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Directorate-General for Research

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A BACKGROUND TO EUROPEAN ECONOMIC POLICY 2003

*Economic Affairs Series
ECON 133 EN*

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TRANS-EUROPEAN POLICY STUDIES ASSOCIATION (TEPSA)

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Authors: Expert group for the Trans-European Policy Studies Association (TEPSA): Iain Begg, Jacques Le Cacheux, Stefano Fantacone, Dermot Hodson, Kerstin Jacobsson, Ingo Linsenmann, Jacques Pelkmans, Lisa Rodano, Wolfgang Wessels.

Responsible Official: Aila Asikainen
Division for Economic, Monetary and Budgetary Affairs
Tel.: (352) 43 00-27002
Fax: (352) 43 00-27721
Email: dg4economie@europarl.eu.int

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Contents

1 - EXECUTIVE SUMMARY.....	5
1.1. OUTLINE OF THE REPORT.....	5
1.2. CONCLUSIONS AND RECOMMENDATIONS	7
1.2.1. <i>The aims of policy co-ordination and the inputs of different actors to the process.....</i>	<i>7</i>
1.2.2. <i>Structural policy co-ordination and the obstacles to achieving reform.....</i>	<i>8</i>
1.2.3. <i>Mechanisms and procedures.....</i>	<i>10</i>
1.2.4. <i>Possible novel measures to advocate.....</i>	<i>10</i>
2 - INTRODUCTION.....	13
2.1. STUDY SPECIFICATIONS PROVIDED TO THE CONTRACTOR	14
2.2. MACROECONOMIC CONTEXT	14
2.3. THE IMPLEMENTATION OF THE 2002 BEPGs.....	16
3 - THE POLICY CO-ORDINATION PROCESS AND ITS EVOLUTION.....	19
3.1. THE EXCESSIVE DEFICITS PROCEDURE.....	20
3.2. PROCEDURAL DEVELOPMENTS	21
3.3. COMMENTARY AND ASSESSMENT	22
4 - THE NATURE OF STRUCTURAL REFORMS.....	25
4.1. PROMOTING STRUCTURAL REFORMS: PRODUCTIVITY AND COMPANY RESTRUCTURING	27
4.2. CORPORATE SOCIAL RESPONSIBILITY.....	29
4.3. ASSESSMENT	30
5 - PUBLIC AND PRIVATE INVESTMENT TRENDS.....	31
5.1. PUBLIC SECTOR DEVELOPMENTS.....	31
5.2. BUSINESS INVESTMENT.....	33
5.3. INVESTMENT IN THE EU: PRIORITIES AND BOTTLENECKS	33
5.4. INVESTMENT CHALLENGES FOR THE PUBLIC SECTOR	34
5.4.1. <i>Investment Challenges for the Private Sector.....</i>	<i>34</i>
5.5. ASSESSMENT AND PROPOSALS.....	35
6 - PROGRESS IN OPENING-UP MARKETS.....	37
6.1. ADVANCING THE INTERNAL MARKET.....	37
6.1.1. <i>On transposition.....</i>	<i>37</i>
6.1.2. <i>Compliance</i>	<i>37</i>
6.1.3. <i>Overcoming gaps and weaknesses.....</i>	<i>38</i>
6.1.4. <i>Key gaps.....</i>	<i>38</i>
6.2. ECONOMIC IMPACT	39
6.2.1. <i>How policy-makers see the impact</i>	<i>39</i>
6.2.2. <i>How business and citizens see the internal market.....</i>	<i>41</i>
6.2.3. <i>How economists see the economic impact.....</i>	<i>41</i>
6.3. PROGRESS ON LIBERALISATION AND REGULATION OF NETWORK INDUSTRIES	43
6.3.1. <i>On the road to Lisbon-2010.....</i>	<i>46</i>
6.4. ECONOMIC PERFORMANCE OF 4 NETWORK INDUSTRIES	46
6.5. THE INTERNAL MARKET: UNDERPERFORMANCE	49
6.5.1. <i>Services.....</i>	<i>49</i>
6.5.2. <i>Mutual recognition</i>	<i>50</i>
6.6. CARDIFF: WHAT IT ADDS.....	50
6.6.1. <i>Entrepreneurship in Europe.....</i>	<i>51</i>
6.6.2. <i>De-linking labour and product markets.....</i>	<i>51</i>
7 - INTEGRATION OF FINANCIAL MARKETS.....	53
7.1. THE INITIATIVES	53
7.2. THE IMPACT OF FINANCIAL INTEGRATION	54
7.3. VENTURE CAPITAL.....	56
7.4. ASSESSMENT.....	57

8 - THE LABOUR MARKET	59
8.1. TRENDS IN LABOUR MARKETS AND IN EMPLOYABILITY.....	59
8.1.1. Unemployment and employment rates	59
8.1.2. Skill gaps.....	60
8.1.3. Training and lifelong learning	61
8.2. ADAPTABILITY	62
8.3. LABOUR MOBILITY	62
8.4. LABOUR MARKET POLICIES IN MEMBER STATES.....	63
8.5. ASSESSMENT	64
9 - TAXATION AND GROWTH.....	67
9.1. AN ANALYTICAL APPROACH.....	68
9.2. GROWTH ACCOUNTING AND THE LEVEL OF TAXATION IN EUROPE: SOME EVIDENCE.....	68
9.3. RECENT DEVELOPMENTS.....	69
9.4. THE OPTION OF "GREEN TAXES".....	73
9.5. COMMENTARY AND ASSESSMENT	73
9.5.1. Some recommendations follow.	74
10 - THE MACROECONOMIC POLICY MIX.....	75
10.1. THE POLICY MIX IN THE LAST YEAR	75
10.1.1. Serious drawbacks of the current rules.....	76
10.2. THE GROWTH SCENARIO.....	77
10.2.1. Significant dispersion across member countries	77
10.2.2. Deteriorating public finances.....	78
10.3. THE EVOLUTION OF THE STABILITY AND GROWTH PACT	78
10.3.1. The need for fiscal rules in a monetary union	79
10.3.2. Public finance rules for monetary stability	79
10.4. COMMENTARY AND ASSESSMENT	80
BIBLIOGRAPHY	81
ECONOMIC AFFAIRS SERIES PUBLICATIONS	85

Tables and Figures

TABLE 1:	CHRONOLOGY OF EXCESSIVE DEFICITS PROCEDURE ACTIONS	21
FIGURE 1.:	THE STRUCTURAL REFORM "J"-CURVE	26
FIGURE 2.:	THE STRUCTURAL REFORM - SCHALLOW AND STEEP "J"-CURVE	26
TABLE 2.:	PUBLIC INVESTMENT AS A SHARE OF GDP IN SELECTED EUROPEAN COUNTRIES	32
FIGURE 3.:	INTERNAL MARKET INDEX: ABOVE EU AVERAGE	40
FIGURE 4.:	INTERNAL MARKET INDEX: AROUND EU AVERAGE.....	40
FIGURE 5:	INTERNAL MARKET INDEX: BELOW EU AVERAGE	41
TABLE 3.:	SELECTED BENEFITS OF THE INTERNAL MARKET: 1992-2002	43
TABLE 4.:	REGULATORY PROGRESS IN EU NETWORK INDUSTRIES.....	45
TABLE 5.:	ECONOMIC PERFORMANCE OF LIBERALISING NETWORK INDUSTRIES.....	47
BOX 1.:	THE HARTZ COMMISSION PROPOSALS – ILLUSTRATING THE DILEMMAS FOR MEMBER STATES	64
TABLE 6.:	GROWTH ACCOUNTING FOR SOME EUROPEAN COUNTRIES	68
TABLE 7.:	TAX WEDGE FOR SELECTED COUNTRIES (1999) *.....	69
FIGURE 6.:	GERMANY - THE LABOUR FACTOR AND THE TAX WEDGE *.....	71
FIGURE 7.:	ITALY - THE LABOUR FACTOR AND THE TAX WEDGE *	71
FIGURE 8.:	FRANCE - THE LABOUR FACTOR AND THE TAX WEDGE *	71
FIGURE 9.:	DETERMINANTS OF PER-CAPITA GDP: GERMANY RELATIVE TO UNITED STATES	72
FIGURE 10.:	DETERMINANTS OF PER-CAPITA GDP: ITALY RELATIVE TO UNITED STATES	72
FIGURE 11.:	DETERMINANTS OF PER-CAPITA GDP : FRANCE RELATIVE TO UNITED STATES.....	72

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1 - Executive summary

1.1. Outline of the report

- This report presents the findings from a study for the European Parliament of the Broad Economic Policy Guidelines for 2003. The purpose of the study is to conduct analysis of key areas of the Guidelines and to assist the EP in putting forward recommendations. In line with the terms of reference, the report concentrates on the supply-side issues covered in the BEPGs by looking at investment, progress in opening markets, integration of financial services, the labour market and taxation. A last section examines the macroeconomic policy mix.
- The elaboration of the Guidelines for 2003 will take place against a background of disappointing and uncertain macroeconomic conditions, with recovery from the downturn of 2001 proving slow to take hold and continuing difficulties being experienced by a number of Member States, especially Germany, the EU's largest economy. However, the underlying macroeconomic "fundamentals" of the EU economy are mostly favourable, with low inflation, generally sound public finances (despite the concern about some countries) and few signs of serious imbalances. The current priority should be to restore growth.
- In its report on the implementation of the 2003 BEPGs, the Commission draws attention to a number of disappointments, especially in the area of structural reforms, and regrets that Member States did not do more in the last upswing to consolidate public finances. The Commission is more positive about labour markets and on measures taken to improve the business environment.
- In the EMU policy system, in which monetary policy is supranational and other economic policies remain with Member States, economic policy co-ordination is central to achieving an appropriate policy mix at the EU level while allowing Member States scope for dealing with national priorities. The BEPGs have a crucial and pivotal role in this process. However, there is a range of other co-ordination mechanisms and a degree of confusion about which does what and how all the co-ordination machinery fits together. We count no fewer than eight distinct co-ordination mechanisms: the Council (above all Ecofin) and the Eurogroup at a political level; the SGP and the Cologne process for macroeconomics; the Luxembourg and Cardiff processes, plus Lisbon/Barcelona (overlapping with the internal market agenda) for microeconomics; and the BEPGs.
- Major procedural changes are due to be introduced in the economic policy co-ordination procedures in 2003. These aim to achieve better "co-ordination of co-ordination" by the "streamlining" of the employment and economic policy guidelines and by shifting to a medium-term time horizon. These are to be welcomed, but the focus should be on strategic policy making.
- The continuing problems on the supply-side of the economy point to a need to reinforce and accelerate efforts towards structural reforms. It is important to recognise, however, that such reforms rarely provide quick solutions and that there may be transitional costs that result from the dislocations caused. While policy should seek to minimise these costs and aim for optimal gains, the prospect of "pain before gain" should not be seen as a pretext for delay or prevarication.

- Investment both by the public sector and the private sector has fallen off, both absolutely and relative to the US. This is especially true of investment in research and development and of spending on information and communications technologies. These trends bode ill for future growth.
- Low productivity growth, especially in recent years, can be explained partly by these shortcomings in investment, whereas human capital has continued to grow. But studies reveal a range of other explanations for observed trends in productivity.
- Although the internal market "scoreboard" shows that most measures have now been transposed by Member States, the pace of liberalisation of services of general interest such as energy and transport remains slow. This hampers efforts to foster greater competition in these vital sectors that could lead to competitiveness-enhancing price cuts. A particular concern is that too much "lip-service" is paid to structural reforms, but that this is not matched by effective action.
- Structural reform is, however, about more than the internal market, as it also covers the many supply-side policies which remain exclusively with Member States. The Cardiff process is intended to encourage the adoption of good practice by Member States, but has much softer oversight and review procedures than the parallel Luxembourg process. Lisbon, similarly, appears to lack teeth. A report commissioned by the Danish government on the role of the Cardiff process in promoting environmental policies comes to a robust conclusion that has echoes for structural policies: *It is clear that although the Cardiff process is focused on the Council, there is a need for the more systematic involvement of the Commission in the development and follow-up of integration strategies. There is arguably a need for greater guidance and co-ordination for individual Councils from the Commission.*
- Both the Financial Services Action Plan and the Risk Capital Action Plan continue to make steady progress towards their ambitious goals. Evidence from recent studies suggests that full integration of European capital markets might yield benefits from more efficient intermediation that could boost the level of EU GDP by up to 1.1% and employment by 0.5%. Another study suggests that financial integration could also boost the growth rate of GDP by as much as 1% in the Member States with the least developed financial services sectors, although this relies on what we consider to be very optimistic assumptions. Nevertheless, both the level and growth rate of GDP should be boosted by full financial integration.
- Labour market policies implemented under the European Employment Strategy have contributed to improvements under all four pillars of the Strategy. Despite these advances, unemployment remains disturbingly high – a clear waste of resources, as well as imposing a heavy social burden – and there is continuing evidence of labour market mismatch and other problems.
- Some progress is also evident in reversing the rise in the share of total taxation accounted for by taxes on labour, and the indications are that this has helped to boost employment.
- The macroeconomic policy mix at EU level remains unbalanced, and there is significant dispersion among the Member States in growth rates and inflation. This inevitably complicates the conduct of macroeconomic policy and raises questions about the underlying rules and "economic model".
- Reform of the Stability and Growth Pact is very much on the agenda at present amid concerns that its rules are not proving effective and that there is a lack of political will to conform to its terms.

1.2. Conclusions and recommendations

The evidence reviewed in this study and our analysis of the challenges facing the EU economy point to a number of areas in which fresh thinking is warranted on the thrust and contents of the 2003 Broad Economic Policy Guidelines. Here, we summarise key conclusions from our analysis and put forward possible recommendations (in bold) that the Economic and Monetary Affairs Committee of the European Parliament might contribute. These suggestions are intended, first, to stimulate discussion, but also have the aim of providing the EP with possible lines to develop in making its input to the 2003 BEPGs.

The aims of policy co-ordination and the inputs of different actors to the process

- EMU is a system of economic governance in which the different elements – monetary policy, fiscal policy and supply-side policies have been reconfigured in a policy framework that differs markedly from those of Member States. A characterisation is that the role of monetary policy (and thus the ECB) is to deal with system-wide economic effects - including symmetric shocks – while national autonomy (fiscal and supply-side policies) is retained to deal with effects specific to the Member State – notably asymmetric shocks. At the same time, fiscal and supply-side policies have to be aggregated in a manner that is consistent with supranationally set monetary policy. The purpose of economic policy co-ordination in this context to combine these three sets of policies (central monetary, national fiscal, and national and EU-level supply side) into a coherent policy mix. **The vital role of the BEPGs in "co-ordination of co-ordination" deserves to be more emphatically stated and explicit.** Consequently, they have to be the means by which the underlying economic objectives are made clear, rather than being limited to a procedural exercise, and must reflect relevant political priorities.
- Strategic BEPGs not only offer the means to bring together the disparate process of fiscal and supply-side policies, but should also allow "real" economy policies to be brought together in a manner that is consistent with monetary policy. If this is achieved, the policy mix will be improved and, with it, the outlook for the EU economy. The implementation of the 2002 BEPGs, as revealed by the Commission report, was deficient in many respects. Member States might, therefore, be reminded that the BEPGs are the core of co-ordination and that the exercise cannot be taken lightly if effective policy co-ordination is to be attained.
- The thrust of the procedural changes to be introduced this year is generally to be welcomed, but it is important to avoid the risk that the formulation of the BEPGs is overly dominated by advocates of a single "model" of economic policy. To guard against this possibility and to ensure that a plurality of views is included, a stronger role for the social partners is advocated in shaping the BEPGs and the importance of obtaining input from different sectoral interests in national government and the Commission should be stressed. Specifically, a balance has to be struck between finance ministries (DG Ecfm in the Commission), economic ministries and those responsible for employment and social affairs (DG Empl.).
- The new much more explicitly strategic orientation of the BEPGs can also be considered desirable, not least because annual recommendations become repetitive and, if repeated too often in too many settings, lose forcefulness as a result. Given that some annual updating is countenanced, the onus should be on the Commission to justify substantive changes and they should be used sparingly.
- The co-ordination of economic policy is central to the proper functioning of EMU, and cannot be seen as just a ritual exercise. An academic colleague has written of the spectre of

the Luxembourg and other processes as monstres de papier consuming not only paper, but also scarce administrative resources and political capital. The EP, in particular, is entitled to call for co-ordination to be taken more seriously, to be subject to greater scrutiny and to be seen as a key part of economic governance.

- The proposals to orientate the Employment Strategy more explicitly towards the Lisbon agenda and timetable make sense. But there is a risk of confusion or - more damagingly – excessive profusion of objectives insofar as the Commission Communication on the future of the EES retains nearly all the elements previously in the Luxembourg process guidelines. Making job creation central to the co-ordination process would seem to be a desirable evolution and there is a clear role for the BEPGs in setting the tone and direction in this regard. In particular, it will be important to examine how entrepreneurship is dealt with¹.
- It has to be recognised that the social partners are important actors in implementing economic policy, not merely worthy bodies to be consulted in a ritual manner. A recommendation to acknowledge this and to strengthen their contribution not just to the formulation of the BEPGs, but also to their implementation would be warranted.

Structural policy co-ordination and the obstacles to achieving reform

- Policy co-ordination in the EU is in a phase of "learning-by-doing". Although the Stability and Growth Pact has, thus far, been the main focus of attention in policy co-ordination, the salience of structural reforms is highlighted by the slow pace of recovery from the downturn of 2001. There is a case to be made for re-balancing supply and demand co-ordination so that the former is not always "residual" or given only second-order importance, especially in relation to investment.
- A particular concern about the thrust of fiscal policy co-ordination is that it may weaken the impetus towards structural reform, especially if a fiscal squeeze leads to disproportionate public investment cuts. A possible solution to safeguard vital public investment would be to introduce a so-called "golden-rule" giving Member States latitude to increase deficits within specified limits – say by 1 percentage point of GDP - in order to invest in public assets. But it needs to be stressed that a golden rule will only work if there is no room for ambiguity about what constitutes public investment and that any "drift" in interpretation would be a recipe for fiscal anarchy. It is also important to recognise that public investment has to be properly appraised to ensure that it yields appropriate returns that underpin economic performance. In examining reforms of the SGP, the implications for the overall system of policy co-ordination, and thus the BEPGs, must be taken into account. A "golden-rule" approach to public deficits should be studied by the Commission to assist deliberations on reform of the Stability and Growth Pact. This must include strict definitions of, and tools for measuring, what constitutes public investment.
- There is a sound case for strengthening the Cardiff process. The Commission should be asked to assess the Cardiff process more intensively, possibly along the lines of the Luxembourg process, because there does not seem to be enough pressure from "Cardiff" to change, via recommendations, targets, benchmarking, etc.
- In relation to structural reform, there is a gap in the co-ordination process which is that some of the politically difficult dimensions of labour market flexibility are covered neither by the

¹ A Green Paper on entrepreneurship was published by the Commission (2003) shortly after this text was completed.

Luxembourg process nor by Cardiff. In addition, there is not an obvious channel for linking the labour market with efforts to reform the market more generally, including the plethora of internal market measures. A strategic recommendation here is to seek more effective integration of the Cardiff and Luxembourg processes, with the BEPGs providing the common ground.

- In relation to internal market measures, the BEPGs say that implementation ought to be correct, a superfluous statement if not complemented with the policy problems and solutions behind these words. It is important expand on the limited and selective perspective on compliance that the Commission and Council versions of the BEPGs (which, on compliance, are identical for 2002) present.
- In any economic change, trade-offs are inevitable and the fact that structural reform can hurt should not be ignored. What is needed is both a political understanding of this and a policy package that takes cognisance of the possible problems of transition and adaptation. Thus, extensive labour market reforms are more likely to be resisted if there is insufficient provision of replacement income and support for adaptation and both sectoral and geographical mobility through training and other means. It is recommended that ways to achieve more effective social partner input should be explored. One option would be for a regular "social summit" to discuss key issues to be fed into the BEPGs. Another would be joint hearings by the Economic and Monetary Affairs and the Employment and Social Affairs Committees of the EP.
- Although the bulk of economic policy co-ordination is operated under "soft law" procedures, it does not mean that it cannot be robust. In this regard, it can be argued that previous BEPGs have been much too bland in relation to structural reforms and the internal market. Structural reform implies action to further the completion and smooth operation of the internal market (and, thus, EU wide measures) as well as measures that are confined to the Member State dimension of policy-making. Recommendations in the BEPGs should emphasise that enhancing the functioning of markets entails action on both fronts. In addition, the EP should urge that guidelines which do little more than sum up what all players have accepted or are now adjusting to, without any genuine acceleration, must be made more ambitious. The EP can also argue for a commitment to acceleration, with a range of explicit deadlines in various network industries.
- Structural problems may, however, reflect market failures and call for public-sector led initiatives. One aspect is striking a balance between flexibility and security: this might be done by seeking a more imaginative social contract.
- There is a fair degree of consensus about the directions structural reform need to take and this is reflected not only in the Lisbon agenda but also in the recommendations that are regularly articulated. Although some minor problems remain in the transposition of internal market measures, the real problems are in compliance and in adhering to the spirit of other structural reform initiatives. All the BEPGs say is that implementation ought to be correct, a superfluous statement if not complemented by the policy problems (and solutions) behind these words. More attention needs to be given to closing the "delivery gap" to ensure that good policy initiatives are not let down by grudging implementation.
- Structural policies are not quick fixes and have to be given time to work, especially in light of the cumulative nature of reforms. At the same time, it is perilous to allow the reform effort to falter, especially when – as it is reasonable to expect in the next year or two - the economy becomes more buoyant again. The shift to the new streamlined co-ordination system should be used to provide stability in the strategy and approach adopted.

- The impact on the operating efficiency of other sectors of hard and soft infrastructure costs deserves to be stressed. This should call for attention to not just the network industries (energy, transport etc.) as conventionally defined, but also extend to a broader definition embracing financial services as "services of general interest". Such improvements bear on the Lisbon "knowledge economy" targets. There should be a request to the Commission to do what thus far has never been done by the Union: formulating an overall strategy for all network industries. The BEPGs ought to reflect the urgency of upgrading the efficiency and underlying economic contribution of network industries, even though 2010 seems so comfortably far away. The EP could call for an empirical economic analysis of the impact of network liberalisation and of its implications for appropriate EU regulation.
- The need for a focus on the quality of investment is also important, paralleling the "quality of jobs" notion that has been accepted in employment policy. Tax policies may need to be revisited to promote these aims, especially in relation to R&D. The causes of sluggish business and public investment need to be investigated further and policies developed to redress them and to enhance the quality of public investment, especially. The EP ought to exert maximum pressure on the Council to accelerate adoption of the European patent.

Mechanisms and procedures

- The reforms currently being introduced to the co-ordination processes, captured in the expression "streamlining" , should help to give the BEPGs the more strategic role that has hitherto been insufficiently developed, and are thus to be welcomed. Careful monitoring of their impact and effectiveness should be encouraged.
- Although the implementation and guidelines packages for the various "processes" are now harmonised, the timetable for production and assessment of the stability/convergence programmes has been left out and kept apart from the guidelines. One explanation for this appears to be the sheer administrative demands on the Commission services in a short period. Another is that because the SGP is bound by the "hard" law provisions of the Treaty articles governing the excessive deficits procedures and the associated regulations (1466/97 and 1467/97), it is qualitatively and legally different from the "soft" processes. Moreover, experience suggests that the stability or convergence plans often duplicate what is in the BEPGs. While expressing sympathy about the bureaucratic demands of co-ordination, the EP might take the view that the ends should dictate the timetable and arrangements, not the means. Further simplification and streamlining should therefore be explored.
- There is little systematic evaluation of the implementation of the various processes or of policy co-ordination more generally, and it can be argued that this hampers effective monitoring ². Evaluation of all co-ordination mechanisms should be strengthened.

