Towards a sustainable balance

How the European Union should combine ambitious sustainable development goals with the need to increase competitiveness

Author:

SPOTDATA

Partner:

This report has been co-financed by the European Commission Representation in Poland. The European Commission, or any person acting on its behalf, is not responsible for the use of the information contained in this report. This report reflects the views only of the authors, and the European Commission cannot be held responsible for any use which may be made of the information contained therein.

Recommendations

To combine ambitious sustainable development objectives with the need to increase competitiveness, the European Union should:

1. Increase the effectiveness of the InvestEU programme in promoting an innovative economy

2. Reform fiscal rules to support investment and R&D spending

3. Keep cohesion policy as close as possible to its current form

4. Support regions in crisis more broadly than it has to date, by combining support with structural reforms

5. Defend the rules of the World Trade Organization

6. Fight for Internet freedom

7. Support those companies that grow, not those which are large

8. Promote the integration of the Eastern Partnership countries into the European Economic Area

9. Promote “just” energy transition

10. Support the development of energy storage and nuclear technologies

Table of contents

1. Introduction *4*

2. Growth and jobs *6*

3. Social cohesion *10*

4. International trade and competitiveness *14*

5. Climate policy *21*

Introduction

The new term of office of the European Commission and the European Parliament* marks a reopening of the European Union's economic policies on many fronts, while continuing the key strategies of the previous term of office. Looking at the process of European integration as a vehicle for change, the European Union is more like a train than a car: it can change the speed at which it moves and the track on which it travels. But changing direction is rather impossible in the short to medium term – and a single term of office comes under that timeframe.

The analysis in this report points out the most important areas where a change of pace and track can be useful. In other words, within the existing EU strategies, we identify those elements which work and those which need to be adjusted or accentuated. We do not discuss any revolutionary changes, but propose adapting strategies to better fit contemporary challenges.

The most important problem we have identified in our analysis of the EU's strategy is the imbalance between the achieving of two major economic policy objectives: sustainable development and competitiveness.

The European Union is a global leader in introducing changes that make economic development more citizen- and environment-friendly. The World Bank once called Europe "a lifestyle superpower". Today, this phrase can be corrected slightly and the European Union can be described as "a sustainable development power". The EU has much better indicators than the United States for social inequality, labour market participation, citizens' health and greenhouse gas emissions. The EU is undoubtedly a better and safer place for the average citizen to live than the USA.

At the same time, however, the European Union is underperforming in areas at the forefront of contemporary global economic competition. It suffers from low economic growth, low labour productivity growth, low spending on research and development, and low investment in intellectual property, which – in the digital age – determines competitive advantages. Another huge problem is the persistence of high unemployment in many southern Member States, which hits young people particularly badly.

*The report was finished in October 2019

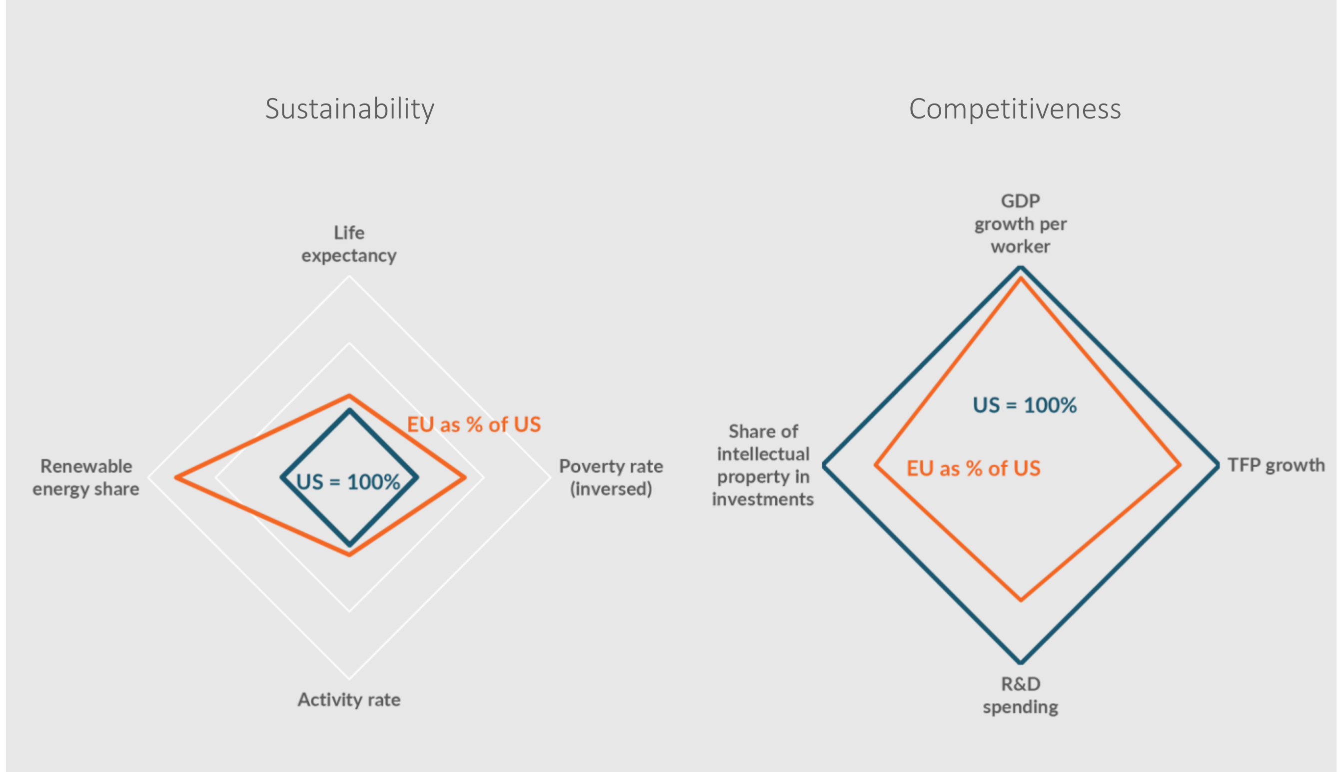
This imbalance between sustainability and competitiveness is shown in Figure 1. It shows how the EU outperforms the USA in terms of sustainability indicators but at the same time loses out to the USA in terms of competitiveness indicators.

Of course, Europe's socio-economic model is different from that of the US. The aim of the European Union is not to imitate the United States but to find its own solutions. Nevertheless, the sustainable development of the EU's economy needs strong growth, strengthened competitiveness and greater labour market mobility within the Union itself. Unlike the USA, the EU does not use the full potential of its internal market. Despite the differences, comparing the EU and the USA shows where the EU needs to find ways to catch up.

We have divided this analysis into four areas we consider to be the pillars of all EU economic policy strategies: growth and jobs; social cohesion; trade and competitiveness policy; and climate policy.

Ignacy Morawski and *Olaf Osica*

Figure 1. Sustainable development and competitiveness indicators - EU in comparison with the USA



Source: Own calculations; the difference in the indicators of labour force participation, GDP per employee and TFP growth has been multiplied by 10 to help illustrate the difference, which is naturally low in these indicators

