# How to Get the Lisbon Strategy Back on Track

*Halfway through the Lisbon process, achievements have in many respects fallen distinctly behind the ambitious aims set by EU heads of state and government in March 2000. What has gone wrong? What changes are required to get the process back on track? Is a Lisbon strategy, even a reformed one, really needed?*

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## Do We Really Need a Lisbon Strategy?

When it was launched, with much fanfare, in March 2000, the Lisbon Strategy was hailed as a breakthrough for pro-market reformers and was widely portrayed as an opportunity to catapult the EU on to a higher growth trajectory. Some of the rhetoric surrounding Lisbon, notably the much-repeated phrase about becoming "the most competitive and dynamic knowledge-based economy in the world", has, deservedly, attracted as much derision as sympathy. Equally, the principal aims of the strategy were broad enough to command a consensus and most of the targets embodied in the strategy are uncontroversial.

Five years on, the evidence is compelling that the strategy has, at best, only had sporadic success. Most Member States can point to some areas where they have managed to make progress, but even in terms of headline goals it is plain that Lisbon has suffered from a delivery gap. Thus, even as early as its spring report in 2004, the Commission[1] acknowledged that the target of a 70% employment rate by 2010 was beyond reach, although it took comfort from the fact that there had been solid progress towards the more specific target of raising the female employment rate to 60%. Similarly, the OECD,[2] in its latest assessment of the euro area, pulls no punches, stating that "structural reforms, required to move the euro area economy towards the ambitious targets set by the Lisbon summit in 2000, have been hesitant and piecemeal."

This article explores three key questions about the Lisbon strategy. First, it considers what has gone awry and how the problems can be explained. Second, it assesses the proposals for change, culminating in the decisions taken at the 2005 spring European Council. Third, the article poses the question of whether even a reformed Lisbon strategy is, ultimately, needed.

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[1] European Commission: Delivering Lisbon. Reforms for the enlarged union, COM (2004) 29 final/2, Brussels, 20.2.2004.

[2] OECD: Economic surveys 2004 - Euro area, preliminary edition, Paris 2004.

### Why Is Lisbon in Trouble?

The Lisbon strategy is one of many processes of economic policy co-ordination in the EU, some of which – the Stability and Growth Pact, for example – are embodied in "hard law", while others are no more than agreements ("soft law") by Member State governments to pursue common policy aims. One of the policy innovations that came out of the Lisbon European Council was the adoption of the open method of co-ordination (OMC) as a means of reconciling national autonomy in the relevant policy areas with having a common approach. An extension of the Lisbon agenda was agreed in 2001 by the Gothenburg European Council which adopted a three-pillar approach to sustainable development comprising the simultaneous pursuit of three dimensions of economic development – competitiveness, social cohesion and environmental protection. This is, unambiguously, a long-term set of goals and, in contrast to the 2010 date set for Lisbon, did not have a target date for achievement. The inference to draw was that sustainable development was to be seen as the over-arching framework, whereas Lisbon was an intermediate goal.

With hindsight, the major weakness of the Lisbon strategy was that its governance simply had not been thought through. By articulating ambitions to accelerate structural reforms, while emphasising social cohesion, and setting quantitative targets such as the 70% employment rate or (as decided subsequently at the 2002 Barcelona European Council) increasing annual spending on R&D to 3% of GDP, the strategy could have helped to establish a momentum for change. But an evident flaw in OMC was that its scope for putting pressure on governments to conform was just too limited, and the fact that Lisbon came to encompass such a wide range of policy initiatives was also problematic. For example, no fewer than sixteen "action plans" have been associated with Lisbon, engendering a risk of "process fatigue" and the strategic thrust of Lisbon seems to have become lost in the flood of targets. The Kok report,[3] in particular, was highly critical of the lack of progress, blaming a lack of political commitment and the proliferation of objectives.

Moreover, it can be argued that the role of the European institutions, especially the Commission, was too vague. According to paragraph 41 of the Lisbon Presidency conclusions: "The Union's role is to act as a catalyst in this process, by establishing an effective framework for mobilising all available resources for the transition to the knowledge-based economy and by adding its own contribution to this effort under existing Community policies". Yet it has always been unclear how the Union should carry out this role, while the financial resources available to support such a contribution from the EU budget were, and are set to remain, limited.[4]

Lisbon may well also have been a victim of unfortunate timing. Early in 2000, with the euro freshly launched, an economic upswing in progress and confidence high, the statement in the Lisbon presidency conclusions (paragraph 3) that "the Union is experiencing its best macro-economic outlook for a generation, … the euro has been successfully introduced and is delivering the expected benefits for the European economy" must have seemed tenable, however Panglossian. Yet within months, the EU economy slumped and in the five years following the launch of the strategy, EU growth was barely half the rate of 3% on which it was predicated.[5] It may be a statement of the obvious, but the lack of growth has severely hampered the strategy, not least because it is much more difficult to achieve structural reforms against a backdrop of economic stagnation.

Differences among the Member States have compounded these difficulties: it is countries such as France, Germany and, especially, Italy which have witnessed the worst conjunctions of low growth and halting progress. By contrast, three Nordic Member States score well on most of the Lisbon indicators. These differences are not solely, or even mainly, the result of an inadequate commitment to the Lisbon strategy by the laggards, because in many cases they started from much worse positions. Italy, for example, had an employment rate in 2000 barely above 50%, whereas Denmark and Sweden already met the target. Similarly, Finland and Sweden exceed the 3% of GNI target for investment in R&D, whereas a majority of Member States are around or below 1%. Nor has it been clear to what extent labour market reform – clearly at the top of the political agenda in countries such as Germany,

[3] Facing the challenge: The Lisbon strategy for growth and employment. Report from the High Level Group chaired by Wim Kok, Luxembourg 2004: OOPEC.

[4] I. Begg: Funding the European Union, London 2005, The Federal Trust for Education and Research.

[5] Paragraph 6 of the Lisbon conclusions states "if the measures set out below are implemented against a sound macro-economic background, an average economic growth rate of around 3% should be a realistic prospect for the coming years."

witness the four rounds of "Hartz" measures – is part of the Lisbon agenda.

It is not all gloom; as Murray and Wanlin[6] point out, there have been successes in dealing with pensions reform, in financial services and in opening-up network industries. In addition, although headline targets such as the 70% employment rate will clearly not be attained by 2010 as originally envisaged, it is conceivable that, on present trends, they will be met two or three years later, though only if growth rates recover and remain robust.

### The 2005 Re-launch of the Lisbon Strategy

Many of the changes to the Lisbon strategy proposed by the new Commission in January 2005 were derived from the work of the high-level group chaired by Wim Kok. The Kok report observes that "there is no single magic bullet that will deliver the higher growth and jobs that Europe urgently needs". Instead, reforms are adjudged to be needed in a range of areas that includes a more flexible labour market, an intensification of competition and the promotion of knowledge-intensive activities, as well as appropriate macroeconomic policies. It is in this sense that Lisbon amounts to a strategy rather than piecemeal initiatives: together, they are expected to add up to more than the sum of the parts.

The revamping of the Lisbon strategy agreed by the European Council on the 23rd of March 2005 puts two ambitions at its heart:

- A re-focusing on growth and jobs
- An attempt to engage the commitment of Member States by a new form of governance

The first of these ambitions is consistent with the Kok recommendation to concentrate the policy effort on a smaller number of aims. The implication is that the environmental and social cohesion objectives of the EU's sustainable development strategy will play second-fiddle to the competitiveness objective. While Kok was probably correct to argue that the proliferation of targets, processes, committees and documents had become excessive, the risk is that initiatives in strategically important components of the other two pillars will lose momentum. It is also important to recall that many elements of the environmental agenda have considerable potential for promoting growth: the EU could, for example, expect to build on its advances in new energy technologies to become the global leader in what will be a large market. Thus, the risk is that the new focus of the Lisbon strategy will overlook the considerable potential for an investment strategy focusing on sustainable development to be a catalyst for growth and job creation

On governance, the key change is that Member States have agreed to produce and implement a national reform programme. This will be complemented by a "Lisbon Community Programme" to be adopted by the EU level. The Member States are enjoined to involve all levels of government, national parliaments and the social partners in the national programmes, with the word "ownership" prominent in the reasoning. The March 2005 agreement rejects a key recommendation of the Kok report, namely the idea that there should be a process of naming, shaming and blaming Member States that fall short on their commitments to reform. This is precisely the problem that bedevils the open method of co-ordination. If there is no price to be paid by Member States that do not deliver, then where is the incentive to accelerate reforms, especially if (as is most often the case) pain precedes gain from structural reforms? It seems that the Member States want to maintain a diplomatic silence about their fellow members.

