CENTRE FOR EUROPEAN REFORM

THE LISBON SCORECARD X
The road to 2020

Simon Tilford and Philip Whyte

CENTRE FOR EUROPEAN REFORM

about the CER

The Centre for European Reform is a think-tank devoted to improving the quality of the debate on the European Union. It is a forum for people with ideas from Britain and across the continent to discuss the many political, economic and social challenges facing Europe. It seeks to work with similar bodies in other European countries, North America and elsewhere in the world.

The CER is pro-European but not uncritical. It regards European integration as largely beneficial but recognises that in many respects the Union does not work well. The CER therefore aims to promote new ideas for reforming the European Union.

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ABOUT THE AUTHORS

Simon Tilford is chief economist at the Centre for European Reform. His previous CER publications include: 'Carbon capture and storage: What the EU needs to do', February 2010 (with Stephen Tindale); 'Rebalancing the Chinese economy', November 2009; 'The Lisbon scorecard IX: How to emerge from the wreckage', February 2009 (with Philip Whyte); 'The euro at ten: Is its future secure?', January 2009; 'Is EU competition policy an obstacle to innovation and growth?, November 2008; and 'How to make EU emissions trading a success', May 2008.

Philip Whyte is a senior research fellow at the Centre for European Reform. His previous CER publications include: 'How to restore financial stability', January 2010; 'Narrowing the Atlantic: The way forward for EU-US trade and investment', May 2009; 'The Lisbon scorecard IX: How to emerge from the wreckage', February 2009 (with Simon Tilford); and 'State, money and rules: An EU policy for sovereign investments' (with Katinka Barysch and Simon Tilford), December 2008.

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Foreword

AstraZeneca

AstraZeneca is delighted to offer its continued support to the CER and the thorough research it has conducted in updating its annual Lisbon scorecard.

Policy makers must continue to focus on areas which can help secure Europe's long term prosperity and meet the challenge of global competition. One of the most strategically important tasks facing the EU in 2010 will be to replace the Lisbon agenda with a new programme of reforms (EU 2020). While some progress was made under Lisbon, it was not sufficient. EU 2020 cannot afford to fail if Europe is to compete in the knowledge economy. The key components of the successor agenda must include research and development (R&D); a sharper focus on raising education and skills; and measures to reward innovation.

The pharmaceutical industry remains a strategically important part of Europe's economy, investing more in R&D than any other industry. For this to continue we must work with the Commission and the member-states to ensure that innovation is encouraged and rewarded. A central theme in this effort needs to be the protection of intellectual property rights, without which no pharmaceutical company could invest the considerable sums required to develop life-saving medicines.

In 2010, the EU will be discussing some important proposals affecting the pharmaceutical industry: measures to combat the counterfeit of medicines, pharmacovigilance, information to patients, the use of animals in research and the EU patent. It is critical that we make progress in all of these areas.

The CER report is instructive and provides some key lessons which must be taken on board when developing EU 2020. I am confident that with the required political will, we can boost Europe's competitiveness.

Ulf Säther

Regional Vice President, Europe

Foreword

CLIFFORD CHANCE

Once again, we are pleased to sponsor the Lisbon scorecard and continue to support the CER's invaluable work. In its tenth and final year, much will be written about the success or failure of the Lisbon agenda. One thing is clear: the policy is a good one and maintaining pressure on EU member-states to continue to reform is imperative.

The new European Commission must demonstrate early on that it has the expertise and drive to continue to push through reforms at a time when member-states may be struggling with other challenges. Key to this programme will be the review of the internal market undertaken by Professor Mario Monti. The internal market is the jewel in the crown of EU policy. In the words of Commissioner Barnier: "The internal market is our best protection in times of crisis". I could not put it better myself. A crucial aspect of the internal market is the services sector, which represents a massive three-quarters of EU GDP. The deadline for transposition of the services directive has passed. If implemented properly, this legislation should open up the services market to true cross-border competition, bringing efficiency gains to a key sector of the European economy. Political momentum must be maintained by Commissioner Barnier and his colleagues.

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

Stuart Popham

Senior Partner, Clifford Chance LLP

Foreword

It is sadly ironic that a decade which started with such high hopes for Europe should end with financial crisis and recession – a long way from the ambition enshrined in the original Lisbon agenda to make Europe "the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010".

It is too simplistic to conclude, as some have done, that the process has failed. This annual publication, sponsored from the start by KPMG, has recorded as many successes as failures.

But it is clear that the reform project is far from complete. And the fact that progress has been less than desirable just emphasises the need to redouble efforts over the coming decade. Where will growth come from? With demand set to remain weak in the short-term as households, businesses and governments repair damaged balance sheets and, in the longer-term, populations decline, reform is even more vital.

The Lisbon agenda needs to be succeeded by a more focused programme. The new EU 2020 agenda should concentrate particularly on the areas likely to have the biggest payoffs in promoting productivity – freeing up of labour markets and the adoption of new technologies – and be sold to the public not on nebulous concepts such as 'markets' and 'competition', but as promoting consumer choice and welfare.

KPMG has been proud to sponsor the CER's European economic reform 'scorecards'. It is vital that this latest assessment is seen as an end of term report, not the end of the process.

John Griffith-Jones

Joint Chairman KPMG LLP

Foreword

Tesco, a global business based in London with a market capitalisation of €38.1bn in February 2010, has stores in six EU countries. We are proud of our record as an employer. We created 20,000 new jobs in the EU last year – many went to young people, and many provided part-time and flexible employment for people trying to balance work and family.

The single market has been good for businesses and growth, and good for consumers and workers alike. It has facilitated vigorous competition in retail, which has delivered to customers enormous benefits: more choice, better service, and lower prices. Tesco focuses very hard on the customer; European and domestic regulators need to do the same.

The need for economic growth and the need to protect the environment are not mutually exclusive. We have to change the way our businesses are run. Tesco has environmental stores across the EU, including one in Rajec, Slovakia, which is partly made of wood, wool and straw. But consumers are part of the solution too. Tesco halved the price of energy-efficient light bulbs and sales increased six fold. Millions of consumers making small changes make a big difference, and business has an opportunity to help them.

Continued reform is vital if Europe is to improve its competitiveness. If the economic and regulatory environment were improved in the EU, there would be more investment, higher growth, and more jobs. The principles of the original Lisbon agenda now need to be reborn in an ambitious and measurable 2020 strategy.

Lucy Neville-Rolfe, CMG

Executive Director, Corporate and Legal Affairs, Tesco

Foreword

Unilever is glad to give its support to this year's edition of the CER's Lisbon scorecard. Unilever was one of the earliest examples of a large European cross-border merger. The firm has supported the European integration process ever since, because we see it as essential for Europe's long-term competitiveness. This timely publication has certainly met its target by continuously stressing the need for change to key policy-makers, the business world and the public at large.

The Economist recently wrote: "Lisbon failed because lots of Europeans do not want to live in the most dynamic and competitive economy in the world. They prefer to work fewer hours than Americans and Japanese (about 10 per cent fewer, on average), to take long holidays, and to retire as soon as possible."

But there is no need to be so pessimistic. Although the implementation of the Lisbon strategy clearly fell short of its original objectives, the process did still bring some positive results as was shown by the various CER Lisbon scorecard reports.

Two things are clear: firstly, the rest of the world will not be standing still, and secondly, a lethargic Europe will certainly not be able to deliver the results European citizens are longing for. Europe will therefore need to re-launch itself.

In the meantime, a wide range of legislative proposals are currently being discussed within the EU that are of crucial importance to our industry sector.

These include proposals for nutrition labelling of foods; the adoption of new authorisation procedures for novel foods; the overhauling of EU rules on cosmetics; as well as the labelling of chemicals in products. The final results will show whether the EU will deliver on its 'better regulation' promise.

There still a lot to be done and we sincerely hope the CER will continue to play its extremely useful watchdog role.

Miguel Veiga-Pestana

Vice President, Global External Affairs, Unilever

1 Introduction

In late 2009, Europe emerged from its deepest recession since the 1930s. Despite the damage inflicted to jobs, businesses and public finances, there was widespread relief at the end of the year that things did not turn out worse. Decisive action by governments and central banks mitigated the severity of the downturn. Unemployment did not rise as sharply as many forecasters had expected (partly thanks to welcome signs of flexibility on the part of workers and employers). And fears that Europe and the rest of the world might lurch into protectionism proved largely unfounded. Actions by governments undoubtedly tested the rules of the EU's single market, and the Commission had to show flexibility in the way competition policy was enforced. But the single market did not unravel.

Having averted the collapse of the global financial system, and weathered a painful recession, it is tempting to look ahead with a sense of cautious optimism. But any optimism should be tempered by the scale of the task ahead. After the unprecedented fiscal and monetary stimulus provided in 2009, policy will have to be 'normalised'. Timing will be crucial: too early, and economies could tip back into recession; too late, and they could face sovereign debt crises (like Greece in early 2010). Even if the policy tightening is timed to perfection, a rapid economic rebound seems unlikely. Recoveries from financial crises are always slower than those from normal recessions (because of tight credit and high levels of debt). And EU countries will find it hard to export their way out of trouble because no other major economy is willing or able to replace the US as the world's consumer of last resort.

The best that the EU can hope for, therefore, is a slow, grinding recovery. The economic, social and fiscal scars left by the financial crisis will be with the region for a long time to come. It will take many years, rather than just a few quarters, before most EU countries return to the levels of economic activity that they recorded in 2008. Unemployment may not have risen as sharply as some observers had feared at the start of 2009, but it will not decline much in the near future: labour hoarding by employers during the downturn, and the weakness of economic growth coming out of it, almost certainly point to a largely jobless recovery. The public finances, for their part, have been durably weakened by the crisis – and will be hard to consolidate at a time when the costs of an ageing population will be kicking in. In short, most EU countries face a hard slog, with little prospect of reaching sunlit uplands any time soon.

Given the scale of the damage inflicted by the financial crisis, it is not unreasonable to question what remains of the Lisbon agenda – the programme of supply-side reforms that was launched in 2000 in an effort to boost the long-term growth potential of EU economies. Since the agenda was launched, governments have found it easier to sell its promise than its content. The reason is that many Europeans have long seen it as a poorly-disguised attempt to import 'Anglo-Saxon neo-liberalism' through the back door – or, which some think amounts to the same thing, to dismantle Europe's cherished social welfare models. Unsurprisingly, these critics have seized on the financial crisis to argue that it discredits a reform programme with deregulation and market liberalisation at its core. The crisis, on this view, has rehabilitated the case for active states and regulated markets.

