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Making the best of the European single market

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Executive summary

THE SLOW-DOWN IN productivity and income over the past decade has weakened the European Union's output legitimacy, which is grounded in delivering prosperity to its citizens. At the same time, decreasing growth reduces the capacity of governments to maintain existing levels of welfare protection and translates into a perception of rising unfairness and inequality across and within EU countries.

IT IS ESTIMATED that remaining non-tariff obstacles, in particular in services sectors, limit intra-EU trade to a level about four times smaller than the intensity of trade between US states. By completing the single market, the EU could generate significant income gains. However the more straightforward steps have already been taken, so the single market agenda now touches upon specific domestic regulations in EU countries.

WE RECOMMEND A two-pillar strategy: for sectors with large externalities and/or economies of scale (such as energy or telecoms), regulations should be harmonised and at least close coordination between regulators should be achieved; for other services sectors, the efficiency of individual regulations on a cost-benefit basis with respect to their objective should be assessed, with systematic benchmarking.

WE ALSO RECOMMEND pursuing a credible environmental policy agenda on a destination basis (impacting both EU and non-EU firms) rather than on an origin basis (which is the case today), through a combination of ambitious technical standards, a reference path for the carbon price and revenue-neutral tax instruments. This would stimulate long-term investment in the energy transition without overly hurting EU firms' competitiveness.

TO FURTHER STIMULATE investment, especially in innovative sectors, we suggest moving ahead decisively with the capital markets union agenda. In parallel, the use of EU funds should be reviewed taking into account the objectives of economic convergence, spillovers between member states and solidarity.

EU NATIONAL GOVERNMENTS are responsible for welfare-related redistribution. However EU policies can help by empowering member countries to address the possible effects of EU integration, or by developing EU-wide instruments to limit its impact on possible losers. We argue that tax and social security avoidance or fraud need to be combatted with modern tools, eg a single electronic interface to monitor the payment of social charges of posted workers in their home countries. In order to fight corporate tax avoidance and improve tax fairness, the interest and royalties directive could be modified if the project of a common, consolidated corporate tax base (CCCTB) proves too difficult to agree.

FINALLY, WE RECOMMEND making social security systems more neutral with respect to intra-EU migration, eg by introducing the full continuation of home-country unemployment rights for migrant jobseekers, with closer cooperation between national employment services, and by centralising information on pension entitlements on a single platform.

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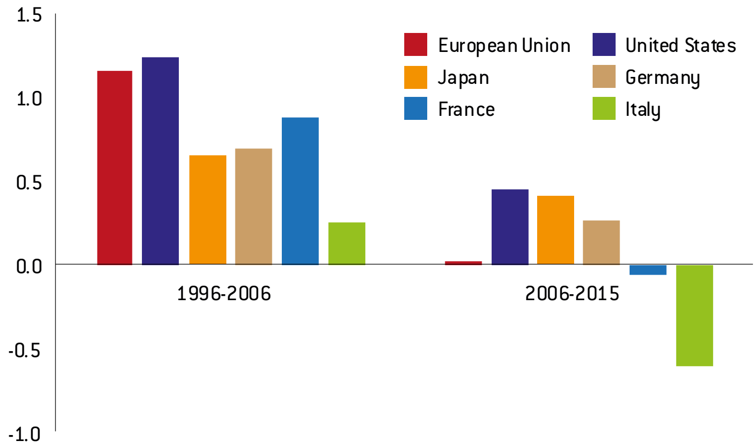
1. Introduction

The European project has reached a critical juncture after the United Kingdom's vote in favour of leaving the European Union, with the potential consequence of leaving the single market as well. In such a situation, the EU needs more than ever to demonstrate the concrete benefits it brings to its citizens. In this respect, two factors are critical.

The first is the significant decline in productivity growth in the EU, which is the consequence of three layers of deceleration: (i) the deceleration of the world economy (including the United States) and the associated concern about secular stagnation[1]; (ii) the deceleration of EU productivity growth relative to the United States and Japan; and (iii) the weakness of some EU countries such as Italy (Figure 1).

Figure 1: TFP growth in selected countries, percent per year



Source: Ameco.

The second factor is the increasing perception of unfairness. There are different ways of measuring inequality, sometimes delivering different messages. All measures show that, despite rising inequality in several EU countries over the last decades and more specifically since the crisis, the EU is by far the least unequal world region (Darvas and Wolff, 2016). However some EU countries (such as France and southern European countries) suffer from high unemployment (especially youth unemployment). In some other EU countries (such as Germany, Austria or the Czech Republic), the rate of unemployment is low but social mobility is relatively limited[2]. In all countries except those of Scandinavia, perceived and actual income distributions differ widely: perceived inequality is much larger than actual inequality (Niehues, 2014). These different elements, combined with the perception that bankers largely escaped personal sanctions after the financial crisis, and that some multinationals largely avoid taxation, feed a sentiment of unfairness whatever the hard data on Gini coefficients has to say. Whether caused by European integration or by technological change, the geographic redistribution of wealth also contributes to a feeling of inequality.

The two factors – lack of growth and unfairness – reinforce each other to the extent that lower growth reduces the capacity of national governments to maintain the welfare state. Both growth and fairness are critical for the functioning and perhaps even the survival of the EU. A slow-down in productivity and growth undermines the legitimacy of the EU, which has always relied on the commitment to deliver prosperity to citizens, ie on 'output legitimacy'.

1 See, for example Teulings and Baldwin (2014).

2 See OECD, *Education at a Glance 2014*, which finds that upward mobility, defined as the percentage of 25-64 year old non-students whose educational attainment is higher than that of their parents, is lower in these three countries than in the United States.

The rationale for the single market is that integration will boost welfare, stimulate growth and increase European competitiveness. But quantifying these effects is complex

Inequality is often perceived to be a consequence of economic integration. Based on an extensive database on party positions and voting behaviour at district level in western Europe from the late 1980s to 2008, Colatone and Stanig (2016) show that voters exposed to competition from China are more likely to vote for candidates with protectionist and nationalistic platforms. Although European integration involves countries with more similar development levels, it also involves winners and losers, with the subsequent risk of the rejection of the whole process. Additionally, the EU is responsible for trade agreements with third countries or regions, so discontent with globalisation will likely generate a backlash against the EU.

