



**Kommerkollegium**  
*National Board of Trade*

**The contribution of trade  
to a new EU growth strategy**

Ideas for a more open European economy

**Part 8**

Evaluating the external dimension  
of a new growth strategy

By  
Henrik Isakson

*The year 2010 is approaching and the Lisbon strategy will have to be replaced by a new strategy. The Foreign Ministry has asked the National Board of Trade to discuss ideas for external commercial policies to support the reforms carried out domestically to increase growth. This can be called an “external dimension” of a new strategy. For this purpose we have written eight reports, covering a range of areas, and a summary. You can find it all at [www.kommers.se/trade&growth](http://www.kommers.se/trade&growth)*

**The “internal dimension” of the Lisbon strategy (for example spending on R&D) is annually evaluated with a set of indicators, attempting to measure the success of the various parts of the strategy.**

**We argue that a new growth strategy must include external trade and investments. Consequently, it is logical that this external dimension should also be regularly evaluated.**

**We suggest that an annual evaluation of the external dimension should be published. The report could be released either alongside the annual strategic report on the Community Lisbon Programme or as a part of it.**

**The report should have revolving themes so that every second year it is a *business structure and survey* paper and every second year an *econometric* evaluation. The approach should be to evaluate the openness of the EU from an indirect perspective, as it is the most efficient way to capture all barriers to trade and investment.**

**The task should be carried out by independent researchers or consultants.**

## Introduction

The purpose of this paper is to discuss ways to evaluate the “external dimension” of a new growth strategy in the EU on a regular basis. Appropriate methodology and indicators are discussed. The evaluation is put into the political context of the present growth strategy – the Lisbon strategy – and related to how the progress of Lisbon is evaluated. The underlying idea behind the suggestion is that a transparent evaluation contributes to peer pressure and thus progress.

## Measuring the success of the Lisbon strategy

### The 14 structural indicators

As the Lisbon strategy was launched in the year 2000 the need to follow up the process was recognised. The Commission was charged with publishing annual progress reports, where a number of quantitative indicators were presented and used to benchmark the success (or failure) of the EU members. The fact that it was the member states that were being benchmarked and not the EU as a whole was natural and was due to the fact that responsibility for the implementation of the reforms called for in the Lisbon strategy laid fully on the national governments<sup>1</sup>.

A set of 14 so-called *Structural Indicators* were used. They were divided into three groups, depending on which part of the Lisbon strategy they measured. The first eight indicators aimed at the *economic* dimension of the strategy<sup>2</sup>:

- \* Employment rate
- \* Employment rate of older workers
- \* Labour productivity per person employed
- \* Youth education attainment level
- \* Gross domestic expenditure on R&D of GDP
- \* Business investment (private sector capital formation as part of GDP)
- \* Comparative price levels
- \* GDP per capita

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<sup>1</sup> Since several EU countries, like Italy and Germany, have large regional imbalances another approach could be to measure developments at the regional level instead of the national level. An aggregated national average sometimes says little. There are various ways to assess regional developments (Eurostat has plenty of data), but regarding the Lisbon strategy it is not appropriate, as it is the national governments – and not the regions – that have committed themselves to the strategy.

<sup>2</sup> The remaining six indicators attempt to measure the social and environmental aspects of the Lisbon strategy and are not discussed further here due to the report’s focus on economic growth.. It is also important to note that the indicators can be broken down into a very large number of subindicators, for instance along gender lines.

As can be seen, the indicators attempt to capture a range of aspects. All are most certainly important for growth. However, the choice of indicators and the way of mixing them like this has been criticised. For instance, should we measure the input or the output of the growth equation? The indicators above appear to measure both. The employment rate – to provide an example – is affected both by policies (input) and reactions in the labour market to these policies (output). Most of the indicators above similarly mix government inputs with market outputs.

In general, and not related to the specific indicators above, it is probable that both input and output need to be analysed for any balanced judgement of the success of a potential/proposed strategy. Only focusing on the input means that we ignore the actual results of the policies pursued by a country. Only looking at the output, on the other hand, is unfair as it is affected by so many factors beyond the reach of a national government. Hence, we need both.

