republic, Romania, Hungary, Croatia and Bulgaria

Note: GDP growth rates are based on the calender adjusted series except for Ireland, Slovakia and Romania for which Eurostat does not provide working-day adjusted GDP series.

Source: Eurostat; 2017 and 2018: EEAG forecast.

Table 1.A.3

Key Forecast Figures for the European Union

	2016	2017	2018
	Percentage change over previous year		
Real GDP	1.9	2.4	2.2
Private consumption	2.3	2.0	1.8
Government consumption	1.6	1.0	1.1
Gross fixed capital formation	3.6	3.4	4.2
Exports of goods and services	3.5	5.2	4.3
Imports of goods and services	4.8	4.4	4.6
Net exports[a]	−0.4	0.5	0.0
Consumer prices[b]	0.3	1.6	1.7
	Percentage of nominal GDP		
Government fiscal balance[c]	−1.7	−1.2	−1.1
	Percentage of labour force		
Unemployment rate[d]	8.6	7.6	6.7

[a] Contributions to changes in real GDP (percentage of real GDP in previous year); [b] Harmonised consumer price index (HCPI); [c] 2017 and 2018: forecasts of the European Commission; [d] Standardised unemployment rate

Source: Eurostat; 2017 and 2018: EEAG forecast.

Table 1.A.4

Key Forecast Figures for the European Area

	2016	2017	2018
	Percentage change over previous year		
Real GDP	1.8	2.4	2.3
Private consumption	2.0	1.8	1.6
Government consumption	1.7	1.1	1.2
Gross fixed capital formation	4.5	3.2	3.6
Exports of goods and services	3.3	5.0	4.4
Imports of goods and services	4.7	4.2	4.0
Net exports[a]	−0.5	0.5	0.3
Consumer prices[b]	0.3	1.5	1.5
	Percentage of nominal GDP		
Government fiscal balance[c]	−1.5	−1.1	−0.9
	Percentage of labour force		
Unemployment rate[d]	10.0	9.2	8.6

[a] Contributions to changes in real GDP (percentage of real GDP in previous year); [b] Harmonised consumer price index (HCPI); [c] 2017 and 2018: forecasts of the European Commission; [d] Standardised unemployment rate

Source: Eurostat; 2017 and 2018: EEAG forecast.

Building Trust between Suspicious Minds

2.1 INTRODUCTION

The modern international system is constructed on the principle of the sovereign nation-state whose citizens have taken their destiny into their own hands. But the actions of nation-states clearly have consequences that go beyond national boundaries. Their economic success or failure impacts conditions elsewhere; they may set positive or negative policy examples; and they may deliberately seek to impose costs on other countries. Coordination between nation-states can clearly create a public good. But to what extent is that element of coordination compatible with the philosophy of the nation-state, and the choices made by citizens in the national context?

Most coordination institutions have states as their members and are owned by states. There is the United Nations Organization, built on lessons learnt from the experience of the League of Nations. The European Union is also built around the same principle, and gives micro-states like Cyprus, Luxembourg, and Malta a formally equivalent voice to France, Germany, or Italy in many institutional settings (including the European Central Bank, ECB). Given global and regional links, in what sense is the nation-state the appropriate setting for thinking about public goods and the general welfare of its citizens?

How is interaction within and between nation-states shaped? Trust is one of the most important elements that hold societies together. Trust is the basis of confidence: indeed the etymological root of 'confidence' is the Latin *confidere*: trusting together. Trust enables economic, social, and political interactions both within countries and internationally. It is also instrumental in forging common social identities. It is strengthened when there is contractual security in a relationship; but it is also created by the simple existence of repeated and continuing interactions between people. There is a spiral of interaction: trust allows good rules to be formulated, and good rules make for more trust. But conversely, the absence of rules increases distrust and makes it hard to establish a secure contractual framework.

The project of building a functional collaborative European community of nations is in many ways a unique experiment (Kohli, 2000). It crucially depends on trust in different ways and on a multitude of levels. Trust between people (individuals) of different nationalities impacts social cohesion within Europe and the eventual forming of an ambiguous and blurry European identity as part of the multi-dimensional identities of people in Europe. Trust between economic entities is essential for fostering close international business relationships and creating successful multinational business networks across Europe.

Mutual trust has also developed as a key legal concept in Europe, with a common judicial space, known as the Area of Freedom, Security, and Justice, created by the Treaty of Amsterdam of 1997, whereby member states are committed to mutual recognition, in other words to give full recognition to judicial decisions taken in other jurisdictions across the European Union. This concept depends on mutual trust that similar standards are applied. Generally, since nation-states play the key role in European politics, trust between European states is critical for fostering the spirit of cooperation in Europe. In the words of the well-known Elvis Presley song, "We can't go on together / With suspicious minds / And we can't build our dreams / On suspicious minds." But trust appears to have been weakened in the aftermath of the financial crisis (Dustmann et al., 2017).

In this chapter we discuss the origins of nation-states and their functionality, before analysing trust in the European context between people, in business transactions and internationally. We then talk about whether trust or distrust in national institutions influences attitudes towards European integration and institutions (as well as international order). We conclude by commenting on the trade-offs inherent in one of the most significant European policy tools to-date, namely EU enlargements. Subsequent chapters in this report examine whether plural closer or larger arrangements between states ('clubs') make the task of coordination easier (Chapter 3); and whether the European Union has produced a convergence that may increase levels of trust (Chapter 4). Has enlargement created significant problems of trust, and reduced Europe's ability to confide or *confidere*?

2.2 HISTORY

Nation-states originated at different times in different parts of Europe. By the later Middle Ages, and certainly in early modern Europe, France, England and then the Netherlands were identifiably states with a fiscal capacity and a strongly developed sense of identity, often defined by geography. As Shakespeare eulogised in his play *Richard II*:

> "This royal throne of kings, this scepter'd isle,
> This earth of majesty, this seat of Mars,

EEAG (2018), "Building Trust Between Suspicious Minds",
EEAG Report on the European Economy, CESifo, Munich, pp. 35–46.

> his other Eden, demi-paradise,
> This fortress built by Nature for herself
> Against infection and the hand of war,
> This happy breed of men, this little world."

Further east and south, the nation-state was fundamentally a nineteenth century development. Namely, many peoples of Central, Eastern and South Eastern Europe were, for centuries, ruled by multi-national Austro-Hungarian and Ottoman empires. On the other hand, Germany and Italy emerged as united nation-states at roughly the same time, namely in the third quarter of the nineteenth century and following wars of unification. The later nation-state was partly the product of a new belief in the importance of linguistic identity as a shaper of political community – articulated above all in Johann Gottfried Herder's path-breaking *On the Origins of Language*. But by the mid-nineteenth century, especially in Germany and Italy, this linguistic definition was coupled with another insight: that the nation was an ideal geographic space for economic development and the management of shared resources. Individual German principalities and city states ('Kleinstaaterei') could not deal with the problems of poverty and migration in the impoverished circumstances of the first half of the nineteenth century. They could not construct the railroad systems needed to link natural resources, above all iron ore and coal. In 1868, on the eve of German unification, the influential journalist August Ludwig von Rochau spoke of unity as not being, "A matter of the heart; for Germans, it is fundamentally a purely commercial business" (von Rochau, 1868). There is an obvious parallel between nineteenth century economically-driven state- and nation-building and the late twentieth century process of European integration, where a search for a framework and a rationale for larger markets drove a process of building new institutions, but also of forging a new identity. There was a hope that common symbols – flags, coins, banknotes – would strengthen a new sense of identity.

Identity is also built by pooling resources. However, when resources are transferred in the absence of a powerful belief in coherence and a sufficiently high level of trust, they may be widely perceived as a painful and destructive extraction of resources. Thus, pooling resources can help to build, but also potentially erode common identity. Nation-states initially developed a fiscal capacity primarily for military purposes, but by the second half of the nineteenth century increasingly for the provision of a broader range of public goods, including the education of national citizens, and subsequently for welfare and transfer provisions, too. In the late nineteenth century the German economist Adolph Wagner formulated a 'law' of increasing state activity (Wagner, 1892). The redistributive functions of states expanded greatly in the twentieth century, along with their democratisation.

At the same time as states moved towards economic interventionism and expanded their activity, the locus of economic activity shifted to a much larger geographic basis. Raw materials, foods, metal ores, and other commodities from outside Europe played an increasingly important role. Some commentators began to argue that the age of the classic nation-state had passed, and that the future belonged to just a few colonial empires. Between them, these empires – the British, French, German, and perhaps also the latecomers like the United States, Russia, and even Japan – would rule the world.

There was thus a fundamental paradox: states were just the right size for social protection, but the wrong size for economic activity. That paradox emerges more clearly with the growing globalisation of economic activity.[1] This phenomenon became particularly apparent at both the beginning and the end of the twentieth century, and much less visible in the interwar era as globalisation retreated and a backlash set in. Small states began to feel more vulnerable on their own, and under pressure to collaborate in order to 'manage' globalisation in their best interests.

In multi-national empires, peoples were restive and craved liberation and the creation of their own nation-states. Smaller nation-states in Europe developed a strong sense of identity in the face of the challenges from imperial systems. In cases where the neighbours were highly threatening, as was Germany in the Nazi period, for example, the external threat facilitated the construction of a social compromise. Building social solidarity through redistributive systems that would include farmers and workers became the core of a new and highly successful example of how democratic consensus politics could be built, above all in smaller states, in Scandinavia and in Switzerland.

So nation-states had – in what economic historians now call the first era of globalisation – two options: they could develop into empires (and Belgium could follow the Netherlands in this regard), or they could develop protective mechanisms for cushioning their citizens from the shocks of globalisation. The first option was bound to create international conflict, while the second was moulded by the threat of conflict.

After 1945, the Western European empires (in which coordination was imposed by a single political authority) quickly disintegrated – often violently as in the cases of Algeria, Kenya, and Vietnam. That left the successful small state model based on social solidarity as a European political ideal, but it also meant that the problem of coordination – with countries making trade-offs involving losses in some areas and gains in others – would be the central issue of European politics.

Trust tends to be higher in small states and communities, and larger states tend to require more rules in the absence of trust. Small states are necessarily more open to global interconnections,

[1] For a discussion of the size of nations see Alesina and Spolaore (2003).

and particularly to trade; they have larger social safety nets, transfer mechanisms, and government spending ratios. These can be seen as an ideal defence or compensation mechanism in the face of globalisation (Rodrik, 2011). On the other hand, states that are bigger and more diverse are less inclined to redistribute (Alesina, Glaeser, and Sacerdote, 2001). They are also less open to trade flows. Rather than compensating for globalisation in the small state mode, they try to use power to shape globalisation in a way that fits in with their domestic balance of interests. These differing mechanisms by which small and large states cope with openness and globalisation largely describe adjustments to the development of trade and to trade shocks.

There is another way in which openness impacts the political process, namely through levels of trust. Globalisation creates greater diversity, but may also create bigger shocks and can leave some people feeling like victims of discrimination. As a result, people may become less likely to build or endorse social support networks that are based on trust (Alesina and La Ferrara, 2002). Transfer payments are less popular when citizens suspect others of cheating or being undeserving. That mistrust increases with ethnic or racial diversity. So globalisation, if coupled with increased migration flows, rubs against the trust established in states and undermines the economic and political foundations that make it possible.

As in the past when nineteenth century nation-building created new units and new sizes of political entities, in times of increasing globalisation the question of coordination arises. National political existence is challenged by internationalised economic behaviour. Modern globalisation, even more than earlier instances, binds national fortunes together. Whereas trade globalisation in the nineteenth century mainly referred to the exchange of manufactured goods for commodities, the new variant of globalisation that has emerged by the end of the twentieth century and in the new millennium involves complex global value chains, in which product specialisation means that goods are shipped back and forth in the course of production and assembly (Baldwin, 2017). The worldwide supply chains that complex products like modern jet aircraft require constitute a new form of global integration. The IT revolution marks a potentially even more radical disruption to the old order of things, and to the very notion of a national economy. Participants from all over the world are increasingly finding their place in the global market with rapidly declining search costs (e.g. without having to move in search of a job). This new type of globalisation provides major growth opportunities. At the same time, it is also an important source of vulnerability for national economies. For smaller economies in particular, finding and maintaining their place within global business networks often requires sacrificing full independence in matters of national economic policy. More specifically, the needs of cross-national business networks often contradict the demands for extensive social protection on which people in many European countries have learned to depend. As more jobs go virtual, this is bound to add to the pressure, creating serious strains in the fabric of society.

2.3 REFORM INITIATIVES AND INTERNATIONAL ORDER

Reforms – whether fiscal adjustment or micro-economic changes to labour market institutions – are initially painful and unpopular. Voters may penalise governments that undertake reforms. Politicians who foresee voter defection may be reluctant to implement measures that will later cost them votes and perhaps their office. As a result, reform packages are typically only adopted once a situation has spun out of control and when muddling through becomes impossible. The major phases of economic crises in Europe have always been associated with some sort of coordinated reform exercise.

The 1970s were widely supposed to have discredited fiscal Keynesianism. Smaller economies in Europe – notably in Scandinavia and Austria – abandoned the very high rates of corporate tax that had developed as part of the interwar compromise, because they feared the loss (“exit” in the terminology of Hirschman, 1970) of large corporations. The 1990s saw another wave of crisis, and another wave of fiscal retrenchment in the wake of housing market and bank collapses in Scandinavia. The global financial crisis produced yet another wave of adjustments. An independent fiscal council with advisory functions was seen as one way of countering the pressure of interest groups on governments and parliaments. After the financial crisis, some European countries instituted such councils: Sweden in 2007, Hungary in 2009, and the United Kingdom in 2010. These bodies have been characterised by a high degree of independence, and a willingness to offer critical assessments of government forecasts and policy. However, they have also led to conflict with governments, and the Orban government in Hungary even ended up replacing its fiscal council. The task of establishing national fiscal councils as an instrument of European cooperation was written into the Six Pack of EU reform measures in 2010.

Some reform initiatives may involve an attempt to free ride, to extract advantages for one national collective at the expense of other collectives. That motivation is especially evident in times of economic hardship, and distributing the costs of a crisis outside the national unit is a very appealing option for politicians. Tax policy or bank secrecy are both often cited as examples of this sort of activity. Smaller European countries may introduce lower rates of capital taxation in the hope of attracting enterprises or of incentivising

multinational enterprises to declare their profits in the country, rather than in another jurisdiction.

Hence, there is a demand for externally managed coordination. In the context of European monetary integration, the European mechanism was often presented as a necessary external compulsion to induce reforms for which there would otherwise be no domestic constituency. The European Monetary System was used to enhance policy credibility, as it functioned as a mechanism for "tying hands" (in the phrase of Giavazzi and Pagano, 1988). The introduction of the euro and the process of following the Maastricht convergence criteria was a way of creating incentives, particularly by lowering the cost of government borrowing, and at the same time of setting up restraint mechanisms to establish credibility.

This may be adequate motivation for a one-off reform or belt-tightening exercise, but is very likely to run into reform fatigue. In the language of international institutions, externally imposed programmes are vulnerable because they lack ownership.

2.4 TRUST AMONG EUROPEANS

It is intuitively clear that the extent to which one can integrate Europe into a functional community of nations (no matter what particular form such a community may take) is greatly influenced by how different European nations view themselves and each other. Various European surveys and opinion polls try to get a handle on this issue. Before presenting the evidence, we would like to highlight that it is primarily generated by surveys where respondents answer questions about their attitudes towards European institutions and/or towards various people in Europe. It goes without saying that asking people questions regarding their feeling of trust in theirs and other nationalities is potentially touchy. For this reason, apparently, these questions were not asked in more recent European surveys. Be that as it may, these kinds of surveys say something about stated preferences of Europeans. Unfortunately, we could not find evidence about revealed preferences of Europeans (for example, the extent to which they intermarry and how that changes over time). Genna (2003) argues that the probability of gaining support for the European integration project crucially hinges on the positive view that people have about other nations with whom they are supposed to integrate. Using the results of the Eurobarometer surveys for the first 12 member states, for the years 1986 to 1994, he finds that support for European integration is far stronger for those individuals that express trust in people from Southern European countries. The same is true for people that hold a favourable view of the two most dominant nations in the Union, namely Germany and France.

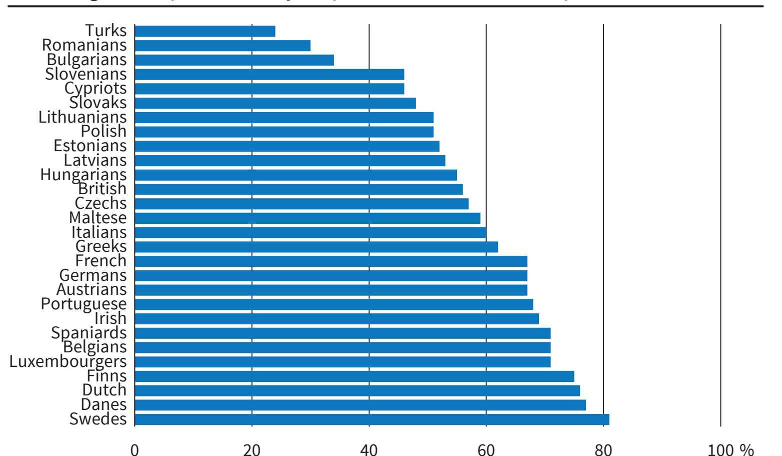
Delhey (2007) discusses how successive waves of European expansion have impacted social cohesion in Europe. He posits that the effect of enlargement on cohesion depends upon how much the existing members differ from the new entrants. The most important differentiating factors are the level of modernisation (including the quality of institutions), cultural proximity (in terms of language and religious proximity) and whether a newcomer is large enough to be perceived as a potential threat. Using Eurobarometer surveys from 1976 to 1997 he finds empirical support for these claims. Moreover, he argues that enlargements towards Northern Europe did not lower social cohesion in the Union. By contrast, expansion towards Southern Europe has done so since these countries differed more both in the quality of their institutions and their cultures from earlier entrants. He goes on to predict that the same would be the case with expansion into Eastern Europe (but this wave of expansion happened in years not included in his sample).

Gerritsen and Lubbers (2010) provide perhaps the most complete and up-to-date study of the factors influencing the trust that EU citizens have both in their fellow co-nationals as well as in members of other European nations. The study is based on over 400,000 trust evaluations made by the European Election Study in 2004. Importantly, and in contrast to previously mentioned studies, this study also includes several Eastern European countries both as trust-givers (a total of 20 countries is included in that sense) and as trust-receivers.

In line with previous studies, citizens of northern countries are trusted the most by other Europeans (see Figure 2.1). Citizens of large European countries like Germans and French are trusted less than those

Figure 2.1

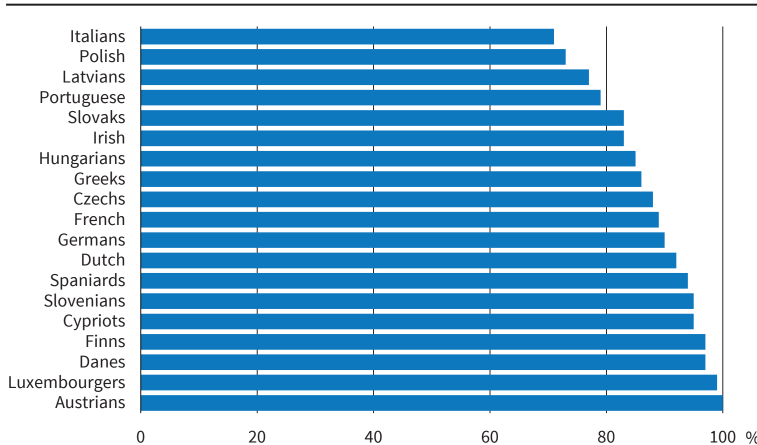
Percentage of People Trusted by Respondents from Other European States



Source: Adapted from Table 1 in Gerritsen and Lubbers (2010).

© CESifo

Figure 2.2
Percentage of People Expressing Trust in Own Population



Source: Adapted from Table 1 in Gerritsen and Lubbers (2010). © CESifo

of Nordic countries and almost to the same degree as Southern Europeans. Below them, in terms of levels of trust by other Europeans, rank Eastern and Central Europeans who had just joined the club in 2004 when the survey was conducted. At the bottom of cross national trust scale were three countries that, at the time of the survey, were not yet members of the EU: Bulgaria, Romania, and Turkey.

It is also interesting to see how much trust various countries place in their fellow countrymen (see Figure 2.2). It is worth noting that Northern Europeans, and especially Austrians, expressed a very high level of trust in their compatriots whereas Italians and several Eastern European nations (and the Irish) seem less inclined to trust each other. But it is also striking that levels of trust vary significantly within individual countries: in the case of Italy, Guiso, Sapienza, and Zingales (2016) argue that the differences in trust levels go back to the medieval experiences of self-governing city-states with high trust in Northern Italy and feudal rule, often with foreign rulers, in the Mezzogiorno.

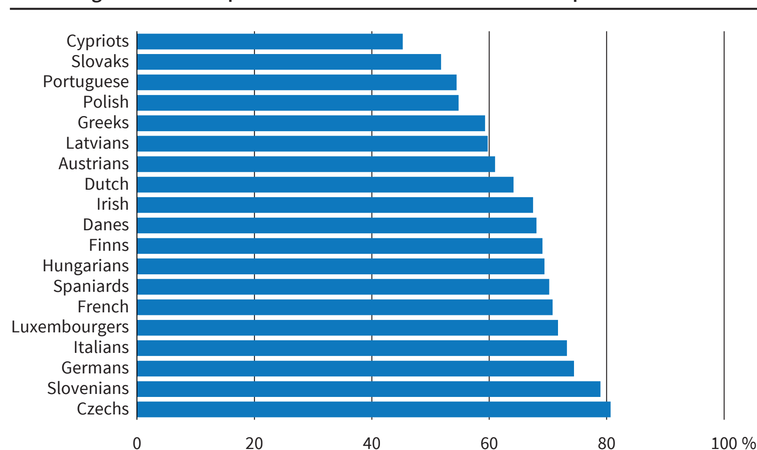
A related question is the extent to which citizens of various countries trust their own people more than they trust other nations. One tentative way to try to get a handle on that could be to divide the fraction of people that expressed trust in other nations by the fraction of people that expressed trust in their compatriots. We can refer to this measure as relative trust. The smaller the ratio shown in Figure 2.3, the more, in terms of trust, a nation 'discriminates' against other nationalities in relative terms.

It is worth noting that the citizens of large European nations (Germans, French, and Italians) together with those of smaller states like the Czechs, Slovenians, and Luxembourgers are far less discriminating in relative terms than some Southern and Eastern European nations. There is also a significant difference in the relative evaluation of foreigners by Germans and Austrians, as well as by Czechs and Slovaks. This is curious since, at first glance, nations in each of the two pairs of states are fairly similar to each other.

So, what are the factors that might explain how much Europeans trust their fellow countrymen, as well as other Europeans? When it comes to trust in their own populations, Gerritsen and Lubbers (2010) arrive at a result that contradicts the widely held view that ethnic diversity, either in form of fragmentation (a lot of different nationalities living within a country) or polarity (few significantly represented nationalities in a country) leads to the loss of social capital and, therefore, to greater distrust in fellow countrymen (see Putnam, 2007). In fact, Gerritsen and Lubbers (2010) find that cross-national differences in trust in their own population can be explained primarily by the level of income inequality (they find all other potential explanatory variables to be insignificant).

When it comes to trust in other nationalities, they argue, like Delhey (2007), that cultural proximity (and particularly, similarity of languages and dominant religion proximity) and the quality and prestige of institutions in the target country are significant predictors for cross-country differences in trust. In contrast to Putnam's hypothesis of diversity breeding distrust, ethnic diversity in the trust-giving country may actually have a positive effect on its citizens' perception of other nations. This conclusion holds using various measures of diversity. Importantly, the authors

Figure 2.3
Percentage of Other People Trusted Relative to Trust in Own Population



Source: Adapted from Table 1 in Gerritsen and Lubbers (2010). © CESifo

claim support for the 'unknown is unloved' hypothesis. Namely, the negative effect of cultural distance between nations is partly mediated by the level of familiarity with a particular population. Higher levels of education among survey participants also reduce this negative effect. The authors find that the initially low levels of trust can be somewhat overcome when people become more familiar with other populations and get accustomed to living together either within their own countries or, more broadly, within the European Union.

The familiarisation effect is consistent with the observation that countries that are longer in the European Union are also more trusted than those that have not yet joined or were members for a short period of time only. While, obviously, there can be alternative explanations for this effect, one way to think about it is that when a country joins the European Union, personal, cultural and business interactions with other Europeans increase and, gradually, trust accumulates. If this argument holds, it is certainly an important validation of the freedom of movement of people rule encoded in the Four Freedoms.

It is important to note that the familiarisation and increase in trust do not depend on identification with a set of values. An insightful contribution by Alesina, Tabellini, and Trebbi (2017) show that there is a substantial cultural heterogeneity in the European Union, but that this heterogeneity is less than within countries like the United States or the United Kingdom, or even within individual continental European states. Their conclusion is that "between 1980 and 2009 Europeans became slightly more different in their attitudes toward trust, values such as appreciation of hard work or obedience, gender roles, sexual morality, religiosity, ideology, the state's role in the economy, and related economic issues." But there is similar diversity in the United States, and more strikingly, even greater diversity within individual EU member states. So the central issue becomes the capacity to create trust both with cultural divides and across political boundaries.

2.4.1 The Impact of Trust on International Trade and Economic Integration

Trust is a critical component of establishing business relationships both within a country, and particularly in fostering international business relationships. This is due to the fact that the level of trust significantly impacts search and contracting costs, costs related to information gathering about product or service quality and potential partner reliability, monitoring and other 'soft' types of transaction costs. When such costs are too high, Pareto-improving trading does not materialise, leaving potential partners worse off. On the global level, a 'missing trade', i.e. international trade significantly below the levels predicted by neo-classical theory, is well documented (Trefler, 1995).

European rules and regulations, as well as European institutions, aim to create mechanisms that would reduce part of the transaction costs in inter-European business not only by abolishing direct trading costs such as tariffs, but also, at least in theory, by helping to increase indirect trust (i.e. by lowering legal uncertainty, protecting the right of equal access, etc.). However, the fact remains that, as we have seen above, Europeans trust their fellow countrymen more than foreigners. This indirect (dis)trust may lead to a home bias in business strategies and to a reduction of potential trading gains and other cross-national business activities.

In their 2003 working paper, den Butter and Mosch study the impact of both direct and indirect trust on international trading costs. They construct a gravity model for 25 developed economies, including many European ones. They use the proximity of the legal systems as the key determinant of the level of direct trust. If two countries belong to the same or a similar legal tradition, corresponding firms may have an easier time agreeing on how to draft an appropriate contract including, for example, how detailed the contract needs to be in specifying contingencies. While reducing direct costs is shown to potentially contribute to reducing transaction costs and, thus, to improving international trade, it is indirect trust that has been shown to have even stronger effects. As a proxy for informal trust they use a Eurobarometer survey question on trust between countries (i.e. trust between populations) and find that an increase in informal trust by one standard deviation may lead to an increase in bilateral trade flows of between 90 and 150% (den Butter and Mosch, 2003).

Combining this with the results of the previous subsection, one could conclude that for European Common Market policy to have a maximum impact, economic integration is not enough. Encouraging much closer contacts between citizens of Europe may simultaneously reduce negative stereotyping as well as help indirectly reduce potential hidden barriers to economic and other cooperation. Top universities, international scientific collaborations, or leading multinational companies provide great examples of what can be achieved when people cooperate irrespective of their national origin, cultural, or political differences.

2.4.2 Trust in Relationships between States

In the current institutional setup (and for the foreseeable future) national governments and their leaders play pivotal roles in the European project. For any institutional arrangement to be workable in the long run, one of the crucial issues is therefore the extent to which European countries (and their political leaders) can trust each other.

But what is trust between states? According to the political scientist Aaron Hoffman, trust between states implies a willingness to take risks on the

behaviour of partner countries under the assumption that the partners will "do what is right" (Hoffman, 2002). Thus, the concept of trust involves both the willingness to take risk by forming an expectation about the behaviour of others and, importantly, a belief in "fiduciary" responsibility in a relationship of trust. In a trusting relationship one state would enact policies that delegate partial control over its interests to the partner state or states. This can only happen if a relatively strong belief exists that the other side(s) are going to behave in a trustworthy manner. Examples of trusting relationships are the abolition of border defence between Canada and the United States and the border controls between most EU countries. By the same token, as trust in Europe weakened as a result of the protracted financial and economic crisis and, later, a large influx of refugees, some forms of border control re-emerged between Schengen countries.

Clearly, there is no absolute and unconditional trust between states. The level of trust between states may change over the years both in scope (i.e. in which areas the other parties are trusted), as well as in the intensity or degree of trust. We now briefly summarise some of the tools that can be used to assess or measure the scope and intensity of trust between countries.

Trust between Country Leaders

Negotiations between states are typically carried out by their representatives. This makes the degree of trust that exists between their leaders a very important predictor of trust. It is well known, for example, that the former German Chancellor Helmut Kohl had close relationships not only with the leaders of France and several other Western European countries; but also, to a large degree, with Mikhail Gorbachev, the last President of the USSR. This was instrumental in allowing Kohl to spearhead the reunification of Germany, and in the creation of the European Union. Trust between the leaders helps negotiate measures that grant other states discretion over outcomes previously controlled by others, with a clear expectation that the partners would "do what is right". On the flip side, a betrayal may be taken personally and can lead to a serious damage in a relationship. Note that private statements of leaders in their diaries or private letters are a far more valuable guide than public statements as to the true nature of personal relationships between country leaders.

Oversight Mechanisms

After identifying the discretion-granting policies negotiated by leaders, the next step in determining the scope and depth of trust is to consider mechanisms used to oversee the exercise of that discretion. Even if leaders trust each other implicitly (which is rarely the case), oversight mechanisms are needed for several reasons. The first is to allay the fears and concerns of people not involved in direct decision-making that agreements will actually be followed. Secondly, in most democracies leaders change on a regular basis and with no guarantee of any kind that the new leaders will understand each other as well as previous ones did.

