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Patrick Lenain

Is Europe Reforming? Evidence from Cross-Country Structural Indicators

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Contents

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Abstract

With the adoption of the Lisbon Agenda in 2000, the European Union established for itself the ambitious goal of becoming the most dynamic and competitive economy in the world by 2010. Despite initial optimism, the first half of the decade has been dispiriting and targets established under the Lisbon strategy will be difficult to achieve. Many observers have concluded that governments have failed to implement the policies required to achieve these targets and that, without radical changes, the strategy will fail to deliver its promises.

Without disagreeing with these conclusions, the present paper argues that they portray the situation excessively negatively. Using cross-country structural indicators compiled by the OECD, it shows that changes have occurred during the first half of the Lisbon programme, although not everywhere. The first part of the paper reviews recent developments in indicators of labour market policies and labour market performance. It shows that structural policies have moved in the right direction in several countries, notably tax wedges on labour income for low-wage earners and the implicit tax on continued work. This has been associated with a somewhat better labour market performance, notably higher employment rates. As well, the easing of product market regulation, which is deemed to increase the competitive pressure felt by firms and incite them to invest and innovate, has been associated with faster productivity growth in some countries and some industries. Nevertheless, the heterogeneity of performance across countries suggests that there is still a large room for countries where reforms are less advanced to adopt good practices. In these countries, more comprehensive implementation of labour market and product market reforms is needed to mobilise unused labour resources, put productivity growth on a faster trend and accelerate the growth of GDP per capita. Based on this overview, the paper raises some political economy issues related the method of coordination adopted by the Lisbon agenda.

1. Introduction[1]

In March 2000, the European Union[2] established for itself the ambitious goal of becoming the most dynamic and competitive economy in the world by 2010. A variety of measurable targets were set accordingly, from increases in employment to higher spending on research and development. Despite initial optimism, the first half of the decade has been dispiriting and midterm targets established under the Lisbon strategy for 2005 will be difficult to achieve. Over the last five years output has moved in fits and starts, without embarking on a sustained expansion, at a time when other OECD economies, notably the United States, were enjoying a strong recovery from the post-bubble recession. On the labour market, high unemployment has persisted in a number of EU countries. As well, trend labour productivity growth has declined toward the lowest pace ever recorded during the post-war period. Many observers have concluded that governments have failed to implement the types of policies required to achieve the Lisbon targets and that, without radical changes, the strategy will fail to deliver its promises[3].

Without disagreeing with these conclusions, the present paper argues that they portray the situation excessively negatively. Cross-country indicators show signs of changes occurring during the first half of the Lisbon programme, even though much remains to be done to catch up with best practice countries. The lowering of tax wedges on labour income for low-wage earners and the reduction in the implicit tax on continued work have been associated, for instance, with a somewhat better labour market performance, notably higher employment rates. As well, the easing of product market regulation, which is deemed to increase the competitive pressure felt by firms and incite them to invest and innovate, has been associated with faster productivity growth in some countries and some industries. While this is welcome, more comprehensive implementation of labour market and product market reforms is needed to mobilise unused labour resources, put productivity growth on a faster trend and accelerate the growth of GDP per capita. Recent labour market reforms, such as those recently enacted in Germany under the Agenda 2010 programme, could have a positive impact during the second half of the Lisbon strategy.

The goal of this paper is to describe changes in structural indicators relevant to the Lisbon strategy. No attempt is made here at linking changes in structural policy indicators to economic outcomes, an ambition that would be beyond the scope of this presentation. But the indicators presented in this paper have been shown to have a significant economic impact in a large body of academic and institutional analyses. The first part of the paper addresses the Lisbon goal of fostering employment by reviewing recent developments in indicators of labour market performance and labour market policies. The second part addresses the Lisbon goal of fostering productivity; rather than covering the many policies that have a bearing on productivity, the paper focuses on one particular policy area where the European Union has specific interest, namely the regulatory policies influencing the degree of competition on product markets. The final part takes stock of this overview and raises some political economy issues related the method of coordination adopted by the Lisbon agenda.

[1] The views presented in this paper are those of the author and should not be construed as representing official views of the OECD.

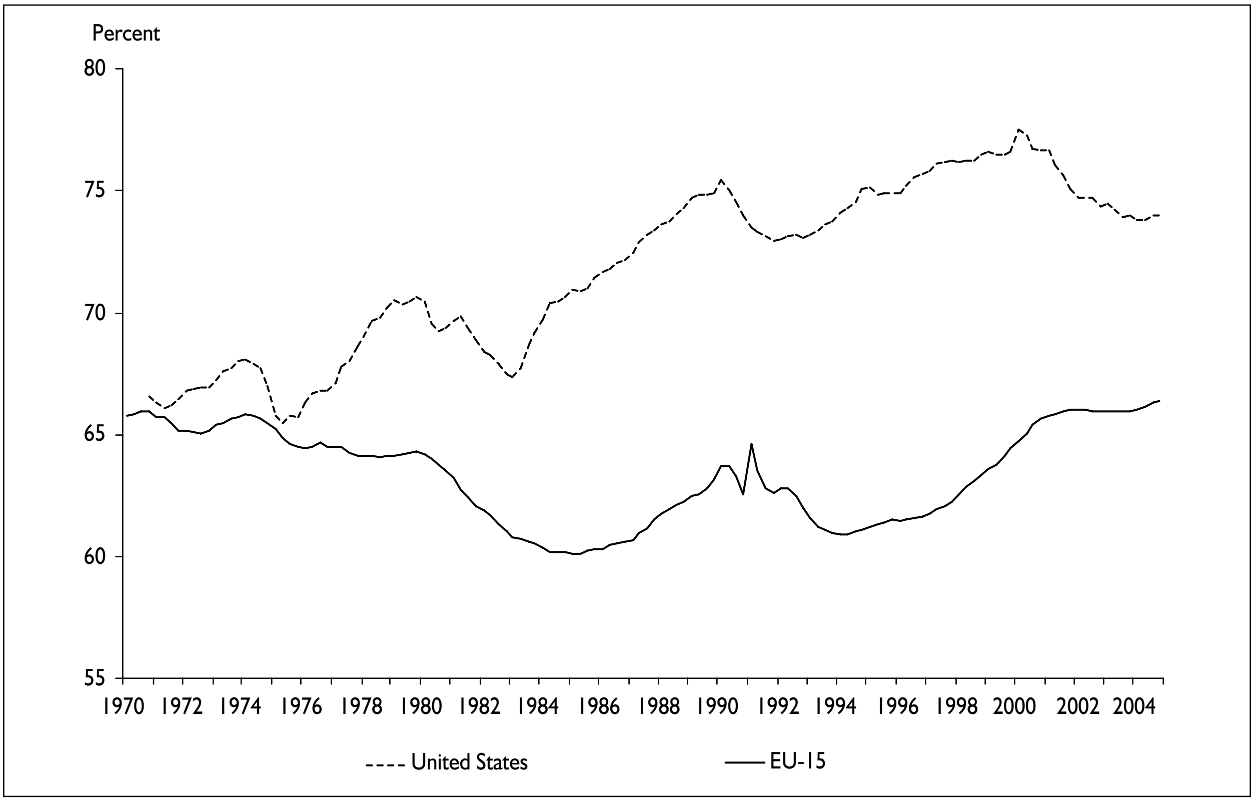
[2] In this paper, the European Union refers to the group of 15 countries that constituted the EU before last year's enlargement. An overall assessment of the EU25 is not possible at this stage due to the lack of OECD data on new member countries.

