ALLIANZ DRESDNER ECONOMIC RESEARCH

# European Growth and Jobs Monitor

Indicators for Success in the Knowledge Economy

theLisbonCouncil
making Europe fit for the future

Allianz

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# I. Lisbon – buried and reborn

When in the year 2000 European Union leaders set out to build "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion," they understood that Europe was entering a new economic age that would forever change the way we live and work. This new era would be marked by a profound transition from manufacturing- and industry-based production to knowledge and services; from an economy based on land, labour and capital to one based on skills and information.

Now, in the seventh year of the Lisbon Agenda, some of the objectives finally seem within reach. Economic growth and rising productivity have in many European countries improved the economic situation of their citizens. But the battle is hardly over. The important lesson now is that tomorrow's success must be built on top of today's progress; it is vital that policymakers use this moment to secure and cement the gains of the past 12 months – brought on in many parts by the successful reforms of the previous six years – and begin preparing their countries for further success in a highly open, 21st century knowledge economy. Faced with an improved economic background, policymakers have an enormous opportunity to pursue reform policies for economic dynamism, sustainable growth and full employment – all goals that were laid down in the original Lisbon Agenda, which very much retains its relevance today.

In an effort to evaluate Europe's recent progress and to shed light on the social and economic challenges we will face tomorrow, we developed **The European Growth and Jobs Monitor: Indicators for Success in the Knowledge Economy.** As in previous times, a new economic era calls for new indicators for success – indicators that will show us where we are today, and help us deepen and manage the ongoing transition. The European Growth and Jobs Monitor seeks first and foremost to evaluate Europe's progress on reaching the Lisbon goals, but it also seeks to quantify and introduce new variables to measure our successful transition to the knowledge age – variables such as the level of workers with higher university qualifications, the amount of growth-oriented investment, the sustainability of public finances and the ability to create ever higher value-added products with less work and fewer inputs, also known as productivity.

To achieve this, the European Growth and Jobs Monitor sets out six target areas for evaluation:

- economic growth
- labour productivity
- employment development
- workforce skill level (measuring workers with tertiary qualifications)
- growth-oriented investment
- sustainability of public finances

The largest nine EU economies were evaluated based on their ability to reach the targets derived from the original Lisbon Agenda in each of these areas. Then, based on their performance in each of the six categories, every country was given an Overall Lisbon Performance Indicator, demonstrating how well that country is performing in the effort to reach the overall Lisbon goals by 2010. The results are striking, and offer valuable information about which countries are doing well today – and which are most on track to meet the challenges of tomorrow.

In a nutshell, the European Growth and Jobs Monitor finds that Europe has finally turned the corner after years of disappointing performance. Against the background of strong economic performance, we see tangible progress in key indicators, such as growth, employment and productivity. And the famous Lisbon targets have come within closer reach throughout the EU than many had thought possible. All countries surveyed made progress last year compared to their performance in previous years. Last year, there were no laggards among the nine countries surveyed, meaning that while some countries improved more quickly than others, not one of the nine countries suffered an overall slip backwards in 2006.

But the broad picture hides significant national differences, with some countries improving much more quickly than others. Germany, for one, did very well, rising to No. 6 from No. 9 in the overall ranking on the basis of strong growth, improving job creation and rising productivity. France, by contrast, did poorly, falling back to second last from No. 6 due to sluggish growth and relatively weak productivity improvement. Sweden, meanwhile, led the pack with an Overall Lisbon Performance Indicator well ahead of its closest competitor (see the box "Secrets of Sweden's Success" on page 24 for more). Italy remains far behind, with particularly low scores in skilled labour and labour productivity.

To be sure, successful reforms depend first and foremost on the decisiveness of the voters, managers, government leaders and private citizens in the EU member states where those reforms will be implemented. But, as the Lisbon Agenda has shown, there is much that the European Union can do to help the reform process along in the individual EU member states. Specifically, the EU can and should take the following steps, if it wants to build on the progress made in the last year and cement prosperity for years to come:

- **Create a modern, contemporary budget** for governing the EU; the EU needs a budget that will channel existing revenues into future-oriented spending and other areas that will benefit the people of Europe the most; the ongoing budget review, due to report in 2009, will be critical in re-orienting the EU budget towards forms of expenditure that encourage growth-oriented investment and sustainable economic growth.

- **Strengthen and complete the internal market.** European Commission President Barroso has promised an overall review of the internal market, with detailed proposals to follow in autumn 2007. It is vital that this review lead to a strong, overall programme capable of consolidating previous success and opening new markets for all members of the EU, especially in the service sector where 70% of modern economic activity takes place.

- **Keep competition policy strong.** A strong competition policy is the key to a healthy economy; it establishes a level playing field where the winners can thrive and helps strong companies create jobs in sustainable businesses.

- **Transparency and open markets.** Consumers can and do drive forward healthy economic growth, using their spending power to reward companies that make good products and offer good services. This, in turn, rewards innovative companies and helps them create sustainable jobs. Improving price and product transparency and facilitating greater market access will be key deliverables in EU consumer policy, which can play an important role in driving forward overall economic performance in the years to come.

# What is the Lisbon process?

Meeting in Lisbon, Portugal in March 2000, European Union leaders proclaimed the goal of making the EU "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion." To achieve this objective, a package of measures for economic, ecological and social renewal was put together. The mid-term review conducted five years later came as a disappointment, however. As a result, while still endorsing the binding nature of the overall strategy, the Union backtracked on overly ambitious targets, declaring that the focus would now be placed more on promoting growth and employment. For this, the member states were called on to draw up National Reform Programmes – the first in autumn 2005 – to which the European Commission would respond. This process of national reform agendas with appraisal by the European Commission also scarcely penetrated the public perception in spite of the big advantages it offers in terms of benchmarking or peer pressure.

# II. The European Growth and Jobs Monitor: Indicators for Success in the Knowledge Economy

The European Growth and Jobs Monitor measures nine countries based on six criteria: economic growth, labour productivity, employment, skill level (workers with tertiary qualifications), growth-oriented investment and sustainability of public finances. For each of these six areas, we set a benchmark or target derived from the original Lisbon resolutions or the clarifications made at subsequent European Council summits. A score of one indicates that a country is on track to fulfil the Lisbon criteria in question; a score of above one indicates that a country has over-fulfilled that criteria, while a score of under one shows that the country still has work to do in that area.

Finally, the six individual scores are aggregated, in equal weights, into an Overall Lisbon Performance Indicator.[1] Based on the best available data, we awarded scores to each of the nine biggest countries in the EU-15 (Austria, Belgium, France, Germany, Italy, Netherlands, Spain, Sweden and the United Kingdom) and gave an overall score to the EU-15 for comparison.

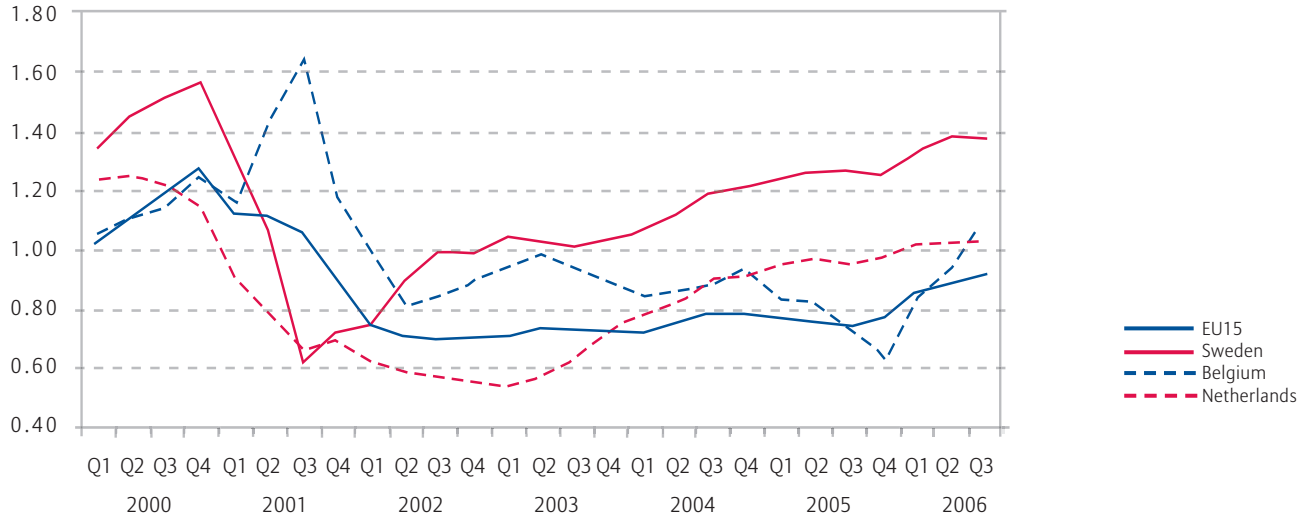
| Rank | Country | Overall Score 2006 Q3 | Change in Ranking since then | Rank one year ago | Score one year ago |
|---|---|---|---|---|---|
| 1 | Sweden | 1.37 | ← | 1 | 1.26 |
| 2 | Belgium | 1.09 | ↑ ↑ | 8 | 0.72 |
| 3 | Netherlands | 1.02 | ↓ | 2 | 0.95 |
| 4 | United Kingdom | 0.98 | ↑ | 4 | 0.85 |
| 5 | Spain | 0.98 | ↓ | 3 | 0.87 |
| 6 | Germany | 0.91 | ↑ ↑ | 9 | 0.65 |
| 7 | EU15 | 0.90 | ← | 7 | 0.73 |
| 8 | Austria | 0.83 | ↓ ↓ | 5 | 0.83 |
| 9 | France | 0.80 | ↓ ↓ | 6 | 0.78 |
| 10 | Italy | 0.43 | ← | 10 | 0.33 |

The key message is that in 2006 EU-15 countries got a good deal closer to the ambitious growth and employment targets set out in the Lisbon Agenda. At the end of 2005, EU countries were at only 73% of the performance level they would have needed to attain that year to be on the way to fulfilling their Lisbon targets: by the end of 2006, they were 90% of the way there – a 23% improvement over the previous year. Sweden is the clear frontrunner, weighing in with an Overall Lisbon Performance Indicator of 1.37, indicating that it could overshoot the Lisbon targets by nearly 40%. Interestingly, Belgium comes in second, having surged ahead to the No. 2 position based on strong performance in labour productivity, skills, growth-oriented investment and sustainability of public finances. Germany also performed well, rising three spots in the ranking to No. 6, putting it slightly above the EU-15 average. Of the other EU heavyweight economies, the UK and Spain held their positions in a fast-improving world. France, meanwhile, slipped to No. 9, while Italy has by far the poorest performance of the countries analysed.

