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## Forward with Europe: A democratic and progressive reform agenda 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 and strengthen 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. The paper presents an analysis of the shortcomings of the Lisbon Strategy and develops a democratic and progressive reform agenda.

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## 1 The Lisbon Strategy's underperformance

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 was intended to solve the most urgent problem of the late 1990s, 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 progressive 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.<sup>1</sup>

The Lisbon Strategy in 2000 had two dimensions:

1. Structural reforms focused on the creation of a knowledge society to raise productivity and to overhaul the European social model, making it compatible with the challenges of the future.
2. Macroeconomic management 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 engender cooperative national governments; but institutional realities and hard-nosed political considerations, serving partial interests rather than the common good, often prevented the realization of the desirable.

In addition, a policy shift occurred. The Barroso Commission took a significant turn to embrace a neoliberal, conservative interpretation of the Lisbon Strategy in 2005. Reform of the social model was reduced to making labor markets more flexible, while the macroeconomic dimension was largely eliminated. 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 has made a

positive contribution to growth dynamics over the last decade – there has been a significant slowdown in labor productivity.

Accelerating productivity growth 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 in which people live longer and have fewer children, the shrinking work force has to become more productive in order to guarantee the supply of health care and retirement for all. Thus, increasing labor productivity is a necessary condition for fighting poverty in the long run.

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

## 2 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. But the two also interact. Labor productivity cannot be considered independent of investment; but only if the total stock of capital grows faster than the capital-labor ratio – also called capital intensity – will employment increase. Hence, both labor productivity and employment growth depend on the conditions of capital accumulation. Focusing on structural reforms without taking the macroeconomic environment into account, as under the neoliberal approach, will not produce a dynamic economy.

Labor 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 labor in the economy and is dependent on industrial policy, structural reforms, and social systems. The Lisbon Strategy aimed at improving TFP, but the results have been disappointing. But while TFP is largely dependent on market regulation, technology, and organizational efficiency, labor productivity depends also on capital intensity, that is, 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 labor force, capital intensity is an indicator of the quantity of capital employed per worker. But accelerating capital accumulation would also improve the quality of

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<sup>1</sup> This article is the short version of a survey written by the same author for the Friedrich-Ebert-Stiftung, Berlin. The study can be downloaded at <http://www.fes.de/ipa>

the capital stock with respect to new technologies that support the preservation of natural resources, protect the environment, and improve health and life expectancy.

In a recent study, the European Commission (2007) claimed that the weakness in Europe's labor productivity is mainly due to the slowdown of Total Factor Productivity and not capital intensity. The Commission therefore recommends the continuation of structural reforms that have not yet had the desired impact on TFP, but hopefully will do so in the future. The problem with this widespread form of wishful thinking is that it fails to analyze the macroeconomic and institutional obstacles to the dynamic performance of Europe's economy. These obstacles cannot be overcome by intergovernmental cooperation alone. In many policy areas, »delivery« of good results is handicapped by free-rider incentives that create collective action problems.

Furthermore, capital intensity is at least as important as supply-side reforms for labor productivity growth, if not even more so. 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 grew 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* increase capital accumulation per worker. For that, a new policy approach in the direction of stronger macroeconomic management is needed.

### 3 Managing Europe's economy

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

#### 3.1 Monetary policy

Maintaining price stability is indispensable for long-term economic growth. A modern and efficient economy cannot function properly without a credible and stable currency. The independence of the ECB and its mandate must therefore not be called into question. But this does not mean that other macroeconomic variables and policies should be ignored. Public debt may compete with private investment for the alloca-

tion of capital, or supplement it; excessive deficits could ignite a price–wage spiral or stimulate demand. 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 will then be obliged to raise interest rates. This will slow down capital accumulation and employment growth. What Europe needs is a concertation of different policies that support stable growth and capital accumulation for at least one decade. This is where the Macroeconomic Dialogue between social partners, monetary and fiscal authorities could play an important part.

#### 3.2 Fiscal policy

If monetary policy has a coherent institutional framework, this cannot be said of budget policy. This is one of the major obstacles to sustained accelerated growth. For example, if the economy is in recession, additional demand for goods and services on the basis of 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.

But Europe's institutional framework is not conducive to such an optimal policy mix. If the Stability and Growth Pact had been properly implemented, the actual deficits of member states would have oscillated 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.

#### 3.3 Income policy

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

The average unit labor cost inflation for the euro area has remained clearly below the 2 % inflation target, except in Greece, Spain, and Italy, where it

is higher than the inflation target. Wage developments in these countries have contributed to inflationary pressures in the Eurozone. However, they are mitigated by low wage settlements in Germany, Austria, Belgium, and Finland. It is the heavy weight of Germany that keeps European unit labor costs from rising. This implies that if German wages were to increase more rapidly, Spanish and Italian wage increases would have to slow down and/or labor productivity rise.

These diverging wage dynamics affect the relative cost competitiveness of member states. For example, Germany's unit labor 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 labor 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 is pursuing a beggar-your-neighbor policy and Spain is riding an unsustainable bubble. This must be of serious concern to policy-makers and citizens. If these trends remain unchecked, European monetary union could break up. This is why income policies must be made 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 consumer purchasing power is increased (an issue particularly acute in Germany) without accelerating inflation.
- (2) Stop and correct the persistent divergence of national unit labor cost levels. This requires a significantly higher degree of coordination in European wage bargaining and the acceleration of productivity growth.

