Rekindling economic growth in the EU: Can the Europe 2020 Strategy meet the challenges?

John Gabriel Goddard
The World Bank

The Feasibility of European Economic Policies
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Motivation

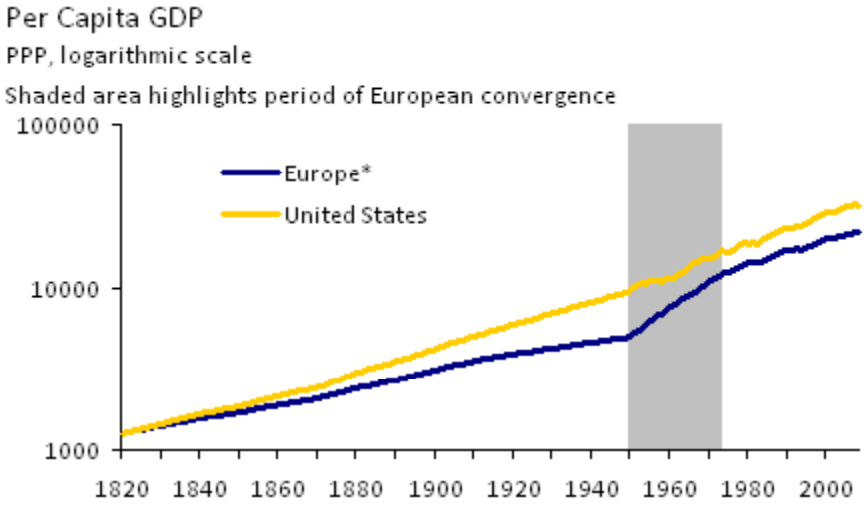
- The global financial crisis may have undermined the prospects for income convergence between the EU and the US, and between new EU members and the EU-15

Questions

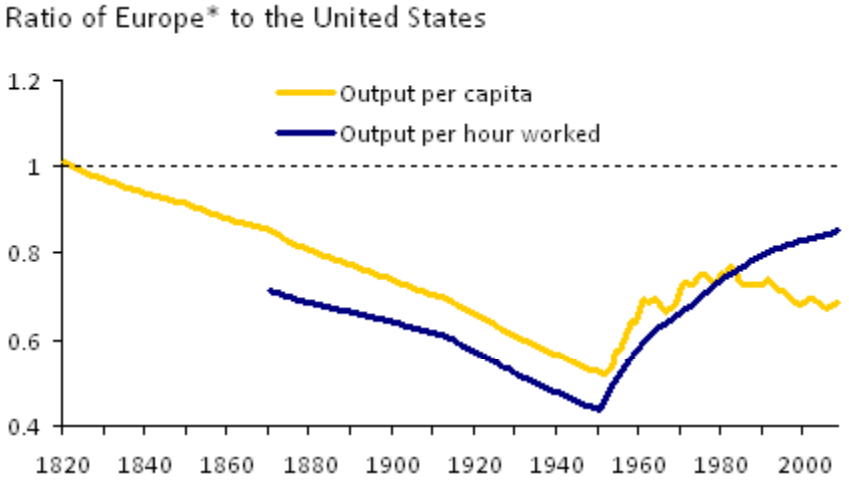
- Can the announced EU 2020 Strategy trigger the needed stimulus in R&D spending and innovation, and thereby catalyze TFP growth?

- What other policy targets or priorities should be set at the national and European level to ensure that the EU 2020 succeeds?

Western Europe's postwar economic renaissance slowed down in the 1970s, with relative incomes stalling at 75% of US levels



* Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, United Kingdom.
Source: Maddison, "The World Economy," (2006).



