Sant'Anna Legal Studies

STALS Research Paper n. 14/2008

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*https://stals.sssup.it*

ISSN 1974-5656

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**Abstract**

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 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.

**Keywords**

Lisbon strategy, Reform Agenda, growth and employment, macroeconomic coordination.

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SUMMARY: 1. Introduction. – 2. Lisbon Strategy's underperformance. – 3. Productivity and employment. – 4. Managing Europe's economy. – 5. An Agenda for Growth and Employment in Europe after Lisbon. – 6. Conclusion.

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**Keywords**

Lisbon

## 1. Introduction.

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

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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 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.

2. Lisbon Strategy's underperformance.

The Lisbon Strategy in 2000 sought structural reforms by creating the knowledge society, to raise productivity and to overhaul the European social model.

Macroeconomic management aimed at 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 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 desirable reforms. Furthermore, in

2005 the Barroso-Commission took a turn to a neoliberal, conservative interpretation of the Lisbon Strategy. 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 has been 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 – a significant slowdown in labour productivity has occurred. Because labour markets have become more flexible at the lower end, firms have hired people, whose productivity was lower than the average.

In the long term, productivity determines the level of real wages. It is also necessary to secure the European social model and welfare. Thus, accelerating the growth of productivity is the economic challenge for the next decade for Europe, but also particularly for Italy, which is the worst performer.

Europe must achieve both: higher employment *and* higher productivity. The question is: how?

## 3. 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 cannot be seen independently of investment. 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, if capital intensity (i.e. the amount of capital per person employed) 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. But higher capital accumulation would also improve the quality of the capital stock, as new technologies support the preservation of natural resources, protect the planets climate and improve people’s health and live expectancy.

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 had the desired impact on TFP, but hopefully will do so in the future. This is wishful thinking. The Commission does not analyse the macroeconomic and institutional obstacles to a more 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 institutional free-rider incentives, which create collective action problems.
Furthermore, capital intensity is at least as important for labour productivity growth, if not more, than supply-side reforms. Thus, tackling the problem of the EU productivity slowdown requires *more* than the pursuit of structural reforms. 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.

## 4. Managing Europe’s economy.

Macroeconomic management in the next decade must 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 not be put into question. But this does not mean that other macroeconomic variables and policies should be ignored. Interest rates are the most important variable, given that 90% of Euroland's GDP is traded within the monetary union and only 10% are affected by exchange rates. Public debt may compete with private investment for the allocation 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 is then 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.

*Fiscal policy*

While monetary policy has a coherent institutional framework, this cannot be said about budget policy. Within the restrictions of the Excessive Deficit Procedure, national governments are autonomous and the aggregate fiscal stance is random. This fact is one of the major obstacles to sustained accelerated growth. If the aggregate budget deficit of the Euro area exceeds potential output, inflationary pressures emerge. In this case the Central Bank has to raise interest rates and mop up the excess demand. Thus, balanced budgets support capital accumulation.

However, because in Europe national governments determine their fiscal policy autonomously, Europe's institutional framework is not conducive to such a 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 on average 1.7%.

*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, except in Greece, Spain and Italy where it is higher than the inflation target. The wage developments in these countries contribute 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 labour cost from rising. This implies that if German wages were to increase faster, Spanish and Italian wage increases would have to slow down and/or labour productivity rise.

These diverging wage dynamics affect the relative cost competitiveness of businesses located in 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. Italy has lost its competitive advantage, with which it entered the Eurozone. These developments increase social and economic tensions in Euroland and could become politically destabilizing. 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:

Bring aggregate wage settlements closer to the inflation target plus productivity so that the purchasing power of consumers is increased (an issue particularly acute in Germany) without accelerating inflation.
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, especially in Italy.

5. An Agenda for Growth and Employment in Europe after Lisbon.

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

*Institutional reforms*

Most of the difficulties encountered by the Lisbon Strategy are due to lack of responsibility. The EU has no government that could implement coherent policies. Despite strong reluctance to address the fundamental issue of institutional reforms in the European Union, they are an essential task for the future of the EU. The way forward is building European democracy, the *Europe of citizens.* 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 an 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. They should design a policy where microeconomic structural reforms are integrated in a macroeconomic strategy that is supported by the democratic choice of citizens.

*Structural reform agenda*

Supply side reforms can improve overall labour productivity. Competition serves the interests of European consumers, particularly in the lowest income categories, because local cartels and monopolies keep prices excessively high and are thereby rationing consumer demand. Especially in Italy this explains the high rate of consumes inflation.

However, for too long, Europe has focused exclusively on microeconomic reforms. 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, co-determination and board representation of workers in European firms.

The Knowledge Society remains a valid policy objective. Furthermore, the objectives with respect to Research & Development and Live-long Learning have not been met under the old Lisbon Strategy. Given that nation states seem incapable to fulfil their objectives, European institutions should come to their help. Government failure by the nation state needs to be fixed at the European level.

Knowledge is based on communication. Studies show that speaking a foreign language, especially English, is a powerful factor in increasing Total Factor Productivity. With only 29% of the population speaking English, Italy is at the bottom of the former EU 15. All EU member states should impose learning English at primary school level.[1] A newly to be created European Teacher and Student Exchange Service could accelerate the build-up of language skills.

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

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. 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. This investment could be financed by issuing Union Bonds. 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. The best way of doing this is to put attention on overcoming regional differences in productivity and capital intensity rather than creating transfer dependency.

However, 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 come from 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. 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 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. But a 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.

*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 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 Economy Policy Guidelines* into an instrument of fiscal federalism. The Guidelines would set the authorized *aggregate* deficit targets for all public authorities (from municipalities to regions, nations and the EU budget), somewhat resembling a European DPEF. Against these authorizations borrowing permits could 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 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 objective require a greater Europeanisation of wage negotiations. Although collective wage contracts cover approximately 80 % of wage setting in most member states of Euroland, 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 productivity developments as well as national standards of living into account.

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, decided by the European Council in 2005, accepted this rule, but actions 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 openly accessible forum. The present Macroeconomic Policy Dialogue does not achieve this visibility. Policy issues that concern all citizens should be discussed in the European Parliament. 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.

## 6. 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 suffers from collective action problems, which ultimately can only be remedied by creating a European democracy. 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.