There are two basic types of oversight mechanisms (Hoffman, 2002) (and many shades of grey in between). One is before-the-fact oversight, which takes place before decisions are implemented. In its full form it can be thought of as intensive policing before a crime (i.e. a violation of good behaviour) has been committed. The International Atomic Energy Association, for example, actively polices countries that are potential violators of the non-proliferation of nuclear weapons. It does not wait for the country to actually violate the rules before it starts meddling into its affairs. Obviously, the degree of intrusiveness is determined by the level of (dis)trust between the parties. Europe's attempt to manage fiscal rules before the financial crisis failed spectacularly, with many states (including France and Germany) breaking the rules and the President of the Commission calling the agreement on fiscal rules "stupid". Another type of oversight is after-the-fact oversight, which takes place after decisions are implemented and can be likened to a fire alarm in case of trouble. One example of such oversight is reports by whistle blowers on human rights violations.

Let us now consider the austerity measures implemented in several heavily-indebted European countries after the outbreak of the global financial and the subsequent government bond crisis in the Eurozone. Clearly, these measures are intrusive. They are also imposed after countries have already violated the spirit of 'good behaviour'. In hindsight, it seems clear that the absence of serious policing of fiscal violations *before* these violations were made (or, rather, before they got out of control) was partly responsible for subsequent problems. On the other hand, the degree to which countries allow themselves to be preventively policed is determined endogenously in the process of treaty negotiation. The more a country is willing to commit to an ex-ante oversight, the more it can be trusted not to violate the rules in the future (and vice versa). The degree of such commitment also depends on its trust in partners that such preventive measures are not going to be abused.

Types of Agreements

While some international agreements are oral,[2] most are written on paper. One may be tempted to conclude that written agreements result primarily from a lack of trust, but this is not necessarily the case. For written agreements are a necessity in a very typical situation when third parties (for example, parliaments) need to approve the agreements. Moreover, written agreements are essential if one is to preserve them for times when those who did the negotiations are no longer in office.

[2] One such oral agreement between the USSR and the West apparently stated that NATO should not spread eastwards upon German unification. Violation of an oral agreement may have equally as grave consequences towards building of trust as a violation of a written agreement.

There are two basic types of agreements that states conclude with each other: the first is a *framework-oriented* agreement type dominated by constitutive rules that specify the basic structure, institutional forms, procedures and rights, but do not cover specific implementation details. By contrast, *statute-oriented* agreements are dominated by codes that try to quite specifically spell out the behaviour of parties under sets of potential circumstances. Framework agreements are more indicative of a trusting relationship, *ceteris paribus*. The *ceteris paribus* caveat is important since parties sometimes simply do not want to commit to a more specific agreement type and the framework agreement then appears as the only viable solution if any agreement is to be reached.

To summarise, when analysing trust in relationships between countries, including members of the European Union, it is useful to consider all three of the dimensions described above and, whenever possible, to start with the first (trust between the negotiating parties), followed by a consideration of oversight mechanisms, and finally of the type of agreement in question.

2.5 COORDINATION

Coordination mechanisms can be thought of as a way of managing the redesign of institutions in accordance with long-term needs, but without the pain associated with crisis measures and exceptional adjustments in difficult circumstances. They deal mostly with the establishment of a framework, but not with specific enforcement.

Logically, coordination can be carried out in a number of ways. The first, most important and most successful way in the European setting, is through competition policy: with rules outlawing cartel formation, and the abuse of market dominance. The idea behind this type of coordination is that the market – and not the state – can deliver good outcomes, but only when the state has established a framework of rules. Some of the impetus behind this mechanism came from German sources: the insight about competition facilitated by a state-given framework or order was at the heart of the Freiburg school of *Ordo-Liberalismus*. But it largely came from the model of the United States, where the second New Deal, in the later 1930s, turned competition policy into the state's key weapon against the abuse of corporate power. In the case of competition policy management, there is a clear enforcement mechanism on a European level.

The second form of coordination drew on an important lesson from the interwar period, when the big losers from the globalisation wave were farmers, threatened by competition from outside Europe and by price declines that led to over-indebtedness and bankruptcy. They became politically radicalised, and formed a core support for radical populist parties, mostly on the right (although in some countries, notably Spain, there were also radical left-wing peasants' organisations). Most of the budgetary resources of the European Economic Community and its successor organisations (including to date the European Union) were devoted to the operation of the Common Agricultural Policy (CAP), designed precisely to compensate for losses, stop rural impoverishment and block political radicalisation.

The third coordination exercise was much more problematic. Both fiscal and monetary policy can produce spill-overs. Inconsistent monetary policy, with exchange rate alterations, threatened the complicated system of subsidies calculated under the CAP. That problem, along with concerns over inconstancy in US monetary policy, pushed Europe to try to coordinate monetary policy more closely from the late 1960s onwards, through a move towards a currency union (first laid out as a plan in the 1970 Werner Report). The inflation of the 1970s, with different European countries taking very different stances, frustrated the move towards monetary integration. In the late 1970s, however, in response to a rapid depreciation of the US dollar that strained European exchange rates as the Deutschemark (and the Swiss franc) appreciated against other currencies, including the French franc and the Italian lira, European countries adopted the European Monetary System, with fixed but adjustable exchange rates. Since a great deal of competition occurs in prices, the manipulation of exchange rates can create advantages. In order to prevent a game of competitive devaluation, agreements on exchange rates – or indeed a complete renunciation of the exchange rate as in the case of the European Economic and Monetary Union (EMU) – can be implemented. However, since internal costs may develop differently, real exchange rates can be badly misaligned in the case of a fixed rate system or a currency union, and may give rise to fresh accusations of exchange rate manipulation.

Unsustainable fiscal states create both domestic and international challenges. Burdened states grow less. Furthermore, given European and global interconnections, fiscally irresponsible behaviour by one country creates negative externalities for other countries in the network, especially if they have the same currency. Markets react by putting pressure on such players (e.g. by increasing interest rates and, if they have their own currency, by devaluing the corresponding currencies). But even these market moves create externalities on other network members. The obvious answer to these problems – domestic reform – is unpopular and hard to implement in a democracy.

Discussions at the time of the Delors Report of 1989 raised the question of fiscal discipline in a monetary union, with many central bankers arguing that market discipline alone would not be enough. This resulted in the devising of a set of convergence criteria for monetary union (the Maastricht criteria) that would later remain the central elements of the Growth and Stability Pact. The two central features were a limitation of public

deficits to 3% of GDP, and public debt levels to 60% of GDP. At the time, these limits were widely criticised by academics as arbitrary. It later emerged that, in the face of a severe recession, setting fiscal criteria expressed primarily as a proportion of GDP was problematical, as collapsing GDP would require further fiscal tightening in order to achieve targets. This became an issue in discussions of the so-called troika of European Commission, ECB, and International Monetary Fund (IMF) with program countries in the financial crisis. The IMF's fiscal criteria were initially expressed in terms of numerical targets for deficits, while the Commission thought in terms of share of GDP.

Surveillance by European institutions, but also by international organisations like the OECD or the IMF, was ineffective, and has been subject to a great deal of retrospective criticism. Eurostat did not detect or report wrong national reporting. International institutions were too keen to believe that the EMU was an intensely political project, with an enormous amount of political capital invested, and that surveillance should thus be left primarily to national governments and the European Commission. They were also too eager to accept national assurances that all was well.

A fourth coordination alternative depends on what is usually termed 'soft law', the establishment of norms and benchmarks, and the publication of comparative data, but without any formal enforcement mechanism apart from peer pressure or naming or shaming. In Europe, this approach was developed with regard to employment policy in the late 1990s, at the same time as the move to a monetary union, in an attempt to establish a parallel mechanism of convergence. It was formalised as the Open Method of Coordination at the Lisbon summit in 2000, and then extended to other areas including social inclusion, and later culture and health. It is – and needs to be – tolerant of differences in national approaches. In some ways it is little more than the employment of government resources to make comparisons and draw lessons, a function that may equally be performed by think tanks, academics, and media commentators. The sensitive issue of differences in house prices and affordability, for instance, which is a central issue for social coherence, has been left largely to academics. More recently, international organisations like the Bank for International Settlements and the IMF have started to collect and distribute data on this topic.

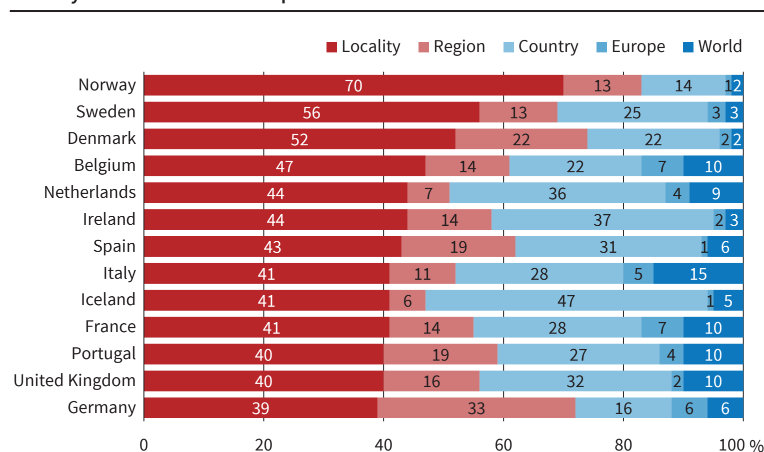
2.6 ATTITUDES TOWARDS A MULTI-LEVELLED EUROPEAN POLITICAL ENTITY

Contemporary Europeans live in a complex political reality. For centuries, people residing in this part of the world have had their local, regional, and national attachments or identities. Now there is a new layer, namely that of a unified Europe. In the political science literature it is often assumed that support for the European project must go hand-in-hand with the establishment of a unifying European identity. Kohli (2000) argues that social identities are dynamic and often conflicting. The predominance of an European identity is by no means a prerequisite for a partial European integration either, but may be necessary to create a federal Europe.

In 1990, citizens of several developed European countries were asked to state whether they primarily identify with their locality (city), region, country, Europe, or the world. Figure 2.4 reveals that most people primarily identified with the local area in which they live, followed by their country or region. By far the smallest fraction viewed themselves primarily as Europeans. On the surface, this is very bad news for European integrationists. Part of the reason for such a low number of 'primarily Europeans' is that those who are globally minded think overwhelmingly of themselves as the citizens of the world. For them, Europe is too narrow a construct. But this result also shows that nation-states do not primarily define the identity of Europeans either. This is especially true in Germany, where people more readily identified with their local place of residence (39%) and Länder (33%) than with Germany as a whole (16%). 6% of Germans and 7% of French also primarily identified with Europe, more than in most other polled nations. Norway, where 70% of the people primarily identified with the local community and just 1% of the people primarily thought of themselves as Europeans, is an extreme case in point.

These results argue for a more nuanced approach towards identity. It makes little sense to force people to choose just one dimension of their social identity (not to mention that geography-based identities may not be very relevant to many contemporary members of our modern global society). As Kohli (2000) shows, when

Figure 2.4
Primary Identifications of Europeans



Source: European Value Study 1990, adapted from Table 1 in Kohli (2000). © CESifo

people were asked whether they would include Europe as part of their identity, over 50% agreed. Thus, people may not primarily view themselves as Europeans, but are including Europe as a component of their more complex social identity.

In Europe, decisions are made at different levels of government. Obviously, most people have a better understanding of local, regional, or national politics than they do of the European political process. For this reason, what happens on the national level may be used to evaluate European institutions and the European integration process in general. In the literature (see, for example, Armingeon and Ceka, 2014), one can roughly classify the different types of trust at a national and European level as follows:

– The 'escapist'; distrusts national government and puts all hopes in the EU.
– The 'nationalist'; trusts national government, but distrusts the EU.
– The 'trusting' citizen; trusts both levels of government.
– The 'detached' citizen; trusts nobody.

In 2007, support for European integration was comparably high in newcomer states and less so in the richest countries of the Union (Figure 2.5, horizontal axis). The global financial crisis followed by the Eurozone debt crisis significantly eroded support for the European Union in many countries by 2011 (Figure 2.5, vertical axis). Unsurprisingly, support dropped the most in those countries that were hardest hit by the crisis (particularly in Greece). On the other hand, in some countries (Finland and Sweden) support for the EU even grew with respect to 2007, although coming from lower initial levels.

An interesting question is the extent to which this drop in support is a result of unfavourable attitudes towards their own government; and to what extent it is a direct reflection of dissatisfaction with the EU austerity policy. Another key consideration is whether more people are switching to 'nationalism' as a result of the crisis? In Figure 2.6 we present how the distribution between the four types of people (in terms of trust placed in their national government and in the European Union) has changed between 2007 and 2011. We do so for those countries that were subject to special IMF measures (crisis countries), those countries that were not in crisis, as well as for the entire EU-27 block.

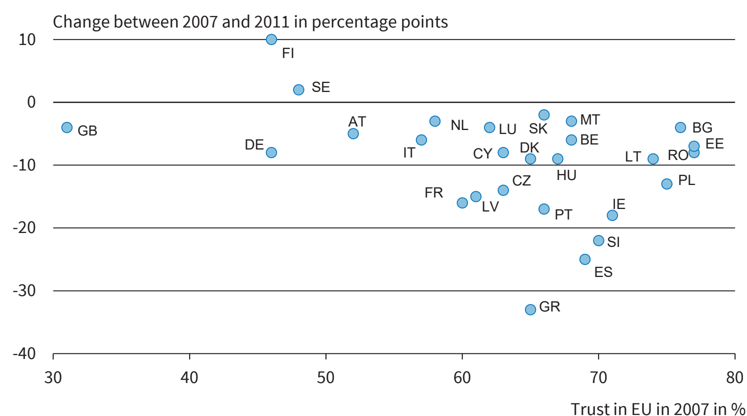
We see that the fraction of people in crisis countries that believed in their government and not in the European Union (the 'nationalists) was quite low before the crisis, and remained low afterwards (it increased from 3 to 4% of the total population). On the other hand, the number of those citizens that trusted everybody dropped from 28 to 21%, while the share of those that did not trust anybody grew very significantly (from 30 to 45%). At the same time, the number of people putting their whole trust in the European Union dropped from 39 to 30%. Thus, before the crisis many people put overwhelming trust in the European Union, while others expressed disappointment in all levels of government.

In countries without IMF conditionality in 2011, by contrast, there were initially more 'nationalists' than in countries without IMF conditionality, and this share remained almost unchanged after the crisis hit (it grew from 9 to 10% of the population). While trust waned across the board, it did so less in countries without IMF conditionality.

In order to better understand the relation between support for national and European institutions, Munoz, Torcal, and Bonet (2011) compare support for national and European parliaments. They study whether political confidence in institutions spills over between the two levels (national and European); or whether citizens compare and compensate by placing more confidence in one level of government when they mistrust another. They find that, in the case of parliamentary trust, both arguments partially hold. At the individual level, levels of trust in national and European parliaments are closely related. However, in countries with better institutions the frame of reference for approval of the parliament's work is set higher. In such countries, support for the European parliament is lower. In countries where national institutions function more poorly, by contrast, approval of the European parliament is higher, *ceteris paribus*. Support for the European institutions is therefore not formed independently of support for national institutions.

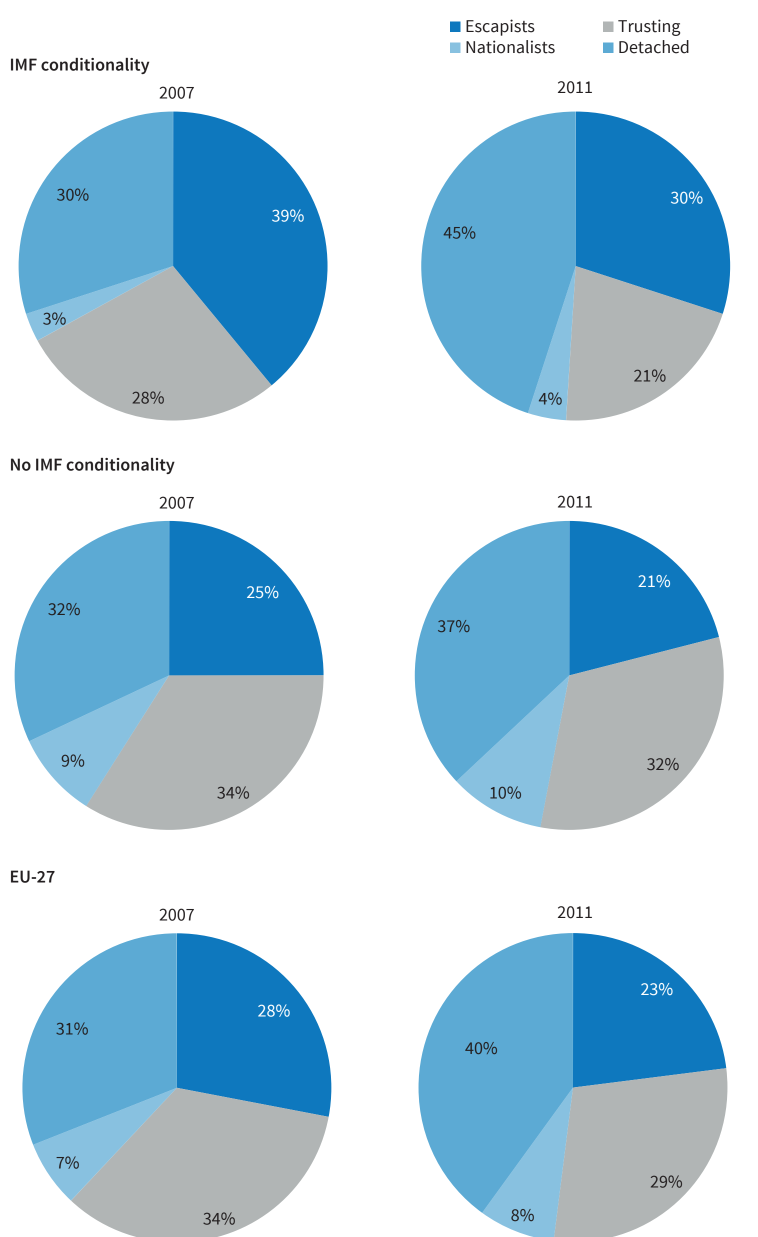
Figure 2.5

Percentage of People Expressing Trust in the European Union in 2007 versus the Difference in That Trust between 2011 and 2007



Source: Eurobarometer survey (2007), adapted from Table 1 in Armingeon and Ceka (2014). © CESifo

Figure 2.6
Trust in EU and National Governments



Source: Eurobarometer survey (2007), adapted from Table 1 in Armingeon and Ceka (2014). © CESifo

2.7 THE ENLARGEMENT PROCESS

We conclude this introduction by briefly commenting on the trade-offs inherent in the European enlargement process. Each political entity has its horizontal and vertical scope (see Genna, 2003). The enlargement process has been a critical strategic tool for the creation of an economically and politically (partially) unified Europe. It ultimately determines the horizontal scope or the boundaries of the European Union.

Imagine the Union without the enlargement. It would consist of three relatively large and three small European countries. Some would argue that a union of just these six countries may well had been more cohesive than is currently the case, and might have advanced further on a notional road to political union. Others, however, would counter that even these six countries are significantly diverse in terms of culture, language, economic prosperity or religion. Part of the attraction of inviting others into the European club of nations has been to try to bring potential allies and/or dilute the influence of other powerful nations. Its primary goal, however, was to extend the common market. One thing is certain: without enlargement, the club would be far less relevant not only in the world, but also in Europe. Germany would probably not have been allowed to unify in such a setup either. Without the prospect of joining democratic and prosperous European nations, it may also be much harder to achieve transitions in both the East and the South East of Europe. Enlargement is driven by the logic of expanding a stabilising mechanism.

On the other hand, a rapid expansion has, as we have seen, increased diversity and suspicion, while reducing social cohesion in the Union. There are growing doubts about the application of the principle of mutual recognition in criminal law. This mistrust, in turn, may have repercussions on the ability of the Union to achieve further integration. Thus, the horizontal scope impacts the vertical one (and vice versa). It is worth noting that in order to have clearly defined and defensible EU borders, as well as for several strategic reasons, it seems clear that sooner or later another expansion may be necessary, namely one that would eventually incorporate the Western Balkan countries (see EEAG, 2016). These countries are already integrated with Europe financially. In addition, European and global business networks are increasingly expanding their production and distribution networks into the region (via companies like Siemens, Fiat, Bosch, etc.). Failure to integrate the Western Balkans into the European Union would open the doors even wider for other nations (China, Russia, Turkey) to exert strong outside influence in the region, of which only China's influence would be primarily economic in nature (the New Silk Road initiative passes squarely through the region).

We have seen that cultural differences and the quality of institutions are significant predictors of people's attitudes towards other nations in Europe (and towards the integration process). On the other hand, the longer countries are together in the Union, the more people get to know each other, and the more relaxed, on average, they start to feel about other European nationalities. A major success of the Erasmus programme has been to demonstrate to young people across Europe that they are all part of something bigger than just their own country, that there is a whole wide world out there inhabited by people just like themselves. One can argue that the cultural differences between people from South Eastern Europe with, say, Austrians, Germans, or even Scandinavians are certainly not insurmountable. This is demonstrated by the ease with which most people from these countries integrate into Western Europe or Scandinavia (and vice versa, albeit in much smaller numbers). Moreover, the evolving global technological revolution is reducing the de-facto distance between cultures as time passes, since most young people today seem to inhabit a similar virtual world.

With the exception of fear of Islamic radicalism and a wider scepticism about Islam, most Europeans do not attach overwhelming importance to practicing religion. Thus, religious differences can hardly be a true impediment to a mutual understanding between most Europeans. One important objective barrier to easier European integration, namely the issue of different languages spoken across the continent, can be overcome over time if at least two foreign European languages (from different major language groups) are studied in schools across Europe. It may also be that machine or automatic translation (both of written and spoken texts) may quickly remove the barrier between people who do not share the same language. In addition, the process of European accession, while difficult, requires improvements in the quality of institutions in those parts of Europe in which they are lagging behind.

REFERENCES

Alesina, A. and E. La Ferrara (2002), "Who Trusts Others?", *Journal of Public Economics* 85(2), 207–234.

Alesina, A., E. L. Glaeser, and B. Sacerdote (2001), "Why Doesn't the United States Have a European-Style Welfare State?", *Brookings Papers on Economic Activity* 2001(2), 187–277.

Alesina, A. and E. Spolaore (2003), *The Size of Nations*, MIT Press, Cambridge MA.

Alesina, A., G. Tabellini, and F. Trebbi (2017), "Is Europe an Optimal Political Area?", *Brookings Papers on Economic Activity* 2017, 169–213.

Armingeon, K. and B. Ceka (2014), "The Loss of Trust in the European Union during the Great Recession since 2007: The Role of Heuristics from the National Political System", *European Union Politics* 15(1), 82–107.

Baldwin, R. (2017), *The Great Convergence: Information Technology and the New Globalization*, Harvard University Press, Cambridge MA.

den Butter, F. A.G. and R.H.J. Mosch (2003), "Trade, Trust and Transaction Costs", *Tinbergen Institute Discussion Paper* 03–082/3.

Delhey, J. (2007), "Do Enlargements Make the European Union Less Cohesive? An Analysis of Trust between EU Nationalities", *Journal of Common Market Studies* 45(2), 253–279.

Dustmann, C., B. Eichengreen, S. Otten, A. Sapir, G. Tabellini, and G. Zoega (2017), "Europe's Trust Deficit: Causes and Remedies", Centre for Economic Policy Research.

EEAG (2016), "Western Balkans: Coming Together", *The EEAG Report on the European Economy*, CESifo, Munich, 99–123.

Genna, G. M. (2003), "Images of Europe and Europeans: In-Group Trust and Loyalty for European Integration", Paper presented at the 2003 annual meeting of the Midwest Political Science Association.

Gerritsen, D. and M. Lubbers (2010), "Unknown is Unloved? Diversity and Inter-population Trust in Europe", *European Union Politics* 11(2), 267–287.

Giavazzi, F. and M. Pagano (1988), "The Advantage of Tying One's Hands: EMS Discipline and Central Bank Credibility", *European Economic Review* 32(2), 1055–1082.

Guiso, L., P. Sapienza, and L. Zingales (2016), "Long-Term Persistence", *Journal of the European Economic Association* 14(6), 1401–1436.

Hirschman, A. O. (1970), *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States*, Harvard University Press, Cambridge MA.

Hoffman, A. (2002), "A Conceptualization of Trust in International Relations", *European Journal of International Relations* 8(3), 375–401.

Kohli, M. (2000), "The Battlegrounds of European Identity", *European Societies* 2(2), 113–137.

Munoz, J., M. Torcal, and E. Bonet (2011), "Institutional Trust and Multilevel Government in the European Union: Congruence or Compensation?", *European Union Politics* 12(4), 551–574.

Putnam, R. (2007), "E Pluribus Unum: Diversity and Community in the Twenty-first Century", *Scandinavian Political Studies* 30(2), 137–174.

von Rochau, A. L. (1868), *Grundsätze der Realpolitik*, Vol. II, J.C.B. Mohr, Heidelberg.

Rodrik, D. (2011), *The Globalization Paradox: Democracy and the Future of the World Economy*, Norton, New York.

Trefler, D. (1995), "The Case of Missing Trade and Other Mysteries", *American Economic Review* 85(5), 1029–1046.

Wagner, A. (1892), *Grundlegung der politischen Ökonomie,* Vol. 1, CF Winter.

All Together Now:

The European Union and the Country Clubs

3.1 INTRODUCTION

The project that was originally formulated in the aftermath of World War II and developed into the European Union is not just a set of intergovernmental treaties and agencies. Like the citizens of traditional nations, its Member Countries abide by a set of constraints, enjoy common policy facilities, and are bound into an entity with a legal personality. Like a federal state, this supranational body rules over its citizens directly, who are all entitled to a uniform set of rights upheld by the European Court of Justice, including the freedom to carry out economic activities throughout its territory. This very special entity was envisioned to assume some of the roles and prerogatives of all governments, along an 'ever closer union' path.

History has not seen uniform convergence towards this ideal. This chapter focuses on past and possible future exceptions to the rule that all European states and their citizens should participate equally in a single integration process. In the past, such exceptions have mostly concerned the United Kingdom and a few other countries. But the idea of explicitly relaxing that rule has been voiced often, particularly after the fall of the Berlin Wall and in the run-up to the introduction of the euro single currency. The euro crisis, Brexit, and global geo-political trends now make it interesting to revisit the issue of whether European states might subscribe to only some of the rights and obligations of membership. This possibility features prominently in the European Commission's (2017a) menu of EU configurations in 2025. That document refrains from conveying a clear sense of which may be the most plausible among the possible scenarios that its readers are asked to contemplate. Like a magician inviting the audience to pick any card, however, placing "Scenario 3: Those Who Want More Do More" in the middle of the deck of five, it does hint that this is not the least likely to be the most appealing. In that scenario, some member countries would be granted new rights and accept new responsibilities in order to foster the coordination of defence, security, justice, tax and social policies. This would solve some problems, but also raise new issues of transparency and accountability of decision-making and heterogeneity of rights depending on residence.

We discuss these and other issues in the light of experience and of the theoretical insights and practical analogies afforded by viewing the European Union, and possible sub-entities within it, as 'clubs' of countries. Individuals may or may not apply and be accepted to be members of a country club that offers use of a golf course, a swimming pool, or other enjoyable facilities as well as the pleasant company and support of selected and well-behaved fellow members. These clubs may or may not work well, depending on what they are meant to provide, and how their members are selected and disciplined. Similarly, European states may or may not apply to join the Union, may or may not be accepted as members, and (as in Brexit) may give up their membership. To ensure that the Union functions smoothly, it is necessary to decide which facilities should be available to members, and enforce membership admission criteria and rules of behaviour. The same considerations also apply to a scenario whereby Europe's countries may join not just one Union, but a constellation of more flexible and specialised arrangements that allow for a 'variable geometry' of continental maps and 'multiple speeds' of policy harmonisation and convergence.

Past Reflections about the Future

To motivate and define these concepts it is useful to recall Schäuble and Lamers' (1994; S&L hereafter) remarkably prescient outline of the problems facing the European economic and political integration process then and now, and their blunt (and, at the time, quite controversial) proposed solution deserves to be kept in mind throughout this chapter.

The two German conservative authors were reacting to the Delors report on Economic and Monetary Union, which in 1989 set out the roadmap for further integration: namely the establishment of a single market, to be followed by the adoption of a single currency. In 1994, S&L saw two sets of problems for this project. Those arising from the post-Cold War geo-political instability and trade globalisation, and especially those deriving from the contrast between French and German positions on the prospect of a common defence framework and on industrial, competition and agricultural policies.

S&L were very much aware of how fundamentally heterogeneous France and Germany were in those respects. However, they felt that Germany's place in Western political culture would be endangered if its path diverged from France's, and thought that frank discussions could somehow convince France that "deepening the Union prior to enlargement" was in its own interest. If the two countries could agree to prevent "regressive nationalism" as a response to "external threats, such as migration", they could then

EEAG (2018), "All Together Now: The European Union and the Country Clubs",
EEAG Report on the European Economy, CESifo, Munich, pp. 47–63.

manage an explicit "variable geometry" configuration of the European integration process (these quotes, which still appear very topical, are some of those highlighted by Pond, 2000).

France and Germany would initially only lead themselves, Belgium, the Netherlands, and Luxembourg; set criteria for membership in that core group; and wait for other countries to make sufficient progress, at their own variable speeds, towards membership. Italy, Spain, and the United Kingdom could hopefully join sooner rather than later. Scandinavian countries, along with Austria, Hungary, and other Central and Easter European countries, would first join the Union and then develop more gradually towards integration in the Franco-German core, rather than just with a German economic block: a possibility that, according to Pond's account of the debate about S&L, was seen by France as spelling doom for its hegemony in the European integration process (Pond, 2000).

3.2 GOVERNMENTS AND CLUBS

To assess the pros and cons of a 'variable geometry' approach to European integration, before examining its practical implementation and performance, we first revisit and summarise how governments and clubs provide facilities and services to their citizens and members.

3.2.1 What Governments Do and Where

Countries have borders, and a key role of their governments is that of supplying *public goods* that are or tend to be non-rival (can be used by many individuals without diminishing their usefulness to each of them) and non-excludable (specific individuals cannot be prevented from using them) within those borders. A *pure* public good is defined as one that is completely non-rival and non-excludable, so that all individuals can and must benefit from it equally.

