

# European Union: challenges and dilemmas

## *Evropská unie: problémy a dilemata*

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**Abstract:** In the last two decades, the EU trails behind the USA in both the rate of economic growth and the rate of growth of productivity. In addition, in the next 25 years, the EU will experience demographic challenges in the form of the rapidly ageing population and a substantial increase in the dependency ratio. To answer these challenges, the EU needs economic policies which will facilitate the utilization of new technologies. To do that and to alleviate the growing pressures on the European social and economic model, the significant economic reforms are necessary. The key to that is the EU-wide integration of the financial sector.

**Key words:** economic growth, demographic challenges, financial integration

**Abstrakt:** V průběhu posledních dvou desetiletí EU zaostávala za USA jak pokud jde o tempo ekonomického růstu, tak v tempu růstu produktivity. EU se bude navíc v příštích 25 letech potýkat s demografickými problémy v podobě rychle stárnoucí populace a výrazného nárůstu míry ekonomické závislosti. Aby se dokázala s těmito výzvami vyrovnat, bude EU potřebovat takové ekonomické politiky, které by podporovaly využívání nových technologií. K tomu, jakož i ke zmírnění narůstající náročnosti Evropského sociálního a ekonomického modelu, budou nezbytné výrazné ekonomické reformy. Klíčem k nim je integrace finančního sektoru v rámci celé EU.

**Klíčová slova:** ekonomický růst, demografické problémy, finanční integrace

The goal of this paper is the analysis of the challenges facing the European Union in the next 10 to 15 years.

It is commonly recognized that the today's EU trails behind the US in the areas of economic and productivity growths (see "Time for a Fresh Start at al" (2005) and Table 1). This is exacerbated by the expected fiscal and social impacts of a demographic shift (Confronting Demographic Change at al (2005)). Ageing of the population increases demands for the pensions and healthcare related public expenditures at the same time when faltering growth reduces public revenues. Results are the growing public deficits and the reduced flexibility of fiscal policy.

The Monetary Union implies no monetary (and exchange rate) policy on the national level. The resulting combination of limited fiscal and nonexistent monetary policies endangers the existence of a common European currency and poses a challenge to the existence of the EU itself.

## CHALLENGES

### Demographic challenges<sup>1</sup>

Demographic developments pose perhaps the greatest long term challenge for the EU countries. In a striking reversal of the historical trend predating the French revolution, the population of the EU countries – 458 million in 2005 – is expected to increase slightly to 469.5 million in 2025 (i.e. the overall increase of 2% over 20 years) and then to decline to 468.7 million by 2030. In contrast, the population of the USA is expected to increase by 25.6% between 2000 and 2025.

Whereas the stabilization of the population growth can be considered a positive development by some, the changes of the age composition within this total are rather ominous.

The most serious is the increase in so called dependency ratio – i.e. the ratio of the population aged 0–14 years and over 65 years to the population aged

<sup>1</sup> The numbers used in this segment of the paper are from the European Commission's Green paper "Faced with Demographic Change, a New Solidarity Between Generations", adopted on March 16<sup>th</sup>, 2005.

15–64 years. This ratio is expected to increase from 49% today to 66% in 2030. Or, to say it differently, whereas today there are approximately two individuals of working age per one dependent, this number will decline to approximately 1.5 individuals of working age per one dependent in 2030.

This increase in the dependency ratio is the consequence of both an expected decline in the total working age population (15–64 years of age – decline by 20.8 million (6.8%) between 2005–2030) and the expected increase in population over 65 – by 39.9 million (52.3%) by 2030. The young population (0–14 years) will decline 6.8 million (8.9%) between 2005 and 2030.

These numbers imply a relatively rapid ageing of the EU population in the next 20–25 years (and in fact beyond that as well).

This trend is the result of two factors. On the one side the life expectancy is increasing across the EU. Between 1960 and 2002 (the last year for which numbers are available) the life expectancy at 60 has increased by four years (19.6 years overall) for men and by 5 years (23.8 years overall) for women. In 2002, the EU average male life expectancy at birth was 74.8 for men and 81.1 for women.

