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the EU: is there a role for the Lisbon Strategy?”**

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**NIPE WP 19/ 2007**

NÚCLEO DE INVESTIGAÇÃO EM POLÍTICAS ECONÓMICAS  
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# Institutions, Governance and Economic Growth in the EU: is there a role for the Lisbon Strategy?

Annette Bongardt and Francisco Torres\*

## ABSTRACT

In order to ensure that the internal market delivers (growth, jobs) in the face of a changing market and technological environment (internal market liberalisation, globalisation, the knowledge-based economy) and to take advantage of the opportunities that it presents, the European Union (EU) needs to create an adequate institutional framework that promotes its efficiency potential and adaptive capacity. In the reality of European mixed economies, its capacity to solve the structural problems that impair productivity and economic growth in Europe hinges very much on governance, in particular when reforms to realise international synergies and complementarities or policy-learning with a view to common goals involve not only the EU but as well the Member State level. The Lisbon Agenda can be considered an exercise of policy coordination that needs to ensure that Member States' over-regulated economies comply both with liberalisation in the Single Market and with an adequate European-wide institutional environment for sustainable growth without coordination mismatches, protectionism and market segmentation. This ultimately raises the question, central to this paper, of the adequate governance level and of the regulatory model to adopt (systems competition and/or European regulation).

**JEL classification:** F15, P48, F50, H73.

**Keywords:** Economic Integration; Governance; European Union; Single Market; Lisbon Agenda; Open method of coordination; Liberalisation; Regulatory model; Growth and competitiveness.

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## 1. Introduction

By many standards economic and political integration in the European Union (EU) has been a remarkable success, despite some recent set-backs (such as the European constitutional treaty or the perceived failure of the Lisbon Strategy to deliver). The “club” European (Economic) Community / EU has proven very attractive indeed: its membership has been growing in six enlargements to date from originally six to at present twenty-seven members, with no end in sight.<sup>2</sup> Distinguishing itself from other international organisations by being highly integrated not only economically but especially by its strong political dimension, the European Union club has expanded at the expense of (and indeed prevailed over) inter-governmental models of European economic integration (i.e. EFTA). The process of integration and decision-making in the EU can be already regarded as a polity.

Progress in the European single market in conjunction with competition policy, European Monetary Union (EMU) and the Lisbon Agenda are all potentially efficiency-enhancing and should thus be expected to contribute to the viability of any “European model”. It seems thus puzzling that economic performance in the EU on the whole has fallen short by its own standards (i.e. the Lisbon growth target of three per cent, although recent data looks more favourable) and compared with the United States, in spite of profound economic integration and many reforms. Yet, delivery is key for the political sustainability of the European integration project, as reflected in the 2005 mid-term refocus of the Lisbon goals on growth and employment.

This paper suggests that while European economic integration and in particular the single European market often appear to be only a smallest common denominator in the EU, they condition the economic policy framework facing Member States and have been instrumental in putting in motion governance patterns. The Lisbon Agenda is a case in point. Motivated by competitiveness concerns, it outlines an economic and social strategy meant to re-launch the EU within the changed setting of world-wide competition and a knowledge-based economy. Its success ultimately hinges on whether necessary coordination to implement policies with an EU rationale can be achieved as to realise the efficiency properties of the internal market when increased liberalisation and market coordination by itself are not sufficient to do so.

The EU treaties define a market-oriented economic constitution. The fact that the very treaty bases of the internal market call for the creation of a European economic area by means of the liberalisation of goods, services and production factors (capital and labour) already implies a need for liberalisation in less market-oriented Member States. For instance, EU competition policy requires Member States to liberalise those goods that can be handled by the market so that they have to adjust their legal frameworks accordingly (see Henke, 2006). In the reality of European mixed economies this

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<sup>2</sup> The European Union can be regarded as a club, being exclusive in terms of membership and providing goods to its members with public-good characteristics (non-rivalry), i.e. equal rights in regard to membership and participation in the customs union, the single market and monetary union. Non-members have incentives to apply for membership when the expected benefits from so doing are larger than the associated cost. Similarly, the club may want to enlarge when a new member, at the margin, adds to its well-being. Economic analysis in terms of cost-benefit offers an important tool for application and enlargement decisions, although political reasons might be decisive in the end.

requires countries to reassess and possibly modify their (distinctive) balance between the provision of private and of public goods by the state. In addition, to the extent that liberalisation and deregulation in the EU do not do away with market failure, the issue turns towards how to avoid governmental (regulatory) failure and towards what regulatory model to adopt.

In European mixed economies institutional frameworks are important for the EU to take advantage of the opportunities that liberalisation in Europe, globalisation and a knowledge-based economy present. To unleash the efficiency-enhancing potential of the single market and solve the structural problems that impair productivity and economic growth in Europe, the EU needs to adapt its economy and functioning to those challenges. The implementation of those common goals calls for coordination of policies at the EU and at the Member State level with a view to interdependencies and policy-learning.

The Lisbon Agenda can thus be considered an exercise of policy coordination. Such an exercise needs to ensure that Member States' over-regulated economies comply both with the Single Market and with an adequate European-wide institutional environment for sustainable growth. Systems competition does not by itself ensure EU-wide competition and competitiveness as national regulations can get in the way of the proper functioning of the Single Market. Letting different national regulatory systems compete as part of a country's comparative advantage (or disadvantage) would not do necessarily away with national market segmentation. For it to work, Member States would need to be (politically) prepared to let the market decide which system is fittest and accept the consequences for competitiveness (comparative disadvantage) or implement policy-learning and institutional change in the light of best practice. The subsidiarity argument (in general a quite valid argument) might also be misplaced and serve as an excuse for national protectionism, using different national regulations to impede effective competition in the internal market. In this context the proposal of an EU subsidiarity test (Pelkmans, 2006) that follows objective criteria to establish the adequate degree of centralisation (but leaves the decision to the political sphere) could offer a solution.

