Europe in the World: Elements of a New Economic Narrative

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Summary

- Prosperity has always been the foundation of political stability. Europe has many misplaced fears about its ability to maintain its prosperity, and this is resulting in a politically debilitating lack of confidence. However, without this confidence Europe will be unable to play the leadership role necessary to secure the global conditions for its future prosperity and security.

- Europe does face economic challenges: high levels of long-term unemployment in some countries; greater global economic competition and faster change; an aging and stabilising population; and tightening environmental and resource constraints. Of these unemployment receives the most publicity, but is probably the easiest to address.

- All other major countries face similar structural stresses, even the US and China will have rapidly aging populations in the next 15 years. But the stabilisation of global population at 8-10 billion is a positive development, as environmental limits have already been breached with only 6 billion people and high levels of global poverty. Europe benefits by being one of the first to stabilise its population, as its ability to trade and invest with fast growing economies increases incomes and eases the pension burden.

- In this world the core founding insight of the EU becomes globally relevant: while companies may compete, countries are interdependent. Europe's history shows how crude economic nationalism leads to conflict, and Europe is ill fitted to prosper in a world of competing "great powers". Europe will have to act as a pathfinder for achieving cooperative global sustainable development. Europe has the economic weight to shape global conditions over the next two decades; if it chooses to take a lead.

- Europe should be more confident in its record of providing prosperity and stability, and its strong assets for delivering them into the future. The single market is deepening and driving up efficiency, supported by EU regulations which have become the global standard in emerging economies. Europe's growing network of major cities is the main

source of new jobs and wealth creation and leads the world in global economic integration. Europe is a pioneer in innovative approaches to the "public purpose" economy; such as the European Emissions Trading system. Europe leads all major economic powers in generating political support for investment in the public goods which underpin the economy: in healthcare; in pensions; in social security; in education; in tackling climate change and preventing poverty and instability outside the EU.

- Europe also outperforms other countries in ensuring economic growth actually leads to increased well-being, equity and social mobility. In contrast, the US and most emerging economies are struggling to generate necessary investment in social security, healthcare, pensions and modern, efficient infrastructure.

- But the process of European economic reform has failed to construct an offer based on these European assets and values, and so lacks public support. Too often reform is presented as if Europe needs to become a pale imitation of the US or China. A credible offer which could build public confidence would: as total GDP growth slows redefine economic success in terms of well-being; reconstruct the social bargain around strong positive incentives for women, older workers, young people and immigrants to work; and use the Lisbon agenda to drive radical increases in resource efficiency across Europe.

- A new approach must also resolve the growing intergenerational tensions inside Europe. Younger people shoulder the fiscal burden of an aging society but have less economic security and face high environmental and energy costs. The new politics of Europe needs to generate intergenerational cooperation to share fairly the cost of higher public investment in pensions, healthcare, resource efficient infrastructure and in tackling climate change.

- Europe cannot secure its prosperity just by focusing internally but must help create the global conditions for prosperity and stability. At the heart of this must lie a more strategic EU approach to building global economic rules, and one which is not subordinated to short term trade negotiations. Economic interdependence also means that the EU must help create the conditions for others to manage common challenges. Global economic and political disruption has increasingly large impacts on the EU; as recent energy shocks have shown. Europe cannot isolate itself from these effects but must work with others to tackle problems at source. Helping resolve US fiscal imbalances, Chinese energy security and global climate change are necessary steps to underpin the economic growth needed to manage Europe's aging population.

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Europe in the World: Elements of a New Economic Narrative

1. Prosperity is the Foundation for Stability

Prosperity is the foundation of political stability, and the motor of effective political action. Europe has long and bitter experience of how economic depression and inequality can fuel political extremism and armed conflict. These lessons form the central founding principle of the European Union: that economic interdependence between states – not strategic competition – is the foundation of prosperity and stability.

In a world of accelerating globalisation, where the need to adapt economically drives social and political tensions, Europe's successful response to its past mistakes carries a global lesson.

However, at the time when Europe should be leading efforts to construct a stable and open world system to manage these tensions, Europe faces a crisis of economic confidence. Only 6% of its citizens think it will remain an economic superpower, and only 16% see globalisation as an opportunity[1]. European leaders have fed these fears by framing the economic debate in terms of "productivity gaps" with the US, focusing on the threats rather than opportunities from China, and bemoaning the slowing of European growth.

This lack of economic confidence undermines Europe's ability to act globally to maintain the conditions for its future prosperity and stability. The political framing of economic reform has become a caricature of choice between risky and uncaring Anglo-Saxon dynamism, and secure and fair Continental decline. This framing is neither accurate nor useful. Neither model has the answer to the challenges that face Europe in the coming decades, as we attempt to manage the rising prosperity and expectations of 6-8 billion people on a planet where environmental and resource limits have already been reached.

2. New Challenges, New Fears, New Approaches

Europe does face new economic challenges, but also has many misplaced fears. Long-term and youth unemployment is unacceptably high in several European countries. Competition from the US is now compounded by the rise of new economic powers led by China, India and Brazil. The aging and stabilisation of Europe's population will reduce the raw growth rate of the economy, and increasingly tight resource and environmental constraints are driving higher prices and threaten to undermine economic development in large parts of the world.