On the other side, the fertility rate – i.e. the average number of children per woman in the child bearing age (15–45) has been falling for over 30 years. In 2003, the EU fertility rate average was 1.48. This is far below the fertility rate 2.1, considered to be necessary to preserve the basic reproduction – i.e. to provide for a stable population (a stationary population equilibrium) over the long run.<sup>2</sup>

It is outside the purview of economics to analyze (or even to speculate) the reasons behind the European demographic dynamics. However, the ageing process, irreversible in short to medium term, gives a rise to significant economic phenomena which will constitute challenges to European economies. And, indeed, one must always keep in mind that these challenges are complex, not only economic, but social and political as well.

Some of those challenges are “objective” in a sense that they would confront any economy in a similar

situation.<sup>3</sup> Other challenges are the EU-specific, stemming from a particular character of an “European” economic model, particularly an existing arrangements in pensions, health care etc.

Among the “objective” challenges, the most important are the shifts in the structure of aggregate demand, changing “average” attitudes toward risk on a society scale, changing the composition of labor supply and the political economy impact of the ageing electorate.

Shifts in the structure of an aggregate demand stem from a simple fact that older people buy different goods than younger ones. The biological factors imply an increase in demand for healthcare and the associated products (pharmaceuticals, care for elderly etc.). But that is only one element. A detailed analysis is, indeed, necessary in this area of the changing demand structure. The challenge for the supply side is a flexible adjustment of supply with all it implies – changes in the production mix, locations, sales methods, provisions of services etc. One would surmise that adjustments to changing demand compositions requires increased flexibility and competitiveness on the supply side – something the EU economies are not quite accustomed to.

Ageing of population combined with the long term decline in fertility implies ageing of labor force. The supply of younger workers will keep declining whilst the supply of older ones will be increasing (at least relatively). That will require changes in hiring practices, wages and leaves arrangements, working conditions in general etc. The overall impact of this change remains unclear. But one may surmise that a large decline of the number of people of working age (20.8 million in the next 25 years) will tend to reduce the excess supply of labor currently in existence (as demonstrated by a persistent large unemployment). That will shift labor markets “relative bargaining power” from employers to labor. Consequences then could be an increased flexibility of labor markets in general, present arrangement and attempted labor markets reforms notwithstanding.<sup>4</sup> Other consequence of the excess demand for labor would be rising real

<sup>2</sup> Of the 25 EU member states, none reports fertility above 2.1, even if France and Ireland are close to 2. On the other side, fertility rate in the Czech Republic is 1.17, Slovakia 1.2 and Slovenia 1.22. Italy, Spain, Germany and Poland have fertility rates below 1.3. The result is that in 2003 the population of 6 member states – Czech Republic, Estonia, Hungary, Latvia, Lithuania and Slovakia – was already falling. Moreover, the projections show that between 2005 and 2050, only UK and France will experience an increase in population. But in both countries this increase is attributed to a “non-European” segments of populations.

<sup>3</sup> Ongoing Social Security debate in the U.S. and coming debate about the extend of Medicare coverage in the US demonstrate this point.

<sup>4</sup> Present labor market arrangements in the EU countries limit the flexibility of employers and, in general, protect employees. Excess demand for labor would, obviously, make the labor protection somewhat redundant and practically unoperational. Excess demand for labor would improve labor mobility and hence employment flexibility all by itself.

wages. That would result in the increased substitution of capital for labor. A positive impact on the productivity and hence per capita growth is then a distinct possibility.

The change of the average attitude toward risk in society is another “objective” consequence of an ageing population. Older people are simply more risk averse compared to younger ones. This has several economic consequences. Perhaps the most important one is related to the nature of economic growth in the contemporary global economy. Modern economy is based increasingly on the innovation and creativity – hence it is more risky compared to the “old” economy of gradual improvements of the known. Hence, activities – and therefore economic growth – in the new economy are inherently more risky. An increase in the average degree of risk aversion across an economy then means that, *ceteris paribus*, relatively fewer innovative and creative, hence more risky, economic activities will be undertaken. The resulting impact on economic growth and global competitiveness is more likely than not negative. Moreover, an increased average risk aversion in a society implies an increased demand for insurance. And the main insurance agent in these circumstances becomes a state. Hence, an increased demand for the state role in the economy. Again, because the “new” economy of creativity and innovation is inherently a private sector economy, an increasing role of state is unlikely to improve the economic performance.