## **2. Economic integration and the policy framework: liberalisation and regulation**

EU market integration is at the core of European integration and hence needs to be perceived as delivering. European economic integration has been both market-oriented and ambitious from the outset, in that the Treaty of Rome did not settle for a free trade area but aimed at higher levels of integration, that is a common market and a customs union, for which in turn some degree of coordination and sovereignty-sharing between Member States are a prerequisite. EU competition to defend the proper functioning of the common market and to ensure a level playing field was created in parallel and delegated to the EU level and evolved, driven by the evolution of the internal market. Economic integration has since progressed to monetary union, (some) economic policy coordination and aspects of a political union.

The attractiveness of Community membership owes much to the advantages it confers on insiders through the sheer scale of its domestic market and the abolition of internal non-tariff, frictional barriers, and the common commercial policy. The Community preference translates into a disadvantage for outsiders. At different times in history, preferential trade integration has afforded the Community an advantage that made entry

for third, in particular neighbouring, countries very attractive. In the first phase the trade-led model of integration allowed for scale economies in an enlarged (albeit incomplete) domestic market in goods protected by common external tariffs. In the second phase characterised by the realisation of the internal market, the root of advantage has shifted towards regulation-based integration.

That successful regulation-based integration is important given that as efficiency-enhancing external liberalisation proceeds – through the World Trade Organisation (WTO) or preferential trade agreements – any discriminatory advantage due to tariff protection that EU members possess vis-à-vis outsiders is reduced. However, a well-functioning internal market can again translate into a cost advantage for Member States, based on efficiency gains associated with the abolition of frictional, invisible barriers to trade and the full liberalisation not only of goods but also of services and production factors, plus the creation of a dynamic advantage through capital accumulation and innovation.

Internal and external trade liberalisation is thus central to past and future European well-being. In the EU, internal market liberalisation and, consequently, necessary restructuring coincide with and are reinforced by the effects of globalisation – external liberalisation being as well an aim of European integration, and like the common market already enshrined in the Treaty of Rome – and a faster pace of technological change within what is commonly denominated the new economy. One of the most visible effects of globalisation to date is the fact that an ever larger share of manufactured goods now comes from developing countries, with China being a case in point (Sapir, 2005).

The new economy is characterised by the importance attributed to knowledge as a production factor and to information and communications technologies that have the potential to raise the productivity of third sectors. It poses a challenge for the EU, to the extent that reaping the benefits from a knowledge-based economy in a globalised world requires changes that are not limited to the level of firms but depend on whether the EU has been able to create an inducive environment for the information economy and for growth. This environment necessarily involves functioning markets, institutions (broadly defined) and a variety of policies that need to be adapted and coordinated and which involve not only the EU but also the Member State level.

On the one hand, therefore, the realisation of the expected benefits from the single market hinges on more efficient resource allocation and deployment and on letting the market work. On the other hand, it needs to be complemented by an adequate institutional framework conducive to static and dynamic efficiency and hence competitiveness by promoting adequate incentives, competition and the functioning of the market, encouraging innovation and facilitating restructuring, and improving the capacity of adaptation (e.g. through the mobility of production factors, labour qualifications, functioning capital markets).

It is illustrative for the driving force that the internal market gained that the number of pieces of EU legislation to complete it has been growing more than five-fold, from the initially about 300 measures enshrined in the White Paper to more than 1,500. There has been significant progress in internal market liberalisation, chiefly in product markets but also for instance in regard to the market-opening of banking, telecommunications,

transport and energy sectors. Yet, the single market is as yet not fully achieved, with progress being slow in some, important areas. Consider for instance the service sector that accounts for more than 60 per cent of EU gross domestic product (GDP) (and which is to date still rather closed and segmented along national lines and will not be substantially liberalised since the services directive shied away from dealing with the problem of national regulatory systems that limit competition), financial market integration (where for instance the take-over directive features clauses that do not implement an EU-wide market for corporate control with the same conditions in all Member States) and labour markets (although there is some benchmarking, reform is very much a Member State competency).

EU market integration and trade patterns reflect this situation, considering that intra-EU trade in goods has grown more than proportionally as compared with EU trade with third countries, while market integration in services is low and its small expansion is largely explained by technological advance (see Gros, 2006a).

### **3. Internal market performance in the context of heavily regulated national economies**

Notwithstanding the considerable progress that has been made over the last two decades in terms of internal market liberalisation, output performance of the liberalisation process is often considered (as for instance by O'Shaughnessy, 2005) to be deceptive by comparison. One would expect growth to be promoted by the impact of liberalisation and trade integration in the Single Market in conjunction with efficiency-enhancing industrial restructuring. Hereby it is a prerequisite for improving the competitiveness of European firms and for taking advantage of the large domestic market that industrial restructuring is allowed to take place.