[3] This includes IMF (2004) and Kok (2004).

2. Recent changes on European labour markets

Fostering the utilisation of potential labour resources is one the main goals of the Lisbon strategy. The strategy aims at increasing the overall EU employment rate from 64% to 70% by 2010, with sub-targets for older workers and female workers. Although midterm targets set for 2005 are unlikely to be met, there

Chart 1. Diverging trends in employment rates



Source: OECD (differs from employment rate calculated by Eurostat).

Table 1. Employment rates by groups of workers

(Share of persons of working age in employment, in per cent)

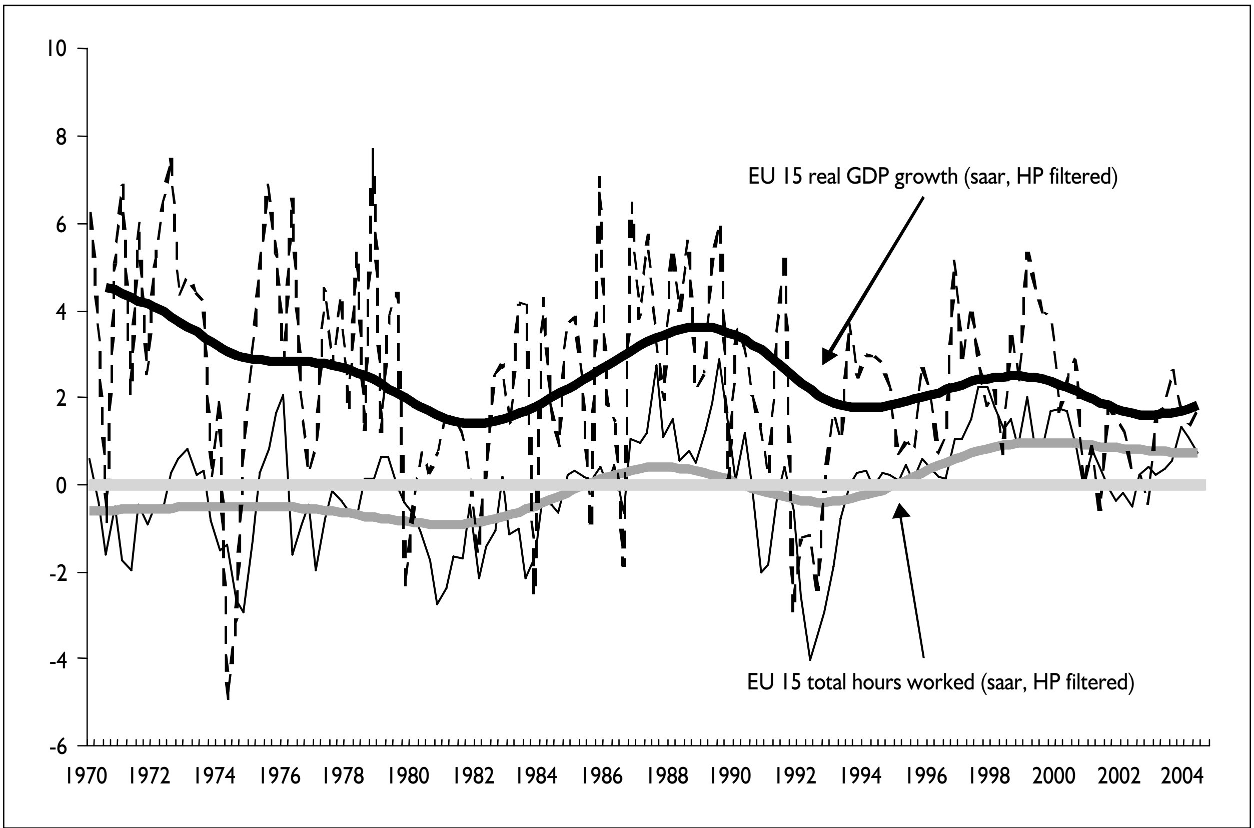
					Lisbon targets	
	1992	1995	2000	2003	2005	2010
European Union						
Total employment rate, of which	61.2	60.1	63.4	64.4	67	70
-- Male workers	72.8	70.5	72.8	72.7	--	--
-- Female workers	49.7	49.7	54.1	56.1	57.0	60.0
-- Older workers (55-64)	36.3	36.0	37.8	41.7	--	50
United States						
Total employment rate, of which	70.8	72.5	74.1	71.2		
-- Male workers	78.3	79.5	80.6	76.9		
-- Female workers	44.6	47.5	50.6	54.5		
-- Older workers (55-64)	53.4	55.1	57.8	59.9		

Source: EU structural indicator database.

are signs that employment trends are slowly changing, as suggested by the increase in the EU employment rate by 4½ percentage points since the mid-1990s (Chart 1). This increase partly reflects a cyclical bounce-back from the severe downturn experienced in the first half of the past decade, but there are also signs that a structural change may be underway. In particular, EU employment was almost unaffected by the recent slowdown of output, whereas large numbers of jobs were lost during previous downturns, and unemployment increased only moderately since the last peak of activity (European Commission, 2004a). This resiliency contrasts with the sharp decline of US employment since 2000, which pushed employment rates down by over 3 percentage points, as discouraged workers exited from the labour market and young people prolonged their transition from school to the job market (Table 1). Although a large gap still prevails between the employment rates of Europe and the United States, this gap may be slowing narrowing.

The fact that a structural change may be occurring can also be seen in the relation between activity and labour input. Chart 2 shows the relation between real GDP growth and total hours worked during the last three decades. In the early-1970s, high real GDP annual growth rates of 4% were associated with a trend decline in hours worked, reflecting the fact that a robust growth of activity did not prevent a decline in labour input. This relation gradually changed and, since the mid-1990s, real GDP growth of 2% has been associated with increase in hours worked of about 1% per year. A structural break in the relation between GDP growth and employment around 1997 was found by recent ECB work (Mourre, 2004).

