Acting together and simultaneously: higher growth and more jobs

⇨ Combining growth and structural reforms
⇨ taking advantage of the European dimension

Adopted by the PES Leaders
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Foreword

Our world is changing. Globalisation is challenging our societies and Social Europe. With millions out of work and many more pessimistic about the future, Europe desperately needs economic growth, and to generate new confidence by investing in growth. We are committed to giving a coherent answer to people's worries and face up to the challenges of globalisation.

Modernisation of our social welfare is needed, but it needs to be done our way. The progressive social democratic way that renews our welfare states without undermining them and modernises Social Europe. We reject any race to the bottom. Reform must be about creating a more active and inclusive society. Investment in training, removing the obstacles to women and migrants entering the workplace, assisting people to change jobs, income support for people between jobs are the sorts of reforms we need. Reform is about helping everybody to prosper in an increasingly global economy.

Reform must be accompanied by public and private investment to boost growth and create jobs. Investment primarily from the member states but with a European dimension. Cross-border projects and coordinated, simultaneous investments in infrastructures, networks and skills would have greatest impact. We have a special responsibility to combat poverty and create more solidarity between regions in Europe, not least in the new member states.

Improved economic policy coordination is a must, not only between national governments but also between the Eurozone group and the European Central Bank.

Public acceptance of some of the more painful structural reforms, a major obstacle in some countries, is made much easier by Governments making a strong commitment to investing in people and projects. Investment and structural reforms go hand in hand to stimulate growth and create jobs, and to build public support for change.

At the PES Council in Vienna in June 2005 we agreed to ask our Finance Ministers and Shadow Finance Ministers to finalise our growth initiative for adoption by the Leaders of our member parties at the Summit in October 2005. This has now been done. Before us we have our new common initiative "Acting together and simultaneously: higher growth and more jobs".

By combining social democratic structural reforms with investment in people and economic growth Europe can reach our goal of full and high quality employment and generate a renewed confidence in the future. This is the direction in which Socialist and Social Democratic Parties must move in the coming months.

Poul Nyrup Rasmussen
President of the Party of European Socialists

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Introduction

State of the present: Insufficient growth

Europe has not regained momentum.

In the European Commission's latest economic forecast the euro area is likely to grow by 1.6% in 2005 and 2% for the EU-25. In 2006 growth is likely to rebound to the 2.1%. Nonetheless, this is not leading to a significant reduction in unemployment.

Unemployment figures are likely to stay unchanged in 2005. The forecasted growth rate will not be enough to create more jobs. For 2006 a small reduction in the unemployment rate is likely to occur. Inflation will fall well below the 2% inflation objective of the ECB.

After 2006, growth rates are likely to be in the range of the 2-2.5% and an unemployment reduction is expected but only marginally.

The situation and prospects within the Euro area and EU-25 clearly shows, that with the present unchanged policies, growth rates are clearly too low to create enough jobs and reduce unemployment substantially.

That is unacceptable.

Without reinforcing growth and pursuing reform-oriented policies we will loose a substantial welfare potential and risk moving into a long-term trap of low growth.

There is a fundamental need for a new combined and simultaneous approach:

- ⇨ We need structural reforms in Europe, but we do also need increased demand.
- ⇨ We need growth in Europe, but we cannot make it sustainable without structural reforms.

There is a strong case for creating a framework for a simultaneous approach for all. That is:

A European dimension of a coordinated investment strategy.

This means a scenario which goes beyond the traditional definition of investment in budgetary terms. The coordinated investment strategy also includes "high quality" public expenditures in human capital, R&D and education. It is in fact a scenario where a balanced economic policy approach, better coordination of economic policies, direct investment, structural reforms and a simultaneous action at the EU level work together for a better common future . (An indicative annex/possible example is presented later in this paper)

In order to increase growth now, measures to enhance the growth potential have to be embedded in due attention and more emphasis given to the demand side of the economy.

Higher consumption and higher investment is essential, not only private but also of public origin. Indeed, efficient public investments together with well-directed expenditures in R&D and education will have a strong multiplier effect on the economy and this should not be neglected. Public-private partnerships could play a prominent role in implementation. This will also serve to increase confidence of economic agents, which according to the last Commission forecasts has again gone down. While a more active public policy is needed for Europe as a whole, some of the solutions will naturally be local. However, if countries act together, positive spill over effects will inevitably occur.

Overall it is clear that increased growth can be achieved by improving the internal market, more public "intelligent and high quality" investments and other important “future” expenditures, an effective monetary policy, reforms of the labour market and – where necessary – in the social security system. This will increase private confidence and thereby increase private consumption and private investments. This European investment strategy is the key to what should be our aim: A serious attack against unemployment

This strategy would be most effective if European countries were to do it together as it would create dynamic effects.

Our strategy to increase growth, achieve full employment and target sound public finances includes five main points that cover both the supply and the demand sides of the economy in a balanced and proactive way. The final aim is higher growth, full employment and sound public finances. In today’s global economy the foundation of economic success should be a framework for macroeconomic policy that supports stability and growth.

1. A balanced economic policy approach
   - Structural reforms, albeit important, do not suffice to re launch economic growth on their own.
   - More attention to the demand side of the economy is essential. We need both, in a balanced way.