The rationale for the single market is that market integration will boost welfare, stimulate growth and increase European competitiveness. However, quantifying these effects is methodologically complex. Mariniello *et al* (2015) concluded that the impact so far has fallen short of initial expectations, because: (1) barriers continue to prevail in the EU, preventing the exploitation of the potential benefits of full market integration; (2) 'complementary policies' to support the single market have not been put in place, or have been insufficient; (3) the single market project has not sufficiently been framed as a key part of the process of creative destruction that Europe needs to embrace to successfully modernise its economy[3].

Progress with further integration might also be slow because of the fear of a populist backlash against deeper integration and the possible effects of deeper integration on inequality. It is mostly the responsibility of national governments to share the gains among all citizens and to help those that lose out to move into new jobs. However, since the winners are typically mobile, they are able to partly escape redistributive taxation. Reciprocally, losers may move to more prosperous countries. More importantly, national politicians might find it politically rewarding to attribute rising inequality to European integration. The EU should thus not disregard this aspect of market integration.

We believe that the EU should pursue its strategy to complete the single market by reducing cross-border impediments to the development of new activities (such as the digital sector) and by incentivising national governments to cut entry barriers and bureaucratic costs. In parallel, the EU should enhance investment in the EU and progressively re-focus the EU budget on those projects with sizeable externalities across member states. Finally, while respecting that national governments are responsible for social policy and influencing income distribution, the EU should develop the internal market in a way that does not undermine the ability of countries to act against tax and social insurance avoidance or evasion. This three-pillar strategy would raise the prospects of a resumption of growth in the EU, while addressing concerns about the unequal distribution of its proceeds.

2 How to boost productivity growth in the European Union

2.1 The single market: a glass half full

The contribution of European integration to growth is difficult to measure because of reverse causality (there is more impetus for integration in a period of growth and convergence) and the difficulty of constructing a credible counter-factual. Few scholars have even tried to measure the effect of European integration on growth, contrasting with numerous studies focused on trade (Sapir, 2011). Applying the synthetic counterfactuals method to various EU enlargements, Campos *et al* (2014) find that *"per capita European incomes in the absence of the economic and political integration process would have been on average 12 per cent lower*

3 See also Monti (2010).

today, with substantial variations across countries, enlargements as well as over time". This average figure is within the range found in the limited and fragile literature on this issue (5 to 20 percent, depending on the study).

European integration has led to a decline in trade costs across EU countries and a subsequent increase in intra-EU competition, and the impact of EU integration is generally found to outstrip that seen in free trade areas[4]. Still, trade between European countries is estimated to be about four times less than between US states once the influence of language and other factors like distance and population have been corrected for[5]. For goods, non-tariff obstacles to trade are estimated to be around 45 percent of the value of trade on average, and for services, the order of magnitude is even higher[6]. If the intensity of trade between member states could be doubled from a factor of 1/4 to a factor of 1/2 in order to narrow the gap with US states, it could translate into an average 14 percent higher income for Europeans (Aussilloux *et al*, 2011). The question then is how to achieve this ambitious objective.

2.2 A renewed, two-sided approach to the single market

The extensive literature on how the single market could be deepened generally concludes that the easy gains have already been secured. The remaining barriers to trade are now in the services sectors and are much more difficult to eliminate, since services are and should be regulated: health care, legal services or data-intensive industries all need proper regulation. Since discrimination between nationals and non-nationals has already largely been eliminated, the challenge now is to harmonise regulations so that companies can develop their activities across borders in the same smooth way as they do within a country. Depending on the sector, two different approaches could be taken.

a. Exploiting EU-wide economies of scale

Despite much talk and some relative successes – for example in the air transport sector – many of the most prominent services sectors remain fragmented. This is the case in the energy sector, rail transport, telecoms, consumer insurance markets, banking and professional services, among others. Although the big players in each of these sectors have activities in several EU countries, they operate not as if there was one single market, but on a series of distinct national markets.

The very slow progress in the pan-European integration of these sectors over the last 20 years suggests that a new approach is needed. For sectors with strong cross-border externalities and/or the potential for large economies of scale[7], the EU could define a single rule book and establish a single regulator or a network of national regulators, similarly to competition authorities. In networks, the national regulators would abide by the same rules, the same principles and methods, and by the same jurisprudence under the supervision and the coordination of a European regulator. This would be compatible with different national policies in certain areas, such as the choice of different energy mixes.

Creating larger and more integrated markets is particularly important in the digital sector. Europe cannot afford to miss out on the next steps in the digital revolution, which is starting to reshuffle the cards in many industrial sectors, such as the car industry, and services sectors. The EU risks falling behind global competitors and losing the most profitable segments of the value chain to digital newcomers from other continents.

Recommendation 1: *In sectors with large externalities and potential economies of scale, the single market agenda should aim at a single rulebook and close coordination (or merger) of national regulators.*

4 See Méjean and Schwellnus (2009) and Sapir (2011).

5 Head and Mayer (2002). The corresponding ratio was 6 in the late 1970s; see Fontagné *et al* (2005).

6 Aussilloux and Emlinger (2011) and Fontagné *et al* (2011).

7 Enderlein and Pisani-Ferry (2014) call them *"borderless sectors"*.

The fast development of US digital champions is especially challenging for the EU since the sector is very much of a 'winner-takes-all' type and companies operating in the US benefit from a large and integrated market. In contrast, digital companies in the EU suffer from market fragmentation, limitations and insecurity relating to the use and exchange of data, and limited availability of venture capital, among other factors (Colin *et al*, 2015). A new EU regulation on protection of personal data will take effect in May 2018 with the objective of modernising and strengthening the EU legal framework[8]. However, it will not provide full clarity for companies on questions regarding safe exchanges of data between them across borders[9]. For that to happen, more precise guidelines would be needed to increase legal certainty, in particular regarding treatment by national data privacy regulators.