To flesh out the two ambitions, the spring 2005 conclusions identify three priorities (knowledge and innovation as the engines for a sustainable growth; making Europe more attractive to invest and work; and more jobs for more social cohesion). Ten "areas of action" are then delineated. As with the original Lisbon agenda, the three plus ten constitute a wish-list that hardly anyone would oppose. Yet this "motherhood and apple pie" menu contains the seeds of its own irrelevance: if all the areas of action are self-evident, the question that is inevitably prompted is what is the added value from bringing them together.

### The Purpose of Lisbon

The rationale for any form of economic policy co-ordination is that there is an EU level interest in countries pursuing similar policies. Despite the reservations about whether the Stability and Growth Pact (even as reformed on the 20th of March 2005) is well-conceived, there is at least a rationale for fiscal policy co-ordination to prevent free-riding, to exert a discipline that lessens the risk of an incompatibility between fiscal and monetary policy, and so on. In the Lisbon strategy,

[6] A. Murray, A. Wanlin: The Lisbon scorecard V: Can Europe compete?, London 2005, Centre for European Reform.

however, a common interest is not especially well articulated. Manifestly, a country will benefit macroeconomically from the increased demand that emanates from higher growth in other Member States, so that to the extent that Lisbon promotes higher growth everywhere there is a pay-off to co-ordination. But though growth is the objective, it does not follow that countries need the same mix of policies to achieve it.

In the open method of co-ordination, the expectation is that countries will learn from one another, that targets or benchmarks can be used to guide policy, and that peer review and other forms of scrutiny will serve to hold governments to account. Seen from an optimistic perspective, OMC is supposed to be a positive influence aimed at improving policy, rather than a disciplining mechanism that constrains, and will work so long as governments are prepared to invest political capital in the process. The trouble is that the evidence generally suggests that the optimistic perspective is not supported, nor is it easy to find a way to make it more credible. Targets (such as the 70% employment rate) are credible, have been shown to be attainable by the best performing Member States and should therefore be retained. But it is clear that because of the macroeconomic stagnation of recent years, neither the various interim nor the 2010 values for the targets are plausible for a majority of indicators.

The question that then arises is whether the reforms now proposed will enable this vision of OMC to become more effective. One solution would be to maintain the broad thrust of the Lisbon strategy, but to introduce a little flexibility into the timing. It would not, after all, matter greatly if key targets were achieved in 2012 or 2013, rather than 2010. The danger, however, is that any such relaxation would be used by recalcitrant governments as a pretext for putting off reforms. But still there needs to be both an incentive for governments to conform and some means of putting pressure on, or even punishing, those that do not.

Incentives are likely to remain limited because there is so little scope within the EU budget for explicit measures to support the Lisbon strategy. In its proposals for the 2007-13 financial framework published in February 2004 and elaborated in July 2004,[7] the Commission does suggest more spending on policies to promote "competitiveness for growth and employment", but even if they were accepted without alteration (unlikely, given the strong demands from the EU's principal paymasters for a lower overall budget), the net new money amounts to just 0.1% of EU GNI.[8] Consequently, any suggestion that EU funding might be used to reward virtuous governments seems implausible, so that it is hard to see how the Community pillar of the Lisbon strategy can contribute much in resource terms.

If there are few carrots, what about sticks? The Kok scenario for the future of Lisbon advocated a more effective form of naming and shaming as a key part of the way forward, and might therefore have been a means of pushing governments to act. However, amid metaphors about not being treated as naughty schoolchildren, even such moderate reprimands were rejected. Instead, the proposals endorsed in March 2005 will leave the onus largely on Member States and the workings of domestic politics. As a result, it is hard to see what co-ordination will bring to the party, other than take-them-or-leave-them targets that Member States are perfectly able to articulate for themselves, and a bureaucratic obligation to report on progress. In short, the added value of Lisbon is elusive.

The EU level does still have a vital role to play in establishing the regulatory framework and there has been a tendency to embrace issues such as the contested services directive or the financial services action plan within the Lisbon strategy. But these regulatory aims are analytically distinct from the objective of co-ordinating the supply-side reforms initiated by Member States. Whether, or how quickly and comprehensively, to move ahead with liberalising the EU internal market is a big question that will have an influence on the EU's underlying competitiveness in the global economy. It does not, however, directly impinge on how determined the German or Italian governments are to confront their structural problems, the decisions by Spain or the UK on raising spending on R&D, or the efforts by the new EU members to raise their employment rates.

Thus, it is in domestic political economy that the main challenges lie and the history of the Lisbon strategy does not afford much confidence that Member States will pay much heed to the demands from "Brussels" for a co-ordinated response. In these circumstances, it may be best to admit defeat by dispensing with the Lisbon strategy.

[7] European Commission: Financial Perspectives 2007 – 2013, Communication from the Commission to the Council and the European Parliament, COM(2004) 487 final, Brussels, 14.7.2004.

[8] I. Begg, op. cit.

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# Lost in Translation

At the beginning of February, four European journals (Handelsblatt, Le Figaro, Il Sole 24ORE and Wall Street Journal Europe) published a letter by Gordon Brown, Hans Eichel, Hervé Gaymard and Domenico Siniscalco. In the letter the four Ministers stress the progress made with the Lisbon agenda by Germany, France, Italy and the UK. It appears to be the same text translated into four different languages. But the English version argues strongly in favour of "pushing forward boldly with liberalisation and economic reform", whilst the French version does not mention the "liberalisation" at all and only advocates generic "réformes économiques". The German version is very short, almost concealed in the internal pages of the newspaper and the full letter is not even on the website of the Bundesfinanzminister. The Italian version is on the front page of Il Sole 24ORE and includes a long paragraph on Italy which is missing elsewhere. This Italian addition advertises a (still pending) reform of the Italian secondary school system and financial incentives to firms (not yet approved by the government).

This is a clear demonstration of the disconnection between the language of the intergovernmental meetings and the public debate in individual countries. At the Council meetings, the Heads of Government make very ambitious commitments, but as soon as they are back home they forget about them as they deal with national lobbies. Four years ago in Barcelona, European leaders officially decided to increase the effective retirement age by five years before 2010. Back home, they all forgot to inform their compatriots of this historic (perhaps not very popular) decision.

The Lisbon process as a whole got "lost in translation" somewhere along the line. In order to revitalise it, a common language should be adopted. And a much simpler one.

First, there ought to be far fewer targets. Lisbon-1 had 117 indicators. Lisbon-2 (the Commission's recent Action Plan) still has too many. To select a few criteria, the following principles may be applied. Targets should

- refer to variables under the control of governments (otherwise one may end up rewarding only lucky governments);
- be consistent with the allocation of tasks envisaged in the constitution signed in Rome last spring.

It is easy to check that most of the "Lisbon indicators" fail either the first or second of these conditions. For instance, EU-wide targets in terms of employment rates (overall and by gender or age groups) would not pass the test. After all, it makes little sense to ask Sweden (with a current employment rate higher than in the USA) to increase it even further when there are other countries (including mine) in Europe where almost 50 per cent of the working-age population is out of work. A Lisbon target should be defined instead in terms of yearly flows of legal migrants relative to the European population. This would prevent the lack of coordination in migration policies leading to unrealistic restrictions, support growth and reduce illegal migration. Another example is an EU-wide R&D spending threshold. Once a few targets have been selected in this way, it would also be possible to introduce enforceable sanctions for countries systematically deviating from the targets.

Second, there ought to be just one unique national Lisbon plan (rather than a number of parallel plans, from stability and convergence to competition, from poverty to employment) encompassing all the various dimensions of economic policy as these are clearly interconnected (not lastly because of the overall fiscal constraint). This unique plan should be approved not only by governments but also by national parliaments, which should receive the commentaries of the Commission on the plans produced by national governments in time to influence them. This would enable supra-national authorities to talk directly to European citizens, highlighting the advantages of competition and other public goods provided at the European level. Clearly, supra-national authorities will have to prove to be apt for this task. Rather than producing national policy reviews which offer a rich menu of rhetorical statements, they should be sharp in documenting the costs for families and firms associated with delays in, say, regulating highway tolls or allowing for more competition in the banking sector. The Commission is in the right position to do this as it can compare the performance of countries which have reformed these features with those of countries that have not.

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# Poetry and Reality about the Future of the Union: Reflections on the Dimensions and Nature of the Re-launch of the Lisbon Strategy

Ever since its adoption in March 2000 the Lisbon Strategy of the European Union has been seen in at least two dimensions. On the one hand, it was seen as a resolute turn away from the concept of "fortress Europe", but also from the more federalist vision of European integration that would have gradually de-emphasised the role of nation states as ultimate power brokers.[1] Meanwhile it was also meant to be different from the large body of EU guidelines and directives with an ambiguous or openly non-binding status. In order to attain this, concrete tasks were listed and regular six month monitoring by the Council was introduced into its method of operation. It has been emphatically suggested by the adherents of this approach[2] that the reference to concrete and measurable tasks as well as reliance on the "open method of coordination", yet another form of soft law, aimed at transforming the polity of the EU in its entirety[3] were the major institutional innovations that were to produce palpable efficiency gains.