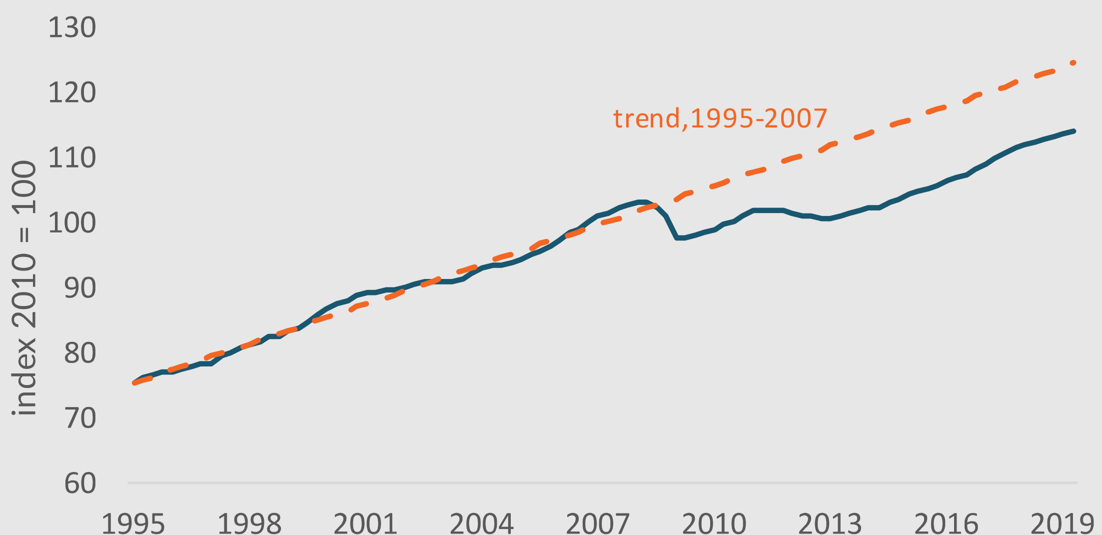
Growth and jobs

After the global financial crisis in 2009 and the debt crisis in the euro zone in 2012, the recovery of the economic growth rate became a priority for all governments and EU institutions. The European Union only reached the pre-crisis GDP level at the end of 2014, and the pre-crisis rate of growth (approximately 2% per annum) only seen again in 2017. Even worse, income levels, which were driven down by the crisis, have not yet recovered and almost certainly will not do so in the near future: a return of income levels to the pre-2008 figures would require sustained (for about a decade) economic growth of some 3% per annum. The last few years show that that is simply not possible.

However, the EU does have a number of important success stories to report with regard to promoting growth and jobs. First of all, what has become known as the Juncker Plan, which initiated the founding of the European Fund for Strategic Investments (the EFSI) and was to stimulate private investment in the EU, turned out to be a success. Originally, that programme had not been expected to have a significant impact on macroeconomic changes, but data shows that since the plan was launched the rate of investment in the European Union has increased significantly. It is important to note that this was not an increase due to wider global trends, as the overall investment rate in developed countries has not changed significantly during that period. Therefore, the investment revival which has been seen since 2015 could have been caused to a large extent by the activity of the European Commission. Financial support for strategic investments in transport, energy and telecommunications infrastructure and for the SME sector stimulated private capital activity.

However, the greatest failure of the EU in this period was it being unable to strike a more favourable balance between inflation rates and unemployment rates. The euro zone (within which a unified monetary policy and a relatively unified fiscal policy are conducted) has a much worse balance between these variables than other large currency areas, i.e. inflation is too low and unemployment is too high. The European Central Bank, which is responsible for controlling the stability of inflation, states directly that it is not able to increase inflation without support from fiscal policy. The ECB has repeatedly appealed to political institutions to soften their fiscal policies, which would allow them to achieve a better policy mix: a better balance in the support of the economy by monetary and fiscal policy. At the moment, the burden of stimulating the economy rests almost entirely on the ECB's shoulders, which poses risks for the stability of the financial system and is ineffective.

Figure 2. EU GDP in the context of the pre-crisis trend



Source: Own calculations based on Eurostat

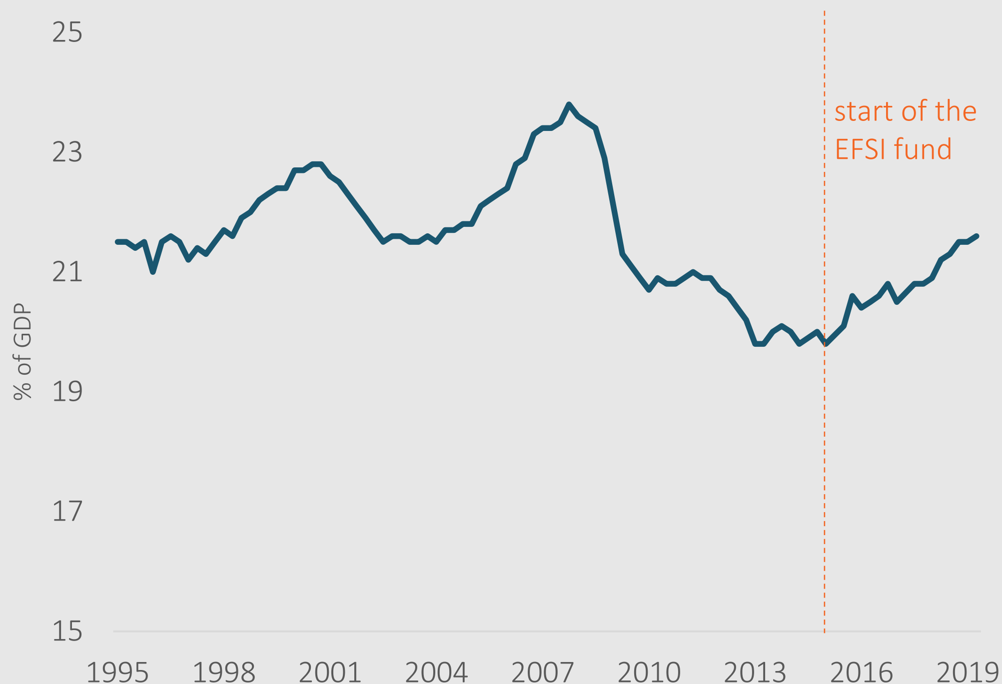
Recommendation 1:
Increasing the effectiveness of EUInvest

The Juncker Plan is naturally linked to the outgoing President of the European Commission. The change of president and the creation of the EUInvest programme, which is based on the Juncker plan, offer an opportunity to give the programme new features that respond to the structural challenges of the European economy. Above all, the plan should give greater support to the areas of research, development and digital investment, fields in which the European Union still lags behind the United States.

As mentioned above, the Juncker Plan has proved to be an effective tool for stimulating investment. The investment gap between the EU and the USA has been closed over the last four years. This is shown in Figure 3. The EU investment rate, i.e. the share of gross fixed capital formation and intellectual property in GDP, started to rise in 2015 and has approached pre-crisis levels. Although there is no clear evidence that the Juncker Plan was a decisive factor here, the fact that trends in investment have not changed in other developed countries during that period may suggest that the plan has had an impact on the investment activity of companies.

At the same time, however, the EU has not made any progress on closing the R&D investment gap. More and more economic analyses show that R&D investment is the pillar on which modern economic development is built and the main reason why the EU stands apart from the USA in terms of innovation and efficiency. The EU is strong on technology transfers between science and business, and maintains a high quality of scientific research, but it has a big problem with the amount of expenditure on research and the implementation of research findings into the industry.

Figure 3. Rate of investment in the European Union



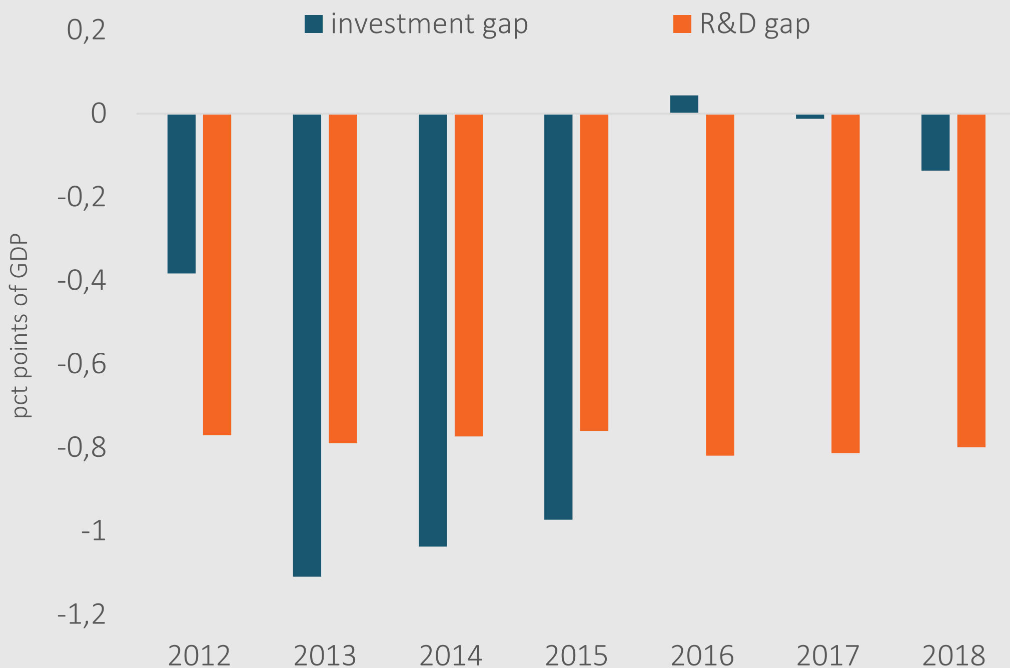
Source: Own calculations based on Eurostat

