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A New Growth Strategy for Europe?

1 Introduction

Does Europe need a growth strategy? And if so, does it need a new growth strategy? These are the two questions I will address in the following.

In midth of the most severe economic crisis ever since the Great Depression, this year's economic forum in Davos has come up with an astonishingly optimistic scenario. According to a study by the Global Research Division of the Standard Chartered Bank (Lyons et al., 2010), we are about to experience a "super-cycle" of historically high growth over the next decades, propelled by booming trade, investment and urbanization. The 2004 Nobel laureate Ed Presott predicts that the "whole world's going to be rich by the end of this century."

There are reasons to be skeptical of this overly optimistic forecast, but even if we were to believe that a new golden area is ahead of us, pushing average GDP per capita up to unprecedented levels, this does not render thinking about growth strategies irrelevant. An equally distributed outcome is highly unlikely, and the successful post-war growth performance of EU Members States holds no promise for the future. This is not only an economic issue: The EU has a political role to play in this world, and its assertiveness will also depend on its economic weight in the world economy.

Hence, the EU definitely needs a growth strategy to keep its position as a relevant player in the world economy. The question that remains to be addressed is whether the EU needs a new growth strategy. In the following, I will argue that it does not. While I am far from claiming that the field of proper growth strategies is fully researched, I am convinced that we do know enough about where to go. Repeatedly reinventing official growth strategies does not help. We had better proceeded with the implementation of existing strategies; and certainly more focus is warranted. In the following, I will summarize what I believe we know about a proper EU growth strategy, emphasizing what I regard as particularly important.

2 A Few Words on the Crisis

In the aftermath of the financial and economic crisis, restoring confidence is and remains the top priority. The "longer uncertainty is allowed to linger, the greater the damage to confidence." (Eichengreen, 2010, p. 25). We cannot go on with business as usual. The roots of the financial and economic crisis have not yet been eliminated. The required steps have been spelled out in a recent VoxEU book by a group of leading economists in that field (see Baldwin, Gros, and Laeven, 2010). Since this is not the topic of this paper let me

just restate the key conclusions of the "eurozone rescue" report (Baldwin and Gros, 2010, p. 18):

In the field of monetary policy: i) embedding financial stability considerations into the ECB's policy mix, ii) clarifying the fact that the ECB is not a fiscal institution.

In the field of fiscal policy: i) clarifying the operational and legal framework of the Special Purpose Vehicle, including limits on the amount of fiscal transfers, ii) making the process of longer-term fiscal consolidations credible through the establishment of independent national fiscal boards, which are coordinated at the European level.

In the field of banking and financial market regulation: i) improving transparency by public release of stress tests, ii) acknowledging losses early, recapitalizing financial institutions with appropriate loss sharing by the private sector, ii) improved regulation at a European level to deal with cross-border bank failures, iii) introducing a European Debt Resolution mechanism.

In the field of competitiveness: i) repairing macroeconomic imbalances through wage adjustments, facilitated by labor market reforms, ii) dampening national wage and price developments undermining their competitiveness. And finally, accelerating structural reforms of goods and labor markets to enhance economic growth.[1] This leads me to the key topic of my talk.

3 An Agenda for a Growing Europe

We do need an agenda for a growing Europe but we do not need a new one. Such an agenda has already been worked out in considerable detail by a group of distinguished economists, headed by André Sapir, on request of Romano Prodi, president of the European Commission at that time. The conclusions of the so-called Sapir report are still valid today and call for an active implementation.

The Sapir report lists a six-point agenda for the EU and its Member States (Sapir et al., 2004):

– Make the Single Market more dynamic
– Boost investment in knowledge
– Improve the macroeconomic policy framework for EMU
– Redesign policies for convergence and restructuring
– Achieve more effectiveness in decision-taking and regulation
– Refocus the EU budget.

Unfortunately, it is no exaggeration to say that the report had no substantial impact on policy making of the EU and its Member States. For space constraints, I am not able to address each of its recommendations. Rather I will pick out three of them, which I regard as particularly important, highlight some recent research and consider the current state of the EU's economy policy in the respective field.

