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Economic Reform in the European Union: Will the 'Lisbon' EU Catch Up with the US?

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Introduction

In March 2000, the political leaders of the European Union decided that the Union must become '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' by 2010. They adopted a program of economic reforms, named the Lisbon Strategy, aimed at achieving this goal. It was probably the most comprehensive growth-supporting economic program in the history of the EU, covering reforms in several areas, including product and labor markets, research and development, investment in human capital, improving the business environment and social security systems and the like. The US economic performance of the 1990s was a crucial reference point for Europeans when accepting the Lisbon Strategy. What is more, an unofficial goal of the strategy was to catch up with the US.

Nonetheless, five years after its adoption, the Lisbon Strategy does not seem to have been a success. There were many weaknesses in the strategy that were identified by economists and policy-makers early on. Among the most commonly indicated were too wide a range of inconsistent priorities resulting in lack of clear priorities, and soft methods of implementation resulting in lack of implementation as well as omissions about how desirable reforms were to be implemented. The strategy's shortcomings caused the EU leaders to launch a mid-term review. The process started after March 2004 and was finalized in 2005 when the strategy was renewed.

In this chapter we analyze the GDP per capita gap between the EU and the US and from this perspective we examine the Lisbon strategy, in both its editions, before and after the mid-term review. The problem we especially concentrate on is linked to structural inadequacies of the strategy related to mismatches between the EU's economic problems and the

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reforms stipulated in the strategy. We argue that there are several omissions in the strategy, making this program potentially ineffective and therefore inhibiting the EU's catching up with the US. Finally we try to assess the future effectiveness of the Lisbon strategy and the factors conditioning it.

The gap

A crucial reason underlying the European Union decision to implement the Lisbon Strategy was the fact that in 2000 the GDP per capita gap between the EU and the US economies was larger than it had been since the beginning of the 1970s. The real GDP gap was even larger than that suggested by per capita indicators, because of the differences in population growth. From 1970 to 2000 the total population of the EU-15 rose by 19 percent, while the US population grew by 34 percent. Therefore the GDP[1] of the EU-15 decreased by almost 20 percentage points in relation to the US, from more than 113 percent of the US total GDP in 1970 to about 93 percent in 2000 (OECD, 2002h). Especially interesting observations can be drawn from the analysis of this gap. The GDP per capita of the EU-15 in 2000 represented about 70 percent of the US GDP per capita. But labor productivity per hours worked in the EU-15 was very close to the US level, about 93 percent. Furthermore, labor productivity per person employed in the EU-15 was also much closer than GDP per capita, representing about 85 percent (Eurostat, 2004). These differences were due to a shorter average working time in the EU in comparison to the US, lower employment rates and differences in demographic structures. It is worth noting that in 1970, in the 11 EU member states[2] average working time was very similar to that of the US, representing about 1915 hours per year. Until 2000, working time decreased both in the EU-11 and in the US, but the scope of the reduction in the EU was much larger. As a result, the average working time in the EU-11 was 1606 hours per year while in the US it was 1835 (OECD, 2002b). There were also substantial differences in employment rates between the EU and the US. The employment rate in the EU was only about 64 percent while in the US it was over 73 percent (OECD, 2002a). Moreover, the working age population's share in total population in the US was much higher than in the EU and represented three-quarters of the total population while in the EU it was only 66 percent (OECD, 2004).

Therefore lower labor utilization in the EU in comparison to the US can be seen as a crucial source of the GDP gap between these two economies. Lower employment rates and lower working time in the EU may of course reflect cultural differences and a preference for leisure time, as some authors think. Nevertheless, high unemployment rates in the European Union suggest that labor markets within the EU do not function effectively and are not able to generate more jobs.

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Sources of the gap

The lower employment rate in the EU, to some extent, may result from a relatively low level of human capital. Only 21 percent of the people of working age in the EU-15 have a tertiary education, while in the US the figure is almost 37 per cent. These figures are very important when you take into account the fact that the employment rates of people with tertiary education in the EU are similar to the US rates, and only the rates of employment of people with less education are lower. These data show that the lower level of human capital is a source of lower utilization of human resources in the EU economies. But these data also indirectly show that it is likely that institutional solutions present in the EU do not support job creation for employees with low qualifications. Institutional problems are also indirectly confirmed by the fact that the Union faces much more serious employment problems than does the US, including also long-term and structural unemployment, although these problems are also connected with a lower level of human capital.

