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# The EU needs a new Economic Policy! – Kick off to the Debate –

## Criticism and Recommendations

I. For decades the prevailing economic policy in Europe has followed an orthodox-liberal credo. It boils down to this: more competition brings more innovation, growth and employment.

II. But the reality is different: decades of liberalization have been accompanied by sinking growth rates of GDP and of macro-economic productivity combined with high unemployment and even higher under-employment. On the one hand the increase in unemployment in recent years has been curbed by a slow-down in the progress of productivity induced by labour market policy. On the other hand the progress in productivity of businesses was often achieved by a cut in employment. To put it bluntly – the prevailing economic policy in the European Union has done little for employment and has contributed instead a lot to un- and under-employment.

III. The attempt to transfer the business world's concept of competitiveness to the overall economy leads to erroneous political recommendations, not only in the area of salaries but often also in the areas of labour market, education and innovation policy. The structural policies followed in these areas cannot produce the desired results in growth and employment without a balanced macro-economic policy.

IV. The EU creates the framework for the member states' employment and growth policies, in particular through the ECB's monetary policy, the deficit criteria, the internal market and competition rules and the priority of competitiveness, as has recently been again stressed in the Lisbon strategy. This framework has not produced the desired results in the areas of growth and employment, but has instead drastically restricted the options of social policy because of high under-employment.

V. The member states cope with this framework in different ways. But overall the EU needs an economic policy which is able to coordinate the interaction of monetary policy, budgetary policy and wages to bring about an increase in demand in order to facilitate markedly stronger growth and higher employment. For monetary policy this also means actively supporting general economic policy in achieving growth and employment targets, as long as price stability is guaranteed. Monetary policy has fallen short of this goal which is stipulated in article 105 of the consolidated EU Treaty (EUT).

VI. It is also necessary to find European answers to the topical question of how to avoid the downward competition of wages and taxes which is accentuated by under-employment. The EU's few social policy powers (e.g. protection of labour, equal opportunities, social dialogue) must be increased and not exposed to further undercutting by re-nationalisation. Company tax must be harmonized.

VII. Under-employment represents at the same time a major growth potential. With a given high profitability and while maintaining price stability, the combined effect of monetary, budgetary and wage policy allows a development in which investment creates the necessary jobs and production capacity and demand further increases. Only this kind of growth can gradually reduce under-employment and at the same time enable research, development, innovation and better training of workers to give their full return.

VIII. In this way progress in productivity will speed up again alongside growth and employment. Simultaneously this means more wealth and healthier competitiveness – a sound foundation

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* The Working Group "European Integration" was founded in 1995. Its members work in EU institutions, federal ministries, research institutions and non-governmental organizations.

upon which the challenge of globalization need no longer be feared but turned to the advantage of all.

IX. To bring about this virtuous circle a change in the prevailing approach to economic policy is necessary. To achieve this we need a sustained and broad public and scientific debate on Europe's economic policy which will question current thinking.

X. Economic failures are largely to blame for the loss of support among citizens for the European project. If we were on the way to full employment, there would undoubtedly have been a positive outcome to the referendums on the constitution in France and the Netherlands. The 'no' vote in these two member states was a way of expressing hope for a more social and just EU.

## The EU's traditional strategy: a strong concept with a weak effect

The origin of the EU's current economic doctrine which is above all prevalent in the economic and monetary union can basically be traced back to a series of past experiences.