### **The National Reform Programmes**

Since the re-launch of the Lisbon strategy after 2005, following the criticism for non-delivery by the so-called Kok-report<sup>3</sup>, each year all member states have had to make a *National Reform Programme*, outlining how it should work in the coming year to achieve the targets in the strategy<sup>4</sup>.

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<sup>3</sup> FACING THE CHALLENGE - The Lisbon strategy for growth and employment, Report from the High Level Group chaired by Wim Kok, November 2004.

<sup>4</sup> To be formal, the programmes are only written every third year. During years 2 and 3 in the cycle the governments release implementation reports, where they, on the one hand, comment on their own achievements and, on the other, look ahead.

In 2007, the annual *Commission progress report*, released in December each year, was renamed the *Strategic report*. The report is mostly aimed at the future and not the past, i.e. its main ambition is not to evaluate what has been done but to focus on what should be done. The latter part also contains Commission assessments of each country's national reform programme<sup>5</sup>. The report contains "points to watch" for each country and also "recommendations" for most countries<sup>6</sup>. None of them are binding, and there are no sanctions attached, but the recommendations are a form of more severe criticism, basically for not having done enough regarding what has previously been singled out as a reform priority in a certain area. The more recommendations a country gets, the worse it is, but they can not just be counted one by one as they might have different degrees of importance. Even though the recommendations are forward looking they serve as an evaluation of how the homework has been done. Thus the process creates a weak form of peer pressure and the recommendations could be said to be some kind of qualitative input indicator.

The fact that the National Reform Programmes looked very different, with quite differing standards of ambition, made it hard for the Commission to evaluate them. This led to the establishment of a new working group, *LIME (Lisbon Methodology Working Group)*. LIME operates under the Economic Policy Committee, which prepares the work for ECOFIN.

The purpose of LIME, which held its first meeting in February 2007, is to devise an explicit methodology to work with the evaluation process. This will be achieved in three steps. First, the National Reform Programmes should be harmonised, with a streamlined set of tables, in order to make them as comparable as possible. This work is completed and the results were used for the work with the programmes in 2007, although it is too early to tell whether the aim has been achieved or not.

Second, work on a methodology for *growth accounting* has proceeded far. The aim is to divide growth into two main components: labour force participation and productivity. There is a parallel to ongoing work on this in the OECD's *Going for growth* exercise, and the ambition is to be able to better track the sources of growth and to help identify underperforming policy areas.

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<sup>5</sup> The assessment of the countries is both quantitative and qualitative and divided into three blocs, namely (1) macroeconomic policies, (2) microeconomic policies (which includes competition) and (3) labour market policies.

<sup>6</sup> Countries not receiving any recommendation are seen as having done their homework in an appropriate way, i.e. no major reforms outstanding for the time being. In the latest report (December 2007) those countries were Denmark, Estonia, Finland, Ireland, Luxembourg and Sweden. Source:

[http://ec.europa.eu/growthandjobs/faqs/developments/index\\_en.htm](http://ec.europa.eu/growthandjobs/faqs/developments/index_en.htm)

Finally, the third project of LIME, which is still at an early stage, is to develop a causality model between reforms and results. Basically the question is “if a country, under these assumptions, carry out a particular reform, what will the result be in terms of growth?”. Naturally, this exercise is the, by far, hardest one and also – sensitive as it is to the assumptions made –, open for interpretation and debate. It should be emphasised that there is yet to be decision on whether the methodologies of the two latter parts of LIME’s work should be used or not.

### **The Community Lisbon Programme**

Not all ownership of the strategy is national anymore. There are clearly also areas where the main responsibility for action lies with the European institutions. In 2005 the Commission presented its first *Community Lisbon programme (CLP)*. A new one has been launched for the period 2008-2010. The ambition of these programmes, drawn up by the Commission, is to complement the National Reform Programmes in areas where there are significant externalities in the policy making process. In some areas the Commission can implement reforms on its own, but in most areas approval is required by the Council and the Parliament.

The areas covered by the CLP are many and diverse. Basically all Commission proposals that have any vital impact on the competitiveness of the EU are considered part of the programme. The first CLP does not have any trade policy proposals at all, but it does have proposals that have an indirect effect on trade with third countries. The most important such example is probably the services directive, which will open up internal services trade within the EU and as a consequence also help service providers from third countries operate within the EU.

