

**LESSONS FROM THE USA FOR THE
EUROPEAN ECONOMIC CONVERGENCE**



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ABSTRACT

One of the most important European Union objectives is to achieve real economic convergence among its member countries. That is, to “push” poorer European countries (in terms of gross domestic product per capita) towards the European average. A considerable portion (33%) of the European budget is allocated for that purpose, and central transfers into poorer countries represent over 1% of their GDP.

Nevertheless, results have fallen below expectations. Economic convergence has been slow in some cases, nonexistent in others. That should not come as a surprise, given the example of the United States; the process of economic convergence is neither automatic nor always speedy. Sometimes, it does not exist at all.

However, what is really surprising is that, today, the economic convergence achieved by the United States is below that of Europe, further illustrating that in the process of development, some regions fall merciless behind, even if they are within the same economic space.

INTRODUCTION

One of the great economic objectives of the European Union is to achieve real convergence among its member states — to bring poorer countries (measured in terms of gross domestic product per capita) into the European average.

For such a purpose, the European Commission in Brussels (the equivalent to the U.S. federal government) has for the past two decades invested, year after year, considerable amounts into the economy of four poorer European countries: Spain, Ireland, Greece, and Portugal. These investments have come in different forms: costs sharing of major public work programs, financing of education, and subsidizing private companies under special programs.

The value of these transfers into poorer countries have been significant. For the European budget, they represent 33% of the total budget. In terms of each country's economy, Portugal, Greece, Spain, and Ireland (the four poorer European countries when they joined) received 2.2%, 1.6%, 1.3%, and 0.33%, respectively, of their gross domestic product in transfers (between 2000–2006, at 2004 prices).

THE PROBLEM

Nevertheless, progress among poorest European countries has been relatively slow.

Portugal joined the European Union in 1986. At that time its GDP per capita was 55% of Europe's average, in 2007 it was 66.1%, an increase of 11.1% in 22 years, for an annual convergence rate of 0.88%. At this rate, Portugal will reach European GDP average only after another half a century — in 2055 (Table I), and the European Union will need to keep on pumping funds at the present rate (2.2% of Portugal's GDP).

The convergence of Greece has been even slower. Greece joined the European club in 1981. At that time its GDP per capita was 86.3% of Europe's average, 27 years later it is at 88.2%, an increase of 1.9% in 27 years, or 0.08% per year. At this rate, Greece will reach the European GDP average in 2163 (see Table 1).

Spain joined in 1986. At that time its GDP per capita was 72.5% of Europe's. In 2007, 22 years later, it was at 93.5%, an increase of 21% in 22 years, or 1.22% per year. If the trend is kept, another six years will pass by before Spain reaches the European average (Table I).

Ireland is the only poor country (when it joined the European Union) that has achieved fast convergence. It joined in 1973 with GDP per capita of 60.8%. In 1998, 24 years later, its GDP per capita reached Europe's average. In 2007 it was 31% above that average.

So, what is the outcome of the European Union process of economic convergence? At best it has had a mixed outcome. Ireland achieved a fast convergence, but for Portugal, Spain, and Greece, convergence was slow, in spite of the fact that all countries received central transfers of more than 1% of their GDP, year after year (except Ireland). Another quarter of a century will be needed before Portugal reaches the European average.

Should this come as a surprise? In part. We know from economic theory that there are forces in favor and against economic convergence (Figure 1).

