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A New Growth Strategy for Europe beyond 2010

1. Europe's Growth Strategy Is Not Working Out

About ten years ago the EU heads of state and government met in Lisbon and agreed that by 2010 they would make Europe »the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion« (European Council 2000: 2). This »Lisbon Strategy« for growth and jobs had at its core a »knowledge society«, a European Social Model as well as innovation. It stated that research and development would receive the same support as concrete employment measures.[1] The spring meeting of the EU Council on 19 and 20 March 2009 and the April meeting of national coordinators of the Lisbon Strategy in Prague will deal with the future of the European growth and employment strategy beyond 2010. Obviously, the effects of the global financial and economic crisis on European growth and the EU's response will be of immediate concern.We believe, however, that the Lisbon Strategy should focus on the long-term orientation of the European Economic and Social Model.

Before the Lisbon Strategy had even reached the halfway stage, it was quite clear that its targets would not be met and that many governments lacked the will to intensify their efforts to make sure it would. The member states' key message was that the Strategy was too ambitious and its priorities could not be reconciled. Furthermore, implementation within the framework of soft law instruments such as the open method of coordination would fail.[2] Eventually, the goals and priorities of the Lisbon Strategy were scaled down in the course of the mid-term review in 2005, and the links weakened between the economic,

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1 The targets laid down were as follows: annual economic growth of three per cent; annual R&D expenditure amounting to three per cent of GDP by 2010 at the latest; an overall employment rate of 70 per cent, as well as employment rates of 60 per cent for women and 50 per cent for older people (also at the latest by 2010).

2 Launched in 2000, the open method of coordination (OMC) is based on the procedures of the coordinated EU employment policy introduced by the Amsterdam Treaty. It is used specifically in areas outside EU competence. After common goals (and common indicators) have been laid down the member states draw up action plans, which are then evaluated by the Council on the recommendation of the Commission. The aim is, besides improving the comparability of individual policies in the EU, to determine so-called *best practices* and so bring about knowledge transfer concerning political reform proposals.

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social and environmental aspects. The predominantly conservative-liberal European governments adapted the Lisbon Strategy in accordance with their economic outlook and henceforth emphasised market deregulation and competition – an overall strategic approach directed primarily towards improving supply conditions for enterprises.

Popular support for this strategy and its protagonists was on the wane before the outbreak of the world financial and economic crisis. The EU's faltering reform process is only one expression of the crumbling consensus. Poverty, social exclusion, unemployment and inequality of opportunity are a social reality in Europe. This shows clearly that the Lisbon Strategy has fallen short where it really counts, that is both in qualitative terms – as an attempt to combine economic, social and environmental aims – and quantitatively, since the goal of a seventy per cent employment rate has been missed by almost five percentage points. What is more, the employment rate will fall further by 2010 due to the financial crisis.

Actors on the progressive centre-left in both politics and civil society have campaigned for a different kind of Lisbon Strategy for years. They promote an approach which includes the building blocks of a socially just market economy and develops innovative concepts for a European economic and social model. Such a strategy for growth and jobs would strike a balance between economic efficiency and social justice rather than playing one off against the other. The central levers of this growth strategy are to be found in increased productivity and stronger macroeconomic coordination in Europe.

The European debate on growth and jobs is centred around different interpretations of productivity and macroeconomic coordination.The current Lisbon Strategy, as interpreted by the Barroso Commission, is an attempt to increase productivity by improving supply conditions for businesses. Critics of this approach emphasise the importance of capital intensity for labour productivity, by which they mean first and foremost investment in jobs. In technical terms, what is at issue here is capital stock per employee. As a rule, high capital intensity is accompanied by high labour productivity. Critics of the Lisbon Strategy take the view that deficient capital intensity is one of the main reasons for Europe's low level of labour productivity (Collignon 2008). The European Commission sees things differently, however, and attributes the failure of the Lisbon Strategy primarily to inadequate structural reforms, for example, on the labour market (European Commission 2007).

In what follows we shall first take a closer look at this dispute between advocates and critics of the current EU growth and jobs strategy. Although conducted in fairly technical terms, this dispute is in fact highly political. In large part it concerns the »true« definition of productivity and so ultimately the appropriate levers of a future growth strategy for Europe. Against this background, we shall examine the debate on Europe's underperformance in terms of productivity growth in Section 3 before outlining the necessary conditions for a »post Lisbon Strategy« in the concluding part. In order to be efficient and fair in equal measure, a growth and jobs strategy beyond 2010 must be considerably more inclusive and more socially oriented than has been the case over the last ten years.