The new programme for 2008-2010 contains 10 key objectives, including a common immigration policy, the reduction of regulatory burdens with 25 %, the integration of the fragmented financial services market and the adoption of the climate change package. The last point of the agenda is the most interesting for anyone dealing with trade policy: it says that the EU should negotiate bilateral trade agreements. This is a novelty as it explicitly links a trade policy proposal to the Lisbon agenda.

The Commission is releasing an annual *technical implementation report* on the progress of the Community Lisbon programme. To measure this is quite easy as it is a pure input exercise. The Commission sets clear targets for which bit of legislation to introduce or propose within which time frame. It has nothing to do with the impact of the reforms; just that the Commission has done its job. Hence, evaluation is fairly straight forward and uncontroversial. It is not unlike the biannual *Internal Market Scoreboard*, which evaluates the transposition of EC law into national law and the infringements of these directives. The procedure to do this is simply to count the number of directives not yet transposed and make a calculation on the percentage of outstanding transpositions to be made. It is a measure of the legal integration of the EU national markets with each other.

## How to measure the external dimension

All the activities with evaluation of various indicators discussed above suggests that the Lisbon strategy is not about to end in 2010. It may end formally, be renamed after a new city and partly refocused, but there will also be an overarching economic strategy for the EU in the coming decade. Europe will continue to want to strive to be competitive in the future.

Openness towards the rest of the world is essential for any new strategy to succeed. To be open can have many dimensions, but in this paper the focus is on trade, or, to be more precise, imports<sup>7</sup>. Trade is an element that is totally missing in the original Lisbon agenda. This is unfortunate as it is well documented in economic literature that imports benefit the importing country. Imports allocate resources efficiently, increase competition, lower prices for both consumer goods and industry inputs and, above all, facilitate structural change. By measuring EU openness for imports one can see to what extent the EU firms operate in a globally competitive environment.

The choice of excluding trade policy in the strategy can now be rectified and there are grounds for optimism as both the *External dimension of the single market* agenda and the new Community Lisbon Programme, as mentioned above, include trade policy. Also, the *Global Europe* strategy, informally attached to the Lisbon strategy, is a pure trade policy agenda.

Let us now assume that the next growth strategy will contain an ample discussion on the merits of free trade as a tool for reaching the targets set out in the strategy. Then it would only be natural to also include an element of evaluation on the trade dimension. After all, other areas of the strategy are being evaluated annually.

Unfortunately, to measure openness for trade is more complicated than most of the indicators discussed above. To begin with, we can see that several traditional ways of doing this are inappropriate. This includes such measures as trade ratios to GDP and analysis of tariffs, at-the-border NTBs and subsidies<sup>8</sup>.

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<sup>7</sup> The benefits of exports are needless to emphasise here as they are uncontroversial.

<sup>8</sup>  $\text{Export} + \text{imports} / \text{GDP}$  is the most traditional way of estimating the openness of an economy. However, it is inappropriate both because it neglects the different characteristics of countries (small countries trade more etc) and also because it to a large degree does not deal with policies but the market. Increased/decreased trade is usually because of economic cycles and not because of policy decisions.

Tariffs are very low today in the EU – the weighted applied average for industrial goods is only 1.3 %. For the vast majority of goods, tariffs today play almost no role and they do not therefore constitute a good indicator. There are still goods with high tariffs, like textiles, but even then tariffs do not make a good indicator because they do not change every year.

However, much advanced work in this area is already carried out by international organisations, consultants and researchers worldwide. Perhaps the most well known and comprehensive study is the *Trade Policy Review (TPR)*, published regularly by the WTO. A review of the EU is carried out every second year. The problem with the TPR is that it is very descriptive and contains little analysis. Probably the most ambitious attempt to directly quantify trade barriers is the World Bank *Overall Trade Restrictiveness Index (OTRI)*, which compares trade policies for trade in goods in a comprehensive and econometrically quantified model. It includes measures of both tariff and non-tariff barriers as well as agricultural support, and boils down all these measures to one figure for each country, which is the tariff equivalent of the total trade restrictiveness. A major drawback is that OTRI does not include services.

