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Which Structural Reforms Does E(M)U Need to Function Properly?

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Abstract

Structural reform proposals have undergone significant change both as proposed by IMF and OECD as by the European Union. From a narrow flexibility-enhancing ('liberalising') focus complementing a strict budget consolidation course, they have evolved towards embracing institutional reforms and promoting of growth and productivity. Some of these reform proposals are motivated by increasing divergence between Member States since the financial crisis, others attempt to compensate for the fact that EMU did not and does not yet constitute an optimal currency area with all its institutions required. This paper analyses the various motivations and restrictions for structural reforms and proposes an even wider array of additional reforms, with the aim to enhance socio-economic-environmental sustainability and well-being in the European Union ('progressive' reforms).

› 'Progressive reforms' should establish equivalence between economic, social and environmental objectives.

› Excessive 'financialisation' of the economy should be reversed by promoting longer-term real investment decisions, by slowing financial trading decisions, by increasing capital requirements of financial institutions, by levying financial transactions taxes, etc.

› Productivity-oriented wage setting and working conditions procedures through collective bargaining covering a wide spectrum of the labour force should be promoted as enhancing workers' well-being and be balanced with flexibility requirements.

› Industrial policies aimed at enhancing the innovative capabilities of countries, with appropriate education, patent and innovation interventions need to gain wide-spread acceptance.

› The 'race to the bottom' with respect to corporate and personal income taxation, as well as generous tax-reducing policies need to be prevented.

› National and regional preferences with respect to social and cultural aspects need to be exempted from competition rules, as manifestations of social cohesion, environmental protection and identity-preserving heritage.

› In cases where cross-country spillovers matter, such 'progressive' structural policies should be set as general framework conditions by the European Union but be adjusted and implemented by the Member States.

Keywords: structural reform, economic growth, institutional reform, Economic and Monetary Union, European Union

JEL classification: E24, F45, O43

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INTRODUCTION[1]

Structural reform is one of the buzzwords of the EU policy jargon. Reforms that 'tackle obstacles to the fundamental drivers of growth' (European Commission, 2018a) figure importantly in the EU's regular country-specific recommendations presented to each EU country during the so-called European Semester. More tangibly, they form part of the strict conditionality of official financial assistance made available to stressed euro area countries monitored by European institutions and the IMF. The Commission's Roadmap for Completing Europe's Economic and Monetary Union holds that structural reforms strengthen the resilience of the euro area (European Commission, 2017a), a view shared e.g. in a recent joint French-German paper (Bénassy-Quéré et al., 2018). Already back in 1958, however, the Austrian economist Fritz Machlup (1958) denounced the pervasively arbitrary use of the terms 'structure' and 'structural change' as 'Weasel words'. The following outline will heed Machlup's criticism.

Typically, economic policy contrasts cyclical developments with structural ones. Structural policies target the fundamental supply side of an economy aiming to produce long-term effects.[2] In that sense, 'structure' comprises many elements of the fundamental policy framework of an economy, including the rule of law, the level of technological development and capabilities, factor endowments, sectoral composition, employment and wage bargaining institutions, competition policy framework, education, welfare state institutions or infrastructure. Depending on one's objectives, one can distinguish between flexibility-enhancing and well-being-enhancing ('progressive') reforms, although there might be substantial overlap between the two. While the first aim to deploy production factors more efficiently and boost economic potential and productivity, the latter foster inclusiveness and sustainability. Quite comprehensively, the recent European Commission's Structural Reform Support Programme (SRSP) lists 34 areas of potential intervention, grouped into five sectors: (1) governance and public administration, (2) tax revenue and public financial management, (3) growth and business environment, (4) labour market, health and social services, and (5) financial sector and access to finance.[3] Still, some 'progressive' areas may be underrepresented there, such as innovation policy, industrial policy, infrastructure or income and wealth distribution, as well as environmental objectives.

This Note proceeds as follows: After analysing the evolving changes in concepts of structural reforms, the reforms that are necessary for the functioning of the European Union (EU) and its Economic and Monetary Union (EMU) are investigated. This is followed by the proposal to complement traditional, mainly flexibility-enhancing reforms aimed at making prices and wages more reactive to shocks by

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1 This policy note is based on a recent paper by Bayer and Breitenfellner (2018).