Possible novel measures to advocate

- The role of corporate governance and corporate social responsibility (CSR) in promoting "Lisbon", especially the conjunction of social and competitiveness objectives, merits attention. One proposal that should be examined is to develop and apply a "scorecard" that could be the basis for incremental upgrading of commitments to CSR.

² For example, a Commission report [EMCO/23/060602/EN_REV 1] on the EES comments that "national evaluation reports do not follow a homogeneous framework of analysis. Some of these evaluations were carried out specifically for the EES evaluation, while other reports review existing literature. Most reports are rather descriptive and do not contain rigorous analysis of the effectiveness of measures, which suggests that little evaluation material readily available.

- There is evidence not just of training and skills shortages, but also of deficiencies in basic education that could be brought within the BEPGs. Educational attainment should be highlighted as an aim that will bolster the long-run performance of the supply-side.
- Entrepreneurship has, up to now, been one of the four pillars of the Luxembourg process, yet could be thought out of place in this setting. It will still be prominent in the proposed new Employment Guidelines, but it may be worth querying the rationale for it remaining. In response to the Commission Green Paper published in January (and the ten questions about entrepreneurship it highlights), Member States should be asked to explore shortcomings in specific dimensions of entrepreneurship, such as whether latent ability can be activated, for example from the under-representation of female entrepreneurs.
- The progress towards a more developed and integrated financial market in the EU, especially in relation to risk capital, has been steady, but needs to maintain its momentum. The support provided through the European Investment Fund's seed capital measures appears to have been beneficial and might be expanded. The attempt by the EIF to foster the development of a cadre of venture capital fund managers is an interesting initiative that could be developed.
- The EP may want to look more closely at the employment outlook and the tricky links to productivity. The other side of the relatively resilient labour market is that productivity gains are expected to remain low for another year in 2003 with, as a consequence, an increase in unit labour costs. Short-term job creation and longer-term productivity advances have to be reconciled and made to be mutually consistent economic aims.
- A strategy of systematically pursuing competitive and dynamic performance of all network industries can contribute in a meaningful way to the achievement of the Lisbon aims for the knowledge intensive economy. Narrow sectoral inhibitions and, at times, fears could be overcome by integrating targets for the development of these fundamentally important network industries into a wider economic perspective over the medium to long run. It would clarify the agenda of deadlines and requirements for all players and decision-makers and help consistency of regulatory approaches. It might facilitate long run investments needed in most, if not all, network industries throughout the Union
- According to the national reports from Spain, Belgium and Germany there have been small but tangible employment gains from shifting from labour taxes to "green" taxes of different sorts. While there are limits to how far such a process can go without engendering market distortions, the "double-dividend" of both promoting employment and curbing "bads" is an appealing one. There is a good case for a general recommendation in the BEPGs that Member States should explore the scope for progressively substituting taxation of labour by green taxes with a view to raising the proportion by a specified amount over the three years of the Guidelines.

2 - Introduction

Economic policy co-ordination in the EU is on the threshold of significant changes that are due to be presented to the 2003 Spring European Council. Within the recasting of procedures, the Broad Economic Policy Guidelines (BEPGs), which have been at the core of co-ordination, will be of critical importance in shaping the overall direction of policy. This report by a TEPSA expert group presents the results of a study for the European Parliament (EP) that appraises the functioning of BEPGs and puts forward suggestions for enhancing the effectiveness of the Guidelines that might be taken up as recommendations by the Parliament. The report draws on the Commission's autumn forecasts, published on the 13 November 2002, the documents published by the Commission on the 14 January 2003 which assess the implementation of the BEPGs and related topics, and a wide range of other material.

These Commission papers reveal the extent to which the EU economy has struggled to recover from the downturn of 2001 and to maintain the momentum of reform. Thus, the November projections present a generally much less optimistic picture than did the forecasts released in the spring. The overall verdict on the functioning of the BEPGs in 2002, similarly, is not that positive. Against this background, searching questions are being asked about the direction of EU policy and the nature of key co-ordination mechanisms, notably the Stability and Growth Pact (SGP).

The Lisbon European Council in March 2000 set the goal of making Europe the most dynamic and knowledge-based economy in the world, capable of sustainable growth with more and better jobs and greater social cohesion by 2010. The Lisbon Strategy remains the headline goal for EU economic policy and provides, according to the 2002 BEPGs, the best way to achieve a balanced and sustainable development of economic activity and an improvement of the well-being of current and future EU citizens. The Commission, in a communication on the future of the European Employment Strategy (EES), also argues that the EES should be designed as a key tool to underpin the Lisbon strategy in the enlarged EU.

Hitherto, the BEPGs have been issued annually, but in response to a call for "streamlining" of policy co-ordination, two major shifts will take place. A first major innovation will be to make the BEPGs more strategic and less detailed, and to shift from an annual to a triennial cycle (though with the possibility of annual amendments). The second is to bring the Luxembourg process and the BEPGs much closer together by adopting a common timetable.

This report provides an appraisal of current and prospective trends in key areas of the supply-side of the EU economy, together with an assessment of the current macroeconomic position. It presents our judgements on the progress the EU has made in responding to the challenges of structural reform and links these to the observed developments of the macroeconomy. This report follows terms of reference sent to the authors in July 2002 and set out in section 2.1. To set the scene, the macroeconomic context and the changes in it revealed by the 2002 Commission autumn forecasts are laid out in the next part of this introductory section, then the main points of the Commission assessment of the implementation of the 2002 BEPGs are briefly summarised and reviewed.

Section 3 of the report concisely describes and comments on the objectives of economic policy co-ordination, and changes in the procedures for co-ordination, generally, and the BEPGs in particular. The following section discusses the scope for structural reforms and the difficulties that can, or might, arise, in trying to achieve more rapid change. Public and private investment are appraised in section 5, then internal market measures in section 6. Progress on developing the European financial area and its potential for enhancing the underlying performance of the EU economy are discussed in section 7. Sections 8 and 9 look, respectively, at the labour market and at the role of tax policies in economic performance, linking these to the Lisbon targets. The

last section looks in more detail at the problems with the policy mix, how they bear on the disappointing macroeconomic trajectory revealed by the Commission's autumn forecasts and discusses possible reforms of policy rules.

2.1. Study Specifications provided to the contractor

The aim of this study is to assist the Economic and Monetary Affairs Committee of the European Parliament in providing its own contribution to the debate on the Broad Economic Policy Guidelines for the year 2003 (Article 99 of the Treaty).

The conclusions of the study should make it possible for the Parliament to set out clear objectives for the economic policy of the European Union.

The list of themes to be addressed by the study is:

- The trends in recent years in public and private investment, the need for public and private investment in the coming years, as well as identification of any bottlenecks in the financing of such investments. It should also be identified in which areas investments are most needed, e.g. human resources, infrastructure.
- The progress in the opening up of markets, especially in the field of energy, the need for further market opening and the contribution of liberalised markets and cross-border competition to growth and employment, both in general and in specific sectors.
- A first evaluation of the impact of an integrated Financial Market as outlined in the Financial Services Action Plan in terms of growth and employment.
- The information deficit as regards companies, especially as regards the effects of restructuring measures on the economic and employment situation in Europe, as well as, the efforts made by companies to promote initial and ongoing vocational training with the goal of maintaining employment.
- Concrete information is needed as regards tax reforms in the Member States and their actual impact on growth and employment.
- Information is also needed as regards the concrete implementation of the macroeconomic policy mix programmes; in this context, information on the actual impact and implementation of the policy mix would be helpful.

For each of these themes, a short analysis together with recommendations for concrete action is required.

2.2. Macroeconomic context

Early in 2002, when the Broad Economic Policy Guidelines for the year (eventually agreed at the Seville European Council in June) were under discussion, the outlook for the EU economy was reasonably encouraging. The slowdown of 2001 seemed to have been short-lived, there were sound analytic reasons for optimism and the stance of policy ought to have been conducive to a steady recovery. In macroeconomic terms, the "fundamentals" – price inflation, balance of payments, public finances and wage settlements - were generally favourable, both for the EU (or the euro area) in aggregate and for most Member States. Cuts in interest rates had rapidly been decided in the wake of "9/11", making monetary policy pretty expansive by historical standards. Although there were some fears that the operation of automatic stabilisers would put pressure on the budgetary positions of some Member States, the conjunction of favourable indicators and benign policy would have been expected to reinforce recovery.

Most forecasts – including those produced in April 2002 by the Commission – anticipated a gradual return to steady, though far from impressive, growth rates in the course of 2002 and

2003. The fact that recovery has faltered, especially since the middle of 2002, consequently has to be seen both as a disappointment and something of a puzzle. The key points from the autumn forecasts, published on the 13 November 2002 are:

- The recovery is much slower than anticipated and the average growth rate in the euro area is estimated to be 0.8 % in 2002 and is forecast at only 1.8 % in 2003.
- These much lower growth figures translate into lower prospective employment growth, and offer no respite to the unemployed, with unemployment having risen marginally and now expected to remain close to its current rate throughout 2003.
- That unemployment will not accelerate is, however, offset by the expectation that productivity growth will be low this year and in 2003. The Commission argues that this is a "normal cyclical reaction as employment lags the activity slowdown, but it nevertheless puts additional strains on corporate profitability and weighs on the resumption of investment."
- Investment in equipment, which fell by 1.1% in 2001, is expected to have fallen by a further 4.1% in 2002, and only to recover to 2.6% growth in 2003. Consequently, it will be 2004 (when it is projected to grow by 6.1%) before it returns to the level it attained in 2000. As with the productivity forecasts, this does not bode well for longer-term performance.
- Inflation in the service sector is expected to remain above the ECB reference value, implying that overall inflation will remain near the 2% level, giving the ECB little room for manoeuvre to cut interest rates so long as it follows its current rules.
- The prolongation of slow growth will take its toll on national budgetary positions, with a widening of the euro area deficit to 2.3% of GDP and only a slight reduction in 2003. How successful Germany's efforts are to rein in its anticipated excessive deficit will be especially critical in this regard.
- Unlike the US, the EU current account balance on external transactions remains sound, with continuing surpluses anticipated.

A number of explanations can be put forward for this economic trajectory. The "bounce-back" in the US economy has, undoubtedly, faltered and this inevitably has repercussions for the EU, although it is important to note that the US economy is estimated to have grown by more than 2% in 2002, comfortably out-pacing the EU. In the forecasts, the Commission argues, first, that it takes time for a cyclical downturn to correct itself, and that the unusual conjunction of supply-side factors associated with the travails of the information and communication technology (ICT) have "led to over-investment and over-capacity, even if not of the same size as in the US, while the increase of food and oil prices eroded purchasing power with a shortage of demand as a consequence". A second reason advanced by the Commission is that there has been an adverse impact on growth from the combination of stock market uncertainty and the geo-political tensions engendered by the "problems in the Middle East". Nevertheless, the Commission analysis remains pretty sanguine, not least in referring to the recovery as being "delayed", rather than in doubt. It stresses the tolerably favourable fundamentals, such as sound corporate balance sheets, muted inflation and (notwithstanding the excessive deficits in Germany and Portugal) responsible budgetary positions.

The factors mentioned have, undoubtedly exerted an influence, notably by denting confidence (aggravated by the effects of the Enron and subsequent disclosures on stock market values), but they do not provide a sufficient explanation. Indeed, the Commission also draws attention to the EU's vulnerability to "remaining rigidities in product, labour and capital markets" and argues that these "make it difficult to deal with shocks." The clear implication of this last statement is that attention needs to be focused on how these markets are evolving, not only in assessing the

current performance of the EU, but also in deciding on the priorities for future policy. The implications for the 2003 BEPGs and for the new "streamlined" approach to policy co-ordination (see section 3, below) are that renewed efforts will have to be put into structural reforms, but also that these will have to be set in a coherent medium-term framework.

2.3. The implementation of the 2002 BEPGs

The Commission's report on the implementation of the 2002 BEPGs suggests a patchy implementation record (Commission, 2003a). It reiterates the economic policy model which underpins the Guidelines and betrays no doubts about the continuing virtues of the strategy of combining sound macroeconomic policy and structural reforms which "has taken shape over recent years and has become well-established".

Although the report draws attention to the disappointing macroeconomic outcomes described above, it follows the analysis of the Autumn forecasts in pointing to a range of special factors that account for the outcomes, rather than any policy mistakes. Only the persistence of services sector inflation, which can be seen as a policy problem, is cited as a contributory factor that cannot be regarded as "special". The report notes that monetary policy had been expected to tighten in the course of 2002, but that in the light of events, the only change was an easing at the end of the year. Fiscal policy, by contrast, is adjudged to have been very slightly expansionary. Criticism is expressed of the rate of wage increases and it is asserted that this has inhibited both the fall in core inflation and the growth of productivity. Although the general deterioration of budgetary balances is attributed principally to the operation of automatic stabilizers, the report is critical of Member States that have opted for discretionary fiscal loosening, the upshot of which has been backsliding on achieving positions close to balance, an early warning recommendation for France, and activation of the Excessive Deficit Procedure for Portugal and Germany.

While applauding the fact that the public investment was generally maintained or slightly increased (except in Germany, Greece, and Portugal) the Commission regrets "the failure to move more decisively towards sound budget positions in Germany, Greece, France, Italy and Portugal" and the lack of reduction of debt in Greece and Italy. The ramifications for meeting future pension obligations are highlighted. The report is, arguably, rather too positive in relation to public investment, given the data and analysis we present in section 5 below, especially if the prospect that public debt – and the need to reduce it – crowds out investment. In relation to the knowledge economy, the report asserts that the EU is slowly catching up with the US in ICT usage (including the internet), but that "gaps in terms of patenting and business R&D remain large and persistent." It singles out the Council's failure so far to agree on the Community Patent, despite repeated calls from the European Council for rapid progress, as a disappointment.

The comments on labour markets are quite sanguine, notably the fact that unemployment did not rise, but the report does not mention the other side of that coin, namely the slow growth of productivity. However, the slow pace of labour market reforms is regretted, not least because it will jeopardize the attainment of the Lisbon targets. Member States are also criticized for the piecemeal nature of reforms of tax and benefit systems aimed at making work pay and for showing insufficient urgency in developing policies to raise the effective average retirement age in line with the conclusions of the Barcelona European Council. Member States are praised selectively for specific actions.

Stronger criticisms are made of the slow progress towards full implementation of the Internal Market and attention is drawn to "the stubbornly high number of Internal Market infringement proceedings, particularly in France and Italy". The lack of urgency shown in dismantling barriers to trade and cross-border service activities is also condemned, although good progress

is noted in strengthening competition and regulatory authorities, as well as in reducing state aid (except in Denmark, Ireland, Luxembourg, and the Netherlands) and the share of horizontal aid. Liberalisation of network industries is adjudged to have been patchy, with benefits emerging for consumers of the telecommunication and energy sectors, and political agreement on opening up electricity, gas, and port services. But the report expresses disappointment that there is no agreement yet "on the revised financial regulation and guidelines for Trans-European transport networks, public service contracts for passenger transport, and airport slot allocation." Overall, this has to be seen as a substantial agenda of unfinished business and, as the EU celebrates the tenth anniversary of the single market, points to an area that warrants renewed emphasis in the 2003 BEPGs.

The Commission's assessment is that integration of financial markets is broadly on track and the report observes that "the ambitious objectives set by the Barcelona European Council for 2002 will be largely achieved", making it likely that the aims of the Financial Services Action Plan will be achieved by the 2005 deadline. The Commission does, however, plead for a stepping-up of effort on the Risk Capital Action Plan and further improvement in cross-border co-ordination of prudential supervision. The language of the report is revealing in relation to initiatives launched to ease cross-border clearing and settlement, as it stresses that "they will have to be followed up by concrete proposals and decisions." The clear inference to be drawn is that action has not kept pace with rhetoric.

A general verdict is that there has been progress in the last year in improving the business environment and encouraging entrepreneurship. Both Community and national measures have contributed to this and the Commission concludes that "the regulatory environment is improving in all Member States." Reform took a number of directions, including reductions in administrative burdens, increasing online provision of government services, lower and simplified corporate tax and progress everywhere in implementing the European Charter for Small Enterprises.

The Commission report concludes that "despite progress in some areas, the overall picture that emerges from this review is rather disappointing." Indeed, the report becomes quite strident in castigating Member States for being reluctant to enact policy changes, for failing to consolidate public finances, and for hesitating to push "through badly needed structural reform to instill the dynamism into the economy that is needed to move decisively towards the Lisbon goals."

The Commission also makes a point that is telling not just about the implementation of the BEPGs, but also has a wider resonance by stating that "it is necessary to match words with action and develop a new sense of urgency."

3 - The policy co-ordination process and its evolution

Economic policy co-ordination is found in a number of Treaty provisions (for a succinct presentation, see Commission, 2002a). These mechanisms have gradually been consolidated since the launch of the euro, yet it has to be stressed that both the EU level and the Member States are in a "learning phase" with regard to economic modes of governance in stage 3 of EMU. The BEPGs provide recommendations for the broad thrust of economic policy. These guidelines comprise general policy aims for the EU as a whole (and not just the euro area), together with specific recommendations for individual Member States. They are both broad and comprehensive, covering macroeconomic policy (for which, read fiscal), a range of labour market and other supply-side policies, and sustainable development. Overlapping with the BEPGs are specific co-ordination "processes" that try to foster common approaches, for example to employment policy (the Luxembourg process), structural policies (the Cardiff process), pension reform and social inclusion policy.

It should, however, be noted that this array of co-ordination machinery does not cover the core of the traditional notion of policy mix, namely how fiscal and monetary policy are combined. Instead, the emphasis is on what might be called horizontal co-ordination across individual policy areas, and the only real links between monetary policy and other economic policy domains are consultative via fora such as the Eurogroup, the Economic and Financial Committee and the macroeconomic dialogue. That monetary policy is not part of the equation is simply explained: an independent central bank with the primary responsibility to assure price stability cannot plausibly engage in the sort of bargaining with other policy actors that would be implicit in co-ordination. If it did, it would open itself to the possibility that the ensuing bargain might mean trading-off higher inflation for other goals, such as faster growth or lower unemployment. The issue is not whether or not such an outcome is desirable (the contrast with the Fed's dual mandate is obvious), but whether it is constitutionally allowed, and our interpretation of the legal texts is that the room for manoeuvre is very limited.

At the risk of stating the obvious, the whole point of the BEPGs is to ensure that the conduct of economic policy in the EU allows two potentially inconsistent aims to be reconciled. The first is to give Member States sufficient flexibility and autonomy to deal both with specific challenges and problems, and to exercise their right to make policy choices that reflect national political priorities. The second is to ensure that the policy mix at EU level is coherent, especially now that monetary policy is set at the supranational level for the euro area members. This, in turn, requires that the different policy domains set by Member States (fiscal policy and the various supply side policies), when aggregated across Member States, combine to give a sensible policy stance. The BEPGs are, or should be, the framework within which that aggregation is mediated so as to fulfil both objectives. In short, the underlying economics of co-ordination should dictate how the BEPGs evolve, with the Guidelines being the means by which overall co-ordination of the different modes of co-ordination is achieved.

They have, however, been criticised from differing perspectives. The present system embraces both formal obligations rooted in hard law (the SGP) and "soft" guidelines and recommendations, with the latter as legally enforceable as these two words imply. Indeed, there have already been high-profile instances of national governments openly disagreeing with, and ignoring, recommendations: the "reprimand" to Ireland for its pro-cyclical fiscal policies is a case in point. The lack of enforcement mechanisms for soft co-ordination - other than the non-coercive mechanisms of peer review, naming and shaming and so on - is compounded by the perceived blandness of many of the recommendations and the sense that excessive detail diminishes their strategic impact. It can also be argued that with so many different co-ordination channels, there is a considerable danger of confusion, not to mention diffusion of effort and purpose. We count no fewer than eight distinct economic co-ordination mechanisms: the

Council (above all Ecofin) and the Eurogroup at a political level; the SGP and the Cologne process for macroeconomics; the Luxembourg and Cardiff processes, plus Lisbon/Barcelona for microeconomics (overlapping with internal market); and the BEPGs.

Responses to three main criticisms of the BEPGs within the broader policy framework have been formulated in the last year. The first is that integration of the processes leading to, respectively, economic and employment recommendations will be, to use the new vernacular, "streamlined" and it is evident that this "streamlining" constitutes an important development in the elaboration of the BEPGs for 2003. Second, there is an acceptance that the BEPGs have, on occasion, been too detailed and that this may have undermined their effectiveness. Third, the intention is to move from an annual to a longer-term (three years) time horizon.

3.1. The excessive deficits procedure

One significant development in the last year is that the "early warning" and "excessive deficit" procedures under the provisions of the Stability and Growth Pact (SGP) were used for the first time since the start of stage 3 (see table 1. for a chronology). The political difficulties that arose in February 2002 have been well-documented. Subsequently, having taken account of revised data on the general government deficit of Portugal in the year 2001, the European Commission recommended a decision of the Council in view of the existence of an excessive deficit in Portugal. The Council, at its meeting on 5 November 2002, followed this recommendation and declared in accordance with Art. 104 (6) TEC that an excessive deficit exists in Portugal. It also issued recommendations on the basis of Art. 104 (7) TEC, setting a deadline for the Portuguese government to bring the excessive deficit to an end. On 19 November 2002, the Commission also launched the excessive deficit procedure (EDP) against Germany by adopting a report on the government finance situation in Germany, based on Art. 104 (3).

On 8 January 2003, following a report of the Economic and Financial Committee, the European Commission adopted an opinion on the budgetary situation in Germany and concluded, on the basis of Art. 104 (5) that an excessive deficit exists in Germany. It proposes to the Council to adopt a similar decision and recommends that the Council issues a recommendation to Germany. A decision of the Council was made on the 21st of January 2003. On 19 November 2002, the European Commission also recommended the adoption of an "early warning" addressed to France.

It remains to be seen how binding the rules will prove to be following the launch of the excessive deficit procedures against Portugal and Germany. In view of the developments in the year 2002, a positive outcome is far from certain. The political dispute on the fiscal policy recommendations for France included in the BEPG 2002 also demonstrated that Member States are willing to engage in European co-ordination policies only to the extent that the recommendations coincide with their own preferences, but appear to be loath to accept policy outcomes that might be unfavourable for them at the national level. In addition, the commitments made by the Portuguese and German governments in February 2002 to avoid the censure of the Council were short-lived and the launching of the EDP against these two countries confirms that the Council statements did not ensure compliance.

Table 1: Chronology of excessive deficits procedure actions

January 2002	European Commission recommends that an early warning be sent to Germany and Portugal
February 2002	After commitments were made by the two countries concerned, the Council closes the procedures without issuing an early warning
July 2002	Launch of the EDP by the Commission against Portugal after the revision of the 2001 deficit to 4.1% of GDP
November 2002	Ecofin declares that an excessive deficit exists in Portugal and adopts a recommendation on measures to be followed by Portugal
November 2002	Launch of the EDP by the Commission against Germany after the assessment of its autumn forecast which predicts a general government deficit of 3.8% of GDP for 2002
November 2002	Commission recommends that an early warning be sent to France after the assessment of its autumn forecast which predicted a general government deficit of 2.7% of GDP for 2002
January 2003	Commission considers that an excessive deficit exists in Germany and proposes and recommends a Council recommendation to Germany
21 January 2003	Ecofin adopts a decision on the existence of an excessive deficit in Germany and a recommendation to Germany with a view to bringing an end to the situation Ecofin agrees a recommendation for an early warning to France in order to prevent the occurrence of an excessive deficit

3.2. Procedural developments

Turning to the procedural aspects of economic policy co-ordination in the year 2002, the Barcelona European Council called upon the Council and the Commission to make proposals for a streamlining of the relevant processes. This was not only to include the BEPG process and the Employment Package, but also other co-ordination procedures. The Barcelona European Council also decided that the timetables for the adoption of the BEPGs and of the annual Employment Package should be synchronised as soon as feasible. The format of the 2002 BEPG was left unchanged, but a revision for the 2003 cycle is now expected.

