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

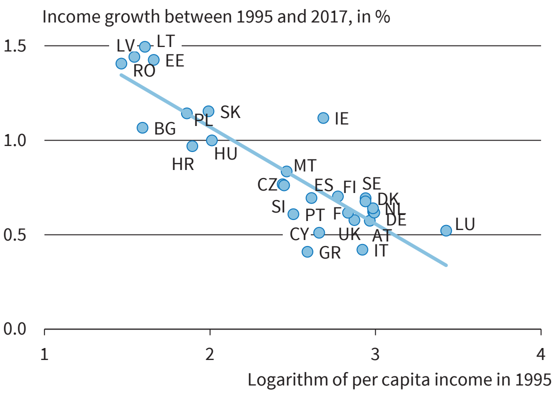
Across EU countries there has been a catching-up process where countries with an initial low level of income have experienced higher income growth than the high-income countries over the period 1995 to 2017 (see Figure 4.1). There is a pronounced negative correlation implying that countries with an initial 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.

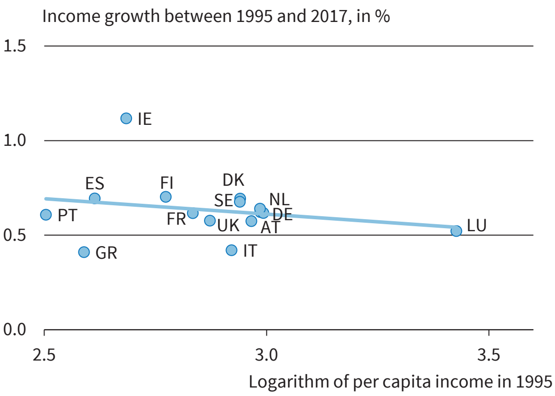
[3] The β-coefficient for the EU-28 sample (Figure 4.1) is – 0.51, with standard error 0.06, for the EU-15 sample (Figure 4.2) it is – 0.16 (0.16) and for the euro sample (Figure 4.3) it is – 0.58 (0.18).

Figure 4.1
Income Convergence since 1995, EU-28



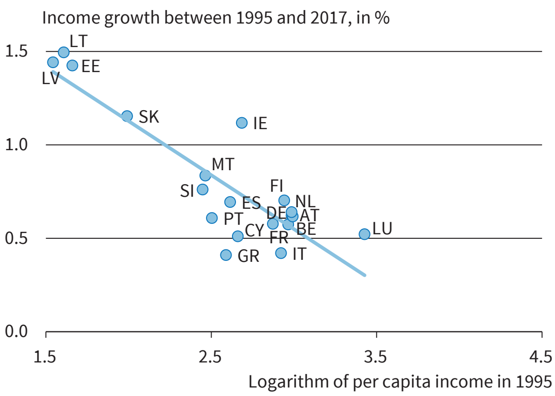
Linear Regression fit: y= -0.5134x + 2.097; R^2 = 0.763
Source: AMECO. © CESifo

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.

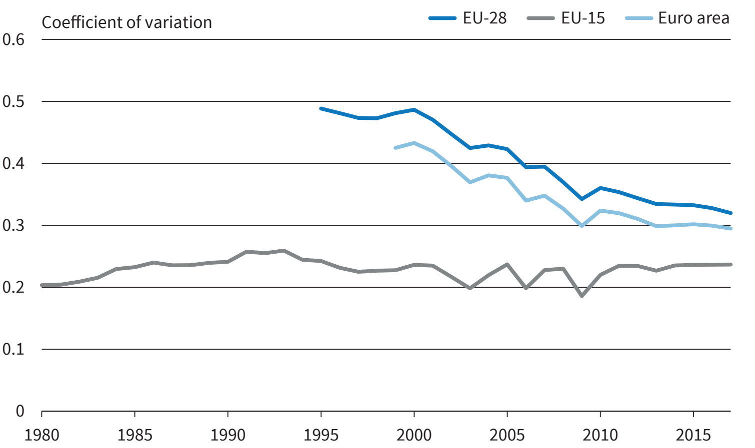
Overall, per capita income convergence did work reasonably well until the onset of the financial crisis. Convergence in Europe was mostly driven by Eastern European states, most of which joined the European Union in 2004. Figure 4.5 shows how average per capita incomes in the group of Eastern and Southern 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

