Summary for non-specialists
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Quantifying the potential macroeconomic effects of the Europe 2020 strategy: stylised scenarios

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The Europe 2020 presents an ambitious and comprehensive strategy to guide the EU out of the economic crisis, to ensure macroeconomic stability and to put in place an ambitious structural reform agenda. An essential part of this strategy is the introduction of reforms with a medium- to long-term horizon that focus on promoting the sustainability of public finances, enhancing potential growth and realising the 2020 objectives, i.e. ensuring that the EU becomes prosperous, green and fair.

Such a comprehensive reform agenda can generate significant gains in terms of additional growth and employment as well as help ensure longer-term sustainability of public finances. Using the macroeconomic model QUEST III, DG ECFIN explored the possible extent of these gains. For this purpose, several stylised scenarios combining fiscal consolidation efforts with differentiated progress in implementing structural reforms have been constructed. The simulations do not attempt to model specific policies foreseen under the thematic pillar of Europe 2020 because the detailed policy agendas are still to be designed and agreed. Their objective is to demonstrate broad benefits that can bring some types of policy measures envisaged under Europe 2020 and the results should thus be seen as purely stylised and illustrative.

To demonstrate the broad benefits of Europe 2020 actions, several scenarios were built, which differ in both the breadth and depth of reforms, i.e. they consider differing range of reforms as well as different degree of progress across scenarios. They demonstrate the effects of (ambitious) fiscal consolidation alone and in combination with structural reforms. The structural reform scenarios combine assumptions on the degree of progress in meeting some of the headline targets (e.g. employment rate and R&D expenditures) with assumptions on progress on some of the policy variables, e.g. mark-ups, fixed costs, capital costs or unemployment benefit replacement rates (measured as closing a certain part of the performance gap with the three best-performing EU countries). All scenarios assume that policy measures start to be implemented in 2011 and will be phased in over a period of several years. In technical terms, the scenarios combine QUEST multipliers of different reforms to obtain the overall growth dividend.

The following scenarios have been constructed:

- The baseline scenario ("unchanged policy" scenario) – embeds the adverse impact of the crisis on potential output and assumes an increase in financing costs due to a protracted resolution of financial sector troubles. It also contains the effect of a gradual fiscal adjustment of 0.5% of GDP every year until the Medium Term Objectives (MTO) are reached, which is the minimum speed of consolidation that the Stability and Growth Pact (SGP) recommends.

- More ambitious fiscal consolidation – this fiscal policy scenario considers a far stronger fiscal consolidation of 1% of GDP annually (i.e. 0.5 p.p. more than in the baseline).

- Limited structural reform – this scenario assumes that, due to the constrained budgetary resources, reform efforts focus on measures with no budgetary costs (e.g. increasing competition, reducing administrative burden or limited budget-neutral tax reforms) which generally succeed in closing 1/10 of the gaps with EU best performers.

- Medium reform – this scenario assumes that reforms have gained momentum across all the policy areas, leading to important increases in knowledge-oriented expenditures and significant reforms in product and labour markets (generally assuming 1/3 reduction in the gaps with the best performers).

- Advanced reform – this scenario brings the highest gains, with very advanced reforms carried out across the board. It generally assumes a 1/2 reduction in the gaps with the best performers which, for example, means reductions in mark-ups or in risk premia on intangible capital to the US levels.

Progress in implementing structural reforms under the main priority areas of EU2020 can generate significant gains in terms of increasing output, creating jobs and reducing unemployment. By 2020, GDP could increase from around 1½% in the limited structural reform scenario up to 7% in the advanced reform scenario compared to the baseline thanks to the implementation of reform policies. Structural reforms thus could help boost annual growth between 2010 and 2020 from 1.7% in the limited reform scenario up to 2.2% in the ambitious reform scenario, to be compared with 1.5% in the baseline. Employment gains would also be considerable: between around 1% and 4½%, which means creating additional 1.5 to almost 11 million jobs.

The extent of the benefits will strongly depend on the depth as well as breadth of undertaken reforms. If the EU succeeds in generating the reform momentum necessary to realise the Europe 2020 vision, the gains could be very substantial. While the simulations do not model specific policies or cover all the policy areas under Europe 2020, the advanced reform scenario shows that the EU could succeed in meeting its employment and R&D targets envisaged in strategy. As the effects of reforms take time to materialise, the long-run gains would still be higher by around 1/3 to 1/2. Such an ambitious scenario would require a significant departure from the past policies and a strong political commitment and consensus on the need for change, which might be difficult to find in reality. On the other hand, piecemeal and timid reform will be insufficient to generate more substantial benefits and would mean a political failure of the Europe 2020 strategy. Intermediate reform scenarios lead to some gains, but clearly less than the full implementation of the strategy.

The results also emphasise that while ambitious fiscal consolidation is crucial to rein in public debt increases structural reforms might support this effort through increasing both GDP and tax revenues. The speed of consolidation needs to go beyond the 0.5% annual adjustment in public balance, which is the minimum required by the Growth and Stability Pact (SGP), which would imply that public debt would approach 100% of GDP in 2020. Fiscal consolidation will not affect negatively GDP growth in the longer-run: it will bring about a slight increase in GDP by 2020, although some GDP loss may be experienced in the short-run. Progress with structural reforms, increasing potential growth and expanding tax bases, can help significantly these efforts with the downward effect on the debt-to-GDP ratio ranging between 4½ p.p. and 14½ p.p.. However, even in the most optimistic scenario, the debt levels would remain well above the 60% reference value embedded in the SGP.