As was mentioned above, among the reasons for lower productivity per person employed in the EU are the lower average working time and low employment rates. According to some economists (for example, Turner, 2003), the systematic shortening of working time and falling employment rates in Europe can be seen to reflect a preference for leisure. Another explanation is proposed by Freeman and Schettkat (2005), who hypothesize that the greater time worked and the higher employment rates in the US are due to the greater marketization of traditional household production in the US. These explanations are interesting, but there are important reasons why the bulk of the blame should fall on labor and product market regulations as well as on welfare state benefits for the relatively short working time and low employment rates in many European countries.

As Figure 14.1 shows, the shorter average working time in many European countries can be explained by the fact that more sources of income other than salary are available for EU employees. Countries in which, in 2000, spending on income transfers represented a larger part of GDP had, at that time, a much shorter working time than the countries that spent less on these transfers. The correlation coefficient between these two variables amounts to –0.58, calculated on the basis of the data for EU member states, the US, Japan, Norway, Island, Australia and New Zealand. This means that there is an inverse relationship between the availability of income other than salary and the tendency to lengthen working time. Like income transfers, the level of income taxes also influences the reduction of working time. EU member states, in comparison to the US, have a relatively high level of taxes imposed on labor. The correlation coefficient, –0.55, between the level of taxes imposed on labor and the average working time also confirms a negative relationship between taxes and average working time.

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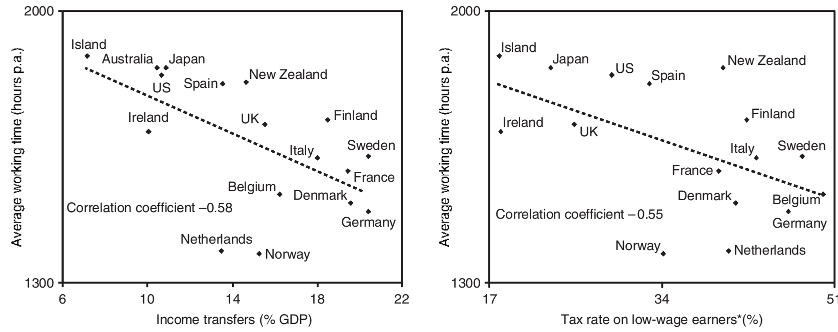

Figure 14.1: Average working time vs income transfers and tax rates on low-wage earners

Note: * The tax rate on low-wage earners calculates the income tax on gross earnings + the employee's and employer's social security contributions and then expresses this sum as a percentage of the total labor cost for the low-wage earner. Tax rates are calculated for a single person without children. When at work, this person earns 67 percent of the average wages of full-time production workers in manufacturing.
Source: Author's calculation using OECD (2002c) and Eurostat (2004).

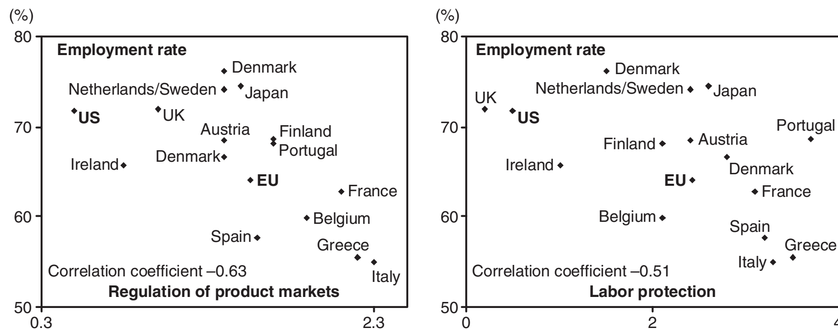

Figure 14.2: Employment rate vs regulation of product markets and labor protection
Source: Author's calculation using Nicoletti et al. (2000) and Eurostat (2004).