2 These supply-side conditions interact with demand conditions to form the overall performance of an economy. In the 1950s, the IMF and the World Bank introduced the term 'structural adjustments' as preconditions for emergency loans, to denote measures like liberalising trade, balancing budgets (which rather belongs to the realm of macroeconomic policies), removing price controls, encouraging foreign direct investment (FDI) and fighting corruption.

3 See https://ec.europa.eu/info/sites/info/files/srsp-policy-areas_en_0.pdf.

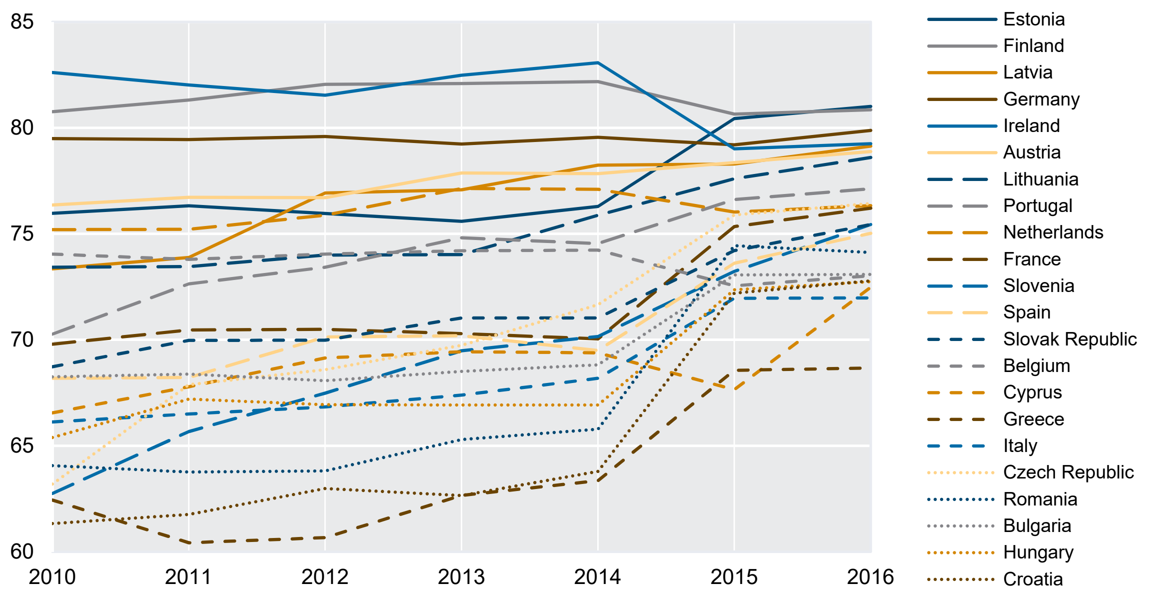
reforms that enhance growth and well-being more directly. Here, industrial policy plays a specific role. Finally, the appropriate locus of structural reforms is discussed, namely either the EU or the national level.

CHANGING CONCEPTS OF STRUCTURAL REFORMS

The meaning of structural reforms has been subject to ever-changing interpretations. Prior to the global financial crisis that started in 2008, the term structural reform was mainly used to describe free market policies, such as cost cutting, deregulation, liberalisation and privatisation. It has been associated in particular with supply-side strategies to overcome stagflation and challenged the Keynesian consensus of the post-war period which emphasised demand-side management (Klein, 2007). OECD and IMF were the major international institutions propagating and imposing such policies (see e.g. Lall, 1995). Applied to emerging and developing economies, these policies constituted the Washington Consensus that guided the Structural Adjustment Programmes incorporating export-led development strategies (Rodrik, 2016).

Figure 1 / Doing Business indicator - distance to frontier, selected euro area and EU countries (2010-2016

Distance to frontier score*



* The 'distance to frontier' score measures the distance of each economy to the best performance observed on each of the regulatory environment indicators across all economies in the Doing Business sample on a scale from 0 (lowest performance) to 100 (the frontier).
Source: World Bank.

Descriptive evidence shows that some 'structural' convergence (European Commission, 2018b) within the EU and the euro area is taking place[4], even though per capita income levels are diverging. Many

[4] Here 'structural convergence' means greater similarity with respect to regulatory and institutional conditions; this may result in more cyclical alignment, but not necessarily in a more similar composition of output, depending on agglomeration effects and direct investment flows.