The Lisbon Strategy has indeed been different from, say, the Stability and Growth Pact which contains only a few, if contested, but clearly operational objectives. By contrast, the Lisbon Strategy contained no less than 28 main objectives, 120 sub-objectives and 117 indicators that were to be followed and reported. Moreover, with the enlargement of the Union no less than 300 annual reports are to be produced in order to check progress. It is hardly coincidence that for several observers, especially for ones coming from the new member states with the vivid memory of Comecon, there is a strong resemblance to the related practices of the Red Bloc in terms of Gorbachev's Long Term Comprehensive Programme of Technological Development until the year 2000, as adopted in 1986.[4] This resemblance, while it certainly does not pertain to the substance and the workings of the European market integration, emerges on several planes. One is the focus on quantitative objectives with the parallel neglect of means. Second, there are commonly set targets without previously dovetailed national plans of implementation, with reference to national diversity, but in reality reflecting the lack of consensus on a number of matters of substance. Finally, in both cases there is an obvious technocratic attempt to replace the market with organisational measures adopted at the political level and elaborated by technocrats, thereby wishing to circumvent the trial and error processes inherent in the functioning of markets in general and in the fostering of innovation in particular. Last but not at all least, in both cases the explicit attempt to keep up the pace of competition with the world champion in innovation, the United States of America, has played a defining role.

In the case of the Lisbon Strategy features of a political compromise outcome, so typical of any EU document, have been manifest from the very outset. On the one hand, the priority given to global competitiveness, up to the point of aiming at the position of the "most competitive community of the globe" and the related focus on R&D and flexibility stood in stark contrast to salient features of the national economic policies in most core EU states. The latter have aimed at preserving rather than transforming the basic features of the social model that lay at the heart of the lack of competitiveness. In the core EU countries like Spain, Germany and France the focus is still on redistribution rather than incentives, and with the dominance of low politics over high politics and economic considerations alike.[5] The latter is particularly obvious

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Useful contributions by Etele Baráth, Dóra Győrffy, Julius Horvath and Zdenek Kudrna are appreciated, without implicating their agreement.

[1] L. Práger: Opening towards a globalized world, in: European Mirror (a bimonthly publication of the Office of the Prime Minister of the Republic of Hungary), special English language edition, Budapest 2001, pp. 85-86.

[2] In more academic terms in the volume edited by M. J. Rodrigues: The New Knowledge Economy in Europe: a Strategy for International Competitiveness and Social Cohesion, Cheltenham/UK and Northampton/Md/USA 2002, Edward Elgar.

[3] S. Borrás, K. Jacobsson: The open method of coordination and new governance patterns in the EU, in: Journal of European Public Policy, Vol. 11, No. 2, 2004, pp.185-208.

[4] L. Csaba: The role of the Soviet Union in CMEA industrial policy cooperation, in: Communist Economies, London 1990, Vol. 2, No. 1, pp. 47-60.

in the ongoing debate over softening up the Stability and Growth Pact based on ambiguous economic argumentation at best.[6] It is even more manifest in the inability of most, though not all, core EU states to reform their unfunded, pay-as-you-go pension systems, which recent political economy analysis has shown to reflect the political concerns of an ever ageing electorate against a smaller and less active young generation, that should be the stronghold of economic/financial sustainability considerations. In reality, thus the explicit and implicit increases of contributions and/or the explosion of general government deficit is becoming the name of the game in many western democracies.[7]

**Ebbing Dynamism of the Integration Process**

Not meeting the business and R&D criteria, however, does not translate into a better meeting of social, environmental and other criteria such as those related to employment and better quality education across the board. The latter should qualify as an attainment in its own right – allowing for a more decent life – and a major contribution to the Lisbon goal of increasing the participation rate, especially of able-bodied middle-aged persons, many of whom are typically retiring in Europe at ages when their career would start to climax in the USA or Japan. In the eurozone, for instance, labour participation rates grew from 67.6 per cent in 2000 to a mere 68.8 per cent by the end of 2004, while the rate of unemployment even grew from 8.5 per cent in 2000 to 8.9 per cent by the end of 2004.[8]

Missing the employment targets is all the more embarrassing, since the pro-employment priority figures high on the agenda of each and every EU government and of the Lisbon Strategy as a whole. If we take a look at the structural indicators elaborated by the Commission to check the progress made in the Lisbon Strategy,[9] we find an extensive list of employment related ones, a series checking youth attainment, the progress of R&D and of social cohesion, as well as progress in protecting the environment. By contrast, the business agenda – covered by "economic reform" – is neither extensive nor particularly innovative.

From this angle we may well not be perplexed to find that the reference to the Lisbon goals has become a decreasingly important, mostly ritual element in the discourse on the European Union. Going through the books – including textbooks – published in the past five years, or through the contents of major specialised journals on the European Union we may well be surprised to observe that what allegedly should have been the core strategy of the Union, has in fact been crowded out by other themes. The latter include the security drift between the USA and a part of the EU in the post September 11 period, the fate and substance of the Stability and Growth Pact, the debates over the major redistributory policies of the Union, the CAP and structural funds, the ongoing debate over the financial guidelines for 2007-2013, managing accession, the question marks over the further accessions of Croatia and Turkey, the changing role of Ukraine and Russia, immigration policy, the Constitutional Treaty and the stance to be adopted in the Doha Round of world trade talks, to mention just a few.

This state of affairs is the reflection of the broader problem of the ebbing dynamism of the European integration process. In reality, each of the big projects currently in the phase of either implementation or consolidation, such as the single market, the single currency or enlargement, all originate with the grand old trinity of Delors, Kohl and Mitterand. No major initiative has emerged since 1989/1990 that would have transcended the status quo, or would have put new issues on the agenda. As a matter of fact, the quite limited success of the three intergovernmental conferences of Turin, Nice and Laeken culminated in a constitutional treaty that falls short of any substantive feature of a Constitution, and moreover is confined to consolidating the status quo ante.[10] Lacking the common political denominator is both a cause and a consequence of the lack of longer term vision, especially for Europe (and most unlike some of the reformatory zeal within some member states, such as Britain or Sweden, or the new member states).

**The Kok Report – Findings and Proposals**

Under this angle the formation of the new Commission and the new European Parliament in November 2004 allowed and called for a reassessment. The High Level Group of Reflection, headed by former Dutch Premier Wim Kok produced a soul-searching situation assessment.[11] The language, as well as the factual material presented, went beyond the usual tone of

[5] So-called active labour market measures, as well as expanding higher education without quality control, have exerted ambiguous impacts at best on the labour markets of EU countries, old and new alike.

[6] L. Csaba: A non-stability and anti-growth pact for Europe? in: L. Csaba: The New Political Economy of Emerging Europe, Budapest 2005, Akadémiai/Kluwer, pp. 82-212.

[7] V. Galasso, P. Profeta: Lessons for ageing society: the political sustainability of social security systems, in: Economic Policy, No. 38, April 2004, pp. 63-115.

[8] According to ECB: Statistics Pocket Book, Frankfurt a.M., February 2005, p. 9.

[9] Structural indicators. EurActiv, 16 March 2004.

[10] D. Grimm: Verfassung – Vefassungsvertrag – Vertrag über eine Verfassung, in: O. Beaud, A. Lechevalier, I. Pernice, S. Strudel (eds.): L'Europe en voie de Constitution, Brussels 2004, pp. 279-287, Beuylant.

[11] High Level Group: Facing the Challenge, in: EurActiv, 3 November 2004.

self-justification. It has done so, *inter alia*, because it had to face the lack of progress, in terms of delivery on the key indicators, as well as in the overall tendency of catching up with America, which has not materialised.

One of the more unusual features of the Kok Report is that it takes failure as given, and focuses on the ways and means the mishap can be remedied. From among the causes the report mentions the too large number of, and incoherence among, the priorities, lack of coordination, both among these and the national priorities, as well as lack of political commitment to the implementation. For this reason the basic suggestion is to narrow down the scope of priorities, focusing on generating growth and employment, and it suggests, in terms of organisational innovation, the elaboration of national implementation programmes.

Whereas the original document is rightly seen as a compromise among economic and social/environmental considerations, the Kok report calls for seeing the Lisbon Strategy as a means of macroeconomic restructuring in the first place, stressing the importance of competition.[12] It highlights the worrying signs, such as the fact that only two member states spend 3 per cent of their GDP on R&D, or that in terms of hourly productivity the EU–15 registered a growth of 1.4 per cent annually in 1996-2003, as against the USA which recorded a growth of 2.3 per cent in the same period. This reflects, according to the report, the slow and inadequate use of information and communication technology (ICT), especially in the services sector. A similar finding, in more detailed and academic form, was produced by the Commission services,[13] highlighting in chapter 3 the structural nature of the productivity problem in the EU, as well as in chapter 4 relating possible productivity improvements to the better absorption of new (IT-related) technology.