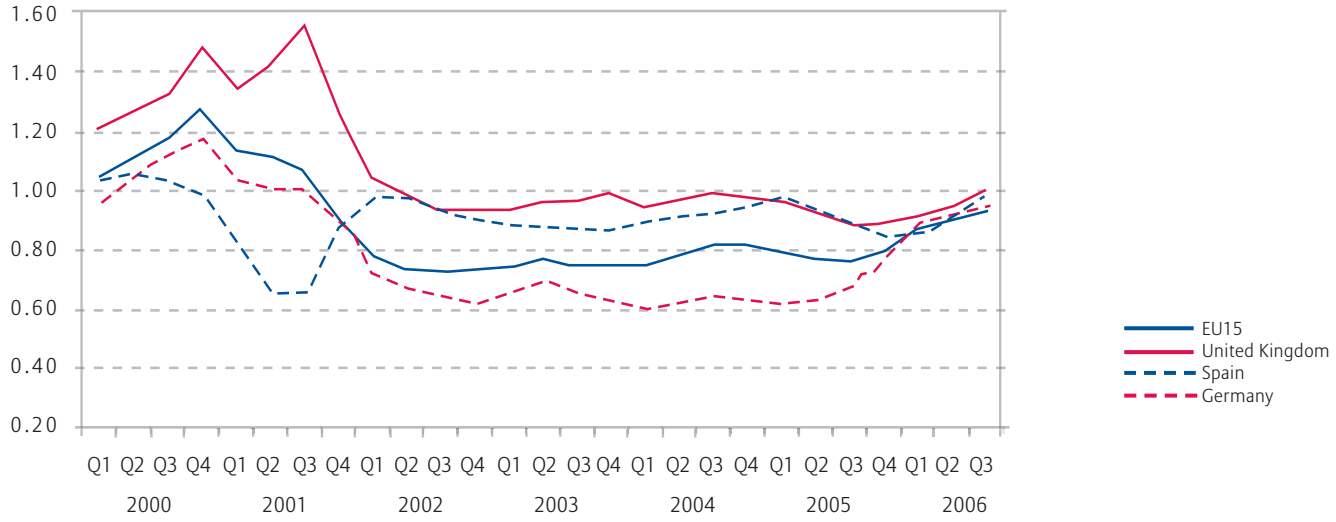
[1] In choosing the time series we looked for good and fast data availability on a quarterly basis so as to track the path in the closest possible real time.

# Growth and Jobs Monitor

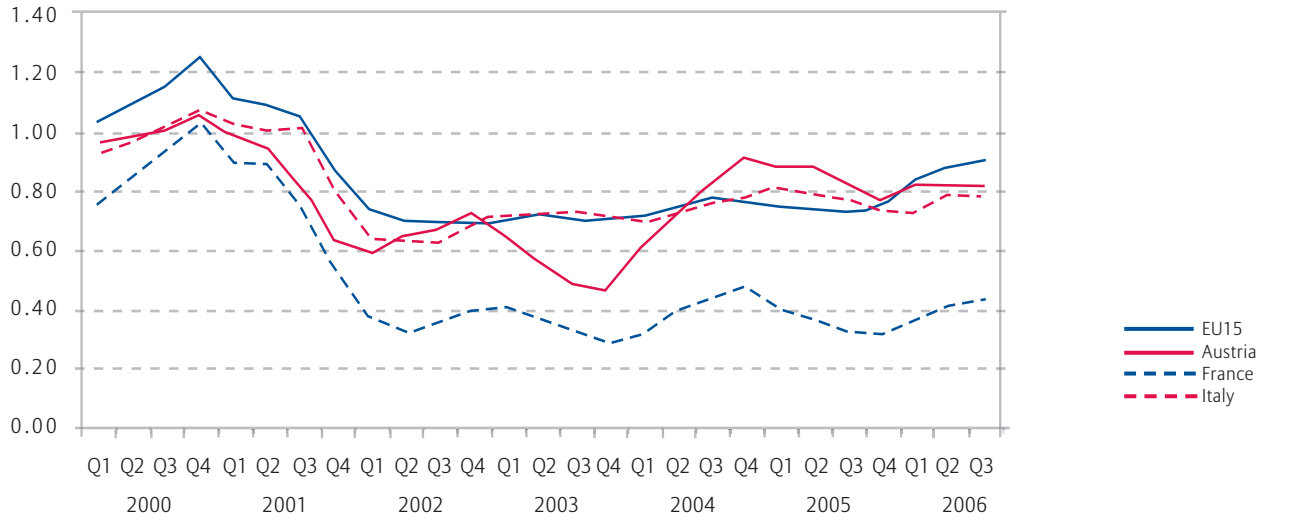
current leading countries




current mid-level countries




current lagging countries



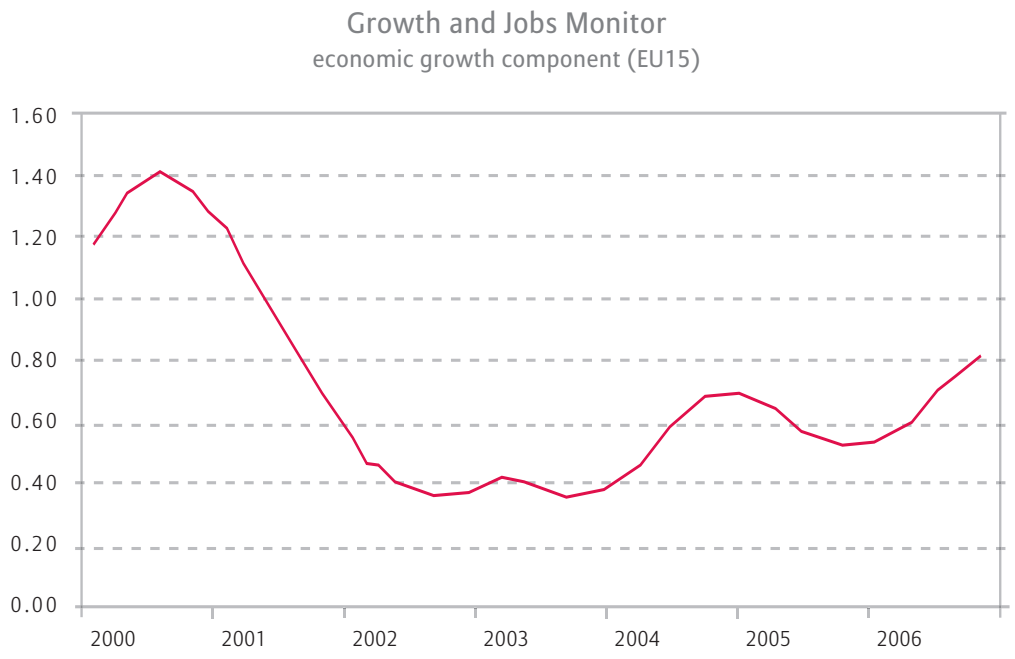
# III. Economic growth – the sine qua non of further success

Growth is a key determinant of success in a modern economy – not simply because it normally translates into more jobs and higher standards of living, but also because it makes solving many other problems much easier. National budgets, for example, are much easier to balance when the economy is growing at a healthy pace. Similarly, tax revenues rise, people have an easier time finding work and the government has more money to invest in the future. Not surprisingly, the original Lisbon Agenda put growth at the centre of European policy, setting a target of attaining average growth of 3% per year throughout the EU. This figure turned out to be wide of the mark (with the actual rate between 2000 and 2005 averaging around 2% a year). But, in 2005, the European Commission again linked hopes of a 3% increase in GDP to its relaunch of the Lisbon Strategy.

Not surprisingly, economic growth has proven to be a key determinant of success in the European Growth and Jobs Monitor. Sweden again leads the field, weighing in with a 1.42 score on the Economic Growth Component. Spain and Austria also scored well in this category, boasting growth of 3.8% and 3.3% respectively in 2006 – comfortably above the 3% Lisbon target. By contrast, France and Italy drag the bottom of the list, both weighing in with 2% economic growth for the year. Germany was most improved, rising to No. 8 on the back of 2.7% economic growth.