3.1 Make the Single Market More Dynamic

The Single Market is and remains the cornerstone of European economic integration. A functioning Single Market fosters competition within the EU, thereby increasing productivity and helping to improve the EU's competitiveness in the world economy. The EU is certainly on the right way here, but it needs to accelerate. The Single Market, launched in the mid-1980s, eventually came into force on 1 January 1993. Evidence suggests that the Single Market had its intended effect in manufacturing industries, but not for services (Badinger, 2007; European Commission, 2002). The *EU Services Directive* should have been the next step in this respect. A heavily revised version of the European Commission's original proposal was ultimately adopted in December 2006 and came into force at the end of 2009. This is more than 15 years after the Single Market should have

[1] *A detailed discussion and priorization of this long list is contained in Baldwin, Gros, and Laeven (2010) and the essays therein.*

been in place already! Even worse, recent studies suggest that the macroeconomic effect of the highly diluted Service Directive will be fairly modest (Badinger and Maydell, 2009; Badinger et al., 2008). While I do not want to downplay the achievements in EU integration over the last two decades, I conclude that we are still far from having established a functioning Single Market. A Services Directive II is highly warranted; and we have to speed up significantly. Similar arguments could be made with respect to the state of the European labor market.

3.2 Boost Investment in Knowledge

3.2.1 Human Capital

Let me hightlight the results of some recent research on the growth effects of human capital, which has turned to more elaborate measures of human capital in terms of cognitive skills, drawing on results of the PISA-type studies. Woessmann and Hanushke (2010) harmonize data on individual test scores in math, science, and reading over the period 1964–2003, aggregate them to the country level for a sample of OECD countries, and include these measures in a growth regression framework. Having estimated the growth effects of human capital they do some interesting simulations on the long-run growth effects of educational reforms over the period 2010–2090. In a nutshell, the simulation predicts that a uniform increase in all countries' human capital by a quarter of one standard deviation, would yield a growth rate that is on average 0.47% higher than in the counterfactual scenario of maintaining the status quo. Accumulating these income effects, their present value in year 2010 amounts to 288% of GDP. Bringing all countries to the level of Finland (the best performing country), the gains would be even larger, more than six times of the current GDP. Of course, one can challenge these point estimates, but taking half of the lower bound estimates, the effects are still enormous.

An as a non-negligible by-product, recent research on the non-economic effects of human capital has confirmed what one might intuitively suspect. Education generates numerous benefits that go beyond increases in productivity and economic growth: more education can i) lower crime, ii) improve health, and iii) increase voting and democratic participation (Lochner, 2011).

In the light of these results one would expect policy to have a clear-cut priority. At least in some EU Member States, the opposite is happening: budgets are reduced in real terms; true autonomy is refused to educational institutions, and structural reforms are often hindered by ideological prejudice. The outcome is not unexpected: The EU has achieved only one of its five educational targets laid down in the Lisbon strategy and concludes that EU Member States would need to invest an average EUR 10,000 more per student per year in higher education to catch up with the USA. (Council of the EU, 2010).

I wish to add that installing appropriate budgets for the education system is only half of the story. Optimizing efficiency and effectiveness of our education system is the other half of it. The results of the literature[2] suggest several

measures: investments in teachers' quality, autonomy in process and personnel decisions (combined with accountability), introduction of *choice and competition* between schools and universities (and between students). Educational checks are an old idea dating back to Milton Friedman – why not give it a try at the European level? Why not take up recent proposals to finance higher education and educational reforms through deferred graduate retirement? (Barakat, 2011) Some visionary policy perspectives are highly warranted here.

3.2.2 R&D and Innovation

There is a large body of evidence on the growth effects of R&D. To mention just one example, Griffith, Redding, and Van Reenen (2004) provide an assessment of the role of R&D (and human capital) as determinants of TFP growth in 12 OECD countries, and find a dominant role of R&D and human capital. They conclude that the "emphasis on human capital and R&D in modern growth theory is well placed." (Griffith et al., 2004, p. 893).

