Key Policy Insights

- *The economic expansion continues*
- *Time is ripe for a reform of the EU budget*
- *Addressing regional divides*
- *Deepening the single market*
- *Strengthening labour markets*
- *Fighting climate change*

Challenges facing the European Union

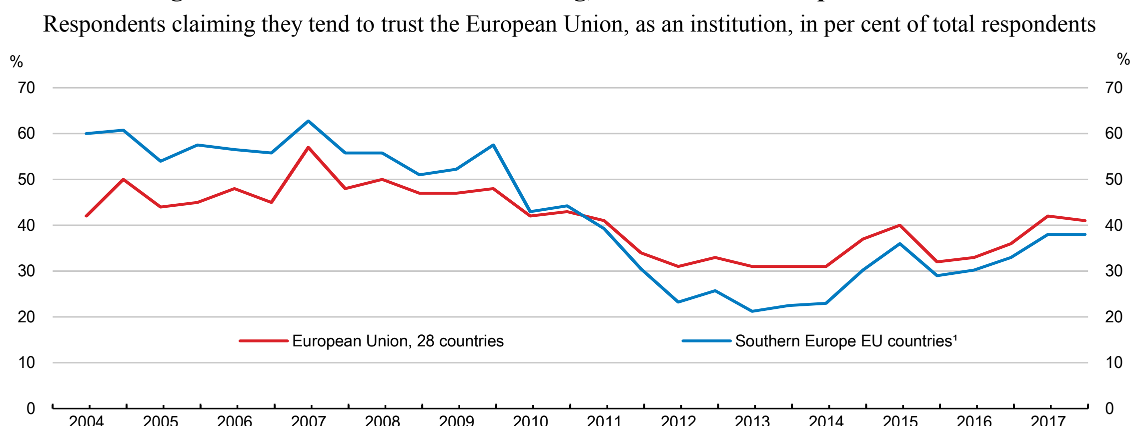
After years of crisis, a positive economic momentum has taken hold in the European Union over the last couple of years, helped by very accommodative monetary policy, mildly expansionary fiscal policy and a recovering global economy. Growth has continued at a dynamic pace in 2017, broadening across sectors and countries and lowering unemployment.

These positive developments provide an opportunity to renew efforts to meet the long-term challenges facing the European Union. Sustained improvements in living standards are held back by weak productivity and investment in many countries. Europe's rapid ageing will lead to a decline in output per capita and squeeze public finances, unless employment rates and productivity increase. The short and medium term economic impact of the UK departure from the EU ("Brexit") on the EU has been estimated to be relatively small (Kierzenkowski et al., 2016), but some short-term disruptions cannot be ruled out. Migration remains an important concern for Europeans. The numbers of refugees entering the EU have come down, but the latest wave of refugees has shown the limitations of the EU policy. An additional challenge, discussed in the accompanying Euro Area Survey, is how to put the economic and monetary union on a stronger footing to make the euro area less vulnerable to crises.

In view of these challenges, the EU needs to show more than ever the concrete benefits it brings to people. Citizens' trust on the European Union is on the rise, after having significantly fallen during the sovereign and refugee crises, but the popularity of the EU remains strikingly low by past standards (Figure 1). Part of this discontent stems from significant gaps in well-being among EU citizens in key areas including income, jobs, health and education (Figure 2). Income inequality is lower in Europe than in other OECD countries, but the crises have left a legacy of social problems. Unemployment remains above pre-crisis levels in many countries and is painfully high in some others (Figure 3), especially among young people. Real wages have stagnated or barely grown in most countries, and have fallen significantly in countries hard hit by the crisis. There are also significant regional divides across Europe. While leading European regions, mostly cities and major urban areas grow ahead, lagging regions seem to stall (OECD, 2018a; Bachtler et al. 2017).

Figure 1. Trust in the EU is recovering, but remains below pre-crisis levels

Respondents claiming they tend to trust the European Union, as an institution, in per cent of total respondents



1. Unweighted average of Greece, Italy, Portugal and Spain.

Source: European Commission, Public Opinion in the European Union, Standard Eurobarometer Survey.

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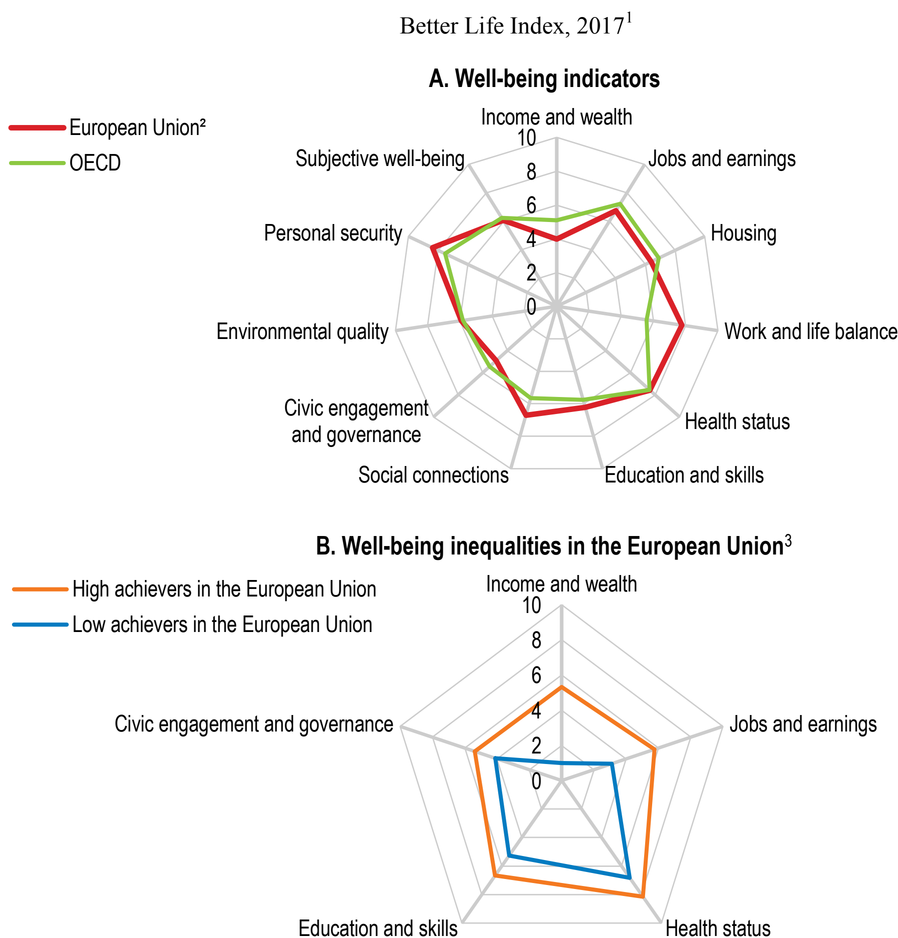
Figure 2. Average well-being is high, but there are significant inequalities

Better Life Index, 2017[1]



1. Each well-being dimension is measured by one to four indicators from the OECD Better Life Index set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 10 (best) and 0 (worst) according to the following formula: (indicator value - minimum value) / (maximum value - minimum value) x 10.
2. European Union member countries that are also members of the OECD (21 countries).
3. The panel shows well-being outcomes in various dimensions for people in the European Union with different socio-economic background. In the dimensions of "income and wealth", "health" and "civic engagement and governance", "high (/low) achievers" are people with an income belonging to the top /(bottom) quintile of the income distribution; in "jobs and earnings", "high (/low) achievers" are people with the high/(low)est educational attainment (i.e. ISCED 5/6 versus ISCED 0/1/2) or with gross earnings belonging to the top /(bottom) quintile of the distribution; in "education and skills", "high (/low) achievers" are people with a score belonging to the top /(bottom) quintile of the PISA index of economic, social and cultural status; Outcomes are shown as normalised scores on a scale from 0 (worst condition) to 10 (best condition) computed over OECD countries, Brazil, the Russian Federation and South Africa.

Source: OECD (2017), OECD Better Life Index, www.oecdbetterlifeindex.org .

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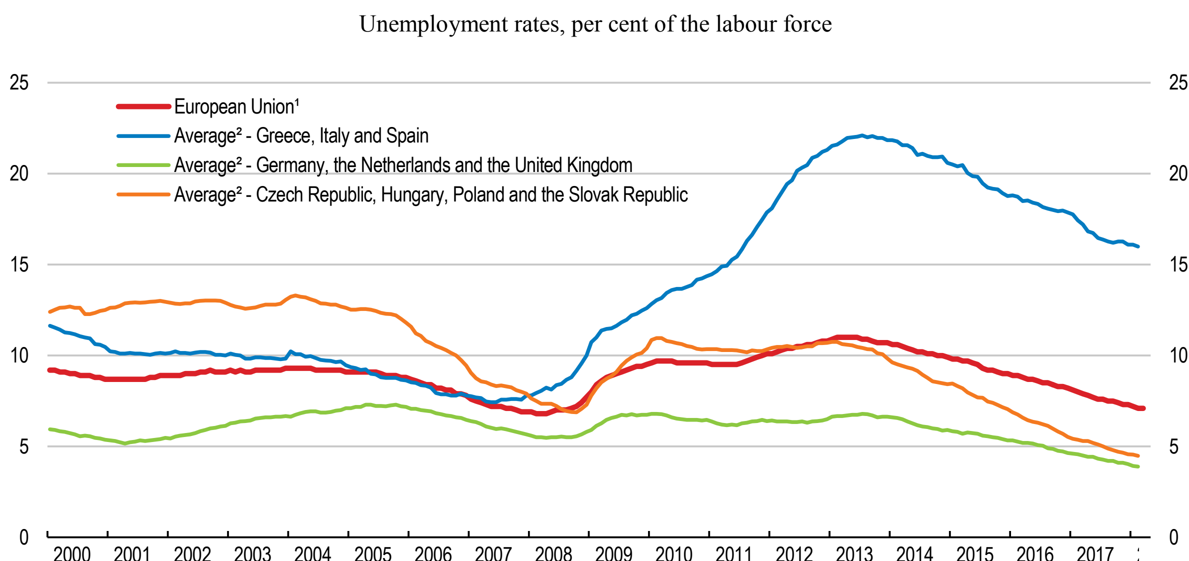
Figure 3. Unemployment has fallen but remains significant

Unemployment rates, per cent of the labour force



1. European Union 28 countries.
2. Unweighted average.

Source: Eurostat (2018), "Employment and unemployment (LFS)", *Eurostat database*.

Policies to pursue stronger growth and make it more inclusive are mostly to be undertaken at the national level, but EU policies are needed to complement national efforts. Against this backdrop, the main messages of this Survey are:

- With an expansion under way, attention needs to shift to Europe's long-term challenges. A reformed EU budget could enhance growth and make it more inclusive by stepping up investment in R&D, better targeted cohesion and agriculture spending to more effectively address regional divides, and increased funding to support less qualified youth.
- To spur long term growth and sustained improvements in living standards, the EU needs to revive the single market project, by removing remaining barriers in services, energy, digital and transport. Greater intra-EU labour mobility and making it much easier to hire skilled workers from outside the EU could ease labour shortages.
- Deepening the single market and faster adoption of digital technologies will create new jobs but put at risk others. The EU should better help lagging regions catch up and support those who lose out from globalisation and are displaced by technological change.

Recent macroeconomic developments and short-term prospects

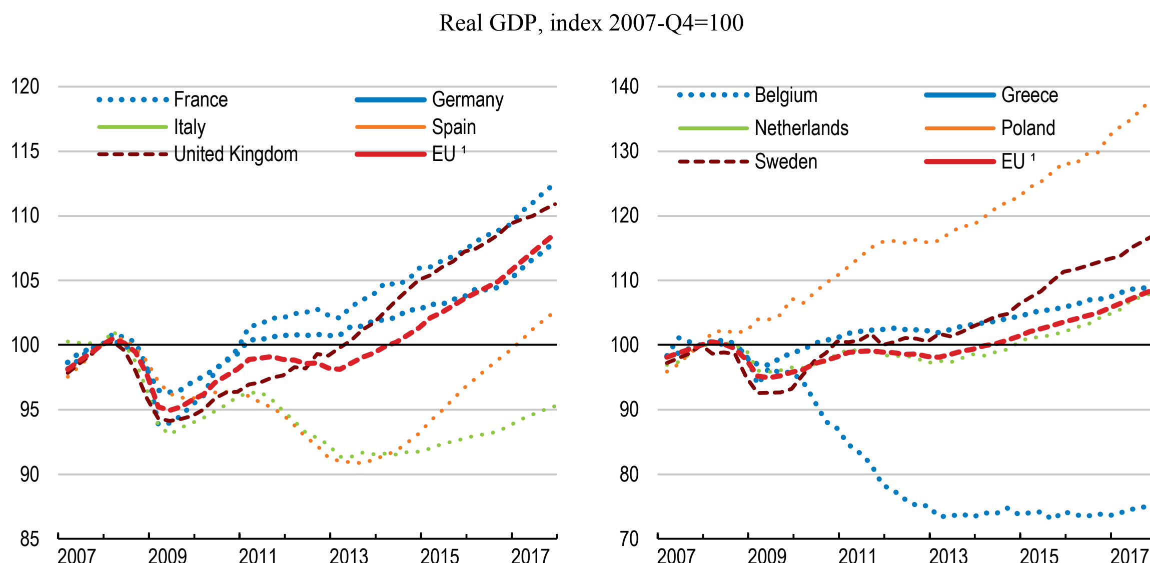
The upswing continues

The European economy is growing at a fast pace (Figure 4), is broadening across sectors and countries, and is supported mostly by domestic demand (Figure 5, Panel A). Improving labour markets and very favourable financing conditions continue to boost incomes, and together with higher consumer confidence (Figure 5, Panel B), private consumption, despite lacklustre real wage growth in a majority of member states.

Investment is expanding at a dynamic pace in most countries (Figure 5, Panel C), as private investment expands sustained by buoyant business sentiment, rising profits and easy financial conditions. Public investment, on the other hand, remains subdued in some member states (Figure 6). Exports have continued to strengthen on the back of an improved economic outlook in Europe and the rebound in world trade. Business and consumer confidence indicators remain very high pointing to healthy growth ahead and in some sectors and countries firms are starting to face equipment and capacity constraints (Figure 5, Panel D).

Figure 4. The upturn continues and is broad-based

Real GDP, index 2007-Q4=100



1. European Union member countries that are also members of the OECD (22 countries).
Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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Figure 5. The broad-based recovery should positively support investment growth

A. Domestic demand is the main driver of growth

Contributions to real GDP growth, %

Total domestic demand

Real GDP growth, year-on-year % changes

B. Private sector confidence is high

Balances[1], %

Industrial confidence

Services confidence

Consumer confidence

Long-term averages

C. Investment is picking up

Real gross fixed capital formation, index Q4 2007=100

France

Germany

Italy

Spain

United Kingdom

European Union[2]

D. More manufacturing businesses are facing equipment and capacity constraints

% of businesses[3]

Balances[4], %

Available equipment limits production (left axis)

Capacity constraints (right axis)

1. Difference between the percentages of respondents giving positive and negative replies.
2. European Union member countries that are also members of the OECD (22 countries).
3. Percentage of businesses answering that their business is limited by shortage of space and/or equipment.
4. Difference between the percentages of respondents assessing that their current production capacity is more than sufficient and the percentage share of those assessing the latter as not sufficient,

Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database); European Commission (2018), *Business and Consumer Surveys* (database), Brussels.