2. A better economic policy coordination
   - Economic policy coordination is an essential ingredient if Europe is to fully gain from the single currency.
   - This coordination needs to occur between governments themselves but also between the Eurogroup and the ECB.
   - European projects, related to the Lisbon objectives, managed in a coordinated way are very likely to augment growth through the multiplier and the splillover effects.
   - a reorientation of the EU budget to investment expenditures plays a key role. We must be able to identify European projects that stimulate growth and if so the full utilisation of the EU budget must be achieved.

3. More high quality, “intelligent” public investment and future expenditures
   - Sustainable well – targeted public investment strategies done at both national and European level.
   - The EIB could play a more important role.
   - This will most likely generate higher private investment and foster economic growth thereby creating a favourable climate for the implementation of structural reforms.
   - PPP’s can be a good mechanism for increased investment.

4. Structural reforms are vital for raising the growth potential and needed in Europe
   - Structural reforms go hand in hand with more increase in demand. The labour market reform, namely via investment in people and through a combination of increased labour market flexibility while ensuring job security plays a central role.
   - This and all other important structural reforms are however easier to implement with high levels of growth. Both structural reforms and a proactive demand policy need each other.

5. Ensuring an European dimension

- Europe has a lot to gain from making things together and simultaneously. It gains both in terms of higher growth and more jobs but also in terms of lowering public deficits.
- A European dimension therefore can act as a catalyst for lower deficits.
- A balanced, simultaneous and coordinated action is of high importance to achieve higher growth, full employment and lower deficits.
- This favourable economic climate will favour the implementation of the structural reforms Europe needs.
- However, this will always respect the national issues of each Member State.

By doing this we can reach our goal. Higher growth, full employment and sound public finances.

1. A balanced economic policy approach

Supply and demand are complementary tools to achieve higher growth, full employment while at the same time lowering budget deficits.

Structural reforms, namely labour market, education, social security, research and environment can significantly contribute to a sustainable economic development in the EU, through the creation of more and better jobs and hence higher growth rates. We believe that in order to rip off more benefits from these reforms we must not do them in an isolated way but rather within a balanced economic policy, whereby structural reforms are combined with a proactive demand policy.

Unemployment, low growth and high deficits are persistent problems in the EU economy that we as social democrats have to face.

The European labour market needs to be reformed. EU workers need to be given more training and be equipped with more skills.

We do not share the neoliberal view to labour market reform. Instead, the concept of flexicurity, which combines the need for more flexibility in the labour market with job, wage and employability security, is a goal to be pursued.

Nonetheless, in order to achieve a good and fair labour market reform that does not erode workers rights, both the supply and demand side must interact.

Demand side needs a new push in Europe as it has been too restrictive for several years. This demand push should take the form of more high quality investment, in areas related with the Lisbon strategy, namely knowledge, innovation, education but also public infrastructures and social services.

This ought to be done on a national level but also within a European dimension whereby countries coordinate their economic policies, which will generate spill over effects across the whole Union. Indeed, it is important to bear in mind that isolated demand pushes creates a lot less growth and jobs. As far as possible, EU countries must do it together. Demand policy and structural reforms must move along the same lines.

2. A better economic policy coordination

Isolated structural reforms or isolated investments will not yield the necessary results. They could even create negative externalities, if they are not effectively coordinated between EU members.

Coordination does not necessarily mean neglecting individual choices and individual actions. The National dimension is of high importance but by coordinating their actions Member States will be better positioned to take better into account their domestic priorities. It goes without saying that coordination does not mean harmonisation.

Indeed, by discussing and coordinating their actions, Member States will not only learn from each other but they will be able to incorporate the externalities caused by others decisions on their own. A possible negative effect of these externalities that could derive from the fact that Member States do not coordinate their actions will be transformed into positive externalities as through discussion and coordination Member States will achieve a higher outcome. As an example, a recent study has shown that economic policy coordination can increase GDP in the EU by 0.2% per year.

But coordination of economic policies will also facilitate the task of the European Central Bank. In Europe there is a single monetary policy and twelve different fiscal policies, and this only reflects the Euro zone countries. If the ECB is faced with twelve non coordinated fiscal policies, designing an optimal monetary policy becomes more difficult and yields a less positive outcome. By coordinating their EU-relevant actions and at the same time make structural reforms, Member States will allow the ECB to pursue a more expansionary policy.

Indeed, according to the same study which is presented in an annex, if interest rate cuts take place due to coordination, the effect of coordination of economic policies on the growth rate augments to 0.4% per year.

It should be clear that the coordinated investment strategy must be sustainable. Sound public finances are key to providing a platform of stability and growth. Because of budget constraints the reorientation to high quality budgets is the core of the strategy. This, together with the coordination of economic policies will lead to higher growth, higher employment and lower deficits due to higher tax revenues and lower welfare subsidies.

Another key aspect of the coordination of economic policies is the identification of European projects that are capable of generating growth and of producing spill over effects. These projects are to be linked with the Lisbon strategy and should reflect the political priorities for Europe. A way to finance these projects would be via the full utilisation of the EU budget.