Where is the emphasis in current growth policies of EU Member States? The Lisbon strategy spelled out the target to raise total R&D expenditures to 3% of GDP and the Europe 2020 strategy sticks with this target. Helmers et al. (2009) consider the evaluation of total and business R&D and R&D capital in EU Member States since 2000 and conclude that R&D expenditures are stable and below target over time. The EU has not moved closer to its Lisbon target. The recent progress report on Europe 2020 does not suggest that this trend is about to change: "The compilation of all provisional national targets indicates an aggregated level of 2.7% or 2.8% of GDP, which is below the expected target of 3% GDP invested in R&D, but which represents a significant effort, particularly in the current budgetary context." (European Commission, 2011, Annex 1, p. 7). Resorting to budgetary constraints is no satisfactory answer. There are resources that could free up by structural reforms that are postponed from year to year, and there are resources that could be rechanneled from projects with much smaller returns.

3.2.3 Human Capital R&D and Technology Transfer

Apart from being the most important propelling forces of economic growth, human capital and R&D are also important determinants of the absorptive capacity of countries and regions, facilitating technology transfer and catching up. Benhabib and Spiegel (1994), Griffith et al. (2004), as well as Kneller and Stevens (2006) provide strong and convincing evidence on this second face of human capital and R&D. In this respect, we should not forget about information and communication technologies. Wolff (2011), using data

[2] *See Woessman and Hanushek (2010b) for a survey on the determinants of schooling quality.*

for the USA over the period 1958 to 2007, finds strong evidence that the magnitude of R&D spillovers has increased sizably over time, a result which he attributes to the penetration of the US economy with ICT technologies. No good news from this side as well: "Europe's gap is even larger in ICT and other non-transport equipment industries." (Helmers et al., 2009, p. 42), a fact the EU Commission is well aware of. The "Commission will propose measures to speed up and modernize standard setting in Europe, including for ICT." (European Commission, Annex 1, p. 5). Again, the key question is whether the proposed measures will be implemented by EU Member States.

4 Improving the Macroeconomic Policy Framework, more Effectiveness in Decision-Taking

The uncoupling of monetary policy from short-run considerations by the establishment of independent but accountable central banks is one of the great success stories in recent economic history, and we should work hard on establishing – at least to some extent – a similiar framework for fiscal policy as well. In light of the recent experiences, I think that EU Member States need fiscal rules, established at a constitutional level, not only the ensure sustainability of fiscal policy, but also to limit the room for discretionary fiscal policy, which has been shown to increase output volatility and thereby to reduced economic growth.[3] No rule fits every situation, of course. The way forward would be to combine "judgment and discipline" by the establishment of independent fiscal councils and their coordination at a European level (see Fatás and Mihov, 2010; Lane, 2010). Inevitably, a better macroeconomic-policy framework with enhanced coordination, monitoring, and enforceement will require more supra-nationality in EU politics. This may still sound utopian, but we should not forget that some decades ago, the present state of the EU would have also appeared utopian at that time. Of course, it is a highly complex question how can we improve the EU's capability to act while at the same time hold up a proper balance of institutions and democratic legitimacy and I do not pretend to have a simple answer on that. This is clearly a field where more interdisciplinary research is needed.

5 Conclusions

Europe needs a growth strategy but it does not need a new one. Apart from dealing with the aftermath of the crisis, there are two main priorities: completing the Single Market and boosting investment into human capital and R&D. These are the key instruments to generate long-run growth and to facilitate positive spillover effects. We should not forget, however, that most "of these measures have to be executed at the national level. The EU – in its current state – can only provide a framework and coordination." (Baldwin and Gros, 2010, p. 25). Hence, we should not blame the EU for the omissions of its Member States. Both the EU and its Member States must commit themselves to act and to "finish the job of restoring stability and prosperity in Europe. The European flotilla may have run aground, but it needs not sink. This will require coordination, teamwork, and discipline. All hands on deck!" (Baldwin and Gros, 2010, p. 21).

[3] *See the seminal paper by Fatas and Mihov (2004) and Badinger (2008) for evidence on OECD countries.*

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