CENTRE FOR EUROPEAN REFORM

THE LISBON SCORECARD VII

Will globalisation leave Europe stranded?

Katinka Barysch, Simon Tilford and Aurore Wanlin

Published by the Centre for European Reform (CER), 14 Great College Street, London, SW1P 3RX
Telephone +44 20 7233 1199, Facsimile +44 20 7233 1117, info@cer.org.uk, www.cer.org.uk
 ★ ISBN 978 1 901229 71 4

The Lisbon scorecard VII

Will globalisation leave Europe stranded?

Katinka Barysch, Simon Tilford and Aurore Wanlin

ABOUT THE AUTHORS

Katinka Barysch is chief economist at the Centre for European Reform. Her previous CER publications include: (as co-author) 'Why Europe should embrace Turkey', September 2005; 'The economics of Turkish accession', July 2005; and (as co-author) 'Embracing the dragon: The EU's partnership with China', May 2005.

Simon Tilford is head of the business unit at the Centre for European Reform. His previous CER publication is 'Will the eurozone crack?', September 2006.

Aurore Wanlin is a research fellow at the Centre for European Reform. Her previous CER publications include: 'The Lisbon scorecard VI', March 2006; (as co-author) 'The EU's new financial services agenda, February 2006; and (as co-author) 'The Lisbon scorecard V', March 2005.

★

AUTHORS' ACKNOWLEDGEMENTS

We would like to thank Marcel Canoy, Luke Georghiou, Roger Liddle, Anne Meuwese, Jorge Padilla, Henri Piffaut and Peter Smith for their contributions, and also Edward Bannerman and Ben Hall for their comments. Thanks also to all the CER staff for their support; to Hugo Brady, Charles Grant, Catherine Hoye and Susannah Murray for their useful comments and editing; and to Kate Meakins for layout and production.

Any remaining errors are the authors' own. The views expressed within do not necessarily reflect those of AstraZeneca, Barclays, Clifford Chance, KPMG, Microsoft and Unilever. We are grateful to all of them for supporting this publication.

★

Contents

About the authors

Authors' acknowledgements

Forewords

1 Introduction 1

2 The Lisbon agenda 13

3 The scorecard

A. Innovation 15
Europe needs demand-side innovation policies 32
by Luke Georghiou

B. Liberalisation 35
The future of the single market 43
by Marcel Canoy, Roger Liddle and Peter Smith

C. Enterprise 59
How to measure regulatory impact? 71
by Anne Meuwese
Innovation, competition and the Lisbon agenda 78
by Jorge Padilla and Henri Piffaut

D. Employment and social inclusion 81

E. Sustainable development 101

4 Conclusion 109

The scorecard table 115

Foreword

AstraZeneca is pleased to support the CER's 'Lisbon scorecard'. It is a very important reminder to all member-states that there is no room for complacency. While much good work has been done there is more to do if we are going to meet the goals by 2010.

President Barroso outlined the position very well during the publication of the annual report: "To get in shape for globalisation every member-state needs to pick up the pace and perform to its full potential... We are on the right road now... Still, there is some way to go. I say: let's step on it – it is time to move up a gear".

The pharmaceutical industry has a big contribution to make in helping Europe meet its goals, in terms of its contribution to research and development expenditure, employment and improved health for its citizens. But as Commissioner Verheugen recently noted, "The time has passed [when] Europe was the pharmacy of the world....we are losing competitive ground to the United States and increasingly, to China, India, Singapore and others".

We are pleased that the Commission has recognised this and that it values the strategic importance of a competitive pharmaceutical industry. We commend Commissioners Verheugen and Kyprianou for the work they have undertaken in initiating the High Level Pharmaceutical Forum.

The scorecard marks important milestones on the journey towards improving Europe's competitiveness. It is vital that we meet these milestones. If business, member-states and the Commission work together, we can deliver the ambitions set out in Lisbon.

Ulf Säther

Regional Vice President, Europe, AstraZeneca plc

Foreword

Barclays is delighted to co-sponsor the CER's latest scorecard on the Lisbon agenda. While there continues to be much debate over the progress that has been made to meet the original Lisbon targets, it is good to have this regular assessment against which the European Commission and indeed individual member-states can benchmark progress. The financial services sector has seen huge change over the past few years, but a true internal market remains a prospect rather than a reality despite the upheaval. The scorecard helps shine a light to guide future progress.

A particularly welcome development has been the willingness of the European Commission to embrace the theme of better regulation. This is welcomed by all businesses who value the prospect of a true single market, but are increasingly concerned that this will involve a host of regulatory obstacles to overcome. Legislative action should be the last resort. The success of the Financial Services Action Plan (FSAP) looks good on paper but must deliver concrete benefits. We wish the reformers within the Commission well in embedding the better regulation approach into their organisational DNA. Enhancing the Lamfalussy process will also play a part in improving the EU regulatory environment for financial services as will continuing efforts to implement existing measures in a proportionate, consistent and timely manner.

Equally important is the need for European institutions and member-states to raise their sights beyond the Union and rise to the challenge of global competition. The EU has a strong financial services franchise but it will only maintain this position if it adapts to the challenges of globalisation rather than sit behind the fence of an EU internal market.

Marcus Agius

Chairman, Barclays

Foreword

CLIFFORD CHANCE

Clifford Chance is delighted to sponsor the CER's Lisbon scorecard. Now in its seventh year, the scorecard has built a reputation for objective analysis of member-states' efforts to create dynamic and innovative economies, while also generating more and better jobs for Europeans. With an economy that now encompasses 27 countries and almost 500 million people, the potential rewards of a truly competitive Europe are great.

EU leaders regularly voice their support for the Lisbon agenda, but recent protectionism in some countries is worrying. Europe will not achieve its goals if on the one hand we embrace economic reform, and on the other resist it for short-term political interests. In this respect, we welcome the European Commission's leadership. It has handed ownership for reform back to national capitals and spoken out against governments reneging on their commitments. Clifford Chance discovered in a pan-European survey last year that this is supported by business.

The adoption of the services directive was significant. That sector, including legal services, now represents 70 per cent of EU GDP. A true internal market for services can only bring benefits. An independent and respected legal system plays a central role in ensuring that can happen.

2007 marks the 50^{th} anniversary of the Treaty of Rome. It is also a year in which there will be significant political change, with a new generation of leaders emerging. We hope this will provide the extra impetus that is required.

We commend and support the CER for their continued work to ensure a competitive Europe.

Stuart Popham

Senior Partner, Clifford Chance LLP

Foreword

KPMG

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

Lisbon is all about removing barriers to the efficient working of the single market, be they structural rigidities in individual countries, such as those keeping unemployment unacceptably high in some member-states, or the costs involved in dealing with the multiplicity of regulatory regimes. Experience shows that regulation – however well meaning, however necessary – can be a significant block to integration and efficiency unless it is co-ordinated across jurisdictions.

This year we are pleased to report a major step forward in the regulation of auditing. Although not directly a result of the Lisbon process, the European Commission's eighth directive is a prime example of the sort of regulation that can support real integration and a properly functioning, efficient single market. The directive clarifies the duties of statutory auditors, sets clear principles for objectivity and encourages cross-border ownership of accountancy firms.

It is precisely because of it that we have been able to start creating KPMG Europe LLP with the merger of our UK and German practices. We are convinced that the new entity – as it inevitably grows to encompass other KPMG practices in Europe – will offer real benefits to our people and our clients.

If Europe is to compete with the markets of China and India in the future, it must act now to make sure it has integrated and efficient market structures, supported by firms that can operate effectively across jurisdictions. This is as true for business in general as it is for professional and financial services in particular.

John Griffith-Jones

UK Chairman, KPMG

Foreword

Microsoft

Microsoft is pleased to support the CER's seventh annual scorecard and is committed to a partnership with the EU to reach the Lisbon agenda goals for a more competitive Europe.

The report shows that innovation is one of the key drivers of total factor productivity growth. Although the level of innovation is patchy across Europe, we disagree with anyone who says Europe is not an innovative place. Innovation is in our DNA as Europeans and we have a history that proves it.

It is equally clear that there must be improvement in several areas if we wish to be more competitive with the US and the rising nations in Asia. In R&D funding, there is a need for more early-stage investment into innovative companies. In education, there is a need for more public-private partnerships to raise the quality of European institutions and to give students access to technology.

Skills training should not stop when people leave school. With Europe's ageing population and declining birth rates it is more important than ever to return Europe to full employment.

At Microsoft we work closely with governments and partners to develop initiatives that align our mutual desire for a more dynamic Europe. It is clear that both private companies and their public partners have roles to play. By working together, we can make innovation, education and employability the key drivers of a more competitive Europe.

Jean-Philippe Courtois

President, Microsoft International

Foreword

Unilever

Unilever is one of the world's leading suppliers of fast moving consumer goods and while we are a very international company our roots are in Europe. A growing and vibrant European economy is vital to our success.

We therefore see the commitment to the competitiveness and growth agenda as a top priority for Europe's political and business leaders. That is why the CER's seventh Lisbon scorecard is so important, as it provides a concise picture of the progress member-states are making to deliver Europe's economic reforms.

As the scorecard highlights, in contrast to recent years, there is reason for cautious optimism. Telecoms markets, financial services and air travel are being liberalised, helping to cut EU unemployment by 1 per cent and the economy to grow by 2.7 per cent – Europe's strongest performance in six years.

Progress has been made but there is no room for complacency. Many challenges still lie ahead and the threat of national economic protectionism looms large.

Globalisation is exposing Europe to more competition than ever before, productivity remains weak, and investment in research and development continues to significantly lag behind the US and Japan at less than 2 per cent of GDP.

To meet these challenges Europe needs to accelerate and improve delivery of its 'better regulation' and Lisbon reform initiatives. This means remaining focused on those key areas that will further unlock Europe's economic growth.

Moreover, Europe's political and business leaders must do more to promote the case for globalisation, as a means to help create new jobs and prosperity.

Unilever stands ready to play its role.

Patrick Cescau

Group Chief Executive, Unilever

1 Introduction

After the EU's low point in 2005, the year 2006 brought enough good news to create some cautious optimism. Despite the rejection of its constitutional treaty, the Union managed to function reasonably well with 25 countries. The ten new members settled into the club, and the EU's economy finally picked up, after years of lacklustre growth. But the EU still looks leaderless and drifting; its institutions and decision-making procedures are outdated; and its popularity remains weak. Worryingly, just half of all EU citizens see their country's membership as a good thing.[1] If the EU is to regain public support and a sense of purpose, it needs to demonstrate that it can help European countries to cope with new challenges: growing global competition, the related rise in economic insecurity, and climate change.

[1] *European Commission, 'Eurobarometer poll 66', December 2006.*

The Lisbon agenda of economic reform provides a ready-made framework to help the member-states meet these challenges, but its profile is nowhere as high as it needs to be. Indeed, the German presidency in the first half of 2007 is playing down Lisbon, fearing that the process may have been discredited by the EU's failure to meet its targets. However, the fact that progress has been disappointing is all the more reason to redouble the energy devoted to Lisbon. After all, it is now even clearer than it was seven years ago – when the programme was launched – that EU countries must become more competitive in knowledge-based industries if they are to flourish in a fast globalising economy.

Europe in a flat world

Europe has benefited from globalisation through the availability of cheaper goods and services and through the emergence of lucrative new markets. But many Europeans perceive it as a threat to their traditions of social market capitalism. There is no doubt that globalisation is forcing Europe to change. Some commentators even claim that the fast-growing global labour force, together with new technologies that allow companies to outsource many of their activities to low-cost countries, have "flattened" the world.[2] More and better jobs will move from Europe and the US to India and China, where millions of people work long hours for a fraction of the wages of western workers.

[2] *Thomas Friedman, 'The world is flat: A brief history of the 21st century', 2006.*

But Europeans should not descend into gloom. Today, the European economy is better prepared for global competition than it was in 2000, when the EU leaders launched the Lisbon agenda. Progress towards many of the Lisbon goals may have been slow, but it has been noticeable. EU countries have created millions of new jobs. Pension reform is progressing in many places. Telecoms markets, financial services and air travel have been liberalised. And across the EU, governments are cutting red tape and making it easier for entrepreneurs to set up a business.

The process of eastward enlargement has also helped European competitiveness. It has added some 50 million low-cost workers to the EU's single market. In response to fierce global competition in sectors such as car-making, chemicals and electronics, West European companies have moved labour-intensive production processes to countries such as Hungary, Poland and Slovakia. As a result, Europe now has a new division of labour that leaves it much better prepared to cope with globalisation.[3] Moreover, the fast pace of change in many East European countries has reinvigorated the EU's debates on reform. For example, Austrian and German businessmen ask their governments why their tax systems have to be so much more cumbersome than the simple, flat-rate regimes of Estonia or

[3] *Katinka Barysch, 'Europe's new division of labour', CER bulletin, June/July 2006.*

Slovakia. Pressure has also come from the bottom up: scores of German companies confronted their workers with the stark choice of either working longer hours for less money or seeing their factory move east. Most workers complied grudgingly, with the result that German real wages have stagnated since the mid-1990s. Germany's new found competitiveness, in turn, is making change in France, Italy and Spain even more urgent.[4]

[4] *Simon Tilford, 'Will the eurozone crack?', CER pamphlet, October 2006.*

For the EU as a whole, the adjustments of recent years appear to be paying off. In 2006, the EU economy grew by 2.7 per cent, its strongest rate in six years, while unemployment across the Union fell by a full percentage point. Germany finally overcame its long period of near-stagnation, posting GDP growth of 2.7 per cent. In France and the Netherlands growth also picked up. The Irish and Spanish economies continued to expand rapidly. Most of the new member-states saw growth rates of above 5 per cent. There was even some improvement in Italy and Portugal, although their growth rates remained worryingly low.

But while some renewed confidence in the EU is merited, it needs to be put into perspective. The recovery in 2006 follows a lengthy period of exceptionally poor growth, in particular in the eurozone. And economists already predict a return to more sedate growth rates of around 2 per cent in 2007, and beyond – too modest to prevent a further widening of the gap in GDP per capita between the EU and the US.[5] And although eastward enlargement has helped to shore up the competitiveness of car manufacturing, electronics and other traditional industries, if Europe wants to benefit from globalisation in the long term, it needs to move into higher value added goods and services. For this, it needs open and flexible markets that allow money and people to move from declining into growing industries. It needs to devote more resources to research, innovation, better education and training systems so that workers can excel in cutting-edge industries.

[5] *OECD, 'Economic survey of the eurozone 2007', 2007.*

The competitiveness challenge

Europe's core problem is weak productivity growth. This, in turn, reflects a lack of innovation and the slow adoption of new technologies. Against the background of ageing populations and (soon) shrinking labour forces, the decline in the rate of productivity growth is particularly worrisome. Whereas growth in productivity has accelerated since the mid-1990s in the US, it has declined sharply in the EU. Europeans tend to worry most about their labour productivity, but this misses the point. Growing output per worker can stem from technical change, but may also simply reflect a preference for capital (machinery and equipment) over labour, which may or may not be a good thing. Policy makers should be much more worried about Europe's weak growth in total factor productivity (TFP). This measure refers to the change in output resulting from technical change, either through the adoption of existing technologies or through the development of new ones.

What drives TFP? Skill levels, open markets, innovation and entrepreneurship are all key factors behind high TFP growth. So are competition and a simple, transparent business environment, because new, nimble and highly efficient firms are an important driver of technological change. All EU countries have been trying to simplify regulations and encourage more competition in sectors ranging from telecoms to professional services. But the pace of change varies enormously. Whereas the levels of competition in Finland, Ireland, Sweden and the UK are now almost as high as in the US, France, Italy and Spain continue to be held back by more tightly regulated markets. Most EU countries are also trying to make labour markets more flexible and more efficient, to make it easier for companies to hire and fire, and for workers to move from one job to the next. While there has been considerable progress in encouraging part-time and fixed-term jobs, standard employment remains heavily regulated in many EU countries.

Competition forces companies to be innovative and search for ways of becoming more productive. So the lack of integration of

its services markets is one reason why productivity growth in the EU is so disappointing. Although the free movement of services is one of the 'four freedoms' guaranteed by the treaty of Rome (the others are the free movement of goods, capital and people), services markets in the EU remain highly regulated and largely insulated from cross-border competition. Services account for around 70 per cent of EU GDP, but only 20 per cent of intra-EU trade – and that proportion has actually fallen over the last five years. The abolition of most barriers to trade in goods has spurred competition and productivity growth and lowered prices. A huge range of services, from construction to advertising, are traded internationally. So there is no reason why a true internal market in services should not deliver similar benefits. Unfortunately, in 2006 the EU missed an opportunity to create such a market when it watered down the Commission's draft services directive.

Innovation is another key ingredient of TFP growth. Average research and development (R&D) expenditure in the EU-25, at less than 2 per cent of GDP, is much lower than in Japan or the US. On current trends, within five years even China will devote a higher proportion of its GDP to R&D than the EU (although there are doubts over the efficiency of much of China's spending). Innovation is particularly important for countries that have reached the high-tech frontier. For them, it is the only available driver of growth. By contrast, less advanced economies can still improve their productivity by adopting existing technologies.

Europe needs to pay more attention to improving education and training. Most EU countries do not invest enough in universities, and their education systems are overly centralised. The result is widespread mediocrity. Only highly-skilled and flexible workers will be able to innovate and to apply new technologies and processes in their jobs. Europe needs more focus on maths and science in both secondary and higher education.[6] The Nordic countries lead the way, but Ireland, the

[6] *Richard Lambert and Nick Butler, 'The future of European universities: Renaissance or decay?', CER pamphlet, May 2006.*

Netherlands and the UK have also made progress in adjusting their education systems to the requirements of a fast-changing economy. In most other EU countries, however, skill levels are better suited to producing capital-intensive goods, such as machinery and cars, rather than the knowledge-based products that dominate US exports, such as software and technology hardware. Competition in industries in which the EU currently excels – such as machinery and equipment, cars and chemicals – is intensifying rapidly.[7]

[7] *Jean Pisani-Ferry, 'Europe's eroding wealth of knowledge', Financial Times, August 23rd 2006.*

The Lisbon league table

The CER's annual Lisbon scorecard provides an overview of the EU's record on economic reform. It is not a predictor of short-term economic performance. Instead, it points to the capacity of member-states to flourish in a world in which high-cost countries cannot sustain their living standards unless they excel in knowledge-based industries. Since we are analysing dozens of policy areas in 25 EU countries, our assessment of national reform efforts is by necessity impressionistic and partial.[8] Nevertheless, 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 or are making slow progress are branded 'villains'.

[8] *This scorecard mainly looks at progress in the member-states during 2006, and in some cases further back. Since Bulgaria and Romania only joined the EU at the beginning of 2007, they are not yet included in the evaluation.*

The scorecard's 'Lisbon league table' (see page 12) provides an assessment of a country's overall Lisbon performance in 2006, and compares it with the previous year.[9] The table is based on the EU's short-list of 'structural indicators', which measure member-states' performance in economic, social and

[9] *Aurore Wanlin, 'The Lisbon scorecard VI: Will Europe's economy rise again?', CER pamphlet, March 2006.*

environmental categories – such as employment rates, greenhouse gas emissions, R&D spending and so on.

Strong performers

The league table once again confirms the strong performance of the Nordic member-states, with Denmark the top-ranked country, closely followed by Sweden. Both score at or near to the top in terms of long-term unemployment, social equity, lifelong learning, R&D, and environmental indicators. Both manage to combine high levels of taxation and comprehensive welfare provision with competitive product markets, and in Denmark's case at least, a significant degree of labour market flexibility. Of course, neither country is perfect. Denmark's economic growth record has been nothing to write home about in recent years, partly because of lacklustre productivity growth. For its part, Sweden suffers from high youth unemployment and large numbers of people on sick leave.

The Netherlands and the UK also perform strongly, ranking 3rd and 4th respectively. The Netherlands is the only EU country that manages to combine high levels of productivity with a high employment rate. The other member-states typically have high productivity and low employment rates (such as France and Belgium) or high employment rates and relatively low productivity (such as Sweden and the UK). The Netherlands scores very well across nearly all categories of the scorecard, with its only real weakness being R&D expenditure. To an extent this probably reflects the fact that the Netherlands – like the UK – has a large and dynamic service sector, and that innovation by service companies is difficult to measure and may pass unrecorded. Having risen two places compared to last year, the Netherlands is a hero of the 2007 Lisbon scorecard, together with Denmark.