Besides such public goods as lighthouses or the protection provided by armies or the police, governments provide a broad range of services that are complementary to each other and to market activities. States help markets to function by providing infrastructures and regulation. These are also geographically and legally limited by countries' boundaries. Money is accepted for payments in specific countries, and a country's courts need not enforce contracts written under foreign law. Because well-organised, competitive, wide-ranging markets need not benefit all individuals, governments also engage in redistribution. To make competition and market integration acceptable for those who own factors and have skills that are better rewarded in the smaller markets of closed economies, welfare schemes replace or complement previous rural and extended-family solidarity in industrialised and urbanised market economies.

The sets of individuals who benefit from government services are in practice geographically and legally limited by the boundaries of the country's enforcement power. Ships cannot be prevented from seeing a lighthouse only if they happen to be within sight of it, and an army or the police cannot single out individuals they will not protect within the area they defend or patrol, but will not defend individuals outside that area. Because the geographic scope of governments is limited, it can be redefined: States may form, dissolve, or be joined in new, larger entities. In history, the geographic scope of governments has grown along with that of markets, driven by economies of scale and specialization that required legal frameworks and solidarity links broader than those provided by natural families.

3.2.2 Club Goods

As the mention of families makes clear, the state is not the only body that produces and administers goods and services that are not rival and excludable, hence *private* and marketable, and manageable by Adam Smith's invisible hand under laissez faire conditions. Some goods and services that are not completely private, but do not quite belong to the category of public goods, can in fact be managed through private contractual arrangements.

A pure private good gives benefits to the person who owns it and no one else. The production of such goods can be left to the market, which, under some conditions, will allocate resources efficiently. At the other pole is the pure public good that does not suffer from congestion, and from the enjoyment of which it is not possible to exclude people. The archetypal example is national defence: all residents of a country receive its benefits, it is not possible to exclude anyone from them, and the country's having a greater number of residents would not cause the benefits received by any one of them to be lower than if there were fewer residents. National defence cannot be paid for in markets. It must be provided by the state and paid for with revenues from mandatory taxes (free riding would be optimal if contributions were voluntary).

Between the two lie the *club goods* analysed by the economic theory of clubs (Buchanan, 1965), which studies provision and allocation of goods that are to some extent non-rival and non-excludable, if only within well-defined limits. A garden or a swimming pool, for example, may be owned and operated by a group of individuals who establish membership criteria and rules for the use of the common facilities, and empower some of their own to maintain and run them, to enforce the rules and keep out outsiders.

In this and other cases resources are used to provide goods or services that simultaneously benefit several people. Due to congestion, the benefit each person stands to gain from them tends, however, to be smaller the higher the number of users. If the cost of

producing or buying the good is shared between the club members, and the benefits of each member depend (positively) on the quantity of the good available to the club, and (negatively) on the number of club members, and membership is determined as to produce the greatest possible net benefits to each member, then membership will be fixed so that an additional member will have (almost) no effect on the net benefits accruing to each existing member. The reduction in the cost of providing the good to each member would be offset by the reduction in the benefits received, due to the greater congestion. The size of the club good should be larger if this increases the benefits per member more than the cost per member. If benefits grow progressively less quickly, and costs grow at a constant or increasing rate, this determines the optimal number of tennis courts, and the optimal size of swimming pools and pleasant sitting rooms conducive to interesting conversations.

Entry fees that cover investment costs, and usage fees meant to control congestion, can implement this optimal configuration. There may be a one-off payment on joining the club, an initiation fee, annual membership renewal fees, and additional fees for using some of the facilities: a golf club may charge a green fee for using the course (and premium fees for peak periods, discounts for mid-week rounds and retired members), and bill bar and restaurant use. There may also be a charge on, or a payoff to, a member leaving the club. Based on this economic cost-and-benefit analysis, membership and facilities should grow if this reduces average production costs, net of additional congestion. When existing clubs do not find it optimal to admit additional individuals, those left out will set up their own new club, and let it grow to the efficient size that maximizes the net benefits enjoyed by each member.

Costs and payments, however, are not all that clubs are about. The operation of clubs is a delicate matter. Sharing arrangements through private clubs can, in principle, allocate resources efficiently, but information problems and transaction costs can make it difficult. This explains why membership needs to be applied for and may not be granted, and why meetings of clubs' governing bodies are not always peaceful.

3.2.3 Good and Bad Clubs

The production of club goods, like that of private goods, should be left to the market if contracts that ensure efficiency can be stipulated and enforced. This is not a small 'if'. Several practical matters make the operation of clubs less straightforward and their benefits less clear-cut than in the simplest case outlined above, and in textbook markets for fruit and vegetables or other simple, homogeneous private goods.

Some problems are like those that may be present in all private markets. A key feature of any club is the ability to exclude non-members from using its facilities, but the club's borders can be difficult or expensive to delimit. Non-members may occasionally use the pool at night, or outsiders may enjoy the view of a beautifully landscaped golf course. Conversely, the club may also disturb non-members if noise or parking congestion spill over its boundaries.

Other problems are specific to the collective character of the services purchased by club membership. One is that members need not all receive the same benefits (subjectively, in terms of the value they perceive that they get) from the facilities provided. Increasing the size of the membership often involves admitting new members with different preferences to those of the original members. In principle, fees and rules could be tailored to individual characteristics: individuals who are unpleasant or heavy users of the facilities should not be excluded, just charged more for the privilege. In practice, imperfect information and simplicity make this impractical. So bigger clubs may enjoy economies of scale, but are more likely to feature a greater diversity of views amongst their members, and worsen problems of reaching agreement on matters of common interest. Will all the golf-club members support the renovation of the club-house and the gilding of the bath-taps? Some may vote for bling, but others prefer more restrained decorations.

A second problem is that clubs, especially large ones with heterogeneous members, can be cumbersome to run and organise. Within a large club, decision is generally devolved to a small committee (the chairman, treasurer, and other offices, and other committee members), often elected by the membership at large, as decision-making by all members becomes too slow and cumbersome. This puts power in the hands of a few, and makes it possible for coalitions within the club to seize the leadership and impose their own preferences.

Much the same issues naturally arise in any collective entity, including local and state governments. In clubs, however, membership is usually a matter of choice, not a birth right like a country's citizenship. This introduces a third set of problems. Deciding *how many* potential members should be allowed into the club is not enough: when people differ in their behaviour and attitudes, the more vexed question arises of *who* those members should be. Existing members may wish to prevent the entry of new members that hold views very different from their own. They may blackball some candidates for entry. The old money may resist the admission of the new billionaires who, if they gain sufficient influence within the club, may foist expensive and tasteless bathroom furnishings on the entire membership. The possible admission veto is also meant to exclude potential members who seem unlikely to behave well. While clubs generally have rules for acceptable behaviour, and procedures for expelling members who do not adequately adhere to them, enforcing rules and expelling miscreants is likely to be a difficult and costly process.

Because miscreants do enjoy disrupting the operations of a club, they will try to gain admission, and blackballing is unlikely to completely exclude them. When the old membership finds some of their fellow new members to be disagreeable company, they may exit and form their own club. In a perfectly frictionless world, this would produce an efficient constellation of clubs, each just large enough to exploit economies of scale, and segregated by member type to avoid excessive taste heterogeneity. In reality, adjustment costs faced by the club as a whole need not correspond exactly to the entry and exit fees charged to individual members. Moreover, because existing members will hesitate to exit if this means forfeiting the initiation fee they paid on entry, they cannot use the exit option to avoid other members' opportunistic and unpleasant behaviour.

These issues complicate the operation of real-life clubs, and mean that clubs need not achieve a socially efficient provision of club goods. Many clubs do function properly, but the real world is rife with dysfunctional clubs that are bankrupted by dishonest administrators or populated by disgruntled members who fight savagely and inconclusively in governing bodies. Bad clubs do face death spirals, as a shrinking membership makes it difficult to maintain facilities attractive to new members. Their dispatch can be slow and gruesome, however, and may dissipate resources, rather than make them available to better clubs.

While a society consisting of clubs to provide the club goods may be an efficient form of organisation, it need not be: like that of any market mechanism, its efficiency depends on whether a set of conditions holds. From the point of view of members, clubs need not provide a good service. A world of private clubs may also be far from efficient from non-members' point of view. If a club that has been set up to give the maximum benefits to its members has negative effects on non-members, it will tend to be too large (in the sense of having too many members and providing too much of the club good), and everybody would stand to benefit in principle from it being smaller. The converse is true for clubs whose existence gives benefits to non-members.

3.3 COUNTRIES AND CLUBS

Membership as a two-sided choice is what defines a club and, to some extent, is also applicable to states. While most individuals are citizens of a country by birth, some do become or cease to be through marriage or migration. Countries may themselves be formed or dissolved consensually, and the economic theory of clubs suggests that the number, size, and shape of countries may depend on heterogeneous taste for public goods (Alesina and Spolaore, 1997) or income inequality and redistribution policies (Bolton and Roland, 1997).

Traditional nation states were formed by less consensual military (or occasionally dynastic) methods. Their size was adequate for industrial revolution, but over time can become too small for their government to play its role efficiently. The obvious economies of scale in defence and police activities can be strengthened by technological progress in weapons and information. Similarly, it is increasingly necessary for countries to play some of the government's economic roles together when production is internationally integrated, and trade involves knowledge and custom-made components, rather than commodities.[1] In the European Union, supranational policies have mostly been confined to the purely economic area of markets and money, leaving redistribution to member states (aside from agricultural policy and cohesion policies meant to ease adjustment and prevent agglomeration). Other government services are provided or coordinated by other international institutions like NATO for military defence.

The institutional framework for this cooperation is very much the same as that of a club, in that these organisations regulate their own membership and the amount and quality of some of the same public goods that governments traditionally provide within countries. Like any club, they cater only for members: the Baltic Republics need to be defended because they were granted membership. As in any club, granting access to facilities also has a price tag: defending both Western and Central Europe need not be much more expensive than defending the former alone, but plausibly makes an attack more likely.

3.3.1 Clubs within States

Before discussing the pros and cons of countries belonging to such club-like groups, rather than having all the same (possibly none) rights or obligations to each other, it is useful to note that similar organisations and issues exist within states, where municipal governments can and do pool sanitation or water supply services, and regional entities are sometimes granted special responsibilities and privileges. Less obviously, and insightfully, citizens within each territorial unity may also be organised in club-like quasi-governmental bodies, or "functional, overlapping, competing jurisdictions" (Frey and Eichenberger, 1996, p. 343). This can be attractive from a point of view that downplays the useful government roles outlined above and, distrusting dangerously powerful Leviathan states, favours the close citizen control afforded by popular referenda and local jurisdictions. It does not imply that some specific class of individuals have different rights (like native Americans in nineteenth century United States, or citizens of occupied European countries in the 1940s). The idea is that a society of free and equal individuals might organise itself in multiple bottom-up clubs, each providing one specific set of public services and competing for the membership

[1] Bernard et al. (2017), Fort (2017), Johnson, and Noguera (2017).

of heterogeneous individuals who choose freely among them, pay membership fees, and participate democratically in their operation. Some aspects of social life are indeed organised in this way. Individuals may belong not only to golf clubs, but also to churches, health insurance schemes, and sports organisations that span the same territory.[2] Moreover, geographical mobility can to some extent allow individuals to choose the local community that provides their most preferred set of public services. Dissolving the unitary state into a constellation of clubs would, however, entail large transaction costs and thorny organisational problems. Frey (2001) suggests that governments need not be territorial, but it is hard to see how the government's monopoly on market regulation and on collection of the taxes that fund public good provision may be enforced other than on a territorial basis. Moreover, clubs do need to belong to a state, because contracts among club members must be enforced by a higher authority (Eichberger, 2001). Families, for example, do overlap geographically, but their membership is based on marriage contracts recognised by a state, and the behaviour of their members is subject to state laws.

3.3.2 Country Clubs in Europe

A *country clubs* structure may or may not have been emerging consciously, but the reality is that Europe already has something in place along these lines. Many country groups already exist within Europe and around all or part of it. The largest, such as the European Council or NATO, provide relatively vague or tightly focused services. The most numerous are intergovernmental or interparliamentary structures that operate more or less formally, form easily, often dissolve, and are usually not much more permanent and influential than occasional summits between pairs of countries.

Examples of groups meant to address issues of common concerns are the Visegrád group of former Communist countries; the now dissolved Franco-German-Polish Weimar triangle, which in 2011 pushed for defence cooperation, but encountered UK opposition; and the Nordic-Baltic 8 group, which included Iceland and Norway along with six EU member countries, and has been superseded by the Baltic Assembly and Nordic Council groups. Drawing Euler diagrams of such European country clubs is an exercise that requires great skill in handling intersections, and conveys little impression of union.[3]

The institutional structures and duties of these country groups differ widely, but their formation and operation generally resemble the mechanisms that group individuals into families and clubs, and cities and regions into states. They are more likely to be efficient and viable if they make available goods that are non-rival for members, or are at least characterised by strong economies of scale, like defence and market infrastructure. They are less likely to function well if member countries have heterogeneous preferences about the type and size of the facilities provided, or ways to try and free-ride on common facilities. They may generate positive externalities for non-members, for example by developing product standards that can be freely adopted, or negative externalities, for example by enforcing border controls that exacerbate problems outside the club.

These issues are relevant in all policy fields, including defence and other examples of pure public goods provided only to a variable and heterogeneous membership. They are arguably more of an issue when economic policy is concerned. Amongst countries some may value the benefits of a common currency more than others. They may have differing views as to how it should be managed, the target inflation rate, exchange rate management, and other such issues. Like the individuals who are members of a club, so the member countries of supranational organisations should clearly agree on the purpose of their operation and abide by suitable behavioural rules.

To this end the operation and governance of European country clubs, like that of any club, would need to rely on enforceable contractual arrangements. There are always conflicts of interest inside clubs and inside countries: very few policies enjoy unanimous support, and every government faces opposition parties. Conflicts of interest are even more abundant across the borders of EU member countries, and so is the need for a clear and enforceable set of membership and behavioural rules.

States can supply the higher authority needed to enforce the rules of clubs that operate within countries, and can therefore be organised to provide complementary services to a set of members that is homogeneous and small enough to operate efficiently. There are good reasons for tennis clubs to focus on tennis facilities and cater mostly for members who are particularly fond of playing tennis: clubs that provide a broad range of services to many members can be so complicated to organize and run as to offset the underlying economies of scale. Unfortunately, enforcement can be very difficult when clubs are formed by sovereign countries. Unlike tennis or whist clubs, clubs of nations need to ensure that good behaviour is the self-enforcing choice of their members. As we shall see and argue below, clubs of geographically and historically heterogeneous countries can be more viable if they agree to provide a broad variety of services, because having multiple issues on the table can enable compromises and foster trust.

3.3.3 The European Union as a Club

Within a supranational entity that encompasses and partly supersedes the powers of traditional states,

[2] They do so with special gusto in Switzerland, as discussed EEAG (2014).
[3] See https://en.wikipedia.org/wiki/Template:Supranational_European_Bodies for such complex and evolving diagrams.

it is somewhat easier to imagine a more flexible organisation of individual rights and obligations. Casella and Frey (1992) extol the virtues of *functional federalism* for the European Union, which could evolve towards a set of "overlapping jurisdictions without explicit ranking, with each jurisdiction responsible for the provision of a specific class of public goods" (p. 640) so that "regions belonging to different states may form cooperative agreements without passing through the higher jurisdictional level [...] in a highly-decentralized system of intersecting alliances" (ibid.). The existence of a supranational legal structures may in fact underlie the propensity of some regions and ethnicities to secede from member states: Catalunya may want to leave Spain, but certainly would not want to be excluded from the European Union.

The European Union does provide an extensive legal framework, but also aims to enforce a comprehensive set of rights and obligations for its citizens and member states. In Europe, countries are the members of clubs that produce such public goods as common foreign trade policies, a single market, a single money, atomic energy infrastructures, fisheries policy, defence, and so on. These are club goods because each one provides a common set of benefits to each of the members, who need not all value them equally. In a world in which there are many club goods, the extent to which they are shareable, and the degree to which they are affected by congestion, is likely to vary from one good to the next. So, the optimum membership of the club is likely to vary from good to good. Setting up and maintaining each of these institutions requires resources, the costs of which must be borne, not necessarily shared equally, by the members. Non-members should be excluded from the direct costs and benefits, but the operation of some of these clubs does spill over onto outsiders: existence of a single market affects trade and economic activity for non-members. Besides economies of scale and congestion effects, heterogeneity matters: admission of more members into each club requires more compromises on policies to accommodate the circumstances of the new ones, diluting the benefits that accrue to the pre-existing members.

The membership criteria and process for admission of states to the European Union are laid out in Articles 2 and 49 of the current consolidated Treaty on the European Union (TEU). They were decided by a Copenhagen meeting of the European Council in 1993, when enlargement (and possible multiple speed) was looming. In some respects, they resemble those for immigration of individuals into a state: applicants must satisfy some conditions (democracy, human rights, the rule of law, a market economy), promise some behaviour (accept obligations of membership and adopt EU law), and the decision is subject to some political discretion (a unanimous decision of the European Council determines whether these criteria are met, and a majority of the European Parliament is also needed). The membership criteria are also a little like the rules that in some countries entitle certain individuals to citizenship, because only European states may apply and perhaps all should. Since the 2000 Lisbon Treaty, exit from the EU club is allowed with a procedure laid out in Article 50.[4] There is no provision for the expulsion of current member states, but those breaching the EU's fundamental values may be stripped of some of their rights through a procedure laid out in Article 7. While clubs may expel some of their members, states do not usually strip individuals of citizenship, and the European Union sets itself a similar standard.

Enforcement of obligations within the European Union is more difficult than within a state, because misbehaviour by sovereign states is not easy to detect and punish. One government policy area that is completely assigned to the Union is trade policy, but its practical implementation is carried out by national authorities, and their incentives to abide by the rules are weak. For example, British customs authorities might accept fraudulently low value declarations on Chinese textile imports because this reduces the expense and bother of collecting duties that are paid into the Union budget and, while benefiting textile producers in other European countries, prevent British consumers from dressing up cheaply. Eschewing such responsibilities is attractive from a country-specific point of view, but of course as patently illegal in a customs union as self-interested leniency or corruption by public officials is within any country. It should, but need not, be prevented and sanctioned by the club's administration.[5]

Given that enforcement is difficult, and the club's operation and members' good behaviour need to be based on trust, it can be a good idea to let some rules be somewhat less than fully clear. If grounds for expulsion were fully specified upon detection of clearly defined improper behaviour, for example, members might well focus more on avoiding detection than on proper behaviour. And if the process that allows countries to exit the European Union were less unclear than it is proving to be in the case of Brexit, members might well focus more on whether they would benefit from exiting than on behaviour consistent with, and conducive to, continued membership.

3.4 SPEEDS OF EUROPE

Countries that are not satisfied with the rights and responsibilities of EU membership may exit (as the United Kingdom is doing). Alternatively, they may form clubs with a more limited and perhaps less permanent scope than the European Union, or may be allowed to opt out from Treaty provisions by Protocols that establish exceptions to Treaty rules.

[4] EEAG (2017) outlines the procedure and discusses issues arising in the context of Brexit.

[5] In March 2017 OLAF, the EU anti-corruption police, did issue a 2 billion euro fine for the UK for its customs' negligence.

3.4.1 Opt-outs

Denmark and the United Kingdom have a formal opt-out from the adoption of the euro. Ireland and the United Kingdom have a formal opt-out from the Schengen process of the gradual abolition of checks at common borders (signed by some member states of the European Union in Schengen on 14 June 1985 and on 19 June 1990, and integrated into the framework of the European Union as a Protocol in the Treaty of Amsterdam of 2 October 1997; there are also non-EU members that only participate in technical committees). Less prominent opt-outs are Denmark in defence, Poland and the United Kingdom in the Charter of Fundamental Rights of the European Union, and Denmark, Ireland, and the United Kingdom in the area of freedom, security and justice. Unsurprisingly, the United Kingdom has the most opt-outs (and the Thatcher budget rebate is another exception to the uniform treatment of members).

All exceptions highlight a rule, and explicit opt-outs make it clear that signing up to EU membership is, in principle, a package that includes a large variety of obligations and rights. While the membership of Economic and Monetary Union, Schengen, and other clubs within the European Union varies over time (in ways reviewed in the next section), it is supposed to be an automatic implication of EU membership: all EU members without opt-out (currently Bulgaria, Croatia, Cyprus, and Romania for Schengen; Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, and Sweden for the euro area) must join once technical requirements are met (but can avoid joining, like Sweden, by not meeting them). Once again, the structure of the European Union is, in this respect, like that of traditional states, where boilerplate contracts are common: commercial law defines just a few types of limited responsibility companies, and states recognise even fewer types of marriage.

3.4.2 Enhanced Cooperation and PESCO

Besides the fragmentation induced by opt-outs and gradual implementation of technical criteria there are more formal, if admittedly so far less prominent club arrangements that allow countries, within the Treaty framework and relying on the European Union's policy determination and administrative framework, to engage in two forms of cooperation.

The Treaty of Amsterdam introduced an "enhanced co-operation" facility, whereby at least nine member states can co-operate without involving other member states, in a framework that has been approved by the European Commission and a qualified majority of the European Council. This is an explicit exception to the single-speed rule: Article 20.2 specifies that "enhanced cooperation shall be adopted by the Council *as a last resort*, when it has established that the objectives of such cooperation cannot be attained within a reasonable period by the *Union as a whole*" (emphasis added).

When approved by a qualified majority of the European Council, enhanced co-operation can rely on the Union's legal framework and enforcement powers. This distinguishes it from less stable groups of countries that, without formal recognition by the European Union, focus on specific projects (such as military procurements) or function as lobbies in the process of EU policy formation. It is in force only in the fields of patents, divorce law, and property regimes of international couples. The reason why unanimity could not be achieved is, unsurprisingly, the heterogeneity of policy preferences. Sweden objected to common divorce and marriage patrimony rules that would be much less permissive than its own, while Spain and Italy felt European patents should be written in their historically important and beautiful languages, as well as in English, French, and German. Enhanced cooperation has been approved, but is not operational, for financial transaction taxes, and has been discussed for the *web taxes* on multinational internet-based companies.

In military defence matters a *permanent structured cooperation* (PESCO) may be established per Article 42: "Those Member States whose military capabilities fulfil higher criteria and which have made more binding commitments to one another in this area with a view to the most demanding missions shall establish permanent structured cooperation within the Union framework." Their cooperation is to be governed by Article 46, according to the criteria in Protocol No. 10. While these criteria are phrased in rather vague "undertake to" and "have the capacity" terms, the resulting set of rights and responsibilities (with provisions for suspension, or withdrawal) is intended to structure the PESCO as a proper club of countries.

3.5 GEOMETRY VARIATION IN THE PAST

We proceed to inspect what actual experience says about the multi-speed idea. History is not very informative, but we can look at the configuration and performance of variable-membership clubs like the euro area and the Schengen agreement, even if they have only been in existence for relatively short periods of time. The PESCO in military and defence matters has not yet begun to operate, and for this reason will be discussed in the next section, along with other future developments.

3.5.1 The Currency Club

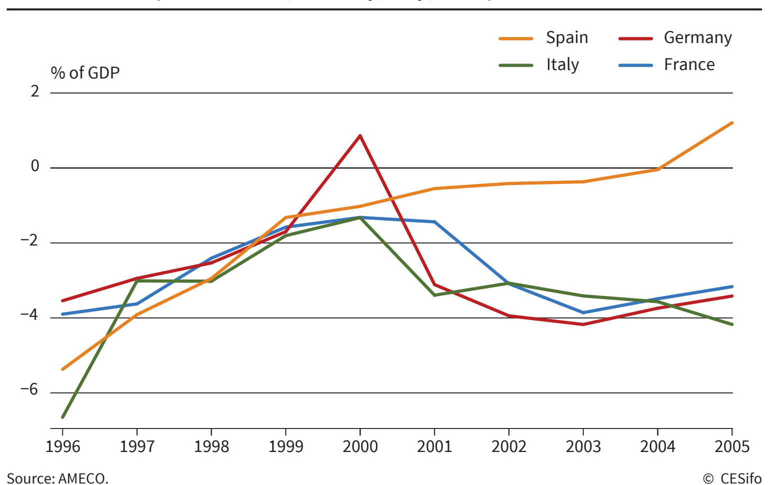
The euro area membership criteria and behavioural rules were agreed in Maastricht, and very much inspired by the variable geometry concept. To be allowed into the single currency club countries need to have low inflation rates, small government deficits, limited or declining public debt, stable exchange rates (and

technically compatible legislation, particularly in terms of central bank independence). Countries that did not satisfy these criteria were to be encouraged to try and catch up to them, at their own speed.

Once in the club, exchange rates were irreversibly fixed and nominal long-term interest rates converged completely. But countries still had to show the seriousness that made them worthy members by abiding by behavioural rules that took the form of the Stability and Growth Pact budgetary limits, later revised, and refined, and extended to include a scoreboard of other macroeconomic policy and performance indicators.

Figure 3.2

Government Surplus for France, Germany, Italy, and Spain



Source: AMECO.

© CESifo

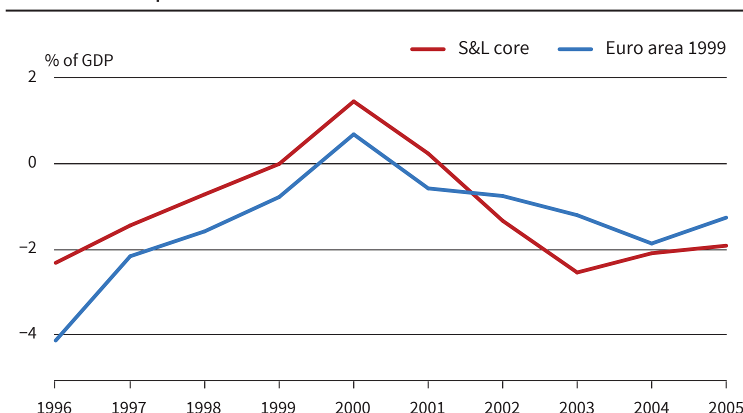
Member Behaviour

When the accession criteria were decided, they might have been expected to keep Italy and Spain out of the club, and restrict membership to the S&L core. That is not what happened, and it is interesting to consult the data to see if the resulting larger club was not as well behaved as the S&L core would have been.

Figure 3.1 displays simple arithmetic averages of government budget balances, which according to the Maastricht criteria should have been balanced or in surplus under normal circumstances within a single-currency area, for both the six-member S&L core and the larger 11-member initial euro area. Sizeable improvements are visible just before the club is set up. In 2000, the core has a slightly larger surplus. Once membership is achieved, however, government budgets veer towards deficit in the following recessionary phase, and the S&L core 'misbehaves' in this respect more strongly than the whole euro area.

Figure 3.1

Government Surplus for S&L Core and Euro Area



Note: Unweighted averages. S&L core: France, Germany, Belgium, Netherlands, Luxembourg. Euro area 1999: S&L core and Austria, Finland, Ireland, Italy, Portugal, Spain.
Source: AMECO.

© CESifo

The early euro area's average fiscal misbehaviour is driven not by Luxembourg, of course, but by France and Germany. The key members of the S&L core group violate the club's fiscal rules soon after its formation. As Figure 3.2 shows, Italy's budget deficit grew sharply after euro adoption, while France's and especially Germany's fiscal behaviour was not better. On this basis, keeping Italy out of the club would not have made it much more viable, and the exclusion of Spain would have been even less justifiable in the light of its strong public surpluses.

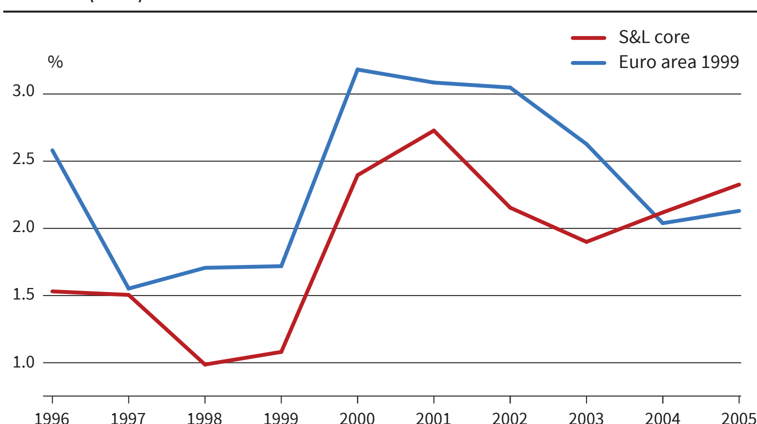
Whether or not one agrees that fiscal rectitude is necessary in a monetary club, the euro area was not equipped with the monitoring and enforcement facilities that are crucial to the proper operation of any club, and particularly not with the means to control its largest and most powerful members. The admission criteria may or may not have been satisfactory, but they did not even keep out Greece, which joined two years later, and currently available data show Greek deficits of up to 8% in the period covered by the figure.

Accession criteria also considered actual inflation, as an indicator of policy credibility. After joining the euro, inflation may or may not be under the control of country-specific policy. Figure 3.3 and 3.4 do suggest that the S&L core did not perform significantly better than the actual euro area in this respect either.

The Maastricht admission criteria did not keep out Italy or even Greece, and the Maastricht behavioural rules did not prevent France or even Germany from misbehaving. This does not exactly support the idea that it would have been better to adopt the different formation envisioned by S&L of a virtuous core surrounded by

Figure 3.3

Inflation (HICP) for S&L Core and Euro Area



Note: Unweighted averages. S&L core: France, Germany, Belgium, Netherlands, Luxembourg. Euro area 1999: S&L core and Austria, Finland, Ireland, Italy, Portugal, Spain.
Source: AMECO.

© CESifo

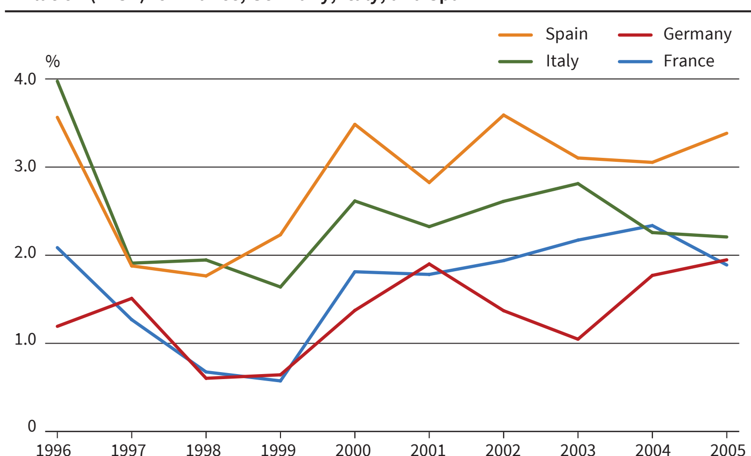
repentant catchers-up.[6] Perhaps S&L were naïve in supposing that countries could be made to behave once in the core. More likely, and quite explicitly in their paper, their criteria for core composition were not economic: severing the knot tied between France and Germany by the European Community would have dire consequences. This very valid point, however, is to some extent applicable to most, if not all, other potential core members. Greece in the Economic and Monetary Union may be problematic, but still preferable to a failed state just outside it, like Libya. When deciding whether to exclude Poland, or separate Germany and France, geo-political considerations can easily end up supporting the traditional view that all European countries should, in principle, satisfy simple conditions for accession to a single Union on a take-it-or-leave-it-basis, and belong to it for better or for worse, in the name of solidarity, as it develops towards ever closer economic and political integration.

