The International Spectator 4/2005

Europe Forum

Issuing Union Bonds to Finance the Lisbon Agenda

*Alberto Majocchi **

Euro-scepticism is once again widespread, as was dramatically confirmed by the "nos" in the French and Dutch referendums on the ratification of the European Constitutional Treaty. The Euro area is involved in a long-standing economic downturn following the launching of the Monetary Union. The Lisbon Agenda has been agreed on politically, but member states, constrained by the rules of the Stability and Growth Pact, are unable to implement it and the European budget is too limited in size to guarantee the funding of new expenditures. In this article, an attempt will be made to define a way-out of the current deadlock, suggesting that the Euro area could help finance the implementation of the Lisbon Agenda through the emission of Union bonds.

Ineffectiveness of expansionary policies at national level

The idea that the EU economy is lagging behind that of the United States is now largely accepted. Per capita income in Europe (before the accession of the ten new member states) was stuck fast at 70 percent of that in the US – the same as twenty years ago. And the difference in GDP increase cannot be

* *Alberto Majocchi* is President of the Institute for Studies and Economic Analyses (ISAE), Rome.

Copyright © 2005 by the Istituto Affari Internazionali.

explained by a higher population growth rate alone since the EU rate of productivity growth dropped below the US rate in the second half of the 1990s – the first time since the end of the war. The approval of the Lisbon Agenda at the European Council in March 2000 was the EU's political answer to this challenge. But, while the Agenda set out a strategy detailing measures to make the 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,[1] practically nothing has been done to implement it.[2]

The member states belonging to the Monetary Union are strongly constrained by the Stability and Growth Pact (SGP) and are unable to support the large increase in expenditure required to achieve the goals stated in Lisbon. As a result, many of them welcomed the recent reforms of the SGP providing more flexibility in complying with the constraints of the Pact in the hope that it will allow them to proceed more smoothly along the path laid out in the Lisbon Agenda. But there are at least two main flaws to the reform:

- a crucial concern of the European Central Bank (ECB) is that such higher flexibility could bring about larger deficits, hence it could gradually increase interest rates, thereby hindering achievement of the Lisbon targets;

- implementation at the national level of a kind of "golden rule" allowing for certain kinds of public expenditure to be excluded from the constraints of the SGP, as suggested by the reform of the Pact, will hardly be able to promote higher growth since the expansionary impact of increased expenditure at the national level is very weak in an integrated market where the share of imports on GDP is very high and a large proportion of the benefits of the enhanced demand support will consequently be enjoyed abroad.

Hence, another way out of the current deadlock is urgently required. During the Great Depression, there was a sharp debate in Britain between the Treasury and John Maynard Keynes, the former supporting the idea that real wages had to be cut down to promote greater employment, and Keynes insisting that a reduction in wages would bring about a further decrease in demand, then an ensuing diminution in the level of output and employment.

[1] European Council, "Presidency Conclusions", Lisbon, 23-24 March 2000 <http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/00100-r1.en0.htm>.

[2] This was clearly spelt out in the Kok Report (*Facing the Challenge. The Lisbon Strategy for Growth and Employment, Report from the High-Level Group chaired by Wim Kok*, 3 November 2004).

The modern version of the former Treasury view is that Europe needs structural reforms, as properly envisaged in the Lisbon Agenda. But, it must be borne in mind that many of these reforms worsen the budget balance in the short run – even if they eventually improve the sustainability of public finance – and are difficult to carry out in an environment marked by a long economic downturn. Furthermore, these reforms represent a necessary, but not sufficient condition for effectively boosting the growth rate in Europe, which apparently requires support from the demand side too, following a more Keynesian approach.

But, if there is an increase in the size of national budget deficits, people know in advance that – since the rules of the Stability and Growth Pact require adjustment – higher taxes or lower expenditures will follow in the near future. Hence, in the current circumstances of the European member states, the Ricardian equivalence – which states that a fiscal expansion prompts expectations of future fiscal contractions in order to repay for the initial loosening – fully applies. Therefore, the expansionary effects of a higher deficit would be entirely balanced by the restrictive impact of the expected future increases in taxation (or the cutting down of expenditures). It follows that, if effective support for demand in the European market is a must, this can only be achieved through the implementation of a "golden rule" at the European level.

