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Towards a New Approach for Upgrading Europe's Competitiveness

By Christian Ketels (Harvard Business School)
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The traumatic experience of the European sovereign debt crisis, followed by the outcome of the British referendum on leaving the European Union, has send shockwaves through Europe. For the first time since the signing of the Treaties of Rome six decades ago, the very notion of European integration as embodied in the institutions of the European Union was being questioned. A substantial improvement in economic conditions and the messy reality of the Brexit process in the UK have since then led to a significant recovery in sentiments about the EU's future. A majority of citizens in all but three EU member countries view membership in the EU as beneficial.¹ EU Commission President Juncker sees "the wind [...] back in Europe's sails."²

Yet key questions about the EU's future course remain unanswered, and there is a real danger that the current economic tailwind creates complacency about the need to address them in ways that take the criticism seriously. While the reasons that led to the UK's referendum result were to some degree UK-specific, they also reflected concerns held more widely across EU member countries. These concerns have been growing for years, and were exacerbated by the handling of the Euro-Zone sovereign debt crisis and the reaction to the refugee crisis in 2015. They will after the upcoming May 2019 elections be faced by a new European Parliament, and a new EU Commission and Commission President.

¹ Parlemeter 2017, European Parliament (2017). Interestingly, even 55% of the respondents from the UK viewed EU membership as having provided overall benefits to their country.

² President Jean-Claude Juncker's State of the Union Address 2017; Brussels, September 13, 2017. European Political Strategy Centre (2018), *Europe is back*, European Commission: Brussels

The diversity of opinion on how to respond to these issues remains large across the EU: While French President Macron³ and the European Commission⁴ argue for more integration at the EU level, EU member countries from Central⁵ and Northern Europe⁶ are skeptical, especially with regards to fiscal policies and EMU governance. There is also a bitter divide among some governments in Central Europe and the rest of the EU that has opened up; concretely about immigration policy and the independence of the justice system and the media, but rooted in much deeper differences on political values.

The Commission's White Paper on the Future of Europe⁷ pointedly refrained from putting out a recommended path.⁸ It documented the EU's remarkable success in overcoming a historical legacy of wars and divisions, achievements that made European integration a role model for many other parts of the world. But it remained silent about why the European integration effort has run into problems, how the approach towards integration needs to change, and what value Europe will be able to provide to Europeans if it follows this new path.

Our response to these questions focuses on the European Union's impact on the competitiveness and prosperity of its member countries. This does not belittle the larger political motivations for European integration. But if the EU is not delivering economic benefits to its members, the EU's credibility and mandate to act in other policy areas is significantly diminished. For many years there was little doubt

³ President Emmanuel Macron, Speech at the Sorbonne, September 27, 2017

⁴ European Commission (2017), Reflection Paper on the Deepening of the Economic and Monetary Union, EC: Brussels

⁵ Joint Statement of the Heads of Governments of the V4 Countries, "Strong Europe – Union of Action and Trust" Input to Rome Declaration 2017.

⁶ Prime Ministers of Finland, Denmark, and the Netherlands, "A Case for a Strong and Focused European Union.", August 5, 2017. See also "Finance ministers from Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden underline their shared views and values in the discussion on the architecture of the EMU," 6 March 2018

⁷ European Commission (2017), White Paper on the Future of Europe, COM(2017)2025, European Commission: Brussels

⁸ See also the The Rome Declaration, March 25, 2017, available at http://www.consilium.europa.eu/press-releases-pdf/2017/3/47244656633_en.pdf which opened up for more diversity in policies across the EU.

about the economic value EU membership offered. Over time, however, headline growth slowed, and the EU was increasingly seen as unable to turn the tide. During the European sovereign debt crisis EU policies were even criticized as exacerbating the challenges facing some EU member countries. It is this perception in a meaningful part of the European public that is threatening the sustainability of the EU.

In our view the growing concerns about the benefits of EU integration are to a significant part the result of a structural disconnect between what is needed for higher competitiveness across Europe and what the EU is offering: the nature of the EU's membership and of the competitiveness issues these members face has fundamentally changed, while the EU's approach towards enhancing competitiveness has not. European countries and regions today need to succeed on highly competitive European and global markets, and they are looking for the EU to help them meet that challenge. The traditional EU model of aligning rules and regulations to ensure similar conditions across Europe was appropriate when removing barriers to market integration among structurally similar countries was the key. But it is failing to meet the current demand for context-dependent strategies that help locations specialize around unique value propositions in a Europe that has become dramatically more heterogeneous.

We believe that to address EU member countries' needs the EU has to transform its approach towards upgrading competitiveness, in particular its role in enhancing the microeconomic assets and capabilities that drive firm-level productivity and innovation. Choices about microeconomic competitiveness are by their nature highly context-dependent, and require deep local and national leadership. EU institutions can help but need to encourage differentiation and uniqueness, not prescribe generic EU-wide policy priorities. At the same time, EU institutions remain critical in securing the Single Market and coordinating policies with strong cross-border spillovers. And they have become even more important in macroeconomic policies where the Common Currency has transformed the context. The choice, then, is

not about more or less Europe, but about rethinking the respective roles that European institutions and EU members need to play for Europe to raise its economic performance.