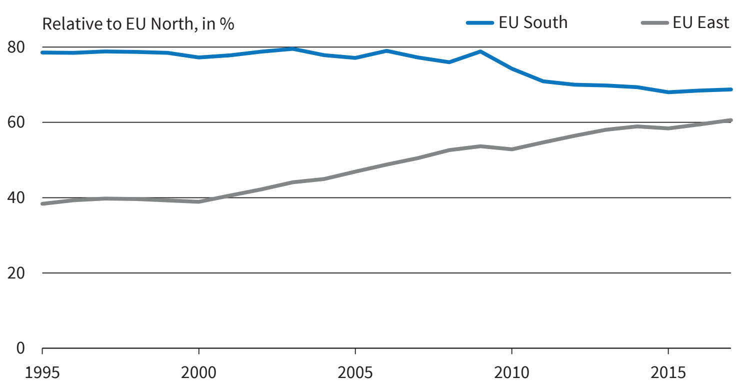
Income Divergence (σ-Convergence)



Source: AMECO. © CESifo

Figure 4.5

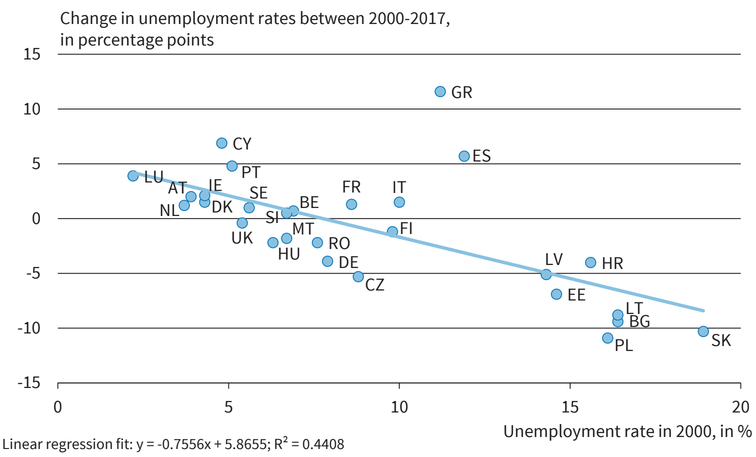
Development of per Capita Incomes



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.

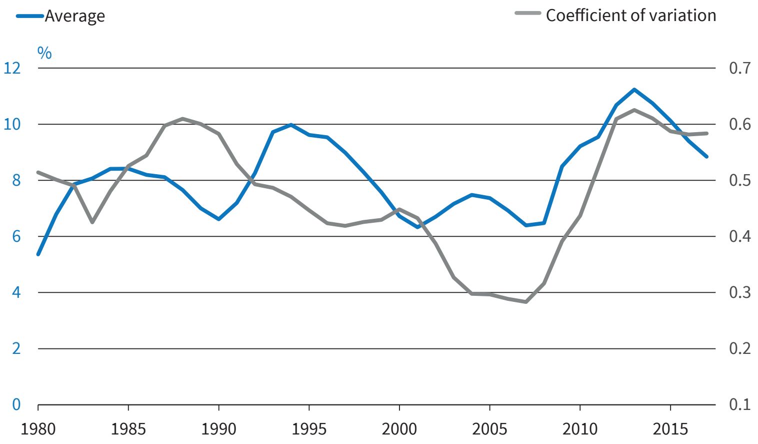
The employment rate is also cyclically dependent, but displays an upward trend (see Figure 4.9). This is partly due to increasing employment rates for the age group 55 to 64. It is interesting that the employment rate for this age group has been rising across all EU countries (except Greece and Romania), 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