The report rightly stresses the need to focus on the implementation of the internal market regime, especially in the areas of financial services, labour markets, transferability of social security claims (a major obstacle to labour mobility), in the energy sector as well as in network industries. It proposes capping state aid to one per cent of GDP.

Perhaps the most controversial work of the Kok Group has been its focus on the labour market. According to the European Socialist group[14] Barroso, following the footsteps of the High Level Group, adopted a neoliberal agenda and has abandoned the social component of the original programme. This might be a bit of an overinterpretation. However it is indeed clear that the idea of an "inclusive" labour market translates into creating incentives to work more and longer, includes life-long learning, and the previously neglected idea of mobility.

### Change of Emphasis

For the new Commission President José Manuel Barroso it was clear from the very outset, that divergent national priorities constrain him onto a narrow path in his attempts to revitalise the EU. Knowing the difficulties of managing diversity, that have substantially increased with eastward enlargement, as well as disagreement among major players, the Lisbon Strategy has remained basically the only option for him to move forward. His repeated stressing of the Strategy[15] together with the Presidency Conclusions of November 2004 have turned the re-launch and reassessment of the Strategy into the major theme for the March 2005 Council.

Given the broad reach of this policy document the reassessment allowed the Commission to come up with a number of streamlining propositions as well as with a host of major policy propositions.[16] It focuses, perhaps even more than the High Level Working Group, on the effective measures to improve the internal market, free and fair trade, better regulation and the need for a more adaptable workforce. It also stresses the need to enhance R&D spending as well as the need for better education and skills. Similarly pro-competitive stances have been voiced by other senior members of the Barroso Commission. Ms Nellie Kroes for instance demanded the integrated competition policy guidelines to be included in the Broad Economic Policy Guidelines, competition screening and sectoral inquiries (especially in financial services and the energy sector) and declared the "less and better aid" strategy for the 2005-2010 period.[17] Likewise Ms Danuta Hübner, talking at the London School of Economics, called for refocusing regional aid to growth,

[12] Comparing these findings to the ritual declarations of good will in Communist Party documents, paraphrased "our goals are correct, only the means of implementation needs to be changed" borders thus on the unfair. Cf. J. Gács: A lisszaboni folyamat – egy hosszú távú stratégia rejtélyei, elméleti problémái és gyakolati nehézségei (The Lisbon process: puzzles, theoretical issues and practical dificulties in implementing a long-term strategy), in: Közgazdasági Szemle, Vol. 52, No. 3, 2005, pp. 205-230, here p. 228.

[13] C. Denis, K. McMorrow, W. Röger, R. Veugelers: The Lisbon Strategy and the EU's structural productivity problem, in: EU Commission: European Economy, Economic Papers, No. 221, Brussels, February 2005.

[14] As reported in : Handelsblatt, 10 and 17 February 2005; Frankfurter Allgemeine Zeitung, 23 February 2005.

[15] J. M. Barroso: The Lisbon Strategy – a key priority of the EU Commission, talk delivered to the ETUC conference, Brussels, and reprinted in: EurActiv, 1 March 2005.

[16] EU Commission: A new start for the Lisbon Strategy. EurActiv, 2 February, 2005. Cf. also Midterm review of the Lisbon Strategy. EurActiv, 1 March 2005.

innovation and competitiveness, making cofinancing imperative and universal.[18]

This change of emphasis is, however, more cosmetic than real, if we take into account the realities of the past years. Putting employment on the Community agenda has not produced agreement over matters of substance, and the open method of cooperation has proven by and large ineffectual under these circumstances.[19] The original Lisbon way of specifying quantitative targets has not been realistic either. Recent analyses have indicated the lack of reliable employment data, especially data that is available in an acceptable period of time and with an internationally comparable substance.[20] Knowing the lack of uniform labour market policies across member states there is nothing to be given up in terms of material substance if the original Lisbon indicators are no longer followed. Indeed, as the recent detailed analysis by Giles St. Paul[21] indicated, rigidities are rooted more often than not in national ideologies, value judgements and perceptions, and therefore in some countries we have already observed a move toward flexibility in labour markets, whereas in others – notably in France and Spain – feet-dragging is likely to continue.

### Limitations to Benchmarking

In a way it is in line with economic insights and with the experience of European economies to highlight that growth and only growth is the way to create employment, provided the labour market institutions do not constrain the creation of new jobs and the employment of new labour. Therefore new member states are likely to be in support of the approach of a pro-employment strategy based on fostering growth.

Another relevant insight is that labour market arrangements are intimately related to cultural traditions and value judgements. If for no other reason, this sets inherent limitations to the use of such concepts as benchmarking, which obviously shaped the original Lisbon Agenda, setting for instance a uniform 70 per cent target on activity levels, irrespective of the grossly different assessment of leisure time by the individual societies and irrespective of the grossly divergent productivity levels. The latter put severe limits on any benchmarking or uniform standard setting in the labour market, as proven by more recent analyses.[22] Also among the new member states the labour market situation is grossly different, with Poland registering an 18.3 per cent and Slovakia a 16.9 per cent rate of unemployment as against 5.5 per cent in Cyprus, 5.8 per cent in Slovenia and 6.2 per cent in Hungary.[23] For this reason the abandonment of the focus on compulsory indicators and benchmarking is only to be welcomed.

### Refocusing on Competitiveness

The refocusing of the Lisbon Strategy on competitiveness is more than welcome for those new member states like Slovakia and Hungary which have already received thinly veiled threats from some old member states, notably France, for their too low corporate tax rates, and have been warned of the possibility of limiting their access to structural funds for this behaviour. The more member states accept the principle of sustained solidarity, as reflected in the work by Barroso and Hübner quoted above, the higher the chance of actually regrouping the funding according to the current – changed – levels of development against the weighty arguments of tradition-based funding for some areas, especially in the more advanced economies.

From this angle it would be wrong to give way to the already ongoing pressure to subordinate the forward-looking goals and organisational arrangements of the Lisbon re-launch to old-fashioned bargains about pork. The latter seems already to have started. In the case of Hungary the competition between the Ministry of Economy and Transport, on the one hand, and the Office of the Minister in Charge of European Affairs, on the other, has become manifest. The former, which is charged with major developments in physical infrastructure, is to take a formative role in interpreting the priorities of the Second National Development Plan for the 2007-2013 period.[24] On the other hand, the Office of European Affairs is adopting a broader vision, orchestrating cross-party dialogue involving the opposition, to identify the priorities best fitted to EU priorities. In this latter approach the priority seems to be the maximisation of the funds that might be drawn for the EU.[25] The latter priority, in my view, may easily be at odds with such broader considerations as the priority

[17] N. Kroes: Building a competitive Europe – competition policy and the Lisbon Strategy –talk given to the Bocconi University, Milan. in : EurActiv, 7 February 2005.

[18] D. Hübner: Regional policy and the Lisbon Agenda – Challenges and Opportunities. in: EurActiv, 3 February 2005.

[19] C. De la Porte, P. Pochet: The European Employment Strategy: existing research and remaining questions, in: European Journal of Social Policy, Vol. 14, No. 1, 2004, pp. 71-78.

[20] A. Atkinson, E. Marlier, B. Nolan: Indicators and targets for social inclusion in the EU, in: Journal of Common Market Studies, Vol. 42, No. 1, 2004, pp. 47-75.

[21] G. St.Paul: Why are European countries diverging in their unemployment experience?, in: Journal of Economic Perspectives, Vol. 18, No. 4, 2004, pp. 49-68.

[22] B. Casey, M. Gold: Peer review of labor market programs in the European Union: what can countries really learn from one another?, in: Journal of European Public Policy, Vol. 12, No. 1, 2005, pp. 23-43.

[23] ECB: Statistics Pocket Book, Frankfurt a. M., February 2005, p. 40.

[24] J. Kóka: Ambíciózus tervekhez szoktam (I am acustomed to ambitious target setting), an interview granted by the Minister of Economic Affairs, in: Figyelő, 7 March 2005.

of national funding as well as with the need to set national priorities in line with global competitiveness, as the general line of the Lisbon Strategy re-launch would suggest. In the latter approach, for instance, the focus on physical infrastructure development projects, that would inevitably dominate the former, would seem superfluous and misplaced.[26] The major issue in using EU funds – but not necessarily across the board in macroeconomic strategy – would be the utilisation of ICT and the streamlining of the system of public dues, as well as bringing about the pro-competitive elements of the single market project in such areas as financial services, energy, air transport, agriculture, rural development and network industries. The emphasis should lie upon promoting the mobility of labour and its flexibility via life-long learning. The latter requires investments in R&D and education as well as in administrative capacities, while the former would focus investment in such traditional big projects as road construction, airports, bridges, border stations, logistical points and the like.