EU Member States, particularly those heavily affected by the financial crisis and the subsequent sovereign debt crisis, have registered an improvement in structural indicators. This is reflected by indicators developed by the OECD, e.g. the Product Market Regulation (PMR) index and Employment Protection Legislation (EPL) index (Fischer and Stiglbauer, 2018). Indices developed by the European Commission (2018b) on labour market reforms and by the World Bank on the ease of Doing Business (Figure 1) give a similar account of reform activities. Analysis built on these data suggests that both the euro area and the EU as a whole have achieved progress with business regulation and institutional quality over recent years, even though substantial differences remain (Canton and Petrucci, 2017).

There is good reason to assume that the structural convergence observed among the euro area countries will lead to business cycle convergence, which in turn facilitates conducting a common monetary policy in the euro area (Lukmanova and Tondl, 2016). Short-term economic activity in EU countries has, indeed, become increasingly synchronised, particularly among euro area countries (Campos et al., 2017). In terms of per capita income levels, however, the post-crisis period has shown real divergence among the 'old' EU Member States (EU-15), most of which are part of the euro area, despite substantial EU transfers via regional and structural funds (Janekalne, 2016). Meanwhile, the 'new' Member States (EU-12) continued to successfully converge to the EU-15 group – with generally higher growth in per capita income –, albeit at a slower pace than before the global financial crisis (Gligorov et al., 2017).

The financial crisis brought about a major shift in the policy prescriptions of international institutions. Most prominently, the OECD – a key advocate of structural reforms, and motivated by an initiative called New Approaches to Economic Challenges (NAEC) – started to zero in on inequality and well-being (OECD, 2015). By going beyond the narrow concept of economic growth, it encompasses material conditions, quality of life and sustainability. The IMF has recently highlighted the importance of supportive macroeconomic conditions and policies, the careful prioritisation and sequencing of reforms, targeting inclusive growth and even accepting a reversal of market-oriented pension system reforms or compromising on capital market liberalisation. The European Commission (2017b), for its part, has elevated equality, fairness and inclusiveness considerations to the same level as efficiency and acknowledged the need for supporting macro policies.

In the policy-oriented debate on macro-structural interdependence, the focus has shifted to an explicit endorsement of a more comprehensive approach where monetary and fiscal policies accommodate structural reforms. Before the global financial crisis, van Riet (2006) stressed that structural reforms render the conduct of monetary policy more effective and efficient by dampening the medium-term outlook for inflation and smoothing the monetary transmission mechanism, respectively. In turn, stability-oriented monetary policy generates price transparency – otherwise blurred by inflation – revealing the need for as well as the welfare-enhancing benefits of pro-competitive reforms. In the course of the crisis, however, the task of monetary policy was extended to 'support economic activity', and policy-makers are urged to raise the effectiveness of monetary accommodation by swiftly implementing structural reforms (Draghi, 2017). Similarly, before the crisis, fiscal policy-makers were focused on stabilising public finances. This was seen both as a precondition for successful growth-enhancing reforms and as a financial stabilisation instrument in itself. According to the OECD (2006), for instance, limited scope for fiscal expansion would leave only structural reforms to exert beneficial effects on employment and potential output.

As the crisis progressed through a phase of painful fiscal consolidation, emphasis shifted to an explicitly supportive role of fiscal expansion to help revive the economy, still remaining in compliance with the EU's fiscal rules, however (Draghi, 2017).

On balance, the economic policy literature recognises the need for carefully designed, packaged and sequenced structural reforms coupled with complementary macroeconomic policies that mitigate transitory adjustment costs (IMF, 2016). However, analysis of the political economy of structural reforms reveals that governments tend to carry out reforms in dire economic times, exactly when fiscal space is lacking (Masuch et al., 2018). Furthermore, evidence shows that governments frequently restrict themselves to reforms for which they have political and public backing.

