

3 Longer-term competitiveness of the Wider Europe

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1 Introduction

This chapter covers a wide range of issues at the cost of a relatively discursive style: We first review some findings concerning growth and productivity developments US–EU over the most recent decades (sections 2 and 3); we shall qualify these findings by taking a broader view of the notion of ‘competitiveness’ (section 4) and point to the heterogeneity of performance within Europe, particularly with regard to the relative success stories of the Northern economies (Denmark, Finland, Sweden) which are often cited as a ‘model’ option for the rest of Europe (section 5). We then turn our attention to the recent process of EU Enlargement and discuss its impact upon the EU’s growth perspectives (section 6) and then to the Wider European region and its neighbourhood (section 7). We make some comparisons of the position of the Wider Europe in the global economy in relation to other regionalist entities (US and East Asia) in section 8. We end with some remarks concerning the outlook for Europe’s competitiveness (section 9) and a discussion of some implications of the analysis for US–European transatlantic relationships and Europe’s global role (section 10).

2 Evolution of US–Europe competitiveness 1970–2005

In this section we shall review the principal features of US–European competitiveness.

1 Europe¹ was on a catching-up path as regards real income developments relative to the United States in the post-war period until the early 1980s (see Figure 3.1). After that, the catching-up process in GDP per capita came to a halt and Europe first held its relative position vis-à-vis the US and, from 1995 onwards, lost ground. Productivity catching-up continued at rates which differed depending upon which measure of productivity is used (total factor productivity, GDP per employee or GDP per hour worked) until 1995, after which Western Europe fell behind. The measured ‘gap’ in productivity levels and real income vis-à-vis the US is smallest when measured as GDP per hour worked and largest when the standard real income measure is used (GDP per capita).

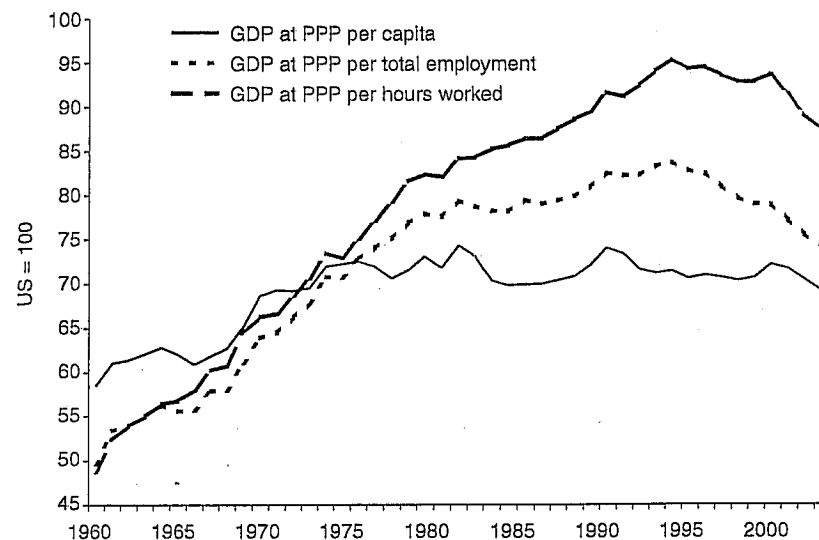


Figure 3.1a European catching-up in GDP per capita, productivity per worker and per hour, 1960–2004 (US=100).

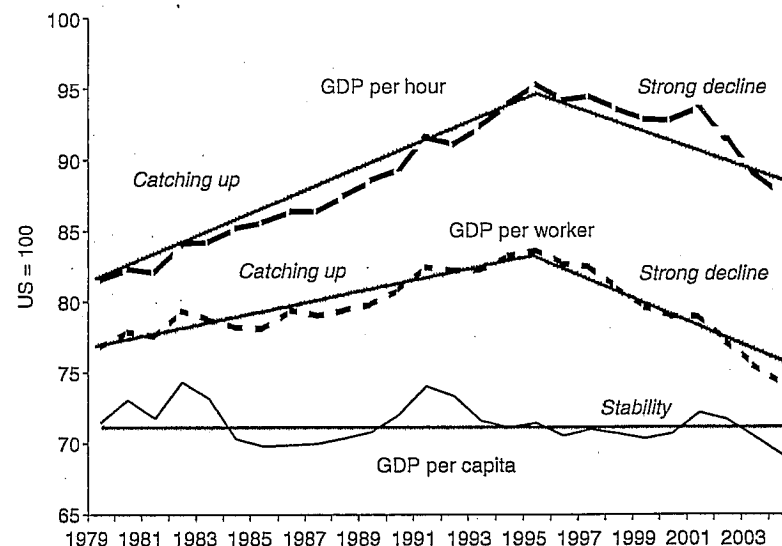


Figure 3.1b Productivity developments, US and EU, 1979–2004 (US=100) (source: Own calculations using data from the Groningen Growth and Development Centre and The Conference Board, Total Economy Database, January 2005, www/ggdc.net).

- 2 Using the terminology of growth theory, we can speak of 'conditional convergence' between the US and Europe, in that productivity and real income catching-up has taken place but come to a halt before the gap has been fully closed. Growth analysts in this case search for 'conditioning factors', i.e. structural and institutional factors which can account for the inability of economies to fully close the gap vis-à-vis more advanced economies. A 'falling behind', as witnessed after 1995, would require further explanation.
- 3 The main factor accounting for the discrepancy between the productivity gap (amounting currently to about 10 per cent, if measured by GDP per hour worked) and the real income gap (amounting to about 30 per cent) lies in the lower levels of utilization of the labour force in Europe as compared to the US.² Three factors in turn account for this: (i) generally lower participation rates (this refers to the share of the population of working age who are looking for jobs; this is especially true for females in general and then, across genders, amongst the older (55–64) age group and the youngest (15–24) age group); (ii) lower employment rates (the share of people who find jobs out of those who are counted as part of the labour force³) or, inversely, higher unemployment rates; and (iii) lower numbers of hours worked per person employed (shorter working week, more part-time jobs, more holiday entitlements).
- 4 As regards the measurement of productivity, there are problems in comparing productivity levels between the US and Europe: specifically problematic are different methods used to account for quality improvements; the major problem of measurement of productivity in the services sector; difficulties of measuring the significance of the 'informal sector' and of 'outsourced homework' (for the latter, see Freeman and Schettkat, 2005). Recent studies emphasize particularly the difference in productivity levels which have opened up over the period 1995–2003 in the ICT-using services industries (retail and wholesale trade, finance/insurance) (see McGuckin and van Ark, 2005; O'Mahony and van Ark, 2003; Gordon, 2004).

Thus, never having fully caught up with the US in levels, GDP, real income and productivity growth all moved onto a lower growth path in Europe compared to the US from the mid-1990s onward. This is a cause for soul-searching in Europe as regards the factors responsible and policy options available to counter this.

3 Factors accounting for lower growth in Europe

The period since 1995 (when the strong take-off in growth took place in the US and the growth performance in Europe lagged behind) is still too short to allow us to dissect in a convincing manner the reasons for Europe's relatively disappointing growth performance. However, we shall try to summarize some of the research findings on this:

Differences in the conduct of monetary and fiscal policy

There is general acknowledgement that the conduct of monetary and fiscal policy has been quite different over the period 1995–2005. Europe was pre-occupied in the latter half of the 1990s with preparing the ground for European Monetary Integration; in this context, the Maastricht criteria imposed relatively strict conditions on those economies which were still far from the fiscal and monetary targets set by these criteria. Overall one can say that the restrictive macroeconomic policy scenario in Europe differed from the accommodating conduct of monetary policy by the Fed in the US (Greenspan was guided by the idea that the 'potential growth path' of the US economy had shifted; and so far he has been proven right). After the collapse of the stock-market boom and the aftermath of September 11, both monetary and fiscal policy were again more responsive and expansionary in the US than in Europe, leading to a deterioration in fiscal and external balances in the US while Europe continued on its relatively low growth path, which by itself generated a crisis in the fulfillment of the fiscal targets implied by the Growth and Stability Pact (GSP). More recently, the turnaround of the US in interest rate policy was again more dramatic than in the Euro-zone.

Strengths and weaknesses in the US and European 'innovation systems'

Innovation indicators (patents, citations, Nobel prizes) reveal a strong and sustained gap between the US and Europe. Studies have pointed out the much higher proportion of private business R&D spending in the US compared to Europe (while public spending ratios in GDP are similar); the much better developed interface of university–business links; the existence of the world's best research universities (which are much more open to international talent than European universities and research institutes) and – similarly – the world's best business schools; the better developed venture capital markets providing the backbone to the setting-up and continued growth of research-intensive SMEs. Europe has made some small steps in closing these gaps and, so far, too little to fulfil the ambitious goals of the Lisbon Agenda. The relative weakness of these features of the European innovation system show up in a lag in the introduction and diffusion of the most recent crops of new innovations, particularly information technology in the 1990s and bio-technology currently (see also Figure 3.2 and Appendix Table 3A.1 on 'growth drivers'). Estimates of the productivity growth gap in the 1990s attributes about a 0.5 per cent annual difference in productivity growth between the US and the EU to slower introduction and diffusion of information technology (see e.g. O'Mahony and van Ark, 2003; Denis *et al.*, 2004).

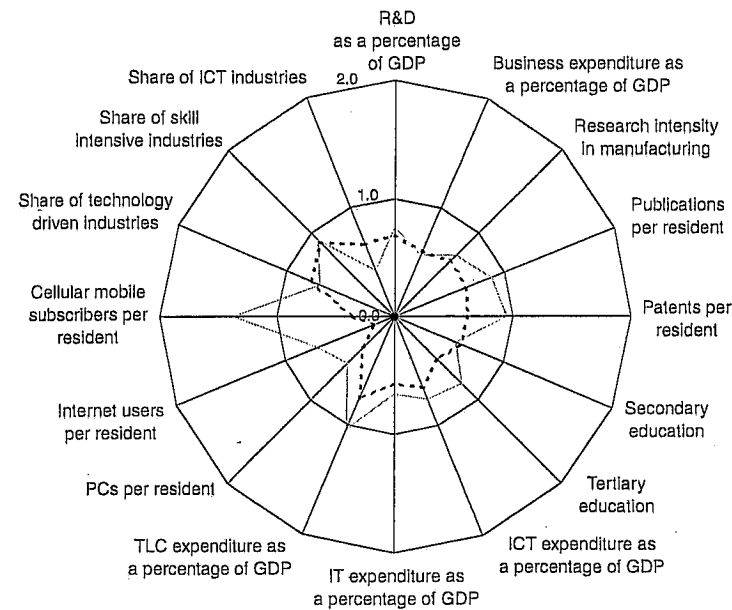


Figure 3.2 Growth drivers: Europe vs. USA (source: Aiginger and Landesmann (2002); see Appendix Table 3A.1 for more detailed descriptions of individual headings).

Note

Each indicator outside the unit circle shows a superior performance of Europe vs. the USA; black (interrupted) line: early 1990s; light (continuous) line: late 1990s.