Getting there will not require dreaded changes in European treaties. But it does imply fundamental changes in how the EU operates. Maybe the biggest change necessary will be one of culture: Brussels needs to learn to follow and support rather than to lead and control. And European countries and regions need to learn to take full responsibility for their policy choices and for the results they deliver, rather than move difficult choices to the EU level and perceive European solidarity as an inherent right.

Europe's current challenges reflect deeper issues that many countries are facing: Globalization has created huge opportunities for achieving higher prosperity but also raised the costs of low competitiveness. National economic policy choices are both more critical in shaping the opportunities that locations have to successfully compete in this global environment and more constrained in relying on the collaboration with others to achieve their full impact. If Europe finds a way to meet these complex demands, it can again be a role model for other world regions.

How European integration drove growth in the past

The European Union achieved remarkable economic success throughout much of its history.⁹ It supported the rapid catch-up of Western European countries versus the United States. It helped

⁹ Campos, N, Coricelli, F and Moretti, L. (2014), Economic Growth and Political Integration: Estimating the Benefits from Membership in the European Union Using the Synthetic Counterfactuals Method, Discussion Paper 9968, Centre for Economic Policy Research: London; Campos, N, Coricelli, F and Moretti, L. (2015), Norwegian Rhapsody? The Political Economy Benefits of Regional Integration, Discussion Paper 10653, Centre for Economic Policy Research: London; and Campos, N, and F. Coricelli (2017), EU Membership or Thatcher's Structural Reforms: What Drove the Great British Reversal?, Discussion Paper 11856, Centre for Economic Policy Research: London. Specifically on the benefits of the European Common Market see the review of empirical studies in National Board of Trade (2015), Economic Effects of the

Southern European economies to reduce the prosperity gap to its Northern peers while stabilizing their political systems after years of autocratic rule. And it enabled a remarkable transition towards vibrant market economies in Central and Eastern Europe, underpinning their reorientation towards Europe as free, democratic societies after the end of the Cold War.

The success of European integration was based on a set of policies that addressed first-order competitiveness challenges facing EU member countries: In the initial phase, these were the fragmentation of markets, barriers to competition, and weak productivity due to a lack of economic specialization. These challenges were best addressed by top-down solutions covering all EU member countries equally, overcoming the power of entrenched local interest groups. The EU focused on market opening to increase the level of competition and specialization, first through the removal of traditional trade barriers in the Common Market and since the mid-1980s through more ambitious alignment of national regulations in the Single Market. It also created a framework for investments in cross-border infrastructure, knowledge exchanges, and cross-border efficiencies. These policies focused on an EU membership characterized by a limited number of neighboring countries at broadly similar stages of economic development. Proximity enhanced the opportunities from integrating markets. Competition among equals was able to drive specialization around differentiated products and services. Incumbents with entrenched local market power were exposed to rivalry. Economic benefits could be gained without the need for dramatic reallocation of resources.

European Single Market. The assessments of the economic costs the UK will have to bear when leaving the EU show as a corollary the economic benefits of membership; see, for example: OECD (2016), *The Economic Consequences of Brexit: A Taxing Decision*, Economic Policy Paper No. 16, OECD: Paris.

In later periods the growth achieved by the initial members was extended to new member countries in Southern Europe, and in recent decades in Central and Eastern Europe.¹⁰ EU membership and policies again provided solutions to key competitiveness challenges faced by the accession countries: small, isolated markets, weak and untested institutions, outdated or non-existent regulatory frameworks, and limited government capacity. These issues were especially acute in Eastern Europe where a full-scale transformation from central planning and communist rule was taking place. Integration into the EU, which required the wholesale adoption of the EU's 'acquis communautaire', was a powerful catalyst to address these weaknesses. Access to the large and nearby markets of Western Europe together with the ability to draw on EU funds and programs provided the context in which the improvements in the regulatory environment could unleash strong growth dynamics. Foreign direct investment, exports, and soon also domestic consumption soared, driving robust improvements in GDP and prosperity. The ability to work anywhere in the EU offered important further opportunities for many Europeans from the new EU member countries and closed labor market gaps elsewhere.

The end of the EU's golden growth

Over time, however, the European economy has been facing increasing headwinds. A first set of problems emerged in the late 1970s. The breakdown of the Bretton Woods system and the oil price shock had triggered high unemployment, and many European countries struggled to get people back into work even as their economies rebounded. Governments were under strain to finance Europe's social

¹⁰ Indermit Gill et al. (2012), *Golden Growth: Restoring the Lustre of the European Economic Model*, World Bank: Washington, D.C. Marcin Piatkowski (2018), *Europe's Growth Champion: Insights from the Economic Rise of Poland*, MIT Press: Cambridge, MA.

model with its significant level of public transfers. EU prosperity levels started to stop converging to those of the United States and remained about 15% behind the U.S. level.¹¹ Prosperity growth also decreased in absolute terms from 4% annually in the 1950s and 60s to 2% in the 1990s.