As far as the political economy impact of the ageing is concerned, in a political democracy (like the EU) the public policies and economic decisions are most influenced by the interests of a largest and most politically active social groups. Hence, these interests – which include preferences in general, stemming from attitudes, fears, worries etc. – of older population will increasingly influence political and economic environment. Reforms of the economic system may be necessary to improve its performance and to stem the tendency to decline. But such reforms will be increasingly difficult.

Challenges posed by the demographic dynamics which are specific to the “European” economic model are predominantly fiscal in nature.

Historically, in the European system of social market economy, the state takes responsibility for the majority of health care, retirement and education areas.<sup>5</sup>

A rapid increase of the number of retired individuals (39.9 million in the next 25 years) then implies a corresponding increase of public expenditures to finance pension and health care.<sup>6</sup> This growth is likely to be faster than the GDP growth, resulting in the pressure to increase the share of public expenditures in GDP.

At the same time, the decline in the number of people between 15 and 64 (by 20.8 million in the next 25 years – see above) implies a relative decline of the taxable incomes as a share in GDP, unless, indeed, the long term economic growth accelerates substantially. But, as is discussed below, in present circumstances such acceleration is unlikely.<sup>7</sup>

The result is the tendency for the faster growth of public expenditures relative to public revenues – hence a tendency for growing budget deficits.<sup>8</sup> And because the rising level of public expenditures stems from the rising public costs of serving public commitments to a rising retired population, such a spending at best preserves the level of aggregate demand. That is, such rising deficits are not expansionary. But they do consume a growing part of national savings. Hence, the rising public deficits in those circumstances are likely to exert on balance a negative influence on the economic growth and performance.

### Challenges of economic growth

Economic growth in the European Union remains rather anemic for the last decade and half. Table 1 illustrates the difference in growth rates between the USA (with the average annual growth rate in the 1993–2005 period 3.32%) and EU (which, for the purposes of the comparison consistency includes only the “original

<sup>5</sup> For comparison: In the US the public portion of the retirement income (Social security) is on average only about 40% of retirement income. The rest comes from private pension funds (often encouraged by employers and unions) and from private individual investments. In contrast, in the EU the publicly (i.e. the tax) financed portion of retirement income is on average over 90%.

<sup>6</sup> In fact the growth of public expenditures will be faster due to the fact that health care costs for older people are higher per person compared to a younger population.

<sup>7</sup> Note that under present structure of taxes and retirement payments (including health care) the economic growth – and hence the growth of individual incomes – would have to offset not only the decline in the numbers of the economically active people, but an increase in the retirement related expenditures as well.

<sup>8</sup> Deficits of large European countries – Germany France, Italy – hover today around 4% of GDP, compared to 3.2% of GDP for the US.

15" states and where the average annual growth rate in the 1993–2005 period was 2.02%).<sup>9, 10</sup>

The reality illustrated by the numbers in Table 1 is confirmed by various authors (Papademos 2004, Musso and Westermann 2005, Siebert 2003 (for Germany only)). In this context, the following two questions can be raised:

- a) Why is an economic growth important? And
- b) What causes Europe's laggard performance?

To answer the first question one could point out to a simple fact that both wealth and income must be first created before they can be distributed. And, indeed, the higher the base (GDP), the more can be distributed or redistributed. However, there are some people – most prominent among them Blanchard

(2004) – who argue that the lower European economic growth is the result of a deliberate choice. In this line of reasoning, it is argued that Europeans by and large have stronger preferences for leisure and environmental and social protection compared to the USA. This then leads to a lower supply of labor and the more extensive government regulation of economic activities. The result is a slower economic growth.

There is some merit in this argument. An average German or French works about 1400 hours a year, whereas an average American works close to 1900 hours annually. Labor force participation rate in the EU is by 8% lower compared to the USA (Papademos 2004).<sup>11</sup> And the role of state is much more significant in European economies. About 50% of German GDP is redistributed via government budgets (Siebert 2003), whereas the corresponding number for the USA is less than 30%. However, the unemployment rate in the EU is at least 3 percentage points above the US (Papademos 2004). And this difference is growing lately. Unemployment rate in the US is under 5%, compared to close to 10% in France and over 11% in Germany.