As requested, the European Commission published its communication on the streamlining of the annual economic and employment policy co-ordination cycles in September 2002³. This proposal is currently under consideration by the Council formations (and the Economic Policy Committee and the Employment Committee) and the European Parliament. The final report of the Council (Ecofin and Epsco) was adopted by the Ecofin in December 2002 and followed largely the communication of the Commission.

The revision of the policy co-ordination procedures will synchronise the cycles of the BEPGs and of employment policy, and provide a more coherent framework for complementary policy areas within the BEPGs. This will enable the Spring European Council to give general political orientations on the main policy priorities. The Commission will therefore present a so-called "Implementation Package" supporting its Spring Report to be submitted to the European Council. This implementation package includes the implementation report on the BEPGs and the Joint Employment Report, as well as other reports.

Based on the steer given by the Spring European Council, the Commission will establish a "Guidelines Package", including drafts of the BEPGs with both general and country-specific

³ COM (2002)v).

policy recommendations, the Employment Guidelines and the employment recommendations to Member States. The Internal Market Strategy will also form part of this guidelines package. The adoption of the BEPGs and other guidelines will then take place after the June European Council meeting by the various Councils. In principle, this overall timetable will bring other policy cycles in line with the already established timetable of the BEPGs and therefore does not change much of the BEPG procedure. As a consequence, the adoption of the Employment Guidelines and the individual employment recommendation for 2003 are expected to be postponed until June 2003. With this approach, a greater coherence of the various cycles can be expected.

At the same time, the streamlined co-ordination cycles will move away from a strictly annual procedure for the BEPGs and the Employment Guidelines towards a multi-annual programme by foreseeing a full review only every three years. This does not preclude the Commission proposing amendments to the recommendations in the intermediate years. The different processes might put particular emphasis on certain aspects of the policy area concerned during one year without going into detail on others. This could help to make country-specific recommendations more precise, discussing the specific needs and possible instruments of a country in a more detailed way while at the same time reducing the number of policy recommendations. It could become even more flexible by foreseeing a revision clause, for example if the macroeconomic context changes.

The European Commission also published proposals in November 2002 for a strengthening of the SGP⁴. In the communication the Commission proposes a tightening of the existing procedures, especially with regard to the budgetary consolidation of countries with high debt levels, rules against "inappropriate pro-cyclical loosening of the budget in good times", as well as a clarification of what would constitute a "satisfactory pace" of debt reduction towards the 60% of GDP reference value. The Commission also advances the discussion on the interpretation of the 3% of GDP reference value in the event of significant divergence from budgetary targets. The Commission proposes a "resolution to reinforce the co-ordination of budgetary policies" to be endorsed by the European Council meeting in Spring 2003.

3.3. Commentary and assessment

The amendments to the coordination procedures implicitly avoid proposals which would necessitate a treaty revision. As a result the current Treaty based co-ordination cycles will become more synchronised, but remain separate. It remains to be seen if the right balance can be found between the BEPG policy documents, providing an overall "broad" strategy both for the European Union and the individual Member States, and the documents covering the specific policy areas.

The Stability and Growth Pact with its multilateral surveillance procedure including national stability and convergence programmes, reports of the European Commission and opinions of the Council on the Member States programmes has been excluded from this streamlining approach, although the Pact is mentioned. While this might be understandable given the fundamental importance of the SGP for EMU, fiscal policy is clearly one of the key pillars of the BEPGs. It can, therefore, be argued that the stability and convergence programme updates might also be "streamlined" as part of macro-economic policy co-ordination. Our view is that, contrary to the Commission communication and the Council report of December 2002, the programme updates cannot be considered a part of the implementation package and the current

⁴ COM (2002n).

Ecofin opinions have little bearing on budgetary procedures for the current year due to the timing of the publication.

By leaving the treaty provisions unchanged, the role of the European Parliament in the various procedures is also not altered ⁵, although the tighter timetable before and after the Spring European Council might further reduce opportunities for the Parliament to table suggestions for the guidelines package. We consider that the right of consultation for the EP on the draft BEPGs cannot be considered as sufficient to make this procedure more transparent.

Finally, possible adaptation processes on the national level should be envisaged. With the proposed " guidelines package" to be adopted in the third quarter of the year and national reports as well as the National Action Plans within employment policy to be submitted at the European level in the fourth quarter of the year, national measures in response to European guidelines are now more likely to be included in the annual budget procedures at the domestic level (for countries with budgetary cycles starting on 1 January). More substantial proposals for the inclusion of national parliaments in the co-ordination process might have been appropriate. Domestic co-ordination of national reporting mechanisms should also be brought in line with the new timetables. In its proposal, the Commission made the sensible suggestion – which deserves attention - that Member States might draw up a single national report on economic policies. However, the Council report calls for free-standing reports as a package, excluding the stability and convergence programmes. Whether this will lead to a greater awareness of the various European policy documents among domestic actors remains to be seen.

⁵ On concrete proposals with regard to the involvement of the European Parliament, cf. last year's study, TEPSA (2002).

4 - The nature of structural reforms

There is a broad consensus that structural reforms in the EU not only continue to be desirable, but also hold the key to medium- to long-term improvements in the performance of the EU economy. The more extreme proponents of this view would, indeed, argue that structural reform is the only answer to the EU's current economic problems, but we hold the view that however strong the case for such reforms, they do not absolve the demand side of the economy from scrutiny.

Structural reform is an expression that embraces a wide range of policies. At EU level, opening up of markets, principally through continuing efforts to complete and enforce the single market are the principal means by which supply-side improvements are advanced. But it also has to be stressed that the removal of obstacles to economic efficiency and the search for productivity gains is very much a concern of national policies. Much of this latter category of policy has, in the last two decades, focused on improving the functioning of markets and ensuring that incentives work. Market failures can, however, be costly as well. Research and development, notoriously, will be sub-optimal if firms find it difficult to appropriate the returns from investment; lax accounting or prudential standards can have devastating effects on counterparties; while pollution can impose burdens that the polluter may not be obliged to compensate. Public policy consequently has to steer between, on the one hand, fostering efficient markets and incentives and, on the other, exerting controls that ensure smooth functioning of the economy.

These are issues for policy co-ordination from two distinct perspectives. First, with increasing economic integration, if some parts of the Union are very divergent in the performance of their "real" economies there will be repercussions for others. Divergence might have knock-on effects for the conduct of macroeconomic policy by increasing the range of conditions with which "one-size-fits-all" policies have to contend. Divergence may also lead to inappropriate responses by vulnerable governments, if they are tempted to reduce well-designed social protection or regulation in a search for competitiveness that leads to a "race-to-the-bottom". In the EU context, a second, much more positive, rationale for co-ordination processes is to stimulate policy learning and enhancement. The latter objective lends itself to the soft "open method of co-ordination" approaches that have evolved in recent years.

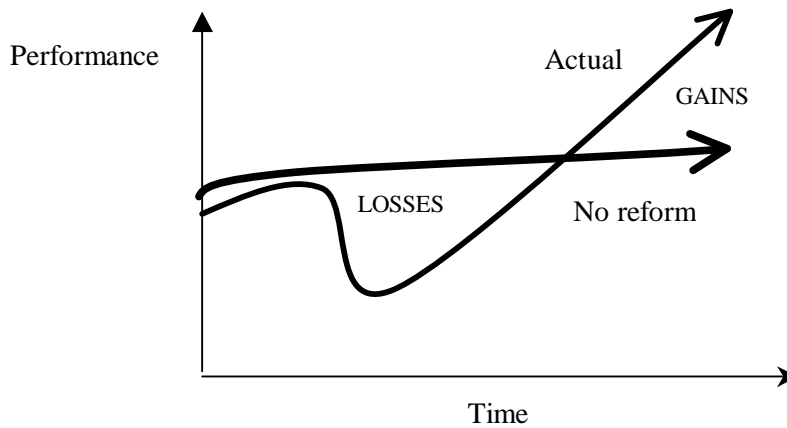
A key point to note at the outset about structural reforms is that they can hurt and may, collectively, have adverse short-term effects on output and employment. Indeed, one can postulate a form of "j-curve" through which the initial impact is depressing to growth or employment, but provides a platform for subsequent improvement. Figure 2. portrays a possible trajectory.

Without reform, the economy would be locked into a trajectory of sluggish performance and might even see a tailing-off, as weaknesses on the supply-side became progressively more debilitating. As an illustration, consider a hypothetical economy that fails to renew its capital stock sufficiently rapidly. Over time, its capacity to compete with other economies that have been investing steadily will erode, undermining its overall performance. Persevering with an outdated regulatory framework or labour market practices could have similar effects.

When structural reforms are introduced, it is probable that the initial dislocations will result in a loss of performance. Under the single market programme, for instance, the elimination of excess capacity in industries that were opened up to more intense competition inevitably saw job losses that resulted in unemployment. This is captured in the downward movement along the j-curve in the early stages. Subsequently, however, the improvements in aggregate efficiency that result from the structural reforms offer the prospect of higher productivity

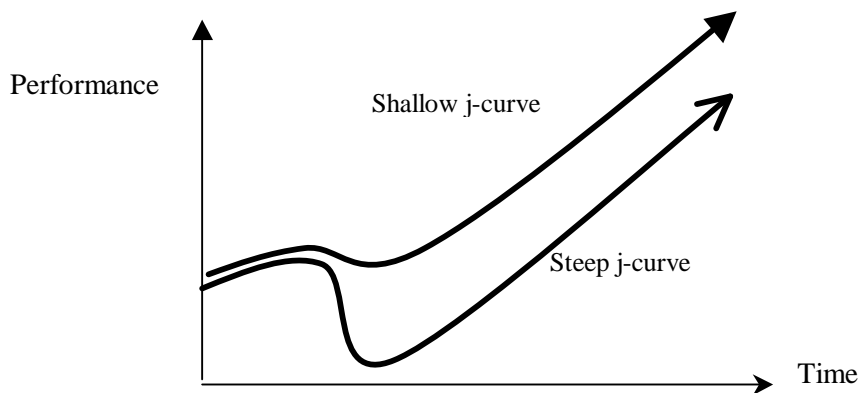
leading to improved competitiveness and thus a better trajectory for performance: this is the upward slope of the j-curve ⁶.

Figure 1: The structural reform "J"-curve
(trajectory of the economy)



The challenge for structural policy is to optimize the shape of the j-curve. An ideal policy will have little or no initial loss of performance, a short wait until improvements kick-in and a steep upturn. The one to be avoided will have such severe short-term costs that it is politically awkward. Figure 2. illustrates these extreme cases.

Figure 2: The structural reform - shallow and steep "J"-curve
(trajectory of the economy)



Unfortunately, there is no easy way to predict whether a particular structural change will conform to the shallow rather than the steep curve, or be rapid rather than protracted in delivering benefits.

Some general propositions can, however, be advanced:

⁶ The j-curve approach was used in analysing the response of the trade balance to a devaluation, with an initial "terms of trade loss" giving rise to a worsening trade balance, but improved price competitiveness eventually facilitating improvement. The difficulty with devaluation, however, is that it risks higher inflation that leads to a further loss to competitiveness. There is no reason to expect such a third phase with supply-side reforms, unless their momentum is lost.

- The first is that structural reforms will almost invariably require a longer time horizon than demand-side policy changes (that is interest rate changes and fiscal adjustments). In many cases, legislation (probably preceded by a possibly extended consultation period) will be necessary, instead of just an executive decision. Implementation will take time and may even be staged to allow new rules or practices to be assimilated.
- Profound structural reforms may call for action in disparate fields to allow the overall aims to be realized, and some pieces of the jigsaw may be more difficult to place than others. The many initiatives needed to integrate financial markets are an example.
- Even if there is a clear de jure timetable for implementation, public and other bodies charged with delivering the reforms may de facto hold up the process. There are both managerial and political sides to such delays, and they cannot just be seen as reactionary responses.
- It is almost a truism that it is easier to achieve change in a period of overall economic expansion than in a downturn, when retrenchment or "what we have, we keep" mentalities predominate. While it would be wrong to infer that structural change must inevitably be slowed down in such circumstances, the importance of accelerating the pace in boom periods has to be stressed, an argument that parallels that for accentuating efforts at fiscal consolidation when the economy is buoyant.
- As a corollary to the previous point, the interplay between demand-side policies and structural reforms has to be emphasized: the latter will be more easily achieved if the former are supportive. The implication is not only that co-ordination must bring together the demand- and supply-sides of the economy, but also that the demand-side, too, may have to adapt, instead of waiting for the supply-side to change.

4.1. Promoting structural reforms: productivity and company restructuring

Labour productivity growth in the EU was only 0.5% in 2001 ⁷. In contrast, in the US, labour productivity growth continued to advance despite the recession, albeit at a slower pace. The productivity growth was 1.2 % for 2001. The European Competitiveness report 2002 concludes that the contrasting experiences of the EU and the US shows the importance of technological and other innovations in supporting productivity growth even during weak economic conditions (Commission, 2002b). The report accordingly saw the deceleration of European productivity as related to under-performance in investment in new technologies, in R&D and in innovation.

Studies of the EU's productivity gap vis-à-vis the US suggest that the principal explanation is the relatively lower rates of, first, expenditure on R&D and, second business investment, especially on information and communications technologies. A recent assessment by the Commission (2002b) finds, however, that differences in human capital supply cannot be considered to be an important factor. Indeed, such evidence as there is suggests that the EU education system is better than the US at matching skills with potential labour demand and that this is more striking in the younger generation. The picture is less rosy when the potential for matching is disaggregated across Member States. Moreover, a worrying finding is that there are grounds for concern about emerging trends such as the higher EU proportion of inactive persons with tertiary educational qualifications.

⁷ The record varied between the Member States. Sweden, Finland, Luxembourg, France and the Netherlands had a negative productivity growth in 2001, while productivity growth substantially exceeding the EU average was seen in Ireland, Greece, Austria, Denmark and the UK (COM (2002o)).

Taken together, the comparisons for human and physical capital hint at an imbalance between the two, principally explained by the relatively lacklustre rate of accumulation of physical capital which was, in fact, higher in the 1980s than in the last decade. Virtually stagnant productivity in services is a reason, and there is as yet no sign in the EU of the sort of leap in productivity in services witnessed in the US where productivity growth in business services, for example, more than doubled in the second half of the 1990s to reach 3.1% per annum. Among the explanations for the disappointing EU trend in services (which, it should be recalled, amount to over two-thirds of the economy, and thus have a strong impact on whole economy changes), three are noteworthy.

First, the benefits of ICT investment in the service industries have been slow to materialise in the EU. Part of the problem is that the acquisition of ICT has to be complemented by organisational change and there are suggestions that the latter has been resisted more strongly in the EU.

Second, in sectors where market liberalisation has been rapid, there has been significantly more rapid productivity growth. However, a balance has to be struck in pursuing this route to avoid damaging deskilling.

In some Member States, regulatory restrictions are also identified as a barrier to productivity growth, notably in the distribution and retail industries.

Achieving structural reform will inevitably be easier if it commands support from all economic actors. Unlike the Luxembourg process where European social partners are consulted and the Cologne process where they are directly implicated, there is no procedure to involve the social partners at European level in the Cardiff process. Moreover, studies show that the social partners are generally not involved at the national level in the EU related economic reform processes either (Foden & Magnusson, 2002). Hence, there is a need to involve the social partners more systematically.

Although, as we discuss in section 6, there are untapped gains from network industry liberalisation, these need to be dealt with carefully. Studies of Sweden and Italy show that liberalisation and/or privatisation of sectors have indeed resulted in increased (total factor) productivity, but at the cost of increased consumer prices and decreased employment in the same sectors. This is reported to be true of electricity, postal services, health care, construction and railway and partly of telecom (depending on service) in Sweden (Jacobsson 2002), and of domestic air traffic, postal services, health care, construction and railways in Italy (Fumagalli 2002). Privatisation and liberalisation of public sectors have also led to job losses in other countries, such as Belgium in the case of postal services, police, hospitals, electricity, telecom and civil service (EIRO, 2002b). Since productivity has increased considerably in the liberalised sectors while consumer prices have also increased, intermediaries and producers seem to have increased their profits at the expense of consumers. There may, consequently be grounds for strengthening the influence of consumers on public policy. Moreover, the authorities may need to strengthen competition policy so as to spread the benefits of market liberalisation.

For three sectors within market services generally, productivity growth seems to be negatively correlated with employment growth: hotels and restaurants, post and telecommunications and transport and storage (COM, 2002b). The service sector is generally characterised by below average productivity growth and at the same time, an increasing share of GDP. Moreover, the positive link between job quality and productivity should be exploited. (On investment in the work place and the labour force: see section 8).

There seems to be little data available on the employment effects of company restructuring. It is reported from Denmark that restructuring has not caused any significant drop of employment levels, but little sign that new jobs for unemployed people been created (EIRO, 2002). Regional

differences in the employment effects of company restructuring are reported from several countries, eg. Germany, Austria, UK, Spain and Portugal (EIRO 2002a) ⁸.

2001 and 2002 have seen several severe job cuts in the telecom sector (British Telecom, Ericsson in Sweden, Dutch Telecommunications Group, Sonera, Finland) following the crisis in that sector (EIRO, 2002b).

4.2. Corporate social responsibility

Following a Green Paper, published in 2001, there has been a growing interest in the notion of corporate social responsibility (CSR), leading to a Commission Communication published in July 2002 (COM, 2002c). In the Green Paper, CSR is defined as a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. The Commission stresses the potential contribution of CSR towards the Lisbon objectives, and notes that although there are variations on the concept, its main features include:

- Behaviour by businesses over and above legal requirements, voluntarily adopted because businesses deem it to be in their long-term interest;
- An intrinsic link to the concept of sustainable development: businesses need to integrate the economic, social and environmental impact in their operations;
- Seeing CSR not as an optional "add-on" to business core activities - but as being central to how businesses are managed.

There is inevitably a risk that CSR amounts to little more than a warm sounding slogan with rather vague aspirations. The communication, for example, states that "[CSR] means a business approach, which puts stakeholder expectations and the principle of continuous improvement and innovation at the heart of business strategies. What constitutes CSR depends on the particular situation of individual enterprises and on the specific context in which they operate, be it in Europe or elsewhere." The communication also highlights the (predictably) divergent perceptions of different stakeholders about what can be achieved and by what means. Nevertheless, there appears to be a momentum behind the concept that could reinforce the message that effective economic management of the EU economy requires input from all stakeholders, not just top-down policy from government.

What is now needed is to turn the nice words into concrete policies and commitments. The EP has already made clear its wish to see CSR "mainstreamed" in areas of EU competence. The challenge for the BEPG's will be to frame recommendations in a way that prompts meaningful action by Member States and goes beyond mere rhetoric. An interesting suggestion in this regard has been made in a report by the Federal Trust (2002) which calls for the development of a corporate "scorecard" based on best practice. This might cover a range of areas, including product safety and quality, environmental indicators, respect of human rights in developing

⁸ Whereas the south of Germany, especially Bavaria and Baden-Württemberg, enjoys remarkably low levels of unemployment and companies even face shortages of qualified labour, unemployment levels in the northern federal states are much higher. While unemployment has fallen in west-German states, it is still high in East Germany. In Austria, while restructuring contributed significantly to a rise in unemployment during the 1990s, this mostly affected formerly strong industrial areas (though these have since recovered). In Portugal, the increase in employment in commerce, hotels and construction has particularly benefited the regions of Braga and Aveiro. Similarly, in the UK, employment in services has expanded more rapidly in the south-east than in the traditional manufacturing locations of South Wales, the North and the Midlands (EIRO, 2000a).

countries, employee rights and support for local community activities. In time, such a scorecard could become part of formal corporate reporting obligations.

4.3. Assessment

There is sometimes an undue pessimism about the outlook for European industry, which as a recent communication on industrial policy observes "is modern and, in many respects, successful. Yet its slow productivity growth is a serious cause for concern." What needs to be stressed is that the productivity slowdown, while it has been evident for some time, has worsened in recent years. Many explanations can be put forward to explain this. There are general concerns that the EU is deficient in generating and developing new technologies and knowledge, slow and half-hearted in innovating and may have lost some of its entrepreneurial capacity to take risks and grow new and bigger businesses. As COM (2002d) comments "Europeans seem too reluctant to bear entrepreneurial risk, too readily satisfied with limited growth of businesses and too reluctant to acknowledge and reward the social contribution of risk-takers."

To the extent that these claims are valid, they point to deep-seated difficulties that are not susceptible to quick or easy solutions. They call for concerted efforts by different levels of government, but also for a better integration of different domains of policy that bear on competitiveness.

5 - Public and private investment trends

In recent years, the relatively low rate of investment – both private and public - has been seen as a problem for the EU. Low investment is of concern because it implies a slower rate of renewal of the capital stock which, in turn, can inhibit structural change and have ramifications for international competitiveness. Crude figures of fixed capital formation as a percentage of GDP are one of the main ways of monitoring investment and it is certainly true that they do not show an encouraging trend in recent years. But quality of investment also has to be taken into account. Ireland, for example, has had an investment rate below the EU average in several recent years, yet its growth record is unsurpassed.

Over the period 1961 to 1990 total investment grew at a broadly similar rate in the EU (3.4%) and the US (3.6%)⁹. This story changed over the course of the 1990s, however. In the first half of the decade, total investment in the US increased by 4.1% and fell by 0.3% in the EU. The EU's fortunes improved between 1995 and 2000 as investment grew by 4.0%, although it fell further behind the US, which enjoyed an 8.4% increase in total investment. The global economic slowdown has, however, seen a sharper decline in total investment in the US than in the EU.

Within the EU, investment in the German economy has been hardest hit by the slowdown. Over the 1990s, total investment in Germany increased by 1.8%. In 2001 total investment fell by 5.3% and it is estimated to have fallen by 4.8% in 2002. Indeed, total investment is expected to fall during 2002 in all Member States with the exception of France, where it is forecast to grow by just 0.1%. The strongest performer is Greece, which has managed to maintain the robust investment performance of recent years. In general though, how can the comparatively weak investment performance of the EU economy during the 1990s be explained? The answer lies in reference to both the public and private sectors.

5.1. Public Sector Developments

Although government expenditure in the EU traditionally accounts for a higher percentage of GDP than it does in the US, this description oversimplifies matters in three important respects. First, as table 2. shows, the share of public investment in the EU declined from 3.8% of GDP to 3.0% between 1970 and 1990, and has since fallen much further to an estimated share of 2.5% in 2001. Within the Union, the Netherlands and Luxembourg are at the top of the league table, spending 3.4% and 4.8% of GDP on public investment, respectively. At the opposite end, the UK and Austria devote just 1.3% and 1.2% of GDP to public investment. Meanwhile, Germany is not far off the bottom, spending just 1.6% of GDP on public investment.

Second, the global economic slowdown has produced a sharper increase in public investment in the US than it has done in the EU. In the US, public investment rose from 2.8% of GDP in 2001 to a share of 3.4% in 2002 and is set to remain there over the forecast horizon. EU public investment has remained relatively stable since the mid-1990s even in the face of turbulent economic conditions. The investment behaviour of national governments under these circumstances is also revealing. Only five Member States managed to increase the share of public investment to GDP in 2001-02 and even then the largest increase (in Luxembourg) was just 0.4 percentage points. Third, the US government spends a greater percentage of its GDP on investment in Research and Development (R&D) than the EU as a whole. The contrast is striking in this respect between the 1960s and 1970s when public investment was, on average

⁹ Unless it is otherwise stated the data used in this paper are drawn from the Commission's autumn forecasts (COM (2002u)).

and as a share of GDP, much higher in Europe than in the US, and the 1990s, when the situation was exactly the opposite. Of course, this observation is no proof that public investment has been insufficient in Europe in the latter period; but it does suggest that the institutional environment, including the impact of European fiscal rules, in which public spending decisions were made in the past decade, was probably not public-investment friendly, at the very least. In fact, as shown in Table 2. for a selection of European countries, public investment has been reduced quite substantially, especially in Germany; the only countries in the sample in which it has not been so are those in which growth performance has been above average in recent years.