Are the critics right? Certainly, the crisis holds important lessons for the regulation of markets – particularly financial ones. It is also true that confidence in world financial markets would have collapsed if governments had not intervened to prop them up. The crisis, in short, provided a reminder of just how crucial states are to the orderly functioning of markets. But it is hard to see how this conventional insight invalidates the case for the Lisbon agenda. The latter, after all, never questioned the state's role in correcting 'market

failures' (like pollution or financial crises) or in providing public goods (such as education and health). All it suggested was that features of member-states' economies were impediments to productivity and employment; and that tackling these obstacles was a condition for future prosperity and the survival of Europeans' cherished welfare systems.

Luxembourg's prime minister, Jean-Claude Juncker, famously remarked that European leaders know what reforms they need to push through – they just do not know how to win elections once they have done so. That being so, a cynic reviewing progress towards the Lisbon targets might be tempted to conclude that reforms have been subordinated to political careers. This would not be entirely fair. Most countries are closer to most of their Lisbon targets now than they were in 2000. Progress has unquestionably been made. The share of Europeans completing secondary and university education has increased. There is more competition in sectors like energy and telecoms. Both the legal and the effective ages of retirement have risen in many countries. The female employment rate has surged. Countries have made good progress towards their environmental targets. And so on.

On the whole, however, the level of progress has been underwhelming. Few member-states have come close to hitting the targets they set themselves in 2000, and the gap between the best and the worst performing countries is arguably wider in 2010 than it was in 2000. It is impossible to tell how reforms would have progressed in the absence of the Lisbon agenda. However, it is hard to shake off the nagging suspicion that most EU member-states' reform paths would not have been very different if Lisbon had never existed. Why? Because there has been no more policy convergence within the EU than there has been between the EU and the rest of the OECD. The Lisbon agenda may have had a modest influence on the reform process in some of the smaller member-states. But in the larger ones, reforms have been driven by domestic political dynamics, not external pressure.

The costs of inaction are now becoming clearer. It is surely no coincidence that the members of the eurozone which are currently experiencing the greatest loss of confidence in financial markets are those which are the furthest from meeting their Lisbon targets and have done the least to reform their economies. Some countries have treated the single currency as a shield, forgetting that it is also a corset (which requires countries to have flexible markets for goods, services and labour). In effect, some eurozone members have squandered the decline in borrowing costs which they enjoyed after joining and put off the reforms that were needed to make their membership of the euro a success. The result is that they are now stuck with rigid and externally uncompetitive economies – and no mechanism to adjust, beyond punishing wage cuts which their societies are disinclined to accept.

Since the Lisbon agenda comes to the end of its term in 2010, EU leaders will shortly have to decide whether they should replace it with a successor. They will almost certainly agree that they should. But if the successor agenda – already dubbed 'EU 2020' – is to have a greater purchase on national reform efforts than the Lisbon agenda, it will need to be given better instruments. Although the underlying diagnosis of the Lisbon agenda remains as relevant today as it was in 2000, EU 2020 would also benefit from a slight reordering of priorities. This report argues, for example, that it is far more important for EU countries' future prosperity and social cohesion to raise the education and skills levels of their populations than it is for them to hit arbitrary (and largely misleading) targets on research and development spending. The conclusion to this report discusses ways in which EU 2020 might be turned in to a more effective reform programme than the Lisbon agenda.

The Lisbon league table

The scorecard's 'Lisbon league table' assesses individual EU countries' performances relative to their Lisbon targets, comparing their standings in 2009 with 2000. The table is based on the EU's

short-list of 'structural indicators', which measures member-states' performance in economic, social and environmental categories – such as employment rates, greenhouse gas emissions, research and development (R&D) spending and so on. These are necessarily lagging indicators – they do not take into account the full impact the crisis will have on countries' scores. For example, macroeconomic data for 2009 were not available at the time of writing. The 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 the 27 member-states, our assessment of national reform efforts is by necessity impressionistic and partial. 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 are awarded 'hero' status, as are those that are catching up at a fast pace. Those that lag seriously behind or have made slow progress are designated as 'villains'.

Strong performers

The five strongest performers in this year's scorecard are the three Nordic member-states, Austria and the Netherlands. They score highly across indicators of social equity, labour market performance and environmental sustainability. Crucially, they combine competitive markets with comprehensive welfare provision. None of these countries, of course, is perfect. Danish productivity growth has been weak for a number of years, holding back growth in per capita GDP. Sweden has high rates of youth unemployment and large numbers of people on long-term sick leave. Austria's effective age of retirement is too low and the country has a relatively poor record of reducing greenhouse gases. Finland suffers from unimpressive productivity. Nevertheless, these five economies come closest to what the architects of the Lisbon agenda envisaged for the whole of Europe.

However, if one country stands out as the 'chief hero' of the CER's Lisbon scorecard it is the Netherlands. It is the only EU country to combine very high levels of productivity with a high employment rate. EU countries typically have high productivity and low employment rates (France and Belgium) or high employment rates and relatively low productivity (Finland and UK). The Netherlands only ranks 4th because of its relatively low level of R&D spending. But this largely reflects the structure of the Dutch economy, which is strongly skewed towards services. Moreover, as we argue in this report, R&D spending is in any case a poor proxy for innovation: a high level of R&D is largely irrelevant if the ideas and technologies generated are not successfully commercialised and do not result in productivity growth. The Netherlands does have one vulnerability, however: the weakness of domestic demand. Exports have accounted for much of the growth in the economy in recent years. In light of the pronounced economic weakness in most of its European trading partners – which account for 80 per cent of the country's exports – the Netherlands will have to take steps to bolster private consumption if it is to maintain its strong economic performance.

Two of the new member-states also rank as strong performers: the Czech Republic and Slovenia, which occupy 10th and 11th places respectively in the scorecard. Both have posted strong economic growth. In 2009 real GDP per capita stood at an estimated 77.4 per cent of the EU average in the Czech Republic and 86.1 per cent in Slovenia. In both countries social inequality is low and education levels high (in secondary schools, at least), and rising expenditure on R&D suggests that manufacturers are moving up the value-chain. However, the countries are not without their weaknesses. Labour markets remain rigid. Both countries suffer from high levels of long-term unemployment, and in the Czech case from a relatively low employment rate. The Czech Republic, in particular, also continues to use energy very inefficiently.

Must do better

Every EU member-state could do better. But Europe's economic prospects largely depend on the performance of five big countries: France, Germany, Italy, Spain and the UK. Together these five account for almost three-quarters of EU GDP. Germany is now the strongest performer among these bigger member-states, ranked 6th, having overtaken the UK, which has slipped to 8th. France has risen one place to 9th. These three countries perform strongly compared with the remaining two big economies, Spain and Italy. Spain remains in 19th place, while Italy has slid two places to 24th. These last two countries are classed as laggards (see below.)

Germany scores well on measures of innovation and environmental sustainability. The country also combines a relatively high employment rate with good productivity. But Germany scores less well for social equity. It is one of the few member-states where social inequalities have risen since 2000, and the share of 25-34 year-olds with a university degree is low by European standards. However, Germany's most serious problem is the extreme weakness of domestic demand, which was masked in the years running up to the financial crisis by very strong growth in exports. Persistent wage restraint and a very high savings rate have depressed consumption, leaving the economy very unbalanced. Inevitably, Germany was hit hard by the downturn, experiencing one of the largest GDP contractions in the EU in 2009, at around 5 per cent. The country's exporters are certainly price competitive, but with the global economy – and many of Germany's European trading partners, in particular – set to remain very weak for a number of years, Germany will not be able to rely on exports to drive economic growth. The challenge for the country is to stimulate domestic demand in order to reduce its dependence on exports. The rest of the eurozone also needs Germany to start growing under its own steam. If it fails to do so the struggling Southern European members of the currency union will find it almost impossible to rebalance their economies and put their public finances on a sustainable footing.

The UK has the most competitive markets for goods and services in the EU and one of the most flexible labour markets. It has a strong record of reducing greenhouse gases. Even after experiencing one of the deepest recessions in the EU in 2009, it will be the second wealthiest of the bigger EU economies, narrowly behind Germany and ahead of France. However, the UK has some major weaknesses. The first is that despite the efforts of the current Labour government, it still performs poorly on many social indicators. A major reason for the government's lack of success has been the failure to address some of the root causes of poverty in the UK – such as exceptionally high drop-out rates from secondary education. Another major weakness is the country's fiscal position, which has deteriorated markedly after a decade-long public spending spree. The UK is now saddled with a large and unproductive state, weak infrastructure and persistently high levels of inequality. The outlook for productivity growth appears poor. Either the British state must shrink substantially, or it must justify the share of economic resources it commands by doing a better job than it currently does.

France boasts strong labour productivity and a relatively high graduation rate from secondary school, as well as a good record of reducing emissions of greenhouse gases. The current government has cut payroll taxes and progressively relaxed the country's 35-hour working week introduced in 2000. It has also cut income and corporate tax rates. But France's employment rate, at 64.9 per cent in 2008, is still well short of the Lisbon target of 70 per cent. The government has done very little to increase competition in product markets, and it remains ambivalent about EU competition rules, which it argues put European companies at a disadvantage. Finally, France's public finances are very weak. The country has done more than many other EU countries, notably the UK, to put the financing of public sector pensions on a sustainable footing. But big cuts in

public spending will be unavoidable if the government wants to prevent a sharp rise in public debt.

Laggards

Four eurozone economies are our villains: Spain, Portugal, Greece and Italy, which rank 19th, 20th, 22nd and 24th respectively in the scorecard. Some of the new member-states score just as badly, but they are considerably poorer and have had much less time to take action to address their weaknesses. All four Southern European economies score poorly across indicators of social equity, labour market performance, innovation and environmental sustainability. All have high levels of inequality and generally poor skills levels. Despite low employment rates (Portugal is a partial exception in this regard), their productivity levels are weak. Crucially, they have made very slow progress on improving their performance. Spain's employment rate did rise from 56.3 per cent in 2000 to 64.3 per cent in 2008, but much of this was down to an unsustainable construction boom which has now turned to bust: the country's rate of unemployment shot up to almost 20 per cent in 2009. The only countries with lower employment rates than Italy are Hungary and Malta. Only Malta has a lower secondary school graduation rate than Portugal, and Spain performs little better. The four Southern European laggards have consistently been among the slowest in the EU to liberalise markets for goods and services, and have very poor regulatory environments for business.

The economic downturn has exposed the unsustainability of all four countries' public finances. Greece is the most vulnerable, but it is just the starkest example of the problems facing economies that have lost competitiveness within the eurozone and now have weak public finances and poor growth prospects. They must cut budget deficits while lowering costs relative to the rest of the eurozone, and this at a time when inflation in economies such as Germany and the Netherlands is very low and investors are jittery about sovereign risk. Unfortunately, none of the four has taken the necessary steps to improve their productivity performance. They must therefore rely on cutting real wages in order to recoup competitiveness within the currency union. As a result, there is a serious risk of them stagnating and sliding into deflation.