It is also important to draw attention to the contradiction between the aspirations of the new members and the harsh realities conditioned by the repeated position of the net contributors that are set to maximise their contributions at the present level below 1 per cent of gross national income. In their view, expounded several times,[27] current EU spending practices are saddled with bureaucracy, inefficiency and the lack of a proven contribution to common goal. Thus the priority in the 2007-2013 financial guideline should be to focus on matters of common concern and enhance the discipline enshrined in the Stability and Growth Pact. In this reading the re-launch of the Lisbon Strategy is equivalent to strengthening the practice of national funding for most of the EU projects, especially in the areas of employment, innovation and the use of ICT. Similarly the initiatives for achieving more coherence between competition and regional policies, that would add up to streamlining the previously liberal practice of allocating funds on a "give and take" base among the big players[28] could free the funds needed for the legitimate needs of the new members.

25 A legtöbb, mi kapható (The maximum available), in: Figyelő (online edition), 19 February 2005.

26 Nobody questions the need for further development of the physical infrastructure in the new member states, as the state of roads, railways and airports obviously requires additional attention. The choice, however, is clearly between more big projects and a plethora of small ones, in sectoral terms between transport and the e-economy and ITC, in organisational terms between publicly organised construction and reconstruction or trials and errors of the private sector, including its penetration of education and health care.

27 More recently D. MacShane: Why the EU Constitutional Treaty is Good for the EU and for the UK, public lecture delivered at the Humanities Center of the Central European University, 2 March 2005.

28 Cf. Handelsblatt, 3 February 2005.

### Bold Objectives – Soft Deeds

In our forecast made before the conclusion of the European Council it can be formulated that no strategy exists in a power vacuum. As could be seen in the evolution of the European Constitution, the political will to manage and overcome diversity and adopt policy measures that would fundamentally upset the balance of bargains, especially in terms of national contributions, is unlikely to find a majority. For this reason the promulgation of bold objectives or harsh analyses can easily co-exist with soft or no deeds. More radical suggestions, such as trimming the farm budget by ten per cent and redirecting this sum to R&D,[29] or the platform of Belgian premier Guy Verhofstad that would include codes of convergence, major shifts in taxation, and the redirection of regional and farm spending to R&D[30] are unlikely to find their way to the policy-making machine. Since the crisis of the EU is not yet imminent in the perception of most policy entrepreneurs, the reaction is likely to be lukewarm. Likewise, the preliminary positions of most member states reflect that redistributory concerns are becoming more prominent than ever. Considering the variety of suggestions to soften up the Stability Pact, all invoking basically redistributory rather than economic concerns,[31] as well as the country positions on regional assistance, nobody should cherish high hopes of a more normative approach based on post-materialistic values.[32]

It seems that the reflection triggered by the unusually frank assessment of the Kok Group and the follow-up initiatives of the Barroso Commission may have contributed to fresh and more forward-looking thinking in and around Europe. These are, however, unlikely to signify the moment for major changes. Although this is sad, the new member states may however, and indeed should, take advantage of their more competitive orientation of promoting globally competitive agenda, where catching up remains a basically national project.[33] This also implies that national policies that offset the macroeconomic conditions of sustainable growth are unlikely to be compensated for by activism at the European level.

29 J. Potocnik: EU research programs need to contribute to delivery, in: EurActiv, 2 March 2005.

30 Verhofstad quests national action plans for Lisbon re-launch, in: EurActiv, 1 March 2005.

31 Financial Times, 9 March 2005.

32 In a similar vein, inefficient regulation especially in the public sector is blamed for Europe's continued lagging behind in O. Blanchard: The economic future of Europe, in: Journal of Economic Perspectives, Vol. 18, No.4, 2004, p. 2.

33 Similarly so the representatives of Scandinavian industry L. Fagernas, H. Stov: Do not scrap Lisbon project, just modify it, in: Financial Times, 9 March 2005.

Sjef Ederveen, Albert van der Horst and Paul Tang*

# Growth and Jobs: a Different Approach for Each

Five years after its start, the Lisbon Strategy has not brought a clear improvement in the European position in the world economy. Even after the internet bubble has burst, productivity growth in the United States is higher than in the European Union; and while the baby boomers are about to retire, some member states are struggling with reforms of their economy.

Not surprisingly, the Lisbon Strategy is due for change. Kok[1] has reviewed the strategy and put forward several proposals to rejuvenate it. Building on this review, President Barroso of the European Commission seeks to renew the Lisbon Strategy in at least two ways.[2]

The first way is to focus: "growth and jobs" must take centre stage. The concern for social cohesion and the environment is downplayed. In fact, higher growth and more jobs are now seen as essential for the financial sustainability of European welfare states and for investments in cleaner technologies. The second way is to put pressure on the member states to deliver. Barroso wants to renew the Open Method of Coordination (OMC), the mode of governance behind the Lisbon Strategy. In National Action Programmes, all member states should write down their aims and means to improve economic growth.

Whereas Barroso treats growth and jobs similarly, we argue that separate approaches are warranted for jobs and growth. While cross-border externalities point to an important role for the community of member states in increasing productivity growth, increasing employment is a concern for the member states themselves. Rather than refocusing (on jobs and growth) or more pressure (on member states) we argue for rearranging competences between the Union on the hand and its member states on the other hand. This rearrangement is essential for making the Lisbon Strategy more effective. Nevertheless, we will also argue that returning to previous growth rates is nearly impossible, with or without Lisbon.[3]

### The European Spillovers of "Jobs and Growth"

The European Union seems to get more and more influence on national policies. Especially with the introduction of the Lisbon Strategy the Union's influence has grown: the Lisbon targets cover various areas, ranging from female labour market participation to spending on R&D, and the OMC applies to education and pension system among other things. The idea behind the expanding influence is that the economic policies of one member state have implications for economic welfare in the others. Indeed, Kok[4] explicitly refers to the perceived European spillovers: "… a jointly created economic tide would be even more powerful in its capacity to lift every European boat". But do spillovers exist for every area of economic policy, more specifically for both jobs and growth?

Employment growth in one country only has a limited impact on other countries. First, imbalances on labour markets could be resolved by an in- or outflow of workers, but these flows are small, even in the short run. This holds in particular for the flows between European countries: a member state with a low unemployment rate attracts more immigrants, not from other member states but from outside the Union. For the long run, there is little evidence that employment rates depend significantly on migration flows. Structurally, employment and unemployment rates are dominantly determined by country-specific institutions.

Second, the effects of an increasing demand are small. When a country experiences employment growth, its production and income will increase and it will demand more goods and services from other countries. Higher employment in one country raises the export demand for others. In the short run, if there is slack capacity, this could spur production and reduce unemployment. In the long run, higher export demand will be accommodated by higher export prices, as slack capacity is not structural. Higher employment in one country therefore benefits others through terms-of-trade gains. Through the (rental) price of

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[1] W. Kok: Facing the challenge; the Lisbon Strategy for growth and employment, 2004.

[2] J. M. Barroso: Working together for growth and jobs; A new start for the Lisbon Strategy, Communication to the spring European Council, 2005.

[3] This article is heavily based on S. Ederveen, A. van der Horst, P. Tang: Is the European economy a patient, and the Union its doctor? On jobs and growth in Europe, CPB Document 80, 2005. The latter is downloadable from www.cpb.nl.

[4] W. Kok, op. cit., p.8.

capital a spillover works also in the opposite direction. A member state will see capital leave when economic success elsewhere brings an increase in the return on capital. A simulation with the CPB general-equilibrium model WorldScan shows that the terms-of-trade gains dominate, but that the effect is small: an employment spurt in Germany raising its national income by 1 Euro would benefit other EU countries by less than 5 cent.

Third, even in the short run, when there is slack capacity, the spillovers of an economic boom and a surge in employment in one member state seem limited. Gros and Hobza[5] look at the short-run cross-border effects of fiscal expansion in Germany, based on simulations with different macro-econometric models. Their overview of simulation results shows that the effects are small or often even negative. A negative effect may arise when a German expansion triggers an interest rate increase in the Euro area.

Whereas employment growth does not add to the European tide, the story is different for productivity growth. Improvements in productivity growth require investments in know-how and technologies. A salient feature of these investments is their external effect on productivity elsewhere. In particular, R&D investments in one country have an impact on the productivity of other countries. Empirical work linking these two is abundant.[6]

Distance may matter for spillovers from productivity growth. The effect on productivity elsewhere is likely to become smaller, the farther a country is from the centre of growth. Indeed, Keller[7] estimates that for every 1200 kilometres the effect of R&D investments is reduced by half.

There are at least two reasons for the strong effect of distance on the spillover from productivity growth, depending on its form. First, it could be that firms learn from observing the technologies that other firms employ. In this way investment in new products and production methods by one firm enhances the production possibilities of other firms directly: a pure knowledge spillover. New communication technologies have made learning at a distance easier. Nevertheless, face-to-face contact remains important, since knowledge about these products and production methods is at least partly tacit. Distance matters for bringing people together.