Table 2: Public investment as a share of GDP in selected European countries

Year	Germany	France	Italy	UK	Ireland	Portugal	Euro area
1970	4.5	4.1	3.2		4.5		3.8
1971	4.4	4.0	3.0		4.7		3.8
1972	4.0	4.0	3.2		4.4		3.7
1973	3.8	3.7	2.8		4.9		3.5
1974	4.0	3.7	3.0		6.0		3.5
1975	3.8	4.2	3.4		5.3		3.7
1976	3.4	4.0	3.3		4.4		3.5
1977	3.2	3.4	3.2		4.5		3.3
1978	3.2	3.2	2.9		4.6		3.1
1979	3.4	3.3	2.9		5.2		3.0
1980	3.5	3.4	3.2		5.7		3.1
1981	3.2	3.4	3.7		5.5		3.0
1982	2.8	3.6	3.8		5.1		3.0
1983	2.5	3.3	3.7		4.5		2.9
1984	2.4	3.2	3.6		3.9		2.8
1985	2.3	3.4	3.7		3.9		2.9
1986	2.4	3.4	3.5		3.6		2.9
1987	2.4	3.2	3.5	1.9	2.7		2.9
1988	2.3	3.6	3.4	1.5	1.8		2.9
1989	2.3	3.7	3.3	2.1	1.8		2.9
1990	2.3	3.6	3.3	2.5	2.1		2.9
1991	2.7	3.8	3.2	2.4	2.2		3.1
1992	2.9	3.8	3.0	2.2	2.1		3.0
1993	2.8	3.4	2.6	2.0	2.3		2.9
1994	2.7	3.5	2.3	2.0	2.3		2.8
1995	2.3	3.4	2.1	1.9	2.3	3.8	2.6
1996	2.1	3.3	2.2	1.4	2.4	4.3	2.5
1997	1.9	2.9	2.2	1.1	2.5	4.4	2.4
1998	1.9	3.1	2.4	1.1	2.7	4.0	2.4
1999	1.9	3.1	2.5	1.0	3.1	4.1	2.5
2000	1.8	3.2	2.4	1.1	3.8	4.2	2.5
2001	1.8	3.2	2.6	1.4	4.4	4.2	2.5
2002	1.8	3.1	2.7	1.5	4.9	4.2	2.5

Sources: OECD, and Creel, Latreille, and Le Cacheux, 2002

From the point of view of fiscal rules and the long-run sustainability of public finances, the real issue is whether public investment is efficiency-enhancing for the private sector, or not. If it is, then additional public spending of this kind will have a positive effect on potential growth, and separating out these expenditures when evaluating long-run sustainability of public finances is then perfectly justified.

It is however fair to say that, so far, the empirical evidence on the positive effect of public investment, or indeed other kinds of public expenditures¹⁰ on growth is mixed and rather inconclusive. What this points to is an imperative of identifying the public capital deficiencies that act as physical or economic bottlenecks that deter business investment. A priority may be to establish, within the BEPGs, how the "investability"¹¹ of EU economies can be improved.

5.2. Business investment

There are surprisingly wide disparities among the Member States in the rate of growth of business investment. Between 1995 and 1999 growth rates ranged from 12.1% for Germany, 18.2% for France and 21.3% for Italy, to 42.3% in Denmark, 48% in the UK and 52.1% in Greece. Meanwhile, since the mid-1990s, business investment in the US grew by 50.3%. The investment by private sector firms in information and communications technology (ICT) has also been considerably higher in the US over this period. Although expenditure on ICT increased in both the US and the EU over the 1990s, the relative share of expenditure is markedly lower in the latter and the transatlantic gap widened over the 1990s. Between 1992 and 1999, ICT expenditure as a percentage of GDP in the US (8.1%) exceeded that in every EU Member State except Sweden (8.2%) and the United Kingdom (8.1%). The weakest performers were Spain (3.9%) and Greece (3.8%).

The relative performance of Member States exhibits considerable variation over the decade, however. The UK and Sweden earned their high technology reputations by accelerating their ICT expenditure over the 1990s. Smaller Member States such as Portugal and Finland lost ground in the second half of the 1990s, as did Germany. These trends are reflected, in part, in differences between the US and EU in business expenditure in the IT sector. In 1999 expenditure on US business expenditure on IT accounted for 4.5% of GDP as compared with a figure of 2.7% for the EU. The shortfall in ICT investment by the EU has been a costly one. The European Commission (2002b) estimates that aggregate economic growth was reduced by "between 0.3 to 0.5 percentage points of economic growth during the 1990s due to its lower investment in ICT".

5.3. Investment in the EU: Priorities and Bottlenecks

Given the superior economic performance of the US economy over the 1990s it is of little surprise that US rates of investment have become a benchmark for EU governments. Two caveats must nonetheless accompany comparisons between the US economy of the 1990s and the EU economy between now and 2010. First, the boom-time rate of investment in the US was not sustainable in the long run. The surge in business investment in the US came at a time when national savings rates have remained fairly constant. The result was that, by 2002, the US current account deficit had burgeoned to 4.7% of GDP, providing a strong indication that US

¹⁰ Expenditures on education or R&D are other likely candidates for a positive effect on economic growth according to endogenous growth theories. In practice, however, the evidence is not entirely convincing on these items either. For a review of recent empirical studies and an attempt at quantifying the effects on growth, See Fitoussi and Le Cacheux, (2003).

¹¹ Defined as conditions conducive to a higher level and quality of investment. See Begg, (2002).

investment exceeded its steady state level ¹². The ageing of the EU population will put a strain on the rate of saving in the economy over the next two decades, meaning that an investment drive by Member States could result in external macroeconomic imbalance.

Second, considerable uncertainty remains as to the precise causal role of investment performance in the US boom. An OECD (2001) study reveals that while 81% of the explained movements in US real GDP over the late 1990 can be explained in terms of investment growth, only 21.5% of the total change can be explained by traditional factors at all. This uncertainty notwithstanding, the fact remains that the EU will require more and better investment if it is to achieve its desired boost to productivity growth. This poses challenges for both the public and private sectors.

5.4. Investment Challenges for the Public Sector

The EU needs a higher rate of public investment and one that is more closely targeted on improving the level of productivity within the economy. The 2002 BEPGs proposed three key areas of reform to achieve these goals: structural reform in product, labour and capital markets; the creation of a business-friendly regulatory environment and the promotion of the knowledge-based economy. More specifically Member States were called upon to increase overall spending on R&D to 3% of GDP by 2010, to promote access to, and use of, ICT and to strengthen education and training efforts. Although such reforms are a persuasive way to enhance investment in the long run, a key issue is whether the need to consolidate public finances within the context of EMU will help or hinder investment objectives. The risk is, in particular, that politicians who are faced with the constraints of the SGP will find it less costly in the short-run to cut back on public investment than on other areas of public expenditure. Recent research by the European Commission would seem to allay these fears. COM (2002e) finds evidence to suggest that the composition of public expenditure improved in "quality" during the Maastricht convergence period rather than deteriorated. Two exceptions are the UK and Italy, which experienced large cutbacks in public investment during the 1990s. By and large, however, other Member States benefited from the reduced burden of interest repayment during this period and used the extra revenue for more efficient purposes. While fiscal discipline may not jeopardize existing public investment, it remains an open question whether it will restrict Member States from increasing investment further.

The experience of the UK in the context of the BEPGs illustrates this concern. In a plan to finance increased public investment on under-funded public services, the UK government is committed to borrowing 1% of GDP over the medium term, thus violating the balanced budget rule of the SGP. The 2002 recommendations for the UK recognised this quandary by suggesting that the dire need for extra public investment coupled with the relatively low stock of public debt in the UK justifies the government's fiscal plans. This demonstrates that fiscal consolidation need not contradict investment commitments, but that the magnitude of the public debt will be a crucial determining factor in whether it does or not.

Investment Challenges for the Private Sector

A priority for the private sector is to enhance business investment and to channel a greater proportion of resources into both R&D and the diffusion of ICT. Over the longer term the surest way to generate this investment is through a comprehensive reform of factor and product markets. In the short-term two key bottlenecks must be resolved. The first is to remove any disincentive to R&D, which may arise in the taxation system. Special tax schemes are playing

¹² It has been argued, however, that the steady state level may have been boosted by such factors as the increased rate of depreciation, or changes in the composition of capital (COM(2002a)).

an increasingly important role within the OECD in attempts to encourage greater investment in R&D (OECD, 2001). Member States such as France, the Netherlands, Austria, Portugal and Spain now offer a positive net subsidy to firms for expenditure on R&D. Germany, Italy, Denmark, Greece, Sweden, Belgium and Finland, on the other hand, continue to impose a positive net tax on such expenditures. Although "high-tech" Member States such as the Netherlands and Sweden are found in both these groups, it remains a basic tenet of economic theory that taxes should take account of the wedge which exists between private and social returns from R&D.

The second is to ensure that the EU's venture capital markets facilitate rather than constrain investment expenditure. Venture capital investment plays a crucial role in the development of ICT and Research and Development. But, as a COM (2002d) report on enterprise in Europe observes, "weak venture capital traditions in the EU have been associated with weak innovation and have been seen as obstacles to Europe's productivity growth. It is in venture capital that the differences between Europe and the US are most marked." At the height of the economic boom in the United States, information technology accounted for nearly half of total venture capital investment. In 2000, venture capital investment accounted for 0.07% of GDP as compared with a figure of 0.02% for the EU. Within the EU, venture capital is most developed in the Netherlands, where it accounts for 0.05% of GDP. Austria (0.003%), Denmark (0.007%) and Greece (0.007%) are the worst performers, while France (0.015%), Spain (0.007%) and Portugal (0.008%) lag well behind the EU average. Although the US economic slowdown saw a 62% fall in the size of US venture capital, it remains several times greater (and more sophisticated) than its EU counterpart. If access to venture capital is to improve then a more liquid, better regulated and more closely integrated EU capital market will be required. In a recent assessment, the COM (2002f) concludes that although risk capital markets have matured since 1998, unfavourable market conditions have hindered the role played by stock markets as an outlet for venture capital (see also section 7 of this report).

A possible policy response would be to increase public sector support for venture capital development. The European Investment Fund, with a capital of € 2 billion - 60% financed by the European Investment Bank and 30% by the Commission, with the balance of its capital subscribed by national financial intermediaries - is an instrument that has been developed to boost venture capital within the EU. It is only allowed to finance firms indirectly by taking a stake in a venture capital fund and, similarly, to provide portfolio guarantees indirectly. The Fund was substantially reformed in 2000, so that it is perhaps too early to judge its success.

5.5. Assessment and proposals

The comparatively weak performance of the EU economy since the mid-1990s is a story of two factors: low productivity growth and a shortfall in high quality investment. The EU's objective of higher productivity calls for greater public and private investment. Thus a key recommendation here is to maintain consistency between investment plans and the need for fiscal responsibility within a monetary union. To achieve this it is imperative that Member States reduce public debt to a sustainable level. In the private sector the priority is for businesses to invest a greater share of resources in R&D and ICT. The achievement of this objective will depend in the long run on the success of product and factor market reform. In the meantime, measures should be taken to ensure that national taxation systems promote rather than deter R&D. Second, effort must be made to gear up venture capital markets for investment in high technology industries. In this regard, the support provided by the European Investment Fund is a valuable, though possibly too limited instrument, and the scope for expanding it should be explored.

6 - Progress in opening-up markets

Opening-up, indeed integrating, national markets is and remains the hard core of European integration. A truly integrated single market with proper and proportionate regulation, where justified by market failure, is by far the most important building block of the Economic Union which, in turn, is the foundation for the Monetary Union. The widening and deepening of the internal market ever since the Single European Act, and recently in the framework of the new Internal Market Strategy (1999 - 2004) as well as the Cardiff process and the Lisbon strategy, has greatly helped the EU to modernize and become a more competitive economy.

A closer inspection shows, however, that, despite the distance traveled in exposing national markets to potential or actual competition in the EU context, much further deepening is desirable. Lip-service is paid to this aim in all kinds of important EU documents from all the EU institutions, but progress in the liberalisation process or in the achievement of the competitive exposure expected from such market opening is distinctly less than satisfactory.

6.1. Advancing the internal market

To advance the internal market, what policy makers, including to some extent the European Parliament, can do in 2003 and beyond can be divided into three types of activities:

- Ensuring proper and timely transposition of directives adopted
- Minimizing the compliance gaps of Member States and economic agents
- Further "completion" and adaptation of the EC rules (liberalisation & regulation)

On transposition

The Commission has been reasonably effective, especially in the last decade, in accomplishing effective transposition. However, what matters in transposition is not so much the legal obligations - deadlines for the transposition of directives are clear – but the administrative, institutional and political frictions in domestic legislative procedures. Public pressure of "naming & shaming" of countries with significant transposition gaps, backed by infringement procedures, has led practically all Member States to introduce administrative and political innovations for the purpose of enhancing their transposition records. In the Internal Market Scoreboard no. 11 of November 2002 ¹³ an interesting survey of such innovations has been provided. Regrettably, it reveals no correlation between the number of such innovations and the transposition record, with the implication that nothing can substitute for strong political will. The overall transposition deficit is low (2.1 % of all directives that should have been transposed by November 2002), although it has inched up from 1.8 % since May 2002. Both are above the standard set by the European Council (1.5 %) and there are marked country differences.

Irritating and selectively problematic as the gap nowadays can still be – especially for companies anticipating new liberalisation or regulation - the transposition gap is no longer a serious economic issue. Nevertheless, it is the credibility of the legal framework and the trust in the EU institutions to be vigilant that is at stake. Even a small gap suggests that Member States have difficulties accepting their essential role in the multi-layered and decentralized EU system.

Compliance

The internal market can only work as intended if compliance with EC rules is guaranteed. The compliance system of the Community is complex. As a consequence it is far from clear what

¹³ Figure 7, p.10.

exactly the degree of compliance with the internal market rules is. In a report about BEPGs it is not suitable to discuss the multiple judicial mechanisms to bring about the proper application of and adherence to EC law¹⁴. Nevertheless, it is important that the European Parliament, in evaluating the BEPGs, does not lose sight of the limited and selective perspective on compliance that the Commission and Council versions of the BEPGs (which, on compliance, are identical for 2002) present. All the BEPGs say is that implementation ought to be correct, a superfluous statement if not complemented with the policy problems and solutions behind these words. The data are worrying (a stubbornly high number of around 1500 open cases) and, in contrast to the downward trend in transposition, the problem is increasing (with a doubling of cases in ten years). Little attention is paid to a successful mechanism preventing the emergence of infringements, namely the 98/34 committee (formerly, the 83/189 Ctee) on technical barriers to trade in goods and information services. In this committee, the Member States routinely assess up to some 700 draft laws and draft decrees of Member States, annually, with a view to preventing new barriers and ensuring the respect of mutual recognition clauses. Only a tiny fraction of this enormous wave of national regulation leads to such problems that approximation is called for. This success story demonstrates that once Member States assume their responsibility in a firm European setting, infringement and centralisation became rare and free movement is assured. This crucial lesson should find application in other areas of the vast internal market domain.

Overcoming gaps and weaknesses

The EC-1992 programme, although a great success¹⁵ did not actually "complete" the internal market. The wording matters a lot. The term "completing" is being used in two distinct ways and this causes confusion. First, "completion" means, and indeed ought to mean, that policymakers tackle all the main elements of the concept of "internal market": they fill the gaps and plug the holes. In this sense, the Union still has work to do but has achieved very significant results. Second, "completion" is employed when referring to the updating of accomplishments in view of technical progress and innovation, to trivial and minor issues indicating imperfections of regulation and to compliance issues. This is unhelpful. National or federal "internal markets" such as those of the USA or Canada or Switzerland may well be more or less complete in the first sense but never in the second sense. Hence, decision-makers such as MEPs, already overloaded by information and analysis, will find it exceedingly difficult to establish firm priorities if the two distinct approaches are not clearly separated.

The internal market is "complete" once the free movements of goods, services and factors of production (that is, labour, capital and technology) are ensured and market failures are overcome by appropriate regulation and competition policy. This definition is not followed in the portfolio distribution of the Commissioners. What Commissioner Bolkestein is responsible for covers no more than a part of the internal market.

Key gaps

The main gaps nowadays are:

Labour: the free movement of workers in the treaty is not mentioned in Art. 3, EC but only in Art. 39 and later. The upshot is that cross-border worker mobility is a "residual" and the economic incentives for labour to go to other Member States are structurally minimised,

¹⁴ See the Annual Reports on Monitoring the Application of Community law which are routinely assessed in the European Parliament and which contain a wealth of data while serving as a demonstration of the said complexity.

¹⁵ Pelkmans, in *Unity & Diversity*, 2001.

frustrated and distorted. As a result, domestic labour markets do not feel any competitive challenge from EU workers from other Member States, even though all Member States adhere in a general sense to the "European social model" in their own distinct ways. This is a fundamentally unhealthy and artificial situation. It amounts to the rather curious and manifestly "incomplete" idea of an internal market without an internal labour market. The taboos resting on this approach make it difficult to render the Luxembourg process truly effective and to let the Cardiff process tackle the better functioning of (national) labour markets. Completion of the internal market by the establishment of free movement of workers in an economic sense (as described above) would inject more flexibility and dynamism, without in any way having to depart from the European social model.

Services: two decades after the liberalisation of services in the EU began, the "internal market" is still far from being completed. The success story is road haulage, a big sector and crucial for the internal goods market. In financial services the first wave under EC-1992 was necessary but seriously insufficient. The current second wave, under the Action Plan until 2005, is therefore a "must". In network industries (telecoms, postal, gas & electricity, broadcasting, rail and air transport) progress is highly uneven but gradual and steady. The virtue of the Lisbon perspective is that it has induced pressures to see the network industries in a dynamic economic context. The potential for improvement both of their economic performance and the provision of (measurable and high levels of) public service is substantial. The internal market for services of professionals is also incomplete, while other business services, ostensibly enjoying "free" movement, have long been suspected to suffer from many invisible obstacles. A top priority for a competitive and dynamic internal market for all services is a *conditio sine qua non* for the Lisbon strategy to make any sense and to have any chance.

Mutual recognition: Despite successes, mutual recognition has not always worked in practice because of the many implicit costs of its application. This is true in goods markets, but more so in services markets, while in labour markets there is scope for further improvement.

Taxation: Taxation is an area that will always be subject to changes and updating, and will always attract controversy. But this does not mean that change is precluded. One hardcore issue is the removal of harmful tax competition. The other is the postponed shift to the origin system for VAT, which results in implementation costs for businesses that should be borne by the state and could be lower.

Patents: In 1962 the EEC had almost adopted a common patent regime, but it has since been stalled. In the spirit of Lisbon, progress on the patent would be desirable, but the BEPGs only mention, in brackets, the creation of an affordable Community patent in passing under the heading "foster the knowledge-based economy". The EP ought to exert maximum pressure on the Council to act in the European interest.

6.2. Economic impact

Measuring the impact of the internal market is a mission impossible, principally because the dynamic effects are hard to calibrate. The full economic impact of the internal market is, almost by definition, far larger than what economic analysis nowadays can come up with. In order to assess the meaning of the BEPGs with respect to the internal market and structural reforms, it is nonetheless important to have a basic understanding of what is presented as "the economic impact" so that MEPs can evaluate priorities and emphases independently.

How policy-makers see the impact

The Commission's Internal Market Scoreboard no. 11 of November 2002 has presented an Internal Market Index (IMI). It consists of 12 indicators with different weights and is supposed to measure internal market policy impacts. As the combined graphs below show the IMI went

up from 100 in 1992 to 143 in 2001. Although selective, the advantage of the IMI is that a rough measure of key indicators is available to assess whether (national) policy makers assume their responsibilities, and indeed over time.

Figure 3: Internal Market Index: above EU average

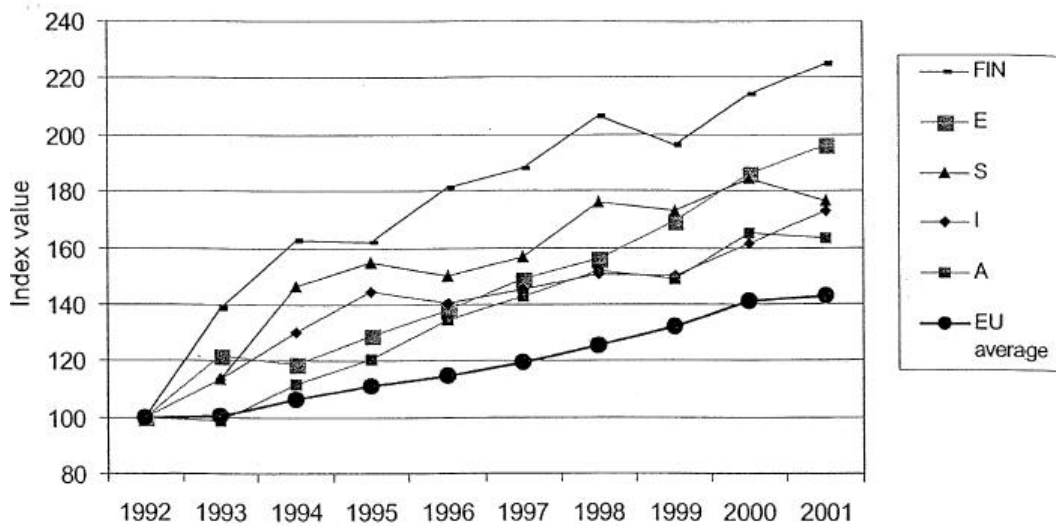
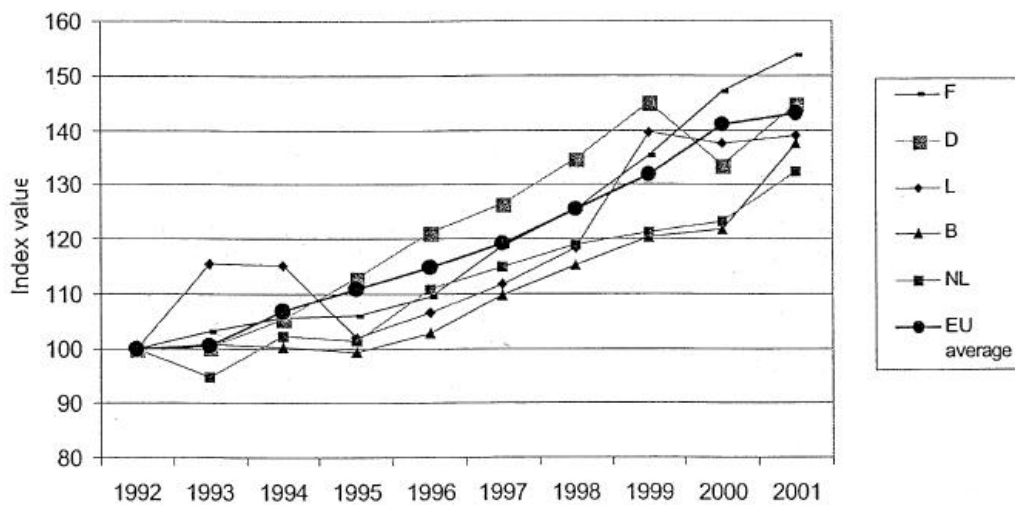
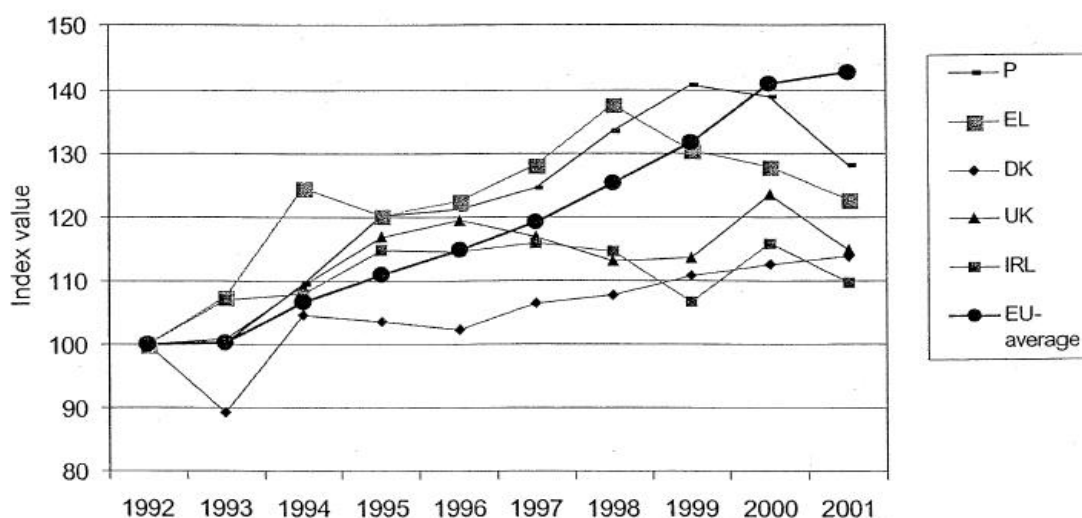


Figure 4: Internal Market Index: around EU average



The Commission warns that the IMI "should be seen more as a reality check than as a precise scientific exercise". It should nevertheless be pointed out that the IMI has drawbacks that should be taken into account. In particular, the choice of key indicators and their weighting in the index is somewhat arbitrary.