The EU itself is a good judge of this problem. However, fiscal savings after the financial crisis meant that there was a shortage of instruments capable of supporting R&D spending. That is why the EUInvest can be effective in this sector. The fund was set up precisely to fill the gap that appeared on the investment market during the period of fiscal consolidation.

As the EUInvest is constructed in such a way as to generate a positive financial return on the resources involved, it cannot engage in very risky undertakings. It cannot directly finance research and development activities, which by their very nature are extremely risky. However, the incentives that the fund is able to exert can be a very effective tool for supporting R&D activity.

First of all, the EUInvest fund should take into account the innovation systems within which the supported companies operate and promote those investments that are able to generate demand for innovative products and services. Moreover, the fund may directly increase the involvement in those companies which have developed R&D activity. It also seems reasonable for the fund's activities to be accompanied by greater support for the developing of digital competences in companies conducting R&D activities within the framework of the European Social Fund.

Figure 4. Gap between the EU and the US in investment and R&D investment rates



Source: Own calculations based on Eurostat

Recommendation 2:
Reform of fiscal rules to support investment and R&D expenditure

The ECB has long appealed to European governments to support economic growth to a much greater extent by loosening fiscal policy. This applies to those countries that have what is referred to as fiscal space, which means that they can increase their deficits in the general government sector without significantly worsening their creditworthiness. However, for that a change in fiscal rules at the EU level is needed. First of all, some of public investment and R&D expenditure should be excluded from the restrictive spending limits.

The EU clearly has a bigger problem with achieving adequate demand growth than other large economies. We can analyse this on the basis of the example of the euro zone, within which inflation processes and the policy mix can be shown in a coherent way. Very low inflation means that the euro zone has a problem with demand. Worst of all, the ECB's forecasts indicate that low inflation – given the current shape of fiscal policy – will continue for many years to come, which means that unemployment may also be higher than the optimum level. Although many analyses published in recent years question the relationship between inflation and unemployment rate, mainstream macroeconomic analysis still indicates that in the short and medium term inflation and unemployment rates move in opposite directions. Thus, inflation which is for years below the target means that unemployment is above the optimum level for the economy.

At the same time, loosening the rules regarding budget deficit in terms of expenditure on research, development and investment gives an opportunity to channel a new fiscal impulse in areas important for the competitiveness of the economy. This would give the European Commission greater influence not only on macroeconomic parameters, such as deficit, expenditure, income, etc., but also on the structural parameters of budgets, i.e. the composition of expenditures. In the current regulatory system, the EC has almost no influence on that, and loosening fiscal rules with regard to investment expenditures and R&D would ensure such an influence and would, at the same time, be positively received by a large number of European governments.

Figure 5. Unemployment and inflation rates in the euro area and other currency areas, in % (data for 2018)

Source: Own calculations based on IMF

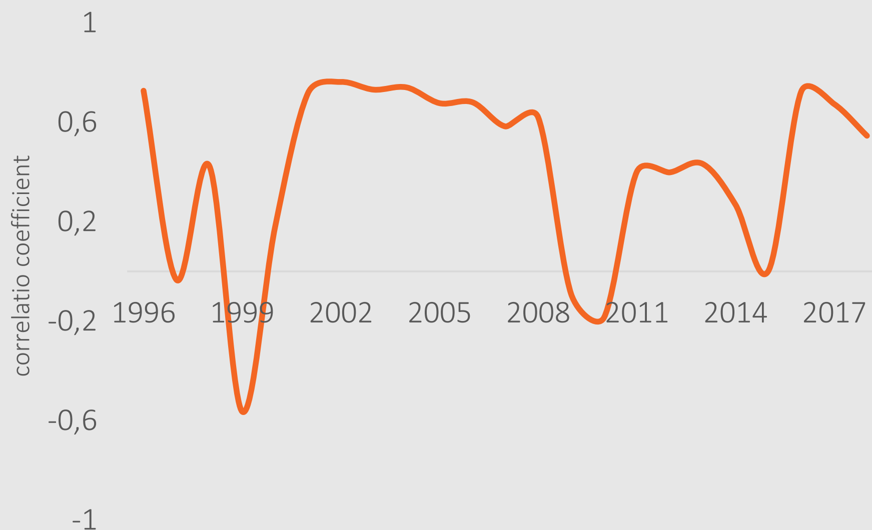
Social cohesion

The European Union is the most effective convergence machine in the world. This means that within the European Communities, and later the EU, the rate at which poorer economies catch up with wealthier economies was the fastest among all regions of the world – a comparable pace of convergence has been seen only in Asia, in the past. The peripheral countries of the integrated Europe are involved on a large scale not only in intensive international exchange of goods and investments, which allows them to more rapidly adopt and diffuse technologies from developed countries, but also in the building human capital through quicker movement of people and institutional capital due to the adopting of legal standards from the most developed countries. At the same time, technological and economic leaders have access to larger markets and cheaper labour. The European convergence machine therefore benefits all of its participants.

Driving the convergence machine is the EU's greatest success in the economic area, and maintaining its operation is the greatest challenge for the future. Convergence within the EU as a whole is still progressing. As Figure 6 shows, the initial level of development determines the pace of development to a very significant degree, which means that less productive countries develop more quickly than more productive countries. But, at the same time, this simple juxtaposition shows the risks facing the European convergence machine. Above all, economic cycles have an extremely destructive effect on convergence: in good times convergence progresses, but in bad times it stops or even reverses. The recent crisis has been particularly acute in this respect, as it has stopped the convergence of southern European countries, leading to the greatest political crisis in the history of European integration.

Behind these crisis phenomena there is another, deeper challenge for the convergence process. While in the 1990s and 2000s the greatest challenge for the EU was to involve Central and Eastern Europe in the process of integration, and to launch convergence mechanisms in this region, in this decade we see the return of an old division line, between the North and the South. This division has always existed, in terms of social, economic and political institutions. In the times of prosperity it was, however, not as visible as the east–west division. Today, as it again significantly affects political dynamics within the EU, the EU must cope with the daunting tasks resulting from east–west and north–south competition for resources. This is an extremely difficult task that requires a well-balanced approach.