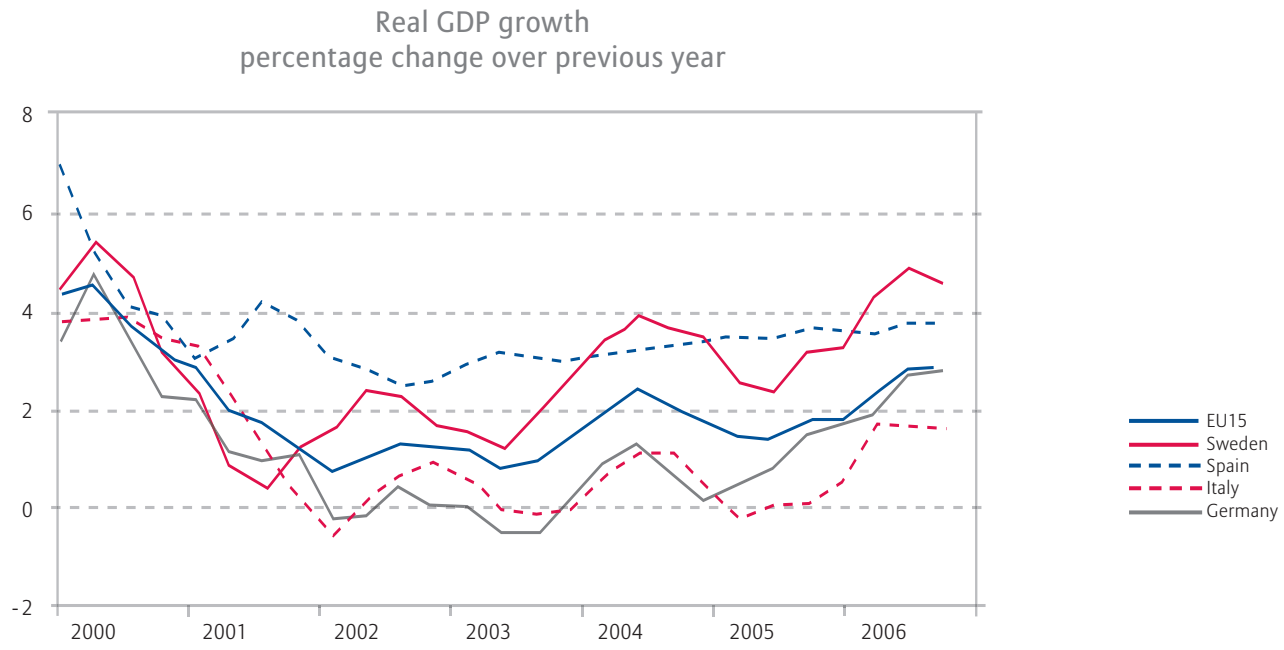
Today, Europe is doing better economically than it has done in any year since 2000, when economic growth briefly brushed 4%. In particular, growth in the EU-15 was a surprisingly high 2.8% last year – the first time since 2000 that EU countries have come close to meeting the Lisbon target in this vital policy area. And growth has become much more stable; there is no "new economy" hype as there was in 2000. But it is imperative that EU countries use this success to build and prepare for the future. Governments should take advantage of the current good economy to push ahead with reform, because the framework conditions will probably not be better for years. Some time between 2010 and 2020, European demographics point to a probable decline in potential growth.[2] In other words, greater effort will be required merely to maintain the pace of expansion – unless policies that can lead to future growth are put in place today.

[2] European Commission, The Long-Term Sustainability of Public Finances in the European Union (Brussels: European Commission, 2006).




current rank
one year ago

| | | |
|---|---|---|
| 1 | Sweden | 2 |
| 2 | Spain | 1 |
| 3 | Austria | 3 |
| 4 | Belgium | 5 |
| 5 | Netherlands | 7 |
| 6 | United Kingdom | 4 |
| 7 | EU15 | 6 |
| 8 | Germany | 9 |
| 9 | France | 8 |
| 10 | Italy | 10 |




Source: Eurostat

# IV. Strong productivity growth – is it here to stay?

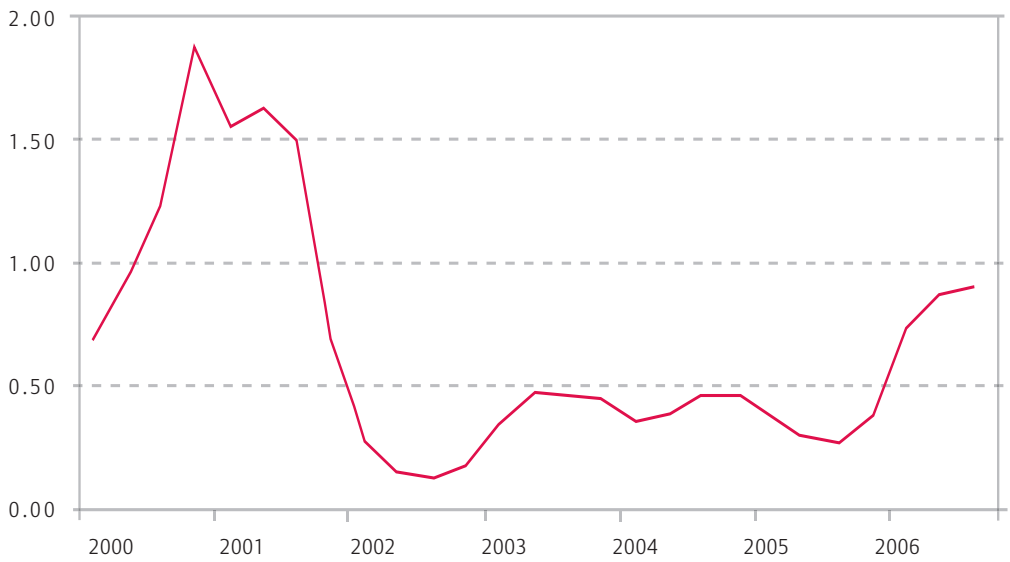
High productivity is key to any successful modern economy. And, while the Lisbon Agenda does not set any specific productivity targets, it does vow to make Europe "the most competitive and dynamic knowledge-based economy in the world" – a ringing declaration which seems to imply that, in the vital area of economic dynamism, Europe can and should be benchmarked against the world leaders. In the area of productivity, that means first and foremost the United States.

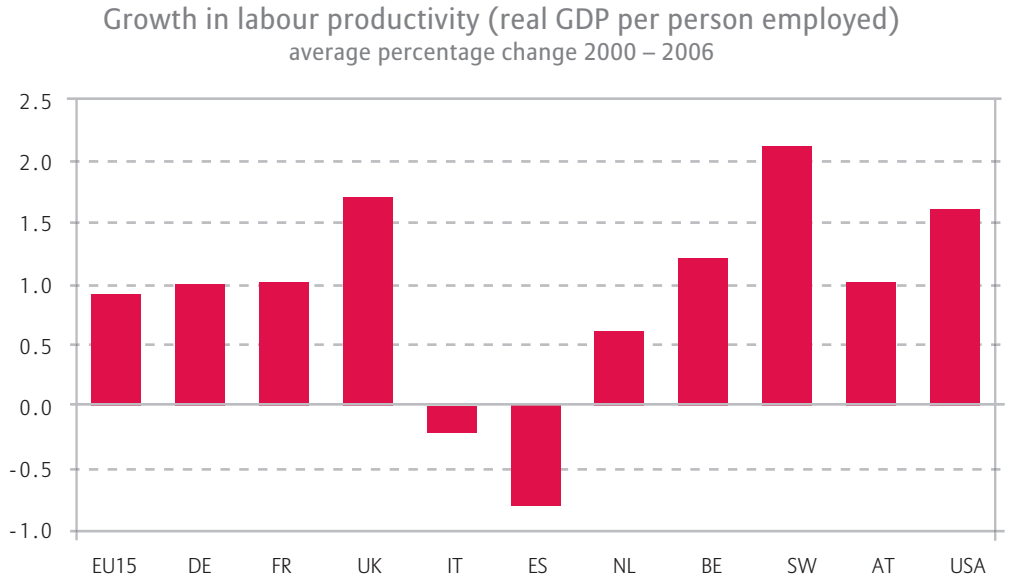
To be sure, the U.S. is a difficult benchmark for Europe to use. Much of the U.S.' success was based on a policy mix that many European countries have de facto ruled out. But the U.S. is especially important in one way: it demonstrates what a mature, developed industrial economy can achieve.

Given the various problems involved in comparing absolute levels of labour productivity, we have taken the relative annual rates of change in productivity for our Productivity Indicator. The indicator sets the annual rates of change in U.S. productivity at one as a yardstick, and shows to what extent each of the surveyed countries have managed to close or surpass the gap in productivity with the United States. Among other things, this method avoids potential distortion from exchange rates. The values are likewise smoothed using a moving four-quarter average.

Interestingly, productivity is now rising faster in a number of European countries than in the U.S. – and in some cases considerably faster. Sweden, Belgium, Germany and the UK all recorded faster rising productivity rates than the U.S. last year. As for the overall European performance, Europe weighed in at just under the U.S. figure – a considerable improvement on 2005.

| current rank | | one year ago |
|---|---|---|
| 1 | Sweden | 1 |
| 2 | Belgium | 8 |
| 3 | Germany | 6 |
| 4 | United Kingdom | 5 |
| 5 | EU15 | 7 |
| 6 | Netherlands | 2 |
| 7 | France | 3 |
| 8 | Austria | 4 |
| 9 | Italy | 9 |
| 10 | Spain | 10 |






Source: Eurostat, own calculations

One of the truly surprising results is Germany, which weighs in at No. 3, ahead of the EU average (for more, see the box "Productivity in Germany: What's behind the numbers?" on page 14).

Even though Europe's overall productivity improved markedly, it cannot mask considerable divergence within the European Union. Italy and Spain, for example, have negative productivity growth rates. There is, in other words, a major north-south divide opening up in Europe around productivity performance – a divide which, if it goes unaddressed, means the living standards of citizens in northern countries will rise more quickly than those of southern countries.[3] This, in turn, will lead to greater social divergence within the EU – a result which the Lisbon Agenda vowed to avoid. Addressing this divergence, however, means the southern states will need to drive forward reforms that will raise their productivity growth rates.

