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Progress for Europe: Which Way to Growth and Employment after the Lisbon Strategy?

- The Lisbon Strategy so far has failed to deliver its promised results. Growth rates in productivity and employment remained below their potential.
- Enhancing productivity and capital intensity are the key factors to growth and cohesion in the European Union. They are also necessary to secure the European social model.
- Economic progress depends largely on a sound macroeconomic environment resulting from the coordination of monetary, fiscal and wage policies.
- For that, institutional reforms are urgently needed to overcome nationalistic blockages.

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Content

Lisbon Strategy's underperformance **2**

Productivity *and* employment **2**

Managing Europe's economy **3**
Monetary policy 3
Fiscal policy. 3
Income policy 3

An Agenda for Growth and Employment in Europe after Lisbon **4**
Institutional reforms 4
Structural reform agenda 4
Macroeconomic management. 5

Conclusion **6**
Our policy recommendations at a glance. 7

To become "the most competitive and dynamic economy in the world" within ten years – that was the commitment undertaken by the European Council in Lisbon in 2000. Eight years later it is clear that the objective will not be met. The so-called Lisbon Strategy intended to solve the most urgent problem of the late 1990's, namely unemployment. But it also sought to renew Europe's social model and accelerate growth. It has made some progress on the first, but little on the latter. A post-Lisbon-Strategy for growth and employment in Europe needs to focus on a binding framework of macroeconomic coordination and the generation and equitable reaping of productivity gains.

Lisbon Strategy's underperformance

The Lisbon Strategy in 2000 had two dimensions:

1. Structural reforms focused on the creation of the knowledge society to raise productivity and to overhaul the European social model, making it compatible with the challenges of the future.
2. Macroeconomic management sought achieving a policy mix between monetary, fiscal and income policies with the purpose of combining price stability with high investment, economic growth and rapid job creation.

These two objectives were matched by a new form of governance: the Open Method of Coordination. Peer pressure, naming and shaming and moral pressure were to bring about cooperative national governments. But institutional realities and hard-nosed political considerations of serving partial interests, rather than the common good, often prevented the realisation of the desirable.

In addition a policy shift occurred. The Barroso-Commission took a significant turn to a neoliberal interpretation of the Lisbon Strategy in 2005. The reform of the social model was reduced to making labour markets more flexible, while the macroeconomic dimension was largely eliminated. The reform of the Stability and Growth Pact increased the autonomy of nation-states and made a growth-oriented macroeconomic policy mix even less likely than before.

The result of this was a rather disappointing economic performance in the EU. Growth rates remained below their potential and underperformed in comparison with the US. While there was some improvement on the employment side – which made a positive contribution to the growth dynamics over the last decade – there is nevertheless a significant slowdown in labour productivity.

Accelerating the growth of productivity is the economic challenge for the next decade. In the long term, productivity determines the level of real wages. It is also necessary to secure the European social model. In a society where people live longer and have fewer children, the shrinking work force has to become more productive in order to guarantee the supply of healthcare and retirement for all. Thus, increasing labour productivity is a necessary condition for fighting poverty in the long run.

Labour productivity has been higher in the United States than in Europe since the mid 1990. Euroland is the worst performer. Because labour markets have become more flexible at the lower end, firms have hired people, whose productivity was lower than the average. The new challenge for Europe is to have both: higher employment *and* higher productivity. The question is: How?

Productivity *and* employment

Productivity is largely determined by the supply-side of the economy, while job creation depends on the growth of aggregate demand and GDP. However, the two also interact. Labour productivity also cannot be seen independently of investment. But only if the total stock of capital grows faster than the capital-labour ratio, also called capital intensity, will employment increase. Hence, both labour productivity and employment growth depend on the conditions of capital accumulation. Focussing on structural reforms without taking the macroeconomic environment into account, as is done by the neoliberal agenda, will not produce a dynamic economy.

Labour productivity is determined by Total Factor Productivity (TFP) and capital intensity (CI). TFP increases as a result of the more efficient use of capital and labour in the economy and is dependent on industrial policy, structural reforms and social systems. The Lisbon strategy aimed at improving TFP, but he results are disappointing. However, although TFP is largely dependent on market regulation, technology and organisational efficiency, labour productivity also depends on capital intensity, i.e. the amount of capital per person employed. If capital intensity is high, the productive capacity of workers is also high. While TFP measures the quality of the capital stock and the labour force, capital intensity is an indicator for the quantity of capital employed per worker.