Figure 6. The strength of the convergence effect in the European Union
(how much the initial level of development correlates with the dynamics of development, with a negative sign)



Source: Own calculations based on Eurostat

Recommendation 3:
The cohesion policy should be kept in a form as close as possible to the existing one

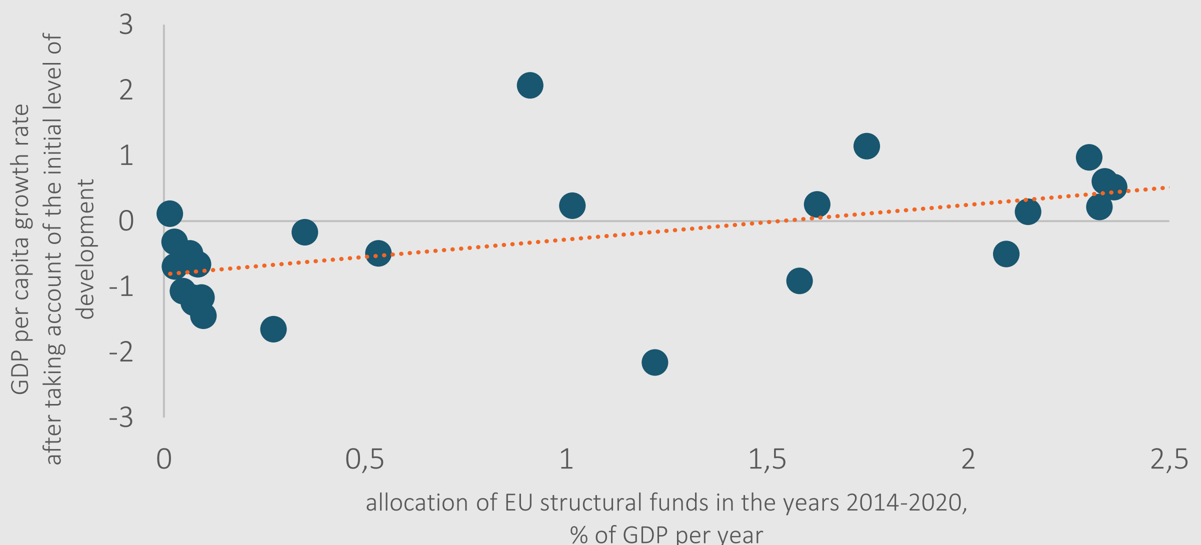
The new economic challenges faced by the EU, including, in particular, the need to support countries affected by the debt crisis and the migration crisis, resulted in the draft Multiannual Financial Framework of the EU for the years 2021–2017 assuming a very clear cut in subsidies for the countries of Central and Eastern Europe. This is largely understandable, as those countries have achieved high growth rates and low unemployment rates. They are on a good convergence path and can withstand a reduction in the flow of European funds.

At the same time, as mentioned above, the greatest threats to Europe's economic disintegration are now found in other parts of the continent.

Excessive reduction in transfers may, however, have undesirable effects. The countries of Central Europe and Eastern have made significant efforts to reform and adapt their economies to the requirements of competition within the single market. They see European funds as support for the process of building market institutions that are historically new and often met with public discontent. European funds have played a very positive role in supporting economic growth in these countries, as shown in Figure 8 – the largest beneficiaries of cohesion policy transfers recorded higher economic growth, after taking into account the initial level of development.

Therefore, keeping the cohesion policy as close to its present form as possible appears instrumental in building consensus among Member States and paving the way for a more ambitious sustainable development agenda for the future.

Figure 7. Inflow of EU structural funds vs. economic growth



Source: Own calculations based on IMF and European Commission

Recommendation 4:
Support regions in crisis more broadly than it has to date, by combining support with structural reforms

The experience of Central and Eastern Europe has taught other regions of Europe important lessons that can be used for designing new support mechanisms under the EU budget for the years 2021–2027. First of all, European funds must create the potential to support private investments – they should act as a stimulus, not just a pure fiscal transfer.

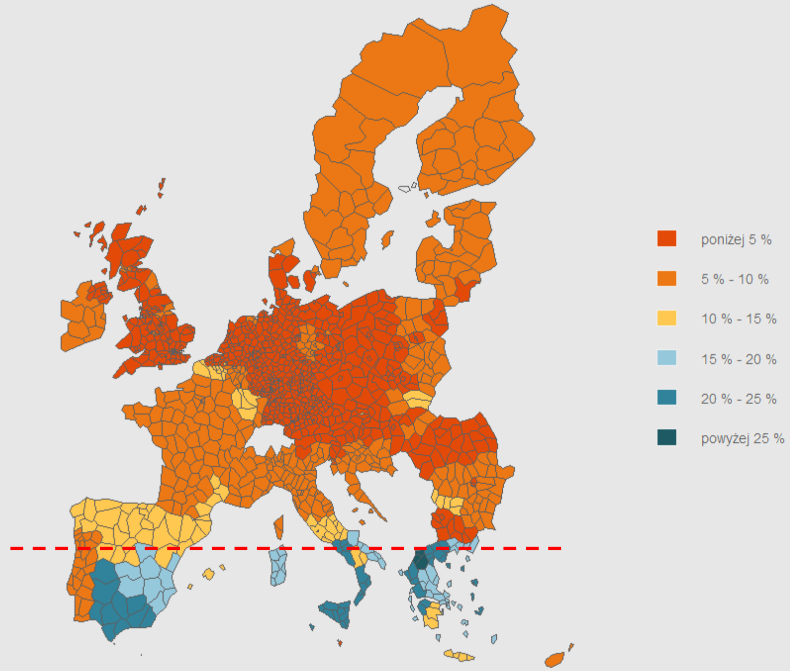
Cohesion funds have proved in Central and Eastern Europe to be an excellent mechanism for supporting convergence, because they have become an incentive to make changes to market institutions, which have translated into the greater attractiveness of these countries. From the very beginning of the integration process, the countries of this region introduced rapid regulatory changes which made statist economies adapt completely to the global free market. Those changes include, for example, state aid law, which significantly limits the ability of governments to support domestic companies which compete with foreign companies, and competition law, which prevents the formation of cartels and protects the market from the largest players exploiting a dominant position. Today the existence of regulations in these areas seems obvious, but their introduction on a pan-European scale required a huge political effort, which was not and is not possible in other international organisations. These regulations have become the platform for building solid foundations for a market economy in all of the countries which participate in the integration process.

Later, when European funds started to flow into the countries of this region, these countries introduced a series of successive reforms that allowed them to achieve positive externalities from public investment. The introduction of long-term strategic planning, improvements in the quality of public tenders and the developing of markets (e.g. the transport industry) gave very positive results not only in terms of improvement of the quality of infrastructure, but also in the developing of private entrepreneurship. Infrastructure investments were inscribed in a broader concept of building trans-European networks, which in turn were inscribed in the process of developing industrial supply chains between the region and Western Europe. This is why the wave of co-financed investments was not accompanied by a deepening of trade deficits, but, on the contrary, by an improvement in the balance of payments of the countries of the region. In the region, the construction and transport industries have developed on a large scale, and indirectly, industries such as logistics have benefited greatly from investments.

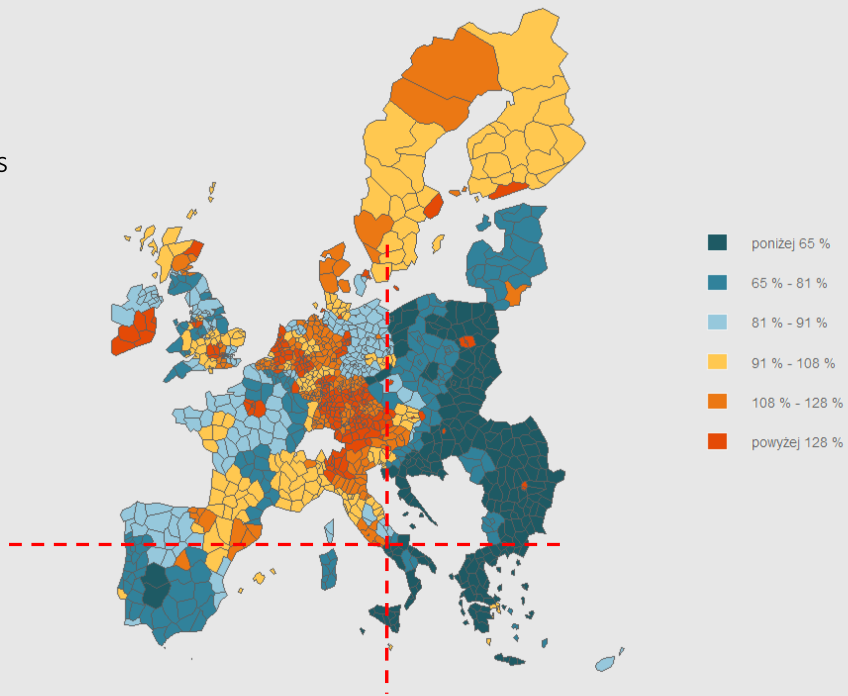
When reforming cohesion policy, the European Union should draw on the experience of the countries of Central and Eastern Europe. Support for cohesion funds makes sense if it leads to changes that increase development potential. The funds affect the economy not only by increasing public investment but, above all, as a stimulus to change in support of private investment.

