CONSULTATION ON THE FUTURE "EU 2020" STRATEGY

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On the credibility and effectiveness of the strategy

1. **Major amendments will be needed to ensure a credible and effective strategy.** EU countries were a long way from achieving the Lisbon targets before the crisis. In renewing the strategy, it is essential to identify what its fundamental flaws were. Making the strategy work rather than focusing on rigid targets should be at the core of the debate. In terms of objectives, EU governments need to focus on creating the best enabling environment for markets. Getting out of the way and shrinking the public sector's footprint is key to reinvigorating growth and facilitating fiscal consolidation. Redressing large intra-region imbalances is also essential, and should therefore form part of the strategy. In terms of governance, past failure in reconciling objectives with outcomes points to weak incentives in the open method of coordination. Europe should consider articulating all the relevant aspects of economic policy surveillance in a single cycle, thus reducing the burden on Member States to report twice on long-term issues—both under the Stability and Growth Pact and the Lisbon processes. Council recommendations on structural policies will need to be more specific.

2. **The EU 2020 strategy will face the double challenge of increasing employment rates and stimulating productivity growth.** In the wake of the crisis, it will be important to achieve higher employment rates, in particular, by avoiding a permanent increase in long-term unemployment. The credibility of the strategy will also require polices to overcome the difficulties experienced by EU countries, prior to the crisis, in improving productivity.

On employment and social justice

3. **Labor market reforms remain key for the employment intensity of growth.** Sectoral specialization will shape labor utilization during the recovery. However, this cannot be directly influenced by policy. Thus labor market reforms will play a prominent role in reducing the disparities in the employment intensity of growth among EU countries. Despite the fact that the speed of recovery will vary considerably across Member States, it will be important to find common ground for reform at the European level supported by ambitious national legislative initiatives.

4. **EU 2020 should revisit the employment strategy in the light of the role of labor market institutions in explaining long-term unemployment.** National governments should take a number of steps to avoid trend increases in structural unemployment. Higher and especially more effective spending on active labor market policies will be key to quickly reallocating workers to new jobs. To minimize adverse effects on search activities, increases in the generosity of unemployment benefits during the crisis should be temporary and accompanied by an enforcement of job-search requirements. Employment protection legislation (EPL) should be eased to facilitate labor turnover from less to more productive firms. Dismantling the dual EPL system still prevailing in some European countries will also be important to distribute the burden of adjustment more evenly between workers. Future fiscal consolidation should focus on tax-broadening while changing the composition of tax wedges to improve work incentives. Finally, Member States should encourage more flexible bargaining systems so that wages reflect trend productivity at the firm level.

5. **Further work is needed to remove artificial obstacles to labor mobility.** Greater portability of social and pension rights is essential for this, as are continued efforts to achieve mutual recognition and compatibility of qualifications.

6. **As recovery takes hold, the focus of the employment policy should shift towards long-term challenges such as ageing and migration.** These issues also have a crisis dimension. In particular, it is essential for fiscal sustainability that older workers are re-integrated into the labor market once the economy picks up and that the effective retirement age is increased. On migration, the EU should make the “EU Blue Card” a workable instrument to attract more talented people from abroad.

7. **The social component of the strategy is important to safeguard social justice while enhancing public support for economic restructuring.** In this difficult environment, the EU should help governments to find budgetary means to protect social assistance, mainly by better targeting social safety net programs. In this connection, recent IMF-supported programs provide examples of cost-effective social spending.

On productivity

8. **The EU 2020 strategy should be flexible in setting objectives for productivity.** Although some argue that it is important to set an objective for labor productivity growth in the new Lisbon strategy, productivity is a complex concept and the links between policy measures and performance are difficult to establish. As a result, a plausible outcome of committing to concrete productivity targets is failure to deliver. Further, the scope for and nature of productivity improvements—as driven by sectoral reallocation, technological catch-up and generation of new knowledge—are, to a certain extent, country specific, and therefore the EU 2020 strategy should be flexible enough in setting policy objectives in this respect. The focus should surely be on the EU adopting joint initiatives in the areas of the single

market, competition, human capital and incentives to innovation which will unambiguously result in higher EU-wide productivity.

9. **Enhanced productivity can benefit from economic restructuring and deepening of the single market.** The main contribution of the Lisbon program to productivity growth is to promote restructuring of non-viable industries severely damaged by the crisis. This means providing EU-wide guidelines and coordinating national restructuring strategies. Heightened doubts about the desirable adjustment process after the crisis and the poor record of governments in picking winning industries, suggests that the pursuit of a policy supporting specific clusters or sectors—i.e., vertical industry measures—should be avoided. In this connection, the need for a dedicated Commissioner for industrial policy should be carefully reconsidered. Meanwhile, the completion of the Single Market should be given renewed emphasis. In this area, there is a continued need for market monitoring along the lines suggested in the 2007 Single Market Review. The successful implementation of the Services Directive will also be central to enhance productivity given the increasingly important services sectors and its sizeable productivity gap with leading advanced economies.

10. **National initiatives aimed at reducing product market regulation should be promoted**. It is important to bear in mind that, in contrast with experience in other world regions (witnessing drastic moves in their economic structures from agriculture to industry and from industry to services), productivity in Europe since the 1990s has been shaped by intra-sectoral increases in labor productivity rather than sectoral reallocations, at least in EMU countries. This suggests that another challenge of the strategy is to encourage national initiatives aimed at improving competition. Not only have reforms in product markets slowed down in recent years but progress has been uneven across sectors, with advances in network industries being hamstrung by lack of reform in professional services and retail trade. In addition to improving productivity, increased competitive pressures will also affect the response of long-term unemployment to the shock.