While the improving picture on productivity is undoubtedly good news, we believe it is still too early to say with any certainty whether the recent productivity gains in the EU-15 reflect structural improvements or are cyclically induced. As on most policy issues, there are two ways of looking at things, and we tend towards the positive scenario. The pessimistic take is that the disappointing overall trend reflects Europe's rigidity and lack of competitiveness in an increasingly globalised and technology-driven world. Some experts lean towards this stance, pointing to the limited impact of technological change, innovation, product and labour market liberalisation in many EU countries.[4] But some of these arguments have recently become less relevant. Labour markets have been deregulated in some countries. Innovation according to the data on patents and R&D has improved at least partially. Our main argument for the more optimistic view is that major restructuring and cost-cutting efforts will yield efficiency gains. This implies that Europe will see continued productivity growth in the months and years ahead as reforms start to pay off.

Despite the progress that has been made recently, Europe still has low productivity in the services sector – an area which covers 70% of modern economic activity.[5] Many experts believe that low application of information and communications technology (ICT) in the service sector is to blame. This implies that promoting the diffusion of ICT is an important must-do task for politicians.

[3] Peer Ederer, Innovation at Work: The European Human Capital Index, Lisbon Council Policy Brief (Brussels: Lisbon Council, 2006).
[4] The Conference Board, Is ICT's Contribution to Productivity Growth Peaking? Executiveaction series, No. 224, January 2007.
[5] ECB, Labour Productivity Developments in the Euro Area, Occasional Paper Series, No.53, October 2006.

# Productivity in Germany: What's behind the numbers?

Labour productivity* in the German economy
- average annual change in % -

| | 2000-2005 | 2006 (estimate) |
|---|---|---|
| All sectors | 1.5 | 2.0 |
| Industry | 3.2 | 6.5 |
| • Manufacturing | 3.2 | 6.6 |
| • Construction | 0.7 | 1.6 |
| Services | 0.8 | 0.2 |

Source: Statistisches Bundesamt and own estimates.

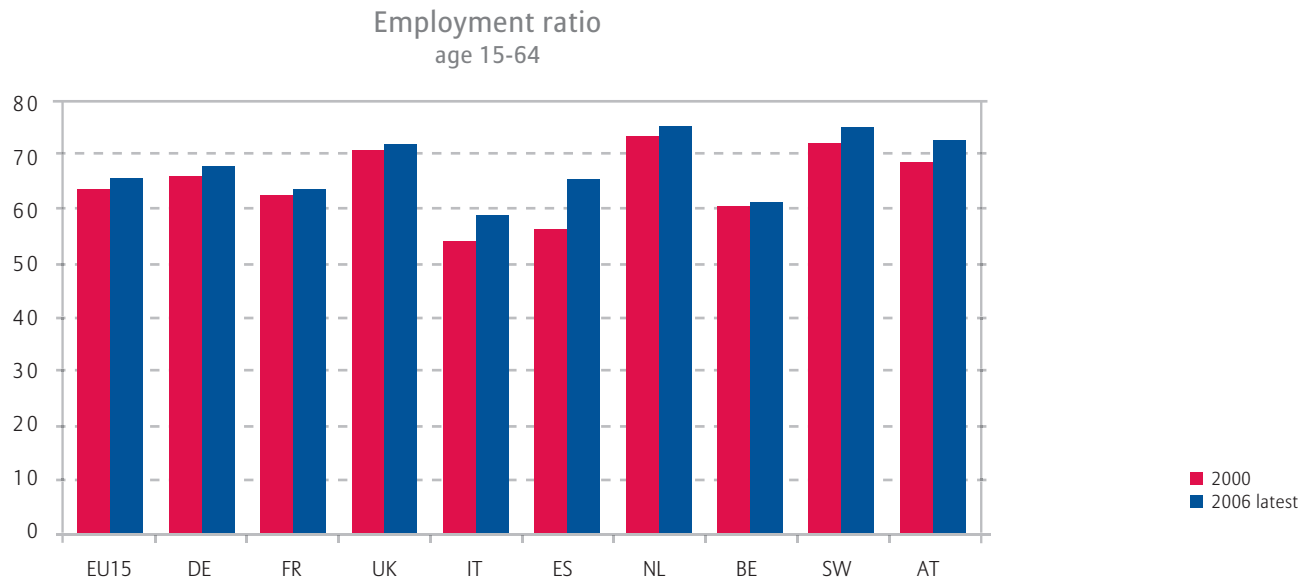
* per hour worked

Labour productivity in Germany is gathering pace again. The trend is particularly marked in industry, where successful restructuring in recent years is now delivering results. In 2006, German productivity growth is set to be more than twice as high as the previous six-year average. But the picture is more mixed in the services sector, where productivity performance is still clearly under par, probably due partly to the emergence of a "low-wage segment" where government promotion is moving people previously on welfare into regular jobs at rates little above standard welfare payments. Labour market reforms, especially Hartz I-IV, have boosted low-skilled employment. While tradable services like communications, financial services and IT are expected to boost productivity gains in the coming years amid tougher global competition, this is not so likely to happen in non-tradable segments such as public services. But, all in all, productivity growth in Germany in the second half of this decade – both labour productivity and most particularly total factor productivity – should turn out higher than in the first five years – a welcome performance, which bodes well for Germany's future economic and social well-being.

# V. More and better jobs

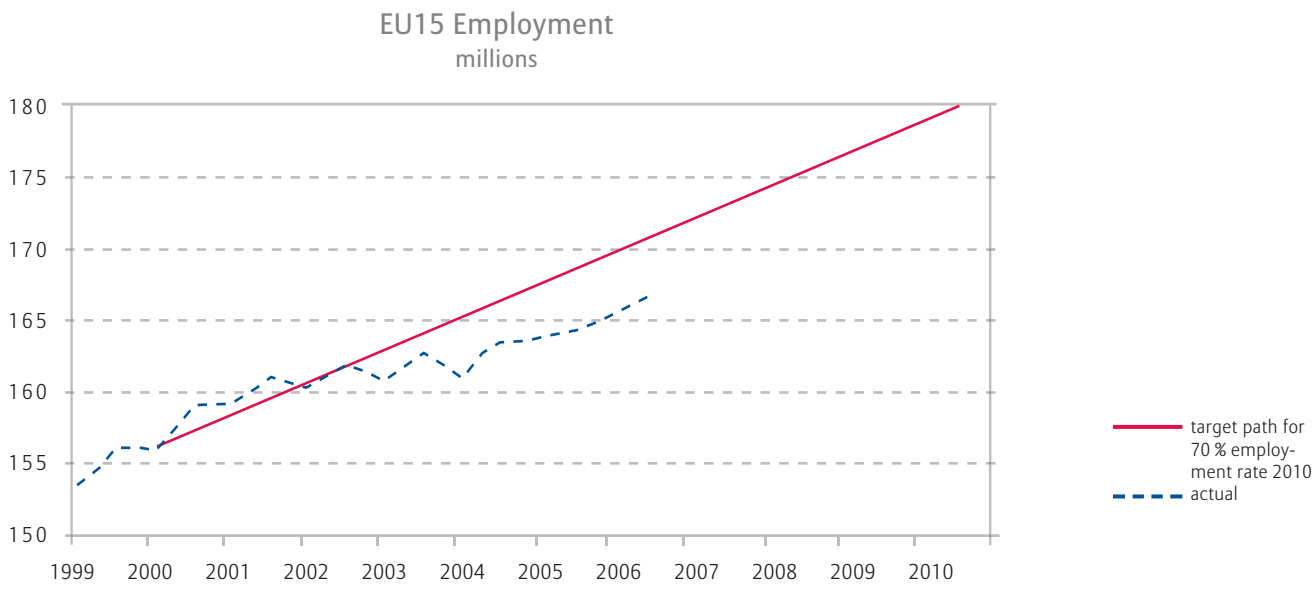
Few issues are as vital to the Lisbon Agenda as job creation and employment.

Although the EU-15 have not fully met the former Lisbon targets of 70% overall employment rate, they have made remarkably good progress, creating more than 10 million new jobs since 2000. Another encouraging sign is that despite the period of economic weakness from 2001 to 2005, more and more jobs continued to be created, leaving a positive trend in employment rates. Meanwhile the EU-15 has reached an overall employment rate of 65.2% – well off the 70% goal, but well up from the 63% rate in 2000.




Source: Eurostat, own calculations

In order to measure countries' employment performance, we have taken the original Lisbon goal of a 70% employment rate by 2010, and devised a target path with the quarterly increases required to guarantee that the 70% rate will be met on time. The current employment rate is set in relation to the target rate where the country should be today if it is going to fulfil the 70% goal on time.