In 2014, the EU adopted a regulation for the mutual recognition of electronic identification for secure transactions between businesses, citizens and public authorities that will apply from mid-2018[10]. In the same vein, the EU could promote EU-wide digital IDs for connection to digital platforms that respect the privacy of consumers and offer an alternative to commercial, lock-in connection tools such as Facebook Connect.

Digital companies in the EU suffer from market fragmentation

As digital markets are changing fast and encompassing multiple aspects, there is a case for a upstream regulation in order to ensure fair competition, through the establishment of a single EU regulator and a single EU rule book. The single EU regulator would develop principles for algorithm governance, support fair taxation of digital players and promote fair conditions of competition in the world of mobile apps[11].

Access to public data (on transportation, meteorology, job vacancies, etc) is also a key issue for the development of innovative services and productivity growth in the public sector. The 2003 directive (2003/98/EC, revised in 2013 as 2013/37/EU) on re-use of public data set the general principle of openness and regulate pricing conditions. Harmonising national practices in terms of which public data sets are open and under which format would help start-ups to emerge and grow faster Europe-wide.

b. Fostering competition through administrative simplification

In other services sectors, overly cumbersome national administrative procedures and regulations are seen by businesses as the main impediment to their development on other EU markets. A large administrative burden can be viewed as a fixed cost that weighs more on small and medium-sized companies (especially foreign ones), and thus favours incumbents at the expense of new, innovative firms. This burden represents the main obstacle to a truly single market, as formal discrimination has been eliminated. Recent progress has been made, for example, with the European legislative package on public contracts: bidders will now only have to fill in the European Single Procurement Document online, while proof of accuracy will only be requested from selected firms. However, many national administrative procedures and regulations remain cumbersome. For instance, it takes an average of 218 hours per year for German companies to pay their taxes (137 in France)[12]. Cross-border procedures are especially cumbersome, for instance in relation to legal proceedings, which is a major impediment to the completion of the single market.

Although they are no longer openly discriminatory against entities from other EU countries, there are still about 3000 national regulatory requirements that apply to professional and business services, including requirements relating to shareholding, specific legal forms

8 Regulation 2016/679 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC, 27 April 2016.

9 This could be resolved by European Commission's free-flow-of-data initiative.

10 Regulation No 910/2014 of 23 July 2014 on electronic identification and trust services for electronic transactions in the internal market and repealing Directive 1999/93/EC.

11 Apps rely on a very limited set of operating systems and platforms. These compulsory data gates tend to reinforce the monopolistic features of the market.

12 See PriceWaterhouseCoopers/World Bank (2016), *Paying Taxes*.

and restrictions on prices or multidisciplinary activities[13]. EU countries should now go a step further and cross-check the performance of these regulations against the public goals they are supposed to pursue (such as public health or safety). This could lead to the identification of overly cumbersome and discriminatory domestic regulations, opening the way for simplification.

In order to accelerate the process and focus on the most relevant areas, a committee of companies from various EU countries could be set up in order to benchmark the different countries on precise areas and foster competition by publicising their rankings. Key areas to be scrutinised could include property registration, dealing with construction permits, accountancy reporting, trading across borders, enforcing contracts and closing down a business. Special attention would be paid to regulations that do not seem to perform well in achieving the public goals they are supposed to achieve, or which involve higher costs in comparison to the best-performing countries. National regulators could commission independent evaluations in this regard and cross-check the results with their European counterparts[14].

In services sectors, individual regulations should be systematically assessed on a cost-benefit basis

Recommendation 2: *In services sectors, individual regulations should be systematically assessed on a cost-benefit basis, with reference to the best practices, in order to reduce undue obstacles to cross-border activity.*

2.3 Towards a destination-based environmental policy

It is no longer possible to discuss growth-enhancing policies without accounting for environmental constraints that will affect productivity either directly (eg in agriculture) or indirectly, through cost-inflating policies such as carbon taxes. In order to maintain the global temperature below 2 degrees Celsius, advanced economies including the EU should reach net zero emissions by 2050 (Auverlot and Beeker, 2016). However, imposing heavy taxes or emission permit restrictions on EU companies is hardly sustainable without a credible international agreement that covers the most polluting countries. In the context of uncertainties around the future of the United Nations Paris Agreement, the EU should think how to develop an ambitious environmental strategy without hurting its own competitiveness too much.

A first avenue is to more systematically redistribute the proceeds of carbon taxation to the polluters themselves in a way that preserves price-driven incentives but without undermining competitiveness. For instance, a carbon tax on passenger and merchandise transportation could be imposed, and the proceeds redistributed proportionally per passenger-km or ton-km. Such a quid-pro-quo would give the transportation sector an incentive to invest in low-carbon vehicles without reducing their overall profitability even in the short term[15]. To the extent that all transport modes are treated the same way, it may also trigger reduced travel and a shift towards less polluting modes (eg rail rather than trucks).

A second approach would be to set ambitious technical standards in a number of key areas with relatively long but credible horizons. Of course, from an economic point of view, price penalties on the externality are preferable to standards because of rebound effects and costly overinvestment. But in some instances, technical standards might be more easily agreed because they contribute to the meeting of societal goals. For example, the EU could set a regulation only allowing very low or zero-emission cars to be sold in or imported into the EU by 2035. Setting the deadline more than 15 years ahead would give the car industry an

13 Restrictions on multidisciplinary activities prevent a company from providing to its clients several types of services, for example architecture, construction and real-estate services.

14 The European Commission's proposals published on 10 January 2017 rely on a similar logic. See 'A services economy that works for Europeans,' http://europa.eu/rapid/press-release_IP-17-23_en.htm.

15 One further advantage would be to make such taxation acceptable not only to national companies, but also to foreign suppliers. See Bureau *et al* (2017).

incentive to invest in clean vehicles while allowing enough time for them and their employees to adapt, without creating a competitive disadvantage for European carmakers since the same standard would apply to foreign models. EU manufacturers could even reap a competitive advantage once other countries eventually introduce similar standards[16].

