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Lisbon Five Years Later

What future for European employment and growth?

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Abstract
At the Lisbon summit of 2000 the European Union (EU) set an agenda for making Europe the most competitive economy in the world. The targets that were set then are unlikely to be achieved. European countries need to concentrate on change in the lower productivity, more labour-intensive service sectors of the economy to improve their poor employment performance.

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Lisbon Five Years Later

What future for European employment and growth?[1]

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The Lisbon agenda

The Lisbon agenda of 2000 was an ambitious agenda for making the European economy the most competitive economy in the world. It was accepted with unanimity by European leaders and has been applauded as a major breakthrough in European integration. But was it realistic, and could anyone be expected to disagree with it? The objectives that it put forward are objectives that every country in the world should have, as a matter of routine. It was essentially an agenda for increasing the wealth of European nations, one with which no politician could disagree. The key questions that will concern students of European integration in the years to come is why did our leaders decide to put their reputations on line and proclaim such an ambitious agenda for Europe? Why were such specific detailed targets set, a practice not common with politicians that come under regular public scrutiny by an inquisitive press? And why was it done at European level and not at the national level, according to each country's preferences and needs?

The experience of the five years that followed Lisbon proved that the agenda was over-ambitious. It may also have given a hint why politicians were prepared to risk their reputation on such specific targets: precisely because it was done at European level. As far as I know, no national politician has been voted down or re-elected on the basis of his or her record vis-à-vis Lisbon. Normally, if Europe is an issue in national elections, it is in connection to the relations between the country in question and the European Union; not in relation to how well the country is doing within an agreed European agenda.

In the words of Wim Kok, who in 2004 headed a High-Level Group on the Lisbon Strategy, the strategy was a kind of "Christmas tree", consisting of over one hundred targets, sub-targets and indicators (in a speech to the Munich Economic Summit, May 2005). The conclusions of the Group were that the Strategy was indeed over-ambitious,

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setting as its primary target the overtaking of the United States as the leading knowledge-based economy in the world. In the five years since Lisbon Europe continued to lag behind the United States, with the gap widening, and dynamic Asian economies have been getting closer to it. The Group emphasized the more sober objective of an economically strong Europe that was also socially responsible and environmentally sustainable. The key objectives were more growth and employment, because a Europe with more wealth is also more capable of supporting better social programmes and a better environment.

My focus in this presentation will therefore be growth and employment. The targets of the Lisbon Strategy are well known: by the year 2010 the European Union should have employment rates for the working-age population (15-64 years) as close as possible to 70 per cent, for women at least 60 per cent and for the age group 55-64 years 50 per cent. As the main driver for growth the Strategy set a target for R&D spending of at least 3 per cent of GDP, with two thirds or more done by the private sector. Although the targets were set at European level, the policies needed to achieve them have to be set at the national level. The evaluation process is also done at national level, and league tables of member states' performance vis-à-vis the targets are regularly published.

The Lisbon Strategy's targets for growth and employment are not likely to be achieved. Progress has been slow, and a comparison between European countries post-Lisbon and other OECD countries does not give one the impression that there is something different about the European countries (see figure 1). As shown in the figure, although some countries improved their employment performance, in the first five years since Lisbon no country that was below the 70% line in 1999 progressed sufficiently far towards the line by 2004. In fact, when it comes to specific measures designed to achieve the growth and employment targets, the Lisbon agenda does not appear to have had an impact on national policies. There has been a lot of talk and a lot of support for the objectives, but not much direct action, at least not more than would have been taken by a responsible government faced with the challenge of economic survival and growth in a rapidly globalizing world.

Because of the failure to address the issues raised by the Lisbon agenda, there are frequent calls for reinvention of the process. New policies and a new focus are constantly sought. But the problem with the Lisbon process is not lack of knowledge of what policies can work. The problem is related to implementation. The European Employment Strategy of 1997 already had several specific measures designed to increase job creation. The OECD has repeatedly emphasized increased flexibility, adaptability, active labour market measures towards the unemployed and lower taxes, for at least those at the lower end of the wage distribution. Similar recommendations were included in the report of the European Employment Taskforce, which reported in 2003. There is abundant knowledge of what is needed, if anything too much is written about what is needed and too little on how to put policies into practice. The reason might be that the types of policies needed are universal, they apply to all countries. But the processes needed to implement them are not common; they need to be decided at the national level, within the context of the institutions and objectives of the national government, which is much more difficult. And there are likely to be objections from many stakeholders who have vested interests in the status quo.

I do not have the knowledge and it is not my objective to look at each member's labour market performance and recommend specific measures for reform in individual countries. I will instead review policies that can be in principle effective in achieving the overall employment objectives. The adaptation to individual country needs will have to be done at the national level. A novel feature of my approach is that it puts policy in the context of the dynamic evolution of the economy, in a world of fast technological progress and increasing international competition. I consider it important to understand the underlying causes of low employment in Europe within the context of economic development and growth, before a policy prescription can be made.