Ageing problem and differences in migration policy

Europe has a more serious ageing problem. Between 1960 and 2000, the average dependency ratio (defined as the number of persons aged above 60 years per 100 persons aged 15–59 years) for the EU-15 rose from 26 to 35. Meanwhile the dependency ratio for the US remained almost constant at around 25. In the EU-15, by the mid-1970s the fertility rate had already dropped below 2.1 per woman, the natural replacement rate, and declined steadily thereafter, while it remained at that level in the US at the beginning of the twenty-first century. Forecasts of the dependency ratio in the EU-15 are 47 in 2020 and 70 in 2050. The European Commission estimates that the pure demographic effect of ageing would be an increase in public expenditure (related to pensions and health care) of eight points of GDP between 2000 and 2050 (see Sapir *et al.*, 2004: 118). The implication of an ageing population for skill acquisition, skill development, organizational flexibility, openness to innovation and entrepreneurship, labour mobility, etc. have not been systematically explored but should not be ignored. The same can be said for differences in migration flows and the differences

between the US and Europe in the ease of integration of new migrants into the host population's culture and labour market opportunities; we shall return to this below.

The negative spiral of ageing, declining productivity, increasing social security costs, and implications for employment

Support for the European welfare system was generous in the period of relatively high productivity growth and relatively healthy demographic structures after the Second World War. With the decline of productivity growth and the ageing process, together with rising labour market problems which manifested themselves in low employment rates and sustained unemployment, the burden for maintaining social services expressed itself in high and rising social insurance contributions in the wage bill. This in turn increased labour costs, which provided incentives to save labour in production – particularly in highly labour-intensive activities (see the sharply rising capital/labour ratios in Europe in comparison with the US over the 1980s and 1990s; Appendix Figure 3A.1). This contributed to the employment problem, particularly affecting the low-wage (and low skill) segment where the sensitivity to labour costs is particularly high. This further reduces employment rates (waves of early retirements and problems with low-qualified youths) and increases in turn the burden on those in jobs to provide the funds to maintain welfare services.

The unfulfilled integration pay-offs of the Single Market

The Single Market Program in 1992, which was designed to remove barriers across all markets within the European Union, went along with high expectations as regards both static and dynamic efficiency gains (see Emerson *et al.*, 1988). Ex post research indicates that the liberalization, particularly in services, utilities and banking, proceeded much more slowly than envisaged. The gains from market integration were consequently lower. As economic growth is affected by other factors (such as the framework for short-run macroeconomic policies) it is nearly impossible to isolate the specific effects of market integration; however, some evidence suggests that higher degree of market regulation and barriers to entry and exit affect Europe's relative growth performance (see, for example, the evidence presented in Nicoletti and Scarpetta, 2003).⁴

The European 'success stories'

It should not be overlooked that Europe can also claim a number of success stories in which innovation systems were very successful and welfare systems were revamped (see, for example, Aiginger, 2004b). Some of the Scandinavian countries (Sweden, Finland, Denmark) developed a highly trained work-force, increased their R&D spending ratios above the US levels and successfully emphasized active labour market policies so that unemployment rates could be

kept low (or fell strongly after the impact of shocks). R&D intensive industries in these countries dominate industrial production and exports. They are in the very top league as regards the production and diffusion of IT technologies and their fiscal situation is very satisfactory (see Figure 3.4 below as well as Figure 3A.2 on growth drivers vis-à-vis the US). Another example is Ireland, which had a successful growth phase in the 1990s based on a sustained effort to improve the quality of its labour force. It consolidated macroeconomically and undertook successful industrial policies which attracted a large amount of FDI which, in turn, contributed strongly to upgrading its industrial structure. Having been in the group of least developed economies in the EU until the 1980s, Ireland now belongs to the richest group of countries and shows clear signs of labour shortages.

4 Beyond growth dynamics

The competitiveness of nations is intensively discussed (see Aiginger and Landesmann, 2002). An assessment of competitiveness has to include market results as well as the conditions of the social, fiscal and environmental conditions under which the results are achieved. This section therefore compares the performance of Europe and the US, including broad indicators on economic welfare.

Growth of output and productivity

As discussed in section 2, economic growth as measured by real GDP grew faster in Europe until the early 1970s. The catching-up process then stagnated and, particularly since 1990, the US has been outperforming Europe: it was less affected by the crisis of 1993, achieved higher growth during the second half of the decade and was more resistant to the downturn of 2001/03. For the period 1990–2004, this difference in GDP growth amounted to 1.14 per cent per annum and 22 per cent cumulatively. The difference in productivity per hour worked was 18 per cent (lower in Europe than in the US) in 1980; this difference declined to 5 per cent in 1995. The difference has then widened to about 13 percentage points in 2004 (see Table 3.1b). The relative improvement on the employment side in Europe since 1995 – one of the factors accounting for lower relative labour productivity performance – has been heralded as good news reflecting labour market and pension reforms (Tables 3.1a and 3.2).⁵

Other components of welfare

Broader comparisons of welfare include: (1) employment and unemployment; (2) distribution of incomes; (3) comprehensiveness of the coverage of social and health risks; and (4) preservation of environment and prudent use of resources. These considerations imply that a more broadly defined economic concept of

Table 3.1a Europe's growth performance relative to the US

	Growth of real GDP		Productivity growth per worker		Employment growth	
	EU	USA	EU	USA	EU	USA
1961–70	4.80	4.22	4.51	2.14	0.28	2.04
1971–80	2.97	3.25	2.59	1.11	0.37	2.11
1981–90	2.41	3.17	1.71	1.32	0.69	1.83
1991–95	1.52	2.48	1.94	1.41	-0.41	1.05
1996–2000	2.70	4.14	1.28	2.10	1.41	1.99
2001–05	1.57	2.75	0.93	2.38	0.63	0.36
1996–2005	2.13	3.44	1.10	2.24	1.02	1.17
1961–2000	4.11	4.67	3.48	2.11	0.61	2.51

welfare embraces employment, income distribution, the comprehensiveness of the social net and ecological conservation.

Concepts of welfare could also be extended to life expectancy, security, cultural goals, the rule of law, and other aspects of human development (see Figure 3.3). The broader the set of goals to be evaluated, the more difficult it is to measure these goals, and the more difficult it is to determine the relative weights of the individual objectives and make a general assessment.

We have already discussed differences with respect to employment and unemployment. The employment rate is currently about 13 percentage points higher in the US, namely 76 per cent versus 67 per cent (see Table 3.3). Until the mid-1970s, the share of employment for the working-age population was higher in Europe than in the US (the employment rate was 70 per cent in Europe, as compared to 66 per cent in the US in 1960). Why the curves crossed is beyond the scope of this chapter (see the discussion by Gordon, 2006, in this volume). One relationship to be explored is the causality between population growth, GDP growth and employment rate in rich economies, especially when population growth is fed through migration flows (on this see e.g. Borjas, 2001). Second, at the lower end of the wage spectrum, US labour became comparatively cheap, increasing the labour intensity of US growth. The US created 78 million new jobs between 1960 and 2000, Europe 42 million. Employment creation in recent years has accelerated in Europe: between 1996 and 2004, the EU-15 created 15.4 million jobs (the US 14 million). Even during three years of slow growth (2001–03) employment has, in contrast to experiences during other periods of sluggish growth, been increasing (while it fell in the US), although many jobs are part-time. Unemployment in 2005 was 5.1 per cent in the US and 8 per cent in Europe (2004).

The social net is more generous in Europe. Net public spending on welfare is about 16 per cent in the US and 24 per cent in Europe. Most Europeans have government funded or commanded health insurance, pensions are higher, retirement can be started earlier and the contribution provided through public schemes is higher. Unemployment payments are higher in relation to income

Table 3.1b Differences in income per capita, per worker and per hour, EU-15/US

	GDP per capita			GDP per worker			GDP per hour		
	EU-15	USA	EU-15/US	EU-15	USA	EU-15/US	EU-15	USA	EU-15/US
	1,000 euro			1,000 euro			euro		
1980	16.30	22.31	0.73	39.84	51.16	0.78	23.00	27.93	0.82
1990	20.08	27.88	0.72	47.43	58.66	0.81	28.82	32.25	0.89
1995	21.30	29.81	0.71	52.52	62.79	0.84	32.53	34.13	0.95
2000	23.93	33.85	0.71	55.81	70.69	0.79	34.90	37.63	0.93
2002	24.43	34.08	0.72	56.26	72.94	0.77	35.52	38.83	0.91
2004	24.92	36.02	0.69	57.12	77.08	0.74	36.24	41.44	0.87

Source: Own calculations using data from the Groningen Growth and Development Centre and The Conference Board. Total Economy Database, January 2005. www.ggdcc.net.

Table 3.2 Employment and unemployment

	Employment rate			Working hours per year and per person			Unemployment rate		
	EU	USA	USA/EU	EU	USA	USA/EU	EU	USA	USA/EU
1980	64.34	71.01	1.10	1,769	1,853	1.05	5.6	7.1	1.26
1985	60.81	72.63	1.19	1,700	1,853	1.09	9.6	7.2	0.75
1990	64.34	77.83	1.21	1,676	1,840	1.10	7.5	5.5	0.73
1995	62.10	77.26	1.24	1,644	1,859	1.13	10.0	5.6	0.56
2000	65.81	79.65	1.21	1,598	1,878	1.18	7.6	4.0	0.53
2005	66.74	76.06	1.14	1,577	1,817	1.15	8.0	5.2	0.65

Source: Own calculations using Eurostat (AMIECO).

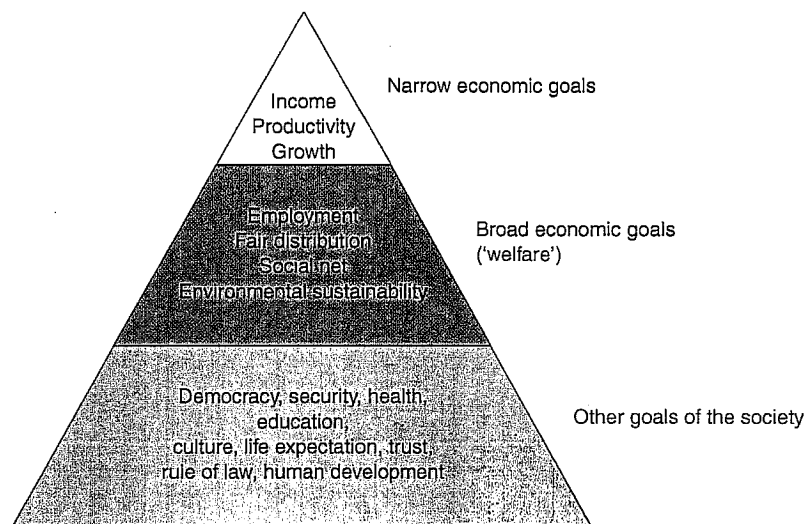


Figure 3.3 Hierarchy of economic and social goals.

(replacement rate), they are paid for a longer period of time, and fall back payments (social assistance) are relatively high and essentially unlimited in time.

Income is distributed less evenly in the US. The top 20 per cent earns 45 per cent of total income, while the bottom 20 per cent earns 4.8 per cent, which results in an inequality ratio of 9.4. In Europe, the corresponding numbers are 38.5 per cent for the top 20 per cent and 8.3 per cent for the bottom 20 per cent, resulting in a ratio of 4.7. The lowest ratio in Europe is 3.2 for Austria, followed by the Scandinavian countries and Belgium; Portugal is the only country where inequality nears US levels. The uneven distribution of income is increasing in many countries, but it is greatest in the US. Contrary to common expectation, the poverty rate is not rising in the US in the long run: it dropped from 22 per cent in 1960 to a historic low of 11.1 per cent in 1973. It later increased to 15.2 per cent in 1983, following the shift in economic policy by the Reagan Administration and the increase in unemployment. It declined in the 1990s to 11.3 per cent and has been increasing slightly since the most recent recession. The reason for the relatively low level of poverty despite increasing income inequality is the relatively high employment rate (amongst men and women).