Table I

The economic convergence of European poorer (when they joined the European Union) countries	Portugal	Greece	Spain	Ireland
Year of joining the EU	1986	1981	1986	1973
Transfer of cohesion funds as % of GDP (at 2004 prices)	2.2%	1.6%	1.3%	0.33%
GDP per capita at year of joining as % of EU average	55%	86.3%	72.5%	60.8%
GDP per capita in 2007 as % of EU average	66.1%	88.2%	93.5%	131%
Number of years to reach the EU average at the present trend (2007+)	48	156	6	Reached EU-15 average in 1998

Sources: Statistical Annex of European Economy - Spring 2008; European Commission

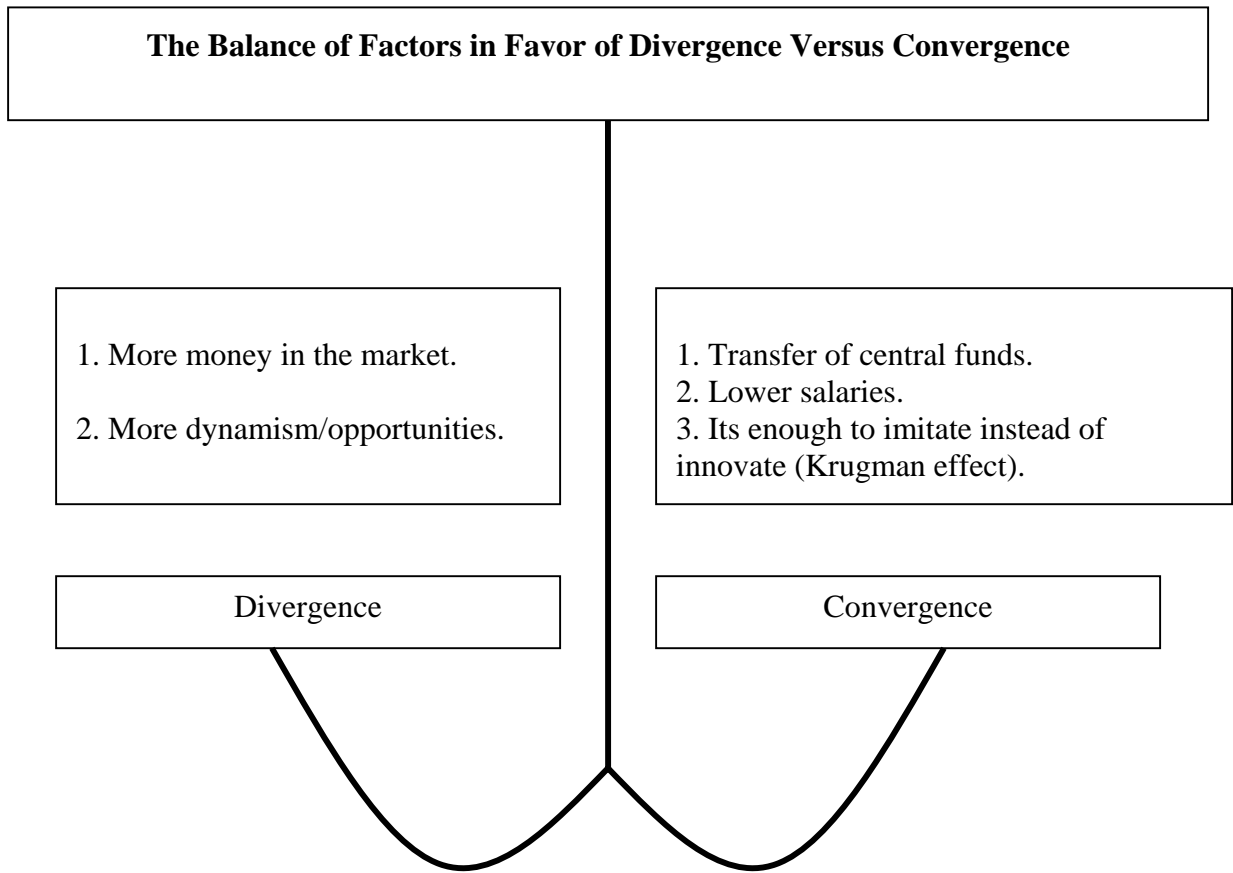
In general, three variables favor convergence of a poor region:

1. Transfers from the central government,
2. Lower salaries, and
3. No need to innovate, only to imitate (the so-called Krugman effect).