Italy provides a graphic warning of what can happen to an economy that habitually postpones economic reforms. The decline in the country's wealth vis-à-vis the rest of the eurozone has been precipitous. In 2000, Italy's real GDP per head at purchasing power parity (PPP) was higher than France's and almost as high as in Britain and Germany. By 2009 Italy had fallen behind Spain. This would have been bad enough had the country at least managed to boost its competitiveness compared to the rest of the eurozone. Unfortunately, Italy has experienced the worst of both worlds: very weak economic growth and a steady increase in its costs vis-à-vis the rest of the eurozone. Italy is running a current-account deficit of 3 per cent of GDP, despite prolonged economic stagnation (an economy growing as weakly as Italy would not normally be running a current-account deficit). The country must raise its game – it scores poorly on just about every indicator: only Bulgaria, Romania and Malta do worse.

The Lisbon process = C-	
Heroes	Austria, Denmark, Sweden, The Netherlands
Villains	Greece, Italy, Spain

The Lisbon league table: Overall Lisbon performance

	Rank 2009	Rank 2008
Sweden	1	1
Austria	2	4
Denmark	3	2
The Netherlands	4	3
Finland	5	5
Germany	6	8
Ireland	7	6
UK	8	7
France	9	10
Czech Republic	10	9
Slovenia	11	14
Luxembourg	12	12
Belgium	13	13
Cyprus	14	15
Estonia	15	11
Lithuania	16	17
Latvia	17	16
Slovakia	18	18
Spain	19	19
Portugal	20	21
Poland	21	24
Greece	22	20
Hungary	23	23
Italy	24	22
Bulgaria	25	25
Romania	26	26
Malta	27	27

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. Japan, the United States and, increasingly, emerging economies such as China look set to dominate the production of high-tech products unless the EU 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 in 2000, 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 give people incentives 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 the 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

At the time of the launch of the Lisbon agenda in 2000, the US was experiencing rapid productivity growth. After closing gradually for the best part of 50 years, the gap in productivity between the US and Europe was again widening. One reason for this was strong US investment in information and communications technology (ICT), accompanied by the organisational changes needed to make the best use of the technology. The EU rightly believed that European countries would need to emulate the application of ICT taking place in the US.

Rates of investment in ICT vary enormously across the EU. Some member-states – such as Finland, the Netherlands and Sweden – have invested more than the US over the last ten years, whereas others – such as Germany and the UK – have invested a similar amount. However, investment in ICT in the southern members of the EU – Italy, Portugal, Spain and Greece – has remained weak.

The top performing EU countries now have very impressive levels of internet use: at the end of 2009 over 75 per cent of households had access to the internet in Denmark, the Netherlands, Sweden, Finland, Germany and the UK, and the EU average was 65 per cent. Ten member-states have higher levels of broadband internet access than the US. By contrast, only half of Italian, Portuguese and Spanish households have internet access, while the figure is under 40 per cent in Greece. As a result, the southern members of the EU now lag many of the new EU members in the diffusion of the internet: in 2009, around three-fifths of households had internet access in the Czech Republic, Estonia, Latvia, Lithuania, Poland, Slovakia and Slovenia.

Access to the internet in 2009

	Percentage of households with internet access	Number of broadband lines per 100 inhabitants
The Netherlands	90	36
Sweden	86	33
Germany	79	26
Finland	78	31
UK	77	28
Slovenia	64	19
Slovakia	62	10
Spain	54	20
Italy	53	18
Greece	38	11
EU-27	65	22

Source: Eurostat

There is a strong correlation between countries' levels of investment in ICT and their rates of growth in labour productivity (see table on page 17). Very weak levels of investment in ICT seem to be one reason why Italy and Spain barely posted any growth in labour productivity at all between 2000 and 2008. However, with the exception of Finland, the Netherlands, Sweden and the UK, the American surge in productivity

growth has not been replicated in Europe. Indeed, productivity growth in France and Germany – both of which have been big investors in ICT – has trailed the US by a considerable margin.

ICT and productivity

	Average growth in total factor productivity, 2000-08	Average growth in labour productivity, 2000-08	Average investment in ICT (per cent, GDP), 2000-08
Finland	2.0	1.9	3.3
France	0.3	0.9	2.7
Germany	0.6	0.9	2.8
Italy	-0.5	-0.1	2.0
The Netherlands	0.9	1.7	3.2
Spain	-0.3	-0.3	2.1
Sweden	0.8	1.5	3.3
UK	0.5	1.6	3.7
US	0.9	1.4	3.6

Sources: Economist Intelligence Unit, Eurostat

Sweden and Finland are the only EU economies to have experienced the spurt in so-called total factor productivity (TFP) that accompanied ICT investment in the US. TFP is a measure of the efficiency with which labour and capital are used. Many economists believe it is a better measure of technological progress than labour productivity, which can be influenced by labour market rigidities and levels of capital investment. In terms of growth in TFP, France, Germany and the UK have lagged behind, while Spain and Italy have performed terribly, highlighting the gravity of the challenge facing these two economies.

The EU's experience shows that it is not enough for institutions simply to invest in ICT; they must also make organisational changes if they are to realise the full benefits of new technology. Institutions in Finland, Sweden and the Netherlands appear to have been able to do this, while those in other EU economies have struggled to do so and are therefore failing to replicate the productivity performance achieved by American counterparts. There are a number of reasons why European businesses are taking too long to restructure. But action is clearly needed in four areas:

1. **Skills:** Many member-states lack workers with the necessary skills to make the most of new technology. Although most countries have made progress in increasing the proportion of their workforces with tertiary education, drop-out rates from secondary education remain high in many member-states (see section D2).

2. **Labour market regulation:** In many member-states excessive labour market regulation makes it very costly to lay-off or redeploy staff. This, in turn, makes it hard for firms to profit fully from investment in ICT, and slows the diffusion of new technology. The financial crisis has damaged the case for liberal economic reforms in the eyes of many Europeans, throwing into doubt the gradual liberalisation of labour markets that has been underway in most member-states. This is unfortunate, because the further weakening of Europe's economic growth prospects requires more, not less, labour market flexibility.

3. **Single market:** The fragmentation of the EU's single market and the lack of competition within and between the member-states both reduce incentives for companies to make the most efficient use of ICT. By contrast, companies in the US operate in a big, seamless market with much lower levels of protection. The EU has made progress in opening up some previously protected service sectors to competition, leading to dramatically higher productivity in the telecoms and airline sectors. But these are the exceptions to the rule. Most European service markets are a long way from being integrated (see section B). Governments need to convince sceptical electorates of the need for further liberalisation, at both national and EU level.

4. **Inefficient public sectors.** Public sector productivity has lagged that of the private sector by a substantial margin in most, if not all, member-states since 2000. Indeed, in some – Italy and the UK, for example – productivity in the public sector has actually fallen over this period. The pace of organisational change across state sectors needs to accelerate if they are to make better use of new technologies and boost productivity. If they fail to do so, big cuts in spending on public services will be inevitable in many member-states.

Information society = B	
Heroes	Finland, The Netherlands, Sweden
Villains	Greece, Italy, Spain

A2. Research and development

★ Agreement on a European Union patent

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

Innovation rightly sits at the heart of debates over economic growth. In the developed economies sustained economic growth is dependent on productivity growth, which in turn requires innovation of one sort or another. The need to raise the innovative capacity of EU economies is now even more pressing than it was in 2000. Without improved productivity, EU governments will struggle to cope with the impact of population ageing on public finances, and living standards will stagnate or even start to fall. However, measuring investment in innovation is far from straightforward. In 2000, the EU adopted the traditional measures – spending on research and development (R&D) as a proportion of GDP, and the number of patents filed. But a much broader measure of investment in innovation is needed; high technology alone will not deliver economic growth.

In 2000 the EU set an R&D target of 3 per cent of GDP by 2010. This target will be missed by a huge margin: in 2008, public and private spending on R&D accounted for 1.9 per cent of EU GDP, unchanged from 2000. Europe continues to perform poorly relative to the US and Japan, where the shares were 2.6 per cent and 3.1 per cent respectively. Just two member-states – Finland and Sweden – meet the 3 per cent target. And 21 of the 27 EU member-states devoted less than 2 per cent of GDP to R&D in 2008. Nor has the performance of the laggards such as Spain and Italy improved. They continue to devote just 1.2 per cent of their GDP to R&D and have been overtaken by a number of new member-states, including the Czech Republic, Slovenia and Estonia.

Meanwhile, progress towards a European patent has been glacial. Firms or individuals still have to file a patent in each member-state where protection is required. For a patent to be effective across the whole EU it also needs to be translated into each of the EU's 23 official languages. The fragmentation of the patent system imposes significant costs on business: an EU-wide patent costs around €70,000, compared with €20,000 in the US. In December 2009, EU industry ministers finally agreed to create a Europe-wide patent as well as a centralised court that would deal with patent-related disputes. This will be a big step forward. However, national governments have yet to resolve the thorny issue of language. Ideally, the EU patent would be in the language of the filer's country of origin and English, the closest Europe has to a lingua franca.

The decision to set a 3 per cent R&D target for all member-states irrespective of their stage of development has been rightly criticised. It makes little sense for Sweden to have the same target as Bulgaria, which can grow rapidly simply by imitating best practice elsewhere. R&D spending (and the number of patents filed) are also strongly influenced by an economy's industrial structure. A country with a big manufacturing sector and/or pharmaceuticals industry will tend to display higher levels of R&D and a greater propensity to file patents than one with a strong specialisation in services. But the former will not necessarily have better economic growth prospects than the latter. Indeed, the relationship between R&D spending and productivity growth is a weak one. Some EU countries with high levels of R&D, such as Finland and Sweden, have grown rapidly over the last ten years. But in others – Germany and Denmark, for example – economic growth has been weak. By the same token, the Netherlands and the UK have relatively low levels of R&D but growth rates well above the EU-15 average (see table opposite).

However, the greatest drawback of focusing so strongly on R&D and patenting activity is that they capture only a small part of the total investment in innovation. Most of the spending that promotes innovation does not take place in R&D departments. Other factors, such as skills training and changes in organisation are just as important as R&D (see the article by Jonathan Kestenbaum, page 26). For example, Apple has been one of the most successful

manufacturing companies of the last decade, but not because it has developed cutting-edge new technologies; the firm's R&D spending has been limited. Rather, it has used existing technology in innovative new ways. America's General Motors entered bankruptcy in 2009, despite having spent more on R&D than any other company in the world over the preceding ten years. New ideas or inventions mean little if they are not successfully commercialised.