Chart 2. Growth has become more intensive in labour

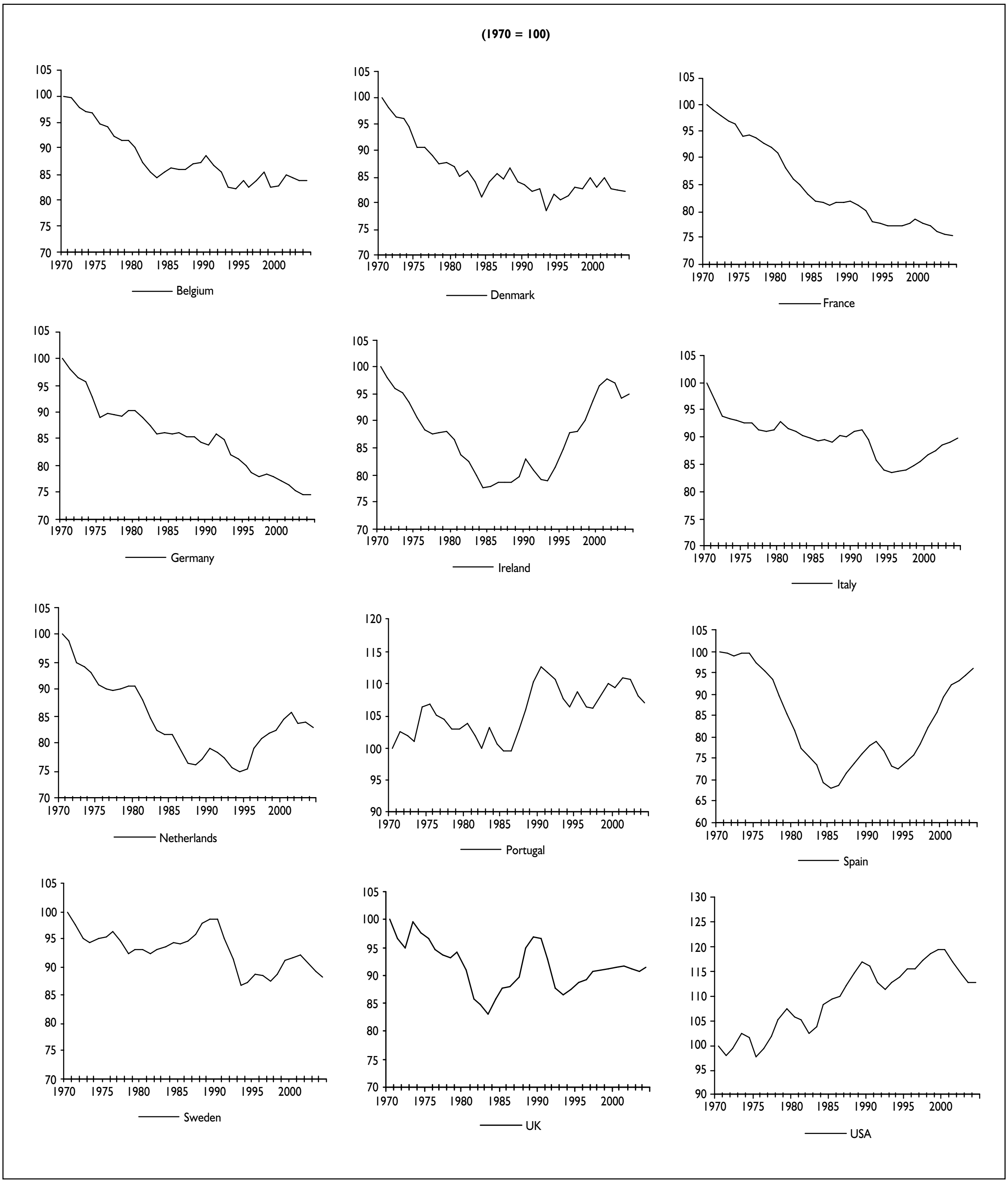


Source: OECD Economic Outlook database

While aggregate labour market conditions have changed in the European Union, significant disparity continues to prevail across countries. The heterogeneity across countries is such that it is preferable to talk about labour market conditions in individual countries, rather than in the overall European Union. Chart 3 and Table 2 show that some countries have never suffered from prolonged periods of high unemployment, apart from temporary cyclical peaks (Austria, Denmark, Sweden). Other countries went through long periods of high unemployment, but have been able to establish conditions propitious to job creation and have brought back unemployment close to 5 per cent (Ireland, United Kingdom, Netherlands). In most of the other countries, the combat against unemployment has been only partially successful and unemployment remains high. In France and Germany, in particular, the decline in labour utilisation has not been reversed as stagnant employment coexists with a shortening of working time.

The persistence of high levels of unemployment has often been associated with the inability of the labour market to adjust after negative shocks (Blanchard, 2004; Blanchard and Wolfers, 1999; OECD, 2005; Nickell, 1997). In countries where the labour market does not adjust rapidly, temporary spells of unemployment tend

Chart 3. A heterogeneity of labour utilisation trends



Source: OECD Economic Outlook database

Table 2. Unemployment rates in EU countries

	1970s	1980s	1990s	2004
Luxembourg	0.3	1.4	2.5	4.3
Ireland	7.4	13.9	11.8	4.5
UK	3.3	9.2	7.9	4.7
Netherlands	2.7	7.6	5.6	5.0
Sweden	2.1	2.5	6.2	5.5
Austria	1.3	3.3	5.2	5.5
Denmark	3.0	6.6	6.9	5.8
Portugal	4.9	7.7	5.6	6.7
Belgium	3.4	9.3	8.5	7.8
Italy	4.7	8.4	10.7	8.0
Finland	3.6	4.9	11.9	8.9
Germany	1.4	5.2	7.3	9.3
France	3.9	9.1	11.0	9.8
Spain	3.4	13.8	15.1	10.8
Greece	1.8	6.6	9.5	11.0
Variance	*3.05*	*13.11*	*10.83*	*5.54*

Source: OECD Economic Outlook database.

to persist and result in high levels of long-term unemployment. By contrast, in countries with well-functioning labour markets, unemployment does not last long, as self-correcting mechanisms, notably lower wage, help to restore the equilibrium. Long-term unemployment does not exercise the same type of pressure on the wage level as short-term unemployment because workers with long duration of unemployment tend to lose their skills and become less employable, and are therefore not seen by insiders as serious competitors. In several EU countries, notably Germany and Italy, more than 50% of the job-seekers are long-term unemployed (i.e. registered for one year or more), suggesting poorly-functioning labour markets and overstretched periods of adjustment. In these countries, the cost of adjustment is likely to be high because insiders will not agree to negotiate lower wages until unemployment reaches very high levels. In other countries (Denmark, Finland, UK, Sweden), the share of long-term unemployment is closer to 20%, suggesting a rapid process of adjustment and well-functioning labour markets. Labour market institutions that encourage a rapid adjustment and a fast return of the unemployed to the labour market are therefore paramount.

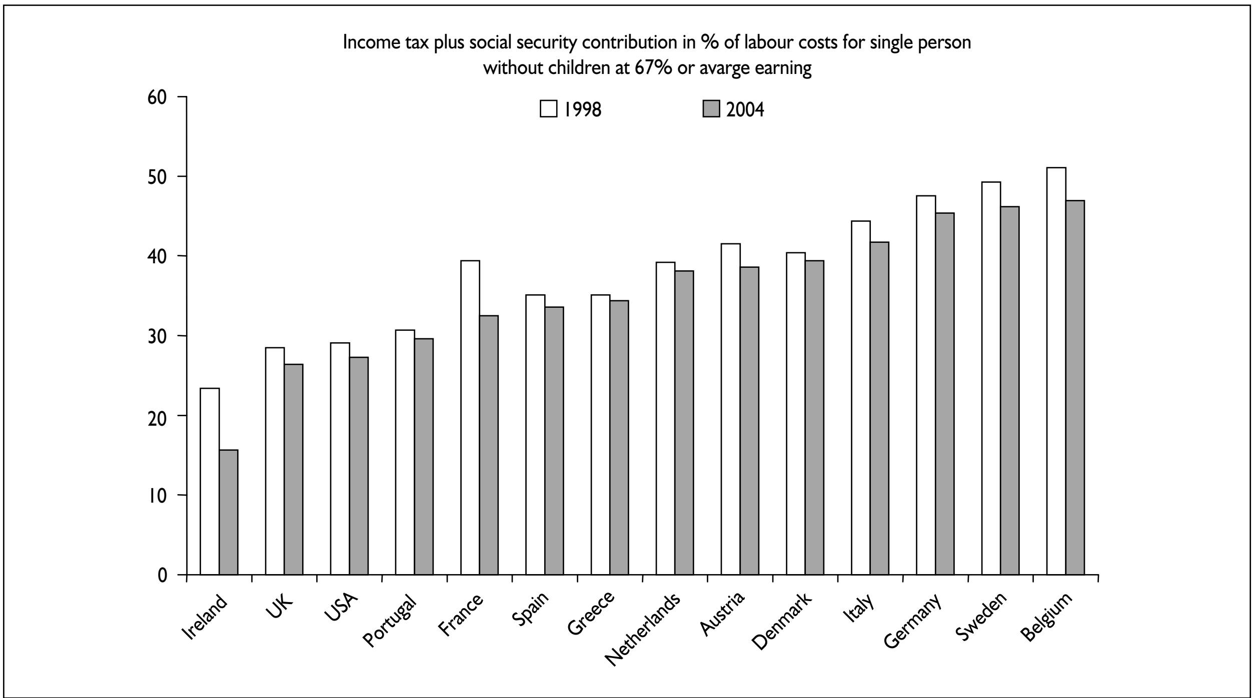
What matters is to find the right balance between the different planks of labour market policies so as to ease adjustment. This goal can be achieved with different combinations of institutions, depending on each country's specific institutional and social norms (OECD, 2004). Thus, labour market institutions can be either job-friendly or job-unfriendly, depending on the overall context. For instance, without adequate accompanying policies, generous unemployment insurance lowers the intensity of job searches and therefore tends to increase the average duration of unemployment spells. However, in countries where it is combined with active job placement policies and low employment protection (such as Denmark and Netherlands), generous unemployment insurance does not impede the search of new jobs and therefore does not increase long-term unemployment. Likewise, high taxation of labour has a particularly negative effect in countries with high minimum wage, which works as a floor on the labour costs for unskilled workers. Hence, the interaction between different features of the labour market plays an important role. The following sections review how individual features of labour market policies have recently evolved, but it is important to keep in mind that their impact is multi-dimensional.