In a recent study, the European Commission (2007) has claimed that the main reasons for the weakness in Europe's labour productivity are due to the slowdown of Total Factor Productivity and not capital intensity. The Commission therefore recommends the continuation of structural reforms, which have not yet

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had the desired impact on TFP, but hopefully will do so in the future. However, capital intensity is at least as important for labour productivity growth, if not more. Thus, tackling the problem of the EU's productivity slowdown requires more than the pursuit of structural reforms. A comparison with the US clearly brings out the fact that productivity increased in the US because of higher capital intensity, and employment in Europe because of lower capital accumulation per worker. If Europe wants to meet the challenge of the next decade, it must raise the overall rate of capital accumulation *and* at the same time increase capital accumulation per worker. For that, a new policy thinking in the direction of a stronger macroeconomic management is needed.

Managing Europe's economy

The major challenge for macroeconomic management in the next decade is to increase the purchasing power of households, while keeping interest rates down. This requires concertation of fiscal and income policies with the stability orientation of monetary policy.

Monetary policy

Maintaining price stability is indispensable for long term economic growth. The independence of the ECB and its mandate must therefore not be put into question. Inflationary pressures will arise when wage bargainers agree on nominal wages in excess of the sum of productivity increases plus the inflation target of the central bank. The ECB is then obliged to raise interest rates. This will slow down capital accumulation and employment growth. This is where the Macroeconomic Dialogue between social partners, monetary and fiscal authorities could play an important part.

Fiscal policy

If monetary policy has a coherent institutional framework, this cannot be said about budget policy. This fact is one of the major obstacles to sustained accelerated growth. For example, if the economy is in recession, additional demand for goods and services from government borrowing may be useful. But, the public deficit is "excessive" when the additional demand exceeds potential output, so that inflationary pressures emerge. In this case the Central Bank has to raise interest rates and mop up the excess demand. Both effects contribute to a negative trade off between budget deficits and monetary policy. In equilibrium, high deficits require high interest rates and balanced budgets yield low interest rates, which supports capital accumulation.

However, Europe's institutional framework is not conducive to such an optimal policy mix. If the Stability and Growth Pact had been properly implemented, actual deficits of member states would have gyrated around the zero line. This is not the case. Since EMU started, the aggregate euro-deficit has been close to 3 %, but has remained far from being balanced.

Income policy

Income policy is the third pillar of macroeconomic management. The average level of unit labour costs interacts with monetary policy. If nominal wages increase faster than labour productivity, unit labour costs rise and the ECB will put up interest rates to restrain inflation. A successful low-interest policy mix must therefore anchor unit labour costs at the price objective of the ECB.

The average unit labour cost inflation for the euro area has remained clearly below the 2 % inflation target. But in Greece, Spain and Italy it is clearly higher than the inflation target. The wage developments in these countries contribute to inflationary pressures in the Eurozone. However, they are mitigated by wage settlements in Germany, Austria, Belgium and Finland. It is the heavy weight of Germany that keeps European unit labour cost from rising. This implies that if German wages were to increase faster, Spanish and Italian wage increases would have to slow down or labour productivity rise.

These diverging wage dynamics affect the relative cost competitiveness of member states. For example, Germany's unit labour costs were close to the average Euroland level when EMU started. Today, they are the lowest in the euro area. By contrast, Portugal and Spain have seen their unit labour cost levels rise 15 % or 20 % above the average Eurozone level. These developments increase social and economic tensions in Euroland and could become politically destabilizing. Germany pursues a beggar-your-neighbourhood policy and Spain is riding an unsustainable bubble. This must be of serious concern to policy makers and citizens. If these trends remained unchecked, European monetary union could break up. This is the reason for making income policies an urgent issue on the European agenda.

A European income policy would have to tackle two problems at the same time:

1. Bring aggregate wage settlements closer to the inflation target so that the purchasing power of consumers is increased (an issue particularly acute in Germany) without accelerating inflation.
2. Stop and correct the persistent divergence of national unit labour cost levels. This requires a significantly higher degree of coordination in European wage bargaining and the acceleration of productivity growth.

An Agenda for Growth and Employment in Europe after Lisbon

In order to accelerate its dynamism, Europe needs (1) institutional reforms as well as a (2) structural reform agenda and a more coherent (3) macroeconomic policy coordination.