Figure 5: Internal Market Index: below EU average

How business and citizens see the internal market

The Internal Market Scoreboard of November 2002 contains major surveys of perceptions of business and citizens about the internal market without frontiers. These surveys are generally upbeat for business and quite positive in the case of citizens. A caveat about such business surveys, at least from an economic point of view, is that what businesses call a "negative impact" may actually be seen as positive from the point of view of the European public interest. It is precisely the competitive pressures in terms of price or quality or variety or innovation that bring the economic benefits, and hence growth, for the EU economy.

How economists see the economic impact

Economists have struggled to assess the net benefits of the internal market. It proved difficult enough in the Cecchini group, the 1996 Single Market Review and the academic literature. The complexity of these exercises notwithstanding, they all suffer from a few strong caveats that should be understood by MEPs and other decision-makers. The greatest problem is how best to convert the many micro-economic effects of numerous internal market measures and instances of removal of barriers into macro-economic effects such as extra actual (or potential) GNP and expected (net) employment impact. The techniques used have limitations and there are methodological problems in assessing long-run effects and quality aspects. It is against this background that the recent Commission (2003b) report on ten years of the internal market (since 1992) should be seen. The macro-economic benefit is estimated to be 1.8 % of EU GNP (€ 164 billion) and some 2.5 million jobs have been created in the EU since 1992 thanks to the internal market. Welcome as this undoubtedly is, these estimates are lower than those of the Cecchini group in 1988, which simulated some 4.5 % extra GNP (although the extra jobs in Cecchini were estimated to be "only" 1.75 million). Strictly speaking, the Cecchini estimate was for the end of 1992 and not for the period following 1992, as the Commission report has now done. Note that the Monti Review estimates a 1994 GDP level of between 1.1 % and 1.5 % higher than without the single market, with a (net) addition of employment between 300,000 and 900,000 jobs.

It is argued that higher investment in the Union for several years could easily induce similar magnitudes of economic growth. This suggests that structural reforms, liberalisation, exposure to competition, better EU regulation, the substitution of 15 national rules, or standards for that

matter, by single European rules and other "supply side measures" (which is largely what the internal market is about) have only fairly modest growth effects. Such belittling of the significance of the internal market is based on a fundamental flaw: investment is largely driven by profit expectations and the prospect of greater sales or higher market shares. The internal market will gradually and in many subtle ways improve the prospects for cross-border market penetration. How exactly this influences investment in turn is complex and not well understood¹⁶. It is interesting that the November Scoreboard finds, in the business survey, that about one quarter of the firms consider that the internal market has contributed to profitability (as well as productivity and employment).

There are good reasons to believe that the entire single market build-up has induced much greater economic effects than can be shown by rigorous economic analysis, but there is only illustrative evidence to underpin such assertions. The Commission's recent survey of ten years of the internal market is to be welcomed because it brings together a range of precisely this sort of illustrative, piecemeal evidence of economic benefits. A selection of such benefits is reproduced in Table 3. for illustrative purposes.

¹⁶ This is confirmed by an analytical survey of DG EcFin, "Determinants and benefits of investment in the Euro area", *European Economy*, no 73, 2001, chapter 3, especially section 3.

Table 3: Selected benefits of the internal market: 1992-2002

Nature/ source	benefits	comment
GNP EU	+ 1.8%	€164.5 billion
Jobs	+2.5 million	
export competitiveness	EU exports of goods up from 6.9% of GDP to 10.2%	difficult to establish how much of this increase is due to the internal market
Attractive location for investment?	FDI inflows from 3rd countries have increased fourfold	both 1992 and 2001 were weak FDI years; flow data do not incorporate disinvestments; difficult to establish what share to attribute to internal market
More competition	to consumers to business	- price convergence in the EU, towards lower levels - more diversity and higher quality of goods (source: consumer surveys; economic assessment extremely hard) - price/cost margins decline (passing on cost reduction to consumers) [the Commission source does not report on the benefits of competition for business; however, competition is not just a threat to a firm; it often fosters higher productivity, an improvement of the goods or services offerings, innovation or investment in reputation-building; in turn, these responses have positive knock-on effects for the economy; also, competition in home markets may spur strategic cross-border trade and/or investment, exactly what the internal market needs]
Public procurement	more cross-border procurement savings by more competitive pricing	from 6% in 1987 to 10% in 1998 (share of all public procurement) little hard evidence; Swedish study estimates 1%; conduct of bidders likely to change because of open procedures, not necessarily because of cross-border bidding; if conduct changes, savings cannot be measured because "old"conduct can no longer be observed and compared; hence, true savings might be much larger.
Network industries	[huge]	[see 6.3]
Financial markets	Potential benefits of Action Plan	up to 1.1% of EU GDP or €130 billion (in 2002 prices) total (not only sectoral) jobs to increase by 0.5%
Regulatory protection	Evidence for "trading up" (i.e. more market with higher standards)	work place; accidents (both total and fatal ones) fell considerably between 1994 and 1998 for relatively risky jobs environment; range of important improvements (emissions, cleaner water, cleaner air) and a fast-growing eco-industry with a 2002 turnover of €183 billion.

Source: European Commission, *The Internal Market – Ten Years without frontiers*, 8th January 2003

6.3. Progress on liberalisation and regulation of network industries

Today, the principal emphasis in the completion of the internal market is on financial services and capital markets (in section 7) and the regulatory reform of "network" industries with the aim of boosting their economic performance, while ensuring a high level of public service. Although they are subject to special demands such as universal access, there is no a priori reason why the usual internal market principles (free movement of goods and services, free establishment and exposure to competition) should not apply to network industries. This is now

much better understood by policy makers. Table 4. provides an overview of the regulatory progress of the six largest network industries.

Great progress has been made in what are complicated industries. Their special characteristics with respect to market structure and conduct related to the physical or logistical networks – not to mention privatisation – in which they operate mean that establishing the optimal combination of liberalisation and regulation is far from easy.

(Table 4: See next page)

Table 4: Regulatory progress in EU network industries

	accomplished	pending problems
telecoms	liberalisation & regulatory package achieved by 1998; further refinements since (e.g. terminal equipment directive); new regime, more based on competition policy, from mid-2003 onwards	unbundling local loop difficult & slow practical application of new regime, in particular NRAs – Commission cooperation
postal	the "gradual and controlled" approach exceedingly slow; postal directive (97) defines basics but liberalizes only 3%; Reims II (1998) has given a boost to quality of service; postal directive of 2002 extends liberalisation to 16% in 2003 and (after review) 25% in 2006.	direct mail incoming cross-border all letters under USOs independence of NRAs perverse incentives between "reserved" and competitive business as well as FDI
air transport	full liberalisation (incl. cabotage) since 1997 in EU, EEA; nowadays also candidate countries	severe constraints on internal market due to restrictive bilaterals with 3rd countries; ECJ ruling of 5 November 2002 victory for internal market; common external regime to be negotiated (tough)
rail	very slow opening up; even basics were inadequately defined in the early wave ('91 and '92, then '95 directives); high-speed rail interoperability accomplished; conventional rail standardisation now progressing; 2001 railway package improvement of basic regulation; freight liberalisation "voluntary" in free-ways; in 2003 freight liberalisation on TENs	change of very defensive and anti-competitive mindset only now beginning; competition policy still very limited capacity constraints very serious public service levels at EU level still undefined early days of liberalisation
electricity	1996 directive with limited liberalisation for business only; considerable gaps and weaknesses in regulatory regime (e.g. state can be regulator: Chinese walls; EU public service ill-defined; access rules with too many options cross-border provisions without incentives, etc.); Barcelona European Council agreed full market opening (for business) by 2004. In principle, cross-border interconnectors towards 10% of domestic capacity in 2005.	1996 directive seriously deficient (for gaps, see 1st column; reciprocity was counterproductive; etc.) merger control experienced difficulties in preventing anti-competitive structures Florence "upgrading" and deepening process helped no independent regulator in Germany draft directive of 7 June 2002 under discussion draft regulation of 7 June on cross-border access under discussion
gas	1998 directive, with limited liberalisation for business only; even more drawbacks than the 1996 electricity directive (e.g. only separate accounts; no reciprocity); exceptions for Member States with emerging networks; slow pace (33% in 2009)	similar problems as in electricity, plus the problem of security due to import dependency no independent regulator in France and Germany Madrid "upgrading" and deepening process helped 7 June draft directive and draft regulation under discussion

On the road to Lisbon-2010

However, the EU has profoundly changed its economic outlook over the last decade. A disappointing record of EU growth and employment - up to around 1997 - and the better performance of the USA both before and after that year further added to the sentiment in Europe that more ambitious economic strategies were needed. The Lisbon strategy of making the EU the most competitive and dynamic economy in the world is of course based on a vague and declaratory aim, but it does express the firm intention of political leaders that the European economy has to mend its ways. The priorities are henceforth on market functioning, innovation and profound structural change. From this new perspective Table 4. looks considerably less impressive. Indeed, it rather looks worrying because in several network industries the pace of regulatory change is too slow for the process to be completed before 2010. What matters more still are the inevitable delays before the benefits of regulatory reform feed into the competition and dynamism of the European economy that is central to the Lisbon perspective. The BEPGs ought to reflect the urgency of the new outlook in the case of network industries, precisely because 2010 seems so comfortably far away. This enterprising spirit is absent from the BEPGs of 2002.

The text urges Member States to "accelerate reforms in the network industries" but this apparent urgency is substantiated merely by a list of statements summing up obligations or political agreements which have already been reached! What acceleration such a list could possibly achieve is mysterious. The European Parliament is advised not to support guidelines which do no more than repeat what all players have accepted or are now adjusting to, without any genuine acceleration. There should be a request to the Commission to do what thus far has never been done by the Union: formulating an overall strategy for all network industries in the light of the expected economic benefits over the long run and the ambitious perspective of Lisbon-2010. This strategy could be an evolving one in the run-up to 2010, given the complexities of the agenda.

6.4. Economic performance of 4 network industries

The turbulence and upheaval in the network industries, if not the shock of undergoing a paradigm shift itself, generate a lot of social and political pressures from stakeholders and some opinion leaders. A good deal of this is national but heavy lobbying has also been directed to the European Parliament. It is therefore of utmost importance that gradually an empirical economic analysis of the impact of network liberalisation, with appropriate EU regulation, is becoming available. The exposition in Table 5.3 below focuses on telecoms, postal, gas and electricity.

Table 5: Economic performance of liberalising network industries
(6 indicators, 4 sectors)

	Telecoms	electricity	gas	postal
market structure	Incumbents' market shares fallen sharply, except for local; mobile, oligopolies; carrier pre-selection grows rapidly	incumbents' market shares lower in countries early with liberalisation; several countries with many local/regional monopolies still; overall concentration high; merger strategies	data on gas poor; some national gas networks still incomplete; picture very similar to electricity	in letters, only monopoly with fringe competition; concentration up (!) in (competitive) ancillary markets (parcels; express services) due to acquisitions
(more?) players & consumer choice	in long distance & international calls (fixed), usually more than 5 operators (or 3-5); in local often less but carrier pre-selection doubled in 2002; in mobile 3-5 players	big business has massively switched supplier or renegotiated ('98 - '01); small business less, but not eligible in 10 countries;	big business shows great disparities (between countries) in switching; data on renegotiation "unknown" ; small business not eligible in 12 countries	overall, incumbents' market share of 84% in 2000 for letters; even in early liberalising countries, competitors' shares only reached between 5.2% - 13% of "open segment" ; in courier & express, incumbents 40%; in parcels, low shares but increasing, with fierce competition & cross-border acquisitions
market integration (cross-border entry & trade)	cross-border services massive & unproblematic (mobile & fixed); cross-border entry probably considerable (proxied by M & A activity) but no exact data	only 7 smaller Member States have "openness" degrees higher than 10% (2000); disparities between technical potential for import competition and the actual cross-border (cross-border "pan-caking" now out); congestion problems in cross-border interconnectors for several markets	"gas release" obligations for import monopolies; severe congestion or anti-competitive obstacles to cross-border competition; 15 years contracts problematic; cross-border trade may be transit, ultimately from 3rd countries (EU import dependence)	cross-border mail still reserved (outgoing will be liberalised in 2003 and is already free in 5 M.S.); competition is nonetheless "substantial"; in parcels, express and "new services" cross-border competition intense; pan-European strategies (with multiple entry) emerging

	Telecoms	electricity	gas	postal
prices	strong price decreases overall, and over a range of years; international & long-distance some 40% - 50% since 1998, with new entrants offering lower prices still; mobile 23% down over 2000-2002; line rentals sometimes up due to "rebalancing" and special tariffs to targeted social groups very low	there are large price differences in the EU, in what are seen as 5 clusters of "regional" markets; so price convergence is slow, but implies contrasting trends between countries; overall, price trends are much below all-services trends and below the general price index; more sharply down in early liberalisers	little price transparency and somewhat volatile trends especially for (the many) gas importing countries; closer relation with (volatile) oil prices than electricity; smaller users in less open countries pay relatively high prices	prices rise only very slowly (less than inflation) between 1997 and 2002, for domestic mail; however, the quality of service has markedly gone up in many EU countries, for these (nearly constant) prices; no detailed data reported
affordability of public (or universal) service*	for 14 EU countries these indices decrease (i.e. lower costs) (1996- 2001), and are further reduced for specially targeted social groups [note, that mobile calls are not in since these are not USO; this makes the price falls less large]	for 14 EU countries electricity affordability has improved (lower costs), both for low income and average income consumers; (1996-2001)	mixed affordability picture (with the producers NL and UK the lowest costs);	(see price & quality info in the row "prices" above)
employment	<u>net increase</u> in jobs 1996-2000; decrease in (most) wireline markets, although new entrants compensate this wholly or in part; strong increase in mobile, incumbents and entrants	liberalisation in the UK (early mid-1990s) and Germany (1998 and later) saw decreases in workforce of up to 20%; COM has not reported EU comparable data; link with (national or EU) liberalisation (or privatisation) not always clear	no data in sources used	direct employment by incumbents decreased by 6%, 1996 – 2000; strictly postal services only; this is compensated by other work of incumbents; if competitors and other postal agents included, jobs grew 4% (19.7% for non-incumbents)

* Affordability indices are defined as the percentage of personal income needed to acquire a certain basket of services (in the relevant network industry)

Sources: COM (2002g); COM (2002h); PLS Ramboll (2002); COM (2001); COM (2002i); COM (2002j).

Table 5. employs six criteria of economic performance. For all six criteria the liberalisation of **telecoms** has greatly improved the performance of the sector. Clearly, this has been greatly helped by fast-moving technology or even completely new services, but the impact of technology would probably have been slower and much of its price benefits might not have been passed on to consumers in less competitive markets. In market structure, incumbents are still (too?) strong in locals calls but otherwise under effective competitive pressure. Choice for

consumers has increased significantly everywhere and carrier pre-selection heightens local competition ever more. Although, for licensing and other reasons, there is still not yet a single market, cross-border entry is no longer a problem and has become extensive. Price reductions have been strong and this over a number of years; this is now beginning to peter out as liberalisation has been going on for a decade. Two sensitive indicators (affordability of public service & employment) are both assessed positively.

For **electricity** (not wholly liberalized and enjoying much less technical progress) similar but weaker trends can be discerned. However, the bulk of the benefits go to business (often obtained by switching or renegotiation) and the disparities in the internal market are still large, mainly because the speeds of national liberalization (equal or faster than the EU speed) differ and cross-border obstacles are significant. Concentration is often uncomfortably high, even locally. Some of these problems are being resolved and further opening could stop or reverse the burden shifting to small business and consumers. The job effects are not well reported but would appear to be negative. Affordability has improved.

In **gas** the picture is much less positive. Regulatory liberalization is slower but the genuine market impact is lagging even more because of long term supply contracts and anti-competitive practices. Moreover, import dependency and a closer relationship with (volatile) oil prices as well as little price transparency and powerful incumbents combine to create an unsatisfactory outcome that needs to be tackled firmly. Also, affordability indices are mixed.

In **postal**, with liberalization only beginning at EU level, prices rise only slowly but competition has markedly increased in the competitive segments; even in countries with far-reaching liberalization, non-incumbents of various kinds typically remain fringe competitors. Reims II has definitely prompted tangible improvements in quality of service. Perhaps surprisingly, employment in postal has increased, with a small decrease for the letter segment of incumbents' turnover compensated by other work of incumbents and jobs created by new competitors. The dynamism in this sector has dramatically gone up in the last five years.

All this evidence demonstrates that an appropriate combination of liberalization and regulation in the EU's network industries can greatly improve their efficiency, quality, universal or public service levels and even, in some cases, employment. In turn, since their services are inputs for numerous other economic activities these benefits have knock-on effects for the European economy as a whole.

6.5. The internal market: underperformance

There are two areas in which the internal market is genuinely underperforming: services and mutual recognition. It is suggested that the European Parliament insists on a more firm and determined pursuit of a better functioning of the internal market in both.

Services

We concentrate here on business services such as consultancy & engineering services, testing and certification, estate agents' services, construction services and similar. In the first ever Commission report on the barriers in these numerous niche markets ¹⁷ bitter complaints about restrictions and arbitrary treatment on the bringing along of employees for temporary service work, causing uncertainty and delays, are found throughout the report. A general point from the report is that services are much more prone to internal market barriers than goods, and are harder hit. Using a six-stage breakdown of the value-chain of services, it is usually the case that

¹⁷ See COM (2002q).

several stages are affected by restrictions. Moreover, there are profound issues of asymmetries of information and the costs of obtaining precise information on the regulatory framework. Frequently, national or regional administrations have not developed a cooperative culture of helping providers irrespective of (EU) origin. A major difficulty for the more enterprising and larger providers is that the same business model cannot be used in pan-European strategies of specialized services, with reduced or throttled competition as a result.

Mutual recognition

Mutual recognition is a remarkable innovation facilitating cross border business, but is the subject of a curious paradox¹⁸. Despite the almost universal acclaim of its merit, mutual recognition has contributed only modestly to free movement in the single market. Business has, moreover, become disenchanted with the principle, because of the many costs and uncertainties in its application which hamper the realisation of welfare gains from greater competition. Above all, what is required is a "mutual recognition culture" at Member States' level, so that the EU can better enjoy the fruits of its own regulatory ingenuity.

6.6. Cardiff process: what it adds

Until very recently it was very difficult to assess the merits of the Cardiff process. It is expected to promote structural reforms, but in some ill-defined blend of internal market and national measures and without the systematic use of indicators or common objectives. There has also not been any systematic assessment in reports, be they academic or by EU institutions. A recent paper drawing on practitioner experience (Dierx, Ilzkovitz & Sekkat, 2002) claims that Cardiff has been quite effective in opening up product markets to competition and in improving the business environment by creating a reform momentum. However, its effectiveness in terms of stimulating business R & D and innovation is apparently more doubtful.

One might question to what extent these conclusions can be substantiated. Cardiff and the Lisbon process have become mixed up and urgently require a more functional structure. In turn, the blending of these two with the internal market strategy renders it next to impossible to understand what targets, other than EU-level obligations, are really pursued at Member States' level for reforms of a national character. One gets the strong impression that Cardiff is a (desirable!) forum for structural reform, but that it is not really output oriented in ways that can be read and understood by outsiders. In our view it is partly for these reasons that Dierx et. al. (2002) find it hard to evaluate what Cardiff adds : "... it remains an open question whether the Cardiff process and the Lisbon strategy have effectively induced Member States to undertake reforms that they would not have chosen to undertake anyway" (p. 23). Moreover, as we argue elsewhere in this report, there are powerful reasons to link the functioning of EU labour markets to the reform process in a convincing and determined way. This implies a deep interdependence between the Cardiff and the Luxembourg processes, which is far from being the case at the moment. The very poor performance in this respect of large countries such as Germany and Italy is clearly and unambiguously a "common concern" in EMU and a major drag on the performance of the Union's economy. One cannot just leave it at mere statements without a much more firm European pressure via policy coordination or via a more radical approach to the free movement of workers or both.

It is a huge challenge to communicate the important message about the priority of deep structural reforms. There is far too much procedural concern in the EU coordination paper mountain. What really matters is to make politicians and opinion leaders better understand why

¹⁸ The arguments are developed in Pelkmans (2002).

structural reforms should be at the center of discourse on economic policy co-ordination for Europe in terms of growth and competitiveness. "Lisbon" is a recognition of this point, but the communication ought to be made more forceful and more credible by backing it up with applied research, and more practical by asking national parliaments to commit to national medium-term programmes, also discussed at EU level, to implement structural reforms on the road to 2010.

Entrepreneurship in Europe

It is useful to develop policies favouring entrepreneurship in the Union, both by removing disincentives (such as inefficient markets, burdensome regulations, etc.) and bolstering incentives (such as facilitating establishment of new firms, innovation, etc.). A recent report by the Commission ¹⁹ speaks of significant improvements in areas such as framework conditions and venture capital. The cooperation between Commission and Member States is further deepened by the introduction of seven sets of quantitative targets which, on the basis of voluntary commitments, will be monitored. Such efforts are helpful in the long road to Lisbon-2010.

It is recommended that this approach be forcefully pursued. Better still, Member States should all commit to a serious attempt at targeting on a multi-annual basis. Although, ultimately, attitudes of risk-taking and the search for opportunities will be decisive for the actual intensity of entrepreneurship in the EU markets, the analysis now being undertaken and the wide range of targets (including links to other efforts such as "the regulatory and administrative environment" and "open and well-functioning markets") serve as useful "necessary" conditions which Europe should eagerly pursue.