STRUCTURAL REFORM AND E(M)U REFORM

Three views on the role of structural reforms in the functioning of E(M)U may be distinguished.[5] The first, here called 'ordoliberal', since it is widely held by orthodox German academics (see survey of De Ville and Berckvens, 2015), argues that every country needs to 'do its homework' in following EU principles and rules. A second view implies a complementary policy role for EU and national levels; since it is held by EU institutions, it might be called 'Brussels-Frankfurt consensus view'. According to this view, E(M)U deepening is useful and feasible only when the country-specific homework is completed (Cœuré, 2016). Many (Anglo-Saxon) economists hold a third view, claiming that EMU institutional reform itself constitutes the most important structural reform; it is the precondition for national reforms to succeed (Baldwin and Giavazzi, 2016). In line with this 'integral' view, a successful currency union requires a unified state or state-like political framework. The Northern, core and Baltic Member States prioritise structural reforms and fiscal responsibility at the national level (Government of Sweden, 2018). By contrast, the French position leans towards greater European solidarity rather than more responsibility – a view essentially shared by most southern Member States (Macron, 2017). Different interests, however, do not rule out compromises, as exemplified by the French-German Roadmap for the euro area, which – while not explicitly mentioning structural reforms – stresses the need for economic coordination and integration in a currency union (German Federal Government, 2018).

The theoretical discussion of the role of structural reforms in contributing to resilience in a currency union harks back to the theory of the optimal currency area (OCA) pioneered by Mundell in the 1960s. According to this approach, in the case of an asymmetric shock, flexible costs and prices would replace the no longer available exchange rate mechanism. Since the euro area did neither at its conception nor does now constitute an optimal currency area, structural reforms (in the narrow, 'flexibility-enhancing' sense) would be necessary to provide the flexibility needed for adjustments within the area.

The important Five Presidents' Report on completing EMU (Juncker et al., 2015) states that 'the ultimate aim is to achieve similarly resilient economic structures throughout the euro area' (p. 7) and 'convergence towards similarly resilient national economic structures would be a condition to access (...)' proposed fiscal capacities for the euro area (p. 21). Providing further specifications, the European Commission's Roadmap (2017a) holds that reform-related funds should be included in the post-2021 Multiannual Financial Framework (i.e. the EU budget). Concretely, the European Commission proposed

5 In line with Article 3 of the Treaty of Lisbon, the ultimate aim of both EMU and the EU as a whole is to enhance the well-being of the EU's citizens.

a new Reform Support Programme with an overall budget of EUR 25 billion (with a duration of seven years). This programme is intended to provide financial and technical support for reforms in Member States identified in the context of the European Semester, or in preparation for euro area membership (European Commission, 2018c).[6]

The question arises where the optimal locus of structural reforms lies, at the EU level or that of the Member States. In this Note it is maintained that EU involvement in national structural reforms is defensible if (1) excessive external or internal imbalances – mainly in current account and fiscal positions – create negative spillovers for other Member States, (2) reforms create positive externalities for productivity growth but possibly also negative ones for the competitiveness of other Member States, (3) they improve the functioning of the Single Market, (4) they prevent regulatory arbitrage ('race to the bottom'), and (5) they promote risk sharing (solidarity).

Proposals for reordering EU economic policies must take into consideration that many policy instruments are already in place, although they may deliver inadequate results (see e.g. Müller et al., 2015).[7] The European Semester as the most important policy tool still prioritises budget consolidation over structural reforms (by providing sanctions). But the Commission recognises in the way it applies the Stability and Growth Pact ('structural reform clause') that the short-term costs of structural reforms may be compensated. More recently, proposals have been made to promote reforms through EU budget conditionality, i.e. to tie flows of structural and cohesion funds to respecting the rule of law (Halmai, 2018).

WHY AND WHERE ARE ADDITIONAL REFORMS NEEDED?

Deficiencies of the current reform agenda

In spite of the recent, long-awaited cyclical recovery of the euro area, a number of not yet completed or not envisaged reform areas at the level of E(M)U have become pressing. The present policy mix of structural and macroeconomic policies is defective. One can infer this from the populist and anti-integrationist reaction to economic developments, especially with respect to long-term wage and employment developments, inequality and poverty levels, a reduction of welfare state provisions, and climate-change-relevant events. This (perceived or real) failure of EU and national politics results in increasing frustration of the EU populace and a concomitant withdrawal of political support from 'mainstream' political parties. That, in turn, endangers social cohesion. Much of the blame for this is directed towards real or perceived malfunctioning of the European Union. Strikingly, there is a productivity slowdown in most countries, despite all the structural reform efforts in the past; there is unsatisfactory progress in environmental/climate change matters; there is a lack of innovation directed towards social/health/environmental areas; there is opposition with precarious labour market conditions; there is little progress in the fight against harmful tax competition, tax avoidance and tax fraud; and there

[6] Additionally, a European Investment Stabilisation Function would complement efforts to absorb large asymmetric macroeconomic shocks in the euro area and its (potential) members, guaranteeing back-to-back loans of up to EUR 30 billion. Such loans would be available to Member States with 'sound fiscal and macroeconomic policies,' which is why no explicit reference is made to any structural conditionality.

