Executive summary

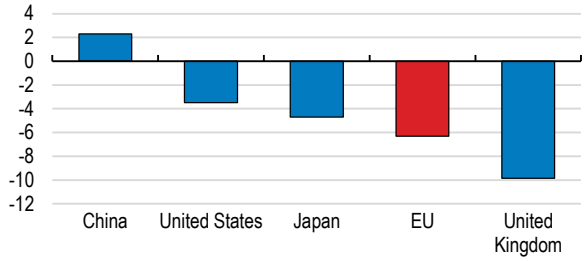
An unprecedented recession calls for the pursuit of bold policy responses

European policies reacted forcefully to the crisis, but risks remain high.

The COVID-19 pandemic plunged the EU into its worst-ever recession (Figure 1), adding economic hardship to a high death toll. Strict containment measures closed large swathes of economic activity and depressed confidence in the face of elevated uncertainty. Except for Ireland, GDP fell in 2020 in all EU countries, varying from -1 to -11%. The largest drops affected countries forced into the strictest lockdowns or whose economic structure was also most sensitive to them.

Figure 1. The output loss in 2020 was very large

Y-o-y % change



Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database).

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Forceful policy reaction helped mitigate the negative impact of the crisis. The ECB expanded significantly its support to the euro area economy, which also benefitted other EU countries through trade linkages and by avoiding financial instability. Unlike in the global financial crisis, national fiscal support was massive, allowed by the activation of the general escape clause of the Stability and Growth Pact. In addition, the EU beefed up existing tools (like the ESM) and adopted two new temporary common fiscal instruments funded by joint EU borrowing: one to support employment through loans to member states (SURE) and one to finance national recovery plans through grants and loans (Next Generation EU). In both cases, support has been mainly allocated to the most affected countries, displaying solidarity and enlarging fiscal space. Swift and effective implementation of recovery plans is the key challenge to turn this opportunity into success.

Vaccination took time to gather speed, but is now giving hope of a more robust recovery. As confinement measures are gradually lifted, growth is projected to rebound strongly in the course of this year, partly due to pent-up demand, and to remain robust in 2022 (Table 1). Still high household savings weigh on growth prospects. Low vaccine effectiveness in case of virus variants or insufficient coverage of the population are downside risks.

Table 1. Robust growth is expected

	2019	2020	2021	2022
Gross domestic product	1.6	-6.3	4.2	4.4
Unemployment rate (%)	6.9	7.3	7.6	7.2
Fiscal balance (% of GDP)	-0.6	-7.1	-7.1	-3.7
Public debt (Maastricht, % of GDP)	80.6	94.3	97.0	95.8

Source: OECD (2021), OECD Economic Outlook: Statistics and Projections (database) and updates.

A weak recovery could threaten the cohesion of the EU

A muted recovery would increase inequalities, fueling discontent and hurting trust in the EU.

The crisis could leave scars and reopen old wounds. The disproportionate impact of the crisis on service sectors with abundant low-skilled jobs may increase inequality and poverty. Soaring non-performing loans could threaten financial stability and slow down the exit of inefficient firms, hampering resource reallocation and growth.

The pandemic's asymmetric territorial impact could compound regional divergence across the EU, such as widening gaps between large cities and rural areas. Some regions have been more affected by the pandemic than others. For example, Southern EU economies, partly due to their higher reliance on tourism and on very small firms, have recorded the largest GDP falls in 2020.

Next Generation EU and the 2021-27 EU budget have the potential to turn digitalisation, the green transition and globalisation into opportunities to increase potential growth and address regional inequalities. If unaddressed by policy action, digitalisation could worsen regional divergence, with further spatial concentration of growth and job creation. Likewise, pursuing carbon neutrality would disproportionately hurt regions heavily dependent on coal extraction and carbon-

intensive industries. However, place-based policies, enhanced competition policy and EU support can help regions upgrade their productive specialisation.

Boosting an inclusive recovery through investment and innovation

The EU can better coordinate green investment and innovation and adjust its competition policy to new challenges.

Increasing investment is key to accelerate the recovery. Long subdued, higher public infrastructure investment can crowd-in private investment. Electricity grids, including cross-border interconnections, are a case in point. Moving to low carbon emissions in transport also calls for coordinated investment, such as an EU-wide interoperable recharging network for electric cars.

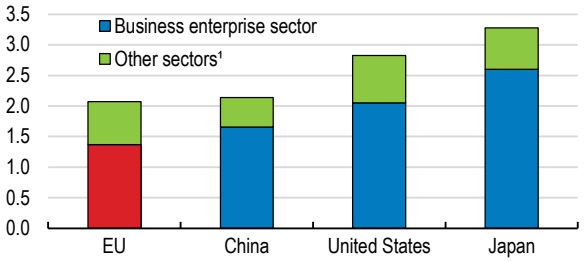
High-quality and affordable broadband connectivity is essential for innovation. It also increases resilience to public health emergencies and helps spread the productivity spillovers from large cities, namely by enabling teleworking. Remaining connectivity gaps in rural and remote areas thus need to be closed, in line with the objectives of the EU's Digital Strategy. As in energy, licensing procedures should be simplified to ease network deployment.

The EU should reverse its decline in innovation (Figure 2) and enhance synergies between national efforts. To exploit the innovation potential of the green and digital transitions, it is key to pursue initiatives to combine public and private funding in cross-country collaborative R&D and industrial innovation projects. Spillovers should be enhanced by promoting participation by firms from less prosperous countries and regions.

Innovation is also a priority to enable convergence of poorer regions, where R&D investment tends to be very low. Stronger investment, which cohesion policy should support, will foster innovation diffusion among local firms. Productivity in lagging regions would also benefit from enhanced agglomeration economies. These can be fostered by public investment to reduce travel time to large cities and closer integration of regional cities with their surrounding territories.

Figure 2. Investment in R&D is low

As a percentage of GDP, 2018



Note: 1. Other sectors include R&D performed by government, higher education institutions and the private non-profit sector.
Source: OECD (2020), OECD Main Science and Technology Indicators - MSTI (database).

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Adjusting competition policy in view of technological and evolving globalisation challenges has been long due. Updating the competition tools may be needed, in tandem with regulation of large digital platforms, to tackle positions of entrenched dominance in digitalised markets, due notably to strong network effects, consumer lock-in or lack of access to data. In addition, there is a need to better avoid that dominant incumbents buy nascent firms to pre-empt future competition or thwart the development of new products, and to tackle distortive subsidies granted by non-EU governments.

Enhancing EU budget support to regional upgrading and convergence

The use of EU funding should be made more efficient to support regional convergence.

Efficient strategies for regional development require integrated use of EU funding and careful project selection. Instead of the first-come first-served approach sometimes adopted, selection procedures should compare applications on the basis of their contribution to regional development objectives. There is also a need for better coordination of rural development policy and cohesion policy in regions eligible for sizeable support from both.

Public procurement, which is central to cohesion policy and Next Generation EU spending, is often not competitive enough. Single bidding is common, and contracts tend to be awarded to suppliers of the same country, and

even region, of the buyer. This can favour inefficient local suppliers, which harms regional development. Greater centralisation of procurement, professionalisation of procurement officials and transparency of procedures would help address these problems. Enhanced data collection requirements on public procurement by cohesion policy are thus welcome.

The deployment of EU funds, not least from Next Generation EU and cohesion policy, must not be marred by corruption and fraud. More effective investigations by EU bodies require stronger cooperation from member states, through timely transposition of relevant directives, operational assistance and judicial follow-up. Greater use of common risk-scoring tools would enhance fraud prevention and detection.

Accelerating climate change policies and a more circular economy

Next Generation EU can help reinforce European leadership in greening the economy.

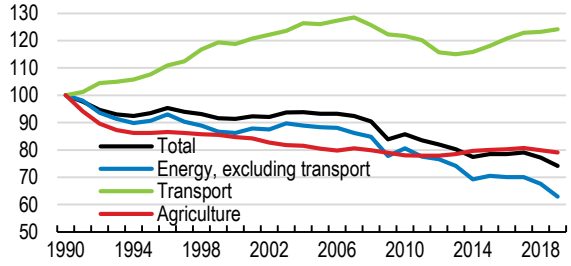
Reducing EU net emissions of greenhouse gases to zero by 2050 requires significant acceleration in emission abatement (Figure 3). Reaching net zero implies electrifying most energy end use, generating most electricity from renewables, developing low-carbon fuels for sectors hard to electrify as well as carbon capture and storage, and increasing energy efficiency.

Higher carbon pricing, stronger regulatory standards and more innovation are key to achieve climate neutrality. Bringing transport and buildings into an Emissions Trading System (ETS), as recently proposed by the European Commission, could spur emission abatement, favouring take-up of electric cars and incentives for renovation. In both sectors, more demanding standards for energy efficiency are also essential. Accompanying targeted support to poorer households would be required. Innovation in batteries and clean hydrogen will speed up the reduction in emissions.

Steering finance towards low-carbon investments requires better assessment and disclosure of climate-related risks. These follow from both extreme weather events and mitigation policies, which require early writing off of high-carbon assets. Though improving, disclosures by banks and large companies are still at an early stage, which calls for more demanding standards.

Figure 3. Emission abatement needs to accelerate, especially in transport

Emissions of greenhouse gases, Index 1990 = 100



Note: Excluding land-use, land-use change and forestry (LULUCF).
Source: Eurostat (2020), "Greenhouse gas emissions by source sector", Eurostat Database; European Environment Agency.

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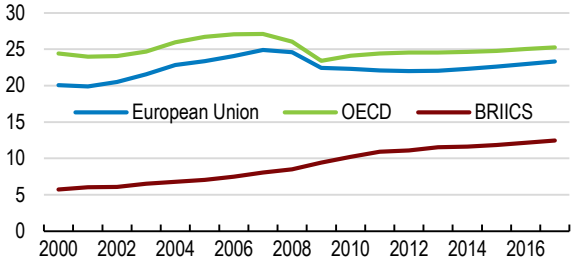
Extraction and processing of raw materials continues to increase (Figure 4), causing carbon emissions, pollution and biodiversity loss. To reduce materials use, circular economy policies encourage reuse, recycling and shared use.

Figure 4. The use of raw materials is increasing

Material footprint, tonnes per capita



Note: Material Footprint is the allocation of global extracted raw materials used to meet the final demand of an economy.
Source: OECD (2020), OECD Environment Statistics (database).

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Digital tools can support the circular economy by reducing information costs and fostering innovative business models, such as digital-based ride sharing. A digital passport could provide information on a product's properties, like repair and recycling possibilities. Information on product durability can substantially influence consumer behaviour.

MAIN FINDINGS	KEY RECOMMENDATIONS
Supporting the recovery in an inclusive way across the EU	
Preparations for the EU recovery plan have taken about one year. National recovery plans combining investment and structural reforms should speed up the recovery from the crisis, but also increase growth potential in the EU, which requires careful project selection.	Swiftly implement national recovery and resilience plans to deliver structural reforms and investments based on sound cost-benefit analysis.
Public investment has been weak over the past decade and achieving climate neutrality will require massive investment, with important scope for coordination at EU level and between public and private sectors.	Invest in European interconnections, such as in electricity grids and smart recharging infrastructure for transport electrification.
Investment in digital infrastructure and energy often faces cumbersome licensing.	Remove barriers to private investment for the climate and digital transitions by simplifying licensing procedures.
Spending on research and development (R&D) in the EU remains far below the 3% of GDP target, and national innovation strategies are insufficiently coordinated.	Promote cross-country collaboration in R&D and in innovative industrial projects.
Poorer regions tend to have very low R&D investment, which hampers innovation and its diffusion.	Devote more cohesion funds in poorer regions to R&D projects.
There is scope to expand productivity spillovers from large cities to surrounding territories. In addition, second-tier cities have often failed to generate substantial agglomeration economies.	Make more regions benefit from agglomeration economies, through reduced travel time to large cities, better ability to telework and closer integration of second-tier cities with surrounding territories.
Competition policy has kept concentration and market power in check. However, it faces new challenges from digitalisation, subsidies from non-EU governments and "killer acquisitions" (firms buying smaller rivals to pre-empt future competition).	Adjust competition rules and enforcement to new challenges: • closely review and prevent "killer acquisitions" • develop new instruments to address distortive foreign subsidies • increase competition in digital markets
Enhancing EU budget support to regional upgrading and convergence	
Half of cohesion funding is spent through public procurement, but tendering procedures are often not competitive enough, which could hinder the selection of the most efficient or innovative providers.	Make public procurement more competitive by increasing the centralization of procurement and the professionalization of officials. Ensure compliance with transparency requirements in procurement procedures.
Projects funded by cohesion policy are often selected on a first-come first-served basis and more consideration could be given to how they contribute to achieving regional growth objectives.	Further adopt competitive project selection procedures, with an emphasis on projects' contribution to regional growth objectives.
Rural regions are often eligible for sizeable support from both rural development policy and cohesion policy, but their interventions are poorly coordinated.	Improve coordination between rural development policy and cohesion policy by implementing integrated strategies funded by both.
Corruption and fraud lower economic growth, weaken institutions and worsen the quality of public spending, including that funded by the EU budget. Most relevant policy levers are controlled at national level.	Step up national efforts to fight corruption and fraud, notably through full and timely transposition of relevant Directives and stronger cooperation with dedicated EU bodies.
Within the EU budget, cohesion policy has a high incidence of fraud. Europe-wide risk-scoring tools, which help identify high-risk projects, have still limited use.	Step up prevention and detection of fraud and corruption involving cohesion funds, notably through the greater use and updating of common risk-scoring tools.
Reinforcing incentives for a climate-neutral and more circular economy	
The EU Emissions Trading System (ETS) covers around 40% of total EU greenhouse gases emissions. Transport accounts for more than 20% of EU emissions, and abatement has proved particularly difficult. Buildings account for 40% of energy consumption and significant resource use. In July 2021, the European Commission proposed to include shipping emissions in the ETS and to set a new, separate ETS for road transport and buildings..	Consider increasing the EU Emissions Trading System coverage, by for instance including transport and buildings. Strengthen regulatory standards for energy efficiency.
Investment in low-carbon activities would benefit from further progress in the assessment and disclosure of climate-related risks for companies and financial markets. Recent draft legislation envisages more informative disclosures by a wider set of firms.	Require comprehensive disclosure of climate and environment-related risks by financial intermediaries and large non-financial firms.
Missing information on used materials and product characteristics hold back the capacity of markets to recycle and use goods for longer. Digital technologies can reduce information and transaction costs and encourage innovative business models.	Introduce requirements for the use of digital tools to provide information on products, including on their recycling and repair possibilities.