CENTRE FOR EUROPEAN REFORM

THE LISBON SCORECARD VI
Will Europe's economy rise again?

Aurore Wanlin

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The Lisbon Scorecard VI

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Foreword

GlaxoSmithKline commends the leadership of European Commission President Barroso on the Lisbon Agenda. To quote from *Creating an Innovative Europe*, "Europe and its citizens realise that the path to prosperity through research and innovation is open if large scale action is taken now by their leaders before it is too late."

The CER's Lisbon Scorecard is a simple but effective way to track progress against the target date of 2010. Much work remains to be done. This is clearly the case with the innovative pharmaceutical industry which can support delivery of some of the key goals of the European Union – improved healthcare for individual citizens, improved economic competitiveness, and increased investment in research and development. However, as recognised in the recent report to the Commission, *Creating an Innovative Europe*, "Europe's position as the world's leading manufacturing location for pharmaceuticals, is under long-term threat despite being the only high technology sector to consistently show a growing positive trade balance."

Commissioners Verheugen and Kyprianou have recognised the contribution of the pharmaceutical industry and the challenges facing it. They are to be congratulated on establishing the High-Level Pharmaceutical Forum. This is but one part of the Commission's commitment to making Europe a more attractive place to invest and work, putting knowledge and innovation at the heart of European growth, and shaping policies to allow businesses to create more and better jobs.

It is critical – for Europe's governments, businesses and citizens – that these goals are met.

Andrew Witty

President, Pharmaceuticals Europe

Foreword

KPMG is delighted to sponsor the CER's European economic reform 'scorecard' once again this year. This is the sixth annual assessment of progress on the Lisbon Agenda for reform adopted in 2000.

2005 was not a good year. As this report shows, progress has been slow and uneven. The run-up to voting on the EU constitution was a major distraction, and its rejection has been seen in several countries as a vote against change. Worse, some governments have shown signs of retreating behind protectionist policies which can only hamper the establishment of the single market.

Meanwhile, the world has moved on. It has become increasingly clear that reform is necessary not just for completion of the internal market, but to enable European business to respond to the challenges of globalisation without one arm tied behind its back. The only viable response to the rise of the new, external economic powerhouses is to create an internal environment in which companies can react to change in a flexible and timely way.

But all is not necessarily lost. In its mid-term review of the Lisbon strategy, the European Commission recognised that the narrower aim of promoting growth and job creation was a pre-requisite for meeting the wider social and environmental ambitions.

The onus is now very much on individual member governments to make this focus a reality. Some of the larger EU members could learn from the more enthusiastic approach of the new member-states, evidenced in this report.

Business also has its part to play in promoting reform. But political leaders must confront the hard choices and provide the leadership for change if Europe is to meet the competitiveness challenge in the 21st century.

Mike Rake

International Chairman, KPMG

1 Introduction

The European Union had a difficult year in 2005. Voters in France and the Netherlands rejected the EU constitutional treaty, leaving European leaders groping for a way forward. Eastward enlargement started breeding resentment in some West European countries. Rather than welcoming the EU's newcomers, politicians and trade unionists in Austria, Germany and elsewhere accused them of 'unfair' tax competition and 'social dumping'. Many people also claimed that the 'old' EU was split between two opposing camps, a liberal 'Anglo-Saxon' one and a more socially orientated continental or 'French-style' one. These splits became particularly obvious in the battle over the EU's future budget, which dominated the agenda in the second half of 2005. Many took the Union's failure to undertake a significant reform of its spending policies as yet another indication of Europe's inability to change.

Economics is a key ingredient of the EU's current political malaise. French voters cited unemployment as one of the main reasons for their rejection of the constitutional treaty. Citizens across Europe feel that the Union has failed to deliver on its promises to boost growth and employment. Economists and commentators never tire of calling on EU governments to speed up economic reform. Labour markets are overly rigid, the single market remains unfinished, education is far from world class, unemployment is high and businesses are not innovative enough. The challenge still facing the EU is a daunting one. However, the member-states already have the mechanism in place to add a European dimension to their attempts to reform. This is the 'Lisbon agenda' of economic reform, launched by EU leaders in 2000 as a comprehensive and long-term programme to make the EU more competitive and prosperous.

It is easy to dismiss the Lisbon agenda. Critics point to the programme's ludicrously ambitious overall objective, namely to turn the EU into "the world's most competitive, knowledge-based economy by 2010". They contrast this with the lacklustre performance of the eurozone's biggest economies, namely France, Germany and Italy. They highlight the fact that Europe is not making any progress in catching up with the US. In 2005, average GDP per head in the EU-15 was 27 per cent below the US average, unchanged compared with 2000. Even more worrying is the fact that productivity growth – the basis of prosperity – is lagging: US labour productivity growth outstripped that of the EU-15 by a full percentage point each year between 1995 and 2005.[1]

[1] *Bart van Ark, Catherine Guillemineau, Robert H. McGuckin, 'As US productivity slows, emerging economies grow rapidly, but Europe falls further behind', The Conference Board, January 2006.*

Not surprisingly, many Europeans conclude that the Lisbon agenda has been a failure. There is no doubt that Lisbon has not lived up to expectations, but to dismiss the entire programme outright would be a major mistake. Something is stirring in the economic heart of Europe.

Lisbon, new and improved?

In 2005, when the ten-year Lisbon programme reached its half-way point, EU leaders took stock. They quietly toned down its most ambitious objective – a hangover from the giddy days of the dot.com boom when Lisbon was launched. They slimmed down the agenda's 'shopping list' of targets, ranging from building highways to preserving Europe's biodiversity. Instead, they decided to focus on two key themes, namely jobs and growth. Other targets, such as fighting poverty, preserving the environment or improving education, were not struck off the list. But, so the reasoning went, the EU would be able to achieve these objectives once it had revived its economy.

In 2005, the Commission went to great lengths to make Lisbon more relevant to other EU policy areas, and so enhance the

consistency of overall policy-making. For example, it has published guidelines to ensure that EU aid to poor regions is spent pursuing Lisbon goals. Similarly, the reform of the stability and growth pact loosened up the excessive deficit procedure for member-states which have reformed their social protection systems or invested in research and development (R&D), both key Lisbon goals. The Commission also proposed to make more money available in the EU budget for policies that enhance growth and competitiveness.

Unfortunately, when EU leaders negotiated the final budget deal in December 2005, the current beneficiaries of the common agricultural policy (CAP) and the regional aid funds – which together account for the bulk of EU spending – refused to see money migrate to new policy areas. Since the big contributors to the budget, such as Germany, the Netherlands and the UK, wanted to limit future budget growth, there was not much money available for new priorities. In the final deal, less than 10 per cent of total EU spending will be on 'Lisbon-type' policies during the budget period 2007-2013.[2]

[2] *Iain Begg and Friedrich Heinemann, 'New budget, old dilemmas', CER briefing note, February 2006.*

So far, one of the key problems of Lisbon has been the lack of political 'ownership' in the member-states. The EU can set targets, cajole or commend. But it is national governments that have to make the – often contentious – decisions that lead to real change on the ground, be it increasing the pension age, improving education or taxing energy consumption. Yet Lisbon is hardly ever mentioned when politicians make such decisions. Most voters across Europe do not know that the Lisbon agenda even exists.

To link the Lisbon programme more closely to national policies, EU leaders agreed in March 2005 that each government should draw up a 'national reform programme' (NRP) that details measures being taken in order to meet the targets. The NRPs replace the current plethora of EU and national progress reports and provide a much

more accessible overview of a country's objectives and achievements. The NRPs should help to tailor Lisbon objectives more closely to individual countries' needs by allowing governments to outline how national priorities fit in with the Lisbon agenda. Each EU government has also appointed an official – a Mr or Ms Lisbon – to provide more consistency to the reform efforts.

It is perhaps too early to judge whether the NRPs will strengthen the link between national reform debates and the EU-level Lisbon process. But there is a real risk that governments will treat the NRPs as a formality, unless these programmes become a prominent part of the national political debate. In some countries, such as Sweden, there has been a lively discussion about the NRP at national and regional level. Several countries appointed a minister as their Lisbon co-ordinator, to make sure that the NRP is discussed at cabinet level. In Italy, for example, the liberal-minded minister for Europe, Giorgio La Malfa, is now also in charge of co-ordinating Italy's Lisbon agenda. However, in some countries, such as Slovakia, the NRP has not even been discussed in parliament. And most governments have made no link between the NRP and the national budget, which means that money may not be available for implementation. Therefore, there is a real risk that the programmes may turn out to be little more than empty promises.

A nascent recovery

There are reasons why Europe is not moving faster. With unemployment stuck at 10 per cent in some big EU countries, and social entitlements being cut back, people are ever more fearful of losing their jobs. In addition, 12 out of 25 EU countries have budget deficits that equal or exceed the 3 per cent of GDP limit stipulated in the stability and growth pact. So there is little money available to sweeten painful structural reforms.

Although the pace of reform may have been sluggish in many countries, it would be wrong to conclude that the EU economy has

not changed since the Lisbon agenda was launched in 2000. In 2004, the EU took in ten more members, thus adding a pool of 70 million low-cost workers. West European companies – themselves under growing competition in a globalised world – have long taken advantage of investment opportunities in the Central and East European countries. The mere threat of the relocation of factories to Eastern Europe (or further afield) has focused the minds of West European governments, and it has made workers in Germany and elsewhere more willing to accept wage restraint and more flexible working conditions. Eastward enlargement and growing competition from emerging Asia appear to be delivering what years of anguished debates have failed to deliver: they are forcing Europeans to accept change.

Despite signs of a re-emerging economic nationalism, businesses are increasingly taking advantage of the single market by engaging in cross-border mergers and acquisitions. In the first two months of 2006, the value of cross-border deals anounced in Europe reached almost $173 billion, a level unrivalled since the peak of the dot.com boom in 2000.[3] There are several factors driving this new wave of cross-border activity, such as strong corporate profits, cheap credit and shareholders' renewed support for takeovers. But it is also a sign that the single market is working, by driving companies towards consolidation. But at the same time, national governments are seeking to protect national champions in sectors such as energy and banking which were largely exempt from cross-border competition in the past.

[3] *Patrick Jenkins and Lina Saigol, 'A bid for strength: Why corporate Europe is smashing through the merger barriers', Financial Times, February 14th 2006.*

All EU countries have made at least some progress in reforming their labour markets and social security systems in recent years. This, together with wage restraint, has created the conditions for the eurozone's incipient recovery. By the end of 2005, German business confidence was improving in leaps and bounds and German industry was doing very well, after years of restructuring and wage restraint.

Germany's rising competitiveness is turning up the heat on its European neighbours. Even though France sometimes succumbs to protectionist pressures, it continues to open up and modernise its economy. In 2005, the French government sold off another chunk of its electricity and gas monopolies, and it liberalised hiring and firing rules. Perhaps most importantly, the French have come to realise that the sustainability of the 'French model' is under threat. Journalists, economists and politicians have finally started debating how France needs to change in order to compete in the future. Europe's reform outlook may improve further after 2006 and 2007, when national elections are out of the way in France and Italy. When EU leaders met for an informal summit at Hampton Court in October 2005, they all agreed that new momentum was needed in policy areas such as research and energy. The summit has put economic reform back on the Union's political agenda.

The Lisbon 'league table'

The CER's annual Lisbon scorecard provides an overview of EU reform efforts. We try to single out those member-states that have done the most to live up to their Lisbon commitments, as well as those that have done the least. Those countries that already meet many or most of the Lisbon targets can achieve 'hero' status, as can those that are catching up at a fast pace. Those that lag behind and make slow progress are designated as 'villains'.

The scorecard's 'Lisbon league table' provides an assessment of a country's overall Lisbon performance in 2005, and compare it with their performance in 2004 (see Lisbon Scorecard V). The table is based on the EU's short-list of 'structural indicators', which measures member-states' performance in economic, social and environmental categories – such as employment rates, greenhouse gas emissions, R&D spending and so on.

The league table once again confirms the superior performance of the Nordic countries. Denmark and Sweden lead our overall

ranking, performing strongly on most indicators, including R&D, market liberalisation, employment and social equity. Finland also scores well in many categories, but its overall performance is held back by a more modest employment record. Denmark's winning combination of fast growth, high employment and high standards of social security has attracted so much attention that economists across the EU are now debating how to copy 'the Danish model'. In 2004, Denmark's employment rate was 12 percentage points higher than the EU average, and it scored at or near the top in terms of long-term unemployment, social equity, lifelong learning, R&D, and environmental indicators.

Both France and the UK have moved up the league table since 2004 and rank eighth and fourth respectively. Real GDP growth in both countries has outperformed the eurozone average every year since 2000, thanks mainly to higher levels of consumer spending. In both countries, growth slowed to 1.5-1.8 per cent in 2005, but is set to pick up again in 2006-7. In some respects, the two countries looked like polar opposites in the past, with France suffering from high unemployment, but showing high levels of social equity. Meanwhile the UK boasted good employment indicators but suffered from significant pockets of poverty. France's unemployment rate remains among the highest in Western Europe, but there were signs of a downward trend in 2005. Moreover, although France continues to score well on the social indicators included in the Lisbon list, the 2005 riots in the country's poorer suburbs indicate that France has some serious problems with social exclusion.

Meanwhile, unemployment in the UK has started to rise, albeit from a low base. The UK labour market continues to do much better than the large eurozone ones, not only in terms of overall employment rates, but also in terms of having low rates of long-term unemployment and keeping older workers in jobs. The UK has also made some progress in fighting child poverty, but it still has one of the worst records in the EU. Neither country can rest on its laurels. Britain continues to perform badly in terms of

productivity, while in France the rate of productivity growth has slowed down. Both countries have to some extent achieved economic growth at the expense of rising public deficits and growing household indebtedness.