Institutional conditions influence not only average working time in the EU, but also employment. In Figure 14.2 we show the relation between the levels of product market regulation and the degree of protection of the labor markets on the one side, and employment rates on the other. The data show that the higher the level of employment protection and the more severe the product market regulation, the lower the employment rates in the economy. EU member states with the highest levels of product market

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regulation and the highest employment protection rates, such as Italy, Greece, Belgium, Spain and France, have at the same time the lowest employment rates. And vice versa, countries with lower product market regulation levels such as Great Britain, the US or Denmark, have the highest employment rates.

This is reflected in a substantial positive relationship between the level of product market regulation and employment protection and unemployment. A similar analysis prepared using the same data for regulation and rates of unemployment shows that the level of unemployment in the analyzed EU member states, the US and Japan is positively correlated with both the level of product market regulation and the employment protection level. The highest unemployment in 2000 could be observed in EU countries with the highest levels of regulation: Spain, Greece, Italy and France. Countries with the lowest regulation and protection levels – Ireland, Great Britain, Denmark and the US – had low unemployment rates.

These relationships have already been demonstrated in analyses carried out by Nickell (1999) and Blanchard (2000). Their findings are generally consistent with the earlier observations made by Siebert (1997), who analyzed institutional and regulatory change in labor markets in EU member states over the last four decades.

The difference between the EU and the US economies concerns not only regulations and institutions but also the role of government in the economy. In the most general way, government's role in the economy is described by indices showing public spending values in relation to GDP, and by the structure of this spending. The data presented in Table 14.1 show that the difference in the levels of public spending in the EU and the US amounted to almost 13 percent of GDP. Over 12.2 percent was of this due to much higher spending by the EU on income transfers, 6.87 percentage points, and higher spending on public consumption, 5.33 percentage points. An additional percentage point, which practically closes the entire public spending gap, comes from subsidies, which were higher in the EU

Table 14.1: Structure of public spending in 2000 in the EU and the US (% GDP)

	Government consumption	**Government investment**	**Subsidies**	**Income transfers**	**Total government disbursements**
EU-15	19.9	2.54	1.42	20.67	47.16
US	14.57	3.26	0.35	13.8	33.62
Difference: EU–US	5.33	–0.72	1.07	6.87	13.54

Source: Author's calculation using OECD (2003).

Table 14.2: Changes in the structure of public spending in the EU-15, 1963–2000 (% GDP)

	1963	1975	1985	1989	1993	2000	Change 1963–2000 (% GDP)
Government consumption	15.09	18.36	20.23	19.46	21.08	19.90	+4.81
Government investment	3.80	3.83	3.12	3.10	3.06	2.54	–1.26
Subsidies	1.44	1.97	2.24	1.96	1.84	1.42	–0.02
Income transfers*	11.58	17.45	19.29	18.68	21.39	20.67	+9.09
Total government disbursements	33.01	43.51	49.45	47.80	53.09	47.16	+14.15

Note: * Social benefits paid by government and other current transfers paid by government.
Source: Author's calculation using OECD (2003).

than in the US. What is more, a specific feature of the difference in the structure of public expenditure in the EU and the US was that the only item on which in 2000 the EU spent less than the US in relation to its GDP was public investment outlays. In addition, the structure of spending in EU countries in 1963[3] was very similar to that of the United States in 2000 (see Figure 14.2). In this context, what is worthy of note is that, in the 1960s, the EU countries developed faster than the United States.

A continuous increase in income transfers and public consumption spending, which can be observed in European countries since the 1960s, was connected to the creation of the welfare state. It was based on extensive social aid and a far-reaching public redistribution of income. These processes had, however, a very severe impact on labor markets. Growing access to income other than wages, measured by the value of income transfers, resulted in growing unemployment underpinned by a lack of incentives for looking for a job. Therefore, the unemployment rate since the beginning of 1970s grew at the same pace as income transfers, as shown at Figure 14.3. The correlation between unemployment and income transfer levels in time series from 1970 to 2000 shows that there is almost a linear relationship between these two variables, and the correlation coefficient is 0.92.