### **An annual evaluation of developments in the external dimension**

As discussed above, both the National Reform Programmes and the Community Lisbon programme are being evaluated annually. However, the ambitions have not been very high. Concerning the evaluation of national progress, not only can the choice of indicators be questioned, but even the publication is strange. In the beginning the indicators were presented openly in a comparative way in the annual progress reports from the Commission. It was easy to see how the countries were faring. However, as countries receiving low scores did not much appreciate this “Eurovision Song Contest”-like exercise it was ceased in 2005. Today, although the indicators are still measured, the results are no longer presented with ranking tables.<sup>9</sup>

With the work of the LIME-group the ambitions appear to have been set higher again, although the evaluation is more qualitative now. The higher ambitions are fine, but at the same time this creates an asymmetry towards the evaluation of the Community Lisbon programme, which is evaluated in a very crude way. As trade policy is an area which falls under the competence of the European institutions it will, if nothing changes, only be evaluated with the crude assessments in the technical implementation reports covering the progress of the Community Lisbon programmes.

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Also, those non tariff barriers (NTB) that are the easiest to measure are at the same time rather irrelevant. Quotas are hardly used anymore. Antidumping and similar trade defence measures are quite commonly used, but they still only affect a small fraction of all trade and they are anyway already measured.

Subsidies affect trade, especially in agriculture. Agricultural subsidies can easily be measured, but there is no reliable data for industrial subsidies.

<sup>9</sup> For anyone interested in rankings of the same indicators used by the Commission, but without the politically correct niceties in the interpretation, see *The Lisbon Scorecard* from the Centre for European Reform (CER). They rank the countries from (in 2008) number 1 Denmark to number 27 Malta, using grades from A to F. They also name the heroes of the year (Austria, Estonia and the Netherlands) and the villains (Greece and Italy).

We propose much higher ambitions. A thorough process of evaluation of the EU's openness for trade is a contribution to a more transparent Europe. It should be simple and clear for anyone to see how open the EU economy is and how this is evolving over time. This is not stranger than to say that it should be easy to follow the developments of R&D spending in Europe. The data and methodology is there if the political will can be found. Maybe the mandate of LIME should be expanded to also discuss how to best evaluate the external dimension? Or LIME is the wrong forum and a new group should be set up? Or maybe no group is needed? All that is needed is a decision to go ahead and work with already established and well known methods.

**We suggest that an annual analysis of developments in the external dimension of a new growth strategy should be released either alongside the annual strategic report or as a part of it. The analysis should have revolving themes so that every second year it is a *business structure and survey paper* and every second year an *econometric exercise*. The task should be carried out by independent researchers or consultants<sup>10</sup>.**

The advantage with the revolving themes is that it will widen the scope of the analysis as we look at different aspects from different angles. It also gets more interesting because the situation does not change dramatically from year to year and by not reporting every year on the same indicators public and media interest might increase when the reports are released.

What is important to note is that the ways we suggest to deal with this all focus on the outputs of trade policy, i.e. actual trade openness and not the policies themselves. We find this indirect approach a better one than any direct attempt to try to measure the EU policies. Below the ideas for the contents of the evaluation are presented. It should be emphasised that these are just ideas and it is up to the researchers who wins the Commission contract to decide on exact methodology.

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<sup>10</sup> Examples of such might include CEPII in France, CPB in the Netherlands, the Kiel Institute for the World Economy in Germany and Copenhagen Economics in Denmark. Then there are universities with an academic track record in this field, such as the University of Sussex in Brighton and Science Politiques as well as Sorbonne in Paris to mention those that we have been in contact with.

### **The business structure and survey**

The idea of such an analysis is both to study to what extent the European economy is globalised (structure) and to find out the way business perceive globalisation from their perspective (survey). These exercises are easy to carry out and the results are easily understood. First, regarding the structural analysis, one could measure such fairly straight forward indicators as *share of internationally trading firms as part of all firms, share of the employees working in such firms, share of employees working for a foreign owned firm or share of the value added produced by foreign firms*. If Eurostat is not already compiling statistics of this kind it should be fairly easy to start such work.

Second, regarding the survey, the combined answers from a large number of firms in all 27 EU countries could be valuable. The people actually involved in the economic interactions do not see the situation from the same birds-eye view as researchers do. But they provide insights of a kind no statistics can.