De-linking labour and product markets

In the OECD a great deal of attention in applied research has recently been paid to a hitherto neglected element of the better functioning of markets, namely, that the degree of restrictiveness of goods and services markets is (among other things) a function of the restrictiveness of labour markets. This finding, confirmed in several studies ²⁰, underscores once again that the co-ordination efforts under the Cardiff and Luxembourg processes have to be firmly linked, with a view to promoting the functioning of markets. This finding applies especially to services markets which, more often than not, are somewhat shielded from competitive exposure which facilitates the introduction of rigidities and, in turn, weakness the performance of these markets as well as growth.

¹⁹ COM (2002r); see also COM (2002s) and COM (2002t).

²⁰ Haffner, et al., 2001, *OECD Economic Outlook 2001*, no 70, chapter 6; Boeri, Nicoletti & Scarpetta, 2000; Nicoletti, Bassanini, et al., 2001.

7 - Integration of financial markets

Integration of financial markets in the EU has long been a priority as part of efforts to complete the single market and, in many respects, can be analysed in similar terms to the network industries just described. Financial market integration is the subject of two principal initiatives: the Financial Services Action Plan (FSAP) and the Risk Capital Action Plan (RCAP), both of which are seen as vital to the enhancement of EU capital markets. Their underlying function is to improve the efficiency of financial intermediation in the European Financial Area, and especially on lowering the costs of cross-border flows of financing. They are briefly described in section 7.1, then some findings on the impact of financial integration are reported in section 7.2.

7.1. The initiatives

The FSAP was launched in 1999 and covered a wide range of desired enhancements of the financial area. These were grouped under four broad heading:

- Completing a single wholesale market
- Developing open and secure markets for retail financial services
- Ensuring the continued stability of EU financial markets
- Eliminating tax obstacles to financial market integration

Successive European Councils and Ecofin meetings (such as the informal Oviedo Ecofin held in April 2002) have reinforced the political impetus behind the FSAP and have helped to secure steady progress. While it is evident that many of the measures have proved to be difficult to agree, it is also clear that there has been steady progress and that the political will exists to bring the FSAP to fruition. A succession of reports (the seventh was published in December 2002) testify to the advances that have been made, with the latest one (Commission, 2002) concluding that "the FSAP is well on the way to completion", while, as always, urging Member States to maintain the momentum. In an interesting pointer to where we stand, the report gives increased emphasis to issues of implementation and enforcement, and stresses the importance of greater co-ordination amongst regulators and supervisors. This can be interpreted as an indication that it is application, rather than legislation, that is becoming the key focus of financial integration.

The RCAP was adopted at the Cardiff European Council in 1998, and is due to be completed by the end of 2003, in line with a deadline set at the Lisbon European Council. Its over-arching purpose is to establish a genuinely European-wide market for risk capital by eliminating all regulatory and administrative barriers. The anticipated result will be an economic environment in which innovative firms (especially SMEs) are able more easily to access risk capital. It is envisaged that a successful development of the risk capital market will not only contribute to the realisation of the Lisbon agenda for knowledge industries, but contribute to a general reduction in financing costs.

One of the key concerns about risk capital is that the EU lags far behind the US in venture capital. Even after the bursting of the "dotcom" bubble, which saw a drop of over 60% in US venture capital activity, it represents 0.36% of GDP in the US in 2001, more than two and a half times the figure for the EU of 0.14% of GDP. Moreover, the data for 2000 and 2001 show that three countries (NL, S and UK) are well above the EU average, while all the others are below it and there were big falls in 2001, except in Sweden, Denmark and Spain (COM, 2002k).

It is also clear that there are far-reaching changes afoot in the scope and character of EU stock markets. The closure of the Neuer Markt in Germany and the lack of new offers in the aftermath of 9/11 on the other "high-growth" markets such as the French Nouveau Marché, Nasdaq Europe or Spain's Nuevo Mercado testify to the lack of demand and liquidity. These may be

transitory difficulties that will be resolved once the present spate of consolidation (e.g. Euronext) is completed, but in terms of the Lisbon strategy, the shortcomings in the supply of equity finance for innovative businesses finance are not auspicious.

COM(2002k) identifies the slow progress in cognate areas that bear on risk capital as a further source of difficulties. For example, it cites legislation on insolvency and bankruptcy, on patenting and, generally, on the tax environment for risk capital as areas where there are continuing obstacles. Among the tax issues that are identified as problematic (for example in a study done by the European Venture Capital Association, 2002) quite apart from the vexed questions of differences between Member States, is that in nearly all circumstances, debt financing is taxed more leniently than equity.

A related issue is whether (or to what extent) tax incentives should be allowed for innovation or R&D related investments. There is an inevitable tension in this regard between efforts to correct market failures that inhibit structural change and state aids which give an unfair competitive advantage. More generally, entrepreneurship is widely believed to be deficient in the EU, a gap which is explored in the Green Paper published in January 2003 which sets out ten questions Commission (2003c). COM(2002k) applauds real progress on implementing the Charter for Small Enterprises " particularly in areas such as start-up procedures and improving legislation". But support through channels such as business "angels" remains disappointing, with the exception of the UK.

The Commission argues that genuine progress has been made since 1998 on all the main headings, and believes that this augurs well for the future. Overall, however, a reading of the documents on risk capital suggests that progress has, at best, been halting, pointing to a possible area for the EP to emphasise in the 2003 BEPGs. In the Multiannual Programme for Enterprise and Entrepreneurship (MAP), one initiative that merits attention is the Seed Capital Action by the European Investment Fund. It includes support for training and bringing on stream EIF venture capital fund managers on the grounds that the efficient deployment of risk capital is not just about finance, but also how to select and nurture innovative companies. This complements the EIF focus on funds for incubators and seed capital. It might, however, be reinforced by further EIF measures to help firms that have graduated from the early development phases.

7.2. The impact of financial integration

When the "1992" programme was devised in the mid-1980s, opening-up of financial services was identified as one of the important potential sources of benefits from completing the internal market. The "Costs of non-Europe" studies summarised in the Cecchini report (1988), attributed as much as a quarter of the potential gains for EU GDP from the single market to the liberalisation of financial services. These gains were projected to arise from competitive pressures that would reduce intermediation margins, thereby lowering the cost of capital to investors; from opportunities to procure services from other Member States; lower regulatory costs; and an impetus to financial innovation. Both microeconomic and macroeconomic benefits were expected.

The review of the internal market conducted in the mid-1990s (see the Monti report, 1996) was markedly less optimistic about the benefits that would flow from the internal market, largely because remaining regulatory and other barriers had inhibited the emergence of genuine pan-EU provision of services. This was especially true of retail financial services, but some barriers also remained in other areas, and it has been observed that there are few moves as yet towards the cross-border consolidation of the financial services industry that would be expected as a concomitant of integration. Indeed, one of the reasons for the FSAP was to restore the impetus towards integration, not least because of the perception that potential gains from greater capital market efficiency were being lost.

Despite all the efforts since the launch of the single market programme in the mid-1980s, integration of financial markets remains uneven, and this has knock-on effects for the dynamism of the economy. Various studies of developed and developing countries show that the character of the financial system can have an influence on the level of output and the rate of growth of the "real" economy. In analysing these impacts, it is important to distinguish between static effects (the one-off impact of a cost reduction) and dynamic effects which lead to repeated gains in efficiency. The "Costs of non-Europe" studies conducted in the 1980s (the Cecchini report) concentrated on the static effects, comparing the "before" and "after" positions of the regulatory changes and coming up with an estimate of gains of the order of 1-2% of GDP as a result of the cost reductions consequent on integration of financial markets.

Economic researchers have identified several possible channels through which undeveloped financial markets hold back growth. Financial weakness is also seen as an obstacle to exploiting new technologies where a different approach is needed to justify the more risky investments implicit in innovative products and services. A strong argument for financial integration is that will allow such innovative investment to occur more readily, thereby promoting overall growth. A study for the Commission by Giannetti et al. (2002) maintains that despite the progress in financial integration in the early 1990s there is still plenty of potential for further integration of financial markets to enhance economic growth.

In more detail, the key mechanisms through which financial integration translates into improved economic performance can be summarised as follows:

- Improvements in the "x-efficiency" of financial intermediaries as competitive pressures oblige them to adopt new technologies, to pare operating costs and to restructure to more optimal sizes. It should be noted that although the outcome will be to lower the cost of services, the other side of the coin is likely to be job losses, a trend that has already been evident in Member States that have been in the vanguard. Moreover, substantial differences between countries remain in the numbers of banks and branches, which could presage further job losses. To cite just one measure, a crude count of the number of banks shows that Germany in 1999 had well over three thousand, compared with just under five hundred in the UK and 101 in the Netherlands, and there are big differences in the number of bank branches per million population (Begg and Horrell, 2002).
- A second competitive effect is that lower cost or more innovative provision may lead to increases in, especially, retail demand for financial services. In this regard there is evidence that new forms of electronic trading have encouraged new consumers to avail themselves of the services (Heinemann and Jopp, 2002). They have also led to sharp falls in the costs of equity trading. Another empirical study conducted by London Economics (2002) suggests that full European integration of equity markets will lead to a further drop in trading costs.
- A third effect of integration is to pool liquidity and thus to deepen the supply of finance. In equity markets, the LE study concludes that the increased liquidity that will arise from integration will lower the cost of capital by an average of 40 basis points. Interestingly, calculations drawing on modelling work as part of the LE study suggest that the cost of capital to firms is also lowered if trading costs fall. This points to an additional channel through which a integration of European markets can be expected to reinforce the efforts in the context of the RCAP to boost the supply of risk capital to SMEs.
- The LE study finds a similar liquidity-pooling gain for the corporate sector from a narrowing of bond spreads and calibrates this at 40 basis points reduction in the cost of bond financing. The authors speculate that a likely outcome will be to increase the share of bond financing instead of bank loans. A further side to the liquidity argument is that as the

euro becomes more used internationally there are potential gains from its use in this respect that would be diminished if fragmentation were to persist.

- The other way of looking at the effects of integration is to assess the macroeconomic impact. While such estimates - often based on simulation models - have to be interpreted with care in so far as the assumptions fed into the models influence the outcomes, the orders of magnitude are striking. Studies by the European Financial Services Roundtable (Heinemann and Jopp, 2002) and by London Economics (2002) find that gains might be of the order of 0.5% of GDP (in the short-term, ERF) to 1% (LE, in the long run). The latter increase in GDP would result – on typical elasticities – in around 0.5% more jobs. The LE study also foresees an increase in business investment which would rise by 6%.
- The Gianetti et al. (2002) study finds, unsurprisingly, that the Member States with the least developed financial markets stand to gain most from accelerated integration, although they also point out that "countries that specialise in financially dependent sectors gain more". Their methodology is to simulate the gains on the assumption that the standard attained is that of the US, the most developed financial market. They point out that even if the individual country does not reach these heights, what matters is that users of financial markets have access to the highest standards because of integration of EU financial markets.

In sum, the potential benefits from integration of financial markets are considerable. The LE figure is, possibly on the more optimistic side and, indeed, the authors point out that the recent fall in equity market capitalisations would lower their estimate to 0.9%. Moreover, both the LE and ERF figures depend on the integration actually happening according to plan. However, both studies use techniques that compare "before" and "after" in a static manner, and do not speculate on dynamics.

According to the Gianetti et al. simulations, the nine Member States (Belgium, Denmark, Finland, Germany, Greece, Ireland, Italy, Portugal and Spain) could expect to increase growth by over 1 percentage point. Austria and France will gain just under 1 percentage point, while the Netherlands, Sweden and the UK – the three financially most developed countries – will gain up to 0.5 of a percentage point in growth. This contrasts notably with the change in level of 1% foreseen by the LE and ERF studies. It should be pointed out however, that these gains in growth in the Gianetti et al. Study are predicated on very optimistic – bordering on implausible - assumptions.

7.3. Venture capital

One of the main obstacles to a more rapid development of the technology intensive industries which the Lisbon strategy highlights is that they require a different form of financing from conventional investments. As Christofidis and Debande (2001) observe "the combination of research and development, intangible assets, negative earnings, uncertain prospects and absence of a proven track record, which are characteristic of start-up and pre-commercial initiatives, leads to an unacceptably high perception of risk for conventional financial institutions and debt financing." Venture capital is the instrument that has emerged in recent decades as the means of filling this gap in the market. In most EU countries, however, the supply of venture capital has been moderate and only came on stream relatively recently compared with the US, where its contribution became substantial in the late 1970s.

As with many other forms of financing, the scope for venture capital to play a prominent role depends, first, on there being a sufficient pool of financing and of associated expertise to cater for the different stages in the development of new firms, while also being able to take account of the differences between firms from different regions or with different markets. At the same time, venture capital depends on the establishment of an appropriate regulatory regime,

encompassing the rules governing the financial intermediation itself (for example, the ease with which the investor can exit by realizing its stake), as well as the associated taxation, accounting standards etc.

As described by Christofidis and Debande, venture capital has both "a demand and a supply cycle." To support initial product development, new firms (typically SMEs) initially look for seed capital to allow them to develop an initial idea; they then go through stages of experimental product development and small scale production – usually at a substantial loss – before they reach the point where sizeable production runs become feasible. In Christofidis' and Debande's characterization, the "cycle closes with the exit, typically a private "trade sale" or "initial public offering" (IPO) on a stock market, and the reimbursement of the invested capital plus gains. Each stage is associated with a different level of risk during which the nascent SME requires sufficient and appropriate funding to sustain growth and avoid liquidity constraints".

The supply cycle also has several stages, which include raising the initial capital for a new fund, constructing a portfolio of investments, then playing "an active role in monitoring, advising and growing the value of investees so that in the later years of the fund's life, investments can be exited from successfully."

Although there has been rapid growth in the overall supply of venture capital in the EU, albeit still well behind the US, there are big differences among the Member States suggesting scope for considerable catching-up. Venture capital is most prominent in the two countries with the longest tradition of equity financing, the UK and the Netherlands, but has been slower to take off in the other "northern" Member States, although they have progressed. By contrast, venture capital is still relatively scarce in southern Europe. These disparities partly reflect the character of the respective financial systems. Christofidis and de Bande, in comparing the US and the EU, note a number of differences in the character of venture capital funding and practice which suggest, inter alia, that the US investors are more willing to take risks and to countenance newer ideas. They also note a number of factors that could be altered to boost the scope and effectiveness of venture capital, including fiscal and regulatory changes to stimulate both demand for and supply of venture capital. One dimension that other research reveals to be important is simply the development of expertise.

7.4. Assessment

There is a strong commitment to integration of financial services and much has been done. Yet, as the ERF report notes:

There is a huge gap between the vision of the EU as the most dynamic economy in the world and the reality of still fragmented EU-markets. In order to reduce this gap, the whole process of European regulation of financial services needs to be speeded up.

Part of the challenge is that it is often uncomfortable for Member States to let go of their existing structures and procedures – fears of the first part of the "j-curve" effect loom large. As in so many other supply-side changes, financial integration will benefit some regions and Member States while others lose. Countries with relatively uncompetitive financial intermediaries could see significant market entry from other Member States. By contrast, the "consumers" of financial services in the same country – especially SMEs - will benefit most. Our verdict on financial integration is that it is on course, but that it will need a combination of political will and further reinforcement of existing measures if the underlying aims of (and benefits from) a more deeply integrated European Union are to be achieved. As the focus shifts from legislation to application, careful monitoring of how Member States implement and enforce rules supporting integration of financial markets will be needed.

8 - The Labour Market

Since the launch of the European Employment Strategy (EES) in 1997, 10 million new jobs have been created in the EU; there are also more than 4 million fewer unemployed persons and the active population contains over 5 million extra people. Nevertheless, unemployment in the EU remains persistently high. According to the most recent data, the unemployment rate in December 2002 was 7.8% for the EU as a whole and 8.5% for the euro area, compared with figures of 5.9% for the US and 5.5% for Japan. There is considerable divergence within the EU: Spain and Luxembourg currently have unemployment rates of 11.4% and 2.3%, respectively. The problem of unemployment has been accentuated by the economic slowdown, with the result that nine out of the fifteen Member States can expect an increase in unemployment between 2001 and 2003. Over this period EU unemployment is expected to increase from 7.4% to 7.7%

8.1. Trends in labour markets and in employability

The complexity and structural nature of the EU's unemployment problem is demonstrated by the fact that it persists at the same time as acute skilled-labour shortages in many of the economy's fastest growing sectors. On one level, the coincidence of labour surpluses and shortages reflects simple cross-national differences in labour markets. The skills-differential is greatest in the three Member States that have unemployment rates below 5%: Luxembourg, the Netherlands and the United Kingdom. This tells only part of the story, however, since the skills-differential is also acute in Germany, France and Italy, each of which has an unemployment rate in excess of 8%. At the sectoral level, the excess demand for labour has been driven in part by developments in ICT. A study by IDC/EITO in 2001 found a skills shortage of 1.2 million extra workers in ICT in 2000²¹.

Unemployment and employment rates

While the EES five-year evaluation pointed to structural improvements of the labour market, serious weaknesses remain in terms of unemployment levels, participation and employment rates, gender gaps, quality of employment, productivity growth and regional disparities (COM, 2002i). Job creation remains a key challenge, and calls for mobilisation for employment based on broad partnerships.

Employment rates, especially for women and older workers remains a problem in many Member States. The EU average employment rate for older workers rose to 38.5% in 2001 (37.7 % in 2000) but still falls far short of the Lisbon target of 50 % by 2010. The female employment rate in 2001 was 54.9% and the total employment rate was 63.9% in 2001. The employment position of disadvantaged people remains weak, which calls for better tailored policies, approaches involving both the supply and demand side and a close link with the wider policies for social inclusion (COM, 2002i). There are significant differences between Member States in terms of employment rates, with Italy, Greece and Spain scoring lowest both as regards the employment rate in general and the one for women in particular. Austria, Belgium, Luxembourg and Italy score lowest as regards employment rate for older workers. According to the Joint Employment Report 2002, active ageing strategies are largely lacking, and incentives for employers to recruit and retain older workers are inadequately addressed (COM, 2002i).

The EES has had a positive impact on the labour market policies of the Member States, shifting in the direction of a more preventive and active and also individualised approach. In 2000, 14

²¹ IDT = International Data Corporation; EITO = European Information Technology Observatory, quoted in COM 2002k, p.28.

Member States had reached the activation rate above the 20 % target. As to the effectiveness of different types of measures, the impact evaluation concluded that training measures have proved effective for particular (but not all) target groups, while the experiences of large-scale programmes are less convincing; subsidised employment shows mixed results and a high risk of substitution of regular employment; self-employment grants show positive results, although the scope may be limited; results with job search assistance are generally positive (EMCO 2002c).

Skill gaps

Unemployment coexists with unfilled vacancies in many Member States, indicating a mismatch in supply and demand of, particularly, skilled labour. But mismatch also arises because of regional disparities in economic performance, and can be aggravated by labour immobility which is worst in Belgium, Germany and Italy (COM, 2002m). According to the European Commission's recent Action Plan on Skills and Mobility (COM, 2002m), geographical and occupational immobility are key factors behind the problem of skills mismatch. In 2000, just 1.2% of the population changed their region of residence. At the county-level in the US, this figure reached 5.9% in 1999. European workers also change jobs less frequently than their counterparts in the US. In 2000, some 30% of US workers had spent less than one year with their present employers as compared with a figure of 16.4% in the EU. Overall educational levels in the EU are marked out as being a cause for concern. In the EU as a whole, 40% of people in the 25-64 year old age bracket failed to complete upper-secondary level education. This figure is as high as 81% in Spain and 63% in Portugal.

Data on employment growth for 1995-2000 show that job growth was largely confined to jobs for medium and high-skilled workers. In contrast, the employment in low-skilled jobs fell in almost all sectors. The combination of growth in high skilled employment, low levels of unemployment in those sectors and relatively low growth suggests that the tertiary-level skill gaps may appear more widely in the Member States as demand exceeds the supply of skilled workers.

Skill gaps are most significant in the fastest growing sectors of the economy (generally business services, and health and social work) across the EU with especially high values for Luxembourg, the Netherlands and the UK. Skill gaps are also prevalent in manufacturing across the EU, following significant structural changes in the skills content of jobs as production has been shifting to more high-tech, innovative, manufacturing services. The effects of this shift were most pronounced in Austria and the UK.

In response to the problem of skills-mismatch, the 2002 BEPGs called for action on two main fronts. First, Member States are encouraged to develop the skills base by promoting human capital formation. Second, it is recommended that the process of wage determination reflect differences in productivity and skill differentials. At a more general level, the BEPGs stress the need to remove obstacles to geographical mobility inherent in national tax and benefit systems. With regard to occupational mobility, the BEPGs call for a greater recognition of educational qualifications across Member States. Although these recommendations represent a step in the right direction they fall far short of those that are contained in the Commission's Action Plan on Skills and Mobility.

An example is a recommendation for human capital formation. This guideline echoes the findings of the Action Plan, but stops well short of its recommendation that "all citizens should be able to have free access to the acquisition of key skills, including literacy and numeracy, but also other key skills, such as maths, science and technology, foreign languages, "learning to

learn" skills, cultural awareness, social/personal skills, entrepreneurship and technological culture" ²². The Action Plan recommends that Member States cooperate with the Commission "to implement and further develop such instruments as the European Credit Transfer System, Diploma and Certificate Supplements, Europass and the European Portfolio and CV by 2003" ²³. The Action Plan also calls for "a serious analysis between immigration policies and employment and social policies in the Union". No such analysis is to be found in the BEPGs even though the Action Plan makes it clear that Member States will unavoidably come to depend on the skills of non-EU workers in the future.

Training and lifelong learning

As to the role of vocational training in improving the efficiency in job matching procedures, data on young people (20-29) suggest that vocational training decreases the likelihood of unemployment. The only exceptions were Spain, Greece and Portugal where low investment in vocational training coexisted with higher unemployment among those participating in vocational training. For the EU as a whole, the rate of unemployment of those not participating in vocational training is twice as high as that of those who do (23.5% against 11.5 % respectively) (COM, 2002m). However, the largest discrepancies between educational attainment and the changing skill content of employment confronts not the youngest but the older age cohorts, which makes vocational training for those already in employment crucial for overcoming the matching problems as well as for improving productivity and competitiveness.

The participation rate for adults in education and training continues to be low and has stayed stable at 8.4% (COM, 2002m). Moreover, there is a widening gap in the take-up of education and training opportunities between those with low and high skills, and between older and younger age groups. Those aged 25-34 are nearly five times more likely to take part in education and training than those aged 55-64, and those with low skills are over six times less likely to participate than those with high skills (COM, 2002m). Employees of small enterprises and those on atypical contracts also have reduced access to job-related training (EMCO 2002). Greater access for adults least inclined and with least opportunities to obtain occupational training is needed. The demographical developments also make it increasingly important to promote the adaptability of older workers. Moreover, access to employer-funded training is often limited to those who are already well-qualified (EMCO 2002). European framework agreements, and if such attempts fail, European minimum directives may need to be considered concerning employer-funded on-the-job training, for all or for particular target groups. Generally, training agreements by the social partners should be encouraged, and fiscal incentives considered.

According to the impact evaluation of the EES, significant efforts have been undertaken to promote a closer match between education and training provisions and labour market needs. The majority of the Member States have revised initial education and vocational training curricula to include more technology, ICT and language skills and introduced more vocational aspects and workplace components (EMCO 2002c). Public expenditure on investment in human resources has generally increased (COM, 2002m).

The notion of shared responsibility for lifelong learning has largely been taken on board by the Member States, but co-operation is mostly limited to the social partners rather than broader-based partnerships (EMCO 2002c). Several Member States are experimenting with various forms of financial incentives for skills development including individual learning accounts

²² COM (2002m), p. 12.

²³ COM (2002m), p. 15.

