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CAN THE RELAUNCH OF THE LISBON AGENDA SOLVE THE PUZZLE OF WHY DEEPER INTEGRATION DID NOT LEAD TO MORE GROWTH IN EUROPE?

Can the Relaunch of the Lisbon Agenda Solve the Puzzle of why Deeper Integration did not Lead to More Growth in Europe?[1]

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After a disastrous performance of the Lisbon Agenda so far, European Commission José Manuel Barroso announced a relaunch in spring 2005, streamlining the numerous goals to "Jobs, growth, the environment and a proper social network". With the slogan "Growth and jobs" he hopes to reconnect with the original Lisbon expectations in the second half of the decade. Although such ten-years plans are reminiscent of Krushchev 1960s' plans to overtake the United States in the production of steel, the ideas behind this strategy are theoretically sound. It is enough if we re-iterate the catch words of the Presidency Conclusions of the Lisbon European Council of 23 and 24 March 2000: information society for all; European area of research and innovation; helping SMEs; genuinely completing the internal market (including for financial markets and services); coordinated macro-economic policies (sustainable fiscal policies); education and training; active employment policy; new open method of coordination.

In principle we know – at least from economic theory - exactly how to create jobs and growth. Why then does this not happen in Europe in practice – at least in the last decade? It is an irony in the history of European integration that it is precisely since the EU began its most ambitious projects - from the Internal Market in 1993 to Economic and Monetary Union (EMU) in 1999 - that the EU has fallen furthest behind the United States, at least in terms of the primary macroeconomic goals of growth and jobs. The response to the not- very-successful start to the Internal Market program in 1993 was the Lisbon Agenda of March 2000. With its strategy one wanted to speed up the growth engine in Europe – but it has still not materialized!

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[1] A slightly revised version of an article, published in: *Deepening the Lisbon Agenda*: Studies on Productivity, Services and Technologies, Austrian Federal Ministry of Economics and Labour, Vienna,, 2006, pp. 161-166.

The diagnostic findings of the Lisbon Agenda, however, did not answer the essential question: Why does deeper integration in Europe – in sharp contrast to integration theory and all the ex-ante model estimations on the possible impact of the Internal Market program (just to mention the numerous studies of the so-called "Cecchini Report" of 1988) - *not* lead to more welfare, as measured by GDP growth and more job opportunities? Whereas in the United States – where there was no change in the overall economic and political framework in the last fifteen years - Europe has changed and integrated its landscape dramatically. On the one hand this has been done by implementing the Internal Market und the Euro, and on the other through an ongoing process of enlargement: in 1995 by three new countries to EU-15; and in 2004 by ten further new member states to EU-25. The process of enlargement continues, with Bulgaria and Romania to become EU members in 2007, followed by some Balkan states (Croatia and Macedonia) and later on maybe by Turkey. Nevertheless, the United States experienced an unprecedented boom, starting in the early nineties of the last century, whereas the EU's economy on average only grew very modestly in the same period. Only one partial – and expected - outcome of the whole integration process has been delivered: the internal market and particularly EMU have stimulated intra-EU trade. However, this positive consequence of integration did not (sufficiently) spill-over to other welfare measures, such as GDP per capita or labour market performance.

Will the most recent EU enlargement help to speed up growth in the EU? For the new member states in Eastern Europe, enlargement will help to stimulate annual growth by around one percentage point. The impact in the old member states varies depending on the level of current trade with the new member states. On average, EU-25's real GDP will grow faster than those of EU-15 by merely one tenth of a percentage point per year. The primary winners in the enlargement game are Austria and Germany with an expected boost of a 1/4 percentage point in additional GDP growth per year. Austria in particular has already enjoyed much of the enlargement boost since the opening-up of Eastern Europe in 1989. This may explain the lead in GDP growth over many other old EU member states, such as Germany. On the one hand the Eastern enlargement of the EU may lead to slightly more GDP growth in the EU on average, on the other hand it has caused a statistical decline in GDP per capita in the EU as a whole by around 10 percentage points.

The same is true for labour productivity. The level of EU's average labour productivity declined after enlargement, its annual growth will increase.

Many analysts erroneously compare the United States economic performance with that of the EU on average. Such comparisons neglect the fact that the United States is a homogenous economy and a federal nation state whereas the EU is far from being a nation. Even if the "Treaty establishing a Constitution for Europe" had been come into force as planned in November 2006 (which did not happen following the negative referendum results in France and the Netherlands), the European Union (the "Union") would not have been transformed to a federal nation or state. The German Constitutional Court (Bundesverfassungsgericht) ruled that the EU is a federation of states (Staatenverbund) and not a state. The EU is still a Europe "United in diversity", and de facto the EU is divided in many areas of economic and political integration. There are several expressions to describe the present integration status of the EU: "differentiated integration", "Kernel Europe", "Europe à la carte", "Enhanced cooperation" etc. Prominent examples of incomplete integration are EMU (only a minority of 12 out of 25 EU member states belongs to the Euro zone; with Slovenia joining in 2007 the number increases to 13) and Schengen. The Schengen agreement means there are no longer any frontier controls at borders, but only between more than half of the EU countries (Ireland, the United Kingdom and the new 10 member states do not (yet) participate in Schengen). The EU also has a huge number of transitional arrangements in many areas of the acquis communautaire of the Internal Market. A key example is the seven year transitional period before full free movement of people, agreed as part of the most recent enlargement (the only exceptions make Ireland, Sweden and the United Kingdom; after the recent assessment by the European Commission also other member states – Finland, Greece, Portugal and Spain and for some sectors also Belgium and the Netherlands - will open up their labour markets). In addition, the highly praised Internal Market is far from being completed.