Experience suggests that the structure, rather than the membership of the euro club, lies at the root of its problems. The European Commission (2017b) reflection paper lists a very exhaustive catalogue of missing facilities in the euro area club, and cites poor internal governance and a lack of trust as the main impediments to their provision. If an extensively patched-up euro area is still struggling to exit the crisis, it may be because a single currency without suitable banking facilities and fiscal backstops is no more viable as a club than a golf course without parking, or a pool without an emergency crew. Sadly, if the club's contract does not envision those facilities, it is not clear who will decide to set them up, pay the cost and choose their operating rules.

The disappointing performance of the euro area club did motivate the introduction of new sets of rules and some further fragmentation of the Union. The Six Pack and Two Pack, which modified the Stability and Growth Pact also introducing a broader scoreboard of macroeconomic indicators and the European Semester policy surveillance framework were implemented by EU regulations and directives. But the Treaty on Stability, Coordination and Governance fiscal compact took the form of a less permanent intergovernmental agreement, meant to be incorporated in EU law in 2018, among a club of countries that did not include the United Kingdom and the Czech Republic. Neither of these fully addressed the issues arising from the lack of stabilising arrangements within the euro area, which were kept under control on an emergency basis by conditional financial support facilities and are only slowly and haltingly being tackled by the development of banking union facilities. Current discussions of a European Monetary Fund focus on whether or not it should be part of the traditional European legal and governance structure. Its governance might conceivably be based on majority rules dominated by relatively large countries, as is the case in the International Monetary Fund. Alternatively, as proposed by European Commission (2017c), it could be anchored in the Union's legal framework, along with the euro area's intergovernmental fiscal rules, which would hopefully be viewed as longer-lasting and become easier to enforce.

Figure 3.4

Inflation (HICP) for France, Germany, Italy, and Spain

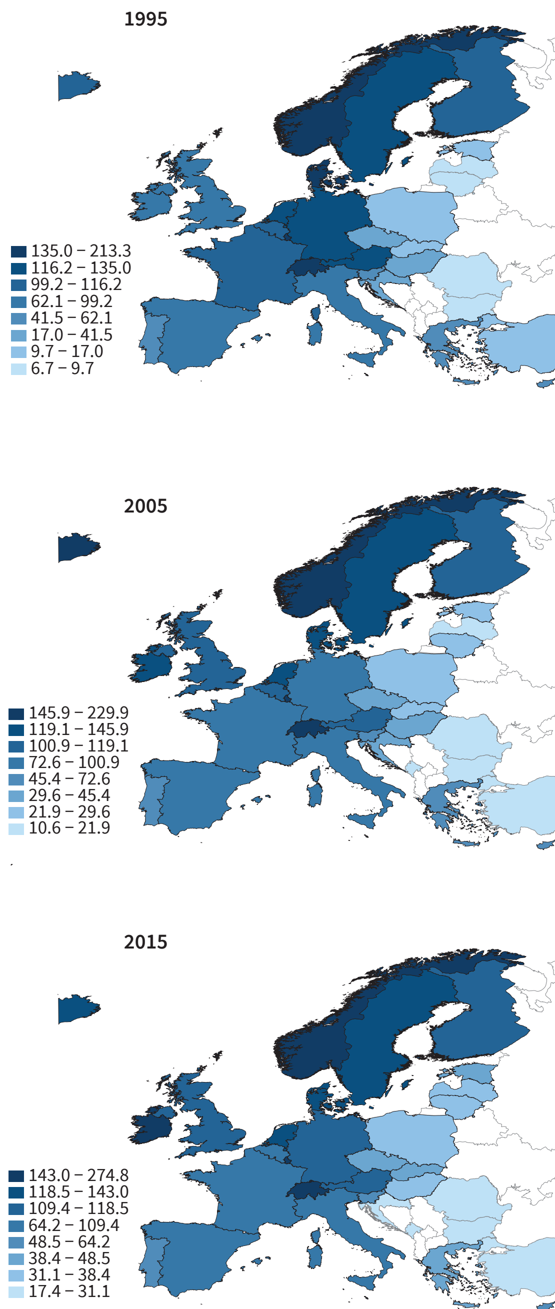


Source: AMECO.

© CESifo

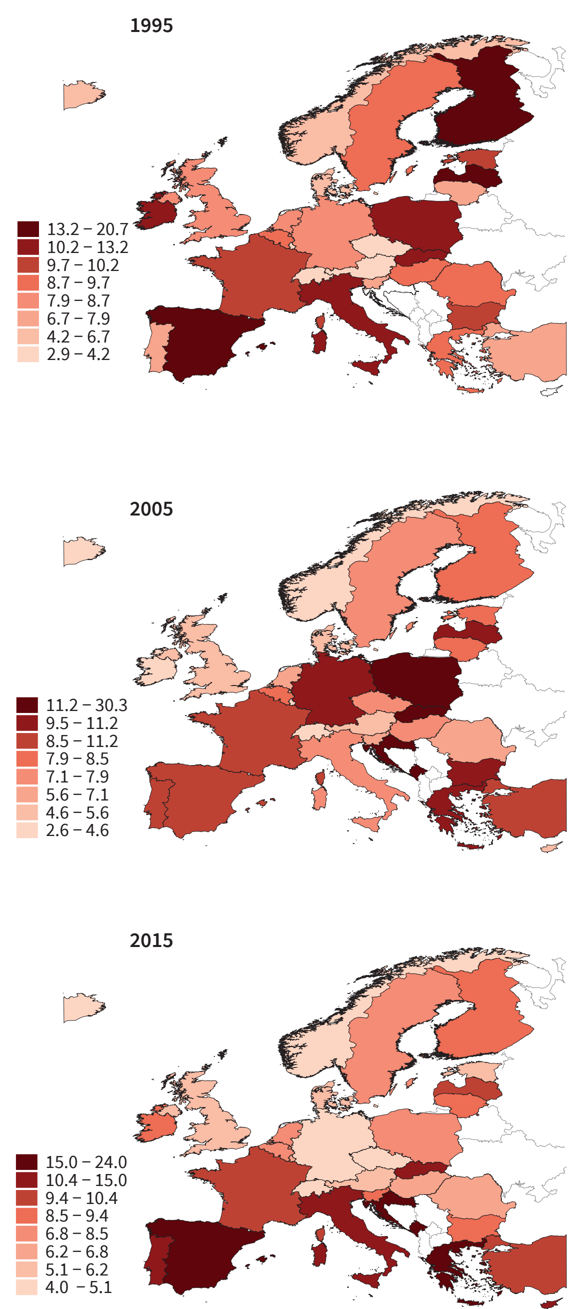
[6] Fixed exchange rates and capital flows did contribute to determining the would-be virtuous core's output and budget deficits. Unless trade and capital mobility were restricted or non-core countries had somehow worked very hard to catch up, however, developments could easily have been worse for a smaller, Japan-like European core.

Figure 3.5
GDP per Capita
EU-15 = 100



Source: AMECO. © CESifo

Figure 3.6
Unemployment Rates
in percent



Source: AMECO. © CESifo

Evolution of Membership

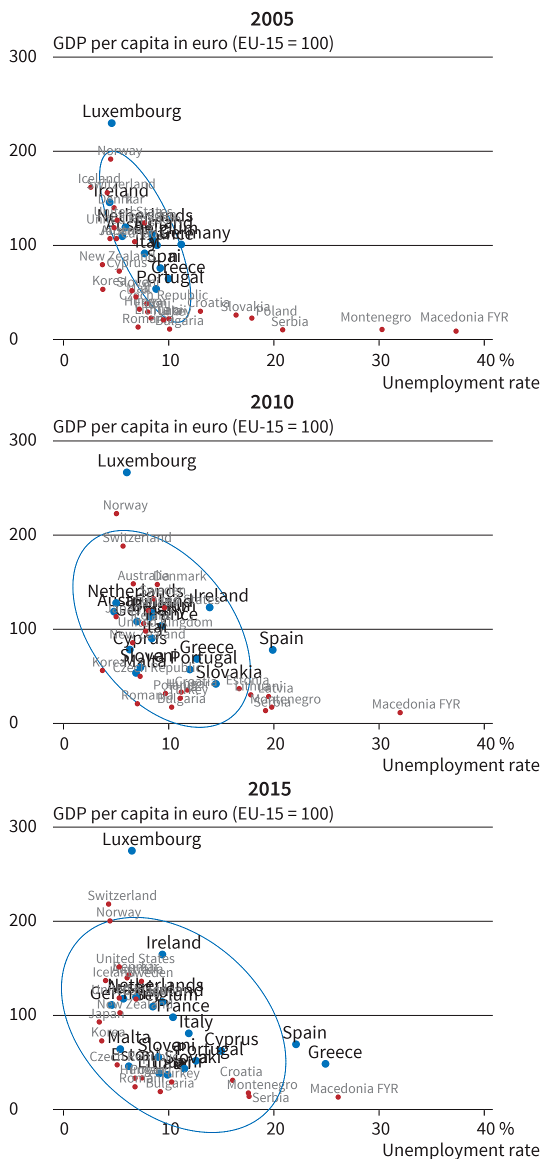
For countries without on an opt-out, euro area membership is supposed to be based on an automatic administrative decision. Both potential members and club managers, however, do have a say in the adoption of the euro. Sweden's membership is prevented by the country's choice not to formally recognise its central bank's independence, and the Commission's decision to allow or prevent specific countries' membership can be based, as in the case of Greece and Estonia, on political considerations, as well as on technical criteria.

To see how opt-outs, economic performance, and delays in the implementation of technical conditions delimit the euro area boundaries over time, it can be interesting to try and see whether the configuration and evolution over time of these clubs' membership lends itself to some sensible economic interpretation.

It would be nice if the outline of the euro area (or indeed of the European Union) was easy to spot in Figures 3.5 and 3.6. But not even France and Germany always display similar income levels or unemployment rates. Somewhat more visible boundaries are apparent

Figure 3.7

GDP per Capita and Unemployment in Developed and/or European Countries

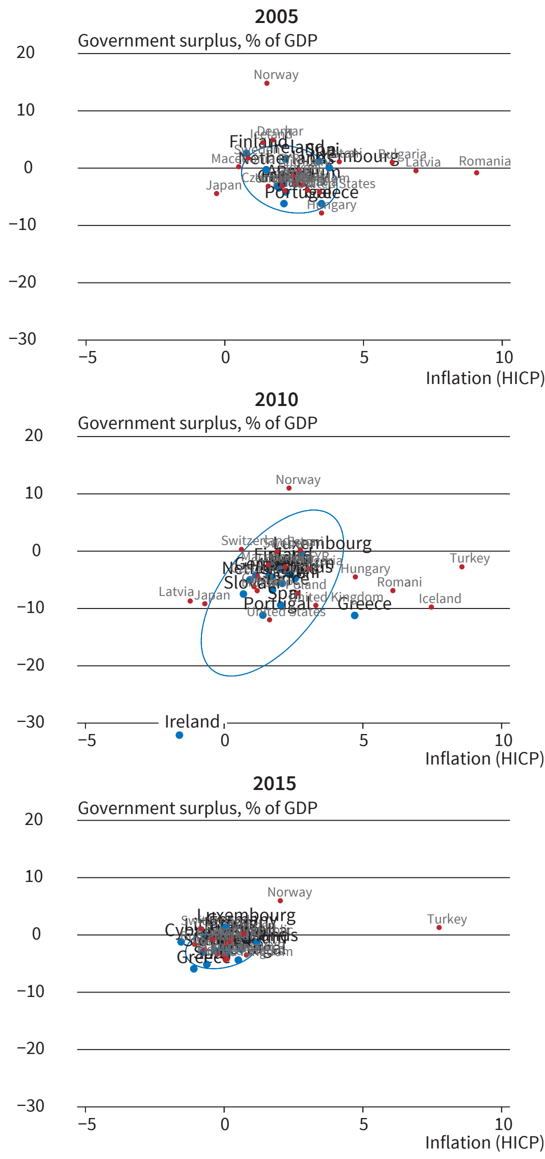


Note: 95% confidence ellipses computed from member countries' means and covariances.
Source: AMECO.

© CESifo

Figure 3.8

Government Surplus and Inflation in Developed and/or European Countries



Note: 95% confidence ellipses computed from member countries' means and covariances.
Source: AMECO.

© CESifo

in the economic and policy spaces defined by GDP per capita, unemployment, government balances, inflation, inequality and distribution. Figures 3.7, 3.8, and 3.9 display available data for the 52 developed and/or European countries covered by the European Commission's AMECO database.

The figures label observations by country names, differently for those that are euro area members, and display the elliptical regions where countries that resemble current members in the respects considered are statistically most likely to fall.[7] The patterns in the figures are generated by membership variation, as well as by variation in member countries' data: the regions covered by each club's membership become larger if increasingly heterogeneous members join and/or if, as discussed in the next chapter, existing members tend to diverge from each other.

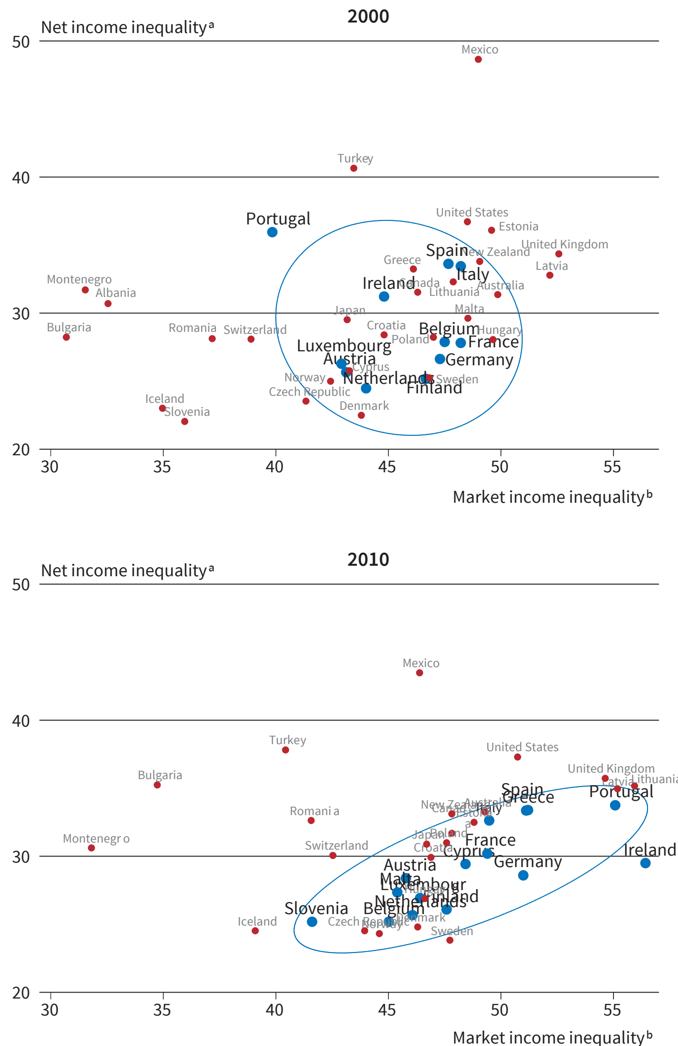
Unemployment and income in Figure 3.7 do tend to be both somewhat higher in the euro area initially, but both the membership and the performance of the club spread out over time, and eventually the ellipse covers many non-members and excludes not only the Luxembourg exception, but also Spain and Greece.

In Figure 3.8, inflation and government deficits, the key policy indicators considered by the club's admission and behaviour rules, are notably more homogeneous than economic outcomes

[7] Bertola (2010a,b) performs a somewhat more technical exercises of this type, focusing on comparisons between countries that did or did not join Economic and Monetary Union, before and after the event.

Figure 3.9

Market Income and Net Income Inequality in Developed and/or European Countries



Note: 95% confidence ellipses computed from member countries' means and covariances.
[a] Gini index of net (post-tax, post-transfer) income inequality
[b] Gini index of market (pre-tax, pre-transfer) income inequality
Source: SWIID, Solt (2016).

© CESifo

among euro area members. The contrast between outcome divergence and policy convergence is more apparent in the more recent data, influenced by perhaps stronger policy coordination and certainly by more asymmetric crisis shocks and post-crisis developments.

Figure 3.9 shows that the initial euro area was significantly more homogeneous and distinct from neighbouring countries in a respect that at least superficially appears quite orthogonal to the adoption of a single currency. Redistribution policies reduce inequality within euro area members more than within non-members. The crisis again has visible effects, increasing the variety of laissez faire inequality within the euro area, and drastically changing the relative position of countries within it.

Club membership has many pros and cons that each country appreciates and suffers more or less strongly, and that are not only economic. Figure 3.10 shows that the euro area, much like the nation states formed within it centuries ago, does tend to develop in geographically compact ways. Proximity to France and Germany does matter. Of course, Switzerland is an obvious exception: the country sits squarely in the geographic core of the European Union, but its economic and cultural peculiarities explain why it prefers not to be a member. But geography does interact with economics and structure. Distance from Russia, a potentially problematic non-member of any European club, may for example explain why among otherwise homogeneous Scandinavian countries, Norway is not an EU member, Denmark opts out of many EU policies, Sweden prefers not to adopt the euro, but Finland participates fully in that and all other EU policies (as do the Baltic countries at present).

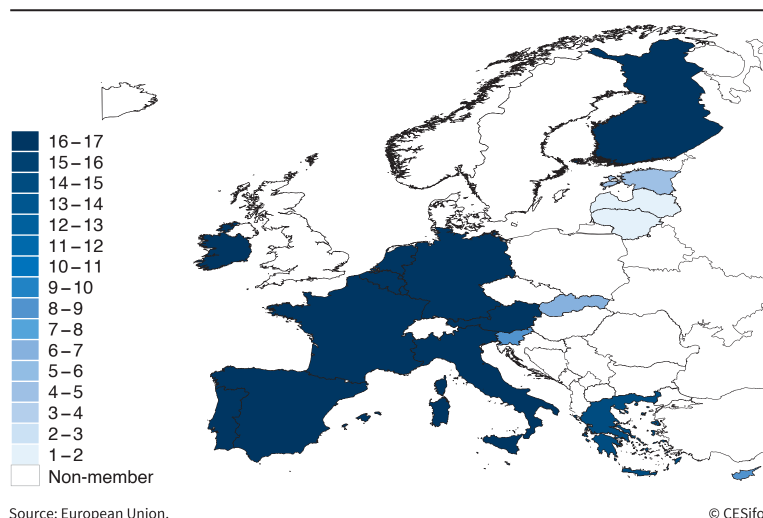
3.5.2 The Borderless Club

Geography is a strong determinant of membership in the Schengen club for even more obvious reasons: even Switzerland belongs to it, as do the Baltics and Finland (see Figure 3.11).

The Schengen club's operation is also like that of the euro area in other respects. Its rules were not designed to enable it to work well. To form a viable club, it is not enough to deprive national governments of some prerogatives. A way must be found to perform together tasks like pooling police information on terrorism and border controls on immigration. The Schengen Agreement envisioned "cooperation and coordination between the police and the judicial authorities in order to safeguard internal security and, in particular, to fight organised crime" and, in practice, development of the Schengen Information System database for certain categories of people and goods. As in the case of the euro area, problems became apparent in a crisis. The Schengen agreement "largely abolished Europe's internal borders, but it did not envisage a strengthening of the continent's external borders. So when the migration crisis erupted, it was seen as a destabilising loss of security" (Draghi, 2016).

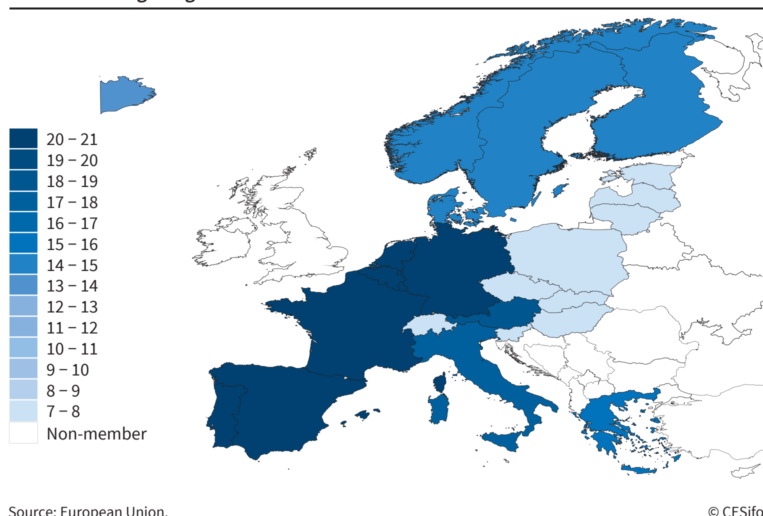
Like the euro area, the Schengen club does not appear to have operated in a particularly efficient way. The club's rules allow members to reinstate

Figure 3.10
Years in Euro Area



Source: European Union. © CESifo

Figure 3.11
Years in Schengen Agreement



Source: European Union. © CESifo

border controls for short periods, of up to 30 days, in case of special events or imminent threats. Based on a proposal by the Commission, they may also obtain permission from the Council to suspend the agreement for longer periods in case of "persistent serious deficiencies relating to external border control". France was allowed to reinstate border controls in the aftermath of terrorist attacks until 31 October 2017, and Germany, Denmark, Austria, Sweden, and Norway cited immigration flows to obtain permission to reinstate border controls on ports and borders between them and with Slovenia and Hungary from May 2017 until November 2017. All suspensions were renewed on expiration for a further six months, which is rather inconsistent with their notionally temporary and exceptional character.

Moreover, as in the case of the euro area, crises not only weakened the club's cohesion, but also prompted a revision of its operations. Just as the euro area is slowly developing a suitable infrastructure for banking and financial activities, so the Schengen area is finally developing the kind of institutional structure that can make internal mobility less problematic: external border checks have recently, per regulation EU 2017/458, begun to be carried out using a common database.

3.6 PATHS FORWARD

After reviewing the configuration and performance of European country groups, we proceed to discuss whether and how it might be possible to improve them in terms of any club's crucial ingredients: sensible membership criteria, and effectively enforced (or self-enforced) good behaviour on the part of members.

The idea of a multi-speed or variable geometry Europe was most seriously proposed and considered when the fall of the Berlin Wall made it necessary to address a trade-off between widening and deepening for the European integration model devised after World War II. In that context, its implementation would controversially put France and Germany, despite their different economic policy approaches, at the core of the fastest group of countries. The idea has remained an idea, often dismissed as an unsatisfactory *à la carte* Europe allowing member states to pick and choose items from a vast, uncoordinated menu, undermining the notion of ever closer union and the progressive integration of member states. The opposing argument is that a multi-speed Europe would enable those members who desire further integration on some issues to proceed with it, without being held back by those who do not. Economic principles endorse variable geometry as a solution to the problem of providing goods or services, or carrying out activities, which can be performed more effectively by a group of countries who share a common interest than by each country independently. Not all countries share the same interests, however, so widening membership of the group imposes costs on the existing members.

In practice, Europe adopted an inclusive path to an extent that, with the benefit of hindsight, may appear to have been excessive and ineffective. Many more countries than anticipated in the early 1990s managed to meet the Maastricht membership criteria and join the euro area core, with Central and Eastern

European countries joining the European Union much sooner than could be envisioned in 1994. Crises are making the multi-speed idea topical again and again controversial. The current politico-economic climate, with populism on the rise in many countries, faces the European Union with a symmetric narrowing or shallowing trade-off. Brexit makes it particularly necessary to revisit the issue. The loss of an odd member with many opt-outs may tilt the EU's path towards a single-speed configuration, where all remaining members proceed together, and the United Kingdom and other non-members take a permanent zero-speed attitude. If other countries are also unsatisfied with the rights and obligations of membership, however, it may be necessary to allow additional opt-outs from existing and future EU features to prevent their exit.

3.6.1 Integration Needs and Ways

The issue can be framed in terms that are simply stated, but have proven hard to resolve. A single market is necessary in a modern economy that needs to exploit economies of scale and diversity with internationally integrated production processes that involve trade in custom-made components, rather than commodities. For much of the EU's history a *negative* dimension of integration was prevalent: member countries agreed to be stripped, through largely administrative measures, of their power to regulate and bound markets. However, a modern economy also needs to rely on a broad variety of complementary government activities, ranging from defence to monetary and banking policies to welfare schemes, which may well need to be delegated or coordinated by a *positive* process of politico-economic integration.

This tension is an old one in the European integration process. The *negative* and *positive* aspects were identified by Tinbergen in 1965 (Scharpf, 1998). That process did over time move from the more *negative* emphasis on free markets and individual freedoms, meant to disempower legacy nations, to *positive* aspects, such as the single currency. In 2000, the Lisbon Treaty envisioned further steps beyond negative integration, towards a competitive *social* market economy. It was then conceivable that the same countries that had delegated their prerogatives in trade and product regulation, state aid and competition policy, and monetary policy to a supranational body would eventually see a need to find ways to perform the fiscal and social tasks of modern states together.

The political will required to achieve this objective waned, however, in an enlarged European Union that made ever closer union seem an unrealistic objective. The great recession, euro crisis, and mass immigration shocks also seem to doom even the multiple-speed idea, which as originally formulated proved less practical than its proponents thought, with the political climate in many member countries favouring zero or negative speeds of integration. This prompts us to consider whether and how a multi-steady-state configuration may be implemented in Europe.

3.6.2 Smaller Clubs

The heterogeneity of tastes or endowments makes it efficient to segregate society into separate clubs. Over 20 years after the 1990s debate about the S&L proposal, it is still not obvious that all European countries naturally gravitate towards a single European integration process (the next chapter examines whether and in which respects there has been or might be convergence in the European Union). Brexit obviously narrows that process. The authoritarian drift of some Central and Eastern European countries could well lead them to fall out of the European Union (on December 20, 2017 the European Commission initiated a process that under Article 7 might eventually lead to suspension of Poland's voting rights in the Council). A lack of cohesion among the other current EU members may make it natural to envision a smaller Union, or the formation of smaller core groups within a broad but shallow Union.

To see the issues clearly, it is useful to revisit the blunt S&L proposal. A single core could continue to centre on Germany and France, as in that proposal. But there may also conceivably be two cores of tighter integration: one including Germany and Central and Eastern European countries to which its economy is strongly linked; the other featuring France, with other Latin countries. Splitting Germany and France may be is as unthinkable now as it was in 1994, but the Franco-German differences of opinion outlined in S&L and analysed more recently by Brunnermeier, James, and Landau (2016) are deeply rooted in different emphasis on discretion, rather than commitment; and administrative solidarity, rather than market discipline. These differences have proven difficult to manage in recent decades and, despite its notional modernity and market orientation, the Macron presidency shows prominent symptoms of traditional French hegemonic dirigisme.

To complete the picture of these alternative EU configurations, two key points must be highlighted. The first is that any articulation of the Union into separate clubs would need to isolate them from each other to some extent. John Donne wrote "No man is an island" (and continued "every man is a piece of the continent, a part of the main; if a clod be washed away by the sea, Europe is the less"). Very few countries are islands in a literal sense; not even Britain (where the land border in Ireland will need to be enforced after Brexit); and all are connected by economic and policy channels. Barriers between a Franco-German union and Mediterranean, Central European, or Scandinavian countries may or may

not be less unthinkable than a strong border at the Rhine, but both are certainly unappealing to firms and individuals on either side of those borders.

The second is that member selection and internal governance of the clubs should be consistent with each other and with functional goals. Just like the European Union as we know it, the mini-Unions we are considering would find it difficult to clearly define their members' rights and obligations, and to enforce the latter. Unlike the European Union, they might choose to be more flexible and envision, for example, the expulsion of misbehaving members. This would come at a cost in terms of mutual commitment, however. Threats of expulsion are very imperfectly credible when such a step would inflict damage on remaining members, and the possibility of exit can encourage non-cooperative behaviour in a club, which may prove politically popular with a myopic electorate. It is not clear that these problems would be any less serious in smaller groups of countries, which need not trust each other any more than the members of a larger and supposedly permanent Union. Although exit is an important protection against decisions by the club that put individual members at a disadvantage, commitment to common purposes is better supported by voice in well-informed discussions.

3.6.3 Defence Anybody?

This line of reasoning tends to suggest that it would be unwise to permanently separate Western Europe into several comprehensive policy clubs. It does not, however, rule out the possibility that smaller groups may fruitfully cooperate in specific policy areas. Forming clubs within the European Union (rather than intergovernmentally) fosters their stability, and makes it possible, at least to some extent, to foster commitment and enforce rules. This key element of the S&L proposal did work its way into the Treaties in the form of enhanced or permanent structured cooperation.

The latter is envisioned to allow the European Union to pool and coordinate military and defence activities. It is a country grouping that would operate as a proper club that countries may join based on verifiable commitments, rather than as a mandatory element with technical conditions and exceptional opt-outs. It is also particularly interesting because defence is the textbook example of a country-specific pure public good. Military cooperation has proven difficult, however, for the usual reason: heterogeneity of potential members' policy preference. At the end of the Cold War, S&L favoured a cooperative attitude towards Russia, but consensus in this respect has been lacking. European countries have taken ambivalent, unsteady, and uncoordinated positions towards developments in former Yugoslavia and the Ukraine (where any common action was very far from being agreeable to Russia).