The US competitive edge

Since the launching of European Monetary Union, Europe has been involved in a cyclical downturn and has seen the gap between its and the US economy widen, with the latter recording growth levels far superior to the former. There is once again talk of a European decline. An in-depth analysis of these phenomena was contained in the 2003 Sapir Report, which set out to define the political agenda to be followed to boost Europe's economic growth.[3]

In the 1980s, the growth rate of the American economy was already 0.7 points higher than that of Europe, but the gap has widened to one point during the last five years. The picture changes a bit if GDP per capita is considered: indeed, while growth of this variable in the Eurozone was higher than in the US from 1961 to 1980, in the following twenty years the reverse was true, even if the difference in GDP growth rates during the last

[3] A. Sapir et al. (eds) *An Agenda for a Growing Europe. Making the EU Economic System Deliver, Report of an Independent High-Level Study Group*, July 2003 <http://www.euractiv.com/ndbtext/innovation/sapirreport.pdf>.

five years has once again been due entirely to the increase in population.

If the factors that have influenced growth rate differentials are to be understood in more depth, the way in which increased hourly productivity has contributed to reducing the income gap between Europe and the United States has to be considered. From the beginning of the sixties up to 1995, the Eurozone recorded higher hourly productivity than the US, a trend dramatically reversed during the last decade, when American productivity shot up and European productivity fell off sharply.[4] But, leaving aside this long-term trend of increased productivity, a factor that really seems to account for the continued disparity in per capita income is labour utilisation, which was 28 percent lower in Europe than in the United States in 2003.[5] In particular, EU employees worked 15 percent less hours than their US counterparts, accounting for half the gap in labour utilisation.

Even taking into account Olivier Blanchard's suggestion that this lower level of labour utilisation could reflect different preferences between leisure and work,[6] the central point in the discussion of the European economy's poor performance during the nineties remains the low rate of productivity growth compared to the United States. This factor also seems to explain the lack of competitiveness of European exports in the globalised world market. But while the existence of this gap cannot be questioned, it is important to analyse more in depth where the main factors that have brought about this relative productivity drop in Europe lie.

Why European productivity lags behind

A good contribution to explaining the origin of different productivity patterns was recently provided in a study by Mary O'Mahony and Bart van Ark,[7] which traces the evolution of productivity in different industrial sectors, divided into Information and Communication Technology (ICT)-

[4] C. Denis, K. McMorrow, W. Röger and R. Veugelers, *The Lisbon Strategy and the EU's Structural productivity Problems*, EC Economic Papers no. 221, Brussels, Commission of the European Communities, February 2005, p. 80. <http://europa.eu.int/comm/economy_finance/publications/economic_papers/2005/ecp 221en.pdf>.

[5] K. Daly, *Euroland's Secret Success Story*, Global Economic Paper no. 102 (New York: Goldman Sachs, 2004).

[6] O. J. Blanchard, *The Economic Future of Europe*, NBER Working Paper, no. 10310 (New York: National Bureau of Economic Research, 2004) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=500183>.

[7] M. O'Mahony and B. van Ark (eds) *EU Productivity and Competitiveness: An Industry Perspective. Can Europe Resume the Catching-up Process?* (Brussels: European Commission, 2003).

producing, ICT-using and non-ICT industries. According to this study, there has been no productivity revival in the US industries classified as either ICT-producing or non-ICT. The core of the US success story appears to be concentrated in the ICT-using industries, that is retail, wholesale and security trading sectors. The US' entire productivity growth differential with respect to Europe in the late 1990s came from these three sectors, with retail contributing about 55 percent of the differential, wholesale 24 percent and security trade 20 percent.

The United States is now almost universally believed to have surged to the forefront in most ICT industries, not just in computer hardware, but more broadly in software, as well as in the pharmaceutical and biotech sectors. The literature points to specific national characteristics that help explain why particular inventions and industries are dominated by particular countries. The traditional factors usually cited to explain the US' competitive edge are educational attainment levels and university research, government-funded military and civilian research, the efficiency of the capital market, the language and immigration. There can be no doubt that the growing US dominance in the fields of ICT, biotech and pharmaceutical innovations reflects the fruitful collaboration of government funding for research, world-leading private universities, innovative private firms and a dynamic capital market.