Institutional reforms

Despite strong reluctance to address the fundamental issue of institutional reforms in the European Union, it is an essential task for the future of the EU. The way forward is building European democracy, the *Europe of citizens.* There is no government in the EU. Although the European Commission is a "guardian of common interests", it is in reality often marginalised by the special interests of nation state governments. This institutional deficiency is increasingly debated. The Belgian Prime minister Verhofstadt and the German Social Democratic Party (SPD) in its new fundamental program have explicitly called for a European government, elected by the European Parliament. The election of the European Parliament in 2009 is a very good opportunity to launch this debate on the European scale. Centre-right parties will support Barroso's neoliberal agenda; European democrats and socialists should reformulate a new strategy that connects the original Lisbon agenda with the broad objectives of a dynamic economy, with rising productivity and full employment, linking structural reforms to macroeconomic management.

Structural reform agenda

For too long, Europe has focused on microeconomic reforms that augment allocative efficiency. Many reforms have sought to improve the motivation of capital owners for investing in Europe; little attention was given to the motivation of workers. Yet, incentives for worker participation in the overall efficiency of their firm would also impact productivity in Europe. Thus, one should re-evaluate the role of works councils, codetermination and board representation of workers in European firms. European company law should incorporate the success stories of national experiences, although this will raise stiff resistance from capital owners.

The Knowledge Society remains a valid policy objective. However, knowledge is based on communication. Studies show that speaking a foreign language, especially English, is a powerful factor in increasing Total Factor Productivity. All EU member states should therefore impose learning English at primary school level.[1]

Macroeconomic supply side reforms are the other dimension for improving overall labour productivity. In principle, more competition serves the interests of European consumers, particularly in the lowest income categories, because cartels and monopolies keep prices excessively high and are thereby rationing consumer demand. Nevertheless, privatisation can also create externalities and slow down productivity growth, when individual decisions are causing costs not taken into account by the decision-making process. Taking such externalities into account requires a European authority, ideally a European government, capable of thinking for the whole of the Union and acting in the common interest.

The European Union must also command resources of its own. The Sapir Report has proposed to "reorganise radically" the EU-budget by setting up three new *Funds* (Sapir et al 2002). Public expenditure by the European Union should focus on three objectives:

1. A *Growth Fund* should support the mobilisation of private and national resources at the edge of technological and industrial progress.
2. The *Cohesion Fund* would contribute to catch-up growth in low income region by increasing productivity and capital intensity at the regional level.
3. A *Restructuring* or *Globalisation Fund* would ease the pressure for those who carry the burden and suffer from the consequences of social change, especially from globalisation.

Pushing the technological frontier by supporting R&D and technological innovation needs the concentration of financial efforts. The adaptation and modernisation of existing capacities requires spreading new technologies across Europe by facilitating the entry and competition of new firms. Supporting national or European champions would simply maintain rigid

1 In Ireland and the UK it should be another foreign language.

monopolies to the detriment of European consumers, especially low-income end. In order to free Europe from the harmful influences of national veto players, the budget should be subject to the co-decision procedure between the European Parliament and the Council and executed by the European Commission.

In this context, the role of public investment needs to be revalued: decades of underfunding in infrastructure have constrained productivity in many member states. The EU could increase its overall growth potential by undertaking public investment that benefits citizens by mobilising local resources and spilling over into different member states. Shifting the balance from public consumption to investment should be scrutinized by the annual Broad Economic Policy Guidelines and the evaluation of national budget policies under the Stability and Growth Pact procedures.

Regional policy should be increasingly used as a means of redistribution but the best way of doing this is to put attention on overcoming regional differences in productivity and capital intensity rather than creating transfer dependency. Furthermore, attention must be paid to the macroeconomic polices in member states that receive structural and cohesion funds. Excessive budget deficits and rising unit labour costs will cause real exchange rate distortions and reduce incentives for investment. Comparing the experience of Ireland and more recently of Greece with the non-performance of Portugal shows that the right policy mix is one of the most important variables in catch-up growth. The effectiveness of transfer payments is greatly enhanced by such policies.

However, European budget policies pose another problem: How are they to be financed? Today more than 90 percent of the EU budget come from national contributions paid by national treasuries, rather than from taxes levied on EU-wide fiscal bases. This creates a classic collective action problem: the provision of collective goods is underfunded, because when member states seek to obtain individual advantages by minimising their financial contribution, they jeopardise the collective interest of European citizens (including those living in their own jurisdiction). The correct systemic response to this problem is to finance European expenditure by European taxes. A European corporate tax is the most appropriate tool to finance the EU-budget, since it would eliminate unfair tax competition in the EU and provide for a fair taxation of multinational corporations (Kellermann et al. 2007). Any European tax cannot be imposed without appropriate democratic representation. It therefore needs to be approved jointly by the Council and the European Parliament, after an initial proposal from the Commission or a later European government.

