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“2014 Elections to the European Parliament: Economic Challenges for Europe”

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I. Economic challenges for Europe

The 2014 elections to the European Parliament take place at a time when Europe is facing considerable economic challenges. These challenges raise complex questions, and Europe’s citizens will expect the new MEPs and the newly formed European Commission to provide answers. The recent economic and financial crisis has had a deep impact. The countries most affected by the crisis have gone through severe recessions. They have implemented difficult economic and social policy reforms, including tough fiscal consolidation measures. At the European level, legislation has been enacted in response to the crisis. The institutional architecture of the euro area has been substantially changed, particularly by the introduction of the European semester and the European Stability Mechanism, and additional large changes are on the horizon with the Banking Union project.

Whether these reforms will be enough to surmount the crisis is a controversial issue. There are encouraging signs of economic stabilisation, but the situation in many member countries is still fragile. The downturn seems to be over, but economic recovery is weak and uneven. Unemployment has stopped rising, but remains at high levels. Many young people in Europe are excluded from the labour market and are losing hope of change for the better. Many households and firms remain highly indebted, and are hesitant to consume and invest. Governments are struggling to bring down their deficits and stabilise debt-to-GDP ratios. Europe urgently needs to achieve a sustainable and inclusive economic recovery.

Against this backdrop, political forces appear to be gaining strength that call into question whether deeper economic and political integration is the right answer to the crisis. These forces vocally doubt the ability of the European institutions to cope with the challenges ahead. Yet at the same moment European institutions are being questioned, the European Commission must draft a new roadmap for growth for the period after 2020.

In this paper we discuss what needs to be done in a number of key policy areas. Certainly, the EU should focus on fields where benefits for all of Europe can be produced, and should withdraw from policy areas where this is not the case. Furthermore, deeper economic and political integration is required to address future challenges in many important policy areas.

- Fully tap potential for growth; continue fiscal consolidation. It is of key importance to fully exploit growth potentials in Europe, in particular through structural reforms at the national level and by deepening economic integration in the internal market. At the same time fiscal consolidation efforts should be continued. Fiscal consolidation in times of weak economic growth is difficult to achieve, but the current economic stabilisation suggests that those who expected fiscal consolidation to be self-defeating were overly pessimistic.
- Reform the EU budget; focus on European added value. The current focus of member states on "juste retour", i.e. considering EU policies from the point of view of how they will benefit their countries, gives rise to spending on policies that are visible in individual member states. However, this approach diverts attention from spending on European public goods, where the common interests of the EU member states and their citizens are at stake.
- Develop a consistent institutional framework for fiscal and economic governance in the eurozone. The euro area is in need of an institutional framework where decision-making powers and accountability for the consequences of political decisions go hand in hand, and where incentives for sound fiscal and economic policies are strengthened. A sovereign insolvency procedure should be part of this institutional framework.
- Continue the process of setting up a European banking union. The banking union should sever the mutual dependence between government finances and banks, remove the fragmentation of financial markets in Europe, improve the efficiency of bank resolution, and protect taxpayers in banking crises.
- Give up the financial transactions tax (FTT) project. A tax on financial transactions in the euro area would be the wrong instrument. While it is correct that the taxation of the financial sector needs to be reformed, introducing a financial transactions tax in the euro zone would do more harm than good. The tax will lead to economic distortions and a re-location of economic activity to other countries. It will contribute little if anything to financial-sector stability. Other instruments, e.g. levies on bank liabilities, are more effective.
- EU policies that battle youth unemployment should focus on encouraging mobility. The existing EU policy initiatives to fight youth unemployment, in particular the Youth Guarantee, should be reviewed in the light of empirical evidence on the effectiveness of labour market programmes. This evidence suggests that the added value of EU policies in this area may be limited to initiatives supporting EU-wide mobility for employment and training.
- Develop a stringent and balanced European energy and climate policy. The targets of the European energy and climate policy, as well as the instruments employed to achieve those targets, need to be set up consistently. The European targets for the reduction of greenhouse gas emissions should be set under the condition that other important emitters like the US and China set appropriate targets as well. Moreover, overcoming the fragmentation of European energy markets should be another key objective of the European climate and energy policy.