A new set of concerns arose during the late-1990s. While the arrival of the 'New Economy' was proclaimed in the U.S., Europeans saw themselves falling behind, stuck in more traditional industries and less open to entrepreneurs and disruptive innovation. These concerns were only growing with the subsequent emergence of new internet-based businesses, the vast majority of whom again hailed from the U.S. And Europe seemed to be losing the race for innovation and entrepreneurship not only against the U.S.: Korea and Taiwan had surpassed European levels of R&D and patenting intensity by 2000, while China's R&D spending relative to GDP reached the EU-28 level by 2012.¹² Israel alone had more companies listed on NASDAQ than the initial six EU founding members combined.¹³

A third shock came with the 2007 global financial crisis and the subsequent European sovereign debt crisis. Some EU member countries were hit by deep recessions; Greece in particular saw GDP per capita levels drop by more than 25%. They had to submit to emergency loans and painful structural reform programs administered by the 'Troika' of European Commission, ECB, and IMF. The post-crisis recovery was slow, with Europe achieving aggregate growth rates comparable to the US only after 2010. Parts of Europe continue to face slow growth and high unemployment, especially among the young.

¹¹ Charles Jones and Peter Klenow (2016), Beyond GDP? Welfare Across Countries and Time, *American Economic Review*, Vol 106(9): pp. 2426–2457 suggest that Europe's prosperity gap to the US is much smaller than suggested by GDP per capita data alone when accounting for a broader measure of welfare.

¹² OECD (2016), Main Science and Technology Indicators, OECD: Paris

¹³ Data retrieved from <http://www.nasdaq.com/screening/regions.aspx>, November 15, 2016

While Europe as a whole was seen to be struggling, a number of European countries performed well: Poland delivered stronger growth than Korea since becoming an EU member. The Nordic countries remained on the top of global innovation rankings, having overcome banking crises at the beginning of the 1990s. Germany initiated labor market reforms in the early 2000s, and saw its economy and labor market become the key pillar of the Euro-Zone. Ireland, hard hit by the crisis, staged a remarkable recovery. The Baltic countries overcame boom and bust to join the Euro-Zone and return to the top of EU growth tables.

On the one hand, this showed that EU membership did not preclude individual countries to implement successful strategies for competitiveness upgrading. On the other hand, the heterogeneity in outcomes deepened the tensions within Europe between perceived winners and losers of European integration.

Europe's response, and why it lost traction

Europe's competitiveness challenges triggered a succession of EU policy initiatives. When Europe's catch-up to the U.S. fizzled out, the Single Market project aimed to reignite the dynamism of earlier market opening efforts by aligning a broad range of beyond-the-border national policies and regulations. When the New Economy dawned, the Lisbon Agenda proposed an ambitious strategy to strengthen innovation, mobilizing a wide range of policy tools. When the sovereign debt crisis exposed the weaknesses in the Euro-Zone's architecture, a beefed up Stability and Growth Pact and a Banking Union aimed to ensure more stability.

As a result, the EU extended its activities to an ever-growing number of policy areas. This trend was further embellished by decisions to extend the EU's role in policy areas not directly related to the

economy, and by strengthening the role of institutions like the European Parliament to provide ‘democratic control’ of the increasingly powerful European institutions. Decision-making was seen to move increasingly to Brussels, something that Europeans accepted as long as it provided meaningful benefits. For the Single Market, it often did. The four freedoms contributed to the resurgence of economic dynamism across Europe in the late 1980s/early 1990s. For the Lisbon Agenda and its successors, however, outcomes remained far behind the ambitions.¹⁴ Significant action was taken at the EU level but both the follow-through and benefits across EU member countries and regions were mixed. Innovation remained behind key global peers, and the US continues to be ahead in new business models and technologies. The Common Currency and the Stability and Growth Pact did at first provide significantly more macroeconomic stability and access to lower cost capital. But they were unable to avoid the crisis that came, and proved unprepared to deal with its consequences. The economic costs were high in many countries; they were dramatic and persistent in the case of Greece. Whether the institutional reforms introduced since the crisis are enough is widely discussed.

What went wrong? One school of thought argues that Europe lost its way as it moved beyond its initial focus on creating an integrated market. More Europe meant more top-down regulations that stifled market dynamism. The Common Currency is argued to have made things worse, sowing the seeds of the sovereign debt crisis and severely limiting national parliaments’ sovereignty over budgets.¹⁵ The opposing view is that Europe has not been integrating fast and comprehensively enough, especially by

¹⁴ On the Lisbon Agenda see the Kok Report, “Facing the Challenge, Report from the High Level Group,” Brussels, 2004, and “Lisbon Strategy Evaluation Document, SEC(2010) 114 final, Brussels, 2010. On the Europe 2020 Agenda see the Communication of the European Commission, Taking stock of the Europe 2020 strategy for smart, sustainable and inclusive growth COM(2014) 130 final/2, Brussels, March 2014.