[7] One could go even further and argue that business-friendly reforms over the last decades led to declining labour shares and rising returns on investment in many OECD countries – without triggering higher investment (Janssen, 2018).

is a rent-seeking dominance of the financial sector over the 'real' economy and the society as a whole. These multiple deficiencies threaten to spark another, and maybe deeper, crisis than that of ten years ago. Some of these negative effects may have been more severe in Member States classed as 'structural laggards', but many of them occur in all Member States.[8]

Future-oriented, 'progressive' reforms

This Note suggests to widen the area of structural reform proposals by recognising that income convergence has stalled, public dissatisfaction with EU economic policy has increased, and the integrationist zeal of before the crisis has come to a halt. Somewhat reassuringly, the current Commission under President Juncker has acknowledged the centrifugal threat stemming from income divergence within the euro area, and consequently changed the structural reform agenda. One result was the Proclamation on the Pillar of Social Rights (Council of the European Union, 2017) which, albeit not binding, has considerably influenced the country-specific recommendations in the latest European Semester. Moreover, the causal relationship between macroeconomic imbalances and structural reforms is unclear (Gros, 2016). For instance, is Germany's current account surplus the result of its restrained budget and wage policies, or of a lack of German demand? The European Commission (2018d, p. 16) recommends both 'fiscal and structural policies to support potential growth and domestic demand'. How contradictory this recommendation is becomes visible when we compare the emphasis to 'boost competition in the service sector' (ibid., p. 12) with the statement that 'service sector wages are the lowest in the EU relative to manufacturing wages' (ibid., p. 28). This example shows the need for further corrections of the EU's policy recommendations which during the euro area crisis have leaned nearly exclusively towards budget consolidation and 'internal devaluation' policies, e.g. wage restraint.

The emphasis should shift to 'progressive' reforms including revenue-securing tax coordination, productivity-oriented collective bargaining, skills upgrading, industrial policy promoting research and innovation, effective anti-monopoly policy as well as strategies fostering decarbonisation, inclusiveness and limiting financialisation.

Additionally, one could ask what should be the 'optimal level of rigidity' of a market economy in E(M)U. The optimality of minimal or even zero rigidity implied by EU policy recommendations would require structural convergence towards a 'one-size-fits-all' model. Although the policy recommendations in the European Semester are indeed country specific, the EU has advised completely diverse countries to carry out the same type of reforms, e.g. in the service sector, in order to solve very different problems of either supply or demand. More essentially, in a managed market economy some 'rigidities' are justifiable on economic grounds – creating a level playing field for countries starting from different conditions – and by non-economic factors: cultural, social, historical, territorial identity traits (e.g. traditions and citizens' preferences) which safeguard the public's support for policy measures[9]. In other words, some degree of 'market imperfection' might be well warranted by political economy considerations.

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8 See the results of the March 2018 Eurobarometer Survey in http://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Survey/getSurveyDetail/instruments/STANDARD/surveyKy/2180.

9 See e.g. the resistance in some countries about exposing water supply to international competition, or to the privatisation of social protection systems.

Furthermore, there is the principle of subsidiarity in EU law to be considered, according to which political issues should be dealt with at the most local level consistent with their resolution: What is the optimal division of labour between E(M)U institutions and Member States with regard to national reforms? One approach could be that the EU level should be responsible for diagnostics, macro objectives and safeguarding the functioning of EMU, while the Member States should be responsible for implementing their own path towards these objectives. Nevertheless, subsidiarity may even imply centralisation of critical tasks and sharing sovereignty beyond loose and slow policy coordination – a concept that is, in fact, reflected in the institutional reform package envisaged in the Five Presidents' Report to accomplish a genuine EMU.