II. What needs to be done?

1. Fully tap potential for growth; continue fiscal consolidation

Many countries in Europe – particularly the highly indebted countries on the eurozone's periphery – have gone through deep recessions and have been forced to implement tough fiscal consolidation programmes to bring down their budget deficits. It is essential that Europe's national economies recover as quickly as possible, and that latent potentials for growth be fully exploited. Many observers have argued that an emphasis on fiscal consolidation is wrong, because it leads to a vicious cycle of collapsing demand, declining tax revenues and rising public debt. The current stabilisation of economic activity in the countries most affected by the crisis suggests that these critics have been overly pessimistic. Yet achieving the right balance between fiscal consolidation and growth remains a key issue.

Looking forward, it is important to continue the process of fiscal consolidation so that public debt as a percentage of GDP starts to fall. At the same time, it is crucial to pursue fiscal consolidation in a way that limits negative impacts on growth. To this end, public investment, particularly in education and R&D, needs to be maintained. Further budget cuts should focus on reducing public consumption.

At the European level, it is important to identify opportunities for growth-enhancing public investment with European added value (EAV) – that is, to identify EU-level expenditures that bring greater benefit per euro spent than similar outlays at the national level. For example, there is significant potential for investment in cross-border transportation and energy networks. Yet developing these networks requires the support of national governments. In our view, member states should step up and agree that these investments are a high priority, and set binding targets in this regard.

In addition, revitalising economic growth throughout Europe should be a key policy priority. To achieve this, the EU needs to exploit the full potential offered by the European internal market, an issue emphasised by the European Commission (2012a). Although economic integration in the internal market is deep, significant barriers to cross-border economic activity persist, including barriers to cross-border activity in the financial and health care sectors, as well as obstacles created by national tax systems. However, rather than aiming at the full harmonisation of rules and regulations in these areas, which is neither realistic nor necessary, an effort should be made to eliminate the most important obstacles.

Clearly, EU policy-makers should abstain from establishing new barriers in Europe's internal market. The free movement of labour and other economic freedoms are essential cornerstones of European integration and are of tremendous political and economic importance. Recent debates – take the Swiss immigration referendum as a point of reference – concerning labour mobility and associated calls to limit immigration from certain countries pose considerable risks. Imposing limitations on internal movement could have a snowball effect and call into question the project of the internal market itself.

Europe has always benefitted from combining a strong internal market with trade to other parts of the world and from rejecting a “Fortress Europe” approach to trade policy. The proposed Trans-Atlantic Free Trade Area (TAFTA) offers considerable opportunities in this regard. Such a treaty could bring new stimulus to global negotiations on trade liberalisation, and would most likely increase the growth potential of all EU economies, including those in crisis. Of course, TAFTA negotiations will be challenging because of the naturally differing views and economic interests of the EU and US in some areas. However, the new European Parliament should see this project as an opportunity and not as a risk or threat.

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2. Reform the EU budget; focus on European added value

The size of the EU budget is a frequent topic of debate. Yet enlarging the EU budget cannot be a meaningful objective unto itself. Currently the greatest weakness exhibited by the budget is not its limited size but rather the ill-targeted structure of spending. Today spending is dominated by outlays that have a very visible impact in individual member states. Expenditures that serve common, European-wide interests but have no direct and visible effects in any particular member state are neglected. It appears that a "juste retour" attitude dominates budget debates. Although the new multi-annual financial framework has largely defined the spending structure for 2014–2020, the next European Parliament should lay the groundwork for a long-term strategy to realign the budget. The European added value (EAV) of spending should be the guiding principle for the budget's evolution. One policy area where the Commission has already systematically addressed this question over several years is in its proposals for the R&D budget.