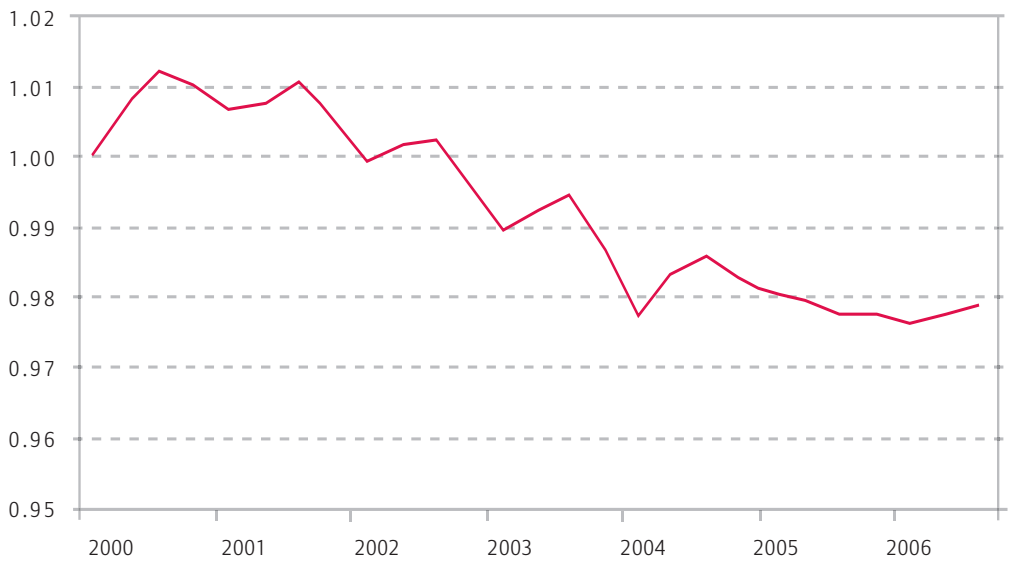

Source: Eurostat, own calculations

In the end, the Netherlands, Sweden and Austria did best, even though all three were already close to or above their 70% mark target. All three continued to push up their employment rates in 2006 instead of simply resting on their laurels. In a particularly gratifying development, Italy and Spain boasted a substantial increase from their low base level.

It should be noted that much of the growth Europe has experienced in the last five years has been labour intensive – a development brought about in no small measure by the relatively moderate rise in wage and labour costs for more than 10 years, with measures to cut the costs of low-skilled work playing a part alongside pay restraint. Structural reform has also been pivotal, bringing greater flexibility to the job market. For instance, some countries introduced rules making part-time work more attractive or simply more accessible (e.g. Germany, Italy, Belgium and the Netherlands in 2000 or 2001). This bolstered the trend to more part-time work, with its share of total employment climbing across the EU-15 from 18% in 2000 to 21% last year. Although more part-time contracts mean a drop in the average hours worked per head, this negative effect on labour input was more than made up for by the rise in the number of people employed. Opportunities for part-time work have particularly benefited female employment, which jumped from 54% in 2000 to above 57% in 2005, edging closer to the corresponding 60% Lisbon target (for female employment). Over the same period the employment of older workers (aged between 55 and 64) also increased from not quite 38% to 44%, due partly to stricter early retirement rules and trimmed benefit entitlements for older workers. However, the 50% goal prescribed in the Lisbon Agenda is still some way off.

In addition to part-time work, fixed-term contracts are also becoming more common (with a 14.6% share in the EU-15 at last count). While most of the former arrangements presumably suit worker preferences, the latter merit more nuanced consideration. Fixed-term contracts can help younger people in search of work get a foothold on the jobs ladder. Equally, though, they can cause a split in the labour market between insiders with permanent contracts and outsiders with fixed-term contracts. Against this backdrop, the "flexicurity" concept touted by the European Commission could prove useful in addressing this challenge. National governments are called on to put reforms in place that combine greater flexibility on the labour market with greater employment security. In other words, when recruitment and dismissal regulations are eased, people must be given the prospect of finding another job quickly or receiving comparatively generous unemployment benefits, coupled with support and training.

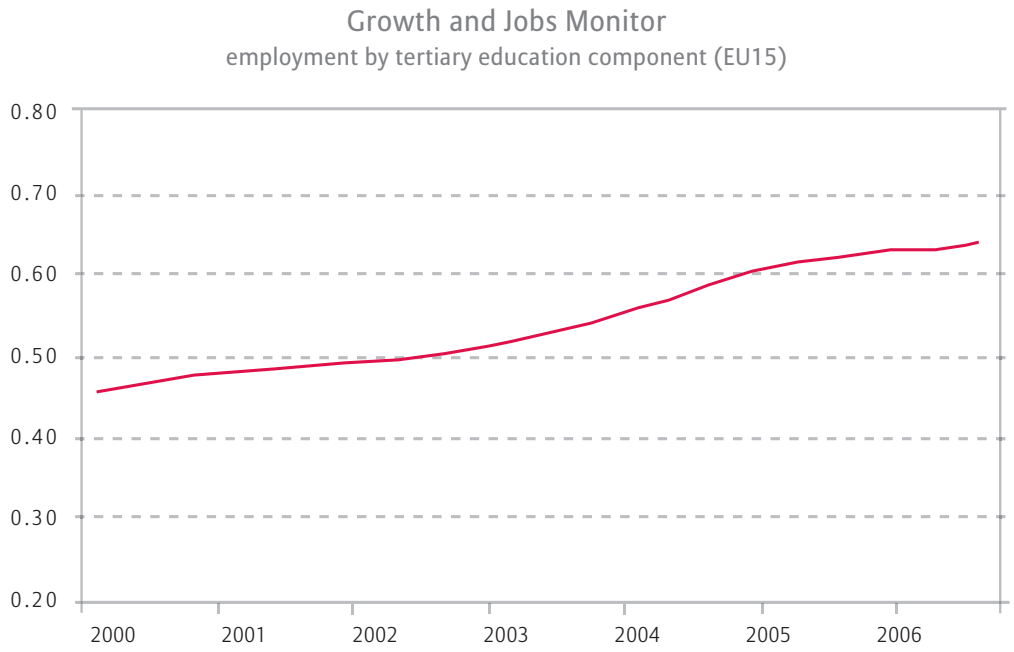
| current rank | | one year ago |
|---|---|---|
| 1 | Sweden | 3 |
| 2 | Netherlands | 2 |
| 3 | Spain | 1 |
| 4 | Austria | 5 |
| 5 | United Kingdom | 4 |
| 6 | Germany | 7 |
| 7 | EU15 | 6 |
| 8 | France | 8 |
| 9 | Italy | 9 |
| 10 | Belgium | 10 |



# VI. Building the knowledge base – Europe is getting better, but challenges remain

In the knowledge age, nothing counts more for economic success than the educational qualification of the workforce. A country with a high percentage of tertiary education graduates is generally credited with greater innovative potential and a higher ability to move into high value-added sectors of the economy than a country featuring a low share of graduates. Ultimately, the number of workers with tertiary education corresponds to the potential pool of labour actively available for the innovation process.

In order to rank countries based on the educational qualification of their workforce, we formed an average of the three highest EU performers and the three lowest over the last six years. Countries were then set out according to their relative position vis-à-vis the highest and lowest.[6] Values around one place the country in the group of "education frontrunners," while values close to zero flag the laggards.

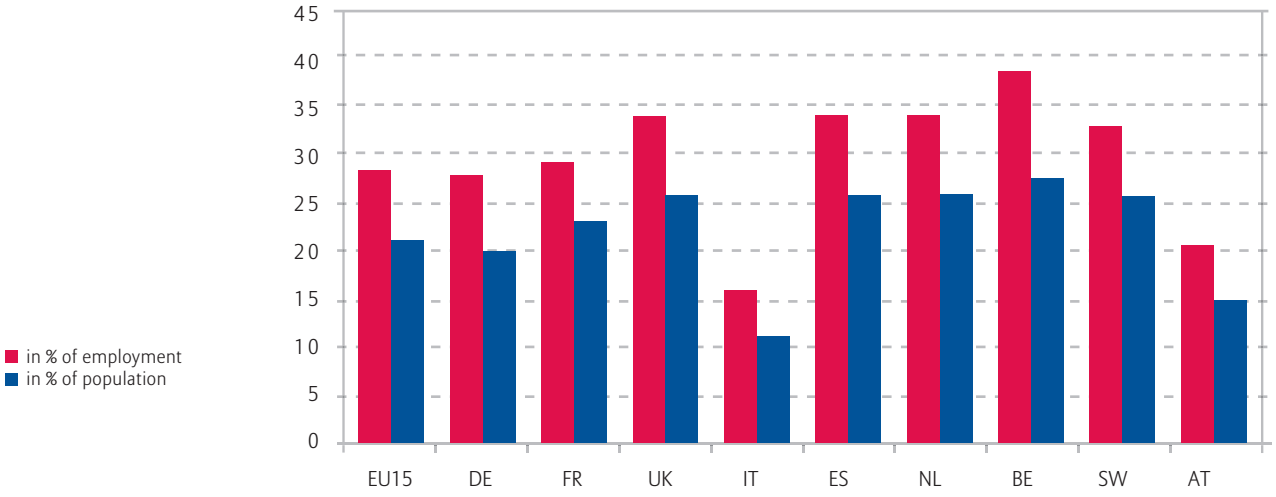



| current rank | | one year ago |
|---|---|---|
| 1 | Belgium | 1 |
| 2 | Spain | 3 |
| 3 | Netherlands | 2 |
| 4 | United Kingdom | 4 |
| 5 | Sweden | 5 |
| 6 | France | 7 |
| 7 | EU15 | 8 |
| 8 | Germany | 6 |
| 9 | Austria | 9 |
| 10 | Italy | 10 |

[6] The first variable encapsulates the proportion of the working population aged 25 to 64 with tertiary qualification in the total workforce of the same age group. Tertiary education comprises education levels 5 (academic degrees, Masters Degrees, universities of cooperative education) and 6 (advanced research qualifications, doctorates) as defined by the International Standard Classification of Education (ISCED).

Surprisingly, Belgium tops the list – weighing in as the only country surveyed to score above one. Nearly 40% of Belgium's workforce boasts a tertiary or higher degree – making the Belgian workforce one of the most educated in Europe. Spain, Netherlands and UK also score well, while Italy again finds itself on the bottom of the list. Austria, too, scores poorly, indicating less innovation potential and labour quality. It is striking that smaller EU-15 countries exhibit an above-average level of education, along with the UK.