Some 'progressive' reform areas

The following paragraphs dig deeper into some specific areas of EU (structural) economic policy which have the potential to enhance the well-being of EU inhabitants in terms of sustainable economic, social and environmental sustainability.[10]

Finance: The assessment of economic conditions, driving most of economic policy, at a global and the EU level, is that of the major financial institutions, including rating agencies. The views of 'investors' determine recommendations aiming at government policy, labour market conditions as well as investment and profit opportunities. There, workers, the environment or the social sector are predominantly seen as cost factors and not as productive assets, let alone constituents of well-being. The role of the financial sector itself, however, is sidelined, despite the devastating impact the financial crisis had on the majority of economies. Indeed, it is plausible to argue that in many economies the sheer size of finance has exceeded its level of optimality. *Financialisation* may have happened at the risk and cost of productive economic activities rather than in favour of the real economy (Mazzucato, 2018, pp. 161ff.). If this is true, the influence of the financial institutions (both the official and the *shadow* institutions) should be reduced, for instance, by means of much higher equity requirements (up to 30% proposed by Admati and Hellwig, 2013) or the introduction of a meaningful financial transactions tax. This clearly would need to be initiated and implemented at the EU level, preferably in cooperation with other countries.

Labour market: If the IMF is right in its recent assessment (IMF, 2016) that the reduction of unionisation has contributed to the rise of inequality over the last decades, it is important to restore the bargaining power of labour organisations vis-à-vis business in order to reverse the universal trend of a falling labour share. In this vein the EU should propose that collective bargaining institutions in Member States should be strengthened, with a view to implementing productivity-related wage increases reversing the long-term stagnation of earnings as well as to regulating working conditions including working hours. In addition, the EU should promote and facilitate the training of a skilled workforce, for instance, through a modernised dual vocational training system (following the Central European apprenticeship model) or through technology-oriented secondary education. Implementation at the national level would be able to take account of country-specific preferences and conditions.

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[10] See, in the same vein, the 'Welfare, Wealth and Work for Europe' project, completed in 2017, http://www.foreurope.eu/fileadmin/project/WWWforEurope_Summary_long.pdf.

Competition: Amid the development of the Single Market during past decades some major sectors of the economy became monopolised. This is especially true of the internet platforms and electronic industries, which today dominate the league tables of the highest valued companies in the world. The most recent highest-ever record-level merger and acquisition (M&A) activities on a global scale also attest to this. Thus, it is high time to re-think competition policy in this new global environment, not necessarily leading to the free-market ideal of small, atomised enterprises, but taking into account the new scale and size conditions of participants in the global economy. A renewed competition policy must also take into account the democracy-threatening influence on citizens' lives of the large internet platform firms.[11] Another important aspect is security-induced protection of national (technological) infrastructure enterprises from foreign takeovers without reverting to populist protectionism[12].

Social and environmental impact of economic policy-making: The concerns of the social sector and of the environment need to be given equal priority in decision-making as those of the business/economic sector. This must also pertain to structural reform. The trade-offs and synergies between the social, economic and environmental policy fields need to be taken into account, depending on the priorities of Member States' populations. In its assessments of Member States' policies, the European Commission should make sure that the economic objectives are widened to encompass social and environmental targets. Especially with respect to the environment and in particular climate change, Member States' own policy directions may not take adequate account of spillover effects.

Promotion of sustainable innovation: EU 'industrial policy' perception has changed significantly (see Box 1 below). More recently, emphasis has been given to enhancing innovation at all levels of society and the economy (Mazzucato, 2018). Most frequently, this is argued with the perceived productivity slowdown observable in all industrial countries. Hover, more innovative focus should be channelled towards the ageing of European populations, their health status, social cohesion, education as well as innovative ways to consume and produce in an environmentally sustainable manner. Areas affected include research and development, investment (e.g. via the European Fund for Strategic Investment) as well as instruments to protect intellectual property (patent regulations).

Taxes: EMU Member States attempt to attract foreign and domestic investment by means of lowering their tax rates. A 'race to the bottom' of corporate income tax rates is taking place globally and in the EU. A special feature are special tax allowances for intellectual property ('patent boxes') which also lead to fictitious transfers of registered business units without real activity following. This counter-productive race to the bottom needs to be stopped. One direction which the EU has been pushing for a long time is the harmonisation of the definition of corporate income tax (CIT) bases, enabling to compare effective tax rates. A complementary effort is to legislate minimum tax rates or tax bands. Given the large divergence of CIT rates (they differ between 12.5% and 35%), taking the present structure as given does not go very far. Corporate taxes should contribute their fair share to total tax revenue. Movement in that direction might also go a long way to narrow the large after-tax income dispersion within Member States.[13]

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[11] See 'The New Titans and how to tame them', *The Economist*, 20 Jan. 2018.