Several of the new member-states are making rapid progress towards the Lisbon goals. Although the three Baltic states have not improved their relative rankings since the last assessment, they remain extremely dynamic, a fact that is also reflected in their impressive GDP growth rates of 7-10 per cent. If they can keep up these rates, their standards of living will double in a decade. Estonia in particular scores well on economic openness and many indicators of innovation and entrepreneurship. Since 2000, the Baltic countries also have steadily increased their employment rates and cut long-term unemployment. In Latvia, in particular, older people are now staying in their jobs for longer, and youngsters are more likely to complete secondary or university education. The World Bank reports that it has become easier to set up a new business in all three Baltic countries.

Hungary and Slovakia also have seen noticeable improvements in recent years, although Slovakia's 2005 tax and labour market reforms have not yet fully translated into the data. Slovenia has speeded up reforms after a few years of rather sluggish progress. There remains the risk that the new members will give in to 'reform fatigue' after a decade of frantic pre-accession preparations. Any complacency would be misplaced, however, since in terms of their overall rankings, the new members as a group continue to lag badly behind the EU-15. If they want to catch up with the old member-states they urgently need to fix their labour markets and modernise their education systems. There also remains much work to be done to improve customs systems, labour codes and taxation. In many of these countries, legal improvements are slow to translate into better business conditions on the ground because state bureaucracies and judicial systems remain slow, ineffective and sometimes corrupt.

Table 1: The Lisbon league table: Overall Lisbon performance 2005*

Rank 2005	Rank 2004	Country
1	1	Denmark
2	2	Sweden
3	4	Austria
4	5	United Kingdom
5	3	The Netherlands
6	6	Finland
7	10	Ireland
8	11	France
9	8	Luxembourg
10	9	Germany
11	12	Slovenia
12	7	Czech Republic
13	13	Belgium
14	15	Cyprus
15	14	Hungary
16	18	Estonia
17	20	Greece
18	16	Portugal
19	19	Latvia
20	21	Lithuania
21	23	Spain
22	17	Slovakia
23	24	Italy
24	26	Bulgaria
25	25	Romania
26	22	Poland
27	27	Malta

** Ranking based on average performance in the EU's short-list of structural indicators.*

Poland is the most worrying among the EU's newcomers: in 2004 only 52 per cent of all people of working age had a job. Despite a modest improvement in 2005, Poland's unemployment rate remains stuck at 18 per cent, twice the EU-25 average, while indicators for long-term and youth unemployment are among Europe's worst. Despite some liberalisation, Poland maintains the highest barriers to foreign ownership in the Organisation for Economic Co-operation and Development (OECD), and product market competition is fairly restricted. The tax system is riddled with exemptions, and bad infrastructure adds to the costs borne by businesses. Recent performance gives little cause for optimism. Foreign direct investment inflows fell significantly from their 2004 peak of over €10 billion. Sluggish reform progress in 2005 may have been expected in an election year. However, the populism of the new right-wing minority government means that controversial reforms are unlikely to move up the agenda, even if early elections can be avoided.

Another country that still needs to do better is Germany. Germany's overall ranking is a mediocre tenth place. Before calling an early election, the government of Gerhard Schröder had adopted significant reforms. For example, it liberalised labour market rules, slimmed down social security and started to put the pension system on a more sustainable footing. In 2005, Germany was once again the world's biggest exporter of goods. However, with unemployment stuck at 9.5 per cent, stagnant real wages and ubiquitous job insecurity, domestic demand remains conspicuously weak. The long-term unemployed now account for more than half of Germany's jobless. Many people in Germany, and the rest of Europe, have pinned their hopes on the new chancellor, Angela Merkel. But it remains to be seen whether she can persuade her unwieldy 'grand' coalition to push through controversial reforms, such as modernising healthcare, or untangling the decision-making powers of the central government and the *Länder*.

Italy was the villain in the CER's 2005 scorecard, and it still ranks lowest among the 'old' member-states. An inefficient bureaucracy,

excessive red tape, inadequate infrastructure and high tax rates are among the factors holding the country back. Italy's GDP and productivity performances are woeful. Its employment rate is the lowest among the EU-15, and despite improvements, the country scores badly on the participation of older workers and women. The tax 'wedge' – the difference between workers' take-home pay and what it costs to employ them – is one of the largest in Europe. However, the government has made some progress on labour market reforms, for example by loosening the rules governing part-time and temporary work. It has also started an overhaul of the pension system. But with one of the lowest birth rates in Europe, and public debt amounting to more than 100 per cent of GDP, Italy needs to work harder to prepare for an ageing and shrinking workforce.

The EU's other Mediterranean members also score poorly on many Lisbon indicators. Malta is difficult to assess because of a lack of data. Cyprus does better overall but ranks near the bottom in a number of categories, such as R&D spending. Although Portugal's employment rate is above the EU average, restrictive labour market regulations and the worst educational indicators in the EU suggest trouble in the future. Greece continues to lag behind the rest of the old EU in terms of innovation, and the heavy hand of the state weighs down on many sectors, including energy and telecoms. The World Bank ranks Greece as the most difficult place for doing business in Europe.

The Lisbon process	**C**
Hero	**Denmark**
Villain	**Poland**

2 The Lisbon agenda

The key elements of the Lisbon agenda are set out below. For the purposes of the scorecard we have grouped the main targets under five broad headings.

★ **Innovation**

Europe will not be able to compete in the global economy on the basis of low-tech products in traditional sectors. Europe's record in generating new ideas is good and it possesses a skilled workforce. But with a few notable exceptions – such as pharmaceuticals and mobile phones – the EU has struggled to commercialise its inventions for international markets. European businesses still spend too little on research and development. The United States, Japan and increasingly China look set to dominate the production of hi-tech products unless the EU rapidly improves its performance.

★ **Liberalisation**

In theory, the EU succeeded in creating a single market for goods and services in 1992. In practice, many barriers to cross-border business remain in place. At Lisbon, the heads of government agreed to complete the single market in key sectors such as telecoms, energy and financial services. The liberalisation of these markets should help to reduce prices for businesses and consumers alike, and accelerate the EU's economic integration.

★ **Enterprise**

Dynamic new firms are the key to job creation and innovation. But Europe does not reward entrepreneurial success sufficiently, while failure is too heavily stigmatised. Europe's citizens are averse to taking financial risks, and small businesses often face obstacles to expansion, such as regulatory red tape. The EU and its governments need to ensure a better business environment for small firms. The EU should also ensure that member-states reduce market-distorting state subsidies and that competition policy promotes a level playing field.

★ **Employment and social inclusion**

The Lisbon agenda spelt out the vital role that employment plays in reducing poverty, as well as in ensuring the long-term sustainability of public finances. The EU and its governments need to find ways of persuading people to take up jobs, and to train them with the skills necessary to compete in fast-changing labour markets. EU member-states must also tackle the problems of ageing populations by reducing the burden of pensions on state finances, while ensuring that pensioners are not pushed into poverty.

★ **Sustainable development and environment**

The EU added the objective of sustainable development to the Lisbon agenda during the Swedish presidency of 2001. The EU is aiming to reconcile its aspirations for higher economic growth with the need to fulfil its international environmental commitments such as the Kyoto greenhouse gas targets.

3 The Scorecard

A. Innovation

A1. Information society

★ Increase internet access for households, schools and public services

★ Promote new technologies, such as 3G (third generation) mobile phones and broadband internet

When the member-states launched the Lisbon strategy in 2000, a key aim was to replicate the technology-driven boom seen in the US. Although the EU is still lagging the US in many high-tech areas, there is little doubt about the importance of new technology for Europe's future competitiveness. Information technology is one of the main reasons why the US has consistently outperformed Europe in terms of productivity growth. European decline in productivity growth, in turn, explains most of the EU's sluggish economic performance over the last years.

Average European labour productivity caught up with US levels in 1995, but since then the US has persistently outperformed the EU. EU-15 productivity growth averaged 1.4 per cent between 1995 and 2005, compared with 2.4 per cent in the US.[4] Productivity growth in the old EU member-states further declined from 1.4 per cent in 2004 to 0.5 per cent in 2005. Labour

[4] *Bart van Ark, Catherine Guillemineau, Robert H. McGuckin, 'As US productivity slows, emerging economies grow rapidly, but Europe falls further behind', The Conference Board, January 2006.*

market reforms account for some of the EU-US gap. Several countries, such as France, have cautiously opened their labour markets, which has had the effect of increasing the number of low-productivity, low-wage jobs. But that is only part of the story. The use of information and communication technologies (ICT) explains most of the EU-US gap. Some 40 per cent of the growth in European labour productivity from 1996 to 2000 was driven by the use of ICT, while in the US the share was twice as high.

There are several reasons why the contribution of ICT to productivity growth is larger in the US than the EU. One reason is that Europe is not investing enough in new technologies. Europe's ICT investment per head is still at levels seen in the US some 20 years ago, according to Ovum, an independent consultancy.[5] In 2004, the 25 EU countries spent an average of 3 per cent of their GDP on ICT investment, compared with 4.6 per cent in the US and 3.6 per cent in Japan. Some EU countries are on a par with the US: Sweden and the UK invested the equivalent of 4.4 per cent and 4.2 per cent of their respective GDPs in 2004. But others are lagging behind. Greece and Lithuania, for example, spent less than 1.5 per cent of their GDP on ICT.

[5] *Ovum, 'Achieving the Lisbon agenda: The contribution of ICT', a report for the Brussels roundtable, January 2005.*

What is more, high-tech investment in Europe seems to have less impact on business performance than in the US. European companies are not as good as American ones in using IT to operate more efficiently and exploit market opportunities. According to Ovum, high levels of employment protection, inappropriate skills and the failure to integrate fully service sectors across the EU explain some of the inefficiency of ICT investment.

Meanwhile, the spread of new technologies across Europe remains uneven and patchy. More than half of all households in the old EU-15 now have an internet connection, and across the EU-25 the proportion rose from 43 to 48 per cent in 2005. However, there are large differences between the member-states. In Germany,

Luxembourg, the Netherlands, Sweden and the UK more than 60 per cent of all households have the internet, whereas, less than 25 per cent do in Greece, Hungary and Lithuania. In terms of progress, Latvia was the EU's top performer in 2005, with the number of households on the internet almost tripling during the year.

Most EU households still log on using slow and sometimes unreliable dial-up connections. The spread of broadband has been disappointingly slow. Only 23 per cent of households in the EU-25 had broadband access in 2005. The Netherlands and Denmark are the best performing EU countries, with 54 and 51 per cent, respectively. In Italy the use of broadband has finally taken off, helped by new government incentives. Many of the EU's newcomers made good progress, albeit often from very low starting points. Hungary, Latvia, Lithuania and Slovenia all managed to double the number of broadband connections in 2005. Ireland, on the other hand, continues to perform poorly, with less than 3 per cent of households using broadband in 2004 (2005 figures were not available at the time of writing). Greece is still the EU laggard, with just 1 per cent using it in 2005.

Another aspiration of the Lisbon agenda is to encourage governments to use the internet to offer cheaper, easier and more efficient services. According to the Commission, in 2004 roughly half of all government services in the EU-15 were available online, up from 45 per cent in 2003. The UN considers some EU countries world leaders in this respect: its 'e-government readiness report 2005' ranks Denmark second, Sweden third and the UK fourth, behind the US. Among the new EU members, Estonia come out best, in 19th place. Hungary and Latvia have also made considerable progress, but Poland has continued to fall behind in this area. Greece is the worst performer among the old member-states, and Lithuania within the EU-25.

Table 2: Percentage of households using a broadband connection

The best EU performers	2005
The Netherlands	54
Denmark	51
Belgium	41
Sweden	40
Luxembourg	39
EU-25	23

The worst EU performers	2005
Greece	1
Cyprus	4
Czech Republic	5
Slovakia	7
Hungary	11

Source: Eurostat

Capgemini, an IT consultancy, looked behind the figures to find out how e-government services differ in terms of scope and sophistication.[6] Some government websites only provide basic information, while others allow citizens to register their car or file their tax returns at the click of the mouse. In Sweden, 74 per cent of the services provided online can be entirely processed through the internet. So far, only one EU country – Denmark – allows its citizens and businesses to handle all basic government services online.

[6] *Capgemini, 'e-Europe: online availability of public services: How is Europe progressing?' web based survey on electronic public services, March 3rd 2005.*

EU governments need to look at the underlying reasons why some countries are so much better at using modern technology than others. Eurostat lists relatively low levels of educational attainment

and poor quality telecoms infrastructure as key obstacles to the spread of ICT.[7] Internet use is also clearly related to education and age. The vast majority of students and employees regularly use the internet, while just 18 per cent of pensioners have access to it. People with university degrees (or other tertiary education) are three times more likely to use the internet than those who have only been to secondary school. The Nordic countries and Germany have done most to close this so-called 'digital divide'.

[7] *Christophe Demunter, 'The digital divide in Europe', Eurostat, October 12th 2005.*

Information society	**B**
Heroes	**Denmark, Estonia, Sweden**
Villains	**Czech Republic, Greece**

A2. Research and development (R&D)

★ Agreement on the European Community patent

★ EU annual research and development spending to reach 3 per cent of GDP by 2010

The original objective of the Lisbon agenda was to turn the EU into a "knowledge-based economy". For this, EU leaders pledged to improve education, foster innovation and increase spending on research and development. In 2002, EU leaders set an overall target for R&D spending of 3 per cent of GDP, with the largest share of this (two-thirds) to come from private sources rather than government. Unfortunately, many member-states continue to under-perform in this area and there is little chance that the EU will meet its target by 2010.

At present, public and private investment is falling far short of national, let alone European, targets in most countries. Even if national targets were met, the Commission calculates that EU spending on R&D would only reach 2.6 per cent of GDP by 2010.[8] For the French government to meet its 3 per cent target by 2010, public spending on R&D would have to rise by 25 per cent, and that of the private sector by 70 per cent, which is unrealistic.

[8] *European Commission, 'Europe on the move: Working together for more growth and jobs', January 2006.*

The EU will continue to lag behind other major economies in this crucial area. Although the gap between the EU and the US has narrowed since 1999, it remains significant, amounting to around 0.6 per cent of GDP. More importantly, the reason why the gap has narrowed is that US investment has fallen, while EU spending has increased only slightly (from 1.94 per cent of GDP in 2000 to 1.97 per cent in 2003). Japan, on the other hand, increased its investment from an already high 2.99 per cent of GDP in 2000 to 3.15 per cent in 2003. China spent 1.3 per cent of its GDP on R&D in 2003, with spending rising ten times faster than the OECD countries since 2000.