Second, it could also be that know-how is embodied in intermediate goods and services and in capital goods. Investments by one firm enhance the production possibilities of other firms indirectly, through the use of these goods and services: a pure rent spillover. Distance matters for international trade in goods and services. As a rule of thumb, the trade volume between a pair of countries reduces by half when the distance between them doubles. Since technical progress is concentrated in the production of tradables, i.e. primary products, manufacturing goods and some services like communication, the rent spillover across countries is economically important.

In short, spillovers from productivity growth are international but are confined to neighbouring countries. This seems to make the European Union well suited to coordinate and even perhaps to implement measures to stimulate knowledge investments. It seems likely that each member state has a stake in the success with which other member states stimulate investments in new products and production methods. Will the Lisbon Strategy successfully boost these national investments benefiting all?

### Does the OMC Work?

The Open Method of Coordination (OMC) is a combination of national policy and informal European coordination, where decisions are based on consensus. The OMC brackets political conflict as it does not impose a single, European vision on the ideal welfare state design.

Union-wide guidelines are translated in quantitative and qualitative indicators for individual member states. Taking country-specific differences into account, these guidelines are translated into national policies. The Union participates in the process, as periodic monitoring, evaluation, and peer review take place.

The OMC does not want to impose one, single standard on all member states, but takes into account the diversity among them. Following the principle of subsidiarity it leaves responsibility with the member states whenever possible. It is a “third way” between laissez faire and coordination.

The OMC could serve at least two different functions: it could help to internalise spillovers and it could stimulate countries to learn from each other. How well has it served these functions? Five years of experience with the Lisbon Strategy should help us to answer these questions.

[5] D. Gros, A. Hobza: Fiscal Policy Spillovers in the Euro Area: Where are they?, CEPS Working Document No. 176, 2001.

[6] For an overview, see W. Keller: International Technology Diffusion, in: Journal of Economic Literature, Vol. 42, No. 3, 2004, pp. 752-782.

[7] W. Keller, op. cit.

*International spillovers*: Coordination is necessary when a policy in one member state influences the others as well. Indeed, the idea behind the OMC is that the economic performance of one country has a positive effect on the performance of the other countries. As such, the OMC is potentially useful for policies to stimulate knowledge investments or to boost innovation, but also for other areas like the environment. The process has similarities with the one that is laid down in the Kyoto Protocol. In the latter process, national targets for the reduction in greenhouse gas emissions add up to a common target for reduction. They are different for different countries, and follow from multilateral negotiations in which a country's specific circumstances play a role. The decentralisation of targets does not restrict countries in the way they want to achieve a reduction in greenhouse gas emissions. In principle, the OMC can work in a similar fashion. In practice, the European goals have not been translated into different national targets. The introduction of National Action Programmes may change this practice, though.

A weak point of the Kyoto Protocol is the commitment to the national targets. When a country does not fulfil its target, is there a sanction that will credibly force a country to comply with its obligation? This same point applies even stronger to the OMC. First, in the OMC formal sanctions do not exist. The main sanction mechanism is informal and relies on peer pressure and public opinion. Second, the Lisbon targets, like the aim to raise R&D expenditures to 3% of GDP, are or may prove to be much more ambitious than the Kyoto ones. The targets are set before the costs of reaching them are known. However, targets are not credible when the costs of reaching them are high.

Since the sanctions are weak and the credibility of the targets is doubtful, the OMC does not seem to solve the problem of free-riders, where countries fail to take into account that the benefits of productivity growth spill over to other European countries.

*Learning*: An important argument for a soft coordination method as the OMC is the potential for policy learning, both bottom-up and cross-national. The idea is that policy learning is stimulated through the process of participation, exchanging information and peer reviews.

Although the OMC academic literature has now become a thriving industry, our empirical knowledge of the OMC at work in specific policy processes remains limited. Still, from the preliminary evidence we can draw some lessons regarding its potential for learning. The overall impression emerges that the results have been very limited till now. According to De la Porte and Pochet[8], the European Employment Strategy has at best sparked national-level discussions. Also cross-national and bottom-up policy learning has been limited.

One seemingly successful result is convergence at the level of ideas in some policy areas, called ideational convergence. This may be an important development, as the convergence at the level of ideas may pave the way towards a European model. Radaelli[9] for instance describes the emergence of an "EU desirable model" in employment policy, which is a hybrid of Anglo-Saxon and Scandinavian instruments. However, these elements of ideational convergence are still embryonic; furthermore, convergence in "talk" may not produce convergence in decisions.

*A single method for jobs and growth?* In some policy areas, like innovation policy, international spillovers warrant coordinated action. Member states should raise investment in R&D beyond their national ambition, to let other countries benefit from their inventions, and vice versa. The experience of the past five years has shown that the OMC is not capable of generating the necessary commitment. Although a greater involvement of national governments is a step forward towards more commitment of national governments, we still should not expect too much in this direction. Ideally, the decision-making power in innovation policy should be delegated to the European Union in order to optimally benefit from its potential.

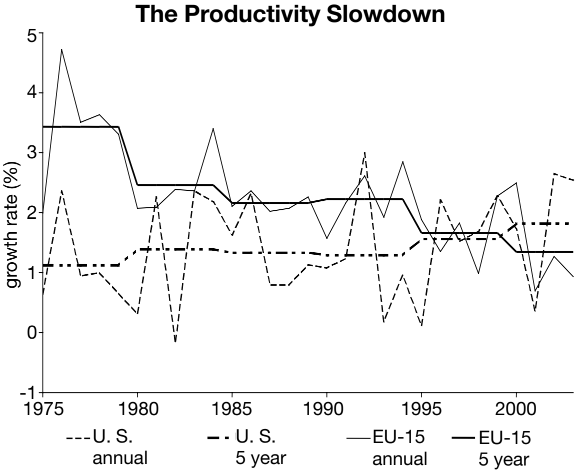
In other policy areas where international spillovers are weak, like in "jobs", the OMC contributes. It takes into account the huge diversity in welfare state regimes within the European Union, which prohibits uniform policy measures but allows for mutual learning. It is questionable whether the emphasis on national action programmes is helpful in this respect. Groenendijk[10] argues that policy learning should be organised as a voluntary process. The attempts of Barroso to reinforce commitment might therefore reduce the potential of learning. The OMC in its current weak form is most appropriate to serve the task of learning.

[8] C. De la Porte, P. Pochet: The European Employment Strategy: existing research and remaining questions, in: Journal of European Social Policy, Vol. 14, No. 1, 2004, pp. 71–78.

[9] C. M. Radaelli: The Open Method of Coordination: A new governance architecture for the European Union?, Report 1, Swedish Institute for European Policy Studies, Stockholm 2003.

[10] N. S. Groenendijk: The use of benchmarking in EU economic and social policies, Paper presented at the conference "The future of Europe" in Odense, 24-25 September 2004.

**Figure 1**
**The Productivity Slowdown**




### Jobs and Growth in the Future

Successful growth and employment policies, whether coordinated or not, could increase prosperity. They will however not bring back past growth rates. For jobs the reason lies in the future: in the coming decades the demographic trends will put pressure on the labour market and it will be a policy challenge to only offset their negative influence on employment growth. For productivity the reason lies in the past: productivity growth might accelerate in coming years, but Europe will not be able to return to the 3-4% productivity growth rates of the seventies, when it was able to benefit from catching up.

Figure 1 puts the recent productivity growth rates in a historical perspective. It was not until recently that America outpaced Europe. In our recent study[11] we show that Europe has been able to benefit from catching up in the seventies and eighties, leading to relatively high productivity growth. As European productivity per hour approaches, or in some countries even surpasses, the American level, the potential to benefit from America's technological lead diminishes.

Given that Europe is at par, why were the United States able to grow faster in the last decade? There are at least two reasons. First, the productivity slowdown is aggravated temporarily by strong improvements in participation rates: the capital stock has not been able to keep pace with the employment spurt in the late nineties. Second, America has accelerated by successfully applying ICT in service sectors like retail trade, wholesale trade and financial intermediaries. Europe has also benefited from ICT, but less so.

An optimistic view of labour productivity in Europe is that the ICT-revolution will come to Europe, and that the downward push due to accelerating employment growth will vanish. Even in this optimistic scenario, however, 2% productivity growth will likely be the limit. Lisbon might contribute, but even the optimistic assessment of the European Commission,[12] measuring the potential contribution of Lisbon to annual growth at ¾%-point, will be insufficient to bridge the gap with the past.