Real GDP growth and R&D (proportion of GDP)

	Average real GDP growth, 2000-09	Average R&D as a percentage of GDP, 2000-08
Finland	2.1	3.4
Sweden	1.9	3.8
UK	1.8	1.8
The Netherlands	1.5	1.7
Denmark	1.0	2.5
Germany	0.8	2.5
US	1.9	2.6
Japan	0.7	3.3

Sources: Eurostat, OECD

Conventional measures of innovation are an even less reliable indicator of innovation in service sectors than in manufacturing industries. This is a major drawback because service sectors account for two-thirds of economic activity in the EU, and it is in this sector that the gap between EU and US productivity growth is the greatest. Practically none of the spending on innovation by service sector companies is captured by figures for R&D or the number of patents filed. For example, airlines such as Easyjet or Ryanair have revolutionised air travel in Europe, forcing down costs and boosting productivity by introducing new business models. But neither firm is 'innovative' in the traditional sense of the word.

There is no doubt that innovation indicators are needed to assess progress and performance. But a meaningful input measure of innovation would need to be much broader than spending on R&D or patents. It would need to comprise investment in knowledge as a whole – not just scientific research, but the spending needed to commercialise new ideas and profit from them. An index of innovation such as the one under development by the UK's National Endowment for Science, Technology and the Arts (NESTA) will be invaluable for those countries that can collect the necessary data. Unfortunately, that is likely to be the case in only a minority of the EU's member-states.

The EU should consider adopting an output measure – the rate of productivity growth – as its 2020 innovation target. The rate of productivity growth gives a good indication of innovation by capturing the impact of spending on R&D but also of investment in crucial factors such as skills and organisational change. It provides a good measure of the sustainability of economic growth and provides a better basis for addressing one of the biggest problems facing the EU economy: weak public sector productivity.

Rates of productivity growth vary, of course, with levels of economic development: poor countries will have stronger rates of productivity growth than mature ones. Labour regulations also influence labour productivity. Rigid employment laws mean that companies operating in France and Belgium have a strong incentive to employ capital over labour, even where this is inefficient. As a result, targets for productivity growth would have to vary across countries. Poor member-states would be expected to deliver faster productivity growth than wealthier ones. Countries where productivity is high and levels of employment low – France and Belgium – would have to meet tough targets for employment rates, but less onerous ones for productivity growth. And countries with high employment rates and relatively low productivity, such as the Nordic member-states and the UK, would be given tough productivity targets. Those with low levels of productivity and

poor employment rates, such as Italy and Spain, would face ambitious targets for both.

Research and development = D	
Heroes	Finland, The Netherlands, Sweden
Villains	Greece, Italy, Spain

New approaches to measuring innovation

The Lisbon agenda put innovation at the heart of the EU's economic future. In particular, its ambitious target of increasing EU R&D spending to 3 per cent of GDP galvanised policy-makers across the continent and spurred a plethora of valuable initiatives. In the wake of the global financial crisis, the agenda looks even more far-sighted: to thrive in the uncertain economy of the coming decade, amid increasing competitive pressures from the emerging economies of Asia and beyond, innovation will be vital.

I hope I will be forgiven, then, for a piece of iconoclasm. For although the Lisbon agenda is more current than ever, its central target is not. It is time to scrap the R&D target as our barometer for our innovative performance.

There are two reasons why the time is right to do this. Firstly, it is increasingly clear that R&D is a poor measure for how much Europe invests in innovation. Secondly, and crucially, we are now able to do better, thanks in part to work done by NESTA and its international research partners.

Let us first consider the case for a new measure. R&D spending is a useful indicator of innovative activity as far as it goes. In some sectors, such as pharmaceuticals, it is a reasonable proxy for innovation. But more often, it reflects a mid-20th century, manufacturing-based paradigm that increasingly fails to represent how the economy works. The largest EU economies are now dominated by services (they make up 78 per cent of the UK's economic output, for example), and innovating to increase their productivity is an overwhelmingly important factor in our economic performance.

The work of successive expert groups has confirmed this, and surveys like the Community Innovation Survey increasingly seek to reflect it. Knowledge-intensive businesses depend on a whole range of intangible investments to innovate. These include not only R&D, but also design, organisational innovation, the development of new skills, and the development of new creative content. Particularly for service businesses, these other, 'hidden' forms of innovation are vitally important. We have seen that in UK firms, R&D represents only 11 per cent of overall intangible investment.

This is where NESTA's Innovation Index comes in. Working with leading innovation researchers and economists, and an international advisory and expert group, we have assembled a pilot version of a wider measure of innovation. The Innovation Index considers the whole range of intangible investments in innovation, from design to copyright, and then measures their effects on the UK's productivity. The findings offer strong support for the overall goals of the Lisbon agenda: two-thirds of the UK's private sector productivity growth over the past decade can be attributed to innovation.

The Index also offers a new basis for comparison: by including more than simply R&D in its definition of the inputs to innovation, it includes many of the investments made by service industries and a wider range of inputs by manufacturers.

Our industries increasingly depend on the ability to combine different types of innovation investment – for example, R&D, customer research and product design to launch a new consumer electronics product, or service design, organisational development and training to launch a new retail banking service. So the time is ripe for a new measure of innovation. We would argue for the measurement not of just R&D as a percentage of GDP, but of all intangible investments. More statistical work needs to be done for this to become a mainstream measure. We are refining our approach over the next six months, and other organisations, including the OECD and the US Department of Commerce, are considering their own versions.

But the direction of travel is clear. Only a wider measure of innovation can provide the insight we need to keep innovation at the heart of EU economic policy. After all, as a wise man once said: what gets measured gets done.

Jonathan Kestenbaum

Chief Executive, National Endowment of Science, Technology and the Arts (NESTA). To find out more about The Innovation Index go to www.nesta.org.uk.

B. Liberalisation

B1. Telecoms and utilities

★ Increase competition in telecoms markets

★ Liberalise gas and electricity markets and improve supply security

Increased competition between telecoms and utilities providers tends to push down prices and improve services for households and enterprises. The liberalisation of EU telecoms markets has been one of the great success stories of the past decade, with the prices of telecoms services falling dramatically in real terms across the EU as a result of increased competition. However, the EU is still a long way from having a single market for such services. Incumbents still dominate telecoms in many member-states. The big differences in the way telecoms sectors are regulated across the EU create substantial barriers to competition. This is especially so in the area of markets for broadband internet access.

Former state monopolies continue to handle around 70 per cent of all local calls (including connections to the internet through a phone line). In many of the new member-states (Hungary, Latvia, Lithuania, Slovakia and Slovenia) there is still little competition. France Telecom and Spain's Telefonica control around 80 per cent of local calls, while in the case of former monopolies in Germany and the UK the proportion is less than 60 per cent. There is more competition among providers of long distance national calls, and more still in international calls, but the ranking of laggards and leaders is roughly the same. In mobile telephony, on the other hand, the incumbents' share of the market is under 40 per cent on average, and as little as a quarter in Denmark and the UK.

Market dominance tends to result in higher prices: in 2008 Slovaks paid almost three times as much for local calls as Swedish customers.

Slovaks also paid well over the odds for national calls, at €1.61 for a ten minute call in 2008, compared to just 28 cents in Sweden. The prices of international calls – where competition is much stronger than in local or national telephone – also continue to vary considerably. But the correlation between liberalisation and low prices does not hold in all cases. For example, despite their countries' liberalised telecoms markets, Finns and Britons pay more than the EU average for a ten minute international call – at €2.29 in the UK and a whopping €4.78 in Finland in 2008. By contrast, German consumers paid just 29 cents for a similar call.

In November 2007, the Commission put forward a package of reforms aimed at creating a genuine single market for telecoms services. But the two most important elements of the package – the proposal to split the management of telecoms networks from the provision of call and internet services ('functional unbundling'), and the establishment of a European telecoms regulator with powers over national telecoms regulators – failed to win the support of national governments. Instead of a pan-European regulator they agreed to set up a new advisory body called the Body of European Regulators in Telecommunications (BERT), whose powers will be limited to making recommendations. Similarly, there will be no forced unbundling. However, it will remain illegal for national regulators to give incumbents 'regulatory holidays' in order to encourage them to invest in expensive new technology, such as fibre-optic networks. Operators that want to use new fibre-optic lines will have to pay a premium to the incumbents in order to compensate them for the risk they have taken on in building the new networks. This should provide the owners of the networks with sufficient incentives to make the necessary investments in new technology, while ensuring that they face competition.

The Commission should now focus on using competition policy to prevent market abuse. In December 2009, the European Court of Justice (ECJ) ruled that a German law allowing Deutsche Telekom to deny possible competitors access to its high-speed broadband network was illegal. Germany had ignored repeated warnings by the Commission that the 2006 law ran counter to EU competition law. This legal precedent, combined with November's decision to rule out 'regulatory holidays', leaves the way open for legal action against a range of countries that accord preferential treatment to their dominant telecoms supplier.

Energy

The liberalisation of European energy markets started later and has not gone as far as in telecoms. Since July 2004 industrial users have had the right to choose between alternative suppliers of gas and electricity. However, former monopolies (many often still with state involvement) continue to play a dominant role in many member-states. This is inevitable in tiny Malta or isolated Finland. But in others, such as France, a reluctance to open markets to competition, or to allow foreign energy firms to acquire French ones, appears to be the main reason.

The problem is that in many member-states, the company that produces or imports energy also controls the infrastructure for distributing it (national electricity grids or gas pipelines). Where this is the case, newcomers struggle to break into the market. France is an extreme example, for both gas and electricity. Gaz de France (GDF) and Total account for 95 per cent of French gas imports and control the country's pipeline network, with the result that customers enjoy very little choice. Meanwhile, Electricité de France (EDF) accounts for 87 per cent of power production, owns the transmission network and directly supplies 95 per cent of the customers. The UK, by contrast, liberalised its energy markets in the 1980s, and now has a multitude of players, ranging from the former state-owned monopolies to foreign firms (including GDF and EDF).

The situation is little better when it comes to the retail sector. Since July 2007, all EU consumers have theoretically had the freedom to switch suppliers, but in practice this has meant little. Only 7 per cent of households switched gas supplier in 2007, and 8 per cent their electricity supplier – despite the fact that a high proportion of those who did reported lower prices as a result. These relatively low levels of switching reflect the fact that it remains difficult to move between suppliers. But it also reflects inertia: the experience of countries which liberalised retail markets long before the 2007 deadline – the Netherlands, Sweden and the UK – shows that it takes quite a while for customers to grow accustomed to switching suppliers.