Table 3: Spending on R&D, as a proportion of GDP

	1995	2000	2003
EU-15	1.88	1.94	1.97
US	2.49	2.7	2.59
Japan	2.69	2.99	3.15

Source: Eurostat

Some EU member-states already exceed the 3 per cent Lisbon target. Sweden devoted 3.74 per cent of GDP to R&D in 2004, and Finland 3.51 per cent. Four other countries – Austria, Denmark, France and Germany – spent more than 2 per cent of their GDP on R&D. By contrast, the performance of the Mediterranean countries is very poor: in 2003 Italy and Spain spent only 1.14 and 1.05 per cent respectively, while Greece devoted just 0.62 per cent.

The new member-states are even further away from meeting the EU target. Only the Czech Republic and Slovenia spent more than 1 per cent of their GDP on R&D in 2004 (with Slovenia mustering a respectable 1.6 per cent). Cyprus and Malta are the worst performers, with R&D spending at 0.37 per cent and 0.29 per cent of GDP respectively. In both Poland and Slovakia, R&D investment has actually declined since 1999.

While the overall numbers are worrying, the EU's record at encouraging private sector R&D spending is particularly disappointing. Although corporate profits have risen rapidly in recent years, European companies remain reluctant to invest in research and development. Across the EU, the private sector accounts for 54 per cent of R&D spending, well short of the EU's 66 per cent target and the current US share of 63 per cent. Again, there are significant differences between countries. Finnish companies accounted for 70 per cent of that country's R&D spending in 2003, and Germany and Sweden already meet the

EU's target. By contrast, British and French firms contributed only 44 and 51 per cent, respectively.

Not all EU companies are shy to invest in innovation. Germany's DaimlerChrysler led the world ranking in 2004, with R&D spending of €5.66 billion.[9] Of the world's top 50 companies in terms of R&D spending, 18 were based in the EU in 2004, compared with 17 in the US and 12 in Japan. Nevertheless, US companies continue to outspend their European counterparts: they accounted for 38 per cent of the R&D investment made by the 942 companies included in the EU scoreboard The EU share was 31 per cent. One of the main reasons for this gap is that the US is home to a much larger number of companies in R&D intensive sectors, such as IT hardware, biotechnology and software services. Among the companies included in the Commission's scoreboard, US firms accounted for 85 per cent of R&D investment in software and computer industries. Another source of concern is that a growing number of large EU firms are outsourcing their R&D activities abroad.

[9] *European Commission, 'Monitoring industrial research: The 2005 EU industrial R&D investment scoreboard', December 9th 2005.*

Capacity for innovation

Low business R&D spending in the EU is mirrored by Europe's poor performance in innovation. One way of measuring innovation is the number of patents filed by companies. In 2003, companies from the EU-25 filed 134 patents per million of the population at the European Patent Office (EPO), while US firms submitted 155 per million of the population. US companies are also more active when it comes to registering their innovations worldwide. They filed 54 so-called triad patents (registered simultaneously in Europe, the US and Japan) per million of population in 2003; the EU total was just 22. Alarmingly, in many EU countries, the number of patents filed at home and abroad has declined in recent years.

As with R&D spending, the Nordic countries lead in terms of innovation, while the Mediterranean ones and the new member-states

lag behind. However, as the Commission's 'innovation scoreboard' shows, there is not always a clear correlation between R&D spending and innovation.[10] For example, in Belgium and the Baltic countries, investment spending on new technologies and R&D generates low returns in the form of patents and exports of high-tech products. In contrast, Germany, Italy, Ireland and Luxembourg boast large numbers of patent applications relative to investment, which implies that their companies are making more productive use of the capital, technology and skills available to them.

[10] *Anthony Arundel and Hugo Hollanders, 'Innovation strengths and weaknesses', December 2005.*

The new member-states face especially acute challenges. The Commission estimates that it will take Malta, Poland and Slovakia some 50 years to reach the EU-25 average innovation performance. Hungary and Slovenia are improving faster, and could catch up by 2015.

Currently, foreign direct investment in mass manufacturing contributes significantly to the dynamism of the Central and East European economies. The assembly of cars or electronic goods does not require large investments in R&D or innovation. However, there are encouraging signs that large multinationals are starting to relocate R&D facilities to make use of these countries' highly skilled (and still relatively cheap) workforces.

The way forward?

The question of how to raise the EU's performance in terms of R&D and innovation is crucial for Europe's future competitiveness. European countries need to make several changes in order to catch up with US:

★ **Enhance the links between academic research and the private sector.** Progress will mainly depend on policy changes within individual EU countries, but the EU can also play a role. The Commission launched a 'regions of knowledge' initiative in

2005, aimed at fostering innovation at the regional level. It also proposed the creation of industrial clusters across Europe to help the exchange of best practice and networking among EU firms. The governments should also make it easier for researchers to move across the EU, and to leave university temporarily to work for businesses without undermining their academic career.

★ **Agree on an EU-wide patent system.** US companies spend €10,000 on average to obtain patent protection in the US. By contrast, an EU-wide patent costs €50,000, since companies have to hire lawyers and translators to file with the various national patent offices.[11] When there is litigation, EU companies have to defend their patent in courts in 25 countries, which may produce conflicting rulings.

[11] *European Commission, 'Second implementation report of the internal market strategy 2003-2006', 2005.*

★ **Improve the availability of finance for small companies and ease the regulatory burden they face.** Europe has plenty of small and medium-sized companies (SMEs), but they are less likely to grow into multinational firms than in the US. EU companies are often held back by a lack of financing opportunities, in particular venture capital. And they also suffer disproportionately from red tape and restrictive labour laws.

★ **Harness the EU to improve research and innovation.** The share of the EU budget devoted to R&D remains disappointingly small, and the way the Commission spends these funds is neither efficient nor effective. Therefore the EU's decision in 2005 to set up a European Research Council (ERC) is to be welcomed. This largely independent body will distribute funds according to a set of objective criteria and peer review.

★ **Compete for the best and brightest.** The US attracts the world's best researchers because it offers large research funds and cutting-edge facilities, as well as attractive salaries. The EU

needs to focus its money on the best and brightest if it wants to stop the 'brain drain' across the Atlantic. For this reason, the Commission's proposal to establish an elite technology institute, loosely modelled on the Massachusetts Institute of Technology in the US, is welcome. But the EU should only put this proposal into practice if it also makes available additional R&D money so that the new institute does not divert funds from the European Research Council or existing universities.

Research and development	C-
Heroes	Finland, Slovenia, Sweden
Villains	Greece, Poland

B. Liberalisation

B1. Telecoms and utilities

★ Increase competition in telecoms markets to reduce charges

★ Liberalise gas and electricity markets

The creation of the single market has been the EU's biggest contribution to its members' growth and prosperity. However, 20 years after the signing of the Single European Act, which provided the means to create the single market, it is far from complete. Barriers to cross-border trade and investment remain in too many sectors. And there are still significant differences in rules, regulations and prices between the member-states.

Telecoms has been a notable success story of the single market programme. All EU countries have either privatised their former telecoms monopolies or are in the process of doing so. National markets for fixed-line and mobile telephony have been opened to competition. Incumbents have been forced to grant access to bits of their network, in particular the 'local loops' – the wires that run from telephone exchanges into homes and offices.

Some members have moved much further and faster than others. Denmark and the UK are the best performers, followed closely by the Netherlands, Spain and Sweden. By contrast, Germany, Greece, Finland and Luxembourg have liberalised more slowly. In Greece, in particular, the former monopoly still handles 91 per cent of the local calls, 84 per cent of long distance calls and 76 per cent of international calls. Moreover, some of the new member-states have barely begun the process of opening their telecoms market to competition: in Cyprus, Hungary, Latvia and Slovakia, the incumbent provider retains almost 100 per cent of the market for local and long distance calls.

Overall, increased competition has driven down telephone charges, especially those for international calls. According to Commission data, the average price of a ten-minute call to the US has fallen from an EU-15 average of €3.10 in 2000 to €1.85 in 2004. Average prices of local and national calls have also declined sharply, the cost of a ten-minute national call in the EU-25 falling from €1.33 in 2000 to €0.87 in 2004. Again, progress varies widely among member-states, with those countries that have liberalised most often enjoying the steepest declines in charges. For example, the price of a national call in the UK fell by over 60 per cent in 2004, whereas charges for national calls have hardly changed in Latvia since 2000.

Meanwhile, the sector is consolidating rapidly as companies respond to intensifying competition in their home markets by expanding abroad. In October 2005, Spain's Telefónica made a £17.7 billion (all-cash) offer for O_2, a UK company with large operations in Britain and Germany. The prospective merger between Telefónica and O_2 would create the world's second-largest phone company by number of customers. Telefónica's bid for O_2 is itself partly a reaction to France Télécom invading its home turf in July 2005, when the French firm bought an 80 per cent stake in Amena, Spain's second-largest mobile company. There is plenty of potential for further deals. Telefónica and others have had their eye on KPN, a leading Dutch operator, while TDC, Denmark's leading phone company has attracted the attention of Deutsche Telekom and Swisscom.

However, despite fierce competition between mobile providers there are still examples of excessive pricing. For example, the cost of 'international roaming', which allows people to use their mobile phones abroad, remains exorbitant. According to Commission data, British tourists in Portugal pay about €5 for a four-minute peak-time phone call to the UK. Roaming charges vary but in this case would probably account for 40 per cent of the total cost. The EU has become increasingly frustrated at what it sees as unjustifiably high charges and poor tariff information for customers. In February 2006, Viviane Reding, the European commissioner for information society

and media, proposed capping overseas roaming costs at the level of a cross-network call. Such a move would provoke opposition, not only from the industry but also from fellow commissioners who believe that market competition should deliver lower prices, not Brussels' intervention.

Slow progress on energy liberalisation

In contrast to telecoms, progress in energy market liberalisation has been painfully slow. It was only in 2002 that EU leaders finally agreed to allow competition in national markets, after overcoming long-standing opposition from France and Germany. EU members promised to open their electricity and gas markets for business customers by July 2004, and for all consumers by July 2007. All EU countries have agreed to set up an energy regulator and to provide transparent tariffs for those wishing to use the transmission system.

Electricity prices are much lower in real terms across the EU than they were in 1997, but the pace of liberalisation has varied enormously between member-states. Copenhagen Economics, a consultancy specialising in economic analysis, reports that Denmark, Finland, Sweden and the UK are the leaders in market opening, while Greece, Ireland and Luxembourg form the rearguard. The national monopoly still retains 100 per cent of the market in Cyprus and Malta. Gas markets present a similar picture. Prior to 2000, among the old EU member-states only the UK and Ireland had opened their gas markets to competition, but now all EU member-states have started the liberalisation process. While the UK market is already fully open, Greece and Portugal have done the least to remove barriers to competition.[12]

[12] Copenhagen Economics, 'Market opening in network industries, part II: Sectoral analysis', September 2005.

Nordic and British businesses have paid lower prices for gas and electricity over the past decade than most of their European counterparts, and three of the six largest energy providers in the UK are foreign-owned. By contrast, the French market has barely

been opened to competition: Electricité de France (EDF) still controls 86 per cent of it. In 2005 Enel, Italy's dominant electricity company, was allowed in, but only after months of horse-trading over EDF's 2003 investment in Edison, an Italian group. Italy has gone further than France in opening its market to outsiders, although the Italian government still owns 30 per cent of Enel and Eni, Italy's major oil company.

Europe's energy market largely remains a collection of national markets, as the marked absence of price convergence illustrates. For instance, in 2005 electricity for households in Luxembourg was more than twice as expensive as in Greece. The level of cross-border trade remains low: in 2004 cross-border flows of electricity stood at around 11 per cent of total consumption – an increase of only around 2 percentage points compared with 2000.[13] With the exception of the UK, few customers have switched from one power supplier to another, and fewer still have chosen a new supplier from a different member-state.

[13] *European Commission, 'Report on progress in creating the internal gas and electricity market', November 15th 2005.*

The slow pace of market opening has several causes. First, infrastructure constraints continue to impede cross-border energy flows. Interconnections between national electricity grids do not have enough capacity to transport electricity efficiently across Europe. The EU target is that interconnections should be able to carry at least 10 per cent of national consumption, but only few countries have that capacity. Big national companies, often active in both supplying energy and running networks, have few incentives to invest in interconnections that would augment competition in their home markets.

In the gas market the barriers are more legal than physical. National monopolies often control transit pipes. They may try to lock competitors out of the market by signing long-term contracts with regional distributors, or in some cases taking direct control of distributors. For instance, E.ON used to sign contracts for 15 years

or more with regional distributors, until Germany's Cartel Office forced it to limit its new contracts to two or four years. According to the Commission, existing contracts signed by incumbents will last on average until 2020, giving only very limited access to transit pipes to new entrants. Access to storage capacity is equally restrictive, with new entrants finding it very difficult to obtain information about availability.

A second reason for Europe's failure to liberalise is state intervention, motivated by a determination to build 'national champions'. France and Germany in particular have done the bare minimum to ensure compliance with EU legislation, while strongly supporting their electricity and gas giants – EDF and Gaz de France (GDF) in France, and E.ON and RWE in Germany. Political intervention is made easier by the weakness of national regulators in some countries, like Germany or Spain. Indeed, the German government ignored a ruling by the country's Cartel Office against a takeover of Ruhrgas by E.ON in 2002. This deal created a vertically integrated group with an impregnable position in the German market. Similarly, the Spanish government has backed Gas Natural's offer for Endesa, despite the opposition of Spanish antitrust authorities.

A third reason, directly related, is the high degree of concentration in Europe's energy markets. Slow market opening has left former power monopolies entrenched in the largest EU markets, while consolidation is creating new European energy giants. Mergers between gas and electricity companies have resulted in new 'dual fuel' companies that further impede competition. Mergers between Electrabel and Distrigas in Belgium, Enel and Camuzzi in Italy, are good examples of this trend.

