**ECONOMIC POLICY COMMITTEE**

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# MID-TERM REVIEW OF THE LISBON STRATEGY:

# ADVANCING REFORM IN EUROPE

*In March 2000, Europe's leaders committed themselves to a ten-year programme, designed to make the European Union "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" by 2010, against a sound macro-economic background. The strategy was intended to deliver "an average growth rate of around 3%" in the years following 2000, and to re-establish the conditions for full employment, reflected in a 70% EU employment target and increased participation rates by 2010. The strategy continues to rely inter alia on "sustaining the healthy economic outlook and favourable growth prospects by applying an appropriate macro-economic policy mix."*

***Despite important efforts to implement structural reform, the Lisbon strategy has yet to deliver the success Europe's leaders hoped for. EU productivity and employment growth continue to lag behind those in the US. Fiscal sustainability is not on track in around half of the Member States. While weak macroeconomic conditions have played a role, there is a need to increase the pace of reform and strengthen the governance of the Lisbon agenda. Europe's economic policies need to be globally orientated, in order for it to keep pace with a fast-developing global economy characterised by significant advances in technology, rapid economic growth of the emerging economies, and an acceleration in the pace of economic change.***

*This EPC progress report intends to assist Ecofin Ministers in their preparation for the mid-term review of the Lisbon strategy. It (i) describes briefly the current state of the Lisbon process; (ii) attempts to single out the main factors for the strategy's lack of success; and, (iii) proposes possible solutions to address the gap in terms of the need for clearer targets, strengthening governance and increasing accountability, including also identifying priority reform measures.*

## 1. Europe's Economic Performance

Average EU growth during the period 2001-2003 has been far below 3% and, at 1.2% a year, below, for example, the US growth rate of 1.9%. While the labour market has proved more resilient than expected during the last four years, total employment in the EU-15 nonetheless stood at a mere 64.3% in 2003, far below the Union's 70% target for 2010, and making the interim target of 67% in 2005 impossible.

Labour productivity per hour, having converged to US levels since 1970, diverged again from the mid-90s, and according to Eurostat, fell from 87% of the US level in 1995 to 82% in 2003. Annual growth in output per worker has also been slowing. This seems to reflect both declining capital-deepening and the poor capacity of Europe's firms to utilise investment in new technology. It may also be because moderate increases in employment mean that Europe is now employing marginally less-productive workers.

Nonetheless, the US has kept its edge on productivity with the catch-up period coming to an end, while employment rates remain considerably higher at around 80%. Since 2000, US and EU GDP per capita have grown at similar rates, although, GDP per capita in the EU-25 is expected to be some 35% lower than in the US in 2005 (or 30% lower in the EU-15).

Unfavourable short-term macroeconomic developments have not helped in advancing the Lisbon economic targets. The effect on activity of low interest rates has to some extent been counterbalanced by the sharp appreciation of the euro against the dollar. In some countries weak transmission channels reduced the impact of monetary policy. The fiscal stance was also constrained by poor initial conditions in some Member States, partly resulting from laxity during the booming years.

However, structural factors must be addressed if Europe is to raise its longer-term growth potential and to improve it's resilience to future shocks. Moreover, ageing populations will put increasing pressure on the sustainability and quality of public finances. Overall, expenditures are currently projected (in a no-policy-change scenario) to increase by more than 5 percentage points of GDP in a large number of countries during the next 40 years.

## 2. Why is there a Lisbon "Implementation Gap"?

Although important structural reforms have been implemented across the EU, many of which take time to show up in improved outcomes, there is ample evidence to suggest that both **the scale of structural reforms and the speed with which they have been implemented have been insufficient** to meet the Lisbon challenge.

Several factors have contributed to the current implementation gap, including:

- **a lack of clarity and prioritisation about the Lisbon objectives has led to** ambiguity in approach and a failure to deliver. An economic and social cohesion agenda originally aimed at increasing long-term growth and employment has become muddied since 2000, with continued pressure to include additional subjects as diverse as maritime safety and space policy. There is even uncertainty about the number of Lisbon objectives and targets; the IMF suggest there are 102 "targets";
- **inconsistencies between some targets** with confusion between core and instrumental targets, and insufficient attention to potential trade-offs, for example the call for both increased public spending in certain areas (such as adequate public pension provisions) and fiscal sustainability;
- **insufficient communication within Member States about the necessity and benefits of reform**, which has allowed too much influence by domestic political pressures and vested interest groups. This is not helped by aggregate EU-level targets where it is sometimes unclear what individual Member States must do, which has resulted in blurred responsibilities and weak accountability. In some cases, the broadening of the research base on the benefits of reform would be useful; and
- **peer pressure and the monitoring process have been insufficiently strong and visible**, with ineffective benchmarking and exchange of best practices, and a lack of rigorous performance evaluation, performance indicators that do not relate to policy instruments and weak governance arrangements.