Taxation of low-wage earners

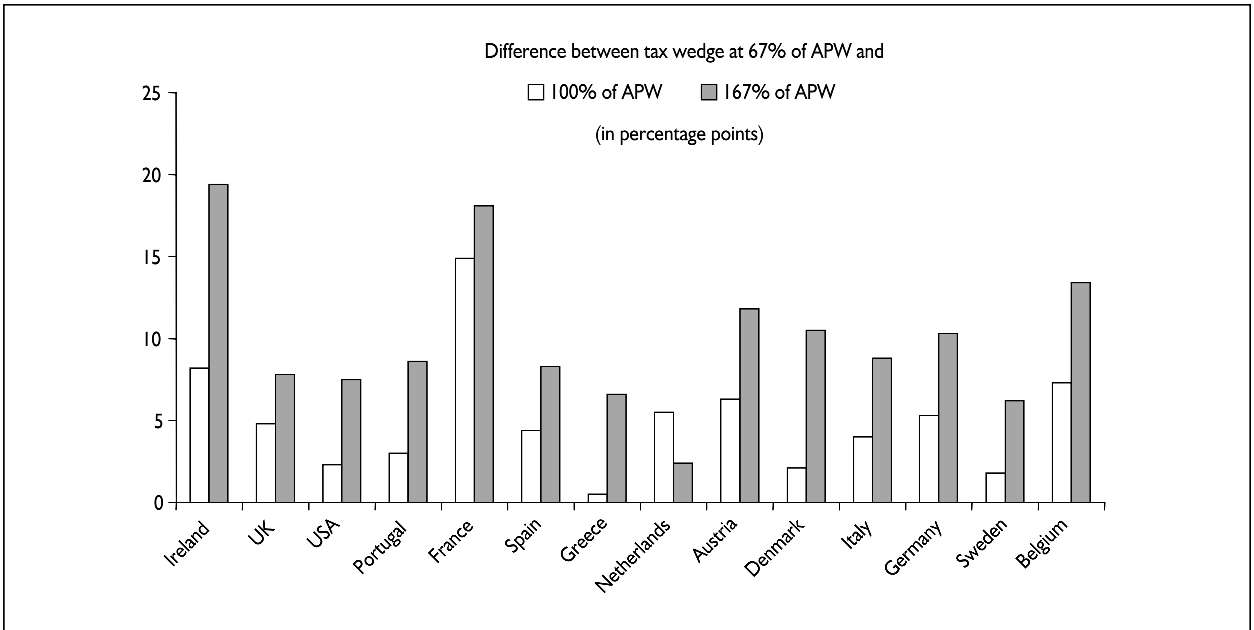
A particularly important category of labour market reform in recent years has been the reduction in labour taxation. High taxes increase the cost of labour inasmuch as workers seek to compensate higher levels of taxes with supplementary wage demands. The effect of labour taxation is particularly large for workers with few skills and little experience because it drives a wedge between their marginal productivity and the cost of their labour. This is particularly the case when a floor is set on the cost of labour by a statutory minimum wage. In view of this, government have sought to lower the burden of labour taxation on targeted categories of workers, notably through cuts in social security contributions and other labour taxes.

Chart 4 uses indicators of labour taxation compiled to measure the tax burden of typical workers at various levels of income and in different family situations. As shown, the taxation of low-wage earners declined between 1998 and 2004 in all EU countries, with more pronounced cuts in Ireland, France and Belgium. The lower chart examines the progressivity of the tax system measured by the differences between tax rates at different levels of incomes. In several countries (notably Ireland and France) the tax

Chart 4. For low-wage earners, the tax wedge has declined



The progressivity of the tax wedge differs across countries



Source: OECD Taxing Wages (2005)

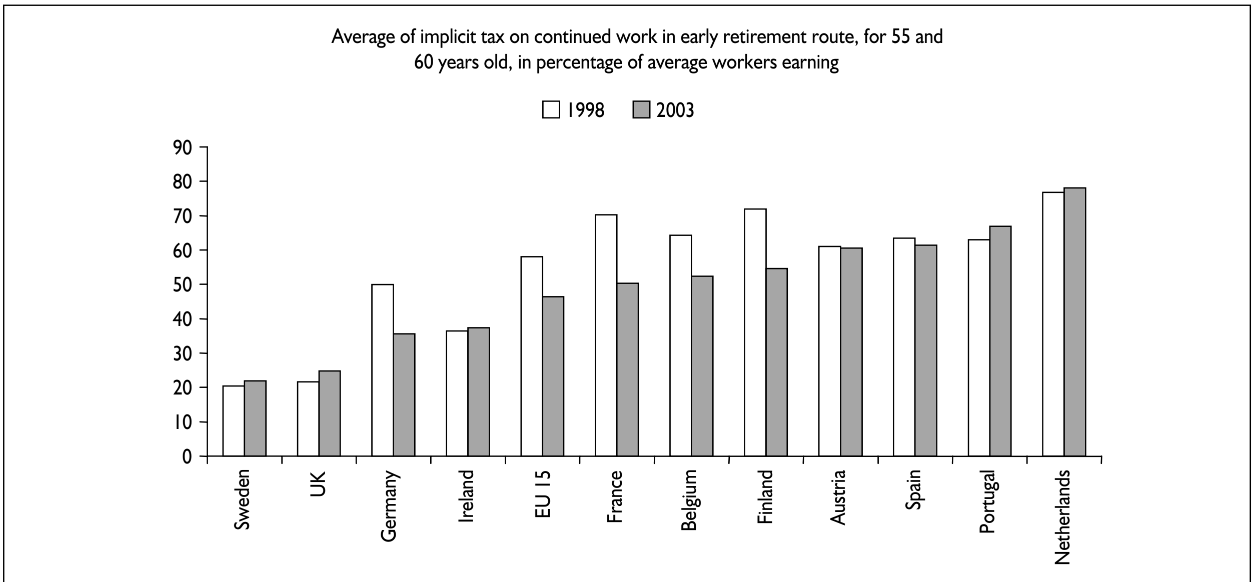
rates are significantly lower on low-wage earners than on average or high-wage earners. In the case of France, however, the cost of unskilled labour is nonetheless the highest in the OECD because a substantial share of the cuts in labour taxes was used to offset very strong increases in the minimum wage.