The connection between growth and jobs

I will argue that although the emphasis in the Lisbon agenda is on the knowledge economy and on high-tech jobs, much of the job expansion that is needed to satisfy the Lisbon employment objectives will be in labour-intensive sectors of the economy, which experience low productivity growth. So job creation is not likely to be the main contributor to growth. The link runs the other way: more growth will bring job creation. There is evidence that increasing the growth rate of labour productivity, either through capital accumulation or through total factor productivity growth, increases the demand for labour, reduces unemployment and increases participation. In research that we did at LSE we found that increasing the growth rate of TFP by 1 percentage point reduces unemployment by about 1.3 percentage points (Pissarides and Vallanti, 2004). Such changes in the growth rate of TFP in Europe are feasible, given the low starting points.

High growth is not spread uniformly across the economy. Inevitably some sectors will grow faster than others. The knowledge economy that is emphasized in the Lisbon agenda is the high-tech sector that is the driver for growth. But it is not the main job creation sector. High growth usually does not create many jobs in the sectors that experience it. It creates wealth and this wealth creates demand for services elsewhere. The jobs growth that comes with productivity growth is more widespread through the economy than the productivity growth itself, and usually more heavily concentrated in low productivity sectors, such as retail trade, community services, medical care and the like. Of course, the people who take these jobs still need to be compensated sufficiently to give them the incentives to enter employment. High compensation in the low-growth sectors is achieved through high prices for their final products, not through more productive use of resources. This is why we experience more price inflation and more job creation in low-productivity service sectors, a process sometimes known as Baumol's cost disease (Baumol, 1967; Baumol et al, 1985).

The European jobs deficit

How can we tell that most jobs will be created in the low-productivity sectors? First, in the recent history of Europe employment has been moving out of agriculture and into the low-productivity service sectors, with manufacturing showing either a small fall or no change. In countries which completed earlier the transition out of agriculture, such as Britain and the United States, the subsequent transition was mainly out of manufacturing and again into services. Importantly, however, although average hours of work decline with economic development, there is also pressure in these countries for an increase in the participation rates of women of working age, especially those aged 15 to 50 years. So historically, European countries should expect that given their small agricultural sectors, there will be pressures on their manufacturing sectors to contract as well, and pressures for an increase in women's employment rates. The pressures on manufacturing to contract are likely to intensify with the emergence of large Asian manufacturing producers. Trade and export-led growth can provide a cushion for manufacturing, as it happened with Japan and Germany in the last thirty years, but it is not likely to continue in the future. Europe has to face the reality of the dynamics of the 21st century: most employment growth is likely to come to service sectors that do not rely on high-tech knowledge or trade. But in some ways this is good news for the employment objectives of Lisbon. The economic forces in Europe should be creating demands for job creation in sectors of the economy that can easily be met with the existing human capital stock of each country.

Creating demands, however, is not equivalent to creating jobs. The United States is the most advanced country in the dynamic economic process that I described. Its manufacturing sector is shrinking and service employment rising. Female participation is also rising. As a result, the main gaps in employment now between European countries and the United States are in service employment. Production industries and agriculture occupy more or less the same fraction of people in most economies, with some small differences. Can Europe expect a similar dynamic evolution as the one experienced by the United States, and so can it sit back and wait for the natural economic forces to satisfy the Lisbon objectives?

This is a difficult question to answer, but given the different performance of countries within Europe, despite their similar level of economic development, the answer is probably no, at least in the foreseeable future. Big gaps remain in employment between Europe and the United States, and within Europe, mainly between the north and the south. These gaps are mainly in business services and community services. Figure 2 shows the gaps in the two types of services. The main gaps are in business services, with only Britain surpassing the United States because of its large financial sector in the City of London. But there are also substantial gaps in community services, with the exception of the Scandinavian countries (Sweden and Denmark), which have many community services supported mostly by the state.

Figure 3 decomposes the employment gaps in the business sector. Here we find the biggest gaps in retail and wholesale trade. There are also gaps in financial services, mainly in business services connected with real estate and in the provision of a variety of other services to employers. The biggest gaps in financial services are in the southern European countries. The third sub-sector in the business group includes transport and communication but gaps here are small.

Perhaps the most interesting figure in this group is figure 4, which looks at employment growth in the business services sector. Over the last thirty years European countries have been achieving good rates of growth in finance, real estate and insurance services, which include high-tech computing services. But they have not been able to match the US rate of growth in the retail and wholesale trade sector, which is the one characterized by lower productivity growth in this group.

It is apparent from this analysis that the jobs deficit in Europe is in sectors which are labour-intensive with low productivity growth. Europe has been creating jobs in the “knowledge” sectors at a comparable scale to the United States, although it has not substantially closed the gap yet. But the low-growth sectors in the United States attract big numbers of workers, especially women, which is not matched in Europe. Compensation in these jobs is good in the United States because the prices of their final products are relatively high. The fact that consumers can afford to pay the high prices is itself the result of more employment. When women leave the home to take employment they create demand for market services such as cleaning, food preparation and child care, which creates more jobs for other women.