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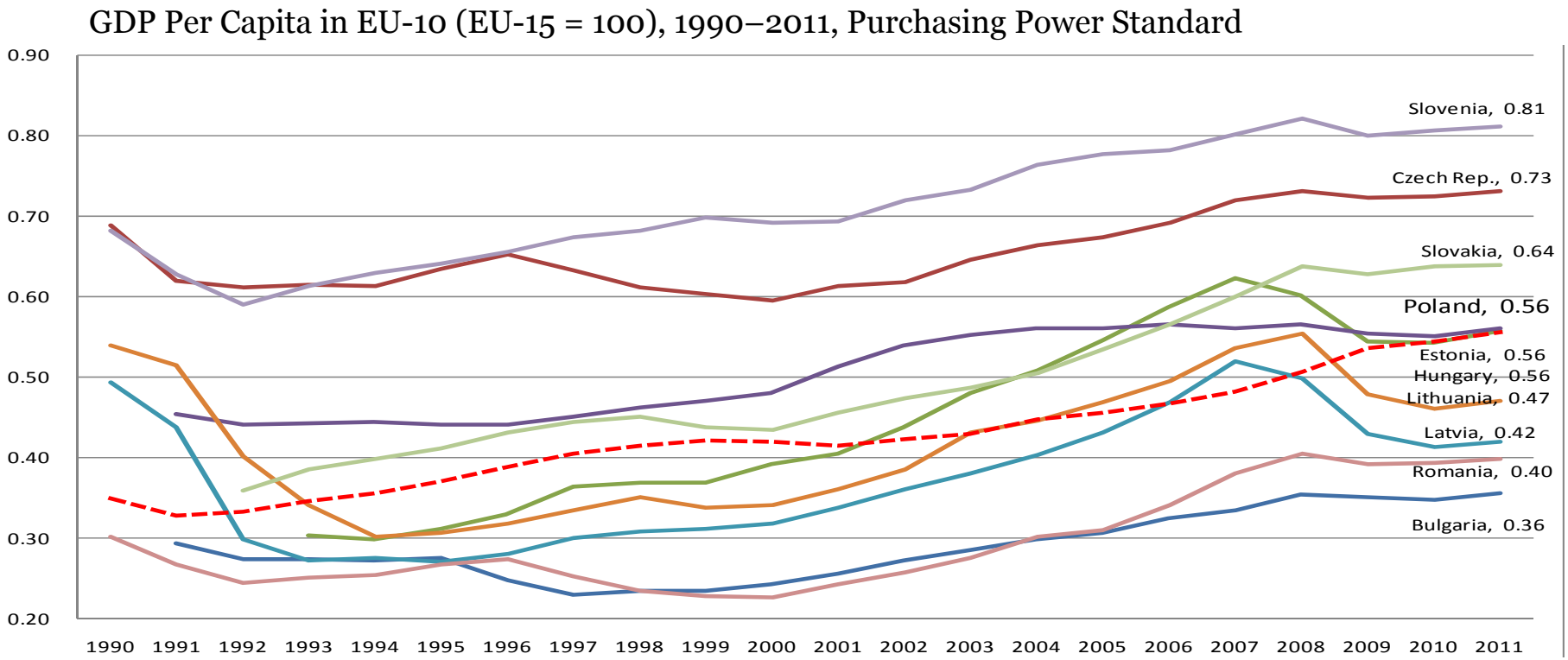
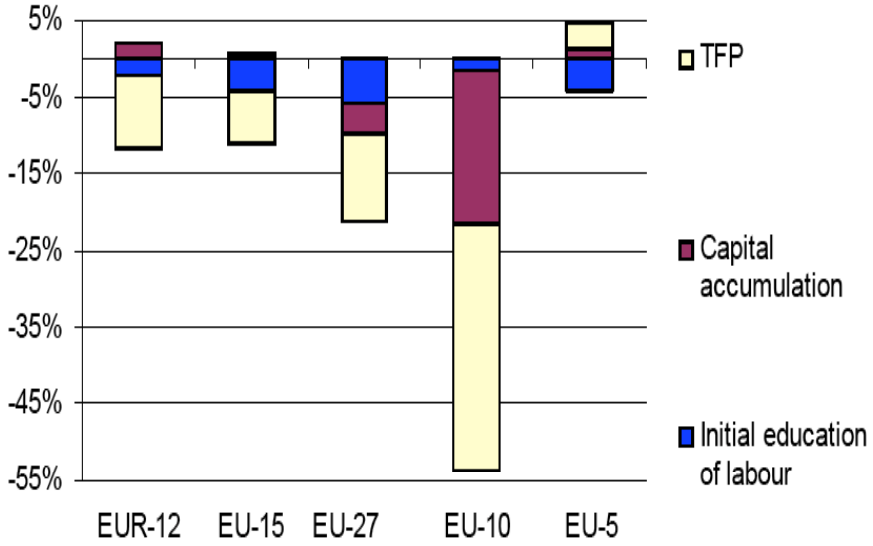
Within Europe, new members were catching up with the EU-15 until the onset of the global financial crisis