- The mistakes of macro-economic policy in the time after the first oil shock in 1974-80: divergent and mostly inflationary macro-economic policies led to major fluctuations in growth and highly diverging inflation rates in the EU.
- The failed French unilateral expansion of demand in 1981/82 at a time when domestic productive capital was insufficiently profitable led to imports instead of domestic production, to devaluation, higher inflation and a long period of slow growth in France.
- The learning process of the EMS in the 80s and beginning of the 90s led the Community not always voluntarily take over the federal bank's macro-economic policy approach (which admittedly was successful in Germany). This approach also reflected in the Maastricht treaty on economic and monetary union.
- The prevailing concept of economic and employment policy in Europe which has determined the drafting of the Maastricht treaty, the Stability and Growth Pact and many other areas of economic policy assumes a simple division of tasks intended mainly to improve supply conditions:
- Monetary policy should guarantee price stability while remaining fully independent. Its role as laid down in article 105 EUT – notwithstanding price stability – is also to support general economic policy with a view to achieving the goals of article 2 EUT (growth and employment), but this task is deemed to have been fulfilled once price stability is guaranteed ('the best contribution of monetary policy to the goals of article 2 is achieving price stability').
- The budgetary policy approach described in articles 101 to 104 EUT[1] is primarily intended to prevent a stability-orientated monetary policy being damaged by unsound budgetary policy. Moreover the Stability Pact (under 'normal' cyclical conditions) aims for a general government budget which is either balanced or slightly in surplus in order to:
  - Speed up debt reduction.
  - Give budget policy enough room during the economic cycle without exceeding the 3% GDP deficit threshold in a recession.
  - Make a clear contribution to total economic savings during the growth process when investment-share in GDP is on rise.
- Budgetary policy as an active means of steering the economy in combination with monetary policy and wage development is not explicitly mentioned. If this aspect is considered at all in the Maastricht Treaty it falls under the very general provisions of the 'Broad Economic Policy-Guidelines' in article 99, EUT.
- Although wage policy is not explicitly mentioned in the treaty, 'moderate' wage agreements are constantly recommended by politicians to contribute to price stability and greater competitiveness and to spare the economy any sudden braking manoeuvres by monetary policy.
- To the extent that there is an employment policy in the strictest sense, it concentrates on supply factors such as entrepreneurship, employability, adaptability and equal opportunities.
- This general framework is supplemented by competition policy and a series of specific policies (structural funds etc) which will not be covered in detail here.

Although this policy has on average brought stability to the EU and in particular to Euroland, growth has remained weak and unemployment is barely going down. The current unemployment rate of around 20

1 Art. 101 EUT: ban on monetary funding of public budgets; art 102 EUT: ban on privileged access by the public authorities to capital markets; art 103 EUT: ban on bailing out public corporations; art 104 EUT: ban on avoiding excessive public deficits.

million only show a fraction of the true underemployment which lies around 30 or 40 million potentially full-time workers. This failure of economic policy in the areas of growth and employment both justifies and necessitates a thorough, critical overhaul of the prevailing approach to economic policy ('pensée unique').

of one company are the income of the other subcontractors and workers. If they go down there will be less money to spend on demand. Export is an (apparent) way out of this, which can compensate for lower domestic demand.

**Table 1: Growth, productivity and employment: Comparing Euroland-USA 1961-2005**

| | | 1961-1973 | 1974-1985 | 1986-1995 | 1996-2000 | 2001-2005 |
|---|---|---|---|---|---|---|
| GDP real growth[1] | Euroland | 5,1 | 2,2 | 2,5 | 2,7 | 1,4 |
| | USA | 4,4 | 2,8 | 2,9 | 4,1 | 2,6 |
| Productivity growth[1] | Euroland | 4,8 | 2,1 | 2,0 | 1,5 | 0,8 |
| | USA | 2,4 | 1,0 | 1,1 | 2,0 | 2,3 |
| Employment rate[2] | Euroland | 62,6 | 58,9 | 58,3 | 60,5 | 64,0 |
| | USA | 63,2 | 65,7 | 70,8 | 73,2 | 72,9 |
| Full-time employment rate[2] | Euroland | - | - | - | 54,3 | 57,6 |
| | USA | 60,9 | 62,6 | 68,3 | 71,1 | 69,9 |
| Unemployment rate[3] | Euroland | 2,4 | 6,6 | 9,7 | 9,8 | 8,5 |
| | USA | 4,9 | 7,5 | 6,2 | 4,6 | 5,5 |

[1] in % p.a.
[2] in % of the population, 15-64 years.
[3] in % of the labour force (= employment + unemployment)
Source: European Commission: statistical annex of the European economy
http://europa.eu.int/comm/economy_finance/publications/european_economy/2005/statannex0205_de.pdf, 17.11.2005

## More competition does not automatically generate more demand

The background to this policy choice has always been the view that an increase of demand does not lead to more real growth and employment but instead increases prices and/or imports. It is assumed that a strengthening of demand is not accompanied by a similar growth in supply. An assumption that goes even further is that business and private households compensate for new public debts by bringing about extra saving because future tax increases are expected – so-called 'rational expectations'. In such a case there would not even be an increase in demand – quite apart from what the consequences might be.