In this context, Engen and Skinner (1992) investigated the impact of the growth of budget spending and tax revenue on the pace of GDP changes in 107 countries in the period from 1970–85. These authors showed that there is an inverse relationship between changes in the levels of the states' intervention in their economies and the pace of growth of their economies. They found that an increase in public spending and tax revenue of 10 percent of GDP with a stable budget results in an average decrease in the pace of long-term economic growth by 1.5 percentage points. This relationship is

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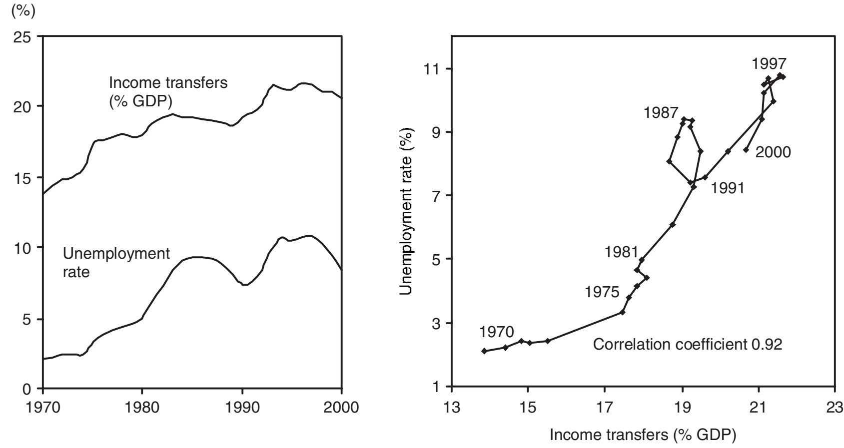

Figure 14.3: Unemployment and income transfers in the EU-15, 1970–2000
Source: Author's calculation using OECD (2003).

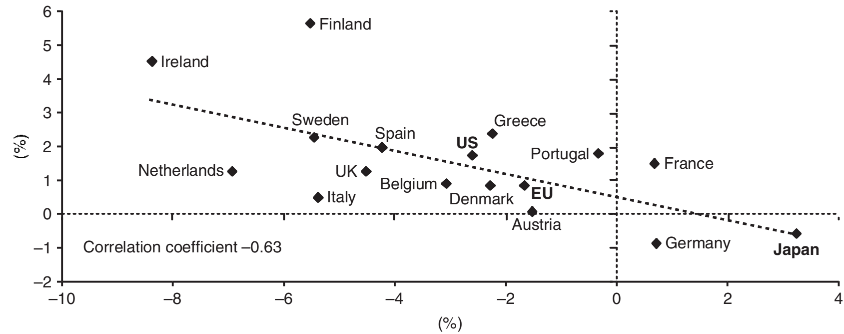

Figure 14.4: Public spending and GDP growth, 1990s
Note: Vertical axis: (average growth in 1996–2000) – (average growth in 1990–95)/difference in percentage points; horizontal axis (average level of public spending in 1996–2000) – (average level of public spending in 1990–95)/difference in percentage points.
Source: Author's calculation using OECD (2003).

confirmed by an analysis of changes in public spending and the pace of economic growth in the 1990s in the EU member states and the US and Japan, as presented in Figure 14.4, which shows that the pace of economic growth in the second half of the 1990s increased considerably in those EU countries that managed to significantly cut their public spending. Among them can be found not only low-spending countries such as Ireland but also traditionally high-spending ones such as Finland or Sweden.

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To sum up, we emphasize that low labor utilization in the EU in relation to the US is the main reason for almost 75 percent of the GDP per capita gap. This is not the consequence of a preference for leisure in the EU but rather of several institutional and regulatory features present in many European countries. As shown, most EU member states still have both high levels of product market regulation and high labor protection. In addition, excessive regulation and low effectiveness of product markets and labor markets in the EU are integral to the welfare state promoted by many EU countries. This model assumes excessive government expenditures, including, in particular, income transfers and public consumption spending. This is accompanied by the higher taxes imposed on labor. These factors discourage Europeans from taking up work or lengthening their working time and European companies from creating more jobs. All those conditions lead to a lower level of employment and lower working time in the EU economies than in the US.

Why was the strategy so ineffective?

The Lisbon Strategy was adopted in 2000, just before the dot-com bubble burst, but still at a time of perhaps naive enthusiasm for the so-called 'new economy' or 'knowledge-based economy.' Consequently it was full of uncritical statements and opinions on the origins of economic growth, usually praising the development of the information and communication technologies (ICT) and the Internet, which were acknowledged to have been essential for economic growth in the 1990s. This context had remarkable influence on the priorities of the strategy as well as on its rhetoric. Hence the development of the most competitive 'knowledge-based economy' and 'information society' were among its main objectives. These were to be reached via three dimensions, economic, social and environmental. Such a multidimensional approach demonstrated the EU's admiration for social cohesion and environmentally sustainable development.