Continued EU convergence vis-à-vis the US and inside the EU will depend on tackling the productivity gap

- Recent analysis decomposing GDP for the EU27 countries and the US shows that:
  - In the EU15 & Euro area, lower labor utilization explains 2/3 of the per capita GDP gap with US, hourly labor productivity. accounts for the remaining 1/3
  - In the new member states, 90% of the gap is attributable to labor productivity.
  - TFP is the main driving force behind productivity dispersion in the EU15 and the euro area. Both capital accumulation and TFP explain the dispersion in new member states.



Source: Gilles Mourre, "What explains the differences in income and labour utilisation and drives labour and economic growth in Europe? A GDP accounting perspective", 2009

But structural weaknesses could hinder post-crisis growth, especially for countries which had large macro imbalances

- The recovery started in early 2010, but it is fragile, uneven, and slower than in other parts of the world.

- The EU is likely to experience slower growth going forward due to:
  - **Lower private investment** due to higher cost of financing, constrained bank credit, lower corporate profitability, and uncertain demand prospects.
  - **Labor contribution to growth is likely to stagnate**, as employment reacts to the economic cycle with a lag, part of the increase in unemployment could prove permanent, and population aging will continue to be a factor.
  - **TFP growth rate may not recover** as productivity-enhancing investment decreases and enterprises undertake less risky projects; and R&D investment may be undermined by lower corporate profitability and declines in public R&D spending related to fiscal adjustment.

The Europe 2020 Strategy: Setting the EU's policy priorities and targets

- The successor of the EU's Lisbon Agenda (2000–2010), the Europe 2020 Strategy puts forward three mutually reinforcing **priorities**:
  - *Smart growth:* developing an economy based on knowledge and innovation
  - *Sustainable growth:* promoting a more resource-efficient, greener, and competitive economy
  - *Inclusive growth:* fostering a high-employment economy resulting in social and territorial cohesion.