Financial incentives to retire early

Another important reform in labour market policy has related to the participation of older workers. Past decades saw governments react to rising unemployment with measures meant to encourage the early withdrawal of older workers from the labour force, notably through early-retirement schemes. These schemes, together with traditional features of old-age pension schemes, have been particularly detrimental to the labour market participation of older workers. Retiring early or at the statutory age of retirement entitles the older worker to a number of benefits, while continued work implies deferring benefits without necessarily increasing their levels. The tax and benefit consequences of working beyond the age of retirement have been evaluated by a new OECD indicator, the "implicit tax on continued work" (Duval, 2003). The indicator takes into account the net present value of additional contributions paid in case of continued work as well as the potential increase in pension benefits accrued when workers decide to continue working past the retirement age. Before recent pension reforms, EU workers aged 55-60 faced implicit taxes of nearly 60% if they decided not to take advantage of early-retirement and regular old-age pension benefits. Such high rates of taxation deterred many workers to continue working, severely depressing the employment rates of older workers.

Faced with the prospect of population ageing, several EU governments have reformed their pension regimes so as to restore long-term financial sustainability. These reforms often changed the main parameters of pension benefits as well as the age of entitlement. Together with stricter eligibility to early-retirement benefits, they have lowered the implicit tax on continued work in several EU countries (e.g. Germany, France, Belgium), and the average EU15 implicit tax has dropped from about 60% to close to 45% of income (Chart 5). An example of such measure is the reform of the French pension enacted in 2004, which introduces an element of actuarial neutrality in the pension system and lowers the disincentive to work longer, while increasing the freedom to retire early with a reduced pension. In several countries, sector-specific early-retirement schemes have been closed, thus reducing the financial disincentive of continued work. This decline in the implicit tax has been associated with an increase the labour

Chart 5. The implicit tax on continued work has declined



Source: OECD, Duval (2003).

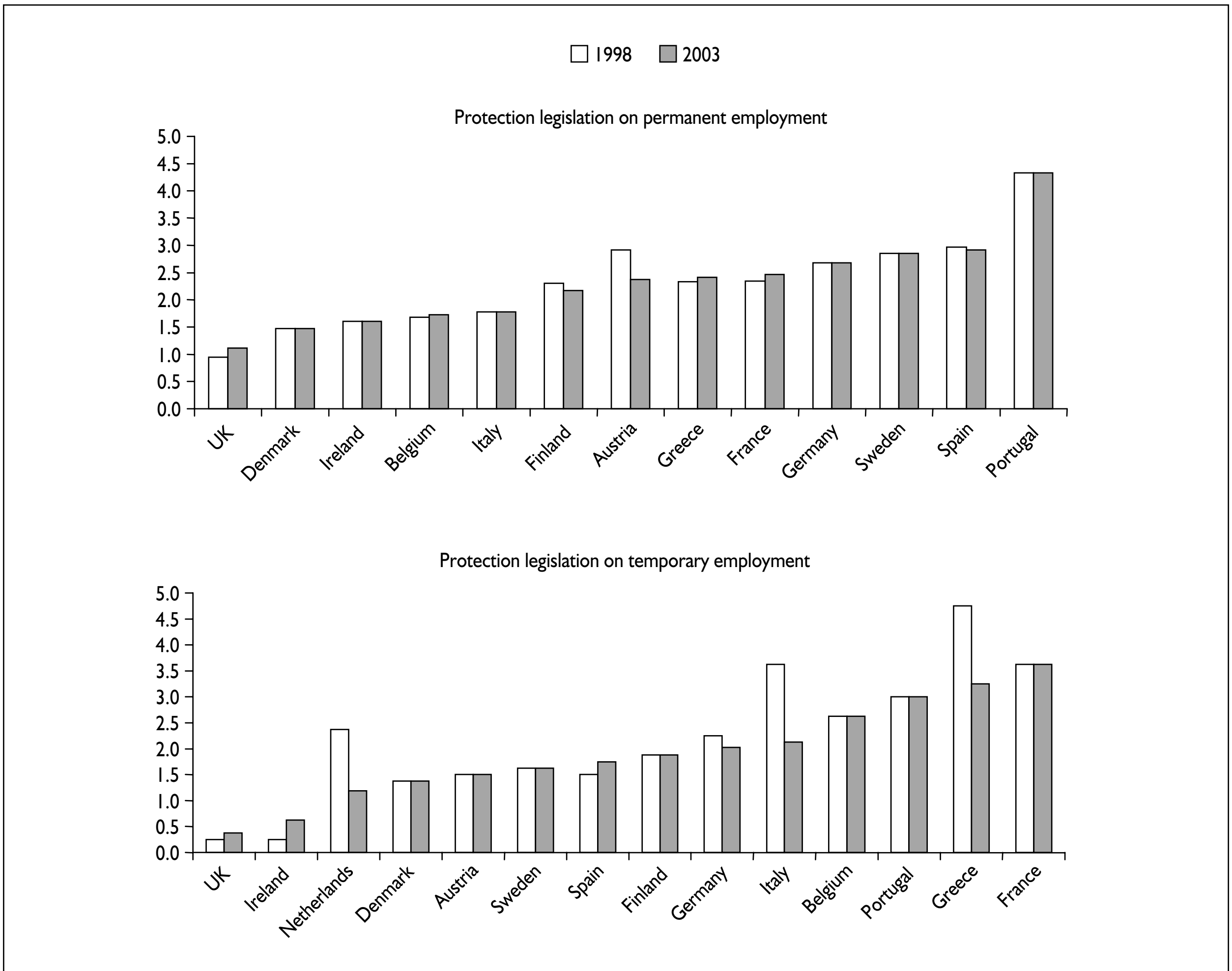
participation of older workers, even though factors other than taxation have probably been at play (notably the increase in life expectancy).

Stringency of employment legislation

Employment protection legislation (EPL) is a third category of labour market policy that limits the adaptability of labour markets. While such legislation is necessary to govern the relations between employers and employees, excessively strict legislation increases the cost, time and legal complexity of dismissing workers. By making it more costly and difficult to make workers redundant, EPL limits the outflows from the labour market, with the negative implication of reducing inflows. Faced with strict EPL, employers will be more reluctant to hire workers, knowing that it will be difficult to dismiss them.

Because it reduces both outflows and inflows, strict EPL has ambiguous effects on employment. What is unambiguous, however, is the asymmetry of effects on various groups of workers. Strict EPL generally protects insiders, but penalises outsiders. Because it lowers labour market inflows, EPL reduces the re-employment chances of jobseekers, making for longer unemployment spells. While skilled and experienced workers are easily employable, they are unlikely to be affected by strict regulation; by contrast, workers with few skills and little experience are likely to suffer because firms will be hesitant to hire them if they are difficult to dismiss. The conventional wisdom is therefore that EPL protects employed workers against the risk of dismissal, but penalises jobseekers.