Other indicators underline the greater downside risk of American society. The number of homeless, illiteracy rates, the share of population in prison, homicides, the relative prevalence of drugs and guns, racial discrimination, and the discrepancies between living standards in slums and suburbs illustrate the point. On the other hand, data on mobility reveal that expected upward mobility is greater, although the difference between the US and Europe in actual mobility is less than commonly believed (Alesina *et al.*, 2001). Immigration flows are

Table 3.3 Broad indicators of economic welfare

	EU-15	USA	Top 3 ⁷ European countries	Big 3 ⁷ European countries
Employment rate 2004	66.5	75.9	72.9	64.8
Employment generation in millions 1996/2004	15.4	14.0	0.6	5.6
Unemployment rate 2005	8.0	5.1	7.1	9.0
Net social expenditures (public and private) ¹	24.9	23.4	26.4	21.2
Net social expenditures (public) ¹	24.0	16.4	24.3	18.7
Income distribution ²				
Share of top 20%	38.5	45.2	34.9	38.7
Share of low 20%	8.3	4.8	9.7	7.9
Relation of top 20%/low 20%	4.7	9.4	3.6	4.9
Energy consumption in Mtoe/GDP ³	0.15	0.26	0.16	0.14
Carbon dioxide in t/GDP ³	0.31	0.57	0.27	0.29
Self assessment of happiness ⁴	7.05 ⁵	7.60	7.87	6.87
Self assessment of life satisfaction ⁴	6.81 ⁵	7.46	7.75	6.68
Health adjusted life expectancy (at birth) ⁶	70.14	67.60	70.67	70.83
Persons sentenced to prison per 100,000	65	469		

Notes

1 Adema (2001) OECD, Society at a Glance, 2003.

2 IMD, Competitive Yearbook, 1999.

3 Total Primary Energy Supply, OECD, International Energy Agency.

4 Veenhoven (1997).

5 Four largest EU countries only (Germany, France, Italy, United Kingdom).

6 OECD, Society at a Glance, 2003.

7 See section 5, Table 3.4.

larger in the US than in the EU. There is also evidence of a difference in the skill mix of migrants between the US and Europe, particularly in the relative attractiveness of the US research institutions and labour markets to highly talented and skilled migrants (on this, see chapters by Peri and Münz in this volume).

Europe is definitely leading the US in ecological performance. Energy consumption per GDP is 73 per cent higher in the US than in Europe (US 0.26 Mtoe/GDP, Europe 0.15 Mtoe/GDP); carbon dioxide is 84 per cent higher relative to GDP. With respect to the dynamics of emissions, Europe is at least trying to fulfil the Kyoto targets of reducing greenhouse gases, while the US is not.

Europeans have more leisure time; this is the other side of the employment picture: as mentioned earlier the share of population in work is smaller by 13 percentage points, and there are 16 per cent fewer working hours per year (more vacations, fewer weekly hours). It is difficult to assess the extent to which these differences are voluntary and to what extent they are by-products of the economic environment – such as the lack of full-time jobs or jobs for workers of particularly vulnerable age groups, those who have problems entering the job market in the first place, and those who have lost their jobs and have little chance of regaining employment. Gordon (2002: 10) ventures the ‘wild guess that about one third of the difference represents voluntary chosen leisure and the remaining two thirds represent a lack of employment opportunities’.

How can these factors be weighted? One way of attaining an overall assessment by means of socio-economic research is to formulate two internationally comparable questions, namely whether a person is happy and whether (s)he is satisfied with her/his life. Results indicate that people are influenced by income, but the rankings ascribed to income and self assessments of life satisfaction are not redundant. For both subjective indicators, Americans rank higher in terms of satisfaction, namely 7.6 for ‘happiness’ on a scale of ten versus 7.1 for the four largest European countries (Germany, France, the United Kingdom, Italy). For ‘life satisfaction’, the US rating is 7.5, while the corresponding value for the four largest European countries is 6.8. Interestingly, intra-country differences within the US are smaller than in France and the United Kingdom (see Veenhoven, 1997, and Deutsche Bank Research, 2006).

5 Performance differences across European countries and their relation to the welfare system and welfare reforms

Differences across European countries in dynamics have become larger in the 1990s. We will use this cross-country difference to qualify the standard judgements made regarding the determinants of growth differentials between the US and Europe. Specifically, if the high welfare costs were at the heart of the European problem of low dynamics, the countries with comprehensive welfare and high taxes should be the worst performing countries.

Sweden, Finland and Denmark are the three countries outperforming the European average, if we combine growth of output, productivity and employment to measure ‘overall economic performance’. These three countries are

welfare states of the Nordic type; they are characterized by high re-distributive policies and a high degree of government involvement. We follow Aiginger (2004b) using indicators on growth of output, productivity and employment, but the same conclusions are reached by assessments of the competitiveness of European countries by IMD, the World Economic Forum and in studies on country growth differences by the OECD.⁶

These successful countries can be seen as following a ‘three tiers’ strategy (see Aiginger, 2004b). First, they contained private and public costs in order to regain profitability and fiscal balance. Second, they fine-tuned their welfare systems and liberalized part-time work as well as product markets in order to improve incentives. Third, investment in growth was increased significantly, surpassing that of the large European economies in research input and output, in education expenditures and quality, and in information technology. In contrast, the large continental economies (Germany, France and Italy) under-performed in terms of investments in such growth drivers.

The structures and policies of the most successful European countries are very different from the US as far as welfare and government involvement are concerned, as well as in their commitment to training and redistribution as goals of labour market policy. Their labour market policy offers a rather high degree of flexibility for firms (easy dismissals, low corporate taxes), but also provides security to individuals in helping them to find new jobs and to upgrade qualifications. The system has been coined ‘flexicurity’ and builds on the importance of ‘active labour market policies’ in these economies. These countries give high priority to new technologies, the efficiency of production, and the competitiveness of firms. They rely on a proactive industrial policy with government-supported strategies for information technology and agencies promoting research, regional policies, and clusters. They suffered a severe crisis (mostly in the early 1990s) in which many of the problems suspected to dampen growth in a highly developed Welfare State occurred (costs increasing faster than productivity, problems with fiscal sustainability). But they changed course without abandoning the goals of the Welfare State and without giving up ecological goals. The specific reform agenda has prompted discussion of the feasibility of a reformed European Model which combines welfare and sustainability on the one hand with efficiency and economic incentives on the other hand.⁷

To summarize the basic differences between the New and the Old Welfare State, here are some of the main points (see also Table 3.5):

- The social system remains inclusive and tight, but the social benefits depend on the individual’s inputs, they may be conditional on certain obligations; replacement rates are lower than they used to be to provide better incentives to work.
- Taxes are relatively high, but in line with expenditures, even in the demanding sense of aiming at positive balances to take care of future pensions or to repay current debt.
- Wages are high, but the individual’s position is not guaranteed. Assistance

Table 3.4 Performance of top 3 and big 3 European countries relative to the EU and the US

	Top 3 European countries	Big 3 European countries	EU-15	USA
Real growth of GDP 1996-2005	2.8	1.6	2.1	3.4
Macro productivity growth 1996-2005	1.9	0.9	1.2	2.2
Employment rate; average 1996-2005	71.4	62.8	64.4	71.4
Unemployment rate; average 1996-2005	8.2	9.5	8.8	5.3
Inflation rate; average 1996-2005	1.6	2.1	2.1	2.5
Public debt in % of GDP 2005	44.6	79.6	64.3	63.5
Budget deficit in % of GDP 2005 (deficit -)	1.4	-3.3	-2.5	-4.0
Taxes in % of GDP 2005	55.4	46.6	45.3	29.5
GDP per capita at PPP 2005	27.4	24.7	25.1	36.1

Source: Own calculations using Eurostat (AMECO).

Note

Top 3 countries: Denmark, Finland, Sweden. Big 3 countries: Germany, France, Italy.

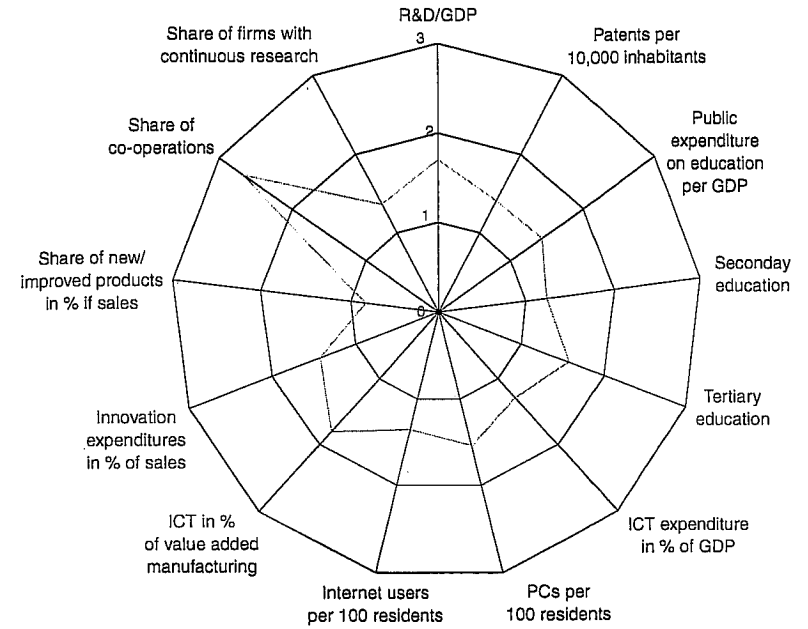


Figure 3.4 Investment in future growth; top 3 European countries vs. big 3 European countries.

Note

Values outside the unit circle indicate greater investment by the top three countries (in the last year that the indicator was available; usually 1999 or 2000).

and training opportunities that are personalized, less bureaucratic and centralized are offered to people losing their jobs.

- Welfare-to-work elements have been introduced, usually on a decentralized, sometimes even private basis; conditions vary according to problem size and problem class, the background philosophy being one of providing assistance while keeping work search incentives intact.
- Part-time work and adaptation of work to life cycle is encouraged, and social benefits are pro rata extended to part-time work, which becomes an individual right and a measure voluntarily taken to enforce, rather than prevent, gender equality.
- Technology policy and adoption of new technologies, rather than subsidizing old industries, are a precondition for the survival of the Welfare State.
- Even where welfare costs are streamlined and incentives are improved, the welfare system offers comprehensive insurances against economic and social risks and a broad coverage of health risks.
- Environmental and social goals as well as equity of income distribution and prevention of poverty are high on the political agenda.
- Government and public institutions play a proactive role in promoting

Table 3.5 Old Model versus New European Model of a Reformed Welfare State

<i>Old model of European Welfare</i>	<i>The new model of leading three countries</i>
<i>Welfare pillar</i>	
Security in existing jobs	Assistance in finding a new job
High replacement ratios	Incentives to accept new jobs (return to labour force)
Structural change in existing firms (often large firms)	Job creation in new firms, in services, in self-employment
Comprehensive health coverage, pensions, education	Coverage dependent on personal obligations
Regulation of labour and product markets	Flexibility as a strategy for firms and as a right for employees
Focus on stable, full-time jobs	Part-time work as individual choice (softened by some rules)
Early retirements	Encouraging employment for elderly workforce
<i>Policy pillar</i>	
Focus on price stability	Focus on growth and new technologies
Asymmetric fiscal policy (deficits)	Fiscal prudence (but flexible in crisis)
Incentives for physical investment	Incentives for research, education, and new technologies
Subsidies for ailing firms (public ownership)	Industrial areas, business–university nexus
Industrial policy for large firms	Start-ups, venture capital, services
Local champions, permissive competition policy	Enforce current strengths (cluster and regional policy) and competition

innovation, efficiency, and structural change, in upgrading qualifications, and in life-long learning. Public institutions also provide the largest part of education and health care.