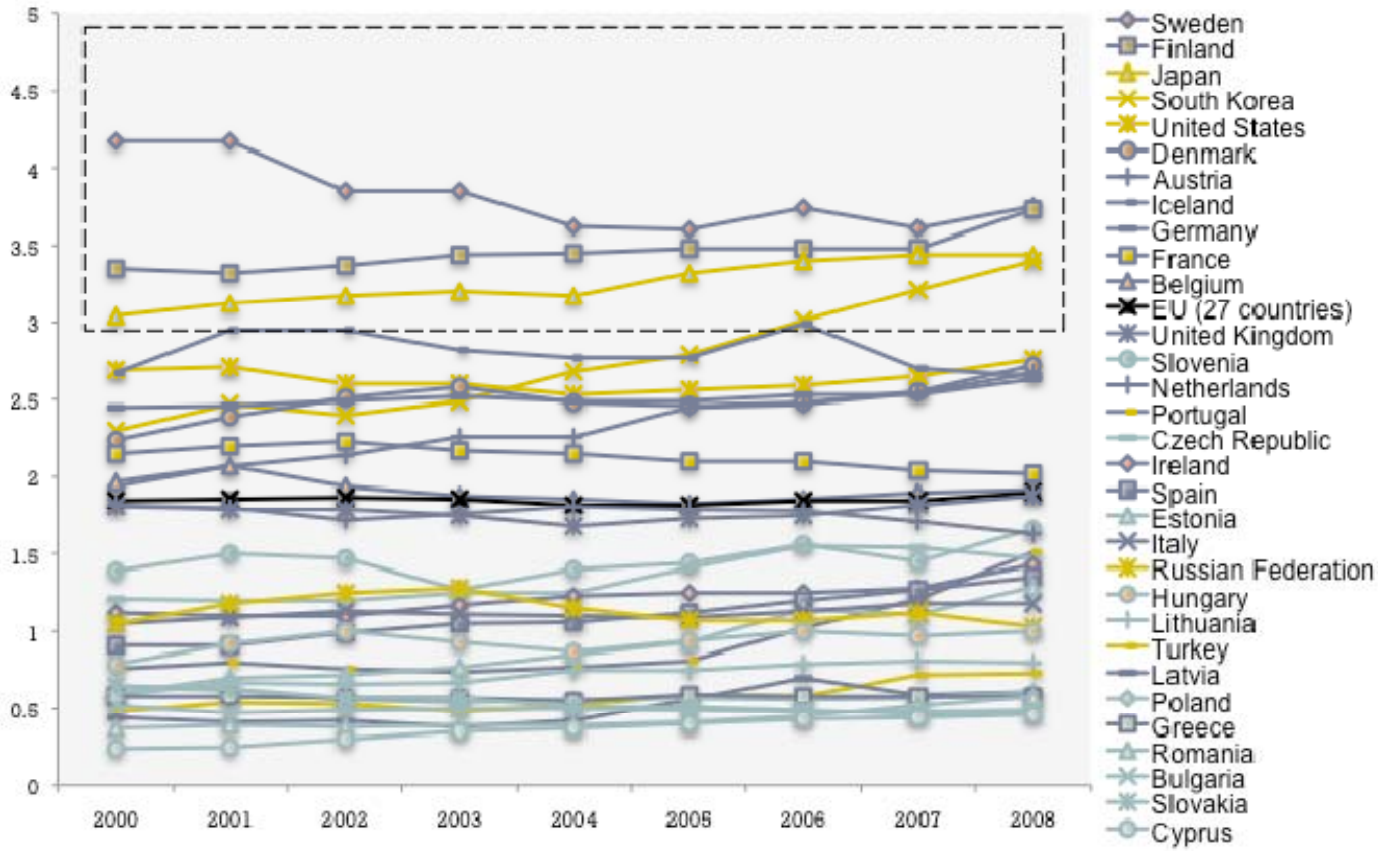
- The EC has proposed the following EU-level **targets**:
  - 75 percent of the population aged 20–64 should be employed
  - 3 percent of the EU's gross domestic product should be invested in research and development
  - The "20/20/20" climate/energy targets should be met (including an increase to 30 percent of emissions reduction if the conditions are right)
  - The share of early school leavers should be under 10 percent and at least 40 percent of the younger generation should have a tertiary degree
  - 20 million fewer people should be at risk of poverty.

For EU 2020 to really foster innovation, its headline targets must translate into real –i.e., fiscal– commitments by countries