3. Higher “intelligent” public investment, via direct investment

Ad hoc increases in public investment do not produce optimal results. Direct investment needs to be pursued carefully and must be planned at both the national and the European level. This can draw up on the examples of past actions such as the white paper on competitiveness, growth and employment which dates from 1993 and more recently, the quick start programme. Basically it is about combining national priorities to create synergies at European level. A higher public investment in a broad sense is part of what should be a European investment strategy.

Notwithstanding, this European investment strategy needs to be coupled with the right domestic policy which could be characterised by stronger demand, namely by high quality public investment in areas related to Lisbon as well as with a redistribution of public spending from less productive areas to the Lisbon ones.

High quality or “Intelligent” investments, as stated above, are related to the Lisbon objectives of better education, improved knowledge, research, child care, social services and life-long learning as well as to a set of European infrastructures and have not only a demand side effect but also a long lasting structural effects on the economy. Moreover, higher “intelligent” public investment will increase economic growth which will in turn boost private confidence. This will inevitably be translated in higher private investment and private consumption, essential to higher growth. Private investment is of extreme importance to the new Member countries but its increase is related to the increase in public investment.

The recent reform of the stability and growth pact encourages investments in line with the Lisbon goals. It must be emphasised that one of the main objectives of direct investment is to reduce the public deficit. This occurs through the effect of higher growth. In fact, higher “intelligent” public investment, that attracts also private investment, will lead to higher economic growth. Economic growth in turn will increase job creation which increases tax revenues and reduces transfer payments by the state. This combination of higher tax revenues and lower transfer payments will than outweigh the initial rise in spending.

Given the fact that in a number of Member countries, particularly in some of the new ones, an indiscriminate increase in public investment could endanger compliance with the deficit criterion and the rules of the SGP over the short- and medium term, increased reliance on the use of private-public-partnership (PPP) might constitute a viable alternative to the direct expansion of public investments. PPPs have a number of beneficial elements:

a. provided that appropriate risk-sharing schemes have been put in place, only the availability fee burdens the expenditure side of the budget, thus costs of the purchased services may increase in tandem with the increased budgetary revenues generated by the (private sector) investment,
b. PPP structures can generate more efficiency, since the design, construction and operation are integrated. Thus private sector investors care about the total costs of the investment. Furthermore, risk-sharing arrangements and other incentives included in the public-private contracts can provide the public partner with sufficient control over the quality of service purchased from the private partner.

As experiences, both positive and negative, have been accumulated by several Member countries having implemented PPP projects in the past, careful examination of the reasons for success and failure, i.e., learning from experience, would be important for those countries which are contemplating the launching of these schemes.

Even with increased reliance on the involvement of the private sector, it is obvious that in a situation where public investment does not take place, economic growth will continue to be sluggish. In that case, more jobs are not likely to be created and therefore the State will have less tax revenues and higher spending on unemployment subsidies. This is less growth generating than the former scenario and tends to aggravate the deficit situation rather than improving it.

4. Structural reforms are vital and needed in Europe

Our overall objective is to ensure that Europe is characterised by full employment, social inclusion, solidarity and good welfare provision in the 21st century.

To achieve full employment, economic policy must focus on boosting employment and combating unemployment. The key to success in this endeavour is a good labour supply combined with a high level of demand. This is the foundation on which our action programme for full employment is built.

High labour demand must be met by a high level of labour supply. Without a good supply of skilled labour that is both willing and able to take the work offered, high demand inevitably leads to inflation and economic austerity measures instead of growth and greater welfare.

Europe can not and should not compete with lowly trained, cheap labour working under poor conditions but must prioritise skills, competence, quality and knowledge. Both poverty traps and unemployment traps must be avoided. An analysis of labour supply must proceed from the individual European countries' welfare, education and tax systems. In this respect, the countries have much to learn from one another, the open method of coordination being a good tool for that matter.

It is a matter of harnessing the desire of all citizens to work and earn their living – including those who today find it difficult to enter the labour market due to their gender, age or ethnic origin. The most important single asset for those wishing to assert themselves in a fast-changing employment situation is education, training and professional development. Also, this is an essential component if today's more flexible world of work is to lead to welfare gains and not exclusion and wider gaps in society. An efficient, high-quality education system accessible to all regardless of age or sex is the best means of creating good employment prospects for everyone. Education and training is an investment that militates against unemployment, boosts incomes and increases welfare, and also improves people's competitive status.

But a good labour supply in the absence of strong demand does not lead to higher employment. On the contrary, such a situation forces those seeking work to join the 'race to the bottom' – a downward spiral of ever-lower wages and ever-poorer employment conditions. Labour demand, therefore, must be kept high and sustained.

We must consider both supply and demand. We must promote both security and economic development. Fair play and growth are mutually supporting. These policies proceed from the notion that a just system is a productive one.

Closer integration and the completion of the internal market enhance the spillover effects of economic policy and development between countries. The common currency is speeding up this process. Therefore it is clear that we need better coordination between EU countries.

A country's prosperity is ultimately dependent on its general employment situation. A high level of labour supply, therefore, must be assured. Without it, increased demand in the economy leads to soaring wages and prices and thus to a lower employment rate. Labour supply is contingent on a number of different factors, and these can be divided into four main groups.

