econPOL POLICY BRIEF

62
2024

July
Vol. 8

Economic Challenges Ahead for the Next European Commission

Clemens Fuest

Key Messages

- Focusing on the "Green Deal" will not be enough in the upcoming legislative period. The new Commission will need a well-thought-out economic policy agenda to respond to the changed geopolitical challenges and to strengthen its competitiveness.
- The EU needs to improve its defense capabilities, overcome international trade frictions, and refine its environmental and climate change policies.
- The EU needs clear policy intervention criteria to deal with supply risks and deepen trade relations with third countries.
- Policy must be upfront regarding the fact that the high levels of investment required for decarbonizing the economy will not be accompanied by an economic boom.
- The European single market could play a central role in strengthening the EU's economic power and competitiveness—if it is deepened further.

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EconPol POLICY BRIEF
A publication of the CESifo Research Network

Publisher and distributor: CESifo GmbH
Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 89 9224-0, Email office@cesifo.de
Shipping not included
Editor of this issue: Clemens Fuest, Florian Dorn

EconPol Europe: www.econpol.eu

Economic Challenges Ahead for the Next European Commission

Clemens Fuest[*]

ifo Institute, Munich, July, 2024

Europe has elected its new Parliament. The legislative period and the new European Commission are starting at a time when the European Union (EU) is facing major economic and political challenges. The outgoing legislative period was dominated by the "Green Deal", which focused on reducing CO_2 emissions while attempting to restructure the economy and society towards greater sustainability and environmental protection. The implementation of this agenda has led to intensive EU legislation. However, the results have been controversial. The main points of criticism are the massive increase in bureaucratic burdens for companies, the planned-economy-tinged concept of such instruments as the Taxonomy for Sustainable Finance, and the lack of an answer to the question of how to reconcile the EU's decarbonization drive with maintaining its economic competitiveness. The focus on the Green Deal will not be sufficient to deal with Europe's major economic and political challenges.

Focus on the "Green Deal" will not be enough

The past few years have been marked by major crises, including the covid pandemic and the Russian attack on Ukraine. These crises have consequences. The pandemic highlighted the need to address the resilience of economies and societies in the face of health crises, and that digitalization plays a central role in this resilience. There is also the question of how to ensure that sufficient medical equipment, masks, ventilators and medicines are available in such crises. Preparing for the next pandemic is not easy, as it is very difficult to predict exactly what will be needed. However, the need for collaboration between EU member states is undeniable, in particular as regards mutual assistance in patient care and the maintenance of cross-border trade.

The consequences of Russia's war of aggression in Ukraine are even more serious. They show that a reassessment of economic and political relations not only with Russia was

* Clemens Fuest, ifo Institute/LMU Munich, Munich, fuest@ifo.de

needed, but also with China. Instead of opposing the Russian attack, China has pursued a policy that often smacks of pro-Russian neutrality. This raises the question of whether economic relations between the EU and China can stay as they are in the context of growing tensions between the US and China. The conflict with Russia revealed the risks of unhealthy dependence on Russian gas supplies, with several EU member states facing serious difficulties after supplies were curtailed. It has also become clear that mutual economic dependence is no guarantee against an armed conflict. A debate is underway about the interaction between geopolitical tensions and economic dependence on China, as well as the implications of a possible conflict between China and Taiwan.

But the EU's problematic dependences are not limited to China. Relations with the United States are also changing. Admittedly, these relations are not comparable to those with China, as the US is a Western-style democratic constitutional state, and the most important ally of most EU member states within NATO. Nevertheless, the EU must urgently address the question of how to reduce dependence on the USA. At the forefront of the current debate are concerns about a possible Donald Trump's election victory and the associated scenario of growing protectionism and declining American support for Ukraine. An associated, and deeper problem is that the EU states have so far been unwilling and unable to defend themselves independently and provide Ukraine with sufficient support. Regardless of whether the next US president is Donald Trump, Joe Biden or someone else, Europeans will have to develop more autonomy. The US geopolitical interests have been shifting towards the Indo-Pacific for some time now. Protectionism is gaining ground across party lines in Washington. The fact that Europe's security has come to depend on the outcome of the US presidential election only shows how far Europeans have neglected their own interests.

