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SMART AND SUSTAINABLE GROWTH

Implementation of Europe 2020: Time to Act

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The agreement on the Europe 2020 Strategy in 2010 came amidst a period of economic upheaval. Europe has been facing a deep recession, suffering a setback in fulfilling its long-term ambition of achieving "the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment".[1]

The economic crisis has made the achievement of the central goal of Europe 2020 – smart, sustainable and inclusive growth – even more important, but at the same time has limited the resources available to pursue the Europe 2020 objectives. This article sets out what critical actions are necessary to drive forward the implementation of Europe 2020 to avoid the Lisbon Agenda's fate of having the right ambitions, but insufficient implementation.

The long term impact of the crisis[2]

While most of Europe is now on the tentative road to recovery, the economic crisis has not only had a profound impact in the short term, but it looks increasingly likely that the crisis will also result in long-term impacts, which will influence Europe's ability to deliver on its development priorities.

The more difficult economic position of the European Union (EU) is not due to the crisis alone: the crisis has aggravated pre-crisis challenges. Growth rates in Europe were already relatively low, for example with average growth from 2002-2006 at around 2%. In part, this is due to

1. Treaty on European Union
2. Economic data in this section is taken from the Autumn 2010 forecast, European Commission

the long-term challenges Europe faces, including a significant ageing of its population, global competition, increasing resource prices and the need to finance climate-change adaptation and mitigation. But, policy also played a significant role: while some of Europe's economies are among the global top performers in terms of competitiveness (with the Nordic EU Member States consistently among the top 10 in the World Economic Forum's Global Competitiveness Index)[3], others have fallen behind, not least due to lack of sustained economic reform.

Falling GDP

The most direct impact of the crisis has been a sharp reduction in Gross Domestic Product (GDP) – the EU lost on average 4.2% in 2009, with the growth rate for 2010-2012 at 2% or below, implying that pre-crisis GDP levels will only be recovered in the course of 2012. This masks significant variation within the EU, with a double-digit contraction in 2009 in the Baltic States (Estonia -13.9%, Lithuania -14.7% and Latvia -18.0%) and contractions of around 8% in Finland, Ireland and Slovenia. In 2010, Bulgaria, Latvia, Ireland and Spain continued to contract (albeit at a marginal rate of between -0.1% and -0.4%), whereas Romania's economy shrank by -1.9% and Greece's by -4.2%.

Reduced economic potential

What is even more worrisome is the reduction in economic potential, which is likely to take place unless new momentum for growth can be mobilised. Some important sectors that were drivers of economic growth in many countries, such as construction or the financial sector, are unlikely to recover to pre-crisis level. In addition, the crisis has accelerated the structural change that has been driven by global competition, with the emerging economies drawing in a bigger share of global economic activity.

The crisis has also served to emphasise that it is not merely growth that is needed, but sustainable growth in every sense of the term – economic, financial, environmental and social. Consumption and profit fuelled by debt and high risk financial transactions can no longer be the foundation of economic success. However, this does not mean that a new sustainable growth model that promises high growth and employment rates is readily available.

A mountain of debt

The future inability to fuel future economic growth through debt-financed spending extends to the public sector. The crisis – and the policy response to it – have resulted in large deficits and consequently mounting public debt burdens. By 2012, average gross public debt will be over 80% of GDP in the EU, up from around 60% before the crisis. Belgium will

3. With Sweden on rank 2, Finland on 7 and Denmark on 9 in the 2010-2011 index. Germany is on 5 and the Netherlands on 8; (World Economic Forum, Centre for Global Competitiveness and Performance, *Global Competitiveness Index 2010-11,* 2010, available at: http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf

have a debt to GDP ratio of 102%, Ireland 114%, Italy 120% and Greece a staggering 156%. Portugal, France and the United Kingdom will be somewhere around the 90% mark. On average, debt financing costs will be around 3% of GDP in the EU but Greece is in a precarious situation at 7.4% of GDP.

These levels of debt will necessitate fiscal consolidation. While in the short term there is a need to avoid a potentially difficult spiral of lower public spending resulting in lower growth and thus lower revenues, necessitating further fiscal consolidation, in the medium term fiscal consolidation will be inevitable. Given the scale of the debt mountain, this will require more than a simple cutback in expenditure and a slight increase in taxation – there is a need to reorganise public services fundamentally. In addition, it is unlikely that the public sector will be able to provide significant public investments which are needed to increase further growth potential.