As a result, the strategy put the greatest emphasis on those factors connected with limited diffusion of ICT and innovation. It presented a relatively good account of the weak points of the EU economy caused by incomplete internal market development and particularly by strong barriers to product market functioning. Deficiencies in the functioning of financial markets were also presented quite successfully. But the strategy addressed labor market weaknesses in only very general terms. On the one hand, it laid a great emphasis on the low level of human capital as a reason for the poor functioning of EU labor markets, but on the other hand, it failed to adequately discuss and address the institutional problems and tight regulations underlying labor market deficiencies, indicating only the high taxes deducted from salaries and making some suggestions concerning the role of a passive employment policy. Moreover the strategy produced only

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generalizations about the role of 'the European social model' and evaded the question of its responsibility for providing ineffective solutions to labor market issues and making labor inflexible. Finally the strategy entirely omitted the issue of the negative influence of the level of employment protection on the level of unemployment, including structural unemployment, in the EU member states.

The same pattern reappeared in the schedule for actions planned by the strategy. The actions concerning support for ICT diffusion and reinforcement of inventiveness were well planned, while the reform aiming at improving the business environment was less satisfactory. Deregulation of network industries and financial market integration were successfully designed. Unfortunately, the issues of reforming labor markets and social security systems were only mentioned in the strategy, but reform was not planned. Although they were included in the document, the actually formulated recommendations were very general and involved more consulting than reforming. Such a state of affairs was supported by political declarations cherishing the idea of a welfare state with an extensively developed social security system. These declarations precisely defined the limits of the reforms postulated in this field.

These weaknesses, together with too many priorities and soft methods of implementation, made the Lisbon strategy ineffective. Without deep reforms, including reforms of labor markets and social security systems, it will be impossible to raise labor utilization in the EU. But a socioeconomic doctrine, according to which the EU has its own 'social model', which is a part of its identity and should be preserved, clearly defines the limits of the reforms postulated in several critical fields. Therefore, the whole of the economic element the Lisbon strategy represents a daring plan of reforms, embracing as it does deregulation of product markets, redirection of public expenses towards investments in human capital, research and development, and the integration of financial markets. Nevertheless, when getting to more sensitive areas from the perspective of the 'European social model' – labor markets and social security systems – the strategy almost entirely omits the need for thorough and complex reform.

This view is confirmed by the empirical analysis of changes in product and labor market regulation conducted by Conway et al. (2005) who argue that from 1998 to 2003, product market regulations have declined in all EU member states. In all EU economies, product market regulation has moved towards the regulatory environment of the more liberalized countries. Nonetheless, changes in labor protection legislation were less visible if not entirely absent. In consequence, in 2003, all EU member states had less regulated product markets, but most of them were still characterized by over-regulated labor markets. Such a situation was in part a consequence of the incomplete package of Lisbon reforms, with well-planned reforms of product markets and almost no reforms of labor markets.

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What should Europe do?

There are only five years left if the Lisbon reform is to be completed in 2010. In this period the EU will not catch up with the US. But it can widen the scope of reforms planned, so as to address all its economic weaknesses. The most important problems are those of the diminishing labor force utilization which underlies the growing GDP gap between the EU and the US.

But in order to make the Lisbon–reform work, the EU has to deal with all the factors that deter Europeans from looking for jobs and deter European companies from creating them. These are inflexible labor markets and high labor protection, relatively high indirect wage costs, excessive income transfers and last but not least the relatively weak educational structure of the working-age population. Therefore, in our view, in its second phase the Lisbon strategy should aim at:

1. Deep reform of labor market regulations and promoting a concept of job security that is based on fostering the ability to create new jobs and not on the protection of current job contracts. Such regulations should improve the ability of companies to create new jobs as well as facilitating labor flows between workplaces and thus accelerating structural changes in the economy as well as technological progress.
2. Reduction of non-wage labor costs to expand job creation in the economy and reduce the negative impact of high marginal tax rates.
3. Reduction of income transfers. It will be difficult to achieve a positive change in labor markets because of the incentives not to work created by overdeveloped social security systems. Therefore, in addition to regulatory changes in labor markets, a deep reform and reduction of social security should be performed.
4. Investment in human capital. Employment rates of those with tertiary education in the EU are similar to US rates, and only the rates of employment of people with lower education are lower. Therefore changes in the working-age population's education structure could improve the situation in Union.