[1] Eurobarometer 2005

The first step in facing these challenges is to regain perspective on Europe's economic performance. The greatest difference between recent European and US economic performance is the faster growth of the US population and longer hours worked. The EU will remain the world's largest trading region and source of outward investment for at least twenty years. The EU annually adds around two times more global purchasing power than China's and will outstrip China as a growing market until around 2030[2].

Despite the often doom-filled rhetoric, Europe will still have the power to shape the global economic landscape for at least the next 20-30 years.

The root of current concerns among European citizens lies in a failure to generate adequate employment; not a slowdown in income growth. People rightly perceive they have a higher risk of losing their jobs, and a lower chance of gaining a new one; at least in much of the EU 15. It is unsurprising then that reforms which are perceived to reduce employment protection and increase economic competition are not politically popular.

There is also confusion over what are the critical problems. Is Europe suffering from a short-term downturn caused by the Eurozone's restrictive rules on interest rates and deficits, or a temporary failure of labour markets to adjust to global competition? Does Europe have the long-term fundamentals for healthy economic performance, or is it somehow intrinsically crippled by demographic, cultural and structural weakness?

There is no definitive answer to the short-term questions, but both factors play their part and both can be solved[3]. Europe certainly seems to be adjusting to the global economy quickly. China has accounted for 25% of the growth in EU imports over the last 5 years and is about to overtake the US as the EU's largest trading partner. There is consistent movement towards economic reform across the continent, though unsurprisingly the impact of this in the real economy will take time[4]. Shifts in employment patterns are naturally lagging behind these changes, as most of the job creation is occurring in the new core "urban economic network" and away from depressed industrial and rural areas.

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[2] Projections based on ECOFIN Pensions Paper February 2006 and Goldman Sachs, Dreaming with the BRICS: the path to 2050 Report 2003

[3] See Blanchard in Economic Policy, 2006 for an extensive review

[4] See Jones and Marzinotto, *The EU needs a strong US economy, not reform*, Chatham House, March 2006 and OECD, *Going for Growth*, 2006.

However, the long-term answer is clear. Europe's current employment problems are not part of a long-term trend connected to demographics or global competition. There is no economic reason why an aging society should create fewer jobs, and many reasons to expect increased employment demands in critical age-related service areas[5].

This is where the focus of Europe's political leaders appears to diverge from public concerns. While the public is focused on short term issues around jobs, disruptive change and security; the Lisbon agenda is mostly focused on Europe's long-term productivity growth rate. As Lisbon defines productivity as doing more with less people (as opposed to doing more with fewer resources and energy), this appears in the short term to be an attack on jobs, and to be biased against lower paid and already insecure workers.

Lisbon seems to be more about European leaders' perceptions of the falling "economic power" of the EU relative to other major countries, than to be an attempt to secure prosperity, well-being and security for European citizens in a changing world.

The resulting debate often uses exaggerated fears about Europe's long-term economic viability to push through reforms which – though mainly useful – will have limited short-term impacts on real employment and security. This has depressed economic confidence; resulting in exactly the type of consumer slow-down that does really reduce employment and growth. It has also left the field open for populist politicians who promise to return to some mythical and unobtainable protectionist golden age

Interdependence not Competition

Europe is not alone in facing these long-term challenges and is better placed than most to manage them successfully. To hear many commentators the biggest threat facing the EU is the stabilisation of its population over the next 50 years. However, Japan and Russia already need to manage the economics of a falling population, and China and the US face shrinking proportions of workers in the next 15 years. Indeed, China's demographic transition will be sharper than any OECD country's.

This is a global transition that should be welcomed not feared. It will be a challenge to deliver stability and prosperity to 8 billion people, many of whom are extremely poor, when we have already exceeded the planet's environmental and resource limits. But this is a lot better than having to manage a world with 15-20 billion people, as was often predicted 20 years ago.

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[5] See Layard, Full Employment for Europe, in WEF Global Competitiveness Report 2005-06 and Alexia Prskawetz et al, The Impact of Population Ageing on Innovation and Productivity Growth in Europe, 2004

An immediate consequence of this welcome stabilisation is that all countries will have to deal with a relative increase in older people. For historical reasons, the EU is changing faster and sooner than most other regions but is not fundamentally different. Indeed, the EU is fortunate to be one of the first to undertake the demographic transition to a stabilised population, because we will have the opportunity to invest and trade with fast growing, younger economies.

China in particular is vital in helping soften the impact of Europe's demographic transition. As the post-war European generation saves for their retirement it will need to export capital, and China's rapid growth means that these investments will be far more profitable there than they would be invested inside the EU. In twenty years time it will be a richer China that funds European investment and keeps our economy solvent[6].

Estimates are that Chinese growth will raise real wages in the EU by between 15 to 40% by 2050 compared to a "slow growth" China scenario. This increased growth will allow lower taxes on workers to finance pensions and healthcare, improve employment rates and make economic space for increased public investment.