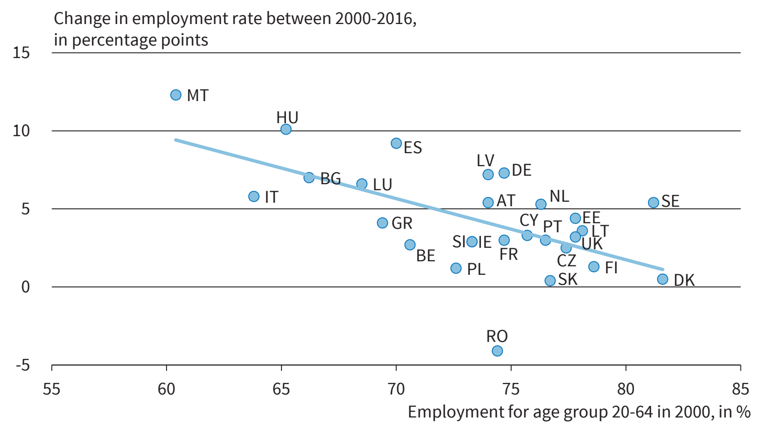
Unemployment Rate across EU-15



Source: AMECO. © CESifo

Figure 4.8

β-Convergence in Employment Rates for EU-28

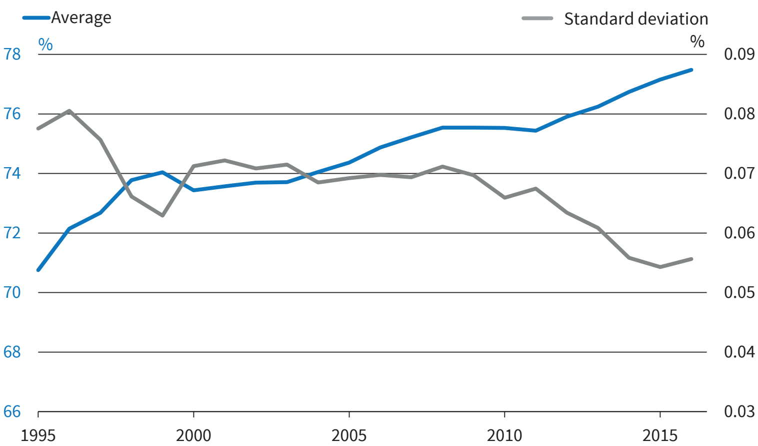


Linear regression fit: y = -0.3914x + 33.056; R^2 = 0.3733

Source: AMECO. © CESifo

Figure 4.9

Employment Rate across EU-28



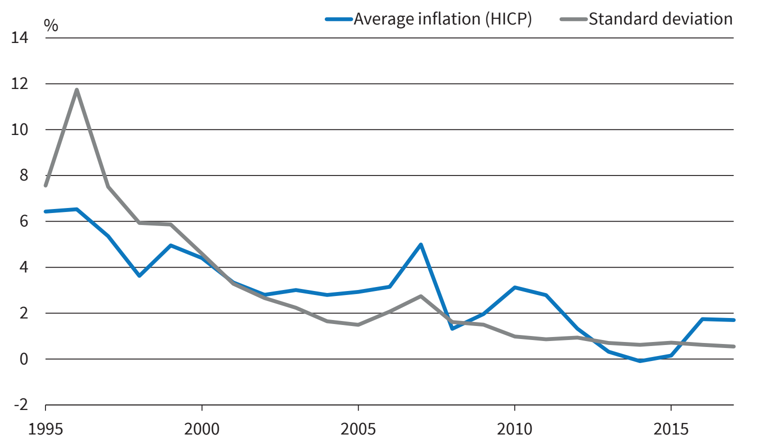
Source: AMECO. © CESifo

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.