A third, complementary approach would be to reduce uncertainty around future carbon prices in order to stimulate long-term investment in low emission manufacturing[17]. Currently, explicit or implicit carbon prices vary widely in different sectors and countries. Many private companies and public bodies base their investment decisions on their own reference value for carbon, generally much higher than current and foreseeable EU emissions trading system (ETS) prices, while technical standards yield also their own implicit prices and carbon taxes vary in different EU countries. Defining a trajectory for the price of carbon as a reference value compatible with the EU's emission commitments would foster consistency of private and public decisions, even though full consistency between ETS prices, carbon taxes and technical standards is probably beyond what can reasonably be achieved. Following the example of the Stiglitz-Stern High-Level Economic Commission launched by the Carbon Pricing Leadership Coalition during the 2016 United Nations climate summit in Marrakesh (COP22), the EU should task a group of experts with defining a carbon price trajectory in line with the EU's commitments under the Paris Agreement. Based on this expertise, a price path would be adopted by the Council of the EU and the European Parliament, with an appropriate commitment device (CIRED, 2015).

Combining the first two approaches would amount to switching from an origin-based environmental policy (under which EU polluters pay for EU emissions, whether the goods and services produced are sold in the EU or on the global market) towards a destination-based policy (under which any polluter has to pay when the goods and services are directed to the EU market). The third approach – an upward convergence of carbon prices within the EU – raises the question of fair competition between EU and non-EU producers of goods that might incorporate different carbon contents arising from different production processes. This issue will need to be solved through a cooperative approach at international level (Bureau *et al*, 2017).

Recommendation 3: *Make EU environmental policy destination- rather than origin-based through the setting of technical standards over long but credible horizons, defining a reference path for the carbon price, and using revenue-neutral tax instruments to discourage greenhouse gas emissions.*

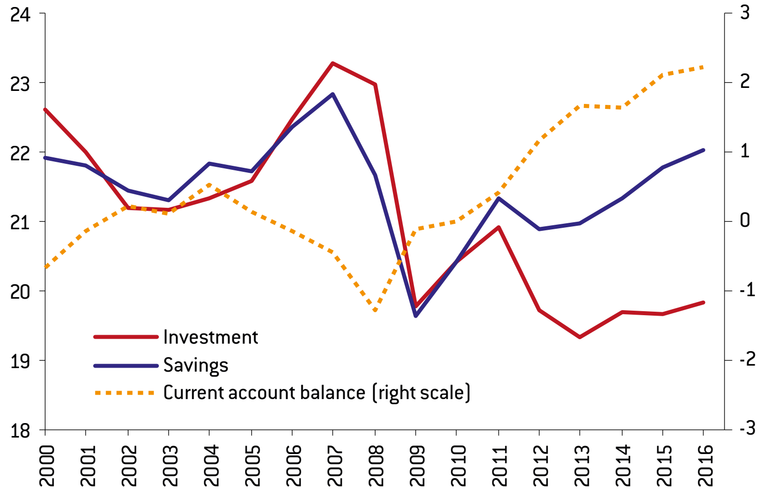
3 A new investment agenda

Since 2007, aggregate investment in the EU has declined by over 4 percent of GDP (Figure 2). At the height of the crisis, the fall went hand in hand with reduced savings. Since 2012, however, savings and investments have diverged. This shows that the EU as a whole has ample resources to invest, but the investment takes place increasingly outside the EU. Beyond the single market agenda and reforms at national level, the EU needs to stimulate investment.

16 In the same vein, the EU could set the rule that by 2030 all products sold or imported in the single market should either be recyclable or biodegradable (the deadline might be adapted by sector and few exceptions might be drawn based on expert panel recommendation).

17 Annual additional investment needed in relation to the Paris Agreement is estimated to be around €38 billion (or approximately 0.36 percent of euro area's GDP) over the period 2011 to 2030; see http://europa.eu/rapid/press-release_MEMO-14-40_en.htm. Without clear price signals, investment is likely to remain subdued however. See Eyraud *et al* (2011).

Figure 2: Saving and investment in the EU28 (% of EU GDP)



Source: IMF, WEO Oct. 2016.

3.1 Making progress with capital markets union

Renewed efforts to complete the single market would stimulate private investment in the EU by creating new opportunities and increasing returns. A key condition is adequate financing, notably through equity, which fits more the needs of new business models, whereas the European economy still relies mostly on bank lending.

More generally, a diverse capital market (ie relying both on bank and market finance) has been shown to enhance growth and strengthen financial stability (Langfield and Pagano, 2015). The EU has not only a strong bias towards bank-based financial intermediation but is also characterised by low cross-border integration in certain segments of capital markets. Hence the single market agenda on capital markets, the so-called Capital Markets Union, is an important project. However, it touches on a multifaceted policy agenda that includes accounting, corporate governance, insolvency regulations and also more simple issues such as the prospectus directive (Véron and Wolff, 2016). Capital markets union also concerns venture capital, which is far less developed in the EU than in the US or even China[18]. In November 2016, the Commission published a proposal on business restructuring and insolvency[19]. Work on these technical issues is key to enable capital to flow smoothly across the EU to provide finance, in particular, for SMEs.

Completing the banking union is also important for the integration of EU financial markets, especially in the euro area. Bank 'de-nationalisation' (by reducing the weight of the national public sector on both the asset and the liability sides) is a precondition for developing a cross-border banking sector in which credit is less dependent on the fiscal and macroeconomic situation in each member state. This is especially important because SMEs will remain heavily dependent on bank lending in the EU.

> **Recommendation 4:** *Continue to address the different structural challenges related to the capital markets agenda, especially in the area of corporate insolvency law, by moving to identical core principles across the single market.*

18 EY Global Venture Capital Trend, 2015.

19 European Commission (2016) 'Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU', COM(2016) 723 final, 22 November.

