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# CURRENT ISSUES IN EVALUATING STRUCTURAL REFORMS WITHIN THE LISBON PROCESS

comments and recommendations about the  
Lisbon Methodology (LIME) Working Group

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## **Current Issues in Evaluating Structural Reforms within the Lisbon Process**

by

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In 2005, shortly after taking office, the Barroso Commission replaced the failed Lisbon process initiated in 2000 (Lisbon 1) by a new one (Lisbon 2) which gave centre stage to the National Reform Programmes (NRPs). A year later, in a paper written at the request of the Austrian Presidency, Jean Pisani-Ferry and I critically reviewed the new process and concluded that “the outcome is mixed at best”. In particular, we emphasised that “There is no explicit methodology behind the evaluation of the NRPs by the Commission.”<sup>1</sup>

The criticism, which we voiced at a presentation to the ECOFIN Council meeting on 14 March 2006, has clearly been heard and is now being acted upon by the Council and the Commission. Indeed, the Economic Policy Committee (EPC), which contributes to the preparation of the work of the ECOFIN Council and provides advice to the Commission and the Council, recently established a Lisbon Methodology (LIME) Working Group with a view to remedying the problem we identified.

I was delighted therefore to be invited by LIME’s chairman, Lorenzo Codogno, Director General at the Italian Treasury, to give the kick-off address at the first meeting of the Working Group on 1 February 2007.

I started my presentation by praising the Commission services for the impressive amount and quality of work contained in the documents distributed for the meeting, which I thought augurs well for the future of the Working Group. I then proceeded to make three remarks based partly on the content of these documents which, in my view, would need to be reflected upon by the Working Group.

First, the goal of the Working Group is to devise a methodology for analysing the economic effects of structural reforms. There is a real danger that, in practice, this seems to be understood as referring only to the impact of structural reforms on macroeconomic indicators such as GDP growth and employment. However, while such indicators, and growth and employment in particular, are indeed at the centre of Lisbon 2, one must not lose sight of the fact that structural reforms are microeconomic policies which first and foremost have microeconomic effects. This suggests two issues worth thinking about. It seems important to begin the evaluation of structural reforms by focusing on their microeconomic effects. This means that before measuring the impact of specific product or labour market reforms on growth and employment it would be important to measure their impact on the functioning of the relevant markets. And great care needs to be taken in trying to evaluate the macroeconomic effects of structural reforms, since these effects work indirectly through microeconomic effects. In particular, this means that using a macro-model to assess the impact of structural reforms requires a careful modelling of the intermediate microeconomic effects.

Secondly, the Working Group should draw a parallel between the EU’s Lisbon Strategy and the OECD’s ‘Going for Growth’ exercise. After all both exercises seek to advise more or less

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<sup>1</sup> See Jean Pisani-Ferry and André Sapir, “Last Exit to Lisbon”, *Bruegel Policy Brief* 2006/02, March 2006.

the same set national governments on more or less the same structural reforms. It is important, therefore, to identify and to understand where and why the advice of the Commission and of the OECD Secretariat differ. There is, however, a fundamental difference between the two exercises that relates to the political nature of the European Union. The OECD is simply a club. The EU, on the other hand, is a political system where Member States share a number of common policies that imply a major EU dimension in the process of structural reforms which needs to be addressed.

The question of reform interdependence within the EU has two dimensions. On the one hand, there is the fact that some reforms take place at the national level while others take place at the EU level. With respect to product and financial market reforms, it is not possible or even desirable to look at reforms in each Member State without taking into account the interaction with reforms undertaken by the EU, in particular in the context of the single market. On the other hand, there are spillovers between Member States that derive from their economic interdependence. This is especially the case for the countries in the euro area that share a common currency and therefore a common interest rate and a common external exchange rate. Reform interdependence is at the heart of the Lisbon Strategy and needs to be factored in when devising the methodology for evaluating structural reforms. This is no doubt an intellectual challenge but it is one that demands serious attention.

Finally, there is the question of complementarities across reform areas. There is always a danger in policy reform exercises of treating reform not as a package but as a series of unrelated measures. In the context of Lisbon there are two illustrations of this danger. The first consists of treating productivity and employment separately. One of the aims, perhaps even the central goal, of Lisbon is to increase the EU's GDP per capita, which has remained at 70 percent of US per capita GDP since the early 1970s. Many, including the Commission services and the OECD, find it useful to express GDP per capita as the product of GDP per hour worked (productivity) and the number of hours worked per head of total population (the labour input). This is obviously a correct breakdown. However what is not correct is to treat the two terms, productivity and the labour input, as independent of one another. During the period 1975-1995 productivity increased more rapidly in Europe than in the United States but labour input increased much slower, so much so that altogether EU GDP per capita remained flat compared to the United States. The opposite occurred during the period 1995-2005: labour input increased faster in Europe than in the United States but productivity increased slower by the exact opposite amount and again EU GDP per capita remained at 70 percent of the US level. What happened is that during the first period part of the gains in productivity came from decreasing the labour input (ie shedding low-productivity labour), whereas during the second period part of the slowdown in productivity came as result of increased labour input and the hiring of low-productivity labour associated with labour market reforms. In other words, *measured* labour productivity and the labour input are related to one another and therefore labour market reforms affect not only the labour input but also productivity. The goal of the Lisbon Strategy is, obviously, to increase both productivity and employment, not to substitute one for the other.

The second illustration concerns R&D and innovation. The Lisbon Strategy has often become associated with the objective of raising the share of R&D expenditure in EU GDP to 3 percent. This objective, however, is not directly under the control of public authorities since a large share of total R&D expenditure is private. True private R&D expenditure is partly related to public R&D expenditure but it depends even more on other factors which also depend on the behaviour of public authorities but that are more difficult for them to influence

than public R&D. And even public R&D expenditure is not simple to increase since it requires not public funds but also highly skilled personnel which may be lacking. This implies that the R&D objective must at the very least take into account reforms of higher education systems.

In conclusion, I would like to emphasise the importance of the work undertaken by the LIME Working Group. The success of the Lisbon Strategy depends crucially on two factors: the partnership between Member States and the Community institutions, in particular the European Commission, and a clear definition of objectives and instruments. The EPC is uniquely equipped to handle both challenges since it brings together expertise from the Member States and the Commission (as well as the European Central Bank). Since time is of the essence for the credibility of the Lisbon Strategy, the LIME Working Group should deliver its conclusion by the summer of 2007 so that it may be used in the next cycle of Lisbon evaluation that will start in the autumn.