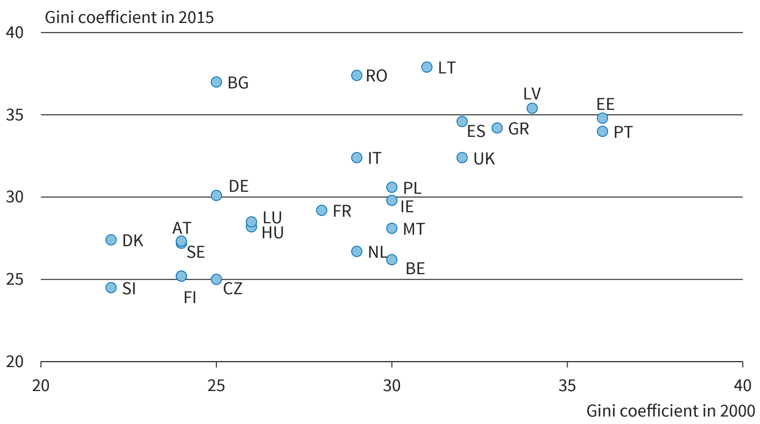
While convergence of real variables has been slow, nominal convergence is much stronger. Figure 4.10 suggests that inflation rates have converged to a low average level and the dispersion across EU-28 countries is small. This is a global trend and therefore cannot be solely attributed to the EMU. Moreover, 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



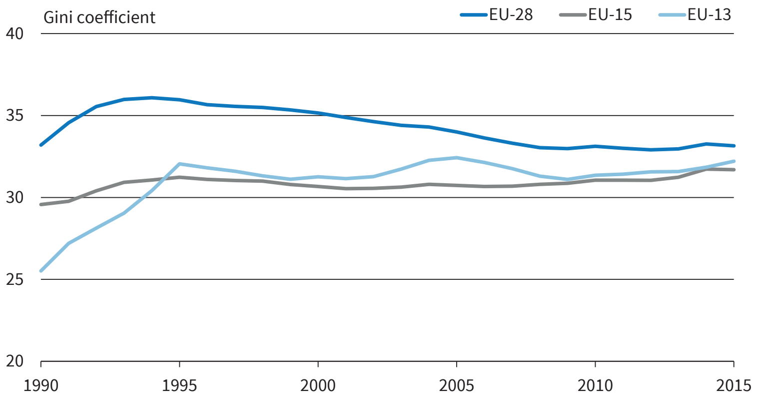
Source: AMECO. © CESifo

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

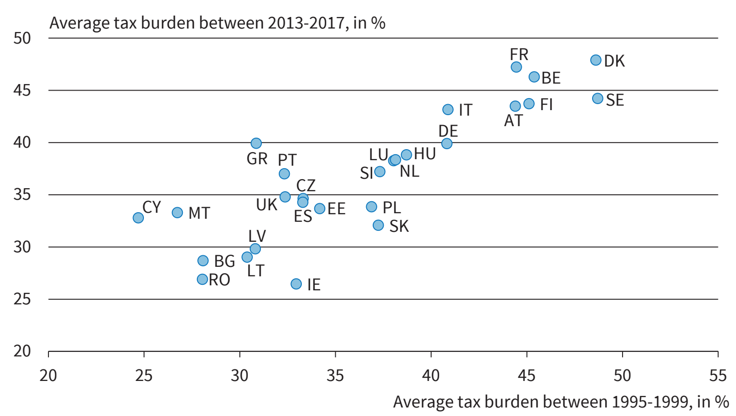
[6] See European Union Commission Directive 97/71/EC of 15 December 1997, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX-:31997L0071&from=EN. There are ongoing discussions to change the directive in the European Council and the Parliament to give larger weight to social concerns,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

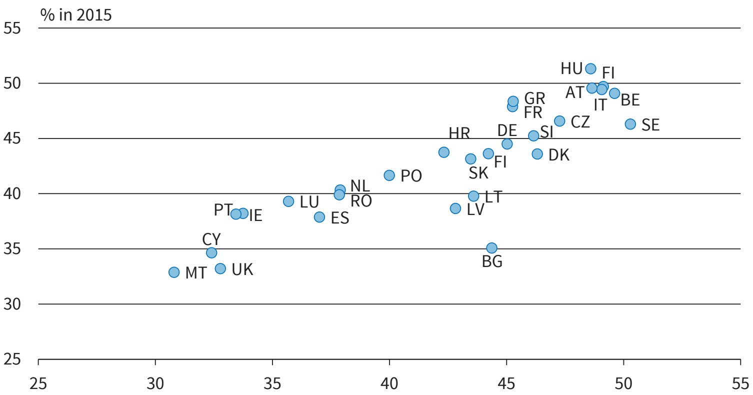
Figure 4.13
Total Tax Burden in the EU-28



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

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.