The UK is the best performer among the bigger member-states. Strong growth has pushed it into 7th place in terms of GDP per capita in the EU, well above France and Germany. Although the UK's labour productivity remains low compared with France and

Germany, it is broadly in line with other high employment economies such as Denmark and Sweden. As in the Netherlands, R&D spending is too low, although investment in information and communication technology (ICT) is very strong. The British government has made considerable progress in reducing social inequality in recent years, but if it wants the country's good performance to continue it will need to redouble its efforts to improve vocational skills levels.

The Czech Republic has moved up the league table since 2005 and now ranks 10th, the best placed new member-state. GDP per capita has risen more rapidly in several other Central and East European countries, but the Czechs score well in a number of areas. For example, their level of R&D spending now easily outstrips that of much wealthier economies such as Italy and Spain. Another newcomer that continues to climb up the ranking is Estonia. Very rapid growth has lifted GDP per capita from under 40 per cent of the EU average in 2000 to almost two-thirds in 2006. But Estonia also excels in terms of many high-tech indicators and it boasts a rapidly rising employment rate.

Must do better

Every EU member-state could do better. But for Europe's economic prospects, it is the performance of the big eurozone countries that matters most. In France and Germany, workers are productive, but to a considerable extent this reflects low employment rates. Unemployment fell sharply in both countries in 2006, but rates of long-term unemployment remain stubbornly high, and in Germany's case, the number of people living in poverty is rising rapidly. Although Germany's R&D spending is among the highest in Europe (as a share of GDP), a very substantial proportion of it is accounted for by car manufacturing, while the share going into cutting-edge industries is declining. Germany's immediate growth prospects are probably better than those of France, due to the competitive edge Germany has gained from years of wage restraint. But both countries face the same challenge of building flourishing knowledge-based economies.

Since the creation of the euro in 1999, Spain has been a star economic performer. Over the last ten years the Spanish economy has grown more rapidly than any other EU-15 country except Ireland. Despite unprecedented levels of immigration, it has closed much of the gap in real GDP per capita with the wealthier member-states over this period. However, as Spain gets richer it will have to compete in higher value-added sectors and it is rather poorly equipped to do so. Very low levels of R&D spending, a flawed education system and a business environment that does little to spur innovation were not serious obstacles to growth when the country was still catching up. Spain also has an exceptionally bad record of combating emissions of greenhouse gases.

It is a long time since Hungary was seen as the star reformer among the post-communist transition economies. Successive Hungarian governments have failed to address the country's structural weaknesses, in particular its bloated and inefficient public sector. The country is running huge budget and current-account deficits: 10 per cent and 7 per cent of GDP respectively in 2006. In the short term, it needs to move aggressively to cut the budget deficit. If it fails to do so, Hungary could well face a financial crisis, brought on by a loss of investor confidence in its currency, the forint. The longer-term challenges are also daunting. The country's population is already falling, the result of a very low birth rate. Therefore, it urgently needs to boost the productivity of its existing workers and bring more people into the workforce. It is making very little progress on either account. Only Malta and Poland have fewer people of working age in employment or lower levels of educational attainment among 20-24 year-olds.

Laggards

Poland has slipped to last place in our ranking. Its per capita GDP rose more slowly than that of any other new member-state between 2000 and 2006. Low levels of investment and employment share much of the blame. Although hundreds of thousands of Poles have moved (if only temporarily) to wealthier EU countries, Poland's rate of employment remains the worst in the EU. The jobless rate fell noticeably in 2006, but only 54 per cent of Poles of working age are in employment. Education indicators are also worrying, while the share of GDP spent on R&D fell between 2000 and 2006. From a low starting point, Poland has made some limited progress with the implementation of its Lisbon national reform programme.[10] But the Polish government needs to move much faster if it is to prevent the country from falling further behind.

[10] The national reform programmes were introduced in 2005. They detail the measures being taken by each member-state in order to meet the Lisbon targets.

Italian GDP per capita is now barely above Spain's, and has fallen far behind that of France and Germany. Italy has to do much more if it is to prevent a further decline in its relative prosperity. The country's biggest problem is a chronically weak productivity performance which, in turn, reflects a dearth of innovation. For an economy with a large manufacturing sector, R&D spending is extremely low – just 1.1 per cent of GDP in 2005. While Italy's employment rate has risen, it remains by far the lowest in the EU-15. And job creation has come at the expense of productivity improvements. To its credit, the Italian government is making an effort to encourage more widespread use of ICT, and to remove the rules that stifle competition in sectors such as taxis, pharmacists and petrol stations. But much more will be required to make product and labour markets more flexible. Meanwhile, the government urgently needs to reign in the budget deficit and to free up resources for investment in education and infrastructure.

Greece has slipped to 22nd place in this year's scorecard. Although the country enjoyed strong growth in real GDP per capita between 2000 and 2006, successive governments have failed to implement the reforms needed for sustained growth. The employment rate remains far below the EU average. Pension reform is lagging. Public investment is too low. And although the budget deficit has come down from more than 7 per cent in 2004, government debt remains

stuck at more than 100 per cent of GDP. It is true that Greece has achieved relatively impressive growth in total factor productivity. But in numerous areas, including R&D expenditure, education indicators and telecoms liberalisation, Greece ranks at the bottom of the EU league. Unlike the new member-states, Greece has had plenty of time to take advantage of the market opportunities, policy dialogues and budget funds that the EU offers to countries that try to catch up with the richest in Europe. But it has wasted many opportunities. For this reason, Greece joins Poland as one of the two villains of the 2007 scorecard.

The Lisbon process = C+	
Heroes	Denmark, the Netherlands
Villains	Greece, Poland

The Lisbon league table:
Overall Lisbon performance 2006*

Rank 2006	Rank 2005	Country
1	1	Denmark
2	2	Sweden
3	5	Netherlands
4	4	United Kingdom
5	3	Austria
6	6	Finland
7	9	Luxembourg
8	7	Ireland
9	10	Germany
10	12	Czech Republic
11	8	France
12	11	Slovenia
13	13	Belgium
14	14	Cyprus
15	16	Estonia
16	18	Portugal
17	21	Spain
18	19	Latvia
19	15	Hungary
20	20	Lithuania
21	23	Italy
22	17	Greece
23	22	Slovakia
24	24	Bulgaria
25	25	Romania
26	27	Malta
27	26	Poland

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

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 high-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 problem 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

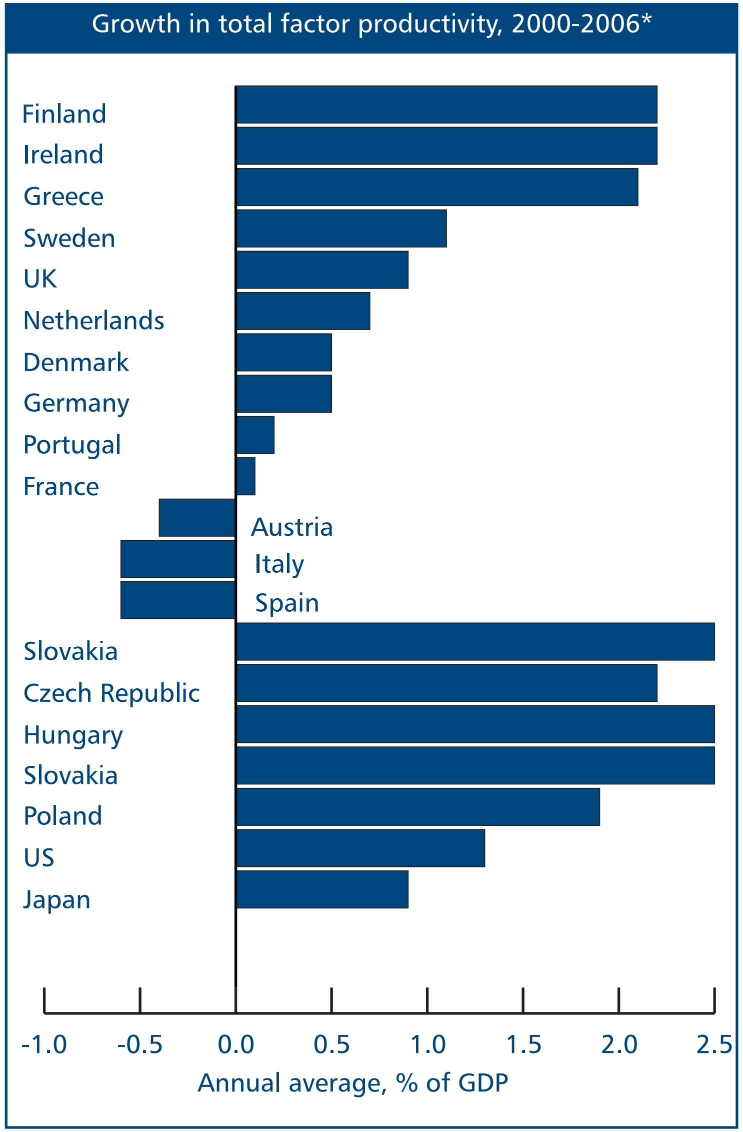
★ Promote new technologies, such as broadband internet

Many EU economies are slow to adopt and spread new technologies. This matters because differences in 'technological readiness' help explain much of the variation in productivity growth between countries.[11] The reasons for Europe's disappointing productivity growth are complex, but its weakness in using information and communication technologies (ICT) is undoubtedly part of the problem. US companies' ability to benefit from ICT, in particular in the services sector, explains much of the gap between US and EU productivity, and especially in total factor productivity (TFP, a measure for the efficiency with which labour and capital are used).[12] There is strong statistical evidence linking expenditure on ICT and productivity growth. Stronger investment in ICT, and the faster TFP this has spurred, explains much of the gap in US and EU economic growth over the last ten years.[13]

[11] Groningen Growth and Development Center, 'Industry growth accounting database', 2006.

[12] Economists think that TFP is a better measure of technological progress than labour productivity, which is largely driven by rates of capital spending. Many factors influence TFP, such as labour market flexibility, education levels, regulatory frameworks, and the general climate for innovation. But the level of expenditure on ICT and diffusion of ICT throughout the economy is crucial.

[13] European Economic Advisory Group, 'Report on the European economy 2006', March 2006.



Source: Economist Intelligence Unit.
**Data for 2006 are estimates.*

The EU-15 countries that have achieved the fastest growth in per capita GDP over the last ten years – Finland, Ireland, Sweden and the UK – have all recorded very high growth rates in IT investment and TFP. Indeed, growth in IT spending has been more important than conventional investment in plants and machinery for Finland, Sweden and the UK. By contrast, weak technological progress has been a key factor holding back the EU-15 countries that have posted the slowest growth in GDP per capita over this period – France, Germany and Italy. In these economies, growth of IT capital has been low and TFP weak, as companies have failed to benefit from using ICT. The case of Italy is particularly striking in this respect: here, TFP growth has actually been negative since 2000.[14] (See table on page 16).

[14] *Groningen Growth and Development Center, 'Industry growth accounting database', 2006.*

Perhaps the single most important thing the EU could do to accelerate the spread of ICT would be to encourage services sector integration (see section B3). Breaking down the barriers to trade in services within the EU would encourage the spread of best practice and force companies to innovate and boost productivity.

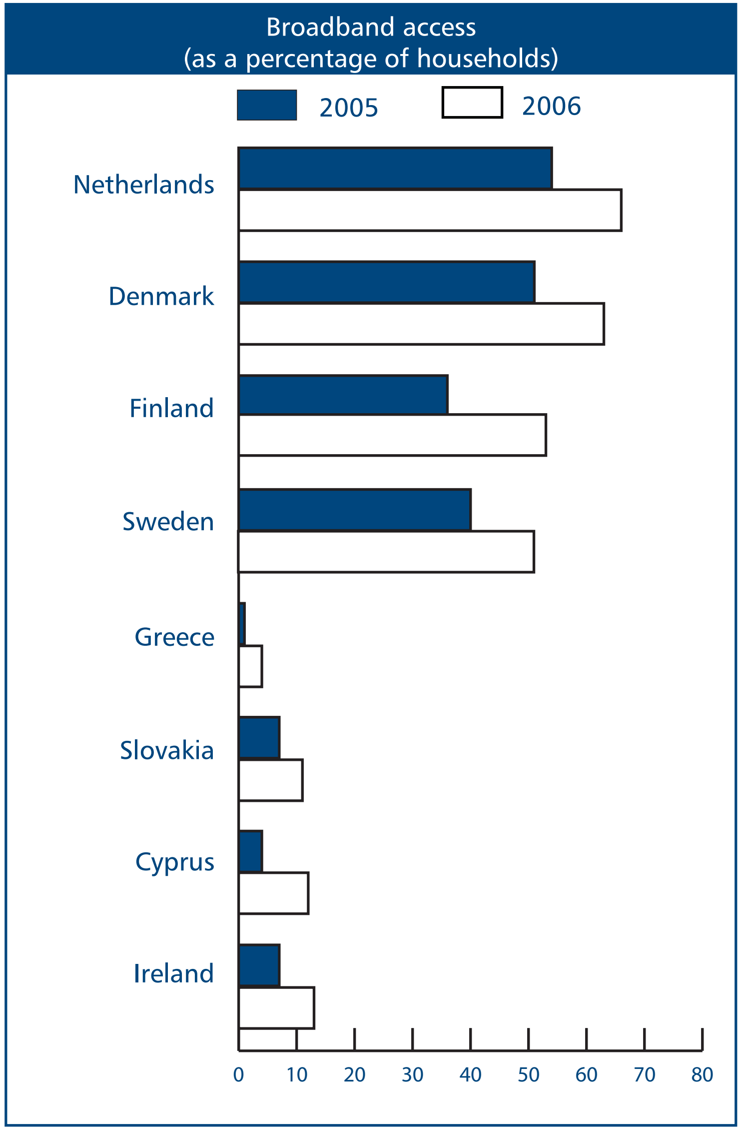
A digital divide

There is some good news on the IT front, in particular the accelerating spread of telecommunications technologies. Over half of EU households now have an internet connection, although differences between individual member-states persist. In Denmark, Luxembourg, the Netherlands and Sweden, more than 70 per cent of all households were wired up in 2006, compared with less than a third in Greece, Hungary and Slovakia. Lithuania made the fastest progress in 2006, with the number of households with internet access more than doubling to 35 per cent.

The proportion of EU households using broadband to access the internet jumped to almost a third in 2006, a rise of almost 50 per cent. The Netherlands and Denmark were the best overall performers, with 66 per cent and 63 per cent respectively. Finland did especially well in 2006, increasing the number of homes with broadband from 36 per cent to 53 per cent. Many EU newcomers are now outperforming the EU-15. For example, Hungary, Latvia, Lithuania and Slovenia all managed to double the number of broadband connections in 2005. Estonia – building on rapid progress in 2005 – raised the share of households to 37 per cent, above those of Austria, France and Germany. Greece remains the EU laggard, with a share of just 4 per cent in 2006. And although broadband finally took off in Italy in 2005, progress since then has been disappointing, with the proportion of Italian homes with broadband rising by just 3 percentage points in 2006, to 16 per cent (see table on page 19).

An e-readiness ranking compiled by the Economist Intelligence Unit (EIU) also suggests that many EU countries, if not the EU as a whole, are now embracing ICT. The EIU's ranking assesses a country's ICT infrastructure, and the ability of its consumers, businesses and governments to benefit from ICT.[15] Five EU economies plus Switzerland are ranked among the top ten worldwide. Denmark is the global leader, ahead of the US. However, the ranking also illustrates the extent of the digital divide within the EU, with the poorest placed EU-15 country – Greece – ranked 29th (out of 68 countries), and the lowest ranked EU-25 state – Latvia – in 39th position.

[15] *Economist Intelligence Unit, 'The 2006 e-readiness rankings', 2006. http://graphics.eiu.com/files/ad_pdfs/2006Ereadiness_Ranking_WP.pdf.*



Source: Eurostat.

E-readiness rankings

2006 e-readiness rank (of 68)	2005 rank	Country	2006 e-readiness score (out of 10)	2005 score
1	1	Denmark	9.00	8.74
2	2	US	8.88	8.73
3	4	Switzerland	8.81	8.62
4	3	Sweden	8.74	8.64
5	5	UK	8.64	8.54
6	8	Netherlands	8.60	8.28
7	6	Finland	8.55	8.32
8	10	Australia	8.50	8.22
9	12	Canada	8.37	8.03
10	6	Hong Kong	8.36	8.32

Source: Economist Intelligence Unit.

Another aspiration of the Lisbon agenda is to encourage governments to make use of technology to offer cheaper, easier and more efficient services. According to the latest figures from the Commission in 2005, 56 per cent of government services in the EU-15 were available online, up from 36 per cent in 2002. The best performing countries were Austria, Sweden and the UK. The UN considers some EU countries world leaders in this respect: its 'e-government readiness report' ranks Denmark second, Sweden third and the UK fourth, behind the US. Among the new EU members, Estonia comes out best, in 19th place. Hungary and Latvia have also made considerable progress, but Poland has continued to fall behind in this area. Spain and Lithuania were the worst performers, ranked 39th and 40th respectively.[16]

[16] *United Nations, 'UN global e-government readiness report', 2005. http://unpan1.un.org/intradoc/groups/public/documents/un/unpan021888.pdf*

Information society = B+	
Heroes	Denmark, Estonia, Sweden
Villains	Greece, Italy, Spain

A2. Research and development

★ Agreement on a European Community patent

★ EU annual R&D spending to reach 3 per cent of GDP by 2010

In today's fast-changing economy, innovation and knowledge can determine whether a business thrives or fails. More broadly, knowledge – its creation and diffusion – is crucial to a country's competitiveness. From this perspective, it is worrying that the EU has made little progress in raising spending on R&D: as a proportion of GDP, total R&D investment in the EU remained unchanged between 2000 and 2005. At just under 2 per cent of GDP, the EU's level of R&D spending lags far behind that of the US and Japan, and on current trends could be overtaken by that of China within five years. Moreover, intra-EU differences are becoming ever more pronounced. The Nordic economies – already R&D intensive at the outset – experienced further strong growth, while the share of R&D spending hardly changed in France and Germany. In Britain and the Netherlands it actually fell.

One consequence of low R&D spending is that European companies file fewer patents than their counterparts in the US and Japan. The fact that the EU still does not have a unitary framework for patent applications – despite this being declared a priority – certainly does not help. The adoption of a European Community patent has been held up by governments squabbling over how many languages each application must be translated into. As a result, companies still have to file separate patents in all the main EU countries, which is both time-consuming and costly.

Spending on R&D
(as a percentage of GDP)

	1995	2000	2005
EU-15	1.85	1.92	1.91
EU-25	1.82	1.87	1.85
US	2.48	2.72	2.66*
Japan	2.92	3.05	3.18*

*Source: Eurostat. *2004.*

Share of R&D spending by governments and business
(as a percentage of total, 2004)

	Government	Industry
EU-25	35.7*	54.1
US	31.0	63.7
Japan	18.1	74.8

*Source: OECD, 'Main science and technology indicators', Volume 2, 2006. *2003.*

Number of triadic patents*

	1995	2000	2003
EU-25	11,511	16,057	16,105
US	12,074	17,440	19,701
Japan	9,326	13,086	13,557

Source: OECD, 'Main science and technology indicators', Volume 2, 2006.
**A triadic patent is a patent that is registered in the EU, Japan and the US.*

The correlation between a company's investment in R&D and its sales and revenue growth is well established. The link between economic growth and levels of R&D, though less strong, is still significant. Yet the EU's decision to set a single target for R&D expenditure for such a heterogeneous group of economies is questionable. The importance of R&D expenditure in a country varies according to the level of economic development: it is much more important for highly developed economies, operating close to the technological frontier, than for more backward ones that can rely on importing technology to boost productivity growth.

The sectoral breakdown of R&D spending is also important. For example, R&D spending in the car industry – a mature and slow-growing sector where companies have to spend heavily on R&D just to maintain sales – will make less impact on an economy's growth potential than R&D in fast-growing industries, such as software or pharmaceuticals. Moreover, much innovative activity is not captured by statistics on R&D spending, for example the acquisition of high-tech equipment, or training and product testing. Since conventional R&D statistics are particularly unsuited for measuring innovation in services industries, they tend to understate the innovative capacity of economies with large and dynamic services sectors.