However, those latter numbers indicate that the EU economies are not growing fast enough to utilize all available resources even if we accept the argument that Europeans have a higher preference for leisure. Obviously, a higher growth is needed to provide everybody willing to work under the existing circumstances with a job and hence a higher income and a better living standard.

But not only that. As the discussion above indicates, the process of ageing – which is irreversible in the short to medium horizon – implies growing public expenditures if the existing social contracts in the EU countries are to be preserved, at least in their basic outlines. At the same time, the number of people in working age (15–64) will be declining, putting downward pressures on the tax base *ceteris paribus*. Assuming that the rate of redistribution (i.e. the average rate of taxation), being close to 50% of GDP (Siebert 2003), cannot be practically increased, the higher rate of the economic growth is needed to generate enough public revenues to service the exogenously increasing public expenditures.

Table 1. Economic growth in selected areas (real GDP: 1993–2004)

	USA	EU	Japan
1993	2.7	–0.4	0.4
1994	4.0	2.8	1.0
1995	2.5	2.4	–2.0
1996	3.7	1.6	0.0
1997	4.5	2.5	–0.9
1998	4.2	2.9	–4.0
1999	4.4	2.9	–2.9
2000	3.7	3.6	0.9
2001	0.8	1.7	0.2
2002	1.9	1.0	1.0
2003	3.0	0.8	2.8
2004	4.4	2.3	–0.5
2005(est.)	3.2	2.1	2.9
Average 1993–2005	3.32	2.02	0.03

Sources: All data are in constant 1995 prices, obtained from the EUROSTAT Web page <http://europa.eu.int/comm/eurostat>), part General statistics. Japanese data reflect the latest revisions published by the Japan Statistical office February 16, 2005.

<sup>9</sup> The US superiority in economic performance continues in 2005. Latest US data indicate the 1Q growth for the US 3.5%, compared to 1.5% for the EU.

<sup>10</sup> Of course, the EU economic performance remains superior to Japan (in the last 15 years) and lags significantly behind China and India. However, in this context one should stress that a) the process of ageing is comparatively more pronounced in Japan than in Europe, and b) both China and India are – and will remain for a long time – underdeveloped countries, growing from a very low base.

<sup>11</sup> Labor force participation rate is the ratio of labor supply (that is the sum of actually employed and unemployed) to the overall number of people between 15 and 64.

Table 2. Relative Spending on Education and R & D in USA, European Union and Japan (as a percentage of GDP)

	USA	EU	Japan
Education	4.8	5.3	3.5
R & D	2.69	2.37	2.98

All data were obtained from the UNESCO's Institute for Statistics, November 2002. Data are for 2000 – the latest available. Hence, the European Union includes only members at 2000.

The importance of the acceleration of economic growth for the EU economies as a whole cannot, therefore, be doubted. But why are the EU economies lagging behind the USA?

Research into the EU (and German) growth performance shows clearly that the most of the difference between the US and the EU growth rates is attributed to the EU lagging in the productivity growth (Papademos 2004, Musso and Westermann 2005, Siebert 2003 (for Germany only)).

But why is it so? After all, in the global economy the EU countries and the US have access to the same technology and face the same set of relative prices. Overall expenditures on R & D and education are more or less the same (as a share of GDP – see Table 2) and hence the labor quality and skills are the same. And, indeed, the average EU savings rate (again, as a share of GDP) exceeds that of the US by a significant margin.

The difference in the productivity and GDP growth between the US and the EU is then often attributed to the fact that the EU markets (both labor and product) are more regulated compared to the US markets and, not the last, the overall European tax burden (around 50% of GDP) is far above the US tax burden (about 30% of GDP).

Those factors certainly play the role. However, to analyze the growth patterns of the last 15 years and the re-emergence of the “American economic dominance”, we have to analyze the relationship between the emergence and growth of the new economic activities and the basic institutional arrangements of an economy.

After all, in the real world the economic growth is not a uniform affair, with all activities growing at the same rate. The growth is, and in the past mostly was, a structural phenomenon, where the “new” activities emerge and their expansion starts to dominate the economy, whereas the growth of “old” activities remains sluggish – in some cases such activities even decline and/or gradually disappear.

The economies which manage to “specialize” in the new activities will experience the medium to long term increase in the economic growth, whereas others will lag behind.