(ILA), vouchers, training levies and fiscal reforms. Experience of individualised financial schemes is mixed. Experiences from the UK of ILA shows that this scheme seems to have been effective in reaching those groups who generally participate less in education and training (low earners and individuals with no qualifications), but the scale of the scheme led to problems with fiscal capacity, and there are also possible quality problems. Individual schemes implemented elsewhere seem to have been taken up mainly by the more traditional participants in training which suggests the need for better targeting and more attention to motivation (EMCO 2002c). Fiscal and other incentives need to be further developed. Moreover, education and training must pay.

While acknowledging that it is difficult to measure the precise impact of lifelong learning on growth, reduced unemployment and social exclusion, the impact evaluation of the EES concludes that there is a positive correlation. High-skilled occupations accounted for 60% of the jobs created in the period 1995-2000; the employment rate for those with low skills is only just over 50% compared to nearly 70% for those with medium skills and nearly 83 % for those with high skills; those with low skills are also more likely to drift into long-term unemployment and social exclusion; geographical mobility is more common among the young with high education (EMCO 2002c).

8.2. Adaptability

The efforts under the adaptability pillar have mainly been concentrated on working time issues at the expense of other aspects of work organisation, such as: work place partnership and dialogue; health and safety and work and quality in work; wider knowledge distribution throughout the organisation; more team-based organisations; and the fostering of creativity throughout the workforce (EMCO 2002b).

While there is no clear-cut empirical data on the impact of atypical work forms on job development, the impact evaluation of the EES states that most Member States report positive effects of the flexibility of labour markets on the number of jobs created. This is particularly notable in Germany and Spain (EMCO 2002b). However, the social partners, for instance in Spain, Portugal and Italy, have reservations about the quality of the jobs created. Also the EES impact evaluation concludes that atypical employment relationships are generally still a disadvantage when it comes to the quality of work in terms of pay and fringe benefits (EMCO 2002b). The key challenge is to strike a balance between flexibility and security. A practical way forward may be a negotiated flexibility, for instance in the shape of "flexibility agreements", at all levels, supported by the social partners. Adaptability requires the engagement of the social partners. Stronger commitment by the social partners is required to encourage and develop negotiations and agreements modernising the organisation of work to meet the competitiveness and productivity challenges but also to improve the quality of work.

European framework agreements, and if such attempts fail, European minimum regulation, may need to be considered concerning the quality of work, not least in the perspective of enlargement and the risk of unfair competition and social dumping, but also in the perspective of demographical developments and the expectation that people must stay in work longer. Another option may be fiscal incentives, such as tax reductions, for employers investing in the work places and in the labour force. The notion of "sustainable workplaces" may deserve to be developed.

8.3. Labour mobility

Geographical mobility, especially between countries, can only be legitimately achieved on a voluntary basis. However, barriers to such mobility can be considerably reduced, by reducing the administrative work related to such movement, by transferability of social security, including pensions schemes, and not least by simplified access to health care across the union

(as in the Commission proposal of a universal health care card). Needless to say, efforts to advance recognition of education, qualifications, and competences must move on, as must the full implementation of Regulation 1612/68 on free movement of workers and Regulation 1408/71 on the co-ordination of social security schemes.

Occupational mobility can be supported by intensified and targeted vocational training (see also above). Moreover, there are experiences, for instance from Sweden, of an "adjustment insurance", a support in the transition from one job to another in the case of major lay-offs, where the employers, the unions and the public authorities (state or municipality or both) have cooperated in this transition process. Support has included a period of training, as well as help in finding new jobs (sometimes by private employment services). Responsibility for the transition to a new job is thus shared rather than being the responsibility of the individual. This is based on the notion that a certain level of security on behalf of the worker is needed for flexibility and mobility.

8.4. Labour market policies in Member States

Over the past decade, a strong negative relationship at the country level can be observed between labour productivity and growth: since 1991, the European countries with higher productivity gains have experienced the lowest GDP growth and vice versa. This can be explained by the significant difference in labour costs within euro area countries and their respective labour market rigidities. Countries with high unit labour costs (ULC) have tended to experience low employment growth as part of the process of restoring their competitiveness. While this has resulted in higher productivity growth, it has also meant lower GDP growth.

The reports supplied by Member States for the review of the European Employment Strategy conducted earlier this year reveal a broad range of labour market policies and initiatives. They also signal that the Luxembourg process is working tolerably well in promoting exchange of experience and in pushing the Member States to tackle common problems. Although the most recent available data are from 1999, information on the scale of expenditure on labour market policies nevertheless reveals large differences between Member States. The aggregate data suggest that six Member States (Belgium, Denmark, Germany, Netherlands, Finland and Sweden) spent in excess of 3% of GDP on all labour market policies, whereas the corresponding figures for Greece and the UK were under 1%²⁴. Part of the explanation for these disparities lies in either the extent of unemployment or the generosity of the replacement incomes in what are classed as "passive" labour market policies. Denmark and Germany, with high replacement ratios for the unemployed, not surprisingly, score highly on these indicators, while Italy is low. Luxembourg has negligible unemployment and consequently spends very little on passive policies.

The Nordic countries lead the way not only in total spending, but also on those categories of labour market policies deemed to be "active" (ALP). Sweden spends nearly 2% of GDP on such policies, double the EU average, while at the other extreme, the UK expends just 0.2% of GDP in this way. While this is a striking disparity, some caution is needed in interpreting it because national policies may either rely on regulatory measures or place more of the burden of activation on the private sector, rather than the public purse. There are also substantial differences between countries in the composition of ALP spending, with the Netherlands noteworthy for devoting half its ALP to this, compared with an EU average of 15%.

²⁴ "Eurostat Statistics in Focus: Population and Social Conditions", *Theme 3-12/2002*, article by Melis, A.

Evidence from the second European Survey of continuing vocational training in enterprises reveals quite marked differences between industries in outlays per employee, with more than twice as much being spent by financial intermediaries than by manufacturing firms, a pattern common to all Member States. Larger firms were found to invest more than SMEs. The highest investment rate of 3% of labour costs was found in Denmark, and the lowest in Austria (at just 1.4%), although five EU countries were not included.

One dimension of entrepreneurship promotion that is clearly a disappointment is the low rate of female involvement. In the EU, in 2000, just over 8% of men were classified as self-employed with employees, an indicator that can be interpreted as acting as small-scale entrepreneurs, whereas the corresponding rate for women is barely 4%. Nor have these relative proportions changed much in the last five years, according to recent Eurostat statistics. This pattern is consistent across age groups, sectors of activity and Member States and it also appears to be the case that women tend to work in smaller enterprises than men.

A problem in assessing national policy responses, however, is that the delivery of policy often consists of measures that fall short of the aims articulated either in National Action Plans or in other reform proposals. The current disquiet in Germany over the reforms of the employment service consequent on the recommendations of the Hartz Commission provides an illustration (see box 1.).

Box 1: The Hartz Commission proposals – illustrating the dilemmas for Member States ²⁵

In August 2002, the Committee on "Modern Services on the Labour Market" ("*Kommission Moderne Dienstleistungen am Arbeitsmarkt*", 2002, called "Hartz Commission" after its chairman Peter Hartz) published proposals for reform of the Federal Employment Service (FES). It was a response to the revelation of poor placement rates and considerable mismanagement (see, Thiel, 2002:14).

Its ambitions included reducing unemployment from nearly 4 to 2 million in the next three years, diminishing the period of job placement from 33 weeks to 22 weeks and decreasing spending on earnings-related benefit and unemployment benefit from € 40 to 13 billion. Proposed instruments included stronger incentives for quick job placement, targeted support for self-employment, and greater resort to temporary employment. The prospect of benefit cuts was to be introduced to promote the co-operation of clients in accepting temporary jobs or agreeing to register quickly for placement services. The concept of *reasonableness to accept jobs* was to be tightened by obliging an unemployed person to demonstrate that a job is unreasonable for them and not the other way around, as it is currently. Young single persons will have to consider relocating to other cities to find jobs and accept lower wages.

The government welcomed the proposals as an active approach to labour market reform, while the CDU/CSU criticised some suggestions, because of some "unsocial" aspects. For the FDP they were perceived as not going far enough in some areas, such as the influence of trade unions. Trade unions welcomed some of the proposals, but were generally against the cutting of unemployment benefit and its merger with welfare subsidies, and disagreed with the temporary work proposals.

The government sought to implement the proposals, and agreed to provide € 2.8 billion in funding even though this will aggravate the budget deficit. But, because of anticipated political difficulties in securing the passage of the measures through the CDU/CSU dominated *Bundesrat*, was obliged split the proposals into two draft bills. As the CDU/CSU has said it will block the Hartz concept in the *Bundesrat*, it looks not only as though what are important reforms will aggravate already stretched public finances, but also emerge in only a watered-down state.

8.5. Assessment

The 2002 BEPGs call on Member States, in general, to promote more and better jobs, to increase the employment rate, to reduce persistently high levels of unemployment, to reduce occupational and geographical mismatch in the labour market and to encourage social

²⁵ We are grateful to Gaby Umbach for providing background information.

exclusion. These are, of course, worthy aims that no-one would dispute. But there is a risk that such statements amount to little more than "motherhood and apple pie" ambitions, and do not confront the hard choices about labour market reform. There is a similar tone to the national recommendations. Thus, Germany is asked to reform its tax and benefit systems so as to remove disincentives to work among women and older people, while Greece is urged to reform its system of pension entitlements to discourage older workers from remaining outside the labour market.

We argue that the social partners have a potentially greater role to play and that the opportunities for constructive engagement with them should be enhanced. In particular, in trying to find a way of bridging the reform agendas of the Cardiff and Luxembourg processes, the social partners are an underused resource that should be more actively exploited to help promote change.

9 - Taxation and growth

Tax reforms are part of the strategy sketched out through the BEPGs for enhancing the EU's potential for growth. Two basic issues are stressed:

- High marginal taxes raise the value of leisure with respect to work effort, thereby reducing labour supply;
- The higher the level of taxation on labour, the higher the incentive for firms to adopt capital intensive techniques and to save on employment.

While often considered altogether, the two issues reflect different transmission channels of tax policy. The former bears directly on the supply of labour, while the latter focuses attention on relative factor prices and on the demand for labour input.

Growth theorists assume the economic system will always operate at its potential. This allows for a decomposition of the level of output into the sum of the two inputs, capital and labour, plus a residual term representing technological progress (or Total Factor Productivity, TFP). Under this accounting scheme, any reduction in taxes capable of augmenting labour supply necessarily increases the level of output ²⁶.

According to the "relative factor prices" framework, firms maximise their profits for a given level of output. When taxes on labour are eased, firms are induced to use more labour and less capital: for the level of output to remain unchanged, labour productivity should diminish. Seen from this perspective, growth may eventually ensue from demand channels. In fact, a reduction in labour costs could allow firms to reduce output price, enhancing international competitiveness and exports. At the same time, it could reduce the general level of inflation, leading to a rise in consumption. An accelerator mechanism could reinforce both these demand effects ²⁷.

In practice, the two transmission mechanisms operate simultaneously, making it a difficult task to distinguish the actual channel through which taxes affect growth. With this in mind, we are mainly interested in considering a special case. The Guidelines for 2002 called for a concentrateion on tax cuts for low-wage workers in order to avoid (or diminish) so-called unemployment and poverty traps. The measure is meant as an incentive for workers to enter the labour market, thus representing a typical supply-side strategy:

By altering incentives to work, save and invest, tax and benefit systems affect private factor accumulation and consequently growth and employment [...]. As regards taxation, high labour taxes at the lower end of the wage scale [...] are source of poverty traps and lower human capital accumulation... ²⁸.

Therefore, in what follows we will try to assess whether this kind of strategy has been implemented and whether it has translated into any impulse on European growth.

²⁶ In more analytic terms this follows from the assumption of infinitely elastic labour demand.

²⁷ Analytically, a reduction of the relative price of labour only implies movements along the isoquant. Shifting to a higher isoquant (i.e. augmenting the level of GDP) requires that the above mentioned demand channels are activated.

²⁸ "The contribution of public finances to growth and employment: improving quality and sustainability", Commission of the European Communities, annex to the conclusions of the Stockholm European Council, March, 23-24, 2001.

9.1. An analytical approach

In order to present some relevant empirical evidence it is useful to start from a simple growth accounting approach, like the one recently proposed by Edward Prescott ²⁹.

Prescott's contribution focuses on the analysis of the main factors explaining long run "depressions and recoveries". In fact, he regards prosperity and depression as relative concepts, in that he studies a specific country's performance with respect to that of the United States. With such an approach he carries out a growth accounting exercise to explain differences in levels of per-capita income through differences in the relative use of inputs and in the relative level of technological progress.

Per capita output can be decomposed into four main factors: a trend growth rate, common to all countries; a productivity factor dependent principally on country-specific technological progress; a labour factor, and a capital factor. We are interested primarily in the role of the labour factor in explaining per capita GDP differences across countries. The introduction of taxes, by making consumption more expensive in terms of leisure, will reduce the equilibrium level of the labour factor, and of income. In particular, the Prescott approach stresses the significance of the tax wedge (a combination of the marginal consumption tax rate and the marginal tax rate on labour income). Higher tax rates yield a relatively lower labour supply. In other words, differences in tax regimes can account for differences in the labour factor, thus giving rise to differences in per-capita GDP across countries.

Our aim is to evaluate whether such a straightforward conclusion applies in the cases of selected European countries ³⁰.

9.2. Growth accounting and the level of taxation in Europe: some evidence

We carry out a growth accounting exercise for three major European countries. Table 6. shows factors accounting for growth in individual countries expressed as percentage differences with respect to the United States.

Table 6: Growth accounting for some European countries
(level relative to the United States)

	Per capita GDP (level with respect to the USA)	Factor		
		Productivity	Capital	Labour
Italy	-26.3%	-9.7%	10.8%	-27.4%
Germany	-22.7%	-30.8%	26.3%	-18.2%
France	-17.8%	-17.1%	18.4%	-19.0%

Germany, France and Italy are currently low relative to the US. Everywhere the labour factor appears as the main factor accounting for these low values. The lower level in European output is also due to the depressed productivity factor, while the capital factor gives a relatively positive contribution to growth. These results demonstrate that a higher relative labour cost in Europe is associated with more capital intensive techniques, but lower levels of productivity.

²⁹ Prescott, (2002).

³⁰ Since Prescott's analytical framework is rather biased against the institutional structures that are typical of European "social market economies", it must be used with caution. However, it is not the theoretical approach that is at stake here. Instead, we are interested in assessing whether such a biased scheme provides sufficient evidence to support arguments for tax reduction.

In this regard, Prescott's approach invites comparisons of fiscal systems across countries, in that differences in the tax wedges may explain differences in the relative contribution of the labour factor to GDP. We compute tax wedges replicating the paper's approach³¹, even though the methodology it adopts for calculating marginal taxes is only crude. The consumption tax rate is calculated as the ratio of indirect taxes to private consumption (net of indirect taxes). The marginal tax rate on labour income is the sum of two components, the social security tax and the marginal income tax. Specifically the average social security tax is the social security taxes to labour income ratio³². The estimate of the income tax consists of total direct taxes paid by households divided by GDP net of indirect taxes³³.

Table 7. presents our estimates for some OECD countries. Tax wedges are markedly higher in Europe than in the United States. To some extent European consumption tax rates may explain these higher tax wedges. In fact the US has the lowest tax rate on consumption. On the other hand, we find significant differences in the overall tax rates on labour income. Although marginal income tax rates are similar in all countries, social security taxes account for much of the difference.

Table 7: Tax wedge for selected countries (1999) *

	USA	ITALY	GERMANY	FRANCE
Tax wedge= $(1+T_c)/(1-Th)$	1.53	1.93	2.11	3.98
Consumption Tax (T_c)	0.13	0.34	0.27	0.41
Labour income Tax ($Th=(a)+(b)$)	0.26	0.31	0.40	0.65
(a) Social Security Tax	0.05	0.10	0.21	0.47
(b) Marginal Income Tax	0.22	0.21	0.19	0.18

* Social security contribution paid by employees

9.3. Recent developments

Evidence from the 5-year review of the EES suggests that since the Luxembourg process was initiated, the prior trend towards a rising tax burden on labour has been reversed, with a drop between 1997 and 2002 of two percentage points in the tax burden on wages. Some Member States, such as Denmark, Ireland, Luxembourg and the Netherlands had moved in this direction before 1997, while Finland and Germany had also initiated reforms. However, a Commission report notes that the Member States with the highest taxes on labour had made the least progress.

One issue that is demonstrated by looking at the various strategies adopted by Member States in relation to tax reform is that job gains can arise through diverse channels. Welfare reforms offer one route, but some Member States have concentrated less on tax-benefit reforms focused on labour supply, preferring to offer tax reductions for enterprises, including incentives for the creation of new enterprises.

In their efforts to strengthen work incentives through tax-benefit reforms, some Member States have also been able to overcome the dilemma between equity (including anti-poverty policy) and efficiency through a variety of instruments (such as in-work benefits, tax reduction, softer

³¹ The tax wedge is defined as follows:

$$\text{tax wedge} = \frac{1+T_c}{1-Th} \quad [T_c: \text{the consumption tax rate} - Th: \text{the labour income tax rate}].$$

³² An estimate of the labour income is obtained from total GDP (net of indirect taxes) times the labour income share.

³³ Such a ratio is then corrected by a 1.6 factor to account for progressivity of tax systems.

means tests, minimum wages) rather than implementing painful benefit reductions and enforcing benefit sanctions etc.

Figures 6., 7. and 8. confirm that a reduction in the tax wedge has indeed occurred in the late 90s in the three European countries considered here. Empirical evidence also shows that the recent decrease of tax wedges coincides with increases in the relative contribution of labour to growth. This suggests that European policies in terms of tax reforms may be associated with an increase in employability.

In a supply side scheme, a reduction of taxes on labour is expected to enhance growth as well. Yet the data show that the desired impulses on growth are still a missing element. As illustrated in graphs 9., 10. and 11., the effects of the increase in employment on growth are offset by a proportional decrease of TFP.

This suggests that the reduction of tax on labour has so far simply stimulated the adoption of less capital intensive techniques, and this may help to explain the weaknesses in capital accumulation mentioned in earlier sections of this Report. Further evidence of this effect is provided by the IMF which, adopting a similar approach to Prescott's, has investigated the negative correlation between TFP and employment dynamics. It is argued that the last individuals entering the job market are the least skilled. For instance, in Italy

[...] there has been a sharp rise in the use of part time and fixed-term labour contracts over the late 1990s. It may be that many of these jobs are less productive, leading to a decline in measured TFP.

An alternative explanation involves the hypothesis that "on-the-job training and experience increase a worker's productive abilities. [...] A surge in newer and hence inexperienced workers would lead to a reduction in the average productivity of the workforce[...]"³⁴. This case would also imply an overestimation of labour productivity with declining TFP, as our growth accounting exercise relies on the assumption of constant labour and capital productivity.

³⁴ "New estimates of potential output", IMF, Italy Selected Issues, Washington, October 2002.

Figure 6: GERMANY - The labour factor and the tax wedge *



Figure 7: ITALY - The labour factor and the tax wedge *



Figure 8: FRANCE - The labour factor and the tax wedge *



* Taxe wedge (left axis) net of contributions paid by the employers - Index 1970 = 0
 Labour factor (right axis) relative to the US - Index 1970 = 0

Figure 9: Determinants of per-capita GDP: Germany relative to United States
(Index 1990=0)

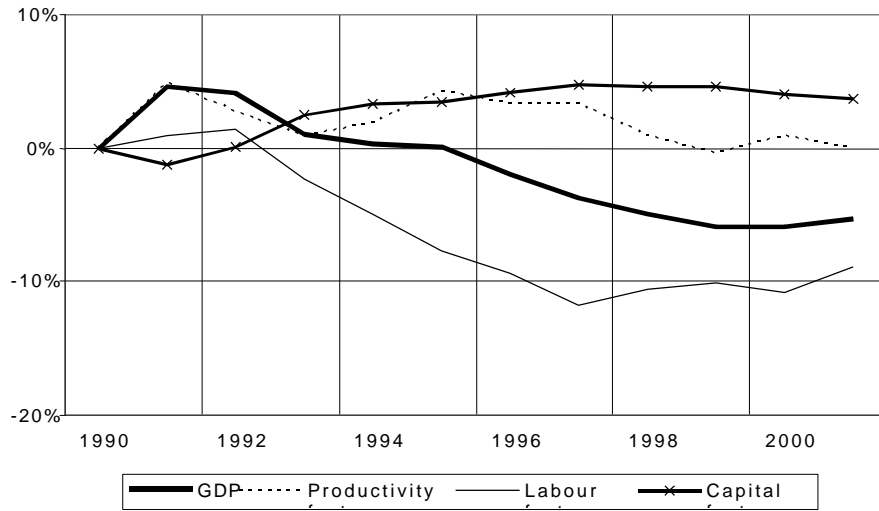


Figure 10: Determinants of per-capita GDP: Italy relative to United States
(Index 1990=0)

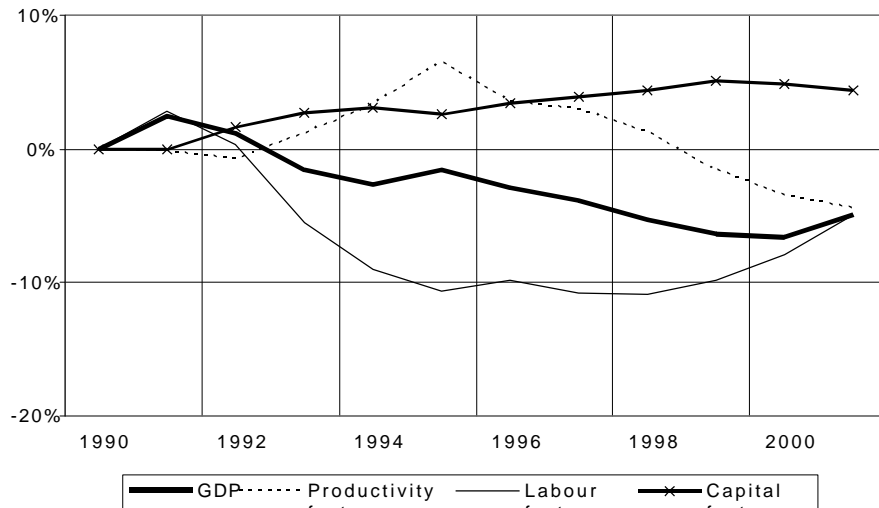
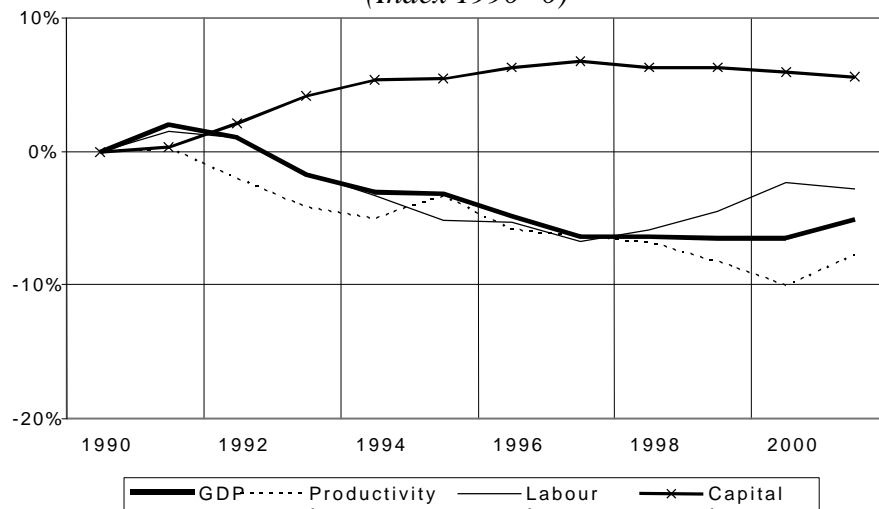


Figure 11: Determinants of per-capita GDP : France relative to United States
(Index 1990=0)



9.4. The option of "green taxes"

Much recent discussion on tax reform has centred on the need to lower labour taxes in order to stimulate employment. The challenge is to find an appropriate alternative. Excluding public expenditure cuts as a solution, the options are limited and, in many cases, problematic. Taxing capital or profits carries the risk that the tax base will migrate and that competition between tax authorities will drive rates downwards. Expenditure taxes tend to be regressive, while taxing wealth can have an adverse effect on the supply of capital. Several governments have, therefore, tried to square the circle by adopting a "green" tax. The essence of this approach is to reorganize the tax system by shifting fiscal pressure from "goods", while levying them on other commodities perceived as "bads".