Not only labor market regulations influence economic growth and employment. Regulation of product markets is also important. Regulation of these markets has a negative impact on labor force utilization in the EU. Moreover these regulations often impose costly obligations on companies, making them less efficient. Therefore deregulation and promoting entrepreneurship should be implemented. The most important actions include:

1. Making the Single Market work in all EU member states and across all areas, including services and financial markets. The Single Market fostered the reduction of many barriers in European markets and

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promoted competition. Nevertheless, there are still many countries that have not implemented all the required legislation. Moreover some markets, especially services, are not part of the Single Market. It is especially important when taking into account that in 1995–2000 almost 90 percent of new jobs in the EU were created in services.

2. Reduction of barriers for companies and promotion of entrepreneurship. A large part of all regulations that worsen the business environment are enacted at the national level and do not depend on the *acquis communautaire*. A lot of these regulations diminish the economic potential of the EU. Therefore, actions aimed at cutting red tape for companies and improving the regulatory business environment should be intensified.

All institutional and regulatory changes should be mirrored by changes in public finance, especially in the structure and the level of public spending. Therefore the third key area of the Lisbon Strategy in 2005–10 should include deep changes in the level and the structure of public spending. Reduction of income transfers and public consumption will create room for further reductions of taxes and facilitate increased spending on investment in human and physical capital, including infrastructure and research and technological development. Such changes in public spending will complement the positive outcomes of regulatory changes described earlier.

These priorities do not cover all the changes and reforms that should be implemented in the EU member states. Each member state has its own specific situation and problems. Moreover, almost all the new EU member states, are much less developed than the EU-15 average. From this perspective catching up with the US is important, but internal economic convergence within the EU must also be considered as a key goal. Internal convergence is a goal of the EU Cohesion Policy with all funds supporting investments in physical and human capital. These investments seem to be more important, at the current stage of economic development of the new members, than other investments prioritized in the Lisbon Strategy. But, in fact, there are no real contradictions between the Lisbon priorities, especially those concerning regulatory reforms, and Cohesion Policy priorities. Indeed, regulatory reforms are of crucial importance for the effectiveness of the Cohesion Policy. Boldrin and Canova (2000), Ederveen and Gorter (2002) and Ederveen et al. (2002) argue that deregulation, competition and open markets are the precondition for faster growth through Cohesion Funds. Therefore Lisbon strategies aimed at such changes in new member states should go hand in hand with their national development planning, based on the EU funds.

In order to make the Lisbon Strategy a reality, the Union should improve economic policy coordination so as to monitor, evaluate and facilitate economic reforms in its member countries. But what is most important, and is also the weakest point of the strategy, is the fact that implementation of all the above reforms relies not only on good planning but is also a function

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of political will at the national level. Lack of such will today makes many reforms impossible.

Mid-term renewal?

The review of the strategy took place in during the European Council's Brussels summit on 22–23 March 2005 (European Council, 2005). While this was not a turning point in the EU's socioeconomic policy-making, it produced some positive effects. During the summit, support for growth and employment was defined as a crucial priority for the next five years of economic reform in the EU. While not questioning the three dimensions of the strategy the economic dimension was prioritized. The renewed strategy covered three areas entitled as follows: (1) 'Knowledge and Innovation – Engines of Sustainable Growth'; (2) 'An Attractive Area in Which to Invest and Work'; (3) 'Growth and Employment Making for Social Cohesion'. In each area, a set of actions was planned or at least declared.

In 'Knowledge and Innovation,' while repeating the priorities of the former strategy, including 3 percent GDP spending on research and development, the role of framework programs for research and a new initiative for supporting dissemination of ICT, the document has some new, potentially risky, features. The most important is the role of an active industrial policy as a way to reinforce the competitive advantages of the EU's industrial base. This can strengthen the tendency to subsidize selected industries in better-developed EU member countries. As a consequence choosing winners can replace a policy based on creating a winning environment. Another feature, probably not so risky, is an intention to establish a European Technology Institute, which seems to be just another EU supranational agency.