All Europe's prime "competitors" face their own critical economic problems. The US has runaway deficits and crippling inefficient health care policies, which have destroyed the competitiveness of much of its automotive and manufacturing industries. All the emerging economic powers face growing challenges to their internal stability, even as the rest of the world is focused on their increasing external power. China and India face endemic corruption, rising social inequality and unrest, and critical water shortages.

Even the largest economies are vulnerable unless they learn to collectively manage a world of climatic change, resource constraints and interlinked vulnerabilities; and the price of poorer countries failing to manage these challenges will be felt globally through humanitarian, security and political crisis and conflict.

This future environment makes redundant many economic assumptions held by policymakers. The rise of China and India is slowly dissolving the last illusions of corporate nationalism – despite recent relapses - and making global interdependence a hard reality. Aging populations will force a redefinition of what counts as economic success and require a new social bargain between generations. The need to keep within

[6] For modelling of EU -China pension interdependences see Börsch-Supan, Ludwig and Winter, Aging, Pension Reform, and Capital Flows: a multi-country simulation model, NBER Working Paper 11850, 2005; Fehr, Jokisch and Kotlikoff, Simulating the Demographic, Fiscal, and Economic Transition Paths of the U.S., EU, Japan, and China, National Bureau of Economic Research, 2005.

natural limits is already fundamentally changing the role of the state in the economy and exposing hidden assumptions about ever falling costs of transport, materials and energy.

The EU must back its hard-won insight that rules-based market economics and embedding interdependence does benefit all. This insight underpinned the creation of the EU and should continue to guide Europe's approach to wider globalisation.

The alternative of "economic nationalism" leads to a situation where a number of "great powers" attempt to compete strategically for global market share and access to resources. Experience shows this results in neither stability nor prosperity. The EU is also poorly placed to compete as a great power, and polls of European publics have repeatedly shown a lack of support for Europe taking such a role[7].

Managing these transitions will require all countries to achieve cooperative "sustainable development". The consequences of not making the necessary choices will be expressed in growing political instability, economic crises and conflict. Europe will be one of the first to face these transitions, and as the worlds largest economy will be a pathfinder towards sustainable development for others.

3. Using Europe's Assets: From Cutting Costs to Creating Value

Europe has a good record in providing prosperity and stability and has strong assets for delivering it in the future. Unfortunately, the current debate does not build on these to generate a positive offer to Europeans of how they can successfully face the future. Europeans – in all their cultural, economic and social diversity – do not want to compete with the US, China and India by becoming like them. They want to compete on European terms and while preserving what they value about European approaches.

Many of the economic reforms are necessary, but there is a lack of political will to carry them through to conclusion; whether on a common European Patent or a meaningful collective energy policy. This political failure requires a political solution.

Creating the political conditions for change is the same everywhere; it requires a compelling vision and clear choices which the public sees as addressing their core concerns. The Lisbon agenda has not provided these conditions. To take a corporate analogy, the Lisbon vision seems to focus too much on "cutting costs" and too little on developing Europe's future "value proposition".

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[7] For example, see responses to Eurobarometer questions on Europe as global superpower 2004-5

Europe's future value proposition will be based on its assets of a deepening single market, the efficient regulatory system, network of dynamic urban economies and critically its ability to invest in the public goods underpinning economic prosperity.

Even in the unlikely absence of further liberalisation, economic logic means that the single market will continue to deepen and drive up efficiency, with enlargement adding further assets and dynamism. The EU's system of competition policy, state aid rules, consumer protection and product and environmental regulation uniquely force companies to compete on product quality and service, not regulatory loopholes.

Much of this regulation is novel, and most is unsurpassed in providing a level-playing field for business even in other major economies such as the US. EU regulation is now becoming the basic standard in emerging economies; from textile standards in Thailand to car emission standards in China. This provides markets and opportunities for the European firms who are already applying them.

Europe's network of major cities is the source of most job growth and wealth creation and leads the world in global economic integration. For reasons of history and diversity Europe's core cities are highly globally connected through economic linkages; with seven European cities in the top 15 connected cities, compared to only three US cities[8]. The focus of the European economy is increasingly concentrating on this network. In the EU15 these city networks accounted for nearly 70% of total GDP and job creation in the last 5 years; and a similar high growth urban pattern is emerging in the EU10[9].

Europe leads the world in generating innovative approaches to driving the "public purpose" economy; such as the European Emissions Trading system to tackle climate change. Many of the fastest growing areas of the economy are in areas where public interest is critical: health; aging; intelligent infrastructure; environment; energy; security. Europe's ability to drive new public-private collaboration in these areas gives it a strong advantage in wealth creation.

Finally, Europe has the best record of any major economic power of generating political support for investment in the public goods underpinning the economy: in healthcare; in

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[8] Taylor, European Cities in the World City Network, Loughborough University, 2003. Published in H van Dijk (ed) (2003) The European Metropolis 1920-2000

[9] Krätke , The Metropolization of the European Urban and Regional System, European University Viadrina Frankfurt/Oder*, March 2006*

pensions; in social security; in education and research; in tackling climate change and preventing poverty and instability outside the EU.