The number of patent applications – another indicator of a country's innovative capacity – also has to be interpreted with caution. The propensity to file patents varies widely across industries. For example, in 2005, €15 million spent on R&D generated a single US patent in the pharmaceuticals industry but more than six patents in the electronic and electrical goods sectors.[17] Hence countries such as Switzerland and the UK, which depend on the pharmaceuticals sector for large shares of their R&D, register relatively few patents. By contrast, countries such as Germany and Japan, which are strong in electronics, car components and (in Japan's case) technological hardware, generate disproportionately large numbers of patents.

[17] *UK Department of Trade and Industry, 'The R&D scoreboard 2006: The top 800 UK & 1,250 global companies by R&D investment', 2006.*

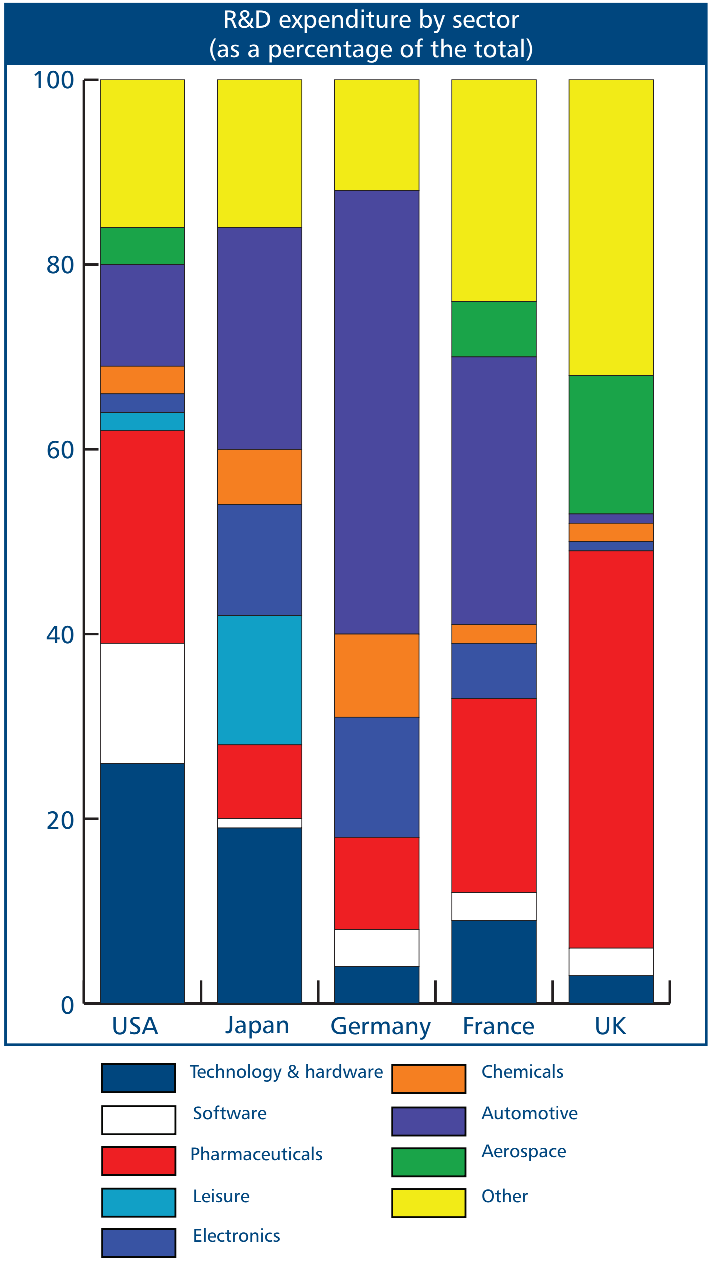
Aggregate measures of R&D spending and patents are therefore not fool-proof indicators of an economy's capacity for innovation. It makes more sense to compare the levels of R&D expenditure among economies of broadly similar levels of development, and to bear in mind their industrial structures. Among the wealthiest 12 EU countries, Sweden devoted most to R&D, at 3.9 per cent of GDP in 2005, followed by Finland at 3.5 per cent, and Denmark and Germany at 2.5 per cent. By contrast, Italy spent just 1.1 per cent, Ireland 1.3 per cent and the Netherlands and the UK, both of which have very large services sectors, 1.8 per cent.

As expected, the poorer EU members are even further away from meeting the Lisbon target, but they show equally large differences in R&D spending. The worst performers – given that they are far from being the poorest countries in the EU – are Greece and Portugal, spending 0.6 per cent and 0.8 per cent of GDP respectively in 2005. Some of the new member-states are doing better. Slovenia, for example, spent 1.6 per cent on R&D in 2005. The Czech Republic recorded the fastest growth rate among the newcomers: its level of R&D investment increased from 1.1 per cent of GDP in 1999 to 1.4 per cent in 2005.

High barriers to innovation

Among the many intractable obstacles to higher R&D investment in the EU, two appear particularly important. The first is the weakness of fast-growing and R&D-intensive sectors, such as pharmaceuticals, software and technological hardware. The proportion of R&D accounted for by high-growth sectors is in fact falling in Europe. Thus R&D investment is increasingly concentrated in mature, slow-growing sectors, such as the car industry.

Each year the UK's Department of Trade and Industry (DTI) ranks the top 1,250 R&D spending companies globally. According to the DTI's 2006 R&D scorecard, over 60 per cent of US R&D is in fast-growing sectors, while the proportion is less than 20 per cent in



Source: UK Department of Trade and Industry, 2006.

Germany. Nearly half of German R&D spending is accounted for by the car industry. It is no surprise that R&D spending has increased most strongly in the Nordic countries, with their fast-growing telecoms and high-tech industries.

One reason why Europe is lagging in research is low levels of R&D in the services sector. According to data from the OECD, services sector R&D in the EU-15 is just a third of the US level, despite the two economies being of a comparable size. This is clearly one explanation for weak growth in services sector productivity across the EU.

A second reason for Europe's poor performance is a dearth of good researchers. Creating and implementing innovation requires above all a highly-trained workforce, with skills in science and technology. The ability to adapt to new technology requires well-functioning secondary schools that are strong in maths and science tuition, and a tertiary education system that facilitates the adoption and diffusion of innovation.[18]

[18] *Richard Lambert and Nick Butler, 'The future of European universities: Renaissance or decay?', CER pamphlet, May 2006.*

EU skills levels are generally suited to producing capital-intensive goods, such as machinery and cars, rather than the knowledge-based products that dominate US exports, such as software.[19] Of course there are exceptions, such as the Nordic countries and Ireland, and to an extent the Netherlands and Britain. The industrialisation of China and other emerging markets has kept global demand for EU machines and investment goods high in recent years, while Asia's growing middle classes spend money on European cars and other consumer durables. However, competition in these sectors is intensifying rapidly. Europe's living standards will only be sustainable if EU companies become more successful in knowledge-intensive industries. This, in turn, depends on the availability of highly-trained researchers.

[19] *Jean Pisani-Ferry, 'Europe's eroding wealth of knowledge', Financial Times, August 23rd 2006.*

The lack of such researchers is driving EU companies to shift more and more of their R&D to non-EU locations. Between 1999 and 2003, British and German companies doubled the amount they spent on R&D abroad. As a result, by 2003 German companies did over 25 per cent of their R&D outside Germany, whereas the proportion for UK companies was almost 40 per cent.[20] Similar trends can be seen in most EU countries, but not in the US or Japan, where the share of corporate R&D undertaken overseas barely rose between 1999 and 2003.

[20] *OECD, 'Main science and technology indicators', Volume 1, 2006.*

The offshoring of R&D would not be such a problem if EU countries were better able to attract outside investment into their R&D intensive industries. There are exceptions: in Austria nearly a third of R&D is financed by foreign investment and in the UK the share is almost a quarter. By contrast, only a tiny proportion of Finnish and German business R&D is paid for by foreign companies (3 per cent and 2 per cent respectively). Shares are similarly small for Spain and Portugal, which – unlike Germany and Finland – also suffer from low domestically-financed R&D investment.

If the EU is to succeed in raising R&D spending, government procurement must play a greater role in stimulating innovation. The EU could do worse than learn from the example of the US's small business innovation research (SBIR) programme. This was established in 1982 and is the world's largest seed capital programme for science and technology businesses. Each year it makes over 4,000 awards to small high-tech US businesses. These awards take the form of contracts for the development of technologies that US government agencies believe they need in order to improve their effectiveness. Many of the leading US technology companies have their origins in the programme. Public procurement of goods and services represents a huge purchasing power – around 15 per cent of EU GDP. EU governments should harness some of that potential to encourage the adoption and diffusion of innovative technologies, as well as to boost public sector efficiency.

Unfortunately, EU state aid rules currently make it difficult to use public procurement to stimulate innovation.

The way forward

The EU needs to move from rhetoric that applauds the knowledge economy to taking concrete steps that will facilitate it. The narrow focus on overall R&D spending is misguided. Instead, EU governments should concentrate on:

★ boosting investment in human capital and reforming higher education. Universities need to be freed from state control, and encouraged to attract private finance. Only then will they be able to compete for the brightest students and best teachers, and to establish the kind of links between academic research and the private sector that have proved so fruitful in the US.

★ stimulating R&D investment in services industries by encouraging the integration of services sectors across the EU. At present, services sectors are fragmented, with the result that there is often insufficient scale to make innovation worthwhile (see section B3).

★ making more intelligent use of public procurement. Public spending has the scale to encourage the adoption and diffusion of innovative technologies (see section C1).

★ removing the remaining legal and tax obstacles to venture capital provision. Some EU countries are already doing well in this respect (see section C1), but on the whole Europe's venture capital industry has been slower to recover from the dot.com crash than that of the US.

★ improving the regulatory environment. Harmonised regulatory regimes and rapid approval procedures can foster the innovation of new products and services by providing

companies with greater economies of scale, and by reducing the cost of regulatory compliance. (See 'Europe needs demand-side innovation policies' by Luke Georghiou on page 32).

★ better targeting of EU funds on research and innovation. The EU needs to spend less on supporting agriculture and more on improving the environment for innovation. The establishment of the European Research Council in 2005, a largely independent body that distributes funds according to a set of objective criteria and peer review, is a positive step and needs to be built on.

★ agreeing on an EU-wide patent system and resolving other outstanding intellectual property issues. This would reduce the cost of filing EU-wide patents – which is currently five times as high as the cost of patent protection in the US – and speed up the approval process.

Research and development = D+	
Heroes	Austria, Czech Republic, Sweden
Villains	Greece, Italy, Poland

Europe needs demand-side innovation policies

Europe's research and innovation policies are hamstrung by the target of increasing average R&D spending to 3 per cent of GDP by 2010. Despite the fact that there is no chance of meeting this target, ministers and senior officials continue to proclaim it as the centrepiece of their strategy for a knowledge-based European economy. This focus misses the point. It is business that provides two-thirds of R&D expenditure. So the key question is: Why is European business spending on R&D more or less stagnant, while it is rising in the rest of the industrialised world? To find the answer, we must ask what mainly motivates firms to invest in R&D and innovation. The answer is simple: market demand.

The biggest barrier to achieving the Lisbon R&D objectives is the lack of an innovation-friendly market in Europe. Innovators face 27 different national regulatory regimes, as well as wide divergences in business culture and consumer tastes. This is very different to the US, or increasingly to China, where the same innovation can be worth much more simply because of the far greater scale available in a homogeneous national market.

The EU cannot rely only on supply-side reforms or increased public spending to achieve its R&D targets. There is no point in offering firms incentives to invest in research and innovation unless they can expect an adequate return on their investment. EU governments therefore must add demand-side policies. They should adopt measures to guarantee demand for truly innovative goods and services. For this, they need to pay more attention to creating 'lead markets', that is national or regional markets that are first to adopt a successful innovation. Lead markets need tech-savvy customers that are willing to pay extra to have the latest product or design. And they need to be big enough for companies to reap economies of scale. Lead markets allow companies to hone their innovations based on customer feedback; and they provide a platform from which innovations can spread and become the dominant design.

Lead markets are a public policy issue. Governments can stimulate their creation and provide the conditions in which they thrive. Governments can bring together innovative firms, researchers, customers, suppliers and regulators. Lead markets can stimulate innovation if government regulation requires specific standards or targets – an approach often used to promote eco-innovation. Most importantly, governments can mobilise public procurement of goods and services, which amounts to between 10 and 16 per cent of European GDP. This huge resource can be used to facilitate innovation if ministries and other public bodies specify functional requirements for goods that off-the-shelf solutions cannot deliver. Any successful tender should incorporate innovation.

Public procurement has played a crucial role in stimulating earlier European technological successes, such as the Nordic origins of GSM telephony. But the EU's increasingly stringent competition rules have outlawed some sensible practices. For example, the public bodies that conduct the tenders and the companies that submit the bids may not work together to develop challenging specifications. By trying to enforce 'static' competition between different bidders, the EU could inadvertently prevent 'dynamic' competition between different innovations. Current EU efforts to re-write guidelines for public procurement go part of the way towards redressing this problem. For example, public bureaucracies and their suppliers can now hold technical dialogues, and agree on what is needed for example for a municipality to build up a zero-emission bus fleet. But the changes do not go far enough.

Europe's leaders need to work together to harness the specific needs of the public sector into a stimulus for innovation. And they need to pool their resources and spending power to create a level of demand that is worthwhile for business investment in innovation. Otherwise the EU will be stuck with the empty repetition of meaningless R&D targets.

Luke Georghiou

Professor of Science and Technology Policy and Management
University of Manchester

B. Liberalisation

B1. Telecoms and utilities

★ Increase competition in telecoms markets

★ Liberalise gas and electricity markets and improve supply security

If energy is affordable and secure, all companies and households benefit. Only if people are able to communicate easily and cheaply can the EU hope to build a knowledge economy. Conversely, if either energy or telecoms markets are disrupted, the damage to the economy and society is disproportionate.

Energy and telecoms have other things in common too. Both markets used to be controlled by state-owned monopolies; in both sectors, the incumbents were usually slow to give newcomers access to their networks; and in both areas, regulating the liberalised market is as important as it is complex. But while telecoms liberalisation has been one of the EU's big success stories, progress in energy remains slow and patchy. Moreover, while there is a consensus across Europe that competition is the best way to provide cheap, reliable telecoms services and spur innovation, there are disagreements over whether liberalisation is the right means to achieve wider energy policy objectives, such as securing supplies and limiting environmental damage. A broader debate about the role of governments in utilities markets is welcome. But there is a danger that some EU governments will use arguments of 'security of supply' as an excuse to protect former monopolies.

Telecoms: innovations drive competition

In telecoms, technical innovation has been at least as important for creating competition as liberalisation or the actions of the competition authorities. In fact, the old fixed-line providers remain dominant in quite a few of the EU countries. In 2004 (the last year for which Eurostat gives comparable figures), national incumbents still handled more than two-thirds of all local calls in the EU-25. Their market shares ranged from 100 per cent in Slovakia and Slovenia, to around 80 per cent in France and Spain, and 50 per cent in Austria and the UK.

But since there are now so many alternative methods of communication and data transfer, these dominant positions matter much less.[21] If fixed-line operators are expensive, people switch to mobile phones: in the new member-states – where liberalisation has been slow – 30-40 per cent of households have no land-line at home, relying instead on their mobile phones.[22]

[21] Thomas Kiessl, Andreas Kuhlmann and Hans Schedl, 'The telecommunications markets in selected OECD countries: Market characteristics and regulatory institutions', CESifo Dice report, autumn 2006.

[22] Eurobarometer, 'E-communications household survey', July 2006.

Similarly, in places where traditional telecoms providers failed to offer affordable internet access, TV companies started selling broadband access through their cable networks. Broadband took off most quickly in the countries that already had a dense cable network, such as France and Italy, but has since been growing faster in those with more liberalised markets, such as Estonia or the UK (see section A1). The fact that over half of EU households (as well as most businesses) now have internet access, in turn, is putting pressure on telecoms providers: more and more people are using internet-based telephony services that are essentially free.

This kind of competition has fuelled business growth (the EU telecoms market was worth around €300 billion in 2006) and pushed down prices to around a third of what they were in 1996.

Some consumers have benefited more than others, however. In 2005 Poles, Czechs and Italians paid four to five times as much for a ten minute national call as Estonians or Swedes, since liberalisation in the latter countries proceeded faster.

Technological change alone is not enough to make markets function. The European Competitive Telecommunications Association (Ecta), a lobby for new telecoms companies, says that even seven years after the start of the Lisbon agenda, progress remains highly uneven between countries. Looking at market access and the quality of regulatory systems, Ecta concludes that the UK has done the most to create a level playing field. Denmark and the Netherlands are also doing well, and France has made very rapid progress since 2003. The laggards are Germany, Greece and Poland.[23]

[23] European Competitive Telecommunications Association, 'Regulatory scorecard 2006', December 2006.

Every year, the Commission sends warning letters to those countries that have not implemented all telecoms directives. Some, such as Greece, have found themselves before the European Court of Justice for ignoring them. The Commission is also threatening to take Germany to court because the country's new telecoms law would shield Deutsche Telekom from competition while it constructs a new, super-fast broadband network.

In some areas, it seems that the mere threat of new legislation has focused the minds of regulators and telecoms providers. For example, the Commission wants to force companies to cut the 'roaming' charges that Europeans pay when they use their mobile phones abroad. More than half of the EU member-states are opposed to price caps and prefer giving the industry a deadline for cutting charges. Although the issue is likely to rumble on until mid-2007, many mobile companies are already offering cheaper packages for travellers. Similarly, Viviane Reding, the commissioner for information society, has been pushing for the creation of an EU super-regulator, to work alongside the national regulatory authorities. While strong national regulators, such as the UK's Ofcom, have not been shy about taking a tough line, in Germany, Ireland and Poland regulators have often been rather too close to national incumbents. Faced with the threat of losing powers to the EU, in October 2006 the national regulators presented plans for more harmonisation and concerted action against recalcitrant former monopolies.

Although the EU's regulatory framework for telecoms is barely five years old, the Commission is already in the midst of a major overhaul to plug gaps and respond to technological change. Following a big consultation exercise in 2005-2006, the Commission will propose laws that could be in place by 2009. The Commission wants not only stronger regulators, but also to reduce the number of sub-sectors (from private local calls to business broadband access) for which national authorities must regulate network access and pricing. The Commission reckons that in much of the retail market, competition is sufficiently well developed for regulators to adopt a hands-off approach.

Disputes over energy security

At their 2005 Hampton Court summit, EU leaders singled out energy as one of the areas where the Union could add real value to the lives of citizens.[24] Since then, high global oil prices, bouts of national protectionism against cross-border mergers, and repeated threats of Russian supply disruptions have kept energy near the top of the EU agenda. As the Commission's recent energy policy package (launched in January 2007) shows, the European energy debate has moved far beyond the completion of the internal market for gas and electricity. The top priorities are now security of supply and the fight against climate change. Therefore, the Commission has proposed a long list of measures – ranging from the increased use of renewable energy sources (see section E) to a more coherent 'energy diplomacy' vis-à-vis big outside suppliers such as Russia.[25]

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

[25] *For all documents on the energy package see http://ec.europa.eu/energy/energy_policy/index_en.htm.*

Concerns about security of supply have made the completion of the EU internal energy market both more urgent and more complex. The Commission, alongside Denmark, the UK and some other EU governments, is convinced that liberalisation and competition are the best way to achieve energy security. Power and gas from one country can make up for shortfalls in another, and an EU-wide energy market encourages more co-operation and solidarity among the member-states, as well as a more cohesive energy diplomacy vis-à-vis outside suppliers. Others beg to differ. France, Germany and Italy argue that rapid liberalisation could lead to unstable prices, and that only cash-rich nationally-based firms will have the strength to make multi-billion euro investments and stand up to Russia's gas monopoly, Gazprom.

The debate about how best to achieve security of supply will continue beyond the EU's spring summit, when the Commission's energy package is due to be discussed. But one thing is already clear: the EU is still a long way from having a well-functioning internal energy market, and this is bad news. EU countries committed themselves to opening energy markets for industrial users by mid-2004 and for households by mid-2007. However, after a series of reviews in 2006, the Commission concluded that "meaningful competition does not exist in many member-states".[26]

[26] *European Commission, 'Energy sector enquiry' and 'Implementation report on EU gas and electricity regulatory frameworks: National reports', both January 2006.*

In Austria, Denmark, France, Germany, Hungary and Poland the former state monopolies still control more than 80 per cent of the national gas market. In the UK it is only 25 per cent. Electricité de France supplies three-quarters of France's electricity market. Spain has only two dominant operators and Germany's power market is carved up between five companies, whereas in the UK nine companies split the market relatively equally.