3.2 Mobilising EU resources

The Juncker plan introduced in 2014 (European Fund for Strategic Investments, EFSI) aims to fill the investment gap in the EU by stimulating investment in relatively risky projects that could not be financed without some form of public guarantee. According to European Investment Bank figures, by 23 September 2016, total investment arising from approved EFSI projects reached €127.2 billion (for 324 approved projects), representing roughly 4 percent of total investment in the EU between April 2015 and March 2016. Although total investment in the EU had increased by €139.5 billion compared to one year before, it is too early to conclude that the Juncker plan really triggered investment projects that otherwise would not have been financed[20]. More importantly, the Juncker plan raises the question of its interaction with the EU budget and the EU's general investment strategy.

It is too early to conclude that the Juncker plan really triggered investment projects that otherwise would not have been financed

Three justifications can be given for investment spending based (partly) on EU resources:

- Economic convergence between EU countries (and more precisely, between EU regions). Convergence is the remit of the Structural and Cohesion Funds[21].
- Existence of spillovers between member states. Initially, food security was considered a common objective of the EU with strong spillovers (given the free mobility of food products), which justified the Common Agricultural Policy. More recently, an active R&D policy has been promoted at EU level. Joint investments in security and borders are also justified on those grounds.
- Solidarity which is a key founding principle of the EU. This less-defined category is ultimately decided unanimously by national governments. For instance, high and persistent youth unemployment in a country could weaken social cohesion to such an extent that EU integration itself is at stake, hence becoming 'systemic' and justifying the introduction of the Youth Guarantee in 2013. Similar arguments could be made for the costs of the refugee crisis: although Germany and Sweden are perfectly capable of meeting the costs of large refugee inflows, EU countries could choose to share the cost for reasons of solidarity.

The balance between these three objectives, and the content of each, may evolve over time. For instance, structural funds may progressively move towards financing institution building (such as more efficient legal systems) or human capital (eg teacher training). As for spillovers, it might be argued that food safety today is more and more an issue of sanitary and environmental standards, which might not necessarily involve EU-level subsidies. Conversely, spillovers in energy, climate change policies or tertiary education have become more prominent. Beyond, the cohesion policy reform of 2014, the EU budget should gradually redirect more resources away from agriculture to meet these challenges. It should also use more often calls for tender to allocate financial resources where they can be of best use.

An EU spending review should be carried out based on an independent audit of the quality of the main expenses and their additionality[22]. Other examples are large parts of the spending under the Common Agricultural Policy and spending on regional and structural policies in member states such as France and Germany[23].

20 In fact, there is still no evaluation that can convincingly prove the additionality of EFSI. Some preliminary evidence suggests caution but also calls for more detailed data to make such an assessment. See Claeys and Leandro (2016).

21 Merler (2016) shows with a novel identification strategy that Structural Funds have helped with economic convergence in particular in the poorer periphery countries, even during the crisis.

22 Our views tend to converge with the Sapir Report (2003) *An agenda for a growing Europe*, the recommendations of which have not been fully implemented.

23 For instance, in recent years the EU provided financial support to the transformation of a public baths into offices in the German city of Pforzheim, the renovation of a market square and the creation of neighbourhood centres in Dortmund and Berlin, the transformation of brownfield sites in Nuremberg and the renovation of water tanks in Brandenburg. These projects may be useful, but EU involvement has no justification in these cases. It generates negative value added because it only adds bureaucracy.

Conversely, the growing mobility of skilled workers within the EU increases the need for coordination of national policies or even some EU-level funding[24]. Such mobility is more marked the higher the level of tertiary diploma and individual reputation. In countries where public budgets heavily support tertiary education, rising mobility risks inducing less investment in human capital. One response could be to privatise this investment by making students paying the full price of their education. But then the risk again is under-investment, not to mention inequality. The alternative is more cooperation on tertiary education. Such cooperation could take the form of a programme for European universities and colleges, which would bid to receive EU extra money based on a set of excellence criteria. Large-scale consortia of universities of excellence would compete for the title of 'European university'. World class but smaller units would compete for the 'European college' title[25].

Along the same lines, the EU could promote genuine recognition of skills, at least in those professions with a shortage of skilled people, for instance through a system of student loans and/or grants associated with EU certification of the degree received[26].

Recommendation 5: *Review the EU budget and Juncker plan in respect of economic convergence, spillovers between member states and solidarity.*

4 The roles of the EU and EU countries in promoting fairness

EU policies and in particular further initiatives to deepen the single market can directly increase inequality or at least the perception of inequality. There are two possible approaches to deal with this. EU countries themselves could reinforce their efforts to address the possible negative implications of integration in terms of inequality, as most policy tools are currently in their hands. The role of the EU would then be to empower member states to fight inequality for instance by protecting the member states' tax bases but also possibly by setting regulatory minimum standards to prevent social dumping.

However, the EU itself might develop instruments to limit the negative consequences of EU integration for possible losers. The European Social Fund and the European Globalisation Adjustment Fund have already been created for that purpose. In this section, we rather focus on the role the EU can play to help member states better distribute the gains arising from economic integration. The general idea is that more coordination in the area of social protection and taxation is an indispensable complement to further integration of the European market.

4.1 Protecting national tax bases and improving social conditions in the single market

There has been a new focus since the 2008 crisis on fighting tax avoidance and tax fraud, notably through G20, OECD and EU initiatives. The different areas of tax avoidance and tax evasion delineated in Box 1 raise a number of policy issues. The first is the widespread perception of unfair taxation, with different treatment for rich and poor households, large and small firms and compliant and non-compliant agents. The second is the efficiency loss (hence lower growth) caused by tax distortions related to tax avoidance and evasion. The third

24 See Garcia-Penalosa and Wasmer (2016).

25 For proposals in the same vein, see Aghion *et al* (2008).

26 Despite the 2005 Directive on skill recognition (revised in 2014), local traditions of very specific education and training systems make skill recognition a dream far from reality for a number of medium-skilled professions.

is a potential erosion of the tax base that might limit the ability of the state to finance public services or social transfers. Although they overlap, the three challenges are not equivalent. For instance, tax avoidance by multinationals has a disproportionate impact on perceptions, compared to its contribution to the overall tax gap. In practice, small businesses as a whole also contribute significantly to the tax gap through VAT and social fraud.