For jobs too, past growth rates are unlikely to return, not because of high growth rates in the past, but because of developments in the future. Two trends are especially relevant, which both threaten employment growth and the European welfare states.[13] First, ageing populations aggravate the employment outflow and raise public expenditures on old-age pensions and health care. Second, the position of high-skilled workers on labour markets is steadily improving relative to low-skilled workers. That the income differences between the two groups have not grown (fast) in the recent past, is a result of the fast increase in supply of high-skilled workers. When the increase levels off, as is expected during the coming decades, the income differences may start to grow. Higher benefit levels prop up wages of the low skilled, but also lead to more unemployment among them.

To offset the pressure on the welfare state, employment should increase. Of course, trimming the welfare state itself may help to lower unemployment and stimulate participation. But the real challenge is to increase employment without downsizing the welfare state dramatically. In a search for alternatives, member states might learn from each others' experiences. The OMC facilitates this.

### Conclusion

The past will never return: sky-high productivity growth is unlikely. The future will come, with downward pressure on participation rates and the financial sustainability of the welfare state. Europe's ambition is to take the bull by the horns: jobs and growth should be stimulated. This medicine for Europe should be given by two doctors: the Union for innovation and the member states for employment. The OMC is well designed for the Union-wide learning of "jobs"-promoting policies, but lacks commitment for a successful boost in R&D-policy.

[11] S. Ederveen, A. van der Horst, P. Tang, op. cit.

[12] European Commission: The economic costs of non-Lisbon. A survey of the literature on the economic impact of Lisbon-type reforms, European Economy Occasional Papers 16, 2005.

[13] R. de Mooij, P. Tang: Four futures of Europe, The Hague 2003, Koninklijke De Swart.

Ognian N. Hishow*

# Lessons from Lisbon, or Why Leisure Harms

The Lisbon idea was born in the late 1990s out of the concern of Europe that it was falling behind the USA in terms of per capita income and the implementation of new technology on the one hand, and out of the optimism of the then dotcom revolution, which just had started to penetrate the EU economy, on the other. The business cycle seemed to belong to the past and not a few Europeans were joining American scholars in saying that the old textbooks deserved to be ripped up. Yet frustration mounted in Europe over the lack of progress in the real convergence of living standards between Europe and America, while the weak contribution of new technology and labour productivity to growth had been identified as a major challenge.

Achieving the Lisbon goals by 2010 sounded ambitious but not impossible. Sadly, just shortly after the Lisbon agenda for an accelerated, knowledge-based growth in the EU was released, the dotcom bubble burst and most of the European economies slid into a recession, which especially in Germany, Europe's biggest economy, proved to be nasty and tenacious. Not surprisingly, by mid-term of the Agenda the EU Commission conceded that the original goal cannot be accomplished on time. (The Sapir Report first sounded the alarm in 2003, and the Report from the High Level Group chaired by Wim Kok restated it in autumn 2004.) A comparison to the benchmark USA in terms of the core issues of the Agenda is instructive: only in one field, sustainable environment, is Europe slightly ahead, while it trails behind the USA in most of the others. What is worrying is that the lag is striking in just those areas in which Europe was keen to take the lead: information society, R&D and the business environment (cf. Table 1).

A glance at the outcome allows for two general conclusions. First, the European Union is too heterogeneous, so the mean result obscures the achievements by individual nations. While the Nordic countries match the USA or even perform better, a number of other EU members also perform sufficiently well. In fact, it is Germany, France and Italy who depress the EU average, yet it is not the size of their economy which is to blame for their lack of progress. The other big EU economy, the UK, boasts a leading position among the nations with the best implementation of the Lisbon goals, whereas many smaller countries struggle to cope with them.

Secondly, in macroeconomic terms, Europe has been undertaking even greater efforts to keep the economy on track than the USA, especially regarding savings and investment. Unfortunately, despite saving and investment rates which have been higher than in America for decades, European growth has proved weaker. The same applies to underemployment, which is troubling because of the alarming social exclusion. It is a daunting fact that the Europeans have been saving and investing more but harvesting less, so obviously they have done it the wrong way (cf. Table 2).

There have been a myriad of ideas and proposals as to what to do, especially suggested by policy-makers, parties and the media. Nevertheless, they tend not to provide a remedy but to make things worse because the Agenda becomes increasingly diluted. That is why in the years which are left the EU should concentrate predominantly on economic issues, which is in line with the recommendations of the Kok group. Specifically, the most attention is deserved by factor input, total factor productivity (TFP), and the quality of the labour force.

**What to address: Leisure, Technology, Education**

Starting with the disturbing observation that the EU falls short of its goal of reaching real convergence of per capita income with the USA, the suggestion should be to boost labour supply either by expanding the number of hours worked or by raising the employment rate. The latter would mean basically a broader inclusion of older workers and the reduction of the overall unemployment rate across Europe. An increase in the number of working weeks per year would be helpful too. This is essential, since the reason for the unchanged income differential between the EU and USA is the clash between two trends in the EU which had cancelled each other out over the past few decades:

- labour productivity rose steadily compared with the USA
- the number of hours worked declined at the same rate.

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**Table 1**
**EU-15: Comparison to the Benchmark: Scores by Key Elements and Difference**
("+": EU ahead; "-": EU behind)

| Heading | USA | EU-15 | EU — US |
|---|---|---|---|
| Information society | 5.86 | 4.61 | -1.25 |
| Innovation/R&D | 6.08 | 4.41 | -1.67 |
| Liberalisation | 5.11 | 4.69 | -0.42 |
| Network industries | 5.85 | 5.81 | -0.04 |
| Financial services | 5.82 | 5.52 | -0.30 |
| Business environment | 5.71 | 4.74 | -0.97 |
| Employment/social inclusion | 5.04 | 4.81 | -0.23 |
| Sustainable development | 4.96 | 5.16 | +0.20 |

Source: World Economic Forum.

**Table 2**
**EU-USA: Macroeconomic Indices 1981-2004 Average**
(in %)

| | Investment rate | GDP growth | Unemployment | R&D, % of GDP |
|---|---|---|---|---|
| USA | 19.1 | 3.3 | 5.9 | 2.6 |
| EU | 21.4 | 2.2 | 8.5 | 1.9 |
| Germany | 22.1 | 1.9 | 7.5 | 2.3 |

Source: Eurostat.

Thus the income differential was maintained (cf. Table 3). Consequently, since the productivity gap was getting narrower, if working time increased the per capita income differential would shrink. However, this outcome was thwarted by the long-term trend of a decline in the rate of employment within the EU. Between 1970 and the late 1990s the employment rate in Europe levelled off at around 60% (in Germany at approx. 65%), whereas the other major economic regions, foremost the USA and Japan, continually maintained higher rates of employment.

Fortunately, after 2000 the employment rate in the EU-15 started to rise. By 2003 it had reached 64.4%, while in the (enlarged) EU-25 it is one percentage point below that figure. Thus the gap between Europe and both the USA and Japan has narrowed. Yet while that positive trend towards rising employment was emerging, it was made up again by another, negative trend: over the same period the number of hours worked has decreased by 5.5%, largely eclipsing the output effect of rising employment.

For this reason the occasionally hailed higher hourly productivity figures in some EU member states are revealed to be fallacious as soon as the statistical effect of shorter working times and higher unemployment is taken into account. Accordingly, the actual gap between the level of productivity throughout the European Union, on the one hand, and its counterpart in the USA, on the other, is in fact wider than the measured difference – including in Germany.

Not only does labour productivity fail to boost growth significantly, but the performance of total factor productivity (TFP) has also been unsatisfactory. As indicated in Table 2, with the marginal product of investment and capital apparently dwindling, there is the assumption that the EU is reaching its individual steady state, so more physical capital input violates the "golden rule". Then the conclusion to be drawn is to improve technology and make it contribute strongly to growth. This would mean a turnaround, since during the last decade and a half the contribution of TFP to growth has been declining. Between 1989 and 2003 the growth accounting produces an average yearly growth rate of 1.79 percent for the EU-15 with strong capital growth and even some labour input growth. Yet further capital deepening is approaching its limit, so the trick is to involve technological progress more actively as a source of growth. Currently the contribution of TFP to output growth is only 20 per cent. It is thus too weak. Moreover, it was declining compared to the respective long-term figure, which fluctuates around 30 per cent in the industrialised world and even more in some countries in transition (cf. Table 4).