Given that no formal cooperation has been implemented yet, it is not possible to assess practical experience, even in the sketchy and inconclusive way applied above to the euro area and Schengen Agreement. In 2017, the European Council finally launched PESCO, aiming to strengthen common security and defence policies in the European Union. The November 13 Notification on PESCO uses the word "binding" 15 times, and the word "must" five times, and outlines how decisions (including that of suspending, but not expelling members who do not perform their duties) will be taken by unanimity. Almost all current EU members subscribed to it at the December summit, the only exceptions being Malta and the frequent opt-outers Denmark and the United Kingdom.[8] From this chapter's perspective, it is interesting to note that the PESCO military cooperation club will itself be articulated into a constellation of projects (currently 17, selected among 50 proposals), each involving a specific subset of the club. So although the overall PESCO project only falls a little short of Council unanimity (which per Article 42.2 TEU would enshrine common defence as a Union competence), its actual operation is very much *à la carte*, and not fully consistent with the textbook supply of a public good.

3.6.4 A Better and maybe Smaller Club

Neither Schengen nor the euro area is a perfect club, but this does not imply that they should be dissolved. It is better to learn to live with imperfections when the alternative is worse. And it is advisable to learn from experience to try to improve their structure and extend it to other policy areas: not only to the most obvious European public goods like defence, energy, and transportation policies, but also to fiscal and social policies that, like banking, would suitably flank economic and monetary union. This scheme might either envision variable speeds towards one final steady state, as in the original S&L proposal, or crystallise into a multiple club geometry for Europe.

Compared to the traditional scheme of single membership terms (with limited opt-outs), either implementation of variable geometries has advantages in terms of flexibility. When S&L made their proposals, Klaus Kinkel, the then foreign minister of Germany, asked whether the speed of European integration should be held back by the slowest ship in the convoy. The question was perhaps meant to be rhetorical, with an implicit "no" answer that is correct if the speedy arrival of at least some ships is of the essence. Allowing countries to pick and choose policy-specific clubs, however, opens up the possibility of bad equilibria, where common interests are not appropriately considered. The size of a convoy should suit the

[8] At around the same time the United Kingdom signed a small new bilateral defence cooperation agreement with Poland, fellow Charter of Fundamental Rights opt-outer and recent recipient of the European Commission's Article 7 proposal for serious breach of the rule of law.

cargo that needs to be delivered, and the protection it provides against packs of submarines is lost if it becomes a collection of advance guards and laggards. A credible, irreversible, take-it-or-leave-it approach to EU membership can make mutually beneficial long-term investments possible. Given that sovereign countries cannot always be trusted to be well-behaved, however, opportunism and free riding need to be prevented by effective governance that defines clearly and enforces policy coordination among members.

The scope of agreement on any single issue is clearly very limited outside of a pure public good with identical tastes. A single-policy club cannot do much without implementing compensatory transfers, or enforcing decisions that will make minorities unhappy and eager to leave. For this reason, a plethora of single-policy clubs is less likely to work than a comprehensive one that offers give-and-take opportunities. Such clubs would clearly need to specify and enforce entry and exit criteria and, as disagreement is likely on each single issue, expulsion and withdrawals would make them very unstable. Heterogeneous countries do not benefit equally from each dimension of supranational policy, but advantages and disadvantaged can balance out across policy areas, as well as over time. The shortcomings of the euro area and the Schengen area, for example, are easier to remedy with compromises across them than in isolation if the countries that feel disadvantaged by a banking union would also like a more comprehensive and restrictive approach to the enforcement of common external frontiers and immigration. In this respect, the European Union may, in fact, not be comprehensive enough, as shown, for example, by the legal and administrative difficulties encountered by efforts to link rights to structural funds disbursement and obligations to accept refugees.

Member heterogeneity does make it difficult and inefficient to operate clubs meant to choose and enforce common policies. This has always made it sensible to restrict membership to European countries that are both geographically and culturally close to each other. This criterion may recommend segregation of Central and Eastern or Scandinavian countries in separate clubs. Drawing the outside boundaries of a 'similar enough' set of countries is far from straightforward, however, and arguments that would exclude Austria are not much more difficult to formulate than those that would exclude Greece. Smaller clubs might but need not be more homogeneous. One including only France and Germany would in fact in some respects be most heterogeneous, and certainly more diverse than that envisioned by S&L, which included the BeNeLux countries sandwiched by the Franco-German duo. And a club that is small but includes some particularly powerful members can on the one hand make other members unhappy, on the other be prey to misbehaviour and disagreements among the largest members.

As the trade-offs outlined in European Commission (2017a) make clear, each possible configuration of Europe's supranational organisation has both advantages and disadvantages, which are relevant to different countries and citizens within countries to varying degrees. However, it is even clearer that the effective and consensual governance of any possible configuration is extremely important. The European Union is the only body capable of providing a legal framework and at least some control of all countries' behaviour, including that of smaller countries (which may do less damage than large countries when they pursue their own interests, but are certainly more aware of free-riding opportunities). The fact that this control has not been stringent in the past does not reduce its potential importance, and the complicated consensual community decision process is the only one that may give the Union sufficient legitimacy and power to ensure that countries take common interests into account. To this end, governance should be disentangled from national politics as far as possible. The European Parliament, where countries are represented by multiple parties, is a more suitable body to ensure governance than a European Council constrained by both national politics and intergovernmental reciprocity.

If governance can be made to work, the disadvantages of heterogeneity can be offset by the benefits of inclusiveness. Should homogeneity be the paramount criterion, then France and Germany might want to join different clubs. Not all countries need to join a single convoy of European states, but there were and still are good reasons for one such convoy to be formed. Voltaire thought that Europe's supranational structure of his time was falsely advertised as Holy, Roman, and an Empire. 'European Union' is also now in danger of becoming a misnomer. Aiming to ensure that its governance coherently and consistently pursues sensible goals is, in many ways, a better option than renaming it to represent a narrower or shallower configuration.

REFERENCES

Alesina, A. and E. Spolaore (1997), "On the Number and Size of Nations", *Quarterly Journal of Economics* 112(4), 1027–1056.

Bernard, A., J.B. Jensen, S. Redding, and P. Schott (2017), "Global Firms", *Journal of Economic Literature,* forthcoming.

Bertola, G. (2010a), "Inequality, Integration, and Policy: Issues and Evidence from EMU", *Journal of Income Inequality* 8(3), 345–365.

Bertola, G. (2010b), "Labor Markets in EMU: What Has Changed and What Needs to change", in: M. Buti, S. Deroose, V. Gaspar, and J. Nogueira Martins (eds.), *The Euro: The First Decade*, Cambridge University Press, Cambridge, 715–758.

Bolton, P. and G. Roland (1997), "The Breakup of Nations: A Political Economy Analysis", *Quarterly Journal of Economics* 112(4), 1057–1090.

Brunnermeier, M. K., H. James, and J. Landau (2016), *The Euro and the Battle of Ideas*, Princeton University Press, Princeton.

Buchanan, J. M. (1965), "An Economic Theory of Clubs", *Economica* 32(125), 1–14.

Casella, A. and B. Frey (1992), "Federalism and Clubs: Towards an Economic Theory of Overlapping Jurisdictions", *European Economic Review* 36(2-3), 639–646.

Draghi, M. (2016), "Reviving the Spirit of De Gasperi: Working Together for an Effective and Inclusive Union", speech delivered at the presentation ceremony of the De Gasperi award in Trento.

EEAG (2014), "Switzerland: Relic of the Past, Model for the Future?", *The EEAG Report on the European Economy*, CESifo, Munich, 55–73.

EEAG (2017), "Britain and EUexit – The People versus the EU", *The EEAG Report on the European Economy*, CESifo, Munich, 67–81.

Eichberger, J. (2001), "A Utopia? Government Without Territorial Monopoly: Comment", *Journal of Institutional and Theoretical Economics* 157(1), 176–179.

European Commission (2017a), "White Paper on the Future of Europe – Reflections and Scenarios for the EU27 in 2025", COM(2017)2025.

European Commission (2017b), "Reflection Paper on Deepening of the Economic and Monetary Union", COM(2017)291.

European Commission (2017c), "Further Steps Towards Completing Europe's Economic and Monetary Union: A Roadmap", COM(2017)821.

Fort, T. (2017), "Technology and Production Fragmentation: Domestic versus Foreign Sourcing", *Review of Economic Studies* 84(2), 650–687.

Frey, B. (2001), "A Utopia? Government Without Territorial Monopoly", *Journal of Institutional and Theoretical Economics* 157(1),162–175.

Frey, B. and R. Eichenberger (1996), "To Harmonize or to Compete? That's not the Question", *Journal of Public Economics* 60(3), 335–349.

Johnson, R. and G. Noguera (2017), "A Portrait of Trade in Value Added over Four Decades", *Review of Economics and Statistics* 99(5), 896–911.

Pond, E. (2000), *The Rebirth of Europe*, Brookings Institution Press, Washington DC.

Scharpf, F. (1998), "Negative and Positive Integration in the Political Economy of European Welfare States", in: M. Rhodes and Y. Meny (eds.), *The Future of European Welfare: A New Social Contract?*, Macmillan, Basingstoke.

Schäuble, W. and K. Lamers (1994), "Überlegungen zur europäischen Politik", available at www.bundesfinanzministerium.de.

Solt, F. (2016), "The Standardized World Income Inequality Database." *Social Science Quarterly* 97(5), 1267–1281.

It's OK to Be Different:
Policy Coordination and Economic Convergence

4.1 INTRODUCTION

In the debate over the economic and political development of the European Union, the perception of growing economic divergence plays a key role. Economic convergence is a declared political objective of the Union. Article 174 of the Treaty on the Functioning of the European Union states that "The Union shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions" (European Union, 2012). There is a widespread view that economic convergence among the EU member states progressed until 2008, but that divergence seems to have prevailed since the outbreak of the global financial crisis and the eurozone debt crisis. At the same time, economic disparity and inequality within member states is a hotly debated topic. In fact, some aspects of convergence were not occurring even before the global financial crisis, as will be shown in this chapter.

There is a concern that these developments could lead to an erosion of what is often referred to as the European model of the welfare state or the 'social market economy', namely an economic system where government intervention assures high levels of social protection and limited inequality. The convergence issue is also discussed in the context of how the gains from economic integration are distributed. Whether or not convergence is achieved may also have an impact on trust in European and national political actors as well as institutions and political support for maintaining or deepening economic and political integration in the European Union.

These observations raise a number of issues. Firstly, it is important to understand what we mean by economic convergence. It is useful to distinguish between 'input' and 'outcome' convergence. The usual starting point for debates over convergence is per capita income, which would be an outcome variable. Other relevant outcomes are employment and unemployment rates, life expectancy, economic stability, or the distribution of income and wealth. Input convergence includes regulations, policies, and institutional quality.

Secondly, is convergence necessary to achieve other objectives like economic efficiency or political stability, should it be seen as an objective in its own right or is it just another unrealistic political promise? Are certain types of convergence related to particular European projects like the European Single Market or the Economic and Monetary Union (EMU)? A primary motivation for and expectation of both the European Union and EMU has been that it would lead to convergence in outcomes. This has only partially been the case – why? It is well-known that convergence or catching-up does not necessarily happen – this is also an experience of countries outside the European Union. This raises the question of why the European Union should be different. Some of the recent policy initiatives in the Union can be interpreted as moving more towards stressing convergence on the input side. One example is the so-called Social Pillar. But there are many more attempts to coordinate policies of the member states, particularly in the framework of the European Semester.

As far as convergence in inputs is concerned, the policy debate seems to take it for granted that it is necessary or a virtue to be 'alike'. But it is far from clear whether input convergence is always required, or even desirable. Being competitive is not tantamount to being alike and implying that all social models have to converge. This view has no support in, for instance, trade theory, which stresses the importance of differentiation and comparative advantages. There is also an increasing understanding that different social structures and institutions can be a source of comparative advantages. A recent literature review criticises traditional analyses for their overly one-sided focus on identifying the optimal institutional setting (see Nunn and Trefler, 2014). There is no such thing as a unique optimal institutional setting. The reason is that various institutional arrangements have pros and cons, which may be a source of comparative advantage. Countries with flexible employment protection legislation and generous unemployment insurance may have a comparative advantage in industries with substantial short-term variation in demand and thus production, while countries with stricter employment protection legislation and less generous unemployment insurance may have a comparative advantage in production of commodities with less variability. The cross-country study by Cuñat and Melitz (2012), for example, finds that countries with more flexible labour markets tend to have a higher degree of specialisation in sectors more frequently exposed to sector-specific shocks. This may be interpreted as reflecting that the nature of shocks or needs for adjustment to some extent is endogenous, meaning that countries (or rather its companies in the private sector) specialise in the activities for which their particular institutional setting has a comparative advantage. This type of research is still in its infancy, but it is highly suggestive

EEAG (2018), "It's OK to Be Different: Policy Coordination and Economic Convergence", *EEAG Report on the European Economy*, CESifo, Munich, pp. 64–82.

of why different institutional settings (welfare regimes) survive. The important lesson – repeating basic insights from trade theory – is that competitiveness is a question of comparative advantages.

If we take it as given that some convergence is desirable, a third issue is whether the current policies of the European Union and the member states appropriately support this objective. In the EU budget regional and structural funds play an important role. The question is whether these policies are effective. If it is correct that there is too little outcome convergence or even economic divergence in the European Union, the question arises whether this is a result of inappropriate convergence policies. Recently, the European Union has undertaken new initiatives aimed at fostering convergence. One example is the Social Pillar mentioned above. In what follows, we will discuss what these policies can be expected to deliver. Clarification is also needed regarding the role of the European Union as opposed to national and subnational governments in policies addressing convergence across and within member states. Should anything be done to change the distribution of responsibilities between the national and the European level – and if so, what?

4.2 WHAT IS CONVERGENCE?

Economic convergence is usually defined as a process whereby a given number of regions or countries tend to reach a similar level of income or wealth, carry out similar policies, develop similar institutions, or share common views on economic, social or political issues. As mentioned before, it is useful to distinguish between outcome convergence and input convergence.

The most widely used indicator for outcome convergence is per capita income. Depending on the question asked, however, other indicators may be relevant. These may include labour market variables like employment or unemployment rates and measures of inequality as well as indicators of economic and general well-being like happiness indicators or life expectancy. Measures of input convergence use policy indicators like the tax burden, tax rates, or institutional quality describing the quality of regulations.

There are different ways of describing and measuring convergence as shown, for example, by Barro and Sala-i-Martin (1995). Two widely used concepts are β-convergence and σ-convergence. β-convergence for income levels implies a negative correlation between the rate of growth of a country and its initial level of income. If initially poor countries grow faster than rich countries, income differences will diminish over time. By comparing growth rates to initial level of income the degree of β-convergence can be assessed. According to the concept of σ-convergence, the dispersion of per capita incomes across countries declines over time (Sala-i-Martin, 1996). This is assessed by computing the coefficient of variation in income levels across countries, for instance. We will use both concepts. If the ultimate aim of convergence policies is to achieve more equal income levels, one could argue that σ-convergence is more relevant. The existence of β-convergence is a necessary, but not a sufficient condition for σ-convergence (Young, Higgins, and Lewy, 2008).[1] This will also play a role in the results discussed below.

The concepts of β- and σ-convergence are mostly used in the analysis of convergence in per capita incomes. As mentioned above, there are other relevant dimensions of convergence. For instance, in the context of the EMU, nominal convergence is important because exchange rate adjustments are not possible. Similarly, labour market developments and inequality are also important. In a broader sense, a certain degree of convergence in institutional quality, economic policies, and views regarding the functioning of a market economy and common political institutions like the European Commission and the European Central Bank is a requirement for an economic and monetary union to be sustainable.

4.3 OUTCOME CONVERGENCE IN THE EUROPEAN UNION

In this section we consider outcome convergence in the European Union for key performance indicators like per capita income, (un-)employment, inequality and wage/price inflation.[2] In Section 4.4 we turn to convergence in policies and institutions (input convergence).

4.3.1 CONVERGENCE OF PER CAPITA INCOMES ACROSS EU MEMBER STATES

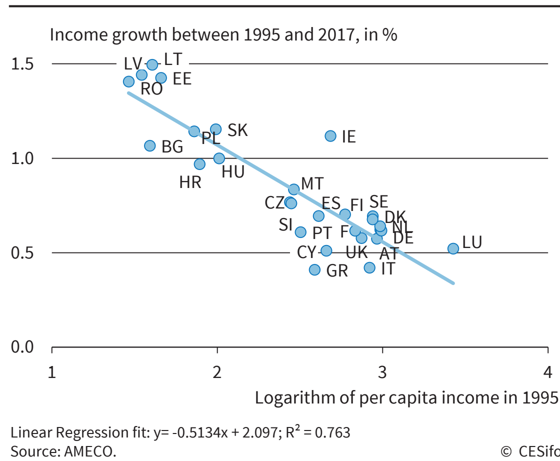
Across EU countries there has been a catching-up process where countries with an initial low level of income have experienced higher income growth than the high-income countries over the period 1995 to 2017 (see Figure 4.1). There is a pronounced negative correlation implying that countries with an initial low (high) per capita income level have experienced the highest (lowest) average growth rates over the period.[3] This works to make income levels converge within the European Union. The process is largely driven by the catching-up of the Eastern European member states, who eventually joined the European Union after the fall of the Iron Curtain. This can be seen from Figure 4.1 where the new Eastern European member states cluster to the north-west in the figure and the

[1] A simple example would be a case where the initial income level of country A is marginally lower than that of country B, but country A grows at a higher rate. Then β–convergence holds, but the dispersion of incomes increases after country A has overtaken country B.

[2] We use data for all 28 EU member countries. However, they differ with respect to the year of entry, as well as euro membership. We present data for all 28 EU countries (EU-28), the 'old' EU member countries entering in 1995 or earlier (EU-15), EU-13 for the new member states having entered since 2004 and the nineteen euro countries. Availability of data determines the time period for the analyses.

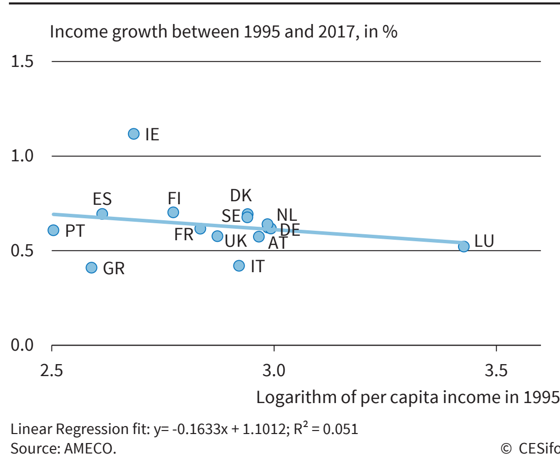
[3] The β-coefficient for the EU-28 sample (Figure 4.1) is – 0.51, with standard error 0.06, for the EU-15 sample (Figure 4.2) it is – 0.16 (0.16) and for the euro sample (Figure 4.3) it is – 0.58 (0.18).

Figure 4.1
Income Convergence since 1995, EU-28



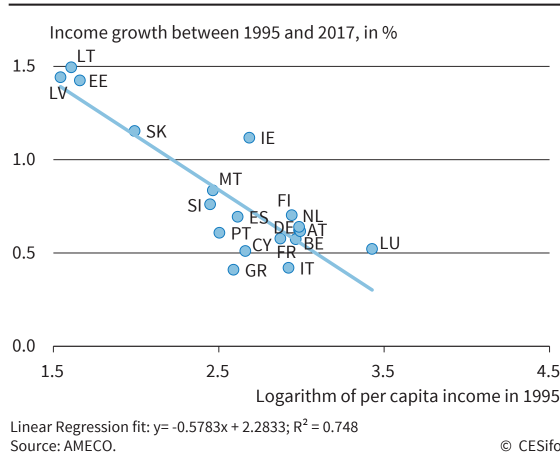
Linear Regression fit: y= -0.5134x + 2.097; R^2 = 0.763
Source: AMECO. © CESifo

Figure 4.2
Income Convergence since 1995, EU-15



Linear Regression fit: y= -0.1633x + 1.1012; R^2 = 0.051
Source: AMECO. © CESifo

Figure 4.3
Income Convergence since 1995, Euro Area



Linear Regression fit: y= -0.5783x + 2.2833; R^2 = 0.748
Source: AMECO. © CESifo

old member states to the south-east. As can already be glimpsed from Figure 4.1, and brought out more clearly in Figure 4.2, there is no convergence among the EU-15 countries. It is worth noting that this conclusion conceals different country experiences. Some countries with below average per capita incomes have been growing quickly, overtaking other member states. In 1995, for instance, per capita incomes (measured on the basis of purchasing power parity) in Ireland was lower than in France. Today, the opposite is true. Ireland is an extreme case of a formerly poor country that has managed to grow quickly and not only catch up with, but actually overtake other countries. Italy, by contrast, had a relatively high income level initially, but subsequently suffered from a very low growth rate, and therefore now ranks among the low income countries in the EU-15.

Among the euro countries there is also a catching-up, as illustrated in Figure 4.3. This is largely driven by high growth rates in some of the Eastern European countries that recently joined the European Union, and which are also euro countries.

Turning to the dispersion in per capita income (σ-convergence) across EU-28 countries, we find a declining trend, especially prior to the onset of the financial crisis (see Figure 4.4). This also applies to euro countries, while the dispersion across the EU-15 countries was rather steady over the period 1980 to 2017. This shows heterogeneity between new and old countries, but also that there are fewer differences across EU-15 countries than across euro countries as measured in terms of per capita income.

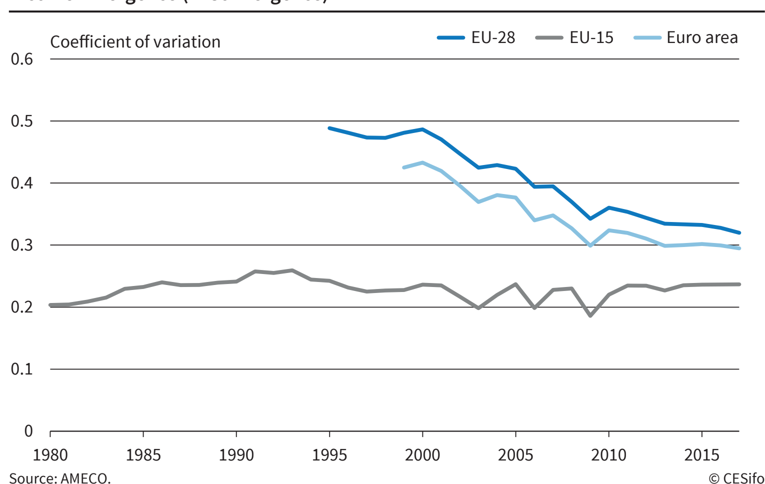
The discussion above mainly pertains to structural issues, but is related to the co-movement or synchronisation across the business cycle, which is especially important for the euro area. Campos, Firdmuc, and Korhonen (2017) conclude in a meta-study that there has been a general trend towards the synchronisation of business cycle fluctuations. The synchronisation is larger across euro than non-euro countries, and there is evidence that the adoption of the euro contributed to the synchronisation of business cycle fluctuations.

Overall, per capita income convergence did work reasonably well until the onset of the financial crisis. Convergence in Europe was mostly driven by Eastern European states, most of which joined the European Union in 2004. Figure 4.5 shows how average per capita incomes in the group of Eastern and Southern European countries have evolved since 1995 in comparison to the North. Relative to per capita income in the North, the South declines whereas the East catches up. In 1995, for instance, per capita income in the Czech Republic was 61% of Italian and 93% of Portuguese per capita income. In 2017, per capita income in the Czech Republic has reached 87% of the Italian level and 110% of per capita income in Portugal.

4.3.2 LABOUR MARKET CONVERGENCE

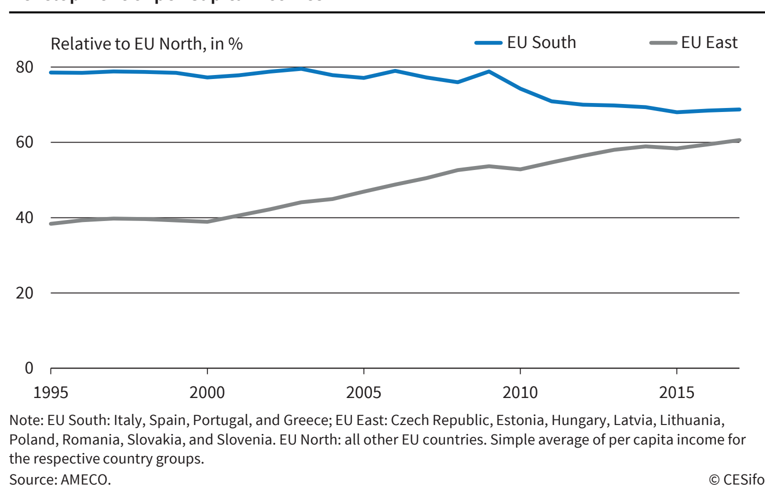
Labour market developments are related to income developments, but are also of interest in their own right due to its close relation to the social consequences of economic developments. (Un-)Employment rates are thus independent political targets. Across the EU-28, there has been convergence in unemployment rates, where countries with initial high unemployment levels have experienced the largest declines (see Figure 4.6).

Figure 4.4
Income Divergence (σ-Convergence)



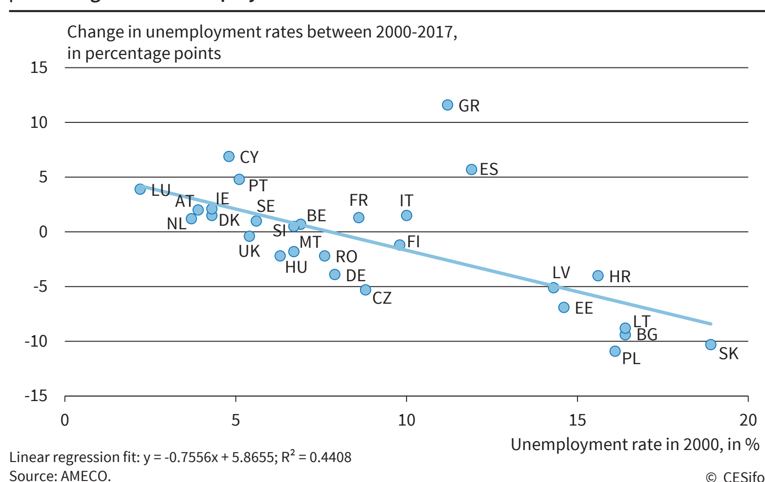
Source: AMECO. © CESifo

Figure 4.5
Development of per Capita Incomes



Note: EU South: Italy, Spain, Portugal, and Greece; EU East: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. EU North: all other EU countries. Simple average of per capita income for the respective country groups.
Source: AMECO. © CESifo

Figure 4.6
β-Convergence in Unemployment Rates for EU-28



Linear regression fit: y = -0.7556x + 5.8655; R^2 = 0.4408
Source: AMECO. © CESifo

The convergence process covers wide country differences and clearly also strong business cycle dependencies. Dispersion in unemployment across member countries has moved counter-cyclically since the mid-1990s, i.e. when average unemployment goes down, dispersion in unemployment rates tends to decrease, and vice versa (see Figure 4.7). Across business cycles, both the average unemployment rate and its dispersion have been rather steady over the period pointing to underlying structural problems.

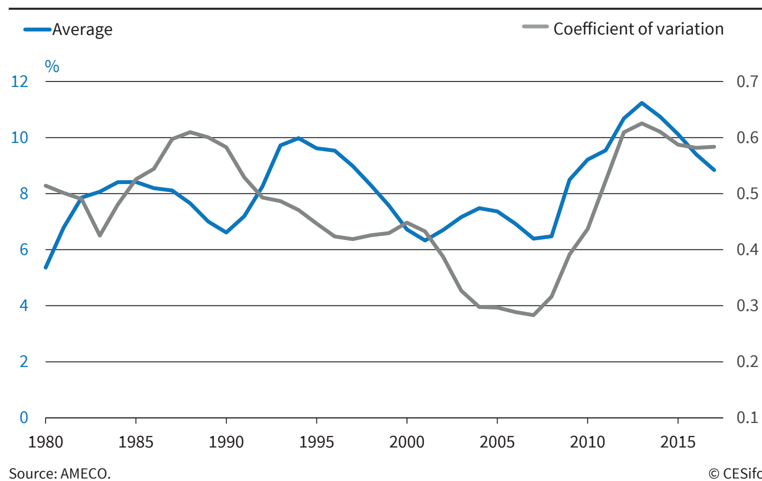
Cross-country differences in unemployment rates may be affected by several factors influencing labour force participation rates, the design of the social safety net and others. These problems are smaller when comparing employment rates (see Figure 4.8). While there is some convergence in employment rates, it is less strong than for unemployment rates. One reason is a structural difference in employment rates for women. It also emerges that the clustering of new member states is less pronounced than in the case of unemployment rates.

The employment rate is also cyclically dependent, but displays an upward trend (see Figure 4.9). This is partly due to increasing employment rates for the age group 55 to 64. It is interesting that the employment rate for this age group has been rising across all EU countries (except Greece and Romania), even during the financial crisis. The EU average is about 10 percentage points higher in 2016 than in 2008. Several factors, including increases in retirement ages and reforms of early retirement schemes, are responsible for this trend. Since later retirement correlates with education, the changing educational structure among older workers also plays an important role.

Convergence in unemployment rates is, like income convergence, driven by the group of East European new member states. In the EU-15 there is no sign of convergence, contrary to the euro countries, where convergence is again driven by the new member states.