However, the EAV principle should be applied rigorously when spending is assessed. In this regard, merely demonstrating that EU spending has a positive impact on specified policy objectives should not be considered sufficient. Spending should only be viewed as providing true added value at the European level if the attained positive effects exceed that of similar national spending. Hence, demonstrating EAV necessarily involves comparing the effects of European and national spending. In recent work, ZEW economists have identified policy areas that offer promise for the generation of EAV, i.e. the same level and quality of public goods could be provided at lower cost than the national level currently does. In this work, ZEW has also made a contribution to refining the methodology used in EAV assessments.

The establishment of joint diplomatic offices is the first area with a clear potential for generating EAV (Heinemann et al., 2013). ZEW's calculations indicate that establishing "one embassy with 28 flags" as a replacement to individual embassies for each member state could produce considerable savings, reducing current national spending on foreign diplomatic offices by between five and 20%. These savings projections take into account language constraints and particular national interests that would make it impossible to shift all embassy functions to a joint European staff (e.g. intelligence or trade promotion).

The second field – which is of much higher budgetary importance – is defence (Bassford et al., 2013). Today EU member countries pay a high price to maintain 28 separate armies, each with its own organisational structure. Clearly, European-wide cooperation in the area of defence could tap substantial economies of scale. The study performed by ZEW on this issue focused on the creation of joint land forces, and concentrated solely on staff costs. According to the study's estimates, an integrated European land army could fulfil the strategic objectives of European defence policy with smaller numbers and higher deployability ratios. The potential savings are substantial: in a scenario with a medium level of integration, some seven billion euros could be saved annually in wage costs alone.

Of course, in both of these policy fields, member countries must trade national autonomy for cost savings. When proposals for projects with a common European interest are brought forth, member states will invariably consider first and foremost how they stand to benefit. As it is unrealistic to expect member states to assess policy proposals from a pan-European perspective, the European Parliament should strive to make the price tag of continuing national fragmentation transparent.

3. Develop a consistent institutional framework for fiscal and economic governance in the eurozone

In the next legislative period, Europe's policy-makers will be shouldered with the responsibility of drawing the right conclusions from the years of crisis. Making the euro area more resilient against economic shocks and systemic risks will be a key goal. The debt crisis has revealed serious flaws in the institutional configuration of the EMU. While the founding of a common currency in the 1990s involved a push for financial and banking market integration, banking supervision and resolution remained a national responsibility. The common currency inherently increased the susceptibility of government bond markets to self-fulfilling default expectations, yet the ECB was not established as a lender of last resort because this would allow individual countries to accumulate excessive debt and let others bear part of the costs. Furthermore, while it was recognised that the unsustainable fiscal policies of individual member states could lead to high costs for all countries in the currency union, weak constraints were placed on national budgetary decisions.

Since 2010, there has been a wave of hasty reforms to address the shortcomings of current arrangements. A banking union is in the making, consisting of common supervision and bank resolution systems. The temporary European Financial Stability Facility (EFSF) and the permanent European Stability Mechanism (ESM) are new multilateral loan facilities created with the aim of stabilising the market for euro-area government bonds. In addition, the European Central Bank has (controversially) accepted a role as lender of last resort through the Outright Monetary Transaction (OMT) programme.

While this reform programme is substantial, there is at least one serious gap: to date no well-defined and feasible insolvency procedure exists that could be applied to restructure the sovereign debt of a eurozone-member state. There was an ad hoc restructuring of Greek public debt in 2012. But eurozone politicians have been quick to describe this as an exception.

For two reasons, the lack of a well-defined insolvency procedure is a major remaining shortcoming in the emerging new institutional setup of the euro area. First, the attachment of conditionality to EFSF, ESM and OMT loans can only be time-consistent if creditors have a realistic alternative to keeping a crisis country liquid whatever it takes. As long as restructuring remains an irresponsible high risk scenario, any threat to stop loans (EFSF/ESM) or bond purchases (OMT) in the event of non-compliance lacks credibility. In this case, public creditors are forced to give fresh money even to an insolvent country. Accordingly, restructuring must be a viable prospect if we are to prevent a system for providing liquidity assistance and averting irrational market panic from turning into a system of permanent transfers. In this sense, the establishment of an insolvency procedure should not be seen as a minor technical issue. Rather, it amounts to nothing less than a constitutional decision on whether the euro area is to be a transfer union based on full bailout-out guarantees.