## 4 A progressive agenda for growth and employment after Lisbon

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

### 4.1 Institutional reforms

Despite the strong reluctance to address the fundamental issue of institutional reforms, it is an essential task for the future of the EU. The way forward is building European democracy, a *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 marginalized by the special interests of national governments. This institutional deficiency is increasingly debated. Belgian Prime Minister Verhofstadt and the German Social Democratic Party (SPD) in its new basic program have explicitly called for a European government, elected by the European Parliament. The European Parliament elections in 2009 represent a very good opportunity to launch this debate at European level. Center-right parties will support Barroso's neoliberal agenda; European democrats and socialists should formulate 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. They should design a policy in which microeconomic structural reforms are integrated in a macroeconomic strategy that is supported by citizens' democratic choice.

### 4.2 Structural reform agenda

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

The macroeconomic supply-side can improve overall labor 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 thereby ration consumer demand. Nevertheless, privatization can also create externalities and slow down productivity growth when individual decisions cause costs that are 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 »knowledge society« remains a valid policy objective. But 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.<sup>2</sup> A newly to be created European Teacher and Student Exchange Service could accelerate the build-up of language skills. Furthermore, the objectives with respect to Research & Development and Lifelong Learning have not been met under the old Lisbon Strategy. Given that nation states seem incapable of fulfilling their objectives, European institutions should come to their aid; government failure by the nation state needs to be fixed at the European level.

Public expenditure by the European Union should focus on three objectives:

- (1) A *Growth Fund* should support the mobilization of private and national resources at the forefront of technological and industrial progress.
- (2) The *Cohesion Fund* should contribute to catch-up growth in low income regions by increasing productivity and capital intensity at the regional level.
- (3) A *Restructuring or Globalization Fund* should ease the pressure on those who carry the burden and suffer from the consequences of social change, especially globalization.

Pushing the technological frontier by supporting R&D and technological innovation needs the concentration of financial efforts. The adaptation and modernization of existing capacities requires the spread of new technologies across Europe by facilitating the entry and competition of new firms. Supporting national or European champions would simply maintain rigid monopolies to the detriment of European consumers, especially at the 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 must be reevaluated: 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 mobilizing local resources, 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 seek to overcome regional differences in productivity and capital intensity rather than create transfer dependency. Furthermore, attention must be paid to macroeconomic policies in member states that receive structural and cohesion funds. Excessive budget deficits and rising unit labor 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.

But European budget policies pose another problem: How are they to be financed? The European Union must also command resources of its own. Today, more than 90 percent of the EU budget comes from national contributions paid by national treasuries, rather than from taxes levied on an EU-wide fiscal basis. This creates a classic collective action problem: the provision of collective goods is underfunded because member states seek to obtain individual advantages by minimizing their financial contribution, and so jeopardize 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 for financing the EU budget, since it would eliminate unfair tax competition in the EU and provide for a fair taxation of multinational corporations. A European tax could not 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 an eventual European government.

### 4.3 Macroeconomic management

Macroeconomic management must create an economic environment in which persistently low interest rates contribute to the acceleration of capital accumulation. It needs proper instruments and policies. Existing forums and instruments, such as the *Eurogroup*, the *Broad Economic Policy Guidelines* (BEPG), and 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 bind all policy-makers. This can be accomplished only by an institution that can command full democratic legitimacy at the European level.

<sup>2</sup> In Ireland and the UK it should be another foreign language.

The optimal policy mix requires the definition of 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 the aggregate, and at the same time more flexible to deal with shocks that affect different individual member states. 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 Economic Policy Guidelines* into a formal piece of European legislation that applies with strict and binding force to the member states of the euro area.<sup>3</sup> 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 that would allow borrowers to enter the capital market. This would oblige member states to respect their European commitments when formulating their national budget laws. But the borrowing entitlements must be transferable. If one government wishes to borrow more than it is entitled to, it must obtain additional permits from a 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 ensuring (1) that average European wage settlements remain fully consistent with the inflation target of the ECB, and (2) that national unit labor costs converge to the average level of the euro area. These two objectives require greater Europeanization of wage negotiations. Although collective wage contracts cover approximately 80 percent of wage setting in most Euroland member states, centralized wage bargaining at the European level is neither realistic nor desirable. Instead, a flexible system is required that takes the ECB inflation target and regional and sectoral developments, as well as national standards of living, into account. This can be achieved if wage bargaining follows 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. The *Integrated Guidelines for Growth and Jobs*, adopted by the European Council in 2005, accepted this rule, but action did not follow. 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 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.

## 5 Conclusion

The EU still has 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 that can ultimately be remedied only by creating a democratic government for Europe. But the practical objectives of increasing productivity and improving conditions for capital accumulation can trace out a progressive post-Lisbon strategy that will make it easier to tackle the institutional problems.

<sup>3</sup> The BEPG could also cover the convergence requirements for future Eurozone member states.



## 6 Our policy recommendations at a glance

1. To achieve the Lisbon goals, Europe's overall productivity must be substantially enhanced by fostering workers' 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 the 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 mobilization of private and national resources at the forefront of technological and industrial progress.
4. The *Cohesion Fund* should focus on catch-up growth in low income regions by increasing productivity and capital intensity at the regional level.
5. The *Globalization Fund* must be extended to ease the pressure on those who carry the burden and suffer from the consequences of social change and delocalization.
6. Public spending needs to be reevaluated and shifted from public consumption to investment under the annual *Broad Economic Policy Guidelines*.
7. Regional policy should increasingly be 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 Economic 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 region-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, that is, a European government must be created to assume responsibility for policies that concern all European citizens.



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