¹⁵ See James Galbraith (2016), *Welcome to the Poisoned Chalice: The Destruction of Greece and Europe*, Yale University Press; Joseph Stiglitz (2016), *The Euro: How the Common Currency Threatens the Future of Europe*, Norton.

centralizing only parts of macroeconomic policy.¹⁶ From this perspective not the Common Currency triggered the crisis, but the lack of common financial market regulations and fiscal policy oversight mechanisms.¹⁷

We argue that both explanations fail to explain the broader trends in Europe's competitiveness performance: More Europe did not simply mean more bureaucracy - the policies and programs the EU pursued were by-and-large in line with global best practices, and their philosophy tended to be more 'market friendly' than in many EU member countries. Reducing this influence of the EU is not going to make Europe more competitive. But more Europe clearly did not achieve the outcomes desired, and it is hard to see how further EU action will produce better outcomes now when it failed to do so in the past. And there are, of course, markedly different views on what 'more Europe' should amount to, from further market liberalization¹⁸ to more ambitious stimulus packages or unemployment insurance.

Our view of what went wrong is markedly different from these traditional views: We believe it is not what Europe has done in terms of policy areas or approaches that is to blame. The problem is *how* Europe has gone about designing and implementing these policies. While the European economy and the nature of its competitiveness challenges changed significantly over time, Europe's approach towards upgrading competitiveness has remained largely the same. It is this disconnect that has to be overcome, by analyzing Europe's competitiveness context and outlining a European new competitiveness strategy.

¹⁶ See the Five Presidents-Report: Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz (2015), *Completing Europe's Economic and Monetary Union*, European Commission: Brussels, and the Reflection Paper on the Deepening of the Economic and Monetary Union (2017), European Commission: Brussels.

¹⁷ Martin Sandbu (2015), *Europe's Orphan: The Future of the Euro and the Politics of Debt*, Princeton University Press: Princeton, NJ.

¹⁸ See Anders Åslund, Simenon Djankov (2017), *Europe's Growth Challenge*, Oxford University Press: Oxford

Europe's current competitiveness context

Europe's successful policy approach of the past was characterized by an alignment between competitiveness needs and the policy architecture to address them. Europe needed to overcome the fragmentation of markets and provide access to a functioning regulatory system. For both of these tasks 'more Europe' was the right answer: Common EU policies decided at the level of EU institutions ensured full market access and a common set of rules and regulations. Making access to the common market contingent on the full application of common regulations was a powerful tool to overcome the resistance of local interest groups dominating local markets.

Europe's current challenges are not the result of the expanding role of the EU across new policy areas. They are instead a reflection of the inability of the old top-down, centralized EU policy approach to deal with the fundamental different competitiveness challenges Europe is now facing, driven both by changes within the global economy Europe is operating in and the profile of the EU economy itself:

- The global economic context has changed dramatically in the last few decades. Globalization has reduced many of the traditional barriers to trade and investment, increased cross-border value-chain linkages, and exposed locations and firms to competition for a wide range of places and rivals. Technological change has spurred this process and itself created a host of new economic opportunities and challenges that locations and firms have to respond to. Finally, the slow-down of productivity growth, a global phenomenon affecting especially the innovation leaders within the OECD, has raised new questions on why it has occurred, and how it can be addressed.

- The EU accession process has made the EU significantly more heterogeneous in terms of economic development, competitiveness, cultures, government structures, and expectations towards Europe.¹⁹ Prosperity differences across EU member countries are now three times greater than across US states. Some EU members face competitiveness priorities similar to Singapore and Switzerland, while others face challenges comparable to Mexico, Thailand, and China.²⁰ Some are among the least corrupt countries in the world and enjoy highly developed institutions, while others have uneven institutions with corruption close to the global median.²¹
- EU policies, too, have fundamentally transformed the European competitiveness context. The Single Market has removed many barriers for cross-border trade, investment, and migration. Those barriers that remain are structurally much harder to address while the economic benefits from removing them are more uncertain. The Common Currency, too, has removed barriers. In addition, it removed key national policy tools traditionally used to respond to economic downturns and volatility while increasing the potential for cross-border spill-overs from macroeconomic crises.

As a result, we see Europe's main competitiveness challenges no longer related to removing traditional barriers to trade and investment or to strengthening linkages across Europe. They are instead driven by how individual regions and countries within the EU can successfully compete in the common European

¹⁹ Alesina, Alberto, Giuseppe Tabellini, and Francesco Trebbi (2017), *Is Europe an Optimal Political Area*, Brookings Papers on Economic Activity, Spring 2017 show a lack of convergence on cultural attitudes and political views across Europe but also argue that these differences are not unmanageable within one structure in comparison to other countries.

²⁰ World Economic Forum (2017), *Global Competitiveness Report 2017-18*, WEF: Davos

²¹ Transparency International (2017), *Corruption Perception Index 2016*, TI: Berlin.

market and the wider global economy. The answer to this question is inherently context-dependent, and in the hand of local groups of public and private entities.

We view Europe's failure to align its policy approach with these new competitiveness challenges as the root cause of many of its current economic challenges: the competitiveness priorities set at the EU level are right on average but wrong for every individual European region and country. Asking how EU members can through their actions contribute to addressing these EU priorities turns EU membership into a cost rather than a benefit. And while access to the EU market continues to be highly valuable there is a rising concern that the EU offers little to those that struggle to successfully compete in this market.