Why are European economies not creating so many jobs?

The same pressures for an increase in the consumption of business and communal services are present in Europe. Europe has more or less caught up with the United States in productivity per hour, although, because Americans work more hours, income per head is higher. But do Americans really work more hours than Europeans? Americans work more hours in the market, and so create more jobs, but they work fewer hours at home. In recent research on the hours worked by Americans and Europeans, Freeman and Schettkat (2005) concluded that they work approximately the same number of hours, but Europeans work much more in the home than Americans do – see table 1. The difference between market and home allocation is particularly marked for women. European women work on average 8 hours less than do American women in the market, but they work 10 hours more in the home. They do more house maintenance, they cook more at home and they look after relatives. They are engaged in "home production", something Americans do much less. The Lisbon agenda wants Europeans to move to the market, to "marketize" their home production. I leave to one side the question whether this is a good policy to encourage, and address the question how can it be done?

The natural conclusion is that in order to increase employment in Europe we need to make the market more accessible to women, who now shy away from market work, and we need to create good jobs in labour intensive sectors of the economy. It is interesting, and encouraging for Europe, that the sectors that lag behind the United States in job creation are female-friendly sectors: retailing, restaurants and hotels, and community services, such as childcare and nursing care. Men need not be displaced from their current jobs in order to make room for women in the labour market.

An explanation why the market pressures that have given rise to more employment in the United States have not had the same impact in Europe runs as follows. Consumers work out the relative cost of buying some services in the market versus providing them at home. When the price of market goods relative to per capita incomes is lower more households will choose to use the market for services that have close substitutes in the home. So in order to understand why Europeans use the market less than do Americans we need to look at the factors that influence the relative costs of buying in the market versus producing at home.

There cannot be large differences in the cost of producing services at home in Europe and America. Consumer durables are widely available and homes are as well equipped in Europe as they are in America. The factors that can explain the differences in employment patterns in Europe and America must be in the returns to market work and in the cost of buying services from the market. The interpretation of these costs must be general, to include convenience factors and not only prices and wages, although prices and wages are important too. Several factors can be contributing to making the products of market work in Europe too expensive for consumers, and market work itself unattractive for workers. The two factors are, of course, interconnected. If there are features that make market work unattractive they could be offset by higher prices for the final product; but higher prices would then choke off demand and so reduce employment.

What can make market work more attractive?

The key question for Lisbon then is what can make market work more attractive? And especially more attractive to women?

First, there are various restrictions on market work, which, although individually may not appear very important, when aggregated they add up to a lot. I include here, flexibility in market work hours, flexibility in shop opening times, and the availability of inexpensive child care services (see Freeman and Schettkat, 2005). These types of facilities make it easier for women with children, and for those without children who have a household to run, to enter employment. Examples of European countries that have liberalized restrictions such as the ones I listed here, and succeeded in increasing female employment to the Lisbon target levels, include the Netherlands and United Kingdom. Both countries have very large numbers of part-time jobs, and, in Britain at least, evenings and weekends are the busiest times in the shops. The Scandinavian countries have also succeeded in increasing female employment. A factor here is the widely available child care, but also the fact that many of the communal services marketized in the United States are provided by the state, which employs large numbers of women.

Another important factor in the employment of women is education. Employment differentials across countries become less at higher educational attainments. Women with university degrees have similar rates of employment everywhere. Of course, it would take long for substantially more women to acquire university degrees and gain employment. But the impact of higher education on women’s employment is not one-for-one. When more women acquire education and gain employment they create demand for the services of other women with less education. There is a multiplier effect of education which brings to the market a larger number of women than the ones leaving college with higher qualifications.

The initiative to increase education in Europe comes from the state. But for it to be effective two pre-conditions need to be satisfied. First, women need to know that jobs will be available and that they would be compensated as well as men’s jobs are. There is legislation in the European Union against discrimination but it is not always effectively implemented (Boeri et al., 2005). Increasing the effectiveness of legislation and making working conditions good for women will certainly improve the chances of the European Union to satisfy the Lisbon objectives. In the United States anti-discrimination legislation has been in existence and given a high profile since the early 1970s, before any European country did it, and it contributed to the expansion of female employment.