**All of the above failings have led to a lack of political ownership at the national level, contributing to the slow pace of reform**.

## 3. Sharpening the Focus of the Lisbon Agenda

Europe must sharpen its focus on the core aims of the Lisbon agenda if it is to achieve its strategic goal by 2010. There must be a **greater degree of prioritisation among the objectives and targets** of the Lisbon strategy, with the focus more sharply directed towards the original objectives of **long-term growth and employment**, within a context of fiscal, social and environmental sustainability. High and sustainable growth is a prerequisite for greater social cohesion, environmental sustainability and being able to deal with the fiscal challenges posed by ageing populations. Suggested actions include:

### a) Clearer Targets

The Lisbon agenda must be underpinned by a **clear set of core headline targets** consistent with this strategic goal and by **more effective checks on progress**, including an annual assessment of the EU's progress against its core targets and the measures available for delivering them. The targets, focusing on the EU's performance relative to the best of the rest of the world, should be based on:

- **prioritisation, and the need to focus on the key drivers of long-term growth by increasing employment and productivity**, including through the use of appropriate policy instruments to deliver the desired outcomes, and in turn, facilitating monitoring and public accountability; and
- **universal ownership by all Member States, new and old, of the existing growth objectives and employment targets**. Softening the targets would be wrong; Member States have different starting points in implementing reforms; but, overall, Europe must aim high.

## b) Strengthening Governance

Although spillovers exist, structural reform is primarily a national responsibility reflecting differing local traditions and circumstances, with Member States able to tailor policy responses to suit local circumstances. In these cases therefore, the Open Method of Co-ordination (OMC) and equivalent processes remains the right approach in an enlarged and increasingly diverse Union. The key question is how to improve the OMC, so as to sharpen its focus on the key policy priorities for Member States and increase incentives for reform. This could be achieved by:

- **putting the Broad Economic Policy Guidelines (BEPGs) priorities once again at the centre of the economic policy co-ordination process**, increasing their effectiveness and commitment of the Member States. This means focusing the relevant OMC processes on supporting the achievement of the Broad Economic Policy Guidelines (BEPGs) priorities, and limiting and controlling the introduction of new OMC processes;
- **strengthening the monitoring process**. The analysis, appraisal and evaluation exercise must be comprehensive, integrated and rigorous, taking into account both product, labour and capital markets, and sustainability, underpinned by appropriate co-ordination at both national and Community levels;
- **using the EPC/Ecofin Annual Report on structural reform to provide a clear basis for benchmarking Member States' economic performance and highlighting best practice**. Policy evaluation should be strict and rigorous, and should therefore rely on both quantitative and qualitative assessments to help identify why some countries have been more successful than others and to promote best practice; and
- **better involvement of all national Parliaments, for example through annual debates devoted to the Lisbon agenda and the BEPGs** to explain the aims of reform and build support for it. This should also be based on broader and more available research base to better explain the benefits of reform.

## c) Increasing Accountability

In addition to enhancing the process of OMC, further steps should also be taken to increase the **accountability** of Member States for implementing reform. There is no single solution to this problem. Rather, a holistic approach, which makes use of several, mutually-supporting reforms, should be considered. Such an approach could include:

- **improvements to the structural indicators** to provide for more accurate monitoring of Member State performance, with refinement of the core economic indicators, data improvements, and a much clearer link between core targets and the indicators. The use of structural indicators in policy evaluation requires careful interpretation, for example, to take account of different institutional contexts;
- **more emphasis on benchmarking national performance** supported by qualitative assessments and best practice sharing. Ranking of Member States' absolute performance and progress over a recent period against core and instrumental economic targets has a part to play, carried out carefully, accompanied by qualitative assessment and reflecting initial structural conditions. The assessment should be included in the Commission's annual Implementation Report on the BEPGs; and

- while fully endorsed by the European Council, ways should be explored for how to **sharpen the commitment to, visibility and ownership of the BEPGs by the Heads of State or Government**.

## 4. Delivering the Lisbon Goals

Raising and exploiting the EU's long-term growth potential requires further reforms of Europe's product, capital and, in particular, labour markets, as well as continued efforts to maintain growth- and stability-oriented macroeconomic policies and to strengthen the sustainability and quality of public finances.

### a) Labour Market Reform

The EU must create another 21million jobs to achieve the 70% employment target by 2010. This is vital for boosting Europe's long-term growth rate, increasing social inclusion, and helping to achieve long-term fiscal sustainability in the face of an ageing population. While several Member States have achieved low unemployment and high employment rates particularly through appropriate labour market reform, progress across the Union as a whole has been slow. Where progress has continued, it has tended to be in areas, such as tax cuts, active labour market policies and strategies for lifelong learning. Less overall progress is evident in areas such as wage bargaining and benefit systems.

