GROWTH, EMPLOYMENT AND SOCIAL JUSTICE, THE LISBON STRATEGY NOTWITHSTANDING

Nikos Koutsiaras, Senior Research Fellow, Eliamep

TWO RECONCILABLE PERCEPTIONS OF EUROPE

As Barry Eichengreen has aptly argued,[1] popular perceptions portray Europe as either an economic phoenix or a basket case. The phoenix perception holds that European (hourly) labour productivity has increased spectacularly since the end of World War II, climbing from 50 percent to nearly 95 percent of US levels on average, whilst levels of labour productivity in some European countries have risen well above US levels. Also, since the beginning of the new century, employment growth in Europe has shown signs of improved resilience, associated with increasing employment rates – even if these still lag behind US rates, on average. Moreover, income inequalities in Europe have historically been narrower than in the US, and European citizens have generally enjoyed universal access to a wider array and of higher-quality social and public services than US citizens. Europeans also show a stronger interest in democratic politics, reflected in a keener and deeper participation than in the US.

On the other hand, the basket-case perception reflects the fact that European output and productivity have grown at lower rates than in the US since the mid-1990s. This has ended a nearly 25-year long period of almost-stable relative per-capita output and caused a trend of diverging living standards. With lower productivity growth than the US, Europe has since the mid-1990s been failing to offset its relative deficiency with regard to the labour input, which arise from lower employment rates and shorter work hours; recent increases in European employment rates have largely been linked to the creation of low-productivity jobs. Labour-market rigidities, product-market regulatory failures, financial-market shortfalls, inadequate R&D spending, distorted public expenditure patterns and high tax rates have all taken their toll on European employment and productivity growth. What is more, those policy and institutional shortcomings may be reinforcing the impact of adverse demographic developments on economic growth prospects. Thus, not only has the desirability of the European economic and social model been put in question, but its long-term sustainability has also been cast into doubt.

Those seemingly opposed perceptions of Europe are neither analytically nor normatively irreconcilable. Over the second half of the twentieth century European economic

1. *The European Economy Since 1945*, Princeton and Oxford: Princeton University Press, 2007.

performance was remarkable, both in absolute terms and relative to the US – thus broadly confirming the phoenix perception. But over recent years this performance has been falling back, giving rise to anxieties about the economic future of Europe and providing substance for the basket-case perception. Furthermore, European economic success over the second half of the twentieth century – mostly over the two and a half decades following post-war reconstruction – was largely predicated on importing technology from the US, increasing investment shares and securing a labour supply to industry, inter alia via rural exodus and sometimes by international migration. Economic openness and the development of welfare-state institutions, along with market interventionism, had all worked as enabling factors; the welfare state had assumed a primary role, strongly associated with its insurance-*cum*-redistribution function, which compensated for the adverse domestic effects of economic openness.

However, Europe has now closed the gap separating it from the technological frontier; its productivity and output growth are no longer dependent on importing technology and accumulating capital. European productivity and output growth has, instead, been increasingly reliant on new technologies and innovation; it is now therefore firmly premised on entrepreneurship, the creation of knowledge and pooling of talent. In consequence, the European welfare state – in particular its labour market policies and institutions which traditionally stress job security; its wage egalitarianism and vocational training; and its financial systems and corporate governance models which put a premium on long-term relationships – has increasingly proven ill-suited to the facilitation of economic growth. Nevertheless, since global trade and capital integration are both strongly desired for their effects on productivity and growth, and since both directly challenge traditional European export industries, the political-economic case for a redistributive welfare state remains strong.

Complying with the requirements of modern economic growth should arguably entail wide-ranging and far-reaching reform of economic and social institutions. Yet dismantling the European economic and social model does not seem advisable, nor has it been attempted. Reform of the welfare state and economic regulation should aim at mitigating policy-induced distortions of economic incentives, thereby discouraging choices which imply high social-opportunity costs, e.g. reduced effective labour supply. Put in other terms, reform of economic and social institutions should aim at allowing European societies to make the best possible trade-offs between efficiency and equity, thus maximising their ethically-weighted social welfare functions. However, reform of the European economic and social model might not result in European employees opting for leisure at the same rate as US employees, or working for an equal number of hours. Nor might it lead to convergence in preferences for redistribution between European and US citizens. Those are matters of tastes, social cultures and institutional histories. By the same token, it is plausible that European welfare-state reform might not raise expectations of eventual convergence in average living standards between Europe and the US – something to be thankful for, students of the economics of happiness might add.