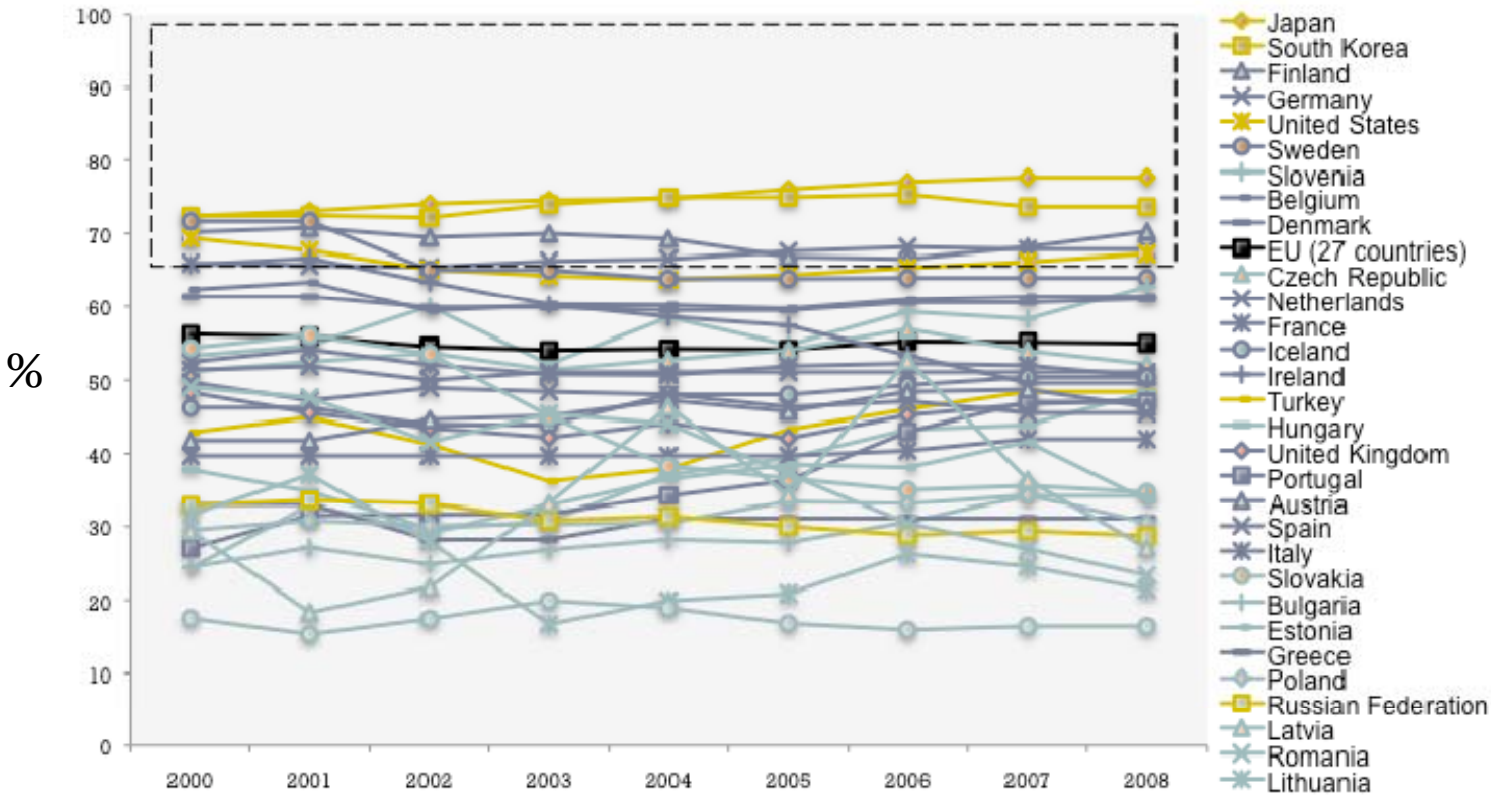
- Past experience shows that EU-level agreements about priorities and targets are not followed by concrete actions at the country-level.
- In 2000, the Lisbon Agenda launched the 3% R&D/GDP target together with a target to increase the private R&D share to two-thirds.
- Although countries had more fiscal space than they do today, government spending in R&D barely kept up with GDP growth.
- Private sector R&D did not grow much more, reflecting the slow development of high-tech industries that are R&D-intensive.

