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WHAT'S WRONG WITH LISBON?

FROM LOW TO HIGH QUALITY GROWTH.

Pierre Defraigne

Fondation Universitaire, EU-JAPAN CONFERENCE

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The annual GDP growth differential between the USA and the EU over the past decade has been around 1%.

Most of it originates in the labor supply differential – due to ageing demography, lower participation rate and shorter working hours – and the rest in lagging behind in information technologies production and absorption.

Although this differential seems modest over a rather short period and could be reversed quickly should the US economy brutally adjust to its impending structural imbalances, it seems nevertheless a prudent strategy to improve the active/inactive ratio and the productivity growth prospects in Europe, especially in view of its rapidly ageing population.

In Lisbon, in March 2000, UK Prime Minister Tony Blair who had inherited Mrs Thatcher's radical supply-side reforms, successfully convinced his colleagues - which included twelve heads of governments with social-democrat participation-to engage in a three-pronged agenda focused on competitiveness, a business concept which sits uneasily when applied to a now 450 million strong continental economy. The Lisbon strategy's main targets are:

- completing the internal market, particularly in the area of services and utilities;
- reforming the labor market and the welfare-state;
- devoting more private and public resources to R&D and facilitating business innovation.

Since most of these tasks are the national competences of Member States, an obvious weakness of the plan is the so-called "open method of coordination" which amounts to push with a string. So far the Lisbon Strategy has not proved very successful.

Is it the right answer to the EU's present predicament? Although I agree that the EU model needs to be modernized and therefore reforms are needed, including - with all due

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caution of the labor market and the Welfare State and although I share the emphasis on a technology-based growth model, I have five major criticisms of the Lisbon agenda.

1. A top-down approach and a partial diagnosis

Whereas both the Single Market and EMU have been prepared by a lengthy and substantive debate, backed up by in-depth economic studies, a White Paper and a new Treaty, the Lisbon agenda came out of the blue. Five years later, there is still no ownership by citizens. The vast majority of people have never heard of it, even among the intelligentsia. This is not a good omen for success. In fact the fall-out from the widely unknown Lisbon agenda is contributing to deepen the divide between the leadership and the people in Europe as borne out by the French and the Dutch referendums on the Constitution. For, reforms of such magnitude succeed only when they rest on people trust and expectations and trust is missing among the public at large.

But above all, the diagnosis is a partial one and therefore is a wrong one for three reasons:

- firstly it focuses exclusively on EU's main areas of responsibilities: efficiency and stabilization for the eurozone; it ignores the interpersonal equity function.
- second, it emphasizes the competitiveness gap with the US whereas it ignores the formidable distributional effects of the rise of China and India through the pressure on labor and wages in industrialized countries. It does address neither the growing gap between losers and winners, nor the diminishing capacity of Member States to cope with the challenge of the availability of financial resources for social policies.
- third, it overlooks the fact that if the enlargement might ease the efficiency issue, it also complicates the equity one among EU 15. No adjustment of the Lisbon Strategy decided in 2000 was made as a result of the enlargement in May 2004.

The lack of impact assessment of the distributional consequences of internal and external evolutions has forever been a constant feature of EU approach to economic policy, under the pretext that equity belongs to the national agenda. This is probably the most serious mistake EU institutions have been making vis-à-vis the public opinion in Europe and a critical factor in the mounting disenchantment vis-à-vis EU among the ordinary citizens.

2. Growth through aggravating or through reducing inequality?

The Lisbon Strategy focuses on growth and job creation, but it does not specifically address the question of aggravating inequality and poverty in our rich societies. It suggests simply that through more labor intensive growth, job creation will do away with poverty. But this won't suffice! Let's just observe that poorly paid jobs in the services sector are already making poor retirees in UK while most part-time jobs are precarious second bests, particularly for single mothers.