Firstly, certain people are not required to be at the disposal of the labour market, depending instead on social welfare payments for their support. Secondly, some people are unable to find work due to a lack of proper training or to health problems. Thirdly, marginal effects resulting from taxes, benefit provision or fees/charges mean that some people are unwilling to work or to work longer hours. Finally, discrimination and rigid employment structures may keep down employment.

By introducing policy measures of various kinds, we can influence these factors and thereby enhance opportunities for employment growth. There are still groups in the community that contribute little to labour supply. There is a potential here for significant improvements.

As regards the first factor, all EU countries have at times sought to reduce labour supply in one way or another, either for welfare policy reasons or in the hope of reducing open unemployment rates. The principal focus has been on women and older workers in the

labour market, but policies have also addressed young people, students and other groups. Unemployment has led to stronger calls for job-sharing or opportunities for people to quit the workforce when no longer required. Shorter working time as a means of reducing unemployment is a path that should be avoided.

Firstly, this path may lead to lower employment without significantly affecting unemployment, whatever the intention may have been. Secondly, together with the ageing problem in most EU-countries and the following labour shortage in the future it establishes a pattern that is difficult to break out of. Both employers and employees grow accustomed to an earlier retirement age, which may lead to less investment in training for older workers. Also, opportunities for premature retirement cost money. Here, the needs of older employees must be weighed against other needs, such as those of the parents of young children wishing to reduce their working hours. Premature retirement is a social policy matter, not part of employment policy.

One of the major problems for European job creation is that barriers and inflexible markets limit the opportunities for longer-term economic progress – and thereby the opportunities for a lasting increase in employment.

Problems with inflexible markets can be illustrated through the development of structural unemployment. Structural unemployment is often interpreted solely as an indicator of the development of the way in which the labour market functions. But this is not correct. Conditions on the labour market and the market for goods determine developments in structural unemployment. Poorly functioning competition, barriers preventing access to capital, too few innovative measures, etc., will also be reflected in a high rate of structural unemployment. But experience shows us that structural unemployment is not a fixed figure - it can be reduced by higher growth and reforms (flexicurity). The PES is indeed launching an initiative on social policy to deeply assess this and other issues.

If structural unemployment in Europe is not reduced, an increase in the rate of employment will be of shorter duration, as economic recovery will be hampered by bottlenecks and growing wage and price rises.

As labour markets in Europe face different challenges there is not one single answer to how to increase labour market flexibility. The Lisbon process provides some of the answers; emphasis on education and life long learning, increased participation rate especially for women and elderly and making work pay by reforming tax and benefit systems. We should combine the unemployment benefit systems with active labour market policies and a higher flexibility at our labour markets (flexicurity).

Higher flexibility is important although this can not be confused with hiring and firing. Flexicurity aims at combining the need for enhancing the flexibility of labour markets, work organisation and labour relations with job, wages, social security and employability security, in an integrated and balanced manner.

As regards the will to work, the combination of taxes, charges and benefit systems may have marginal effects and make employment unprofitable to the individual. However, it is not that simple such that a high tax ratio necessarily generates high marginal effects.

Education, training and competence are the key to the type of high employment and growth that does not entail greater injustice and wider gaps in society. Consequently, further proactive investment in knowledge is required. Knowledge is a crucial factor for growth, education and modernisation. Investment in education, therefore, is a vital component in policies that seek a fairer distribution of income.

Expanding the education system reduces the supply of labour. Nevertheless, this approach is preferable in both the short and the long term. The students will in all probability return to the workforce after completing their studies, and also be better equipped to deal with new challenges. Initiatives in the education field represent an important public investment.

This is directly linked with the concept of job quality. Europe cannot and shall not create jobs at any price. Good quality jobs, whereby the individual is equipped with better skills are essential.

Opportunities must also be provided for people to study on an ongoing basis throughout their working lives. Employers cannot be relied upon to supply adequate training opportunities for their staff. They seldom take full responsibility for improving their employees' skills – especially in the case of older workers and women and those with little education. As the average term of employment grows shorter, investment in employee training yields fewer returns. Meanwhile, the need for recurrent training during people's working lives has grown, both for the individual and for society as a whole. Here, both the social partners and central government have a role to play.

The skills of all employees must be properly exploited at the workplace. The organisation concerned must take full advantage of the power inherent in employee competence and strength of purpose. The EU countries must seek to get a competitive advantage through having modern organisational set-ups that allow staff to exercise an influence and that emphasise co-determination.

It is clear that certain groups are subjected to discrimination. Within these groups, certain problems exist that make it difficult for those concerned to find work, such as a poor command of the language. Here, education is a crucial factor. Further explanations for discriminatory practices may include the employers' own attitudes, their perception of customer attitudes, or a tendency to ascribe certain qualities to a job seeker on the grounds of his or her affiliation to a certain group. Discrimination resulting from the employers' own attitudes is difficult to tackle in the short term, but efforts must be made to alter these attitudes over time. Anti-discrimination legislation is an important component in this respect. But employment policy measures should also be introduced to strengthen the position of discriminated groups, primarily by giving them the opportunity to prove that employer prejudice is unfounded.