STRUCTURAL REFORMS AND THE ROLE OF THE EU REVISITED

Wide-ranging and far-reaching reform of the European economic and social model may, in principle, entail no less than a radical overhaul of the regulatory and institutional framework of product, financial and labour markets, as well as a restructuring of public finances to make them solvent and sustainable. Those structural reforms may pose a daunting task for democratic (and electorally non-suicidal) governments and national political systems, for the principal reason that the benefits and costs of the reforms are unevenly distributed amongst individuals, socio-economic groups, geographical regions – and also over time, albeit in ways that differ between policy areas. Yet, as has often been said, structural reforms may be both achievable and sustainable. Those embracing a systemic view of the European economic and social model, whereby various complementarities between policy areas are deemed functionally indispensable and politically crucial, may therefore plausibly imagine that reformist governments might need only to vigorously confront the regulatory failures and institutional rigidities in one policy area in order to facilitate structural reforms in other areas. In fact, it may have been possible to put in place – wisely and perhaps even uncontroversially – an almost ideal sequence of structural reforms following the establishment of the internal market associated with product and financial market deregulation. It has accordingly been argued that in a world of lower rents – related to product market deregulation – and higher elasticity of labour demand (linked to financial market liberalisation and high capital mobility), reform of labour-market institutions may follow almost inevitably as European trade unions adjust to the changing circumstances. The European Monetary Union (EMU) may have further reduced trade unions' resistance to labour-market reform, firstly by effectively increasing both market competition and the elasticity of labour demand, and secondly by removing a policy instrument that was meant to withstand country-specific external economic disturbances – thereby placing a premium on swift market adjustment. What is more, product-and financial-market deregulation and, for that matter, institutional reforms in those areas, have often been directly enforced and/or dictated by Brussels, which has allowed national governments to spend most of their precious political capital on labour-market and social-policy reform.

In fact, this has broadly been the logic underlying the Lisbon Strategy, much inspired by the so-called "there-is-no-alternative" view of structural reforms; this view itself reflects a certain perception of the dynamics of European economic integration, in conjunction with the aforementioned systemic view of the European economic and social model. Indeed, whether in its original emphasis on diffusion of best practice, peer pressure and policy learning, or in its mid-term renovation and relaunching – which entailed refinement of policy guidelines, streamlining of open coordination processes, and addressing issues of national ownership – the Lisbon Strategy has mostly been concerned with technical and procedural aspects of structural reforms. The implicit assumption was that the need for those reforms has largely been appreciated by national governments, whose commitment to reform is thereby strengthened.

However, there has been scarce empirical evidence to validate the Lisbon Strategy's approach to structural reforms. For example, it has been observed that the pace and intensity of reforms, and governments' commitment to them, have varied considerably across member states; meanwhile, progress has also been uneven across different policy areas. Furthermore, implementation of the Lisbon processes has barely changed relative national attitudes towards reforms and has little affected relative policy quality – let alone relative economic performance. Interestingly, too, a sort of reform fatigue has affected both the pace and content of Community policies to complete the internal market for services and remove obstacles to labour mobility. This is less so with regard to initiatives to simplify regulation and reduce burdens on business.

Since the beginning of the present decade, European labour market performance has been constantly improving: there have been significant reductions in unemployment rates and a notable increase in employment rates. A trade-off between employment and productivity growth has nonetheless been evident, most pronounced in member states experiencing stronger employment growth and more frequently observed in low-growth "old Europe" than in fast-growing "new Europe". Those developments are causally related to the pattern of reforms that have already been implemented in European labour markets, which has often entailed partial relaxation of employment rules. The result has been two-tier labour market institutions, as well as changes in active work policies, unemployment benefits and labour taxation; early retirement, regular employment protection and wage-setting institutions have been little affected. Low-productivity and low-wage job creation – associated with increasing use of so-called flexible employment contracts – has evidently been encouraged by those, mostly marginal, reforms and has significantly contributed to European employment growth.