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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).

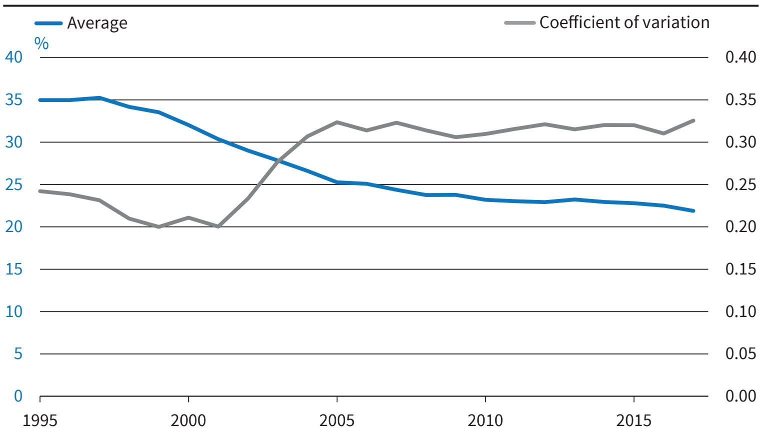
As mentioned above, one of the classical examples of a race-to-the-bottom mechanism is the corporate tax rate. For EU-28 countries – as for most countries – there has been a trend towards a decline in the corporate tax rate, from an average rate close to 35% in 1995 to about 22% in 2017 (see Figure 4.15).[11] 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.

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

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.

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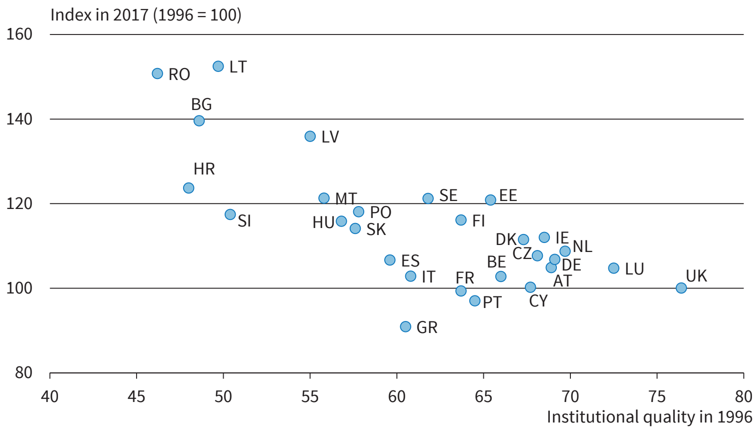
[10] The slope coefficient is estimated to be 0.77 (standard error 0.09) and significantly below one. This relation implies convergence to a tax wedge of around 45% in the long-run.

[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 4.16

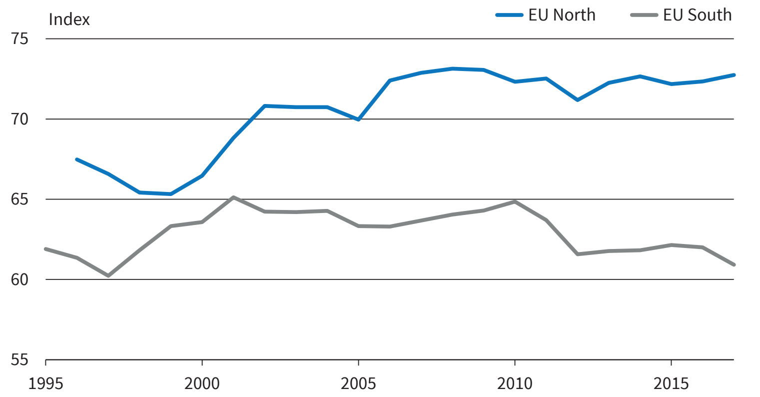
Convergence in Institutional Quality in EU-28