The simple objective is to refocus the tax burden on polluting forms of production in order to use the environmental tax revenues to finance tax reductions on labour input or other production factors. The attractive feature of a revenue-neutral "green tax" reform – that is one which does not alter the total tax raised from all tax instruments - is that it offers a double dividend. This dividend arises if, in the presence of interactions between new policies and pre-existing taxes, the overall effect of the tax system on a crucial target variable such as employment is positive, while at the same time society gains benefits due to environmental quality improvements.

It must be stressed, however, that theoretical and analytical models suggest that under general conditions there is no certainty that a "green" tax reform will result in a double dividend (see, *inter alia*, Goulder et al., 1999; and Goulder, 1995). In fact three different components need to be analyzed in order to understand whether there is room for a double dividend to arise. This latter is the net effect arising from:

- The higher costs resulting from the need to adjust the production method to the new environmental restrictions;
- The higher producer prices caused by higher environmental taxes;
- The so called revenue-recycling effect (arising when tax revenues are used to correct distortions of pre-existing taxes on production factors so that the overall social costs of the tax system are reduced)

A double dividend exists when the monetary impact of point 3 exceeds the sum of values under points 1 and 2. Obviously, the net effect of such mechanisms cannot be said *ex-ante* to be necessarily positive.

Parry and Bento (2000) claim that under some less general assumptions, a double dividend can still arise. In particular, if the polluting good and leisure are assumed to be complements, there is room for a double dividend to be positive. Alternatively, if the green tax reform is introduced to compensate a pre-existing relative over-taxation of one of the two factors of production, then a double dividend can occur. This could indeed be the case in Europe where there is a general presumption that taxation of labour has become excessive and is damaging employment.

More generally, the scope for achieving a double dividend from green taxes appears to be more an empirical fact than a question that can be settled theoretically. Indeed, as already noted, according to the national reports from Spain, Belgium and Germany there have been small but tangible employment gains from shifting from labour taxes to "green" taxes of different sorts, but such success stories still seem episodic.

9.5. Commentary and assessment

A rapid glance at some theoretical approaches shows that high taxation may in fact negatively affect growth in the long run. At the same time, data show that relatively high tax rates are essentially a European problem. At first sight, a lowering of taxes on labour might, therefore, be

seen as the optimal recipe for enhancing European growth. But we hesitate to advocate such a course too emphatically.

Empirical evidence shows that higher social security contributions explain a significant part of the difference in relative tax wedges, suggesting that it is necessary to look at tax reforms in tandem with the more controversial issue of the optimal choice between alternative pension systems.

On the other hand, the implementation of tax cuts on labour may have produced an incentive to substitute capital with labour, thus adopting more labour-intensive production techniques although, as we point out, this has not translated into higher levels of output. In fact, a common feature to all the European countries we examined is the similar dynamics of relative output, and of its components, during the last decade. Along with the rapid growth of relative employment, European TFP level is slowing down, helping to explain lagging output levels relative to the US.

So far, supply side effects associated with tax reductions have therefore failed to materialise. This is not surprising in the light of economic literature, as summarised by Goolsbee (1999):

An influential group of supply side economists argued that high marginal tax rates were severely reducing the incentives of people to work, and that cutting tax rates, by stimulating people to work harder and earn more income, could actually rise revenues.. This idea is known in popular parlance as the Laffer curve.. As a testable hypothesis, however, the Laffer curve has not fared well.. An extensive literature in labour economics has shown that there is very little impact of changes in tax rates on labour supply.. This would seem to indicate that the central tenet of the Laffer curve is demonstrably false: marginal rates seem to have little impact on the amount that people work.

Some recommendations follow.

First, stimulating growth through tax reforms could take some time so that a deterioration of the budgets should, as Goolsbee (1999) shows, be expected at least in the short run:

The notion that governments could raise more money by cutting rates is, indeed, a glorious idea... Unfortunately for all of us, the data from the historical record suggest that this is unlikely to be true at anything like today's marginal tax rates. It seems that, for now at least, we will just have to keep paying for our tax cut the old-fashioned way.

Second, lowering taxes on labour may indeed bring about higher levels of employment. Although socially desirable, such measures could induce an increase in the supply of low skilled, low waged workers therefore inducing a reduction of the average labour productivity. Optimal strategies for growth should then imply complementing tax reductions with measures aiming at enhancing technological progress and human capital accumulation, thus allowing for recovery of productivity.

In considering a switch towards green taxes, accurate analyses at national level are needed to identify whether conditions actually exist for getting a widespread double dividend. This notwithstanding, the introduction of green taxes might offer an opportunity to reduce the current high levels of taxation on labour, without compromising budgetary stability. For this reason, there is a good case for a general recommendation in the BEPGs asking Member States to conduct further empirical exploration on the subject and to adopt green taxes where the empirical case is persuasive. In terms of the BEPGs, any double dividend would contribute to two over-arching objectives: boosting employment and promoting sustainable development and it is clearly an area where the principles of exchange of experience (or good practice) and benchmarking apply.

10 - The macroeconomic policy mix

The uncertainties surrounding the world and European macroeconomic outlook are as great as a year ago and have, if anything, become greater in the last few weeks since the interim report of this study was produced. In its 2001 autumn forecasts, issued a year ago, the Commission revised downward its figure for 2001 economic growth in the euro area and announced a progressive recovery during the year ahead, mostly under the assumption that the US economy would start picking up in the second half of 2002. In the 2002 autumn forecasts released in mid-November 2002, the scenario is almost identical, except that all phases have been shifted forward by one year. For the euro area as a whole, growth is now predicted not to exceed 0.8% in 2002, and to accelerate in 2003 and 2004, to 1.8% and 2.6%, respectively. Average (HICP) inflation rate is still forecast to be above 2% in 2002, for the third year in a row, and to decline to 2.0% in 2003 and 1.8% in 2004. In spite of the disappointing growth performance, unemployment is foreseen to be almost stable, at 8.2% in 2002, then 8.3% in 2003 and 8.0 in 2004.

Forecasts subsequently released by national, private and public institutes, as summarised in the consensus, have revised the growth projections downwards slightly, taking into account the relatively disappointing estimates for the third and fourth quarters of 2002 in the US and Europe. The lingering issue of a war in Iraq, with direct effects on oil prices and indirect negative consequences on private economic behaviour, especially consumption and investment has also been a factor. On the other hand recently published German confidence indicators suggest that there may be an improvement in sentiment in Germany which could foreshadow recovery.

10.1. The policy mix in the last year

These macroeconomic trends prompt questions about whether the policy mix has been appropriate and, if not, whether there are systematic problems resulting from the policy rules or decision-taking procedures that prevent the "right" policy mix being achieved. In this regard, the BEPGs have an especially important role to play, as noted in section 3. On this, there are, perhaps inevitably, competing points of view.

The European repo rate was unchanged at 3.25% from November 2001 until December 2002 when it was cut by 50 basis points. Thus, despite the significant downward adjustment in economic growth in the euro area, the persistent external appreciation of the euro and inflation prospects showing the average HICP rate falling back to target in 2003, monetary policy has not been changed at all. Whereas this short-term nominal interest rate - and the corresponding long-term nominal rates - correspond to reasonably low (or even negative) real interest rates in countries having relatively high inflation, they yield high real rates in countries with lower than average inflation. Hence, for instance, the short-term, ex-post real interest rate in 2002 is -1.5% in Ireland, and the corresponding long-term rate a modest 0.1%, while the same real rates in Germany respectively stand at 1.9% and 3.4%!

Fiscal policy, on the other hand, was allowed to ease, partly through the operation of automatic stabilisers, but also in some Member States, as a result of discretionary decisions. The current macroeconomic policy mix in the euro is seen by many economists as increasingly inappropriate, and this is mostly the result of inadequate rules and objectives having been set for the authorities responsible for the two major macroeconomic policy instruments, i.e. monetary policy and fiscal policies. Indeed, the situation would clearly be improved if fiscal policies were less expansionary, with national budgets closer to balance and debt reduction policies being resumed in the most indebted countries, and monetary policy were somewhat more accommodating.

Implicit in the current European fiscal rules is the (unwarranted) assumption that inflation rates are the same all over, and that public expenditure - or taxes - has no effects on the nominal growth rate. Because the various Member States are currently facing different inflation rates, while nominal interest rates are very similar across the euro area, domestic real interest rates vary markedly, so that domestic monetary conditions are effectively different. This has a number of implications. First, if one takes this and the current fiscal rules at face value, it would imply tighter fiscal policies in countries having lower than average inflation rates, a counterintuitive prescription. Alternatively, one might conclude that either monetary policy should be loosened (with the risk that average inflation would increase, leaving the problem unsolved), or the fiscal rule should somehow take real interest rate differences into account, for instance by looking at the primary deficit ³⁵.

At the same time, current fiscal rules seems to be based upon the assumption that fiscal policies do not influence potential growth ³⁶. Of course, lip service is being paid to the consequences of improved public spending and better conceived taxation on long-term growth. But in practice, the SGP has mostly led to cuts in income taxes in good times - with debatable effects on long-term growth - and above all to cuts in public investment expenditures in bad times, a move that is clearly detrimental to potential growth.

Serious drawbacks of the current rules

The relatively favourable macroeconomic environment of the first two years of the euro and the previous efforts made by many governments to reduce public deficits and debts before entering monetary union, meant that the deficit ceiling in the SGP did not prove excessively binding until recently. But, because it now appears that even some large countries of the EU have difficulties in abiding by the rule, its credibility itself is shaken, and with it, the credibility of the SGP (Fitoussi and Le Cacheux, 2002; Creel, Latreille and Le Cacheux, 2002).

The pro-cyclical bias, which aggravates business fluctuations, was apparent even before the launch of monetary union, during the preceding decade of weak growth (Fitoussi, 2000). It has also been observed that, since 1999, the favourable business conditions have led national governments to relax their efforts to reduce deficits and instead induced them to increase expenditures and cut taxes at a time of buoyant economic activity. Now, national governments are having to implement more restrictive fiscal policies at a time of slow growth, or even recession in some countries. This long-identified bias has even been recognized by the Ecofin Council itself. Solutions may involve changing the rule and moving to a ceiling in terms of a cyclically adjusted public deficit, i.e. a structural budget deficit (see, for instance: Buiter, Corsetti and Roubini, 1993; Creel and Sterdyniak, 1995; Eichengreen and Wyplosz, 1998). Even the Commission seems to have taken this point on board and is now discussing prospects in terms of structural deficits.

³⁵ A number of authors have long recommended this kind of rule (e.g., Creel & Sterdyniak, 1997). A recent paper (Creel, Latreille et Le Cacheux, 2002) takes a more negative stance on this, because it would, if implemented in the simplest way, award more room for manoeuvre to highly indebted countries, which would be contrary to the goal of long-term sustainability.

³⁶ The criticism of the Irish government in 2001 for an overly expansionary fiscal policy, at a time when the letter of the Stability Pact was being respected, but Irish inflation was much above average, may be interpreted as acknowledgement that, in monetary union, national fiscal policies may be used as a tool to fight domestic inflation...

10.2. The growth scenario

Behind the relatively weak growth scenario for the euro area presented in the Commission Autumn forecast - and indeed in most currently available forecasts for the euro area - are two major assumptions: one regards the developments of demand components; the other one is about potential growth. The Commission foresees no major picking up of the domestic components of final demand: private consumption growth has weakened significantly in most euro area countries in 2002 and is expected to stay weak; investment has dropped and is not expected to recover until after the other components of final demand show strong signs of recovery (accelerator effects), while inventories are expected to rise again. Government consumption growth is expected to decelerate, based on the maintained assumption that fiscal policies will come back on course in 2003 (see below); the most dynamic component is expected to be exports, whose growth is forecast to accelerate in 2003 and 2004. Thus the scenario is essentially an export-driven recovery, with no autonomous domestic engine.

The sharp and persistent downward adjustment of stock prices, triggered almost two years ago by problems in the "new economy" sector in the US, then spread to virtually all sectors in all countries, has generated a halving of stock market wealth in the US and Europe. At least three major uncertainties surround the potential consequences of this decline. The first concerns stock market prospects in the short and medium run; the second one is about firms' investment behaviour, especially given their high levels of indebtedness; and the third one is about the magnitude of the (negative) wealth effect on households' consumption spending.

With regard to the longer run, and the evolution of aggregate supply, the scenario is one of relatively modest potential output growth, meaning that the recovery will soon (already at the end of 2003, according to the Commission forecast) hit capacity limits and slow down. Potential output growth is seen to lie slightly above 2% and, given the estimated level of "equilibrium" unemployment, the output gap is also estimated to be small, so that longer term prospects are relatively modest.

Significant dispersion across member countries

Domestic macroeconomic performance in individual countries of the euro area has tended to be widely dispersed over the past few years, much more so than expected by most experts before the launching of the euro. These disparities are not expected to diminish in the near future. Among larger EU countries, only France and Spain are expected to have a (slightly) above-average growth performance (France: 2.0% in 2003 and 2.7% in 2004, following a modest 1.0% in 2002; and Spain: 1.9% for 2002, 2.6% in 2003 and 3.2% in 2004. In Germany, after two years of quasi-stagnation (0.6% in 2001 and 0.4% in 2002), growth is foreseen to accelerate only very slowly, with 1.4% in 2003 and 2.3% in 2004. And the scenario is very similar and equally pessimistic for Italy, with 0.4 in 2002, 1.8% in 2003 and 2.4% in 2004. Some smaller countries seem better placed, though after a marked slowdown, notably Ireland (3.3%, 4.2% and 5.2%) or Greece (3.5%, 3.9% and 3.7%). But others face very weak growth (Belgium, Austria, the Netherlands, Portugal).

In terms of domestic monetary conditions, too, there are quite significant differences across Member States of the euro area. Whereas monetary policy is the same everywhere, so that short-term nominal interest rates are almost uniform within the euro area, and long-term nominal interest rates are also very similar across Member States³⁷, domestic inflation rates do differ persistently and significantly. Hence real rates - the ones that matter for private economic

³⁷ According to the figures in the Commission Autumn Forecast, long-term rates in the Euro area in 2002 stand at an average 4.8%, ranging from 4.8% in Germany to 5.1% in Greece and Portugal.

decisions, such as investment, and for the sustainability of public debt (see below) - are different, both ex-post (based on realised inflation) and ex-ante (based on expected inflation). After an initial year of very low average inflation (as measured by the Harmonised Index of Consumer Prices, HICP) at 1.1% in the euro area in 1999, inflation had slightly accelerated to reach a "peak" at 2.5% in 2001; it is now decelerating and should be at 2.3% in 2002, and is forecast to decrease to 2.0% in 2003 and to 1.8% in 2004. But behind these small movements in the average, there are quite large and persistent differences between domestic inflation rates: hence for 2002, Germany has an inflation rate at 1.4%, Belgium at 1.6%, Austria, Finland, France and Luxembourg at 1.9%, but the Italian inflation rate is 2.6%, the Portuguese one 3.5% (after 4.4% in 2001), the Spanish one 3.6%, the Greek one 3.8%, the Dutch one 3.9% (after 5.1% in 2001), and the Irish one 4.8% (after 5.3% in 2000 and 4.0% in 2001).

Deteriorating public finances

After a period of relatively high economic growth that had allowed a significant consolidation of public finances in most countries of the euro area, but had also induced some governments (in particular in Germany and France) to cut taxes and social contributions, the marked slowdown in economic activity has revealed the vulnerability of European public finances, while clearly showing the need for automatic fiscal stabilisers. In the euro area as a whole, the ratio of government gross debt to GDP, that had been declining since the 1990s, to 69.3% in 2001, will increase slightly for the first time in 2002 (to 69.6% according to the Commission Autumn 2002 forecasts). In individual countries, the debt ratio will be rising in Germany (at 60.9%), France (at 58.6%), Italy (at 110.3%), and Portugal (at 57.4%).

This deterioration will mean increased budget deficits or reduced surpluses in all countries of the euro area, except Greece (expected to be in balance in 2002) and Portugal (which reduces its deficit from 4.1% to 3.4% of GDP). For the euro area as a whole, the forecast budget deficit is 2.3% of GDP, but with a range from a 3.8% deficit in Germany to a surplus of 3.6% of GDP in Finland. Hence, the Broad Economic Policy Guidelines, and the National Stability Programs that had been adopted at the beginning of the year are clearly obsolete, insofar as they were based on more optimistic economic forecasts for the euro area³⁸.

10.3. The evolution of the Stability and Growth Pact

Deteriorating public finances and the reaction of the Commission under the SGP has ignited a lively debate about the nature of the rules governing national fiscal policies in the euro area and about the appropriateness of the current macroeconomic policy mix. Following the aborted early warnings to Germany and Portugal, all national governments committed themselves at the Barcelona European Council meeting, to bring their budgets into balance by 2004. In September, on the eve of the unveiling of the draft French budget for 2003, the Commission proposed a new interpretation of the medium-term budget balance objective in the SGP. Acknowledging that the 2004 balanced budget target was not achievable for a number of countries (including Germany, France, and Italy), the Commission offered to postpone the end date to 2006, but in exchange for a commitment by all national governments to reduce their structural (cyclically adjusted) deficit by at least 0.5 point of GDP each year, starting in 2003. It should be stressed that this rule is arbitrary, especially if the rationale for imposing fiscal rules on national governments is public finance sustainability and long-term price stability.

But in the 2003 French budget, as presented to Parliament, no reduction in the structural deficit is foreseen, and indeed a rise in the current deficit, to 2.8% of GDP is expected according to the

³⁸ See Creel, Latreille & Le Cacheux (2002) and the 2002 TEPSA report for the European Parliament.

latest French government forecasts. In mid-November 2002, as noted in section 3 above, the Commission therefore proposed to the Ecofin Council that the procedure for excessive deficits under the SGP be launched for Portugal and Germany, and that an "early warning" be issued for France, because its current and forecast deficits are dangerously close to the 3% of GDP limit.

The French government decision not to try to reduce the deficit in 2003 together with Romano Prodi's comments that the SGP was "stupid", sparked a debate about the rules governing national fiscal policies in the euro area. If the current rules are not being obeyed, should they be enforced regardless, or does this demonstrate their bad design and, possibly, the impossibility of enforcing them and making them credible? Should they then be abandoned? Or should the rules be renegotiated?

The need for fiscal rules in a monetary union

The most economically convincing justifications for fiscal policy rules rest on the notion of spillover effects amongst decentralized governments in an economically and financially integrated area. Indeed, the spillover arguments appear to have inspired the rules in the Maastricht Treaty and carried forward into the SGP. The logic is that due to market integration, "excessive" public deficits in one country will have adverse effects on others through higher interest rates, threats of higher future inflation, etc., in a way similar to pollution or any other external effect. Examples are common trends in long-term interest on public debts in federations and, since the inception of monetary union in Europe, the observed trends in, and the narrow band of risk premia on, European governments' debts.

Agreeing on the virtues of rules to constrain national fiscal policies in a multilevel government setting leaves open the question of the nature and content of the rules. The SGP is complemented by the BEPGs which, in the field of fiscal policies, include the national stability programs describing medium-term public finance strategies of national governments. Adverse macroeconomic developments in some EU countries are currently threatening strict respect of the SGP, while national stability programs have rarely been implemented strictly and are currently subject to large revisions. These difficulties raise questions about the credibility of the current institutional setting and re-open the debates on fiscal policy rules in the Euro area (Creel, Latreille and Le Cacheux, 2002).

Public finance rules for monetary stability

Although rules may not fully resolve fiscal policy co-ordination problems in the euro area, there is little doubt that rules are needed to prevent governments from engaging in policies that would be detrimental for the union as a whole by undermining the commitment to price stability. But rules should focus on the sustainability of public finance developments, rather than purely current flows, such as the current budget deficit. The sustainability of public debt is influenced by the difference between the apparent nominal interest rate on public debt and the nominal growth rate of the domestic economy. This implies targeting the public debt ratio by setting a medium-term objective for it, as in the Maastricht Treaty³⁹. It also reinforces the case for stronger statements within the BEPGs on the conduct of fiscal policy and its medium- and longer-term objectives.

³⁹ Whether it is aimed at a 60% of GDP figure or any other is really a matter to be discussed, with no particular meaning attached to the figure. Clearly, however, a zero target would not make much sense, unless one has other reasons for aiming at the disappearance of public debt in Europe. Everybody knows that the debt criterion was not included in the Stability Pact because a number of countries entered monetary union with debt ratios well above the 60%-of-GDP ceiling.

10.4. Commentary and assessment

The current European fiscal rule tends to produce an excessive contraction in public investment spending by national and sub-national governments, which may be detrimental to growth and may run counter to other European Union objectives, such as enhancing transportation networks. This bias against public investment arises from the political difficulty of cutting current expenditures, which consist largely of civil servants' wages and transfers to households, or by increasing taxation in the face of a forthcoming slowdown in economic activity. To avoid such a bias, the public deficit ceiling could be recast as a "golden rule of public finance", similar to the one currently applied in the UK, which has a medium-run target for the net-public-investment deficit. Such a change would lead to adopting a fiscal rule that would have a ceiling - possibly zero, if one wants to signal fiscal "virtue" for the ratio to GDP of the structural, net-public-investment public deficit (Creel, Latreille and Le Cacheux, 2002).

In addition to the above mentioned political vulnerability of all expenditures that do not have immediate benefits and/or constituencies, there are at least two related reasons to single out public investment expenditures and treat them separately in a fiscal rule: one is the direct effect that public investment, as a public good, is supposed to have on welfare; the other one is the induced effect on potential growth, hence on the sustainability of public finances.

Reaching an agreement on what is "structural" may not be easy; but it can be done and the Commission is working on it. It must be said, though, that the figures proposed in the Autumn forecasts are highly debatable, as they evaluate structural deficits for countries like Germany or France as being very close to observed current fiscal deficits. This means that the Commission deems current output in these countries to be close to potential, i.e. current unemployment to be mostly "natural", a judgement that is questionable on various grounds. Similarly, agreeing on what is "productive public investment spending" may be even more difficult; but after all, this is the kind of conventions upon which private accounting is built, and a thorough discussion of public accounting practices would be welcome. To the extent that the expenditures included in the category of public investment are effectively productive, the proposed amended golden rule will ensure stability and sustainability, while being conducive to higher long-term average growth and short-term, differentiated stabilization policies. Thus, the overall objective of price stability, which implies long-term sustainability of public debts, would be preserved, while leaving some margins of manoeuvre for national governments to pursue fiscal policies that correspond to domestically defined choices and priorities and compatible with long-term growth in the Euro area as a whole.

The current macroeconomic policy mix could be improved if there were a more credible and more effective fiscal rule, i.e. one that would in effect induce governments to reduce their deficits sufficiently in good times so that they could afford at least automatic fiscal stabilizers in bad times, while keeping the indebtedness ratio on track, would in turn encourage the central bank to play a more cooperative game, and adopt a more active stance in the face of business fluctuations.

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