An essential ingredient to achieve the Lisbon objectives is to balance economic policy in a more efficient way. This does not solely mean fiscal and monetary policy but also an interaction of the former ones with structural reforms, the final objective of Europe being to grow and to augment its growth potential. Other reforms are also fundamental to foment EU's economic growth, namely services, energy, innovation and improved regulation.

The PES strongly supports the creation of a European market for services as the next step in the creation of a single European marketplace. Services now account for the bulk of GNP and employment in the EU and they are the major source of new employment for Europe's citizens. A European services market would bring benefits to consumers, employees and businesses.
All economies, including those in Europe, are now facing the linked challenges of energy security, rising energy prices and climate change. We think that a coordinated international policy framework is very important. That coordination is essential in Europe to start with.
We also support new initiatives to ameliorate regulation in the EU. More effective regulation is essential to create a more competitive business environment and to encourage private initiative.

Europe must invest more in R&D. Europe ought to facilitate all forms of innovation and promote the use of ICT as mechanism to build a fully inclusive information society.

5. Ensuring a European dimension

The choice of the right domestic policy needs to be complemented by a European dimension. We underline the importance of doing the right economic policy together and simultaneously. If countries act together, they will be able to learn from each other and to take advantage of the spill over effects that are generated.

It is also very important to act – where economically appropriate - simultaneously. That allows the multiplier effect to act. Moreover it provides an added value both in terms of growth and job creation and in public finances.

It should be noted that the European dimension complements the national dimension and does not replace it. Member States will continue to pursue their domestic policies but coordination brings an added value which is not to be neglected.

The European dimension recognises the different economic and political situations of Member States but neither the European dimension questions the national dimension nor the opposite occurs. It is instead a way of doing things together with the objective of increasing growth.

Higher growth, full employment and sound public finances

We aim at a balanced economic policy approach that combines a proactive demand policy with structural reforms. Both move along each other and target the same overall objective which is higher economic growth and employment. Higher growth favours the implementation of structural reforms and in order to achieve higher growth more demand management is needed.

This balanced approach could – where possible from a budgetary and appropriate from an economic view - include direct investments that do not jeopardise the inflation level the ECB has set for himself. Where direct investment due to budgetary constraints is not possible at the moment or an already buoyant macroeconomic situation affords no additional public spending, high quality reorientation of the budgets is essential. More high quality “intelligent” public investment in R&D, education, child care and others will increase growth potential. This in turn favours private confidence thereby increasing private investment which will increase job creation. This will lead to higher tax revenues, lower transfers and hence lower deficits.

Investments must be done at both national and European levels, in areas that are related to the Lisbon objectives, infrastructures and to other growth generating European projects that will be identified. Financing should come from the full utilisation, whenever the projects justify it, and – most important – from a quality reorientation of the EU budget to intelligent investment. PPP’s that can also be effective in some types of intelligent investments. Private investment will respond, taking advantage of the further investment opportunities that will be created due to higher growth.

At the same time we have make structural reforms to increase the employability so that higher growth creates job and not inflation. To many Europeans are afraid of change. By creating bridges for the individual so they can jump between different kind of jobs Europe will become more dynamic. By strengthening the individual Europeans will be more pro change.

All this makes sense if coordinated and done simultaneously at both the domestic and European dimensions. The size of the spill over effects will be greater the more economic policy coordination we have.

Hence, a balanced economic policy, with a proper interaction between a proactive demand side and structural reforms, done in a coordinated manner, simultaneously and at the European level will be conducive to higher growth, full employment and sound public finances. This is what we as Socialists and Social Democrats aim at.

ANNEX

Taking the offensive against unemployment

To show the combined effect of investments, reforms and simultaneous actions a scenario for growth and prosperity in Europe will be outlined. In this scenario growth is increased from a good 2 percent per year to a good 3 percent per year up to 2010. The initiatives are to be regarded as additions to initiatives which were previously agreed upon. Previous initiatives have already been incorporated in the latest forecast from the European Commission while this high growth scenario adds to the present forecast. This higher growth scenario will have a large impact on employment, unemployment rates and the public deficit.

Table 1. A scenario for higher growth in EU-15.

	2005-2006	2007-2008	2009-2010
GDP growth average (per cent)	3.2	3.1	3.1
Export growth (per cent)	7.8	6.7	6.8
Employment rate end of period (per cent)	66.2	67.6	68.8
Unemployment rate end of period (per cent)	7.3	6.9	6.7
Fiscal balance end of period (per cent of GDP)	-2.0	-1.0	0.1
Inflation average (private consumption deflator)	2.1	2.2	2.0