However, the completion of the internal market is not only a dynamic, on-going process but it also extends to many different policy areas. In the reality of European mixed economies it calls for a good deal of coordination between institutions and policies at the EU and the Member State level and indeed for high levels of economic integration (economic policy coordination, monetary union, possibly political union), in particular when there are interdependencies. In addition, the changes in the external environment brought about by globalisation and the new economy have obvious repercussions for the competitive pressures facing firms while economic agents' incentives and their capacity to react or take a pro-active stance are conditioned by (the design of and incentives provided by) social and economic institutions. Those (broadly defined) institutions can either smoothen and facilitate or retard necessary adjustment. The question is thus whether the economic and institutional framework (EU and Member States) is adequate for the internal market to deliver.

This type of consideration was not an issue at the forefront at the time of the inception of the Single Market programme by the mid-80s, which tended to be presented as a technical, deregulation exercise to stimulate the supply-side. Yet, putting in practice the four freedoms becomes highly political in the context of the reality of European mixed economies: what is at stake is the role of the state in the economy and reforming (path-dependent) national institutional frameworks. For the reasons outlined above, reforms that bring about changes in the institutional framework in which markets and the state operate are necessary to realise the potential gains from trade.

The Lisbon Strategy, created in 2000 and reformed in 2005, represents an attempt to realise the potential efficiency properties of the internal market while facing up to structural problems within the new competitive environment. In March 2000 the Lisbon European Council had set the strategic goal of turning the EU into the most competitive and dynamic knowledge-based economy in the world by 2010 as to ensure that the internal market delivered while safeguarding environmental sustainability and cohesion. The Lisbon Strategy was drawn up against the background of a productivity slowdown in Europe that contrasted with a productivity revival in the United States from the mid-1990s onwards, attributed to European structural problems and to the challenges of the new economy within the context of globalisation. It is mainly subject to soft coordination through the Open Method of Coordination (OMC), with action plans at the national level. Underlying the OMC is the recognition that policy coordination is a necessary condition for internalising international spillovers and complementarities.

The European Council had held that an average economic growth rate of three per cent of GDP was possible, provided that a broad range of measures were taken that would – directly or indirectly – facilitate the shift towards an information society, such as to complete the internal market, promote research and development (R&D) and the creation of small and medium-sized enterprises, modernise the European social model (e.g. by strengthening education and training, developing an active employment policy, raising the employment rate, modernising social protection), and ensure a sound macroeconomic setting.

Within this context the completion of the single European market and of its efficiency potential is key. The Lisbon Strategy can work as a European industrial policy, not of the interventionist type - choosing winners - but one that creates generally favourable conditions for competition, ensures a level playing field for economic agents (hence the importance of competition policy) and remedies market failure. However, it hinges on complementary and coordinated policies in many domains that involve not only the EU but also the Member State level.

Successive European Councils sought to improve the Lisbon Strategy by formulating deliverables. Yet, half way into the decade the failure to reach the targets had become obvious. The Kok report (Kok, 2004) attributed the lack of success to both EU and Member State failure to implement the Strategy, more specifically, to an excessive agenda and to shortcomings in the governance structure. The 2005 mid-term review led to sharpening the Lisbon objectives to focusing more narrowly on employment and growth. It also suggested the need for changes in governance in particular to ensure the coordination of national reform programmes (NRPs, which are Member States' responsibility). Governance changes however fell short of the recommendations made in the Kok report. The attainment of the common goals (growth and jobs) however depends on both commitment in governance and on the acceptance of the market by Member States.

#### **4. Reform and governance of policies in the context of European mixed economies**

Member States' economic policy frameworks are conditioned by the EU internal market and external challenges (globalisation, the new economy). Liberalisation and deregulation are driven by the European Single Market which is mostly in the EU

domain, but for output delivery Member States need to accept the functioning of the market and need to coordinate policies (create an adequate economic and institutional framework) so that delivery of the Single Market is neither impaired by Member State protectionism nor by inadequate institutions / their sub-optimal interaction. It has been a major challenge to adequately adapt national institutions and policies with an impact on the internal market which were not only created in a very different economic and technological environment but which are often the product of country-specific factors. To the extent that deregulation requires forms of economic coordination other than through the market it ultimately raises the question of European regulation and of the regulatory model (this issue has become highly visible in the case of the services directive).

Furthermore, while society as a whole stands to benefit from gains from trade and liberalisation that contribute to higher living standards, within society there are winners and losers. Whether and how these latter ones are to be compensated will not only be important for the political acceptability of reforms (issues of equity and distribution), but also raises the question of sustainability and of the efficiency (providing adequate incentives) of social systems. Adequately designed social policies can be efficiency-enhancing. The 2005 Lisbon mid-term review's innovation in terms of governance consists in the introduction of NRPs, to be coordinated by the Integrated Guidelines for Growth and Jobs (2005-8) adopted by the Council.<sup>3</sup> It is the main instrument to achieve coherence. To the extent that it succeeds in increasing stakeholder involvement (ownership in governance) it might mitigate conflicts and thus foster the implementation of national reforms with a view to the Lisbon goals.

The success of the venture would be important: Not only have liberalisation (within the internal market and with respect to the rest of the world) and benefits from trade contributed to high present European living standards and are at the heart of European economic and political integration but Europe needs to adapt itself as to take advantage of globalisation and raise productivity and growth in order to confront future challenges (such as an ageing population ,enlargements or indeed reform). It is a functioning internal market that holds the key to the challenges ahead for the EU. The failure to deliver satisfactory economic performance and/or an adequate (or perceived as such) social system in a changed setting imply political risks, to the extent that public opinion might turn against internal and external liberalisation on the European single market and in the WTO, respectively, and resist necessary structural and institutional change or enlargement in the name of some "European or national model", which might eventually threaten the EU political integration project itself. The initial Bolkestein services directive, and its role in the rejection of the EU constitution in the Netherlands and in France, is a case in point.