Box 1: Some tax and social contribution avoidance landmarks

In the debate on tax avoidance and evasion, the focus is on four main areas. Firstly, according to Zucman (2014), offshore wealth increased between 2008 and 2013 by about 28 percent globally. This is partly due to valuation effects, and part of the related income is declared by the beneficiaries to their respective tax administrations. However, Zucman estimates that more than 60 percent of foreign-owned deposits in Switzerland 'belong' to the British Virgin Islands, Jersey and Panama and largely escape residence-based taxation in the country of the ultimate beneficiary. He estimates the tax revenue loss to be close to $200 billion globally, and $75 billion in Europe.

The second focus area is avoidance of corporation tax. Many companies use complex corporate structures involving tax havens and special tax regimes (such as the 'double Irish with a Dutch sandwich' technique, or intellectual property boxes). This is not always done with the objective of avoiding taxes. But there is ample empirical evidence that multinational companies organise their legal and financial structures with a view to reducing their tax bill (Fuest *et al*, 2013). These tax avoidance activities are usually perfectly legal, and many countries actively create loopholes for multinational companies with the aim of attracting tax revenue from other countries. From the perspective of the EU as a whole, though, this form of corporate tax avoidance is undesirable because it is a zero-sum game.

Third, the avoidance of personal and corporate taxes remain small compared to the 'VAT gap' (ie the difference between effective and expected VAT receipts), which is estimated to have been close to €160 billion in 2014 for the EU as a whole, partly related to cross-border schemes (carousel fraud), and with significant differences between EU countries[27].

Fourth, social security optimisation, avoidance and fraud are highly contentious and complex issues in the debate on posted workers. A 2016 report for the European Commission highlighted the impact of the level and the structure of social contribution systems on the intensity of social competition and fraud. However, though loopholes remain in EU welfare rules, a report commissioned by the European Commission in 2013 concluded that 'welfare shopping' claims are not supported by data, and are rather an issue of perception (Juravle *et al*, 2013).

Rising mobility of goods, services, capital and labour across the EU should go hand-in-hand with greater capabilities of national tax and social administrations to identify cross-border avoidance

It is not our purpose to discuss in detail the different strategies to reduce tax avoidance. We would rather link this discussion with the single market agenda by noting that rising mobility (of goods, services, capital and labour) across the EU should go hand-in-hand with greater capabilities of national tax and social administrations to identify cross-border avoidance. The key issue here is that of cross-border information systems, which are lagging behind. Bold action needs to be taken in this area.

A first step is the under-construction Business Registers Interconnection System (BRIS), which aims to connect national commercial and company registers by 8 June 2017. The BRIS will take the form of a portal through which a company or a tax administration from an EU country will be able to retrieve relevant information from a foreign company or branch, based

27 See European Commission, *Study and Reports on the VAT Gap in the EU-28 Member States: 2016 Final Report*, September 2016. The VAT gap is partly due to bankruptcies, financial insolvencies, but fraud, evasion and avoidance are also part of the picture.

on a single identification number[28]. The BRIS will reduce information asymmetry between national and cross-border activities. For instance, it will allow an SME in Germany to check the basic legal and financial situation of a potential supplier in Italy (including possible ongoing legal procedures). The system will also give national tax administrations greater scope to assess the risk related to individual companies, in terms of avoidance or fraud[29].

The total number of posted workers, although still limited in proportion to host labour markets, has been growing rapidly in recent years

A second issue is posted workers, whose total numbers, although still limited in proportion to host labour markets, have been growing rapidly in recent years[30]. The Commission proposal of 8 March 2016 to revise the Posting of Workers Directive focuses on the need to ensure a level playing field between posted and local workers. However, the main problem may be less in the design of the rules than in their implementation. According to Chevreux and Mathieu (2016), the labour cost for a French worker at the minimum wage is actually lower than that of a posted worker from Spain or Poland. The worry is that posted workers might not be declared, or they might be wrongly declared in terms of skills or hours worked, leading to artificially low social charges (Cytermann, 2014). The technology for declaring posted workers – the A1 form – is from the twentieth century: each posted worker is supposed to carry a paper copy with him/her; if it cannot be shown during a check, the administration of origin is required to provide the form, with sometimes long delays. Starting in July 2019, the Electronic Exchange of Social Security Information (EESSI) will smooth the exchange of information between social security administrations. However, the exchange will still rely on voluntary cooperation and action, and the recovery of social security contributions or social transfers will remain difficult. A modern system based on electronic data and single identification numbers could be designed in a way to reduce fraudulent practices and could thereby address the main factual concern relating posted workers, especially if the burden of proof is shifted to the company that, in case of irregularity, would be asked to pay the social contributions in the destination country.

> **Recommendation 6:** *Make sure social charges for posted workers are effectively paid in the home country by developing proper electronic interfaces, and make the company in the destination country liable for showing prior authorisation.*

4.2 Corporate tax avoidance and tax coordination

Taxation in general and dealing with tax avoidance are member state responsibilities, not responsibilities of the EU. However uncoordinated national tax policies can create obstacles to cross-border economic activity in the European internal market, making some tax coordination necessary.

In October 2016, the European Commission relaunched its initiative from 2011 to introduce a common consolidated corporate income tax base (CCCTB) in the EU. The scheme will be compulsory for EU groups with annual sales exceeding €750 million, and will be offered as an option for smaller groups. Participating companies would see the taxable profits of their different affiliates in the EU (and of their parents) calculated according to the same rules and consolidated across countries. The taxes due would then be allocated to the different member

28 See EU Directive 2012/17/EU on the interconnection of central, commercial and companies registers, 13 June 2012.

29 Along similar lines, the Commission is preparing a legislative proposal to introduce a single taxpayer identification number for European households. This number would simplify registration procedures and access to social transfers when moving across the EU. It would also make it easier for tax administrations to communicate and identify tax avoidance or fraud, through the operation of the automatic exchange of information. See also the European Parliament report on the Anti-Avoidance Directive (27 May 2016).