Politicians across the EU have learned to game this structure: They follow EU recommendations where they fit with national policy priorities anyway, but otherwise pay largely lip-service to the EU rhetoric without taking ownership of the policies needed. They publicly acknowledge that the Common Currency creates a fundamentally different macroeconomic policy environment but have shown insufficient willingness to make the necessary changes in policy areas that had traditionally not been addressed at the EU level, from increasing factor market flexibility to coordinating fiscal policies and aligning banking regulation. Changes only came about in response to crisis, when member countries had not alternative and the EU could serve as a scapegoat for necessary but painful reforms. Where things go well, Europe is not perceived to play a relevant role. Where things go badly, Europe is there to be blamed.²²

Furthermore, the current EU model has affected the ability of member countries to make their own economic policy choices in very different ways: For prosperous EU members in the North and West EU

²² Christian Thimann (2015), *The Microeconomic Dimensions of the Eurozone Crisis and Why European Politics Cannot Solve Them*, Journal of Economic Perspectives, Vol. 29. No. 3, pp. 141 – 164.

policy instruments play a marginal role in financing public investment; there is very limited leverage the EU has to influence their national policy decisions.²³ For EU members in the South and East, however, EU funds finance a large and in some cases dominant share of their investments. Here EU programs are ‘the’ economic development strategy, and decisions made in Brussels have huge implications for national policy. This imbalance is politically difficult but in many ways the inevitable result of a wider EU role within a more heterogeneous Europe.

A new competitiveness strategy for Europe

Making the European Union more effective in upgrading competitiveness requires an alignment with the current circumstances in Europe. A strategy has to set action priorities, clarifying what is most critical and adapting individual policies to the existing conditions. Critically a new strategy has also to put much more emphasis on the how: the roles and responsibilities that the EU institutions as well as EU member countries and regions have in implementing the strategy.

Microeconomic competitiveness anchored in specific local competitive advantages that enable firms from across the EU to compete successfully in European and global markets needs to be at the heart of Europe’s new competitiveness strategy. Many examples of competitive locations and clusters exist across Europe, and many useful policy tools are available. What is missing, is an architecture that channels these assets more coherently into the development of unique local strategies by all EU regions and member countries. The EU can play an important role in supporting them, but the ultimate decision

²³ And they sometimes even bend the rules that apply to all countries: Germany and France were in 2004 the first countries to violate the fiscal rules of the Stability and Growth Pact but managed to avoid sanctions.

power and responsibility for implementation and outcomes needs to rest with national and regional governments.

Macroeconomic policy coordination, the Single Market, and cross-border collaboration remain critical areas for EU policies towards competitiveness upgrading. If the collaboration in these traditional areas of EU activity wanes, the actions of countries and regions in terms of microeconomic upgrading will be significantly less powerful in driving higher prosperity and innovation. However, even in these policy areas it is important for the EU to align its approach with the new realities that characterize the European economy. Here it is less about redefining the role of the EU, and more about rethinking the philosophy of the policy choices to be made.

1. Transform the EU's approach towards upgrading microeconomic assets and capabilities

The central competitiveness challenge European countries and regions are facing is microeconomic: what is needed, is strengthening the fundamental drivers of firm level productivity and innovation. Each location in the EU needs to develop a clear sense of its unique value proposition in the European and global economy. This value proposition has to be grounded in the competitive advantages present in the location, and will be reflected in a specific set of clusters that draws most value from these advantages. A clear value proposition then drives policy priorities for strengthening specific assets and capabilities.

Enhancing competitiveness in Europe is no longer about harmonization and convergence towards common standards, but about creating a context that enables specialization and leveraging each country's unique circumstances. Europe needs to become more heterogeneous for Europe and all of its

parts to become more prosperous. This heterogeneity is not an alternative to market integration and common 'rules of the game' but a critical element adding to their value.

Microeconomic competitiveness requires a bottom-up driven approach that is fundamentally different from what we see in Europe today. The strategic decisions about value propositions and action priorities have to be taken within regions and countries. This the level at which competition between locations takes place and where specialization in clusters emerges. For policy, it is where the necessary information resides to make context-driven choices, and where public and private institutions have to collaborate to implement action.

The EU institutions play an important role in microeconomic competitiveness as well, but a very different one from today. The EU can help regions and countries make better policy choices, collecting data on what works and what type of approaches are available. It can assess individual policies, approaches, and actions; it needs to stop setting European action priorities or encourage the simple copying of best practices in leading regions. The EU can also help by co-financing local policies that meet standards of good practice. And it can play a role in developing government capacity at regional and national levels.

This division of roles will empower EU member countries and regions but gives them also significant responsibilities. Following general EU guidelines is not a strategy; countries and regions need to make their own choices. And outcomes are no longer there to be blamed on the EU; if decisions are largely national and regional, that is where the political responsibility for the results should be placed.

2. Refocus cross-country collaboration within the EU on macro regions

Collaborating in areas with meaningful cross-border spill-overs is a traditional domain of EU policy action. Especially in innovation but also in infrastructure collaboration across borders can be a critical conduit to enhancing competitiveness and enable the functioning of European markets.

With the growth of the European Union over time it is important to review which activities have truly EU-wide spillovers and which are more macro-regional in nature, affecting a set of neighboring countries.