A second reason why the prospect of sovereign insolvency is important is that it is crucial to safeguard market discipline as a complement to rule-based fiscal discipline. If the restructuring of individual euro-area states is not a viable possibility, then creditors do not face a default risk when purchasing sovereign bonds. Governments thus have the privilege of a perfectly elastic credit supply at moderate interest rates that are based on the creditworthiness of the euro area as a whole. This creates distorted incentives for individual national governments to massively increase public debt, because the cost of excessive debt – i.e. default – is mostly borne by other countries. Only the realistic prospect of some kind of sovereign default can induce borrowers to carefully examine the creditworthiness of euro area countries before buying bonds. The important role of market discipline in encouraging sustainable fiscal policies has also been emphasised by the European Commission (2012b).

Thus, while it is important to introduce an insolvency procedure for sovereigns when reconfiguring the EMU, this will not be an easy feat. The financial and economic situation in the euro area will remain fragile for a considerable time as a consequence of the crisis. Panic-driven turbulence in euro area bond markets has subsided since 2012, partly due to the ECB's OMT programme. However, the resurgence of acute crisis and contagion is an omnipresent and latent danger. No improvement has been achieved thus far in the debt-to-GDP ratios of the eurozone's crisis-racked countries. Furthermore, the growth outlook for these countries remains weak, and they have only begun to catch up in international competitiveness. In this environment, the introduction of a detailed insolvency procedure is risky. It could be seen as a signal that restructuring is imminent, which might trigger a new flight from government bond markets in peripheral countries. Thus, there is an underlying dilemma to the introduction of a sovereign insolvency procedure: Calm and stable years would offer ideal conditions for establishing transparent restructuring rules, yet it is only during an acute debt crisis that the need for such rules is recognised. This dilemma also explains why earlier initiatives failed, like the Sovereign Debt Restructuring Mechanism (SDRM), which was considered by the IMF in the early 2000s.

ZEW researchers have developed a new approach to overcome this problem (Fuest et al., 2014). While the Viable Insolvency Procedure for Sovereigns (VIPS) shares similarities with many proposed restructuring mechanisms, it is unique in that it explicitly addresses transitional periods. Under this insolvency procedure, member states with financial difficulties can apply for support under an ESM programme. However, if the programme does not allow the country to return to capital markets within a period of three years, further support will only be provided within the framework of an insolvency regime, where financial help is combined with debt restructuring. We propose that a decision to introduce this insolvency mechanism be made now, but with time lag before it comes into force. The new regime could start at a specified date in the future – for example, in 2020 – or before that date if the average public debt of eurozone member states falls below a specified level – for example, 80 per cent of GDP.

On the one hand, VIPS takes a cautious approach and avoids any sudden measures that could destabilise the present fragile situation. Full implementation will be delayed until important objectives in reconfiguring the EMU have been achieved (e.g. a stabilised banking system, a functioning banking union, and progress in cutting back public debt). However, the VIPS proposal does require immediate decisions and the phasing-in of institutional adjustments that would make the later full introduction of the insolvency procedure irreversible. Thus, the VIPS proposal takes advantage of crisis-related problem awareness and momentum for reform to initiate a far-reaching institutional innovation. At the same time, it seeks to minimise the risks of introducing the insolvency procedure at a time when the crisis has abated in intensity but the economic situation is still fragile.

4. Continue the process of setting up a European banking union

The introduction of a European banking union is a key element in the strategy to make the euro area more resilient to economic shocks. The banking union project aims to sever the interdependencies between national governments and their banking systems that intensified the recent economic crisis. Moreover, it is hoped that a banking union will reduce fragmentation in the internal market in the area of public services; lead to greater financial sector stability and more effective banking supervision and resolution; and, last but not least, protect taxpayers in the event of banking crises.