By overemphasizing short-term competitiveness, the EU puts an excessive share of the adjustment burden on labor in Member States. Downward pressure on real wages not only contributes to reduce the share of labor compared to capital in EU GDP, it also exerts an additional deflationary effect on overall demand in Europe, already hampered by the restructuring of public finances and by the appreciation of the Euro. Therefore quasi stagnation of real wages and the corollary increase in precautionary saving contribute to high unemployment in Europe.

The key question here is about the trade-off between efficiency and equity familiar to economists. This trade-off might be a necessary evil in fast growing emerging or converging economies. But the problem is different in advanced societies like Western Europe. Here, there is indeed here a choice between different growth strategies, some that aggravate and some that reduce inequality. It all depends on the quality of flanking policies, in particular social policies, as borne out by Nordic countries' experience. Targeting inequality reduction might even fuel growth. Just look at what fairer access to education for gifted students from poor backgrounds or safer dwellings and neighborhoods represent in terms of a growth potential which is wasted in unequal societies.

This question is particular acute in rising knowledge societies. Yet whatever the rhetoric, Lisbon is more about a knowledge economy than a knowledge society. The focus is on closing the gap with the US in advanced technology. But the challenges posed by the growing relevance of knowledge go wider and deeper. Will it become the preserve of an elite mainly selected on the grounds of social status rather than on intellectual skills? What about culture? How do we improve the cultural level of the youth and of ordinary people so as to enrich their minds, to free them from abusive consumerism and trash and to prepare them better for participatory citizenship? Avoiding digital divide is necessary; yet more important is to ensure that basic skills are effectively taught and learned also in poor neighborhood primary schools where discrimination begins. This is the real issue nowadays in most European countries. Culture and equal opportunities in knowledge societies are broader objectives that are vital for the future of our European civilization. It goes beyond economics and business whose importance should not be allowed to obscure or overlook fundamental societal issues.

3. An agenda institutionally biased against equity

There is a nice language about social progress in the Lisbon Strategy. But for both political and institutional reasons, the Lisbon agenda is biased towards an ever-growing role for the market and against redistribution policies both at EU and at national level. On the one hand liberalization, deregulation and privatization - the latter remaining however the exclusive preserve of national governments - are carried out either on the basis of qualified majority voting in the Council or on European Commission's own powers with regard to the internal market and competition policy. On the other hand social and tax harmonization require the unanimity of Member-States. The latter has got yet more difficult to gather since enlargement and the subsequent growing heterogeneity of collective preferences within EU-25.

More importantly, tax competition on mobile factors such as financial savings and corporate profits brings far reaching consequences, in particular for the financial ability of Member States to conduct their own social policies and to supply public goods such infrastructure, quality education and research. One can hold different views on whether taxation levels are too high in Europe or whether emphasis should rather be put on making social policies more effective, in particular with regard to primary and secondary education, health care, employment and compensation policies. We probably should look at both. What is outrageous is that this fundamental debate does not actually take place. The matter is being handled in an implicit way through tax competition, which has been eased by the mobility of factors across EU and in particular the Eurozone. Income tax progressivity, once considered a major social victory by the Left, is being surreptitiously eroded by the ongoing slide towards flat tax and generalized tax cuts for the highest income bracket in most

Member States. The same holds true for corporate tax which is going down across EU under pressure from the new Member States despite the fact that they badly need more fiscal revenues to keep up with the demand placed on infrastructure, institutional building, and education as well as the construction of an effective social safety net.

4. An agenda biased against an EU hands-on industrial policy

EU actually needs more global firms in high-tech sectors. EU will only be a full fledged global economy if it counts enough EU based global firms. But Market liberalization alone won't suffice to bring the EU companies to the US and Japan levels. EU support through strategic industrial policies is an imperative.

Yet the Lisbon Strategy is still marred by the 80's and 90's thinking putting the anathema on State intervention and exalting market virtues in resources allocation. While Member States are forbidden to implement any specific industrial policy in order not to distort competition in the Single Market, the EU's formidable size is not exploited to encourage the development of global European champions in the fast growing and high tech sectors connected for example with defense, EU-wide networks, space or environment. The launching of any sectoral industrial policy initiative is seen as dangerous and ludicrous on the European scene whereas US and Japan take advantage to the full of their large domestic markets, public procurements and corporate tax loopholes to back up their large companies.