[12] See the recent efforts by the German government and the European Commission to find rules protecting high-tech know-how from Chinese takeovers.

[13] This discussion goes beyond the present purpose of this Note. In order to overhaul tax structures in EU countries, also the schedules of personal income taxes should be considered as well as the desired distribution of tax revenues between income taxes (business, capital and personal), social security contributions and value-added taxes.

Together with an overhaul of CIT, efforts must be strengthened to combat tax avoidance and tax fraud, within and beyond the European Union. This should also include efforts to outlaw specifically designed complex organisational and tax structures with the purpose to minimise tax obligations. A good starting point is the initiative of the OECD to tackle base erosion and profit shifting (BEPS). Here over 100 countries and jurisdictions are collaborating to implement measures against tax avoidance strategies that exploit gaps and mismatches in tax rules to shift profits artificially to low- or no-tax locations.

Industrial policy in the EU

In this Note, industrial policy (IP) is regarded as a special case of structural policies; it means government interventions targeted at the industrial sector in the widest sense of the word, also including a number of utilities (network services), infrastructure and business services related to manufacturing operations.

The free market paradigm taking global command in the 1980s shunned distortive government intervention into the economy, the so-called 'picking the winner' strategy, but stressed the importance of 'structural reform' of framework conditions for the growth prospects of the economy. Direct sector intervention was tabooed. Only at the beginning of the 1990s did the recognition take hold that developed economies could not just rely on the ever-increasing services sector as a source of (income) growth. It took the financial and economic crisis of 2008 ff. to show that countries with a larger manufacturing sector fared better. This led to a more positive attitude towards industrial policy, which now also included digitalisation, innovation, R&D, etc. It has been recognised that there is a strong connection between macroeconomic policy and industrial policy. EU policy before the crisis, relying mainly on monetary and fiscal policies, had reached its self-imposed limits: public budgets were constrained by the ramifications of the Stability and Growth Pact, monetary policy has exhausted its instruments after quantitative easing. Thus, following Mazzucato (2013, 2018), a broader role for public intervention needs to be acknowledged by looking at the empirical evidence that in the US in most innovative ventures government had played an important role. In this vein, it falls to government to create and structure markets towards innovative, inclusive and sustainable growth. This would attribute to government a much wider role than 'just' formulating framework conditions for the private sector to thrive. The more recent EU industrial policy communications seem to (silently) tiptoe towards such an approach. However, EU industrial policy is not leading, but rather (reluctantly) following the challenges of global developments.14 A more pro-active role, accepting industrial policy as a legitimate national objective at the EU level, while leaving its concrete formulation and implementation to the national level, would be beneficial.

[14] The recent effort of the Bulgarian EU Presidency during the Informal Industry Council in Sofia on 1 Feb. 2018, with the purpose to examine the key challenges towards 'an ambitious industrial strategy geared towards the future', points in this direction. This council set up two working groups, one to establish Europe's competitive advantage in industry (infrastructure, education, technological know-how, etc.), the second to work out the consequences of digitalisation on skills development, employment levels and distribution of income (Agence Europe, 31.1.2018, https://agenceurope.eu/fr/bulletin/article/11950/2).

BOX 1 / MODERNISING INDUSTRIAL POLICY IN THE EU

Until the 1990s, the EU promoted the development and the competitiveness of sectors by means of quasi-protectionist measures. The customs union, the single market and structural funds are instruments of 'healing' backwardness and fostering competitiveness. The term 'industrial policy' never appears until the Maastricht Treaty of 1992 which contains wider competences for industrial policy: Art 3 TEU[15] mentions the 'strengthening of competitiveness of EU industry' as one of the objectives to be pursued by the European Union. As a result, a flurry of reports and papers ensued: The White Paper 'Growth, Competitiveness, Employment' in 1993; the Bangemann Report 'Europe and the Global Information Society' of 1994; the Lisbon Strategy of 2000 with its objective to make Europe 'the most competitive and dynamic knowledge-based economy in the world (...) by 2010'; followed in 2010 by the Europe 2020 Strategy with its aim of 'smart, sustainable, inclusive growth'.