The decision to create a common system for banking supervision – the Single Supervisory Mechanism (SSM) – and a common institution for bank resolution along with a fund financed by contributions from banks – the Single Restructuring Mechanism (SRM) and the Single Restructuring Fund (SRF) – were important steps into the right direction. But more needs to be done.

First, an important element of the banking union is that potential losses resulting from bank restructuring be covered by the shareholders and creditors of the banks, and not by taxpayers. To achieve this, a rule has been proposed: a minimum "bail-in" of private investors equal to eight per cent of the bank's overall liabilities. Banks will be required to demonstrate that there are sufficient liabilities that qualify for this bail-in. While these rules are essential, they may not be sufficient. If a bank classifies as "bail-inable" liabilities that are held by other vulnerable financial institutions (for instance, other banks), writing down these liabilities in the event of a crisis may pose a threat to financial stability or lead to contagion, such that the bail-in does not take place. Additional safeguards are required to make sure banks demonstrate that bail-in liabilities are held by investors who can absorb losses. This last point was recently emphasised by the Scientific Advisory Board of the German Federal Ministry of Finance (Wissenschaftlicher Beirat beim Bundesministerium für Finanzen, 2014).

Second, the financial interdependencies between banks and governments will continue to be present as long as governments claim privileged access to bank financing. Currently it is still possible for banks and other financial institutions to classify sovereign debt and bonds as a no-risk investment. As a consequence, investments in sovereign debt do not increase the capital requirements of banks, meaning that sovereign debt is indirectly subsidised. Such a subsidy distorts the incentives of both lenders/investors and borrowers: investors have an incentive to take on outsized sovereign debt positions in their portfolios, as the costs of these investments in terms of capital requirements are too low. On the other side, borrowing countries have to pay a relatively low price for funding, which increases debt ratios above an economically appropriate level. In addition, restructuring government debt when government finances are unsustainable becomes untenable if this restructuring will inflict losses on banks they cannot absorb, as pointed out in the preceding section. Therefore, the possibility of avoiding capital requirements on sovereign debt should be abolished. Banks and other financial institutions should hold the usual amount of equity for their investments in sovereign debt based on an objective estimation of the investment's risks.

5. Give up the financial transactions tax (FTT) project

In February 2013, the European Commission submitted its proposal to introduce a financial transactions tax (FTT) within the framework of the enhanced cooperation procedure. While a previous proposal for an EU-wide FTT failed to find the necessary unanimous support among the member states, eleven countries, including France, Germany, Italy and Spain, are willing to go ahead and introduce the FTT.

The objectives of the FTT are as follows: First, to raise revenue from the financial sector, not only to compensate taxpayers for the costs of the recent financial crisis, but also to correct for the absence of a value added tax on certain financial services as well as to pay for the subsidy to banks created by implicit bailout guarantees. Second, the FTT aims to create disincentives for financial transactions that do not enhance economic efficiency (such as high frequency trading, which is a widely cited but controversial example). Third, the FTT aims to avoid a fragmentation of the internal market for financial services that might be caused by the uncoordinated introduction of tax measures by national governments.

Several studies on the FTT have pointed out that the objectives pursued by the European Commission are very reasonable, but that the FTT is not the right instrument (see Vella et al. [2012] and the studies cited there). In an influential paper, the IMF has argued that it would be better to raise a contribution from the financial sector to cover the costs of the financial crisis in the form of a financial activity tax (FAT), which could be designed in different ways but is essentially a tax on profits plus wages paid by banks (IMF, 2010).

The VAT exemption for financial services is a complex issue, and it is empirically unclear whether this exemption is an advantage for banks because it means that they cannot reclaim VAT on inputs. In any case this exemption could also be addressed by the FAT. The FTT is not suitable for neutralising the VAT exemption. The subsidy created by implicit government bailout guarantees for large banks is an important issue, but it is best addressed by levies on bank liabilities. The FTT paid by an institution would be largely unrelated to the size of the implicit subsidy.