Chart 6. Employment Protection Legislation is unchanged, except for temporary work

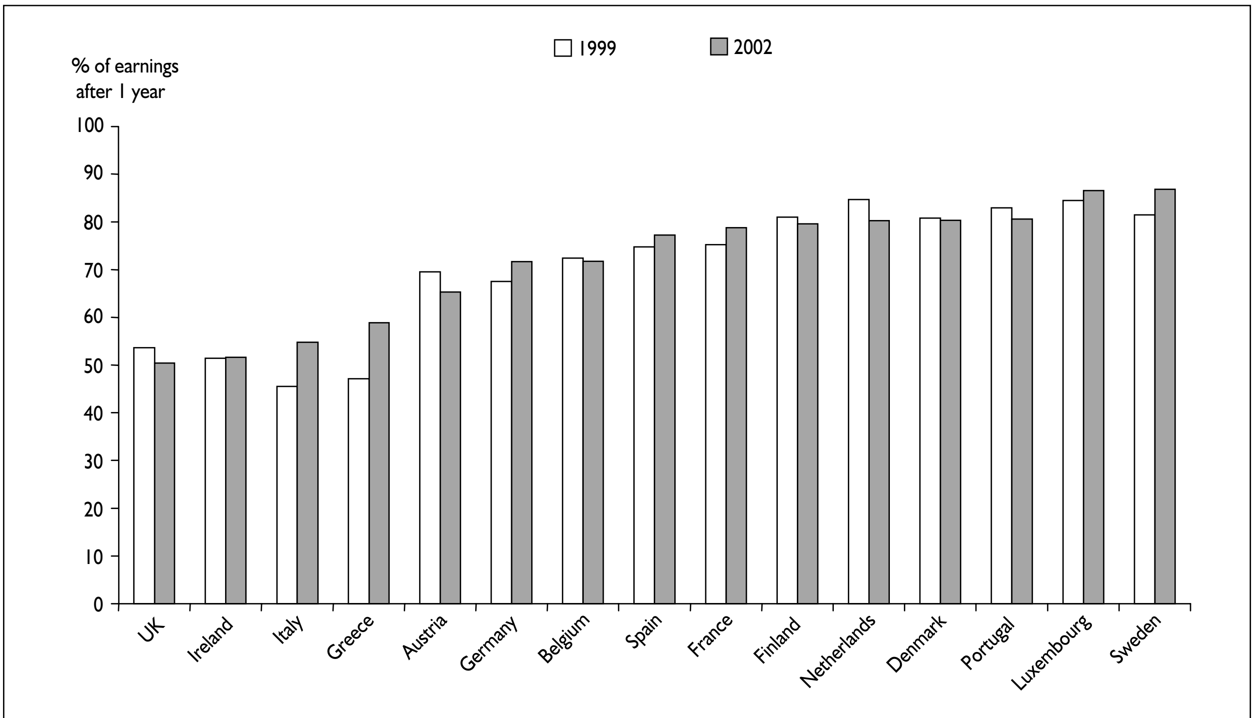


The scale of indicators is 0-6 from least to most restrictive.
Source: OECD *Employment Outlook:* 2004.

In view of the importance of EPL, the OECD has built indicators that compare the strictness of employment protection legislation across countries. The overall EPL indicators combines three components related to the protection of regular workers against individual dismissals, the specific requirements for collective dismissals and the regulation of temporary forms of employment (OECD, 2004). Because these indicators have been compiled with identical methodologies for 1998 and 2003, the change in EPL strictness over time can be evaluated. As shown by Figure 6, the strictness of EPL governing regular employment has remained nearly unchanged in the past five years. The cross-country divergence in EPL strictness that prevailed in 1998 is nearly intact 2003. In several countries (UK, Ireland, Denmark), firms can dismiss workers without having to deal with a costly and lengthy regulatory process, while in other countries (France and Southern Europe) strict EPL makes it difficult to fire workers.

In order to circumvent strict EPL on regular employment, firms may hire workers under temporary contracts, which are in many countries regulated by less strict rules. Chart 6 shows that EPL on temporary contracts has been eased more frequently than EPL on regular contracts. As a result of this divergence, some countries have stricter EPL regimes for regular work than for temporary work. This has been found to encourage labour market dualism because firms can have recourse to regular and protected contracts for skilled workers and temporary contracts for the others (OECD, 2004). Although not an optimal solution, the easing of EPL on temporary workers has helped to foster the creation of temporary jobs; this might be a reason for the rapid increase in the employment rate of female workers, which are over-represented in the group of temporary workers, notably in the services sectors and in part-time jobs.

Chart 7. Little change in income replacement for unemployment



Average of replacement rates for those who earned 67% and 100% of average working earnings.
Source: OECD

Unemployment insurance

In other policy areas, little change can be seen in structural indicators. For example, little change has occurred in the level of unemployment benefits. These benefits, while providing a sense of income security, have the potential to lower search intensity and therefore increase the duration of average unemployment spells. High levels of income replacement may translate into a rigid wage formation process and therefore increase the cost of adjustment in the aftermath of a negative shock. Chart 7 shows the rate of replacement income for unemployment in 2002 compared to its previous measure in 1999. The figure illustrates the great heterogeneity of unemployment insurance policies, with replacement rates ranging from 50% of previous earnings (UK) to nearly 90% (Sweden). Notwithstanding existing evidence that generous benefits encourage longer spells of unemployment and reduce labour market adaptability, few EU governments have attempted to reform them. Little has been done in the most generous countries to cut these entitlements.

The absence of reforms in this area might be explained by the social cost that they would entail, at least in the short-term, as the replacement income of jobseekers would fall immediately, while structural changes in employment trends would take time to appear. This is perhaps why countries have emphasised job placement policies, such as the recent measures under the German Agenda 2010 plan, which limits the duration of unemployment benefits and lower their level, while at the same time increase the resources available for personalised job search assistance.

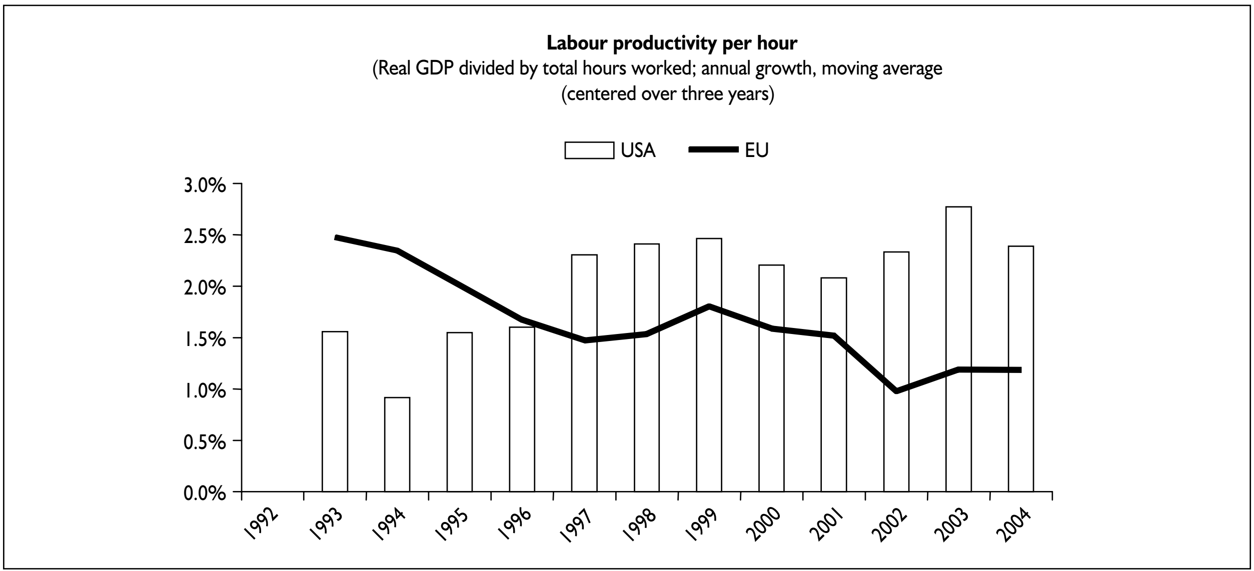
To summarise, a change in employment trends seems to have occurred in Europe, not only thanks to the cyclical rebound of the late 1990s but also to a more fundamental improvement. Yet, a large degree of heterogeneity prevails across countries, with some countries having achieved sharply lower unemployment, while others still experience two-digit unemployment rates. Where employment has improved, this seems to have resulted from a combination of changes in policies that made the labour market function in a more effective manner. In high-unemployment countries, structural reforms have either been insufficiently ambitious, combined in a suboptimal way or implemented too recently to produce significant effects. There is therefore wide agreement that labour market reforms need to be implemented in a comprehensive and coherent way (European Commission, 2005). The way to achieve this policy coherence depends on country circumstances and institutions (OECD, 2004). Given the country-specific nature of labour market reforms, there is little room for having a unique and centralised approach at the EU level. This has implications for the Lisbon Strategy, which are further discussed below.