The Commission has been pursuing a twin-track strategy to open up energy markets. The main approach has been legislation. The legislative battle to force large integrated energy groups to 'unbundle' their distribution networks was decided in 2009: the EU's 'third package' of energy laws allowed gas and power companies to keep their networks provided they run them as separate entities. A minority of governments – led by France and Germany – had fiercely opposed unbundling, arguing that only big vertically integrated groups had the necessary financial resources to invest in new capacity. Further progress on the creation of an integrated market will now depend on how the new rules are implemented by EU governments, and whether companies finally build the interconnectors needed for a pan-European power and gas market. But it will also depend on whether the new Commission decides to pursue liberalisation through the use of competition rules.

Indeed, action by the EU's competition authorities will probably do more to shape the future of the EU energy market than the political compromise reached in the 'third package'. Competition policy has become the principal driver of energy market liberalisation. In 2008, the largest German energy group, E.ON, announced that it would sell its power grid, while RWE, another big German power firm, decided to spin-off its gas distribution infrastructure. Both firms made this decision after the Commission had found that they had used their control of networks to prevent rivals from entering the regional markets they dominate. The firms agreed to unbundle in exchange for not having to pay fines, which in the case of E.ON

could have totalled €7 billion. In July 2009, E.ON and Gaz de France were each fined €553 million for collusion (in a deal which ran until 2005, they had agreed that they would not compete on each other's national territory). This was the first time the Commission had fined energy companies for breaching anti-trust rules.

Telecoms and utilities = C	
Heroes	Sweden, The Netherlands, UK
Villains	France, Germany, Poland

B2. Transport

★ Increase competition in transport services

★ Encourage investment in trans-European networks

★ Make the transport sector more environmentally sustainable

The transport sector accounts for 7 per cent of EU GDP and 5 per cent of total employment. But its importance to the European economy goes well beyond its direct contribution to growth and employment. Because of the central role that it plays in labour mobility and the distribution of goods and services, a modern, integrated and reliable transport system has an important influence on productivity. However, transport also generates externalities – costs such as pollution that are imposed on everyone, whether they travel or not. One reason why EU countries have struggled to contain the growth in their greenhouse gas emissions is that economic expansion generates increased demand for transport services.

So EU transport policy has focused on meeting two objectives that have proved hard to reconcile. The first has been to improve the efficiency with which people and freight move around the EU. This has involved liberalising the provision of services within each transport mode (air, road, rail and water), and improving infrastructure by developing transport links between countries (known as 'trans-European networks' or TENs). The EU's second aim has been to improve the environmental sustainability of the transport sector. EU countries have made greater progress on the first objective than the second. There is more competition than there was in 2000 (even if there are still large variations across countries). But the EU has struggled to make the sector more environmentally friendly. Greenhouse gas emissions have risen faster in the transport sector than in any other sector of the European economy.

Improving the efficiency of the transport sector

There is unquestionably more competition within the transport sector than there was a decade ago. The poster child of liberalisation has, of course, been the air transport sector, where increased competition has brought about dramatic falls in prices and huge rises in passenger volumes and choice. Progress has been recorded in other sectors too. Since 2001, the EU has adopted three legislative 'packages' aimed at opening railways to greater competition. Rail freight was liberalised in 2007, domestic and international rail passenger services in 2010. However, the actual degree of competition which currently prevails in rail transport remains much lower than it is in the air transport sector. Several years after EU legislation was adopted and was supposed to have entered into force, a variety of national institutional impediments continue to prevent new entrants from breaking in to formerly monopolistic markets.

In member-states such as Germany, Sweden and the UK, competition in freight and passenger rail services is already well advanced. But many countries have not yet fully implemented key provisions in the directives, and the Commission has had to send infringement letters to most of them. The most common faults have been the failure to separate adequately the management of the infrastructure from the train operators; the setting of discriminatory access charges; and the failure to set up independent regulatory authorities with the necessary powers to enforce competition. The upshot is that in many countries the institutional arrangements continue to favour the incumbents. Some of the worst culprits have been the Czech Republic, Greece, Romania and Slovenia.

Improving transport connections between countries has also been difficult. Although many EU countries boast some of the finest transport infrastructure in the world, cross-border links leave much room for improvement. The Commission has long viewed the development of 'trans-European networks' (TENs) as a central element of the EU's single market programme. However, progress on

the 30 'priority axes' that have been identified has been slow. Though it has been hampered by procedural and technical problems, the main obstacle has been financial. The problem is three-fold: the cost of completing the EU's 30 priority axes is huge (an estimated €250 billion); EU funding for TENs is miniscule (just €5.1 billion between 2007 and 2013); and it has proved difficult to mobilise national sources of funding for cross-border projects which are complex and financially risky.

Making transport more environmentally sustainable

Perhaps the greatest disappointment has been the failure of EU countries to set the transport sector on a more environmentally sustainable footing. Transport is the only sector of the European economy in which greenhouse gas emissions have increased over the past decade. Transport now accounts for almost a quarter of all greenhouse gas emissions in the EU-27. Although the sector has become more energy efficient, the improvement has not been enough to offset the rise in transport volumes (particularly of freight). Changes in transport patterns have not helped either. Transport volumes have grown fastest in the most polluting sorts of transport (air and road), while the share accounted for by the least polluting method (rail) has declined since 2000. In the absence of changes to policy, these trends will persist – and prevent the EU from meeting its emissions targets.

On current trends, emissions from transport alone will exceed the EU's target for all sectors in 2050. So the EU will have to start making big absolute cuts in transport sector emissions. Much hope is being pinned on technological innovation to improve energy efficiency and, in the longer term, to reduce reliance on fossil fuels. But innovation on its own will not reverse the trend of rising emissions over the coming decade, not least because the growth of road traffic is likely to outstrip gains in energy efficiency. Other policies will therefore be needed if emissions from the transport sector are to be contained. A key objective should be to limit, and if at all possible reverse, the adverse trend in the transport mix: measures must be introduced to slow the growth in the most polluting forms of transport and to boost the least polluting ones.

This will not be an easy task. But the EU (and individual member-states) can help by doing more to boost competition between different kinds of transport, rather than just within them. Currently, the cleanest forms of transport are not competing on an equal footing with the dirtier ones, because the latter are not yet internalising the full costs of their activities. For example, road transport imposes costs on non-users – in the form of congestion, pollution and noise – which amount to an estimated 2.6 per cent of EU GDP. An important part of EU transport policy is to make sure that users pay a greater share of these costs. The 'Eurovignette' directive, which has entered into force in 2010, applies the 'polluter pays' principle by imposing road charges on heavy goods vehicles. And the airline sector is set to be brought within the scope of the EU's emissions trading scheme by 2012.

During the course of 2010, the Commission will publish a White Paper on the future of EU transport policy. Much of its thinking has already been foreshadowed in a 2009 communication.[1] The Commission wants to encourage the development of green technologies, notably via incentives in the EU's R&D budget. It also – rightly – wants to ensure that competition is properly enforced (particularly in the rail sector). But it will need to give more thought to upgrading creaking rail infrastructure, particularly in Central and Eastern Europe. As a recent report points out, the EU will not meet its environmental targets unless various policy strands are pursued together. Whatever is done to liberalise the rail sector, new entrants will remain elusive if the networks are run down, infrastructure charges are too high, and other forms of transport are effectively subsidised by the taxpayer.[2]

[1] *European Commission, 'A sustainable future for transport', June 2009.*

[2] *Chris Nash and Bryan Matthews, 'European transport policy: Progress and prospects', September 2009.*

Transport = C	
Heroes	Germany, Sweden
Villains	Greece, Slovenia

B3. Financial and general services

★ Create a single market in services

★ Complete the financial services action plan

The completion of the EU's single market in services was a central objective of the Lisbon agenda. It is not hard to see why. Services account for 70 per cent of EU GDP, and the widening of the transatlantic productivity gap since the mid-1990s has been largely due to accelerating productivity growth in the US service sector. Since services markets are less integrated in the EU than in the US, removing barriers to trade between member-states was thought to be one way of improving Europe's productivity performance. Of all the Lisbon objectives, however, this has proved to be one of the most fraught. The Commission's efforts to open the market for general services ran into bitter opposition in 2005. And the financial crisis has raised awkward questions about the EU's single market in banking.

General services

Firms have long struggled to provide services seamlessly across the EU. Rules that discriminate overtly against foreign providers have admittedly become rarer as they have been challenged and struck down by the courts. Even so, the existence of 27 different national regulatory regimes has inevitably created obstacles to firms wanting to provide services across borders. These national obstacles have stifled competition, acted as a drag on productivity – and spawned special interest groups opposed to change. In an effort to lower these barriers, in 2005 the Commission tried to apply a mutual recognition regime. This would have allowed firms providing services on a temporary basis in another EU country to follow the regulations of their home country. However, the proposal (the so-called Bolkestein directive) was blocked by countries fearing it would spark a 'race to the bottom' in social rights.

A less ambitious directive therefore had to be adopted. Instead of trying to prise open national markets by applying the principle of mutual recognition, the directive reasserts existing treaty commitments to the free provision of services, and circumscribes the exceptional circumstances under which national restrictions can be justified. The services directive entered into force at the start of 2010. However, a number of EU countries have yet to implement the directive into their domestic law; and many countries will continue to defend aspects of their regulatory regimes which interfere with the free provision of services on their territory. Despite the directive's entry into force, therefore, it will be some time before national barriers to the cross-border provision of services are lowered. Their removal will be a laborious process, because each regulatory barrier will have to be challenged individually in each sector and country. In every case, moreover, the onus will be on the service provider to prove that national rules flout EU law by being discriminatory, disproportionate or unnecessary.

Financial services

In contrast to the market for general services, that for financial services had been proceeding rather well until the financial crisis broke. Regional market integration in the financial sector had been spurred by the introduction of the euro; by improvements in the underlying technological infrastructure; and by an ambitious legislative programme, the Financial Services Action Plan (FSAP), which aimed to lower the regulatory barriers to financial firms selling their products and services across the EU. But some national barriers still remained. Securities markets, for example, continued to be impeded by the fragmentation of national clearing and settlement systems, which arrange the payment and transfer of securities between buyers and sellers. And the cross-border integration of the retail banking market was still a work in progress.

The financial crisis has not reversed the past decade's advances in integration. But it has exposed fault-lines which will have to be

tackled if the EU's single market in banking is to be preserved. Since the late 1980s, the EU has sought to create a single market by allowing firms to open branches, or provide services on a cross-border basis, in another EU member-state, on the basis of a single authorisation from their home country (an arrangement referred to in EU jargon as 'passporting'). Several problems, however, have come to light – most of them exposed by Icelandic banks. First, the 'passport' has encouraged the emergence of banks which threaten the fiscal solvency of their home country. Second, some home countries may be financially unable to honour commitments to depositors in other countries if one of their banks fails. Third, cross-border co-operation between supervisors has not been up to scratch and has proved fragile in a crisis.