Supply (that is, production and employment) does indeed only grow if the corresponding demand is expected. These expectations are pinned on the most recent experiences of businesses. If their production remains partly unsold and not many orders are coming in, then production and jobs are cut. For the individual businessman, cutting costs appears to be the ideal way of increasing sales. But the costs, in particular wages,

In Germany in particular the internal market, enlargement to the east and globalization have led to cost reduction and productivity increases, which are in themselves to be welcomed. But the labour market reforms intended as employment policy have further undermined productivity and demand (growth in productivity 2001-2005 was only 0.8%). Despite a big increase in exports, German growth remains weak. The extra jobs in the export sector are insufficient to turn around the labour market and with it, domestic demand.

## Where will demand and new jobs come from?

Extra demand requires extra money. Private households, businesses, general government or other countries must draw upon savings or take out new loans, and develop a purchasing power of demand exceeding income from current production. Till now it was always other countries, the USA to be precise, which fulfilled this role in the global economy. Over the last ten years in Euroland it has been the peripheral countries which have gone into debt, goaded into doing so by the historically low interest rates. To bring about the same effect in Europe's core economies lower real interest rates would help. Interest rates are indeed historically low but this is equally true of the rate of inflation, above all for domestic production (i.e. after deducting the increase in raw materials). Just this price development is particularly relevant for businesses if they compare loan costs with future profits.

Companies only go into debt (or draw on savings due to an accumulation of profit) if new investments to expand production capacity appear profitable in the light of expected demand. Discounting foreign markets and net investment by business, the only way to boost the economy is the private households with their consumer-driven demand or the state through debt or dissaving. In comparison with the USA both actors have exercised restraint. The EU has contributed to the low level of state debt in Europe with its stability policy, although it became clear that both companies and private households tend to over-save. The difference compared with the USA is even clearer concerning private households – private consumption in the EU in 2001-2005 increased annually only between 1.4% (EU-12) and 1.8% (EU-25), whereas it grew by 2.9% in the USA. The effect is accentuated by the fact that the share of private consumption in GDP is structurally lower in the EU than in the US.

It is not enough for monetary demand to work, new jobs must be created. This is more likely in those sectors not severely exposed to low wage competition. Among these are public services which when expanded made a tangible contribution to cutting unemployment in the UK. The services directive could in principle contribute to the creation of a European market, but should focus more on securing current working conditions and pay rather than bringing about a race to the bottom and an expansion of grey markets by introducing unrealistic regulations on market control (by the supervisory authorities of the countries of origin).

## The EU's macro-economic role

According to articles 98 and 99 EUT the member states remain responsible for economic policy which they should conduct in such a way to (art 98 EUT) contribute to achieving the goals of article 2 EUT (growth, jobs). Member states should see their economic policy as a matter of common interest, which must be coordinated in the Council according to the 'Broad Economic Policy Guidelines' as laid down by the Council in a complex procedure (art.99).

Now that monetary policy in the economic and monetary union (EMU) has been centralized on the basis of the Maastricht Treaty, there is a clear deficit in defining the economic policy. Obviously decisions on the other two variables which determine macro-economic policy alongside monetary policy – namely budget policy and wages – cannot simply be centralized at EU level. The sovereignty of the member states in the area of budget policy and the independence of the collective bargaining partners on wage issues must be respected. However, in the Community and in particular in the EMU there is still a pressing need to effectively coordinate the policy mix of monetary and budgetary policy as well as wage development in order to take into account the Community interest to realize growth and employment. What aspects should be taken into account in this coordination process?