Share of tertiary education level attained
age 15 - 64, average 2006*



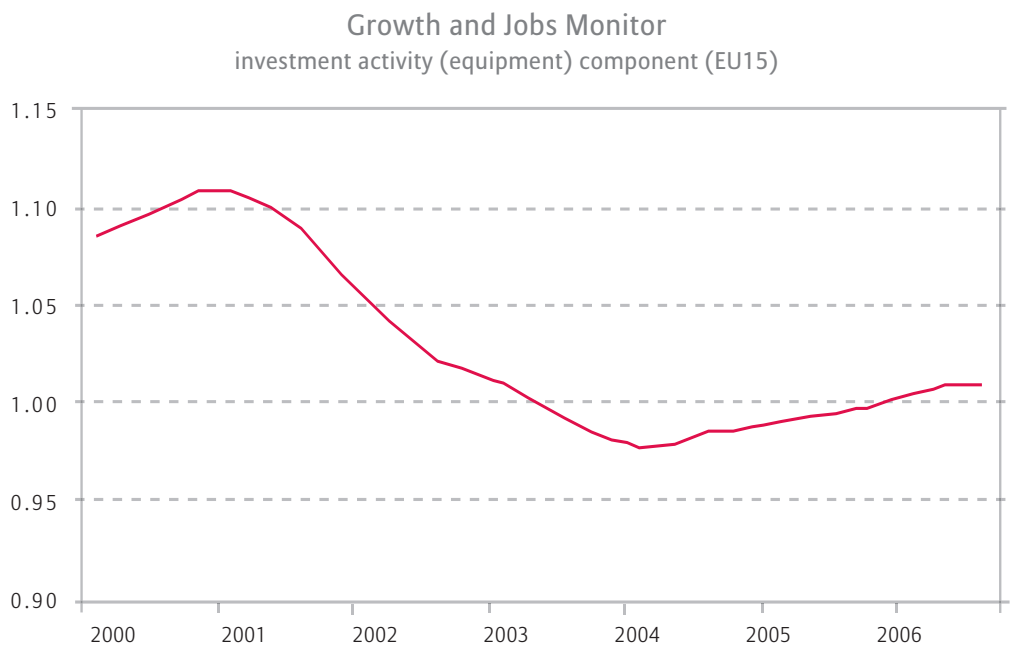

* partly estimated
Source: Eurostat, own calculations

Importantly, the overall proportion of employees with tertiary education is steadily rising. In 2006, 29% of the workforce in the EU-15 countries had tertiary or higher education, up from 25% in 2000. These figures bode well for the European economy in general and labour force participation rates in particular, when you consider that some 82.5% of Europe's highly skilled have jobs and participate in the labour market, while only 46.4% of low skilled do so.[7] As a rule, the figures show that a high tertiary employment rate rests on a comparatively broad knowledge base in the population as a whole.

[7] European Commission, Employment in Europe 2006 (Brussels: European Commission, 2006).

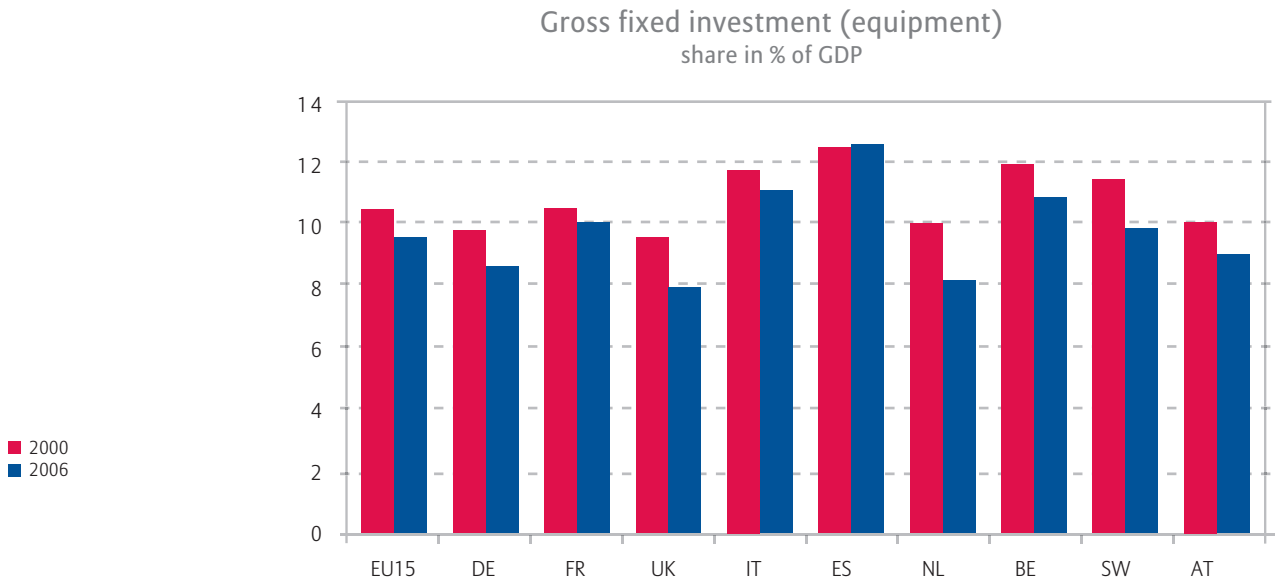
# VII. Investment is up – but how solid is it?

The implementation of technology is fundamental to a knowledge-based economy. To track progress on this key variable, we ranked the nine countries surveyed by investment in machinery and equipment as a percentage of GDP. Investment in new machinery and equipment is how technical progress is introduced into the economic process, where it enhances economic growth through improved factor productivity. To rank countries based on their investment in new machinery and equipment, we chose the investment ratio of the G3-aggregate, consisting of the EU-15, USA and Japan, to serve as benchmark. In order to eliminate fluctuations based on the economic cycle, we chose a multi-year average. Then we ranked the nine countries surveyed according to performance relative to the benchmark.



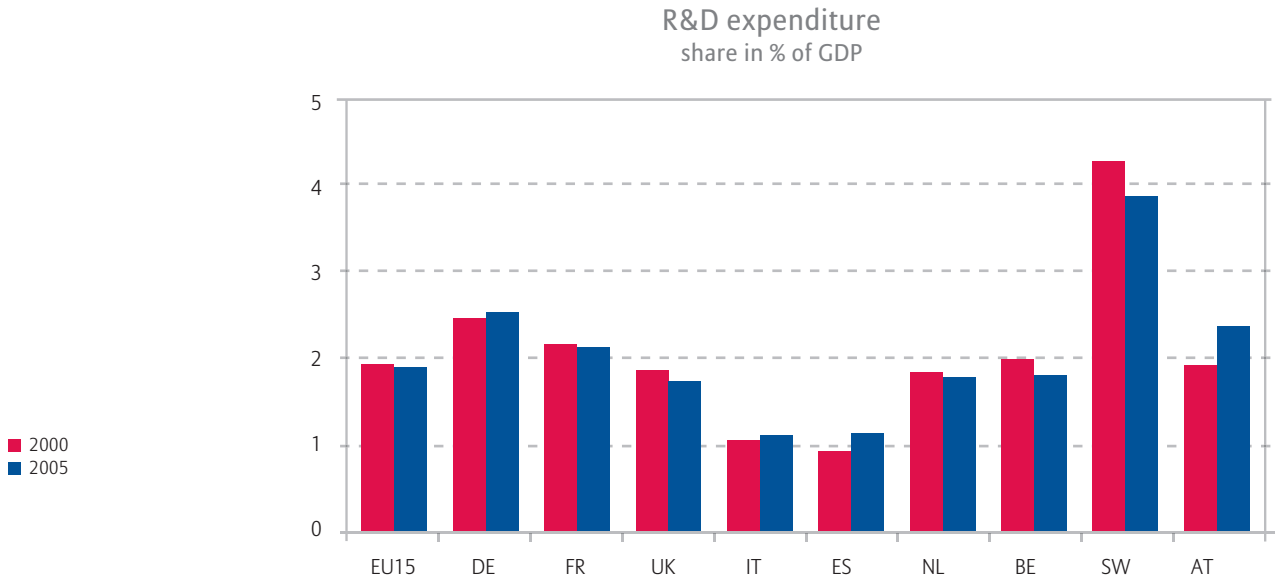

| current rank | | one year ago |
|---|---|---|
| 1 | Spain | 1 |
| 2 | Italy | 2 |
| 3 | Belgium | 3 |
| 4 | France | 4 |
| 5 | Sweden | 5 |
| 6 | EU15 | 6 |
| 7 | Austria | 7 |
| 8 | Germany | 8 |
| 9 | Netherlands | 9 |
| 10 | United Kingdom | 10 |

Apart from Spain, investment ratios in the EU countries analysed have not yet regained the levels they hit in 2000, the last boom year. However, in the past two years most countries have halted their decline and are showing marked improvements. All in all, we hope that the investment upswing now underway will persist; all the signs – sales outlook, corporate financing conditions and earnings situation – look good. The rebound so far is encouraging, although there is still room for improvement in capital stock growth.




Source: Eurostat, own calculations

The Lisbon Agenda specified a prominent target for research and development spending, which the EU wishes to see expanding to 3% of GDP by 2010. However, data on this is available only yearly and with quite a time lag, which is why we have not included it here. We also believe that ultimately the important factor is how research results or innovations are put to work and that expenditure on machinery and equipment says more about the diffusion of new technologies than simply taking into account overall R&D spending. Besides spending on machinery, computers etc., our definition also encompasses investment in intangible assets such as patents or self-produced software.