It is hard to think of an arrangement more likely to undermine EU citizens' faith in the single market than one which exposes them to the risk of losing their savings to a reckless bank established in another member-state. Equally, it is difficult to see how the EU can continue encouraging financial integration in the region if the member-states do not trust or cannot work effectively with each other. As the UK's Turner Review into the financial crisis points out, the EU therefore faces a choice: either it accepts that host countries will have to wield more power over foreign banks operating on their territory, which would open the door to the very restrictions and discriminatory treatment that the single market was designed to eliminate; or it overhauls prudential supervisory rules and significantly increases the level of institutional co-operation at EU level in an effort to rescue the single market in banking.[3]

[3] *Financial Services Authority, 'The Turner Review: A regulatory response to the financial crisis', March 2009.*

Unsurprisingly, the EU has chosen the second of these options. In 2009, the European Commission submitted a proposed directive that largely followed the recommendations of a committee headed by Jacques de Larosière.[4] The directive, which commands the broad support of the member-

[4] *Jacques de Larosière, 'Report of the high-level group of financial supervision in the EU', February 2009.*

states, will beef up supervisory arrangements by turning the so-called 'Level 3 committees' (which co-ordinate regulatory approaches across the EU) into European Supervisory Authorities (ESAs) for banking, securities and insurance. The ESAs will have greater resources and responsibilities than the Level 3 committees. But they will not supplant national authorities, which will remain responsible for day-to-day supervision. The task of the ESAs will be to develop a common rule book; mediate between supervisory authorities when disputes between them arise; and co-ordinate risk management.

The future of the financial sector

As the EU overhauls the way the financial sector is regulated and supervised, it needs to have a clear idea about what it wants to achieve. Following the financial crisis, there is no question that a comprehensive overhaul of prudential supervisory rules is necessary if the financial system is to be placed on a more stable footing. But there is no free lunch. If the regulatory pendulum swings too far, the price paid for a more stable financial system may be permanently lower economic growth. The challenge for the EU is not to abolish risk or legislate future crises out of existence. It is to design a system that strikes a sensible balance between financial stability and economic growth, and that makes sure that risks are borne by those who take them (rather than being offloaded on to the taxpayer). In addition, as the EU overhauls financial regulation, it is important that it does not overlook the need to improve the efficiency of the financial system – notably with regard to funding start-ups (see Section C1).

Financial and general services = C	
Heroes	None
Villains	Too many to mention

C. Enterprise

C1. Business start-up environment

★ Encourage entrepreneurship

★ Create the right environment for start-ups

Young firms are the bedrock of most dynamic economies. Not only are they usually the source of most of the jobs that are created. They are also the strongest drivers of productivity growth. It is not hard to understand why. Because they are less hamstrung by inherited working practices and business assumptions, they are usually more nimble and are often better at exploiting new, productivity-enhancing technologies. Their very existence, moreover, provides a much-needed competitive spur to established firms, forcing them to innovate and become more efficient in turn. It is no surprise, then, that the Lisbon agenda places such high importance on the need to improve the environment for entrepeneurship. There have always been plenty of good small and medium-sized enterprises (SMEs) in the EU. But in many cases this has been in spite of the business environment, not thanks to it.

Numerous factors make it harder to establish a firm in the EU than in the US – and for that firm to grow into a global giant. Burdensome regulations inhibit the emergence of new firms by increasing start-up costs. Funding for start-ups is less freely available. Tacit or explicit government support for 'national champions' in some countries creates a bias in favour of incumbents and raises barriers to entry. Restrictive labour laws interfere with the process of 'creative destruction' by hampering the growth of new firms and slowing the exit of older, less efficient ones. And all sorts of barriers – cultural, linguistic, fiscal and regulatory – still make the EU a less integrated market than the US. Improving the environment for start-ups is consequently a wide-ranging task which involves everything from reforming labour laws and bankruptcy regimes, to improving the availability of seed capital.

Encouraging entrepeneurship

It would be churlish to deny that reforms have led to a modest improvement of certain EU countries' business environments. Encouragingly, many of the countries where obstacles to start-ups were the greatest ten years ago – notably Greece, the Czech Republic, France, Hungary and Italy – have taken the largest steps. France, once notorious for stifling entrepeneurial spirit with bureaucracy, is now one of the easiest countries in the EU in which to set up a business. However, even though progress has been made since the launch of the Lisbon agenda, it has not resulted in a transformation of Europe's business environment. Across the EU as a whole, bureaucratic requirements for start-ups remain far too onerous. And many problems – high barriers to entry, segmented national markets, unhelpful regulations, and so on – remain as pressing now as they were back in 2000.

Consider where EU countries stand in relation to their counterparts elsewhere in the world. Every year, the World Bank monitors many of the policies that matter most for SMEs through its 'Doing Business' survey. The survey measures the ease of setting up or closing a business, employing staff, registering property, obtaining funding and so on. According to its latest survey, only four EU member-states – Denmark, Ireland, Sweden and the UK – rank in the world's top 20 locations for ease of doing business. In a large number of EU countries, the bureaucratic obstacles to opening a new business remain depressingly widespread. Only two EU countries – Ireland and the UK – rank within the top 20 places. According to the World Bank, it takes fewer days to open a business in Argentina, Syria or Russia than it does in Spain or Greece.

European countries do, of course, have many advantages. Their business environments are generally more stable and predictable than in many other parts of the world, and contracts are better enforced. But they also have numerous weaknesses – and these are depressingly common across the EU. Labour laws are more

restrictive than elsewhere, imposing greater costs on European SMEs. The tax burden remains much higher in the EU than it does in almost any other region in the world. And obtaining construction permits or registering property still takes far too long in many EU countries. These features are, of course, longstanding. They reflect social choices that European voters show no desire to abandon.

Even so, there are still many prosaic, unglamorous things that EU governments can do to improve the environment for entrepeneurs. One is to improve the legal framework for businesses that fail. Evidence suggests that the medium-term returns from such reforms are significant. Why? Because regimes where bankrupts are not ostracised are usually associated with higher rates of business creation. Unfortunately, bankruptcy retains a stigma in much of Europe that it does not in the US. True, countries such as Denmark, Finland and Ireland already have efficient bankruptcy regimes, even by global standards, with high rates of recovery for creditors. But others, such as the Czech Republic, France, Greece and Hungary do not. Well-designed bankruptcy regimes should rehabilitate viable firms, liquidate those which are not as quickly as possible, and maximise recovery rates for creditors.

Funding start-ups

Another traditional Achilles heel in much of the EU has been the relative dearth of risk capital to fund start-ups and their subsequent expansion. This is certainly not true across all EU countries. Denmark, Sweden and the UK already have thriving venture capital industries, and France's has grown strongly since reforms in 2003. But the sector in many other countries is almost non-existent. Moreover, even where the industry is well-developed, venture capitalists tend to prefer investing in firms that are already established. Add to this the fact that banks are reluctant to lend to entrepeneurs with good ideas but little collateral, and it is not hard to see why start-ups have a harder time in Europe than in the US. The issue has received less attention than it deserves. Of the Lisbon agenda's 24 'integrated guidelines', none focuses specifically on the financing of innovative firms.

It would be wrong to imply that the EU has ignored the subject altogether. The Commission has advocated making greater use of the European Investment Bank (EIB) and the European Investment Fund (EIF) to provide financial support to SMEs. And in 2007 it issued a communication designed to encourage the emergence of a pan-EU venture capital industry by lowering the barriers that impede cross-border business in the sector. The Commission's thinking is that if cross-border activity can be boosted, funding problems for start-ups in countries with under-developed venture capital sectors may be alleviated.[5] Even so, it remains true that the question of funding innovative start-ups has not been a prominent feature of EU policy since the Lisbon agenda's launch. A successor to the Lisbon agenda must do more to improve start-up companies' access to funding.

[5] *European Commission, 'Removing obstacles to cross-border investments by venture capital funds', December 2007.*

Business start-up environment = B-	
Heroes	Ireland, UK
Villains	Greece, Spain

EU R&D policy: Time for some real innovation

For over a quarter of a century, European R&D policy has been dominated by the idea that multi-partner collaboration between companies and universities in different countries is the key to building a successful innovation-driven economy. It is a philosophy rooted in the desire of Viscount Etienne Davignon, the former industry commissioner, to encourage cross-border co-operation and mergers in the early 1980s. The idea was forged at a time when policy-makers everywhere were awed by Japan's Ministry of International Trade and Industry (MITI) and the collaborative R&D programmes on which its success seemed to rest.

One product of this era is the EU's Framework Programmes for Research and Technological Development. The seventh such programme (FP7), which runs from 2007 to 2013, makes roughly €7.5 billion available a year – two-thirds of it for collaborative R&D grants. However, despite the increasing importance ascribed to R&D by politicians and policy-makers, the percentage of GDP spent on R&D across the EU remains below 2 per cent, barely higher than ten years ago, and well short of the 2010 target of 3 per cent set at the Lisbon summit in March 2000. SMEs only receive around 12 per cent of total EU grant monies, smaller even than the pathetically low target of 15 per cent set by the Commission.

The disproportionate contribution of SMEs to innovation is widely acknowledged by policy-makers. According to the US Small Business Administration, small businesses generate 13-14 times as many patents per employee as larger ones, and are responsible for 60-80 per cent of new jobs. So the inability of FP7 to enrol European SMEs in its flagship R&D programmes is a major indictment of EU innovation policy.

University intellectual property (IP) plays a smaller role in high growth start-ups than policy-makers often assume. In Cambridge, one of Europe's leading clusters for science and technology based start-ups, the most successful firms in their early stages rely strongly on customers – through R&D contracts and the commissioning of prototypes – to stimulate innovative solutions and to fund development. Addressing customer needs through the discipline of a contractual relationship plays a critical role in the innovation process. Conventional venture capital has tended to play at most a secondary role in the funding of these firms. And importantly, the most successful firms have tended to avoid becoming involved in multi-partner, collaborative R&D projects, especially those funded by the EU. These EU R&D programmes are generally seen as a distraction: too far removed from the market to be of interest to SMEs, with conflicting objectives and priorities among the partners, and large management overheads for very little funding.

The contrast with US policy could not be greater. For nearly 30 years the lead US policy to encourage innovative SMEs has been the Small Business Innovation Research (SBIR) Programme – a procurement-based, competitive programme that awards R&D contracts to fund the development of new technologies in response to federal agency needs as customers. Worth $2.3 billion a year, the SBIR programme makes some 4,000 awards each year in two phases. Crucially, firms retain the IP, and collaboration with other firms is not required. In contrast to the partial funding approach of EU R&D grants – a major disadvantage for cash strapped early stage firms – SBIR awards cover 100 per cent of project costs plus a small profit element. Most of this funding goes to firms employing fewer than 25 people.