According to fiscal federalism, governance should take place at the EU level when there are economies involved in pooling competences and when preferences are similar, whereas it should take place at the national level when preferences and circumstances are different. As pointed out in Sapir et al. (2004), political economy reasoning suggests that changes at the Community level, subject to qualified majority voting (QMV), tend to go through more easily than changes at the national level, more liable to be held up

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<sup>3</sup> See Pisani-Ferry and Sapir (2006).

and resisted by political economy forces. National policy makers are more prone to give in to political economy arguments at the national level (although burden-sharing might be easier in smaller countries), while it is easier for governments to circumvent special interest groups when there is QMV. Resistance at the national level is aggravated by the joint impact of single market restructuring plus globalisation.

While measures at the EU level hence condition the expected benefits from the internal market and from a single currency, the successful implementation of the Lisbon goals depends on the coordination of many (reformed) policies and institutions at the EU and/or the national level and on governance patterns conducive to innovation and change. Within the present fast-changing technological and market environment and in order to take economic advantage of globalisation and the knowledge society, this means that innovation needs to be encouraged, financial markets need to function and institutions need to promote change. Among others, (reformed) institutions in Europe need to facilitate factor mobility, namely of labour out of unprofitable businesses and sectors into competitive areas as well as of capital mobility, hereby including well-functioning markets for corporate control.

The issue is then not only to avoid a policy mismatch but to realise synergies and complementarities and to facilitate policy-learning. Coordinated efforts make sense when there is interdependence between Member States, such as in the case of synergies (e.g. spillovers in the case of R&D) or complementarities (e.g. regarding liberalisation and reforms in the product and in the labour market), or when there is scope for policy-learning with a view to common goals (the case of social systems). Coordination would then take the form of joint action and of benchmarking in the light of structural differences and of policy differences, respectively (Pisani-Ferry and Sapir, 2006). This translates into a rationale for EU involvement in the Lisbon process in many policy areas relevant for an EU growth strategy. Yet, despite the potential benefits from coordination, in many of those the EU cannot act by itself or only if the Member States give their consent. To the extent that a coordination mismatch can be expected to negatively affect performance, it might be less puzzling that EU coordination efforts seem not to have translated into a growth dividend, despite the single market and EMU.

Just consider that policies whose coordination is vital for the implementation of the Lisbon goals involve different governance levels (EU and the Member State) and coordination modes (Sapir et al., 2004): With respect to the four freedoms in the internal market, capital and product market regulation is decided upon at the EU level, while the regulation of labour markets and social systems are in the national sphere. While product market regulation and competition policy are (mostly) in the Community sphere, as to assure a level playing field without distortions created by firms or governments and as to provide incentives for and reward innovation in the market and facilitate restructuring, other policies that are meant to produce synergies or complementarities are not delegated to the EU (as diverse as education, national R&D spending, labour markets, social systems, or service and utility markets), rendering their coordination and implementation more difficult and/or time-consuming. For instance, as far as R&D policy is concerned, EU R&D policy is delegated to the Community sphere, while national R&D policy is in the national sphere. Direct taxation (including R&D fiscal incentives) is subject to autonomy at the national level, while VAT rates are subject to commitment (indirect taxes being considered more harmful to trade within the context of the internal market). As far as macroeconomic policies are concerned,

monetary policy falls in the EU sphere and is subject to delegation to an independent agency, while fiscal policy falls in the national sphere (with commitment in the case of Euro-zone members – Stability and Growth Pact).

It should be noted though that EU market integration has set in motion governance levels and modes and has meant that the competitiveness issue has gained ground.<sup>4</sup> In the case of competition policy, industrial restructuring has led to more delegation to the EU level (merger regulation) but also the decentralised, parallel application by national competition authorities of EU competition law.<sup>5</sup> Also, to the extent that production factors become more mobile (in particular capital, whereas labour tends to be rather immobile within the EU and at national levels) the discussion of direct taxes with a view to competitiveness/localisation of investments and of an eventual harmonisation of direct taxes has become an issue. For instance, the Commission is trying to form a consensus on firms' tax base in the light of different Member State regimes. The regulation of labour markets and of social systems has remained at the national level since the Treaty of Rome, but has become subject to benchmarking at the EU level. This reflects the fact that the question of wage and price flexibility assumes particular importance in a monetary union where there are larger interdependencies (thus the rationale for EU coordination is reinforced in the Euro-zone), given that there is a single monetary policy with only fiscal policy commitments, and also the need for innovation and productivity in the EU that puts emphasis on the adjustment capacity of the industrial fabric and of the labour market (and of institutions in general). National labour markets (and employment policies and social systems) hence are being ever more measured against their performance in terms of flexible adaptation, high levels of human capital (qualifications and skills) and a high participation rate. Social systems as well have a bearing on labour mobility in the EU.

The Lisbon Strategy is often identified with soft coordination through the OMC. The OMC's weak point reportedly is its reliance on benchmarking (that is, peer pressure and public opinion) in the absence of formal sanctions whereas successful reforms require commitment apart from functioning markets. The fact that the implementation of national action plans that were to stimulate R&D investments, as to translate EU goals through national targets, has been slow, is a case in point. Moreover, the fact that the OMC seems not to have worked as a commitment device for the Lisbon strategy contrasts with Economic and Monetary Union (EMU) where there was a timetable and there were conditions that had to be met by Member States. The institution of NRPs in the refocused Lisbon strategy aims to involve stakeholders and thus increase commitment.