The Commission has started dozens of infringement procedures against 20 of the member-states. It has also launched raids on German energy companies suspected of collusion. But EU officials, and many experts, believe that a more comprehensive overhaul of EU regulations and policies is needed to open up markets.[27]

[27] For example, Joachim Bitterlich, 'Pour une haute autorité européenne de l'énergie', Fondation Robert Schuman, June 2006; Guillaume Durand, 'Gas and electricity in Europe: The elusive common interest', European Policy Centre, May 2006.

★ **Energy prices still do not reflect market signals.** Electricity and gas prices initially fell after liberalisation started. But they have risen in recent years, especially for big industrial users. In the case of electricity, higher taxes played a role, while the costs of gas have been pushed up by the oil price (to which they are linked). Many companies may also have passed on the costs associated with the EU's emissions trading scheme to their customers. Nevertheless, it is puzzling that energy prices vary so much between different EU countries. For example, even before taxes, German gas prices are a third higher than the eurozone average, which is why both the Commission and the German economics ministry are looking into possible collusion among providers. The Commission also alleges that the price controls used in Poland, Spain and elsewhere are an illegal industrial subsidy and discourage investment in new generating capacity.

★ **Vertically integrated energy companies keep competition at bay.** Under current EU rules, energy companies can own production, transmission and distribution, but they must run them as separate businesses. In practice this legal or functional 'unbundling' has not worked well. In Germany and Italy, for example, the Commission found evidence that the network or pipeline operators that also produce energy (or buy it from abroad) are reluctant to give equal access to alternative suppliers. The Commission's preferred option would be for these companies to sell either the network or their generating capacity.

But France, Italy, Spain, and to a lesser extent Germany, have already made it clear that they are against 'ownership unbundling'.[28] So the EU may end up with the second-best option of adopting stronger controls against conflicts of interest.

[28] Michael Glos, 'Energieperspektiven und zentrale Handlungsfelder der Energiepolitik', speech in Berlin, January 2007; Letter from François Loos to Commissioner Piebalgs, January 10th 2007.

★ **Stronger oversight is needed, in particular if ownership unbundling does not happen.** In some countries, such as the Netherlands and the UK, regulators are well-staffed, independent and competent to decide about network access, competition and other key issues. But in others, such as France, Poland or Spain, the division of competences is unclear and regulators have often been toothless in the face of strong industrial lobbies. The Commission wants a new EU regulator, or at least a tighter network of independent national regulators that watch over each other.

★ **Markets remain fragmented.** Even if national power and gas sectors became more open, this would not automatically result in a Europe-wide market. Although EU countries promised in 2002 to make 10 per cent of energy tradeable across borders, many are still 'energy islands', says the Commission. Companies have few incentives to invest in the 'interconnectors' that link their network to a neighbouring country since they could push prices down. The Commission wants to speed up four priority projects, for example linking Germany's grid with that of Poland and Lithuania, by appointing EU co-ordinators and investing EU money. Consolidation across borders has also been slow. In some cases, EU governments have stepped in to defend their national champions. For example, France's government tried to engineer a merger between Gaz de France and Suez to prevent the former from being taken over by Italy's Enel. And Spain's government has tried to forestall a bid by Germany's E-On for Endesa.

Telecoms and utilities = C	
Heroes	European Commission, United Kingdom
Villains	France, Germany, Poland, Spain

The future of the single market

The EU's single market programme (SMP) has brought direct gains to enterprises by giving them easy access to markets in other EU countries. For citizens, the benefits are often indirect, and they range from product safety to lower air fares and mobile charges, easier access to healthcare in other EU countries, and easier travel in the Schengen area. Nevertheless, large potential benefits remain unrealised, and the single market – even complemented by the euro – has not spurred the EU economies to outperform those of other OECD members. Nor is there a guarantee that the SMP, as presently framed, will unleash its untapped potential in the future.

The reason is that the context in which the single market operates has changed fundamentally. First, with enlargement, the EU market has become more diverse – culturally, linguistically, and in levels of development and administrative capacity. Second, the nature of competition has evolved, due to technological change and globalisation. The SMP was originally designed for an economy based around the mass manufacturing of standardised products that benefit from economies of scale. But today's economy is much more reliant on knowledge- and service-based industries, that produce a much greater variety of goods and services. Companies need to innovate, adapt and rapidly bring new products to the market. This means the focus of the SMP has to change from removing internal borders to showing how the EU dimension can help the European economy compete with the rest of the world.

Since the Commission launched the SMP in 1985, the programme has essentially moved along a single trajectory: more policy areas have been added to the initial list of some 300 liberalising measures; increased attention has been paid to the implementation and enforcement of those measures; and the focus has remained on removing legal and regulatory barriers, rather than economic, physical (infrastructure), cultural or linguistic ones. The EU needs to fundamentally redesign the SMP, so that it can continue to bring benefits to European businesses and consumers, for at least five reasons:

★ The notion of the single market as a static, once-and-for-all construct misses the point. Most people think that the SMP can be completed by adding more legislation, often in particular sectors, or by improving transposition and enforcement. Although progress can be made in these areas, the single market can never be complete. Markets are dynamic not static. New non-tariff barriers are being created within the single market.

★ The EU will find it harder to keep adding new areas to the single market. The SMP is now extending into sensitive areas – such as healthcare – that affect citizens directly and cannot be assessed by the criterion of economic efficiency alone. This will lead to more resistance to the single market in member-states.

★ The primary law-making process is slow. Much of the original single market legislation is now over ten years old, while markets have become fast-moving and more complex. But introducing new directives or updating old ones takes many years, once a law has been debated, passed through the EU system and transposed into 27 national legislative systems.

★ SMP laws can stifle innovation and competition. Early directives had a tendency to harmonise EU rules on the basis of existing national rules, and were often greatly influenced by trade associations representing the interests of existing dominant companies. As a result, some EU directives create significant barriers to new entrants.

★ The SMP assumes that all EU countries are equal. But in the enlarged EU they differ greatly in terms of economic development and administrative capacity. The SMP's focus on harmonisation may burden some countries with legislation that is overly cumbersome and not best suited to their specific situation. Hitherto, the EU has not made ease of implementation a top priority in the development of single market legislation. But the success of such laws depends in large measure on the way they are applied.

Taken together, these points imply that if the EU continues with the present kind of SMP it will miss the innovation boat. All the available evidence points to innovation-driven productivity growth as the main source of future economic prosperity. Therefore the starting point of a new SMP strategy should contain the following elements:

1. Prioritisation. The original SMP approach focused on removing legal obstacles to doing business across borders. But it took scant account of the fact that not all barriers are of the same importance. Innovation thrives on market opportunities for new products. Only by eliminating the obstacles that make it hard for companies to place new products on the market will the SMP help raise Europe's growth potential.

2. De-legalisation. The EU's growing diversity requires a new regulatory approach, with simpler legislation that deals only with the principal obstacles to economic integration, rather than comprehensive harmonisation. The EU should adopt framework regulations in place of detailed directives wherever possible, and give more responsibility to decentralised and flexible bodies to implement decisions.

3. Differentiation. The new SMP needs a sectoral approach that takes account of both the diversity of national markets, and the requirement for coherence between different EU and national policies. Energy is a prime example of an area where the objective of creating competitive markets is more important than legislative uniformity.

4. Co-ordination. Much better co-ordination of the SMP with other EU policies, in particular competition, trade, environment and consumer policies, will be required. Furthermore, the SMP will not fulfil its potential unless it is made more coherent with national policies, particularly the functioning of labour markets.

The SMP's prime objective should no longer be the creation of an integrated Europe that is based around a homogeneous legal order. Instead, it needs an economic objective: the stimulation of competition and the encouragement of innovation. This implies far-reaching changes in the outlook of the Commission and the way it organises itself. The skills required to analyse a market, break down barriers to entry and stimulate competition are different from those required for the harmonisation of existing national rules. The Commission needs a realistic diagnosis of current trends and the available policy options. The college of commissioners will have to provide strong political direction to the institution's various departments. And it should reject proposals that seek to build the future SMP around 'better implementation' or 'filling in the remaining gaps'.

Marcel Canoy, Roger Liddle and Peter Smith

The authors are policy advisers in the European Commission's Bureau of European Policy Advisers.

B2. Transport

★ Increase competition in the railways sector

★ Create a single European sky

★ Encourage investment in trans-European networks

Transport accounts directly for around 7 per cent of EU GDP but, like telecoms and energy, the sector is of disproportionate importance for the functioning of the EU economy. It is also a prime example of how different policy objectives can conflict within the Lisbon agenda. For instance, there are concerns that rapid liberalisation of formerly state-controlled industries, such as railways, could result in cut-throat competition and discourage much-needed investment in infrastructure. Also, since the opening of the aviation sector, millions of Europeans can now fly cheaply for business or pleasure. As a result, the sector's greenhouse gas emissions are now 80 per cent higher than they were in 1990. Similarly, the EU wants more roads to connect peripheral regions to booming centres. But there are already 200 million cars in Europe, and the Commission estimates that the total environmental costs of the transport sector amounts to more than 1 per cent of EU GDP.

Despite these conflicting objectives, the EU's priority remains to liberalise the transport sector, in particular sea, rail and air transport.[29] The opening of port services remains stuck after the European Parliament twice voted against Commission's proposals, in 2003 and 2006. And while progress in the air transport sector has been good, little has been achieved in railways.

[29] *European Commission, 'Keep Europe moving – Mid-term review of the 2001 transport white paper', June 2006.*

Railway opening remains slow

Road transport accounts for more than 40 per cent of freight and 85 per cent of passenger travel around Europe. Railways are comparatively unimportant, accounting for only 10 per cent of goods and 6 per cent of passengers, and these shares have been falling for decades. Business demand for just-in-time deliveries, and the fact that road transport prices do not reflect true environmental and infrastructure costs, explain much of this. But the lack of competition and modernisation in much of Europe's railways sector has certainly not helped.

A decade ago, the EU set about opening the railways sector in an attempt to reverse that decline. The EU's first railways package, adopted in 1998, required member-states to 'unbundle' the management of rail tracks from the actual transport services. A second package from 2002 foresaw complete liberalisation of freight transport by 2007, allowing companies to offer their services Europe-wide. A third package is in the pipeline, which would provide for the full opening of international and domestic passenger services by 2010. It would also include common rules for licences of train crews, and compensation for passengers faced with severe delays. However, in January 2007, the European Parliament – under pressure from reluctant governments in Austria, Belgium, France, Luxembourg and the Netherlands – voted against the liberalisation of domestic markets for passengers.

Despite the flurry of legislative activity, little has changed on the ground. In most EU countries, including France, the Netherlands and Spain, the former state monopoly still controls the entire market. Some governments have been dragging their feet with legal changes, hoping to give their national rail champions some breathing space. Latvia, Portugal and Slovenia have not yet fully applied the second railways package. But even in those countries that started liberalising more than a decade ago, most notably Germany, Sweden and the UK, competition remains limited.[30] In the UK, for example, the dominant freight operator still controls 70 per cent of the market. In Germany, new private companies transport 15 per cent of rail freight, but at least that share is growing noticeably.

[30] *Eric Heymann, 'Competition in the European railway market – morning has broken', Deutsche Bank Research, November 2006.*

As a result, competition has remained limited, both within national rail markets and across EU borders. French freight services, for example, remain slow and expensive. Yet British, Dutch, German or Spanish operators have hardly any access to French tracks. The Rail Freight Group, an industry lobby, estimated that in 2005 cross-channel rail freight transport was running at only 20 per cent of potential because France was maintaining this 'Atlantic wall' to pan-European transport.[31]

[31] *Tony Berkeley, 'Rail freight and France', Rail Freight Group 2005.*

The limited successes of newcomers even in those countries that have gone furthest with liberalisation suggest that there are also administrative and practical barriers to effective competition. The high costs of acquiring the necessary permits and licences deter potential new entrants. Even in the UK, the administrative costs of setting up a railway service can amount to £1 million. For an operator to gain a foothold in another EU market is particularly difficult, because of differing technical and safety standards, licensing requirements and tariffs. For example, Germany and the Netherlands have relatively transparent and quick procedures for licensing the use of locomotives within each others jurisdiction. But Austria and Germany do not. Although those two countries have the same technical standards, the Austrian authorities refuse to certify German locomotives, arguing that their electronics would disturb signalling.[32] A services provider that wants to run a train through several EU countries still needs to get authorisation in all of them.

[32] *Review of European Economic Policy, 'The liberalisation of rail transport in the EU', Volume 41, November-December 2006.*

Another major impediment to pan-European services is the existence of more than 20 different speed control and traffic management systems. When a train crosses a national border, the driver needs to switch from one system to another in order to communicate with local controllers. So the EU has designed a 'European train control system' to replace national standards and promised to co-finance its installation. But since this system will probably take years to be rolled out across Europe, the EU should prioritise harmonisation on key international routes. The EU also needs to find a common method for calculating the charges that independent freight companies pay for using rail-tracks. At the moment, big national differences impede cross-border competition. Many of the new member-states, for example, use high charges for freight companies to subsidise loss-making passenger services.

Open skies agreements

In contrast to the rail sector, the liberalisation of air transport has been a European success story. Since 1997 all airlines registered in an EU country (plus Iceland and Norway) can carry passengers within any other EU member-state. The result has been a proliferation of carriers, including low-cost ones, which now account for a quarter of intra-European flights. Air transport more than doubled its share of intra-EU passenger transport between 1995 and 2004, to 8 per cent of the total.

The boom in air travel is fuelling concerns about the environmental cost, and about the impact on the efficiency and safety of the services provided by European airports. The Commission has launched several initiatives to improve air traffic management so that it can cope with growing flight volumes. One of these, called SESAR (single European sky air traffic management research), is aimed at modernising air traffic controls and creating EU-wide standards. The Commission is also planning to include air traffic in the EU's emissions trading scheme (see section E).

There are also external challenges for EU air transport policy. The Commission is busy negotiating agreements to free up air travel between all EU member-states and non-EU countries. In 2005 and 2006, for example, it signed such 'open skies' agreements with Morocco and several Balkan countries. It is also negotiating with Ukraine and would like to start negotiations with Russia. But a deal on the all-important transatlantic route

remains elusive, despite years of tough negotiations. Among the main obstacles is America's reluctance to allow foreigners to own US airlines (currently they are limited to 25 per cent of voting rights). US congressmen cite concerns over security as the reason, but EU airlines see this as a simple case of protectionism.

Although the EU-US deal remains stuck, the Commission proposed in January 2007 to open similar negotiations with Canada. It estimates that an EU-Canada open skies agreement could by 2011 boost passenger numbers from 8 million to 14 million, save travellers €72 million through lower fares and create up to 3,700 new jobs.

Connecting EU countries

European countries already boast some of the best infrastructure in the world. But more investment will be needed to avoid congestion and make the single market function efficiently in the future. The Commission estimates that freight transport alone will increase by two-thirds between 2000 and 2020. In the new member-states, billions are needed just to bring railways, roads and airports up to EU standards. In countries such as Poland and Slovakia, infrastructure bottlenecks are a brake on economic growth: workers from areas of high unemployment cannot move to booming capitals and industrial centres, while potential investors are deterred from venturing into new regions.

National governments are responsible for the bulk of investment in roads, airports and railways. The EU is trying to add missing cross-border links, especially in places where such connections would make a real difference to local economic development. In 1996 the EU agreed on 14 priority 'trans-European networks' (TENs), to better connect its member-states. With eastward enlargement in 2004, the EU extended the list to 30 projects. However, by 2006 only three of them had been completed: the Øresund rail and road link between Denmark and Sweden, a high-speed train between Brussels and Marseille, and Malpensa airport near Milan.

A dearth of public money is the main reason for the delays. The total cost of the 30 projects is estimated at €250 billion, but the EU budget for 2007-2013 sets aside only €8 billion for this purpose. Meanwhile, spending by EU governments on transport infrastructure is falling (it amounted to less than 1 per cent of EU GDP in 2005).

So the EU should prioritise a limited number of key cross-border projects, while national governments must do more to attract private investment for them. This will not be easy: these large-scale cross-border projects are complex and financially risky. Since several countries are involved in each TEN, there is a risk of legal confusion and a lack of project leadership. In July 2005, the EU appointed special co-ordinators to look after six priority projects and improve co-operation among the various national and European authorities involved. In their first progress report in September 2006, the co-ordinators submitted detailed cost projections and made a number of recommendations. They said, for example, that the EU should concentrate on cross-border bottlenecks and resolving inter-operability issues. The EU needs to make further efforts to give potential investors a clearer idea of the costs and benefits of each project. In particular, clearer legal rules will be needed. At present, the EU lacks regulations to cover international public-private partnerships, which creates uncertainty for potential TEN investors.

Transport = C-	
Heroes	Germany, Sweden
Villains	France, Latvia, Portugal, Slovenia

B3. Financial and general services

★ Complete the financial services action plan

★ Create a single market in services

The free movement of services is one of the 'four freedoms' guaranteed by the treaty of Rome. However, services sectors in most EU countries are highly regulated, with the result that national markets remain largely insulated from cross-border competition. Despite accounting for around 70 per cent of EU GDP and a similar proportion of employment, services represent just 20 per cent of intra-EU trade – a proportion that has actually fallen over the last five years.

The abolition of most barriers to trade in goods spurred competition and productivity growth, and lowered product prices. A huge range of services, from legal services to advertising, can easily be traded internationally, and many believe that a single market in services would deliver similar benefits. According to estimates from the Commission, such liberalisation would raise EU GDP by 1.8 per cent and create 2.5 million new jobs.

General services

If Europe is to improve its economic performance, it must make its services sector more open and efficient. Unfortunately, it missed a big opportunity to do this last year when the Commission's draft services directive was heavily watered down in the face of strong opposition from many MEPs and member-states. The 'Bolkestein directive', named after the former internal market commissioner, Frits Bolkestein, was intended to remove the numerous national rules that prevent EU companies from offering their services outside their home country. Central to the Bolkestein directive was the 'country of origin' principle. This would have allowed services providers to do business anywhere in the EU under the rules and regulations of their home country. So it would have required many member-states to deregulate their services sectors significantly – at a time when popular resistance to economic reform is strong.

Countries with large and dynamic services industries, such as the Netherlands and the UK, strongly supported the Bolkestein directive, as did the new members from Central and Eastern Europe. But Austria, France, Germany and other eurozone countries were fiercely opposed to it. Opponents argued that it would lead to 'unfair' competition and an erosion of social standards by allowing companies to register in member-states where wages were low, and where rules on consumer, health and environmental protection were weak. Advocates of the Bolkestein directive argued that such fears were unfounded. Workers posted to other countries would still have had to be employed under the terms and conditions of the host state. For example, a Polish builder working for a Polish construction company in Germany would no doubt earn less than a German, but local rules on minimum wages and health and safety would still have had to be respected.

There is no doubt that lowering barriers to entry in the way envisaged by the Bolkestein directive would have required many EU countries to accept a significantly greater role for the market in guaranteeing quality. Liberalisation would certainly lower the prices of many services, but cheaper need not mean inferior. The removal of regulatory barriers to competition could just as easily force up standards across the EU, by leaving firms with no option but to become more efficient. The result would have been lower prices, higher productivity (and hence higher real wages) and an expansion of services sector employment.

The watered-down directive does reduce the number of administrative procedures a company has to comply with before being allowed to offer services in another member-state. It also requires EU countries to give services providers from other member-states a single point of contact – where they can complete all the forms required and access all the necessary information. It should therefore make it easier for

services providers to work in different EU member-states. But its overall economic gains will fall far short of those that full liberalisation would have brought.

Financial services

In contrast to the Bolkestein directive, the EU has met little opposition to its Financial Services Action Plan (FSAP), which EU member-states signed in 2000. The initiative aims to reduce legal obstacles that prevent financial businesses – ranging from retail banks to insurance companies to stock exchanges – from selling their products and services across the EU.

The FSAP has been a notable success, with agreements reached on virtually all of the plan's 42 measures within the five-year deadline. However, this raft of new laws has triggered a bout of 'legislation fatigue' among EU businesses. Even the City of London, initially a strong supporter of the plan, has been calling on the EU to slow down its legislative activity.[33] When Charlie McCreevy became the European single market commissioner in November 2004, his strategy was clear: only legislate when necessary.