The SBIR is effectively 'the largest seed capital fund in the world', and has played a critical role in the funding of early stage US science and technology companies. Unlike the EU's collaborative R&D programmes, it has an enthusiastic following amongst entrepreneurs, venture capitalists and policy-makers, and it is admired throughout the world. In recent years, both the UK and the Netherlands have developed successful small-scale SBIR programmes of their own. However, EU procurement rules discourage this kind of programme at national level, and the problem is compounded by current pressures on the public finances.

The EU could create an equivalent of SBIR if it allocated €800 million a year from the eighth framework programme (FP8) to fund 40 per cent of the cost of programmes run by national public sector agencies – in areas like healthcare, the environment, energy and transport. This would give firms access to important customers early in the product development cycle. As a first step, this kind of programme could be piloted during the remainder of FP7.

As the EU faces growing competition from technologically-sophisticated but low wage countries like China and India, an SBIR initiative could provide just the kind of innovative boost that Europe's small science and technology based firms need. It is time for some real innovation in EU R&D policy.

David Connell

Director, TTP Capital Partners Ltd and Senior Research Associate, Centre for Business Research, University of Cambridge.

C2. Regulatory burden

★ Member-states to implement 99 per cent of all single market legislation

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

The global financial crisis has provided a stark reminder that market economies rarely function properly without an appropriate regulatory framework. Regulations and public bodies play a vital role by correcting market failures, protecting consumers, preventing market abuse and enforcing competition. But regulations can have all sorts of unintended consequences. By reducing choice, for example, they can damage the consumer interests they are designed to protect. In addition, poorly-designed regulations can impose major costs on the broader economy. They can stifle innovation and productivity by deterring the creation and expansion of new firms. And they can hinder the creation of new jobs. In other words, poorly-designed and over-burdensome regulations can ultimately damage the two determinants of a country's prosperity over the long run: the levels of productivity and employment.

Implementation and enforcement of EU laws

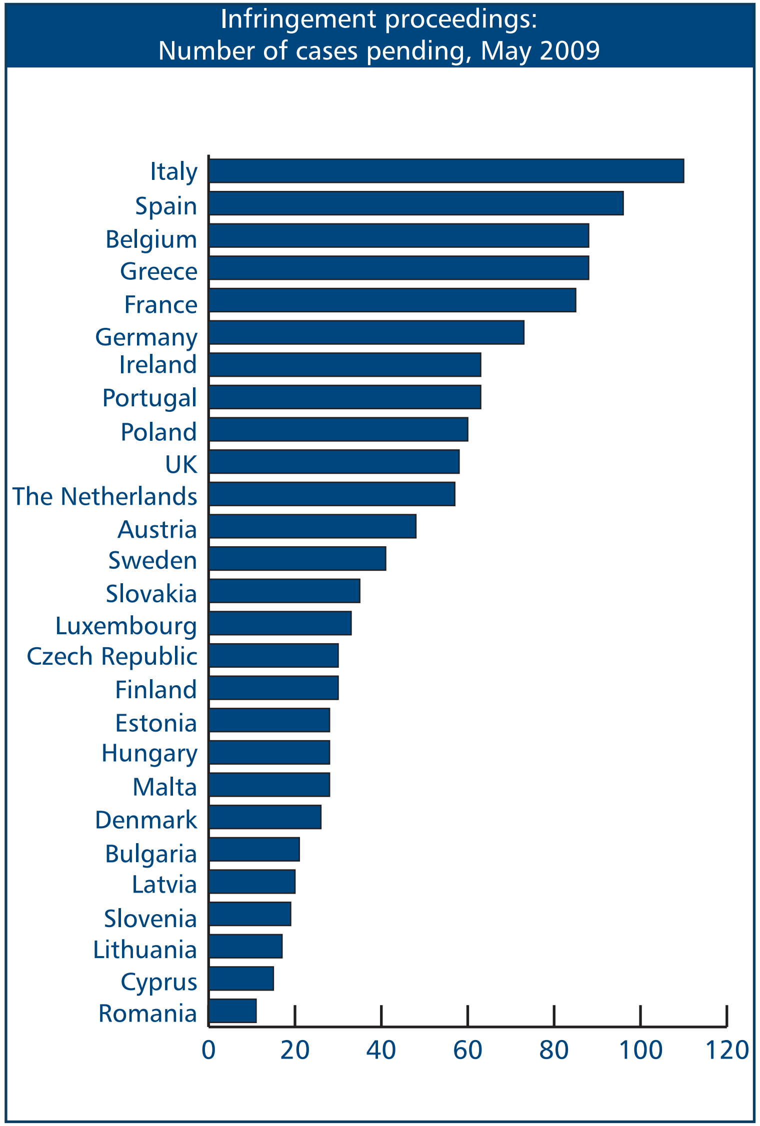
Some degree of regulatory convergence is necessary at EU level to ensure that different national standards do not impede cross-border trade. However, the EU's single market has long been blighted by the fact that many countries are slow to transpose EU directives into national law. And once they have done so, they are sometimes reluctant to enforce them or comply with their spirit. The goods news is that EU member-states have become better at implementing single market legislation – so much so that the Commission felt able in 2007 to raise the bar by setting them a more ambitious target of implementing 99 per cent of all single market legislation by 2009 (up from 98.5 per cent previously). The Commission's latest scoreboard shows that 18 out of 27 countries met this target in early 2009, but that the Czech Republic, Greece, Italy, Poland and Portugal were still well off it.[6]

[6] *European Commission, 'Internal market scoreboard', July 2009.*

Implementing legislation is one thing. Adhering to the rules is another. Depressingly, many of the countries that are slow to transpose EU legislation into national law are the same ones that do not comply with its letter or spirit once they have done so. A fair proxy for national adherence to EU law is the number of infringement proceedings which the Commission opens against member-states (see bar chart on page 55). As of mid-2009, a mere four countries – Belgium, France, Italy and Spain – accounted for 38 per cent of all infringement proceedings within the EU. Uneven adherence to the rules distorts the single market; too often, firms are not competing on a level playing field.

Infringement proceedings can be costly and usually take a long time to resolve. To mitigate this problem, the EU has dreamt up an imaginative instrument in the form of SOLVIT – a pan-European network of centres that handle complaints about countries' failure to comply with EU rules. The SOLVIT network has been a success. It has become a useful means for identifying problems. And it has provided a channel through which countries can get together to resolve them, without the Commission having to initiate infringement proceedings. Almost 80 per cent of cases that are brought before a SOLVIT centre are resolved. However, not all SOLVIT centres are equally effective. Germany's centre has a good reputation. But others are not adequately staffed to deal with their caseloads. And a third of SOLVIT centres complain that national authorities are not always willing to solve problems informally.[7]

[7] *European Commission, 'Development and performance of the SOLVIT network', 2009.*



Source: European Commission, 'Internal market scoreboard', July 2009.

Improving the regulatory environment by cutting red tape

Aside from ensuring that single market rules are uniformly enforced, the EU's other priority has been to reduce the amount of red tape associated with such rules. The first prong of its 'better regulation' agenda has been to avoid the adoption of unnecessary rules by improving the quality of the Commission's impact assessments. In theory, all proposals for EU legislation must now pass a series of tests before they are submitted. The Commission must prove that alternatives to legislation have been considered; that the social, economic and environmental impact has been properly assessed; and that the legislation is proportionate to the objective it is intended to meet. Impact assessments have improved since the Commission established a board to exercise quality control over them. But they need to improve further in order to allay suspicions that they are just fig-leaves to justify predetermined policy choices.

The second prong of the EU's better regulation agenda has been a programme of 'simplification'. This has entailed withdrawing proposals that can no longer be justified by more rigorous impact assessments; repealing redundant laws; and making laws that are still in force easier to understand by consolidating (or 'codifying') the initial texts and their subsequent amendments into one document. This programme has been laborious, but it has delivered results. Since 2005, the Commission has withdrawn 108 proposals that were in the legislative pipeline but which could no longer be justified. And by 2008, the EU had finished codifying 229 of the 436 laws that it had targeted. The Commission estimates that this has already cut the volume of the acquis (the body of EU law) by 10 per cent.[8]

[8] *European Commission, 'Third strategic review of better regulation in the EU', January 28th 2009.*

The final plank of the better regulation agenda has been to reduce the administrative burden that EU laws impose on businesses. In 2007, the Commission identified 42 pieces of legislation in 13 priority areas that, combined, imposed an estimated €115-130 billion in administrative costs (such as form filling) on businesses across the

EU. On this basis, it has established a programme that aims to reduce administrative costs on business by 25 per cent by 2012. The Commission has proposed several measures to meet this objective, including a revision to a VAT directive that aims to remove regulatory obstacles to electronic invoicing. The very smallest firms should be the greatest beneficiaries of the drive to reduce the administrative burden. For example the Commission is proposing to exempt them from statistical reporting requirements on intra-EU trade, as well as from EU accounting rules.

Better regulation: The challenge ahead

There has been a profound culture change in the Commission since the Lisbon agenda was launched. It has become far more sensitive to the costs that EU legislation imposes on businesses. And it has displayed a welcome appetite for reducing the amount of red tape to which firms are subject. The challenge now is to make sure that this change of culture starts producing tangible savings for business. This task, however, cannot be the responsibility of the Commission alone. Since most EU laws cannot take effect until implemented into national law, businesses will not reap the benefits of better regulation unless national governments take the concept seriously. The national context is all the more important given the tendency of certain countries to 'gold-plate' EU laws by adding national requirements over and above those required by the directives they are implementing.

The EU must continue to give high priority to its better regulation agenda. And it must not allow itself to be side-tracked by current arguments surrounding the regulatory overhaul in the financial sector. It is tempting to think that because the crisis exposed inadequacies in the way the financial sector was regulated, the need is for more regulation – in finance and elsewhere. This line of reasoning, however, is too simplistic. An overhaul of the way financial markets are regulated and supervised is unquestionably needed. But the purpose should not be to expand the volume of rules per se. It should be to improve their design. The EU's 'better regulation' agenda has not, therefore, been invalidated by the crisis. Regulations can sometimes be justified. Unnecessary costs never can be.

Regulatory burden = B-	
Heroes	Denmark, European Commission, Finland
Villains	Greece, Italy, Spain

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

Competition policy is one of the few instruments the Commission can deploy directly against companies and governments that do not play by the rules of the single market. Neelie Kroes, who held the competition portfolio in the previous Commission, upheld the competition rules in an uncompromising manner. Her successor, Joaquín Almunia, will face a tougher task. The consensus across the EU in favour of robust competition policies was always patchy but has recently frayed further. The financial crisis has emboldened those governments that have long believed that the EU's competition rules are placing European firms at a disadvantage compared with their competitors in other economies. The Commission will have to find a way of reconciling pressure from member-states for more activist industrial policies with adherence to an independent competition policy.