EU R&D intensity remains under 2%, with few stellar performers

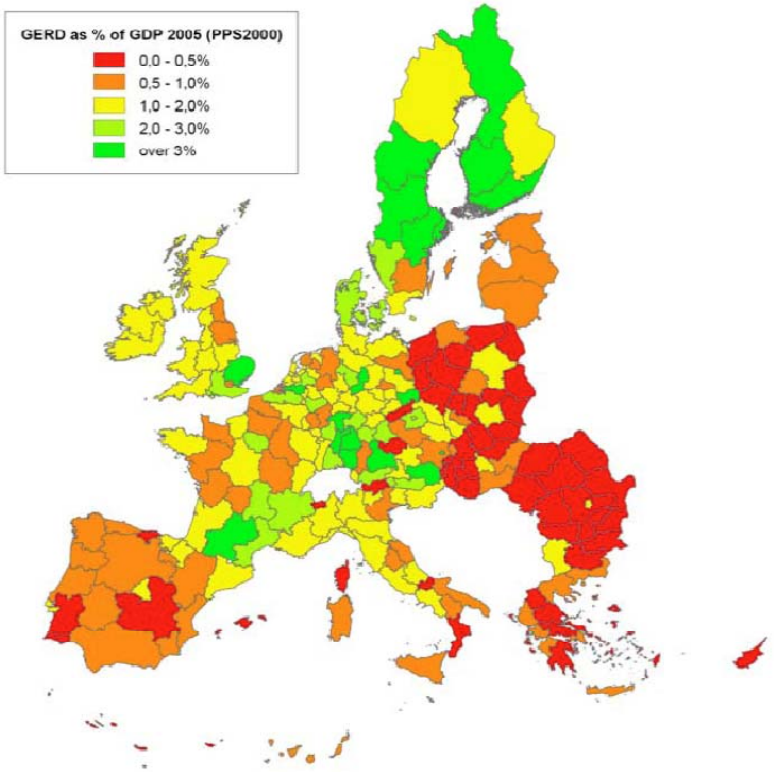
R&D to GDP (%)



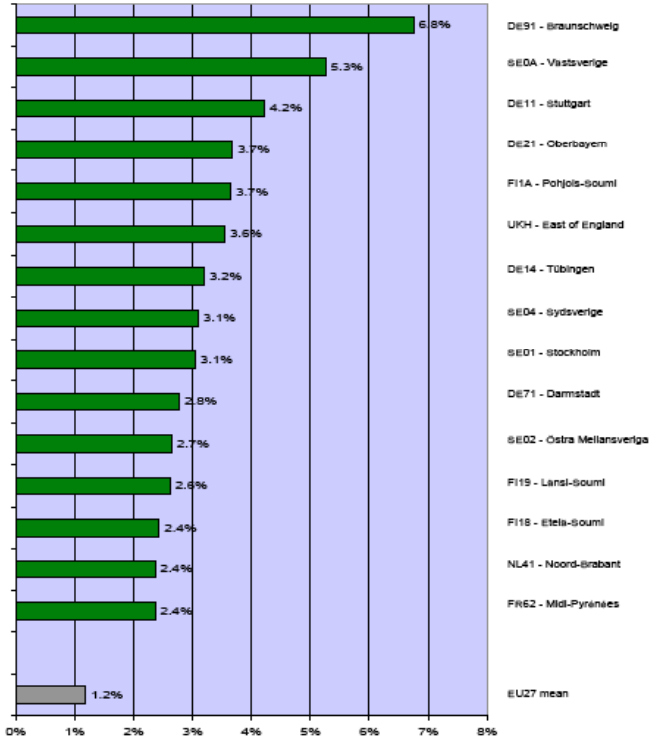
The share of business R&D has not increased visibly either, and remains lower in the EU-12