A road map for labour market reform was provided by Wim Kok's European Employment Taskforce. Member States should commit to implementing these reforms fully and effectively in their own labour markets, focusing on the priorities identified by the Ecofin Council, namely:

- Increasing flexibility of labour markets in order to unlock the dynamics of employment creation, including appropriate adjustments in wage bargaining systems;
- Modernising the concept of job security to focus on improving employability; and
- Taking action on benefit and tax reform to improve incentives and make work pay.

### b) Product Market reform and the Knowledge-Based Economy

Europe must speed up reform of its product markets. It lags far behind competitor economies such as the US in its performance on enterprise, innovation and the knowledge-based economy. All too often, excessive or disproportionate regulation has stifled dynamism and business growth. The immediate priorities for the EU are to:

- Promote the full **completion** of and more effective **competition** in the Single Market, including by addressing in particular the remaining barriers in services and network industries, and by more-actively enforcing competition policy in areas where economic evidence suggests it is most needed.;
- **Regulatory reform**, including introducing competitiveness testing to support impact assessments for all new legislation, simplifying the existing *acquis*, and improving the analysis and use of market-based alternatives to regulation;
- Stimulate a healthy **entrepreneurial climate,** building on the priorities identified by the Competitiveness Council, in particular, promoting an entrepreneurial culture and improving access to finance for business start-ups and innovative firms; and
- Speed up the transition to the knowledge-based economy and **boost innovation**, by making the EU an attractive place for business to invest in research and development, through improved framework conditions, such as a strengthened intellectual property regime; improving education and training systems to better meet demands for highly skilled labour; and, by improving the effectiveness of national and EU spending on R&D.

### c) Promoting the Single Market in Financial Services

Further integrating **financial markets**, and facilitating the continued consolidation of the financial sector, is a high priority, requiring the full and consistent implementation and effective enforcement of the Financial Services Action Plan. The approach should be based on rigorous analysis of the remaining barriers and the impact of tackling these for each market segment on a case-by-case basis, along the lines of the conclusions of the June 2004 Ecofin Council. Attention should be paid to cross-border supervisory co-operation and further action will be needed on certain horizontal and specific issues.

## d) External Openness

Greater openness to trade and foreign direct investment can reinforce delivery of the Lisbon agenda, acting as an important spur to growth, employment and productivity by increasing competition and lowering barriers to entry. Empirical studies have shown that dismantling the EU's external barriers could deliver benefits on the scale of those from the Single Market. The Mid-Term Review should corroborate the linkage between EU external openness and growth and employment, and identify the main barriers to external openness to trade and investment and quantify the benefits from dismantling them. The immediate priorities for the EU now are to:

- Take a leadership role in negotiations to maximise the benefits form multilateral trade liberalisation, pushing for a significant and fast reduction in barriers to trade; and
- Strengthen economic relationships with major and growing trading partners, including by enhanced regulatory co-operation, focusing on the US, the emerging economies, and eastern and southern neighbours.

## e) The Sustainability and Quality of Public Finances

Sustainable public finances are important for strengthening economic growth. Permanent public deficits and increases in the stock of public debt shift savings away from productive capital, reducing potential output. Further work is needed to:

- improve the quantitative indicators and qualitative features used in assessing the sustainability of public finances; improving the quality of the long-term budgetary projections with regular updates; and extending them to cover EU-25 by mid-2005;
- enforce the three-pronged strategy agreed at the Stockholm European Council, focusing on increasing employment rates, on the reduction of public debt, and on reforming pension and health care systems; and
- improve the links between the assessment of the long-term sustainability of public finances, including the effect of structural reforms, and short- to medium-term budgetary policy.

While maintaining budget discipline and a sustainable fiscal position, improving the quality of public finances is important to ensure the most efficient and growth-enhancing use of public resources. Agreed long-term projections on the impact of ageing imply further relative increases of ageing-related expenditure categories. In this context, it will be particularly difficult to create room for manoeuvre; without continuing expenditure control and further reforms to social welfare systems, it will be very difficult to create room for redirecting public expenditure towards high priority areas while at the same time respecting overall budgetary limits and avoiding further rises of taxes and social contributions. Therefore:

- public budgets should, while respecting overall budgetary constraints, be redirected towards growth-enhancing, cost-effective investment in physical and human capital and knowledge. However, crowding-out of private productive expenditure is to be avoided. Furthermore, the efficiency of the public sector should be increased, *inter alia*, by introducing mechanisms to assess and evaluate the relationship between public funds and policy objectives and to help control spending;
- Member States should introduce frameworks for budgetary re-allocation processes, expenditure control and "high quality" fiscal consolidation. At the EU level, the exchange of national experiences and "best practices" is necessary; and
- to help develop an understanding of the qualitative aspects of public finances and to improve the data-collection, it is essential to develop a coherent framework for assessing the composition of total public expenditure, including in line with the strategic priorities of the Lisbon Agenda.

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