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

The Commission has kept its word. It has consulted widely with banks and other financial businesses. Wherever possible it has focused on the implementation of existing rules, and on market-based solutions to problems, rather than introducing new laws. In particular, the Commission has so far refrained from legislating on cross-border clearing and settlement (C&S) – the unglamorous but lucrative 'back-office' task of paying for shares and transferring the necessary paperwork.

Currently a cross-border transaction can cost up to six times more than a domestic one. In an attempt to integrate Europe's highly fragmented C&S market, the Commission proposed a code of conduct and a timetable, which the industry signed up to in October 2006. The code aims to give customers a choice of C&S providers, so that they do not have to use the one selected by the exchange on which they trade. However, a number of exchanges make a lot of money from C&S. For example, Deutsche Börse, which owns Eurex Clearing – one of the leading clearing houses in Europe – has little incentive to sell off this lucrative business or make it easier for competitors to access the market. The Commission could yet have to legislate in order to effect real change.

The Commission is not the only institution pressing for reforms of C&S. In October 2006, the European Central Bank (ECB) put forward controversial plans to bring together the patchwork of clearing networks into a single system. According to the ECB, this project, called Target2-Securities (T2S), could cut average transactions costs within the EU to 28 cents, compared with 45 cents today. However, some member-states, notably the UK, are opposed to this idea, fearing that it would create a public monopoly. Although it does not require political support in order to press ahead, the ECB is unlikely to ignore the views of influential EU countries.

The other big item on the FSAP agenda is the 'market in financial instruments directive', or Mifid. Member-states were due to put Mifid on their statute books by January 2007, while companies need to comply by November 2007. The directive will allow financial services providers to operate across the 27 member-states under the regulation of their home country. It also aims to harmonise investor protection rules, and requires brokers to offer their clients the lowest possible price for dealing in shares and other financial instruments (the principle of 'best execution').

Many European financial firms have expressed concerns over the complexity and cost of implementing the directive, in particular the cost of the technology needed to meet the best execution requirement. The UK Financial Services Authority estimates that compliance with Mifid will impose one-off costs of between £877

million and £1.17 billion on UK-based financial firms, followed by ongoing annual costs of between £88 million and £117 million. However, it also estimates that cuts in transactions costs, as well as the general benefits of having more efficient capital markets, will outweigh these costs in the long-term: the direct benefits to firms could amount to around £200 million per year, and the overall annual benefits to the UK economy to as much as £240 million.[34]

[34] *Financial Services Authority, 'The overall impact of Mifid', November 2006.*

Already, new trading platforms and looser regulations have eroded the monopoly that stock exchanges have traditionally enjoyed in trading securities. Mifid will fully open trading to other players, in particular banks, which already trade growing volumes of stocks and bonds in-house. This will no doubt strengthen the ongoing consolidation between stock exchanges in search of greater economies of scale.

Meanwhile, transatlantic tie-ups – such as between Euronext and the New York Stock Exchange – are raising concerns that European exchanges could become subject to stifling US regulation. Take, for instance, Sarbanes-Oxley: this American law was passed in the wake of the Enron scandal to tighten corporate accounting and controls. It is widely criticised for being excessively intrusive and expensive, and for deterring non-American firms from listing in New York, to the benefit of London. The UK authorities, in particular, are anxious to protect London's 'light touch' culture of regulation. To prevent such US regulatory overreach, the EU needs to push hard for enhanced co-operation between EU and US regulators.[35]

[35] *Nicolas Véron, 'Pour les marchés financiers l'Europe n'est plus un espace pertinent', Telos, April 8th 2006.*

Retail banking – unfinished business

While the EU has made good progress in establishing a legal framework for wholesale financial markets, the retail banking market remains highly fragmented. There have been big cross-border deals, such as the takeover of Hypovereins Bank of Germany by Unicredit of Italy and the purchase of the UK's Abbey National by Spain's Banco Santander. But firms find it difficult to offer standardised products – such as bank accounts or mortgages – across the EU because of differences in regulatory requirements, such as consumer protection rules. The tax treatment of financial products also varies widely between member-states. Other obstacles to greater integration are more intractable, such as differences in language, culture or spending and saving patterns.

In 2005, the Commission launched a competition inquiry into retail banking. The report, published in January 2007, shows that there remain many regulatory obstacles to cross-border competition, including collusive behaviour between banks aimed at keeping competitors at bay.[36] In some member-states, it is very expensive to switch banks. Also, foreign financial services firms often have difficulties accessing credit data, making it harder for them to enter new markets. Technical barriers and high fees impede access to payment card networks. The industry will gradually address some of these issues, but many will require action by the Commission and national competition authorities.

[36] *European Commission Communication, 'Sector inquiry under article 17 of regulation 1/2003 on retail banking (final report)', January 31st 2007.*

Financial and general services = B-	
Heroes	The Netherlands, United Kingdom
Villains	Austria, France, Germany

C. Enterprise

C1. Business start-up environment

★ Create the right environment for start-ups

★ Encourage entrepreneurship

Europe needs to do more to encourage start-ups. New firms are often more innovative and dynamic than those that have been around for a while. They introduce new products, working methods and technologies. They create jobs and put pressure on incumbents to innovate and become more efficient. The EU is not short of small companies: there are 23 million small- and medium-sized enterprises (SMEs) – defined as companies with fewer than 250 employees – in the enlarged EU. They account for two-thirds of private sector jobs, compared with half in the US.

However, Europe lags behind the US in at least two respects: first, setting up a business remains expensive and cumbersome in many EU countries. Second, Europe's start-ups are much less likely to grow into a Google or a Microsoft. The average SME in the EU employs six people, compared with 19 in the US. That is partly because European markets are more fragmented than those in the US. But, business regulations, restrictive labour laws, high and complicated taxes, and inadequate financing opportunities all curtail Europe's entrepreneurial dynamism.

Pushed by the Commission – and their own business lobbies – every EU government has in recent years taken steps to make life easier for new firms. Most have cut red tape (see section C2), introduced simpler regulatory regimes specifically for SMEs, reformed bankruptcy regimes to reduce the cost (and stigma) of failure, and encouraged the provision of seed capital. Many have set up specific task-forces or departments to defend the interests of SMEs in the policy making process (for example, the UK's Small Business

Service). Less progress has been made, however, in helping small companies to expand abroad, in making it easier for them to hire and fire employees, or in giving them better access to public procurement budgets.

The World Bank monitors many of the policies that matter for SMEs through its annual 'Doing business' survey, which covers the ease of setting up or closing a business, employing staff or registering property.[37] In 2006, Britain was the easiest place to do business in the EU, followed by Denmark, while Greece was the most difficult. Germany and France ranked 21st and 35th, respectively, out of 175 countries. The best progress in improving business environments in 2006 was recorded by Romania, Bulgaria and Latvia.

[37] *World Bank, 'Doing business 2007', January 2007.*

Such international comparisons have focused minds in those countries that rank lowly. An easily comparable indicator is how long it takes to set up a business. In Denmark, the average time needed is five days, whereas in Greece and Hungary it can take up to 38 days. In January 2007 Italy announced measures to reduce the time it takes to establish a new business to one week or less – down from the current five to eight weeks.[38]

[38] *Tony Barber, 'Italy tears up red tape in liberalisation drive', Financial Times, January 26th 2007.*

The cost of setting up a business also varies considerably: in Denmark it is free while in Greece the costs amount to the equivalent of 24 per cent of average annual per capita income. But rapid progress is possible. Portugal, for example, managed to get the cost of starting a business down from 13 per cent of average annual income to 4 per cent in 2006.

As elsewhere in the world, European SMEs get most of their capital from their own savings, loans from friends and family, and from retained earnings. Banks tend to be reluctant to lend money to entrepreneurs who have little to offer apart from their intellectual

capital. Venture capitalists are more willing to make risky investments, and they can also offer guidance to entrepreneurs, for example on how to write business plans, access new markets and grow a business.

Europe's venture capital industry has seen strong growth since the setback of the dot.com crash, but it still lags behind the US: in 2005, venture capital (VC) investment in the EU amounted to €13 billion, compared with €17 billion in the US.[39] Moreover, Europe's venture capitalists prefer investment in companies that are already well-established, while their American counterparts are more likely to provide seed capital to new ventures.

[39] *Thomas Mayer, 'Venture capital in Europe: Spice for European economies', Deutsche Bank Research, October 2006.*

Funding opportunities for start-ups vary greatly across the EU. In Denmark, Sweden and the UK, VC investment is higher as a share of GDP than in the US. According to KPMG, the consultancy, France, Ireland and the UK provide the most favourable tax and legal environments for venture capital in Europe.[40] In particular, they offer tailored tax relief, and have made it easier for pension funds and insurance companies to invest in VC funds. Progress in France is particularly encouraging, since it was one of the worst performers in 2003. Germany's VC industry – at around €1.3 billion in 2005 – was half the size of the EU average, if measured as a proportion of GDP. The German government is trying to encourage more VC activity. For example, in 2005 it joined forces with a number of big companies to set up a €272 million fund, designed to invest up to €500,000 per high-tech start-up. In other EU countries, however, such as the Czech Republic and Greece, the development of VC is still lagging badly.

[40] *KPMG, EVCA, '2006 EVCA Benchmarking study', December 2006.*

A successful VC industry also needs easy 'exit channels' that enable venture capitalists to turn their investment into cash. From this perspective, Europe's efforts to facilitate stock market listings for small companies are encouraging. For instance, since its launch in 1995, over 2,500 companies have joined AIM – the London Stock Exchange's international market for small fast-growing companies – raising more than £34 billion in the process.

But what if new ventures fail? The spectre of lengthy and expensive bankruptcy procedures is a powerful deterrent to budding entrepreneurs. Portugal and Italy have redoubled their efforts to reduce the time and legal complexities of their bankruptcy procedures. However, it still costs on average 10 per cent of what the company is worth to close a business in Europe, ranging from 22 per cent in Italy and Poland to 1 per cent in the Netherlands.

Rigid hiring and firing laws also pose a particular problem for SMEs. Faced with limited funding and volatile markets, they need to be flexible to adjust staffing levels quickly. In France, for instance, rigid labour laws, along with excessive taxes and long delays in payments from clients (including the government), are hampering the growth of small companies. Unlike their British and German counterparts they rarely expand beyond a certain threshold, so there is a dearth of medium-sized companies (employing between 50 and 500 people) in France.[41] In 2005, the government introduced a new law allowing small firms to hire people on a fully flexible contract for up to two years. However, the Socialist Party's programme for the 2007 presidential elections promises to scrap the law.

[41] *Jean-Paul Betbèze, Christian Saint-Étienne, 'Une stratégie PME pour la France', Conseil d'Analyse Économique, June 2006.*

Most EU economies are small, so companies need to expand across borders. For small companies, however, the challenges of selling in other countries are disproportionate. A lack of information about foreign markets and scant export finance, as well as regulatory barriers, deter many small companies from seeking to do business abroad. Small businesses cannot afford to engage in lengthy business disputes with foreign partners, grant credits to foreign

customers or lobby for better business conditions in potential foreign markets.[42] Of course, governments can help, for example by supplying up-to-date information about potential export markets.

[42] *OECD, 'Removing barriers to SME access to international markets', November 2006.*

Finally, EU governments need to do more to exploit the innovative potential of their small companies, many of which operate close to the technological frontier. Small businesses already account for half of business R&D in Greece and Ireland, and 65 per cent in Italy.[43] They receive two-thirds of government support for R&D in Portugal, Hungary and Italy. However, government support is not enough. The tax incentives available usually cover only a limited amount of the cost of a research project. The task of finding the balance of the funds needed to develop a new, unproven technology or product is a challenge that is beyond most start-ups – unless they can find customers that are willing to take the risk of using these new technologies before anyone else. Governments can be such customers. The American government spends up to 40 per cent of its massive public procurement budget on home-grown, small innovative companies. But in the EU, outdated public procurement rules – that do not allow governments to discriminate – would rule out such a policy.[44]

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

[44] *David Connell, 'Secrets of the world's largest seed capital fund: How the United States government uses its small business innovation research (SBIR) programme and procurement budgets to support small technology firms', Centre for Business Research, University of Cambridge, 2006.*

Business start-up environment = B	
Heroes	Denmark, France, Latvia, United Kingdom
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

Better regulation is one element of the Lisbon agenda on which all member-states have made good progress in recent years. Governments across the EU have been working on programmes to reduce the regulatory burden on enterprises, as well as trying to ensure that business and consumer concerns are taken into account when new rules are drawn up.

Better regulation has the potential to bring significant economic benefits. In Germany, for instance, laws, rules and regulations may cost the economy between €46 billion and €80 billion a year, with small- and medium-sized companies bearing the brunt. Were Germany to reduce its regulatory burden by 25 per cent, its GDP could rise by up to €20 billion.[45] A particular problem is administrative costs, such as unnecessary reporting requirements, that swallow too much of companies' time, at the expense of their core business. According to the Commission, such costs amount to more than 4 per cent of GDP in Austria, Italy and Portugal, and as much as 5 per cent in Poland. By contrast, they only amount to 1.5 per cent of GDP in Finland, Sweden and the UK.

[45] *Raimar Dieckmann, 'Better regulation facilitates economic growth', Deutsche Bank Research, April 2006.*

The EU's better regulation agenda has three main elements: consultation – giving those affected by new rules a say in the decision-making process; impact assessment – advance estimates of the impact that new legislation could have on business, consumers and the environment; and easing regulation – the EU's promise to get rid of outdated or overly complicated laws.

Under President Barroso, the Commission has made the fight against red tape a priority and it has mostly lived up to its commitments. It has consulted businesses, consumers and other stakeholders on all its key legislative proposals. For example, in 2006 the commissioner for the internal market and services, Charlie McCreevy, conducted 19 different consultations on issues ranging from cross-border payments to the future of single market policy. A dedicated Commission website lists all past and current consultation processes to allow for widespread input and participation.[46] The Commission has also set itself the ambitious target of simplifying and modernising about 200 EU laws by 2008, ranging from customs requirements to financial services reporting to the cosmetics directive.

[46] *http://ec.europa.eu/internal_market/consultations/index_en.htm.*

But despite its best efforts the Commission has fallen behind schedule. It has only reviewed 27 of the 71 laws it promised to codify in the 2005-2006 period. However it has managed to screen all the 183 proposals that were in the pipeline when it took over in 2004, and has withdrawn 68 of them.

Impact assessment

The Commission is now conducting comprehensive impact assessments on all draft directives. It considers the potential economic, social and environmental effects of alternative policy options, including those that do not require legislation. However, critics point out that of the 70 impact assessments undertaken in the 2003-2005 period, only 40 per cent involved a cost-benefit evaluation with hard numbers, and only 17 per cent compared net benefits.[47] Some also say that the Commission's assessments focus too narrowly on business concerns, and not enough on social and environmental issues. However, the critics may be misunderstanding the nature of the exercise.

[47] *Andrea Renda, 'Impact assessment in the EU', CEPS, January 2006.*

Impact assessments are ex-ante evaluations of the future effects of a directive. This process is inevitably uncertain, especially for social

and environmental effects, which are hard to forecast. To better evaluate the impact of legislation, the EU – as well as the member-states – should make wider use of ex-post assessments. These can help greatly to assess which policies work or which do not, correct past mistakes, and provide guidance for future legislative proposals.

Another problem with impact assessments, both at EU and at national level, is that they tend to be conducted by the same officials who draft the laws or directives. Some may therefore lack objectivity. This has led the German chancellor, Angela Merkel, to propose that independent experts should play a bigger role in better regulation. She has suggested that the EU follow the model of Germany's *Normenkontrollrat*, an expert body that has been evaluating the business costs of existing and future laws since June 2006. The German body, in turn, followed the example of the Netherlands, one of the pioneers in measuring the costs of regulations on business. Britain and Ireland also have dedicated organisations for improving the regulatory environment, and other EU countries should follow suit. They need to ensure, however, that regulatory bodies have a high-level of political support and strong links to the departments that carry out strategic planning.[48]

[48] *Mandelkern group on better regulation, 'Final report', November 2001.*

The EU is also following the Dutch example in setting numerical targets for the reduction of certain administrative costs. The Dutch government is using the 'standard cost model' to measure the costs of business reporting requirements. And it has promised to reduce these administrative burdens by 25 per cent by 2007. Seventeen other EU countries have launched similar initiatives. The Commission would like to use the standard cost model to measure administrative costs across the whole Union, and it wants EU leaders to adopt a target of a 25 per cent reduction by 2012. National experience shows that the setting of precise targets can help to create momentum for cutting red tape.[49]

[49] *European Commission, 'Measuring costs and reducing administrative burdens in the European Union', November 2006.*

However, requiring all 27 EU countries to measure and reduce administrative burdens at the same time, by the same amount, may prove impossible. For example, it is not clear how the 25 per cent reduction target would be divided between the EU level and the member-states.

Most member-states now seem to be serious about improving the quality of regulation. Perhaps the biggest change has come in Germany, where the Merkel government has appointed a minister to lead efforts to simplify and improve regulation. According to the Commission, Poland is also now conducting regular impact assessments, consulting with businesses and introducing simpler regulations for SMEs.[50] Progress is also being made in countries that were initially slow to adopt the better regulation agenda, such as France. In 2005, the Commission ranked France as one of Europe's worst performers in this area.[51] Since then, the French government has created a better regulation office within the finance ministry, although the proposed better regulation programme has not yet passed through the parliament. The new law would require the government to conduct impact assessments on all new legislative proposals, as well as repeal outdated laws.[52]

50 & 51 European Commission, 'Better regulation for growth and jobs in the EU', March 16th 2005.

52 Jonathan B. Wiener, 'Better regulation in Europe', Duke Law School Working Paper Series, Paper 65, 2006.

Moreover, Germany, as the EU president in the first half of 2007, has suggested that the EU should adopt 'the principle of discontinuity'. In most EU countries, legislative initiatives become void whenever a new parliament gets elected. At the EU level, draft directives can hang around for decades. Merkel has suggested that in the future all draft directives that have not been adopted during the five-year term of the Commission and Parliament should be withdrawn or re-submitted. Some policy makers would like the EU to go further and adopt a 'sunset' clause: all EU laws would become void after a fixed period of time, unless explicitly re-enacted.

Implementation across the board

Even streamlined law-making procedures and thorough impact assessments will do little to help businesses unless EU regulations are implemented and enforced consistently across the Union. In theory, the single market offers businesses the same regulatory framework across the entire European Economic Area.[53] In practice, much remains to be done. EU governments are often slow to transpose EU directives into national law. When doing so, they frequently interpret EU directives differently, and they sometimes embellish them with additional rules and requirements, a practice known as 'gold-plating'.

53 The European Economic Area consists of the 27 EU members plus Iceland, Liechtenstein and Norway.

The EU missed its original 2002 deadline, by which member-states were supposed to have transposed 98.5 per cent of all outstanding single market directives. But the Commission's latest 'internal market scoreboard' shows significant progress in this respect.[54] The number of countries failing to meet the target is down to four (Greece, Italy, Luxembourg and Portugal). Many of the new member-states (with the exception of the Czech Republic) are particularly conscientious in adopting EU laws. Denmark and Lithuania are the best performers, along with Finland, Latvia, Slovakia and the UK. One reason for the improved performance is that the EU produced fewer directives in 2006. But there also seems to be a genuine determination on the part of governments to tackle this problem.

54 European Commission, 'Internal Market scoreboard', February 2007.

However, the governments' improved record at transposing EU laws is not matched by their compliance with them. The EU is no closer to its target of halving the number of infringement procedures launched by the Commission against governments that fail to implement EU laws properly. Out of 25 countries, only Germany, France and six other member-states managed to reduce the number of infringement procedures pending against them in 2006. The situation is particularly worrying in Italy and Spain, where laws are often poorly implemented.

Better regulation and implementation may not suffice to create the light regulatory touch that businesses need. The traditional EU method, of creating a level playing field through harmonisation of standards and mutual recognition, has proved its worth. However, as the European economy becomes less dependent on manufacturing and more dependent on knowledge-based industries, some experts are questioning that approach. Marcel Canoy, Roger Liddle and Peter Smith argue that the EU may need to rethink its whole approach to the single market (see their article 'The future of the single market' on page 43).

Regulatory burden = B	
Heroes	European Commission, Finland, the Netherlands, United Kingdom
Villains	Greece, Italy, Portugal

How to measure regulatory impact?

We now have a consensus in Europe that too much or overly complex legislation can harm the economy. It is widely acknowledged that measuring the impact of legislation can help policy makers to avoid such an outcome. But it is also clear that it is not possible to produce reliable, hard numbers on all existing and potential regulatory costs and benefits. Prioritising is the key.