In Europe, creating a successful knowledge-based economy involves both enhancing the EU's capacity to invent, implement and export a series of world-class innovative technologies and establishing an environment conducive to the imitation and absorption of externally available know-how. This means that Europe needs to shift the emphasis in its present economic model towards more innovation, by embracing an open-economy- and innovation-based model that emphasises the importance of

- world-class educational establishments;
- higher levels of excellence-driven and better targeted R&D expenditure;
- more market-based financing systems;
- more flexible regulations and institutions providing a more dynamic and competitive business environment.

This is the challenge that Europe decided to take up when it defined its new growth strategy in Lisbon.

Failure of the Lisbon Strategy

Why have the results of the Lisbon Strategy been so poor to date? We have to go back to the main causes of Europe's relative failure after the launch of Monetary Union in 1999. In most of the literature, this failure is explained by two factors: the crisis of public finance in many European states and the failed completion of the EU internal market.

As is well known, the Maastricht Treaty considered external diseconomies flowing from excessive deficit in a member state of the Monetary Union a risk and laid down rules to avoid this risk. With much difficulty, a partial consolidation of public finance has taken place, but it has not been sufficient to restore the confidence of firms and consumers and to have a positive impact on the rate of economic growth.

The second explanation relates to the failed completion of the EU internal market, especially in the services sector, where the most significant gap with the US lies with regard to productivity growth rates. Some progress has also been achieved here, but much has still to be done to provide a clear impact on growth. Thus, a third factor probably has to be considered to explain the gap between Europe and the US, and that is the different stance on fiscal policy.

In the United States, an expansionary monetary policy has been backed by a growing federal budget deficit: in fiscal year 2000, the surplus was equal to 0.9 percent of GDP, while in 2004 the budget balance had been reversed, with net borrowing equalling 4.9 percent of GDP. In Europe there has also been a worsening of fiscal balances in the last years, but with no expansionary impact on domestic economies. This is due mainly to:

- the fact that the efforts of member states are uncoordinated and aimed at promoting their own policy, without regard for what the others are doing;
- the low level of the multiplier effects on domestic demand within the internal market, due to the large leakages from the income circuit through increased imports;
- the Ricardian equivalence.

In principle, the implementation of the Lisbon Strategy at member state level seems to require two different fiscal policy measures: one supporting domestic demand, and the other implementing the unavoidable reforms on the supply side. But supporting domestic demand through fiscal policy measures is difficult: first because of the 3 percent of GDP Maastricht ceiling on national budget deficits, as already pointed out; and second - but probably equally important – because expenditure increases or tax cuts have

little impact on national income since the benefits of an expansionary policy are also exploited by the other member states acting as free riders. As usual, when there are external benefits, production of the public good, "stabilisation" is less than optimal.

But equally important are the shortcomings of measures impacting the supply side of the national economies, since many reforms, even if they improve the budget balance in the long run, have a short-term negative impact. This is true, for instance, of political measures aimed at reforming the pension structure, moving towards a capitalisation system. In conclusion, it is quite difficult to implement the Lisbon Agenda at the member state level. In fact, the recent reform of the Stability and Growth Pact seems unable to tackle these difficulties and could ultimately even worsen the prospects for economic growth within the Monetary Union. The only result could well be a stiffening of the European Central Bank's policy, should it fear a further deterioration of public finance balances due to the greater flexibility allowed by the new Pact.

What to do?

The only way out would seem to be to implement the Lisbon Agenda at the European level. This means increasing EU expenditures for:

- completing the TENs programme in the field of transport, energy and telecommunications;
- promoting R&D and supporting improvements in EU higher education systems to raise the competitiveness of European goods and to strengthen the formation of human capital;
- supporting the adoption of advanced technologies in the industrial sector;
- funding projects aimed at raising the quality of life of EU citizens (sustainable mobility, quality of water supply, conservation of natural and cultural resources) and at guaranteeing plentiful – and possibly cheap – new environmentally-compatible energy resources for the Union (renewable energies, clean energy).

Implementing such a programme would come up against numerous financial constraints, however, as shown by the difficulty in reaching an agreement on the Financial Perspectives 2007-2013, and in particular in promoting a shift of resources from the agricultural sector to the new pattern of expenditures sketched out in the Sapir Report. Taking these constraints into account, it seems reasonable to conclude that, if the Lisbon Agenda cannot be fulfilled

at either the national level or through the European budget, due to the budget's small size and the member states' unwillingness to increase their contributions, the only way out is to implement the "golden rule" at the European level, that is by partially financing the expenditures required by the Lisbon Strategy through the emission of Union bonds. Obviously, this funding would have to be supplemented by private investments. The Union bonds could be placed on the international market, exploiting the strength of the euro and thus balancing the negative effects on European exports of an overvalued EU currency.