Structural reforms may in fact barely conform to a self-perpetuating learning process, almost inexorably spilling across policy areas, as is implicitly assumed by the Lisbon strategists. Labour market reforms in particular have largely been shaped by political considerations – which were initially prompted by the uneven distribution of benefits and costs from reforms, and subsequently influenced by shared perceptions of fairness and distributive justice and often by interest group politics; the perceptions of fairness serve occasionally to add ideological legitimacy to interest-group demands. Proliferation of flexible employment contracts, often associated with precarious jobs, may have nothing to do with inclusiveness, security and fairness in the labour market; instead, it increases the incidence of low-wage employment, and reduces competitive pressures on core labour-market insiders.

The chances of comprehensive labour-market reforms being implemented may, thus, largely depend upon improving their distributive effects – in particular, increasing the benefits from reforms and bringing them forward, whilst discounting their costs and providing for adequate compensation to those bearing most of the burden. Comprehensive labour-market reforms may nonetheless put an end to the proliferation of flexible job contracts, thereby also dissociating employment growth from low-productivity, low-wage jobs, and reducing the influence of rent-seeking and interest-group politics in the labour market; rent-reducing, productivity-enhancing product market reforms may thus become more achievable. A higher employment and productivity growth path for Europe may therefore be accessible.

The crucial issue then becomes how to bring closer a better, fairer and more politically sustainable distribution of benefits and costs from structural reforms, especially reforms of labour market institutions. Fiscal policy may be cushioning temporary increases in the output gap associated with structural reforms, thereby averting short-term yet politically undesirable increases in unemployment. The budget may also be footing the bill of compensation packages granted to reform losers so that they stop resisting policy change and/or funding policies to bring employment gains forward. Although the reformed Stability and Growth Pact may, in principle, allow for temporarily conditioning of fiscal consolidation on practicing structural reforms, much depends on its implementation. Yet a loose implementation of the Pact may arguably jeopardise the credibility of its fiscal rules, harming its contribution to stable public finances. On the other hand, an accommodating monetary policy stance may, in principle, be conducive to structural reforms, by providing for a better-balanced and more tolerable distribution of gains and losses over time and across market participants. But in practice a monetary stimulus to structural reforms may only be in short supply, as it would take a great deal of (perhaps inflationary) monetary easing to cater for divergent short-run labour market and macroeconomic equilibria.

Convincing arguments have been made that European macroeconomic policy, especially monetary policy, should be more flexible, hence taking more into account output and employment – particularly given widespread real labour market rigidities, which give rise to (un)employment persistence. However desirable it might be, a (realistically not much) more expansionary monetary and macroeconomic policy might only slightly compensate for a fundamental weakness of the EU economic governance system, namely its failure to provide adequate incentives for comprehensive reforms of product and (mainly) labour markets – either in the form of sticks or, most importantly, carrots. This being so, stimulating structural reforms may better be accomplished via a system of financial incentives, in effect transfers of EU funds aiming at rewarding effective policy efforts and alleviating political-economic constraints to structural reforms. Specifically, EU financial resources may entail supporting national government policies and supplementing national budgetary resources in order to obtain a socially tolerable and politically acceptable distribution of gains and losses from structural reforms. For instance, EU support may be granted to – and reward – policies aiming at making work pay, or simplifying employment protection legislation. Accordingly, EU resources may provide for lower national spending cuts and/or tax increases than would otherwise be the case; or they may be used to (co-)finance compensatory measures for those left worse off following reform.

While drawing on the experience of the recently established European Globalisation Adjustment Fund, the aforementioned proposal goes many steps further and even gets into the (sacred) area of redistribution, albeit not unconditionally. The Lisbon Strategy may thus be considerably strengthened and its national ownership may be substantially increased something that would help comprehensive structural reforms and raise expectations for better economic performance. After all, the Lisbon Strategy should not only be about policy learning: informal policy-learning processes may equally be effective, to say the least. And Europe should not only be about growth: equity and redistribution have seldom been left aside, to say the obvious.