Second, highly qualified women need to know that there will be less qualified people around, mainly women, prepared to do for compensation the tasks normally done in the home. This is where childcare services becomes important, but equally important, because they affect larger numbers of women, are the availability of workers who would be prepared to work as cleaners, in restaurants and in laundries. In order to achieve this the European Union needs to think seriously about unskilled migration and its potential contribution to the Lisbon agenda. To bring an example from a smaller country with which I am familiar, in Cyprus employment levels are within the Lisbon targets. Educational levels and female employment rates are unusually high for a Mediterranean country. These rates are supported by large numbers of unskilled immigrants on regulated fixed-term contracts, working in business and community services, mostly domestic service, nursing and retailing. Similar patterns are apparently observed elsewhere: the Pilipino domestic worker has freed many European women from home production and helped her make the transition to the market (see Ehrenreich and Hochschild, 2003, cited by Duflo, 2005)

Making it easier for employers

Job creation needs to be attractive to potential employers too. An obvious policy reform here is that labour markets should be liberalized, especially at the lower end of the skills distribution. This is not new: it has been emphasized in numerous writings by the OECD and the European Commission. But reforms have not been forthcoming at the required speed. The administrative burden on companies, especially on new companies and on small ones, certainly explains some of the gaps in service jobs. Jobs in business and community services are frequently performed within small companies, or by individuals working on their own account. It is important if these individuals are to be attracted to the market that setting up a small company and running it should be easy and inexpensive. For example, there should be one window for completing all the necessary administrative work for a new company, setting it up should be fast and completed within a week, and the company should not be required to report detailed accounts and register for VAT if turnover is expected to be below a certain limit, which should be generous. Direct assistance from the state for new entrepreneurs is also important.

There is good correlation across countries between the severity of barriers to entry and employment. Not surprisingly the correlation is better with business services, which as we saw are dominated by shops and small offices, than with community services, which are mainly related to health and education (see figures 5 and 6). In a more micro study of the French retail sector Bertrand and Kramarz (2002) also found that barriers to the setting up of supermarkets have a negative impact on the local labour market. And other studies done by industrial economists have discovered that unimpeded entrepreneurship helps both in the diffusion of new technologies and in the adaptation of businesses to new challenges. Diffusion and adaptability are important for Europe in a world that combines the two challenges of technological catch-up with the United States and globalization. In fact, in the presence of these two challenges adaptability is more important than R&D geared to new discoveries.

Another obvious factor in the attractiveness of job creation, that has attracted a lot of attention recently, is taxation, which can discourage both employers and employees. The reason for the recent interest is Prescott’s (2002) claim that the entire gap between European and American hours of work can be explained by it. Taxation makes home work relatively more attractive because it is not taxed. But econometric evidence has failed to find a large impact of taxation on employment. There seems to be a divergence between the findings of studies based on computations with simple equilibrium models, such as those of Prescott and Rogerson (2005), and the findings of econometric studies. A criticism that can be made of the computational findings is that they do not distinguish between different types of taxation and the uses to which the tax revenue is put into, which must influence the impact that taxation has on employment. They model taxes as a proportional tax on income from work which is subsequently returned to the worker as a lump sum transfer. This type of tax has the biggest impact on the supply of labour, but it is not necessarily the typical European tax.

Nevertheless, taxation has a bigger impact on economic activity at the lower end of the productivity distribution. Profit margins and net gains from employment are smaller when productivity is lower so a given tax takes a bigger proportional slice of net gain. Low-wage labour and jobs should not be taxed. It is now widely accepted that capital should not be taxed much because it is mobile. If one country taxes it, capital will flee to another. The experience with home and market work in Europe shows that low-wage labour is also mobile, between the home and the market. Based on the same principle, low-wage market work should not be taxed much either. Otherwise it will flee to the home.

What can the Commission do?

As I emphasized, the most important reforms that are needed to achieve the Lisbon targets are at the national level. Not all countries of the Union need the same reforms and it is up to individual governments to look into their own situation and decide what is more urgent. But the Commission can also help. The final question that I want to address is, Is there anything that the European Commission can do other than give advice and exert moral pressure?

The answer is that there is – and although a lot has been done a lot remains to do. The Kok report highlighted five areas of policy that require urgent action. Four of them are firmly in the national domain: encouraging R&D, improving the business climate, improving the performance of the labour market and ensuring environmental sustainability. But the fifth, the completion of the single market, requires largely action from European institutions. The most important steps towards the single internal market were taken in connection with the 1992 process. Integration is important because European companies can take advantage of economies of scale. Prices of goods are generally lower in America than in Europe and the reason is that American companies have better distribution networks and make better use of diversified locations within the United States. Europe can do the same, but it is not doing it yet. The main benefits from European integration so far have been the benefits from free trade. The Commission estimates that in the first ten years of the single market European GDP gained about 1.5 per cent. This is not very much when compared with the annual rate of growth of GDP, in fact it corresponds to about a year's growth. There have also been some gains in job creation but with respect to services, the biggest component of GDP, integration has not yet taken place. The Kok Group rightly emphasizes that efforts towards completing the single market should be stepped up, especially in the liberalization of services. Even financial services are not fully integrated, although there is an agreement that they should be. On paper integration is complete in the goods sector, but the large differences in prices that remain across Europe is evidence that it has not yet fully taken place. However, the limits here may be due to corporate policies and not a matter of national policies. If that is the case the Commission can again take action to improve integration.