The Kok report had advocated improving the governance of the Lisbon strategy by a three-legged approach, namely NRPs coordinated by EU guidelines, an EU budget with adequate resources and priorities with respect to the Lisbon objectives, and benchmarking as a coercion mechanism for poor performers.<sup>6</sup> In the event, the

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<sup>4</sup> The competitiveness objective is also ever more becoming embedded in European institutions such as the Commission or the European Parliament. See Smith (2006).

<sup>5</sup> EU market integration led to a different evaluation of the centralisation versus decentralisation trade-off (access to information vs. regulatory capture). See Bongardt (2005).

<sup>6</sup> See Pisani-Ferry and Sapir (2006).

governance system of the reformed Lisbon strategy fell short of recommendations and came to rely on NRPs, with EU budget reform postponed and benchmarking through comparative performance indicators watered down. Coordination of reforms rests on the Integrated Guidelines for Growth and Jobs which establish numerous objectives (albeit without priorities and without differentiating between countries) which should be the basis for evaluation of NRPs by the Commission (although that seems not so clear in practice). Stakeholder involvement in NRPs should augment national ownership of reforms (although the Commission is perceived to apply the concept in a narrow way) so as to help overcome national resistance to reforms with an EU rationale.

In conclusion, Lisbon priorities and common goals are not reflected or implemented through the EU budget and “naming and shaming” as a coercion mechanism was further weakened. It remains to be seen to what extent NRPs will trigger a national debate in poorly performing countries and whether national ownership proves sufficient to overcome national resistance to reforms with an EU rationale and increase commitment as to successfully implement reform programmes.

Despite those possible governance weaknesses, it might be important to not lose sight of the fact that the very discussions prompted by and facilitated within the context of the Lisbon Agenda have meant that Lisbon has in practice already moved on beyond the OMC and makes use of a range of instruments. Increasing EU market integration is having an impact on governance, leading to new coordination needs, making coordination requirements and mismatches more visible and their resolution more pressing in the light of competitiveness considerations. On the one hand, the Lisbon process has made shortcomings more visible and led to more similar preferences and possibly circumstances. Furthermore, issues have been pulled to a European level and institutions were created, it has resulted in the application of the normal legislative process (EU directives that are the result of discussions within the Lisbon strategy), or in EU regulations.

## **5. The Productivity slowdown in Europe and governance**

On the face of it, EU living standards are high, the result of fast productivity growth in the past. Productivity per working hour is not that different from the US, whereas gross domestic product (GDP) per capita is significantly lower. In some European countries productivity per working hour is higher than in the US.

More specifically, in 2003 the productivity of the EU15 (measured as GDP per hour worked in per cent of US figures) corresponded to 93 per cent of the US figure, comparing with a GDP per capita ratio (GDP/population in per cent of US figures) of only 72 per cent; comparative growth rates of GDP per capita were 1.9 per cent for the EU15 and 2.2 per cent in the US, and growth rates of GDP per hour worked amounted to 1.5 and 2.4 per cent, respectively (see Van Ark, 2005). It is the slowdown in European productivity growth from the mid-1990s onwards (in contrast to the US) and the link between productivity and growth that have given rise to the discussion of whether current productivity levels and living standards are sustainable in the medium term. European productivity growth gradually declined from levels that were higher than the US rate in the 1970s and 80s, while in the US productivity growth accelerated since 1995.

The existing GDP per capita gap might be ascribed to different preferences or to institutional failure. Blanchard (2004) argues that figures might give a distorted picture when used as the sole benchmark of well-being to the extent that lower GDP per capita in the EU also reflects different European societal preferences for more leisure (shorter working days, longer holidays). Moreover, it is a specific sector - retail - that importantly accounts for the differential between the US and Europe, once again due to preferences of society for more urban, smaller-scale units of distribution rather than large, out-of-town supermarkets. On the other hand, rather than a matter of preference it might reflect institutional failure, i.e. a lower employment rate due to a disincentive to work in the face of high tax rates. Yet, then the question arises whether lower incomes would not also incentivate work (and whether substitution and income effects might not cancel out).

Accepting that it would be important for the EU to grow faster - for reasons that rest on the sustainability of European varieties of the social model in the face of unfavourable demographics (an ageing population), the need to facilitate catching-up of the new and of future members, and the fact that low growth makes the political task of reform more difficult (see Sapir et al., 2004, and Pelkmans and Casey, 2004) or the EU's political influence negligible (Alesina and Giavazzi, 2006), its capacity to do so hinges on the ability to adjust flexibly in order to be able to take advantage of globalisation.

What are the factors that influence GDP per capita growth? GDP per capita growth can be explained by the variation of labour productivity (GDP growth divided by hours worked) and the variation of labour utilisation (the number of hours worked per capita). In turn, the variation of labour utilisation can be decomposed into the variation of the employment rate and the variation of the number of hours worked per person. Labour productivity can be explained by investment levels/capital intensity (including human capital, technology adoption) and the effects of this investment (total factor productivity (TFP), the residual factor). TFP thus captures competitiveness gains, the productive creation and utilisation of knowledge, or a favourable regulatory environment. This already serves to highlight what seems to be the motivation within the context of the Lisbon Agenda to raise the employment rate and invest in human capital (high qualifications raise productivity and labour mobility, but also prevent social exclusion), but as well to liberalise further and to create an inducive (lighter, better) regulatory framework.