Then, against convergence, that is in favor of more developed regions, there are two factors:

1. More money, therefore a larger market making possible greater specialization and company scale economies, without the onus of transport costs; and
2. Greater dynamism, thus more opportunities (the rhythm of a chain, is the rhythm of its slowest link).

Figure 1



So, we knew from economic theory that there were factors for and against economic convergence. However, it was thought that in the long run, forces in favor would outweigh those against. That this is not the case comes somewhat as a surprise. But that should not be so if one had looked at the example of the United States.

The U.S. Example

The United States has been an economic union (no internal trade tariffs) for more than 200 years (Europe started, slowly, in 1957). It has been a monetary union for long, too (single currency), and has a federal budget more than 16 times larger than Europe's.

And what is the result? What economic convergence has been achieved by the United States?

The answer is: much lower than could be expected. There are two ways of seeing this. The first is by looking at the difference in the standard of living among the 50 U.S. states and the District of Columbia. The other is by comparing the level of that difference with the difference among the 15 countries of the European Union.

Indeed, among the states there are great differences. The average GDP per capital (PPP¹) in 2006² of the United States was USD 44,363 (Figure 2). But the state of Mississippi is 34.79% below (GDP per capita equal to two-thirds of the U.S. average). West Virginia is 30.95% below and Arkansas 26.4% below. And there are the richest states: District of Columbia is 240% above the average; Delaware is 60% above; and Alaska 38.3%.

Comparing the richer states with the poorer, the differences are enormous. In relation to the average of the three poorest states (Arkansas, Mississippi, and West Virginia) the GDP per capita of the District of Columbia (location of the U.S. capital, Washington) is 400% times superior, Delaware is 130% superior, and Alaska 100% superior.

So, there is a large economic divergence, a few states are very much above the average, and others well below after 200 years of an economic and monetary union (Figure 2).

¹ Purchasing power parity.

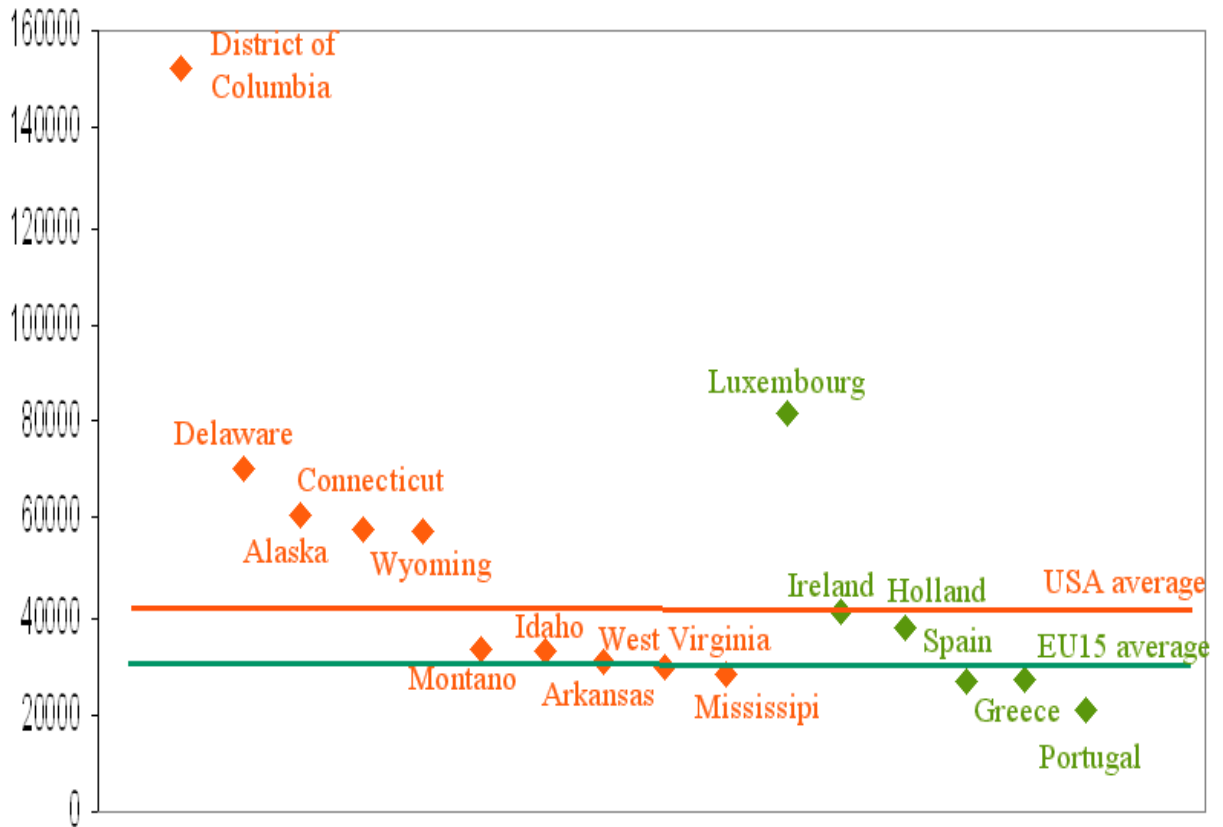
² Most recent data available for international comparisons.