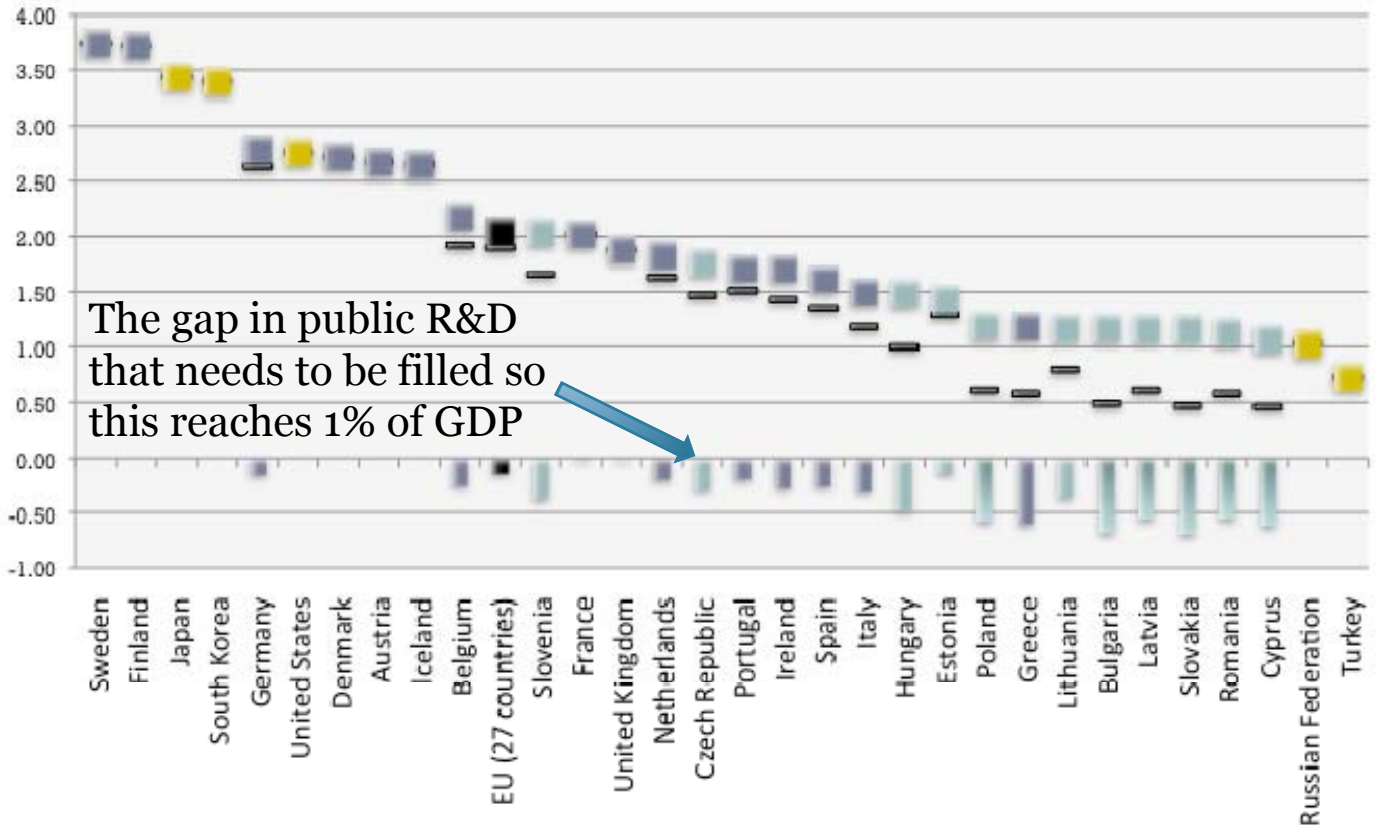
The disparities in R&D intensity are larger at the regional level