In innovation policy we see a case for EU wide collaboration in specific areas: Supporting excellence at an EU rather than national level can focus resources on higher-quality efforts. And enabling European-wide innovation networks can strengthen the flow of knowledge. The benefits of these actions will ultimately depend on EU member countries and regions microeconomic competitiveness, driving their ability to benefit from and contribute to the European innovation system.

In infrastructure and economic development the focus is likely more between groups of neighboring countries; this is where the spill-overs occur and the benefits from coordination are the highest. The macro-regional strategies launched by the EU over the last decade are a useful step in this direction. But financing for cross-border activities is small relative to national use of structural funds, and in infrastructure the role of the EU is largely concentrated on planning, not on mobilizing capital. Here a re-orientation could be useful, drawing also on the support available from the European Investment Bank.

3. Deepen the Single Market, not the alignment of rules and regulations

The Single Market with its Four Freedoms is the traditional core of Europe's economic integration model. It requires EU-level institutions to develop and defend common rules against narrow interest groups, often organized at the national level. It is the area where for trade and competition policy the EU has acquired own executive authority. Even in these policy fields affecting the overall rules of the game on European markets it is important to respond to the changes that have emerged.

First, the Single Market needs to deepen its digital dimension. As technology has changed, digital markets have assumed a much more important role in the economy. And they are often deeply interlinked with traditional markets; as long as digital markets are separated by national regulatory boundaries, many physical markets will stay that way too. Here the European Commission has an important role to play. Important steps in this direction have been made, but Europe needs more progress.

Second, the Single Market process has removed many of the traditional barriers to cross-border integration. These achievements can not be taken for granted; a sustained political commitment is need to keep markets open. Over time, however, this has pushed the legislative and regulatory activity more and more into fields that are traditionally national in nature, even when they involve choices that also affect trade. The economic benefits of aligning rules have been reduced, while the political costs of achieving them has increased. The EU is at a stage where it has to consider the balance between these two more carefully. Common rules are not an objective themselves; a more competitive market environment is. And here other policy choices, often linked to upgrading the different aspects of

microeconomic competitiveness discussed earlier, might be more important than further top-down alignment of policy choices.²⁴

Third, the mobility of labor, a key part of the Four Freedoms, has different implications in a European Union with countries of highly different wage levels and social security systems than among the EU's founding members. Labor mobility has significant economic benefits, for both the countries receiving and sending labor. But it has proven to also create political concerns, especially about social security system arbitrage. There is very little evidence that this is taking place in Europe to a large extent. And the EU regulations give member countries leeway to deal with such cases already. But it is time to emphasize that the freedom to move needs to be incentive compatible to be politically sustainable.

4. Strengthen macroeconomic coordination, not EU control

Macroeconomic policy has since the EU sovereign debt crisis dominated the discussions on EU economic policies. While macroeconomic coordination has been a topic of EU collaboration since the 1970s, the Common Currency has significantly changed the context. The full removal of exchange rate flexibility and the creation of the ECB have left countries in the Euro-Zone without some of their key macroeconomic policy instruments. This was, of course, not an accident but a purposeful decision to enhance the quality of macroeconomic policy and deepen integration across European markets. And it had much of the

²⁴ Mario Mariniello, André Sapir, and Alessio Terzi (2015), *The Long Road Towards the European Single Market*, Bruegel Working Paper 2015/01, Bruegel: Brussels

desired effects in these two areas. But it also significantly raised the cost of domestic policy mistakes as became evident during the crisis.

The European discussion seems now stuck between two equally uncomfortable scenarios: Move towards full integration of fiscal policy and risk sharing at the EU level, or dissolve the Euro-Zone. The prior requires a willingness to shed national sovereignty and agree to cross-European transfer for which there is no political support. The latter will have significant economic and political costs that few Europeans want to incur. Policy practice is for the time being trying to dodge this choice by strengthening the existing system through more EU-level safeguards without creating a transfer union.

We see an alternative path where the EU focuses on managing cross-border spillovers from macroeconomic challenges at the national level as well as an organized process for crisis support when needed. Some new proposals outline in more detail how such risk sharing could be aligned with incentive compatibility.²⁵ The recent reforms in the Banking Union, and in the European Stability Mechanism are steps in this direction but seem stuck in achieving a balance between these two goals that is both economically effective and politically acceptable. Details matter as the Semester process²⁶ indicates: It puts national budgets, a key element of sovereignty, under EU review permanently, not just in times of crisis. While this might be done with the intention of helping countries adopt more sustainable policies, it creates the impression of EU control and responsibility and weakens countries' responsibility for policy choices made. We advocate more freedom *and* responsibility for EU member countries, combined with

²⁵ Bénassy-Quéré, A, M Brunnermeier, H Enderlein, E Farhi, M Fratzscher, C Fuest, P-O Gourinchas, P Martin, J Pisani-Ferry, H Rey, I Schnabel, N Véron, B Weder di Mauro, and J Zettelmeyer (2018), *Reconciling risk sharing with market discipline: A constructive approach to euro area reform*, CEPR Policy Insight No. 91.