30 +45 percent since 2010, and approximately 1.9 million, or 0.7 percent of the total EU workforce in 2014. See Pacolet and Wispelaere (2015). The latest figure for France would be a 'stock' of posted worker of 286,025 in 2015, or about 1 percent of total employment. The count of posted workers however relies on the A1 forms and may not be exhaustive. See CLEISS (2016), and Voss and Maack (2016).

states according to a formula depending on the location of assets, employees (and wage bill) and sales.

The new CCCTB blueprint proposes as a first step to start with the introduction of a common tax base without consolidation. The main advantage of this first step is that it will reduce the tax compliance costs associated with dealing with 28 different regimes; these costs have been shown to be substantial, especially for SMEs[31]. CCCTB will also reduce certain forms of tax avoidance that rely on the different treatment of the same flows in different member states. However, by making the effective tax rates in different EU countries more transparent, this first step will likely intensify competition to attract investment.

Once consolidation has been introduced, standard forms of profit shifting – eg through intra-group pricing or lending – will no longer be possible. However, new forms of profit shifting will be made possible, depending eg on the rules that might be introduced on the location of 'permanent establishments', and on how corporate groups are structured (Fuest, 2008).

Therefore, CCCTB should be encouraged essentially on efficiency grounds, because it will simplify corporate tax systems, reduce compliance costs and reduce cross-border barriers to activity. Although it will likely reduce tax avoidance, it will not eliminate it. The implementation of CCCTB will be complex because member states need to agree on a common set of rules, which will not be easy.

Another approach could be to re-consider the Interest and Royalties Directive[32], which currently limits the right of member states to levy source taxes on interest and royalty payments that companies transfer between them. An unintended side effect of this directive is that royalties charged to subsidiaries operating in high-tax EU countries reduce the taxable profits in those countries, without necessarily being taxed in any other EU country. This is because some EU countries do not tax royalties that are channelled towards non-EU countries, even when the latter are tax havens. If royalties paid to EU member states and royalties paid to third countries were both taxed at source, widely used tax-planning strategies based on the location of intellectual property in tax havens would become ineffective. Of course, allowing for more source taxes would require these taxes to be credited in the countries where they are received. Since this would lead to a redistribution of tax revenues between countries, it might be difficult to agree on such a reform. Alternatively, member states could coordinate their double taxation agreements with third countries and their rules defining tax residence, making sure that royalties or interest paid to tax havens outside the EU do not go untaxed[33].

In its recently adopted Anti-Tax Avoidance Directive, the EU wants to tackle tax avoidance in the framework of a more general approach based on the concept of 'artificiality' of business conduct. The advantage of this approach is that it allows member states to react flexibly to different forms of tax avoidance. The disadvantage is that it creates considerable uncertainty for companies relating to the tax implications of their activities. At the same time, double taxation can easily arise if the actions of individual member states are not coordinated.

Recommendation 7*: Modify the Interest and Royalties Directive to allow for more extended use of source taxes on royalties and interest. Alternatively, coordinate double taxation agreements with third countries.*

31 According to the European Commission, overall tax compliance costs for companies operating in the EU would decline by €0.7 billion annually; see European Commission (2011), Questions and Answers on the CCCTB, Memo 11/171, 16 March 2011.

32 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

33 For more detail, see Finke *et al* (2014).

4.3 Intra-EU migration

In 2014, 14.3 million Europeans lived in another EU country, against an overall EU population of more than 500 million. Each year about one million people change countries, 25 percent of whom are returning to their country of origin. The latter bring back skills that they have acquired during their time in another European country, increasing the human capital of their home country. However, some countries in Europe experience a steep decline in their active, skilled populations, because of net outward migration. This can be problematic because it reduces the potential for growth in these countries. It might also be an issue of fairness because the investment in education financed by the country of origin might ultimately benefit the recipient country, even though emigrants may send significant remittances back to their origin countries[34].

From the perspective of the destination country, immigration from other EU countries is commonly found to have a positive impact, even when narrowly looking at the net contribution of migrants to the social security system. Migrant workers are on average younger and more economically active than host countries' own populations, and therefore usually contribute more in taxes and social security contributions to the host country budget than they receive in benefits[35].

From the perspective of the destination country, immigration from other EU countries is commonly found to have a positive impact

Even though fraud and abuse exists, there is evidence that 'welfare shopping' is currently of limited relevance as far as intra-EU migration is concerned. First, the majority of migrants move to find (or take up) employment: more than 60 percent of intra-EU migrants work, and this proportion has increased over time. This proportion is not far from the EU28 aggregate employment rate, which was 70 percent for the 20-64 population in 2015. Second, 79 percent of non-active EU migrants live in economically active households. Third, 64 percent of currently non-active migrants have worked before in the current country of residence. Fourth, non-active intra-EU migrants do not form a static group: a third of EU migrant jobseekers (32 percent) were employed one year before. And finally, intra-EU migrants are less likely to receive disability and unemployment benefits than natives. This suggests that the 'welfare magnet effect' is rather small or not statistically significant[36]. Empirical studies measuring the impact of social welfare generosity on the skill composition of immigrants have led to mixed results, although some studies do find an effect for intra-EU migration (Razin and Wahba, 2011).

One reason for the limited effect of the welfare magnet in the case of intra-EU migration could be that there is no unconditional right to stay in a host country for EU citizens before they have reached five consecutive years of legal residence. During that period, a country can ask a person to leave under certain conditions if the person has no means to sustain her needs or has no serious prospect of finding a job[37]. Thus, during that period and under EU law a country can still act to clamp down on abuses. After five years of consecutive residence, all rights are the same as for nationals and a country cannot ask a person to leave (Box 2). However, though the basic principles of EU law are rather clear and simple, diverging interpretations can arise in individual cases between member states and the EU Court of Justice.

34 For example, Poles living in Germany send each year about €2 billion in remittances to Poland, amounting to 0.5 percent of Polish GDP. This is also the proportion for Portuguese nationals living in France. Source: Eurostat (2016) Net workers' remittances and compensation of employees.