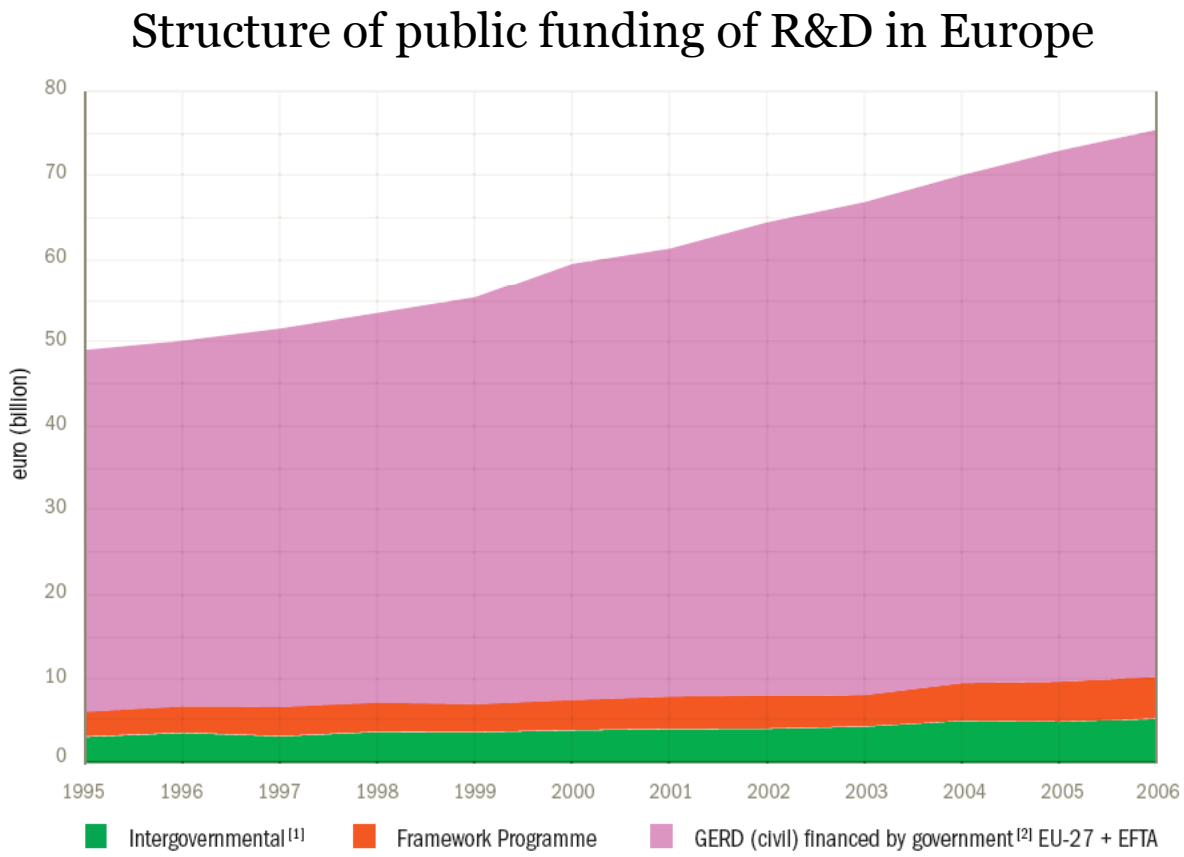
European regions with highest business R&D intensity (BERD as % of GDP), 2003



Setting realistic national budget increases would help– e.g., public R&D/GDP to reach 1%



In parallel, EU funds earmarked to innovation should grow significantly in FP 2014-2020



Fresh national and EU funds should be directed to attracting more private R&D, or raising the efficiency of public R&D

- Private incentives to undertake innovation could be increased through:
  - Increases in matching grants for early stage R&D and commercialization
  - Continuing funding "consortia" of firms and research organizations
  - Development of venture capital funds in partnership with IFIs and private investors

- Public R&D efficiency could be improved by:
  - Supporting reforms of State-owned R&D institutes, especially in EU-12, including through restructuring and enhanced commercialization
  - Underwriting deeper collaboration and mobility among research institutions in the European Research Area
  - Promoting coordinated investments in the "innovation infrastructure", e.g., developing a robust and integrated cyber-infrastructure to support advanced data acquisition, storage, management, etc.