The survey could address both small and large firms and preferably in all sectors and not just be limited to the tradable sector. The advantage with the latter is that it would look at the effects of foreign commercial activity also on those firms that are not themselves active in trade. By doing that we get a fuller picture. Even if a firm is not exporting or importing and not even competing with imported goods and services it will still be affected by trade and foreign investments in the inputs it buys etc. The questions to be asked should concern how the firms feel affected by foreign competition.

One should also seriously consider the idea to carry out a similar survey with firms outside the EU to see how they regard the EU market. Is it open or closed? What barriers, obstacles and problems do they encounter as they try to enter the EU market? Such a survey would provide complementary insights.

A problem with these kinds of surveys is that they disturb the firms and they might be disinclined to answer as they see no immediate benefit for them. On the other hand, surveys are regularly used by the World Bank<sup>11</sup>, and also within the EU for economic forecasting.

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<sup>11</sup> <http://rru.worldbank.org/EnterpriseSurveys/>

Both the structural data and the survey data should be, to the largest/greatest extent possible, analysed with an internal market/external trade perspective. For example, regarding the structural part, an indicator such as the number of employees working for foreign owned firms should be divided into EU and non-EU foreign firms. Concerning the survey part, a question such as how the firms perceive foreign competition in their sector could be further broken down into asking from which countries the competition is coming. The idea of this internal/external analysis is to be able to analyse both the extent of globalisation and the extent of integration within the EU.

### **Econometric evaluation 1: gravity equations**

This is considerably harder than the analysis discussed above. Sensitive as it is to the assumptions made, it is open – as are all modelling exercises – open to academic criticism. The results are therefore also open for interpretation and can not be taken at face value, unlike the analysis above. It is also harder to present the analysis to a non-academic audience in an easily understood way. Nevertheless, it is worthwhile to conduct analysis of this kind as it provides a completely different kind of insights and broaden our understanding of how trade policy in reality affects trade. We propose two kinds of econometric evaluations, carried out every second year. The two will complement each other. Both are indirect ways of measuring trade barriers.

First, we suggest a gravity model to be developed. A gravity model predicts a theoretical trade flow and compares it with a real one. The model is loaded with data on geographical distances, language barriers, GDP, population, factor endowments etc for all countries. A calculation is made based on how much trade there should be between various countries according to the model. It is then compared to actual trade which will be different from the model. The difference (the residual) contains everything the model did not capture. Some of that might be protectionism, but there might also be other explanations, such as consumer preferences (often home bias), substitutability of goods and foreign direct investments replacing some trade flows.

Fontagné et al (2005)<sup>12</sup> have developed a very useful new gravity model. Probably it has a higher explanatory value than previous models as it better isolates the protectionist contents from the other causes of the residual from each other<sup>13</sup>. They use trade flows between and *within* eight of the EU countries as well as the US and Japan for 26 industries to evaluate the overall effect of national borders on trade. The advantage with doing this on an industry level is that protectionism can be studied sector by sector, which is important since differences in protection varies widely between sectors. For example, Fontagné et al show that imports to the EU of US-made scientific equipment does not encounter any statistically significant potential protection at all, whereas imports of US furniture and plastics has a severe border effect, i.e. trade is drastically reduced due to the border.

By using Fontagné's gravity model several useful results can be obtained. Let us assume we are interested in the trade barriers between Germany and the US. As the EU is not fully harmonised<sup>14</sup> these will differ a bit from the barriers between, for example, France and the US. The model can estimate Germany's "trade with itself" (German production minus German exports) and then compare it with Germany's trade with the US. Then various factors that naturally decrease German-US trade are isolated and the remaining residual is the estimated trade barrier. What is more, the same exercise can be carried out *between* member states of the EU. By doing both we can get a picture of the degree of integration in the EU internal market compared to the degree of integration in the global economy. This can be done by, for example, first estimating German-US barriers and then German-French barriers. The latter will be smaller and the difference in "lacking trade" is an indication how much more integrated Germany and France are than Germany and the US.

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<sup>12</sup> Fontagné, Mayer and Zignago (CEPII, Paris), *Trade in the Triad: how easy is the access to large markets?* Published in Canadian Journal of Economics 2005.