Figure 8. Unemployment rate and GDP per capita in EU regions (NUTS3).
There are two most important tectonic dividing lines in the European Union: East-West and North-South

Unemployment rate in %, 2018



GDP per capita as % of the EU average, 2017



Source: Own calculations based on Eurostat

International trade and competitiveness

One of the far-reaching consequences of the 2009 economic crisis is a radical change in the attitude of countries towards trade, economic and investment co-operation. The worst examples of this are the American–European and American–Chinese disputes, the effects of which include, among other things, the imposing of import duties on steel and aluminium produced in Europe and the threat of them being imposed on the automotive sector too. A number of Chinese producers and goods have also been subject to US sanctions, which has been met with retaliation by Beijing.

Opinions that the USA–China dispute will lead to a full-scale trade war, which will then lead to another global economic crisis, have so far turned out to be too alarmistic. Nevertheless, the uncertainty surrounding the prospect of disputes, combined with Brexit and the signals of the global economic slowdown, increase the risk of significant losses for the global economy, including the European economy. The consequences of the increase in global protectionism, however, are far more profound and complex than the issue of lower economic growth or financial losses for European companies.

Firstly, the EU's position in international trade is a source of political strength. As a civilian power that brings together mainly small and medium-sized countries, the Union has no military strength compared to its economic weight. The EU's interests and influence are protected by a global order based on international law and the institutions it upholds, such as the World Trade Organization. The crisis, or the prospect of the collapse of this order, is a fundamental threat to the development of the European Union and its place and role in global politics.

Secondly, the risks facing global economic co-operation and trade raise questions about the EU's ability to protect the European social and economic model. This can be seen in the debate about the European market for digital equipment and services, in which technological giants from the 'Silicon Valley', known as the GAFA (Google, Amazon, Facebook, Apple), have gained the lion's share of the EU markets. The lack of barriers and regulations concerning digital market has raised questions about the EU's digital strategic autonomy and technological sovereignty, including the protection of the privacy of its citizens.

Another challenge is the growing pressure on European industry, especially the most innovative parts of it, from Chinese capital funds, which aggressive pursue acquisitions of European technology companies. Competition with Chinese businesses, where the dominance of the state-owned enterprises (SOEs) and its political objectives is evident, is impossible without special protection of the market. Moreover, China itself consistently protects its internal market from an influx of goods and investment from Europe.

Thirdly, the protectionist sentiment in the global economy has been shared by many EU member states, undermining the EU single market. Examples of this are the directive on posted workers and the mobility package for road transport. These measures are intended, from the formal point of view, to improve the situation of workers in the single market and to ensure fair wages and working conditions for them. In practice, the solutions under discussion create barriers to the provision of services, thereby reducing both social and political cohesion and the pace of convergence between Central and Eastern Europe and the western part of the continent.

Recommendation 5:
Defending the World Trade Organization's rules must continue to be an objective of the EU

Along with the USA and China, the EU is one of the leading global players in international trade. The EU market, with its 500 million inhabitants (less than 7% of the world's population) is responsible for about 15.6% of global trade.

A year after the introduction by the USA of prohibitive customs duties on imports of aluminium and steel from the European Union, the economic consequences of the trade dispute have turned out to be less harmful than expected. The positive trade balance of the EU with the USA totalled almost EUR 75 billion, i.e. it has increased by 11% year on year. The trade war is still more of a challenge than a reality in EU–US relations.

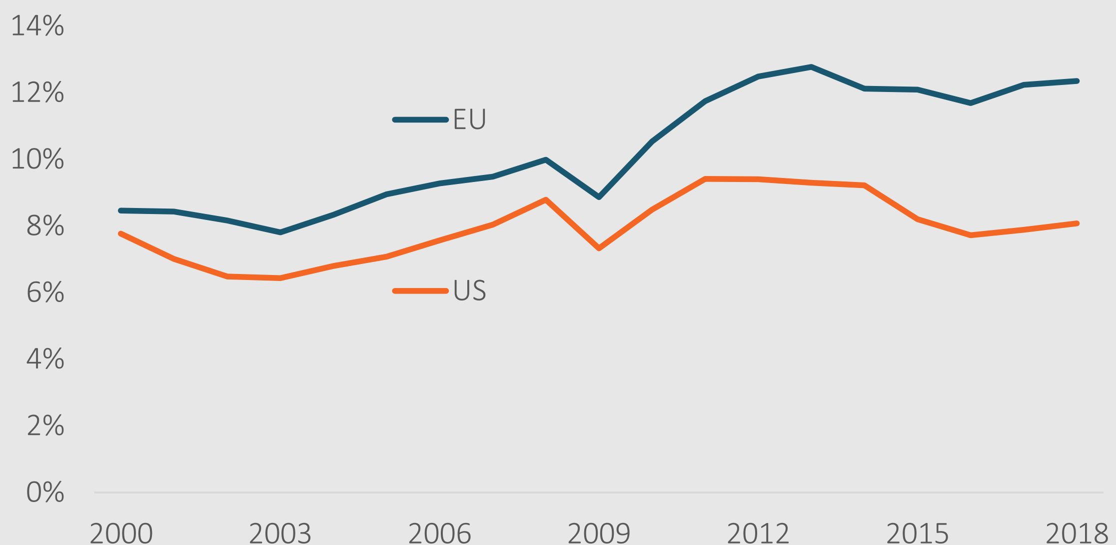
However, this may change if the Trump administration imposes tariffs on the European automotive sector or takes retaliatory measures in connection with the EU introducing a digital tax or – in the future – a planned carbon border tax.

The EU's response to increased protectionism in international trade and pressure from the USA and China is, on the one hand, to continue negotiating and concluding free trade agreements. Such agreements have been concluded with Canada, Singapore, Japan, Vietnam and the MERCOSUR countries. Additional agreements are being negotiated with Mexico, Australia and New Zealand.

On the other hand, the Union has announced its readiness to retaliate against the United States and if its goods and services are pushed out of the market by tariff measures or regulatory barriers. The EU has also named China "a systemic rival" indicating readiness to fight for EU economic interests.

Both strategies have their political and economic rationale. However, they will not solve the main problem, which is how to adapt free trade rules to the new realities of the global economy: a de-globalisation phenomenon and technological changes. As Figure 9 shows, the EU is much more dependent on exports of goods than the USA is.

Figure 9. The ratio of exports of goods to GDP, in %



Source: Own calculations based on IMF

Access to markets is therefore crucial for Europe's economy and companies to grow and develop. Therefore, despite the political temptation to retaliate, which is evident in the capitals of some EU member states, the European Commission should concentrate on negotiations and reform of the World Trade Organization, so that the new rules are politically acceptable on a global scale and, at the same time, protect the European social and economic model.

Only then will sustainable development goals, along with climate policy goals, have a chance to feature more firmly on the agenda of the World Trade Organization or bilateral free-trade agreements, securing a level playing field for European businesses in the future. Without a sort of a world-wide "green deal" the EU's ambitions may never turn into reality.

However, including new climate and sustainability clauses in the negotiations on the future of the global trade and investment system results in a significant conflict between the EU and its partners, both developed countries which do not share European ambitions in terms of climate and environmental protection and developing countries for which sustainable development is, above all, a huge cost.

It may therefore transpire that the EU will face a dilemma which will determine the direction of its policy for years to come. It will either transfer its regulatory philosophy to the level of global institutions and take a "pole position" in the new distribution of the global economy, or it will be forced to restrict access to its market for producers which do not meet its high standards. This would, in turn, hit European companies which would lose access to foreign markets as a result of retaliatory measures.