Beyond this channel, which is important enough, the Commission has been emphasizing mainly the need for reform and the need for more effort to achieve the Lisbon objectives. But it has not taken concrete action. The failure to take the necessary action at he national level is partly the result of countries not doing what they said they would do, and partly not saying or doing what is needed. The Commission could work out a system or incentives to make countries more willing to take on the necessary measures. For example, it could give some financial compensation for research and other spending which is now financed by national budgets, but which contributes to the Lisbon objectives. Financial aid or incentives have not been tied closely to the Lisbon objectives. If the Commission wishes to accelerate the reform process this is one area through which it could contribute a lot.

Final remarks

I conclude by listing the main claims made in this paper

1. The job creation required to achieve the Lisbon targets will be mainly in sectors with low productivity growth: retail trade, a variety of business services, and community services.

2. European countries have been successful at creating jobs in the “knowledge sectors”, such as financial services, but have been unsuccessful at creating them in the more labour-intensive service sectors.
3. Most new employment will come from women now outside the labour force and it will “marketize” many of the services now done in the home, such as child and other personal care, cleaning, shopping etc.
4. In order to achieve the new job creation employment needs to be made more female-friendly through more flexibility of working hours, more flexibility in shop opening hours and easier availability of domestic service.
5. Education needs to be further advanced and supported by less expensive immigrant labour in the labour-intensive service sectors, including the home.
6. Other labour market reforms include an increase in the flexibility of employment, less taxation of low-wage jobs and less administrative burdens on new entrepreneurs.
7. Finally, it should be apparent from this discussion that the failures of Lisbon are not due to lack of knowledge of the principles behind the right policies, but to lack of urgency in the reform and implementation process needed to put those principles into practice.

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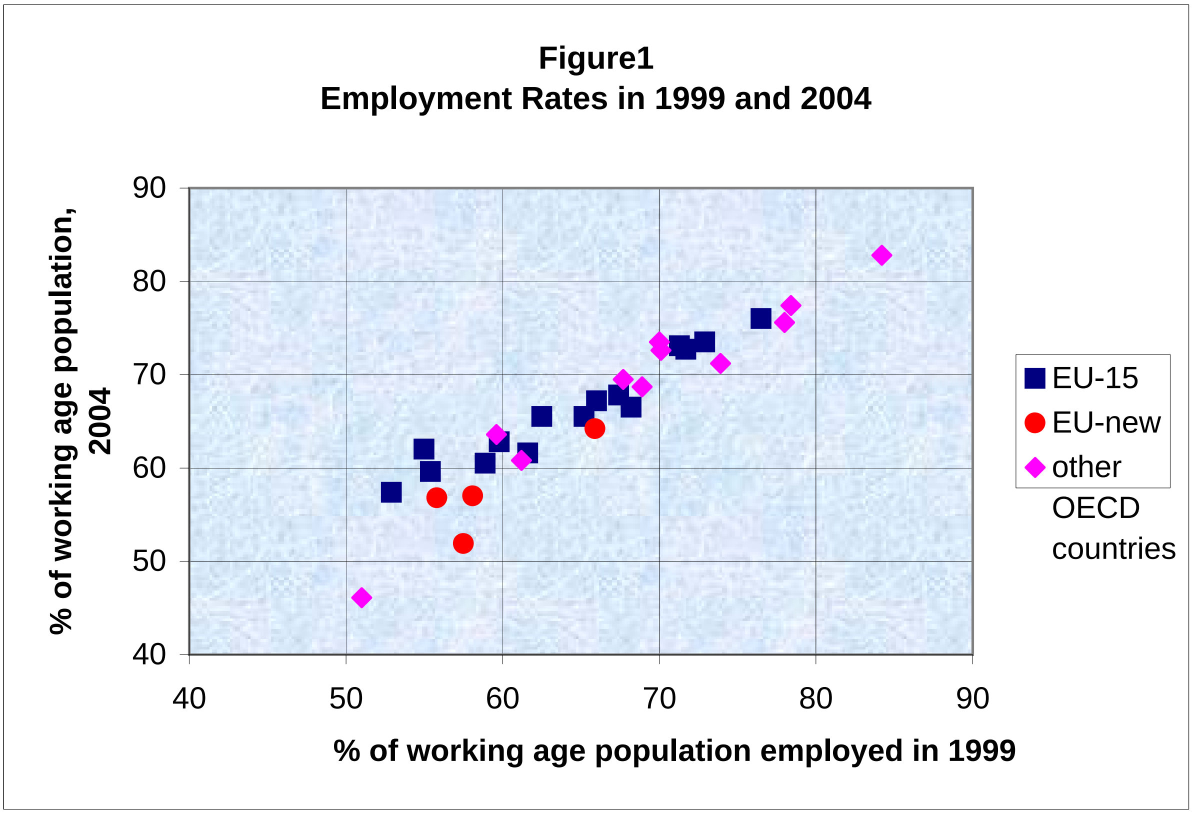
Table 1