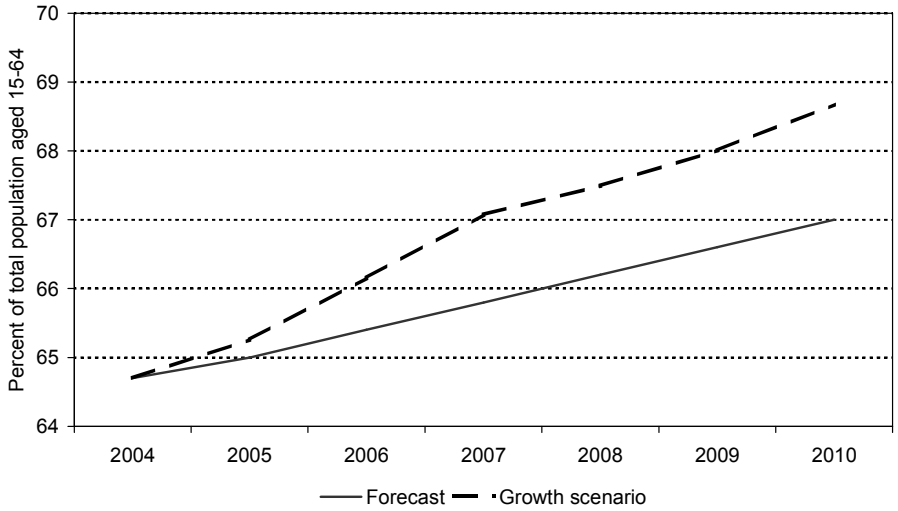
Source: Calculation by ECLM based on the international model "HEIMDAL".

The increased growth in the scenario is the outcome of a proactive economic policy in all “old member countries”. This includes structural changes in the labour market, improving the internal market, lower interest rate, total utilisation of the EU budget i.e. no refunds of payments to the EU system and making additional "intelligent" public investments in areas which have a long lasting effect on the growth rate i.e. research and development, education systems and childcare etc. in line with the Lisbon strategy. Each government makes its investments and reforms in line with the specific needs of the country.

Because all countries take react against unemployment at the same time they also harvest the advantages of the positive dynamic effect from the other countries. This is illustrated by the larger growth in exports partly caused by spill over effects created by the higher growth rates in the other EU-15 countries.

The scenario will have a large impact on the employment in Europe even though the EU-15 will not reach the Lisbon goal of an employment rate of 70% by 2010. Chart 1 shows the present forecast for the employment rate in EU compared to the development in the growth scenario. The difference adds up to 4 million employed in 2010.

Chart 1. Development in employment rate, 2004-2010



Source: The European commission, economic forecast autumn 2004 (forecast: 2004-2006) and ECLM (forecast: 2007-2010) and calculation based on the international model "HEIMDAL".

The larger growth and the reduction of the unemployment rate in the EU will make it easier to implement structural reforms on the labour market, on the markets for goods and services etc. Changes are more easily accepted in a booming economy. The low growth environment has been pinpointed as one of the explanations of the poor performance of the Lisbon strategy in the recent report from the Wim Kok group[1].

The new member countries in the EU are assumed to continue their public investments at a growth rate that is higher than in the EU as a whole. But it is assumed that they will also redirect their public investment towards "intelligent" investments that have long lasting structural effects on the economy according to the Lisbon strategy. The new member countries of course also gain from the improved internal market, the lower interest rate and the fact that the investment policy in the EU-15 countries have spill over effects. Table 2 illustrates the effect of the scenario on growth in EU-15 and EU-10.

Table 2. Effect on member countries.

	2005-2006	2007-2008	2009-2010
	GDP growth (per cent per year)		
EU-15 (old member countries)			
Present forecast	2.3	2.4	2.4
Scenario for larger growth	3.2	3.1	3.1
EU-10 (new member countries)			
Present forecast	4.5	4.5	4.5
Scenario for larger growth	5.2	4.9	4.9

Source: European Commission, economic forecast autumn 2004, NIESR October 2004 and calculation by ECLM based on the international model "HEIMDAL".

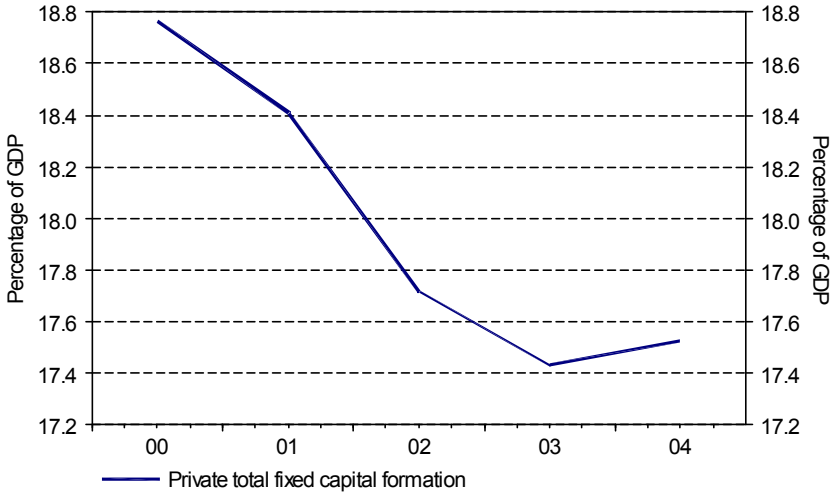
[1] "Facing the challenge, The Lisbon strategy for growth and employment", Report from the High Level Group chaired by Wim Kok, Nov. 2004, page 10.

The table shows that the scenario will also have considerable impact on the new member countries. The average growth in 2005 and 2006 is increased from 4.5 per cent to 5.2 per cent and growth rates in the following years will also increase. The marginal effect on the new members are not as large as on the EU-15 but this is due to the fact that the new member countries do not increase public investments but only redirect them.