### The financial markets and the new economy

Technology can be considered to be the base of the new economy – but what some people call “Internet Age” would arrive much more slowly without the access to capital – i.e. without being fueled by a properly structured profit seeking financial sector.

To see the key role the financial markets play in the creation and functioning of the new economy, let us consider the following:

a) The essence of the “new economy” is the individual creativity and innovation. This not only creates the new technology itself, but it is crucial in practical utilization of new technologies. Entrepreneurs always stand at the cutting edge of business and economic development. But what distinguishes the “new” economy from the “old” is the emergence of entrepreneurship as a widespread phenomenon. Moreover, because the role of entrepreneurship (i.e. the individualistic creativity and innovation combined with risk-taking) is the key in the business utilization of the new technology applications, private entrepreneurs cannot be emulated and/or replaced by a state – i.e. by the public economic sector. The “new economy” is inherently the one of a private enterprise. But the private enterprise needs financing – which again can be provided only by profit motivated agents – i.e. by the private financial sector.

b) Entrepreneurial economy based on the innovation and risk taking is inherently more risky than the “old” economy based on the extension of known and copying. Risk is – and always was – the part of an innovation. After all, any innovation is the attempt to harness the unknown. Indeed, any economic activity – and the creation of any business – is risky, even in the “old” economy. However, in the “old” economy the risks can be evaluated based on the past performance and experience. The evaluation of risk – and therefore the financing – is much more difficult in the “new” economy. After all, innovation has neither past performance, nor experience.

c) Financial systems based on the prevalence of the bank credit are unsuitable to finance the business ventures of unknown and unmeasurable risk – i.e. exactly the business ventures associated with the “new”, entrepreneurial innovation based new technology economy. Banks are considered to be “custodians” of public money (deposits) – and bank-

ing regulations and supervision in most countries limit the amount of risk banks can carry in their asset portfolios. And whereas some may consider banking regulations and supervision to be an intrusion on the principles of free enterprise, one has to keep in mind the moral hazard problem, strong externalities and a semi-public good nature of the banking industry, together with often devastating effects of banking crises on economy as a whole, to realize the practical need to limit the banking sector's ability to undertake an extensive financing of projects of often unpredictable risks.

The limitations on the banking sector notwithstanding, the "new" technology based entrepreneurial economy still needs financing for its very existence. Whereas one should not underestimate the creativity and innovativeness of the financial sector, to date the most effective tool in financing the "new" economy business are American venture capital funds.

(For a simple comparison: in 1988 – before the explosive growth of the new economy started – the amount of business financing provided by venture capital funds was about \$ 5 billion, compared to \$ 134 billion spent in corporate R & D. In 2000, the venture capital financing amounted to about \$ 100 billion, compared to \$ 150 billion in corporate R & D.)

The mechanism of a venture capital fund is rather simple (for an excellent analysis and detailed description, see Gilson 2003). Investors (mostly institutional investors like pension funds, insurance companies, some banks, endowments, foundations, universities, investment funds etc.) form limited partnerships funds with a general partner. The purpose of these funds is to finance (i.e. to create) new companies in the risky but attractive and potentially very profitable "new" economy technology area. Hence the name for these funds – venture capital funds (VCF).

In such a fund, the general partner – whose financial participation seldom exceeds 1% – makes, closely monitors and liquidates investments. The general partner itself is commonly a specialized company of professionals in finance, management and importantly in the areas of activities (both technological and marketwise) of new firms financed by a VCF.

Limited partners participation in VCF's is motivated by the opportunities to diversify into the areas of relatively high expected returns, albeit with higher risks. The general partner is motivated by a high expected return (far in excess of its actual financial participation in the fund). Moreover, the individual VCF's are for a fixed term, with the mandatory liquidation. This is the strong performance incentive for the general partner, because his success (in terms of the successful liquidation of the initial VCF via the

sale of firm(s) this VCF created and financed) is a precondition for raising money for the subsequent VCF's. Liquidation may take place in a variety of ways. New firms may be bought by other companies or by the entrepreneur himself, or they may go public in a form of IPO. The latter is the preferred way of the VCF's liquidation for two reasons.

Empirically, it provides the highest expected return for both limited partners and the general partner. However, more important is the fact the IPO liquidation implies the contract between the entrepreneur, the general partner and limited partners which displays the strong resemblance and characteristics of stock options (Gilson 2003). Options type of contracts then generate strong incentives for both the entrepreneur and the general partner to succeed.