Moreover, as the July 2007 deadline for the full liberalisation of EU energy markets approaches, the sector is experiencing a new wave of consolidation. In February 2006, E.ON bid €29 billion to take over Endesa. At the same time, Italy's Enel launched a takeover bid for Suez, a move that so concerned the French

government that it engineered a merger of Suez with Gaz de France. These moves may signal the emergence of a superleague in Europe's liberalising energy market, led by a few national champions such as E.ON, EDF and Enel.

This new wave of mergers runs counter to the Commission's efforts to increase competition in energy markets. Frustrated with the slow progress of market opening, the Commission has stepped up pressure on the member-states to comply with EU legislation. In March 2005, it took Belgium, Germany, Greece, Latvia, Luxembourg and Spain to the European Court of Justice for failing to implement the electricity directive. The Commission also launched an investigation into higher prices and the lack of choice for consumers. In a report published in February 2006, it argues that there are serious problems in the EU's energy markets that will require action from competition authorities.[14] The Commission has threatened that it would launch antitrust investigations against individual companies. It could also sue some countries for failing to abide by EU laws.

[14] *European Commission, 'Sector inquiry under article 17, regulation 1/2003 on the gas and electricity markets', preliminary report, February 16th 2006.*

Meanwhile, high energy prices and concerns about security of supply have fuelled calls for a common EU response. At the 2005 Hampton Court summit, Tony Blair, as president of the European Council, called for an EU energy policy. Such a policy would require genuinely open energy markets across the Union, co-ordination of national stocks, and co-operation in ensuring diversity of supplies from outside the EU. Governments would have to make sure that national regulators have the powers to enforce competition rules. The EU would also have to identify the missing links between national markets and design a roadmap to create a true European grid.

Telecoms and utilities	C+
Heroes	Sweden, UK
Villains	Greece, Portugal, Slovakia

B2. Transport

★ Increase competition in the railway sector

★ Create a single European sky

European countries are slowly opening up their transport sectors to greater cross-border competition. A more efficient transport system would help the EU to fulfil its economic, social and environmental Lisbon targets. Transport contributes up to 10 per cent of the EU's GDP, employing around ten million workers.[15] It is directly responsible for nearly a third of the Union's entire energy needs and generates 28 per cent of Europe's greenhouse gas emissions.

[15] *European Commission, 'Energy and transport, report 2000-2004', 2004.*

Rail

EU member-states started to open up their rail sectors in the 1990s, but since 2000 the liberalisation process, in particular in the passenger sector, has almost come to a halt.[16] In the UK and Sweden, liberalisation has gone furthest and passengers can already choose between different rail companies on some routes. In Greece and Ireland, on the other hand, the railways are still run as monopolies. These two countries are the laggards when it comes to opening rail freight markets while Denmark, Germany, the Netherlands and the UK have made significant progress.

[16] *Copenhagen Economics, 'Market opening in network industries, part II: Sectoral analysis', September 2005.*

Railways in the new member-states have undergone significant change, yet nearly all remain state-owned and require massive investment to bring them up to EU standards. Estonia has moved the furthest: in 2001 it sold its entire rail network to an international consortium of investors, which has invested heavily in upgrading the country's rail infrastructure. Poland, which has by far the largest rail network of the new member-states, has done little.

Since 2000, EU governments have passed two 'railway packages' designed to open up rail services and increase cross-border competition. Member-states are committed to separating the ownership of rail infrastructure from operations in order to allow for more competition – a process known as 'unbundling'. They are also supposed to open up national freight services to competition from 2006, and establish a European railway agency to oversee international services. So far, progress towards meeting these commitments has been very slow.

In December 2005, EU governments agreed to increase competition for international rail passenger services by 2010. This will also allow trains from one EU member-state to pick up and set down passengers at stations located in another member-state, a practice known as '*cabotage*'. This means that services such as Thalys and Eurostar could face competition on key cross-border routes.

Ports

The European Parliament has twice voted against Commission proposals to open port services to greater competition, in 2003 and again in January 2006. The latter decision followed violent protests in Strasbourg by dockers from across the EU. The Commission's draft directive would have abolished existing monopolies on cargo handling, and allowed shipping firms to appoint private contractors to unload vessels. It would also have opened the way for the crews of vessels to load and unload their cargo, speeding up turnaround times in the process. Left-leaning MEPs opposed these plans on the grounds that they could lead to job losses and a lowering of safety standards in European ports. Many centre-right MEPs, on the other hand, were concerned that the amended proposal did not go far enough in liberalising services. The EU transport commissioner, Jacques Barrot, has promised to take into account the MEPs' concerns when redrafting the Commission's proposal. However, he must find a way of doing this while addressing the acute shortage of port capacity across the EU, and the lack of transparency over port practices and fees.

Air travel

The liberalisation of air transport has gone much further than that of rail and port services. Since 1997 any airline registered in an EU country (plus Iceland and Norway) can carry passengers within any other EU member-state. The result of this deregulation has been a dramatic increase in competition, symbolised by the rise of low-cost airlines such as EasyJet, Sky Europe and Ryanair.

One area where liberalisation has been slower is transatlantic air travel. The routes between Europe and the US are already among the busiest in the world, generating revenue of €18 billion a year. But the Commission estimates that fully opening up transatlantic air travel could increase passenger numbers by up to a quarter.

Some EU countries have concluded bilateral agreements with the US on mutual access to their respective airports. However, these deals are imbalanced because American carriers can fly from anywhere in the US to European cities, while a European carrier can only fly from its home base. European carriers are not allowed to transport passengers between different cities in the US. Moreover, since these deals favour airlines from signatory countries, they inhibit the integration of the European airspace.

In 2002 the European Court of Justice declared parts of the bilateral deals illegal. As a result, member-states asked the Commission to start negotiations with the US on behalf of the whole EU. However, national vested interests have slowed the pace of negotiations. Britain in particular has sought to defend the privileges enjoyed by airlines based at Heathrow, Europe's busiest airport. Currently only four airlines – British Airways, Virgin Atlantic, United Airlines and American Airlines – are allowed to fly between Heathrow and the US.

Eventually, in November 2005, the EU and the US struck a preliminary accord that could provide the basis for a settlement. The US no longer insists that European airlines can only fly to the US

from their home countries, which means that French or German airlines would soon be able to fly to America from Heathrow. However, some obstacles remain to a final agreement. EU governments want the US to abolish a rule that currently limits foreign ownership of US airlines to 25 per cent of voting rights. The US Congress, which would have to approve such a change, cites national security concerns as a reason to rule out foreign ownership of a major US airline. The stakes involved in this agreement go beyond the liberalisation of transatlantic travel. An eventual EU-US deal would most likely be followed by the consolidation of the sector into a small number of cross-border giants.

Infrastructure improvements

Plans for the upgrading of transport infrastructure also form part of the Lisbon agenda. A decade ago, the EU agreed on 14 priority 'trans-European networks' (TENs). To date, only three of these projects have been completed: the bridge/tunnel link between Denmark and Sweden, a high-speed train between Brussels and Marseille, and Malpensa airport in Northern Italy.

Lack of money is the main reason why the TENs have fallen behind schedule. In 2005, EU government spending on transport infrastructure amounted to less than 1 per cent of GDP. In an attempt to attract more private finance, the Commission has developed new rules for public-private partnerships, including the provision of loan guarantees to cover some of the risk for investors. It is also reviewing procurement rules to make it more attractive for businesses to invest. In 2005 the Commission appointed six European co-ordinators to help raise finance, consult with local authorities, NGOs and transport users, and report annually on the progress made in implementing the project.

However, even if the Commission does succeed in attracting more private investment for pan-European projects, progress on completing trans-European networks will continue to be undermined by insufficient public investment in transport infrastructure.

Transport	C+
Heroes	Denmark, Germany, the Netherlands
Villains	European Parliament (for the port services directive), Greece, Poland

B3. Financial and general services

★ Complete the financial services action plan by 2005

★ Create a single market in services

Services is the most important sector of the EU economy, accounting for 68 per cent of EU GDP. Over the last three decades, the services sector has created most new jobs, as employment in industry and farming has declined. Today, services businesses employ 70 per cent of all workers in the EU. However, unlike in goods, the EU has not yet created a fully integrated European services market: services account for only a fifth of intra-EU trade. The lack of competition is one reason why productivity growth in the EU services industry has lagged behind that of the US.

A well-functioning financial services sector is of particular importance for the European economy. It ensures the efficient allocation of capital, mobilises savings and helps to discipline management. Easy access to capital is also essential for new and innovative businesses to succeed.

At their Lisbon summit in March 2000, EU leaders signed up to an ambitious programme to create a single market in financial services by 2005. The financial services action plan (FSAP) was an attempt to reduce the legal obstacles which prevent financial businesses – ranging from retail banks to insurance companies and stock exchanges – from selling their products and services across the EU. On paper, the FSAP has been a notable success, with agreements reached on virtually all the plan's 42 measures within the five-year deadline.

However, a fully integrated single market in financial services is still far from reality. While the EU has made good progress in establishing a cross-border legal framework for the wholesale markets, such as securities, the retail market remains highly

fragmented. In a white paper from December 2005 the Commission emphasised the need for consolidation over the next five years, rather than a new raft of legislation, stating that it will only take action on a "carefully targeted, evidence based, bottom-up" basis. This approach takes into account the fact that EU governments and financial businesses still need time to implement and digest previously agreed measures. However, it does not mean that financial services are slipping down the EU agenda.[17] Action is still needed in a number of areas:

[17] *Alasdair Murray and Aurore Wanlin, 'The EU's new financial services agenda', CER working paper, February 2006.*

★ **Retail banking**

The EU's success in integrating wholesale financial markets has not been matched by progress in the retail sector. For example, Italians have to pay average charges of €252 a year to hold a current account. By contrast, in the UK and Belgium, annual costs are below €70, and Dutch customers pay as little as €34 a year.[18] Some caution should be exercised – consumers use current accounts in very different ways – but it is clear that more competition would benefit consumers through cheaper prices and greater choice.

[18] *Capgemini, 'World retail banking report 2005', March 2005.*

As a result of the high degree of political sensitivity aroused by moves to liberalise retail banking services, the Commission is wary of using 'one size fits all' directives. Charlie McCreevy, the single market commissioner, has made clear that he would prefer to find non-legislative methods of forging a single market in retail financial services. In particular, the Commission is looking at using competition policy to encourage greater market integration. It has launched an investigation into the application of competition rules in financial services, to find out to what extent regulatory obstacles and market collusion are preventing new entrants from competing for retail business. The Commission has also promised to take a closer look at establishing common rules for retail products, such as loans and mortgages.

★ **Single payments area**

National payments systems in the EU differ greatly in terms of their legal basis, technical standards, business practices and payment instruments. As a result, consumers face many extra costs and obstacles to cross-border payments. For example, some transactions that are standard at the national level, such as direct debits, are not always available across borders.

Under some pressure from the Commission, in 2002 the EU's banking associations promised to develop a eurozone payments infrastructure, with common standards and products, by 2010. However, progress towards this goal has been extremely slow, prompting the Commission to publish a draft directive in December 2005, calling for the establishment of a common legal framework for all electronic payments. The directive would apply to all member-states and is designed to provide the legal foundations for a single payments area. It would ensure that businesses other than banks have access to a new cross-border payments system and can compete for consumers.

★ **Investment funds**

The Commission has also started a review of the legal framework for retail investment funds, or UCITS in EU jargon (Undertakings for the Collective Investment of Transferable Securities). Existing legislation has so far failed to create a single market in this area: funds still need to be registered in every member-state where they are sold. Moreover, national tax rules often prevent the cross-border mergers of funds, which would help achieve greater economies of scale and cut management costs.

The EU needs to revise the current rules in a way that encourages greater cross-border competition and removes regulatory impediments to cross-border mergers. In the green paper it published in July 2005, the Commission proposed several steps to

improve the current framework, such as clarifying the definition of the assets acquired by UCITS and simplifying the notification procedure for transferring funds across borders. It is also working closely with the Committee of European Securities Regulators, to forge a consensus on common enforcement practices to improve transparency in the market. Financial firms have broadly welcomed these ideas, and the Commission now needs to bring forward concrete measures to foster a competitive and stable environment for European investment funds.

★ Slow consolidation

There have been few major cross-border mergers or takeovers in the banking section. Cross-border mergers and acquisitions accounted for just 20 per cent of total mergers and acquisitions (M&A) activity in the financial services sector between 1999 and 2004. In other business sectors, the share of cross-border M&A are more than twice as high, an average of 45 per cent. The largest to date has been Banco Santander Central Hispano's €12.5 billion purchase of Abbey National, the UK's sixth largest bank, in 2004. There have also been a large number of foreign acquisitions in the new member-states, where typically 80 per cent or more of total banking sector assets are foreign controlled.

The relative lack of cross-border activity partly reflects the reluctance of banks to enter markets they are unfamiliar with. However, it is also due to large parts of Europe's retail sector remaining protected from takeover. For example, around half of Germany's banks are publicly or mutually owned, and some member-states continue to use consumer protection or prudential banking rules to obstruct foreign takeovers or the launch of new products. There have even been cases of political or administrative interference, to keep local banks out of foreign hands. In 2005, for example, Italy's central bank governor, Antonio Fazio, had to resign after it was revealed that he had actively favoured an Italian bank over a Dutch one during a takeover battle for an Italian bank. In

some countries, cross-border consolidation has led to unforeseen problems. In Poland, for example, the government sought to block the merger of two local banks after their foreign owners (Italy's UniCredit and Germany's HVB) had merged. In February 2006, Poland launched a legal challenge to the European Commission's decision to approve the merger of UniCredit with HVB.