This reality gives rise to three major challenges for the EU:

(1) Improving EU’s Defense Capabilities

First, EU countries must improve their defense capabilities. The accession of Finland and Sweden to NATO was an important step, but much more is needed. Defense spending needs to be increased, raising the question of how to finance it (see Dorn et al. 2024a). After the end of the confrontation with the Warsaw Pact, many EU countries reduced their defense spending and increased social spending. Reversing this will face considerable political resistance. Tax increases are also likely to be difficult. The tax burden in most EU countries is already significantly higher than in other OECD countries, so that additional burdens would further impair Europe's economic development and competitiveness. That said, the EU’s military weakness is only partly due to a lack of defense spending: it is also a result of the fragmentation of Europe's armed forces and defense industries. The more improvements are made in these areas, the less the need to expand defense budgets. Increasing efficiency through greater collaboration, however, requires relinquishing a certain degree of national sovereignty in security policy. Although this kind of national sovereignty has little weight nowadays in most EU member states, there is scant willingness to relinquish further national sovereignty for the sake of deeper European integration.

(2) International Economic Frictions

The second challenge is to respond to the increasing frictions in international economic relations. The European economy is more vulnerable than the USA or China to restrictions on international trade resulting from geopolitical tensions and protectionist tendencies, because European companies are more integrated in the international division of labor. This applies to both imports and exports. For example, the share of economic value added that is directly or indirectly dependent on exports in the EU is around 20 percent and rising. In China, on the other hand, this share is declining and recently came down to 18 percent. In the USA, it is only 9 percent (Baur et al. 2023).

(3) Refining Environmental and Climate Policies

The third challenge is to shape the “Green Deal”, and in particular decarbonization, in a way that does not jeopardize the EU’s economic prosperity and competitiveness. While climate policy plays a central role, environmental problems encompass far more and decarbonization measures may well conflict with other environmental policy objectives. For example, the loss of biodiversity is hardly less serious than the global rise in temperature. This means that the need for action is even greater than solely achieving decarbonization (see Fuest 2023).

An Agenda for European Economic Policy by the Incoming EU Legislature

The European Council already agreed on new strategic priorities for the next five years, adopted by EU leaders at the Brussels summit in late June (European Council 2024). It is a shift away from the agenda of the last legislative period, which focused on environmental policy and the transition to climate neutrality. Defense and competitiveness are now at the heart of the political roadmap. The coming legislative period will be about taking a broader approach and tackling the challenges outlined above. It needs to respond to the changed geopolitical and foreign-trade setting, as well as reconcile the strengthening of economic power and competitiveness with environmental and climate protection goals.

Shaping Foreign-Trade Policy in the Face of New Geopolitical Risks

A key foreign trade policy question is how to build resilience to geopolitical crises without unnecessarily jeopardizing the benefits of international trade that are so important for Europe. Calls are becoming louder to reduce dependence on countries such as China for important goods and inputs, as government subsidies are being directed towards producing domestically previously imported goods. An example of this is the construction of semiconductor facilities by Intel in Magdeburg, Germany, for which government subsidies of around EUR 10 billion are being granted.

In this area, it is particularly important to examine carefully and critically the cases in which such government intervention makes sense. Given that international trade and the benefits of the international division of labor promote prosperity in the EU, replacing imports with domestic production can entail very high costs indeed. Not surprisingly, many domestic industries would like to be classified as "critical" or "strategically important" and receive subsidies. In macroeconomic terms, however, these interventions are very expensive and therefore need to be convincingly justified (see Bertola 2024). In essence, companies have a vested interest in weighing the risks of long and crisis-prone supply chains against measures to increase security of supply. In doing so, they should focus not only on having important precursors produced nearby instead of, for example, in China, but also on diversifying their suppliers, increasing their inventory levels, or reducing their vulnerability to supply disruptions through recycling and other innovations.