Source: Heritage Foundation Economic Freedom Index. © CESifo

Figure 4.17

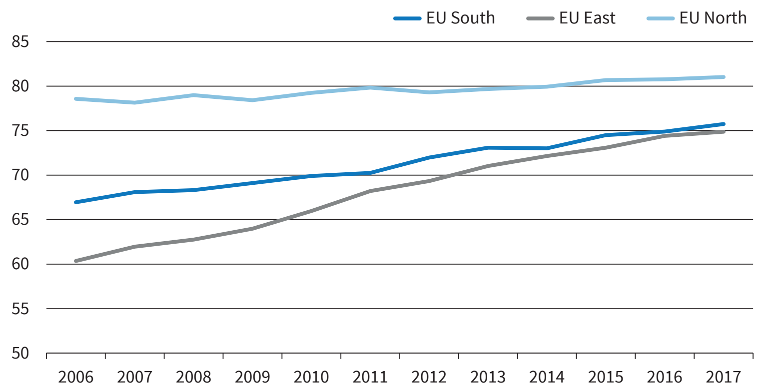
Economic Freedom Heritage Foundation Index



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.

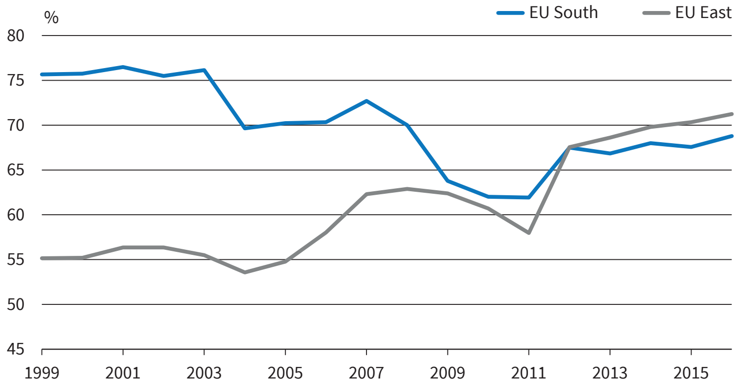
Figure 4.16 illustrates the development of institutional quality as measured by the Index of Economic Freedom provided by the Heritage Foundation. In the EU-28, this index has converged in the last two decades. Again, this process is mostly driven by the countries of Eastern Europe. If we exclude these 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.

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.

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.

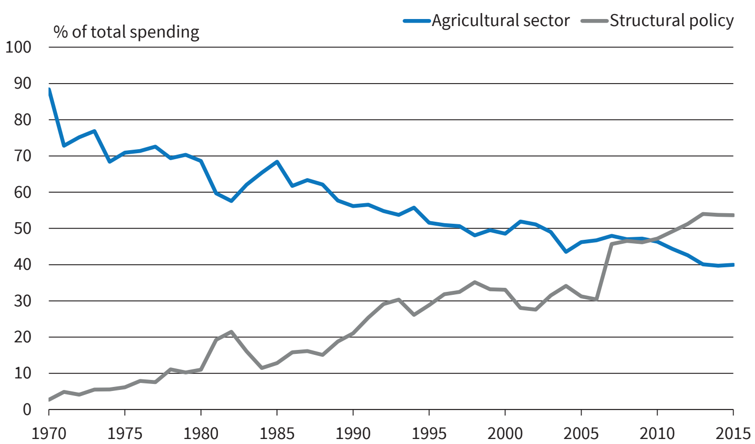
As far as institutional convergence is concerned, it is important to note that institutions are an important driver of economic development, but changes in the economic environment also affect institutional development. Bertola (2017a) shows that economic changes like the introduction of the euro, can cause institutions to diverge. The introduction of the euro triggered capital flows from the core of the eurozone to

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.