Since the importance of market pressures or a conducive regulatory framework has been discussed above, let us now look more specifically at knowledge creation and its commercial exploitation. Information and communication technologies (ICT) are often focused upon due to their efficiency-enhancing potential. Yet, the prime cause for the productivity slowdown in the EU15 may not reside in the under-development of information technology production in Europe. Data on annual average productivity growth (GDP per hour worked) in sectors that produce, utilise or do not make use of ICTs for the EU15 and for the US (see Van Ark, 2005) suggest that while ICT production had a significant productivity-enhancing effect in industry, in the EU it was lower than in the US, whereas the EU enjoys an advantage in ICT-producing services. Regarding the utilisation of ICTs, it is noteworthy that productivity in the EU is much lower in services (which include retail) but less so in industry; in the sectors without ICT the EU has an advantage. Some studies (see for instance Daveri, 2004) suggest that the growth slowdown and the EU-US growth gap are related to the non-IT part of the

economy: firstly to a slowdown of non-IT capital deepening and secondly to a lack of acceleration in TFP growth.

The first one is caused by an increase in the employment content of economic growth from 1995 onwards and thus reflects the successful creation of jobs. There has been a turnaround in the pace of job creation in Europe after 1995, measured by the growth rate of hours worked - and the integration of new entrants in the labour market with low human capital endowment (and more likely to be employed in traditional industries), facilitated by labour market reforms effected in some EU countries in the 1990s. Gros and Mortensen (2004) provide two possible interpretations for the productivity slowdown, the first one more optimistic and the second one more pessimistic. On the one hand, it might be transitional to the extent that the lower capital-labour ratio is due to the integration of unskilled workers and a higher participation rate. On the other hand, it might indicate the need for government intervention to facilitate flexible adjustment, reforming goods and labour markets and institutions with a view to higher mobility and efficiency, to the extent that the productivity slowdown in non-durable, mature manufacturing industries reflects insufficient reallocation of workers away from declining into newer, more dynamic sectors. Secondly however, and unlike in the US, in the EU TFP is lower and has not been rising.

The EU25 aim to increase spending on R&D as a percentage of GDP from currently about two to three per cent of Community GDP and to promote the commercial application of knowledge by raising the share of the private sector to at least two-thirds (Barcelona European Council, March 2002) reflects the recognition of the link between R&D and TFP growth.

Investment in knowledge has features that justify public intervention (i.e. uncertainty, appropriability problems and higher social than private returns). R&D investment promotes the accumulation of know-how that then needs to be commercially applied in the market (new products and services, technology licences). Innovation is by nature often disruptive (Schumpeter's creative destruction) and the benefits from innovation and a knowledge-based economy can only accrue provided that multi-dimensional adjustment is allowed to take place. This encompasses functioning product and financial markets (focussing attention not only on firms' incentives to invest in innovation and technological development but also on financing those investments), effective public support for R&D of various kinds to foster synergies and provide the right incentives for firms (research infrastructures, training, patent system) but as well competition policy enforcement (notably the absence of state aids and restrictive practices) and labour markets and social systems that smoothen adaptation. The European Council recognised in 2003 that the potential of any R&D policy within the Lisbon Strategy rested on global and coordinated reforms (notably in terms of structural reforms, employment policies and social protection, apart from macroeconomic coordination).

The case for the EU to coordinate and/or take measures to promote knowledge investments rests on international spillovers (promoted by geographical proximity) between Member States<sup>7</sup>, while the need for large-scale investment is related to

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<sup>7</sup> Ederveen, van der Horst and Tang (2005) show that the impact of an increase in R&D expenditures on TFP growth is inversely related to distance, that is, because of learning effects it tends to be larger for neighbouring countries.

Europe's proximity to the technological frontier so that productivity growth depends more on (the accumulated effect of) domestic European R&D and its commercial exploitation rather than on imitation or assimilation of knowledge from abroad.<sup>8</sup> Yet, the EU budget is small with respect to Member State budgets and moreover inconsistent with Lisbon priorities such as R&D (agriculture and structural funds account for about two thirds). EU budget spending on Community R&D policies is also rather small in absolute terms compared to national R&D. As a consequence, EU innovation performance is strongly conditioned by the Member States' innovation policies and their commitment to agreed targets. Member States' insufficient and not sustained investment can be taken as an indicator of their (in)capacity to reform and insufficient commitment towards creating a dynamic knowledge economy, and a critical impediment to higher EU long-run economic growth.<sup>9</sup>

Drawing on Gros<sup>10</sup>, the implementation of the Lisbon targets of three per cent of GDP by 2010 implies an increase of about €100 billion, only part of which can come from the Community budget, the largest share having to be financed by Member State R&D. The fact that the implementation of productivity-raising R&D investments thereby depends crucially on Member States raises two issues. Firstly, to ensure commitment at the Member State level when coordination relies on the OMC to internalise international spillovers from R&D; secondly, apart from R&D spending targets it is necessary to consider effects on the private sector (tax policy is at the national level) and the output efficiency of R&D spending. Cost-effectiveness could be promoted by the opening-up of national R&D funding to EU-wide competition – as happened with public procurement in the past - hence putting an end to the segmentation that in practice still exists along national lines. Thereby the public research efforts could contribute to creating better scale, avoid duplication and promote excellence by channelling the funds to the best researchers or research institutes at the EU level.