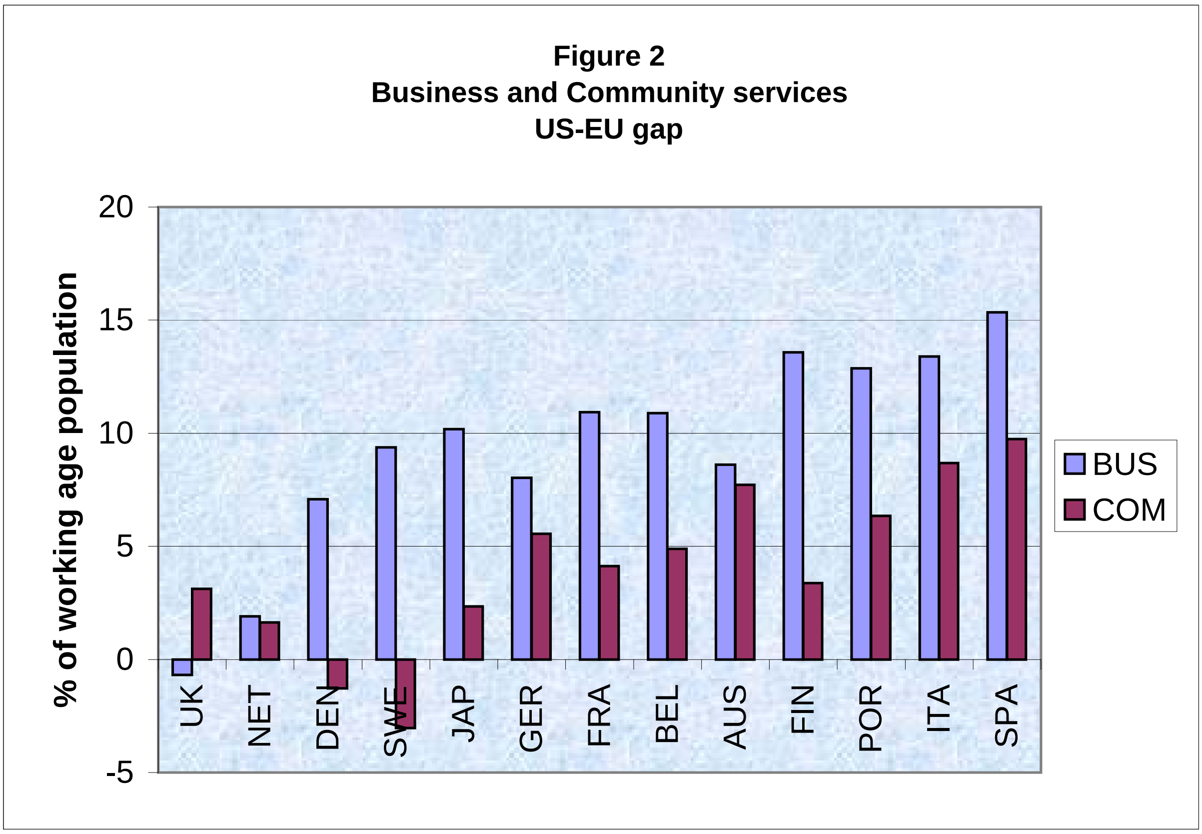
Weekly hours of work, early 1990s, ages 25-54

	men			women		
	market	home	total	market	home	total
US	44.1	16.1	60.2	28.7	30.1	58.8
EU	43.4	13.6	57.0	20.7	40.5	61.2