The services directive as a test case

In contrast to the financial sector, the EU has made very little progress in liberalising trade in other services. National rules and regulations still often prevent companies – ranging from IT consultants to lawyers and building contractors – from offering their services outside their home country. Spain, for instance, has 700 laws governing restaurants, and France has 12 for taxis. In 2004, the then internal market commissioner, Frits Bolkestein, proposed a new directive to liberalise services across the EU. According to estimates from the Commission, such liberalisation would increase EU GDP by 1.8 per cent and create 2.5 million new jobs.

However, the 'Bolkestein directive' became highly divisive, with businesses and economic liberals defending the initiative against heavy criticism from the trade unions and centre-left parties. The UK, the Netherlands and most of the new member-states are in favour of wide-ranging liberalisation, while Germany, France, Austria and other eurozone countries have been far more sceptical. In the ensuing national debates, the issue of services market liberalisation has become entangled with the more politically charged question of the free movement of labour in the enlarged EU.

The directive's opponents are particularly concerned about the 'country of origin' principle that would allow a company to offer services across the EU on the basis of the rules and regulations of its home country. This principle, the critics argue, would open the door to 'social dumping', a politically charged term for low-cost

competition. They fear that a 'race towards the bottom' in employment rules and social standards could undermine the more generous social models of some West European countries. Therefore, in many ways, the services directive has become a test case for the EU's ability to continue its liberalising agenda after enlargement.

After months of heated debates, at times accompanied by street protests, a compromise was reached in February 2006, when the European Parliament backed a timid version of the directive. If accepted by the Commission and the EU members in its current form, this will remove as many as 65 widely encountered national barriers to the cross-border trade in services. In particular, businesses would be able to offer their services in a different EU country without having to open a local office or register with the national authorities. However, MEPs removed the controversial country of origin principle from the draft, and they also decided to exempt a number of sectors, including social services, temporary work agencies, taxis and casinos. Moreover, the new draft gives national governments leeway to restrict services providers on grounds of public policy, security or public health, or for environmental reasons.

Although the potential economic benefits would be much less significant than under the Commission's original plan, the parliament's compromise should make it easier for service providers to do business across Europe. If this compromise marks the beginning of an incremental liberalisation of the service sector it will do some good. However, the risk is that subsequent attempts to liberalise further will be fiercely contested, making progress very slow.

Financial and general services	**C-**
Hero	**European Commission**
Villains	**Italy, Poland (financial services)**

C. Enterprise

C1. Business start-up environment

★ Develop a programme to support enterprise and entrepreneurship

★ Develop and implement a European charter for small businesses

In developed economies, small and medium-sized enterprises (SMEs, defined as companies with less than 250 employees), typically provide two-thirds of employment in the private sector and create most of the new jobs.[19] Making it easier for entrepreneurs to establish and expand enterprises is therefore an integral part of the EU's agenda for growth and jobs.

[19] *OECD, 'OECD SME and entrepreneurship outlook', 2005.*

However, burdensome regulations and a lack of access to suitable finance continue to deter budding entrepreneurs in many EU countries. Existing SMEs in Europe tend to be less dynamic and create fewer jobs than their American counterparts. For instance, in Portugal, which has one of the most heavily regulated labour markets, a business is 40 per cent less likely than an American one to create jobs during an economic upturn. The Global Entrepreneurship Monitor (GEM) found that, between 2000 and 2004, only 11.4 per cent of Europe's start-ups planned to hire at least 20 people in the next five years, compared with 17 per cent in the US. This discrepancy is the result of numerous factors, including cumbersome and costly administrative procedures, high taxes and licensing fees, and restrictive labour market regulation.

However, in recent years, national governments, in particular in the new member-states, have adopted a raft of reforms aimed at making it easier to create and run a business. According to the World Bank's 'Doing business' database, Denmark is the easiest place to do business in the EU, followed by the UK, Ireland, Finland and Sweden; Greece is the most difficult.[20] The Baltic countries are the best performers among

[20] *World Bank, 'Doing business 2006', 2006.*

the new members, with Lithuania and Estonia following Sweden in the World Bank's ranking of EU countries.

All EU member-states are taking steps to encourage business start-ups, and many have already made significant progress in reducing the time and cost of setting up a new business. According to the World Bank, it now takes less than two weeks to start a company in Denmark, Finland, France, Italy and the Netherlands, and just three weeks in Germany. By contrast, it can take up to 60 days in Slovenia and 54 days in Portugal. In 2004, Slovakia managed to cut the start-up time by 80 days to just 25, through imposing limits on the amount of time it takes to issue trade licences and simplifying the tax registration.

Moreover, the cost of starting a business varies from nothing in Denmark to several thousand euro in Greece. In many member-states, entrepreneurs also have to deposit cash in a bank before being granted permission to establish a business. Poland is the EU country that requires the highest amount relative to average per capita incomes (220 per cent). However, competition from other countries – Ireland and France require no capital to be deposited, and in the UK the sum is a nominal £1 – is forcing governments elsewhere in the EU to speed up the pace of reform in this area. For example, the German government has proposed cutting the deposit from €25,000 to €10,000, in response to the rising number of German businesses registering abroad.

Complex and costly bankruptcy proceedings also often deter people from setting up their own company, or to have another try after a failure. Traditionally, bankruptcy procedures across the EU have been creditor-friendly, with the result that potentially viable European companies have been less likely to survive than their American counterparts. But this is now changing. A number of EU governments, including those of Italy, Portugal and the UK, have recently relaxed their bankruptcy laws, with the aim of achieving a better balance between the rights of borrowers and creditors. Many

others, however, need to relax their rules. For example, it takes up to nine years in the Czech Republic to execute bankruptcy procedures, while bankrupt companies in Lithuania can face criminal penalties even where there is no suspicion of fraud.

One of the underlying problems in the EU is that Europeans tend to be less entrepreneurial and more risk averse than Americans. Most member-states are therefore introducing business education in schools, to foster knowledge about how to do business. For example, the UK is providing five days of entrepreneurship lessons to all children aged 14 to 16. The Spanish government has plans to teach pupils of all ages about entrepreneurship and how to cope with business failure. And the Netherlands is introducing so-called 'incubators' in schools that will provide information about starting a business.

The EU is also looking at ways of easing the regulatory, administrative and tax burden facing SMEs. For example, the Commission is encouraging member-states to introduce a VAT exemption for companies with a turnover of less than €100,000 a year. It has also proposed a 'home state taxation' rule, under which SMEs with a subsidiary or branch in another member-state could file just one tax return in their home country. EU legislation is now often tailored towards the needs of small companies. For example, the Commission is introducing longer transition periods or simple reporting requirements for SMEs in its new legislative proposals.

The availability of finance is a perennial problem for European start-ups, in particular for high-tech firms that cannot offer anything but their intellectual capital as collateral to potential investors. In the late 1990s, the venture capital industry expanded rapidly across the EU, driven by the optimism of the dot.com boom. But since then, the industry has stagnated in many countries. The Nordic countries and the UK already have well developed venture capital sectors, but in many member-states the sector barely exists. For instance, in 2003, venture capital represented 0.081 per cent of GDP in Sweden,

compared with 0.001 in Czech Republic and 0.002 per cent in Slovakia. In a move aimed at boosting the sector, Denmark, Ireland and the UK have followed the US example and allowed pension managers to invest in venture capital funds.

Business start-up environment	**B**
Heroes	**Denmark, Estonia, UK**
Villains	**Czech Republic, Greece, Poland**

C2. Regulatory burden

★ Simplify the EU's regulatory environment to reduce the burden on business

★ Member-states to implement 98.5 per cent of all single market legislation by 2002

Business organisations are increasingly vocal about the damaging impact of poorly framed and cumbersome EU rules on the European economy. Companies have repeatedly criticised EU initiatives, ranging from financial services legislation to rules on working time, for increasing compliance costs and undermining their ability to compete in a global market. Smaller companies, in particular, find compliance with many European and national regulations costly and time-consuming.

The Commission has sought to respond to these criticisms in various ways. It has vowed to respect the subsidiarity principle, which demands that the EU should only make rules which add value, when compared with national or local decision-making. Since the beginning of 2005, the Commission has undertaken an impact assessment study of each major legislative proposal, and it has promised to ensure that new legislation is fully consistent with existing rules. To show that it is serious about cutting red tape, the Commission scrapped 68 pending proposals in October 2005, withdrawing, for example, planned directives on the labelling and advertising of foodstuffs, on limits to using lorries over the weekend, and on protecting workers from optical radiation. It has also published plans to simplify, repeal and rewrite over 220 EU laws over the next three years, and to introduce more 'sunset' clauses into its legislation (these would trigger the repeal of a law after a set period unless the EU agrees to renew it).

However, EU governments will have to follow the Commission's example if the fight against red tape is to be successful, since most of the regulations affecting businesses are national, not European.

Most member-states have already made significant progress in improving the business environment, for example through consulting more with businesses; curbing red tape; making rules for SMEs more flexible; and using the internet to help companies to obtain information and deal with government bureaucracies (Section A1). According to the OECD, many EU governments, led by the UK and the Netherlands, now conduct impact assessments, consult businesses before introducing new regulations, and provide assistance to SMEs in meeting their regulatory requirements.[21]

[21] *OECD, 'OECD SME and entrepreneurship outlook 2005', 2005.*

The UK has spearheaded the EU's better regulation campaign, especially during its presidency in the second half of 2005. Better regulation has also become a domestic priority for the British government. Each government department now has a regulation minister and a better regulation unit. Impact assessment and a 12 month consultation period are mandatory for any major new legislative proposal. The British Small Business Service is a good example of how to safeguard SME concerns in the regulatory process. The UK 'think small first' initiative, originally aimed at making the UK the easiest place to start a business in Europe, and the government's Better Regulation Commission, are proving particularly efficient. The think small first initiative brings together all the government's services for small businesses to make them more consistent, simple and affordable.

However, many EU countries need to reinforce their efforts in this area. The Commission is especially critical of the quality of business regulation in France, Portugal, Slovenia and Slovakia. In 2004 only seven countries tested the impact of new legislation on small enterprises and few countries reviewed the impact of existing legislation.[22] Indeed, a number of member-states are suspicious that the better regulation agenda covers a hidden agenda for deregulation. In particular, the Commission's decision to repeal several draft directives revived

[22] *European Commission communication, 'Report on the implementation of the European charter for small enterprises', 2005.*

fears in France that the fight against red tape could undermine the *acquis communautaire*.

The EU's better regulation agenda is not only about curbing red tape. Businesses cannot take full advantage of the single market if key legislation is not properly implemented throughout the EU. It is crucial that member-states implement EU legislation in a timely and efficient manner. EU governments promised to transpose (that is, write into national law) 98.5 per cent of single market legislation by March 2002. Although better progress was made in 2005 than 2004, they have not yet met this target.

The Commission's most recent 'internal market scoreboard' shows that the transposition deficit in the EU-25 narrowed from 3.6 per cent in 2004 to 1.9 per cent in 2005. The deficit was slightly higher in the EU-15, at 2.1 per cent, the second best result since monitoring started in 1995. The better performance of the new member-states probably reflects their recent experience in adopting the EU's *acquis* under heavy time pressure in the run-up to accession. Five new member-states have reached the 1.5 per cent target, compared with six countries from the old EU-15. Denmark was the best performer among the EU-15, while Germany and Malta made the most progress. Greece, Italy and Luxembourg are the worst performers, with Italy's backlog increasing significantly in 2005.

Regulatory burden	**B+**
Heroes	**Lithuania, UK**
Villains	**Greece, Italy, Portugal**

C3. State aid and competition policy

★ Promote competition and reduce subsidies to industry

★ Overhaul state aid rules and make them accessible to SMEs

An effective competition policy is vital to the long-term competitiveness of the European economy. Competition increases incentives for firms to reduce costs, cut prices, and improve the quality of their products. The reallocation of resources from less to more productive firms benefits not just consumers through lower prices and better products, but also businesses which gain from greater competition between suppliers.

Over the last year, the European Commission has taken a tough stance on competition policy, launching investigations into retail banking, mobile phone roaming charges, and energy and gas markets. The EU has also worked hard at modernising its competition and state aid rules. Reforms that came into effect in 2004 have allowed the Commission to focus its resources on the most important competition cases. For example, businesses no longer have to notify the Commission of the many routine agreements that they sign with competitors, such as supplier deals or joint ventures. Also, companies can now call upon the Commission to review a proposed merger where the regulatory bodies of three or more member-states are involved. In response to criticism that it pays excessive attention to market share when deciding whether to approve a merger, the Commission now also analyses how the planned merger would affect prices.

Competition is undermined not only by the exercise of monopoly power or price collusion between companies, but also by state subsidies. In 2005, the new Commission began to update the EU's state aid rules. In June it put forward a state aid action plan that proposed a comprehensive reform of rules and procedures over the next five years. It wants national governments to limit their use of state aid to cases that would boost the competitiveness of the EU

economy.[23] The current EU rules limit state aid to a maximum of €100,000, except for support of R&D, regional development, the environment, and training – 'block exemptions' in EU jargon. The Commission is proposing to amend these rules to enable member-states to provide greater support for SMEs.

[23] European Commission, 'State aid action plan, less and better targeted state aid: A roadmap for state aid reform 2005-2009', 2005.

The Commission argues that state aid should be focused on start-ups, improving the availability of risk capital and supporting businesses that launch innovative new products.[24] It is planning to change its rules governing state aid for R&D to encourage cross-border co-operation and public-private partnerships. It intends to make rules for risk capital more flexible in an effort to improve the availability of finance for start-up companies. The Commission will also set out procedures for notifying state aid simpler, quicker and more transparent. It is considering calling for the creation of independent authorities in each member-state to enforce state aid decisions and recover illegal aid.

[24] European Commission, 'Consultation document on state aid for innovation', 2005.

Overall, the EU still has much work to do to reduce state aid and ensure that resources are targeted on the priorities of innovation and R&D. Much will depend on national governments making greater efforts. Member-states are committed to reducing the overall level of industrial subsidies, but have made very little progress over recent years. The Commission's state aid scoreboard shows that EU member-states have spent the same amount of state aid in 2002-2004 as in 2000-2002.[25] State aid accounted for €62 billion, or 0.6 per cent of EU-25 GDP in 2004.