35 See Eurofound (2015) and Juravle *et al* (2013). In the UK case of the UK, Dustmann, and Frattini (2014) find that immigrants from the European Economic Area contributed £20 billion more to public finances through taxes than they received in benefits and public services between 2000 and 2011. The fiscal impact of overall immigration (including from non-EEA countries) is more mixed. Countries with generous welfare states and those who attract low skilled migrants or refugees tend to lose fiscally from immigration, at least in the short and medium run, see OECD (2013) *International Migration Outlook*, chapter 3.

36 These figures are taken from Juravle *et al* (2013). See also Medgyesi and Poloskei (2014).

37 See Article 14(1) Directive 2004/38/EC and Article 14(4) lit. b Directive 2004/38/EC. Wollenschläger and Ricketts (2014).

The general principle governing labour mobility in the EU should be the neutrality of welfare systems so that job opportunities are the key driver of labour migration

The general principle governing labour mobility in the EU should be the neutrality of welfare systems so that job opportunities are the key driver of labour migration. The welfare system should thus neither encourage nor discourage labour mobility. Such neutrality does not exist today. For instance, a worker who has lost his/her job will receive unemployment benefit for different periods depending on whether he/she is looking for a job in the same country as the previous job or in another EU country (in the latter case, the benefit is limited to three months, paid by the country of the previous job, according to the 'continuation' principle). Conversely, a worker who has lost his/her job in a country, moves to another country and works there for only a short period before becoming unemployed, can ask for an 'aggregation' of his/her contributions and then receive unemployment benefit paid only by the last country visited, despite the short period worked there.

Full neutrality of unemployment insurance is probably impossible to achieve. A major constraint in this area is the link between the payment of unemployment benefits and the active job search, which needs to be closely monitored by a single job service. However, there are several ways of making social security more neutral. First, the 'continuation' principle could be extended to the same duration as that enjoyed while staying in the country of the previous job. In order to check that the jobseeker does continue to look actively for a job in the new country of residence, the employment service of origin would have to maintain regular contact (distance contact) with the jobseeker, or choose to delegate assistance in the job search process to the employment service where the person lives. Second, the aggregation of unemployment benefits could come along with annual transfers between national unemployment services to compensate for costs arising in the different countries. For instance, a country with good job opportunities might attract jobseekers from other EU countries, some of whom could benefit from 'aggregated' unemployment benefits paid by the local unemployment service, and later compensated for by the different origin countries, , possibly through a central clearing platform.

Recommendation 8: *Make unemployment insurance more neutral with respect to intra-EU migration through the full continuation of rights when leaving one country for another EU country, and through compensation payments between countries for the costs incurred by the application of the aggregation principle.*

The Commission's December 2016 proposal[38] goes in this direction, with two building blocks: (i) an extension from three to six months of the minimum duration of the continuation of unemployment benefits when a jobseeker moves to another EU country; (ii) a minimum qualification period of three months of activity in a given member state before a worker can ask for the aggregation of his/her entitlements[39]. On (i) we believe that the objective should be full continuation of the benefits, provided closer coordination can be organised between employment agencies. On (ii), although the minimum employment period will eliminate a whole category of abuse, transfer payments need to be organised between member states in case aggregation is more frequent in one country than in others.

As for pensions, the principle of aggregation currently applies: periods of employment completed in different EU countries in the course of a career are taken into account when calculating pension entitlements from each country. Unfortunately, the scheme does not cover so-called occupational pensions, except when they result from compulsory insurance

38 European Commission (2016) 'Proposal for a Regulation amending Regulation No. 883/2004 on the coordination of social security systems and Regulation No. 987/2009 laying down the procedure for implementing regulation No. 883/2004', COM(2016) 815 final, 13 December.

39 The Commission also proposes that unemployment benefits for cross-border workers be paid by the member state of the most recent employment, rather than by the country of residence with reimbursement by the country of employment.

obligations (Garcia Peñalosa and Wasmer, 2016). More importantly, information on pensions is held in the different countries of residence, so it is difficult for a worker to have an idea of her (future) total pension before actually retiring. An EU worker should be able to access a European platform displaying his/her individual pension entitlements in a comprehensive way (by incorporating employment periods in all EU countries), based on the different national pension systems that would remain separate.

Recommendation 9: *Improve information on pension entitlements by centralising personal information on a single platform.*

Box 2: Freedom of movement for EU citizens: basic principles and implementation

EU law considers three different categories of people with regards to the freedom of movement: workers, non-working citizens and jobseekers. Each category has different rights of residency and access to social benefits. A worker has the right to stay in the country where he or she works and to benefit from the same social benefits as a national. During the first three months in the country, however, a non-working person can be refused access to social benefits.

After three months and up to five years, a non-working person is entitled to stay on the condition that he or she has full health insurance coverage and sufficient means to meet his or her needs. This condition does not apply to jobseekers, though to retain their right of residency a jobseeker must be able to prove that he/she is actively looking for a job and has good chances of finding one. There is of course some degree of judgement on whether these two conditions are met. But the basic principle is that freedom of residency is not unconditional. A member state can ask a jobseeker who is evidently not looking for a job or has little chance to find one (for instance after a long period of unemployment) to leave the country. A member state can also refuse to give a non-working person access to the right of residency if he or she has no means to sustain him or herself, and might therefore place an *"unreasonable burden"* upon the welfare system. There is some divergence between certain EU countries and the EU Court of Justice on what this means concretely, but the UK and Austria have legally set up a 'test of right to residence' to check early on if a national of another EU country has sufficient resources to sustain his needs or enough of a chance to find a job.

The different elements we have highlighted suggest that it is feasible for the EU to make progress on growth and fairness. In particular, the new information technologies provide an opportunity to revive productivity growth and to make European integration 'fairer' by reducing tax avoidance opportunities, and progressing towards more neutral welfare systems with respect to intra-EU migration. Reaping this double gain will however involve far-reaching institutional reforms in order to equip administrations and agencies for this new world.

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