The European Commission initially did that in 2002, when it introduced the 'integrated impact assessment' (IA). IA looks at the economic, social and environmental impact of various policy options. Even though IA does not necessarily rely on hard numbers, its underlying philosophy is that of cost-benefit analysis. The objective is not to force law-makers to minimise regulatory costs, but to make them aware of both the benefits and the costs of different policy options. Since IA is a 'soft' tool, its main impact is on the way politicians and parliamentarians think. Progress is slow and hard to communicate in terms of numbers. Although the Commission is now committed to carrying out IAs for all major legal proposals, there have so far been only a limited number of cases that have visibly influenced policy making, exceptions being the 'clean air for Europe programme' and the proposed pre-packaging directive.

Some EU countries, led by the Netherlands, have focused on developing an alternative approach: the so-called standard cost model (SCM). This is a targeted methodology to measure administrative burdens, narrowly defined as the costs businesses incur complying with the information requirements of existing laws. The SCM can produce a fairly precise measurement of such costs, partly because it only deals with a small part of the total regulatory burden. And it allows politicians to set numerical targets for the reduction of these information costs. The SCM, in other words, is not a tool for weighing different policy options, but for kicking governments into action. The Dutch government, for example, is in the process of reducing the administrative burden of information requirements by 25 per cent over five years. It claims that so far the project has saved businesses €2.7 billion, and that it is on track to meet the overall target of €4 billion by the end of 2007.

Politicians clearly find the SCM's 'hard' use of numbers more appealing than the gradual culture change promoted by an 'integrated impact assessment'. Among the countries now using or adopting SCM are: Belgium, the Czech Republic, Denmark, Estonia, France, Hungary, Italy, the Netherlands, Norway, Poland, Sweden and the UK. In response to persistent worries about competitiveness, the EU is the latest SCM convert. In January 2007, the Commission proposed an EU-wide target of a 25 per cent reduction in administrative costs by 2012; and it identified 13 priority sectors, ranging from company law and food safety to taxation.

While the SCM may be good for getting governments to cut one particular type of regulatory cost, it may be less suitable as a policy-making tool. There is some evidence that enterprises are more concerned about the costs caused by changes in the regulatory framework than about the absolute burden of regulation. Also, the decision to measure only information requirements is based on the unfounded assumption that such regulatory 'dead wood' can be culled without removing benefits.

Yet the SCM continues to gain popularity. The Commission is not only planning to measure and reduce existing administrative burdens, but also adding a test for potential ones to its broader impact assessments. In good EU-fashion, this test will be extended to cover not only costs incurred by businesses, but also those borne by the voluntary sector and public authorities. There is a clear risk that the growing focus on the detailed measurement of the costs of information requirements will divert attention and resources away from the assessment of wider regulatory costs and benefits under the IA methodology. The Commission's impact assessment no longer prioritises. It muddles the line between two very different methodologies. Whatever happened to 'less is more' as an objective for better regulation policy?

Anne Meuwese

Research fellow, Centre for Regulatory Governance, University of Exeter

C3. State aid and competition policy

★ Promote competition and reduce subsidies to industry

★ Overhaul state aid rules while taking into account the needs of small businesses

An effective competition policy is vital for achieving the objectives of the Lisbon agenda, for at least two reasons. First, in open markets, firms are constantly under pressure to cut costs and prices, to innovate and become more efficient. Competition therefore is key to productivity and GDP growth. Second, competition policy is one of the few instruments the Commission can deploy against companies and governments that do not play by the rules of the single market. It allows the Commission to step in when legislation alone has failed to create a level playing field.

The Commission's stance on competition policy has become tougher in recent years. The EU competition commissioner, Neelie Kroes, has launched several large-scale investigations, for example into possible collusion among energy companies (see section B1). And she has fought against protectionist policies in those EU countries that have sought to prop up national champions.

In 2005 and 2006, in particular, several national governments opposed key cross-border mergers, fuelling concerns that the EU was in the grip of a new wave of protectionism.[55] Among the most high-profile cases were France's opposition to Pepsi's acquisition of Danone, a dairy company; Spain's attempt to forestall E-ON's bid for Endesa; Italy's objection to a merger between its motorway operator, Autostrade, and Abertis of Spain; and the outcry in Belgium, France and Luxembourg when Mittal Steel tried to take over Arcelor.

[55] *Mark Landler and Paul Meller, 'Grappling with EU protectionism', New York Times, March 14th 2006. Tobias Buck and others, 'Bidders feel chill wind of protectionism', Financial Times, December 28th 2006.*

In practice, national governments cannot do much to break EU competition rules and thwart such mergers. The occasional protectionist knee-jerk reaction could even be a sign that the single market is working. Mergers and acquisitions in Europe have reached record levels and, despite the resistance of some governments, are increasingly prevalent in hitherto closed markets like energy and banking. The vast majority of mergers go through without problems.

Meanwhile, the EU has taken several steps to modernise its competition regime, starting with its anti-trust policy. The point of anti-trust rules is to prevent dominant companies from abusing their market power to keep competitors at bay. They also prohibit companies from striking deals that fix prices or carve up markets. EU rules allow such deals only if they have a limited effect on competition and a positive economic impact, for example on consumers. (See the article 'Innovation, competition and the Lisbon agenda', by Jorge Padilla and Henri Piffaut on page 78).

The 2004 reforms

Until 2004, the Commission had exclusive competence for deciding whether such deals were legal. Since then, it has asked national competition authorities and courts to apply EU anti-trust rules. Also since 2004, European businesses are no longer obliged to notify the Commission of all the agreements they sign with competitors. The companies themselves have to assess whether their behaviour is compatible with EU rules. This frees the Commission and national authorities of the burden of ploughing through routine cases. Instead, Commission officials can concentrate on the cases that really threaten to undermine competition in the single market. The EU has also shifted the burden of proof: in the case of an investigation, it is now up to the companies to show that their agreements respect EU competition rules.

The EU has also overhauled its rules for merger control. This followed several cases in which the European Court of Justice

overturned Commission decisions (notably Airtours/First Choice, Schneider Electric/Honeywell and TetraLaval/Sidel). The Court reasoned that the Commission's analysis of the economic impact of these mergers was flawed. In response to these rulings – and wider criticism of its technical approach to merger control – the Commission made a number of important changes, of which two are particularly important.

First, instead of asking whether the merged company would have a 'dominant' market position, the Commission now looks at mergers that could 'impede effective competition'. This new criterion is stricter and requires a finer economic analysis: a merger may impede competition even if the new company does not have a dominant market position.

Second, the new rules recognise that a merger can have a positive economic effect, through strengthening the competitiveness of the firms concerned. However, they also require a thorough evaluation of these benefits. The problem is that it is extremely difficult to judge what the long-term economic impact of a merger will be. The companies involved tend to over-estimate the future gains of a merger, to win the Commission's approval. To support its new approach, DG Competition has appointed a chief economist, and replaced what was the single 'merger task force' with teams that look at specific sectors, such as pharmaceuticals, the media and services.

State subsidies

The third pillar of the EU's competition policy is the control of industrial subsidies (or state aid) that could skew cross-border competition. Under current EU rules, governments are not supposed to pay out more than €200,000 over a three-year period to an individual company, unless it is in support of R&D, regional development, environmental protection or training – the so-called block exemptions or horizontal aid, in EU jargon. The EU has worked hard to make it easier for small companies to benefit from government subsidies. In particular, its decision in December 2006 to double the ceiling for state aids from €100,000 to €200,000 made it easier for governments to give money to small companies. It has also modernised its rules for innovation and R&D, as well as venture capital, so that small businesses get a better deal.

Despite the EU's objective of curbing industrial subsidies, the number of notified cases submitted to the Commission keeps growing: from 475 in 2000 to 617 in 2003.[56] According to the Commission's state aid scoreboard, EU governments dished out subsidies worth €47 billion a year, on average, between 2003 and 2005, which is only slightly less than the annual average of €52 billion between 2001 and 2003.[57] EU countries spent an average of 0.4 per cent of GDP on subsidies in 2005, but in Germany the figure was almost 0.7 per cent, while in Austria, Belgium, Greece, the Netherlands and the UK the share was less than 0.3 per cent. The new member-states tend to spend a larger proportion of their (admittedly much smaller) GDP on subsidies. In Cyprus and Hungary, for example, state aid amounts to more than 1 per cent of GDP, and in Malta over 2 per cent.

[56] *David Encoua, Roger Guesnerie, 'Politiques de la concurrence', Conseil d'Analyse Économique, 2006.*

[57] *European Commission, 'State aid scoreboard – autumn update', December 2006.*

The EU has traditionally taken a rather cautious approach to clamping-down on subsidies. Between 2000 and 2002, for example, the Commission ruled against only 7 per cent of the state aid cases that national governments submitted. This could indicate that EU governments are increasingly compliant with EU state aid rules. But that figure could also suggest that political pressure from national governments is pushing the Commission to let them prop up ailing national champions – such as Alstom and Bull in France, or Bankgesellschaft Berlin AG in Germany.

The Commission should take the continuing review of its state aid regime as an opportunity to fortify itself against national lobbying.

Should it fail to do so, voices calling for an EU independent competition authority will grow stronger. Gordon Brown, the UK prime minister in waiting, for instance, is thought to favour this idea. Other governments generally oppose it. The best way to ensure that the idea of a new competition body does not gather support is for the Commission to maintain a tough stance on all aspects of competition policy.

State aid and competition policy = B-	
Heroes	Austria, Belgium United Kingdom
Villains	Cyprus, Germany, Malta

Innovation, competition and the Lisbon agenda

Innovative sectors such as the telecommunications, pharmaceutical and computer industries are an important driver of growth and employment. But the incentive to innovate and invest today depends on future profits, which in turn can be affected by competition policy. The very nature of innovation in these dynamic sectors often creates barriers to entry and positions of market power. In recent reforms of its competition policy, the Commission has tried to take better account of the particular needs of these industries. However, there is still room for improvement. A particular problem is the Commission's review of its policy towards the abuse of dominant market positions.

Of course, the rules of competition policy should apply to dynamic industries. However, competition authorities should take account of these industries' special characteristics when considering intervention. Innovative industries are highly sensitive to changes in the competition policy regime. For example, if too much emphasis is placed on short-term price competition and the protection of the 'competitive process', rather than on innovation and long-term consumer welfare, when assessing these industries, innovation is likely to suffer. Interventions that compel dominant firms to license their intellectual property, for instance, may limit the rewards they would gain from being first to innovate, and hence weaken the incentives for innovation.

Enhancing innovation and promoting competition are two fundamental aims of the Lisbon agenda. Recent reforms of EU competition law do emphasise consumer welfare and efficiency as key objectives of competition policy. For instance, the Commission has committed to assess mergers and acquisitions in terms of economic benefits to consumers rather than simply determining whether they create a dominant market position for the firms concerned. This new economic approach reflects a change of thinking on the part of the Commission, but is also a consequence of the European Court's review of the

Commission's decisions. These changes should improve decision-making and create better conditions for innovation.

The new approach is less prescriptive: assessment of whether state aid is permissible or not no longer relies exclusively on a set of formal criteria. State aid for R&D is now permissable in order to address a market failure, as long as it is well-targeted. The Commission can now allow state aid if R&D in a particular sector is too weak, for example because the benefits of the R&D are too easily gained by third parties. This approach is likely to contribute to more efficient R&D spending throughout the EU.

The Commission's reform of its competition policy is a step in the right direction, but more work is needed in order to ensure that it encourages rather than hinders high-tech innovation. In a discussion paper aimed at explaining its new approach to abuses of a dominant market position, published in December 2005, the Commission seems to establish an exclusive link between low prices and positive economic effects for consumers, thus down-playing how consumers may benefit from innovation. This is a particular problem for industries in which companies compete less on price than on innovation. Consumer welfare does not only depend on low prices; it is also positively affected by the emergence of new products, technologies and services.

EU competition policy needs to take better account of economic efficiency in terms of the long-term benefits from innovation, and attach relatively less importance to the short-term effect on prices. Only then will competition policy really foster innovation and, in that way, facilitate the achievement of the goals set out in the Lisbon agenda and the Commission's 'i2010' strategy.

Jorge Padilla and Henri Piffaut

The authors are economists at LECG Consulting.

D. Employment and social inclusion

D1. Bringing people into the workforce

★ Raise the employment rate to 70 per cent by 2010

★ Raise the employment rate for women to 60 per cent and that for older workers to 50 per cent

Almost half of EU citizens say that unemployment is their number one worry, well ahead of other concerns such as terrorism, pensions or immigration. Only 29 per cent of Poles and 34 per cent of Italians are confident that they will still have a job in two years time. In Germany and France, the share is also below 50 per cent.[58] Pessimism on that scale makes Europeans fearful of change, which is one reason why labour market reforms tend to be too cautious.

[58] *European Commission, 'Standard Eurobarometer 65', July 2006, and 'Special Eurobarometer – European employment and social policy', October 2006.*

This caution partly explains why the EU is almost certain to miss its main employment target, namely to get 70 per cent of all people of working age into jobs by 2010. Progress in raising the employment rate has been slow. The proportion of the labour force employed rose from 62.4 per cent in 2000 to 64.4 per cent at the end of 2006. The EU-25 unemployment rate – while down almost a percentage point since 2005 – averaged 7.5 per cent in December 2006, well above levels in other big OECD economies such as the US (4.5 per cent) and Japan (4.1 per cent). The overall EU figure is skewed by the lacklustre performance in the three big eurozone countries, France, Germany and Italy. But Austria, Ireland, the Netherlands, the Nordics and the UK are all close to or above the 70 per cent target.

The EU has made better progress towards its supplementary employment targets, those for women and older workers. The female employment rate reached 56 per cent at the end of 2005 (from 53 per cent in 2000), but this figure masked wide variations, from 65-70 per cent in the Netherlands, Sweden and the UK, to only 45-47 per cent in Greece, Italy and Poland. The employment rate of older workers (over 55 years old) in the EU-25 has risen by 7 percentage points since 2000 – although at barely 43 per cent it still remains far below the Lisbon target of 50 per cent.

In 2006 overall employment growth in the EU-25 accelerated to 1.4 per cent, according to Commission estimates. Cyclical factors partly explain faster job creation. In Germany, the best economic growth performance since 2000 helped to create almost half a million jobs. In both Germany and France, the unemployment rate fell below the critical 10 per cent mark. In Italy, the employment rate rose by a full percentage point, although it remained under 60 per cent. Ireland and Spain saw particularly fast employment growth in 2006, partly because of immigration.

Some good news also came from the new member-states, where employment rates tend to be far below the EU-15 rates, and unemployment is twice as high on average.[59] The three tiny Baltic countries together have created almost as many jobs over the last five years as France. In both Poland and Slovakia, unemployment rates dropped by a remarkable 3 percentage points in 2006 – although they remain Europe's highest, at 13 and 14 per cent respectively.

[59] *Katinka Barysch, 'East versus West? The EU economy after enlargement', CER essay, January 2006.*

Economists are still arguing about what was behind the good 2006 performance: GDP growth, wage restraint, the rapid rise in part-time jobs, immigration, recent labour market policies (such as the 'Hartz' reforms in Germany or France's loosening of the 35-hour week), or a combination thereof.[60] However, few economists

[60] *Deutsche Bundesbank, 'Zur Dynamik auf dem EWU-Arbeitsmarkt im aktuellen Konjunkturzyklus', Monthly Report, January 2007.*

dispute that further progress with labour market reforms will be needed to ensure sustained growth in employment.[61] Both the Commission and the OECD predict that employment growth will fall back to 1 per cent or lower in 2007. To meet the 70 per cent target by the 2010 deadline, the rate would have to be more than 2 per cent.

[61] *OECD, 'OECD employment outlook 2006 – boosting jobs and incomes', May 2006. European Central Bank, 'Developments in the structural features of euro area labour markets over the last decade', January 2007.*

'Flexicurity' for everyone?

Rather than pointing its finger at the laggards, the European Commission has been redoubling its own efforts to help Europe's workers. For example, its new jobs portal (called Eures) listed one million vacancies and 100,000 jobseeker CVs when it was launched in May 2006. Some 200,000 people flocked to a series of European job fairs across the EU last year. To make it easier for Europeans to work in other EU countries (only 2 per cent do so at present), the Commission has suggested a 'European qualifications framework'. It also wants an EU 'green card' to make it easier for immigrants to move around. Furthermore, under the EU's new budget, Europeans who lose their job because of restructuring will be able to apply for help from the new European 'globalisation adjustment fund'.[62]

[62] *Katinka Barysch, 'The GAF – so nearly a good idea', European Voice, March 30th 2006.*

However, as the Commission points out time and again, the main responsibility for dealing with the EU's 19 million unemployed lies with governments, businesses and trade unions. What the EU can do – and does – is encourage EU countries to learn from each other.

Europe's star performers in terms of employment are Denmark, the Netherlands and Sweden, which all have employment rates well above 70 per cent (Finland is catching up). These countries also meet the other Lisbon targets for the employment of women and older workers. And unlike the UK and Ireland – which also boast good employment numbers – the Nordics have managed to combine highly efficient job markets with very generous welfare entitlements.[63] No wonder that the EU is a buzz with talk about 'flexicurity', the awkward term now widely used to describe Denmark's successful combination of permissive hiring and firing rules, and comprehensive help for the unemployed (in terms of cash, retraining and job-search assistance).

[63] *André Sapir, 'Globalisation and the reforms of European social models', Bruegel policy brief 1, 2005. Anthony Giddens, Patrick Diamond, Roger Liddle (editors), 'Global Europe – social Europe', October 2006.*

However, there is little agreement on how the other EU countries can and should adopt flexicurity. The Commission has promised a paper on the subject by mid-2007. But already in 2006, fierce disagreements between employers and trade unionists about the right balance between flexibility and security forced it to postpone a brainstorming on labour markets.[64] Many EU governments claim that their national traditions stand in the way of a one-size-fits-all employment policy. For example, France's combative trade unions are unlikely to sign up to the kind of grand bargain (with business and government) that underpinned labour market reform in Denmark and the Netherlands. Italian workers will continue clinging to their jobs as long as there is no effective system of unemployment benefits. Cash-strapped East European governments will not be able to offer the kind of retraining and job-search assistance enjoyed by the jobless in Nordic countries.

[64] *'Commission to cancel labour market communication', EurActiv, November 20th 2006.*

Many EU countries have started to loosen up their labour laws – but only at the margins. The result is a growing gap in their labour markets between 'insiders' – people in traditional, well-protected employment – and 'outsiders' – those drifting between unemployment and insecure, low-skilled work. Most of the jobs created in the EU since 2000 have been part-time and/or fixed-term. In total, more than 40 per cent of EU workers are now in 'non-standard' employment (which also includes self-employed people and those working for temp agencies). Behind this figure there is

good news, such as the growing availability of part-time jobs for women returning to work; but also bad news, for example evidence of companies replacing regular employees with workers on less secure contracts and without social security commitments.[65]

[65] *Anna Turmann, 'Getting Europe to work – the role of flexibility in tapping the unused potential in the EU labour markets', CEPS working document 250, September 2006. European Commission, 'Employment in Europe', October 2006.*

Germany now has more people on social benefits (including pensioners) than people in regular employment that pay social contributions. In Spain and Portugal, employers prefer temporary contracts (which now account for more than a third of total employment in these countries) because rules for permanent jobs are too tough. In the Netherlands, three-quarters of all women work part-time (half for less than 12 hours a week), partly because childcare is expensive.

With ageing populations, Europe urgently needs to find ways of keeping older people in jobs for longer (see section D3). Most governments have developed plans for 'active ageing' although some, such as Greece and Portugal, are still working on theirs. But EU countries also need to extend working life at the other end: the share of youngsters with jobs is lower still than that of older people (only 37 per cent of 15-24 year-olds are working). Youth unemployment is more than twice as high as average unemployment in the EU. In Poland, almost 40 per cent of youngsters are looking for a job. This implies that education systems are not teaching the right skills (see section D2) and that labour markets are not flexible enough to allow young Europeans an early start. Almost all EU countries now have targets for giving young job-seekers a contract, an apprenticeship or other training within three to six months of them becoming unemployed. But with the exception of the Nordic countries and the Netherlands, progress on meeting these targets has been slow.

