Europe's newest members challenge the old
By Carl Bildt

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The resilience of the productivity revolution in the US and the failure of the Lisbon process of economic reform in Europe often make it seem as though the European economy is in crisis.

Hopes that this month's term review of the Lisbon agenda by European Union leaders will change that picture are not high. Some governments seem more interested in fighting than supporting proposals from the new, reform-oriented European Commission under José Manuel Barroso.

But the focus on top-down economic reforms has distracted people from another, potentially far more important, process of change - a bottom-up economic restructuring triggered by EU enlargement.

The 10 countries that joined the EU last May increased the size of the Union's economy by only about 5 per cent, but their impact on the process of economic restructuring is likely to be far greater.

In fact, the forces of competition are probably increasing faster in Europe than anywhere else in the global economy, triggering an overhaul of the manufacturing sector and changes in the regulatory and tax environment.

Take flat taxes. Estonia got the bandwagon rolling in 1991, but the flat-tax principle has since proven its worth in other "Baltic tiger" economies. Estonia started with a 26 per cent income tax; it has since reduced that to 24 per cent and is aiming to cut it to 20 per cent. Lithuania just announced its intention to lower its 33 per cent flat tax rate gradually to 24 per cent.

The second wave of this revolution was started by Slovakia as it desperately tried to catch up with the other central European nations. Its radical 19 per cent tax on income, capital and consumption is set to transform Slovakia and has become a new benchmark for the rest of central Europe. With elections coming up in Poland this year and the Czech Republic next year, the leading opposition parties are advocating flat taxes. Hungary will not be far behind. Romania introduced a flat tax this year.

The big question is when the third wave - which would see this flat-tax bandwagon roll into one of the "old" EU states - will come. It is not imminent - but on present trends it may well be unavoidable.

When the World Bank recently assessed reforms to improve the business climate around the world, it concluded that Slovakia was the world's leading reformer, and that in general "the major impetus for reform was competition in the enlarged European Union". No fewer than seven of the top 10 reformers in the global economy were existing or new EU members.

With Slovakia as a neighbour, Austria has had to reform its corporate taxes, with positive results. Now Bavaria is feeling the heat, and pressure on Berlin is increasing. In the north, Finland is feeling the pull of Estonia next door and Sweden will not be able to ignore the changes that may result.

This is only one part of the change triggered by enlargement. Whereas during the 1990s European industry looked west and invested heavily in the US, manufacturers are now starting to look east. The flow of investment is heading towards eastern Europe and east Asia, where Europe's new production capacity is increasingly located.

The automotive industry illustrates the trend. With only rare exceptions, new plants are being built in the east. In a few years' time, Slovakia will be producing more cars per capita than any other country in the world.

In Germany, there are fears that the country is turning into a "bazaar economy", where factories merely assemble finished products from components produced elsewhere. But if Germany is turning into a bazaar, it is for the positive reason that integration of the European economy is taking a quantum leap forward.

As it restructures under the pressure of globalisation and enlargement, European manufacturing industry is becoming more competitive. Throughout central Europe both manufacturing output and exports grew in double digits last year.

Governments can grumble as much as they like - and to little effect - but for most it will be a question either of reforming their economy or starting to lose important parts of it.

Not everything is rosy in Europe. But, with the strong wave of economic reform coming from the east, it should come as no surprise if, after a decade of disappointing expectations, the European economy soon begins to exceed forecasts. If that happens, it is likely to be down to the "Tallinn-Bratislava process" rather than the Lisbon process.

The writer is former prime minister of Sweden, chairman of the Kreab Group and board member of the Centre for European Reform