²⁶ Amy Verdun & Jonathan Zeitlin (2017): Introduction: the European Semester as a new architecture of EU socioeconomic governance in theory and practice, *Journal of European Public Policy*, DOI: 10.1080/13501763.2017.1363807

technical support by the EU where wanted. In crisis situations budget sovereignty is anyway a fiction – the EU needs to be transparent about the support it is going to provide as well as the conditions it will attach to this help.

In such a scenario, Euro-Zone member countries also need to do more. It is now clear how fundamentally the common currency affects their ability to react to shocks. The initial Stability and Growth Pact with its focus on some core fiscal and monetary aggregates was clearly not sufficient to prepare countries for this different context. More is needed in terms of labor market flexibility and other measures. And opening markets needs to be connected to a clear strategy for driving productivity growth and innovation. Here member countries need to take the lead even if learning from and with others in Europe can help. And Europe as a whole needs to recognize that achieving a sustainable new governance of the Eurozone also has to have a strong pillar dedicated to upgrading microeconomic competitiveness.

A new ambition for Europe: The value of EU membership

A new strategy will get political traction only if EU membership is seen as providing benefits to European countries. The changes in the EU's membership and economic circumstances require a new articulation of what these benefits are.

- The key economic benefit of EU membership is the **access** it provides **to one of the world's largest markets**, enabling European countries and regions to leverage their existing assets and capabilities. Other EU countries constitute the main trading partners for all EU members, and will continue to do so merely as a matter of geographic proximity and size. Access to this market is

achieved not just by the removal of barriers at the border, but also by a much deeper alignment of non-tariff rules than in any other common market. The removal of exchange rate risks and transaction costs in the Euro-Zone removes further barriers. And the investments in cross-border infrastructure and knowledge linkages further connect firms and consumers across Europe.

- Membership in the Single Market also provides **important direct competitiveness benefits**, adding to the capabilities that European countries and regions have: The larger size and higher degree of rivalry within the European market spurs innovation and productivity upgrading. And the heterogeneity within the EU enables companies to create regional value chains that exploit differences in local circumstances to achieve higher productivity as well as cost efficiency within Europe, rather than relying on low cost locations in developing countries. In fact, it is this combination of a huge market *and* a high degree of internal heterogeneity that sets the EU economy apart from its global rivals.
- Given the significant spill-overs among neighboring countries the EU also provides an **efficient platform for organizing joint action**. There are the traditional benefits from coordinated investments in those specific areas with significant economies of scale (although finding areas for which there are economies of scale that they could not achieve at a national level is not simple, especially for larger EU member countries). And there is the joint management of policy areas with significant cross-border externalities. The EU can significantly reduce the costs of pursuing such activities, both across the entire EU and among variable groups of member countries.
- The EU can significantly **help member countries and regions enhance the quality of their own policy choices**. The EU can provide data and benchmarks that can inform policy. It can provide

an environment where member countries can learn from each other, particularly relevant where similarities between countries make approaches and solutions transferable. And the EU can be used to support good local practices by providing technical support and co-financing. The EU needs to create incentives for local adoption of tailored policies, and use data and market-mechanisms to increase the cost of poor policies or lack of implementation. Today the EU is increasingly doing the opposite: member countries and regions are threatened with financial penalties or losing access to structural funds if they do not comply with top down EU rules.

- The EU offers an **important laboratory** for further developing Europe’s powerful combination of social and economic progress. The ambition to pursue these in parallel is widely shared across Europe, and the Social Progress Index reveals that that many parts of Europe have a solid track-record.²⁷ We believe that social progress will ultimately enable greater growth and shared prosperity in the decades ahead. Being part of the EU enables countries to collaborate with like-minded peers in finding ways to continuously evolve this model, and strengthen the economic benefits it offers to Europe’s citizens.

European integration is driven by more than just short-term transactional benefits. But requiring Europeans to support further integration based on a commitment to shared values alone is not enough if their every-day experience does not reflect the value from collaboration.

²⁷ In the *2017 Social Progress Index* 10 EU member countries rank higher than the US, including four of the largest five: <http://www.socialprogressimperative.org/global-index/>. Other approaches, like the BCG Sustainable Economic Development Assessment, come to similar conclusions: <https://www.bcg.com/industries/public-sector/sustainable-economic-development-assessment.aspx>

A more competitive Europe: Getting there

Changing how Europe does things is difficult. The 'Brussels reflex' has traditionally been to launch a succession of more ambitious policy initiatives led by EU institutions in the spirit of 'completing the Union'. However, everything we know about the microeconomic foundations of competitiveness tells us that in the current context this is a pathway to further disappointment. It will lead to policies that may be right 'on average' but wrong for the specific conditions in individual European regions and countries. And further centralization will confirm the view that EU institutions infringe on the sovereignty of the nation states, which for most Europeans, including many of those in favor of deep European integration, continue to be the key point of reference and identity.

But we also strongly disagree with the EU-sceptics that see the answer in dialing back European integration²⁸ and dissolving the Euro-Zone.²⁹ Both the Single Market and the Common Currency have enabled more open competition and specialization within Europe. Rolling back these policies would undermine the powerful economic benefits that a common context for market rivalry has created. Many individual countries' policy choices would likely revert towards less open markets or even economic nationalism, undermining competitiveness. And while the economic merits of the Common Currency can with hindsight rightly be discussed (and were extensively discussed before its introduction), ending it now would disrupt markets and create massive uncertainty.