## **6. Regulation-based integration – some considerations on regulatory competition in services**

As discussed above, the service sector lags behind the goods sector with respect to European market integration despite its potential for employment creation. Liberalisation has been slow and the services sector in the EU is still segmented along national lines by national regulations with intra-EU trade in services low. The lack of competition is problematic in the light of unrealised efficiency gains to raise productivity and the need for the Single Market to deliver, in particular since the weight of the services sector in the economy is so large (over 60 per cent of EU GDP). Nevertheless, the Bolkestein services directive of 2005 aimed at liberalising the sector was rejected and gave way to a watered-down compromise version that does away with

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<sup>8</sup> Another issue is whether the translation of EU targets into national targets makes equal sense for all Member States or whether they should be able to define priorities, for instance according to a country's proximity to the technological frontier (see Pisani-Ferry and Sapir, 2006, for a further discussion).

<sup>9</sup> See Pelkmans and Casey (2004).

<sup>10</sup> Daniel Gros (2006b) adds that one should look at output indicators rather, since compared to the US, European R&D spending is more inefficient in terms of output (the rate at which R&D spending generates commercially exploitable ideas). He argues that a rise in the quality and efficiency of R&D spending is equivalent to an increase of R&D spending (0.2% of GDP in his calculations).

the home country principle of regulation and thus with competition between national regulatory systems.

Deregulation in the internal market raises the question as to the regulatory model when pure market coordination is regarded as not sufficient. There are various styles of complex, country-specific domestic regulation in EU Member States and different degrees of tightness of regulation.<sup>11</sup> In this setting, different regulatory systems are likely to contribute to the segmentation of the single market. However, national regulations that constitute invisible barriers to trade are incompatible with the common market and market integration and the goal of services liberalisation already enshrined in the Rome Treaty. So, the question is not whether but how liberalisation will take place in Europe (negative or positive integration), by simply letting the market work or through European regulation, harmonised European essential rules in conjunction with the mutual recognition of national regulation, or just mutual recognition.<sup>12</sup> Far from constituting a mere technical deregulation exercise the liberalisation of the services sector and more specifically the fate of the services directive has illustrated that the choice of the regulatory model happens to be highly political.

In the light of different national circumstances and/or preferences and the difficulty to have European regulation on the one hand and the need to guarantee non-discrimination on the other, the Bolkestein services directive had initially embarked on the third option, mutual recognition of home country regulation for the provision of services in the internal market. Opposition to the directive was directed importantly against the home country principle which implies competition between national regulatory systems. The resistance owed much to political economy reasons, that is to powerful lobbies in (often relatively small but well protected) service sectors protected by high barriers who stood to lose most, such as liberal professions and public sector services and which managed to mobilise public support.<sup>13</sup> An economic agent's competitiveness would to an important degree depend not on own efforts, but on the – more or less – favourable regulatory framework provided by his/her home country. Firstly, it is questionable whether this is politically acceptable in the Single Market, as in that case a country's regulatory system would be part of its comparative advantage (or disadvantage).<sup>14</sup> Secondly, it might as well be debatable whether there would have been any race to the bottom or whether countries would not have tried to compete via more efficient and better quality regulatory frameworks. In the event, the discussion became focused on the defence of social models and turned against Europe (the European Constitution).

The compromise version of the services directive, approved by the European Parliament on 15 November 2006 and adopted by the Council on 11 December 2006 by qualified majority, and to be implemented within three years, abandons the home country

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<sup>11</sup> Surprisingly, the need for liberalisation does not vary in function of old or new Member States but the new Member States display heavy regulation similar to some of the old Member States (e.g. France and Italy, but also Ireland) while Great Britain and Germany have lighter regulation. See Gros (2006a), based on 2006 OECD indicators.

<sup>12</sup> See Messerlin (2005).

<sup>13</sup> See Sejerøe et al. (2005).

<sup>14</sup> See Schaefer (2006) for an argument in favour of systems competition as part of a country's comparative advantage.

principle and thus regulatory competition. Member States preserve the right to fix general obligations applicable to the service providers on their territory. This will also create more legal uncertainty that will have to be sorted out by the European Court of Justice in due time (see Pisani-Ferry, 2006).<sup>15</sup> Labour law (which protects insiders and may slow down restructuring unlike social protection that can facilitate adaptation by protecting against unemployment) does not fall under the scope of the services directive.

It should be added that the liberalisation of network industries (infrastructures and services) is beset by a similar problem. Network industry liberalisation in the internal market is one of the goals of competition policy. Liberalisation is based on a two-legged approach that involves on the one hand the regulation of network infrastructures (based on natural monopoly reasoning) notably in terms of pricing and access conditions and on the other hand the application of competition policy to the services based on those infrastructures. National regulatory authorities regulate network infrastructures and they are part of a European Regulatory Network meant to ensure necessary coordination. However, there is no European Regulator to oversee the Community dimension, whereas there is in the case of competition policy. As national regulation authorities are meant to create *ex ante* the conditions for the good functioning of the market (while the competition authorities basically enforce it *ex post*), if they limit themselves to their national market they are unlikely to create the conditions for the good functioning of network industries at the level of the single market. Governance in the EU so far has not tackled this problem. The present discussion around utilities, in particular the energy sector, is a case in point of protected national markets and lacking EU-wide competition.