[25] European Commission, 'State aid scoreboard – autumn update', December 2005.

However, there are wide disparities among EU countries. Finland, which heavily subsidises uneconomic agriculture in the north of the country, pays out proportionately the most aid, at 1.7 per cent of GDP. Poland and Cyprus follow closely, with around 1.5 per cent of

GDP. Greece and the UK granted the least, at 0.3 per cent of GDP. Cyprus, the Czech Republic, Ireland and Malta have made most progress in reducing aid. By contrast, France significantly increased the levels of subsidies, largely as a result of the cost of restructuring the engineering group Alstom.

Although the absolute level of state aid provided by national governments remains high, it should be noted that they are shifting subsidies towards 'horizontal' goals such as protecting the environment, boosting R&D and providing assistance for SMEs (horizontal aid does not favour particular companies or sectors). Between 2002 and 2004, the EU-25 spent 68 per cent of state aid on horizontal goals, compared with 64 per cent between 2000 and 2002. By 2004, 76 per cent of all subsidies went on horizontal objectives, with spending on environmental goals having risen sharply.

A number of member-states have also introduced laws to ensure that the use of state aid remains a second-best option. Sweden, for instance, established the so-called 'restraining' principle, meaning that financial support cannot be a first choice solution to help an industry. Slovakia designed a 'competitiveness strategy', adopted in early 2005, to ensure that the state intervenes only to the extent necessary to address a market failure. For its part, Cyprus is in the process of assessing the efficiency of all existing and new state aid schemes.

Recently, the Commission's tough stance on competition policy appears to have triggered a backlash in several member-states. In December 2005, the French government introduced a new law designed to protect companies in 11 'strategic' sectors from foreign takeovers. The list ranges from research and the production of chemicals that could be used in terrorist attacks to casinos – which the government fears could be used to launder money. After unsuccessfully calling on the French government to revise the law (which directly contravenes EU competition guidelines) the Commission is threatening to take France to the European Court of Justice.

State aid and competition policy	**B-**
Heroes	**Czech Republic, Sweden, UK**
Villains	**France, Poland**

D. Employment and social inclusion

D1. Bringing people into the workforce

★ Raise the overall workforce participation rate to 70 per cent by 2010

★ Raise the participation rate for women to 60 per cent by 2010

★ Raise the participation rate of older workers to 50 per cent by 2010

Economic reform in the EU will be judged a success if Lisbon's employment targets are met. According to the OECD, the main reasons why GDP per head in countries such as France and Germany lags behind the US are lower employment rates and shorter working hours.[26] Productivity per hour in these countries is roughly comparable to the US – although it has started to diverge in recent years, as the rate of growth in US productivity has accelerated.

[26] *OECD, 'Going for growth, structural policy indicators and priorities in OECD countries', 2005.*

Many EU countries are not making full use of their labour forces. In 2004, only 63.3 per cent of the EU's working age population was in employment, only a marginal improvement on the previous year (62.9 per cent in 2003). This suggests that the Lisbon target of 70 per cent by 2010 will not be met. According to the Commission, EU countries would have to create around 20 million jobs by 2010 to reach this target.[27]

[27] *European Commission, 'Draft joint employment report 2004-2005', January 2005.*

The EU also continues to lag badly behind the US and Japan, where employment rates stood at 71.2 per cent and 68.7 per cent respectively in 2004. Some EU countries, notably Denmark, the Netherlands, Sweden and the UK had already met the employment

target in 2004 – and even exceeded US levels. By contrast, Italy's remained the lowest in the EU-15, at just 57.6 per cent.

The picture is even worse in many of the new member-states, where employment rates are generally below those found in the old EU. In 2004, only the Czech Republic and Slovenia came close or matched the EU-15 average of 65 per cent. In Poland, only around half of all people of working age have a job in the formal economy. At least the downward trend has been reversed, and most of the new members record stable or rising employment rates. Foreign investment and small enterprises are driving job creation. But both tend to cluster around fast-growing urban areas in the western parts of the new Central and Eastern European members. Meanwhile, in rural areas and declining industrial heartlands, unemployment remains stuck at extremely high levels. Inflexible housing markets and inadequate transport make it difficult for workers to move to where job opportunities are better. And foreign investors rarely venture into the eastern parts of the new member-states, where infrastructure and education levels are often poor. [28]

[28] *Katinka Barysch, 'East versus West? The EU economy after enlargement', CER essay, 2005.*

Europe's disappointing employment levels reflect not only high unemployment rates but also widespread early retirement and low female participation in many countries. Many member-states have made it harder for workers to retire early. As a result, 41 per cent of 55-64 year-olds were working in the EU-25 in 2004, up from 36.6 per cent in 2000. However, the EU remains worryingly far from its Lisbon target of getting 50 per cent of older workers into active employment by 2010. Again the Nordic countries are leading the way, with employment rates among older workers of 69 per cent in Sweden and 60 per cent in Denmark. Estonia, Finland, Portugal and the UK are also above the 50 per cent target, while Cyprus, Ireland, Latvia and Lithuania are within striking distance of it. By contrast, Poland has the EU's lowest rate, at just 26 per cent, while Austria and Slovakia are not doing much better.

The EU has also made progress at encouraging more women into the workforce. In 2004, the female participation rate in the EU-25 stood at 55.7 per cent, not far from the EU's 2010 target of 60 per cent. But again, the average figures mask wide differences among the member-states. In Denmark and Sweden, more than 70 per cent of women work, whilst another seven member-states – Austria, Estonia, Finland, the Netherlands, Portugal, Slovenia and the UK – have female employment rates above the EU's 60 per cent target. Other new member-states also perform well in this area, partly a legacy of their communist past, when most women went out to work. Women are least likely to be working in Malta (33 per cent of them in 2004), Greece and Italy (both with 45 per cent).

Female participation in the job market depends on various factors, including the availability of affordable childcare, rules on parental leave and the tax system. In most EU countries – except Finland, Greece, Hungary, Sweden and the UK – a married woman often pays higher taxes as a so-called 'second earner' than a single one. According to the OECD, women are more likely to work full-time if they receive generous childcare benefits and paid parental leave. Social attitudes to working mothers and school opening hours are also important. For example, although the UK has limited childcare facilities and ungenerous parental leave rules, female participation in the labour force is high.

Most economists think that EU employment growth is being held back by inflexible labour markets. Some countries are also cutting back unemployment benefits, to provide jobless people with incentives to seek work. In 2004, Germany reduced unemployment benefits for the long-term unemployed, so that the level is no longer determined by the worker's last salary. The French government launched a similar reform in 2005, although both countries have shied away from weakening employment protection.

The Nordic countries have taken a different approach. Denmark in particular manages to combine very liberal hiring and firing rules

with generous unemployment benefits. It also relies heavily on so-called active labour market policies, such as job search assistance and retraining facilities. Many other EU countries are now seeking to copy this model (dubbed 'flexicurity'), by introducing new measures to help the unemployed find a job, such as individual job counselling and monitoring. The Commission is studying how the success of flexicurity could be replicated more widely across the EU and will publish a paper in the first half of 2006.

However, labour market reforms have proved highly contentious in many of the member-states. Most countries have done little to make it easier for companies to hire and fire workers. As a result, in countries such as France, Germany and Italy, labour market policies risk creating an 'insider-outsider' split: they heavily protect people in standard, full-time employment but discourage the hiring of new workers and increase the insecurity of marginalised outsiders.

Bringing people into the workforce	**C**
Heroes	**Denmark, Sweden**
Villains	**Greece, Italy, Poland**

D2. Upgrading skills

★ Halve the number of early school leavers

★ Foster a culture of lifelong learning, with support from social partners

There are several ways in which the EU needs to respond to the spectre of an ageing and shrinking workforce, including improving participation rates and increasing the productivity of existing workers. Both steps require well-functioning education and training systems. Highly educated workers tend to be more productive and more flexible, and thus less likely to become unemployed and more likely to find a new job. With working lives lengthening, people need to be given the opportunity to retrain and upgrade their skills. The EU has therefore set Lisbon targets for increasing the number of young people in higher education, and for providing more training for those already in employment. However, the Commission is sceptical that the EU will meet either target by the 2010 deadline.[29]

[29] *European Commission communication, 'Modernising education and training: A vital contribution to prosperity and social cohesion in Europe', November 10th 2005.*

The member-states have had some success in reducing the number of early school leavers among the 18-24 year-olds. But the Commission thinks it highly unlikely that the rate will fall to the Lisbon target of 10 per cent by 2010. Only nine of the 25 EU countries already met the target in 2004, with the best performers found in Central and Eastern Europe (namely the Czech Republic, Poland, Slovakia and Slovenia). Among the EU-15, just four countries – the three Nordic countries and Austria – had sufficiently low drop-out rates. Malta and Portugal had the worst record, with 40 per cent or more of 18-24 year-olds dropping out of education. The UK has made good progress in this area, partly as a result of the introduction of 'education maintenance allowances' for 16-19 year-olds who remain in school.

The EU's battle against 'functional illiteracy' has had only mixed success. In 2003 – the latest year for which data is available – 19.4

per cent of the 15-year-olds in the EU had only the most rudimentary reading and writing skills, which was almost unchanged from 2000. The EU's objective is to get the numbers down to 15.5 per cent by 2010. Finland is by far the best performer, with just 5.7 per cent of 15 year-olds experiencing reading difficulties. Latvia and Poland made the most progress since 2000, while the situation deteriorated in Austria, Italy and Spain. Greece and Portugal are the worst EU performers.

Another Lisbon goal is to increase the number of people with university degrees or other forms of tertiary education. According to figures from the OECD, 40 per cent or more of 25-34 year-olds had attained a degree in Belgium, Finland, Ireland and Sweden in 2002, compared with less than 20 per cent in Austria, the Czech Republic Hungary, Italy, Portugal and Slovakia.

More and better-targeted funding is needed if the EU as a whole is to succeed in upgrading the skills of its workforce. Public spending on education as a percentage of GDP is increasing in most member-states – the EU-15 average stood at 5.2 per cent of GDP in 2002, compared with 4.9 per cent in 2000. However, the EU figure masks wide differences among the EU member-states. Sweden spent almost 8 per cent in 2002, compared to only 4 per cent in Greece or 4.4 per cent in the Czech Republic and Spain.

With fiscal pressures limiting the scope for increased public expenditure on education, many EU countries are trying to encourage more private sector spending. In 2002, the private sector accounted for 26 per cent of total US spending on education, compared with just 11 per cent in the EU-25. EU governments are trying to stimulate private spending by increasing university tuition fees or offering tax incentives to businesses. For example, the British government now permits universities to charge up to £3,000 a year in tuition fees.

In a fast-changing economy, education needs to continue beyond the school and university campus. So there is a Lisbon target for

12.5 per cent of the working age population to receive some form of training in any given year. Some progress has been made in recent years, but the EU is unlikely to meet the target by 2010. According to the Commission, only 11 per cent of the working population received training in 2004, although the proportions varied from 30 per cent in Sweden to less than 2 per cent in Greece. The shortage of training is a particular concern in the new EU countries: in 2004, Slovenia was the only new member to perform well, with 18 per cent of the workforce in training.

If the EU wishes to raise the proportion of 55-64 year-olds in employment, older members of the workforce must be able to retrain. In 2004, only 4 per cent of people in this age group undertook some training, far fewer than among younger age cohorts. Sweden is an exception: older workers are more likely to receive training than the young.

Upgrading skills	**B-**
Heroes	**Finland, Slovenia, Sweden**
Villains	**Malta, Portugal**

D3. Modernising social protection

★ Overhaul pensions systems to ensure the long-term sustainability of public finances

★ Increase the effective retirement age by five years (to 65) by 2010

★ Significantly reduce the number of people at risk from poverty and social exclusion

The EU has added two broad social policy objectives to the Lisbon agenda: the modernisation of social security and pension systems to make them sustainable in the face of demographic change; and fighting poverty (or what the EU refers to as 'social exclusion'). Since the EU has very limited responsibility for social policy, the achievement of these objectives is primarily the job of the national governments.

EU legislation in social and employment policy is restricted to minimum health and safety standards at work, and anti-discrimination rules. Other EU initiatives, such as those limiting working hours, have proved controversial among the member-states. Nevertheless, many politicians argue that Lisbon's liberalising agenda should be balanced by a social dimension. French voters rejected the EU draft constitution, in part, because they felt the treaty undermined 'social Europe'. Growing fears across the EU of the social consequences of enlargement and globalisation have complicated the task of modernising social protection systems, with even modest reforms often provoking stiff resistance.

Ageing populations pose economic and social challenges for all EU member-states, but to varying degrees. Dependency ratios (the number of people of working age for each retired person) are set to deteriorate particularly sharply in Italy, Spain, and the new East European members. These countries therefore have to raise retirement ages, reform their pension systems and increase

employment in order to put their pension and welfare systems on a sustainable footing.

Most member-states rely on 'pay-as-you-go' pension systems that are financed from current tax and social security contributions. Exceptions include Ireland, the Netherlands and the UK, which have large privately funded pensions in addition to minimum universal state pensions. The pension challenges facing these countries are less severe, although this has as much do to with their more favourable demographic profiles and lower replacement rates (the proportion of earnings replaced by pensions) than their reliance on funded provision.

In 2004 and 2005, significant reforms were implemented in Austria, France, Finland, Germany, Italy and Portugal. Some of these countries, such as France and Germany, have shifted pension entitlement from a pre-defined retirement age to the number of years that the worker has contributed to the system. Among the new members, the three Baltic countries, Hungary, Poland and Slovakia have added funded private pension schemes to their tax-funded pay-as-you-go pension systems. However, the Commission and the OECD both argue that most EU countries still have to go much further to ensure the sustainability of their pension systems.[30]

[30] European Commission, 'Europe on the move: Working together for more growth and jobs', January 26th 2006, and OECD, 'Economic policy reforms – going for growth', 2005.