3. Productivity and product market competition

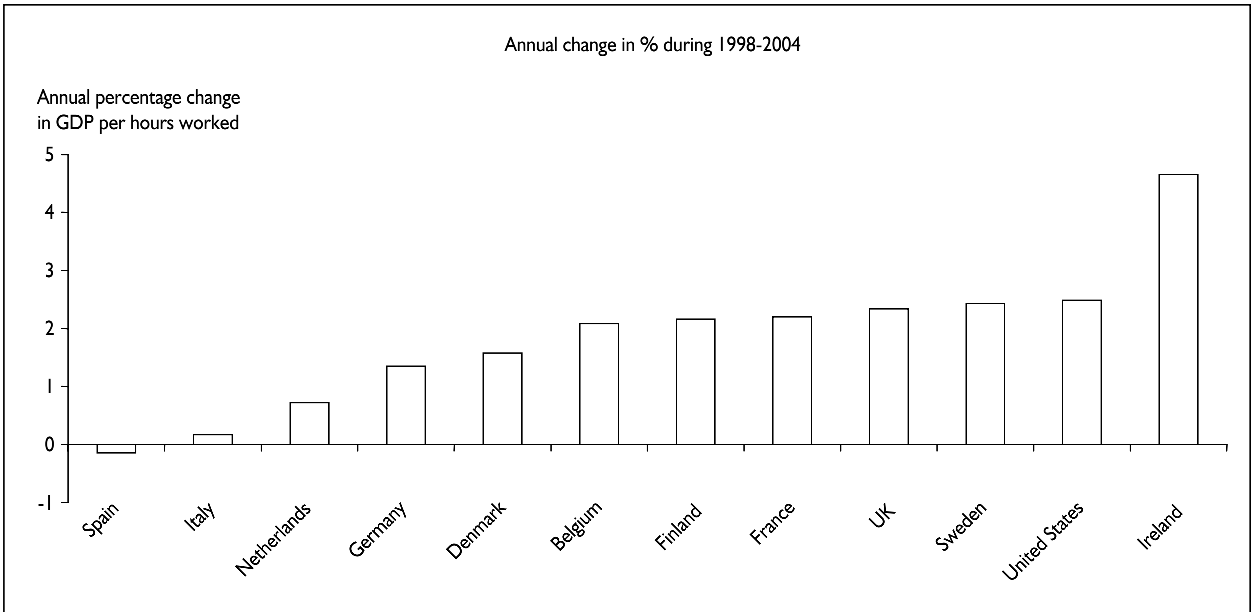
Increasing productivity growth is another important goal of the Lisbon strategy. The Lisbon programme aims at making Europe the most dynamic economy in the world, a goal that cannot be achieved without dynamic trends in labour productivity. Despite the importance of this goal, Figure 8 shows that the trend of hourly productivity has fallen in recent years, preventing the European Union from gathering speed. Hourly labour productivity growth has barely exceeded 1% annually in the European Union during 2000-2004, sharply less than the pace of 2% to 2½% recorded in the United States. Hence, the productivity gap between the two regions is widening.

This widening of the productivity gap stems from two changes in opposite directions. In the United States, productivity accelerated in the mid-1990s, a development that has often been attributed to the diffusion of new information and communication technologies and the associated surge in business fixed investment. In Europe, by contrast, the diffusion of the same new technologies did not increase productivity growth. In fact, EU productivity slowed after the mid-1990s. While some sectors benefited from the use of ICT technologies (notably telecommunication), a majority of other industries saw their productivity growth decline significantly (O'Mahony and Van Ark, 2004). The fact that the acceleration in

Chart 8. EU hourly labour productivity growth has fallen below the US level



There is a large disparity of productivity growth rates across countries



Source: OECD

US productivity and the deceleration in EU productivity have lasted for an entire decade suggests that this was more than a simple cyclical phenomenon. A fundamental change seems to have occurred.

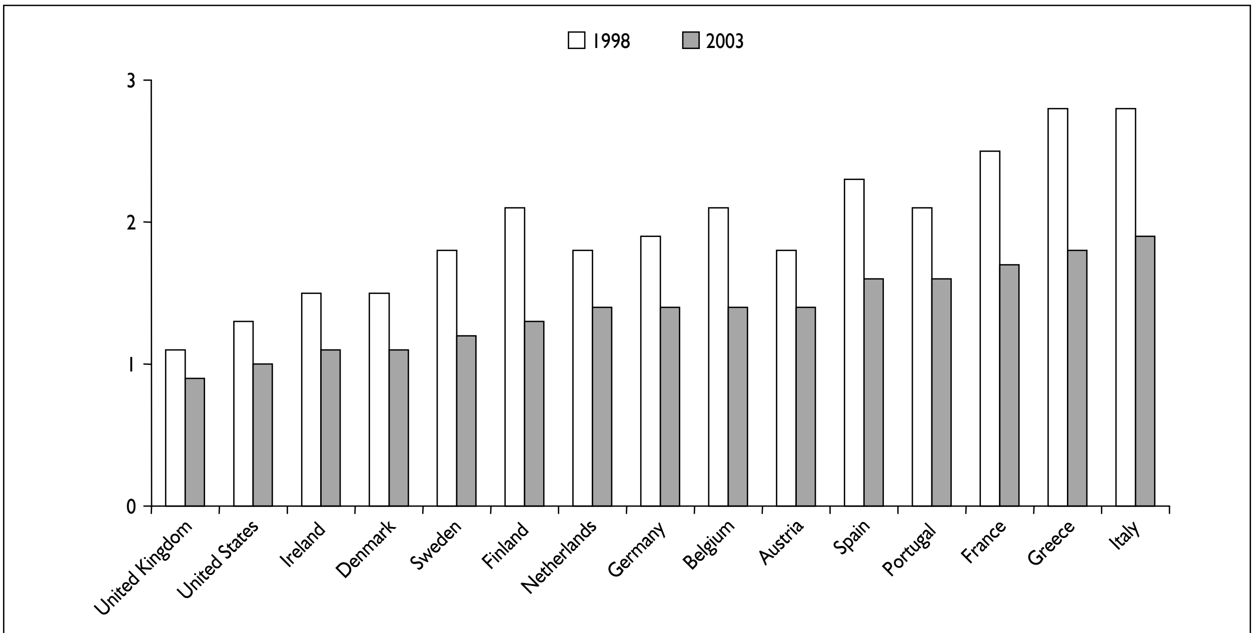
Within the EU, productivity growth differs across countries. A few economies have achieved levels of productivity growth similar to that of the US (Ireland, Sweden, UK), while in other countries productivity nearly came to a standstill (Spain and Italy). This variety of experience suggests that policy settings have influenced productivity outcomes. Although governments do not influence productivity directly, a variety of structural policies have an indirect influence on it, including policies related to education, innovation and investment. Likewise, the type of labour market reforms discussed in the first part of this paper may exert a temporary drag on productivity insofar as low-productivity workers are reabsorbed into the labour force.