Since in Europe TFP has been losing ground in favour of capital deepening, now the Lisbon strategy calls for a reversal of this process by the more aggressive implementation of new technology. Yet this requires the conversion of Europe's economy into a knowledge-based one, which means augmenting the educational level of the labour force in order to have recourse to an ever growing stock of human capital. By international standards, however, expenditure on university-level education in the EU-15 is relatively low. As we all know, there is already a North-South divide in connection with this indicator, too, for the Nordic countries spend more. However, the EU average is largely determined by the continent's leading economies, namely Germany, France and Italy, countries which still invest relatively little in university education. The specific combination in the EU of a high standard of technology and relatively high proportions of people with a simple or medium educational background is counterproductive in the long run. Moreover, the situation in the EU is typified by the very low proportion of private expenditure on university-level education. In the USA such spending accounted for roughly 1.6% of GDP back in 1999, not only outstripping government spending in that domain, but also exceeding total spending (by both the public and the private sectors) in most EU countries (the 1999 average is 1.4% of GDP). But whilst in America higher education is viewed

**Table 3**
**GDP and Productivity Indices for the EU[1]**
(USA = 100)

| | GDP per capita | Hourly productivity | Hours worked per capita |
|---|---|---|---|
| 1970 | 70 | 62 | 108 |
| 1980 | 70 | 78 | 90 |
| 1990 | 70 | 87 | 80 |
| 2000 | 70 | 92 | 78 |

[1] Numbers rounded.

Source: Eurostat.

**Table 4**
**Average Growth of Output and TFP, and TFP Contribution to Growth by Country**

| Country, first year of statistical record | | Growth rate per worker and year, % | | |
|---|---|---|---|---|
| | | GDP | TFP | TFP relative to output |
| Belgium | 1846 | 1.92 | 0.54 | 0.28 |
| France | 1850 | 1.61 | 0.33 | 0.20 |
| Germany | 1880 | 2.59 | 0.78 | 0.30 |
| Ireland | 1926 | 3.62 | 1.06 | 0.29 |
| USA | 1870 | 1.68 | 0.53 | 0.32 |
| Czechoslovakia/ Czech Republic | 1921 | 3.75 | 1.17 | 0.31 |
| Poland | 1931 | 3.22 | 1.33 | 0.41 |
| Russia | 1917 | 1.98 | -0.41 | -0.21 |
| Ukraine | 1990 | -6.51 | -6.75 | 1.04 |

Source: S. Baier, G. Dwyer, R. Tamura: How Important Are Capital and TFP For Economic Growth?, in: Federal Reserve Bank of Atlanta, Working Paper 2002-2a, April 2002, Appendix, Table 1.

as an investment in the country's own national human capital, spending in this domain in European countries is frequently just considered burdensome.

Furthermore, an improved educational level would encourage more research and development and cause the economy to move closer to the technological frontier. The breakdown of Europe's output pattern would improve too. In the EU-15 the high-tech sectors' share of GDP is roughly one third and thus smaller than is the case in the USA (almost 40%). The major reason for the gap is the hesitation displayed in the past to implement new technologies. Only the Nordic countries find themselves in the leading group here, whereas some major EU economies, especially France, have only put in a mediocre performance in this connection. Another unfavourable fact is that the share of expenditure on ICT in the EU-15 appears to be declining. Consequently, research and development (R&D) do not yet play the role they were intended to play. One problem is that the Union as a whole invests a lower proportion of its GDP in R&D than the USA and Japan; another is that R&D spending by some major EU economies, like France, is waning, whereas in the United Kingdom it is stagnating, and in Germany too it lags behind the USA and Japan in this respect. Moreover, it is still true today that less corporate research is being conducted in Europe than in the USA, yet it is that very research which determines an economy's ability to innovate, for state-organised R&D tends to be more basic and therefore impacts less on growth and modernisation than application-oriented research conducted by businesses. Again, some major EU economies, in particular France, Italy and the United Kingdom spend comparatively little on the latter kind of research.

### What to address (2): Labour Market Reform

The most challenging problem Europe has been facing for decades is the stubborn structural unemployment with rates in the core EU economies France, Germany and Italy which are decidedly too high by OECD standards. While Germany's labour market woes could be partly attributed to the nation's reunification in the early nineties, unemployment rates in other EU countries cannot be explained by a particular macroeconomic shock (only Finland may be an exception). Rather, domestic reasons are responsible for the sluggish progress on this front in France and Italy, and increasingly as time passes, in Germany too.[1]

Academic research has dealt intensively with the issue of structural unemployment, and an uncounted number of studies has been produced. Some research work results blame the inability of business to hire more and the unwillingness of the jobless to search for a job more energetically on the overloaded social state in Europe. Other researchers conclude that the state should redistribute even more, i.e. raise the taxation of the well-off to help the poor meet ends and spend on goods and services to boost the aggregate demand. However, in recent years a fairly liberal approach has been gaining ground, resulting in reform efforts to redefine the social role of the state and to overcome rigidities at the low end of the labour market. Europe is increasingly aware of what is sometimes dubbed the "irreconcilable trinity": first, full employment; second, high payroll taxes; third, wage floors (or unions-negotiated wages across the board, which translates into the same thing). In such an environment the chance that labour costs mismatch productivity is great.

Yet from a macroeconomic perspective, the structural employment rate can be cut only by making the

[1] For recent figures cf. Jean-Philippe Cotis: What is the economic outlook for OECD countries?, Paris, 17 February 2005, at: http://www.oecd.org/dataoecd/2/49/34460630.pdf.

marginal productivity of labour match labour cost. Accordingly, the unemployed whose productivity is low would be paid less by their employers than they have to be paid now. (However, to keep social imbalance in check those persons should receive transfers from the budget.) In the years to come, the business sector should be responsible to a lesser extent for the mismatch between productivity and earnings than it has been until now.

In a simple aggregate model today's unemployed can get jobs when the economy moves from its current equilibrium with high productivity per worker and relatively low productivity per capita to a new equilibrium point with lower productivity per worker. This is the case when all the unemployed are hired at once, and since GDP cannot change immediately, wages per worker will have to decrease. In contrast, income per capita would stay unchanged. The only change would be that in the new equilibrium unemployment is – other things left unchanged – eliminated.

Reality, of course, is more complicated. But the model describes at least vaguely the philosophy of the reform agenda in many European countries, foremost in Germany, where the "Agenda 2010" is controversial but underway.

Firstly, given the low growth rate in Europe, full employment will not last for long, because of Okun's law: an arduous GDP pace will produce unemployment again, so fighting unemployment by wage cuts is a blind alley.

Secondly, in Europe the state is a major employer, yet the public services are not paid according to their marginal products, so misallocation and the overburdening of the private sector with even more unemployment here is the outcome. However, in the Nordic EU member states public employment is regarded as a remedy for (labour) market failure, yet at the expense of high taxation and a large government sector relative to GDP. (Notwithstanding, Finland's unemployment rate is as high as the mean rate in the EU-15.)

But what policy-makers in Europe in reality opt for (while ideologically condemning it) bears remarkable resemblance to the Anglo-Saxon model. The EU is quietly moving towards larger before-taxes spreads between the high and low ends of the labour market (somewhat mitigated by subsequent budget transfers), a smaller government sector, reshuffled budget revenue breakdown relieving corporations and charging consumption, and so forth. To expand employment, the European Union will have to lower the existing wage floors, in some cases even to scrap minimum wage rules. In addition, a redesign of the current system of labour taxation is being discussed. The task is tough because existing arrangements reflect a political equilibrium with economically inefficient features which are fiercely defended.[2] However, the economics of lowering the unemployment rate is compelling: by cutting payroll taxation and/or minimum wages governments try to make labour cheaper and thus to pave the way for the employment of the less productive parts of the workforce that are now idle.

### Proposals for a Remedy

The Lisbon Strategy should clearly focus on the major challenges related to high unemployment and the staggering of economic growth in many member states. In fact, governments realise that reforms should ensure

- stronger competitiveness in various markets
- R&D and innovation that accelerates output growth.

As for the first issue, while the single goods market has actually been completed, the EU has still to fully open other markets, particularly utilities, energy and financial services, as they still enjoy protection and are heavily regulated. In line with this, the reorganisation of the labour market, foremost its deregulation and greater flexibility at the low end, will positively contribute to the core Lisbon goal of cutting unemployment and raising social inclusion.

As for the second issue, to make R&D deliver to growth and technological innovation, spending on R&D will have to reach the required benchmark of 3% of GDP. In addition, the currently overcrowded general concept needs to be rethought. The EU's research budget should be shored up, as it is now partly wasted in a large number of small spending programmes without an effect on the economy.

This latter need for the concentration of spending and activity applies to virtually all EU policies with respect to Lisbon. To raise the efficiency of the various policies it endeavours to link them closely to the envisaged objectives. Now the reverse is true – the myriad programmes introduce a random element into the Lisbon strategy. Not only does it lack clear priorities, but also conflicting definitions of the objectives themselves plant a great deal of confusion into the Lisbon agenda. For this reason, and bearing in mind that the Lisbon agenda is first of all a strategy for growth, the focus should be confined to a very few clear objectives.

[2] C. Wyplosz, G. Tabellini: Supply-Side Policy Coordination in the European Union. A report to the French Prime minister, IGIER, Universitá Bocconi and CEPR, Graduate Institute of International Studies, CAE and CEPR, at: http://heiwww.uige.ch/~wyplosz/cae_cwgt.pdf, p. 32.