The next area, 'An Attractive Area in Which to Invest and Work,' focuses on the regulatory environment of product and service markets, especially those making the internal market complete. The most important aspect here is the willingness to make internal service markets fully operational. Unfortunately, there is a catch: internal service markets need to preserve the European social model. This means that the 'Bolkenstein Directive' will most probably be watered down as a part of the Lisbon strategy. Other actions described in this area are similar to the previous version of the strategy and concern a reduction of state aid, improving the regulatory environment, cutting red tape, especially for SMEs, and supporting transport infrastructure. All of these seem to be in line with the EU's economic needs.

The third priority area, devoted to 'Growth and Employment,' was little changed. It starts with a declaration that 'raising employment rates and extending work life, coupled with reform of social protection systems, provide the best way of maintaining the present level of social protection.' This means that there is no political will in the EU to implement deep reforms, especially with regard to social protection. These parts of the

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renewed strategy contain no new instruments, nor are there any real instruments to support labor market reforms.

These minor improvements cannot qualify as a relaunch of the Lisbon strategy. The corrections to the agenda by the European Council do not address either the crucial weaknesses of the former document or the EU economy's weak points. What is more, the sources of the new Lisbon weaknesses seem to be of political nature, linked to the socioeconomic doctrine dominant in the EU, which is now being imposed on all the member states of the enlarged European Union.

Despite these reservations, there are some positive features of the renewed Lisbon strategy. One of the most important is the fact that all EU member countries can write down their own Lisbon strategies – as national reform programs – taking into account their specific economic problems. Moreover, the European Commission seems to be more aware of the economic problems faced by the EU than most of political leaders at the national level. Therefore 'Integrated Guidelines for Growth and Employment' (European Commission, 2005) for the period 2005–08 presented by the Commission in April 2005 are much more realistic and consistent than the Presidency Conclusions agreed in March 2005 (European Council, 2005). Reforms presented in the guidelines are divided into three dimensions: macroeconomic, microeconomic and employment guidelines. Macroeconomic guidelines focus on growth – supporting reforms of public spending supported by structural reforms. Microeconomic guidelines include product market reforms and some actions based on facilitating ICT diffusion and investments in research and development. Employment guidelines focus not only on investments in human capital and active labor policy, but also on promoting flexibility of labor markets and reform of social security so as to support job creation. These three areas are to provide a framework for the establishment of national reform programs to be prepared by autumn 2005.

All this demonstrates that the EU as a whole is not politically ready to implement deep reforms especially in sensitive areas. Nevertheless the European Commission, while trying to make compromises between those for and against deeper economic reforms in the EU, supports the former.

Conclusions

Despite its many weaknesses, the Lisbon Strategy is at present the only EU-wide economic program supporting changes that can make the EU economy more competitive. It seems obvious that the strategy will not make the EU more competitive than the US by 2010, as was hoped in 2000, nor make the EU catch up with the US by this date. Nevertheless the Lisbon Strategy of 2005 is more realistic than the strategy of 2000. Regrettably, due to political reasons, there are still many omissions, especially in sensitive areas, such as labor and social protection.

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Implementation of the strategy at national level, via the national reform programs, means that a crucial battle for more effective European economies will take place at the level at which most of the EU economic weaknesses have their source. Fortunately, the renewed Lisbon strategy, while giving inadequate support to reforms at the EU level, provides national governments with enough room to maneuver so as to prepare more efficient national reform packages.

The Lisbon strategy is not an economic program to be implemented, it is rather a temporary compromise between those for and against deep reforms. It however supports reforms above the status quo. The Lisbon strategy is a catalyst for reform in the EU and gives support to the EU's reformers. It is, however, still weak.

Notes

1. Per head at the price levels and PPPs of 1995 (USD).
2. Unweighted average for the Netherlands, Germany, Denmark, France, Belgium, Italy, Sweden Ireland, Great Britain and Spain.
3. As reconstructed thanks to OECD databases for the EU-15 member countries.

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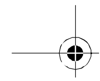

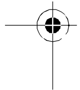
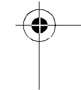

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