Boosting private confidence

It is a common perception that lack of confidence in the private sector is a major problem in the European economy. This is leading to a low level of investment, which is illustrated in chart 2.

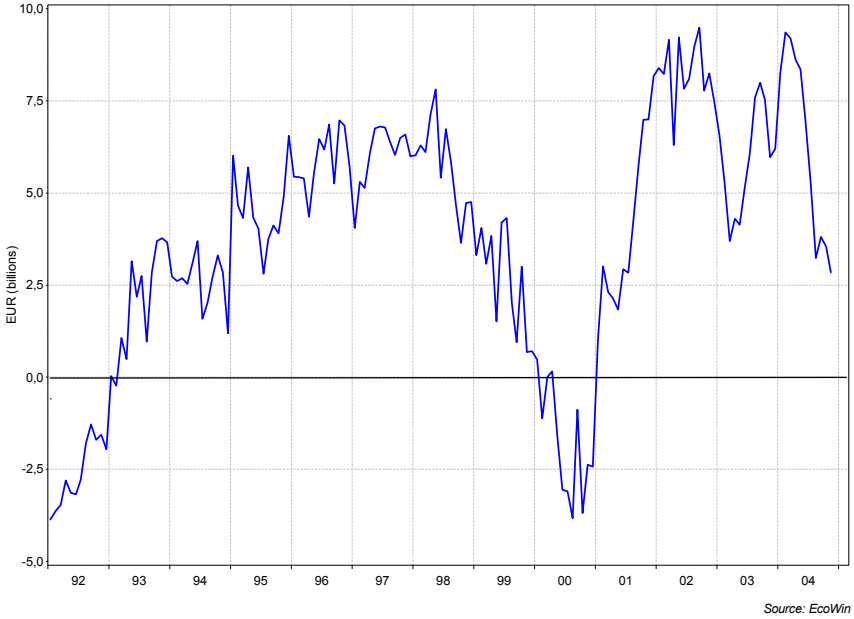
Chart 2. Private investments in EU



Source: OECD Economic Outlook

Some claim that low confidence in the private sector is due to declining competitiveness in the EU. It might well be that some sectors and some regions have problems in competing with the rest of the world but overall the facts do not support this view. In last few years EU has had a surplus on its trade balance despite the depreciation of the US dollar. Chart 3, shows the trade balance between the euro-zone and the rest of the world.

Chart 3. Trade balance Euro zone, monthly obs., seasonally adjusted



Source: EcoWin

We must face the fact that internal demand in Europe must rise to increase growth and with that private confidence. It si good news that internal demand to a large extent can be influenced by domestic economic policy. By implementing the right policy it is possible to increase internal demand, private confidence and thus growth.

When promoting internal demand by monetary and fiscal policy together with structural changes, there will be considerable effects on the growth in the EU. The main idea is that increased growth promoted by improving the internal market, higher public "intelligent" investments, lower interest rate, labour market reforms among other things gradually will increase private confidence and thereby increase private consumption and private investments.

This idea to combine macroeconomic policy with structural reforms is also mentioned in the report on the Lisbon process from the Win Kok group:

"The wider macroeconomic framework, both the pursuit of monetary and fiscal policy, must be as supportive of growth as possible. In the light of this, the High Level Group supports the recent proposed reforms by the European Commission of the Stability and Growth Pact…" The need is to give business the confidence to invest and innovate in the knowledge that the over-riding objective is to sustain the current upswing and with it the chances of implementing Lisbon."[2]

Improving the internal market and other structural changes

Even though the internal market has come a long way since 1985 there is still some way to go before the EU forms one single market. Some directives need to be implemented and additional reforms need to be agreed, especially regarding services and network industries.

[2] "Facing the challenge, The Lisbon strategy for growth and employment", Report from the High Level Group chaired by Wim Kok, Nov. 2004, page 16-17.

The development of the internal market will increase competition and productivity but will also have more dynamic effects by improving the economic climate by forcing governments to perform a more farsighted industrial policy. Several evaluations point to the fact that the internal market has improved growth and employment in Europe. In 1996 the commission presented a report which stated that from 1985 to 1994 the internal market had increased prosperity in the EU by 1.5 per cent.

It is fair to assume that there still are some gains to be harvested by further developing the internal market.

Table 3. Effects of the Single Market, 1985-91 – projected in 1994

	Per cent
GDP	1.5
Employment	0.5
Investments	4.5
Intra EU trade	4.7
Productivity	1.0
Real earnings	1.9
Consumer prices	-0.7

Source: NTUA, CES & Middlesex University, Aggregate Result of the Single Market Programme, December 1996

Specific recommendations on how to improve the internal market by speeding up implementation of legislation, removing obstacles to the free movement of services and resolving the cross border problems of financial services can be found in the resent report on the Lisbon process by the Win Kok group[3].

More investments in line with other parts of the Lisbon process could also encourage growth through structural change. Even though the problems vary between countries initiatives include promotion of entrepreneurship, more education for youth and adults, vocational training, development of childcare to increase women participation in the labour market etc. Implementing the Lisbon process together is a part of the scenario to promote growth and prosperity in EU.