The hardwon acceptance than public goods such as healthcare and education should be provided communally (even if mechanisms differ between countries) represents a clear source of European economic advantage. In contrast, in the US, China and India public underinvestment in education, infrastructure and healthcare is regularly cited by business leaders as a significant source of competitive disadvantage[10].

The main areas where Europe needs to raise its levels of investment are in tertiary education and research and development; where the US and Japan are world leaders. However, Europe has a far easier political task in generating additional investment in these relative narrow areas on the economy, than other countries have in emulating Europe's investment in healthcare, social security and infrastructure.

These assets provide a firm economic basis for building a new political offer which reflects the long-term challenges Europe faces, and builds public acceptance for change. A credible offer which could win public support will need to: redefine what economic success means as total GDP growth slows; reanimate the social bargain to give stronger positive incentives for women, older workers, young people and immigrants to work; use the Lisbon agenda to drive radical increases in resource efficiency across Europe; and, generate intergenerational cooperation on higher public investment in pensions, healthcare, intelligent infrastructure and measures to tackle climate change.

4. Redefining Success

We have no choice but to go through a demographic transition, the question is how well we manage the process. The criteria for success cannot be raw GDP growth rates; these will obviously fall as growth in the European workforce slows and then falls[11]. European growth rates will only be around two thirds that of the US even if productivity growth and labour utilisation is identical. Europe needs to redefine what economic success means in order to maintain economic confidence in the face of reduced growth.

The first part of maintaining confidence is to ensure that people have adequate pension provision for the future; as 54% of all Europeans have low trust in the sustainability of their future state pensions[12].

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[10] WEF Competitiveness Survey 2005-06

[11] ECOFIN projections February 2006

[12] EU Quality of Life Survey 2005, Institute for the Improvement of Living and working Conditions, 2005

The second part is showing what tangible gains will come from people accepting increased economic risks. The promise of higher – or maintained – income is not attractive enough on its own, as Europeans increasingly value gains in security, welfare, health and time reductions more highly. In the EU15 income levels are not correlated with surveys of life satisfaction, though in the newer member states low incomes are still seen as a strong negative factor in people's welfare. Surveys suggest that the most negative impact on peoples' well-being in the EU15 comes from unemployment.

Europe has the advantage of being the most successful region in the world at creating the public goods which people value: security; health provision; education; leisure time; art and culture; quality public spaces; and environmental quality. OECD analysis shows that across an aggregate of different social indicators the US underperforms all the EU 15 countries[13].

This also raise the "real" productivity of the European economy. For example, WHO figures show that the EU15 achieves better aggregate health outcomes for under half of the total per capita health spending of the US[14]. This higher efficiency is equivalent to a gain of over 7% of GDP; far larger than the 3% cumulative productivity advantage the US enjoyed over Europe from 1990-2004. The countries regularly seen as most competitive in the EU - Finland, Sweden, Denmark, the Netherlands[15] – all invest highly in these public goods and all sit at the top of European life satisfaction surveys.

In this framework, the fact that Europeans can choose to work fewer hours and take longer holidays than Americans should also be seen as expression of social choice not a problem. A majority of US workers consistently say they would value more leisure time over more income but are unable to make this choice.

Europe also has a remarkable record of generating both social justice and social mobility. Public investment in education and healthcare has weakened the link between background and destiny across much of Europe. Social mobility seems to be significantly higher in the EU than the US and is highest of all in the Nordic countries[16].

In contrast, most productivity growth in the US has been captured by a very small portion of the population. From 1966 to 2003 the top 1% of US earners gained more than the bottom 50% of earners, and 90% of income gains went to the top 10% of wage

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[13] OECD, Alternative Measures of Well-Being, Working paper 476, January 2006

[14] E3G calculation from WHO Health Indicators 2005

[15] For example, in the WEF 2005-6 Competitiveness Survey

[16] Blanden, Gregg and Machin, Social Mobility in Europe and North America, CEP 2003

earners[17]. This means productivity growth failed to translate into general wage growth; as median wages grew at 0.3% per annum even though labour productivity grew at 1.6%. While US cultural attitudes may be able to withstand such growing inequality without a political backlash, such inequality of rewards would be unsustainable in Europe.

New Tools - New Measures

To successfully manage these new challenges current macro-economic management systems need a radical overhaul. The suite of measures and indicators defined during the Keynesian consensus gives us little guidance in how to manage our core human, social and resource assets, and even less understanding of the future liabilities implied by resource and carbon-intensive investment.

There is too much focus on short term business cycles and imbalances, and very poor measurement of long-term structural issues. The effort placed in managing risks of inflation is not matched in assessing the risks of failing to integrate young immigrants into the economy or the damage from climate change. As a result, investment in long term challenges usually plummets if growth slows in the business cycle.

In contrast, a sustainable macroeconomic stimulus package would focus on generating public goods and providing greater certainty in future incomes. This would require countries to raise social investment levels through measures such as increased education, health and environmental expenditure. All of these are labour intensive areas which put money directly into lower income households.