But whereas the mechanism of their functioning is rather simple, the venture capital funds require financial markets that are deep, broad and liquid for their very existence.

On the "supply of finance" side, the limited partners must have an opportunity to choose (and to allocate their money accordingly) between financial opportunities (in essence between different kinds of investment funds etc.) which reflect different individual preferences as far as attitudes toward risk-return combinations are concerned and, indeed, changes in those preferences over time. Such a diversification requires an ability to acquire a portfolio of assets of varying risk, maturity, yield etc., and the ability to trade these assets throughout and without restriction in order to adjust the composition of the portfolio to changing circumstances.

On the "demand for finance" side, both the entrepreneur and the general partner benefit from the broader demand for their product, both in a sense of a broader supply of finances and broader IPO opportunities (both positively associated with the breadth, depth and liquidity of financial markets).

Therefore, to be hospitable to the venture capital funds expansion, the financial markets must be large as far as the number of financial issues traded is concerned, deep in a sense of a large variety of different types of financial issues traded (stocks, bonds, currencies, precious metals, but derivatives markets as well, all of it in different maturities, yields etc.) and liquid in a sense that any individual demand for a financial issue always finds supply and vice versa.

### *Specialization in the "new" economy*

The "new" economy became the engine of growth for world economies from 1990s. The US economy

“specialized” in the “new” economy activities – hence the US economy displayed an economic growth significantly exceeding the performance of other developed countries (Europe and Japan). Why is it so?

Alfred Marshall said that “the causes which determine the economic progress of nations belong to the study of international trade” (Salvatori 2001). And the basic theorem in the theory of international trade, the Heckscher-Ohlin theorem, states that “each country specializes in economic activities whose production is relatively intensive in factor(s) the country is relatively abundantly endowed with (Jones 1999).

The discussion in the previous part demonstrated that the “new” economy is intensive in the innovation – i.e. the creation and utilization of knowledge, and in the financial structures able to cope with and internalize the higher risk associated with activities geared to exploit the creativity and innovation.

As far as the creation and utilization of knowledge is concerned, it is difficult to argue that there are any meaningful differences between the USA on the one side and Europe and Japan on the other side. After all, at the age of Internet, global trade and global communications, any segment of knowledge created (publicly) at any country becomes publicly available very fast – either directly as knowledge itself, or indirectly, embedded in the traded products. And as far as the utilization of knowledge is concerned, barriers to the effective mobility of knowledge workers are limited (in a stark contrast to other kinds of labor).

Hence, one cannot argue that the USA specializes in the “new” economy activities (and hence experiences higher growth than other developed countries) because it is relatively abundantly endowed with knowledge leading to innovation and creativity. (Relatively vis a vis other developed countries. For the data regarding the comparisons of education and R & D spending, see Table 2)

Things are different as far as the “financial input” – i.e. the ability to finance risky new ventures – is concerned. Only American markets are broad, deep and liquid sufficiently to support a large number of venture capital funds. In comparison, the European markets remain divided and segmented – into 25 different financial markets – even if the European economy overall is about the size of the US economy and the single currency should facilitate financial integration. And, indeed, Japan remains far behind, with economy of less than 20% of either the US or Europe.

The size of the underlying financial markets (broadness, depth and liquidity) is obviously important to the engine of “new” economy financing – the venture capital fund. It affects the costs of arbitrage and diversification, the ability to compensate for

risky assets (i.e. the financing of “new” economy companies) and the ability to continuously adjust the portfolio to maximize its yield in a constantly changing riskiness.

Indeed, the requisite size could be substituted for by a simultaneous access to several distinct financial markets. But given the fact that different financial markets have different rules and regulations (both with respect to trading and the requirements for issues traded), operating in different financial markets under different jurisdictions implies higher transaction costs. But that means that venture capital funds operating on the US markets will exhibit a higher return *ceteris paribus*. Consequently, the supply of venture capital will be higher (in comparable circumstances) in the US than in Europe or Japan.

Therefore, we may conclude that the US economy is relatively abundantly endowed with a financial structure needed to exploit the innovation and creativity, but higher risk associated with the “new” economy. Hence, the US will specialize in the “new” economy activities and will experience a higher economic growth compared to the rest of the developed world (both Europe and Japan).