In addition, there is growing evidence that the degree of competition in product markets has an important influence on productivity (Nicoletti and Scarpetta, 2003; European Commission, 2004b). A high degree of competition plays a key role in influencing firms' incentives to seek efficiency gains either via the adoption of technological and organisational best practices, so as to use production factors more effectively. A high level of competition also encourages firms to innovate and move closer to the technology frontier. Combined with labour market reform, a greater degree of product market competition reduces the level of mark-ups and lowers the bargaining position of insiders, with beneficial impact on employment trends. In addition, relatively "liberal" regulatory policies are often associated with easy employment protection legislation.

Product market regulation indicators, compiled by the OECD for 1998 and 2003, measure the change in the setting of policies influencing competition (Conway et al, 2005). These indicators were developed to describe broad differences in product market policies across OECD countries. They seek to evaluate the regulations that have the potential to reduce the intensity of competition in areas of the product market where technology and market conditions make competition viable. The structure of indicators, which are based on questionnaires sent to OECD governments, takes the form of pyramid with 16 detailed indicators at the base that are aggregated successively to produce indicators in three domains (state control, barriers to entrepreneurship, and barriers to trade and investment) that are summarised in one product market regulation indicator at the top. Thus, detailed aspects about regulatory practices (such as licensing requirements or trade tariffs) are combined with industry-specific regulations (such as rules governing retail trade) to produce an overall assessment of the regulatory stance. The production of the indicator uses a variety of verifications, for instance to ascertain the quality of answers to the questionnaires or to test different weights used in the aggregation. Nonetheless the indicators remain largely confined to formal regulatory policy requirements and do not directly take into account informal regulatory practices or the strictness of implementation of these requirements.

The indicators, which were initially produced for 1998, have been recently updated for 2003 with the objective of ensuring full comparability between the two observations. Between these two dates, the regulatory stance of all OECD member countries has been eased significantly (Chart 9). State controls have been lowered, price controls have been lifted, state ownership of enterprises has been reduced, barriers to entry have been removed, trade barriers have been eliminated and countries have become more open to foreign direct investment. In Europe, the implementation of single market directives has helped to boost

Chart 9. Product market regulation has become less stringent



The scale of indicators is 0-6 from least to most restrictive.
Source: Conway et al. (2005).

cross-border competitive pressures, especially in the market of goods. Other European initiatives to foster competition is various sectors, such as telecommunications and air transport, have also helped to increase competitive pressures, notably by allowing the entry of new players. If the past relationship between pro-competition policies and productivity growth continues to prevail, some acceleration of productivity could occur in the second half of the decade in countries that have undertaken the greatest liberalisation efforts.

Nonetheless, the indicators show that important differences continue to prevail across EU member states, despite the adoption of EU directives on the functioning of the single market and competition policy. The United Kingdom, Ireland and Denmark have adopted pro-competition policies, while other member states have stricter regulatory stances. This large variance is possible because many policy areas related to competition do not belong to the prerogatives of the European Commission, such as the extent of state ownership, which remains a policy issue in the hands of national policymakers. In addition, some member states do not transpose EU Directives in full, or transpose them late. Overall, product market competition has become more intense in the EU, but much remains to be done to open a number of markets to competition and remove existing barriers.

4. How to reinvigorate the Lisbon Strategy?

Initially adopted to promote growth in Europe, the Lisbon Strategy is often viewed as a symbol of Europe's inability to improve its economic performance. As argued in this paper, this assessment is undeservedly negative. While EU-wide performance has indeed been dispiriting in many respects, there are a number of areas where changes in slowly occurring. Employment trends appear to be improving at the aggregate EU level, and most particularly in some countries, and the large gap in labour utilisation between the US and the EU has slightly declined. EU-wide productivity growth has decelerated, but there are a few countries that have recorded a pace of productivity similar to that of the US. Where employment and productivity trends have improved, this appears to have been associated with the implementation of structural reforms.

Despite this initial improvement, progress has been limited and much remains to be done to close the gap with best practice countries in the OECD. This does not mean that the Lisbon Strategy should be abandoned. Its framework is sound and it appropriately aims at fostering growth, through higher employment and faster productivity. But the implementation of policies by member states has fallen short of expectations. This raises the question of how the Lisbon Strategy could stimulate a more proactive implementation of structural reforms. At present, the strategy relies on the "open method of coordination" to encourage the implementation of reforms in member countries. The method combines the utilisation of benchmarking exercises, which assess the performance of each country against a set of numerical targets, and regular peer review sessions, which are deemed to encourage less-performing countries to accelerate their reforms. Besides these informal arrangements, there is little that the EU can do to stimulate reforms in member countries, given the lack of legal instruments in most areas.

This is particularly the case in the labour market area, which impinge on policies that are largely within the prerogatives of national governments. The EU has established a framework to co-ordinate employment policies, under the *European Employment Strategy*, which encompasses the Employment Guidelines, the Council Recommendations to member states on employment policies, the National Actions Plans on employment policies, and the Joint Employment Report. While this framework aims at co-ordinating the employment policies of member states, there is widespread belief that structural reforms in this area are largely based on national objectives, rather that being guided by the EU (Alesina and Perotti, 2004).

Hence, there is support for maintaining a large degree of decentralisation in labour market reforms (Boeri, 2004). As noted, the goal of making labour markets function better can be reached in different ways, and notably with different combinations of policies, depending on country circumstances and institutions. What seems to matter is to achieve coherence in the setting of the various instruments, so as to obtain maximum synergies. Given the various interactions between instruments and the country-specific features, the bulk of decision-making needs to remain at the national level.

Based on past experience, EU policy initiatives are successful when they produce a common good. For instance, they have been successful in removing intra-EU customs barriers, because this produced a common good with obvious benefits, notably lower prices for consumers and easier market entry for firms. Similarly, the process of monetary union, the launching of the euro and the establishment of the ECB have had positive externalities associated with lower transaction costs, exchange rate stability and low inflation in all member countries.

Given this backdrop, the Lisbon Strategy might be more successful if refocused on areas where a common good could be produced. Fostering product market competition, notably in the services sector, is a good candidate in this respect. The benefits of enhancing competition within Europe should be obvious to all, including to consumers benefiting from lower prices, to firms taking opportunity of lower barriers to entry and to workers finding jobs in deregulated sectors. The spill-over effects of enhanced competition could be particularly important in the euro area: increased competition could translate into faster productivity and increased potential growth, making faster pace of activity possible without rekindling inflationary pressure.

In view of the large externalities that could be obtained, it would seem appropriate to refocus the Lisbon Strategy on the objective of enhancing product market competition. Completing the single market, notably in the services sector, seems a good candidate for a reformulated and more focused Lisbon policy agenda. By putting this goal at the centre of the Lisbon Strategy, Europe would get a greater chance to become a very competitive and dynamic region by 2010.

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