Environmental and resource taxes would rise to help balance this expenditure, combined with classic Keynesian public borrowing. Additional measures would shift economic incentives to encourage innovation and investment in less resource intensive private and public investment. These longer-term incentives are key to helping offset the decline in private R&D typically seen in recessions, laying a basis for future sustainable growth.

Building confidence in Europe' economic future requires a political reframing in terms of the quality rather than the quantity of future growth as the basis for a new social bargain. This should be underpinned by imaginative and meaningful set of measures of sustainable prosperity which track areas such as well-being, income stability, human capital, environmental quality and social mobility.

[17] Dew-Becker and Gordon, Inflation Dynamics and the Distribution of Income, *Brookings Papers on Economic Activity,* 2005:2

5. Building a new European Social Bargain

The Lisbon agenda contains three simple proposals to improve European economic performance: increase the number of people in the workforce; increase the quality of people in the workforce; create the conditions for greater competition and innovation. However, this simple logic hides the deeper political choices which these reforms imply.

Increasing the number of people in the workforce requires fundamental changes to family and community life, at a time when both are under strain from changing economic and demographic patterns. Increasing the quality of people in workforce requires individuals to invest in their future at a time when many are highly pessimistic about available opportunities. Increasing competition and pursuing innovation imposes higher risks and stresses on individual workers and businesses.

This is not an argument for stopping reform, but one for engaging in the right kind of public debate. Public political support for European reforms will only come if individuals feel that there is a compelling future offer for why change is necessary, which builds on European strengths and values. Reiterating a fear of global competition will not achieve this, but instead drives people further into a bunker mentality.

Managing the inevitable fiscal stresses of the retiring "baby boomers" requires more women and older people to participate in the workforce for longer. The aim is that this should be a positive choice, not one driven by dire economic necessity.

These are far from dry economic issues but will require a cultural shift as to what is desirable and acceptable in terms of family and work-life in many parts of Europe.
It is obviously a false GDP gain to move millions of currently unpaid carers – mostly women – into the formal workforce, if this just displaces care of the elderly population into the paid sector. The real welfare benefits of bringing inactive workers back into the workforce should also be acknowledged, as other wise this will be seen as lowering per capita productivity growth in the European economy.

The EU should avoid being seen to impose (or being blamed for) solutions on countries which have a wide range cultural norms towards the family, and where many different bargains can be formed. The Lisbon targets for workforce participation should be revised as they are far too blunt to capture the complex choices societies will have to make in these areas.

The European social offer must be compelling enough to encourage greater risk taking, personal investment and entrepreneurial activity and avoid an ultimately doomed retrenchment into the politics of insecurity.

In a continent with a declining proportion of younger people its is imperative that Europe is an easy and attractive place for young people to set up in business; for Europeans and talented people globally. Inside Europe, London acts as a hub for young EU workers and entrepreneurs, attracting up to 250 thousand young French people alone[18]. Silicon Valley plays a similar role in attracting dynamic young Indian entrepreneurs to the US so successfully they are responsible for nearly half the new business start ups.

Europe's increasingly globalised cities should cooperate to form the basis of a common entrepreneurial network to attract European and global talent; developing a common approach to business start-ups and entrepreneurial urban zones with time-limited tax incentives for younger business people.

Lisbon also has a focus on increasing older workers participation rates in the European economy, particularly men in the 50-60 year old group where inactivity is often high. This approach should be extended beyond this range as changes in life patterns, education, health and skill sets in the European economy have made redundant previous assumption of declining productivity in older workers.

Extending the working lives of the highest productivity employees currently in the "bulge" generation of 40-55 will have a real impact on European economic performance over the next 20 years[19]. Europe should take the lead in developing a new bargain for older workers where those working on after retirement age receive attractive tax incentives to continue at least part-time working.

These issues are best solved at the national level, where the complexities of national circumstances and approaches are best balanced. The European-level discussion should ensure common benchmarks and measures of performance, but should avoid the type of over-simplification caused by raw targets for workforce participation.

The exception to this "subsidiarity" rule is where Europe needs to send a strong external messages; as with the offer to young globally mobile entrepreneurs.

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[18] A. Favell, London as Eurocity: French Free Movers in the Economic Capital of Europe, UCLA, 2004

[19] See Alexia Prskawetz et al, The Impact of Population Ageing on Innovation and Productivity Growth in Europe, 2004

A critical area where there is an urgent need for a cross-European approach is in the integration of immigrant communities. A disproportionate share of the future European workforce will come from ethnic minority communities which currently suffer from the highest levels of unemployment and social exclusion. ECOFIN already assumes an extra 40 million immigrants into the EU by 2050, and this is probably an underestimate. The integration of migrant communities, especially future generations of Muslims born in Europe, requires a concerted pan-European model to ensure a framework of common standards and approaches.

A concerted approach to EU policy on integration and anti-discrimination needs to include a more consistent, scaled-up and subtle approach to external relations in the European neighbourhood. As the Danish cartoon crisis showed, Europe is increasingly seen as a unitary actor in key neighbourhood countries in North Africa, Africa and the Middle East, who are likely to supply the majority of future economic migrants. Problems with communities in any part of Europe will affect all European countries' ability to attract valuable labour and integrate communities.