2. The Dispute about »Real« Productivity

As already mentioned, when the Lisbon Strategy was adopted about ten years ago it had ambitious aims. In particular, it focused on an increase in labour productivity, which had fallen behind that in the booming USA at the turn of the millennium. At a time when the population is aging and fewer and fewer workers have to provide for an increasing number of pensioners, productivity per working hour fundamentally affects overall prosperity. Labour productivity is the basis for more growth and employment in the EU. Rising real wages and properly financed social security systems can be achieved over the long term only if workers' productivity increases. Productive labour is therefore the foundation of the European Social Model.

However, productivity gains in the EU have been disappointing since the Lisbon summit and have played a decisive role in the failure of the Lisbon Strategy. Although developments in the EU are very different – some countries have attained high productivity growth, while others have managed only a very low level of growth or have even witnessed a decline – overall productivity growth has lagged behind that of the USA. In fact, the productivity gap between the USA and Europe has increased since the 1990s with particularly bad results for the Eurozone (Collignon 2008: 12; European Commission 2007: 25). A new study by the Conference Board commissioned by the Friedrich-Ebert-Stiftung confirms this development also for the recent past (summary in Bormann entitlement al. 2009).

There are a number of reasons for this development. According to the established view, economic growth is due to the deployment of the factors of production, that is capital and labour (comprising both quantity *and* efficiency). If employment increases, overall growth rises, but this is not necessarily valid for growth per capita. The latter increases first and foremost as a consequence of higher labour productivity, which depends on, among other things, the amount of capital invested per person employed. This requires higher investments in so-called capital stock, which includes all capital goods, such as machinery, plant and equipment, factory buildings, and so on. Labour productivity is therefore a decisive lever for growth. Labour productivity can be calculated as the product of multi-factor productivity (MFP) and capital intensity. Multi-factor productivity measures the efficient utilisation of the factors of production capital and labour.[3] It includes everything that changes the relationship be-

3 The debate on multi-factor productivity stems from the understanding that overall economic growth cannot be reduced to the sum of its component parts. On the classical model, for example, a large proportion of growth could not be put down to utilisation of the factors of production capital and labour. The difference between overall economic growth and the contribution of the factors of production is therefore first of all a re-

tween inputs and outputs. This includes technological development and organisational efficiency, but also social institutions and regulatory policies, such as legal certainty and security of contract, effective and incorruptible bureaucracies, as well as free trade (Hall/Jones 1999). Attempts are frequently made to increase multi-factor productivity by structural reforms.

While multi-factor productivity denotes the quality of factor inputs (capital and labour), capital intensity describes the quantity of capital in relation to the deployment of labour. Capital intensity therefore increases with better machinery, computers and vehicles and makes workers more productive. Labour productivity, then, is higher, as a rule, the more capital intensive a national economy is, and the more innovative and progressive the technology utilised. This constitutes the foundation stone of a growth and jobs strategy beyond the current Lisbon Agenda. If both labour productivity and employment is to grow in the EU the capital stock must grow more quickly than capital intensity. That is why employment growth depends on the level of investment. It follows that growth and productivity in the EU can be increased only on the basis of dynamic capital accumulation, which means above all investment in new production technology and demand stimulation. Structural reforms alone will not suffice.

3. The Debate on Europe's Underperformance

Advocates of the Lisbon Strategy consider its goals to be right and claim that its lack of success so far is due to the hesitant implementation of the corresponding structural reforms. They hold that the low growth of per capita income in the EU is based primarily on low innovation (Sapir 2003: 28f). The reasons for the widening productivity gap between the EU and the USA should therefore be sought in inadequate technological development. In particular the IT sector, whose high productivity growth in the USA spills over into other sectors, is developing too feebly in the EU and is adversely affecting MFP growth. And apart from the IT sector productivity increases are scarcely to be found (van Ark 2005: 192f). The service sector is also partly blamed for the EU's low productivity growth (Besch/Zimmermann 2006; Bormann et al. 2009). Naturally, the European Commission also focuses on low productivity growth. It perceives a definite connection between the expansion of employment in the less productive segment of the economy and the fall in overall labour productivity, although it considers this as a subordinate and medium-term conflict of aims (European Commission 2007: 103). The Commission's approach concentrates rather on problems in certain sectors. From this standpoint, inflexible markets, a lack of competition and corporatist institutions are responsible for weak productivity growth. The Lisbon Strategy is failing, therefore, not because of its proposed remedies, but because of a lack of implementation.

The structural reforms that could lead to an increase in labour productivity include: revamping employment protection, reducing wage costs, heightening incentives to work and to accumulate human capital, reform of competition law, consumer protection reforms, taking down barriers to market entry and exit, and promoting goods market integration (Besch/Zimmermann 2006: 81). Hence the supporters of this interpretation of the Lisbon Strategy are concentrating for the most part on the need for microeconomic reform. Their demands largely chime with the current Lisbon Strategy, and often go beyond it. On this basis, there is no reason for a change of course; instead, the goals of the Strategy should simply be pursued by the member states with more determination.