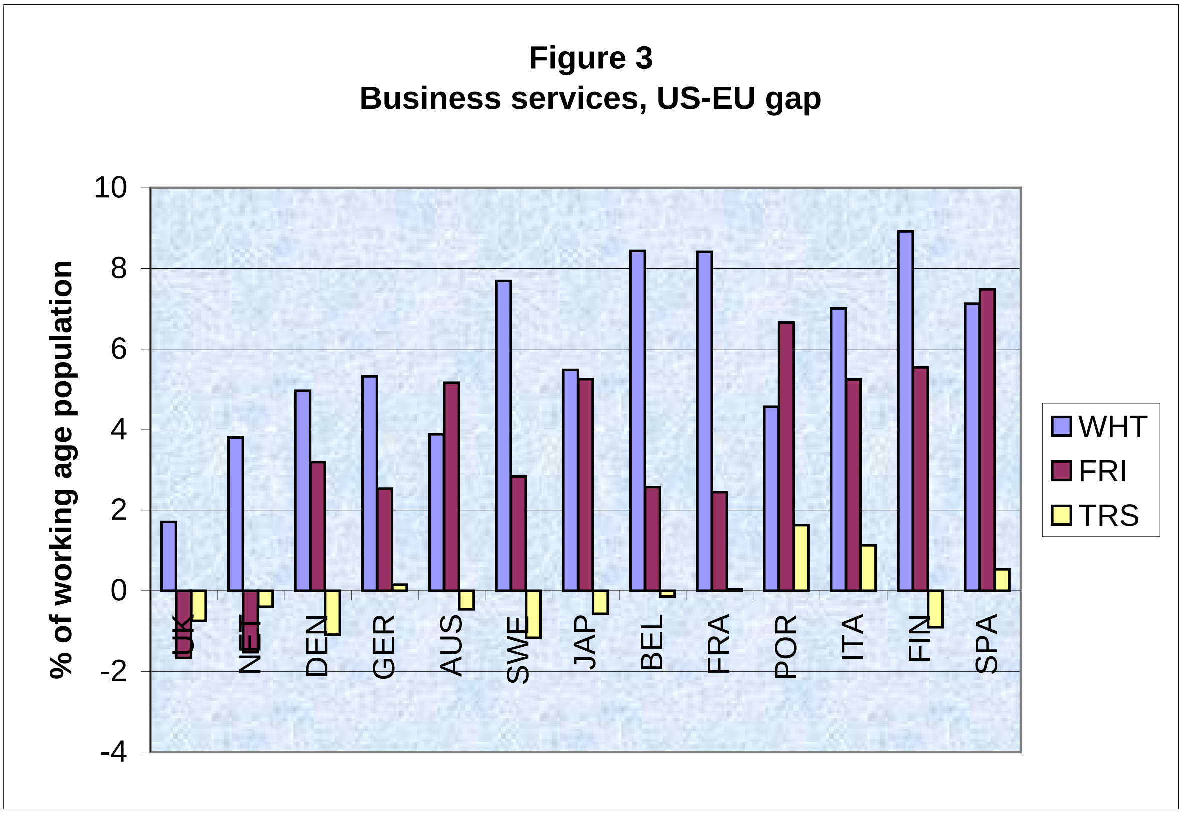
Source: Freeman and Schettkat (2005)



Source: OECD *Employment Outlook*



Source: OECD *STAN Database* (online)



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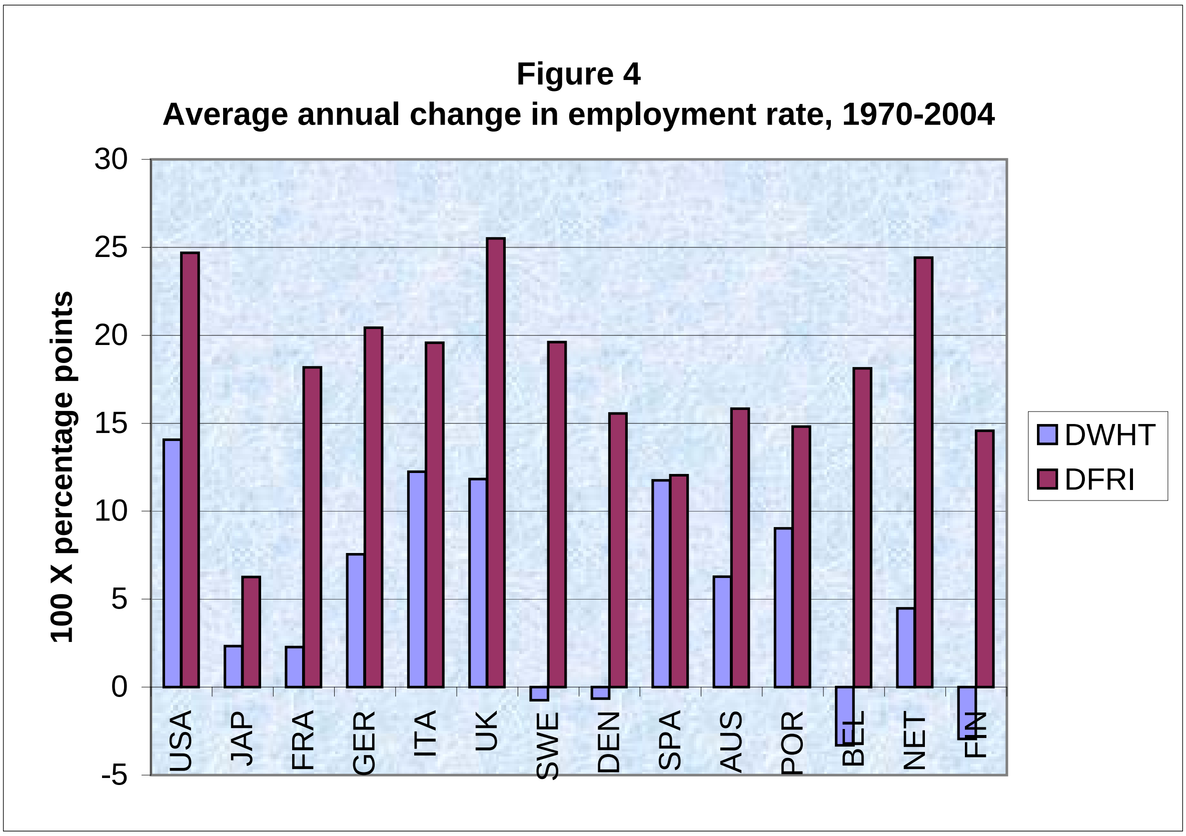
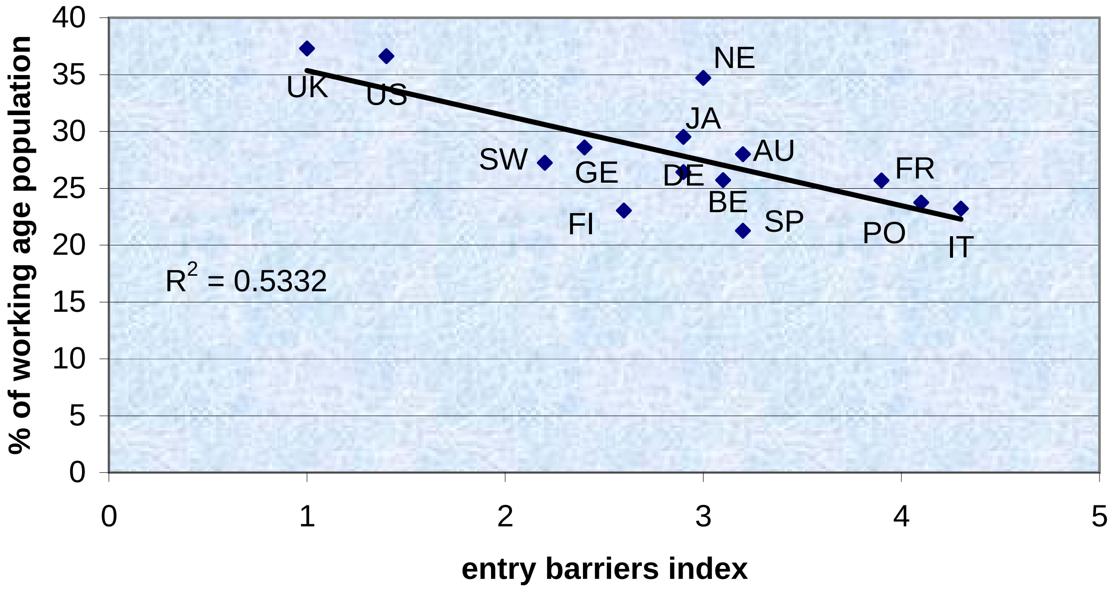