## POLICY DILEMMAS

The analysis in this paper indicated that the demographic challenges and the challenges of economic growth are closely related.

Demographic challenges result in both the growing pressure on the expenditure side of public finance and the tendency to limit the growth of public revenues (sometimes even reducing public revenues in absolute terms). *Ceteris paribus* that leads to rising deficits of public finance. Under the common currency (EURO) regime, governments borrowing requirements (as a share of GDP) tend to increase.

In an attempt to keep under control the costs of servicing the rising public debt, governments try as much as possible to preserve autonomous domestic (i.e. segmented) financial markets. The idea is that as a dominant player, the government will pay a lower interest rate on its domestic financial market (which can be influenced by domestic regulations etc.) compared to an interest rate they would have to pay to borrow in the integrated pan-European financial market. Hence the policy (common to all EU governments) to preserve the financial markets segmentation and domestic autonomy and to prevent financial markets integration.

But the integration of the financial markets is the only method how to create an environment hospita-

ble to VCF – i.e. the environment instrumental for the expansion of the “new” economy activities and hence the acceleration of the growth of productivity and the economic growth in general. The failure of so-called “Lisbon agenda” should serve as a warning, but...

The failure to accelerate economic growth (and hence to address the complex social and economic problems which will become more serious over time) then generates a pressure to abandon the one of the major achievements of the European economic integration – the common currency Euro. In fact, the issue of the Euro is rapidly becoming “the issue” in the EU economic debate (as of June 2005).

However tempting the abandonment of Euro and the re-introduction of domestic currency may appear to some EU countries today (Germany and Italy come to mind immediately), such a development would be detrimental to the EU economic perspectives in the medium to long run.

If the financial integration is the *sine qua non* to the European economic renewal, the common currency is the necessary first step. It is not sufficient as we know today, but it is absolutely necessary.

The other dilemmas the EU economy faces are of a lesser importance, even if they receive more attention in the public debate.

Among these, one should mention two. First is the question of labor mobility in general and immigration from non-EU countries in particular. An increased labor supply via immigration would certainly alleviate economic pressures stemming from a decline in labor force. It would increase the “potential” growth and hence *ceteris paribus* the public revenues. That would alleviate the pressure on pensions and health care reforms. Such reforms are not only highly unpopular, but given the above discussed political economy of ageing, increasingly unlikely to be enacted in an orderly, non-crisis fashion.

However, two important factors mitigate against the “immigration” solution. The existing high unemployment in the majority of the EU countries (all except the UK and Ireland) creates a very inhospitable environment for foreign workers. But, perhaps more importantly, the cultural differences – most of foreign workers would have to come from non-European social and cultural milieu – create the atmosphere of an active hostility and resentment to foreign workers and their families. And this attitude goes far beyond the purely labor market issues.

Second is the issue of the retirement age – respectively its increase. An increase in retirement age would reduce financial requirements related to pensions (but, significantly, not financial requirements related to

healthcare) and increase public revenues. Dependency ratio would decline. And, indeed, an increased life expectancy, which indicates an improved general health of population of older age, make an increase in retirement age an attractive option.

On the other side, policymakers must take into account different physical requirements of different jobs. University teacher or accountant can retire at 70 or perhaps even later. On the other side, the physical ability of a roofer, miner, steel worker etc. to perform their jobs productively in their sixties remains certainly questionable.

Political economy of ageing is somewhat complicated as far as an increase in the retirement age is concerned. It is generally assumed that as the population becomes older, the political resistance to an increase of the retirement age increases. On the other side, if the retirement age is increased gradually and in a “distant” future (10 to 15 years into the future – so that the current and “near” retirees are not affected) and if it can be explained to the electorate at large that an alternative to an increased retirement age is the combination of higher taxes on the currently working and lower benefits for the future retirees, then a political majority for an increase of the retirement age is possible.

## CONCLUSION

The restoration of a dynamic economic growth becomes the imperative. The changing nature of the world economy, characterized by a shift toward the activities based on the creativity and innovation, requires the integration financial markets – which challenges not only the current structure of economic decision making, but the core idea of the EU as a system of shared and coordinated national sovereignties as well.

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