In any case, reshoring is not an option for raw materials for which no domestic sources exist. Relying on market forces alone, however, does not make sense if the costs of supply shortages are not fully internalized by the companies involved. This is certainly the case for essential medicines such as antibiotics. If EU countries were cut off from antibiotics in the event of a conflict, the consequences would be catastrophic. For this reason, government intervention to build up a domestic supply may well be justified. The situation is different for goods needed to expand the supply of wind and solar energy, for example. Here, too, it is often argued that Europe should use subsidies to prevent the production of solar panels and wind turbines from migrating to third countries. This is not convincing, because in the event of a conflict with China, the capacity already installed would continue to operate. Further expansion would be slowed, but that would be the least of the problems in such a conflict.

The EU therefore needs a well-thought-out strategy and clear intervention criteria to deal with supply risks. Another key element of this strategy is to deepen trade relations with third countries through new partnerships and trade agreements. In this respect, it is important to consider carefully whether EU-imposed conditions on potential partner countries to comply with certain social or environmental regulations should be given such a high priority as to sink trade agreements if such demands are not met (and thus in effect forfeit the implementation of these or even less far-reaching requirements).

Shaping Climate Policy Efficiently and Dealing Openly with Costs

The European Union Emissions Trading System for CO_2 emission certificates has proved to be an economically very efficient environmental policy instrument for climate protection. But the integration of sectors not yet covered by this system should be pushed forward more forcefully, while less efficient instruments, in particular regulations that are not aligned with the CO_2 price, should be withdrawn. Whatever political decision is finally adopted on whether the decarbonization targets are tightened further, as proposed by the European Commission in its latest impact assessment (European Commission 2024), left unchanged, or made less ambitious, its economic consequences must be taken into account.[1] Decarbonizing the economy will require very high levels of investment, but these investments will not trigger an economic boom in the sense of expanding private households' consumption possibilities, as was the case in Germany in the 1950s and 1960s. This is because these investments do not primarily create additional production capacities, but rather replace existing ones. For this reason, these "conversion investments" require a greater reduction in consumption than other investments. The faster the conversion, the greater the reduction in consumption.[2] Decarbonization therefore does not primarily equate to an economic upturn, but rather to foregoing consumption during the transition period (see Fuest et al. 2024 for a discussion). This is not to say that such costs should be rejected, but rather to highlight the importance of being upfront with the public about the costs of climate protection, and of keeping in mind that tangible benefits of decarbonization in terms of reduced global warming can only be expected if ambitious climate policies are pursued worldwide. There is a risk, then, that if decarbonization in the EU is accompanied by high welfare losses, the chances that other

[1] In a recent policy brief, Mier (2024) compares three different scenarios and quantifies the total benefits of a joint European effort at EUR 248 billion between 2024 and 2050. In the worst-case scenario, total costs could reach EUR 8.629 trillion.

[2] This is also emphasized by the OECD (Guillemette, Y. and J. Château 2023, p. 32), which explains this as follows: A scenario with a substantial energy transition by 2050 almost surely involves a significant increase in the share of global GDP devoted to investment, thus reducing global consumption possibilities. The resulting differential between the growth rate of GDP and private consumption is likely to be most apparent early in the transition, as the investment share is built up.

countries will follow might decrease (*Wissenschaftlicher Beirat beim Bundesministerium der Finanzen 2010*).

The EU Needs Economic Strength and Competitiveness

The EU and its member states will only be able to meet the challenges ahead if they succeed in strengthening their economic power and competitiveness. This idea is hardly new; it was at the core of the EU's Lisbon Agenda, adopted in 2000. Important goals set at that time, such as increasing spending on research and development to 3 percent of GDP, have not been achieved. But that does not mean we should not try again, although the volume of R&D investment is not the only problem. A commission headed by former ECB President Mario Draghi is currently working on proposals to strengthen European economic competitiveness, an endeavor in which the EU's flagship project, the European single market, plays a central role. The EU has come a long way in removing barriers to cross-border economic exchange, but there are still many obstacles that lead to a fragmented market and untapped potential for wealth creation−in particular by deepening the integration of the service sector across the EU (see also Letta 2024; Dorn et al. 2024b; Pinkus et al. 2024).

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