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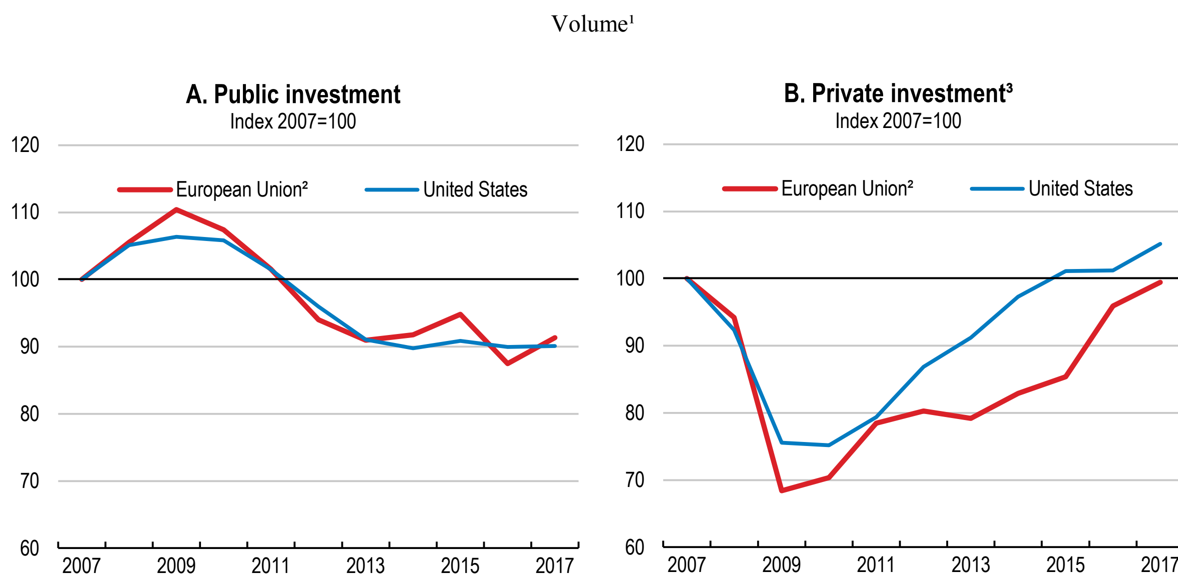
Figure 6. Private investment is recovering, while public investment remains subdued

Volume[1]



1. The series underlying the displayed indices are deflated by the GDP deflator.
2. European Union member countries that are also members of the OECD (22 countries).
3. Private investment is obtained as gross fixed capital formation of the total economy minus government fixed capital formation (appropriation account).

Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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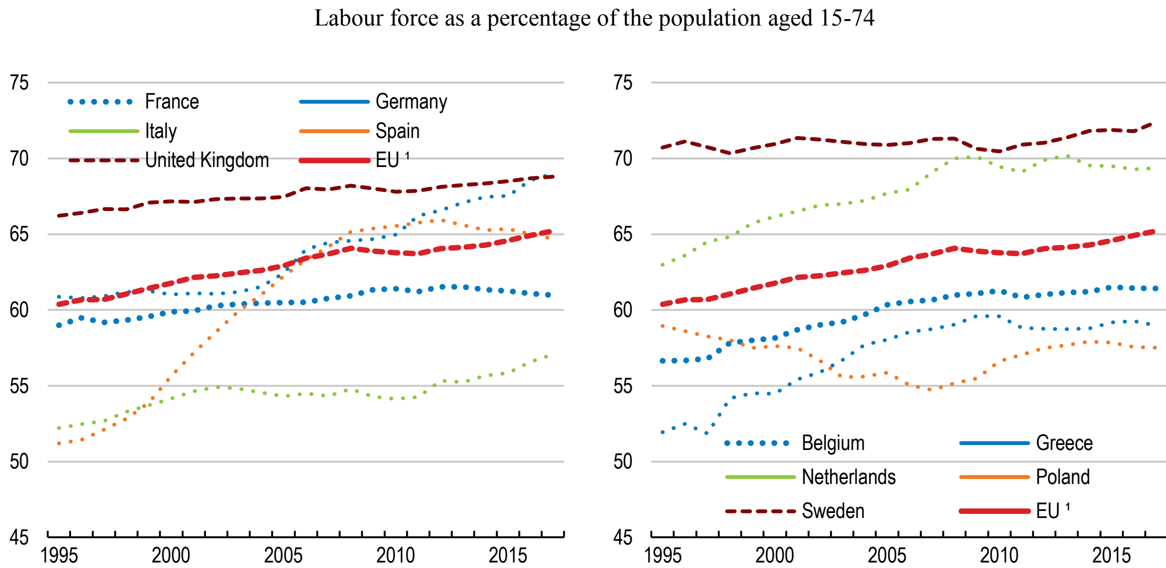
Labour market conditions also continue to improve. Employment and labour force participation rates in many countries are now above their levels prior to the crisis (Figure 7), helped by stronger demand and by reforms that have raised activation, enhanced job creation and lowered barriers to female labour force participation (OECD, 2017a). The EU average unemployment rate was 7.1 in April 2018. Yet, significant differences remain across countries (Figure 8, Panel A) and most EU countries have yet to regain their pre-crisis unemployment levels. There are also significant differences in unemployment across regions (Figure 9).

Figure 7. Participation rates have risen in many countries

Labour force as a percentage of the population aged 15-74



1. Unweighted average across European Union member countries that are also members of the OECD (22 countries) and Lithuania.
Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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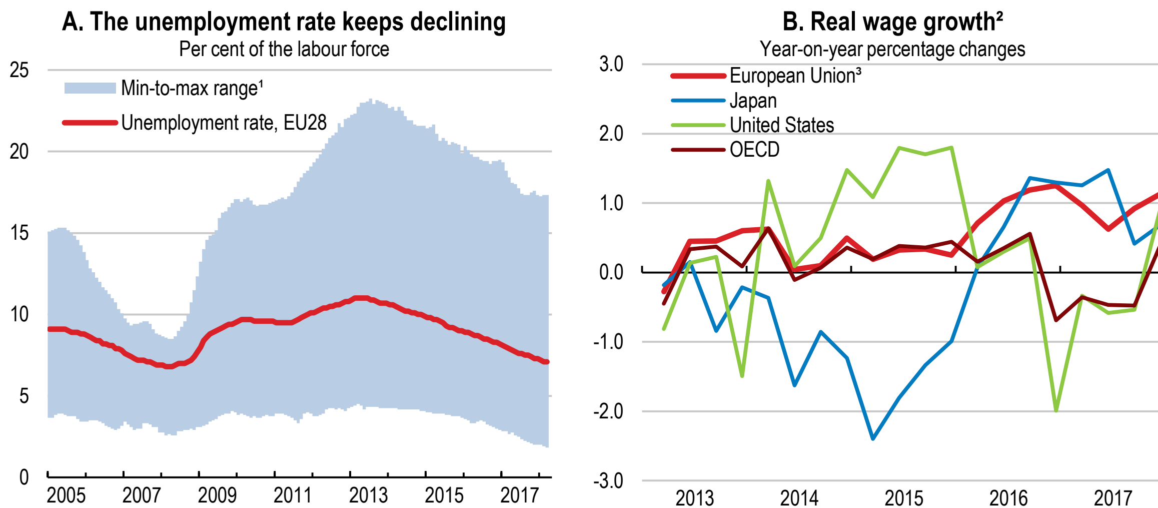
Figure 8. The labour market is improving but wage pressures remain limited



1. Measures, for each single monthly observation, the range between the minimum and the maximum unemployment rate registered across EU Member States.
2. Real wages are measured as labour compensation per employee deflated by the GDP deflator.
3. European Union member countries that are also members of the OECD (22 countries).
Source: Eurostat (2018), "Employment and unemployment (Labour Force Survey)", *Eurostat database*; OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

StatLink http://dx.doi.org/10.1787/888933747679

Although labour shortages are beginning to appear in some countries, improving labour market conditions have not yet translated into much wage pressures (Figure 8, Panel B). A number of factors seem to weigh on wage growth including still significant labour market slack in some countries and weak productivity growth in past years. The shares of involuntary part-time work and discouraged workers in the labour force are still elevated and declining only slowly (OECD, 2017b), suggesting that labour market slack is probably bigger than what the unemployment rate suggests. Faster wage growth may have also been held down in recent years by an increasing share of part-time jobs, rising female labour force participation and growing employment in low-wage service sectors (OECD, 2018b; Broadbent, 2015; Daly and Hobijn, 2017).

Figure 9. Regional unemployment rates in the European Union: difference in levels between 2007 and 2016

Unemployment rates decreased
Unemployment rates increased by less than 5 pps
Unemployment rates increased by more than 5 pps

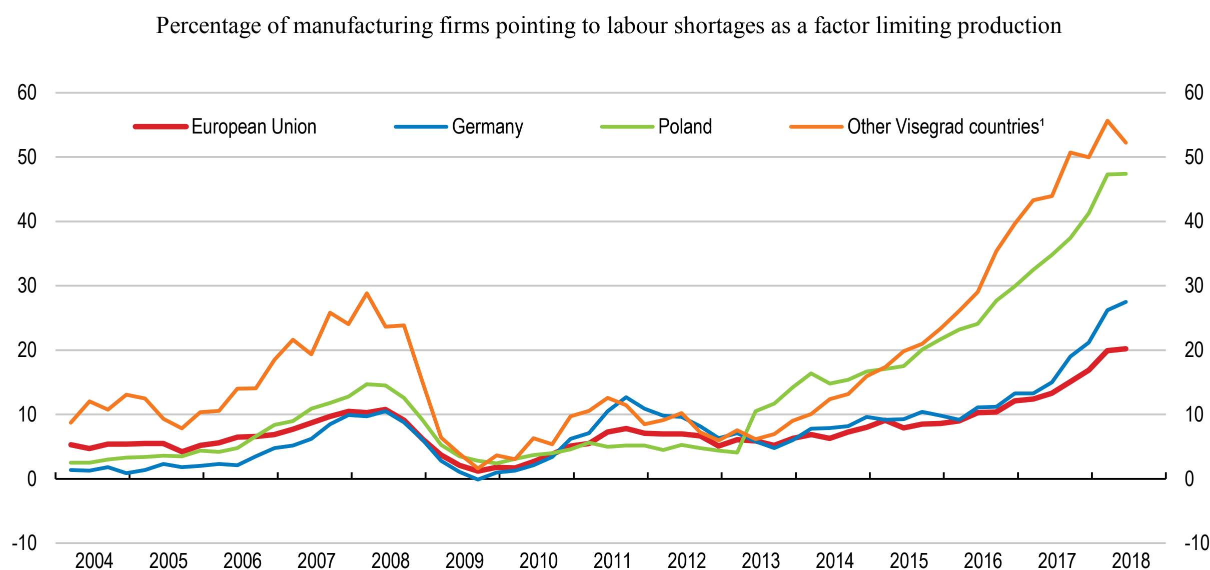
Source: Eurostat (2018), "Regional labour market statistics", *Eurostat Database*.

StatLink http://dx.doi.org/10.1787/888933747698

At the same time, the labour market situation is not homogenous across Europe. While some countries, like Greece and Spain still face high unemployment rates (Figure 3), the labour market is tightening in a number of central European countries like Germany and Poland. Indeed, business surveys indicate that labour market shortages are a key factor limiting production and firms' growth in Poland and other Visegrad countries (Figure 10), that are benefiting from the revival in the global economy thanks to their close ties to global value chains.

Figure 10. Labour shortages are increasing in some countries, especially in central Europe

Percentage of manufacturing firms pointing to labour shortages as a factor limiting production



1. Hungary, Czech and Slovak Republics; unweighted average.
Source: European Commission (2018), "Industry/Business Climate Indicator", *Business and Consumer Surveys*, Brussels.

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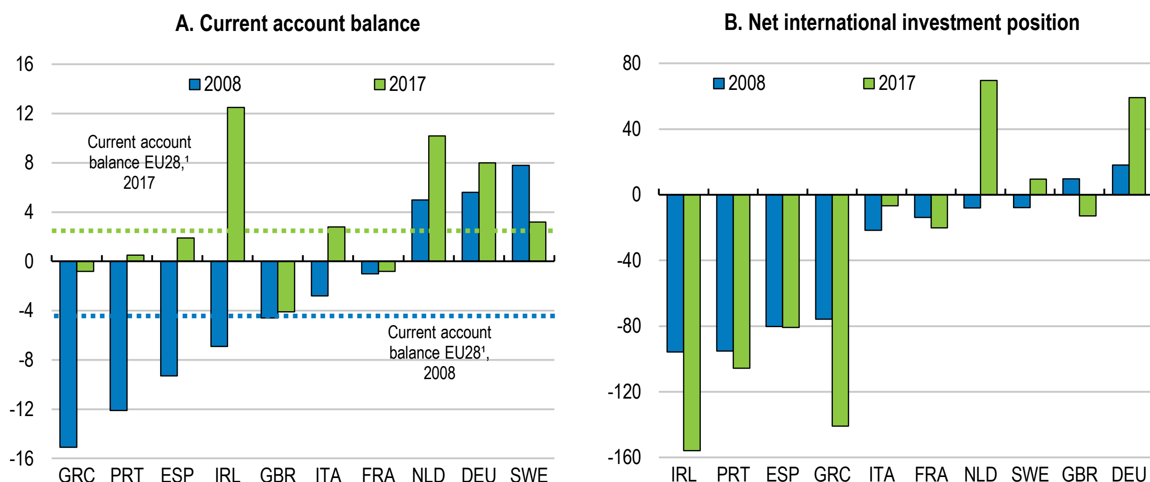
Imbalances within Europe have declined asymmetrically since the financial crisis, with adjustments mainly taking place in countries with larger net external liabilities. Net external debtor countries that had persistent and large current account deficits before the crisis, such as Portugal and Spain, have seen significant current account and some net foreign asset adjustments (Figure 11), reflecting moderated domestic demand and a more competitive economy. However, additional adjustments are needed to bring the net international investment position to more sustainable levels in some countries. At the same time, elevated external surpluses have persisted in Germany, the Netherlands and Sweden. These external surpluses have led the European Union average current account surplus to reach a peak of 2.6% of EU GDP in 2017, with significant projected current account surpluses also in 2018 and 2019. Reforms to remove barriers to entry in services and higher spending in public infrastructure, would help reduce the large current account surplus in Germany, while higher public spending in R&D would in the short term reduce the current account surplus in the Netherlands. In countries with previously large current account deficits, structural policies aimed at fostering productivity growth and further improvements in price and non-price competitiveness would help to unwind the large net foreign liabilities.

Figure 11. The EU current account surplus remains high

As a percentage of GDP



1. The EU28 is an unweighted average.
Source: Eurostat (2018), "Balance of payments statistics and international investment positions (BPM6)", *Eurostat Database*.

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GDP growth is projected to average slightly above 2% per annum in the region in 2018-19 supported by accommodative macroeconomic policies and a recovering world economy (Table 1). While all EU economies are showing positive growth rates, they are at varying points in their cycles (Table 2). Rising employment should boost incomes and support private consumption, as wages are expected to rise faster than in the past. High business confidence, increasing corporate profitability and encouraging global demand should keep supporting investment. Despite tepid export growth, a large area-wide current account surplus will remain, with a projected continuation of significant current account surpluses in Germany and the Netherlands. Inflation will gradually strengthen in an environment with higher oil prices, disappearing slack and higher wage growth.

Table 1. Macroeconomic indicators and projections

European Union, [1] annual percentage change, volume (2015 prices)

				Projections	
	2015	2016	2017	2018	2019
Gross domestic product (GDP)	2.2	1.9	2.6	2.3	2.1
Private consumption	2.0	2.3	2.0	1.7	1.7
Government consumption	1.3	1.6	1.2	1.5	1.3
Gross fixed capital formation	3.5	3.0	3.8	4.3	3.9
Final domestic demand	2.2	2.3	2.2	2.2	2.1
Total domestic demand	2.2	2.2	2.2	2.2	2.1
Exports of goods and services	6.0	3.6	5.7	4.7	4.6
Imports of goods and services	6.2	4.8	4.9	4.6	4.7
Other indicators (growth rates, unless specified)					
Potential GDP	1.4	1.4	1.4	1.5	1.5
Output gap[2]	-2.1	-1.7	-0.5	0.3	0.9
Employment	1.2	1.7	1.4	1.3	0.9
Unemployment rate	9.5	8.6	7.7	7.1	6.8
GDP deflator	1.2	0.9	1.3	1.6	1.9
Consumer price index	0.0	0.3	1.8	1.8	1.9
Core consumer prices	0.9	0.9	1.2	1.4	1.9
Household saving ratio, net[3]	5.2	4.9	4.3	4.2	4.1
Current account balance[4]	2.1	2.1	2.6	2.7	2.8
General government fiscal balance[4]	-2.4	-1.7	-1.0	-0.8	-0.5
Underlying general government fiscal balance[2]	-1.3	-0.9	-0.7	-0.9	-0.9
Underlying general government primary fiscal balance[2]	0.6	0.9	1.0	0.7	0.7
General government gross debt (Maastricht)[4]	87.0	86.5	84.2	82.4	80.7
General government net debt[4]	67.5	68.5	64.9	63.1	61.2
Three-month money market rate, average	0.2	0.0	-0.1	0.0	0.3
Memorandum item					
Gross government debt[4]	105.1	106.0	102.2	100.2	98.2

1. European Union member countries that are also members of the OECD (22 countries).
2. As a percentage of potential GDP.
3. As a percentage of household disposable income.
4. As a percentage of GDP.

Source: OECD (2018), "OECD Economic Outlook No. 103", *OECD Economic Outlook: Statistics and Projections* (database).

Table 2. Projected real GDP growth rates in the European Union

Year-on-year percentage changes[1]

Year	2018	2019	Year	2018	2019
Member states:					
Austria	2.7	2.0	Latvia	4.1	3.6
Belgium	1.7	1.7	Lithuania	3.3	2.9
Czech Republic	3.7	3.2	Luxembourg	3.6	3.8
Denmark	1.7	1.9	Netherlands	3.3	2.9
Estonia	3.7	3.2	Poland	4.6	3.8
Finland	2.9	2.5	Portugal	2.2	2.2
France	1.9	1.9	Slovak Republic	4.0	4.5
Germany	2.1	2.1	Slovenia	5.0	3.9
Greece	2.0	2.3	Spain	2.8	2.4
Hungary	4.4	3.6	Sweden	2.8	2.2
Ireland	4.0	2.9	United Kingdom	1.4	1.3
Italy	1.4	1.1			
Aggregates:					
European Union	2.3	2.1	OECD	2.6	2.5

1. European Union member countries that are also members of the OECD (22 countries).
Source: OECD (2018), "OECD Economic Outlook No. 103", *OECD Economic Outlook: Statistics and Projections* (database).

Policy uncertainty remains high and could increase further. Brexit is not considered a major macro-economic risk for the EU as a whole, as discussed below, nonetheless, countries with the closest trade links to the United Kingdom could be severely impacted if the United Kingdom left the European Union without any trade agreement. An increase in trade protectionist measures or a sudden tightening of global financial conditions would negatively affect global demand and Europe's trade and investment. A too rapid tightening of monetary policy could weigh on the recovery in countries with high unemployment and negative output gaps. High debt countries may have difficulties coping with higher borrowing costs if monetary accommodation is rapidly reduced. On the upside, the cyclical recovery in world trade or stronger confidence generated by on-going momentum in solving euro area institutional weaknesses could lead to stronger than expected growth in Europe. The EU's economic prospects are also subject to medium-term risks, the problems and consequences of which are difficult to quantify in terms of risks to the projections (Table 3).

Table 3. Risks about the European Union economies' growth prospects

Risks	Possible outcome
EU disintegration	The worst of the euro area crisis has passed, but the UK is leaving the EU. Populist parties in favour of referendums on membership of the EU, the euro or both could gain power across the continent.
Rising protectionism in trade and investment	Many EU economies are dependent on unimpeded trade and investment flows. An increase in trade protectionism would negatively affect confidence, investment and jobs, and harm longer-term growth prospects.

Dealing with the UK departure from the EU

Risks on macroeconomic and financial stability are manageable

Brexit is not considered a major macro-economic risk for the EU. While a "hard" Brexit would generate a large negative shock to the UK economy reducing GDP by an estimated 3.3% by 2020, the impact on the EU as a whole will reduce GDP by around 1 percentage point by 2020 according to OECD estimates (Kierzenkowski et al. 2016). Nonetheless the impact will vary across member states and some countries, like Ireland will be more severely impacted (OECD, 2018c). The political agreement between the EU and UK to set up a 21-month transition period after Brexit is a positive step in defining the economic relationship during the transition period (Box 1 and OECD, 2017c). However, there are still areas where agreement needs to be reached for the transition period to take effect as part of the withdrawal agreement.

Box 1. Overview of key developments in the Brexit negotiations since early 2018

On 28 February 2018, the European Commission published the EU's proposal for a Withdrawal Agreement between the European Union and the United Kingdom that translates into legal terms the joint report from the negotiators of the European Union and the United Kingdom government from December 2017 on the first phase of negotiations.

On 19th March 2018, lead negotiators from the European Commission and the UK government presented a coloured version of the Draft Agreement on the withdrawal of the UK from the European Union. Text highlighted in green in the Draft Agreement corresponds to issues that were agreed at negotiators' level and will only be subject to technical legal revision, such as citizens' rights, the financial settlement, the transition period, some of the other separation issues. Notable details include:

- The transition period will last until 31 December 2020. During this period the UK will continue to apply fully the Union acquis, therefore effectively remaining in the EU single market and customs union.
- The rights of UK citizens living in EU countries and EU citizens living in the UK will be fully protected according to Union law. Individuals who relocate during the transition period will continue to have their rights protected after 2020 in line with the arrangements found in the Draft Withdrawal agreement.
- The UK will have the right to negotiate trade deals with other countries. However if a trade deal is agreed upon during the transition period, it cannot be implemented until after December 31, 2020.
- During the transition period, the UK is excluded from participation in the Union decision-making but may be exceptionally invited to attend, without voting rights, comitology or Commission expert groups or similar meetings where the UK is concerned or where it is necessary for the effective implementation of Union acquis. The UK will remain subject to the EU Common Fisheries Policy, and will have consultation rights regarding the setting of the 2020 fishing opportunities.
- The draft Agreement includes a Protocol providing for a "backstop" solution for the border between Ireland and Northern Ireland issue that the Joint Report called for. This states that in absence of any agreed upon solutions, Northern Ireland will maintain full alignment with the single market and customs rules following the end of the transition period.

- During transition, institutions of the European Union will have the Treaty powers in relation to UK as if it were a Member State. In particular the Court of Justice will have the same jurisdiction as now with respect to UK.

However, transitional arrangements are part of the Withdrawal Agreement. This means that there will be no legal certainty about the transition until the Withdrawal Agreement has been ratified by the EU and the UK.

On 23rd March 2018, the European Council adopted the guidelines on the framework for the future relationship with the UK after Brexit. The EU stated its determination to have as close as possible a partnership with the UK in the future. Such a partnership should cover trade and economic cooperation as well as other areas, in particular the fight against terrorism and international crime, as well as security, defence and foreign policy.

The Brexit process is now on-going in several strands:

1) Pursuit of negotiations and finalisation of the Withdrawal Agreement with the UK, which includes an agreement on transitional arrangements.

2) Scoping of the framework for the future relationship. This will be elaborated in a political declaration accompanying the Withdrawal Agreement.

3) Preparing EU institutions, Member States, and stakeholders for the UK becoming a third country, possibly without a ratified Withdrawal Agreement.

Sources: European Council (Art. 50) guidelines on the framework for the future EU-UK relationship; Draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community; Text of the Draft Withdrawal Agreement.

Risks on financial stability for the EU as a whole from Brexit should be manageable if financial market participants are sufficiently prepared for various exit scenarios. The Financial Policy Committee at the Bank of England and the European Banking Authority have pointed to several risks of disruption to the end-users of financial services (BoE, 2018; EBA, 2017). Although a number of important financial services are provided from London, it is unlikely that the access of EU entities' to financial services will be restricted (ECB, 2017). EU entities will probably retain sufficient access to wholesale and retail financial services post-Brexit, as most financial services are currently already provided in the EU-27 and relevant UK entities can relocate part of their activities to other EU member states.

On the other hand, moving from a wholesale banking centred in London to a potentially more fragmented banking landscape might increase the cost of capital for households and non-financial corporations, as the economies of scale and scope of the London industry may diminish (ECB, 2017). In this respect, the EU should see the UK departure from the EU as an opportunity to advance faster on the Capital Markets Union, as argued in the Euro Area Survey. A fully developed Capital Markets Union would enhance both the domestic and cross-border supply of capital, especially to small and medium-sized enterprises, and facilitate risk-sharing in the European Union. Recent proposals by the Commission for more harmonised rules on distribution of investment funds, cross-border transactions in claims and regulatory treatment of covered bonds, as discussed in the Euro Area Survey, are a step in the right direction.

Brexit will have significant consequences for the EU's finances, as the UK is one of the biggest net payers to the EU budget. The consequences of Brexit on the 2014-2020

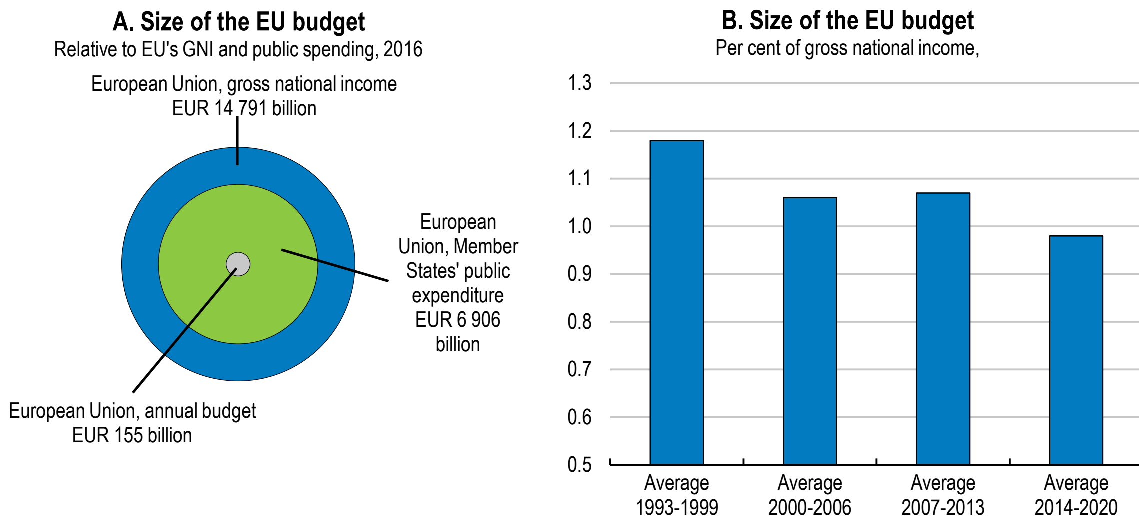
multiannual financial framework have been addressed by the UK commitment to pay its annual contribution until 2020, as well as outstanding commitments as at end-2020, which will be paid after 2020. However, from 2021 onwards the UK departure will likely lead to a permanent funding gap of about 7% or 10 billion Euros per year (EC, 2017a; Hass and Rubio, 2017).

Time is ripe for a reform of the EU budget

The negotiation of the next multiyear budgetary period to start in 2018 and the UK departure from the EU present an opportunity to reform the EU budget. The EU budget is already stretched and some spending had to be reduced in recent years to finance emerging needs (ECA, 2016). The entire EU budget accounts for approximatively 1% of the EU's annual GNI (Figure 12), and around 2% of EU public expenditure. In view of scarce resources, the EU budget should complement national budgets by focusing on EU policies with the highest potential for value added and where EU funding can lead to economies of scale, efficiency gains and generate cross-national externalities and benefits for the EU and its citizens. Examples of these include cross-border infrastructure projects, R&D spending, or to fight climate change.

In addition, new challenges need to be addressed. For instance, the recent migration crisis has showed that additional EU action will be needed to address internal, external security or external border control issues that are now only marginally financed by the common budget (EC, 2018a).

Figure 12. The EU budget is small and has declined over time



Source: European Commission.

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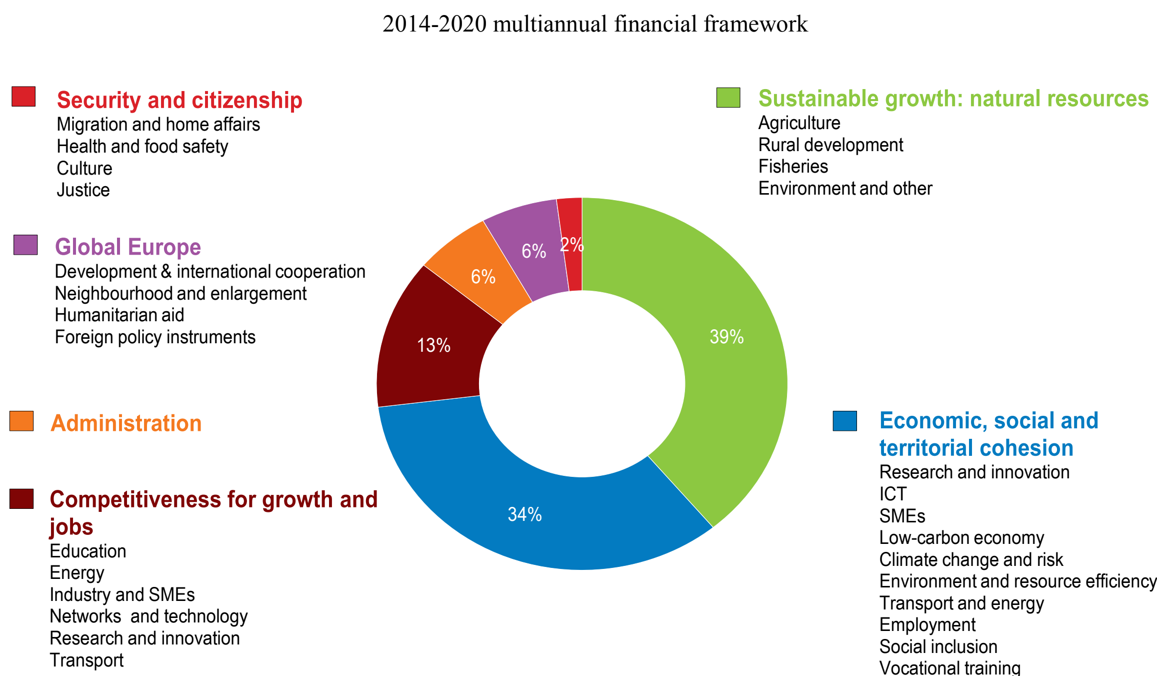
Reducing economic and social differences between member states and regions are also important challenges for the European Union and crucial for the long-term success of the EU project. A significant part of the EU budget (43.6%) already seeks such redistribution mainly through cohesion policy, which promotes economic convergence as well as social and territorial cohesion, and via the Common Agricultural Policy through support for rural development, accounting for around 24% of the CAP budget (Figure 13).

Figure 13. What does the EU budget finance?

2014-2020 multiannual financial framework



Source: European Commission.

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There is scope to make EU cohesion spending more redistributive. The bulk of cohesion support does go to poorer regions and poorer member states. But, relatively wealthier regions also receive significant cohesion support: 25% of the funds (90 billion Euros) over 2014-20 will go to regions with a GDP per capital above 75% of the EU-28 average. Although politically difficult, cohesion funding should be directed mostly to lagging regions with a GDP per capita of less than 75% of the EU average. Improving spending oversight and reducing bureaucracy, could also bring some savings and improve the effectiveness of cohesion policy, as discussed below. Moreover, the EU budget could become more inclusive by supporting better those left behind in the EU. The European Globalisation Fund needs to be improved and its scope broadened not only to help workers displaced by globalisation or an economic crisis, but also due to other reasons such as automation. Additional funding to support the career and mobility opportunities of less qualified workers, especially youth, through strengthened mobility programmes would also be helpful, as discussed below.

There is also scope to reform the Common Agricultural Policy (CAP). Reforms since the nineties have considerably reduced its weight in the EU budget (from 70% in the 1960s to 37% today) and improved the composition of support (OECD, 2017d). Payments that do not require production have gained weight, offering producers the flexibility to respond to market signals and make production choices independently from support. However, about 27% of the support to producers is linked to production and maintains prices above world levels. In addition, direct payments (about 70% of CAP spending) are still largely determined by historic entitlements and concentrated on large farms and land owners (EC, 2017c). In a recent evaluation of the CAP (OECD, 2017d), the OECD advises that to achieve long-term competitiveness and productivity gains, production based payments

need to be phased out. Direct support should be re-assessed and better targeted to the provision of European public goods such as environment and climate change and to facilitate the transition towards farming methods more resilient to climate risk. Agricultural reforms carried out in other countries, such as Australia, could provide useful insights.

Higher spending in R&D should be a priority for the future in a context where EU productivity is low and European research competes with other global players. However, research and development accounts only for about 13% of the EU budget and 10% of total public investment in research and innovation in the EU, despite of evidence of significant value added of EU spending compared to national R&D public spending. According to its interim evaluation, 83 % of Horizon 2020-funded projects would not have gone ahead without EU-level support (EC, 2017b). The budget for the post-2020 EU research and innovation programme should be significantly increased.

How to finance new priorities and fill in the UK gap in the EU budget?

Given the political difficulties in increasing member states contributions or on agreeing on new sources of funding, cutting spending in some areas to finance others might appear appealing. However, research suggests that financing the UK gap only via spending reductions would imply a significant cut in some of the EU's flagship programmes, such as eliminating the entire EU R&D funding (Horizon 2020) plus the fund for asylum, migration and integration (Hass and Rubio, 2017). This suggests that financing new priorities and filling the UK gap will require higher member states' contributions, finding new sources of revenue, reducing spending or a combination of these different options.

At present, about 70% of the budget is financed through member states contributions based on their income level (GNI), with the rest coming from contributions from national value added taxes and custom duties collected at EU external borders. EU countries have historically supported GNI-based contributions to finance the EU budget as it is seen as a fair burden-sharing system reflecting countries relative ability to pay. But, when account is taken of the special reductions ("rebates") that some of the largest net contributors (including the UK, Germany, the Netherlands, Sweden and Austria) have the budget is regressive (Monti et al. 2017). The withdrawal of the UK from the EU entails the end of the UK reduction. Eliminating the reductions for the other countries ("rebates on the rebate") would bring additional resources, and make the system more redistributive and, less complex and opaque.

Additional revenues from national taxes could complement member states GNI-based contributions, as proposed by the high level committee on own resources appointed by the Commission (Monti et al. 2017). Depending on its design, this could provide a tighter link between EU financed spending and those financing it (Monti et al. 2017). A first promising option to raise revenues from national taxes is reforming the current VAT-own resource system. The VAT already finances about 12% of the EU budget by levying a 0.3% rate on member states VAT bases, with member states VAT bases capped based on their GNIs to make the system less regressive. However, the system is very complex and non-transparent. National VAT bases are theoretically harmonised through difficult calculations to offset the impact of diverging rates and structures on national VAT bases. Moreover, the "rebates" make the system even more complex and non-transparent, as they imply reductions for some countries in their VAT contributions. Higher revenues and a less complex system could be achieved by applying a single EU rate to a broader harmonised VAT base on all goods, services and transactions, as proposed by the high

level committee. The Commission VAT Action Plan, which includes various measures to improve the operation of the VAT system and to fight fraud, could provide the necessary momentum for the reform. Further VAT reform could contribute to fight fraud and reduce cross-border administrative burdens for businesses. Annual estimates of cross-border VAT fraud account for 50 billion a year. Tackling this cross-border VAT fraud would not only broaden member states' VAT base but indirectly also VAT receipts paid to the EU budget.

Another new source of revenue could be an EU corporate income tax. The Commission has recently put forward a package to re-launch the common consolidated corporate tax base (CCCTB). While the initiative aims at developing a consolidated tax base, a share of the CCCTB could be transferred to the EU budget. Under the Commission current proposal, a constraint would be that participation is based on the voluntary registering of companies, except for large companies (Monti et al. 2017), which might reduce the size of country contributions to the EU budget.

Other alternatives include a carbon-based tax own resource and the proceeds from auctioning ETS permits (Monti, et al. 2016). At present six EU countries have a carbon tax in place (Denmark, Ireland, Finland, Sweden, France and Slovenia), however, rates and coverage differ between countries. A European carbon tax based on a single minimum rate for CO2 emissions to all sectors not covered by the EU ETS, as the Commission proposed in the context of the revision of the Energy Taxation Directive, could be an option to finance the EU budget. Using the proceeds from auctioning ETS permits to finance the EU budget would be another option; however, as proceeds are relatively small and unstable over time, they would need to be complemented with other revenues.

Finally, savings, although insufficient by themselves, could help. The Commission conducts mid-term spending reviews to assess the efficiency of EU budget programmes. But these are not comprehensive enough to identify spending inefficiencies. As recommended by the European Court of Auditors (ECA, 2016), a first step would be to carry out a comprehensive EU spending review to assess if the allocation of the EU budget reflects the EU strategic priorities, as well as assess performance and added value of the various programmes. Moreover, a streamlined, simplified approach to budget reporting, both ex-ante and ex-post, would help to improve public assurance and trust, as recommended by the OECD EU budget review (OECD, 2017e).

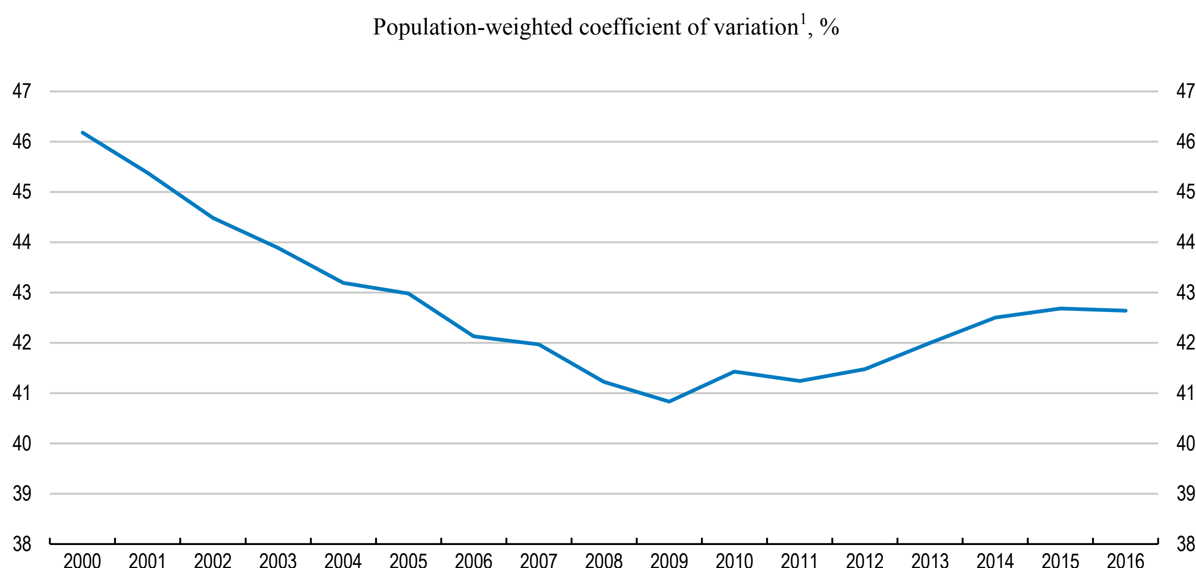
Regional divides need to be addressed more effectively to foster greater trust in the EU

Evidence suggests that those who tend to be left behind, such as workers with low levels of education, are those who are less supportive of the European Union (Dustmann et al., 2017). This is particularly the case in some regions affected by on-going globalisation trends. For instance, votes for populist anti-European parties have grown in regions hard hit by import competition in the EU-15 (Colantone et al. 2016). The continuous improvement of labour market conditions across Europe should help to improve citizens' trust in the EU, as economic insecurity is an important source of people's concerns. However, the EU can play a better role in supporting those left behind by reforming cohesion policy to more effectively address regional disparities.

Reforming cohesion policy to make it more effective

The prime goal of cohesion policy is the reduction of regional income per capita disparities. The record of EU cohesion policy is, however, mixed: in the majority of EU countries regional GDP per capita disparities have declined over time and there is convergence both at the country and regional level, as shown in the thematic Chapter. However, progress on regional convergence came to a halt with the crisis and has not resumed since 2009 (Figure 14). This suggests there is scope for making cohesion spending more effective. However, cohesion policy is not a silver bullet. EU efforts to foster convergence via cohesion policy are only a complement to other factors affecting regional convergence. A more effective use of the funds must be accompanied by national policies to develop a favourable environment for investment and for human capital development.

Figure 14. Convergence in regional GDP per capita came to a halt with the crisis



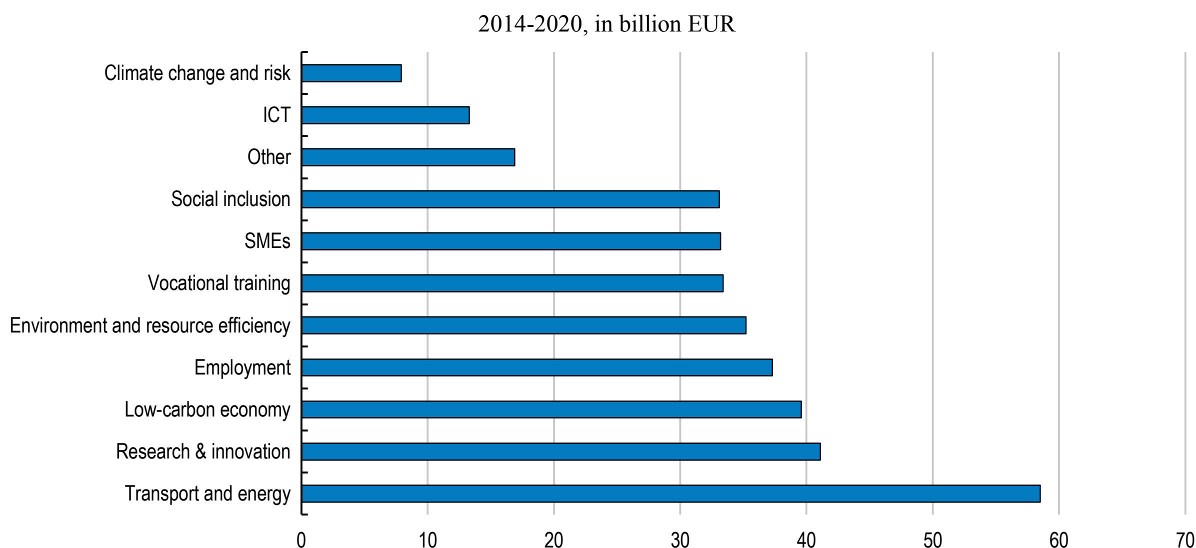
1. The graph shows disparities in GDP per capita (in PPS) between NUTS-2 EU regions.

Source: European Commission (2018), DG for Regional and Urban Policy, calculations based on Eurostat data.

The next programming period, starting in 2020, is an opportunity to deeply reform cohesion policy. The goals of cohesion policy seem very ambitious: fostering economic convergence, facilitating integration, encouraging sustainable development (Figure 15). So many objectives risk reducing the effectiveness of cohesion policy, scattering resources and making evaluating its effectiveness very difficult. Cohesion spending should focus on items that will support higher sustainable growth, including human capital (education and training), innovation and infrastructure projects with clear spillovers across borders, such as transport, energy or digital projects.

Figure 15. What does cohesion policy finance?

2014-2020, in billion EUR



Source: European Commission.

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The Commission has introduced stronger focus on performance as of 2014 - including ex-ante conditions to access funding, performance targets to monitor progress, and tighter monitoring -, but the new performance tools are cumbersome and as a result member states are having difficulties to implement them. At the beginning of each programming period authorities need to set-up a performance framework, select indicators to monitor progress and establish clear, realistic and measurable milestones. Monitoring has also been strengthened: every year, countries have to report progress towards targets and submit detailed progress reports at the end of the funding cycle. The Commission has also set up a so-called performance reserve to reward projects and priorities that have achieved their milestones ahead of schedule.

Deeper changes are needed to further improve spending effectiveness. Member states co-finance cohesion spending to ensure additional investment. The problem is that such additionality is hard to enforce and verify and evidence suggests that there is crowding out of national public investment by EU structural funds (CPB, 2012). An additional problem is that there is too much focus on spending the funds, especially towards the end of the programming period, for fear of losing European money, and not enough on the quality of investment (ECA, 2017a). Returns on projects financed by cohesion policy can also be low as authorities consider the full-benefits of the project, but not the full costs. Higher co-financing rates are needed to reduce the risk that EU funds are spent on low value projects.

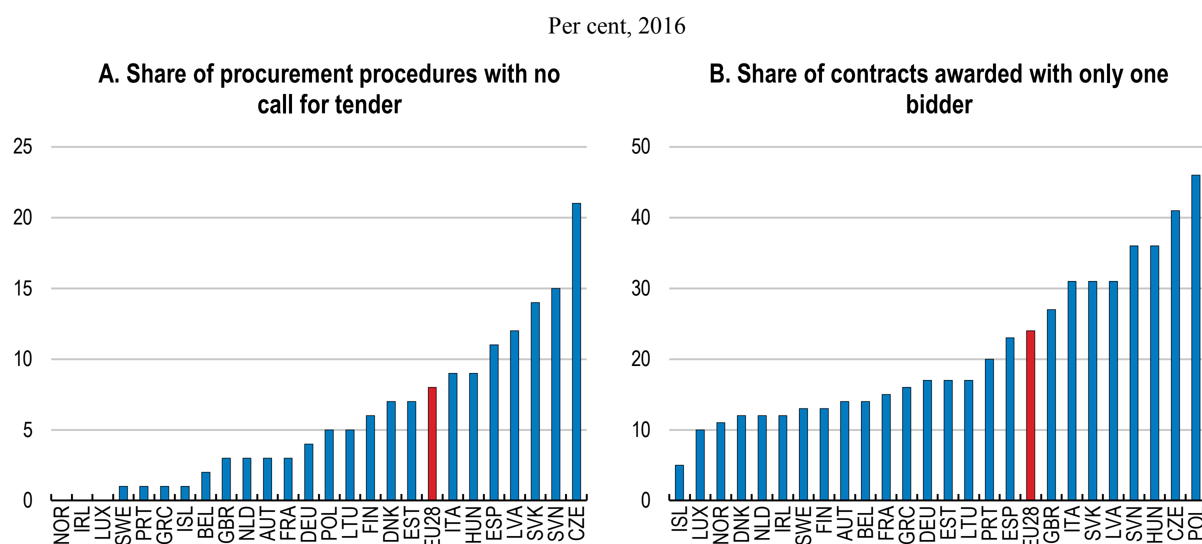
Reducing the administrative burden is necessary to make cohesion policy more effective. Merging the different structural funds into one fund, although difficult because it would require changing the EU treaties, would have important benefits as it would minimise duplication, reduce the scattering of resources, and facilitate synergies and planning. Perhaps more politically feasible in the medium-term would be to move towards "a single-rule book" with a common set of rules and definitions covering the five structural funds. Even if this would still require difficult coordination across several Commission

directorates, and the need to manage several funds, it could still help simplify administration and foster synergies.

More efforts are needed to improve control of how structural funds are spent. Cohesion policy has been marred by the highest implementation errors in the EU budget (ECA, 2014). Some of these errors are minor, but others involve serious breaches such as absence of fair competition in the awarding of projects or projects not awarded to the best bidders (ECA, 2017b). There is significant scope to improve public procurement practices in many countries (Figure 16). This should be coupled with simplification of the rules and greater use of e-government and e-procurement to help improve efficiency and reduce opportunities for abuse of power.

Figure 16. Competition in public procurement is weak in many countries

Per cent, 2016



Source: European Commission, Single Market Scoreboard, http://ec.europa.eu/internal_market/scoreboard/performance_per_policy_area/public_procurement/index_en.htm .

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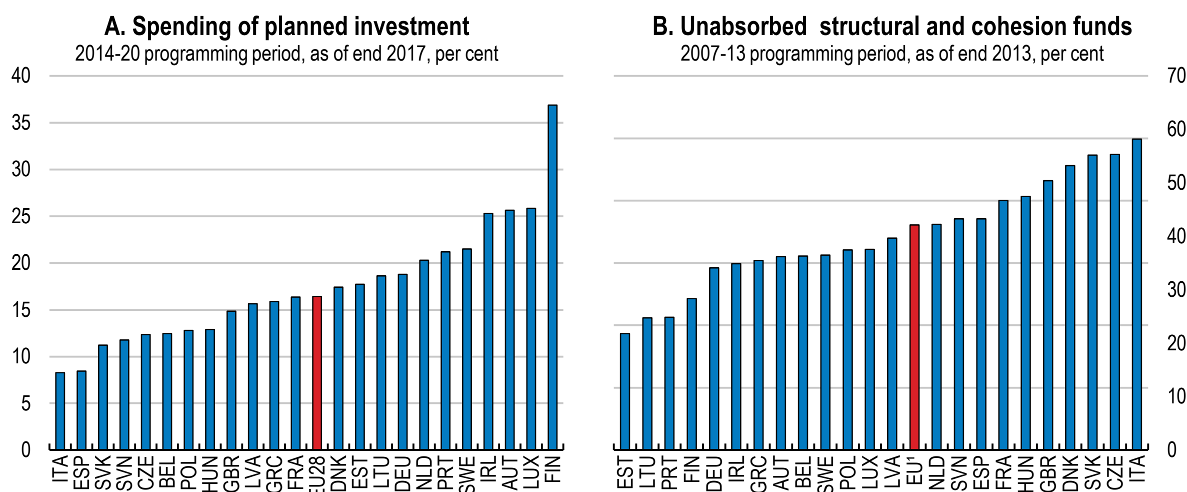
Fraud in the use of structural funds also occurs (EC, 2012a), and should be better addressed. In 2016, the European Court of Auditors estimated that 60% of the fraud affecting the EU budget was in the area of cohesion and fisheries spending, amounting to an estimated annual €391 million (ECA, 2017c). This is about 0.5% of total cohesion spending in 2016; however, given the relatively uncoordinated web of national and European checks and balances controlling cohesion policy it is hard to quantify how much fraud is truly going on. The European Parliament has backed the creation of a European Public Prosecutor Office to strengthen the fight against fraud in the use of EU funds. All member states should join the jurisdiction of the new European Public Prosecutor.

Slow starts of projects are a recurrent problem. By end 2017, only 16% of expenditure of that planned over 2014-2020 had been disbursed (Figure 17). Slow starts are problematic because they lead to a back-loading of investment and can result in poor project quality and higher risk of irregularities (OECD, 2016a; OECD, 2014). An earlier start of spending would allow for a smoother distribution of investment over the period, which would help create a more stable macroeconomic environment. The experience of Czech

Republic, Latvia, Lithuania, Slovak Republic, Slovenia and Hungary in 2015-2016 shows that uneven distribution of significant public investment over time makes macroeconomic management challenging in countries where the structural funds account for a significant part of investment (OECD, 2017a; Figure 18).

Figure 17. Slow use of structural funds is common



1. Unweighted average across 25 EU countries.
Source: European Commission (2018), Open Data Portal for the European Structural and Investment Funds (https://cohesiondata.ec.europa.eu/); European Commission (2014), "Analysis of the Budgetary Implementation of the Structural and Cohesion Funds in 2013".

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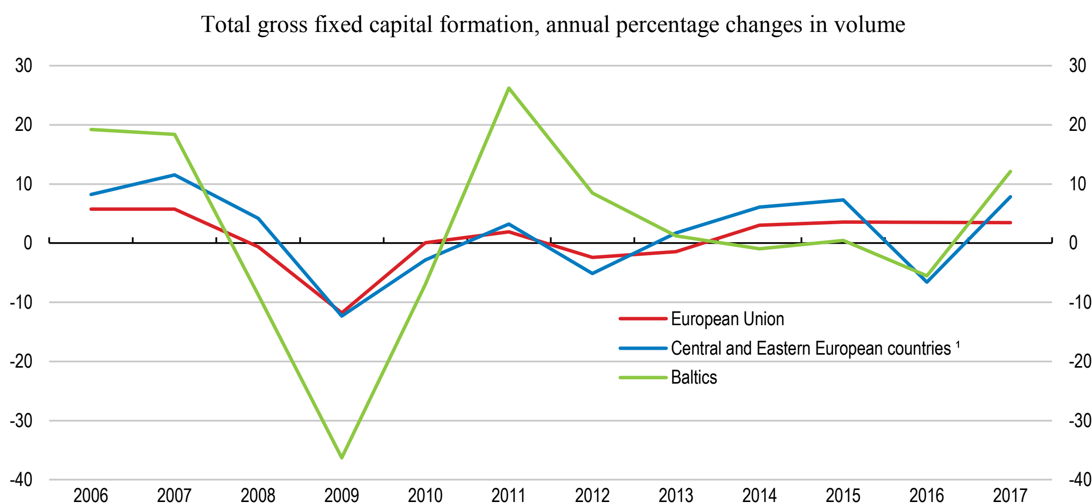
Figure 18. Macroeconomic management is challenging in countries receiving a substantial share of cohesion funding

Total gross fixed capital formation, annual percentage changes in volume



1. Simple average across the Czech and Slovak Republics, Hungary, Poland and Slovenia.
Source: Eurostat (2018), "GDP and Main Components", *Eurostat Database*.

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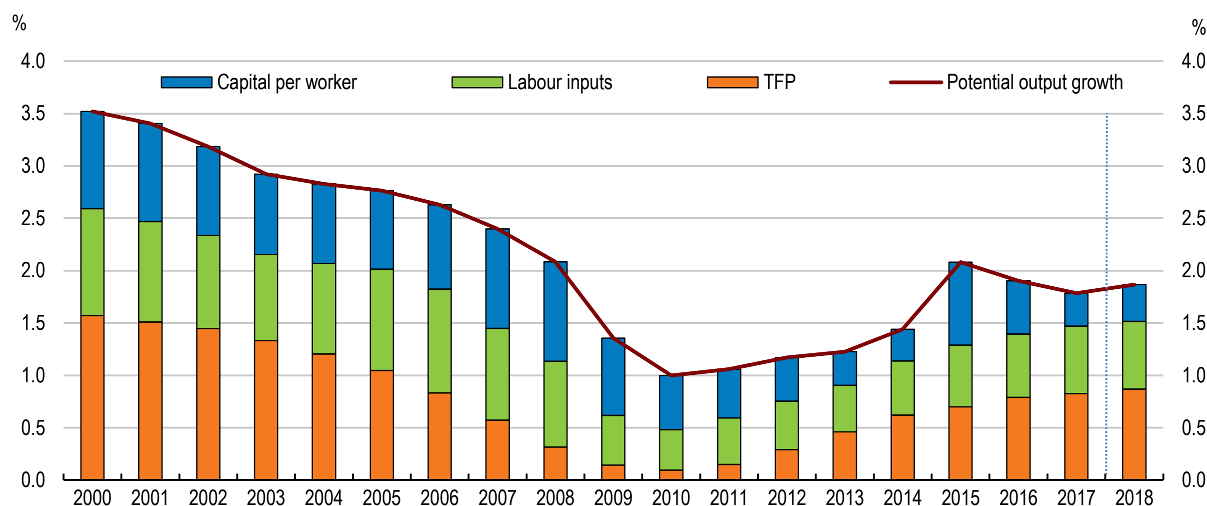
Several measures can be taken to reduce slow starts and smooth transitions between the structural funds financing periods. On the EU side, speeding up the negotiation of the programming period, which is often very slow and leads to delays in implementation, would help to reduce slow starts. There is also scope for the Commission to prepare guidance documents in a timelier manner and to simplify the carrying over of projects from one period to the next. On the national side, countries should streamline administrative procedures, strengthen administrative capacities to manage the funds, harmonise EU and national criteria, and improve the timeliness of project approval, building on existing country experiences to improve the absorption of structural funds, discussed in the thematic Chapter.

Deepening the single market to boost long-term growth

As every OECD European Union Survey since 2007 has noted (Table 4), one of the European Union's strongest tools to boost the EU's weak long-term growth (Figure 19) is the binding instruments that underpin the Single Market Project to dismantle barriers to the free movement of people, goods, services and capital. The single market is one of EU's greatest achievements. It eases intra-EU trade by reducing non-tariff barriers, facilitates capital flows and trade in services and grants full mobility to EU citizens. According to Commission estimates it generated a 2.1% increase in EU GDP in its first 15 years (EC, 2012b).

Figure 19. The EU has seen a significant decline in potential output growth



Note: European Union refers to OECD EU Member countries excluding Estonia, for which data covering the entire reference period are unavailable.
Source: OECD (2018), *OECD Economic Outlook: Statistics and Projections* (database).

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Yet, the single market remains incomplete, holding back the EU's economic performance, as discussed in the thematic Chapter. Goods are rather easily traded across borders. However, services, energy, transport, finance and digital markets are far from integrated. Labour mobility is also relatively low: only 3.9% of EU citizens in working age lived in 2016 in another member state.

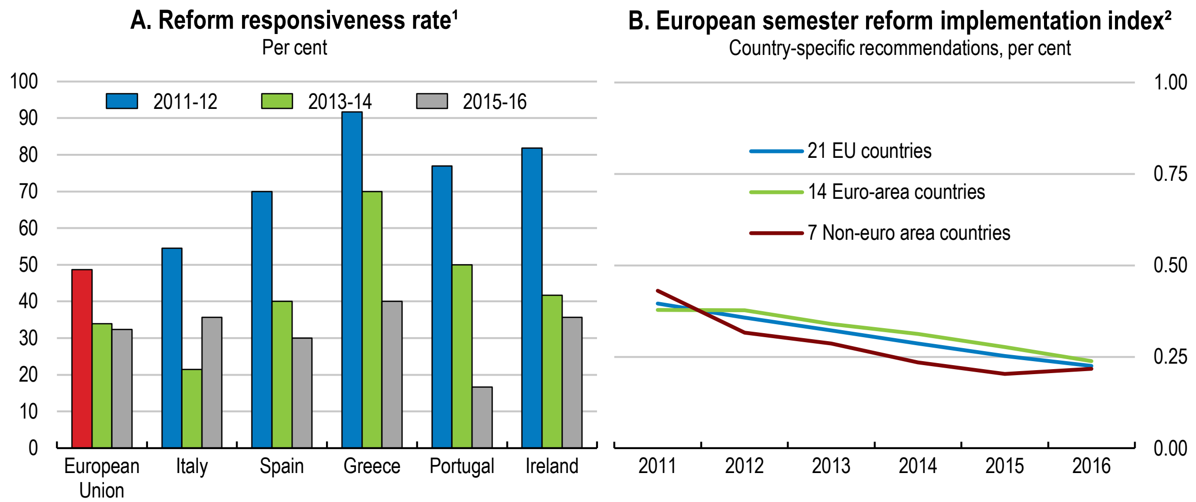
Renewed political commitment is needed to deepen the single market. When the Commission took office in 2014, it vowed to accelerate integration in energy, digital services and capital markets, but progress has been slow, despite significant potential benefits. For instance, fully implementing the current services directive could add 1.7% to EU GDP (European Commission, 2017b). An integrated digital market could in theory add about 8 billion Euros a year to EU GDP (European Commission, 2015a).

Table 4. Past OECD recommendations to deepen the Single Market

Recommendations in 2016 Economic Survey	Actions taken since 2016
Improve the quality of impact assessment of legislative proposals, notably amendments, and the quality of ex post evaluation of policies.	The Better Regulation Guidelines and the underlying toolbox were updated and strengthened in July 2017.
Prioritise the Trans-European transport and energy network projects to support the completion of the Single Market.	Four bottlenecks on TEN-T core network corridors have been removed in 2016, with additional 11, 25 and 53 expected in 2017, 2018 and 2019.
Harmonise, taking into account the specificities of each member state, national regulations and technical specifications in network sectors, with the target of transferring decision powers in technical matters to a single EU regulator.	The proposal of September 2016 for the European Electronic Communications Code defines how providers of networks and/or services can be regulated by national regulators.
Harmonise the rules for online purchases and reduce unjustified geographical discrimination of consumers.	In 2017, there were political agreements a) new legislation to address unjustified geoblocking and other forms of discrimination on the grounds of nationality, residence or establishment in the internal market and b) a legislative proposal on cross-border parcel delivery services to increase transparency of prices and improve regulatory oversight.

Actions at the EU level to deepen the single market should be accompanied by renewed national efforts to foster growth-enhancing reforms, in line with country-specific recommendations in OECD Economic Surveys and in Going for Growth. The reform momentum in EU countries has declined over time (Figure 20, Panel A), especially in countries most affected by the crises. The implementation record of the European Semester country-specific recommendations is also weak, and keeps deteriorating since the Semester was established in 2011 (Figure 20, Panel B). The momentum for reform is weakening at a time when renewed efforts are needed to boost productivity and long-term growth. OECD estimates suggest that reforms to raise productivity could increase GDP by as much as 0.7% up to 2023 in the EU alone (Figure 21). Reforms that stimulate innovation and enhance competition in product markets and reforms that improve the business environment and the quality of institutions could help also to foster economic resilience in the member states and the euro area as a whole (EC, 2017d).

Figure 20. Implementation of policy recommendations is weak



1. Number of actions taken as a percent of total country-specific policy recommendations.
2. The indicator is the ratio of the sum of scores to the total number divided by the number of recommendations; each country-specific recommendation is assigned a score ranging from 0 (no or limited progress) to 1 (full, substantial progress). The series displayed are unweighted averages across 21 EU countries for which data are available.
Source: OECD (2017), *Going for Growth 2017*, OECD Publishing, Paris; Bruegel and OECD based on European Parliament studies.

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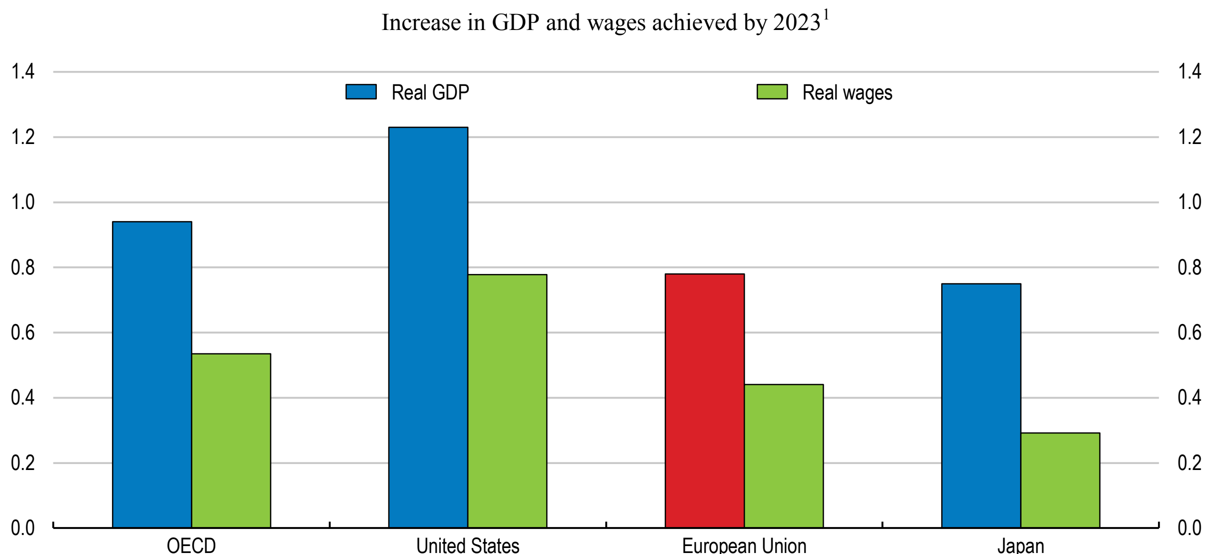
Figure 21. Gains from reforms raising productivity by 1% over 5 years

Increase in GDP and wages achieved by 2023[1]



1. The scenario considers the effects of raising labour-augmenting technical progress by 0.2 percentage point per annum in all of the advanced economies for five years, beginning at end-2017, with the 1% higher level of technical progress being maintained permanently thereafter.
Source: Box 1.1. in OECD (2017), OECD Economic Outlook, Volume 2017 Issue 2, OECD Publishing, Paris; OECD calculations.

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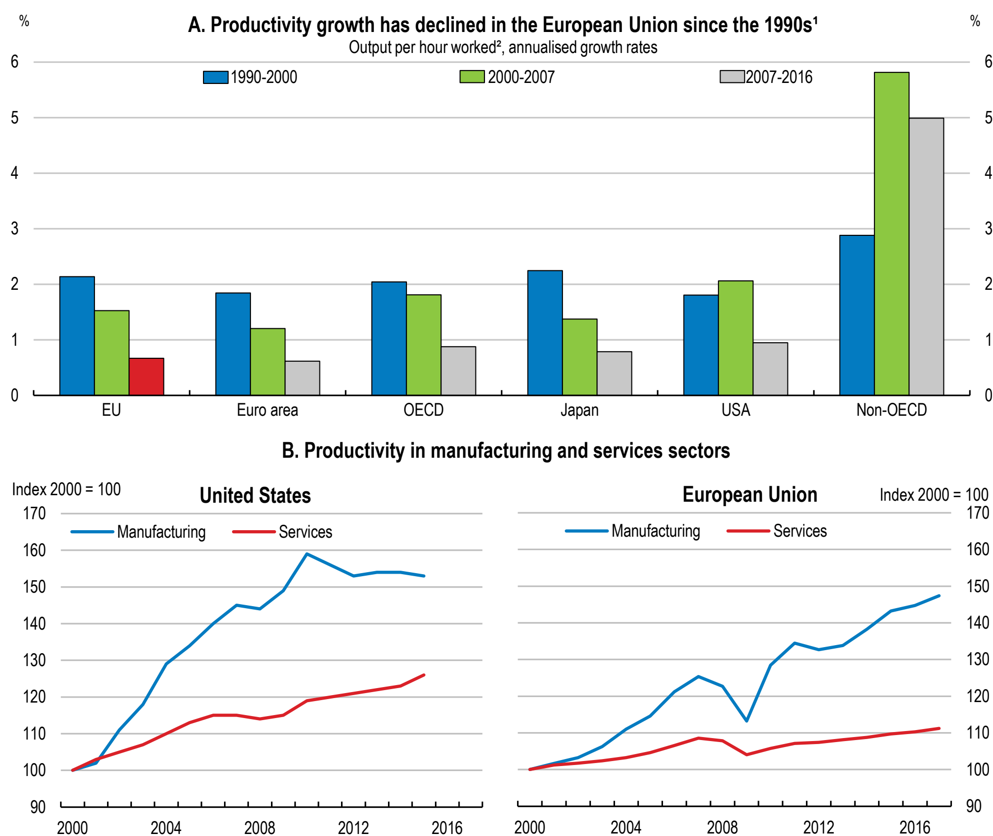
Services experience significant administrative and regulatory barriers when going cross-border

Service sectors are particularly fragmented. Cross-border services make up only 5% of EU GDP, despite accounting for 70% of EU GDP. This weighs on productivity. The EU productivity gap, increasing since the 1990s, is particularly wide in service sectors (Figure 22). At the firm level, there is an increasing productivity gap between leading frontier firms and the rest in both manufacturing and services as there is insufficient diffusion of technology and knowledge from frontier to lagging firms (Andrews et al. 2017; 2016). Businesses still experience many administrative and regulatory barriers when providing services in another member state, including high shareholder requirements, requirement for professionals to hold 100% of the voting rights in some countries or compulsory minimum tariffs for some professions (EC, 2017e). Administrative complexity and costs are also high, including lack of information about applicable rules, differences in rules and requirements among countries, complexity of procedures and formalities, lack of electronic procedures, unclear deadlines and multiple fees. These policy obstacles fall disproportionally on smaller firms.

Figure 22. The productivity gap is particularly large in services



1. The EU and the Euro area aggregates refer solely to Member States that are OECD countries. Non-OECD is Argentina, Brazil, China, Colombia, India, Indonesia, Latvia, Lithuania, Russia, South Africa and Saudi Arabia. EU, Euro area, OECD and non-OECD are aggregated using GDP PPP weights. Data for several countries begin between 1991 and 1995, not in 1990.
2. Productivity is measured as output per employee for Non-OECD countries.

Source: OECD estimations using OECD National Accounts database; OECD Productivity database; International Labour Organisation database.

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To further reduce barriers, the Commission launched a new services package in January 2017 that aims at facilitating the mobility of professionals and streamline cross-border administrative procedures in construction and business services (e.g. accounting, tax advice, architecture, engineering, IT) (Table 5). One of the key measures proposed was a new services e-card to help reducing information asymmetries and eliminate the need for multiple requests of information to facilitate more firms go abroad. E-cards were intended to facilitate the temporary provision of services across borders and the set-up of agencies, branches and offices, where administrative complexity and legal uncertainty is still an important challenge, as recommended in the 2016 Survey. However, the e-card proposals in their current form are unlikely to be approved in the EU legislative process. A solution should be found to reduce barriers in the business services sector by simplifying procedures for self-employed and companies to complete the administrative formalities to establish and provide cross-border services.

There is significant scope for improving the functioning of the European retail sector. Retailers face persisting barriers to market entry including burdensome and complex authorisation processes, restrictive requirements linked to the size and location of shops, as well as operational restrictions, including shop opening hours or rules on promotions and discounts. As a result, evidence by the Commission shows that, as a result, consumer prices are high, and product innovation and labour productivity growth are low (EC, 2015a). The Commission has launched an initiative in May on April 19th, which consists of best practices to guide member states' reforms of the regulatory environment for retail. Such efforts are welcome. Close monitoring by the Commission of the level of regulatory restrictiveness in the retail sector and its economic impacts should be used to measure member states' reform efforts.

An integrated EU energy market would be good for consumers, energy security and the environment

Despite progress made in recent years, much remains to be done to achieve a fully-integrated internal energy market. The European energy market is still too fragmented; high market concentration and weak competition remain an issue, infrastructure is outdated in some areas, investment is insufficient and final energy prices are high for citizens and businesses (IEA, 2014; OECD, 2016b). Trading of electricity across borders has increased markedly since the 1990s and, in recent years, average prices have fallen and some of the largest divergences between countries narrowed. But there remain significant price divergences across countries, in part because of lack of sufficient cross-border interconnection capacity. The economic losses due to these price divergences are substantial, amounting to around €1.1 billion annually by some estimates; incumbent electricity producers benefit particularly from the reduced competition resulting from the lack of adequate connectivity. A well interconnected grid is also crucial to accommodate increasing levels of renewables in a cost-effective way and help meet the EU climate goals. An integrated electricity market would increase the potential for renewables to be supplied beyond national borders contributing to the shift towards a low-carbon economy and to fight climate change.

To further integrate energy markets, investment needs are substantial. The Commission estimates that some EUR 200 billion are needed up to 2020 to build the necessary infrastructure to adequately interconnect all EU countries, about half of it for electricity projects alone out of which 35 billion are needed for interconnections (EC, 2015b). As recommended in the 2016 Survey (Table 4), EU funding, including through the structural funds and the Investment Plan for Europe (so-called "Juncker plan"), should prioritize

trans-European energy networks to fill some of those investment gaps with a positive cost-benefit analysis outcome.

But low investment is not the only constraint on cross-border trade in electricity. Security of supply concerns reduces efficiency and cross-border trade. National operators tend to keep higher reserve capacity margins on cross-border lines than they do on domestic ones, as insurance against occasional unexpected losses of power or surges in demand, reducing cross-border energy supply. The Commission's proposed modification to the regulatory framework for the internal electricity market would help minimise regulatory barriers by explicitly requiring national regulators to treat cross-border links in the same way as the domestic equivalent in market planning. A review of regulations to try to minimize any inadvertent regulatory barriers to cross-border trade would also be welcome. Encouraging regional solutions on power system operation and trade would also help to reduce energy costs and ensure security of supply and the "Clean Energy for Europe" package should provide solutions and practical guidance to revitalise regional cooperation. To make best use of developing technologies (which will require investment in physical infrastructure but also in software), "integrated resource planning" is needed, where the development of generating capacity, the distribution network and market design are all considered together. To enhance trade between member countries, integrated resource planning needs to take place across the whole network, reaching across national boundaries. The ten year investment plans, updated every two years, by the European Network of Transmission System Operators employ such methods and national system operators have to follow up with their own plans.

Deepening the digital single market

The EU is still lagging behind in the uptake and use of digital technologies and this is holding down Europe's growth potential. While some countries like Sweden and Finland are leading on the global stage, the ICT sector value added is significantly smaller in most European countries, and some large economies are trailing behind the EU average. Less than 30% of European businesses in important manufacturing sectors like automotive and mechanical engineering are exploiting digital technologies (EC, 2017f). Business uptake of digital technologies could be improved in many EU countries, especially among smaller companies (Figure 23). This implies an untapped potential to allow firms to capture customers' demand more accurately and reduce failures in the innovation process.

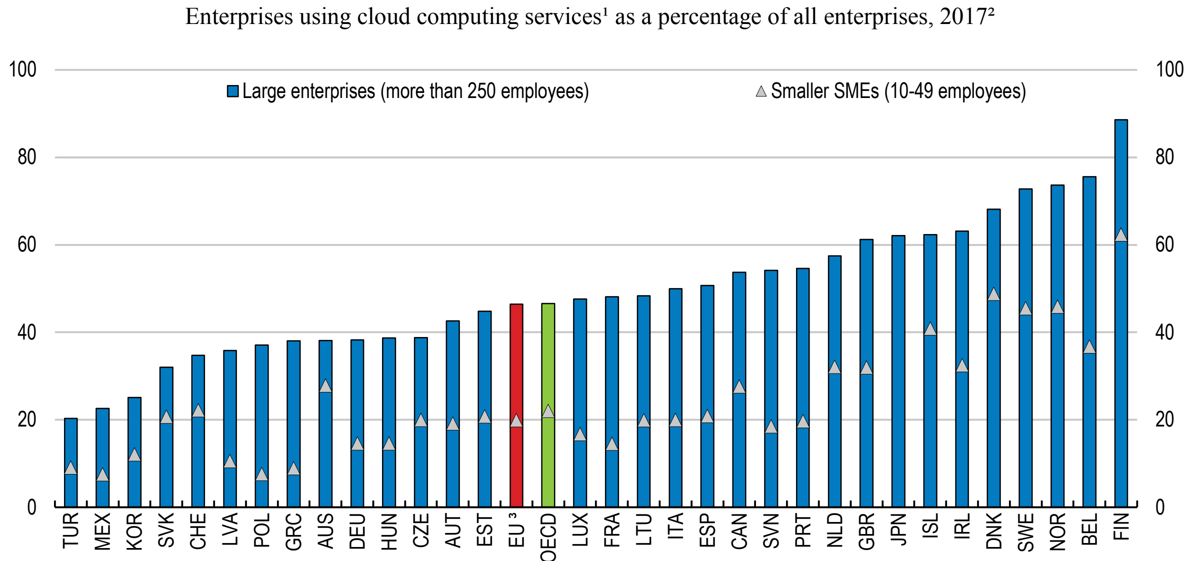
The EU and member states have made deepening the digital single market a priority, aiming to establish common rules for online purchases, integrate telecom regulations, improve postal services and reduce the burden on businesses caused by diverging VAT regimes, among others. Important achievements have been made including improved cross-border portability of online content services and the removal of roaming charges and geo blocking (Table 4). But much remains to be done to create a unified digital market. Other important legislative measures such as modernisation of copyright rules, taxation of e-commerce, cyber-security and addressing unfair contractual clauses and trading practices identified in platform-to-business (P2B) relations are still in the legislative process (Table 4). Moreover, access to proper funding is a critical barrier to the development of digital start-ups. Further efforts to develop the Capital Markets Union, as discussed in the Euro Area Survey would enhance both the domestic and cross-border supply of capital, especially to small and medium-sized enterprises.

High quality network infrastructure is the backbone of the digital economy. However, some member states have weak digital infrastructure, as evidenced by slow average internet connection speed (Figure 24). Digitalisation can facilitate the diffusion of new

technologies and boost productivity by enhancing efficiency in production and administration.

Figure 23. Business uptake of digital technologies could be improved in many firms, especially among smaller ones

Enterprises using cloud computing services[1] as a percentage of all enterprises, 2017[2]



1. Cloud computing refers to ICT services used over the Internet as a set of computing resources to access software, computing power, storage capacity and so on. Data refer to manufacturing and non-financial market services enterprises with ten or more persons employed.
2. Or latest available year; 2016 for the EU and the OECD average.
3. Unweighted average across European Union member countries that are also members of the OECD (22 countries) and Lithuania.

Source: OECD (2018), *ICT Access and Usage by Businesses* (database).

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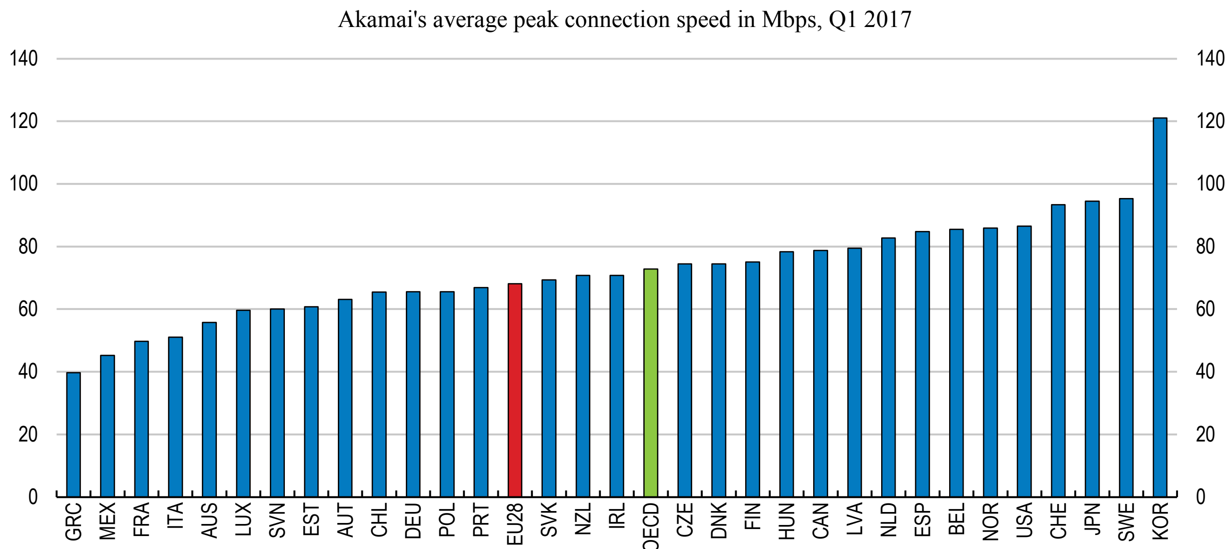
Figure 24. The internet connection speed is still relatively modest in some countries

Akamai's average peak connection speed in Mbps, Q1 2017



Source: Akamai (2017), "Akamai's state of the Internet report: Q1 2017 report", https://www.akamai.com .

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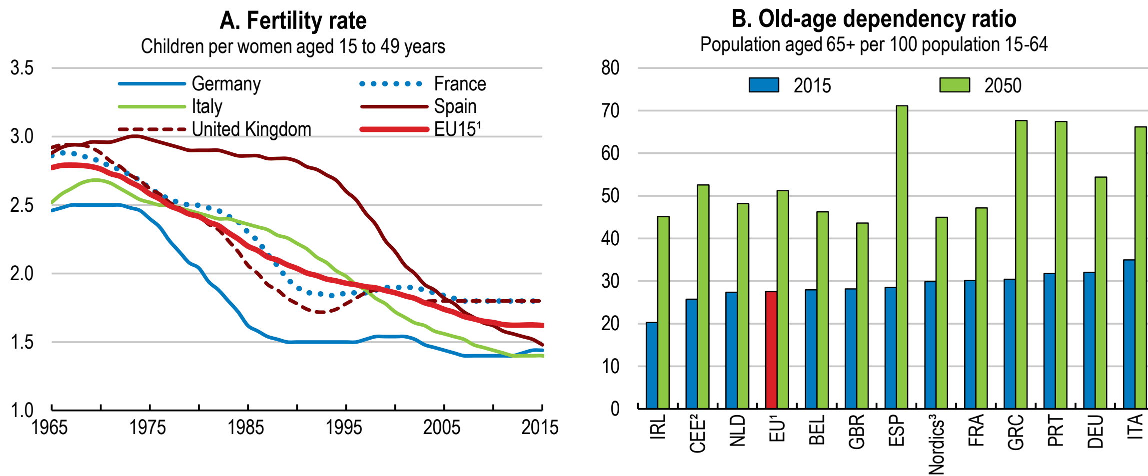
This situation reflects years of low investment in digital infrastructure, and spending remains low (EIB, 2017). The EU supports investments in connectivity through the European Regional Development fund, the Connecting Europe Facility, the Juncker plan and other tools. Such financing can contribute to alleviate the financing gap by easing access to credit and leveraging support for high risk projects. The Commission has also proposed the revision of the regulatory framework for electronic communication markets to provide, among other aims, greater incentives for infrastructure investments in very high capacity networks, especially in less viable areas. The Commission proposal requires national regulators to refrain from imposing regulation on dominant operators regarding new network elements when they offer a possibility for other operators to invest together in new high capacity networks and provided that pre-defined conditions for such co-investment offer are met. However, the body of European regulators for electronic communications (BEREC, 2017) has warned that such co-investments can lead to anti-competitive coordinated behaviours among operators and advised that to exempt co-investment projects from regulation a case-by-case in depth assessment of competitive dynamics would be advisable. The Council and the European Parliament have provided amendments to the Commission's proposal, reflecting their respective views on the rules under which regulatory incentives should be granted. The legislative process is still on-going.

Ensuring that everyone has the right skills for an increasingly digital and globalised world is essential to promote inclusive labour markets and to spur innovation, productivity and growth. At the moment, a shortage of people with the right digital skills is an important bottleneck to greater digitalisation. Close to half of the EU population have insufficient digital skills (Rute, 2017). The Commission is monitoring and forecasting supply and demand of IT professionals in Europe and supporting the development of new curriculum guidelines for schools and universities. The EU launched in June 2016 a Skills Agenda for Europe that also aims at improving digital skills. These efforts are welcome and should be stepped up by establishing common definitions of digital skill needs. The EU could also help member states by developing data tools to monitor skills gaps.

Strengthening the labour market through greater labour mobility and a better EU-level immigration policy

Some central European countries are already facing labour shortages and many businesses see labour shortages as an important constraint to further investment. Now is the time to build on national reforms to increase labour force participation of women, youth and older workers to improve the labour market opportunities of these groups and help alleviate labour shortages. Moreover Europe is rapidly ageing (Figure 25). Immigration has played a role in attenuating the effects of ageing and has helped to fill in labour shortages in the last two decades (EC-OECD, 2014) and it is likely to continue doing so in the future, but immigration alone cannot compensate for Europe's rising age profile. Europe can do better at fostering labour mobility across Europe, attracting high skilled migrants and integrating refugees (Table 5).

Figure 25. Europe is rapidly ageing



1. Unweighted average.
2. Eastern European Member States, including Bulgaria, Croatia, Hungary, Poland, Romania, Slovenia and the Czech and Slovak Republics; unweighted average.
3. Refers to Denmark, Finland, Sweden and the Baltic States; unweighted average.

Source: OECD (2018), *OECD Health Statistics* (database); United Nations (2017), World Population Prospects, 2017 Revision.

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Table 5. Past OECD recommendations on labour market mobility and integration of migrants

Recommendations in 2016 Economic Survey	Actions taken since 2016
Reduce the administrative burden associated with recognition of professional qualifications by using electronic procedures such as the European Professional Card.	In 2017, the European Commission presented a communication on reform recommendations for regulation in professional services addressed to each member state, a proposal on a proportionality test before adoption of new regulation of professions, and a proposal for a European services e-card simplifying administrative formalities required to provide services in another Member State. The Commission proposed establishing a single digital gateway to provide information, procedures, assistance and problem solving services.
Legislate effective portability of supplementary pension rights.	EU member states have been transposing Directive 2014/50/EU, with a deadline of 21 May 2018.
Simplify the eligibility requirements and procedures of the Blue Card scheme to make it more attractive to non-EU high-skilled labour migrants than existing schemes.	In June 2016, the Commission proposed a revision of the EU Blue Card Directive to harmonise conditions, procedures and rights.
Strengthen joint protection of external borders.	The European Border and Coast Guard was established in October 2016.
Speed up administrative decisions on asylum applications and ease labour market access for recognised refugees.	In July 2016, the Commission presented a second package of legislative proposals to complete the reform of the Common European Asylum System.

Fostering intra-EU mobility whilst respecting fair competition and workers' rights

While growing steadily, intra-EU mobility is still relatively weak owing to linguistic and cultural differences as well as policy barriers such as difficulties in having professional qualifications recognised. Migration between EU countries stood at 3.9% of the EU

working age population in 2016 (about 11.8 million people), up from 1.6% in 2004, though is still below inter-state mobility in the US or other federal systems (OECD, 2016b). Moreover, during the crisis, while labour mobility increased in the EU, its shock-absorption role remained modest especially in the euro area (Jauer et al. 2014). Migration flows directed towards the UK and Germany increased, as a result of significant outflows from many Eastern European countries, while outflows from countries suffering deep economic stress remained modest compared to their record-high unemployment rates.

The complexity and heterogeneity of the migration and integration patterns of highly qualified intra-EU immigrants make it difficult to identify brain drain and gain processes within the EU (Schellinger, 2017). On the one hand, outflows of highly-skilled workers, if permanent and of large scale, can lead to skilled labour shortages in the sending countries, weakening productivity and hurting growth. On the other hand, sending countries may benefit from increased remittances or transnational networks (Chiswick, 2005), citizens' strengthened incentives to invest in human capital (Beine et al., 2008) or improved domestic labour allocation (Kaczmarczyk, 2015). Moreover, mobile workers, especially young ones, may return to their home country later, bringing new experience and new skills, acquired in the host country.

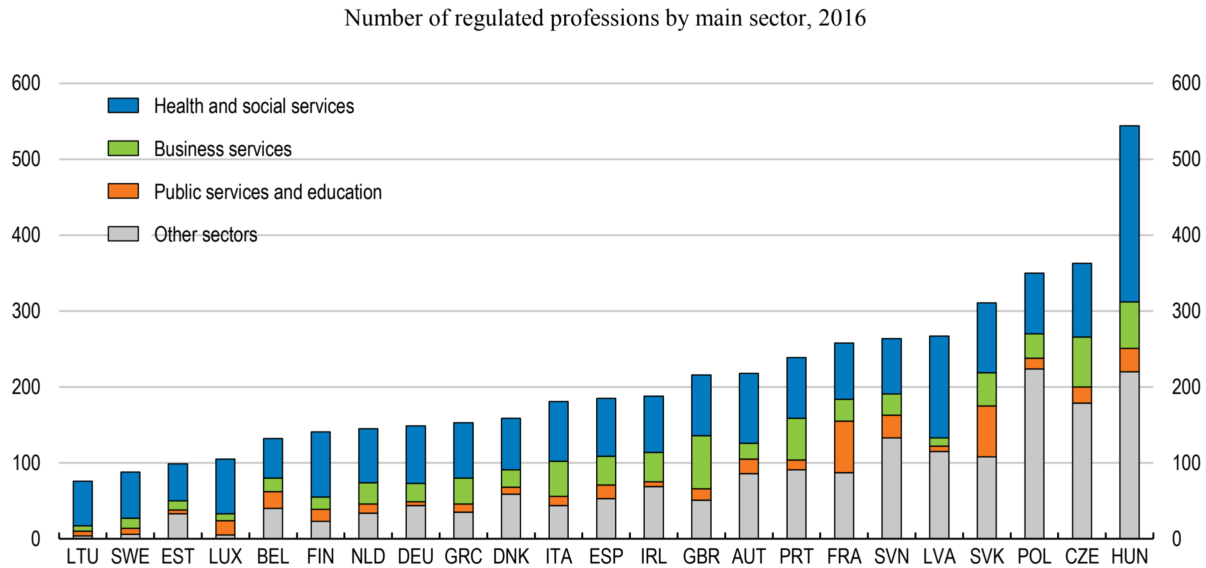
To mitigate the adverse effects of international mobility on their economies, sending countries could create an environment that encourages potential mobile workers to stay and that promotes their return. Beyond increasing investment in education and innovation to create better jobs, sending countries could facilitate the validation of experiences and skills acquired abroad and engage more actively with so-called "diasporas" to advertise domestic business and job opportunities (OECD, 2016c; OECD, 2018e). By taking further steps to deepen the single market and a more effective use of cohesion funds, the EU can also contribute to foster growth and convergence in sending countries which could help to attract back mobile workers.

Language seems to be the most important barrier to intra-EU mobility (European Commission, 2010). Evidence suggests that experiences abroad enhance students' career opportunities (Alfranseder et al., 2012), through improved knowledge of foreign languages, acquisition of soft skills, or increased probability to pursue doctoral studies (Grotheer et al., 2012). The 2014-2020 Erasmus+ programme has a budget of EUR 14.7 billion (around 1.3% of the EU budget), which can only offer learning mobility opportunities to less than 4% of young people living in Europe (EC, 2018). Cultural exchange programmes including the Erasmus + should be expanded to further facilitate mobility. To make mobility opportunities more inclusive, the successor of the current Erasmus+ programme could expand in particular its school and VET related parts and include targeted actions for disadvantaged learners.

Better recognising the qualification of learners and skilled movers would also help to enhance mobility. Qualification and training requirements to access regulated professions vary widely across countries and the recognition of qualifications is often made on a case-by-case basis, favouring uncertainty. Increased harmonisation of professions' curricula at the EU level beyond the seven professions currently covered could help make recognition of qualifications more automatic. The recently introduced electronic European Professional Card that ensures the recognition of professional qualifications via digitally-secured information exchanges between authorities should be equally generalised. Further reducing the high barriers to access regulated professions, whose number remains high, in many countries (Figure 26), could further support mobility, as well as long-term productivity growth.

Figure 26. In many EU countries the number of regulated professions is high

Number of regulated professions by main sector, 2016



Source: European Commission (2017), Regulated Professions Database.

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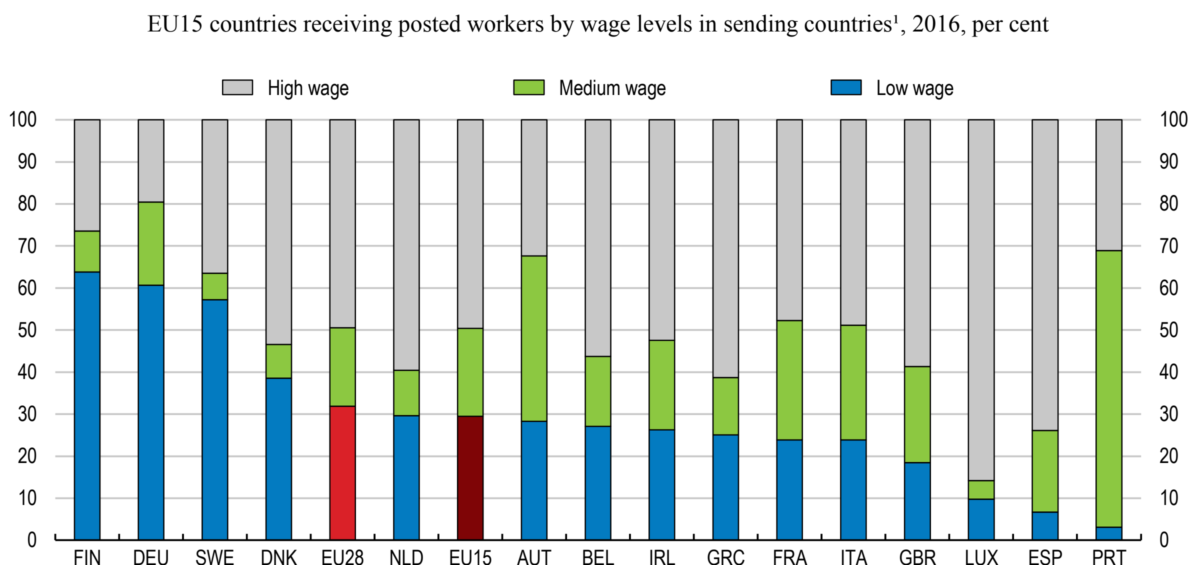
Persisting differences in the principles and generosity of national social security systems still complicate migration (Meyer et al., 2013). Strengthened mobility incentives require more harmonised social security systems. While the EU has no competence to harmonise the social security systems, the EU has rules in place to coordinate national systems to make sure people do not lose their social security rights when moving to another member state. Improvements in the portability of pension rights as well as the recent Commission proposal to extend the exportability of unemployment benefits from three to six months or make the country of last employment responsible for paying cross-border workers' benefits (instead of the country of residence) have contributed to ease EU-movers' concerns about their social rights. Moreover, the Electronic Exchange of Social Security Information (EESSI), a secured digital platform linking EU social security institutions – at national, regional and local levels – to be implemented by all participating countries by mid-2019, will allow for a quicker, easier and secure exchange of social security information throughout the EU, thus facilitating administrative processes. Citizens who have lived and worked in several of the participating countries will see their social security benefits calculated quicker and more efficiently. The platform, if backed by single European social security and business registration numbers, could also effectively contribute to ease administrative burdens and improve cross-border monitoring and surveillance (Aussilloux et al., 2017).

Having grown by more than 40% since 2010 (Pacolet and De Wispelaere, 2016), workers who are employed in one member state and are sent by their employer temporarily to another member state (posted workers) have become a sensitive political issue, despite accounting for less than 1% of total EU employment in 2015. Their strong concentration in labour-intensive sectors (construction, manufacturing as well as health, education and professional services), coupled with significant wage differences between local and posted workers of up to 50% in some sectors, have led to growing fears of wage and

social dumping (FGB, 2016; Houwerzijl, 2013), despite the fact that only a quarter of posted workers in the EU-15 comes from low-wage countries (Figure 27).

Figure 27. Only a quarter of posted workers in the EU15 come from lower-wage countries

EU15 countries receiving posted workers by wage levels in sending countries[1], 2016, per cent



1. EU28 countries sending posted workers in the EU15 are included in the high, medium or low wage group if, in year 2012, their average wage was above, around or less than half of the EU average, respectively. High-wage countries include Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands and Sweden. Medium wage countries are: Greece, Portugal, Slovenia and Spain. Low wage countries include: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and the Slovak Republic. Data on the destination of postings from the UK are not available.
Source: European Commission.

StatLink http://dx.doi.org/10.1787/888933748040

To ease these concerns, on 19th March 2018, the Commission, the Council and the European Parliament provisionally agreed new rules revising a 1996 directive and requiring that posted workers become subject to full-blown host country's labour laws when their posting exceeds 12 months (extendable up to 18 months) and that they have the same working and salary conditions as local workers from day one. Though still pending final approval by the European Parliament and Council, these steps to address concerns that workers are treated fairly while not creating obstacles to the free movement of services are welcome. However, they could prove of limited effectiveness, insofar as posted workers' remain affiliated to their home social security system (Richard, 2016) and there are significant cross-country differences in labour taxes. Moreover, in international transport, which is one of the areas where wage gaps are most significant, the posting directive is only partially applied in practice, pending the approval of an EU transport legislation, currently under discussion.

Better protecting mobile workers' rights requires more effectively coordinated cross-border policies. Differences in wages between posted workers and other workers are limited to some sectors and countries, but methods to circumvent the law, like "letter-box" companies (firms with no or very little activity at the place where they are established) and "bogus" self-employment (individuals working de facto as employees but registered as self-employed), are increasingly widespread, creating tax revenue losses

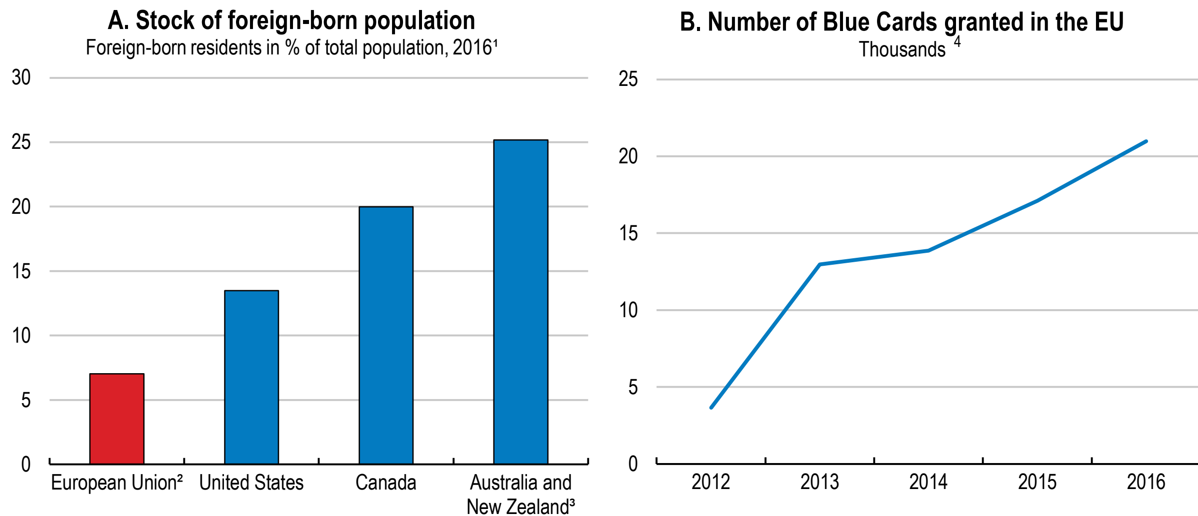
and possibly abuses of workers' rights (Wickham and Bobek, 2016). To strengthen transnational coordination in the fight against fraud, a 2014 EU directive has clarified and enhanced administrative cooperation procedures and improved tools for controlling the lawful nature of postings and hiring businesses (Cremers, 2016). In addition, deadlines to respond to cross-border requests for information have been significantly shortened. Although welcome, these measures disregard the impact the likely surge in cross-border information requests and infringement procedures will have on the already understaffed national labour inspectorates (Walters, 2016). At the national level, strengthening national labour inspectorates would help. At the EU level, a recent proposal to set up a European Labour Authority to better coordinate the design and organisation of joint cross-border labour, social security and tax control and monitoring activities could boost the effectiveness of transnational efforts against labour fraud and undeclared work.

A better EU approach to immigration

The EU is underachieving on the global competition for talent (Figure 28, Panel A; OECD, 2016d). One key problem is that labour market and migration regulations are different in each member state. The Blue Card, an EU-wide scheme, allowing high skilled non-EU citizens to work and live in any EU country (excluding Denmark, Ireland and the UK), was designed to make the EU attractive to skilled migrants by offering common admission conditions and set of rights for highly skilled foreigners to live and work in the EU – including provisions for intra-EU mobility and better long-term residence rights. However, the EU Blue Card has proven to be insufficiently attractive, with only a limited number of permits issued (Figure 28, Panel B). Restrictive admission conditions and different rules, conditions and procedures across the EU have limited the use of the scheme (EC, 2016). As recommended in the 2016 Survey, the scheme should be modernised and its eligibility requirements and procedures simplified, so it is more often used (Table 5). In June 2016, the Commission proposed a revision of the EU Blue Card Directive to harmonise conditions, procedures and rights.

Integrating refugees early is key to improving their wellbeing and labour market opportunities and to strengthen people's trust. Europe has experienced the largest inflow of asylum seekers since World War II, with 3.6 million first-time asylum applications since early 2013 (29, OECD 2017d), and this is an important concern for Europeans, as shown by the Eurobarometer Surveys. At the EU level a coordinated and comprehensive policy response is essential to effectively integrate asylum seekers as the 2016 Survey argued (Table 5). The best way to integrate newcomers is to get them into work quickly. Boosting early labour market access, further increasing places for integration programmes and language training (including vocational language training), accurately assessing the skill levels of immigrants and tying the dispersion of asylum seekers more to areas with better labour market conditions in the host country could all improve the wellbeing of migrants and promote more inclusive growth (OECD, 2017g). In a welcome move, the Commission has developed a skills profile tool to support early identification of the skills and work experience of refugees, migrants and other third country nationals and to provide guidance on training, education or employment. The influx of refugees included many children, and educating them will be crucial for their long-term integration. For instance Germany, has recruited new teachers and set up one-year "welcome classes" for newcomers with a focus on language teaching.

Figure 28. The attractiveness of the EU to foreign migrants, especially highly skilled ones, is still relatively limited



1. 2015 for the United States, 2014 for Australia-New Zealand and 2013 for Canada.
2. Mid-year estimate, excluding intra-EU mobility.
3. Excluding bilateral mobility between Australia and New Zealand themselves.
4. The EU Blue Card offers highly educated and skilled workers of non-EU countries the opportunity and the right to work and stay in the European Union.

Source: Eurostat (2018), "Population Statistics", *Eurostat Database*; OECD (2018), *International Migration Statistics* (database).

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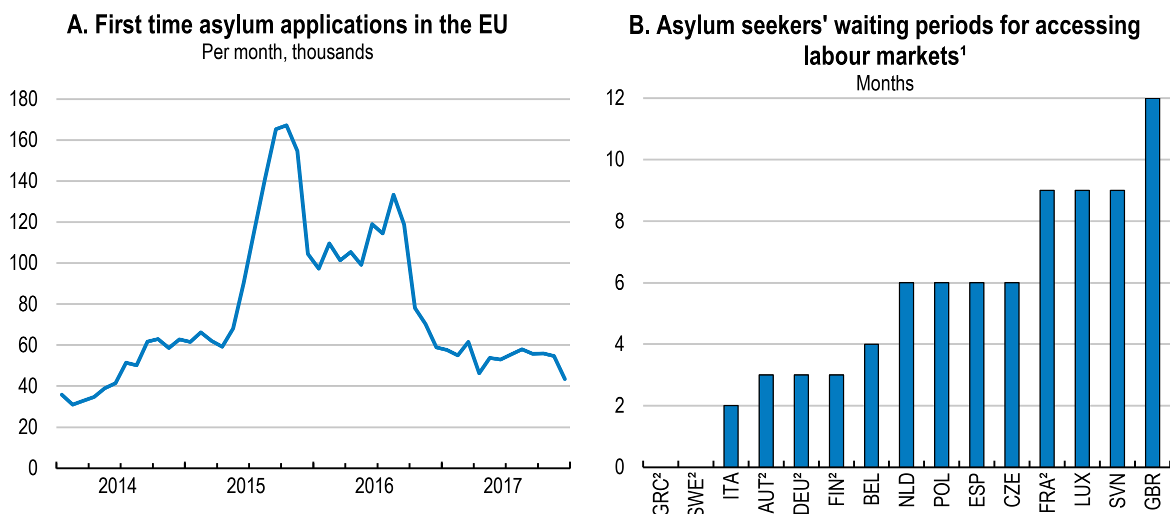
Figure 29. The inflow of refugees is an important challenge



1. Asylum seekers' most favourable waiting periods for labour market access in a selection of EU countries.
2. Access to labour market is granted under certain conditions.

Source: Eurostat (2018), "Asylum and managed migration", *Eurostat Database*; OECD (2016), Migration Policy Debates No. 10.

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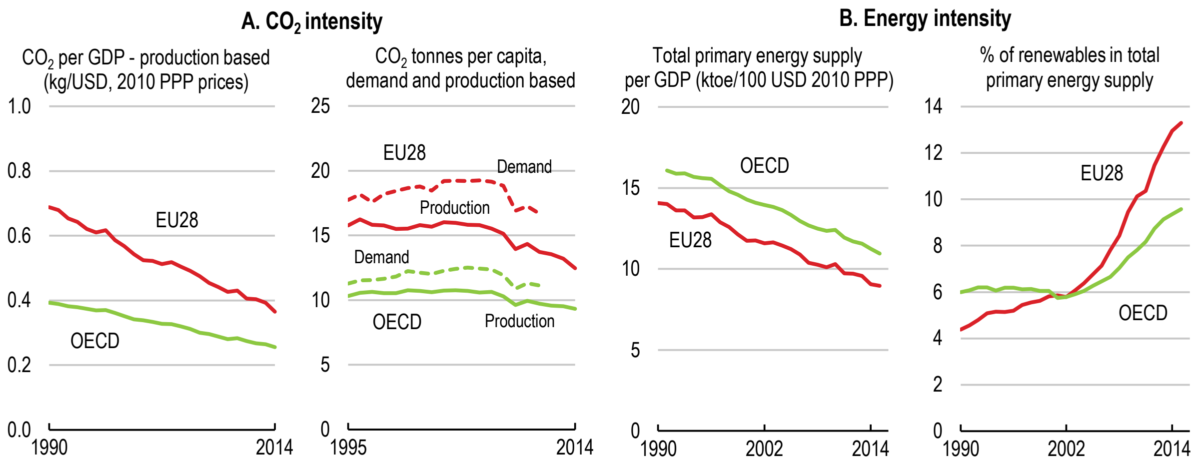
Strengthening the drive to fight climate change

According to a recent Eurobarometer, over 90% of Europeans see climate change as a serious problem (EC, 2017g). Emissions of CO_2 per capita and per unit of GDP are higher than the OECD average but have been steadily declining (Figure 30). In 2007, the EU pledged to reduce its greenhouse gas emissions by at least 20% from their 1990 levels by 2020. The EU is on track to meet its target to reduce its greenhouse gas emissions by at least 20% from their 1990 levels by 2020, partly because of the impact of the recession. Most countries are expected to reach their 2020 targets (EC, 2017h).

Figure 30. $C0_2$ intensity and energy intensity have fallen in the EU



Source: OECD (2018), *Green Growth Indicators* (database).

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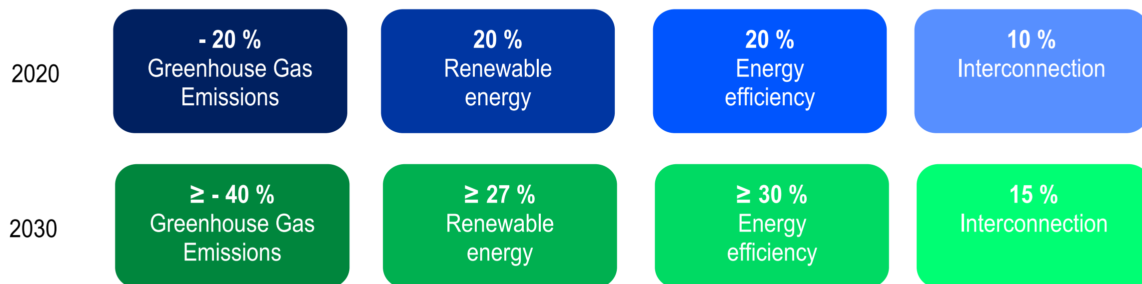
The main EU-level policy instrument – the EU emissions trading system (ETS) – is supplemented by a battery of EU legislation mandating various intermediate targets (Figure 31).Under the Paris agreement, the EU and its member states have collectively committed to decrease their domestic greenhouse gas emissions by at least 40 % by 2030 from 1990 levels (Figure 31). On current policies, greenhouse gas emissions are projected to exceed the 2030 target.

Figure 31. Agreed EU headline targets for climate and energy



Source: European Commission (2017), Third Report on the State of the Energy Union.

The ETS is often regarded as the main tool for cutting emissions, but it has probably had a limited impact when it comes to driving low-carbon investments: the price of emission allowances, which has long been under 10 euros per tonne, is too low to drive long-term low-carbon investments. Estimates suggest that a carbon price of 30 euros would be needed to make onshore wind investment profitable, while a price of 40 euros would be required to shift production from coal to gas, according to analysis from the International Energy Agency and business groups (EIA, 2014). This low ETS price is due to a combination of low economic growth, extensive promotion of renewable energy and the large inflow of international credits from the Clean Development Mechanism. The supply of credits has exceeded emissions, leading to a surplus of unused CO_2 emission allowances.

Some recent measures aim at making the ETS more effective. In November 2017, EU negotiators agreed to reduce the number of allowances by 2.2% per year from 2021 on (Table 6). It may take some time for this to have an impact. In addition, the so-called Market Stability Reserve ("MSR") agreed in 2015 will start operating as of 1 January 2019 with a view to address the current surplus of allowances. Whenever the surplus exceeds a predefined threshold of 833 million allowances (equivalent to almost one half of current annual emissions of installations covered by the ETS), some allowances due to be auctioned will not be auctioned but will instead be placed in the MSR, thus tightening the annual supply of allowances further. The amount thus placed in the MSR in a year will be 24% of the surplus for the first five years of its operation and 12% of the surplus after that. If the surplus falls below 400 million allowances, allowances from the MSR will be released for auction.

Also in November 2017, changes to the Market Stability Reserve were agreed, enabling it to double the speed at which it absorbs the surplus in the first five years of its operation and introducing the provision that allowances in the MSR above a previous year's auction volume will lose their validity as from 2023 onwards, meaning that they cannot be released back into market. This measure could be a useful tightening. Phasing out of free permits outside the electricity sector could further strengthen low carbon investment signals (Flues and Van Dender, 2017).

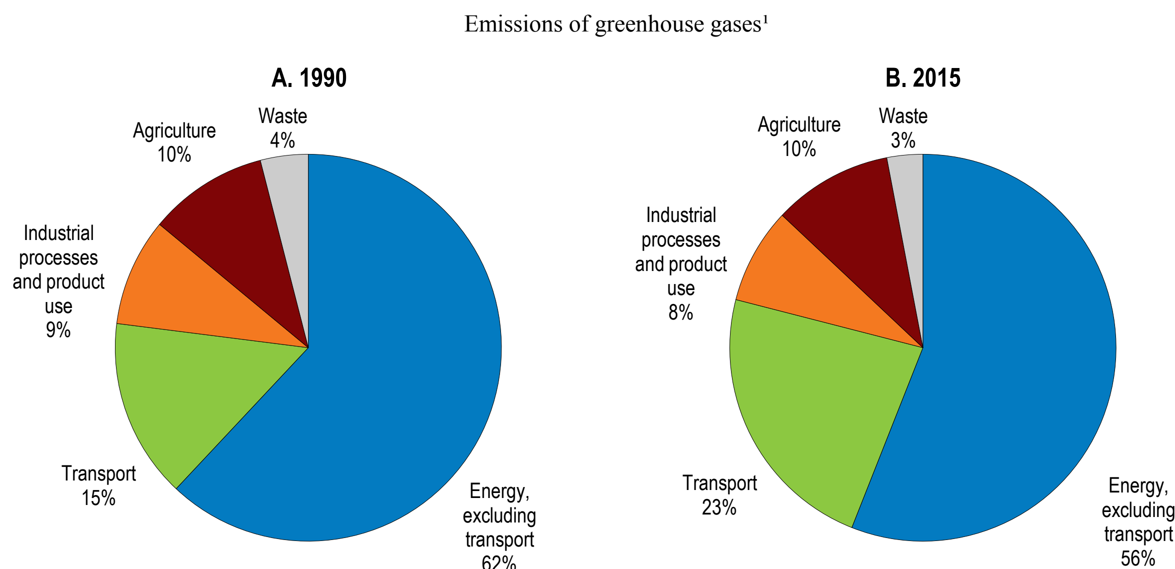
Table 6. Past OECD recommendations on environmental policy

Recommendations in 2016 Economic Survey	Actions taken since 2016
To ensure a functioning EU carbon market, reform the ETS by reducing the emissions cap and introducing a reserve of allowances to smooth market fluctuations.	The EU has revised the EU ETS and corresponding legislation for the period after 2021. The cap will be reduced by 2.2% per year as of 2021 and the Market stability reserve, to address the surplus and improve the ETS's resilience to major shocks, will start operating as of 1 January 2019.

The absence of some key emitters from the ETS, notably fuel for transport, commercial and household heating, means that other policies have to be used to tackle those sectors. Transport is the EU's second-biggest greenhouse-gas emitter after energy and is generally the main cause of air pollution in cities. It represents a rising proportion, currently about one fifth, of greenhouse gas emissions (Figure 32), with road transport accounting for some 80% of these (EC, 2017f). EU Member States have the possibility of including the transport sector – or any other sector – in the ETS.

Figure 32. The rising share of transport in European Union GHG emissions

Emissions of greenhouse gases[1]



1. Excluding land use, land-use change and forestry (LULUCF).

Source: Eurostat (2017), "Greenhouse gas emissions by source sector", *Eurostat Database*; European Environment Agency.

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Widening the ETS to include transport and all other uses of fossil fuels, with a cap to match the 2030 target, would move the EU towards a simpler, more direct and more cost-effective policy: the various intermediate targets and sector-specific policies could be progressively eliminated. Relying fully on the ETS implies some risk of very high emission allowance prices in some circumstances, but a phased approach, which would be necessary anyway, would minimise this risk.

While a widened ETS is the best tool to reduce GHG emissions in nearly all sectors, other policies matter. For example, taxation, public procurement, land-use policies and urban planning can all be more or less climate friendly; urban planning is especially important as it constrains choices on transport and heating for long into the future. The OECD Aligning Policies report (OECD, 2015) surveys a wide range of such policies. Policies in agriculture and waste, whose emissions are difficult to include in the ETS, may also need reinforcing; a cost benchmark related to the ETS allowance price (or estimated costs of other mitigation policies if these continue to dominate) could be applied. Moreover, the Commission has issued in March 2018 an Action Plan for Financing Sustainable Growth to be rolled out in 2019, which aims at re-orienting capital flows towards sustainable investment, to manage financial risks stemming from climate change and to foster transparency in financial and economic activity (EC, 2018b).

Instead of mandating the inclusion of transport in the ETS, the EU authorities are planning a battery of measures for the sector: in July 2016 the Commission adopted an EU Strategy for low emission mobility (EC, 2017f) addressing key levers: efficiency of the transport system, low – emission alternative energy for transport and low and zero emission vehicles. The Commission has now proposed legislative initiatives to implements this strategy, including: 1) revisions of Eurovignette, Clean vehicles and

Combined Transport Directives, 2) a recast of the renewable Energy directive with a blending mandate on fuel suppliers to ensure that by 2030 at least 6.8% of low-carbon and renewable fuels will enter the EU market, and 3) a proposal for CO_2 emission standards for new cars and vans. The latter proposal also includes incentives for zero and low-emissions vehicles. The overall level of taxation on emission-creating activity will need to increase. The EU cannot act directly on taxation, but minimum levels can be agreed on: the tax on diesel fuel should always be higher than that on petrol, since it emits at least as much and usually more pollution, including CO_2, per litre consumed. Despite signs of change, diesel taxes per litre remain lower than those on petrol in many countries (OECD, 2018f).

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