The third alternative is to strongly limit the EU's ambitions in order to not undermine the competitiveness of European companies and to maintain access to other markets.

Facing this dilemma seems inevitable if sustainable development objectives are to improve the competitiveness of the EU economy. The EU should therefore take a pragmatic stance and carefully pick the battles it wants to fight and win, rather than launching an ambitious, sustainable-goals offensive and being defeated.

Recommendation 6:
Internet freedom and digital commerce must be interlinked

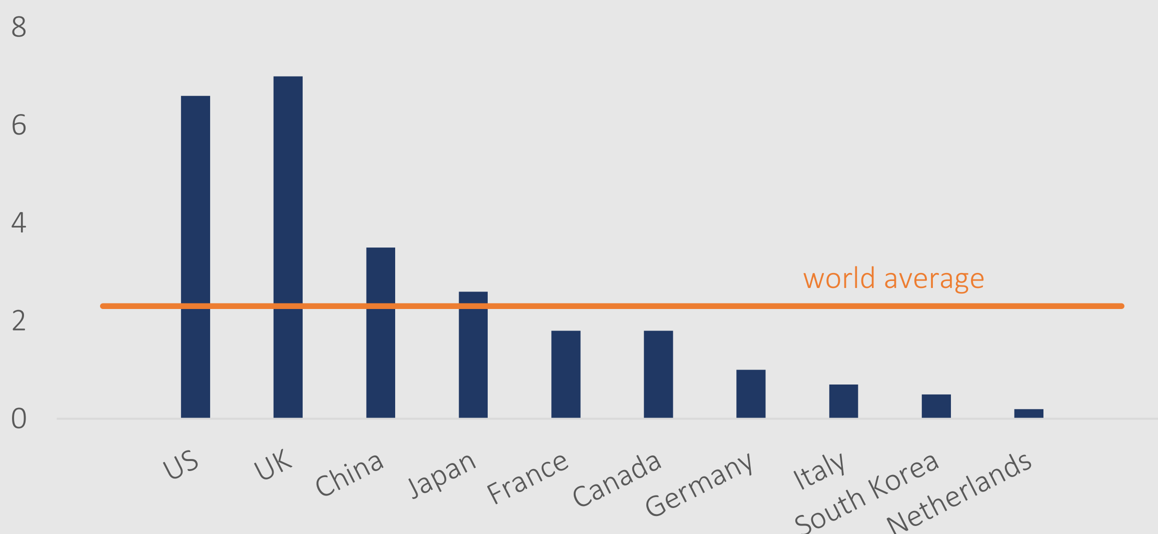
Alongside the wave of protectionism, a challenge to world trade rules is the technological revolution, a driving force for digital commerce (e-commerce). Looking at the dynamics of e-commerce growth and its role in trade, not only between companies (B2B) but also between companies and retail customers (B2C), it is in the digital sector that the foundations of a new global order in trade are being laid.

At the end of March 2019 UNCTAD estimated ICT-enabled global e-commerce sales (defined as transactions ordered digitally, regardless of whether they are delivered digitally or physically) in 2017 at nearly USD 29 trillion. About 88% of those sales are between businesses (B2B). However, these estimates relate to global sales and do not specify cross-border proportions, except for B2C estimates, where the share of cross-border transactions worldwide is estimated at 2.3%.

The European Commission's 2018 concept paper on the directions for WTO reform argues that establishing rules covering digital trade (trade in services and goods) is important not only for removing unjustified barriers to trade by electronic means, but also for ensuring legal certainty for businesses and a secure online environment for consumers. The new rules should not only cover trade in services but also apply to all sectors of the economy.

Negotiations on the rules which will govern this sector have only just begun, within the framework of the World Trade Organization. As Figure 10 shows, the Member States still do not use the potential of e-commerce to export goods and services as much as the USA and China do. In order to maintain their chances of catching up, not only are clear rules for digital commerce, including privacy issues needed, but also access to other countries' digital markets.

Figure 10. Share of e-commerce (B2C) in the export of goods, in %



Source: Own calculations based on UNCTAD

The example of e-commerce shows two phenomena of great importance for the EU.

On the one hand, it is a question of Internet freedom. Internet control, the blocking of foreign sales platforms and bans on applications other than those authorised by a government are a threat not only to the future of digital commerce, and thus to international trade as a whole, but also to civil liberties.

On the other hand, the ability to order goods via external digital sales platforms makes it possible to bypass internal regulations on product safety and quality, as well as – due to the volume of small consignments – to bypass taxes and levies. It is also an export of surplus production that does not meet environmental standards and those of a closed-circuit economy.

The new European Commission should consistently strive to preserve the freedom of the Internet as the foundation of free trade and civil liberties, and at the same time to develop principles and introduce a digital tax for all sales and communication platforms in the EU single market. The lack of a uniform approach to the digital economy – regulatory and fiscal frameworks – invites external players, particularly the USA and China to play Member States off against each other.

Recommendation 7:
Support for growth, not size

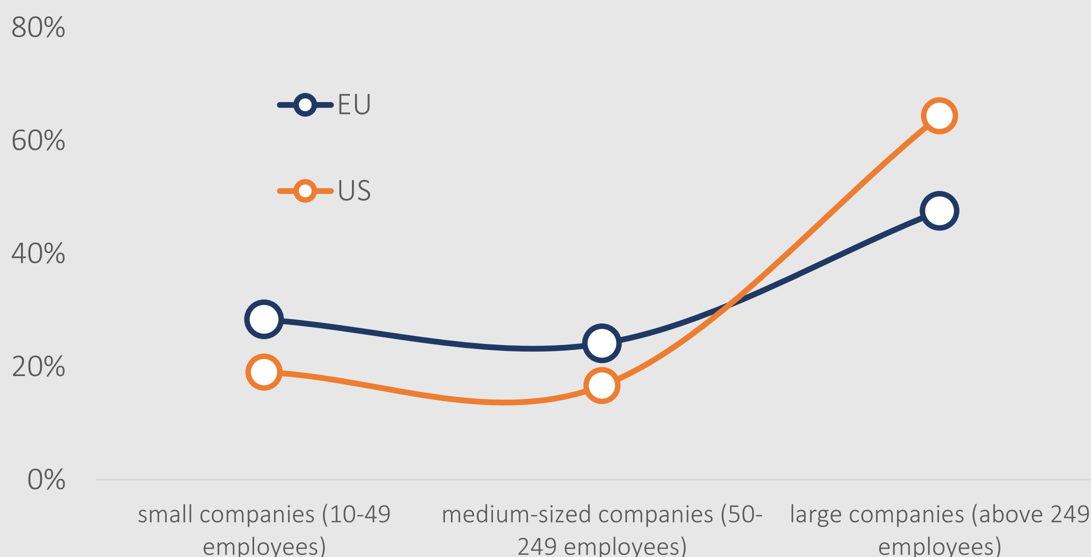
The Commission's decision to block the merger between German Siemens and French Alstom has provoked a debate on how European companies should compete globally with Chinese and American companies. In the discussion there was an argument to change EU competition law in order to allow the emergence of European corporations ("champions") capable of competing with the world's largest companies, especially those supported by the state (SOEs).

Such a change may seem justified if one looks at the size and strength of non-European firms, which are not covered by a number of regulations on market shares, monopolistic practices or state aid. Its introduction would, however, take place at the expense of SME development opportunities, would deprive consumers of choice and would not give any chances for technological advancement to Member States which do not have their own "champions".

The EU is firmly based on small and medium-sized enterprises. In other words, the fundamental problem is the small number of large companies and not the small scale of the existing European giants. Therefore, the priority should be to support the development of SMEs so that they become large, and not to create conditions for a narrow group of "champions". This is also the key to preserving the European social and economic model and increasing the competitiveness of the European economy on a global scale. Strengthening the global position of large European firms will not be achieved by copying the solutions of others. The experience of the banking sector also shows that the sheer scale of operations and the size of a company are no guarantee of the development and growth of the position of European companies in the world.