Despite progress in some countries, the to-do list for EU governments has changed little since the inception of the Lisbon strategy. It includes direct labour-market policies such as more liberal hiring and firing rules to encourage companies to create jobs; better targeted welfare systems to create incentives for the unemployed to look for work; decentralised wage setting regimes so that pay reflects productivity levels; and more extensive retraining facilities for laid-off workers. But meeting EU employment targets also requires a broader reform agenda, including changes to education systems, taxation and the business environment for small companies.

Bringing people into the workforce= C+	
Heroes	Denmark, Ireland, the Netherlands
Villains	Greece, Poland, Portugal

D2. Upgrading skills

★ Halve the number of early school leavers

★ Raise the share of 20-24 year-olds with at least upper secondary education to 85 per cent

★ Raise the number of graduates in maths, science and technology by 15 per cent

★ Foster a culture of lifelong learning and provide training to 12.5 per cent of the workforce

Education is the best unemployment insurance. More than 80 per cent of Europe's university graduates have a job, but less than half of those with only primary education. The employment rate for those with A-levels, *baccalauréat* or other secondary education qualifications is around 70 per cent. Well-educated workers will be better able to cope with the rapid change that comes from global competition. They will also be richer: the Commission estimates that salaries rise by 6-9 per cent for each additional year in school or training.

Education is crucial for achieving many of the other Lisbon objectives, such as higher growth, more and better jobs, more innovation and entrepreneurial activity. Economists have found a close correlation between skill levels and economic growth: one additional year of education adds an estimated 3-6 per cent to economic output in developed countries. Higher R&D spending only makes sense if EU countries have enough good researchers, as well as skilled workers to actually use innovative technologies. Since better educated people are more likely to be in work, education is also crucial to raising the employment rate to 70 per cent. In America, the employment levels of the different skill groups are roughly the same as in Europe, but it has a much higher proportion of graduates. This implies that Europe could raise its employment rate to the US level simply by matching America's higher share of skilled workers.[66]

[66] Daniel Gros, 'Employment and competitiveness – the key role of education', CEPS policy brief No 93, February 2006.

The EU is getting there: almost 30 per cent of young Europeans in their twenties now have a university degree, a share that is three times higher than among those over 60. But unless graduation rates improve further, it will take the EU another two generations to catch up with the US. Moreover, there are concerns over the quality of higher education, not least because funding has not kept pace with growing student numbers. The EU is also likely to miss its target for secondary school education (which is the minimum someone needs to get a decent job and salary in a developed economy): 85 per cent of all 20-24 year-olds should have completed upper secondary education by 2010. In 2005, the share was 77 per cent on average, with national shares ranging from over 90 per cent the Czech Republic, Hungary and Poland to less than 50 per cent in Portugal.

Nor is the EU making sufficient progress in cutting the number of school drop-outs. Some countries have pioneering schemes that could be copied by others. For example, the UK pays teenagers from low-income households to attend school, and Hungary tries to lure early school-leavers into apprenticeship programmes.[67] A looming teacher shortage could make it harder to meet education objectives: almost a third of Europe's six million teachers are over 50 and getting ready for retirement. In Germany, Italy and Sweden, the situation is even worse, not least because large numbers of young teachers are switching to other professions. Today's teachers are required to have a multitude of skills – from counselling to IT literacy – but their salaries have not kept up with those in other sectors.

[67] European Commission, 'Draft 2006 joint progress report on the implementation of the education & training 2010 work programme', November 2005.

While the Lisbon benchmarks are useful for comparing EU countries, it is the OECD's 'PISA' surveys that really focus the

minds of policy makers. Every three years, the OECD asks students who are about to leave school in over 50 countries to sit tests on literacy, numeracy, problem solving and other basic skills. The results show huge differences within the EU. Dutch and Finnish students top the league tables on mathematics, but their counterparts from Greece and Italy do poorly. Czechs teenagers are particularly good at science while Portuguese ones score the lowest in the EU. Finnish, Irish and Swedish schools are good at teaching literacy while Italian, Slovak and Spanish ones are lagging badly.[68] A study of the education systems of 125 countries by the World Economic Forum paints a similarly disparate picture: Finland has the best education system in the world, while Belgium, Denmark, Ireland are also in the top ten. But Portugal and Greece rank 58th and 60th, respectively.

[68] OECD, 'Education at a glance – 2006'. 'Education for the new economy: Country ranking maps', Financial Times, October 17th 2006. European Commission, 'Detailed analysis of progress towards the Lisbon indicators in education and training – 2006 report', 2006.

Researchers have found no strong correlation between spending on secondary education and student performance. Denmark, for example, spends 50 per cent more on education than other EU countries, but on many indicators its performance is average. What matters is that schools are given a free hand when allocating their budgets, hiring teachers and dealing with students.[69]

[69] Peer Ederer, 'Innovation at work: the European human capital index', Lisbon Council policy brief, 2006.

More autonomy is also needed for Europe's universities. While the US concentrates research funds and talents on a small handful of elite universities, scarce resources are spread too thinly among Europe's 4,000 higher education institutes. The result is widespread mediocrity.[70] Curricula are overloaded, academic staff lack motivation and drop-out rates among students are high. Among the world's top 100 universities, 54 are in the US and 11 are in the

[70] Richard Lambert and Nick Butler, 'The future of European universities: Renaissance or decay?', CER pamphlet, May 2006.

[71] *Shanghai Jiao Tong University, 'Academic ranking of world universities – 2006', 2006.*

UK. But the rest of the EU only has 18.[71] Although the EU has a higher proportion of students graduating in maths, science and technology than the US, far fewer of them subsequently apply their knowledge in highly-skilled jobs.

New challenges also come from emerging economies. In 2003, China for the first time had more graduates in maths, science and technology than the EU. Admittedly this is in a far bigger population, and only a small share of China's graduates are sufficiently well-educated to work for a multinational company. Although a third of India's population is still illiterate, the WEF rates the quality of its maths and science education above that of all EU countries bar Belgium, Finland and France. The IT revolution allows companies to move jobs for programmers, designers and accountants to wherever skilled workers are available (and cheap). Unless developed countries fix their education systems, white-collar jobs could increasingly move to Asia.

EU countries are taking cautious steps to rectify the situation. All are adopting a shorter, more flexible two-tier degree structure, as agreed in the Bologna declaration of 1999. The UK is plugging funding gaps through higher tuition fees (up to £3,000 per year) and efforts to attract fee-paying overseas students. Finnish, Irish and Spanish universities are forging links with private business. Denmark, the Netherlands and Sweden have given their universities more autonomy to hire lecturers, select students and write curricula. Austria and Germany have introduced performance-related pay for professors. But reforms are only just beginning in many places. In Italy, ministerial approval can still be required for hiring a lecturer. In Germany, the fact that the 16 *Länder* (states) are responsible for education has not resulted in healthy competition but bureaucratic rigidity. In an attempt to encourage excellence, the government has designated three 'elite' universities and given them an additional €120 million each (although this pales into insignificance with Harvard's $25 billion endowment or Yale's $7 billion). In France,

the 50 or so Grandes Écoles produce high-calibre technicians, though while sapping resources from the rest of the education system they do not conduct research.

Even the best university degree does not suffice to ensure that its holder will remain well-equipped for the fast-changing economy. The Lisbon objective is for EU countries to provide training to 12.5 per cent of their workforces (measured over a four-week period preceding an annual survey). The EU is on course to meet this aggregate target. But whereas up to a third of Britons, Swedes and Danes received language, IT and other training in 2005, fewer than 5 per cent of Poles, Portuguese and Slovaks did so. Unskilled and older people are less likely to get training than graduates and younger workers. Since Europe's ageing societies will require more older people to work, EU countries need to redouble their efforts to keep them agile and informed. They also need to think about how to create incentives for companies to train workers. While the continuing shift towards part-time and fixed-term jobs adds flexibility to the EU labour market, it also makes companies less likely to invest in the training of their staff.

Educational indicators for selected EU countries and the US

UK	Germany	France	Italy	Netherlands	Greece	Poland	US
% with tertiary education, 2004							
26	25	24	11	29	21	16	39
MST graduates per 1,000*							
21	8	22	7	7	n/a	9	11
Education spending, % of GDP, 2002							
5	5	6	5	5	4	6	5
Spending per tertiary student, $ at PPP, 2003							
11,900	11,600	10,700	8,800	13,400	4,900	4,600	24,100
Quality of education system**							
4.5	4.4	4.6	3.3	4.9	3.6	4.4	5.0
% of students with lowest/highest maths scores***							
n/a	9/4	6/4	13/2	3/7	18/1	7/2	10/2

*Figures are rounded; n/a = data not available. *Maths, science and technology graduates per 1,000 of 20-29 year-olds in 2003. **WEF ranking of 125 countries, scores from 1 (worst) to 7 (meets the needs of a competitive market economy). ***Lowest score = students who do not comprehend the test of the skills that PISA is trying to measure; highest score = students are capable of advanced mathematical thinking and reasoning; and they can precisely communicate their findings and arguments. From PISA 2003.*

Sources: European Commission, OECD, World Economic Forum.

Upgrading skills = B-	
Heroes	Finland, the Netherlands, United Kingdom
Villains	Greece, Italy, Portugal

D3. Modernising social protection

★ Overhaul pension 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

Many Europeans think that pressures on their social security systems stem from globalisation, and also eastward enlargement. Yet internal changes are much more important: population ageing puts unprecedented pressure on Europe's pensions and healthcare systems. And the breakdown of traditional family structures and technological change is behind the persistence of poverty, including that of children. The EU itself has very limited competences in the field of social security, beyond setting health and safety standards at work and ensuring equal opportunities for men and women. The main responsibilities for reforming pension and welfare systems remain with the 27 member-states. But although the various EU countries have very different policies, there are some challenges that most of them have in common. There is therefore much scope for learning from each other.

Most European countries are recording a combination of declining fertility rates and increasing life expectancy. European women now have on average 1.5 children. Only France comes close to the replacement rate of 2.1 needed to keep the population constant. Curiously, the lowest fertility rates are recorded in traditional catholic countries with low female employment rates, such as Italy, Poland and Spain. The new member-states also have particularly low rates. The Nordic countries (as well as the UK), where the vast majority of women work, have fertility rates well above the EU average. At the same time, Europeans can expect to live even longer. In 2004, the average life expectancy for men in the EU was 74, and for women over 80. By 2050, life expectancy is expected to rise by another five years.[72]

[72] *European Commission, 'The demographic future of Europe – from challenge to opportunity', October 2006. David Willetts, 'Old Europe? Demographic change and pension reform', CER pamphlet, September 2003.*

As a result, the number of Europeans of working age will start shrinking after 2010, while the ranks of pensioners are swelling. The Commission predicts that there will be two people of working age for each retiree by 2050, twice today's dependency ratio of four to one. Pressure on public finances will rise accordingly: public spending on pensions, healthcare and other services to the elderly will rise by 3-4 percentage points of GDP. Shrinking workforces, higher taxes and the general decrease of innovation and risk-taking that is associated with an ageing society will all reduce Europe's growth potential. The Commission estimates that unless policies change radically, the impact of ageing will cut the EU's trend growth rate in half, from 2.4 per cent now to 1.2 per cent after 2030.

A plethora of pension changes

All EU countries have embarked on more or less ambitious programmes to put their pension and welfare systems on a sustainable footing. National pension systems usually have two pillars: a first one for state pensions, funded by social contributions, and a second one for private pension schemes. EU countries start with very different systems, which means there is no single suitable reform path.[73] However, most reform programmes contain the following elements: slimming down publicly-funded pension systems; increasing private provision; and encouraging longer working lives.

[73] *Edward Whitehouse, 'Pensions panorama: Retirement-income systems in 53 countries', World Bank, January 2007.*

With ageing populations, the tax-funded systems are coming under increasing strain and many countries have sought to reduce entitlements. Replacement rates – how much of his or her former

salary a retiree can expect – vary vastly among the different countries. For average earners, they range from around 30 per cent in Ireland to 75 per cent in Austria, Greece, Italy and Spain. Some countries, such as Belgium and the UK, stress the equity of their pension systems: they have low replacement rates for average earners, but much higher ones for poorer people. In Germany and Italy, there is little variation according to income levels.

Most EU countries, to reduce entitlements, have shifted from 'defined benefit' systems (where the pension payout is based on the final year's salary) to 'defined contribution systems' that take account of the contributions made throughout a whole career. Greece and Spain are the only EU member-states that still base pensions only on final salaries. In the Czech Republic pensions are based on average salaries during the 30 years before retirement. Poland has been one of the pioneers in introducing 'notional accounts' (a system where pension contributions are financed out of taxes or social security contributions, but each worker accumulates entitlements in a fictional, personal pension account that mimics private pension schemes).

As publicly-funded systems are scaled back, private pension provision becomes more important. In the UK, for example, a limited state pension leaves many pensioners reliant on other welfare payments, such as housing benefits. Although most people already have additional occupational or private pension funds to rely on, an expert report in 2006 suggested automatic enrolment in personal pension savings schemes, and urged the government to increase public spending on pensions.[74] In Germany, where the public pay-as-you-go system is still the mainstay of the pension system, private retirement savings have been slow to take off. However, tax incentives are starting to make a difference: in 2006, Germans opened two million new private pension accounts, an 80 per cent increase compared to the previous year. Some countries, such as the Nordic ones and many of the new member-states, have made individual retirement savings compulsory.

[74] *Adair Turner, Jeannie Drake and John Hills, 'A new pension settlement for the 21st century', April 2006.*

One way for governments to take pressure off public systems is to raise the retirement age, or lengthen the period during which employees have to contribute before being entitled to pay-outs. However, governments are often tempted to put off these changes until well after the next election. Many countries are planning to incrementally raise official retirement ages from 65 to 67 – but only in several decades time. In Germany, for example, the gradual rise in the retirement age to 67 will not start until after 2012. Similarly, France decided in 2003 to lengthen the contribution period for both the private and the public sector from 40 to 42 years – by 2040 (although further increases are possible in line with life expectancy). However, experts say that an increase to a minimum of 45 years of contributions will be required, by 2036.[75] Meanwhile, France's official retirement age (at 60) is still one of the lowest in Europe. And neither of the front-runners in the 2007 presidential election, Ségolène Royal and Nicolas Sarkozy, has dared to suggest an increase.

[75] *Le cercle des économistes, 'Politique économique de droite, politique économique de gauche', 2006.*

Across the EU, people tend to retire well ahead of their official retirement age. In 2002, EU leaders promised to raise the effective retirement age by five years. But progress has been minimal: the average EU citizen now stops working half a year later than in 2002. Only 13 per cent of the French and 18 per cent of Italians work beyond the age of 60 (and hardly anyone stays beyond 65). The Nordic countries, Luxembourg and the Netherlands have removed tax incentives for early retirement. Other countries are planning to follow suit.

Pockets of poverty

Another objective of the Lisbon agenda is to reduce the number of people at risk from poverty and social exclusion. At the Laeken summit in 2001, the EU member-states agreed on 18 indicators to define social exclusion and set EU-wide objectives.

The main focus is on relative poverty indicators. In particular, households with an income of less than 60 per cent of the country's median income are considered to be at risk from poverty.[76]

[76] *Sarah Bouquerel and Pierre-Alain de Malleray, 'L'Europe et la pauvreté: quelles réalités?', Fondation Robert Schuman, March 2006.*

According to this indicator, 16 per cent of the EU-25 population was at risk of poverty in 2005. The highest rates (18-21 per cent of the population) were recorded in the Mediterranean countries (Greece, Italy, Portugal and Spain), the Baltics, Ireland and the UK. Among the new members, the Czech Republic, Hungary and Slovenia still have rather equal distributions of income and therefore a low incidence of relative poverty. The Nordic countries perform particularly well on this score.

However, since there are vast absolute differences in incomes in the EU, these indicators need to be interpreted cautiously. In the Netherlands or the UK, a household with an annual income of €20,000 (measured at purchasing power parity) would be considered at risk of poverty. In the Baltic states, the threshold is less than €5,000.[77] Poverty outcomes are closely linked to public policy: if social transfers are taken out of household income, the share of EU households at risk from poverty rises from 16 per cent to 25 per cent.

[77] *Anne-Catherine Guio, 'Income poverty and social exclusion in the EU-25', Eurostat 2005.*

It is similarly difficult to assess income trends over time: some experts say it is impossible to say whether poverty has decreased or increased over the last decade.[78] However, the statistics seem to indicate that the share of those considered at risk of poverty in the EU-15 is falling slightly, from 18 per cent in 1994 to 16 per cent in 2005.

[78] *Atkinson, Cantillon, Marlier, 'Taking forward the EU inclusion process', August 2005.*

To assess the risk of poverty, the EU also looks at long-term unemployment rates, on the basis that jobless households are most at risk of poverty. Long-term unemployment rates range from around 1 per cent of the labour force in Austria, Denmark, Sweden and the UK, to more than 10 per cent in Poland and Slovakia. But in some countries with very low long-term unemployment rates, many people have simply dropped out of the labour force altogether. In Austria and the UK, for example, 9-10 per cent of population live in jobless households.

The EU also pays particular attention to child poverty. This is crucial, because a lot of studies show that poor children are more likely to fail in education, become unemployed, fall ill or resort to crime later on. In about half of the EU countries, children are more at risk of poverty than old people. In the UK, child poverty has fallen by 23 per cent since 1998-1999, but one in five children still live in relative poverty.[79] Child poverty rates are even worse in Italy, Portugal and Slovakia. In the UK, much of the reduction in child poverty has stemmed from getting parents into jobs. Yet the fact that half of all children in poverty in the UK have parents with jobs implies that employment alone is not enough.

[79] *Lisa Harker, 'Delivering on child poverty: what would it take?', November 2006.*

Governments need to invest more in early education and give greater direct financial support to mothers. They also need to find ways of allowing parents to spend more time with their offspring. A recent study claims that one of the reasons for Sweden's economic success is that parents spend more time with their children than those of any other EU country.[80]

[80] *Peer Ederer, 'Innovation at work: The European human capital index', Lisbon Council Policy Brief, March 2006.*

Modernising social protection = C	
Heroes	Czech Republic, Denmark, Finland, Sweden
Villains	France (for pensions), Italy, Portugal, Slovakia

E. Sustainable development

E1. Climate change

★ Reduce greenhouse gases 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 traffic volumes by prioritising public and environmentally-friendly forms of transport

The EU will miss its targets for reducing greenhouse gas emissions and for increasing the share of renewables in energy provision. However, increasing awareness of the threat posed by global warming is pushing governments to think seriously about their environmental policies. The publication of the British government's Stern report, which argues forcefully that global warming will impose huge economic costs, has helped to change the terms of the debate.[81]

[81] *Nicholas Stern, 'The Stern review on the economics of climate change', HM Treasury, 2006.*

The EU has a better environmental record than other developed economies. EU countries are the world's biggest investors in renewable energy sources. The Commission has set ambitious targets for energy efficiency and renewable energy, and has stepped up support for R&D into low carbon energy sources.[82] In 2005, the EU also established the pioneering 'emissions trading scheme' (ETS) to help member-states meet their Kyoto protocol commitments, despite the US refusal to ratify that treaty.

[82] *European Commission, 'An energy policy for Europe', January 2007.*

The ETS, a so-called 'cap and trade' scheme, covers energy-intensive industries such as oil refineries, energy utilities and steel producers. In total, these industries represent around half of the EU's emissions of greenhouse gases, while households and transport generate the bulk of the remainder. The ETS sets a limit, or 'cap', for each member-state's emissions from the industries covered. Emissions permits are then allocated to individual companies. Companies are free to buy or sell the 'right' to emit carbon dioxide, with those emitting less than their limit able to sell emissions certificates on the open market.[83] Those emitting more than their limit must buy certificates, which should motivate them to emit less.

[83] *Companies can also invest in 'emission-abatement' projects in other countries and use the resulting emissions credits to help meet their Kyoto targets.*

Unfortunately, the first phase of the ETS – from 2005 to 2007 – has suffered from very low and unstable carbon prices, and as a result has not provided any real incentives for the development of new clean technologies.[84] This is the result of a number of key weaknesses in the system:

[84] *Simon Tilford, 'Time to get tough on carbon emissions', CER Bulletin, December 2006/January 2007.*

★ Member-states are responsible for setting their own emissions caps or 'national allocation plans' (NAPs). The Commission's authority is limited to assessing whether these caps are consistent with the country's targets under Kyoto, and to preventing governments from deliberately allocating excess allowances (which would constitute illegal state aid). Under phase one of the ETS, nearly all member-states allocated more emissions permits than the industries included in the scheme actually needed. Companies from EU countries that set tough caps have been placed at a competitive disadvantage, compared to those in more generous countries.