The fact that the Internal Market and the EMU are not yet completed (in addition to the examples of financial markets and services, one could also add the less flexible labour market in Europe) may be the biggest difference from the United States and could be an explanation of why Europe lags behind in economic growth, employment and technology – though not so far in "international competitiveness". In view of the huge and increasing deficits in the trade and current accounts the United States can hardly claim to be competitive. Europe on average and Germany in particular is "export world champion". This indicates that, as far as international competitiveness is concerned, the EU and its member states are far ahead of the USA. When looking at the EU, however, one must keep in mind that its average consists of countries with very good performance and countries with bad performance. Behind the meagre average annual GDP growth of EU-25 in the period 2000-2006 of 2.1% (EU-15 2%; USA 2,8%), we can identify 12 countries with growth rates well above the famous Lisbon target of average GDP growth of 3% (9 of the new 10 member states, Greece, Ireland and Luxembourg); six countries have a growth rate higher than or equal to that of the average of EU-15 (Belgium, Finland, France, Spain, Sweden and the United Kingdom). Only 7 EU member states perform worse than the average GDP growth of EU-15 (Austria, Denmark, Germany, Italy, Malta, Netherlands and Portugal). The problem with the latter group is that Germany has the worst growth performance - only 1.3% annual GDP growth in the period 2000-2006. Germany, the third largest industrial nation in the world and by far the most potent economy in the EU, alone comprises a fifth of the economic weight in EU-25. An ongoing mediocre economic performance of Germany threatens negative spill-over effects for its neighbouring countries.

As well as GDP growth rates within the EU, unemployment rates also vary greatly between Member States. Interestingly, even the faster growing member states in Eastern Europe exhibit higher unemployment rates (e.g. Poland more than 18%) than low growth countries such as Germany (around 9%). The fact that the new member states, which are partially still in a transformation process, exhibit higher unemployment rates also affects the average EU rates. In the EU-25, the average unemployment rate amounts to 9%, one percentage point higher than in the slower growing "old" EU-15.

Which situation then are we confronted with in Europe? A constellation of "jobless growth" or cases of "growthless jobs"? In their 2005 Joseph Schumpeter lecture *"Appropriate Growth Policy: A Unifying Framework"*, delivered to the 20th Annual Congress of the European Economic Association in Amsterdam, August 25, 2005, Philippe Aghion and Peter Howitt tried to explain theoretically the puzzle why European labour productivity growth was much higher than US growth during the sixties and seventies (3.5% versus 1.4% on average during the 1970s), given that R&D investments were higher in the US (2.5% of GDP) than in Europe (2%) throughout this period, and why since the early 1990s GDP growth was persistently slower in the EU (less than 2% a year against 3% in the US between 1995 and 2000). They argue that Schumpeterian theory, in which growth results from quality-improving innovations, may provide a good explanation and could also lead to a reasonable theory for policies aiming at growth. With the Aghion-Howitt approach à la Schumpeter, one can explain how a country's growth performance (in our case the EU average) will vary with its proximity to the technological frontier (For example the USA in the 1990's). One can also assess the extent to which the country will tend to converge to that frontier, and what kinds of policy changes are needed to sustain convergence as the country approaches that frontier. After World War II the European economy caught up technologically to the US, surpassing the growth performance of the US. However its growth began to slow before the gap with the US had been closed, because its policies and institutions were not designed to optimize growth when close to the frontier. All things being equal, this would have resulted in the growth rate dropping to that of the US but no further. What happened then, however, was that the IT revolution resulted in a revival of the US frontier growth rate in the late 1980s and early 1990s. Starting with the Internal Market program, followed by the EMU, meant Europe was not as well placed as the US to benefit from this technological revolution. As a result a growth gap between Europe and the US opened up. The Aghion-Howitt model implies different policies for frontier countries (at present the US; "the innovators") than for the lagging-behind countries (Europe as a whole, "the imitators"):

(i) *Education policy:* As a country moves closer to the technological frontier (like Europe as a whole), tertiary (higher) education (especially graduate and university) education should become increasingly important for growth compared to primary/secondary education. Presently, Europe spends less on higher education than the US;

(ii) Competition policy: So far competition policy in the EU has emphasized competition among incumbent firms, but paid insufficient attention to entry. Aghion-Howitt's model shows entry and entry threat as enhancing productivity growth and innovation in sectors or countries that are close to the technological frontier; entry and entry threat, however, discourage innovation and productivity growth among incumbents in sectors or countries that are far below the frontier.

(iii) Macropolicy: What are the consequences of the interplay between countercyclical budgetary policies and structural reforms such as product or labour market liberalization? It can be demonstrated that the two are complementary: a higher degree of product or labour market liberalization increases the positive growth impact of countercyclical budgetary policy.

In taking stock there are some explanations why Europe – despite putting considerable effort into accelerating the economic integration process - fell behind the US in the growth performance. However, many questions remain unanswered. Comparing the starting positions in the early 1990s, one can state the following transatlantic differences:

(i) The United States is a nation state with a well functioning, long established single market with highly flexible labour, product and housing markets; the whole US single market operates with a single currency (the Dollar) and has the advantage of a single language. In addition, the macro-political architecture is symmetrical, with a centralized monetary and fiscal policy which acts very countercyclically.

(ii) The European Union is still no nation state and only began the Internal Market in 1993; the Internal Market is far away from being completed (financial markets; services markets); labour markets are still very rigid; only a minority of the EU member states operates with the Euro; EMU’s political architecture is asymmetric, implying a centralized monetary policy and a decentralized (and badly coordinated) fiscal policy; as the unpleasant experience with the Stability and Growth Pact showed, it mainly acts procyclically; and last but not least the EU does not possess a common language!