There are large dynamic effects to be gained by simultaneous investments across Europe.

Dynamic effects on the public deficit

In this scenario there are large dynamic effects that influence the public budget. The lower interest rate results in lower payments on the public debt, higher private sector confidence, increased growth ,higher tax payments and the dynamic effects from the other EU-15 countries would result in higher exports which would also trigger higher growth and tax payments.

In this scenario, governments make no effort to balance their budget increases in the first three years as the tax rates are not increased. From 2007 to 2010 tax rates are increased just to finance the larger investments. But as a result of the large dynamic effects the public budget is positive when all adds up despite the lack of direct financing from the government.

[3] "Facing the challenge, The Lisbon strategy for growth and employment", Report from the High Level Group chaired by Wim Kok, Nov. 2004, page 23-27.

It must be emphasised that net positive effect on the budget is a result of the combination and weighting of different policies and that the increase in public investments and public employment on its own has a negative impact on the public budget. This is illustrated in table 5.

The first row of the table "present forecast" is the forecast on the average public deficit by the commission and NIESR.

The second row "Domestic fiscal policy only" shows the effect on the public budget respectively when only the public investments and public employment are increased. This is a worst-case scenario because all investments are initiated by the public sector i.e. there are no public-private partnerships or the like. In this scenario the public balance is worse off because the governments make no effort to balance their budgets by increasing tax rates while increasing expenditure. Actually the worst year (not tabled) is the third year of fiscal policy without financing (2007) where the average public deficit in EU-15 is an additional 0.3 per cent of GDP.

It is noteworthy that in 2010 the public budget is better than in the present forecast despite the fact that the policy is exactly financed by tax increases. This is because of the dynamic effects in the model e.g. the positive spillover effect facilitated by all the other countries leading an offensive policy. The end result is that by the end of 2010 the public debt in EU-15 has risen by an average of 0.6 per cent of GDP in this scenario because of the larger deficits in the first two periods.

Table 5. Effect on the public budget with and without other policy factors.

	2006	2008	2010
	End of period (per cent of GDP)		
Present forecast	-2,3	-1,8	-1,2
Domestic fiscal policy only	-2,5	-1,9	-1,1
All policies excluding increased private confidence	-2,1	-1,2	-0,2
Total effect including increased private confidence	-2,0	-0,9	+0,2

Source: Calculation by ECLM based on the international model "HEIMDAL".

Looking at the effect of all the implemented policies; domestic public investments, investments facilitated by EU, lower interest rates and structural reforms the picture is brighter because the additional initiatives have positive spill-over effects on the domestic public budget without loading the public budget with expenses. Hence the public deficit is smaller than in the present forecast. At the end of 2010 the average deficit is 0.2 per cent of GDP when all policies are implemented compared to 1.2 per cent of GDP in the present scenario.

When the effect of increased private sector confidence is included the effect is even more positive cf. the last row in table 5.

Are we in conformity with the EU regulations?

The short answer is yes.

First, the scenario does not imply larger public deficits than today. Even if the public deficits were to be larger in the first couple of years it would still be in line with the Growth and Stability Pact. According to the Growth and Stability Pact the goal is to have a budget position "close to balance or in surplus". This has been enforced as a deficit no larger than 3 per cent of GDP. This enforcement of the Growth and Stability Pact has had some obvious drawbacks noted by the Commission[4] among others.

The policy illustrated in this scenario is in line with the proposals of the Commission. Thus the economic policy respects the Growth and Stability pact but the implementation is based on the more flexible approach by the Commission, which among other things entails budgetary objectives that take account of the economic cycle.

The easing of the monetary policy is also in line with the Treaty. According to the Treaty the primary objective of the ECB is to maintain price stability[5] and inflation is only rising marginally in this scenario. It is also worth noticing that this high growth scenario paves the way for structural reforms which helps keeping the structural inflation low.

Investments and stronger demand for new growth

To sum up, a co-ordinated investment plan, supported by a stronger demand policy could increase growth levels and significantly reduce unemployment. A right domestic policy is essential and should include larger public investments and an increase in public consumption in areas that have long lasting effects i.e. education, vocational training, research and development etc. Taking the offensive to achieve the Lisbon objectives by increasing "intelligent" public investments together with other structural changes in the labour market would result in better functioning labour markets. It will be easier to implement reforms on the European labour markets in this scenario of falling unemployment.

But the right domestic policies are not enough on their own. They must be coupled with a European policy strategy. Part of this strategy is to fully use the European Union budget. Indeed, it would be growth generating to invest the money, that is not used, in common European projects. As an example, after the 2002 financial year 7.4 billion euro was refunded to the member states out of a payment of 95.6 billion euro. This could have been invested in infrastructure (roads, railways, ICT etc) in Europe or in European research projects. Through the multiplier effect, the higher employment and growth created will eventually be higher than the funds Member States receive.

In conclusion, an increase in both public and private consumption/investment is key to lower unemployment figures in Europe. Both domestic and European policies will play an important role. In both cases, if countries act together, positive externalities will take place, which will be likely to boost further economic growth.

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[4] Strengthening the co-ordination of budgetary policies. COM(2002) 668 final.
[5] Consolidated version of the Treaty establishing the European Community, Article 105.