However, on the one hand, for the protection and development of European industry, it is essential to have a consistent policy of controlling investments and to protect the public procurement market from companies from outside the EU. On the other hand, Europe must increase spending on research and development, change the education system for the industry and its environment (digitisation!) and create regulations that will make possible the rapid commercialisation of innovation.

Figure 11. Employment structure by size of company in the EU and US



Source: Own calculations based on Eurostat

Recommendation 8:
Promote the integration of the Eastern Partnership countries into the European Economic Area

The accession of the countries of Central and Southern Europe in 2004 and 2007 was a huge impulse for growth and development for the entire European Union. However, it brought the conviction of many in western Europe that enlargement has been a huge political and social challenge that has profoundly altered the level-playing field in the EU single market and affected common political institutions. This was reflected in what is known as "enlargement fatigue". Today, therefore, there is no political climate for the accession of Eastern European countries.

The Union's focus today is on the Balkans: the European Commission has advocated the opening of accession negotiations with Albania and North Macedonia. Thus, both countries may join Serbia and Montenegro as future members of the EU.

For East European countries, the EU has developed the Eastern Partnership (the EaP) initiative implemented within the framework of the European Neighbourhood Policy. The EaP includes association agreements (AAs) and the introduction of deep and comprehensive trade agreements (DCFTAs), and the opening of the EU single market to goods, services and workers from countries such as Ukraine, Moldova and Georgia. The EaP is today a key instrument in deepening co-operation with EU without the clearly stated goal of membership. However, the main shortcoming of the EaP is not only the lack of a strategic goal of membership: it also is a fact that the EaP might be a vehicle for third countries to access EU market through investments in Ukraine, Moldova or Georgia.

As the EU has decided to sign AAs and DCFTAs with Eastern Europe, it seems inevitable that the EaP countries' markets will be tied more and more closely to the single market, and that sustainable supply chains that meet sustainable development goals will be built. The mid- and long-term tool for such integration seems to be the European Economic Area, the waiting room for which is the full implementation of association agreements and DCFTAs.

Climate policy

The European Union is a leader in achieving the 2015 Paris Climate Conference target of limiting by 2100 global warming (global temperature increase) to no more than 2° Celsius compared to pre-industrial times. To achieve this, the countries of the Union have committed themselves to, by 2030:

- reducing greenhouse gas emissions by at least 40% (relative to 1990 levels)
- increasing the share of renewable energy in total energy consumption to at least 32%
- increasing energy efficiency by at least 32.5%

Despite uncertainty as to whether these goals will be achieved within the given time framework, the EU's climate policy is a success compared to the rest of the world. The Union is the world leader in the energy transformation and a "sustainable development power", whose economy – as shown in the Commission's report on the state of the Energy Union in 2018 – is growing without an increase in emissions. This is the best evidence that the change towards the low-carbon economy is structural, and not cyclical.

On 28 November 2018 the Commission presented a long-term strategic vision for a prosperous, modern, competitive and climate-neutral economy by 2050. The aim is both to raise existing targets and to extend climate policy to other sectors. The ambitious fight against climate change is supported by the great majority of EU citizens.

There is therefore no turning back on the energy transformation – reducing CO2 emissions by replacing fossil fuel energy with renewable energy. However, maintaining its pace, or accelerating change, requires a balance to be struck between its four objectives: availability of energy for all; environmentally neutral generation; security of supply; and affordable prices for EU citizens. In other words, the pace of climate policy cannot disregard its socio-political costs and technological deficits, without which climate neutrality will not be possible. Underestimating the socio-political context in climate policy can lead to a wave of protests, as it happened in the context of the rapid globalisation process that eventually became a source of protectionism in international trade.

Figure 12. The European Union's share in global GDP, population and CO2 emissions

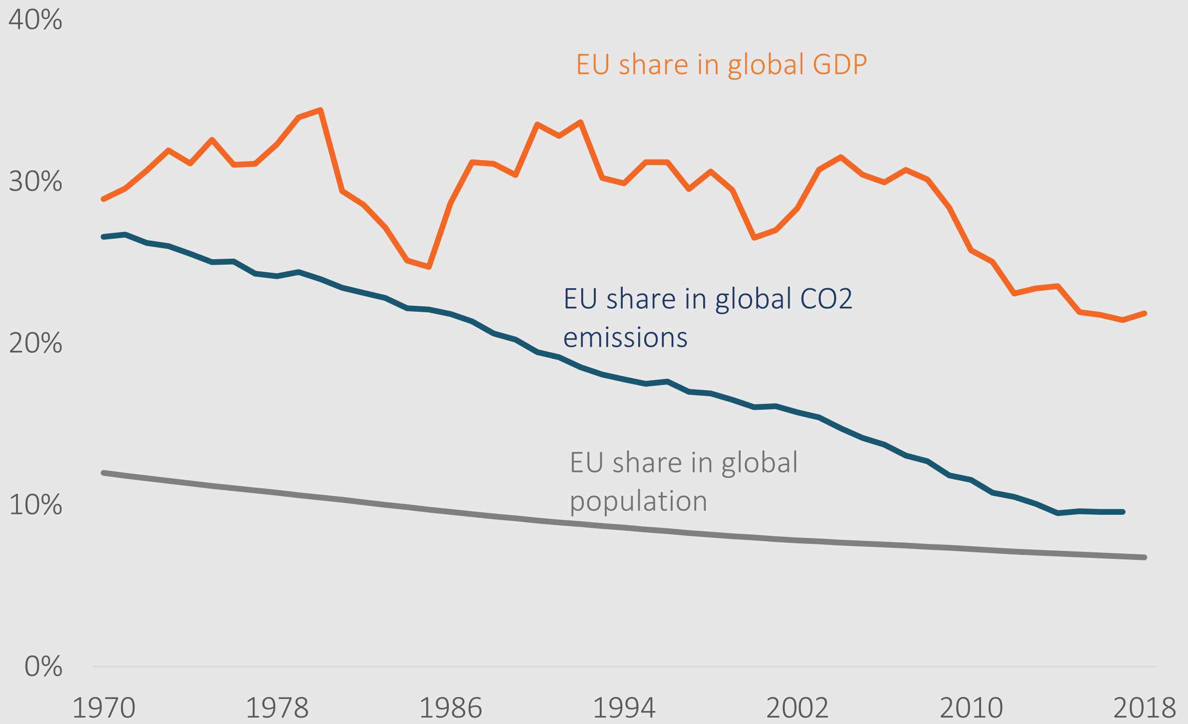
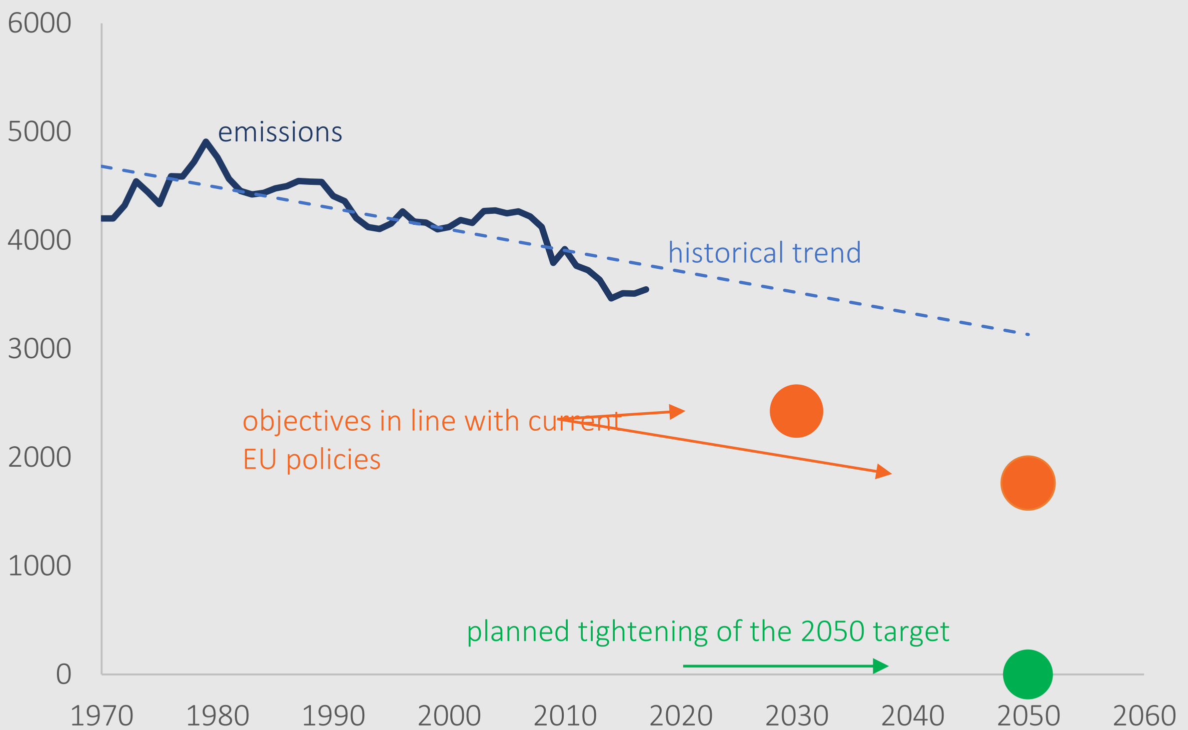