- Social partners (institutions comprising representatives of firms and employees) determine many elements of wage formation and play a decisive role in shaping labour laws, in certain institutional developments, and in the formulation of economic policy in general.
- Government is large and taxes are high, even if mechanisms are put in place to limit increases in spending and for achieving a sound fiscal policy in periods of increasing demand.

6 The impact of enlargement on Europe's growth prospects

With the fall of the Iron Curtain and the ensuing rapid process of East–West European economic integration, culminating – so far – in the accession of 12 new countries to the European Union in 2004 and 2006, the diversity of living standards and the differentiation of structural and systemic (institutional and behavioural) features within the European Union has vastly increased.

Figures 3.5a and 3.5b show the dispersion of GDP per capita across the

European continent, first in relation to the shares which the different countries represent in Europe's population (Figure 3.5a) and then in relation to their shares in Europe's GDP (measured in PPP) (Figure 3.5b). We see that the dispersion of income (between the richest and poorest of the EU-25 economy) has dramatically increased through the recent wave of enlargement, and that further prospective waves bringing in the candidate countries and potential future applicants (the countries in the ACS and SEE groups⁸) would lead to further dispersion.

We shall shortly review developments in Central and Eastern Europe from the early 1990s and then refer to current developments and the impact of enlargement upon the EU economy and governance issues.

Transition in Central and Eastern Europe and (re)integration into the European economy

The starting point of the transformation processes in 1989 in Eastern Europe meant an enormous change in economic structure, trade arrangements, adjustments in the policy tools used and, of course, fundamental institutional and behavioural changes. After a difficult transitional period in which the 'newly emerging market economies' (NEMs) of Eastern Europe experienced a dramatic recession (mostly induced by a radical shift from one system of allocation (planning) towards another (markets) as well as the sudden regime switch towards very far-reaching trade, exchange rate and price liberalization), the more successful of the Central and Eastern European economies (Poland, the Czech and Slovak Republics, Hungary, Slovenia and the Baltics) gradually regained stability and, from the mid- to late 1990s, started to grow at rates which were double those of the EU-15. Together with systemic and macroeconomic changes came important structural transformations: there was an influx of foreign direct investment and upgrading of industrial production structures, technologies, and product quality. All this took place at a relatively rapid pace (see Landesmann, 2000; Landesmann and Stehrer, 2002; Landesmann, 2003). The current trade and production integration between the new members and the 'old EU' (the EU-15) is strong, particularly with the neighbouring countries, Austria, Germany, Italy and Greece. There have been significant developments in terms of cross-border production networks and the development of an industrial production belt (in cars, machinery, electrical goods, etc.) in the border regions of the new members with the old EU. A 'new division of labour' has developed, with medium-tech industrial production stages shifting towards the new members. The EU-15 countries, on the other hand, benefit from a high demand in the new members for financial and business services. In these areas they have substantial trade surpluses, while the new members have increasingly become important locations for industrial production (see Figure 3A.3).

The impact upon the EU economy and the EU policy framework

Much more differentiation and coping with heterogeneity

The new European Union is characterized by a much wider range of real income levels, productivity and wage levels than the EU-15 (the range of real income differences – at the national level – between the richest and poorest EU member in the ‘old EU’ was of the order of 40 per cent; in the new EU this range has expanded to about 70 per cent; see Figure 3.5). Sectoral structures still differ

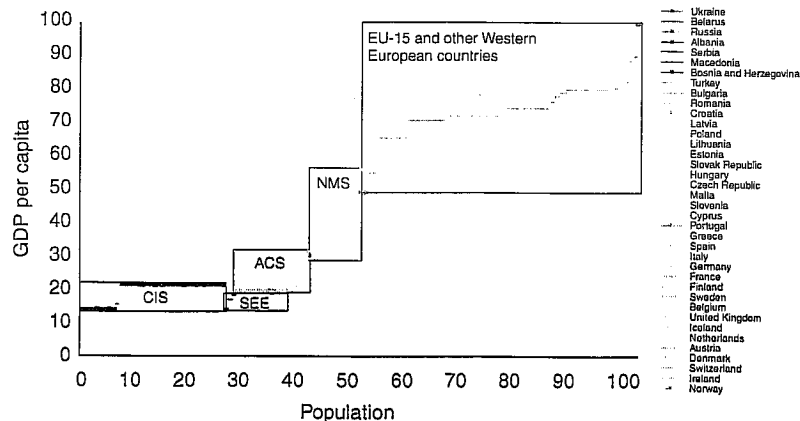


Figure 3.5a Income levels in the Wider Europe region: GDP per capita (PPP) vs. share of population, 2004.

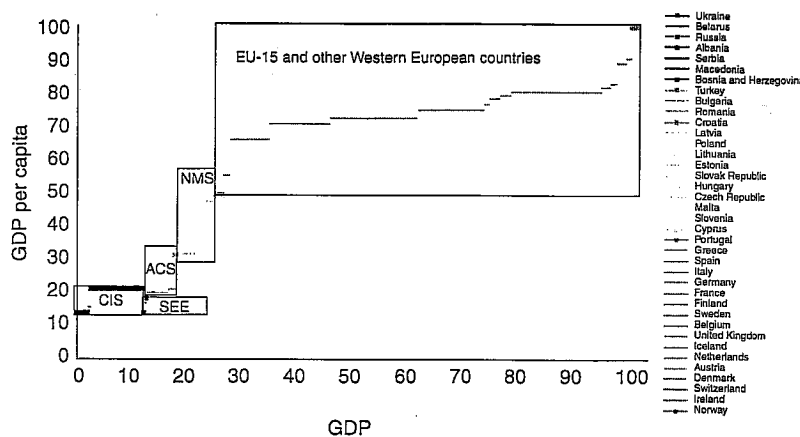


Figure 3.5b Income levels in the Wider Europe region: GDP per capita (PPP) vs. share of GDP, 2004.

substantially between the NMS and the OMS (see the shares of agriculture and services in GDP, but more importantly in employment; Table 3.6) and even more so in the candidate countries. This indicates still substantial forthcoming processes of sectoral structural adjustment. The regional dimension (below country level) shows a further increase in regional disparities (e.g. a large share of the poorest regions of the EU-25 is in the new member countries; see Landesmann and Roemisch, 2005). There are opportunities and challenges in this increase in heterogeneity: the opportunities lie in the possibilities of complementarities in comparative advantage structures and the increased scope for production location decisions and the setting-up of production networks by EU and international companies across the enlarged European Union. The challenges lie in cohesion policies on the one hand, which will have to be applied at both national and European levels and difficult adjustment processes in the old EU members which face the difficult task of adapting economic structures that result from the new division of labour in Europe and globally (see, e.g., Sinn, 2005).

Challenges for decision-making structures and the conduct of macroeconomic policies

Decision-making in the EU has become a major problem with 27 members (and will become more so as more countries enter): the changes that were to be introduced with the new Constitution would have eased these problems, but, at the same time, would have generated a new dynamic of coalition-building which is untested in its potential efficiency or inefficiency. The conduct of macroeconomic policy is in a state of disarray, with monetary policy having been centralized (for the Euro-zone) and a clear – and unlikely to be changed – constitutional role being given to the ECB to conduct monetary policy in line with the former Bundesbank model. On the other hand, fiscal policy coordination and the framework for the Growth and Stability Pact (GSP) are in a state of flux and a major factor in a feeling of disenchantment with the overall macroeconomic policy framework. Reform of the GSP reflects efforts at rational reform of the fiscal policy framework in the direction of an orientation towards ‘longer-run fiscal sustainability’ and a complex web of particular countries’ interests given their economic positions (France, Germany; new members). There are definitely new challenges created by the increased heterogeneity which get reflected in differences in trend growth paths, different inflation scenarios reflecting catching-up processes, and different demographic situations which would allow different longer-run fiscal and debt arrangements; it has been acknowledged that such increased heterogeneity should be reflected in a reformed GSP. However, the unclear division of powers between the Commission, the councils of ministers and the ‘Euro-group’ to initiate and carry through reforms have made it difficult to go beyond a marginal reform package and find a longer-term solution.

Table 3.6 Central and East European new EU member states (NMS-8): an overview of economic fundamentals, 2004

	NMS-4 ¹	NMS-8 ²	EU-15	AC-3 ³	Turkey	Ukraine
Population – thousands, average	27,693.3	72,962.9	385,059.0	33,894.5	72,003	47,281
GDP in EUR at exchange rates, EUR bn	226.03	459.08	9,793.85	105.97	243.04	52.17
GDP in EUR at ER, per capita	8,162	6,292	25,435	3,127	3,375	1,103
GDP in EUR at PPP, EUR bn	394.84	868.97	9,383.48	250.92	486.07	280.85
GDP in EUR at PPP, per capita	14,258	11,908	24,369	7,403	6,750	5,920
GDP at constant prices, 1990=100	121.4	132.2	131.6	103.8	162.1	61.0
GDP at constant prices, 1995=100	132.3	140.0	121.6	122.0	138.4	127.6
GDP at constant prices, 2000=100	114.6	114.7	106.1	123.9	114.1	141.1
GDP, p.a. growth (per cent, 1990–2004)	1.4	2.0	2.0	0.3	3.5	-3.5
GDP, p.a. growth (per cent, 1995–2004)	3.2	3.8	2.2	2.2	3.7	2.7
GDP, p.a. growth (per cent, 2000–04)	3.5	3.5	1.5	5.5	3.3	9.0
Gross value added, in % of GDP ⁴						
Agriculture, forestry, fishing						
Industry total	2.9	2.9	1.8	10.3	11.7	10.8
Services	30.7	28.2	24.3	30.6	28.2	32.6
Employed persons in, LFS in % of total ^{5,6}	56.8	59.2	66.5	47.7	62.3	47.3
Agriculture, forestry, fishing						
Industry total	5.2	12.3	3.9	25.9	34.0	23.1
Services	36.8	32.1	24.3	30.5	23.0	25.6
Public sector expenditures, EU-def., in % of GDP ⁷	57.9	55.5	71.9	43.5	43.0	51.3
General government deficit, in % of GDP av. 2000–04	47.1	46.8	48.0	36.1	32.6	29.4
	-5.4	-4.2	-1.5	-2.7	-11.3	-0.5

Sources: wiiw, EUROSTAT, AMECO, ILO.

Notes

- 1 NMS-4: Czech Republic, Hungary, Slovak Republic, Slovenia.
- 2 NMS-8: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia.
- 3 AC-3: Bulgaria, Croatia, Romania.
- 4 Data 2003 for Romania, Turkey, NMS-4 and NMS-10 (NMS-8 plus Malta and Cyprus).
- 5 Bulgaria, Croatia employment by registration.
- 6 Ukraine employment by registration, data 2003.
- 7 EU-15 and NMS according to EU definition (excessive deficit procedure); Bulgaria, Romania, Turkey and Ukraine national definition; Croatia IMF-definition and data 2003.

The future of EU policy programmes

The year 2005 saw conflicts emerge over the next Financial Framework as expenditure plans for EU programmes had to be finalized for the period 2007–13. The major spending components in the EU budget are the Common Agricultural Policy (CAP) and the Structural and Cohesion Funds. The plan submitted by the European Commission (see Figure 3.6) envisaged a decline in the share of spending on the CAP (currently amounting to about 45 per cent of overall spending), constancy in the finance provided for Structural and Cohesion Funds (currently amounting to about 35 per cent), and an increase in spending on the Lisbon Agenda, particularly for research, and on international development and common foreign policy programmes. The Commission’s proposal wanted to keep the commitment of member states to the EU budget at current levels (1.27 per cent of EU GNI) but was countered by the position taken by the group of ‘net payers’ which wants to reduce the commitment ceiling to 1 per cent. A compromise was struck, reducing the commitment to 1.06 per cent of GNI. Furthermore a conflict erupted between the UK and France, when the UK (which held the EU presidency in the second half of 2005) sought to reopen negotiations with respect to reforming the CAP before finalizing the 2007–13 Financial Framework. Allocations to the CAP budget for this period had been fixed by the acceptance in 2002 of a limited reform package pushed through by Commissioner Fischler. In any case, the current situation seems to indicate continued conflicts over the three major EU expenditure items, the CAP, Structural/Regional policies and innovation-support measures which should go some way towards achieving the Lisbon Agenda objectives. There is currently no willingness to increase the overall EU budget and thus shift expenditure structures between the EU and national levels.

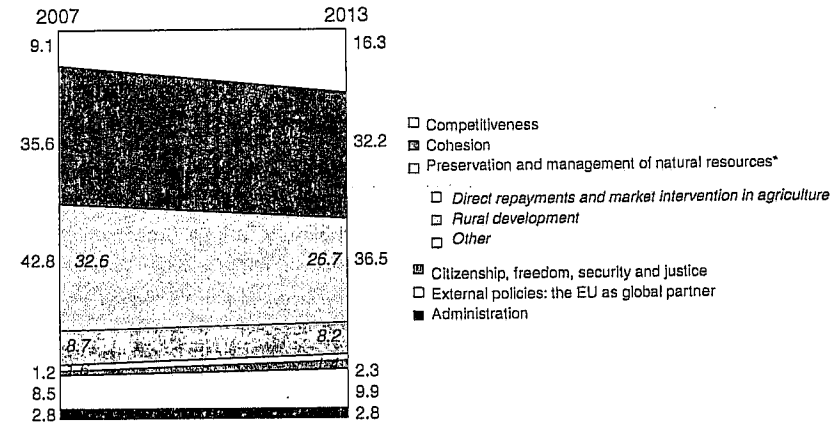


Figure 3.6 The composition of expenditures of the European Union's budget in 2007 and 2013 according to the European Commission's proposal (in %) (source: Richter (2005)).

Note

The internal distribution of 'Preservation, etc.' is indicated by the figures in italic.

Hence the EU will remain a midget in budgetary terms, which constitutes a major difference with respect to the federal structure in the US.

The impact upon 'model competition' within the enlarged European Union

Over the past few years it has become clear that the new members have embarked upon a path which will enhance 'model competition' within the enlarged European Union. While earlier in the transition there were indications that the NMS would follow the social-democratic, corporatist approach of their immediate neighbours (Germany and Austria), more recent developments indicate a turn towards a more liberal economic orientation. There have been moves towards flat tax or near flat tax regimes in a succession of NMS, there have been developments towards a stronger mix of private-public segments in the health and education systems, and the overall fiscal constraints (given the pressures to fulfil GSP criteria and ambitions to join EMU) point towards a reduced role of the (inherited large) state in economic life. Pension reforms, privatization of utilities, and the presence of foreign investors have moved in many of the new member countries beyond the levels achieved in many of the 'old' member states. In most of the NMS there is – after the dismantling of the Communist trade union organizations – also relatively low union membership and hence little basis for developing strong social partnership arrangements. The presence of a group of fast growing economies, attractive to FDI (which mostly comes from the EU-15), with low wages and a tendency towards very low corporate tax rates, and more liberal corporate regulations (in shop opening hours, shift work, standards of safety regulations), introduces new momentum into the already diverse picture of 'model competition' in the European Union previously characterized by Anglo-Saxon, Scandinavian, corporatist continental, Southern cohesion country models, and the Irish catching-up model (which many of the NMS want – in part – to emulate⁹).

7 The concept of the 'Wider Europe' and its neighbourhood

'Enlargement' and 'Association' have been buzzwords in the European integration process for 25 years and will continue to be so at least for the coming decade. The track record shows, first, that – over a longer time horizon – integration with the European Union benefits particularly catching-up economies, previously the cohesion countries (Ireland, Spain, Portugal, Greece) and most recently the new members from Central and Eastern Europe. Second, the benefits of enlargement accrue in part in advance of actual membership. In a phase of catching-up or 'transition' the institutional anchorage (or 'lock-in') with the more mature institutional and legal frameworks of Western Europe is an important factor in tipping developments towards institutional and economic upgrading. The same can be said for the economic integration process through trade liberalization, FDI flows, the entry of foreign banks, fiscal and monetary policy coordination with more advanced, high income economies. These provide a major spur for upgrading economic structures and in the conduct of economic

policy. Hence Association and prospects for EU membership provide a major pull for economies which are (1) less developed than the EU and (2) in the EU's neighbourhood so that substantive economic integration provides a realistic scenario.

In the following we shall discuss the various 'layers' of the Wider Europe and the impact that tighter economic and political integration in the Wider Europe will have for Europe's competitiveness and position in the global economy.

Layers of the Wider Europe

The EU-25

The EU-25 is characterized by increased economic heterogeneity and unresolved governance structures as regards its own functioning. These two issues are core issues in the political debate in Europe and will absorb many of the resources of the political establishment devoted to EU integration over the current decade. The reform backlog and the growth weaknesses of the larger continental European economies (Germany, France, Italy) indicate that there will be a phase in which national political processes will be the determining factor in tackling economic reforms, while the resources and instruments available at the EU level are too weak to play a decisive role in this respect over the coming years.

In spite of the setback over the acceptance of the European Constitution, there seems to be nonetheless a continuous push and – in the final analysis – inescapable dynamic towards further enlargement (in Southeast Europe) and increased ties with neighbouring countries and regions.

The follow-up round of enlargement (Romania, Bulgaria, Croatia)

This further enlargement will take place in 2007–09. Negotiations with Croatia were delayed as it was dragging its feet to comply with the Hague Tribunal to extradite accused war criminals, but they are now on course. The issues with this further round of enlargement are no different from those of the previous round: there will again be transitory arrangements with respect to full participation in EU programmes and the opening up to full mobility of labour which should ease adaptation from the EU-25 side. Given that the countries join after the principal decisions regarding the 2007–13 Financial Framework have been taken, they have very limited influence on the budget over the first period of their EU membership. The increase in membership numbers from this wave of enlargement will not make a significant difference with respect to the already problematic state of decision-making processes in the EU of (then) 28 members.

The 'rest of the Balkans' (Macedonia, Serbia, Montenegro, Bosnia-Herzegovina, Albania, potentially Kosovo) and Turkey

This is a 'weightier' enlargement in terms of numbers (5–7 new members) and also in economic terms, because of the big weight of Turkey and some very poor coun-

tries and regions (in the Balkans and Eastern Anatolia). The adjustment processes required from the then EU 33–35 would therefore be far more difficult and put new strain on cohesion policies and decision-making structures. From today's perspective it looks as if a 'special partnership' arrangement with Turkey is the most likely outcome, although there is no way to foresee developments over the coming decade (both within the EU and in Turkey). The rest of Southeast Europe (Western Balkans) is likely to gain full membership because of its small economic weight, and the incentive to support political and economic stabilization in the region and to provide contiguity for the EU geographic entity. One reason that the 'special partnership' option with Turkey might be the more probable outcome is that it might also provide a precedent on how to deal with other weighty aspirants such as Ukraine or Belarus. The likely time horizon for the West Balkan enlargement is 2013–17.

Ukraine, Russia, CIS

Russia is already strongly linked through trade with the EU, and the other CIS countries remain strongly linked to Russia but also increasingly to the EU (see Astrov and Havlik, 2004). Links with the EU, furthermore, provide more scope and incentive for upgrading production and expenditure structures and, most importantly, institutions. This provides the 'pull' to Association and, for some countries (Ukraine, Moldova, Georgia), full membership of the EU, although the possibility of an EU of 35–37 by 2020 has become much less likely after the Constitution debacle. That this region might form part of an economic entity with considerable market integration and policy coordination is more likely.

MENA region

Many authors have written about an EU 'soft-power' effect on the Middle East, the Eastern Mediterranean, Iran, and Northern Africa. Developmental prospects of this region are strongly linked to tighter economic relationships with the EU. The question is whether a more forceful EU 'neighbourhood policy' can influence socio-economic and political blockages to economic development. One of the most important issues with potentially far-reaching social and economic consequences lies in the strong demographic complementarity of this region with the enlarged EU, but difficult issues of migration policy will have to be resolved.¹⁰

Complementarities and growth impetus from a 'Wider Europe' – a 'regionalist' arrangement

There are good reasons why 'Wider Europe' can – and already does – provide significant growth stimulus for the enlarged European Union. Figure 3.7 presents the differences of growth rates of the EU-15, the EU-25, the EU-28+Balkans and Turkey, and finally the EU-28+Balkans+ Turkey+Ukraine over the years 2002–04 and then a projection for the period 2005–20.¹¹ The Wider Europe (defined here as the last group, i.e. excluding Russia and any other CIS

country except Ukraine) displays a significant growth differential compared to the EU-15 (this differential amounted to 0.6 per cent in 2002, 0.7 per cent in 2003, and 0.8 per cent in 2004). With assumptions about differential growth rates also for the future for the EU-15, the NMS, the Balkans, Turkey and Ukraine, we see that while the EU-15 is assumed to grow at the rate of 2.3 per cent per annum, the Wider Europe region would grow at 3.1 per cent per annum. Due to the differential growth performances of the non-EU-15 members of the Wider Europe region, the weights in the overall GDP of the Wider Europe region would shift as well: using purchasing power estimates, the weight of the EU-15 in the Wider Europe region was 83.7 per cent in 2000; it would fall to 73.2 per cent in 2020; that of the NMS-10 was 7.6 per cent in 2000 and is projected to rise to 10.7 per cent in 2020; the Balkan region plus Turkey amounted to 6.8 per cent in 2000 but would account for 11.7 per cent of Wider Europe GDP in 2020; and Ukraine moves from 1.9 per cent to 4.5 per cent. Hence the non EU-15 countries would together account for about 27 per cent of Wider Europe GDP in 2020 as compared to 16.3 per cent in 2000.

More important are the structural aspects of the integration processes which are likely to deepen further within Wider Europe and in relation to the neighbouring region (particularly MENA-20 and Russia). We have already pointed out that the much increased heterogeneity in wage and productivity levels in the Wider Europe region provides a scope to gain from an increased division of labour built upon exploiting comparative advantages, and from the increased scope for vertical differentiation, fragmentation and integration of production stages across the wider European economic space. This can enhance the internationalization of a wide range of European businesses (not only the very large enterprises). Additionally, the presence of fast-growing economies exerts strong pressure for productivity and quality upgrading in the advanced Western European countries, as maintaining their high income positions depends upon continuous and successful attempts to upgrade their skill and production structures and improve framework conditions. These pressures are already evident in the Western European economies, where they have been met with varying success (see Germany and France vs. Scandinavian economies discussed earlier).

The crucial issue is that painful structural adjustment processes are needed to reap the gains from regional and global integration and the emerging new division of labour. Particularly negatively affected are low- and medium-qualified jobs in advanced economies, not just in industry but also in some services (tourism, distribution, post and telecommunications, health and welfare services). The pressure on these jobs in so-called 'tradable' sectors has been apparent for a long time; more recently 'outsourcing' and fragmentation possibilities have expanded strongly in what used to be 'non-tradable' sectors due to improved logistics, communications and transportation technologies. There is also increased competitive jobs pressure within countries through increased migration flows. The nature of these pressures depends upon the skill structures of migrants, labour market institutions (such as minimum wage legislation,

controls on illegal migrants, etc.) and migration policies designed to affect the supply structure of migrants and the dynamics of their positions on host countries' labour markets. The above processes of direct and indirect labour market integration within the Wider Europe's regionalist and global context will shape labour market developments in Western Europe to an increasing degree. An important question in this respect is whether the New European (Scandinavian) social model – discussed in section 5 – will remain viable and become more or less likely as an option also for the larger continental European economies.

8 The Wider Europe in its global context

Both the US and the EU have increasingly come under competitive pressure from a widening group of successful Asian economies. The emergence of China and India as major exporting nations has added to the impact of globalization upon the 'older' advanced economies (US, EU, Japan). There is a shift in world market shares towards the group of catching-up economies, first of all in goods trade (see Figure 3.8), but there is also the potential for an increased position of some of these economies in the services trade.¹²

Globalization has both a truly global and a 'regionalist' dimension. If one looks at trade flows, one can perceive a distinct orientation of a group of catching-up economies towards the advanced economies of their respective region: thus there is an overwhelming trade orientation of the Central and Eastern European countries

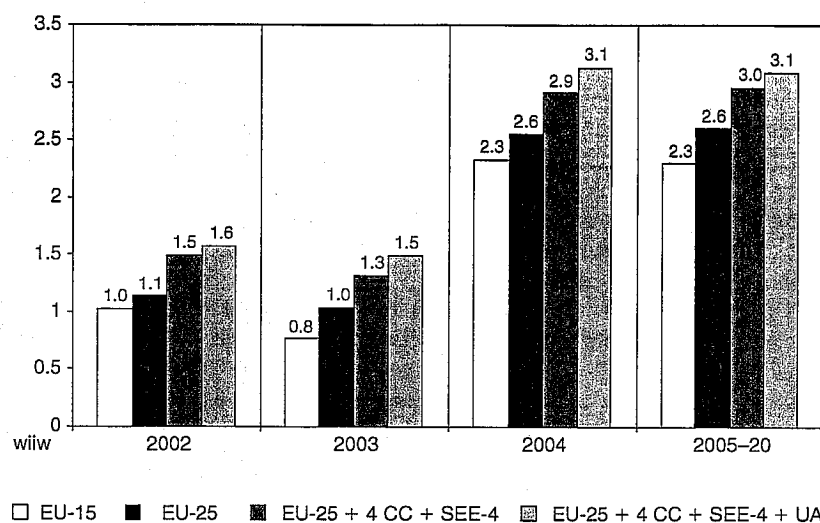


Figure 3.7 Growth of gross domestic product: EU-15, EU-25 and Wider Europe % annual change, 2005 and 2005–20 forecasts.

Note

Own calculations (wiw and Ameco databases) and projections.

(and, previously, of the Southern cohesion countries) towards the EU-15, while they trade very little with, for example, the US. Mexico is singularly dependent upon trade with the US, and Japan has strong trade links with the economies of Southeast Asia and very little trade with the catching-up economies in the other regionalist blocs (on this see Figure 3.9). Hence there is a strong regional dependence between the set of catching-up economies and the large neighbouring 'Northern' economies. One relative exception is the Asian economies, which have made strong inroads into all the three Northern economies' markets (i.e. into the US, EU, and Japanese markets).

In this context, Wider Europe is somewhat special, as compared to North America (NAFTA) and South-Southeast Asia. Wider Europe shows a much stronger continuum of differentiation in behavioural and institutional developmental levels, and in productivity and wage levels, than does NAFTA, in that the gaps between the US and Canada, on the one hand, and Mexico, on the other hand, are vast. The other distinct, but related feature of the Wider Europe is that it occupies a mid-position between the US, which is a well-established federal state, and the Asian region, which is made up of a collection of nation states each following its own national development agenda. Europe is undergoing the (protracted) birth pangs of an evolving agenda of delegating and redistributing powers between the supra-national, national and regional levels. This can mean a considerable transitory disadvantage, as these developments mean that the allocation of powers to the different levels is in a state of flux. This can result in a major gap in the efficiency of governance structures for a considerable period of time relative to the maturely functioning structures of a large federal state such as the US. On the other hand, we cannot exclude the possibility that the types of supra-national and national state structures which might evolve from this phase of European economic and political integration might equip Europe with more appropriate (and effective) institutional structures for the twenty-first century.

As to Asia, it has developed successful structures for the (mostly) mercantilist strategy pursued at the national state level, but so far lacks institutions for conflict resolution and for proper regional economic integration. Institution-building at the supra-national level is so far practically non-existent.

9 Outlook on Europe's competitiveness

Priorities in Europe's development policies

Demographic factor and migration policy

Adjustments to the 'demographic traverse' (the strong jump in expected old age dependency ratios) is now a high priority in attempts to reform pension systems. But equally important would be to support labour market adjustments to increase employment rates of the older cohorts; to focus training and retraining institutions on this task; to adjust employment contracts, etc. Furthermore, there

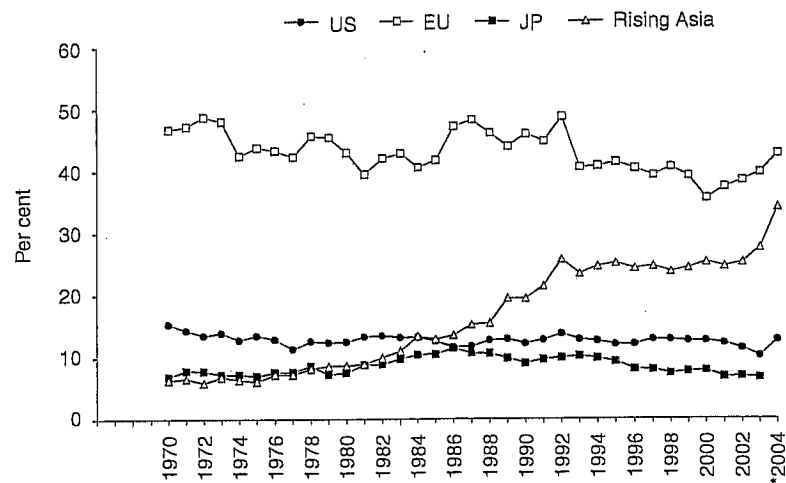


Figure 3.8a Shares in world merchandise exports (including Intra-EU).

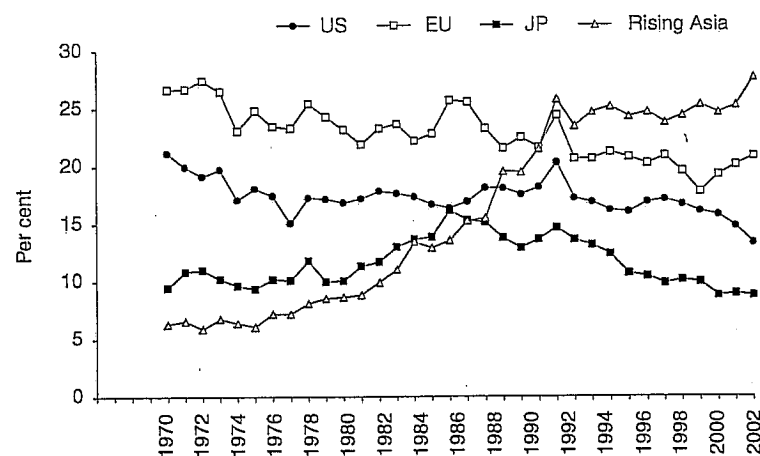


Figure 3.8b Shares in world merchandise exports (excluding Intra-EU) (source: UN Comtrade).

Note

Rising Asia comprises China, India, Hong Kong, Singapore, Taiwan, Korea, Philippines, Thailand, Malaysia, Indonesia.

has to be a major move on migration policy, both as regards selectivity at entry and with continued integration into the host societies. Migration can play a major role in improving mobility features of the European labour markets (see also Borjas, 2001) and in contributing to skill availability and entrepreneurship in a service and knowledge-based economy.

Further moves on market integration

The potential for market integration is still far from being fully exploited (see the earlier discussion in section 3). There are many residual entry barriers, especially in services, labour markets and financial markets. The issues have become more sensitive with the increase in the dispersion of developmental levels across the enlarged EU – as the recent crisis around the Commission's Services Directive has shown. This will require a parallel strategy of speeding up convergence processes, gradual harmonization, and further market integration in these sensitive areas.

European innovation system

This refers to efforts to increase corporate R&D spending, improve spill-over effects of public spending efforts on private R&D activity, develop complementarities of R&D policies at European, national and regional levels, encourage the further development of university–business links, develop research institutions and research networks of global excellence, develop venture capital finance and improve corporate legal governance frameworks, and openness to highly trained non-EU nationals. In all these areas there are substantial reforms across EU member states and gradual improvement in the EU's standing relative to the US. At the same time, new competitive pressures are emerging from the strong emphasis in many Asian economies on developing innovation capacities and a strong skills base.

Gradualist transformation of European social policies

These should become more targeted towards the most vulnerable groups; see also Levy (2006). However, a high degree of heterogeneity will likely be preserved reflecting country preferences (and levels of economic and social development). This heterogeneity also provides the basis for continued 'model competition' and the spread of better practice policies across Europe (see also Boeri, 2002). Distributive, employment and growth (and competitiveness) goals have to be looked at interdependently in reforming social policy frameworks.

Labour market (specifically educational and training) policies

This refers to policies targeted at low- and high-skill segments, and at different age segments and genders. The aim is to continue to increase participation rates with emphasis on those groups where these rates continue to remain very low by international comparison. Avoidance of a low-wage (working poor) segment through intensified efforts in educational and training upgrading is another desirable goal. This should specifically extend to immigrant groups to avoid sedimentation.

In addition, there is a host of other policies undergoing reform at the EU and national levels in the light of the debates over the Lisbon Agenda. These include regional policies, cross-European infrastructural policies, and remnants of industrial policy (see Sapir *et al.*, 2004).

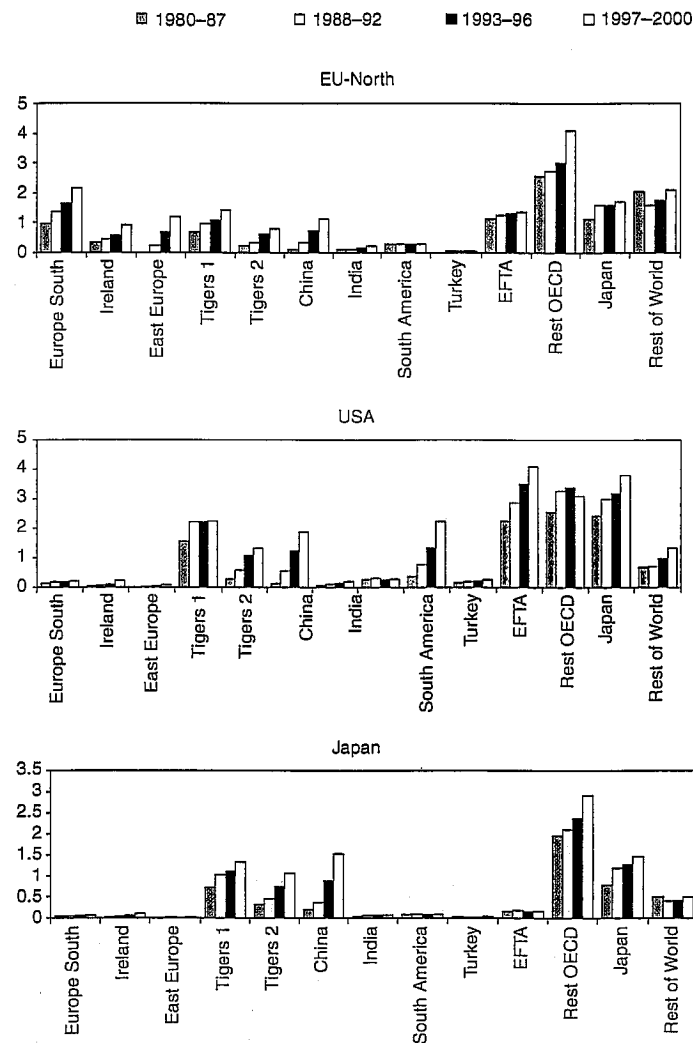


Figure 3.9 Import penetration ratios in total manufacturing.

Two possible scenarios

One can envisage both optimistic and pessimistic scenarios in Europe's development.

Continued slow growth scenario

Gaps in innovation systems persist; demographic developments take their toll, and migration and other policies are not courageously developed; asymmetry between

centralized monetary policy and badly coordinated and badly designed (rule-based) fiscal policy persists; growth stimulus for the wider economic space does not materialize as economic and political crises intervene in the Balkans, the CIS and Turkey.

Catching-up scenario

Benefit from diffusion of latest generalized process technologies (GPTs) allows Europe to follow the improved productivity performance of the US; significant improvements of European innovation systems (at European, national and local levels), including university-business links, cross-European networks of excellence and development of top universities, venture capital institutions and changes in corporate governance structures – all of which should contribute to Europe positioning itself closer to the global technology and innovation frontier. This would also involve improvement and harmonization of EU immigration and intra-EU migration policies; reforms and targeting a new 'European social and labour market model' (see Aiginger, 2004a and b, and section 5 in this chapter).

The authors give a 50-50 chance to either of the two scenarios materializing.

10 Europe's limited global role

The EU will remain Europe-oriented in both the above outlined scenarios. The basic pre-occupation with deepening and widening will continue to occupy a large part of the European political agenda and available resources. In foreign relations, the EU's relations with its immediate neighbourhood (see section 8 above) will dominate; there will also be an interest in building a wider 'regionalist perspective' including the Middle East, North Africa and CIS.

There will continue to be an interest in maintaining an independent stance towards the US. There will be no complete convergence of US-European 'models'; this provides grounds for 'model competition' and also potentially an alternative option in countries/regions that develop an antagonistic or critical stance towards the US (and the 'US model').

Europe has to be seen as a regional entity (East/Southeast Asia is also increasingly developing into one) with distinct interests. It will want (or be pushed) to play an enhanced role on the global stage which will increasingly be shaped by the complex relationships among such regional entities (US and NAFTA; EU and Wider Europe; Russia and CIS; China, Japan and East Asia).

The main 'pull' of the European Union as a 'model' is the role it plays in countries that are politically and socially unstable and for which targeting an association with or accession to the European Union provides an anchor in institutional and political development (given the conditionality the EU imposes on association and accession). Such an anchor has been shown to have been of crucial importance in those transition economies which have now become members of the EU; it has already played this role (and will, hopefully, continue to play) in the Balkans, some CIS countries (Ukraine, Georgia), and Turkey. It is possible that the EU can play a similar role in the future in other CIS countries (Caucasus, Belarus, Moldova,

possibly Russia), the Middle East and North Africa. However, the resources the EU can devote to encourage such processes are negatively affected by the recent 'Enlargement fatigue', the limits of its budget, and concern about the EU's capacity to adjust its decision-making procedures to further widening without strengthening its internal functioning. Nonetheless, the EU's efforts in these neighbouring regions can constitute a significant complementarity to US foreign policy.

Given the current state of Europe's integration process, it seems clear that Europe and the US will play different roles on wider globalization issues: Europe will have a regional political and strategic agenda (i.e. within its 'neighbourhood') while limiting itself to looking at wider global issues (e.g. the rise of China) predominantly in economic relations terms. The US, on the other hand, is not handicapped by basic structural transformations in its decision-making mechanism. Hence it will act as a well-defined strategic actor on geo-political issues. Take the example of China's exchange rate policy: both the EU and the US are interested in appreciation of the Chinese currency, but the US has to consider a much wider range of geo-strategic and economic issues when pressuring China into an appreciation (the future of the Asian political and economic alignments, the impact upon the general long-run relationship between the various regional powers, the impact upon the international financial architecture, etc.), which is not much of an issue for the EU which does not intend to play a significant role in Asian political and strategic relations. The same applies to developments in sub-Saharan Africa and the rise of India.

11 Conclusions

This chapter has presented some of the problems related to the issue of Europe's longer-term competitiveness. It has discussed problems of its internal functioning, the picture of heterogeneity it presents, and the difficulties of its governance problems in its current historical juncture as a collection of highly interdependent nation states on a clear path towards harmonization and coordination of most of their policies but without strong (or efficient) institutional and budgetary features at the European level.

Europe will remain pre-occupied with deepening and widening issues for a long time to come. Enlargement – which will be an ongoing process over the next two decades – will exert overall a growth boost to the European Union, although cohesion and governance problems get compounded by it.

The 'regionalist perspective' of the Wider Europe construct will be of crucial importance for transatlantic relationships, insofar as the Wider Europe and its neighbourhood is also of crucial strategic interest to the US. Apart from this, the competition of a 'reformed European model' with the 'US-Anglo-Saxon model' will provide for continued – hopefully creative – tension.

Appendix

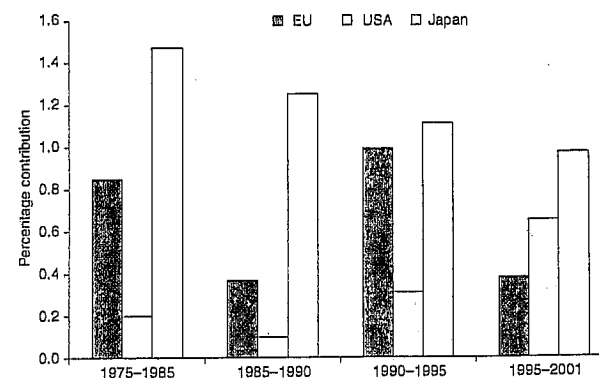


Figure 3A.1 Capital deepening (source: European Competitiveness Report 2001, Commission staff working document). Figures indicate the contribution of the growth of capital stock per employee to overall labour productivity growth.

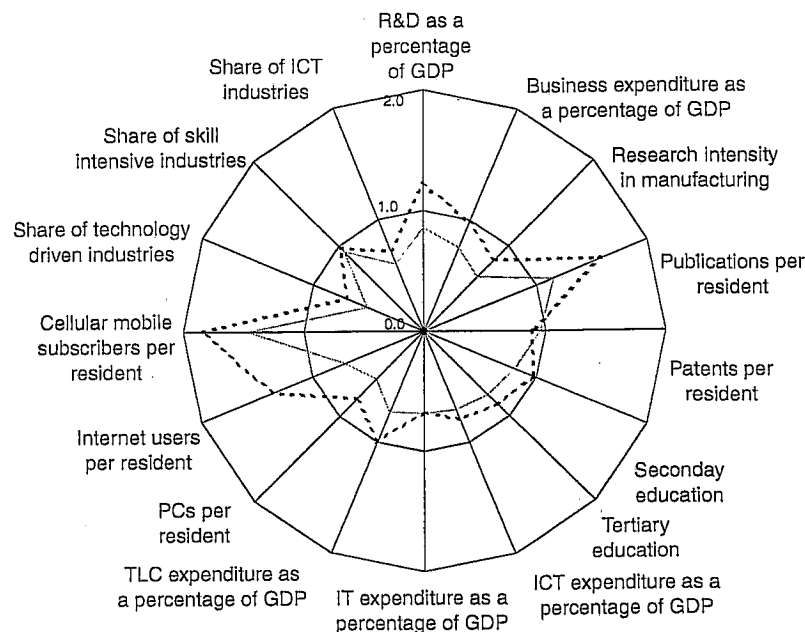


Figure 3A.2 Growth drivers Sweden, Finland and Denmark vs. USA (source: Aiginger and Landesmann (2002); see Appendix Table 3A.2 for more detailed descriptions and individual headings).

Note
 Top 3: Sweden, Finland, Denmark. Each indicator outside the unit circle shows a superior performance of the top 3 European countries vs. the USA. Interrupted line: early 1990s; continuous line: late 1990s.

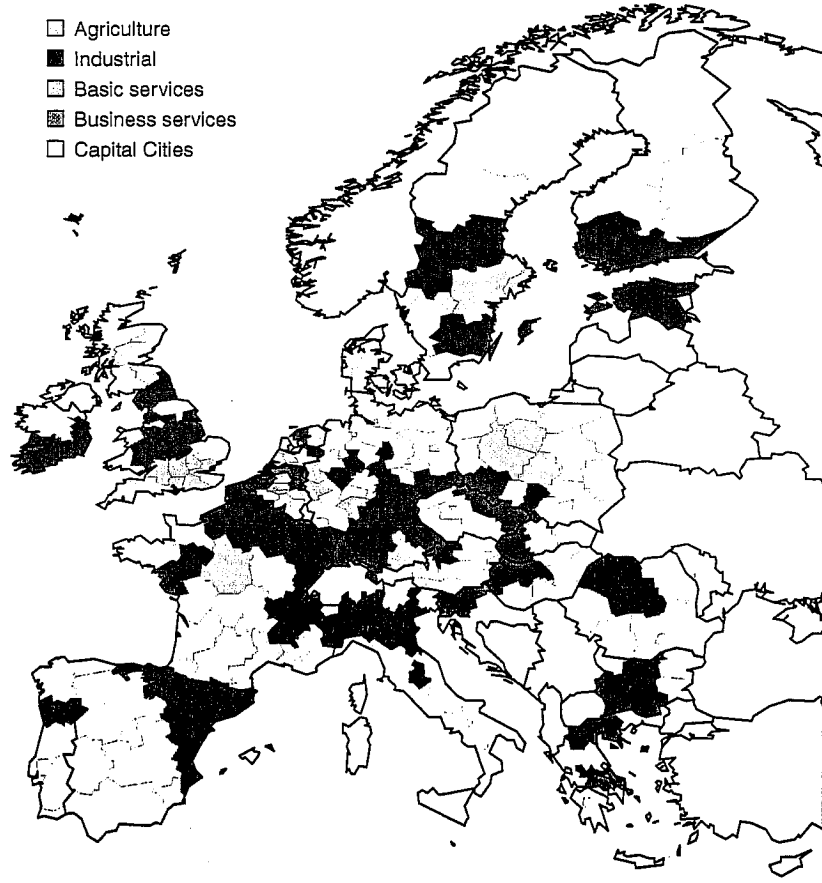


Figure 3A.3 Specialization of regions (NUTS 2 level) in the enlarged EU.

Note

Specialization of a region has been defined in terms of the largest deviation of the sectoral share of employment of a region relative to the national employment structure.

Table 3A.1 Differences in determinants of long-term growth (growth drivers): EU-15 vs. USA

	Position of EU to USA		
	EU/USA	EU/USA	Absolute
	First year	Last year	change
Indicators on R&D: input and output			
Total expenditure on R&D in % of GDP 1992/2001	0.693	0.733	0.040
Business Enterprise expenditure on R&D (BERD) in % of GDP 1992/98	0.606	0.564	-0.042
Research intensity in manufacturing 1990/98	0.652	0.623	-0.029
Publications per inhabitant 1992/99	0.646	0.878	0.232
Patents per resident 1990/97	0.617	0.554	-0.064
Indicators on education system: input and output			
Percentage of the population that has attained at least upper secondary education, by age group (1998)	0.609	0.795	0.186
Percentage of the population that has attained at least tertiary education, by age group (1998)	0.514	0.694	0.181
Indicators on ICT production and use			
ICT expenditure in % of GDP 1992/2000	0.654	0.731	0.077
Information technology (IT) expenditure in % of GDP 1992/2000	0.568	0.493	-0.075
Telecommunication (TLC) expenditure in % of GDP 1992/2000	0.749	1.135	0.385
PCs per inhabitant 1992/99	0.369	0.481	0.112
Internet users per inhabitant 1992/99	0.178	0.584	0.406
Cellular Mobile Subscribers per 100 capita 1992/99	0.356	1.271	0.914
Indicators on share of 'progressive' industries (see Section 5)			
Share of technology driven industries in nominal value added 1990/98	0.826	0.757	-0.069
Share of skill-intensive industries in nominal value added 1990/98	0.920	0.895	-0.025
Share of ICT industries in nominal value added 1990/98	0.723	0.475	-0.248

Notes

First (last) year means that year in the 1990s for which earliest (or latest) data are available (both are indicated after the name of the variable). For percentage with secondary and tertiary education the older (45-54) and the younger (25-34) age groups are compared.

Table 3A.2 Large countries persistently behind, while top performers catch up with the USA

	Position of large countries EU to USA		Position of leading 3 EU to USA		Absolute change
	First year	Last year	First year	Last year	
Indicators on R&D: input and output					
Total expenditure on R&D in % of GDP 1992/2001	0.838	0.714	0.861	1.231	0.370
Business Enterprise Expenditure on R&D (BERD) in % of GDP 1992/98	0.766	0.672	0.753	0.967	0.215
Research intensity in manufacturing 1990/98	0.766	0.690	0.636	0.834	0.198
Publications per inhabitant 1992/99	0.767	0.990	1.158	1.589	0.430
Patents per resident 1990/97	0.961	0.803	0.953	0.888	-0.086
Indicators on education system: input and output					
Percentage of the population that has attained at least upper secondary education, by age group (1998)	0.759	0.856	0.816	0.970	0.154
Percentage of the population that has attained at least tertiary education, by age group (1998)	0.595	0.722	0.748	0.870	0.123
Indicators on ICT: production and use					
ICT expenditure in % of GDP 1992/2000	0.740	0.736	0.703	0.796	0.093
Information technology (IT) expenditure in % of GDP 1992/2000	0.692	0.596	0.681	0.680	-0.001
Telecommunication (TLC) expenditure in % of GDP 1992/2000	0.794	0.974	0.730	0.993	0.262
PCs per inhabitant 1992/99	0.445	0.529	0.556	0.790	0.234
Internet users per inhabitant 1992/99	0.169	0.585	0.712	1.363	0.651
Cellular Mobile Subscribers per 100 capita 1992/99	0.359	1.116	1.461	1.841	0.380
Indicators on share of 'progressive' industries (see Section 5)					
Share of technology driven industries in nominal value added 1990/98	0.945	0.859	0.561	0.696	0.135
Share of skill-intensive industries in nominal value added 1990/98	0.978	0.933	0.980	0.976	-0.003
Share of ICT industries in nominal value added 1990/98	0.819	0.535	0.628	0.715	0.087

Notes

First (last) year means that year in the 1990s for which earliest (or latest) data are available (both are indicated after the name of the variable). For percentage with secondary and tertiary education the older (45-54) and the younger (25-34) age groups are compared. Large European countries: Germany, France, United Kingdom. Leading European countries: Sweden, Finland, Denmark.

Notes

- 1 Unless otherwise stated we shall refer to 'Europe' as Western Europe including the European Union members prior to May 2004 (i.e. the EU-15) as well as the other countries of Western Europe such as Switzerland, Norway, Iceland and Liechtenstein. The 'Wider Europe' includes the previous group plus the countries which joined the EU after May 2004 as well as current and future candidate countries of the EU. The concept of Wider Europe will be discussed in the later sections of this chapter.
- 2 If we take the year 2003, the EU per capita income level was 71 per cent of the US level. Productivity (in terms of output per hour worked) accounted for just 8 percentage points of this 29 percentage point difference. Of the remaining 21 percentage point gap, roughly 75 per cent was associated with fewer working hours (per person employed). The other 25 per cent came from lower participation rates, i.e. lower employment relative to the total population, and involved differences in such things as retirement ages (earlier in Europe) and unemployment rates (higher in Europe). It is interesting to see the changes in the components which make up the gap in per capita income between the EU and the US: in 1990 the gap in income per capita between the EU and the US amounted to 27 percentage points: lower productivity accounted for 10 points, fewer hours worked for 8 points and lower participation rates for 9 points. In 2003 the gap amounted to 29 percentage points: of these 8 points were accounted for by productivity, 15 points by hours worked and 7 points by the difference in participation rates. (The information in this note is extracted from R.H. McGuckin and B. van Ark: *Performance 2004: Productivity, Employment and Income in the World's Economies*, The Conference Board, New York, 2004).
- 3 Thus the difference in employment rates in 2002 between the US and the EU for men in the age group 15-64 was 5.1 percentage points, for women 10.7 points; for men in the age group 25-54 there was no difference between the US and the EU (for women 5.0), while for the age groups 15-24 the difference was 13.4 for men and 17.1 for women and for the age group 55-64, 15.8 points for men and 22.2 for women. Source: OECD, *Employment Outlook, 2003*, Tables B, C, D; see also Freeman and Schettkat (2005).
- 4 A contributory factor to the slow accrual of a growth dividend from the Single Market programme is the resistance put up by large incumbent (and state-backed) firms especially in some of the large continental European economies (France, Italy, Germany) to implement fully the non-discrimination obligations of the Single Market. Such companies were used to a strong domestic market position and preferential treatment by national and local governments and thus had much to lose from a full implementation of the Single Market programme. The defensive strategies often pursued by these companies (e.g. Italian and French car manufacturers) prevented a forward-looking restructuring strategy to exploit the potential of a liberalized EU-wide market. This might explain the difference to the more successful adjustment of large companies in smaller EU economies (such as in Sweden, Finland, Denmark, the Netherlands) which were - given the relatively smaller size of the domestic market - already highly export-market oriented even before the implementation of the Single Market rules. Nonetheless, the scenario for the privileged companies of the large continental economies seems to be changing (see Pisani-Ferry, 2006).
- 5 See also Pichelmann and Roeger (2006).
- 6 Ranking the countries according to the indicators in Table 3.4 reveals Ireland as the top-performing country, followed by Sweden, Denmark and Finland. While Ireland is a remarkable story of catching up and finally forging ahead (in a subset of indicators, not in income per head or wages per worker), we consider the other three as important examples of how mature and rich countries can continue to grow and call them 'top 3 European countries'.
- 7 For earlier suggestions along this line see Aiginger (2002), Aiginger and Landesmann (2002) and Aiginger (2004a); see also Levy (2006) and in this volume. The basic

- unresolved issue here is whether the large continental European countries (France, Germany, Italy) can be reformed along the experiences of the Scandinavian countries or whether the experiences cannot be easily replicated in larger, more heterogeneous states. Furthermore there is a question of whether the 'Northern model' is itself sustainable in the context of further pressures of globalization (see, for example, the recent widespread discussion on out-sourcing).
- 8 ACS refers to accession and candidate countries including Bulgaria and Romania which have joined the European Union in 2007 and Croatia and Turkey which have the status of candidate countries. SEE refers to the other countries of Southeast Europe (Albania, Serbia, Montenegro, Bosnia-Herzegovina, Macedonia).
 - 9 While some of the policies which made Ireland very attractive to foreign investors are emulated, such as low corporate tax rates, other elements – such as a very strong public effort towards training and the development of excellent educational institutions as well as elements of an active industrial policy – are less noticed and, given the fiscal constraints in the NMS, feature less in their policy strategies.
 - 10 The following are some figures on the demographics of the Wider Europe and its neighbours: Western and Central Europe's (i.e. EU-25 plus EEA plus Switzerland) total population size will remain roughly stable over the next 20 years (2003: 467 million; 2025: 466 million). In the Rest of Eastern Europe plus Turkey and Central Asia the population will also remain stable over the next 25 years (2000: 405 million; 2025: 407 million); there is a mix here with positive population growth in Azerbaijan, Turkey and most parts of Central Asia and considerable demographic decline in Russia, most Balkan countries and Ukraine. In Europe's southern and southeastern neighbours (the Middle East, North Africa, and the Gulf states, i.e. MENA-20) the population will grow steadily from 316 million in 2000 to 492 million in 2025 (i.e. a 56 per cent rise) and to 638 million by 2050 (+73 per cent). Together with these differences in overall population growth there are major differences in the shares of people of working age and those older than 65 in the various regions, e.g. in the absence of massive recruitment of economically active migrants, the number of people between 15 and 64 will decrease in the Western and Central European region from 312 million in 2000 to 295 million in 2025 (–5.5 per cent) to 251 million in 2050 (–20 per cent), while the number of people older than 65 will increase from 73 million in 2000 to 104 million by 2025 (+42.5 per cent) and then to 125 million in 2050 (+71 per cent). In contrast, the number of people between the ages of 15 and 64 in the MENA-20 region will increase from 187 million in 2000 to 323 million in 2025 (+73 per cent) and to 417 million by 2050 (+123 per cent). The demographic complementarity between the Western and Central European region and the MENA-20 region should be obvious from this. All the above information is extracted from Holzmann and Muenz (2004), pp. 15–16.
 - 11 Detailed assumptions behind these projections can be obtained from the authors.
 - 12 One reason for a catching-up of some economies in business services is the pressure which Chinese dominance in manufacturing production imposes upon other Asian economies and which makes a specialization on business and financial services attractive to these economies within the context of increasing intra-Asian trade flows. This comes on top of the opportunities which global outsourcing of services represents for countries like India.

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The European Economy in an American Mirror

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