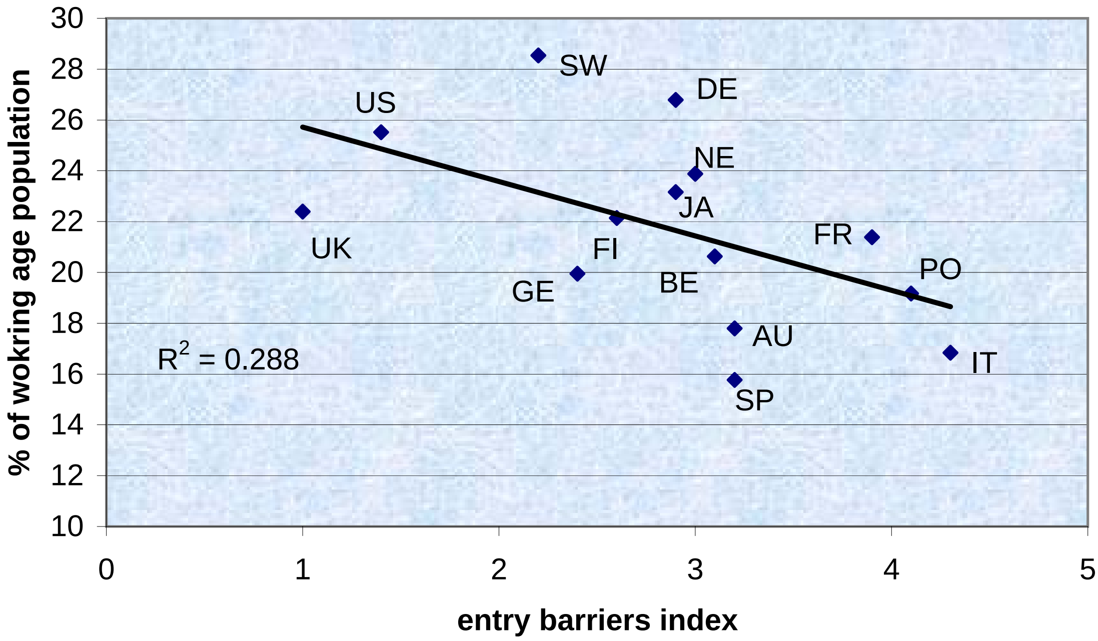
Source: OECD *STAN Database* (online)

Figure 5
Business services employment and entry barriers



Source: OCED *Employment Outlook*

Figure 6
Community services employment and entry barriers



Source: OCED *Employment Outlook*

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