Figure 13. CO2 emissions in the European Union, in million tonnes



Source: Own calculations based on EDGAR and European Environment Agency

Recommendation 9:
Priority for a "just" energy transformation

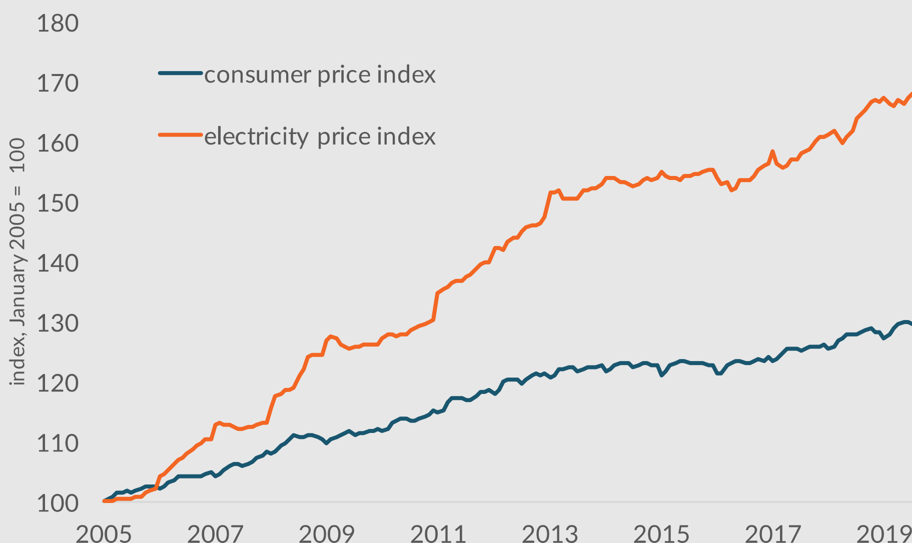
In the short and medium term, the rapid pace and success of the energy transition to meet climate targets puts pressure on energy prices for private consumers and industry. In countries with ambitious climate policies, such as Germany and Denmark, this is due to, among other things, taxes and subsidies, which amount to 54% and 64% of final energy prices for households respectively. In countries with a large share of fossil fuels in the energy mix, e.g. Poland, the increases will result from, among other things, more expensive CO2 emission allowances. As Figure 13 shows, the average electricity price in the EU increased between 2010 and 2018.

According to estimates by the EU Energy Poverty Observatory, more than 50 million EU households are experiencing energy poverty. Taking into account that, according to Eurostat, there are 2.3 persons per statistical household, this means more than 100 million citizens, or 20% of the EU population.

The threat of energy poverty also prompts governments to change their regulatory policies. Socially motivated protection against high prices, rather than the stability and development of the energy sector, becomes the overarching goal. A side effect of this has been the growing pressure on market regulators: they are to take care of social interests, and not the sustainable development of the sector and economic rationality, which is an obstacle to the construction of the Energy Union.

Without greater coherence between an ambitious climate policy and public support for its costs, climate policy will become a victim of populist backlash. The concept of a "just" transformation and its future fund, if created, will be an important shielding tool for the labour market in, for example, mining regions. However, a "just" transformation must also take into account the risk of radical increases in energy costs for the home consumer in the countries making the transformation.

Figure 14. Change in electricity and gas prices for end users in the EU (including taxes and charges, per 100 kWh)



SPOTDATA

Source: Own calculations based on Eurostat

The prices and availability of energy also translate into political stability. As the protests of the yellow vests in France and Belgium (2019) have shown, sudden changes in energy prices cause significant social disruption. This applies to consumers as well as companies and employees in the energy sector. Overly rapid and unprotected implementation of the climate agenda in transport or agriculture may undermine the stability of the SME sector, which needs cheap green technologies which enable it to switch its operations to a climate-neutral economy.

The aim of the new European Commission should be to place a strong emphasis on the socio-political consequences of climate policy. The energy transformation is increasingly being associated with rising living and business costs, and is becoming the fuel for political dispute. Meanwhile, the positive outcome of the implementation of climate targets creates space to strengthen consensus on the energy transformation and gives member states time to catch up with the green-deal process without compromising the objective of a climate-neutral EU.

Recommendation 10:
Support the development of energy storage and nuclear technologies

Achieving climate neutrality requires mature and accessible technologies for citizens and SMEs to adapt to a low-carbon economy. This particularly applies to energy storage technology and its integration into machinery. Despite huge progress in the development of photovoltaics and wind turbines, it will be impossible to give up fossil fuels without this technology. As the report of the United Nations Economic and Social Council reads:

“Storage is a key enabling technology. However, storage technologies vary widely in terms of efficiency, charging and discharging rates and energy storage life. Current battery technologies are unlikely to be sufficient to store energy on a large scale so that solar energy can be stored in summer to heat buildings in winter.”

The lack of such mature and ready-to-use technologies is the biggest barrier to the EU achieving climate neutrality. This means that a system based on the dominant role of renewables needs support from a sustainable power source. Gas may be such a transformation fuel, but it is a fossil fuel the use of which is not climate-neutral. Therefore the EU should give the green light and provide funding for research into modern and safe nuclear technologies. Investments in new-generation nuclear power plants should be treated on a regulatory basis on an equal footing with investments in renewable sources of energy, because they bring European economies significantly closer to the objective of climate neutrality and facilitate the transition from fossil fuels to renewable energy.

Authors:

Ignacy Morawski founder and head of SpotData. He worked in the banking sector (WestLB, Polish Bank Przedsiębiorczości), where he was the chief economist. In the years 2012-16, he won many awards in numerous rankings, including twice on the podium of the competition for the best macroeconomic analyst organized by the National Bank of Poland. In 2017, he was included in the New Europe 100 list, which distinguishes the most innovative people in Central Europe, published by the Financial Times. He was also a member of the team preparing macroeconomic forecasts at the Polish Academy of Sciences, he also worked for the WiseEuropa think tank. He began his career as an economic reporter for the Rzeczpospolita daily. He graduated in economics from the Bocconi University in Milan and in political science from the University of Warsaw.

Olaf Osica director for research and development. at SpotData. From 2011 to 2015, he was a director and currently chairs the Board of the Mark Karp Centre for Eastern Studies (OSW). As a manager and consultant he worked on projects for the European Economic Congress in Katowice, Polityka Insight and College of Europe in Natolin. He has extensive experience in managing analytical projects and strategic consulting for public and private stakeholders, as well as in conducting briefings and developing analytical materials for the management level. He received PhD in political and social sciences from the European University Institute in Florence, and has been a scholarship holder of the US Department of State, the French Ministry of Foreign Affairs and the GFPS-Poland.

Partner: