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Structural Reforms and Economic Growth in the EU: Is Lisbon the Right Agenda?

Thank you very much, Edi, for the kind invitation. Thank you to the Austrian National Bank. It is a great pleasure and a great opportunity to make a presentation on structural reforms and economic growth in this forum.

I thought that the idea that we need structural reforms for economic growth would be accepted by everybody in the room. So I decided to add a subtitle. Since the conference is about the perspective from the Lisbon agenda, I thought I would try to pose the question whether the Lisbon agenda is the right one in order to implement structural reforms and to promote economic growth in the EU.

Let me start by saying that there is a great deal of confusion about the meaning of "Lisbon agenda." I believe that "Lisbon" encompasses three different meanings. First of all, Lisbon is an objective, namely to make Europe "the most competitive and dynamic knowledge-based economy in the world" by 2010. Secondly, Lisbon is a strategy for coordinated structural reforms. And, finally, Lisbon is a method for implementing the strategy and reaching the objective of higher growth. The issue I want to discuss is whether Lisbon is the right objective, the right strategy and the right method.

First, the objective. The challenges that Europe is facing are enormous. We are confronted with rapid developments in demography, technology and globalization. These developments demand important structural reforms for all our economies. In addition, we are now involved in an unprecedented process of enlargement of the European Union. It is certainly a great political achievement, which might also result in important economic benefits for the Union as a whole. But it also raises a number of challenges. And the challenges in economic terms, it seems to me, come from the fact that the Europe of 25 will be more diverse than it has ever been before. We have already seen differences in economic situations, certainly since the 1980s, when Greece, Portugal and Spain joined the EU. But this time around, the economic differences across countries are far greater than ever before.

It seems to me that we do need to promote growth as the number one priority in Europe. As Commissioner Monti said earlier, we need to go beyond declarations of intentions and take action to implement structural reforms and foster growth. I think the growth priority is absolutely essential, at least for two economic reasons: one is the sustainability of the social model. We, in Europe, are very proud of different features of our social model. The key ingredient of our social model is solidarity. Solidarity is very important to European citizens and, indeed, it should be. But solidarity comes at a price. We need to produce more wealth if we want to redistribute it. Sustaining our social model therefore requires structural reforms and growth. I think that this is one of the realities of life in Europe political leaders must explain to the people. They must explain that the purpose of structural reforms is to promote growth in order to sustain our social model. Only by promoting growth, we will be able to retain the essential features of our social model.

But the other reason why growth is absolutely crucial is to make a success of enlargement. The countries that are now entering into the EU have great income disparities with the 15 incumbent Member States. As we very well know, the per capita income in the ten new countries is on average less than 50% of the average per capita income in the old EU-15. For enlargement to be a success, one needs to be sure that growth in these countries and growth in the EU in general accelerate in the coming years.

The debate on structural reforms and growth is not a new one in Europe. It was about 20 years ago that the then president of the Kiel Institute – a predecessor of my discussant, Dennis Snower, who will soon become the new president of the Kiel Institute – coined the expression "eurosclerosis." In the early 1980s, indeed, Europe was also very much in need of structural reforms to promote growth and employment. Europe did devise a strategy of structural reforms, the Single Market Programme (SMP). The objective of the SMP was to promote growth. The idea was to raise growth to the 3% mark. In reality, growth has severely declined over the past 20 years and today potential output growth in the EU-15 is barely 2%.

In the 1970s, potential output growth in the EU-15 stood at 3%. In other words, in one generation, i.e. in 25 or 30 years, we have lost one full percentage point of potential output growth in Europe. This compares with a situation in the United States, where potential output growth has increased during the same period from 3% to 3.5%. Today, therefore the gap between the EU and the U.S. is 1.5 percentage points of potential output growth, of which two-thirds is accounted for by the decline in EU growth and one-third by the increase in U.S. growth. The gap with the U.S. has been increasing, especially since the mid-1990s. But what is most worrisome is that the EU has lost ground compared with its own situation 25 to 30 years ago.

The upshot has been that convergence of per capita incomes between the EU and the U.S. has completely stopped in the past 25 to 30 years. In 1950, the GDP per capita of the EU-15 stood at about 40% of the U.S. level. By the mid-1970s, it had reached 70% as a result of faster growth in Europe than in the United States. Since the mid-1970s, however, the GDP per capita of the EU-15 has remained constant at 70% of the U.S. level. So we had a period of fast catching-up during the "Trente Glorieuses," the period of 30 years running from the end of World War II to the mid-1970s, followed by a period of stagnation in relative terms. There has been no more convergence for the EU-15 average. Obviously, the individual performance of Member States has varied a lot. It has been rather good in countries with relatively low incomes, namely Greece, Ireland, Portugal and Spain. On the other hand, it has been particularly disappointing in certain high-income countries like Germany and Italy.

This counter-performance appears to be the result of two trends: declining productivity growth and diminishing labour utilisation. Compared with the U.S., EU labour productivity has steadily increased and stands currently at about 90% of the U.S. level. However, the rate of increase of EU productivity has declined steadily. And for the first time since World War II, productivity growth since 1995 is lower in the EU than in the United States. At the same time, labour utilisation has sharply fallen in the EU compared with the United States. In 1970, the total number of hours worked per head of total population was higher on our side of the Atlantic. Thirty years later, it was barely 80% of the U.S. level. This is due, partly, to a reduction of hours worked per employee. But the main reason is the sharp reduction in employment rates in the European Union. Dividing the labour force into three age groups, less than 25, 25 to 55, more than 55, one finds that employment rates for prime-age workers (25 to 55) are very similar on the two sides of the Atlantic: they are identical for males and a bit lower for females. The main difference between the high employment rate of the U.S. and the low rate in the EU stems from differences at the two ends of the age spectrum. For young workers, the employment rate in the EU is 40% compared with 60% in the U.S., which reflects the very high youth unemployment rates in many EU countries, with levels of 25% to 30% in some cases. For older workers, the employment rate in the EU is again around 40% compared with 60%, which reflects the proliferation of early retirement schemes in many EU countries. The upshot is that the figure of 90% for EU labour productivity compared with the U.S. is an over-estimate, which compares the labour productivity on the two sides of the Atlantic by making an abstraction of the differential in labour utilisation rates. In other words, part of our apparent good performance is simply explained by the fact that EU labour markets have excluded workers at the two ends of the age spectrum which have on average lower productivity than prime-age workers. When the proper accounting is made, as the Banque de France recently did, one finds that EU productivity is closer to 80% than 90% of the U.S. level.

The EU performance is all the more surprising since the size of the home market, the high level of human and physical capital, the potential for catching up with the U.S. and the efforts made to promote more competition should together have provided a solid basis for sustaining above-average growth over a number of years.

Besides the vast costs of German reunification during the 1990s, there are three main reasons for the failure of the Single Market Programme in delivering higher growth.

First, the SMP was never fully implemented. Since 1993 the Single Market has been a reality for goods. On the other hand, service markets – including financial markets – remain highly fragmented. Yet, efficient provision of services, many of which are vital inputs for producers, is crucial for the growth of a modern economy.

Second, the SMP excluded the liberalisation of labour markets, which largely remains the prerogative of Member States. Yet, without such reform and greater labour mobility within and across companies, the liberalisation of product markets is unlikely to trigger the reallocation of resources necessary to produce higher growth.

Third, the conception and implementation of the SMP were rooted in yesterday's thinking. They were based on the assumption that Europe's fundamental problem was the absence of a large internal market that would allow European companies to achieve big economies of scale. It has now become clear that the problem lay elsewhere. In the modern world, characterised by rapid technological change and strong global competition, what Europe's industry needs is more opportunities for companies to enter new markets, more retraining of labour, greater reliance on market financing and higher investment in both research and development and higher education.

Now, is the Lisbon strategy the right one? My answer is yes because Lisbon addresses the three shortcomings of the SMP that I have just identified. Lisbon addresses the problem of the implementation of the Single Market, the problem of complementary policies and the problem of design.

The completion of the Single Market is an important part of the Lisbon strategy. This renewed commitment on the part of heads of state and government to indeed complete the Single Market Programme is crucial. But Lisbon also encompasses the modernisation of labour and social policies. This is an essential ingredient of reform for the success of the overall strategy and to promote growth. Finally, Lisbon puts a great deal of emphasis on the issue of innovation and knowledge. Innovation, as we all know, requires two elements. One is a competitive environment, which encourages firms to innovate. The other is the right public intervention. Europe needs more *and* better public investment in knowledge, i.e. in R&D and in higher education.

But the Lisbon strategy is more than these three ingredients. It is also a strategy for coordinated action in all the Member States. There is clearly an issue of economic governance in the EU that comes from the existing assignment of economic policies.

On the micro-economic side, we have policies that pertain to product and capital markets, which fall within the realm of the EU through the Single Market Programme. On the other hand, labour market policies are clearly within the domain of competence of Member States. This poses one set of coordination issues.

On the macro-economic side, we have monetary policy that, for euro area members, is squarely an EU policy, and budgetary policy, which is primarily a competence of Member States, but with a degree of coordination through the Stability and Growth Pact. This poses another set of coordination issues.

Is there a coordination problem in Europe? This is a very complex question, which I cannot address fully here. All I want to say is that Lisbon is an attempt to solve part of this coordination problem. First of all, Lisbon rightly recognises that reforms in product and capital markets cannot be dissociated from reforms in labour markets. We need to tackle all these micro-economic reforms simultaneously. Secondly, we need more coordination of macro-economic policies. I do not mean coordination between monetary and budgetary policy, which European central banks fear so much, although more dialogue between the ECB and the Eurogroup could be useful. Rather, I mean greater coordination

between national budgetary policies, which the Stability and Growth Pact has not provided thus far. Thirdly, there is the issue of coordination between micro- and macro-economic policies. Too often we hear national governments demand that the ECB changes its monetary policy and the ECB respond by demands that governments implement structural reforms. What we need, instead, is a "two-handed approach" whereby all governments undertake structural reforms, which then allows the central bank to conduct a more growth-friendly monetary policy.

In principle, therefore, a coordinated strategy like Lisbon seems very desirable since it deals with all markets at the same time and with both micro- and macro-economic policies. But there is a downside to coordination, as Otmar Issing has often noted. Coordination may lead to confusion of responsibility. By making all actors, national and EU ones, jointly responsible for every layer of policy, there is a danger that no layer is ultimately responsible for anything. The blurring of responsibility is certainly a danger that should not be underestimated. I believe that one of the explanations for the failure of Lisbon is precisely the confusion of responsibility between Member States and Community actors. Who is responsible for Lisbon? Is it the European Union or is it the Member States? The answer is obviously that they are both responsible and that failures of delivery cannot and should not be ascribed to one side by the other. Failures should instead be ascribed to the system of governance. Blaming the Commission or blaming the Member States is far too simple and simplistic. Overcoming the failure of Lisbon will require instilling a greater sense of responsibility, a greater sense of ownership in all actors alike.

Let me come to the last issue, the question of the method. Lisbon has certainly set extremely high ambitions, but at the same time we only have very weak instruments at our disposal. This naturally produces a delivery gap. And the question is what should we do about this? Should we give up on the objectives or should we adapt the instruments?

As far as I am concerned, I have no doubt that we cannot afford to give up on the objectives. The objectives, as I have said before, are to promote growth in this environment of tremendous change of demography and technology and globalization and the change associated with enlargement. We have to promote growth and we have to promote policies – ambitious policies. So that means therefore that we have to adapt our instruments in order to deliver on the Lisbon agenda.

We have already touched upon the differences between the Single Market Programme and the Lisbon agenda. One of the key elements of the Lisbon agenda is the method, the so-called "open method of coordination." This method has not been very successful so far. If it can succeed at all, its scope will have to be focused and its implementation strengthened.

But above all, I believe that one has to provide incentives in the system. There is a reason why governments are not implementing the reform policies. At the EU level, one should put into place elements that help governments to act. We should provide them with incentives, the EU should act as a facilitator, just as we suggested in our report.[1] One important tool that should be used for this purpose is the EU budget, which should be partly redirected towards fostering investment in knowledge activities. Besides, at the institutional level, this means that one needs to strive for improvements at all levels, at the level of the Commission, at the level of the Council and at the level of the Member States. Essentially, one has to, as I have pointed out before, take greater responsibility. That is the case within the Commission. I therefore support the idea of having a leading commissioner who coordinates the Lisbon agenda. I think one needs, also, within the Council

[1] *André Sapir, Philippe Aghion, Giuseppe Bertola, Martin Hellwig, Jean Pisani-Ferry, Dariusz Rosati, José Viñals and Helen Wallace, with Marco Buti, Mario Nava and Peter M. Smith (2004), An Agenda for a Growing Europe: The Sapir Report, Oxford University Press: Oxford.*

greater coordination provided by the Competitiveness Council, which also implies that, within each government, there should be greater and better coordination of economic reforms.

The EU needs a better budget. It needs a budget to meet its economic challenges: meeting the Lisbon agenda and making a success of enlargement. It needs a budget for the future, not a budget for the past. Commissioner Monti was kind enough to make reference to the proposals contained in our report. Lisbon and enlargement are the two crucial economic issues that require support from the EU budget. We proposed that the part of the EU budget devoted to internal economic policies be organised in three funds, one for growth, one for convergence and one for restructuring.

I believe that the Prodi Commission took a step in the right direction in February 2004 when it made its proposals for the 2007–2013 Financial Perspectives. It was not, however, as bold as we were in the report in shifting substantial resources from agriculture to growth as the Lisbon agenda would require. It was not able to, indeed, ignore the unanimous decision by the Member States to freeze agricultural expenditures until 2013, which leaves little room for manoeuvre to increase the part of the budget devoted to Lisbon – unless the budgetary envelope is raised altogether.

What do I conclude?

Conclusion number one: Europe does need high ambition. There is no alternative to structural reforms and policies to promote growth if we want Europe to adapt to the rapid changes in demography, technology and globalisation. If we want to sustain our social model and if we want to succeed with enlargement, there is no alternative to high ambition and high growth.

Conclusion number two: Lisbon indeed sets high ambitions. I think this is very good. I applaud fully this high degree of ambition. I would not propose that we give up. I think it would be a tremendous mistake if we were to say now because of enlargement we can no longer meet our objectives. These objectives are even more important to meet in this new environment.

However, and that is my third conclusion, Lisbon cannot succeed if it is not reformed. There are too many objectives in Lisbon, or let's put it differently, it lacks clear-cut priorities, and this is a problem. One needs to give priority to economic reform and growth. The agenda has been extended to also include the environment. I think it is very good to combine economic, social and environmental issues. But one nevertheless has to prioritize and, I think, the number one priority must be growth. In addition, one also needs to reform the instruments. There is true consensus it seems to me throughout Europe in favour of growth. There is also a huge amount of tremendous political capital that has been invested by leaders in the Lisbon strategy. And that, I think, is very good. We should now press them to move forward and to assume the leadership that is required in order to forge the necessary social consensus for reforms. The next few months will be absolutely crucial in reforming Lisbon. Let us keep the objective, let us keep the strategy, but let us reform the way to implement it. ❧