Critics of the Lisbon Strategy, in contrast, attribute the unsatisfactory growth of per capita income in the EU to the lack of capital intensity, that is, the low capital expenditure per employee. Wage restraint and deregulation trends in the labour market have reduced the cost of labour in comparison to capital to such an extent that investment pressure for enterprises has fallen accordingly. At the same time, investments in capital stock have become comparatively unprofitable due to relatively higher interest rates and lower sales expectations in the Single Market. Hence the weak growth of labour productivity so far (Collignon 2008: 16f).

In this interpretation low EU growth and employment rates are not in the first place the result of inflexible markets, but due primarily to a below average return on »real« investments. Another important factor in this respect is the economic policy pursued in most EU member states that focuses on the supply side and neglects what is going on on the demand side (Alexiou/Pitelis 2003). In addition, a whole series of institutional impediments prevent the necessary macroeconomic coordination in the EU. Thus the Lisbon Strategy is applying the wrong levers and has counterproductive effects.

Adherents of this view therefore favour a mixture of public investment in education, research policy and more strongly coordinated European monetary, fiscal and wage policy (Collignon 2008). European economic policy should stabilise the environment of national economies, cushion external shocks and improve the prospects for long-term investment. There is a close causal connection between the rate of regular employment (i.e. full-time with indefinite contracts), reasonable wage development and domestic consumption. Coordinated policies and an employment-friendly interest rate should provide a favourable investment climate. The aim of such proposals is economic-policy support for technological development and improved conditions

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sidual quantity, known as the »Solow residual« after the man who discovered it, or simply as multi-factor productivity (Solow 1957). MFP has a particular significance in neoclassical growth theory because the theory assumes that over the long term production per capita can be increased only if higher profits can be obtained from the same level of capital and labour by means of technological development. The advantages of an increase in capital intensity are limited accordingly. A worker's productivity therefore increases considerably when he or she looks after two machines rather than one. However, if he or she starts looking after ten rather than nine machines he or she is only slightly more productive. This is known as the *diminishing marginal productivity of capital*.

for the accumulation of capital stock. Accordingly, investment-friendly monetary policy, public investment and a demand-boosting incomes policy on the part of the social partners should complement the promotion of innovation.

4. Conditions for a New Growth Strategy

Ultimately, it is obvious that reforms for increasing growth and productivity must target both the efficient allocation of factors of production (MFP) and increasing the capital stock, and so, capital intensity. The basic thrust of the Lisbon Strategy, which is to promote a knowledge-based society, is scarcely controversial. Investments in training, research and development and an innovation-friendly patent law are widely supported. Besides that, such a strategy could provide for the establishment of growth and cohesion funds, as well as the – qualitative – extension of the globalisation fund. These funds would constitute the EU's own resources, which in the short term should be used to offset (external) shocks, thereby creating long-term security and an investment-friendly environment. Growth defects due to the underutilisation of capacity and a shortage of capital can be remedied only by coherent cooperation among economic-policy actors (Collignon 2008: 21f).

A crucial lever in a common strategy would be closer wage policy coordination oriented towards price increases and productivity with a view to creating an effective domestic demand. Productivity, in turn, would have to be understood in terms of »social productivity«, the core of which would comprise an increase in quality of jobs, the inclusion of external costs (for example, environmental damage) and sustainable consumption. Social productivity, that is, is a condition of a real increase in prosperity beyond monetary and numerical variables, by means of which the ideal of an innovation-based competitiveness can be combined with a socially just and sustainable model of society. It entails above all redistribution, of key importance for national economies, more particularly the just redistribution of productivity gains to workers, by means of which, in turn, demand and thereby returns on investments that raise productivity will be increased.

The Open Method of Coordination has failed as an instrument because it does not provide for an effective control mechanism for the common goals. In its current form it allows member states to integrate European objectives into national interests thereby making policy according to the changing facts on the ground. Without a robust and binding mode of coordination, Europe-wide macroeconomic management will be pursued in vain. A progressive growth policy must be combined with a new mode of cooperation – in fact, it depends upon it.

A »post Lisbon Strategy« would not represent a total renunciation of previous Single Market and competition policy, but would build on existing EU structures, institutions and mechanisms. To gain the support of the member states, it is central to combine further coordination with the preservation of some degree of national autonomy. Apart from that, in principle a more democratic overall structure is needed for the European Union, including a European economic government in order to facilitate a stronger redistributive and development role at EU level over the long term.

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