## **7. On European economic integration and social models**

The Lisbon Strategy entails the recognition that social policy can be efficiency-enhancing. This represents an evolution since the Treaty of Rome, very ambitious indeed with respect to economic integration, had omitted any harmonisation of social policies as they would not distort competition.<sup>16</sup>

Yet, a social system can actually encourage adjustment and thereby facilitate adaptation and relocation of production factors (labour and capital) with a view to higher efficiency, but also promote cohesion, another Lisbon goal. In fact, classifying Member

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<sup>15</sup> In total, there are 42 measures to remove barriers and 65 to improve procedures. Member States will be required to screen their existing legislation with an impact on service providers so as to remove any unjustified protectionist obstacles or unduly complicated requirements. Services of General Economic Interest are included as far as the application of establishment rules and administrative cooperation is concerned. Yet, their exclusion from Article 16 implies that the cross-border provision of those services will be subject to the legislation of the Member State where the service is provided. Health care services, audiovisual services, gambling, security services and employment agencies, and social services relating to social housing, childcare and support for families and persons in need are also excluded.

<sup>16</sup> According to Baldwin and Wyplosz (2006, section 2.1.3), this omission can be ascribed to both political and economic factors. There were political difficulties to social harmonisation due to different national circumstances and preferences, and the economic logic that prevailed in the Treaty of Rome suggests no need for harmonising different social standards, since general policies (as opposed to sectoral policies) would not result in competitiveness effects. Given wage and/or exchange rate flexibility, different social standards would trigger wage adjustments that would offset competitiveness effects.

States' social models in regard to two dimensions, efficiency and equity, it can be argued that the evolution of European social models towards higher efficiency is an imperative for their future sustainability, whereas equity is a matter of preference of society but also has an impact on the adjustment capacity.<sup>17</sup> Adopting a dynamic perspective, social systems – more precisely their capacity to adapt and promote restructuring and more efficient resource deployment - are important from a competitiveness perspective and for realising the benefits of the Single Market.

Having taken stock of these differences between the efficiency/equity properties of social systems in the EU and their ramifications for their sustainability and for the good functioning of the internal market, it is important to note that European social models are proving not to be monolithic and thus open to different efficiency/equity constellations.<sup>18</sup> It is the very process of European economic integration that conditions social systems through EU regulation and coordination and there has been an on-going and dynamic reform process in recent decades that revealed the adaptive capacity of the European welfare states.<sup>19</sup> Fundamental welfare reform in Member States is characterised by a very large variety of social and economic policy redirection and the elaboration of new principles of social justice.

## **8. Concluding remarks**

In order to ensure that the internal market delivers the EU needs adequate institutions that promote change in a context of a different market and technological environment (globalisation, the knowledge-based economy). The capacity of an economic and social strategy such as the Lisbon Agenda to unleash the efficiency potential of the single market hinges very much on governance, in particular when reforms to realise international synergies and complementarities or policy-learning with a view to common goals involve not only the EU but as well the Member State level. A coordination mismatch, on the contrary, can be expected to impair performance. Regulatory competition might not be politically acceptable in the internal market, as illustrated by the compromise on the services directive, and not do away with protectionism and market segmentation.

Reforms do take place and institutions evolve (albeit somewhat scattered) at the European and at the Member State level, and they do so notwithstanding the absence of a constitution. The European Single Market and the defence of a level playing field is at the basis of any European model and it has to deliver for the model to be sustainable, as recognised in the Lisbon Agenda in particular in its 2005 refocus. There is also some evidence that competitiveness objectives are becoming more widely entrenched, not only in regard to the wider recognition of the potentially efficiency-enhancing

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<sup>17</sup> Sapir (2005): Efficiency referring to the participation rate and low unemployment, and equity to the probability of poverty. According to that author, in Europe, at present only the Nordic countries manage to achieve both efficiency and equity, while Great Britain and Ireland are efficient but not equitable, the Mediterranean countries are neither efficient nor equitable and Continental countries are equitable but not efficient. The situation would however look less favourable in terms of efficiency for the Nordic countries if only private employment was used instead of total employment – see Heipertz and Ward-Warmedinger (2006).

<sup>18</sup> See Wincott (2005).

<sup>19</sup> See Hemerijck (2005).

properties of the Single Market, EMU and the Lisbon Agenda, but also within European institutions (the Commission, the European Parliament).

With respect to governance, the Lisbon Strategy is often equated with the OMC and its shortcomings (reliance on peer pressure, lack of commitment given no formal sanctions). As far as the refocused Lisbon Agenda is concerned, it is still early to evaluate to what extent the complexity of the guidelines and the practical evaluation criteria of country-specific NRPs will incentivate national debate in poorly performing countries and whether national ownership is sufficient to successfully implement reform programmes with an EU rationale.<sup>20</sup> However, it might be important not to lose sight of the fact that the very discussions prompted and facilitated within the context of the Lisbon Agenda have meant that governance has in practice moved on beyond OMC. The European integration process depicts some adaptive capacity. The dynamics of EU market integration have not only led to the identification of new coordination needs but also built up pressures to resolve them and led to governance responses. Among others, matters related to the single market have moved from the intergovernmental to the community pillar. While the OMC looks important for policy-learning, the Lisbon Agenda moves on to other governance modes.

Efficiency is a necessary condition with a view to the sustainability of any European model albeit not sufficient, as equity considerations and ownership of reforms seem important for successful implementation (services directive, reformed Lisbon Agenda) and not necessarily contradictory (social models). The realisation of the benefits from EU market integration and the way deregulation is conducted (regulatory model) is not an apolitical process in European mixed economies, as the Bolkestein services directive illustrated with respect to the rejection of the European constitution in the Netherlands and in France.

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<sup>20</sup> See Pisani-Ferry and Sapir (2006).

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