Macroeconomic management

Macroeconomic management must create an economic environment where persistently low interest rates contribute to the acceleration of capital accumulation. It needs proper instruments and policies. All existing forums and instruments, such as the *Eurogroup*, the *Broad Economy Policy Guidelines or* the *Macroeconomic Policy Dialogue* do not allow for binding policy commitments. If macroeconomic management is to become more efficient, the institutional arrangements, especially in the euro area, must become more coherent, and decisions must oblige and bind all policy makers. This can only be accomplished by an institution that can command full democratic legitimacy at the European level.

The optimal policy mix requires defining a fiscal policy stance for the euro area as a whole that interacts with monetary policy in determining the growth-supporting level of equilibrium interest rates. Fiscal policy must become more coherent in aggregate and at the same time more flexible to deal with shocks that effect individual member states differently. In non-euro member states, fiscal policy must be coordinated with the objective of exchange rate stability in order to avoid distortions in the single market.

The aggregate fiscal stance should be defined at the European level in consideration of the business cycle. This could be done by turning the *Broad Economy Policy Guidelines* into a formal piece of European legislation that applies with strict and binding force to the member states of the euro area.[2] These Guidelines would set the authorized *aggregate* deficit targets for all EU public authorities (from municipalities to regions, nations and the EU budget), effectively defining the aggregate budget deficit of the European Union for any given year. Against these authorizations borrowing permits would be issued, which would allow borrowers to enter the capital market. This would oblige member states to respect their European commitments when formulating their national budgets laws. However, the borrowing entitlements must be transferable. If one government wishes to borrow more than it is entitled, it must obtain additional permits from another member state that does not wish to make full use of its own quota. In this way, compliance with the overall aggregate fiscal policy stance is assured.

With respect to income policy, there is the issue of (1) ensuring that average European wage settlements remain consistent with the inflation target of the ECB

2 The BEPG could also cover the convergence requirements for future Eurozone member states.

and (2) that national unit labor costs converge to the average level of the euro area. Therefore, wage bargaining must follow clear guidelines. A rule of "nominal wage increases being equal to productivity increases in the specific sector or region plus the ECB inflation target" would allow negotiators to render decentralized settlements coherent and compatible with the overall requirements. Deviations from the rule should be publicly discussed and justified. In order to increase public acceptance and compliance, this debate should take place in a transparent, mutual and openly accessible forum. The present Macroeconomic Policy Dialogue does not achieve this visibility. The European Parliament is where policy issues that concern all citizens should be discussed. It would therefore be an improvement to link the Macroeconomic Policy Dialogue with the EP's regular public Hearings of the President of the European Central Bank.

Conclusion

The EU has still significant opportunities for economic growth, provided supply and demand side policies start to reinforce each other. At present, this is not the case. Europe's economic handicaps suffer from collective action problems, which ultimately can only be remedied by creating a democratic government for Europe. However, practical objectives of increasing productivity and improving conditions for capital accumulation can trace out a post-Lisbon strategy that will make it easier to tackle the institutional problems.

Our policy recommendations at a glance

1. To achieve the Lisbon goals, Europe's overall productivity must be substantially enhanced by fostering worker's participation, co-determination, investment in training and education (especially foreign language skills) and increasing capital intensity.
2. Increasing employment depends largely on a sound macroeconomic environment resulting from a stimulating and stabilizing coordination of monetary, fiscal and wage policies. Institutional reforms are urgently needed to overcome nationalistic blockages.
3. In the shorter run, the European Union must command resources of its own via a European corporate tax and create a *Growth Fund* for the mobilisation of private and national resources at the edge of technological and industrial progress.
4. The *Cohesion Fund* should focus on catch-up growth in low income region by increasing productivity and capital intensity at the regional level.
5. The *Globalisation Fund* must be extended to ease the pressure for those who carry the burden and suffer from the consequences of social change and delocalisation.
6. Public spending needs to be revalued and shifted from public consumption to investment under the annual Broad Economic Policy Guidelines.
7. Regional policy should be increasingly used as a means of redistribution. The optimal starting-point lies in overcoming regional differences in productivity and capital intensity rather than creating transfer dependency.
8. An aggregate fiscal stance should be defined at the European level in consideration of the business cycle. The *Broad Economy Policy Guidelines* should set the authorized *aggregate* budget targets for all EU public authorities and assign transferable quota for borrowing permits to national authorities.
9. Wage bargaining must be in line with sector and regional specific productivity increases and the ECB inflation target.
10. In the long run the Commission's accountability must be enhanced via democratic checks and balances, i.e. a European government must be created to assume responsibility for policies that concern all European citizens.

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