11. **It is arguable whether the Lisbon target of R&D expenditure of 3 percent of GDP should be retained.** Although the links between R&D efforts and innovation outcomes remain unclear, they strongly depend on economic structure. EU countries ahead of the technological curve enjoy higher returns in R&D expenditures and thus may have an interest in reinforcing R&D investments; by contrast, countries that are highly specialized in low-tech industries would benefit more from fostering higher education as a means to boost productivity. Setting a joint benchmark for research activities and higher-education expenditure instead of the current Lisbon target would allow room to choose the proper mix between knowledge creation and diffusion.

12. **Improved R&D should be mainly pursued by removing obstacles to innovation**. An important component of the shortfall of productivity in the EU vis-à-vis the US is the relatively weaker productivity performance in high-tech manufacturing sectors where research efforts show few signs of gathering pace. Policies should prioritize the creation of

favorable conditions for innovation over pursuing specific R&D spending or subsidy benchmarks. Measures directed toward ensuring access to finance of high-risk capital, especially by removing obstacles to cross-country venture capital provision, should reinforce the role of financial markets as a catalyst for innovation. Efforts should also be scaled up to introduce a Community patent within the shortest delay. Improved tertiary education systems should contribute to better train researchers.

13. **Prospects for the creation and diffusion of innovation can also benefit from labor and product market reforms.** High labor adjustment costs due to strict EPL–that in many cases act as costly exit costs–tend to discourage specialization in high-technology sectors, and the adoption of new technologies or human capital accumulation in every sector, thereby leading to lower productivity performance. Easing EPL should therefore be a priority in the EU 2020 strategy. Reducing red tape for business and reforming bankruptcy codes to enable business continuity to failed entrepreneurs remain equally important to promote entrepreneurship and facilitate the catching up with industry productivity best practices.

14. **Catching up with technological leaders requires additional efforts to increase the quality of tertiary education in Europe.** R&D subsidies, policies to increase the supply of researchers and product and labor market reforms will not be enough to catch up with leading economies. A major obstacle is that the average skill level of high skilled workers in those economies exceeds that of the EU. Consequently, additional efforts to increase the quality of tertiary education in the EU are required. Better higher education can build on the success of the Bologna process in coordinating Europe's education systems. The emphasis of the strategy on lifelong learning, including through digital means, is also very welcome.

On sustainability

15. **An essential element for sustainable growth is fiscal consolidation.** Substantial consolidation efforts will be needed to reverse the deterioration of budgetary positions and place public debt onto sustainable trajectories. Concerns about sustainability can undermine the effectiveness of fiscal policy: thus an early return to rules-based consolidation and adoption of institutional reforms to enhance credibility are apposite. The procedures under the SGP are helpful, but will need to be further strengthened and their focus expanded to cover the size and composition of fiscal adjustments and age-related entitlement reforms.

16. **Sustained growth will require regional rebalancing.** A shift from internal demand to external demand is needed in deficit countries matched by counterpart adjustments in surplus countries heavily reliant on export-led growth. Broadening the scope of macroeconomic surveillance to ensure an effective correction of competitiveness imbalances in the region, especially within EMU countries, should form part of the renewed strategy.

17. **No sustainable growth will be possible without curbing climate change.** The European agenda deserves recognition in this respect. Fighting climate change has been introduced as a policy objective in the Lisbon Treaty and the climate problem should

certainly be rooted firmly in the strategy. The EU's "20/20/20" climate-change Plan has already taken important steps to address climate change, namely, mitigation through carbon pricing, improved efficiency in energy consumption and green innovation. However, three main challenges remain ahead. First, ceteris paribus policy objectives, there is still room to refine the EU instruments used to fight climate change as argued in other IMF staff publications.[1] Second, there seems to be no consensus—neither in science nor in economic analysis—on whether climate policy should give a more pivotal role to breakthrough innovations instead of focusing on carbon pricing. EU policymakers need to consider this bearing in mind the impact of alternative packages on fiscal positions. Finally, relying on its experience in this area, the EU should take a leading role in international negotiations, as climate change policies cannot be successful if they are not coordinated globally.

On governance

18. **EU's governance needs to be strengthened, both regionally and globally.** Without a significant breakthrough in making the coordination of structural and fiscal policies more effective, especially for the members of EMU and not just during crisis times, it is difficult to see how the EU 2020 objectives will be achieved. Moreover, experience with the method of open coordination so far suggests that ambition quickly falls to the lowest common denominator. In this respect, it will be important to align the macroeconomic scenario of the Stability and Convergence Programs with the description of the supply-side of the economy that is consistent with the reform intentions, possibly through growth accounting techniques. It will also be essential to clearly track individual country progress against uncontroversial and absolute performance indicators and be concrete in country-specific recommendations made by the Council, as well as about the consequences of non-compliance. Similarly, at the global level, Europe needs to define a regional economic strategy and speak with one voice in international forums, including in the IMF. The Lisbon Treaty, which allows for majority in decision-making in more policy areas and formalizes the Eurogroup of finance ministers for the first time, should facilitate progress on these issues.

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[1] See chapter 4 "Climate change and the global economy" in *World Economic Outlook*, IMF, Spring 2009, and Jones, B. and M. Keen, "Climate change and the Recovery", IMF Staff Position Note, 09/28.