This happens despite the existence of a large number of states with a GDP per capita close to the average, forming a solid nucleus of convergence: Louisiana, Texas, Hawaii, Washington, Maryland, Illinois, etc. But afterwards, there are extreme cases of richness and of poorness. Included among those poorer states, along with Arkansas, Mississippi, and West Virginia, are Idaho (23.3% below the U.S. average), Montana (22.9% below the average) South Carolina (22.2% below the average), and Kentucky (21.8% below the average), among others.

Figure 2

The divergence in the USA and the European Union: the average, the richer, and the poorer economies in each union.

GDP (PPP) per capita 2006, U.S. dollars



Sources: Statistical Annex of the European Union, Spring 2008, European Commission; U.S. Bureau of Economic Analysis; U.S. Census Bureau.

Then, there is a major surprise. When one compares how similar the 50 U.S. states are among themselves with how similar are all 15 European countries, in terms of GDP per capita, one reaches the conclusion that European countries are more similar (have greater convergence) than U.S. states!

Two measures indicate that much: the Gini Index and the GDP per capita variance divided by its mean.

As Table II shows, the Gini Index is greater for the United States (0.22) than for Europe (0.16).¹ Thus, the economic divergence is greater in the United States and convergence is larger in Europe. The 6% difference is represented in Figure 3, where the U.S. Lorenz curve (the geometric representation of the Gini Index) is below that of Europe.

Indeed, the greater the economic divergence, the flatter over the horizontal axis the curve would be. On the contrary, in the case of no divergence whatsoever (total convergence), the curve would be equal to the straight line linking the southwest and northeast corners.

Another indication that U.S economic divergence exceeds Europe's is provided by the GDP per capita variance divided by its average. The 15 European countries rate here far below the 50 U.S. states: 3.82 versus 6.45 (see Table III), indicating that variability is far greater in the USA (two times greater) than in Europe.

¹ The Gini Index ranges from zero (total economic convergence, that is, no difference in GDP per capita) to 1 (total economic divergence, very large GDP per capita differences among states or countries). So, the higher the value of the index, the greater the difference in GDP per capita.