It is also unclear whether the FTT would be an effective instrument for deterring undesirable speculation and other transactions. Clearly, high frequency trading would be affected, but it may be more expedient to address this form of trading by direct regulation. Such direct regulation would avoid the risks posed by FTT – namely, that a reduced number of transactions in specific markets would lead to reduced liquidity and increased price fluctuations. One should also bear in mind that, to large extent, the recent financial crisis was initially spawned by a market with extremely slow transactions – namely, the real estate market.

Finally, it is even likely that the FTT would increase fragmentation of Europe's financial markets, given that only eleven countries will participate. In addition, there is a significant risk that economic activity will be relocated after the introduction of the tax.

Overall, the expected costs and disadvantages of the FTT by far exceed the benefits. It would be best to abandon this project and focus on more suitable instruments for financial-sector reform.

6. EU policies that battle youth unemployment should focus on encouraging mobility

At present, more than one in five young Europeans on the labour market cannot find employment. As the social and fiscal costs of this "lost generation" are an increasing concern, the Commission has been taking direct action to combat youth unemployment. A key policy tool is the Youth Guarantee. This policy aims to ensure that all young people under 25 receive a quality job offer, the chance to start an apprenticeship, or receive additional training within four months of leaving formal education or becoming unemployed.

One priority in EU labour market policy in the next legislative period will be to accelerate the implementation of the Youth Guarantee. However, the available empirical evidence suggests that Europe's policy-makers shouldn't view this instrument as a panacea. Youth guarantees were previously implemented in the Nordic countries in the 1980s and 1990s. Yet there is little evidence that they have generated stronger impact on youth unemployment than a selection of targeted active labour market measures would have done. In fact, experience of the Nordic countries suggests that the implementation of a Youth Guarantee is extremely challenging, and may fail to produce the intended effects due to the use ineffective measures and poor implementation.

Impact assessment studies, on the whole, suggest that primarily tailor-made interventions are effective, especially when combined with intensive counselling and obligations on the part of participants. Yet public job creation schemes often do not create lasting employment effects, and education expansion may aggravate skill mismatch if the economy fails to create enough jobs that require the additional skills. Thus, the one-sided input orientation of the current EU Youth Guarantee scheme – which seeks to place everybody in some sort of programme within a given time frame – could likely be counterproductive. Putting agents in the wrong active labour market programme can be more harmful to their long-term employment prospects than doing nothing.

Successful implementation of a Youth Guarantee also requires capable labour market authorities that have the experience and capacity to manage active labour market measures in an efficient manner. An additional prerequisite is the ability to monitor impacts and to stick firmly only to active labour market measures with proven, lasting employment effects. Finally, a youth guarantee requires substantial financial means, particularly if the eligible population is defined in a broad manner. Accordingly, even if programme expenditures can be recovered later through the long-term positive effects of reduced unemployment and inactivity, immediate outlays represent a real burden, especially for governments that are currently under pressure to consolidate their budgets.

In sum, implementing comprehensive Youth Guarantee schemes in member states with less well-developed public employment services, more limited experience in designing efficient active labour market policies, and tight fiscal resources seems to be a highly risky and potentially wasteful approach. The preferable alternative would be the piecemeal realignment of active labour market policies at the national level. The first step in this regard would be to review the structure of existing active labour market policies, and concentrate resources consistently on those measures with proven positive effects. Public employment agencies may then seek to gradually expand the group of eligible agents, by identifying and actively reaching out to the neediest young people who are currently not covered by their services.

The EU should refrain from redirecting a higher share of the Brussels budget into national Youth Guarantees (or less ambitious active labour market programmes), even if the additional spending would have a positive impact on youth employment. In the realm of active labour market policies, there is little evidence that the positive effects of EU-level spending would exceed that of similar national spending, i.e. they do not provide positive European added value. Youth unemployment is mainly driven by specific conditions and policies at the national level. Therefore, counterbalancing measures need to be developed and paid for at the national level as well. Significant EU financial support may even be harmful, for it removes pressures on member states to firmly engage in the reforms necessary to tackle the structural sources of youth unemployment – e.g. insufficient job creation, labour market segmentation, and inefficient education and training systems.