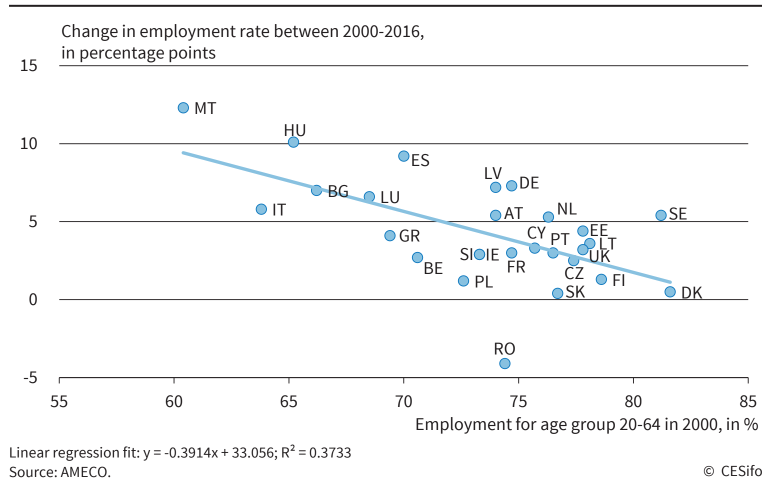
The lack of labour market convergence, and particularly the high structural unemployment rate in a number of countries, is striking. The issue of labour

Figure 4.7
Unemployment Rate across EU-15



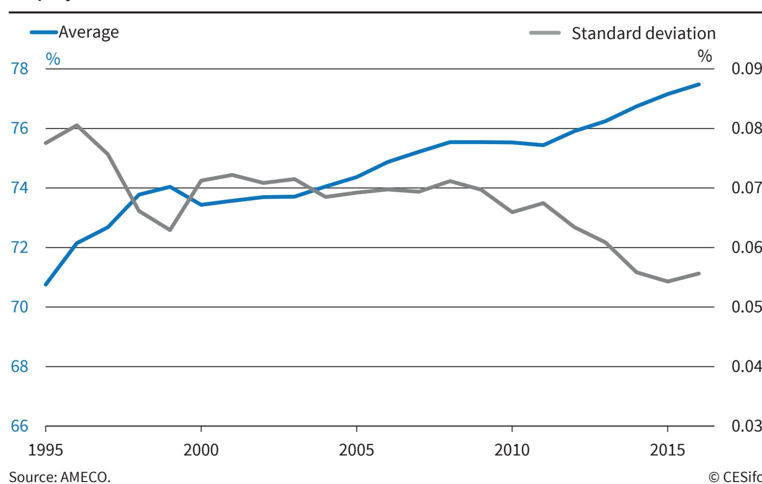
Source: AMECO. © CESifo

Figure 4.8
β-Convergence in Employment Rates for EU-28



Linear regression fit: $y = -0.3914x + 33.056$; $R^2 = 0.3733$
Source: AMECO. © CESifo

Figure 4.9
Employment Rate across EU-28



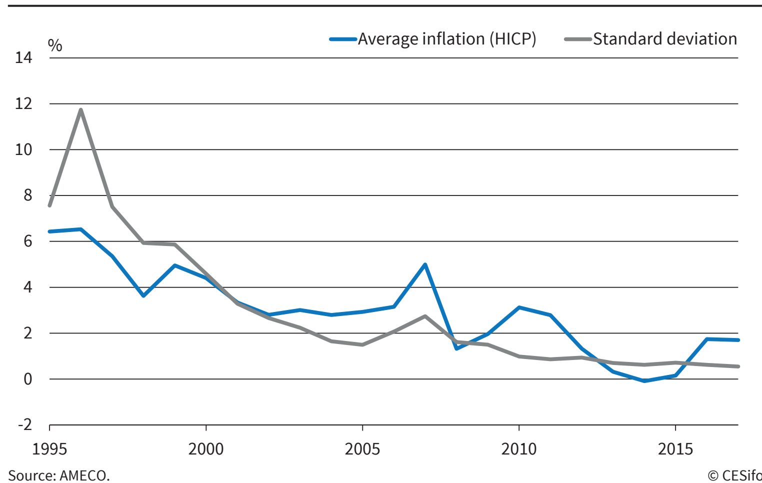
Source: AMECO. © CESifo

market convergence has mostly been discussed in relation to the theory of optimal currency areas. When monetary policy/exchange rate policy can no longer be used to address domestic imbalances, it is important that the labour market is flexible, either via wage adjustments or other forms of adjustment; or via worker migration across EMU-countries. These adjustment mechanisms will work to reduce asymmetries in economic developments across EMU countries. A corollary to this discussion has been the TINA ('There Is No Alternative')-argument which says that once inside the currency area, countries would have to undertake needed reforms to ensure flexibility. Experience has shown that the TINA-argument has not been very compelling, though.

Worker migration has increased within the European Union, but it remains quantitatively much less important than immigration from outside the Union (see EEAG, 2017). The increase in mobility is largely driven by flows from the new Eastern member countries to EU-15 countries, but worker mobility between the latter has also increased. In addition to migration, worker mobility is also reflected in work-home commuting across EU borders, and staff posted for a limited period in an EU country other than their country of residence. Arpaia et al. (2014) find that worker mobility within the European Union responds to the business cycle, and more so for euro countries.

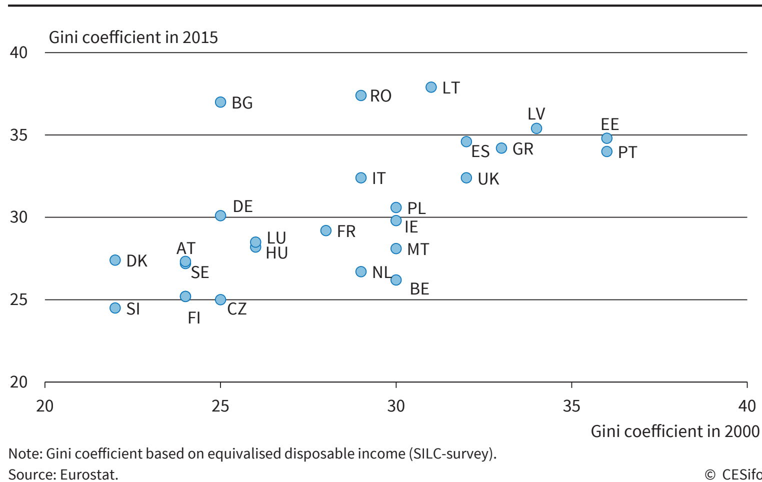
While convergence of real variables has been slow, nominal convergence is much stronger. Figure 4.10 suggests that inflation rates have converged to a low average level and the dispersion across EU-28 countries is small. This is a global trend and therefore cannot be solely attributed to the EMU. Moreover, there is still large dispersion in relative prices across EU countries (see for example Estrada et al., 2013). Wage responsiveness to labour market developments also differs widely across EU countries. There is a high level of dispersion in wage increases across countries, partly reflecting different business cycle situations, and wage responsiveness to unemployment also differs (see for example ECB, 2016).

Figure 4.10
Inflation Rate across EU-28



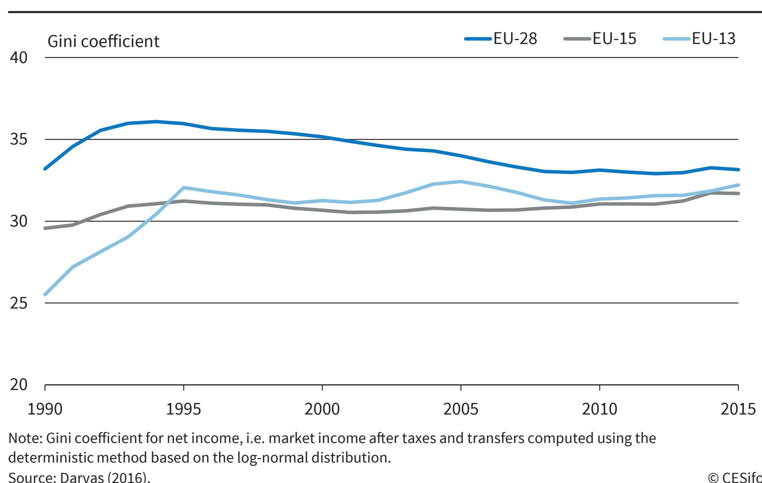
Source: AMECO. © CESifo

Figure 4.11
Gini Coefficients for EU-28



Note: Gini coefficient based on equivalised disposable income (SILC-survey).
Source: Eurostat. © CESifo

Figure 4.12
Gini Coefficient



Note: Gini coefficient for net income, i.e. market income after taxes and transfers computed using the deterministic method based on the log-normal distribution.
Source: Darvas (2016). © CESifo

4.3.3 INEQUALITY

Across EU countries – as for OECD countries generally – there has been a trend towards an increase in inequality. However, there are significant country differences as shown by Figure 4.11 that compares income inequality in 2000 and 2015. Most EU countries have experienced increased income inequality over this period, but there are exceptions like, for example, the Netherlands, Austria, and Malta. It is noteworthy that none of the countries having caught up on income and (un-)employment have experienced lower inequality. Considering convergence, there is no β-convergence in income inequality over the period 2000 to 2015, and the measure of σ-convergence displays a weak U-shaped pattern: first declining and then increasing after the onset of the financial crisis.

In-work-at-risk-of-poverty rates among the age group 18 to 64 differ significantly between EU countries. The EU-28 average is close to 10%, ranking from 3.5% in Finland, 4% in the Czech Republic, and 4.5% in Austria to 13.2% in Spain, 13.4% in Greece, and 19.6% in Romania.

Inequality measures take a country perspective, and cannot simply be added or averaged to display overall inequality within a group of countries like the EU-28 or euro countries. Figure 4.12 shows inequality measures constructed for the entire EU-28, EU-15 and EU-13 (see Darvas, 2016). For EU-28 there was an increase in inequality in the early 1990s followed by a weak downward trend. For EU-15 countries there was a weak upward trend, while the EU-13 countries experienced a steep increase in inequality in the early 1990s, which has remained relatively steady ever since. In a breakdown of the EU-28, Darvas (2016) shows that increases in mean income (income convergence) contributed to the decline in EU-28 inequality, while within-country inequality worked in the opposite direction. For the EU-15 and EU-13 the increase in income inequality is largely due to increases in within-country inequality.

4.4 CONVERGENCE IN POLICIES AND INSTITUTIONS

Globalisation implies a deeper integration of product, financial, and labour markets. Barriers to trade, exchange and mobility are reduced both due to technological advances lowering information and transportation costs, and political moves to integrate markets by removal of tariff and not-tariff barriers, deregulation to make market entry easier etc. The Single Market ensures free mobility for goods, services, capital, and labour. The euro takes this one step further in terms of monetary unification.

How does economic integration affect policies and institutions? Will it lead to convergence in policies and institutions, or will country differences persist? And is this good or bad?

From a normative perspective, political convergence may be desirable. To the extent that the European Union is a political project to develop and strengthen common interests and to create a common European identity, political convergence can be seen as an important factor.

In some policy areas it is rather obvious that cooperation necessarily requires all countries to adopt the same policies. This applies, for instance, in relation to the Single Market, with respect to tariffs on non-EU countries or monetary policy for euro countries. However, in crucial policy areas like labour markets, taxation, or social policies and thus ultimately the design of the welfare systems, the subsidiarity principle is in place. Countries still have the freedom to set their own policies, and yet the European Union has undertaken many efforts to harmonise these policy choices, mainly through the Open Method of Coordination (see Section 4.6 on social policies).

Economic policies can have spill-over effects to other countries. In designing policies, single countries do not take these spill-overs into account (non-cooperative policies). If that happens, the final outcome may be suboptimal for all countries. The cooperative policy taking spill-overs into account is often different from the non-cooperative policy, which is implemented when countries individually pursue their interests.[4] However, the cooperative policy is not easily implementable, since countries have an incentive to free-ride and only take country-specific effects into account.

The Single Market is an example of a cooperative policy whereby all countries decide to adopt common policies in specific areas to reap the gains from economic integration. How does this affect policies in other areas – will a convergence process be triggered? Or will tensions build up?

The question of whether economic integration enforces a convergence in the area of welfare policies (labour market, social policies, tax policies etc.) has been discussed intensively. To some, EU membership is seen as a way of ensuring convergence with higher social standards, while others see it as a safeguard against overly generous welfare arrangements.

In the academic literature on this topic, there is a longstanding debate over the two different views on the implications of international integration for welfare arrangements. The *system competition view* stresses race-to-the-bottom mechanisms causing a convergence with a leaner public sector and welfare arrangements (see e.g. Zodrow and Mieszkowski, 1986, and Sinn, 2003). If the public sector is ridden by rent-seeking activities, the pressures from intensified competition due to economic integration may be welfare enhancing. But if policies are driven by the desire to maximise welfare – through the provision of social insurance or the repair of market failures – competition between countries constrains desirable policies. This is an undesirable side effect of economic integration. The opposite view – the *compensation view* – holds that economic integration may increase the need for welfare arrangements. Integration is taken to lead to more risk and volatility in economic variables. The compensation view stresses that welfare arrangements provide insurance either via the social safety net, or via a large public sector not directly influenced by market forces. Deeper integration leading to higher risk therefore increases the demand for implicit insurance via welfare arrangements (see Rodrik, 1997 and 1998). Empirical evidence indicating that more open economies also tend to have larger public sectors is given in support of this view.

The system competition view starts from the idea that increased integration makes it easier to relocate production and capital across countries. Proximity to customers matters less when trade is easier, and location will be more influenced by where the lowest cost of production is offered. This gives rise to a process whereby countries may reduce taxes and/or labour standards to attract foreign firms and thus production and jobs. All countries are forced to follow this race-to-the-bottom process with the result that standards are lowered, possibly with little net effect on production location. Source-based corporate taxation is often seen as a prime example of international policy competition, since corporations are 'nationless' and may relocate production to take advantage of cost differences.[5] In a labour market context the posted worker directive is an example of a policy that is

[4] Importantly, the cooperative outcome does not necessarily require that all countries adopt identical policies. Differences in economic fundamentals and policy preferences are taken into account in the cooperative policy, the purpose is to internalise spill-overs. This may be an argument for agreeing on minimum levels or standards which contain race-to-the-bottom mechanisms on the one hand, but leave room for country differences on the other.

[5] For a survey of the literature on this topic see Keen and Konrad (2013). At the same time, economic integration also releases forces that create incentives to increase corporate taxes. For instance, countries have incentives to tax foreign-owned firms because at least part of the tax burden falls onto foreigners (see Fuest and Huber, 2002).

often interpreted as creating a race-to-the-bottom in labour standards.[6] The directive allows companies established in any EU member country to temporarily post employees to work in another EU country under the labour regulations in the home country. This gives companies in low-wage countries (new member states) a competitive edge when offering services in high-wage countries. For the new member states this is a possibility to use their comparative advantage, old member states and trade unions in these countries see this as undermining labour market standards.

The race-to-the-bottom argument rests on a positive policy spill-over, that is, higher taxes in one country spill-over to trading partners by giving them a competitive edge. However, spill-over effects can also be negative (beggar-thy-neighbour effects). If the public sector is expanded, the tradeable sector is squeezed, and with differentiated products, this will under very general conditions produce a terms-of-trade gain reducing the costs of expanding public activities. In the cooperative case there is no such terms-of-trade effect,[7] (in the symmetric case it is absent), and therefore non-cooperative policy making may lead to larger public sectors than in the cooperative case (see, for example, Epifani and Garcia, 2009, and Andersen and Sørensen, 2012). Moreover, and importantly, since economic integration is associated with gains in terms of higher incomes and thus private consumption, one would expect this to increase the demand for public activities, since the income elasticity of such services (e.g. health) is high. These effects can bring about the effects described by the compensation hypothesis, that is, a growing public sector in response to more economic integration.

The political economy responses to market integration are far from trivial, and uniform policy responses should not usually be expected. Although market integration in general creates aggregate gains, there will be winners and losers, not only within, but also between countries. How this translates into policy responses clearly depends on the specific changes and the political environment. Intra-European integration may create different winners and losers in specific countries, and therefore different policy responses. As an example, capital market integration will lead to capital flows that would benefit capital owners and harm labour in capital abundant countries and vice versa in countries experiencing capital inflows (Bertola, 2017a). The political economy response may therefore be deregulation (via reforms making labour markets more flexible, for instance) in the capital abundant country, and more regulation in the country experiencing capital inflows. Changes in market fundamentals and political economy effects may thus generate complicated policy responses and need not lead to policy convergence.

4.4.1 CONVERGENCE IN PUBLIC SECTOR SIZE AND TAX STRUCTURES

It is beyond the scope of this chapter to provide a detailed account of policy developments and possible convergence across all policy areas. But to put the issues discussed here into perspective, it is useful to consider the development in the overall size of the public sector, since this lies at the core of the convergence discussion.

The extent of welfare arrangements as measured by the size of the public sector displays strong persistence across EU countries. Figure 4.13 shows the size of the public sector in the late 1990s and the 2010s measured by the tax burden, i.e. total tax revenue as a share of GDP (a similar relation holds for total expenditure as a share of GDP).[8] Strong persistence prevails. Countries with a relatively lean public sector in the 1990s also have a lean public sector in the 2010s and vice versa.[9] This shows that various hypotheses regarding trend changes in the public sector do not hold for EU-28 countries over this period. It also shows that fairly different social or welfare systems co-exist within the

[6] See European Union Commission Directive 97/71/EC of 15 December 1997, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX-:31997L0071&from=EN. There are ongoing discussions to change the directive in the European Council and the Parliament to give larger weight to social concerns, but country positions are very different.

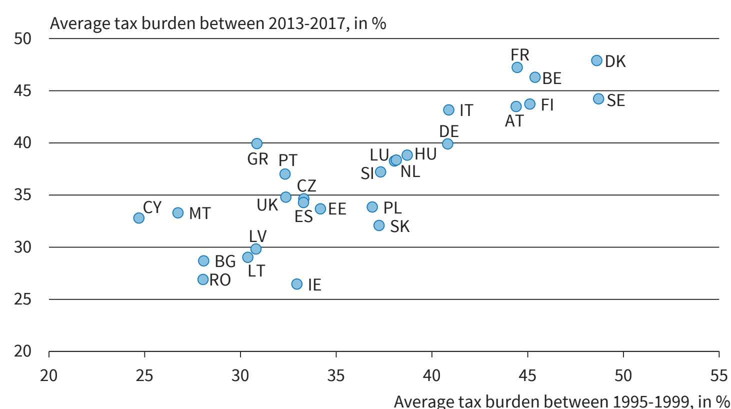
[7] The policy may have various benefits and costs, but in the non-cooperative case the benefit side includes a terms-of-trade-effect which does not appear in the cooperative case.

[8] Both the tax burden and the expenditure share display strong cyclical dependencies (automatic budget responses), making it difficult to separate structural and cyclical aspects by comparing single years. To reduce cyclical effects, the average over the period 1995 to 1999 is compared to the average over the period 2013 to 2017.

[9] The cross-country correlation between the tax burden in the 1990s and the 2010s is 0.84. A simple linear regression of the tax-burden in the 2010s on the tax burden in the 1990s yields a coefficient below, but not significantly different from one.

Figure 4.13

Total Tax Burden in the EU-28

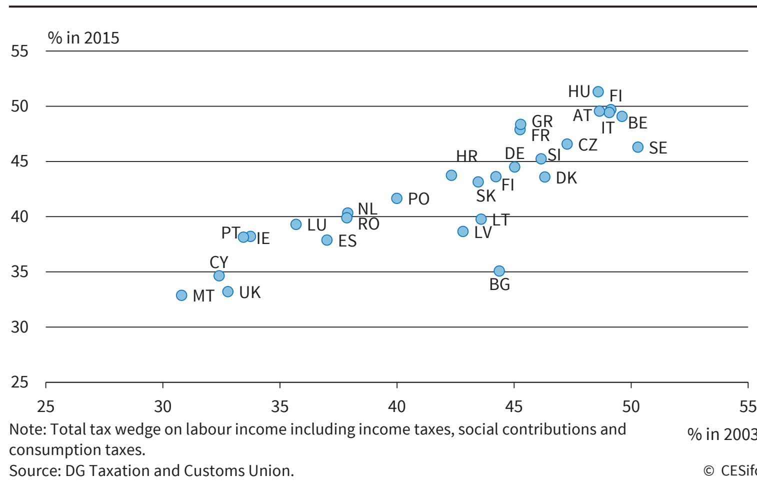


Note: Total tax revenue in % of GDP. Simple averages over the stipulated periods.
Source: AMECO.

© CESifo

Figure 4.14

Tax Wedge on Labour for EU-28



Note: Total tax wedge on labour income including income taxes, social contributions and consumption taxes.
Source: DG Taxation and Customs Union.

© CESifo

EU-28. This raises several issues that are discussed in greater detail in Section 4.6.

It is challenging to quantify the development in structural policies across EU countries. A specific and comparable measure is the tax wedge on labour income (see Figure 4.14). Although there is a high degree of persistence over time, there is some indication of weak convergence, but not a race-to-the-bottom. Among countries with an initially low (high) tax wedge, a tendency to increase (decrease) the tax wedge has emerged.[10]

Information on labour market reforms is provided by the LABREF-data base covering the period 2000 to 2014, which indicates a high frequency of reforms (Turini et al., 2015). However, reform directions are far from uniform and do not show a clear pattern of convergence (Bertola, 2017b). Some countries have launched reforms to make labour markets more flexible, while others are moving in the opposite direction. Even at the country level, reform directions change over time depending on, for example, the business cycle situation, including the unemployment level and capital flows (current account positions). Labour market reforms tend to respond to the labour market situation: with deregulation in periods of increasing unemployment, while policies change more passively when unemployment is low (Bertola, 2017b).

As mentioned above, one of the classical examples of a race-to-the-bottom mechanism is the corporate tax rate. For EU-28 countries – as for most countries – there has been a trend towards a decline in the corporate tax rate, from an average rate close to 35% in 1995 to about 22% in 2017 (see Figure 4.15).[11] The variation in tax rates declined initially, then increased and subsequently declined moderately, i.e. there are still substantial country differences. In their survey on empirical evidence on tax competition, Devereux and Loretz (2013) conclude that there is empirical evidence of tax competition among EU countries. It is worth noting that revenue from corporate taxation has remained fairly constant at a level of about 2.5% of GDP over the period in question, i.e. there is no trend towards a decline in revenues, suggesting that corporate tax competition has not undermined the financial viability of public sectors to date. Tax rate reductions nevertheless matter, however, since revenue could have been higher, but this figure also depends on profit developments, the shifting of income between the personal and the corporate tax base, and other effects.

[10] The slope coefficient is estimated to be 0.77 (standard error 0.09) and significantly below one. This relation implies convergence to a tax wedge of around 45% in the long-run.

4.4.2 CONVERGENCE IN INSTITUTIONAL QUALITY

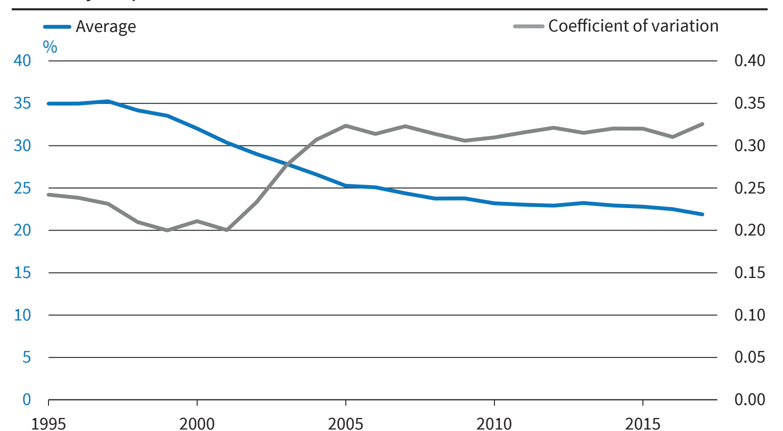
In this section we consider convergence in indicators of institutional quality. We do so mainly because convergence in the quality of institutions can be seen as an important factor for achieving convergence in economic outcomes like per capita income or high levels of employment.[12] In addition, high levels of

[11] Further decreases are likely to come. The Netherlands, Sweden, and the United Kingdom have announced reductions in the corporate tax rate. At the level of European Union there are various initiatives regarding tax cooperation via the introduction of minimum rates, but such moves require unanimity among EU countries and this constrains the process.

[12] Of course, it cannot be excluded that the causality may also run from better economic performance to institutional quality.

Figure 4.15

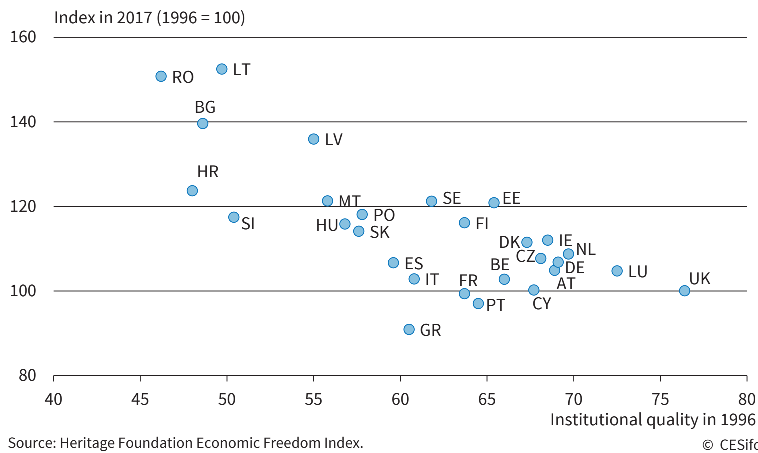
Statutory Corporate Tax Rates across EU-28



Note: Top statutory corporate income tax rates (including surcharges).
Source: DG Taxation and Customs Union.

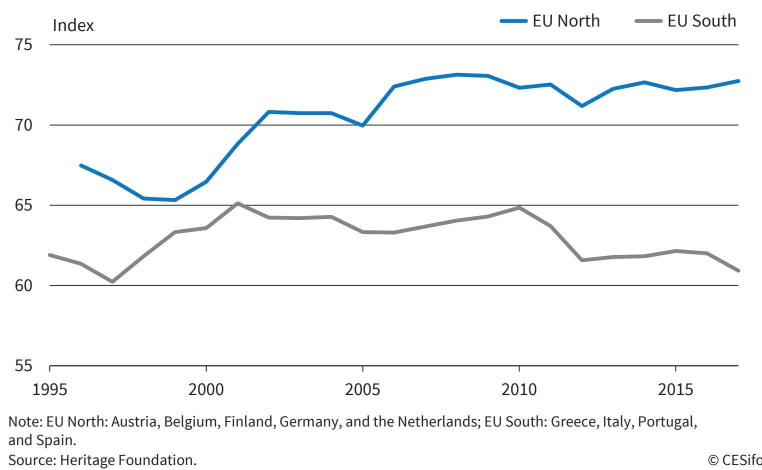
© CESifo

Figure 4.16
Convergence in Institutional Quality in EU-28



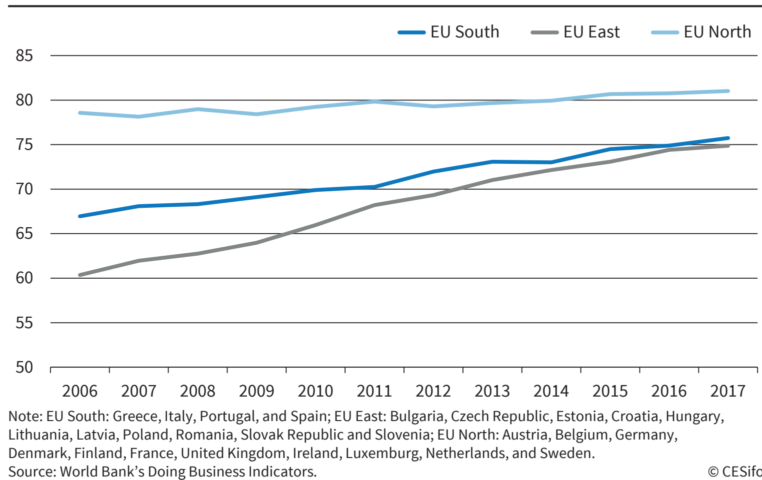
Source: Heritage Foundation Economic Freedom Index. © CESifo

Figure 4.17
Economic Freedom Heritage Foundation Index



Note: EU North: Austria, Belgium, Finland, Germany, and the Netherlands; EU South: Greece, Italy, Portugal, and Spain.
Source: Heritage Foundation. © CESifo

Figure 4.18
Doing Business Indicator



Note: EU South: Greece, Italy, Portugal, and Spain; EU East: Bulgaria, Czech Republic, Estonia, Croatia, Hungary, Lithuania, Latvia, Poland, Romania, Slovak Republic and Slovenia; EU North: Austria, Belgium, Germany, Denmark, Finland, France, United Kingdom, Ireland, Luxemburg, Netherlands, and Sweden.
Source: World Bank's Doing Business Indicators. © CESifo

institutional quality can be seen as a key component of the political objective of cohesion within the European Union.

Compared to outcome indicators like per capita income or unemployment rates, institutional quality is more difficult to measure. A wide variety of institutions make a difference to economic growth and convergence. Countries may have appropriate institutions in some areas and inappropriate institutions in others. An in-depth discussion of the different types of relevant institutions is beyond the scope of this chapter. In the following, we consider some key aggregate summary measures of institutional quality such as economic freedom indices and indicators on the ease of doing business in different countries.[13] It is important to bear the limitations of these indicators in mind.

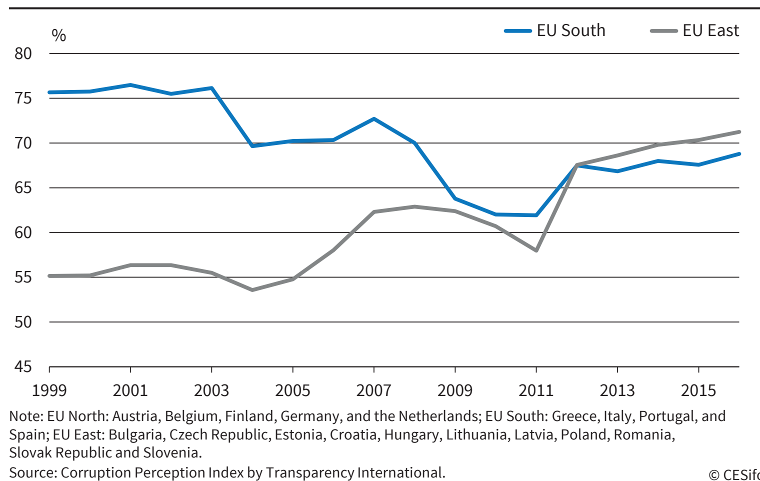
Figure 4.16 illustrates the development of institutional quality as measured by the Index of Economic Freedom provided by the Heritage Foundation. In the EU-28, this index has converged in the last two decades. Again, this process is mostly driven by the countries of Eastern Europe. If we exclude these countries and compare the group of Northern European countries belonging to the eurozone to the group of Southern European countries, the trend towards convergence disappears, as illustrated by Figure 4.17.

Another widely cited indicator of institutional quality is the World Bank's Doing Business Indicator. Figure 4.18 shows the development since 2006. As in the case of the other indicators, the East European member states are clearly catching up. For the group of Southern European countries convergence with the level of the North is clearly slower, but at least there is no divergence.

A narrower, but widely cited index of institutional quality is the Corruption Perceptions Index published by Transparency International. An increase in the index reflects an improvement, namely a decline in corruption.