Regardless of the relative weights of funded and unfunded schemes in their pension systems, nearly all member-states need to increase the proportion of their labour force in jobs, in order to contain the rapid deterioration in their old-age dependency ratios (see section D1).

Most EU countries offer people the opportunity to retire before they reach the official retirement age. Therefore effective retirement ages tend to be lower than statutory ones. So far, the EU has made no progress with raising the effective retirement age. On the contrary, the average in 2004 was somewhat lower

than in 2003, at 60.7 years, according to Commission data. French, Greek and Polish people tend to retire even before they reach 60. Effective retirement ages exceed 62 years in just six member-states – Estonia, Ireland, Latvia, Portugal, Spain and the UK. While Estonia and Latvia made significant progress in increasing retirement ages in 2004, Greece and Lithuania recorded drops.

Social exclusion remains a serious problem in a number of member-states. According to UNICEF – the United Nations Children's Fund – Ireland, Italy, Portugal and the UK have the highest rates of child poverty in the EU, ranging from 15 to 17 per cent of the population, and Denmark and Finland the lowest, at just 3 per cent.[31] Ireland and the UK have made concerted efforts to reduce their exceptionally high rates, but progress has been slower than hoped because of widening income inequalities. The worst deterioration has taken place in Hungary, where child poverty rates have risen from 7 to 20 per cent of the population. Germany has also seen a notable deterioration: in West Germany, the child poverty rate doubled from 4.5 per cent in 1989 to 9.8 per cent in 2001. In East Germany, child poverty rates stood at 12.6 per cent in 2001.

[31] *UNICEF, 'Child poverty in rich countries', 2005.*

However, measuring poverty is far from straightforward, and caution should be exercised when interpreting these figures. While absolute measures of poverty make little sense in a group of countries as heterogeneous as the EU-25, a reliance on relative measures can also be misleading. For example, the Commission and UNICEF say that a child is in poverty if it lives in a household whose income is less than half the national average. Employing the relative measure, there are more children in poverty in Italy, Ireland and the UK than in either Lithuania or Poland, which would not be the case if absolute measures were used. Similarly, the rise in the proportion of German children in poverty may reflect widening income inequalities rather than an increase in the number living in absolute poverty.

Indeed, poverty and social exclusion are a particular problem in the new East European member-states.[32] In some countries, long-term unemployment is the main reason for this.[33] In 2004, more than 10 per cent of Slovaks and Poles had been looking for a job for more than one year. The EU-25 average figure stood at around 4 per cent while in the US long-term unemployment is a mere 0.7 per cent of the labour force. Ineffective and badly targeted social security and welfare systems are another factor behind persistent poverty in Central and Eastern Europe. On average, the new member-states spend as much of their GDP on social security as the old members, but because means testing is rare the money often does not reach the poorest parts of the population. Sub-standard housing and under-funded healthcare systems make the plight of poor people even worse. The worst affected groups are minorities such as the Roma, but also disabled people and the rural poor. According to the World Bank, absolute deprivation exists even in relatively well-off countries such as Hungary.[34]

[32] *European Commission, 'Report on social inclusion 2005, an analysis of the NAP on social inclusion (2004-2006) submitted by the 10 new member-states', February 2005.*

[33] *Catherine Palpant, 'European employment strategy, an instrument of convergence for the new member-states', Notre Europe, Policy paper No 18, January 2006.*

[34] *World Bank, 'Study on the impact of growth on poverty and inequality in eastern Europe and the former Soviet Union during 1998-2003', 2005.*

Modernising social protection	**C**
Hero	**Denmark**
Villains	**Italy, Poland, Slovakia**

E. Sustainable development

E1. Climate change

- ★ Reduce greenhouse gas emissions by 8 per cent from 1990 levels by 2010, in line with the Kyoto protocol
- ★ Increase to 22 per cent the amount of electricity derived from renewable sources by 2010
- ★ Break the link between economic growth and transport volumes by prioritising public and environmentally-friendly forms of transport

During the Swedish presidency in 2001, the EU added a number of environmental goals to the Lisbon agenda. These goals either reflect long-standing commitments, such as a reduction in greenhouse gas emissions in line with the Kyoto protocol, or comprise very vague aspirations, such as breaking the link between economic growth and transport volumes.

As part of its commitment to reducing greenhouse gas emissions, the EU launched its carbon emissions trading scheme in January 2005. The European Trading Scheme (ETS) currently covers 12,000 companies, operating in the most energy intensive sectors such as oil and metals. Member-states grant businesses permits to emit greenhouse gases up to a certain level, which they can then buy and sell according to their requirements. The companies concerned can also gain extra permits by financing clean development projects in developing countries. The ETS is the cornerstone of the EU's commitment to the Kyoto protocol and has the potential to serve as a model for the rest of world – provided that remaining flaws in the system are fixed.

First, some of the more polluting sectors, such as aviation, are outside the scheme. Second, the way in which emission limits are

set is flawed. Rather than agreeing on a total EU ceiling (based on expert advice) and apportioning national quotas to member-states, the individual governments are free to decide how many permits national industries need. As a result, the EU's overall ceiling is too high and the price of permits too low.[35] Third, the ETS grants permits only until 2008, which provides insufficient time to justify investment in cleaner technologies.[36]

[35] Stephen Tindale, 'The EU must do more on climate change', CER bulletin, February/March 2006.

[36] Dieter Helm, 'European energy policy: Securing supplies and meeting the challenge of climate change' October 2005.

The ETS suffered a further setback in December 2005, when the UK won a court case against the European Commission, allowing it to apply looser limits on the emissions of the most polluting industries. There are concerns that other member-states might follow suit in revising emissions caps upwards, thereby threatening the long-term success of the emission scheme and the EU's Kyoto commitments.

The EU's overall target under Kyoto is to cut greenhouse gas emissions by 8 per cent between 1990 and 2010. The European Environment Agency (EEA) predicts that emissions in the EU-15 (the new member-states have their own targets) will be 9.3 per cent below 1990 levels by 2010. Since there is much scope for cuts in the energy-intensive industries of Central and Eastern Europe, the reduction for the EU-25 is likely to be somewhat larger, at around 11 per cent. The EEA expects that 17 of the 25 member-states will meet their national targets. However, these projections assume that the member-states take significant steps to control emissions over the next four years; sticking to existing policies would only reduce them by 1.6 per cent. Such optimism is likely to prove misplaced – emissions actually rose by 1 per cent between 2001 and 2003.

The EEA warns that the EU will only meet its overall target if certain member-states, most notably the UK and Sweden, continue to pursue separate national targets that are more demanding than their Kyoto commitments. For instance, the UK government is

committed to cutting carbon emissions by 20 per cent by 2010. UK businesses complain that their government's ambition may put them at a disadvantage internationally. Yet the UK government's chief scientific adviser, Sir David King, has warned that his country is unlikely to meet the 20 per cent target.[37]

[37] BBC news, 'Government forces emmissions CO_2 rethink', December 23rd 2005.

Meanwhile, in many EU countries carbon emissions continue to rise. The performance of Italy, the third biggest emitter of carbon dioxide in the EU, has been of particular concern. But Austria, Denmark, Finland, Greece, Ireland, Portugal and Spain have all allowed their carbon emissions to rise by more than 20 per cent since 1990, and hence stand little chance of meeting their Kyoto targets. Meanwhile, the Central and East European countries, with the exception of Slovenia, have made good progress and are well on track to reach their targets. The new EU member-states have recorded steep declines in emissions – averaging about one-third since 1990 – due to the restructuring of heavily polluting and energy intensive industries.

To meet their Kyoto targets, EU countries need to step up their efforts to improve the energy efficiency of their industries and to rely more on cleaner and renewable sources of energy. The EU's target under Lisbon is that by 2010 renewables should account for 22 per cent of its total energy requirements. Some countries, such as Denmark, Spain and to a lesser extent Germany, have done well in this regard, yet their efforts have been insufficient to offset disappointing progress elsewhere. In 2003, the share of electricity produced from renewables in the EU as a whole stood at only 13.7 per cent. It is clear that the EU will not meet its target unless substantial investments are given the go-ahead over the next 12 months.

There is plenty of scope for saving energy. The Commission estimates that a more efficient use of energy could reduce EU energy consumption by around 20 per cent – the equivalent of Germany and Finland's joint annual consumption.[38] Every EU

[38] European Commission, 'Green paper on energy efficiency', 2005.

household would save between €200 and €1,000 per year, with total savings for the EU as a whole reaching €60 billion. Currently, Denmark has the most energy efficient economy in the EU, followed by Austria, France, Germany and Ireland. Meanwhile, the new member-states are some of the least efficient in their energy use.

The EU has traditionally relied on regulatory measures to promote environmental objectives, such as the directive to promote energy efficiency in buildings. Most of these measures are part of the so-called Europe Climate Change Programme (ECCP) launched in 2000. However, the Commission has made it clear that, for the second phase of the ECCP that started in 2005, it intends to move away from a regulatory approach towards a greater focus on market-based instruments.

The Commission has also proposed placing greater emphasis on developing new clean technologies, or what it calls 'eco-innovation', through targeted state aid. This shift should make it easier for the EU to align environmental policies with Lisbon's focus on innovation and competitiveness. EU companies have leading positions in the development of most clean energy-generating technologies, such as wind and solar power. So the Union should be able to capitalise on its current strengths both to clean up the environment and boost competitiveness. Global demand for such technology is certain to grow rapidly as efforts intensify to combat the effects of global warming.[39]

[39] *Iain Begg and Allan Larsson, 'A 'smart growth' strategy for sustainable development', CER briefing note, November 2005.*

The rapid growth of transport is a principal reason for the EU's failure to contain the use of fossil fuels: in 2003 carbon emissions from transport exceeded the 1990 levels by 24 per cent. Transport growth is particularly fast in the new member-states, reflecting steadily improving infrastructure and the rapid pace of economic growth. The Commission wants 5.75 per cent of Europe's transport fuels to come from plant sources by 2010. Previous EU attempts to encourage farmers to grow energy crops have failed to increase the

supply of biofuels. The Commission is therefore considering measures that would make oil companies blend biofuels into petrol and diesel before they reach the pumps. Some member-states have already taken such a step. The UK, for instance, is committed to raising the proportion of petrol that derives from biofuels to 5 per cent by 2010, up from 0.5 per cent in 2005.

Climate change	**B**
Heroes	**Denmark, Sweden**
Villains	**Italy, Slovenia, Spain**

E2. Natural environment

★ Reduce human exposure to particulates and ozone emissions

★ Improve management of natural resources and stop the depletion of biological diversity

In addition to climate change, the EU has added another set of environmental targets to the Lisbon agenda, namely to reduce air and water-borne pollutants and preserve Europe's biodiversity.

An Environmental Performance Index produced by Yale University provides a useful guide to the overall quality of a country's environment and the sustainability of its economic policies. It ranks countries according to criteria such as air quality, bio-diversity, water quality, population pressures and policies towards the environment.[40] The Nordic countries, which possess ample natural resources, low population densities and well-developed strategies for preserving the natural environment score very highly. Sweden and Finland rank second and third globally. The Czech Republic and the UK, which also devote significant resources to environmental protection, follow in fourth and fifth place. Belgium, Cyprus and Poland are the lowest ranked EU member-states.

[40] *Yale Centre of Environmental Law and Policy, 'The pilot 2006 environmental index', 2006.*

Growing concerns over the impact of tough environmental legislation on industrial competitiveness were one reason why EU governments made the environmental targets secondary to growth and job creation during the 2005 Lisbon review. Subsequently, the Commission toned down its own proposal to extend clean air laws to sectors not yet covered, such as agriculture and transport.[41] The Commission calculates that the new and less ambitious targets for the reduction of pollutants will cut compliance costs for EU industries by €4 billion annually, compared with the original proposal. The remaining costs, forecast

[41] *Euractiv, '2006: Crunch time for EU environmental policies', December 16th 2005.*

at €7.5 billion a year until 2020, are unlikely to affect the overall competitiveness of the EU's €10 trillion a year economy. The Commission estimates that the directive will save the EU €42 billion each year, as a result of fewer working days being lost through ill-health and lower healthcare expenditure.

Following two years of negotiations, the European Council in December 2005 finally agreed on a version of the Commission's 'REACH' directive on the health and environmental impact of commonly used chemicals. Although the number of chemicals covered by REACH was reduced by 12,000 – prompting criticism that too many concessions had been made to the industrial lobbies – its significance should not be downplayed. It will still force EU companies to register around 30,000 widely used chemicals and to conduct tests to prove that they do not pose health or environmental risks. At the time of writing (March 2006), the draft law was back in the European parliament for a second reading.

The preservation of Europe's flora and fauna is the target of other Lisbon objectives. According to data from the Commission, bird populations – a good indicator of the state of biodiversity – stabilised during the 1990s but since 2000 have been declining again.[42] Although there is no conclusive evidence, experts think that this reduction in diversity is linked to agriculture, the destruction of habitats and also global warming.

[42] *Eurostat, 'Measuring progress towards a more sustainable Europe: Sustainable development indicators for the European Union, Data 1990-2005', 2005.*

Reforms of the EU's common agricultural policy (CAP) agreed in 2002 provide new incentives for farmers to take care of the environment by tying subsidies to compliance with a broad range of environmental and animal welfare standards. Since no recent data is available, it is too early to judge the impact of the 2002 reforms on land-use. The proportion of EU-15 agricultural land covered by environmental programmes stood at 24 per cent in 2002 (compared with 20 per cent in 1998), while the percentage devoted to organic farming was 3.7 per cent (up from 2.9 per cent in 1998). One drawback of the current

system is that it is not binding – individual governments decide how much direct support to farmers should be linked to environmental standards. For example, France, the biggest recipient of CAP money, has decided to pay farmers according to past subsidy levels, rather than any environmental criteria.[43]

[43] *Jack Thurston, 'Why Europe deserves a better farm policy', CER policy brief, November 2005.*

An effective fisheries policy is another key objective of the EU's development strategy. However, the EU has struggled to improve its record of preserving fish stocks. More and more of the fish caught in EU waters come from stocks that scientists consider depleted: in 2003, more than 60 per cent of the fish caught were from endangered species such as cod, haddock and hake, compared with 42 per cent in 2000. In December 2005, EU governments once again ignored the advice of scientists when setting fisheries quotas by opting to increase the permitted cod catch.