6. Generating Intergenerational Cooperation

The combined logic of the challenges facing Europe is that the critical political fault line in the future will not be between insiders and outsiders in the labour market, or between labour and capital, but between generations.

The key future trends all place higher costs on the young and give benefits to older citizens. Increasing global competition is raising risks and reducing job protection for the young; while the economically established face lower prices and higher returns on their investments. The demographics of the post-war bulge will result in high dependency ratios, social security and health costs for younger generations; but fewer secure benefits for those who shoulder these burdens. Tightening environmental constraints will need to be managed by a younger generation which has not benefited from the era of cheap fuel, and who will bear the direct legacy costs of climate change, water shortages, environmental disasters and biodiversity loss.

Younger generations have no choice but to accept higher future economic and environmental risks and will in part be compensated by higher incomes. However, this must be accompanied by a fair burden sharing of public investment between generations in social security, health care, energy security and climate security.

If such an intergenerational settlement is not forthcoming it is likely that the European social contract will fail. The most productive of the younger generation will leave for lower tax countries, and the remaining population will face large incentives against taking employment. An equally disturbing risk is that these fiscal burdens may lead to a rejection of higher investment in securing Europe's long-term future, either to tackle climate change and energy security, or to invest in political stability in Europe's neighbourhood.

The EU is not the only one facing these problems, with estimates of US unfunded liabilities reaching $64 trillion equivalent to 8% of GDP, mainly driven by for Medicare and social security for the old[20]. China has yet to construct the public mechanisms to look after is growing older population in the face of rapid failure of traditional family care systems. Europe has to take an interest in how these imbalances are managed, as they will be critical in other countries being able to play an active role in tackling climate change and other global problems.

This generational conflict is not an issue of the distant future but is embodied in current decisions over critical infrastructure investment.

7. Investing Intelligently for the Future

In a world dominated by uncertainty some things are clear, the era of cheap natural resources is over and carbon constraints are an ever-tightening reality. Europe will also soon face the need for large reinvestment in basic energy-using infrastructure, including 50% of its current power stations over the next 25 years.

This long-lived investment needs to be resilient against the global realities of 2030, not just the short-term economic demands of today. As population stabilises demand for transportation will shift as older people have historically travelled less and at off-peak times. The European economy will continue its 30 year shift away from transport and resource intensive economic sectors, and mobility for leisure and consumption purposes will dominate transport growth. Higher energy and resource prices will change patterns of demand and movement, especially when coupled with the need to reduce carbon emissions to at least 40% of 1990 by 2050.

A key principle of achieving sustainable development is replacing resources and capital with intelligence and design. Europe is already one of the world's high efficiency economies but could do a lot more. Hedging against future risks will involve investing in flexibility and avoiding rigid "mega-solutions": road pricing to reduce congestion not new motorways; energy efficiency not new power stations; water efficiency not new dams;

[20] Gokhale and Smetters, Fiscal and Generational Imbalances: An Update, August 2005

European innovation networks and entrepreneurial clusters not new industrial champions.

The common denominator in all these solutions they generate immediate benefits by radically improving resource productivity in the European economy, alongside increasing labour productivity. For example, in the face of higher oil prices in 2005, European vehicle economy standards saved nearly 0.5% of EU GDP per year compared to the US[21]; equivalent to over 3 years of faster US productivity growth. Estimates put the savings from efficient road pricing in the main economies of Europe as around Euro 40-45 billion per annum[22].

Advances in materials science, nanotechnology and biotechnology promise to offer many more radical improvements, but only if successfully harnessed to the public purpose. The convergence of cheap communications, computing power and mobile personal devices has generated a host of possibilities for changing how infrastructure is designed, used and paid for, but only a fraction of these opportunities have yet been exploited at scale[23].

The US has generated the most effective military and security innovation system ever seen; the EU has the capacity to generate an analogous system to manage climate, energy and resource security. This is not about throwing huge amounts of money at silver bullet solutions; something at which the US will always do better than Europe. Managing environmental and resource scarcity requires convergent institutional, economic and technological innovation across a range of services and products.

The EU is uniquely positioned to drive this revolution in the "intelligent infrastructure" needed to support sustainability, because of its experience of developing innovative and pragmatic public-private partnerships and high-levels of public support for tackling environmental problems.

Europe can use public investment and incentives such as the EU Emissions Trading Scheme to promote innovation and lower future costs. Strong signals now to EU investors both prevents wasteful and obsolete investment and acts as an effective R&D credit. The Lisbon process could help provide a stronger stimulus for European-wide processes in all these areas, joining up current sectoral initiatives and driving a joint pooling of currently fractured R&D efforts.

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21 E3G calculation based on EC statistics.

22 OECD-ECMT, Reforming Transport Taxes, 2003

23 For example, see UK Foresight programme, Intelligent Infrastructure Futures, at www.foresight.gov.uk

The upcoming budget review in 2008 should reallocate existing EU resources away from securing food security and towards investment in climate and energy security. European structural programmes should be focus on driving efficient infrastructure and climate proofing in the poorer member states, and to managing risks to stability on European borders through the Neighbourhood Policy.