Table II

GDP per capita	Gini Index
USA	22%
European Union	16%
$\frac{\text{USA}}{\text{European Union}}$	137.5%

Figure 3

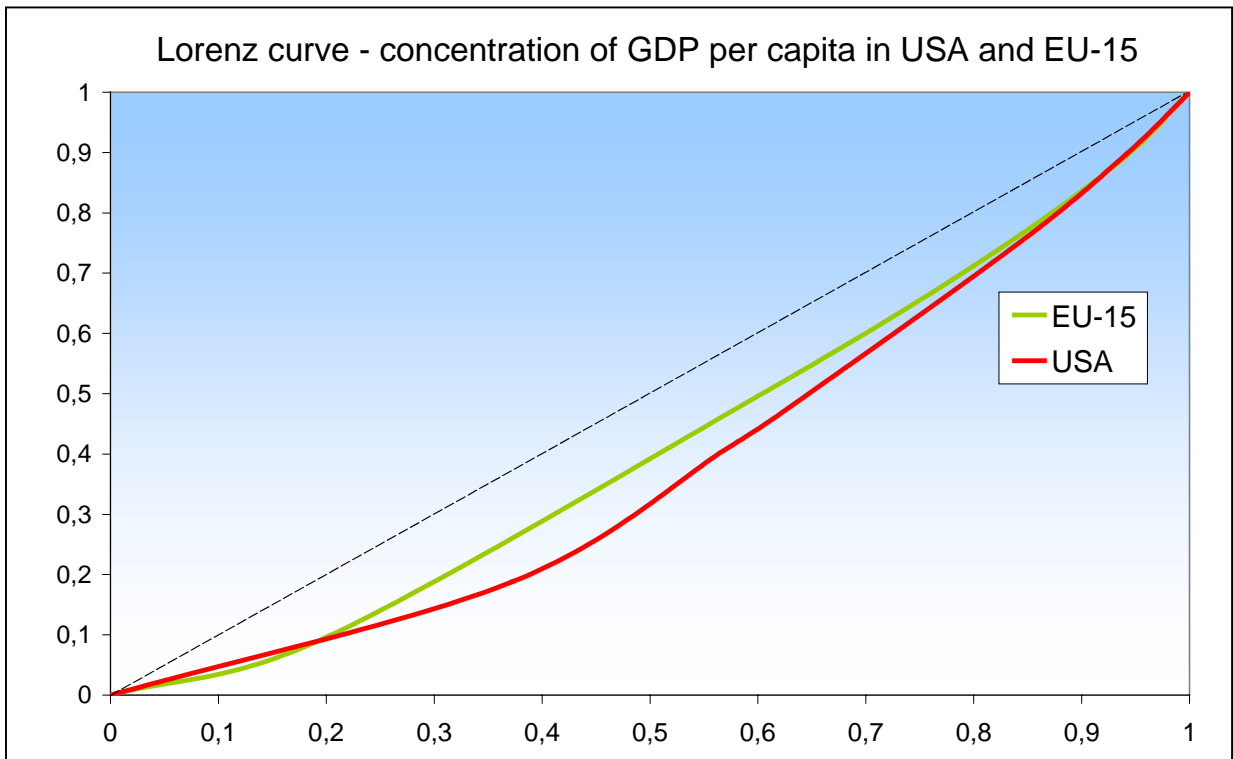


Table III

GDP per capita	<u>Variance</u> <u>Mean</u>
USA	6.45
Europe	3.82
$\frac{\text{USA}}{\text{European Union}}$	1.69

CONCLUSION

It should come as no surprise, based on the U.S. example, that the economic convergence of some poorer European countries has been slow in some cases (Portugal), and practically nonexistent in others (Greece).

Two hundred years of economic, monetary, and political union have not been sufficient to achieve that convergence in the United States: Arkansas, Mississippi, and West Virginia stand out as the most important nonconvergence cases.

However, what is most surprising is that, at present, economic divergence is greater in the United States than in Europe (Table II). That indicates that, contrary to the widespread belief, time and transfers of central funds will not do it all.

Thus, we can conclude that the sole way of achieving and speeding up the process of economic convergence is through structural reforms in the economy of each state or country. Without them, all regions may equally benefit from the transfer of central funds, but in the end, some will be more equal than others.

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