<sup>13</sup> All goods with tariff lines where there are no tariffs or NTBs recorded (dummy variable = 0) are regarded as goods for which there is free trade, i.e. any trade "missing" can thus not be blamed on protectionism.

<sup>14</sup> Most importantly, there are national technical regulations that are different in different member states of the EU and which affect trade.

## Econometric evaluation 2: price differentials

Second, a price analysis should be carried out. The prices for identical goods in different markets are rarely the same. The “law of one price”, which states that if markets are open prices will eventually converge, can not function in reality. The reason is that there are transaction costs, geographical differences, taxes, regulations, non-tradable costs (local rents, marketing costs etc), that will produce different prices in different markets even if there are no formal trade barriers. This is the case even within countries. However, researchers have isolated the price effects by policy decisions, like regulations, from other effects, like geography and transaction costs. By focusing only on price effects of policies one can see the aggregate costs of these policies, even if one can not attribute any particular price hike to any particular policy. Also, price analysis can not distinguish between effects arising from the internal and external markets. If the prices are falling due to the internal market or external trade policy liberalisation, we can not say.

The advantage with this method is that it captures the full effect of all policies and that it also finds the effect on services. Bradford and Lawrence (2004) have shown that in the 1990s five EU countries, in aggregate, lowered their prices and concluded that this was the result of lowering trade barriers<sup>15</sup>. Nevertheless, there are grave problems. One is that it is impossible to distinguish “good” policies from “bad” ones. Maybe we accept higher prices for a higher environmental standard? The key is that the products that should be compared must be *like* products, i.e. you can not compare prices for one brand of shoes with another brand or for an environmentally certified good with one that is not.

The idea to carry out this kind of price analysis should fit well with the Commission’s plan for a *consumer scoreboard*, which was unveiled in “A single market for the 21st century”<sup>16</sup>. In the scoreboard the Commission plans to study five aspects of consumer concerns, one of them is prices. The Commission writes: “Higher prices can be due to differences in demand or cost structure. Price levels can also signal a less efficient market from the point of view of consumers due to the regulatory framework or the competitive environment.” It is the latter aspect that we are interested in. The Commission also says that comparable price data for

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<sup>15</sup> Bradford, Scott C and Robert Z Lawrence. 2004. *Has globalization gone far enough?* Institute for International Economics. Washington DC.

The IIE study showed that price hikes caused by policies fell moderately in the 1990s. This was partly due to falling prices for agricultural products. For agricultural goods there is the producer Nominal Production Coefficient (pNPC) measure, produced by the OECD. It can easily be transformed to a price gap analysis. It then shows the degree of protection awarded to a particular good by showing how much more the good costs in the EU than in the world market. It is clear that EU prices for agricultural goods have converged dramatically with the rest of the world in the last decades, although they are still far above world market prices.

<sup>16</sup> More about the consumer market scoreboard at [http://ec.europa.eu/consumers/strategy/facts\\_en.htm](http://ec.europa.eu/consumers/strategy/facts_en.htm)

all but a few sectors is a rare commodity in the EU. Thus, any attempt to improve the data situation to be able to work with the consumer scoreboard will at the same time make it easier to work with a price analysis of the kind we propose.

### **Conclusion regarding the two set of evaluations**

The evaluation exercise is not politically neutral. The purpose of the evaluation is not just to amass data, but to see if developments are on track or not and how countries are faring in their pursuit of competitiveness. Therefore, the indicators to be used in the methodology discussed above should have an aim to strive for. The aim of the business indicators are not so clear cut though. One can not say that “the larger part of the economy that is owned by foreign firms the better” or “the more we import the better”. Rather, those indicators simply need to be followed to see that commercial influences from abroad (both intra- and extra-EU) do not fall to levels where competition pressures are diminishing.

However, with the econometric indicators the aim to strive for is easier to formulate. It is zero. That is, trade barriers should be reduced to zero, both within the EU and externally. At the same time, policy induced price differences should also be reduced to zero. If this happens, we know that economic integration is “completed” and all unnatural trade barriers have disappeared. This is of course not possible, and in several ways not really desirable as policy differences between countries are natural in some areas due to different national preferences. Nevertheless, to strive to get the estimate of “lacking trade” and price differentials down as much as possible is a suitable target.