[13] De Haan and Sturm (2000) investigate how measures of economic freedom are related to economic growth and find that improvements in measured economic freedom seem to boost growth. A comparison of different economic freedom indicators can be found in Hanke and Walters (1997).

Figure 4.19
Perceived Corruption in the EU Relative to Northern EU Countries



Note: EU North: Austria, Belgium, Finland, Germany, and the Netherlands; EU South: Greece, Italy, Portugal, and Spain; EU East: Bulgaria, Czech Republic, Estonia, Croatia, Hungary, Lithuania, Latvia, Poland, Romania, Slovak Republic and Slovenia.
Source: Corruption Perception Index by Transparency International.
© CESifo

The pattern is similar to the one shown by other indicators. There is convergence in Eastern Europe, but institutions in Southern Europe have deteriorated, particularly since the year 2000, with a slight recovery in the last five years.

4.5 ECONOMIC CONVERGENCE IN THE EUROPEAN UNION: WHERE DO WE STAND?

What are the lessons that can be drawn from the development of economic convergence in the European Union? Neither economic theory nor empirical evidence from outside Europe or from periods other than that considered above suggest that economic convergence happens automatically or should be taken for granted. In the European Union economic convergence seems to have worked fairly well, particularly with respect to the catching-up process of the Eastern European countries, which entered the Union in 2004 and later.

There has been less convergence between Southern and Northern Europe. Over the last two decades, the gap in per capita incomes between Southern and Northern Europe has widened. This process of divergence has gained momentum since the financial crisis and the beginning of the eurozone debt crisis, but began prior to these events.

As far as institutional convergence is concerned, it is important to note that institutions are an important driver of economic development, but changes in the economic environment also affect institutional development. Bertola (2017a) shows that economic changes like the introduction of the euro, can cause institutions to diverge. The introduction of the euro triggered capital flows from the core of the eurozone to the periphery. A government that maximizes domestic income may well react to such a capital inflow by increasing the cost of labour or by reducing labour market flexibility, with the objective of letting domestic workers capture a larger share of the additional output. In the countries experiencing capital outflow the equivalent reaction would be labour market reforms leading in the opposite direction. This is a possible explanation for at least part of the institutional divergence observed.

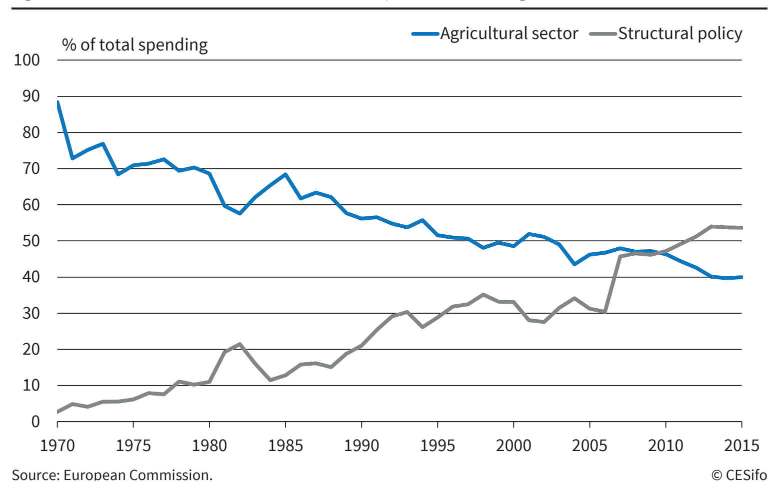
One should note that the focus on broad groups of countries may divert attention away from the fact that their development is quite different. Some countries of Southern Europe experienced an unsustainable credit boom prior to the financial crisis and the eurozone debt crisis, meaning that their economic difficulties since the crisis may just be a return to normal. But in other countries, and particularly in Italy, the slowdown in economic growth began much earlier, and the country did not experience a credit boom. This suggests that the factors driving the economic divergence between Southern Europe and the rest of the European Union are diverse.

4.6 WHAT DOES THE EUROPEAN UNION DO TO SUPPORT ECONOMIC CONVERGENCE?

Economic convergence is an important political objective of the European Union. Article 174 of the Treaty on the Functioning of the European Union puts this as follows:

"In order to promote its overall harmonious development, the Union shall develop and pursue its actions leading to the strengthening of its economic, social and territorial cohesion. In particular, the

Figure 4.20
Agricultural Subsidies and Structural Policy in the EU Budget



Source: European Commission.
© CESifo

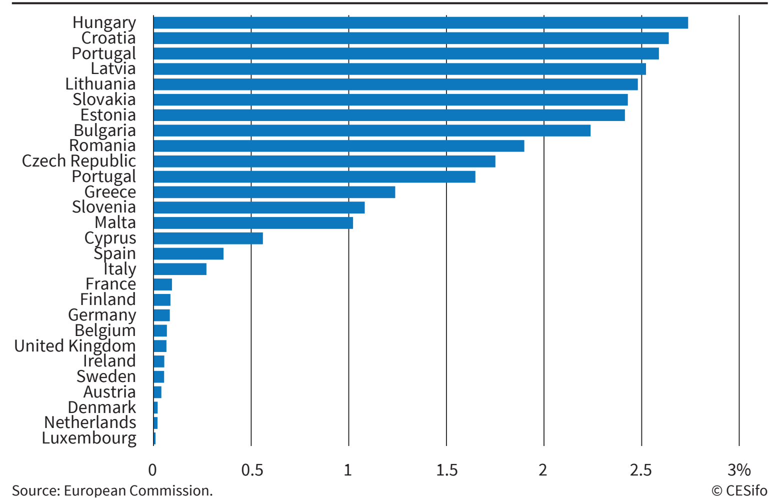
Union shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions" (European Union, 2012).

What does the European Union do to foster convergence? Firstly, the European Union itself pursues policies to bring about convergence, particularly through its structural and regional funds in the EU budget. Secondly, the Union supports various forms of policy coordination among member states, with the objective of fostering economic convergence both across and within member states. One example is the European Semester. A recent initiative is the so-called Social Pillar of the European Union.

Figure 4.22

EU Structural Fund Allocations 2014-2020

Percent of GNI



Source: European Commission. © CESifo

4.6.1 THE EU BUDGET

Traditionally the EU budget had a strong focus on providing agricultural subsidies. However, over time agricultural spending as a share of the budget has been reduced and other items have become more important, notably spending on regional and structural policies.

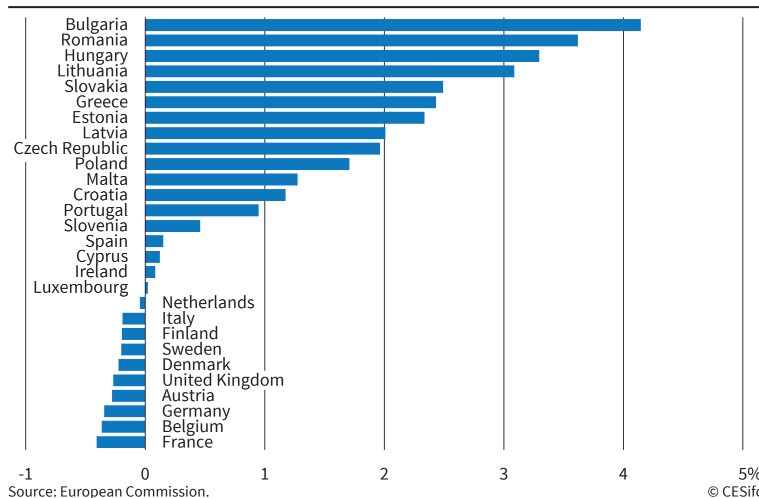
Figure 4.20 shows that agricultural subsidies as a share of overall spending accounted for almost 90% of the EU budget in the 1960s and has declined steadily ever since, reaching approximately 40% today. Spending on structural policy has increased over time and now accounts for over 50% of the budget.

The overall volume of the EU budget does not represent more than roughly 1% of EU GDP. Nevertheless its redistributive effects are of relevant magnitude, particularly for the less wealthy member states. Figure 4.21 offers an overview of the net balances of the member states with respect to the EU budget.[14]

Figure 4.21

EU Budget Net Balance

Percent of GNI



Source: European Commission. © CESifo

The net balances shown in Figure 4.21 relate the contributions to the budget to financial flows received by individual member states in 2016, as a percentage of gross national income (GNI). Not all of these payments are related to structural or regional policies, but the numbers indicate that some of the poorer EU member countries receive significant financial support from the EU budget. Figure 4.22 shows the allocation of structural funds across member states for the period 2014 to 2020.

4.6.2 HOW SUCCESSFUL IS THE EU'S COHESION POLICY?

The European Commission regularly evaluates the impact of the EU's cohesion policies. The evaluation of the period 2007 to 2013 concludes that "1 euro of Cohesion Policy investment in the period 2007-13 will generate 2.74 euros of additional GDP by 2023" (European Commission, 2016a). The trouble with this number is that it is not based on an ex post evaluation of convergence policies, but on a simulation analysis that tries to estimate the future effects of the policy using a macroeconomic

[14] Net balances are often criticised as being an inappropriate indicator of what the member states get out of the European Union because net balances suggest that Union spending is a zero sum game. The weakness of this critique is that a large part of the EU budget is indeed spent on redistributive policies, rather than on the provision of EU wide public goods. To the extent that this is the case, net balances are an appropriate indicator of the distribution of what member states get not out of being a member of the European Union, but what they get out of the EU budget.

simulation model (European Commission, 2016a, p. 3). For a credible assessment of the effects of cohesion policy, a number of challenges need to be addressed. The most important challenge is to construct a plausible counterfactual scenario; to establish how a region or a country would have developed in the absence of regional policies or if the money had been spent differently.

Independent academic research on the impact of EU regional policies is far more critical of the ability of such policies to increase economic growth. An early contribution to this debate is Sala-i-Martin (1996). He uses cross-sectional regressions to compare the pattern of regional growth and convergence in the European Union to that of federations outside the Union, which do not have convergence policies. He finds that the convergence patterns do not differ substantially and concludes that EU regional policy is not effective. Of course, this analysis is based on the assumption that the European Union is comparable to existing federations like the United States in all aspects apart from regional policy. This is certainly a strong assumption. Boldrin and Canova (2001) study the same question, but use a different approach. They focus on regional growth within the European Union and compare regions that receive regional policy transfers to regions that do not. Their findings are similar to those of Sala-i-Martin (1996).

However, there are also studies with different results. Midelfart-Knarvik and Overman (2002) look at industry location and agglomeration at the national level and find that structural fund programmes have a positive effect. A positive relationship between structural policy spending and GDP per capita growth is found in Beugelsdijk and Eijffinger (2005), as well as in Ederveen, de Groot, and Nahuis (2006). At the sub-national (NUTS1 or NUTS2) level, Cappelen et al. (2003) as well as Ederveen et al. (2002) find that structural funds have a significant positive impact on regional growth, while Dall'erba and Gallo (2008) do not find any positive growth effects.

Evaluations that simply compare regions receiving regional policy transfers to those that do not, face the difficulty that these two groups of regions differ in various ways, meaning that differences in economic growth between these groups do not necessarily reflect the impact of regional policy transfers. Moreover, it is likely that regional policy not only affects the supported regions, but also other regions. For instance, companies may relocate their investment to regions where subsidies are paid. This implies that their effect on overall economic growth may be small and the benefit of these policies may be overestimated. Using appropriate identification strategies is therefore of key importance.

A number of more recent studies place a greater emphasis on the identification issue than previous papers. Becker, Egger, and van Ehrlich (2010) exploit the fact that the selection criteria for the EU Structural Funds programme introduced in 1988 (the so called Objective 1) includes a discontinuity. A region qualifies for support if its per capita GDP is below 75% of the EU average. They identify the impact of regional policy by comparing regions below and just above this threshold. They find that each euro spent on regional policy generates a return of 1.2 euros in the form of higher GDP in the supported regions. This would suggest that EU regional policy has a positive effect.

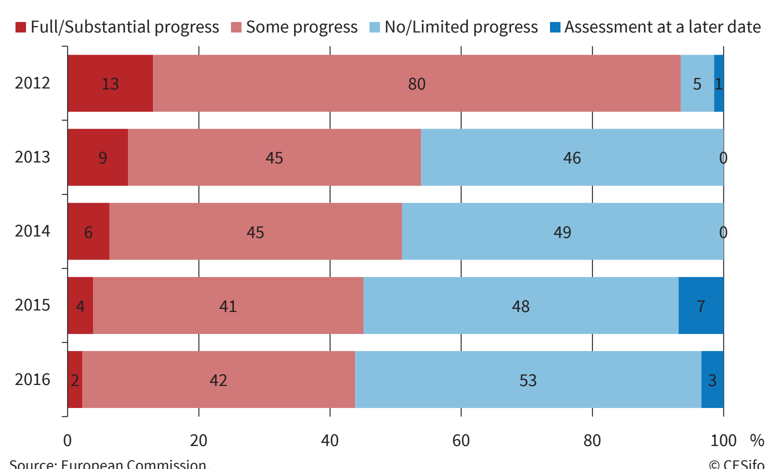
In a recent study, Breidenbach, Mitze, and Schmidt (2016) do not find any positive effects of EU regional policy transfers. They use various spatial econometric models to identify the effects of structural fund spending on regional economic growth, taking into account spill-overs to non-funded regions. Their findings suggest that regional economic growth is even negatively correlated with structural fund receipts. A possible explanation is that many of the supported regions are held back by a lack of appropriate institutions or complementary policies, which would create favourable conditions for economic growth. The authors emphasise that regional funds may lead to a relocation of economic activity, but do not generate additional aggregate growth. They call their results "sobering" and conclude that the EU's regional policy "currently fails in its allocative goal to foster income convergence" (Breidenbach, Mitze, and Schmidt, 2016, p. 29).

Overall, the available evidence suggests that the efforts of the European Union to support economic convergence through structural and regional policy may have led to a relocation of economic activity to these regions, but that the contribution to overall growth and convergence is limited. More needs to be done to properly evaluate and compare the impact of regional policy and different instruments used within the framework of this policy. It is also plausible that the effectiveness of convergence policies depends on the local conditions in the regions supported.

4.6.3 THE EUROPEAN SEMESTER

Most policies that have a significant impact on economic growth or employment are the responsibility of member states, which limits the European Unions's ability to influence economic convergence in Europe. The European Union nevertheless tries to influence national policies. It does so through a large number of initiatives focusing on policy coordination. The so-called European Semester is a key element of EU economic policy coordination. The European Semester was introduced in 2010. Its objective is not to achieve binding agreements on particular policy issues like tax rates or regulations. Instead, it defines a process of information exchange and dialogue between European institutions and member states. The European Semester covers three policy areas: structural reforms aimed at increasing growth and employment, fiscal policy, and macroeconomic

Figure 4.23
European Semester: Implementation of Country-Specific Recommendations



Source: European Commission. © CESifo

imbalances. The objective of the European Semester is to ensure that member states pursue sound and sustainable fiscal policies, to avoid macroeconomic imbalances and to support the member states in developing policies that enhance economic growth and employment.

The basic procedure of the European Semester is as follows: each member state submits plans regarding the fiscal and macroeconomic policy and structural reforms it intends to undertake. The European Commission analyses these plans and makes suggestions for policy changes and additional reforms. The council then may or may not adopt these country specific recommendations. Compliance with these recommendations is voluntary.

What is the impact of the country specific recommendations? The European Commission has repeatedly pointed out that the member states are reluctant to implement recommendations emerging from the European Semester. Figure 4.23 offers an overview of the implementation of the recommended reforms. It reveals a decline in compliance over time.

The fact that the EU member states are reluctant to implement recommendations made in the process of the European Semester does not necessarily imply that the process itself is flawed. Debate over economic policy reforms may take time before it has an impact on policy decisions. But critics of the European Semester point to other issues. One key question is whether the recommendations made are actually appropriate, both in terms of their content and legitimacy. One of the weaknesses of the European Semester in its current form is that the policy recommendations are generated in a process that is remote from the national political and economic environment.

This suggests that national institutions, like the fiscal councils of the member states, should be more involved in the process of generating policy recommendations, as well as monitoring their implementation (Pisany-Ferry, 2016). This would make the recommendations more acceptable to national debates; and probably also more tailored to each country's specific political and economic situation. One should be aware, however, that giving national institutions greater weight in the European Semester may also have its drawbacks. More specifically, these institutions can be expected to focus on the needs and interests of their country; and place less emphasis on possible spill-overs of national economic policy decisions. So if national institutions are given greater weight, it is equally important to raise awareness of spill-overs and the potential implications of national economic policy decisions for European interests and policy objectives.

4.6.4 THE EUROPEAN SOCIAL PILLAR

The so-called Five Presidents' Report (Juncker et al., 2015) launched a process to develop a Social Pillar for EMU countries. Other EU countries can opt to join in. According to the report, "Europe's aim should be to earn a 'social triple A'". Jean-Claude Juncker also stated: "I will want to develop a European Pillar of Social Rights, which takes account of the changing realities of the world of work and which can serve as a compass for the renewed convergence within the euro area" (Juncker, 2015). This is seen as a necessary step towards completing EMU.

The proposal for the Social Pillar was launched in April 2017 and states 20 principles structured around three themes: (I) Equal opportunities and access to the labour market, (II) Fair working conditions, and (III) Social protection and inclusion (see Box 4.1 for details).

The Social Pillar is a response to two main problems with the EMU. Firstly, heterogeneities in economic performance across EMU countries persist, meaning that few states find the common monetary policy appropriate for their particular country. Secondly, the legitimacy and thus political support for the EMU – and more generally the European Union – fundamentally depends on a favourable economic and social development across all EMU countries. High levels of unemployment, widening income inequality and policy responses during the Great Recession have exposed a 'social deficit' and the perception that policies pursued serve the interests of the elite, rather than those of the ordinary people. The Social Pillar builds on the belief that the success of EMU depends on making both economic and social outcomes more inclusive and fairer.

The Social Pillar is based on the idea that economic and social challenges are linked (Council of the European Union, 2017). More explicit and effective, social rights are seen as necessary to ensure fairer and

Box 4.1
EU Social Acquis and the European Social Pillar

The Treaty of Rome embraced social and employment issues and featured articles on discrimination and gender equality. Although initially focused primarily on free mobility and the common market, initiatives have recently turned to more broadly defined employment and social issues. EU social policy is defined by the EU Social Acquis (Treaty provisions, regulations, directives, decisions, European Court of Justice case-law, and other Union legal measures, binding and non-binding), including laws, principles, policy objectives, declarations, resolutions and international agreement, see European Commission, 2016b). Social policy at an EU level mainly relies on the Open Method of Coordination focusing on benchmarking, target setting and mutual learning processes. The main responsibility lies with the member states (subsidiarity principle). However, the European Union has a law-making competence to adopt directives, but it is limited by the principle of 'shared competence' and it can only establish minimum requirements. There are directives in the area of working environments and access to work (relating to equal treatment in the workplace, reconciling family and professional life, protection of health and safety, for example), collective labour relations (like worker representation, information, and consultation, collective redundancy, restructuring of enterprises), as well as a few directives on social protection (social security coordination, equal treatment within social security, and social integration). A wide range of social rights and principles are defined in the EU Charter.

Social aspects form part of the EU's ten-year growth strategy, Europe 2020. The overall aim for the European Union is to foster "smart, sustainable and inclusive growth" (European Commission, 2010). The strategy includes specific targets for the European Union as a whole, but also translates these into country specific targets. Targets related to employment and social conditions to be reached before 2020 include: I) Employment: 75% of the 20 to 64 year-olds to be employed; II) Education: a) Reducing the rates of early school leavers below 10%, b) At least 40% of 30 to 34-year-olds completing tertiary education; and III) Poverty and social exclusion: At least 20 million fewer people in or at risk of poverty and social exclusion. Each member state is to adopt its own strategy to reach these targets and may set additional ones.

The European Pillar of Social Rights aims "to serve as a guide towards more efficient employment and social outcomes when responding to current and future challenges which are directly aimed at fulfilling people's essential needs, and ensuring better enactment and implementation of social rights" (European Commission, 2017b, p. 4).

The Pillar states 20 key principles, structured around three themes:[1]

1) Equal opportunities and access to the labour market
   - Education, training, and life-long learning
   - Gender equality
   - Equal opportunities
   - Active support to employment
2) Fair working conditions
   - Secure and adaptable employment
   - Wages
   - Information about employment conditions and protection in case of dismissals
   - Social dialogue and involvement of workers
   - Work-life balance
   - Healthy, safe, and well-adapted work environment and data protection
3) Social protection and inclusion
   - Childcare and support to children
   - Social protection
   - Unemployment benefits
   - Minimum income
   - Old age income and pensions
   - Health care
   - Inclusion of people with disabilities
   - Long-term care
   - Housing and assistance for the homeless
   - Access to essential services.

In terms of the amount of detail provided, principle 1 on "Education, training and life-long learning" reads as follows:

"Everyone has the right to quality and inclusive education, training and life-long learning in order to maintain and acquire skills that enable them to participate fully in society and manage successfully transitions in the labour market" (European Commission, 2017c, p. 58).

Principle 13 on "Unemployment benefits" reads:

"The unemployed have the right to adequate activation support from public employment services to (re) integrate in the labour market and adequate unemployment benefits of reasonable duration, in line with their contributions and national eligibility rules. Such benefits shall not constitute a disincentive for a quick return to employment" (European Commission, 2017c, p. 60).

The European Pillar of Social Rights is intended for euro countries, but other EU countries have the option to join. The Pillar falls under the Open Method of Coordination, hence the main responsibility for implementation rests on member states. Monitoring of progress will take place via a Social Scoreboard, including a limited set of indictors to assess employment and social trends.

[1] See European Commission (2017c).

more well-functioning labour markets and welfare systems. This is expected to create a new process of convergence, making the EMU more resilient to shocks, ensuring a higher employment level, and fairer outcomes. The Social Pillar builds on initiatives already taken by the European Union but aims to state new and more effective rights for citizens (see also European Commission, 2017a-d).

The subsidiary principle applies in the policy areas related to the Social Pillar; and hence the main responsibility rests on member states. Country differences are explicitly recognised and it is stressed that initiatives have to be country-specific, and a 'one-size-fits-all' approach is not the aim. The pillar is intended to be a framework guiding future actions by member states. Initiatives and coordination rests on the open method of coordination reinforced by a scoreboard featuring employment and social indicators.

From the inception of the EMU there has been criticism of setting inflation as the primary target for monetary policy. Critics have argued that insufficient weight is attached to employment and social conditions, and therefore by extension that unemployment, for example, should also be an explicit target. The Social Pillar recognizes this critique, but takes a different approach, and aims in broad terms, via changes in labour market and social policies, to strike a balance between social protection and economic flexibility.

Over the years a number of EU initiatives have been launched, including the EURO 2020 targets, the Youth Guarantee and others. Eurostat publishes data on no less than six groups of EU policy indicators: Europe 2020 Indicators, Euro Indicators, Sustainable Development Indicators, Economic Globalisation, Macroeconomic Imbalance Procedure, and now the European Pillar of Social Rights. The number of initiatives and indicators is so large that few have an overview. The large number of EU initiatives – the effectiveness of which is not clear – creates an overflow of processes and indicators, which risk developing into a parallel world that is out of sync with the economic and political debate in member states.

The idea underlying the Open Method of Coordination is that information and monitoring foster knowledge exchange, learning and inspiration, as well as increasing the political costs of inaction. The effects of such EU initiatives are two sided: international comparisons can be forceful arguments in favour of initiatives to avoid lagging behind other countries, but if pushed too hard by the European Union, such initiatives can also backfire and can be seen as 'external' interferences in domestic issues. The dilemma for the European Union is the tendency of policymakers to attribute positive developments to their own efforts, and negative effects to outside forces including EU interference or lack of action. Without national ownership of the objectives, little action can be expected. The conundrum for the European Union is that it is held responsible for something, which it, at best, is only partially in control of.

The Social Pillar takes a different approach by aiming to win general acceptance for the principles in the anticipation that this will lead to policy actions. One possible underlying rationale may be that the quantitative targets did not work because countries did not agree on objectives in the first place; and by agreeing on the principles, progress can be made. However, quantitative measures still play a role, since the Pillar is accompanied by a Social Scoreboard.

The principles of the Social Pillar are broadly laid out, leaving ample scope for interpretation and thus differences in implementation, and hence they may be insufficient to 'screen, drive, and compass' a development leading to greater convergence. Therefore, even if countries adapt the principles and take initiatives, there is no guarantee that the underlying problems of insufficient convergence and asymmetries will be resolved. The design of labour market and social

policies is difficult. How to design social systems so as to provide insurance and at the same time maintain flexibility is not a trivial exercise. Since there are so many design routes to be taken, while still adhering to the principles, it is an open question whether this will contribute to a better-functioning EMU.

In the broader sense, the Social Pillar aims to address the problem of the social deficit in the construction of the EMU (and of the European Union more generally). The risk is that the principles are formulated in such a general manner, that while most agree with them, few would take ownership and push for the changes and reforms required to implement them. In the absence of any progress in these areas, the initiative may backfire and be seen as yet another initiative that is 'fine on paper', but which does not have much effect. National governments that fail to do their 'homework' will then blame the European Union for the unsatisfactory results. The discussion of how to ensure convergence within the EMU (and European Union) is old (and different initiatives have been taken, such as Europe 2020 including employment and social targets). Since there has been insufficient progress with reforms, it is questionable whether the real obstacle is in defining social objectives, or whether it is more political in nature.

4.7 CONCLUSIONS AND POLICY RECOMMENDATIONS

Our analysis has shown that economic convergence in the European Union has worked for certain groups of member states and during certain periods, but that there are also trends towards growing divergence. This is particularly true of the EU-15, where the gap between the Northern and the Southern European countries does not seem to be closing. This holds for important dimensions of outcome convergence like per capita income and unemployment. The gap also exists in various aspects of input convergence, and particularly indicators of institutional quality. In other areas, notably inflation, convergence has been achieved. Summary measures of economic convergence look better for the EU-28, but this process is mostly driven by the EU member states in Central and Eastern Europe, which joined the European Union after 2000.

In general, neither economic theory nor historical experience suggest that economic integration will automatically lead to economic convergence either in inputs, that is institutions or policies, or in outcomes such as income per capita and labour market participation. History also shows that even countries with strong national institutions and considerable fiscal redistribution across regions have often been unable to bring about economic convergence between rich and poor regions.

Under the existing institutional setup, economic policy at the EU level has limited resources and limited influence on economic convergence in Europe. Whether institutional and political conditions favour economic convergence depends mostly on the policies of the member states. Achieving convergence is therefore primarily a responsibility of national governments.

The European Union can support the convergence process in two ways: firstly through the EU budget and its regional and structural policy; and secondly through policy coordination and dialogue, particularly in the framework of the European Semester.

The EU's regional and structural policies do not yet work well enough. The academic literature on this topic does not generally support the optimistic results generated by the evaluation commissioned by the European Commission. Recent studies of EU regional policies, which have the advantage of using more appropriate methods to identify the causal effects of regional policies, suggest that regional policy transfers only have a limited impact on the economic development of the receiving regions. These effects are partly the result of diversion of investment from neighbouring regions. Results suggest that, as funds increase, the effectiveness of more spending declines.

More research is clearly needed in this area, and particularly on how different economic and institutional conditions in the regions receiving support impacts its effectiveness. The evaluation of these policies initiated by the European Commission should place strong emphasis on up to date methods for the identification of regional policies.

In addition, the funds made available through the EU budget partly go to rich countries and even rich regions within these countries that do not need this support. The money could and should be put to better use. Making more resources available for EU regional policies is not the answer as long as there is potential to improve the effectiveness of the funds already available.

The European Semester is a useful process, despite the fact that only few of the recommendations are implemented. Its impact could be increased by giving greater weight to national institutions like, for instance, independent national fiscal councils. This would increase national ownership of reform proposals. At the same time, it is important to raise the awareness of all of the players involved that national policies may lead to spill-overs, which implies that a purely national perspective on domestic reforms is incomplete. Alongside facilitating policy reforms that enhance national economic performance, it is the European Semester's objective to raise awareness of the European implications of national economic and fiscal policies.

In the debate over the lack of convergence in Europe, suggestions are often made to extend the role of the European Union in economic and social policies. This can be helpful, particularly if it applies to areas where national economic policies generate large spill-overs. Greater EU in-

volvement, however, also bears the risk of blurring responsibilities. In addition, it may lead national politicians to blame the European Union for the poor results primarily caused by the shortcomings of national policies. As long as the political process including public debate and democratic control mainly takes place at the national level, EU involvement in too many policy areas, often accompanied by big promises, is likely to produce disappointment and undermine political support for the European Union as a result. Potential for improvement through greater EU involvement should focus on areas where national policies give rise to spill-overs. At the same time, the European Union should only implement policy initiatives if it is equipped with the instruments to deliver on its promises.

REFERENCES

Andersen, T. M. and A. Sørensen (2012), "Globalization, Tax Distortions, and Public-Sector Retrenchment", *Scandinavian Journal of Economics* 114(2), 409–439.

Arpaia, A., A. Kiss, B. Palvolgyi, and A. Turrini (2014), "Labour Mobility and Labour Market Adjustment in the EU", European Economy, Economic Paper 539, European Commission.

Barro, R. J. and X. I. Sala-i-Martin (1995), *Economic Growth,* MIT Press, New York, St. Louis.

Becker, S. O., P. Egger, and M. von Ehrlich (2010), "Going NUTS: The Effect of EU Structural Funds on Regional Performance", *Journal of Public Economics* 94(9), 578–590.

Bertola, G. (2017a), "Wedges: Distribution, Distortions, and Market Integration", *CESifo Working Paper* No. 6627.

Bertola, G. (2017b), "EMU and Labour Market Policy: Tensions and Solutions, European Economy", *Discussion Paper* 54, European Commission, Bruxelles.

Beugelsdijk, M. and S. C. W. Eijffinger, (2005), "The Effectiveness of Structural Policy in the European Union: An Empirical Analysis for the EU-15 in 1995–2001", *Journal of Common Market Studies* 43(1), 37–51.

Boldrin, M. and F. Canova (2001), "Europe's Regions — Income Disparities and Regional Policies", *Economic Policy* 16(32), 207–253.

Breidenbach, P., T. Mitze, and C. M. Schmidt (2016), "EU Structural Funds and Regional Income Convergence – A Sobering Experience", *Ruhr Economic Papers* No. 608.