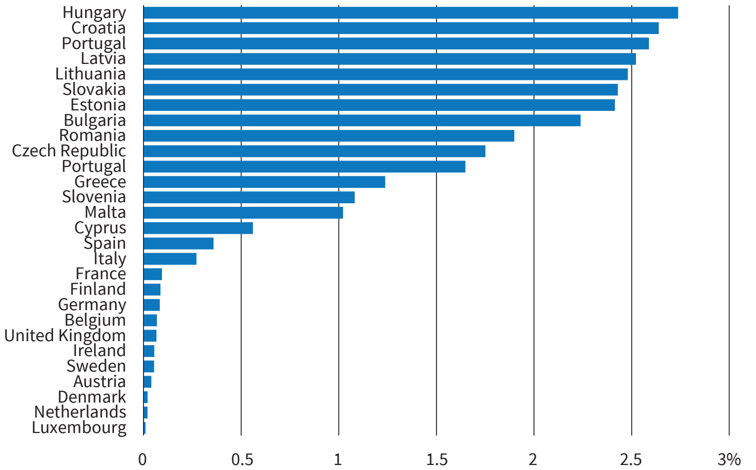
Union shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions" (European Union, 2012).

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

Figure 4.21 offers an overview of the net balances of the member states with respect to the EU budget.[14]

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.

4.6.1 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.

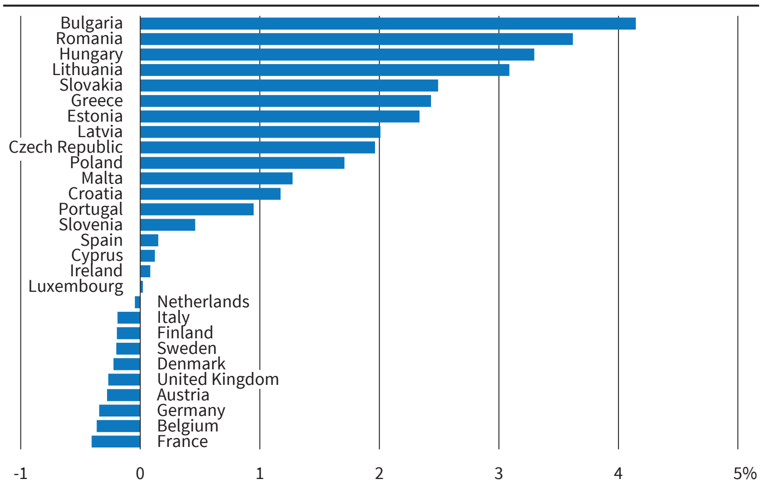
Figure 4.20 shows that agricultural subsidies as a share of overall spending accounted for almost 90% of the EU budget in the 1960s and has declined steadily ever since, reaching approximately 40% today. Spending on structural policy has increased over time and now accounts for over 50% of the budget.

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

EU Budget Net Balance

Percent of GNI



Source: European Commission. © CESifo

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.

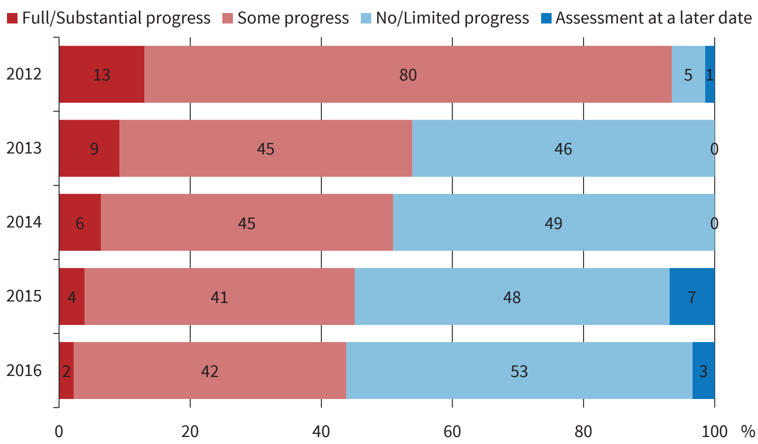
In a recent study, Breidenbach, Mitze, and Schmidt (2016) do not find any positive effects of EU regional policy transfers. They use various spatial econometric models to identify the effects of structural fund spending on regional economic growth, taking into account spill-overs to non-funded regions. 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.
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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 involvement, 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.

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