Union bonds

The basic idea is that the different projects envisaged in the Lisbon Strategy could be funded through project financing or public/private partnerships depending on the different degrees of risk/profitability involved. The public share could be divided between the member states and a European Lisbon Agency, which could get the funds from the market by emitting Union bonds through the European Investment Bank (EIB). The private sector involved in the projects could get funds either from the market or the EIB. The European budget would cover the interest payments on the bonds emitted on the market and the costs of interest allowances granted to the EIB.

According to a recent study,[8] following the suggestions put forward in the Sapir Report concerning the share of investments needed to promote growth within the European Union distributed over three different areas (55 percent R&D, 28 percent infrastructures and 17 percent education and training), one GDP point of additional investment could be funded from the private sector for 0.584 percentage points, with the Lisbon Agency and member states each providing 0.208 percentage points. The study also estimated the possible impact on growth during the 2006-2010 period of a new investment flow increasing from 0.2 percent of European GDP in the first year – corresponding to almost 20 billion euro – to 1 percent in 2010, a target that represents half of what was considered in the Sapir Report as the minimum amount of investment needed to achieve the Lisbon goals. According to this hypothesis, the financial commitments of the Lisbon Agency would increase from 4.2 billion euro in 2006 to 21.2 billion in 2010 to cover its share of capital expenditures, while the European budget would have to provide an amount varying from 0.5 billion euro in 2006 to 7.7

[8] ISAE Report, *Le previsioni per l'economia italiana,* (Rome: ISAE, July 2005) pp. 58-64.

billion in 2010 and the following years for interest payments, up to full reimbursement of the debt. Assuming that the European Central Bank were to keep interest rates constant, the study estimated that at the end of the period in question, the European GDP would have increased by 1.5 percentage points, with an annual increase varying between 0.3 and 0.4 percentage points. The higher rate of growth would also have a positive effect on the overall budget balance which would improve, by 2010, by 0.3 percentage points.

Acknowledging all the limitations of this kind of forecast, these results show that new life can be breathed into the European economy if the Lisbon Agenda is implemented by funding part of the new investments needed to achieve the goals through the emission of Union bonds. The Euro-scepticism that now prevails must and can be overcome by a political initiative showing not only that implementation of the Lisbon Agenda is possible, but also that it would relaunch growth and improve the welfare of European citizens.

Conclusion

The role of an expansionary economic policy seems particularly relevant in the present difficult circumstances, after the "nos" in the French and Dutch referendums and the difficult – and low-profile – agreement reached on the Financial Perspectives 2007-2013 at the Brussels European Council on 15-16 December 2005. In this framework, if one wants to guarantee compliance with the Maastricht Treaty constraints by all member states and at the same time finance the Lisbon Agenda, the only solution is to find additional resources at the European level, outside the EU budget. At the same time, it seems convenient to exploit the strength of the euro and import capital from the rest of the world to supplement the largely available domestic funds in financing a European Growth Plan.

From a political point of view, the willingness to accept a federation as the final goal of the process of European unification would be required after completion of the Monetary Union to provide an effective governance for the European economy. This was the original goal of Monnet and Spinelli, the founding fathers, but not all 25 EU member states share this view. If Europe is to move ahead, an initiative should be taken for a new round of institutional reforms, aimed at establishing a "hard core" with a federal structure in the framework of a larger Union enjoying the existing institutions and exploiting the *acquis communautaire*.

Hence, a two-speed Europe seems to be the only way out, given the difficulties in proceeding towards a federal solution in the framework of a

European Union of 25 – or more – member states. This implies that if the financing of the Lisbon Agenda can, under the present conditions, be guaranteed only through the emission of Union bonds, the political framework in which this decision should be taken is the Euro-zone. The boost that a successful economic growth process would give Europe could also create the climate of confidence needed to support further advances in the institutional field towards a truly federal Constitution that would have to be approved by a Europe-wide referendum during the 2009 European Parliament elections.