› Art 173 TFEU in 2009 circumscribes objectives, tasks and instruments of IP: flexibility, adjustment to external structural change, small and medium-sized enterprises, enterprise cooperation, innovation, R&D. The perception was that EU industry had fallen behind due to globalisation and a lack of competitiveness. As a result, more pro-active, preventive instruments are proposed, mainly geared towards more innovative policy.
› In 2010, the EC issued the communication 'Industrial Policy for the Globalisation Era' that contained four important initiatives.[16]
› In 2011, 'Industrial Policy: Strengthening of Competitiveness' (COM(2011)642) followed, proposing to support structural change in the economy, strengthen the innovative potential of industry, sustainability and resource efficiency, improve the framework conditions for enterprise in the single market, and promote SMEs.
› In 2012, 'A Stronger European Industry for Growth and Economic Recovery' (COM(2012)582) proposed the promotion of investment in environment-oriented innovation, in 6 sectors: modern production technologies for environmental production; key technologies; ecologically-based production; sustainable industrial and construction policies; raw materials; environment-friendly vehicles; intelligent networks.
› The communication of 2014 'For a European Industrial Renaissance' (COM(2014)14) proposed to increase the share of manufacturing in EU GDP from 16% to 20% by means of better internal market policies, rejuvenation of infrastructure, more investment, better cooperation for efficient administration, commerce and R&D.[17]

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15 TEU: Treaty of the European Union, signed in Maastricht 1992; TFEU: Treaty on the Functioning of the European Union, formerly known as the EC Treaty, the Treaty of Rome or the Treaty establishing the European Community. The TFEU was given its name and amended by the Lisbon Treaty. The TFEU sets out organisational and functional details of the European Union.

16 'Innovation Union' (COM(2010)546); 'A Digital Agenda for Europe' (COM(2010)245; 'An Integrated Industrial Policy for the Globalisation Era' (COM(2010)614); and 'New Competences for New Employment' (COM(2008)868).

17 The objective to raise manufacturing's share to 20% has been ridiculed, since productivity increases in manufacturing are generally faster than in the rest of the economy; it would thus be near impossible, if market forces drove the relative price of manufacturing down, to increase its share (Peneder, 2014).

CONCLUDING REMARKS

There is consensus in the literature that macroeconomic policy effectiveness interacts with structural conditions and vice versa. The latter are vaguely defined as the fundamental institutions and regulations of an economy and society, having evolved over time. There is also widespread agreement that structural reforms, while on balance positive for medium-term growth and employment, may cause short-term costs to society, the economy and the environment. Public acceptance of reforms will depend on how governments manage these costs and their distribution. Conventional economic policy advice mostly centres on 'defensive', flexibility-enhancing structural reforms: Labour market and product market rigidities are considered to be mainly cost factors that influence competitiveness negatively (and hence lead to a policy focus on internal devaluation18). In contrast, a number of 'progressive' structural reforms, which enable the economy to progress towards the technological frontier and enhance economic, social and environmental conditions, still attract less attention. There are, however, signs of a gradual shift in the European Semester procedure in this direction.

National preferences (e.g. for more ecology-oriented production and consumption or for publicly provided health care) will determine the 'optimal' structural conditions for each country or each region. Not all such preferences are 'rigidities' to be reformed away, but rather help create markets and/or safeguard political and social cohesion. Thus, there is no single optimal policy framework across all Member States and societies, but a variety of appropriate sets of policies based on historical, social and cultural diversities. Whether structural reforms may contribute to sustainable and inclusive growth depends on their actual design, sequencing and timing. While international institutions tend to recommend comprehensive packages that combine, for instance, carefully sequenced product and labour market reforms with macroeconomic incentives, other policy advisors suggest that priority should be given to tackling the most binding constraints to prosperity (Rodrik, 2016). At the same time, several institutional conditions must exist for market economies to flourish: the rule of law, property rights, effective tax collection and budgeting, regulation of industries, level playing field competition, adequate education, social security, regard for the environment and social cohesion, and freedom of firms entering and leaving the product market.

In line with the subsidiarity principle, it can be concluded that most of these policies should be implemented at the Member State level, not least to meet diverse national preferences. However, where (negative and positive) spillovers exist, and where the smooth functioning of the Single Market and of Europe's Monetary Union is at stake, the initiative for devising appropriate structural reforms should come from the EU and be supported by local consensus building.

[18] With regard to the controversial debate about internal devaluation and its extent and conditions, e.g. Wyplosz and Sgherri (2016) show that internal devaluation strategies might have failed in the past, for instance, due to underestimated fiscal and external multipliers.

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