Over-fishing and global warming have led to a considerable loss of marine biodiversity in Europe's seas. In October 2005, the Commission introduced a new strategy to combat this decline and restore all marine waters to good health by 2021. The Commission is proposing that member-states sharing the same waters should draw up and implement national programmes in co-ordination with each other and co-operate more with non-EU countries. It has asked them to set their own targets and review their national programmes regularly.

Natural environment	**C-**
Heroes	**Czech Republic, Finland, Sweden**
Villains	**Belgium, Poland**

4 Conclusion

The member-states have implemented a raft of economic reforms since the March 2005 mid-term review of the Lisbon agenda. These reforms will help to improve the EU's growth rate and boost job creation in the short to medium-term. However, if the EU wants to face up to long-term challenges, governments need to take their Lisbon commitments much more seriously. Three key developments will force Europe to accelerate the pace of change: globalisation, in particular competition from emerging Asia; an ageing and shrinking workforce; and the need to secure energy supplies.

★ **Globalisation**

The integration of China and India into the world economy will roughly double the global labour force. Europe will not be able to compete in labour-intensive industries and services. Globalisation is forcing EU countries to move quickly into higher added-value goods and services. West European companies have reacted by relocating some labour-intensive factories into Central and Eastern Europe, where labour is cheaper. The new members, meanwhile, are coming under even fiercer competition from emerging Asia. Many of them specialise in the types of goods that lie behind China's export success, such as textiles and consumer electronics. All EU countries need to improve their education and training systems, spend more on R&D and encourage innovation if they want to compete successfully in a globalised economy.

★ **Ageing societies**

In the EU, the working age population will fall by 20.8 million between 2005 and 2030. Europe's annual potential growth could fall from 2-2.25 per cent today to 1.25 per cent in 2040. The new member-states cannot plug the demographic gap: they have workforces that are ageing even faster than those in Western Europe. Pension reforms alone will not be sufficient to make up for the predicted doubling of the 'dependency ratio' (the ratio of active workers to pensioners). The key to future growth and the sustainability of public finances will be to bring more people into the workforce and to make existing workers more productive. Labour market reforms, high investment rates and improved education and training are all needed to prepare European economies for the impending demographic shift.

★ **Energy and climate change**

In January 2006, Russia briefly cut vital gas supplies to Western Europe, after failing to resolve an energy price dispute with Ukraine. The episode drove home to the Europeans their critical dependence on outside supplies of energy. At the same time, high energy prices are squeezing the profit margins of many industries, and households are struggling with higher bills for electricity and heating. These developments have rekindled a debate within the EU about how best to secure reliable and affordable energy supplies in the future. The EU is also at the forefront of efforts to reduce greenhouse gas emissions. Europe will have to find a way of fighting global warming while boosting the competitiveness of its economy.

These three trends affect all 25 member-states, albeit to differing degrees. Taken together they are a creeping threat to Europe's future prosperity. If EU countries do not prepare themselves properly, they will face gradual decline. The EU does not have all or even most of the answers to Europe's economic malaise. But it can help the

member-states, individually and collectively, to cope with global competition, ageing and energy insecurity. The Lisbon programme provides EU governments with possible solutions. It sets targets and benchmarks against which to measure national performance. And it encourages EU countries to learn from each other, to copy policies that work and to discard those that do not.

Many economists think that a crisis is exactly what is needed to focus policy-makers' minds. In the past, radical reforms in Europe have often happened after an economic crisis, such as in Britain in the late 1970s, in Finland after the collapse of the Soviet Union, or in Sweden after the financial turmoil of the early 1980s. However, today, the EU itself makes the recurrence of such economic shocks less likely. The EU has encouraged macro-economic stability and economic openness, thus leaving its member-states with more stable and deeply integrated economies. Those countries that have joined the euro no longer face the threat of a currency or balance of payments crises, so their incentives to reform may have been even further reduced.[44]

[44] *Romain Duval and Jorgen Elmeskov, 'The effects of EMU on structural reforms in labour and product markets', OECD economics department working papers 438, 2005.*

Politics tend to favour the status quo because structural reforms usually create winners and losers. The losers are often small, well-defined and vocal groups (think of farmers or steel workers that benefit from subsidies or protectionism) while the potential winners are too numerous and amorphous to organise effectively. Moreover, the losses from reforms tend to be immediate while the benefits are normally more long-term, leaving governments with insufficient incentive for immediate action.

Consensus and confrontation

The countries which can reform most easily are those which can forge a national consensus around the need for change. Finland and Sweden had little choice but to change, following their respective

economic crises, but in both cases they managed to forge a strong national consensus in favour of reform. When Finland plunged into its deepest recession since the Second World War in the early 1990s, its employers and workers agreed on a pact to maintain social stability, while the government struggled to find the right policies. Similarly, in the 1982 Wassenaar agreement, Dutch trade unions promised to accept wage restraint and flexible wage bargaining in return for government efforts to consolidate the budget, lower taxes and focus on job creation. Consensus also underpins Denmark's success.

However, in other countries, the task of building a consensus behind reforms has proved far from straightforward. In the UK, economic change only became possible after the trade unions had lost most of their political clout. Worryingly, other countries appear to be stuck between the worst of both worlds: influential trade unions but no consensus on what needs to be done. In France, the resistance put up by trade unions has become a major obstacle to reform. The country's adversarial political culture – in which negotiations are a sign of weakness and compromise is equated with defeat – does not help either.

Germany is a good example of a country where change has started elsewhere, namely at the company level. While economic commentators were still speculating whether Angela Merkel could become Germany's Margaret Thatcher, the threat of the relocation of production facilities to Eastern Europe or Asia appears to have strengthened the hands of managers vis-à-vis workers. Scores of large and small companies confronted their workers with the choice of either working longer hours for the same money or less – or face the threat of their job moving elsewhere. As a result, real unit labour costs have fallen by an average of 0.5 per cent every year since 1995, boosting the competitiveness of German industry.

Where the EU adds value

The EU can help its member-states to accelerate economic reforms in three ways. It can foster competition between different economic

and social models and so helps to spread best practice. It can also encourage national governments to co-ordinate their economic policies where needed. And finally, it can implement certain policies at the EU level to increase their efficiency.

First, most of the measures that make up the Lisbon agenda require action at the national, not the EU level. The EU has therefore devised the 'open method of co-ordination' to encourage governments to work together in areas where the EU has no competence. Although the open method has its critics, it has fostered a useful process of benchmarking across the EU. The current EU-wide interest in the Nordics' model of 'flexicurity' is only one example. Hungary and Sweden provide useful lessons on how to reform national pension systems. The UK's 'one-stop shop' approach to helping the unemployed has been copied by France and Germany (both countries now have 'job centres' bearing the English name). The Commission has sought to support the open method through its various 'scoreboards' that rank EU countries according to their performance measured against Lisbon goals. But it has become a lot more cautious in 'naming and shaming' the laggards in its annual report. And it has also sought to avoid offence in its comments on the new 'national reform programmes'. If these programmes are to have an impact, both the Commission and the Council should have the courage to name those countries that fail to live up to their reform commitments.

Second, there is a wider argument to be made why EU countries should co-ordinate their reform policies. Since European economies are so closely intertwined through multiple trade and investment links, they cannot be indifferent to each others' reform efforts. This argument is particularly true for the eurozone, where spill-over effects are much stronger because the euro countries have a common monetary policy. Suppose that Germany pushes through structural reforms but France does not. In Germany, lower public spending (helped by higher growth and a fall in unemployment) and

reduced cost pressures translate into lower inflation, which means somewhat lower inflation for the eurozone as a whole. The European Central Bank (ECB) lowers interest rates – but less than if France had reformed too. Germany does not reap the full benefits of its reform efforts while France gets a windfall for doing nothing. Conversely, France's refusal to reform could push up its budget deficit, which in turn could induce the ECB to keep interest rates higher than they would otherwise be. Therefore, in the eurozone, there is a stronger case for policy co-ordination than for the EU as a whole. However, at present, the eurozone countries only meet at the level of finance ministers (in the shape of the Eurogroup). Finance ministers cannot set the reform agenda, but heads of government can. Jean Pisani-Ferry of Bruegel has therefore suggested that the leaders of the eurozone countries should meet on a regular basis to discuss their reform agendas.[45]

[45] *Jean Pisani-Ferry, 'Only teamwork can put the eurozone on a steady course', Financial Times, August 31st 2005.*

The third way in which the EU can help to secure Europe's future prosperity is through EU-level policies in areas where the Union can bring added value to national efforts. One example could be immigration policies, which will be an important part of Europe's reaction to demographic change. Skilled immigrants could help to plug gaps in national labour markets. Since they tend to be more mobile than national workers, they can also add a degree of flexibility to the EU labour market. However, the EU has a poor record of attracting skilled migrants, and national rules make it extremely difficult for immigrants to move around within the Union. The EU's governments should agree on a new type of flexible residence permit that would allow migrants to move between countries and types of employment. Similarly, the EU is waking up to the fact that the best way of enhancing the security of energy supplies would be to design a coherent EU energy policy. For example, member-state governments could build more links between national power grids and co-ordinate their plans for improving gas storage.

Research and higher education are areas where national governments would gain from acting at the EU level. The EU (collectively) spends a lot less on R&D than the US. The money is also spread more thinly than in the US, where it is concentrated on a limited number of 'centres of excellence'. If the EU wants to stop the 'brain drain' across the Atlantic and improve the quality of its research output, it needs to learn a lesson from the US. The idea of building European centres of excellence, for example through creating a European Institute of Technology and a European Research Council, is a good one.

But the EU has yet to put its money where its mouth is. The EU's common budget has limited resources, amounting to little more than 1 per cent of EU GDP. This is why an expert group under the leadership of André Sapir recommended in 2003 that there should be a shift of EU spending from traditional policies, such as farm support and regional subsidies, to 'Lisbon-type' policies, such as support for small companies, industrial restructuring and research.[46] However, the EU's next long-term budget for 2007-2013 – agreed by EU leaders in December 2005 – again allocates less than 10 per cent of the money to measures designed to enhance the EU's competitiveness.[47] The EU countries have another chance to rectify this situation in 2008-09, when they will conduct a thorough review of the EU's budget.

[46] *André Sapir and others, 'Agenda for a growing Europe', European Commission, July 2003.*

[47] *Iain Begg and Friedrich Heinemann, 'New budget, old dilemmas', CER briefing note, February 2006.*

In the long term, there is a risk that the EU's reform efforts may have political costs. Many people, in particular in the big eurozone countries, are becoming more critical of the EU. They think that the EU pursues a narrow agenda of liberalisation and structural reform, without caring about the economic dislocation and social consequences that may ensue. Economic insecurity and a backlash against low-cost competition from the new member-states both contributed to the the French rejecting the EU constitutional treaty in 2005.

Therefore, it is vital that the EU and its member-states strike a proper balance between economic liberalisation and social protection. Tilting too far in one direction could lead to public animosity that ultimately risks undermining the achievements of 50 years of integration. Tilting too far in the other direction threatens Europe with economic stagnation.

Overall assessment of results: C

The Scorecard table

Issues	2006	Heroes	Villains	2005	2004	2003	2002	2001
A. Innovation								
Information society	B	Denmark, Estonia, Sweden	Czech Republic, Greece	B	B-	B-	C+	B+
Research and development	C-	Finland, Slovenia, Sweden	Greece, Poland	C-	C	C-	C+	B-
B. Liberalisation								
Telecoms and utilities	C+	Sweden, UK	Greece, Portugal, Slovakia	C+	C+	B-	B-	B+
Transport	C+	Denmark, Germany, Netherlands	European Parliament (port services directive), Greece, Poland	C+	C+	B-	D-	D
Financial and general services	C-	European Commission	Italy, Poland (financial services)	B-	C+	B-	B-	C+
C. Enterprise								
Business start-up environment	B	Denmark, Estonia, UK	Czech Republic, Greece, Poland	C	C	B-	D	D
Regulatory burden	B+	Lithuania, UK	Greece, Italy, Portugal	C+	C	C+	C-	D+
State aid and competition policy	B-	Czech Republic, Sweden, UK	France, Poland	C+	C+	C+	B-	B+

Issues	2006	Heroes	Villains	2005	2004	2003	2002	2001
D. Employment and social inclusion								
Bringing people into the workforce	C	Denmark, Sweden	Greece, Italy, Poland	C	C-	C	B-	B-
Upgrading skills	B-	Finland, Slovenia, Sweden	Malta, Portugal	C+	C	C	C-	D
Modernising social protection	C	Denmark	Italy, Poland, Slovakia	B-	B-	C	B-	C+
E. Sustainable development								
Climate change	B	Denmark, Sweden	Italy, Slovenia, Spain	C-	C-	C+	C	(N/A)
Natural environment	C-	Czech Republic, Finland, Sweden	Belgium, Poland	C	C+	C	C-	(N/A)
Conclusion								
The Lisbon process	C	Denmark	Poland	C	C	C+	C-	B+
Overall assessment of results	C			C	C	C+	C	C+

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THE LISBON SCORECARD VI
Will Europe's economy rise again?

Aurore Wanlin

The European Union and its 'Lisbon agenda' of economic reform, have received a battering over the past year. The pace of reform has remained slow in the big eurozone countries. Fears over the EU's eastward enlargement and high levels of unemployment have fostered a new spirit of national protectionism. Yet Aurore Wanlin argues that many underlying trends are positive. Enlargement and globalisation are slowly forcing Europeans to accept change. The eurozone is showing signs of recovery. Many European economies are performing strongly. Furthermore, a new wave of cross-border mergers suggests that the single market is making an impact. This pamphlet, the CER's sixth Lisbon scorecard, assesses the progress of the various member-states – and highlights the heroes and villains of economic reform.

Aurore Wanlin is a research fellow at the Centre for European Reform.

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