- Since according to article 105 EUT monetary policy – irrespective of the goal of price stability – is meant to support general economic policy with a view to growth and employment, its margin of manoeuvre will depend on how well the other major economic variables (budgets and wages) accommodate the economy's overall needs. This positive economic mix of budget, monetary and wage policy can be described as follows:
- Budgetary policy: In a period of recovery and during the growth process, public finances should strive towards a general equilibrium or even a slight surplus. This contributes to consolidation and debt reduction and improves the overall economic balance between savings and investments. But in a recession or when growth is slowing down, public finances need greater flexibility – also the indebtedness of individual countries and their balance of payments should be taken into account (or the way in which the balance between savings and investments is realized). For certain categories of spending which are of particular importance to growth (public investment, spending on education and research etc.) reference values could be fixed.
- Wage policy: the wage policy of the collective bargaining partners has an important role to play in the macro-economic policy mix. We basically need collective agreements which realize a unit labour costs development which neither conflict with the aim of stability nor jeopardize the profitability of investment. On the other hand the partners must take into account real wage increases which determine

consumer demand together with employment and savings. Indeed, consumer demand is also an important determining factor of investments and jobs. Collective agreements will also have to continue to cover the shift of real exchange rates within the EMU – more so than budgetary policy. This all sounds like squaring the circle, but looking at wage increases in recent years they have indeed met these requirements.

- Monetary policy: Assuming that budgetary policy and wage increases fulfil well their macro-economic role, monetary policy then needs to use its margin of manoeuvre. Expectations of it are high, because it can react much more flexibly to external economic developments than budget and wage policy. Moreover, the desired process of growth is not even possible if it is not funded through monetary policy. Whether monetary policy really can fulfil its margin of manoeuvre in supporting growth depends on how it is designed, and this must be openly and critically discussed. This is not an attack on the independence of the central bank. However, it is also important to determine how reliably the independent central bank assesses the conduct of public budgets and collective bargaining partners. The macro-economic dialogue was created in Europe for that very purpose – it must be strengthened and in the future this includes also a better institutional framework. The role of the Commission in the macro-economic dialogue should also be strengthened.

In order to achieve growth and more jobs the macro-economic mix of monetary and budgetary policy and wage developments should be regularly discussed in the Council of Ministers and in particular for the EMU in the Eurogroup. The role of the Eurogroup should also be institutionally strengthened at some later date. When drafting the guidelines of economic policy the Commission as the representative of Community interests should have a formal right of proposal, as it is also the case in all other important policy areas at Community level.

## Regulating competition between the member states

The member states still have considerable powers and possibilities within the EU of promoting growth and employment and boosting their citizens' income on their own territory. One of the symptoms of the current weak growth and high under-employment is that many of the measures implemented to achieve this end up selfishly achieving progress at the expense of other member states and their citizens. Some of these steps also have the cumulative effect of producing results for EU competition which make it more difficult for everyone to increase growth and employment. The current model of integration provides incentives in particular for small countries to attract production and jobs through low wages and taxation at the expense of others. This is because the reactions to shrinking domestic demand and a low tax rate are easily more than compensated for in small economies by the advantages of the big export markets and the growing tax base.

Many internal market regulations are intended to forestall policies designed to improve the competitive position of one's own producers to the detriment of competitors (duties, subsidies, special provisions on products or processes etc). In addition, monetary union has removed currency devaluation as the last adjustment possibility in Euroland.

However, other areas are barely regulated at all and enable competitive advantages, in particular taxation and salary levels. Different taxation levels should not act as an incentive for the regional distribution of investment and production. The Irish example where a major part of accounting, fiscal and statistically recorded added value is created through distorted transfer pricing within multi-national companies, with the intention of avoiding high taxation in other countries and then transferring this value abroad in the form of profits, cannot be a model for the enlarged Europe. A single pan-European company tax would be preferable (which would also solve the problems of subsidiaries using profits to offset losses). The tax would be best paid into the EU budget and used to fund regional policy.

## Glossary

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| GDP | Gross Domestic Product |
| EU | European Union |
| EU-12 | European Union of 12 member states |
| EU-25 | European Union of 25 member states |
| EUT | EU Treaty, consolidated version |
| EMS | European Monetary System |
| ECB | European Central bank |
| EMU | Economic and Monetary Union |