²⁸ Jakub Grygiel (2016), The return of Europe's nation-states: The upside to the EU's crisis, *Foreign Affairs*, 95(5), 94-101. Matthias Matthijs (2017), Europe After Brexit: A Less Perfect Union, *Foreign Affairs* 96 (1), pp. 85-95.

²⁹ See James Galbraith (2016), *Welcome to the Poisoned Chalice: The Destruction of Greece and Europe*, Yale University Press; Joseph Stiglitz (2016), *The Euro: How the Common Currency Threatens the Future of Europe*, Norton. Both argue that changes within the Euro are unlikely to be achieved and thus see the dissolution of the Common Currency as the preferred choice. Martin Sandbu (2015), *Europe's Orphan: The Future of the Euro and the Politics of Debt*, Princeton University Press, instead sees the faults in specific policy decisions that could be changed, leaving the Common Currency intact.

What we propose in this article moves beyond the stale discussion of more or less Europe. The vague promise of a 'multi-speed Europe' reflected in the European Commission's White Paper or the hope that in a time of crisis Europeans will simply regroup around the Union as it fails to address the real concerns about the EU's ability to enhance Europe's competitiveness. Based on an analysis of the current European context we distinguish distinct roles that have to be played by the EU in addressing key European competitiveness issues versus others where member countries have to take the lead. Collaboration within the EU continues to provide huge value to its member countries. But the way Europe works has to substantially change, to enable more progress on upgrading competitiveness.

A clear and publicly visible commitment from European leaders to a new set of principles will be essential to make the transition towards a new policy approach towards European competitiveness a reality.³⁰

- Europe needs to become more different in terms of regional value propositions and patterns of specialization to become more prosperous overall and in all of its parts
- Europe needs to become more different in terms of regional value propositions and patterns of specialization to become more prosperous overall and in all of its parts
- The economic mission of common EU institutions is to raise the ability of all EU member countries and regions to compete successfully in the European and global economy, not only to enhance market integration
- European countries and regions take responsibility for political decisions and their outcomes locally and nationally; they accept that the sovereignty to make decisions at that level requires a willingness to accept heterogeneous outcomes across Europe

³⁰ It is worrying that competitiveness has not been made the topic of a reflection paper in the White paper process on the Future of Europe. The papers on Globalization and the EMU touch upon aspects discussed here, but only in passing.

- Europe is based on solidarity and openness, anchored in rules and regulations that are compatible with the differences in prosperity and social systems across Europe

A shift towards this new approach can happen without treaty changes. Elements of the new approach are already visible in some European policy practice: the European Union's new regional policy puts a strong focus on regions developing their own strategies, based on an in-depth assessment of local circumstances. The European semester process combines an EU role in providing benchmarks and diagnostics with national responsibility for designing national reform programs that address country-specific competitiveness priorities. The (still relatively small) Structural Reform Support Service (SRSS) provides technical support to EU member countries on their action plans to achieve more sustainable growth and competitiveness. And the EU's macro-regional strategies are a platform to enable deeper engagement between groups of neighboring countries. Put into the context of a new policy approach, these elements of European policy practice can unlock significantly more benefits than they do today. What is needed, then, is not a wholesale restructuring of the EU system, but a very public and forceful reinterpretation of how this system should operate.

A reformed European Union in the Global Economy

Europe is an important pillar of the global economy. A Europe better able to sustain and upgrade its competitiveness provides huge benefits not only for Europe but also for the rest of the world. A fractured Europe turning inwards and losing its confidence will hurt Europeans but also slow down global growth and prosperity. The new model for upgrading European competitiveness is driven by the opportunities

that we see for Europe, not simply react to the challenges Europe is currently facing. These challenges are real. But Europeans should recognize that they signal that Europe needs to evolve its model for collaboration, not that collaboration itself was the wrong path to choose.

Many of the problems that Europe is facing are a reflection of broader issues visible in other countries as well. Globalization and technological change have created tremendous opportunities but also put pressure on many societies and policy structures. Outcomes are becoming more heterogeneous across different groups and regions within countries. While opportunities are rising for many individually, there is a sense that collective institutions are losing their ability to influence key policy choices. The political backlash that these trends have triggered is now threatening some of the key elements of the institutional structure that has been underpinning the growth of global trade and investment in recent decades. But economic nationalism and protectionism are not going to cure the economic pains that exists; they will in many cases make them harder to resolve. The answer need to be a set of policies that take these concerns about unbalanced gains from globalization seriously, and look for reactions that address their root causes.

European integration is in many ways an attempt to create a political architecture across countries to deal with these challenges through collaboration. It is under strain because the pressure to deliver has become stronger. A new answer, more aligned with the economic realities of today, is not only critical for Europe. It can also provide important direction to other economies around the world dealing with the same changing global context. And it will increase the odds the Europe is a key partner in transforming the rules and institutions of the international economy to address the very real tensions that have emerged over time.