★ Companies also allocated permits according to the current needs of companies, with sometimes perverse effects. For example, a coal-fired power station that generates a similar amount of energy to a gas-fired one but emits twice the volume of greenhouse gases, receives double the allocation of permits. This undermines the incentive for energy producers to invest in more environmentally friendly plants.

★ Aviation and road transport, the two fastest growing sources of greenhouse gas emissions, are not included in the ETS. Although greenhouse gas emissions from most sectors fell between 1990 and 2004, those from aviation rose by 80 per cent and from road transport by a quarter. The Commission has no plans to bring vehicle emissions into the ETS, preferring to rely on energy efficiency standards. However, it has announced plans to include the aviation sector in the ETS by 2011.

★ Uncertainty over what will replace the current Kyoto protocol, which expires in 2012, has undermined investors' confidence in the long-term significance of the carbon market. This has deterred companies from investing in clean technologies. However, the Commission's recent proposal of a unilateral 20 per cent cut by 2020 (rising to 30 per cent if the US and others come on board) may have allayed some of these concerns.[85]

[85] *European Commission, 'An energy policy for Europe', January 2007.*

The Commission calculates that EU emissions of greenhouse gases in phase two of the ETS – which runs from 2008 to 2012 – will need to be 7 per cent below their 2005 levels if the EU is to meet its obligations under Kyoto. Collectively, the second phase NAPs that have so far been submitted to the Commission would barely reduce emissions, compared to the first phase of the ETS. This has prompted the Commission, to its credit, to reject many of the plans.

The Commission needs to stick to its guns. Unless the caps are tightened, the EU will have no chance of meeting its Kyoto commitments. According to the European Environment Agency (EEA), only Sweden and the UK are likely to meet their targets by a significant margin, while seven countries (Austria, Belgium, Denmark, Ireland, Italy, Portugal and Spain) are on course to miss theirs, some by a huge margin. While greenhouse gas emissions fell sharply in almost all of the new member-states between 1990 and 2004, this was mainly the result of the closure of inefficient industrial capacity. Emissions in most of these countries are set to rise, in some cases very strongly, between 2004 and 2010.

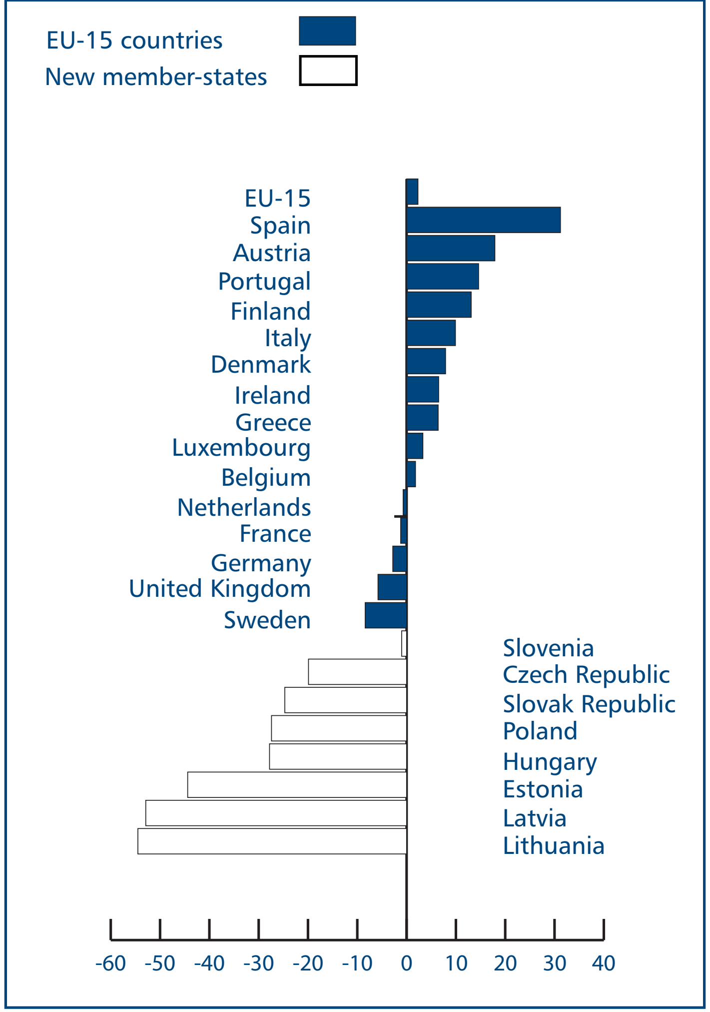
One reason for the EU's mixed progress towards meeting its Kyoto target has been weaker than expected investment in renewable energy sources. The Commission aims to increase the share of the EU's total energy needs that come from renewables to 12 per cent by 2010, and to 20 per cent by 2020. In 2005, the figure stood at 7 per cent. Although some countries, notably Denmark, Germany and Spain, have made rapid progress in this area, others, such as France and the UK, have lagged behind. High oil and gas prices, and concerns over rising dependence on imports from Russia and an unstable Middle East, have made renewable energy more attractive. However, even if investment in renewable energy capacity were to rise strongly over the next two years, the target would still be missed.

Improving the efficiency with which we use energy is as important as the way we generate it. The Commission wants to reduce energy consumption by 20 per cent by 2020.[86] Such a saving would equate to over €100 billion per year, or an average of around €700 for each household in the EU. In October 2006, the Commission published an action plan laying out the measures that would need to be implemented over the next six years to achieve that target. These include minimum energy standards for a wide variety of appliances and equipment, energy efficiency requirements for new and renovated buildings, and a drive to improve the efficiency of power-generating capacity by reducing transmission and distribution losses.[87]

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

[87] *European Commission, 'Action plan for energy efficiency: Realising the potential', 2006.*

Distance-to-target (Kyoto Protocol) in 2004
(percentage points below (-) or above (+) target path)*



**The distance-to-target indicator measures the deviation in percentage points of actual emissions in 2004 from a (hypothetical) linear path between base-year emissions and the burden-sharing target for 2010. A positive value suggests an under-achievement and a negative value an over-achievement by 2004.*
Source: European Environment Agency.

Road transport poses a big challenge. The current strategy of high fuel taxes combined with voluntary emissions targets for the car industry has failed to arrest the rise in the sector's emissions. Europe's car manufacturers have failed to abide by a voluntary agreement with the EU to lower emissions to an average of 140g per kilometre by 2008. In February 2007, the Commission retreated from its plan to recommend a mandatory target of 120g per kilometre by 2012, following intense pressure from the German government (which fears for the competitiveness of its luxury car-makers). Instead, the Commission is now considering a less demanding target – perhaps 130g per kilometre – together with an ambitious plan to force oil companies to blend biofuels with petrol. Under the proposals, petrol would have to contain at least 5 per cent ethanol by 2011, rising to 10 per cent by 2020. Together, the Commission hopes these measures will be enough to deliver the objective of 120g of emissions per kilometre by 2012, which would suffice to stabilise emissions from road transport.

A question of competitiveness?

Fears that tight emissions controls could impair Europe's competitiveness are exaggerated. First, there is a strong correlation between high energy prices and energy efficiency. Anything that encourages European businesses to adopt energy efficient technologies will stand them in good stead in a world of increasing energy scarcity, and strengthen the EU's energy security. Second, tight emissions controls would enable Europe to consolidate its existing lead in many energy efficient technologies, and help European companies to set global technical standards.

The EU certainly needs to work hard to persuade other countries, and crucially the US, to take aggressive steps to tackle emissions of greenhouse gases, so as to establish a level playing field. Nevertheless, the EU should not wait until the US can be persuaded to climb aboard before taking concerted action. Unilateral steps by the EU would increase pressure on other countries to implement

similar measures. For example, tight EU energy efficiency standards would leave businesses in other parts of the world with little option but to follow suit, because it would not be worthwhile to develop separate product lines for the EU. The Commission is also studying the possibility of levying taxes on imports from countries that refuse to sign the Kyoto protocol (or its replacement). Such a step should be a last resort, but could prove a useful source of leverage.

Climate change = B-	
Heroes	Denmark, Sweden, United Kingdom
Villains	Italy, Slovenia, Spain

4 Conclusion

Globalisation is producing winners as well as losers. Company bosses, bankers, engineers and other highly-skilled professionals are benefiting, whereas unskilled workers in labour-intensive manufacturing and basic services are threatened with falling wages or job losses. Popular fears that globalisation could undermine living standards are therefore understandable. However, attempts to insulate economies from globalisation are counter-productive. Protection will ultimately undermine competitiveness and economic growth, and thus weaken governments' ability to assist or compensate the losers.

The most successful EU projects have been those with clearly defined objectives and a single method for achieving them. The Lisbon strategy, however, contains a raft of different goals and makes use of a wide range of instruments, including the 'open method of co-ordination' – the EU's system of benchmarking and peer pressure. For most of the Lisbon objectives – such as preparing national budgets for ageing societies, or making life easier for small companies – EU governments have prime or even sole responsibility. There is only so much the Commission can do to cajole governments into accelerating the pace of reform. More naming and shaming of recalcitrant members would be welcome, but ultimately delivery has to come at national level.

Political leaders need to step up their efforts to convince voters that the most essential reforms – such as the liberalisation of labour and product markets, and more investment in education and training – will boost economic growth while helping to sustain public services and welfare states. Greater flexibility does not inevitably lead to widening inequality or the dismantling of the welfare state. Politicians need to counter the suspicion – particularly widely held in France, Germany and Italy – that economic reform benefits the better-off disproportionately, and that it exacerbates inequality. After all, Europe's most competitive economies, such as the Nordic countries and the Netherlands, manage to combine market-orientated policies with a high degree of social equality.

The priorities of the Lisbon process – competition, innovation and education – are the key challenges facing the EU countries. Yet journalists, officials and politicians are often dismissive of the EU's structural reform agenda. Its over ambitious goal of building "the most competitive, knowledge-based economy in the world" (a leftover from the giddy days of the dot.com boom), and the mediocre progress of most of the big EU countries towards those targets, have helped to create the impression that the Lisbon process is a failure. While most Europeans associate 'Kyoto' with fighting climate change and know that 'Maastricht' has something to do with the euro, very few would be able to say what the Lisbon agenda was about.

The Lisbon process certainly has weaknesses, and some of these have been heightened by enlargement. In a Union of 27 countries at very different stages of development, it may not make sense for all to share the same targets. Instead, the EU needs a more qualitative approach to discussing problems and possible solutions. Thus we have argued that for countries as diverse as Denmark and Poland to share the same R&D target (3 per cent of GDP) is problematic. Similarly, some countries already exceed the 70 per cent employment target, while many others do not stand a chance of meeting it by 2010. EU-wide poverty targets are increasingly misleading because of the wide income differentials between countries such as Denmark and the UK on the one hand, and Latvia and Poland on the other. The accession of Bulgaria and Romania – where incomes are only one-third of the EU-25 average – will exacerbate this problem.

Old Lisbon had more than 100 targets; the revamped Lisbon introduced in 2005 is supposed to focus on jobs and growth.[88] Social policy objectives have been packed off into a separate strategy, as have environmental targets. The EU used to have separate policy co-ordination processes and objectives for employment issues, budget policies and micro-economic reforms. Under the 2005 revamp, these were merged into one process with one set of targets, consisting of 24 'integrated policy guidelines'. The EU also devised new ways of linking its objectives with national reform initiatives, in the hope of fostering a sense of ownership of the Lisbon agenda.

In 2005 the governments drew up – for the first time – 'national reform programmes' (NRPs), in which they detailed their policy priorities for the following three years. Now they submit annual implementation reports on these programmes. The European Commission continues to monitor national reform efforts – and in line with the more streamlined nature of 'Lisbon 2' summarises its findings in one short annual document for each EU country.[89] Although an EU group of experts chaired by Wim Kok had urged the Commission to chastise under-performers, the Commission let itself be persuaded by some EU capitals that 'naming and shaming' would be counterproductive.[90] But there are some tentative signs that it could adopt a more forthright approach. For example, in December 2006, the Commission submitted to the Council of Ministers a list of country-specific recommendations. The Commission considers some countries – Denmark, Estonia, Finland, Ireland, Luxembourg and Sweden – to be so good at sticking to their NRP commitments that they do not need any recommendations. Greece, Italy, Poland and Hungary have the longest to-do lists. It remains to be seen whether EU leaders will adopt these recommendations at their spring summit.

[88] *House of Lords, 'A European strategy for jobs and growth', March 2006.*

[89] *All Lisbon related documents are available on http://ec.europa.eu/growthandjobs/.*

[90] *European Commission, 'Facing the challenge: The Lisbon strategy for growth and employment', November 2004.*

Less than two years into the 'new' Lisbon strategy, a few things have already become clear.[91] First, the attempt to focus on jobs and growth has only been a partial success. The strategy has not paid sufficient attention to the key obstacles to faster growth, such as insufficient competition across much of the EU economy, a relatively poor skills base, and the consequent weakness of innovation. Moreover, objectives are once again proliferating: EU leaders have added four 'priorities' to the 24 integrated guidelines, while energy policy and the completion of the single market have been bolted on to the Lisbon agenda.

[91] *Iain Begg, 'The implications of the integrated guidelines during 2005-2006 policy cycle', CEPS, 2006.*

Second, the Lisbon agenda is only very slowly becoming an integral part of national reform debates. Some member-states, such as Estonia and the Netherlands, have ambitious NRPs and are already making good progress in implementing them. Some, such as Poland, have ambitious plans but have so far delivered little. And most others, including Greece, Hungary and the UK, built their NRPs mainly around existing policy initiatives. Nor is it clear that the NRPs have fostered a sense of national ownership. Some EU members, particularly the newer ones, have attracted public attention to their NRPs by discussing them with parliamentarians, trade unions and NGOs. But in many others, including the biggest member-states, the NRP looks like just another bureaucratic exercise with few, if any, links to national policy debates.[92] Although all countries have now appointed a 'Mr or Ms Lisbon' to co-ordinate the different bits of the programme, these individuals are of variable quality and standing. For the NRPs to fulfil their function, lobbyists, journalists and politicians need to use them to hold their respective governments to account.

[92] *European Commission, 'Economic reform and competitiveness: Key messages from the European competitiveness report 2006', November 2006.*

The criticisms we have made of the Lisbon process in this report are not meant to call into question the usefulness of the exercise per se. The Lisbon agenda is far from being defunct. Although the

Commission's influence over member-state governments is inevitably limited, it can encourage EU countries to learn from each other. Indeed, member-states are now much more aware of what goes on elsewhere in the Union. There is hardly a European country that is not studying the Danish model of 'flexicurity', the Finnish success in higher education, or the pros and cons of UK-style energy and transport market liberalisation. The Commission can help by offering expertise and advice. For example, its latest 'European competitiveness report' gives tips on how to encourage innovation. The solutions remain national, but the reform narrative has become, to some extent, European in nature.

Similarly, despite our reservations, for example on the utility of single targets for such a diverse range of countries, we do not advocate further reform of the Lisbon process. The last thing Europe needs is another debate about the mechanics of Lisbon. The Commission has implicitly recognised the limits of one-size-fits-all targets in the NRPs, and this revised approach needs to be given time to work. One thing the EU does need to do, however, is to set a modern budget. The review of the EU budget due to take place in 2008-2009 should ensure that significant funds are targeted on Lisbon objectives. If the EU can agree upon a forward-looking, pro-Lisbon budget, it would demonstrate that it is serious about meeting the central challenge facing its member-states: the transformation of economies faced with rapid globalisation and accelerating technological change.

Overall assessment of results: C

★

The scorecard table

Issues	2007	Heroes	Villains	2006	2005	2004	2003	2002
A. Innovation								
Information society	B+	Denmark, Estonia, Sweden	Greece, Italy, Spain	B	B	B-	B-	C+
Research and development	D+	Austria, Czech Rep., Sweden	Greece, Italy, Poland	C-	C-	C	C-	C+
B. Liberalisation								
Telecoms and utilities	C	European Commission, UK	France, Germany, Poland, Spain	C+	C+	C+	B-	B-
Transport	C-	Germany, Sweden	France, Latvia, Portugal, Slovenia	C+	C+	C+	B-	D-
Financial and general services	B-	Netherlands, UK	Austria, France, Germany	C-	B-	C+	B-	B-
C. Enterprise								
Business start-up environment	B	Denmark, France, Latvia, UK	Czech Rep., Greece, Poland	B	C	C	B-	D
Regulatory burden	B	European Commission, Finland, Netherlands, UK	Greece, Italy, Portugal	B+	C+	C	C+	C-
State aid and competition policy	B-	Austria, Belgium, UK	Cyprus, Germany, Malta	B-	C+	C+	C+	B-

Issues	2007	Heroes	Villains	2006	2005	2004	2003	2002
D. Employment and social inclusion								
Bringing people into the workforce	C+	Denmark, Ireland, Netherlands	Greece, Poland, Portugal	C	C	C-	C	B-
Upgrading skills	B-	Finland, Netherlands, UK	Greece, Italy, Portugal	B-	C+	C	C	C-
Modernising social protection	C	Czech Rep., Denmark, Finland, Sweden	France (for pensions) Italy, Portugal, Slovakia	C	B-	B-	C	B-
E. Sustainable development								
Climate change	B-	Denmark, Sweden, UK	Italy, Slovenia, Spain	B	C-	C-	C+	C
Conclusion								
The Lisbon process	C+	Denmark, Netherlands	Greece, Poland	C	C	C	C+	C-
Overall assessment of results	C			C	C	C	C+	C

CENTRE FOR EUROPEAN REFORM
publications

- **Divided world: The struggle for primacy in 2020**
  Essay by Mark Leonard (January 2007)
- **Turkish business and EU accession**
  Essay by Sinan Ülgen (December 2006)
- **The EU and Russia: From principle to pragmatism**
  Policy brief by Katinka Barysch (November 2006)
- **Europe's blurred boundaries: Rethinking enlargement and neighbourhood policy**
  Pamphlet by Charles Grant (October 2006)
- **Will the eurozone crack?**
  Pamphlet by Simon Tilford (September 2006)
- **The EU must keep its promise to the Western Balkans**
  Essay by Tim Judah (July 2006)
- **Cyprus, Turkey and the EU: Time for a sense of proportion and compromise**
  Policy brief by David Hannay (July 2006)
- **How to strengthen EU foreign policy**
  Policy brief by Charles Grant and Mark Leonard (July 2006)
- **The future of European universities: Renaissance or decay?**
  Pamphlet by Richard Lambert and Nick Butler (June 2006)
- **Let justice be done: Punishing crime in the EU**
  Policy brief by Hugo Brady and Mónica Roma (April 2006)
- **The EU's awkward neighbour: Time for a new policy on Belarus**
  Policy brief by Charles Grant and Mark Leonard (April 2006)
- **Democracy in Europe: How the EU can survive in an age of referendums**
  Essay by Mark Leonard (March 2006)
- **The Lisbon scorecard VI: Will Europe's economy rise again?**
  Pamphlet by Aurore Wanlin (March 2006)
- **EU2010: A programme for reform**
  CER manifesto (March 2006)
- **The EU's new financial services agenda**
  Working paper by Alasdair Murray and Aurore Wanlin (February 2006)

Available from the Centre for European Reform (CER), 14 Great College Street, London, SW1P 3RX
Telephone +44 20 7233 1199, Facsimile +44 20 7233 1117, kate@cer.org.uk, www.cer.org.uk
COVER IMAGE: STEVE CHADBURN - mail@steve-chadburn.com

CENTRE FOR EUROPEAN REFORM
NEW IDEAS FOR A NEW EUROPE

THE LISBON SCORECARD VII
Will globalisation leave Europe stranded?

Katinka Barysch, Simon Tilford and Aurore Wanlin

Globalisation and the rapid integration of China and India into the international economy present huge opportunities for the European Union. But only those member-states with a strong comparative advantage in knowledge-based goods and services will benefit. The CER's seventh Lisbon scorecard paints a mixed picture of the EU's prospects. While some member-states are well-placed, others are not and must invest much more in human capital and research and development.

Katinka Barysch is chief economist, **Simon Tilford** is head of the business unit, and **Aurore Wanlin** is a research fellow at the Centre for European Reform.

ISBN 978 1 901229 71 4 ★ £10/€16

AstraZeneca BARCLAYS CLIFFORD CHANCE
KPMG Microsoft Unilever