The EU should instead concentrate on further developing the substantial but largely untapped potential of cross-border labour mobility. As structural reforms to fight youth unemployment will require considerable time to generate positive effects, geographical mobility is an important short-term valve for reducing numerical imbalances in unemployment rates. Mobility for education may also help to reduce skills mismatch. Furthermore, EU-level policies to promote geographic mobility offer the potential of European added value. One key challenge is to improve information outreach, particularly concerning opportunities abroad and the assessment of foreign qualifications. Therefore, the further development of the European job mobility portal EURES should be expedited according to the market needs. Another challenge is to encourage the many small-scale initiatives developing at a decentralised level, and to empower them to bring to bear their full potential. Therefore, efforts should be made to quickly develop the intra-EU job mobility scheme supported by the Commission (YfEJ) beyond its pilot stage.

7. Develop a stringent and balanced European energy and climate policy

One of the major challenges facing the newly formed Commission is the development of European climate and energy policy for the period after 2020. The Commission proposes a reduction in greenhouse gas (GHG) emissions of 40% below 1990 levels, as well as a 27% share of energy from renewables by 2030. In February 2014, the European Parliament voted to continue the current policy with three different targets, calling for a GHG reduction of at least 40%, a renewables target of 30% and an increase in energy efficiency of 40%. Germany, as well, would like to continue with a set of three targets. But because this decision requires a unanimous vote in the European Council by all 28 heads of state and government, it is very likely that less ambitious targets will be adopted.

A sole focus on overall targets may ignore important mechanisms that are potentially crucial for the success of European climate policy. First, a clear-cut economic justification is needed for the specific policy instruments that are chosen and their design. Each policy target (such as a reduction in GHG emissions) should be addressed with exactly one policy instrument. Additional instruments directed at the same target may have no effect, or even cause costly inefficiencies due to overlapping regulation. For example, policies to support the expansion of power generation from renewables reduce fossil fuel consumption and, in turn, GHG emissions. As the amount of GHG emissions is fixed under the EU Emissions Trading System – the key instrument of European climate policy – any additional abatement in the electricity sector causes no net reductions in emissions in the system as a whole. The abatement effect of these renewable policies is purely distributive and only reduces abatement efforts in other sectors.

The implementation of multiple instruments may be justified if additional market failures can be identified. But even then, the instruments and targets should precisely address these market failures. This means, for example, that policy targets for the expansion of green power should focus on the externalities in R&D and diffusion processes that hinder the realisation of cost reduction potentials and restrain the competitiveness of these technologies. Instruments such as standards that lack targeted justification should not be used.

Second, it is important to realise that the costs and benefits of European GHG mitigation efforts depend crucially on the efforts of other large economies to mitigate emissions. The expected decision of the European Council this October on the 2030 framework for climate and energy policies will send an important signal about the European position in international climate negotiations, and it is hoped this will lead to a worldwide agreement on the regulation of GHG emissions at the UN conference in Paris by the end of 2015. In the absence of commitments by other large emitters, the EU's resolve to achieve a widely decarbonised economy by 2050 is likely to founder. Thus, a more credible approach would be to declare targets that are conditional on the efforts of other large emitters. This would lead to greater international burden sharing, and would be politically more acceptable.

In the interest of cost efficiency, European climate and energy policy should also aim to reduce fragmentation in Europe's energy markets. This will require the expansion of European transmission grids, not least to better exploit regional differences in the efficiency potential of renewables. In addition, policy measures in individual member states need to be better coordinated with the policies of other member states and with measures at the European level. Parochial politics, whether in Brussels, Strasbourg, Paris or elsewhere, will only increase the costs of European climate and energy policy and undermine its chances of success. In addition, more investment in energy networks would be welcome as a stimulus to economic activity.

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