Divergence

There is not only a growth crisis across the EU when compared to the rest of the world, but also increasing divergence within the EU, which is a major driver behind the current eurozone crisis. While divergence pre-dates the economic crisis, most notably in balance-of-payments performance, it looks increasingly likely that some of the weakest economies will be left even further behind. While countries such as Germany are rebounding strongly, economies such as Portugal and Greece record low growth and investment rates. The fundamental question is whether this is a temporary phenomenon or whether it represents a trend towards further divergence. It is true that there is a need to rebalance economic policies in the weaker economies and this will have a short-term impact. But it also seems unlikely that in those economies with a fundamental structural problem the current wage moderation in itself will be enough to restore competitiveness.

A growth strategy for Europe

The developments charted above make it essential that a significant focus of EU policy must be on encouraging economic growth, with a particular focus on growth in Europe's weakest economies. As a starting point, the EU has agreed on the Europe 2020 Strategy, which aims to stimulate "smart, sustainable and inclusive" growth.

Strengths and weaknesses of Europe 2020

The Europe 2020 Strategy does represent in many ways an improvement on its predecessor, the Lisbon Strategy. For a start, it has a clearer focus with only five headline objectives – on innovation, labour market participation, education, combating poverty and climate change mitigation. It also specifies seven flagship initiatives with – more or less concrete – areas of action for the EU. Importantly, Europe 2020 recognises that the main problem with the Lisbon Strategy was not its ambition, but the implementation, which varied greatly across Europe. The architects of Europe 2020 have tried to overcome this by creating more buy-in at the highest level, giving the European Council a much greater role in implementation.

But nagging doubts remain – is the implementation mechanism strong enough to overcome significant resistance in many Member States, especially in the context of a very difficult economic environment? There is also a noticeable contrast to the current discussions on economic governance where ambitious plans are being put forward for more integrated economic governance. The political emphasis is currently on better governance for fiscal policy with a real question remaining over how strongly structural reform is going to be promoted.

But despite its shortcomings, the Europe 2020 Strategy is an important element of European policy development, which can potentially help to overcome the crisis. This article now focuses on three areas for action that can potentially be crucial components in the implementation of the strategy by generating investments in future growth: reform of the public sector, European-level investments and the creation of the right framework for investment through the further development of the Single Market.

The missing link

One significant absence from Europe 2020 is any detail on public-sector reform, and even less on an implementation mechanism. The importance of public-sector reform is noted: "Fiscal consolidation and long-term financial sustainability will need to go hand in hand with important structural reforms, in particular of pension, health care, social protection and education systems. Public administration should use the situation as an opportunity to enhance efficiency and the quality of service."[4] But beyond the general monitoring of reforms, Europe 2020 does not give much concrete information on what to do, and how to ensure these structural reforms take place.

Arguably, this is not a problem. In traditional economic growth theories, the public sector does not feature. However, this ignores both its importance for the long-term development of a country and its role in tying up crucial resources. This is especially true in Europe, where the public sector has a proportionally larger role than in the rest of the world. In Europe, the public sector can provide a crucial role in creating the framework conditions for growth in three ways: by focusing on growth enhancing spending it can boost overall long term economic performance, for example focusing on the formation of human capital; by helping to develop new areas of competitive advantage for European firms, for example pioneering the use of "green" goods and services; and, by minimising the level of inefficient or ineffective spending, freeing up resources to be used elsewhere in the economy.

4. European Commission, "Europe 2020: A European strategy for smart, sustainable and inclusive growth", p. 24 available at: http://ec.europa.eu/europe2020/index_en.htm

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The achievement of such public-sector reform could be supported more effectively at the European level. As a crucial first step, much more emphasis should be given to public sector and social innovation. In monitoring the implementation of Europe 2020 and of fiscal policies, more emphasis should be given to identifying and promoting structural reform that can simultaneously help to reduce public-sector deficits and encourage growth, for example removing provisions in public pension systems that encourage early labour-market exit. In short, public sector reform should be a fundamental and integral component of Europe 2020 implementation.

The investment challenge

To achieve the objectives of Europe 2020 will require significant investment, which is a particular challenge in times of public-sector austerity. Funding is, for example, required to realise invest-to-save schemes, aimed at achieving the transformation to the smart economy. At the same time, there are still significant infrastructure needs across the EU, both in forms of traditional infrastructure such as roads and rail, but also in terms of new infrastructure in relation to smart grids and next-generation broadband. In addition, there is a need to accelerate investment in education and skills formation to help Europeans realise their full potential and to increase the value-added of European goods and services, enabling Europe to continue competing with the emerging economies, which are investing tremendous efforts in this area.

The challenge to generate such investment is particularly large in the economically weaker European economies, both in Mediterranean and new Member States. Here, such investment can fulfil a dual purpose: in addition to boosting competitiveness and productivity, it can help new Member States catch up faster with the rest of Europe. This would be difficult in the absence of private foreign direct investment, which suffered in the crisis. It could also help to counteract the austerity measures in the Mediterranean countries, helping to make public-finance reform less painful and more socially acceptable.