5. Is America the right benchmark for EU?

The US may well grow faster and create more jobs than the EU. In particular, they have undoubtedly a leading edge on Europe in high technology. But are we as Europeans, ready to close the technology gap with the US in the American way? Are we, for example ready to accept that in the most advanced technology society of the world, almost one American in two adheres to the Bible's creationist thesis, or that one in five is practically illiterate, or that one in six does not have access to health care, and this in the richest country of the world? Are we ready to use twice as much oil per head as in Europe? Are we ready to live off world savings, including off massive capital inflows from developing countries? Are we ready to lure in scientists from China, India, Latin America and Europe, thereby deepening the North-South knowledge divide? Would we be ready to spend as much as the whole rest of the world on weaponry, in order to protect not only our values, but above all our dispensable way of life? Would the rest of the world readily accept that EU behaves more and more like America? Would the planet resist? The truth is that US performance is at the same time the cause and the product of major systemic dysfunctions of the global economy since structural imbalances -US deficit and Asia surplus- constitute a major threat for the stability of the world economy. Even if the resilience displayed so far by the global markets in handling this potential instability, is reassuring, potentially dangerous situations persist, partly as a result of EU ineffectiveness in punching its full weight in global economic governance.

Conclusion on high quality growth

Growth remains a must in a market economy, but not just in order to respond to the inner dynamic of profit. It must above all make sense from both an environment and equity standpoint. This is what I call high quality growth.

Environment is very timely as an issue today since at this very moment, 180 countries are gathered in Montreal to discuss climate change. We all know – or we should all know- that with the present state of technology, it would take five planets to allow India and China to reach US standards of consumption per head. But we only have one. On the contrary nobody knows whether technological progress will move fast enough to offset the growing pressure on the environment from China and India's economic rise. So the question arises: isn't it time for advanced countries to change their way of computing GDP, in such a way that national wealth accumulation would be accounted for only after deducting the corresponding environmental costs, wherever they take place on the planet. It seems to me essential that not only local negative environmental externalities, but global ones are explicitly taken into account. The brutal expansion of the production sphere brought about by the entry of China and India into the global economy is indeed changing the whole picture. A system simply geared towards higher GDP growth as computed today in advanced countries would soon be getting out of balance with environmental constraints. More sober and more efficient patterns of production and consumption must be encouraged. But of course this consideration makes more acute the question of social justice in our societies.

Let me end up precisely on this point with a question which I hope will be perceived more as thought-provoking than simply provocative. Who is going to benefit from that additional one percent of growth EU is trying to achieve in Europe? It all depends on the flanking social polices! If such additional growth is achieved through a deterioration of the distributional balance, at the expense of the vulnerable and the poor because of free-for-all tax and social competition amongst Member States, surely, the price would be too high! Is it worth putting at risk social justice, which is one of the core values of European civilization, and moreover one of the hallmarks of the EU's image in the world? Is it worth destabilizing Europe just to make the upper centile richer as it has been happening in the US over the past two decades? This might suit the least enlightened part of the European establishment, but it would fuel anxiety, frustration and anger amongst the vast majority exposed to more flexibility, mobility and vulnerability. In the same way, as it would be very unwise to put off the accurate inclusion of environmental nuisances and waste into GDP figures, it is becoming impossible to ignore the societal - and eventually the political-costs of additional growth obtained through unfair policies. Is it necessary to recall the political costs of the French and the Dutch No, the low turn out in the British election, the recent incidents in ghettos in France, the surprising result of the last German poll and the degradation of the political situation in Poland and Italy?

Eventually, the Lisbon Strategy main fault line resides in the fact that it looks more as a business than as political project. And EU's main predicament today is not the economy, but the society. It's the civilization, stupid!