Campos, N. J., J. Fidrmuc, and I. Korhonen (2017), "Business Cycle Synchronization in a Currency Union: Tacking Stock of the European Evidence", *Bank of Finland Research Discussion Papers* 28.

Cappelen , A., F. Castellacci, J. Fagerberg, and B. Verspagen (2003), "The Impact of EU Regional Support on Growth and Convergence in the European Union", *Journal of Common Market Studies* 41(4), 621–644.

Council of the European Union (2017), "Proposal for a Interinstitutional Proclamation on the European Pillar of Social Rights", Brussels 20 October 2017 (OR. en) 13129/17.

Cuñat, A. and M. Melitz (2012), "Volatility, Labor Market Flexibility, and the Patterns of Comparative Advantage", *Journal of the European Economic Association* 10(2), 225–254.

Dall'erba, S. and J. Le Gallo (2008), "Regional Convergence and the Impact of European Structural Funds over 1989-1999: A Spatial Econometric Analysis", *Papers in Regional Science* 87(2), 219–244.

Darvas Z. (2016), "Some Are More Equal than Others: New Estimates of Global and Regional Inequality", *Bruegel Working Paper* 8-2016.

Devereux, M. P. and S. Loretz (2013), "What Do We Know about Corporate Tax Competition?", *National Tax Journal* 66(3), 745–774.

ECB (2016), *New Evidence on Wage Adjustment in Europe during the Period 2010-13, Economic Bulletin,* Issue 5 / 2016 – Article 2, available at: https://www.ecb.europa.eu/pub/pdf/other/eb201605_article02.en.pdf?a2dfdad6587e64565fe2867c7c7b4999.

Ederveen, S., J. Gorter, R. de Mooij, and R. Nahuis (2002), "Funds and Games: The Economics of European Cohesion Policy", *CPB Special Publication* No. 41.

Ederveen, S., H. L. F. de Groot, and R. Nahuis (2006), "Fertile Soil for Structural Funds? A Panel Data Analysis of the Conditional Effectiveness of European Cohesion Policy", *Kyklos* 59(1), 17–42.

EEAG (2017), *The EEAG Report on the European Economy*, CESifo Munich, 1–110.

Epifani, P. and G. Gancia (2009), "Openness, Government Size and the Terms of Trade", *Review of Economic Studies* 76(2), 629–668.

Estrada, Á., J. Gali and D. López-Salido (2013), "Patterns of Convergence and Divergence in the Euro Area", *IMF Economic Review* 61(4), 601–630.

European Commission (2010), "Communication from the Commission: EUROPE 2020 – A Strategy for Smart, Sustainable and Inclusive Growth", COM(2010) 2020 final, 3.3.2010, Brussels, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52010DC2020&from=en.

European Commission (2016a), "Ex post Evaluation of the ERDF and Cohesion Fund 2007-13", *Commission Staff Working Document* SWD(2016) 318 final, 19.9.2016, available at: http://ec.europa.eu/regional_policy/sources/docgener/evaluation/pdf/expost2013/wp1_swd_report_en.pdf.

European Commission, (2016b), "The EU Social Acquis", *Commission Staff Working Document* SWD(2016) 50 final, 8.3.2016, available at: http://ec.europa.eu/social/BlobServlet?docId=15292&langId=en.

European Commission, (2017a), "Establishing a European Social Pillar", Communication form the Commission to the European Parliament, The Council, The European and Social Committee and the Committee of Regions.

European Commission, (2017b), "Establishing a European Social Pillar", Commission Staff Document accompanying the document: Communication form the Commission to the European Parliament, The Council, The European and Social Committee and the Committee of Regions.

European Commission, (2017c), "Reflection Paper on the Social Dimension of Europe".

European Commission (2017d), "Commission Recommendation (EU) 2017/761 of 26 April 2017 on the European Pillar of Social Rights", *Official Journal of the European Union* L113, 29.4.2017.

European Union (2012), "Consolidates Version of the Treaty on the Functioning of the European Union (TFEU)", *Official Journal of the European Union* C 326, 26.10.2012.

Fuest, C. and B. Huber (2002), "Why Capital Income Taxes Survive in Open Economies: The Role of Multinational Firms", *International Tax and Public Finance* 9(5), 553–566.

de Haan, J. and J.-E. Sturm (2000), "On the Relationship between Economic Freedom and Economic Growth", *Journal of Political Economy* 16(2), 215–241.

Hanke, S. and S. Walters (1997), "Economic Freedom, Prosperity, and Equality: A Survey", *Cato Journal* 17, 134–163.

Juncker, J.-C. (2015), *State of the Union speech to the European Parliament,* on 9 September, available at: http://europa.eu/rapid/press-release_SPEECH-15-5614_en.htm.

Juncker, J.-C., D. Tusk, J. Dijsselbloem, M. Draghi, and M. Schulz (2015), *Completing Europe's Economic and Monetary Union,* European Commission, Brussels.

Keen, M. and K. A. Konrad (2013), "The Theory of International Tax Competition and Coordination", in: A. Auerback, R. Chetty, M. Feldstein, and E. Saez (eds.), *Handbook of Public Economics* Vol. 5, 259–330, Elsevier, Amsterdam.

Midelfart-Knarvik, K. H. and H. G. Overman (2002), "Delocation and European Integration — Is Structural Spending Justified?", *Economic Policy* 17(35), 323–359.

Nunn, N. and D. Trefler (2014), "Domestic Institutions as a Source of Comparative Advantage", Chapter 5 in: Gopinath, G., Helpman, E., & Rogoff, K. (eds.), *Handbook of international economics* Vol. 4, Elsevier, Amsterdam.

Pisani-Ferry J. (2016), "The Eurozone's Zeno Paradox – And How to Solve It", Vox-EU, 10 April 2016.

Rodrik, D. (1997), *Has Globalization Gone Too Far?*, Institute for International Studies, Washington.

Rodrik, D. (1998), "Why Do More Open Economies Have Bigger Governments?", *Journal of Political Economy* 106(5), 997–1032.

Sala-i-Martin, X. (1996), "Regional Cohesion: Evidence and Theories of Regional Growth and Convergence", *European Economic Review* 40(6), 1325–1352.

Sinn, H. W. (2003), *The New Systems Competition*, Wiley-Blackwell, Oxford.

Turini, A., G. Koltay, F. Pierini, C. Goffar, and A. Kiss (2015), "A Decade of Labour Market Reforms in the EU: Insights from the LABREF Database", *IZA Journal of Labor Policy* 4(1), 1–33.

Young, A. T., M. J. Higgins, and D. Levy (2008), “Sigma Convergence versus Beta Convergence: Evidence from U.S. County-Level Data”, *Journal of Money, Credit and Banking* 40(5), 1083–1093.

Zodrow, G. R. and Mieszkowski, P. (1986), “Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods”, *Journal of Urban Economics* 19(3), 356–370.

LISTS

LIST OF FIGURES

Figure 1.1:	World Economic Growth and Growth in Industrial Production	10
Figure 1.2:	Trade and Industrial Production in the Advanced and Emerging Economies	11
Figure 1.3:	Global Economic Policy Uncertainty Index	11
Figure 1.4:	ifo World Economic Survey – Economic Situation	11
Figure 1.5:	Output Gap and Inflation in Advanced Economies	12
Figure 1.6:	Inflation in the World and Oil Price Movements	12
Figure 1.7:	Contributions to GDP Growth in the United States	12
Figure 1.8:	Business Cycle Developments in the United States	13
Figure 1.9:	Unemployment Rates	13
Figure 1.10:	Contributions to GDP Growth in the European Union	15
Figure 1.11:	Business Cycle Developments in the European Union	15
Figure 1.12:	Unemployment Rates in Selected Euro Area Countries	16
Figure 1.13:	Price Developments in the Euro Area	16
Figure 1.14:	Government Structural Budget Balances	20
Figure 1.15:	Central Bank Interest Rates	21
Figure 1.16:	Balance Sheet Sizes of Major Central Banks	21
Figure 1.17:	Credit Developments in the Euro Area	22
Figure 1.18:	Interest Rates on Loans to Businesses in Selected Countries of the Euro Area	22
Figure 1.19:	10-Year Government Bond Yields	22
Figure 1.20:	Differences between 10-Year Government Bond Yields and 3-Month Interbank Rates	23
Figure 1.21:	Regional Disparities in Government Bond Yields in the Euro Area	23
Figure 1.22:	Developments in International Stock Markets from a Euro-Area Perspective	23
Figure 1.23:	Shiller Price-Earnings Ratio for the US Standard & Poor’s 500	24
Figure 1.24:	Developments in Selected Stock Markets within the Euro Area	24
Figure 1.25:	Real Effective Exchange Rates around the World	24
Figure 1.26:	Exchange Rate of the Euro against the US Dollar and PPP	25
Figure 1.27:	World Economic Growth and the ifo World Economic Climate	26
Figure 1.28:	ifo World Economic Survey	26
Figure 1.29:	Regional Contributions to World GDP Growth	27
Figure 1.30:	Economic Growth by Region	28
Figure 1.31:	Confidence Indicators for Different Sectors in the European Union	29
Figure 1.32:	Real GDP in the European Union	29
Figure 1.33:	Demand Contributions to GDP Growth in the European Union	30
Figure 1.34:	Employment in the European Union	30
Figure 1.35:	Unemployment Rates in the Euro Area and the European Union	30
Figure 1.36:	Economic Growth in the EU Member Countries	31
Figure 1.37:	Output Gap Estimates in Selected Countries	31
Figure 2.1:	Percentage of People Trusted by Respondents from other European States	38
Figure 2.2:	Percentage of People Expressing Trust in Own Population	39
Figure 2.3:	Percentage of Other People Trusted Relative to Trust in Own Population	39
Figure 2.4:	Primary Identifications of Europeans	43
Figure 2.5:	Percentage of People Expressing Trust in the EU in 2007 versus the Difference in That Support between 2011 and 2007	44
Figure 2.6:	Trust in EU and National Governments	45

Figure 3.1: Government Surplus for S&L Core and Euro Area 54
Figure 3.2: Government Surplus for France, Germany, Italy, and Spain 54
Figure 3.3: Inflation (HICP) for S&L Core and Euro Area 55
Figure 3.4: Inflation (HICP) for France, Germany, Italy, and Spain 55
Figure 3.5: GDP per Capita 56
Figure 3.6: Unemployment Rates 56
Figure 3.7: GDP per Capita and Unemployment in Developed and/or European Countries 57
Figure 3.8: Government Surplus and Inflation in Developed and/or European Countries 57
Figure 3.9: Market Income and Net Income Inequality in Developed and/or European Countries 58
Figure 3.10: Years in Euro Area 59
Figure 3.11: Years in Schengen Agreement 59

Figure 4.1: Income Convergence since 1995, EU-28 66
Figure 4.2: Income Convergence since 1995, EU-15 66
Figure 4.3: Income Convergence since 1995, Euro Area 66
Figure 4.4: Income Convergence (σ-Convergence) 67
Figure 4.5: Development of per Capita Incomes 67
Figure 4.6: β-Convergence in Unemployment Rates for EU-28 67
Figure 4.7: Unemployment Rate across EU-15 68
Figure 4.8: β-Convergence in Employment Rates for EU-28 68
Figure 4.9: Employment Rate across EU-28 68
Figure 4.10: Inflation Rate across EU-28 69
Figure 4.11: Gini Coefficients for EU-28 69
Figure 4.12: Gini Coefficient 69
Figure 4.13: Total Tax Burden in the EU-28 71
Figure 4.14: Tax Wedge on Labour for EU-28 72
Figure 4.15: Statutory Corporate Tax Rates across EU-28 72
Figure 4.16: Convergence in Institutional Quality in the EU-28 73
Figure 4.17: Economic Freedom Heritage Foundation Index 73
Figure 4.18: Doing Business Indicator 73
Figure 4.19: Perceived Corruption in the EU Relative to Northern EU Countries 74
Figure 4.20: Agricultural Subsidies and Structural policy in the EU Budget 74
Figure 4.21: EU Budget Net Balance 75
Figure 4.22: EU Structural Fund Allocations 2014–2020 75
Figure 4.23: European Semester: Implementation of Country-Specific Recommendations 77

LIST OF TABLES

Table 1.1: Labour costs 17
Table 1.2: Public Finances 20
Table 1.A.1: GDP Growth, Inflation and Unemployment in Various Countries 33
Table 1.A.2: GDP Growth, Inflation and Unemployment in the Countries of the European Union 33
Table 1.A.3: Key Forecast Figures for the European Union 34
Table 1.A.4: Key Forecast Figures for the Euro Area 34

LIST OF BOXES

Box 1.1: On the Effects of the Tax Reform in the United States 19
Box 4.1: EU Social Acquis and the European Social Pillar 78

THE MEMBERS OF THE EUROPEAN ECONOMIC ADVISORY GROUP

Torben M. Andersen

(PhD, CORE, Université Catholique, Louvain-la-Neuve, Belgium, 1986) is Professor of Economics at Aarhus University, Denmark and a Fellow of CESifo, Centre for Economic Policy Research and IZA. He has served as department head and member of various university committees. He has had various short-term visiting positions at other universities, served as editor of the *Scandinavian Journal of Economics* (1991–1997), and as member of several editorial boards. He has been extensively involved in policy advice in Denmark and abroad. In Denmark among other as chairman of the Economic Council (1993–1996 and 2001–2003), the Welfare Commission (2003–2006), and the Pension Commission (2014–2015) and as member of the Systemic Risk Council (since 2013). Abroad his advisory activities include the EU Commission, member of the Fiscal Policy Council in Sweden (2007–2011), Economic Policy Council Finland (since 2014) and chairman of the Economic Council, Greenland (since 2012), and commission on Migration in Norway (2009–2011). Most of his research has been on macroeconomics, labour economics and the economics of the welfare state. He has published in many scholarly journals, including the *Economic Journal, Journal of Public Economics, Journal of International Economics, Economic Theory,* and *European Economic Review.* He has published several books and edited volumes, most recently *Reform Capacity and Macroeconomic Performance in the Nordic Countries*, edited with U. Michael Bergman and Svend E. Hougaard Jesen (Oxford University Press, 2015).

Address:
Torben M. Andersen
Aarhus University
Department of Economics and Business Economics
Fuglesangs Allé 4, building 2621, 2
8210 Aarhus V
Denmark
tandersen@econ.au.dk

Giuseppe Bertola

(Ph.D., Massachusetts Institute of Technology, 1988) is Professore di Economia Politica at Università di Torino (Associato since 1993 and Ordinario since 1996). He was on leave in 2011–15 as Professor of Economics at EDHEC Business School and in 1997–2003 as full-time Professor at the European University Institute. In 1989–93 he was Assistant Professor and Assistant Director of the International Finance Section, Princeton University. He has served as a Managing Editor of *Economic Policy* (2001–2008), Condirettore of *Giornale degli Economisti e Annali di Economia* (1996–2011), and a Programme Director of CEPR's Labour Economics programme (2009–2013). He has performed scientific advisory work for the European Commission, the European Central Bank, and other organizations. His research currently focuses on the structural and institutional aspects of labour and financial markets, from an international comparative perspective, particularly as regards their distributional impact and interaction with the European process of economic and monetary unification. He has applied similar methods to exchange rate and money-market policies, interactions between growth and distribution, households' durable consumption and borrowing, and educational systems. He has also published widely in the *Review of Economic Studies,* the *American Economic Review,* the *European Economic Review*, other academic journals and books, also authoring chapters in *Handbook of Labor Economics* and *Handbook of Income Distribution* (North-Holland, 2000), co-authoring *Models for Dynamic Macroeconomics* (Oxford University Press, 2004) and *Income Distribution in Macroeconomic Models* (Princeton University Press, 2014), and co-editing *Welfare and Employment in a United Europe* and The *Economics of Consumer Credit* (MIT Press, 2006).

Address:
Giuseppe Bertola
Università di Torino
Dipartimento di Economia e Statistica
Lungo Dora Siena 100
10153 Torino
Italy
giuseppe.bertola@unito.it

John Driffill

(Ph.D., Princeton University, 1977) is a Visiting Professor and Director of the Division of Social Sciences at Yale-NUS College, National University of Singapore. He is also a Visiting Professor at Birkbeck College, University of London, and a Fellow of the Centre for Economic Policy Research. From 1999 to 2016 he was Professor of Economics at Birkbeck College. He has previously worked at the University of Southampton, Tilburg University, and Queen Mary and Westfield College, University of London, and held visiting positions at Queen's University (Kingston, Canada), in Stockholm, Aarhus, Tokyo, and Paris. From 2004 to 2010 he was the Director of the UK Economic and Social Research Council's programme on World Economy and Finance. From 2000 to 2004 he was on the Council and Executive Committee of the Royal Economic Society. He has advised the House of Lords Select Committee on the European Union (Sub-Committee A: Economic and Financial Affairs) in enquiries into the euro and the Stability and Growth Pact. Most of his research has been on macroeconomics and monetary policy, and he has published in many scholarly journals, including the *American Economic Review,* the *Review of Economic Studies,* the *Journal of Monetary Economics*, and the *European Economic Review.* He has published two edited volumes, one on *A Currency for Europe*, another on *The Role of Financial Markets in the Transition Process,* and an introductory textbook, *Economics* with Joseph E. Stiglitz (W. W. Norton and Co, 2000).

Address:
John Driffill
Yale-NUS College
28 College Avenue West
Singapore 1138533
John.driffill@yale-nus.edu.sg

Clemens Fuest

(Ph.D., University of Cologne, 1994) born in 1968, is President of the ifo Institute, Professor for Economics and Public Finance at the Ludwig Maximilian University of Munich, Director of the Center for Economic Studies (CES) and Executive Director of CESifo GmbH.

Since 2003 Clemens Fuest is a member of the Academic Advisory Board of the German Federal Ministry of Finance (head of the board from 2007 to 2010). He is a member of the European Academy of Sciences and Arts and of the German National Academy of Science and Engineering (acatech). Furthermore, Clemens Fuest is Board Member of the International Institute for Public Finance (IIPF; Vice President since 2014) and a member of the Minimum Wage Committee of the Federal Republic of Germany and of the "High Level Group on Own Resources" (Monti-Commission) of the European Union. In 2013 he received the Gustav Stolper Prize of the Verein für Socialpolitik (Social Policies Society – VfS). He was awarded an honorary doctorate of the Karlsruhe Institute of Technology (KIT) in 2017.

His research areas are economic and fiscal policy, taxation, and European integration. Before he was appointed ifo President in April 2016, Clemens Fuest was President of the Centre for European Economic Research (ZEW) in Mannheim and Professor of Economics at the University of Mannheim. From 2008 to 2013 he was Professor of Business Taxation and Research Director of the Centre for Business Taxation at the University of Oxford. He taught as a Visiting Professor at the Bocconi University in Milan in 2004. From 2001 to 2008 he was Professor for Public Economics at the University of Cologne.

Clemens Fuest has published widely in German and international academic journals including *American Economic Review, European Economic Review, Journal of Public Economics, Journal of International Economics, National Tax Journal, International Tax and Public Finance* and *International Economic Review*. He has published a number of books and contributes to public debates on economic and fiscal policy through articles in renowned newspapers including *Handelsblatt, Frankfurter Allgemeine Zeitung, Süddeutsche Zeitung, Wirtschafts Woche, Financial Times* and *Wall Street Journal*.

Address:
Clemens Fuest
ifo Institute
Poschingerstr. 5
81679 Munich
Germany
fuest@ifo.de

Harold James

(Ph.D. Cambridge University, 1982) is Claude and Lore Kelly Professor in European Studies and a Professor of History at Princeton University, a Professor of International Affairs in the Woodrow Wilson School, as well as an Adjunct Professor at BI Norwegian Business School, and the official historian of the International Monetary Fund. He is Director of the Program in Contemporary European Politics and Society and serves on the editorial committee of the journal *World Politics* and is Chairman of the Academic Council of The European Association for Banking and Financial History (EABH). Before coming to the United States in 1986, he was a Fellow of Peterhouse for eight years. He was awarded with the Ellen MacArthur Prize for Economic History at the University of Cambridge in 1982, the Helmut Schmidt Prize in Economic History at the German Historical Institute in Washington, D.C. in 2004 and the Ludwig Erhard Prize for writing about economics in 2005. His research focuses on European economic history, and globalization. He has published and co-authored several books analysing Germany's financial history in the interwar era, the changing character of national identity in Germany and detailed studies about the Deutsche Bundesbank. His latest books, *Making the European Monetary Union* published by the Harvard University Press in 2012, and *The Euro and the Battle of Ideas,* written with Markus Brunnermeier and Jean-Pierre Landau (Princeton University Press, 2016) aim at a deeper understanding of the European monetary crisis by tracing the historical background of Europe-wide monetary union and common currency, and the differences in national approaches to economic policy in the EU's member countries.

Address:
Harold James
Princeton University
History Department
129 Dickinson Hall
Princeton, NJ 08544-1017
USA
hjames@princeton.edu

Jan-Egbert Sturm

(Ph.D. University of Groningen, 1997) is Professor of Applied Macroeconomics, Director of the KOF Swiss Economic Institute at the ETH Zurich, President of the Centre for International Research on Economic Tendency Surveys (CIRET) and Editor of the *European Journal of Political Economy.* He was a researcher at the University of Groningen, The Netherlands, until 2001, and taught as Visiting Professor at the School of Business, Bond University, Gold Coast, Australia, in 2000 and 2005. As Head of the Department for Economic Forecasting and Financial Markets at the ifo Institute for Economic Research, he was also Professor of Economics at the University of Munich (LMU) at the Center for Economic Studies (CES), 2001–2003. He held the Chair of Monetary Economics in Open Economies at the University of Konstanz, Germany, which was coupled with the position of Director of the Thurgau Institute of Economics (TWI) in Kreuzlingen, Switzerland, 2003–2005. In his research, Jan-Egbert Sturm relies heavily on empirical methods and statistics, concentrating on monetary economics, macroeconomics as well as political economy. His applied studies have focused on, for example, economic growth and central bank policy. He has published several books, contributed articles to various anthologies and international journals including the *American Economic Review,* the *European Economic Review,* the *European Journal of Political Economy,* the *Journal of Banking and Finance,* the *Journal of Development Economics,* the *Oxford Economic Papers, Public Choice,* and the *Scandinavian Journal of Economics.* Jan-Egbert Sturm headed the ifo research team in the Joint Analysis of the Six Leading German Economic Research Institutes, 2001–2003. Since 2001 he has been member of the CESifo Research Network and since 2003 Research Professor at the ifo Institute. In 2006 he was appointed member of the User Advisory Council of the ifo Institute.

Address:
Jan-Egbert Sturm
ETH Zurich
KOF Swiss Economic Institute
LEE G 116
Leonhardstr. 21
8092 Zurich
Switzerland
sturm@kof.ethz.ch

Branko Urošević

(PhD Business Administration, U.C. Berkeley, 2002; PhD Physics, Brown University, 1995) is Professor of Finance and Operations Research and Director of the International Master in Quantitative Finance (IMQF) programme at the University of Belgrade. Previously he taught and directed the Master of Finance programme at Universitat Pompeu Fabra, Barcelona. He is Vice-Chairman of the National Council for Higher Education, the regulatory body for higher education in Serbia, and a member of the Advisory Board of the Diligan Research Center of the Central Bank of Armenia. He is a permanent member of the Committee for Economic Sciences of the Serbian Academy of Arts and Sciences, a visiting professor at ICEF, Moscow, and a member of the International Scientific Committee of UniCredit and Universities Foundation, Milan. His research is published in the leading international journals including *Journal of Political Economy, Economic Theory, Journal of Financial Markets, European Journal for Operations Research, Proceedings of the American Academy of Sciences* (PNAS), and *Management Science,* among many others. His interests include dynamic moral hazard problems, banking and risk management, education economics, real estate finance, and asset pricing. His research was supported by grants from EU, Spain, US, and Serbia. He worked as a consultant in McKinsey & Co and KPMG in Chicago, IL. He consulted, also, central banks of Armenia and Serbia, the Ministry of Finance of Serbia, and a number of commercial banks. He is one of the founders of a consultancy specializing in financial risk management and was the Chairman of the largest private pension fund in Serbia.

Address:
Branko Urošević
University of Belgrade
Faculty of Economics
Kamenička 6
11000 Belgrade
Serbia
urosevic@ekof.bg.ac.rs

PREVIOUS REPORTS

The EEAG Report on the European Economy 2017: Economics of Populism

Macroeconomic Conditions and Outlook
Economic Policy and the Rise of Populism
Britain and the EUexit
Immigration and the Refugee Crisis

The EEAG Report on the European Economy 2016: What next?

Macroeconomic Conditions and Outlook
Intergenerational Fairness
Tuning Secondary Education
Denmark: Too Good to Be True?
Western Balkans: Coming Together

The EEAG Report on the European Economy 2015: Blurring the Borders

Macroeconomic Outlook
The European Energy Conundrum: Power Failure
European Regional Disparity: Borders Strike Back
Migration in the European Union: Too Much of a Good Thing?

The EEAG Report on the European Economy 2014: The Road towards Cohesion

Macroeconomic Outlook
Switzerland: Relic of the Past, Model for the Future?
Austerity: Hurting but Helping
Banking Union: Who Should Take Charge?

The EEAG Report on the European Economy 2013: Rebalancing Europe

Macroeconomic Outlook
European Imbalances
Labour Market Reforms and Youth Unemployment
US Precedents for Europe

The EEAG Report on the European Economy 2012: The Euro Crisis

Macroeconomic Outlook
The European Balance-of-Payments Problem
Banking Regulation
The Swedish Model
The Hungarian Crisis
Pricing Climate Change

The EEAG Report on the European Economy 2011: Governing Europe

Macroeconomic Outlook
A New Crisis Mechanism for the Euro Area
Greece
Spain
Taxation and Regulation of the Financial Sector

The EEAG Report on the European Economy 2010: Exiting the Crisis

The European Economy: Macroeconomic Outlook and Policy
A Trust-driven Financial Crisis. Implications for the Future of Financial Markets
From Fiscal Rescue to Global Debt
Implications of the Crisis for US Adjustment Needs
The Financial Crisis: Risks and Challenges for the Euro Area

The EEAG Report on the European Economy 2009

The European Economy: Macroeconomic Outlook and Policy
The Financial Crisis
Private Equity
Country Chapter: France

The EEAG Report on the European Economy 2008: Europe in a Globalised World

The European Economy: Macroeconomic Outlook and Policy
How Much Real Dollar Depreciation Is Needed to Correct Global Imbalances?
The Effect of Globalisation on Western European Jobs: Curse or Blessing?
Industrial Policy
Global Warming: The Neglected Supply Side

The EEAG Report on the European Economy 2007

The European Economy: Macroeconomic Outlook and Policy
Macroeconomic Adjustment in the Euro Area – The Cases of Ireland and Italy
The New EU Members
Scandinavia Today: An Economic Miracle?
Tax Competition
Economic Nationalism

The EEAG Report on the European Economy 2006

The European Economy: Macroeconomic Outlook and Policy
Global Imbalances
Economic Growth in the European Union
Prospects for Education Policy in Europe
Mergers and Competition Policy in Europe

The EEAG Report on the European Economy 2005

The European Economy: Current Situation and Economic Outlook for 2005
Outsourcing
Longer Working Hours – The Beginning of a New Trend?
Pensions and Children
House Prices in Europe

The EEAG Report on the European Economy 2004

The European Economy: Current Situation and Economic Outlook
Labour Market Reform in Europe
Pay-setting Systems in Europe: On-going Development and Possible Reforms
The Economics of Discrimination: Equity, Equality and Diversity in the New European Constitution
The 2004 EU Enlargement: Key Economic Issues
Acceding Countries: The Road to the Euro

The EEAG Report on the European Economy 2003

The European Economy: Current Situation and Economic Outlook
Fiscal Policy and Macroeconomic Stabilisation in the Euro Area: Possible Reforms of the Stability and Growth Pact and National Decision-Making-Processes
Rethinking Subsidiarity in the EU: Economic Principles
Financial Architecture
Should We Worry about the Brain Drain?

The EEAG Report on the European Economy 2002

The European Economy: Current Situation and Economic Outlook
The Weakness of the Euro: Is It Really a Mystery?
Fiscal and Monetary Policy
Prices, Wages and Inflation after the Euro – What Europeans Should or Should not Expect
Growth and Productivity
Welfare to Work
CAP Reform

CESifo Economic Studies

Visit the website to read **free content**, sign-up for electronic alerting services, recommend to your library and submit your work.

cesifo.oxfordjournals.org

Publishing **provocative, high-quality, accessible** articles in economics, with a particular focus on policy issues

— **SPEED:** Quick online submission, speedy review time, advance access publication

— **VALUE:** Free editor‘s choice articles thoughout the year, free sample issue, numerous special issues

— **IMPACT:** Over 2,500 institutional subscribers worldwide, over 5,000 full-text downloads per month

CESifo

OXFORD UNIVERSITY PRESS

THE MEMBERS OF THE EUROPEAN ECONOMIC ADVISORY GROUP

Torben M. Andersen
Aarhus University

Professor of Economics at the Department of Economics and Business Economics, Aarhus University. Former chairman of the Danish Economic Council.

Giuseppe Bertola
Università di Torino
EEAG Chairman

Professore di Economia Politica at Università di Torino.

John Driffill
Yale-NUS College, National University of Singapore; and Birkbeck College, University of London

Visiting Professor in Social Sciences at Yale-NUS College, National University of Singapore and Visiting Professor at Birkbeck College, University of London. Formerly, Director of the ESRC research programme on 'World Economy and Finance' from 2004 to 2010.

Clemens Fuest
ifo Institute and LMU Munich

Professor of Economics and Public Finance at LMU Munich, President of the ifo Institute, Director of the Center for Economic Studies, and Executive Director of CESifo GmbH.

Harold James
Princeton University
EEAG Vice-Chairman

Professor of History and International Affairs, Claude and Lore Kelly Professor of European Studies, and Director of the Program in Contemporary European Studies at Princeton University.

Jan-Egbert Sturm
KOF, ETH Zurich

Professor of Applied Macroeconomics and Director of the KOF Swiss Economic Institute, ETH Zurich. President of the Centre for International Research on Economic Tendency Surveys (CIRET) and Editor of the European Journal of Political Economy.

Branko Urošević
University of Belgrade

Professor of Finance and Operations Research and Director of the International Masters in Quantitative Finance (IMQF) programme at University of Belgrade.