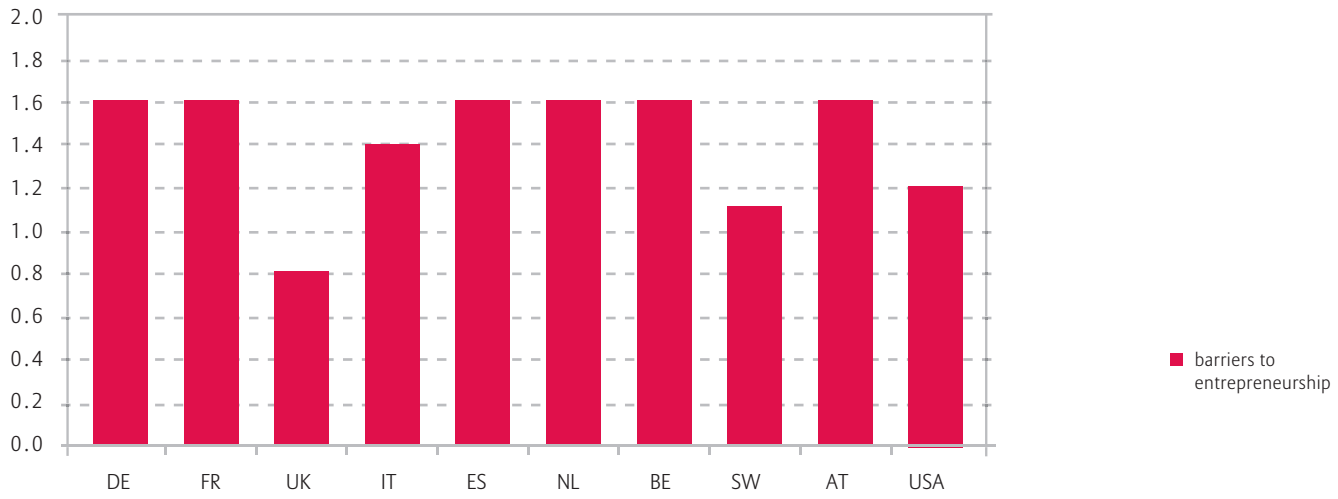



UK, IT, NL 2004; SW 2001
Source: Eurostat

This is not to gloss over in any way the unsatisfactory headway made on R&D spending. Throughout the EU-15 its share of gross domestic product remains stuck obstinately at 1.9%. Italy and Spain are the conspicuous laggards, although the Spanish ratio is rising. In contrast, Sweden is way out front. In its new annual progress report, the European Commission writes that if all countries were to meet the target R&D ratios set in their National Action Plans, research spending in 2010 would account for 2.6% of GDP. While that would be a marked improvement on the stagnation registered since the launch of the Lisbon Strategy, it would still fall short of the 3% goal.

Arguably, regulatory practice will play a pivotal role in the diffusion of technological progress, also because competition encourages innovation. The OECD, for one, calculates a string of indicators that seek to quantify the degree of regulation hampering innovation in various OECD countries. The survey gives a rough picture of the otherwise highly convoluted regulatory framework in many places. Not surprisingly, the UK does well, boasting an economic environment that encourages innovation. By contrast, Austria, Belgium, France, Germany and the Netherlands all rank poorly – indicating that their countries still boast too much regulation that hampers entrepreneurship. However, Sweden does surprisingly well – weighing in with less entrepreneurship-stifling regulation than the United States[8].

OECD regulatory indicators 2003



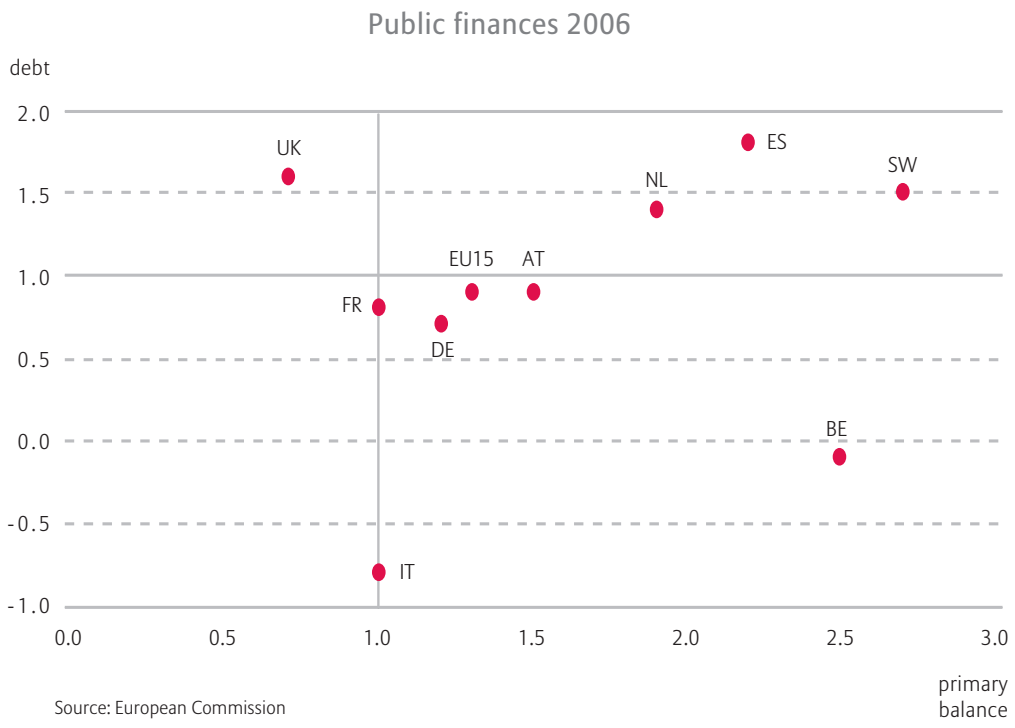

Source: OECD

[8] The assessment scale ranges from 0 to 6; the higher the values, the greater the need for deregulation.

# VIII. Public finances on a tentative road to recovery

Few issues touch more deeply on contemporary policy debates than the sustainability of public finances. Long thought to be a mostly technical issue that only finance ministers needed to worry about, profound demographic change means public finance is taking on a moral dimension. Will this generation leave a life as prosperous as the one we enjoy today to the generation following in our footsteps? Or will we consume our own resources, leaving under-funded and deficient social systems behind for our children to fix after we are gone?

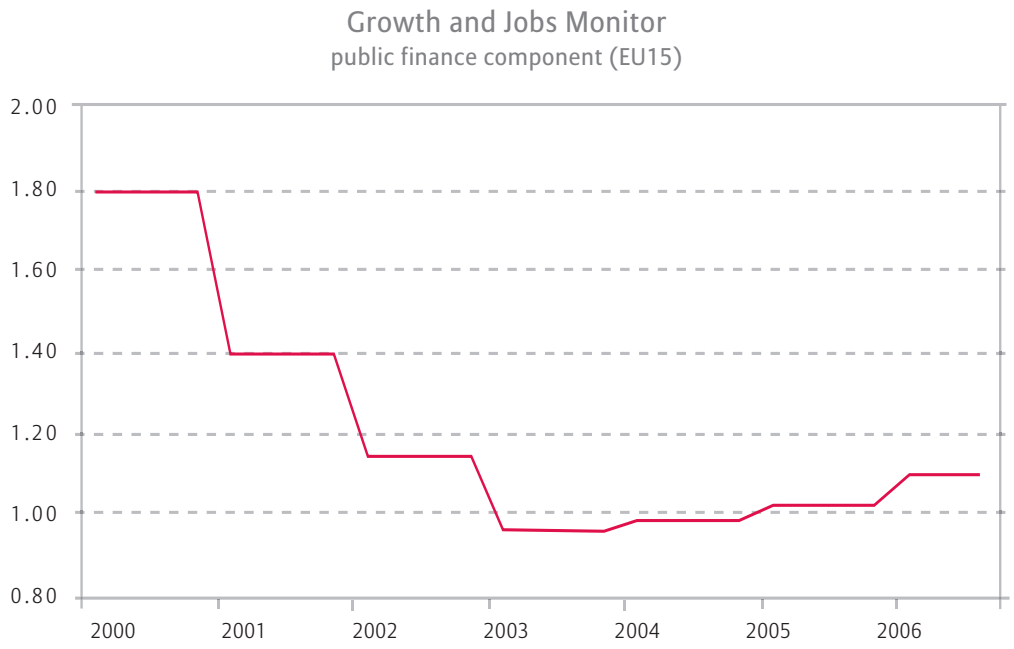
To measure the sustainability of public finances, we looked at two indicators: the primary balance (the difference between government receipts and expenditure excluding the interest paid on the public debt outstanding) and the public debt level, each as a percentage of gross domestic product. We have defined achievement of primary balance as on-target performance; a country which has a primary balance equilibrium receives a score of one. The debt burden is considered separately as the second component, taking a 60% debt ratio in compliance with the Maastricht criteria as on-target. Both components are entered into our partial indicator of the sustainability of public finances with equal weightings.




Source: European Commission

Only Spain, the Netherlands and Sweden perform well in both components in the upper right-hand quadrant. As the example of Belgium illustrates, a high level of debt clearly requires a high primary surplus, or to put it another way, it requires that the former be compensated by the latter. That is precisely what bottom-of-the-league Italy is currently failing to do with a combined indicator reading of just 0.1. Viewed over time, the public budget situation for the EU-15 as a whole was at its best in 2000 – following the consolidation drive in the run-up to Monetary Union and bolstered by buoyant economic activity at the time. Subsequently the picture steadily deteriorated. The first signs of a turnaround surfaced in 2005 when the EU-15 primary balance clambered clearly above zero again, to 0.5% of GDP. In that year, though, the debt ratio climbed further to 64.5%, causing our combined indicator to stick at 1. Last year the primary surplus relative to GDP will presumably have nudged up again EU-15-wide and the debt ratio fallen slightly for the first time since 2002. The tendency to improvement is expected to continue, given the solid economic forecast and more stringent fiscal policies, notably in Germany and Italy.