Additional pan-European funds should be raised based on carbon emissions and earmarked for investment in new European energy networks and collaboration on clean technology with China, India and other emerging economies.

Europe must harness the diversity of its member states and consumers as drivers for innovation. This should mean a move away from forcing artificial pan-European collaboration on R&D, and towards focusing increased funding on the best institutions and networks and promoting effective collaboration outside the EU.

Priority should be given to promoting innovation in services to provide water and energy efficiency, and spreading cutting-edge, efficient construction techniques across Europe. The public benefits of liberalisation in terms of reduced waste and pollution (when accompanied by appropriate framework regulation) seldom feature in European economic debates but could be a powerful driver for change.

Aggressive liberalisation of services, networks and resource using sectors can be strong driver for resource efficiency and innovation, if harnessed inside a clear framework of European rules. The Lisbon Process should prioritise progress on competition and innovation in areas of high energy and resource use such as transport, utilities, transportation, utility networks, construction and chemicals.

Most European discussions on focus on incentives to suppliers of good and services[24], but increasingly it is forward-looking consumers in the US, Japan, Finland and Korea have been the real difference in driving successful innovation. If Europe is to create a truly "smart" economy then a significant section of consumers must be encouraged to value investment in quality and efficiency. European programmes should promote consumer-led innovation in a market for new, efficient products and services.

An aggressive programme to stimulate consumer demand and recognition of resource efficient technology should be promoted through the Lisbon Process. For example: high-profile prizes for efficient and innovative products; preferential

[24] For example, see the yearly EC Innobarometer Reports

access to government procurement for innovative design; lower VAT on the most efficient products; and stronger marketing standards on green claims.

8. Building a World Safe for Europe

The European project is based on the fact that while companies compete, countries are interdependent. This insight underpinned the creation of the EU and should continue to guide Europe's approach to wider globalisation. Taking interdependence seriously requires the EU to create the international conditions for its own future prosperity, as well as addressing internal economic challenges. This is the natural evolution of the core European project which drove interdependence at the regional level as the foundation for stability and prosperity.

Economic interdependence also means that the EU must help create the conditions for others to manage these common challenges successfully. Global economic and political disruption will have increasingly large impacts on the EU; as recent energy security issues have shown. Europe cannot isolate itself from these effects but must work with others to tackle problems at source.

Managing Scarcity by Building Sustainable International Rules

Europe will remain one of the major economic players on the global stage for the next 30 years. In this period, Europe has the opportunity to shape the international legal environment to promote the type of sustainable development it aims for at home.

Europe needs a clearer vision of how it sees the evolution of international rules on trade, investment, competition, corruption and IPR supporting its overall strategic goals. Current EU policy in these areas is still focused on short term economic gains (particularly when linked to trade negotiations), and because of this often lacks global support. However, Europe has the ability to build a wider coalition for stronger international economic governance.

After trade, the next critical area for international negotiation is the deepening of global climate change negotiations which will need to combine rules on investment incentives, intellectual property rights, financing and carbon trading. Europe's approach to this must go beyond the environmental "ghetto" which has absorbed most international effort to include complementary approaches in other fora and through enhanced bilateral relationships.

Europe should develop a clearer forward-looking agenda for strengthening the global economic architecture outside the WTO. Focus should be placed on areas

with strong synergies with climate change and energy security objectives such as anti-corruption measures and expanding norms on global competition policy.

The alternative to a rules-based system is a situation where a number of "great powers" attempt to compete strategically for global market share and access to resources such as oil and gas; using financial, diplomatic and military power to secure their aims. As Europe learnt to its cost, this type of competition undermines peace and stability, and fails to provide prosperity. This is as true globally as it has been in the EU since the end of World War II.

The danger of falling into such a world is real. For example, as demand grows global energy markets are becoming less market driven as state energy companies aggressively buy up resources, and countries such as China, India and the US form strategic alliances with oil and gas producers to secure supplies. These alliances are destabilising parts of Africa and Central Asia and helping strengthen autocratic and repressive regimes. History has shown repeatedly that while buying your own dictator may lead to short run stability, it also usually results in medium term instability and loss of investment.

Europe cannot – and should not – compete in this way. Instead it must work to forge agreement to an open market basis for accessing energy supplies. This must provide security for emerging powers such as China and India that they will not be denied energy by military means and stimulate an environment where producer countries are both open to pressures for political reform and helped to maintain legitimate stability. Such a cooperative approach is in the interest of all energy importers but needs European leadership to make it a reality.

The EU should aim to conclude an agreement with major energy importers – US, China, India and Japan – for a framework to govern fossil fuel markets, including: a commitment to market approaches and pricing transparency; cooperation on preventing instability in producer countries; coordination of military protection of installations and seaways; revenue transparency rules; cooperation to prevent illegal resource extraction and marketing; rules for respecting human rights and promoting sustainable development in communities near extractive sites.