The benefits from such investment are significant – both for the countries concerned and the economically stronger countries in the EU from where the investment must come or at least be underwritten. It would improve cohesion in the eurozone as well as delivering, productively, European solidarity. At the same time, helping to develop these countries in the direction of smart, sustainable and inclusive growth will encourage European companies and individuals to provide additional investment.

At European level, much can be done to help this process. The resources of the EU budget, such as cohesion funding for example, could help leverage investment in these areas, but it would require reform, including for example much closer public–private partnerships and more investment in the development of human capital. In addition, the activities of the European Investment Bank could be greatly expanded to provide more low-cost investments. The idea of EU project bonds, as noted in the Budget Review should also be implemented, to provide crucial investment in pan-European infrastructure projects.[5]

Size matters

Probably the most important function the EU can fulfil is to develop the Single Market further. European companies have the ability to generate tremendous amounts of investment, but they require an integrated market that makes it worthwhile. The Single Market, as it stands, is the most significant result of European economic integration, but it is far from complete. Not only is more work required in realising the original four freedoms, but the Single Market also needs to be made ready for the future knowledge economy.

Many of the problems encountered by firms and consumers within today's Single Market are not due to the overall framework of rules, but to its incomplete or indecisive implementation. More needs to be done at EU level to ensure that the rules are applied uniformly and consistently across the EU, with a particular focus on ensuring that legislation is evaluated ex post to ensure that it has delivered the desired market integration.

This is particularly important for the services Directive. While much has been achieved in the free movement of goods, the services Directive has only been in force for just over a year and it still has many shortcomings. The free movement of capital has also taken a blow through the economic crisis, especially from a consumer perspective, where cross-border access to capital remains elusive. The free movement of people remains one of Europe's proudest achievements but it, too, needs to be updated to reap the full benefits: Europe needs a Single European Labour Market with measures that encourage mobility and open European labour markets to the rest of the world.

To generate additional growth and enable the transformation to the knowledge economy, creation of the Digital Single Market is critical, which is recognised in Europe 2020: "The aim is to deliver sustainable economic and social benefits from a Digital Single Market."[6] This requires making progress on a number of thorny issues including, for example, harmonisation of consumer and data protection, common standards for e-invoicing and e-signatures, a pan European patent, IPR and licensing framework and significant investment in hard (broadband) and soft (skills) infrastructure.[7]

5. European Commission, Communication, "The EU Budget Review, SEC(2010) 7000 final", 19 October 2010, available at: http://ec.europa.eu/budget/reform/library/communication/com_2010_700_en.pdf
6. European Commission, "Europe 2020: A European strategy for smart, sustainable and inclusive growth", *op. cit.*, p. 12
7. For details please see European Policy Centre, *Establishing the Digital Single Market,* available at: http://www.epc.eu/dsm/6/Policy_recommendations.pdf

But the potential benefits for the EU economy are large: it could add at least 4% to EU GDP, help create European digital companies of scale, as well as helping to integrate EU labour markets, combating climate change and countering the effects of population ageing.[8] It would bring many benefits to consumers, not least to a new ICT-savvy generation that expects a free online market where they can, for example, download music anywhere in Europe.

At EU level, there has been much progress: the Digital Agenda,[9] the Citizenship Report[10] and the consultation on the Single Market Act.[11] The latter two followed on directly from the Monti Report[12], which provided a comprehensive blueprint for the development of the Single Market. However, it remains to be seen exactly how ambitious, integrated and visionary the concrete proposals will be and what, in the end, will be translated from ambition to reality, given the difficult economic and political environment as well as protracted European decision-making mechanisms.

A more competitive, sustainable knowledge economy

If the coming presidencies put their weight behind reform in these three crucial areas – inclusion of the public sector in economic governance and Europe 2020 considerations, reform of the EU budget and associated loan-based instruments with a particular view towards generating the investment needed to underpin Europe 2020, and pushing forward the further development of the Single Market, in particular the Digital Single Market – much could be achieved in turning Europe 2020 ambitions into reality. Conversely, without decisive action in these areas, Europe 2020 might well remain a laudable ambition that will go undelivered. In the current economic situation, Europe does not have many opportunities to generate future growth: it is critical to turn Europe's public sectors, European funding and the European Single Market into assets that will deliver smart, sustainable and inclusive growth.

8. For further details please see European Policy Centre, *Europe Needs a Digital Single Marker Now*, April 2010, available at: http://www.epc.eu/dsm/
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