But fiscal belt-tightening must not be allowed to flag, especially in view of the demographic challenges the future holds. In other words, the latest EU-15 indicator reading of slightly more than 1 does not mean that a country can rest on its laurels here. Countries must continue to consolidate their budgets, so that we will have an easier time to meet our existing social commitments with fewer people in the workforce, more people in retirement and a life expectancy extending well into the 80s.




| current rank | | one year ago |
|---|---|---|
| 1 | Sweden | 1 |
| 2 | Spain | 2 |
| 3 | Netherlands | 3 |
| 4 | Austria | 4 |
| 4 | Belgium | 9 |
| 6 | United Kingdom | 5 |
| 7 | EU15 | 6 |
| 8 | Germany | 8 |
| 9 | France | 7 |
| 10 | Italy | 10 |

# The secrets of Sweden's success

Sweden is the shining star in The European Growth and Jobs Monitor. The individual components of our Overall Lisbon Performance Indicator show the Scandinavian country in the lead on economic growth, labour productivity, the employment rate and public finances. The percentage of the workforce with tertiary qualifications and the machinery and equipment investment ratio, although not quite so convincing in fifth place each, are still quite respectable. But these two partial indicators of the knowledge base aside, Sweden sparkles as the biggest R&D spender relative to GDP.

The country has notched up real economic growth since 2000 of almost 3% a year, practically one percentage point a year more than the EU-15 average. Key to this outstanding achievement is that labour productivity growth over the same period was more than one percentage point higher than in the EU-15. Sweden managed to combine this powerful productivity trend with higher employment just above the European average. Given such dynamic economic growth and solid employment gains, healthy public finances come as no surprise. Sweden's 52.3% debt ratio, already comparatively low in 2000, is estimated to have dipped below 50% in 2006. Primary surpluses in the order of 4.5% were slated in the past two years. Certainly, looming demographic problems in Sweden, too, argue for continuing to raise the overall number of hours worked. But such comfy public finances permit the higher public R&D spending now planned and can accommodate current income tax cuts unquestionably justified by the high tax-to-GDP ratio.

Sweden's success story began when it refocused its economic policy in the early 1990s. Following a very severe economic crisis at the beginning of the decade, government took a no-gain-without-pain tack, implementing root-and-branch welfare reform cutting deep into the social security net, shaking out public budgets and rolling back public sector employment. This was accompanied by a reduction in company taxes and measures to promote employment. The repositioning worked for Sweden. But that does not necessarily mean the same combination will be effective elsewhere. There is no one-size-fits-all solution, the impact of reforms will always depend on given structures and traditions (Sweden, for instance, had and has a very generous welfare state). Each country can learn from and be inspired by its peers, but ultimately it must decide on its own road to prosperity.

# IX. Summary

The European Growth and Jobs Monitor: Indicators for Success in the Knowledge Economy shows that Europe has finally turned the corner after years of disappointing performance. The Lisbon targets have come within closer reach than many had predicted. Only one year ago, the Overall Lisbon Performance Indicator stood at a disappointing 0.73; today, that index stands proudly at 0.9 for the EU-15 – surprisingly close to the 1.0 level that would indicate European countries are on track to fulfil the ambitious goals of the 2000 Lisbon Agenda.

With regard to the six components of The European Growth and Jobs Monitor, the following points can also be drawn:

1) Last year, the European Union experienced the strongest economic growth since the boom year 2000. Corporate restructuring and past reforms undoubtedly helped power this, but that is no reason for complacency. The current economic tailwind should be used to bring about further progress.

2) The recent acceleration in labour productivity growth is a welcome development, and can already be seen as a key contributor to economic expansion. Although we cannot yet say for certain whether the faster pace of productivity gains is driven chiefly by the economic cycle or is structurally induced, we do find evidence to suggest that structural improvements are playing a significant part in recent productivity trends.

3) The relatively low increases in labour productivity in Europe for quite some time were obviously due in part to successes on the employment front. Notwithstanding lacklustre economic activity between 2001 and 2005, more than 10 million jobs have been created in the EU-15 since the launch of the Lisbon Agenda, and employment rates are on a rising trend, even if they are unlikely to be fully on target by 2010. This achievement would not have been possible without the rather moderate development in labour costs and greater flexibility on the job market.

4) To avoid a possible trade-off between productivity gains and employment growth, greater technical progress and more innovation are absolutely essential. Europe must evolve into a more vibrant knowledge-based economy if it is to head off international competition. One positive trend in terms of innovation potential is the steady increase across the EU-15 in the percentage of working people with tertiary qualifications in the total workforce.

5) Education and research alone are not enough for a knowledge-based economy; equally important are the use of human capital and the diffusion of new technologies. Investment in machinery and equipment as a percentage of GDP can shed light on the latter aspect. The revival in expenditure so far, while definitely promising, is not yet entirely convincing. Regrettably, though, R&D spending relative to GDP has not budged since 2000.

6) In terms of the sustainability of public finances – another indication of how well Europe is prepared for the future – some things have taken a turn for the better. The 2006 primary surplus, as a percentage of GDP in the EU-15, will presumably have notched up another slight increase, and for the first time since 2002 the debt ratio has shrunk a little. But mindful of the demographic challenges for the public budgets, national governments should not ease up on consolidation instead of simply relying on sustained support from the economic cycle.

7) The chief responsibility for boosting growth and prosperity still lies with national governments themselves. It is up to them rigorously to implement the programmes set out in their detailed National Action Plans. But the European Commission also has an important part to play; measures to foster growth and employment need to be given priority in practical policymaking and not just in communiqués – particularly when it comes to structuring the Community's annual budget and deciding on policy directives that may hamper economic growth (such as strict working hour regulation or excessive bureaucratic burdens on companies). What is more, market integration – especially in the service and energy sectors – must be driven ahead forcefully.

All in all, we hope that the progress we have highlighted here will act as a spur to address the Lisbon process with renewed vigour. Good reform policies drive economic growth; conversely, when the economy is humming along it is easier to reform. It is this kind of virtuous circle – with good policies making it easier to implement even better ones – that European countries, and the European Union itself, should aim for. The Lisbon Strategy has not failed, and it must not be allowed to founder, because Europe's future hinges on it.

# ANNEX

## Growth and Jobs Monitor
current scoring

| Current ranking overall | Country | Overall score | Economic growth | Labour productivity | Employment ratio | Employment by tertiary education level | Investment activity (equipment) | Public finance |
|---|---|---|---|---|---|---|---|---|
| 1 | Sweden | 1.37 | 1.42 | 1.76 | 1.06 | 0.83 | 1.05 | 2.10 |
| 2 | Belgium | 1.09 | 0.89 | 1.29 | 0.93 | 1.12 | 1.14 | 1.20 |
| 3 | Netherlands | 1.02 | 0.88 | 0.86 | 1.06 | 0.90 | 0.85 | 1.60 |
| 4 | United Kingdom | 0.98 | 0.82 | 1.19 | 1.02 | 0.89 | 0.84 | 1.10 |
| 5 | Spain | 0.98 | 1.23 | -0.59 | 1.05 | 0.90 | 1.31 | 1.96 |
| 6 | Germany | 0.91 | 0.76 | 1.27 | 0.99 | 0.62 | 0.90 | 0.93 |
| 7 | EU15 | 0.90 | 0.80 | 0.91 | 0.98 | 0.63 | 1.01 | 1.09 |
| 8 | Austria | 0.83 | 1.05 | 0.45 | 1.04 | 0.26 | 0.95 | 1.20 |
| 9 | France | 0.80 | 0.56 | 0.67 | 0.96 | 0.66 | 1.06 | 0.89 |
| 10 | Italy | 0.43 | 0.47 | -0.10 | 0.94 | 0.03 | 1.16 | 0.10 |

## Growth and Jobs Monitor
one year ago

| Ranking overall | Country | Overall score | Economic growth | Labour productivity | Employment ratio | Employment by tertiary education level | Investment activity (equipment) | Public finance |
|---|---|---|---|---|---|---|---|---|
| 1 | Sweden | 1.26 | 0.99 | 1.72 | 1.04 | 0.77 | 1.03 | 2.00 |
| 2 | Netherlands | 0.95 | 0.49 | 0.92 | 1.04 | 0.90 | 0.85 | 1.50 |
| 3 | Spain | 0.87 | 1.16 | -1.01 | 1.05 | 0.87 | 1.27 | 1.86 |
| 4 | United Kingdom | 0.85 | 0.70 | 0.63 | 1.02 | 0.84 | 0.83 | 1.10 |
| 5 | Austria | 0.83 | 0.86 | 0.67 | 1.02 | 0.26 | 0.95 | 1.12 |
| 6 | France | 0.78 | 0.49 | 0.73 | 0.97 | 0.63 | 1.04 | 0.84 |
| 7 | EU15 | 0.73 | 0.52 | 0.26 | 0.98 | 0.62 | 0.99 | 1.01 |
| 8 | Belgium | 0.72 | 0.57 | -0.11 | 0.94 | 1.09 | 1.14 | 0.70 |
| 9 | Germay | 0.65 | 0.24 | 0.42 | 0.97 | 0.65 | 0.86 | 0.76 |
| 10 | Italy | 0.33 | 0.03 | -0.39 | 0.94 | -0.01 | 1.15 | 0.22 |