Embedding Interdependence in External Relations

The EU must back its hard-won insight that rules-based market economics and embedding interdependence does benefit all. Rather than looking at growing US productivity as somehow a threat to the EU, we should realise that this will be a motor driving the European economy. The deep interdependence between the two economies is exemplified by the $900 billion of EU investment in the US; giving over 40% of all EU external investment income. These strong links mean that Europe benefits from any increased profits from its US subsidiaries, and companies will bring any new innovations back to Europe. This interdependence also makes current US macroeconomic imbalances the biggest short-term threat to European economic stability and job creation.

Europe's interdependence with China, and other emerging economies, is smaller but growing fast. Though trade flows are similar to the US, Europe still holds far less investments in China (under 1% of total EU stock). However, this will change quickly and China will become increasingly important as one of the main destinations for EU investment over the coming decades; when China becomes crucial to softening Europe's demographic transition.

The downside of this interdependence is that it exposes Europe to instability in other economies. In the next two decades Europe will become increasingly reliant on economic and political stability in China, and to a lesser extent India, Brazil and South Africa. This is a change from when Europe mainly trading and investing with other developed countries, except for energy, mineral and commodity imports. It is far harder to isolate your economy from external shocks when you have committed long term manufacturing and services investment in a country.

Though China is becoming increasingly important for the European economy, it remains a developing country with immature and fragile social and political structures which are suffering from immense stress from the pace of economic growth. Many of these stresses stem from natural limits in the supply of water, soil, land and environmental degradation, and result in political and social tensions due to poor governance, corruption and inequality. RAND Corporation[25] estimates that significant crises in any of these areas are highly likely and could derail Chinese growth for several years, with knock-on effects for investor confidence and future growth. China also faces growing energy security problems, particularly for oil, and the impacts of climate change are estimated to be highly negative in the next decades.

The EU should invest more seriously in helping create the external conditions for a stable China by helping China manage the tensions its unprecedented growth generates; in particular reducing its impact on global climate change and helping improve energy and water security.

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[25] RAND Corporation, Fault Lines in China's Economic Terrain, 2003

As part of this cooperation, Europe would work with China to create robust rules-based systems to manage the global economy and provide the stability needed to ensure sustainable development in other regions. For example, empowering the UN to take a stronger role in conflict prevention and crisis intervention, implementing global rules on corruption and illegal natural resource trade, and limiting the negative impacts of extractive industry foreign investment in poor Asian and African countries.

Though Europe should aim to increase its innovative capacity, policy should not be aimed at trying to recreate "national champions" on a European scale. In an interdependent world Europe needs all countries to use resources efficiently in order to secure its own future. Europe has the assets and political will to take a lead – and in doing so will make a profit – but this should not be always seen as the primary aim. Expanding markets and innovation for efficient products helps spread the risks and benefits of technology development, and increases the likelihood that real markets will grow fast and barriers to trade (especially due to national standards) will be minimised.

Europe should take the lead in establishing an international clean transport agreement, firstly with China and California but open to others, with the aim of creating a dynamic single market in highly efficient cars and freight vehicles. The agreement would set equivalent and increasing efficiency targets to 2020, mutual recognition and harmonisation of testing regimes, and joint market incentives for ultra-efficient vehicle development.

Europe has more to gain economically by securing a stable global climate than it will profit from selling proprietary low carbon technology. Changing the patterns of Chinese, Indian and American energy and transport investment is a priority which is worth a more open approach to sharing technology and intellectual property rights. Given the scale of infra-structure investment in China and India it will also be cheaper and faster to develop new approaches in these economies first, and re-import efficient technology back into Europe. For example, China will build over 2000GW of power stations over the next 30 years compared to 700GW in Europe.

Europe should examine more flexible ways of sharing clean technology with emerging economies, including through stronger technology co-operation at research and demonstration stage; following up the example of EU-China Carbon Capture and Storage demonstration plant agreed in 2005

9. Conclusion: Economics as if Politics Mattered

Any set of policies aiming to reverse Europe's crisis of economic confidence needs to focus on how to use Europe's strengths to generate sustainable well-being, not appear to constantly look to other countries and regions for blueprints for higher growth.

Europeans need assurance they will not buy future prosperity at the expense of community and family welfare and be given a compelling offer as citizens on the benefits they will gain by funding the necessary public investment. The challenge of intergenerational equity needs to be faced, not least by avoiding a new generation of wasteful resource intensive investment.

Europe is well positioned to drive action towards a sustainable and innovative economy because of its historical strength in building the political coalitions around the provision of public goods. Europe is also the only area with the political will and power to lead the development of construct the necessary agreements at the global level.

This is the heart of the political dilemma of Europe. Without economic prosperity and confidence Europe will not be able to take the global leadership needed to build the conditions for sustainable development. If Europe does not play this role the current security and stability of Europe - which many use as an argument against economic reform - will be swamped by larger external forces.

Europe needs to recover its economic confidence and dynamism, not because it is obsessed with becoming wealthier, but because in an interdependent world this is necessary to preserve the fundamental values and choices of Europeans.

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