The amount of state aid paid out by EU governments fell from 0.71 per cent of EU GDP in 2002 to 0.53 per cent in 2007. Moreover, governments spent less on bail-outs and aid for corporate restructuring, and more on meeting the EU's 'horizontal' objectives: environmental efficiency, regional economic development, the growth of SMEs and R&D. However, this favourable trend came to an end in 2009. In response to the sharp deterioration in the availability of credit following the financial crisis, the Commission temporarily eased state aid rules to allow governments to guarantee loans to firms and to increase subsidies to small companies suffering from the credit drought. Governments have made use of this temporary relaxation. For example, the French government has extended huge aid to the country's car industry, ostensibly to support the development of low emission cars.

Although the Commission is now in the process of reversing this temporary relaxation of the rules, state aid will remain a battlefield. Against a backdrop of very weak economic growth, many high profile European firms will go bankrupt over the next few years. Faced with high unemployment and growing frustration at what they see as unfair competition created by global currency misalignments and interventionist industrial policies, EU governments will be tempted to step in and rescue them. Although this could make sense for the member-state in question – if only in the short term – it would not do so for the European economy as a whole. Bail-outs of struggling firms would exacerbate the problem of over-capacity, thereby reducing profitability and future investment. Governments that keep struggling companies alive risk retarding the reallocation of resources from underperforming sectors to faster-growing, high-tech ones that is needed to boost productivity.

Should competition rules be relaxed?

Many EU governments believe that the rise of economies with interventionist governments means that Europe can no longer afford its laissez-faire approach to state aid and the ownership of companies. They are especially worried about China, which combines very activist industrial policies with mercantilist trade policies, and is now the world's largest exporter. In addition, the extent to which resources were misallocated by financial markets in the run-up to the crisis has made some governments doubt that the market is the best way of channelling resources to cutting edge sectors. They want to be free to intervene directly to foster the growth of businesses they consider to be strategically important and to prevent foreign takeovers of such firms.

Various governments, including the British one, have called for a more 'flexible' competition regime for high-tech firms. For example, the current business secretary (and former EU trade commissioner), Peter Mandelson, wants to make it easier for governments to extend risk capital to high-tech firms. Europe certainly needs to do more to

encourage the growth of firms in high-tech sectors, where it continues to perform poorly. However, there is no case for loosening state aid rules to allow direct support to high-tech firms. These rules are already much more flexible than the Commission's critics acknowledge. Europe's weak performance in high-tech sectors reflects, among other things, the EU's very costly patent regime, the lack of properly pan-European capital markets, and governments' failure to invest enough in higher education. Allowing governments more freedom to support their chosen firms would do nothing to address these problems, but would introduce distortions into the single market.

However, there is one area where there could be a case for more flexible EU competition rules. Governments can stimulate innovation by establishing regulatory standards or setting specific targets. This works particularly well in sectors such as green technology, as the Commission has recognised. But the EU also needs to learn from the US about the contribution that public procurement can make to fostering new technologies. Public procurement accounts for over 15 per cent of EU GDP, which makes it a formidable resource.

Unlike in the US, EU rules do not allow public bodies conducting a tender and the companies submitting bids to work together to develop the specifications. The Commission is understandably wary of changing the rules, fearing that national authorities would give preference to local firms. However, if European countries are to succeed in boosting public sector productivity and in stimulating the growth of more high-tech firms, they have no choice but to use public procurement more creatively. This will require the Commission to craft guidelines which allow creative relationships between the public sector and firms, yet avoid compromising the single market. It will also require a cultural change on the part of the public sector. Fiscal austerity and the need to do more with less money could help to achieve the necessary evolution in thinking.

There is no doubt that the structure of the Chinese economy and the Chinese authorities' manipulation of its currency pose a serious challenge for European policy-makers. Unless China changes track, it will be hard for them to resist protectionist pressure. Nevertheless, any dilution of EU competition rules would be bad news for the EU economy. Rather than weakening the case for robust competition policy, weak economic growth strengthens it. Competition is key to productivity growth. In properly contested markets, firms have to strive to be innovative and to maximise their productivity if they are to flourish. The record of the last few years suggests that financial markets are a long way from allocating capital to those that can employ it most productively. But they are surely still better at this task than governments.

State aid and competition policy = C+	
Heroes	European Commission, The Netherlands, UK
Villains	France

A European industrial policy for the 21st century

As Europe moves hesitantly out of recession, it is time to reappraise where manufacturing fits into the continent's economy. Contrary to a widespread belief prevalent for the past decade, there is scope for manufacturing to expand as a proportion of total output. It could take up some of the slack in the economy that is likely to appear from the weakening of the financial services sector.

In helping manufacturing to perform better, the European Commission can play a role. Now is not the time to revert to the policies of supporting 'national champions' by handing out large sums of money, either in the form of direct support or special contracts. What is required instead is a more refined strategy built around aiding the development of those areas of industry where Europe has an advantage.

A key task is to understand what modern manufacturing means. It encompasses all the parts of the 'value-chain' connected to the physical production of goods. This means that even companies doing little manufacturing themselves, but which devise and sell factory-made products, are part of manufacturing.

Think of Apple: a company with virtually no factories but whose products sum up some of the best qualities in engineering, design and user applications. Europe has plenty of companies such as this, in fields from babies' buggies to computer chips; they are manufacturers in the sense of being concerned with the product even if they might contract out physical production to others, perhaps in lower cost countries such as China.

In addition to these so-called 'virtual manufacturers', there are 'servi-manufacturers': companies which gain a large percentage of their revenues from services as well as manufacturing. Rolls-Royce gains half its revenues from maintaining and monitoring the aero-engines it makes, sometimes while they are flying.

A third broad category is the ‘touch-manufacturers’. These are the companies in specialist disciplines where a lot of manual production techniques and craft-based skills are required, in areas such as machine building or high-value automotive parts. Often, products are made in short production runs where rapid changes in specification are needed to fit in with customers’ preferences.

In all these fields Europe has a good track record. Policy-makers and business people need to understand that successful manufacturers require a range of strengths in different disciplines, often concerned with selling services, and that nurturing the relevant skills is important.

To build on this, the Commission should concentrate on a broad approach of encouraging technology development in universities and other academic establishments; supporting training programmes to boost more commercial thinking in science and technology (such as through creating university spin-out companies); and a modest programme of R&D grants to help small and mid-sized businesses.

National governments should be encouraged to spend more of their public procurement funds – for instance in large information technology projects – on contracts with small rather than big companies, so as to give entrepreneurially-minded smaller businesses a useful boost. Such programmes would not only help the business of wealth creation, but could also play a part in increasing the effectiveness of many large state-funded technology projects, the results of which are often disappointing.

Projects of this kind would be inspired by schemes in the US that help small and innovative businesses, such as the highly successful series of grants run by the National Science Foundation.

Above all, the Commission should be concerned with education in the broadest sense: bringing to the attention of the wider public the achievements of the continent’s best manufacturers, and encouraging future entrepreneurs to consider them as role models.

This means supporting the efforts by private sector think-tanks and university institutes to discover the ingredients that make these companies what they are, and to make these more generally known.

Manufacturing has a huge potential to stimulate economic growth over the next 20 years. Rather than stay on the sidelines while the US and Asia make the running, Europe should be at the centre of efforts to gain the maximum benefits from what manufacturing has to offer.

Peter Marsh

Financial Times

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

When the Lisbon agenda was launched in 2000, around two-thirds of the gap in transatlantic living standards was explained by different levels of 'labour utilisation': Europeans were poorer than their US counterparts because fewer of them had jobs, and because those who did have jobs worked shorter weeks and took longer holidays. There is no reason why Europeans should aspire to close the transatlantic gap for its own sake – particularly as that gap partly reflects a perfectly legitimate preference for leisure over income. But economic inactivity cannot be explained by a cultural preference for leisure alone. There are many people across Europe who are not working but would like to be – and this was true well before the large-scale job losses resulting from the global financial crisis in 2008-09.

There are two central reasons why the Lisbon agenda seeks to encourage EU countries to raise their employment rates. The first is to tackle social exclusion. In many EU countries, far too high a share of the working age population does not belong to the labour force. Too often, this reflects a 'discouraged worker' effect – that is, the prevalence of people of working age who have become so disheartened looking for work that they have stopped doing so altogether. The second reason for raising employment rates is to place social welfare systems on a more sustainable long-term footing. As European populations get older, the level of participation in the labour force needs to rise, so that social welfare systems remain affordable.

In some EU countries, raising the employment rate requires something of a Copernican revolution: they need to do the exact opposite of what they started doing in the 1970s. The good news is that most governments seem to have abandoned the flawed policies of the past, which tried to keep the unemployment rate down by rationing work (in the form of shorter working weeks) or by actively encouraging economic inactivity (in the form of early retirement). The bad news is that few countries have done much to tackle the dual nature of their labour markets. The result is that labour markets in many EU countries – France and Spain among them – are still divided between privileged ‘insiders’ on full-time contracts (with high levels of job protection and generous pension provisions) and ‘outsiders’ (usually the young) who, if they are lucky enough to find a job, have to get by on a succession of short-term contracts with no perks.

The employment rate has risen

How have EU countries progressed towards their employment targets? At first glance, there are grounds for encouragement. At the time of writing, data for 2009 were not available. However, between 2000 and 2008, the employment rate rose in all but two member-states – Portugal and Romania (see table on page 71). In some countries – such as Bulgaria, Estonia, Latvia – the rise was spectacular. But solid increases were also posted in Cyprus, Germany, Greece, Italy, the Netherlands, Slovenia and Slovakia. Moreover, employment rose in all the EU’s wealthiest member-states between 2000 and 2008 – a period when 12 poorer countries were admitted to the EU and imports from China surged. This should lay to rest a persistent myth about globalisation: namely, that the growth of trade with, and ‘offshoring’ (*délocalisation*) to, low-wage countries condemns higher wage countries to rising unemployment.

The main beneficiaries of rising employment since the launch of the Lisbon agenda in 2000 have been women. The rate of female employment in the EU-27 increased from 53.7 per cent in 2000 to

59.1 per cent in 2008 – within touching distance of the 2010 target of 60 per cent. Gratifyingly, many of the countries that posted the largest increases (Estonia, Germany, Italy, Latvia and Spain) were those with the lowest initial female employment rates. True, female employment in a handful of countries – such as Hungary, Malta and Slovakia – has stagnated at low levels. But overall, the trend across the EU has been positive. The female employment rate remains much lower in Greece and Italy (where it is below 50 per cent) than it is in Denmark, the Netherlands and Sweden (where it exceeds 70 per cent). However, the gap has at least narrowed since 2000.

The other great beneficiaries of job creation since 2000 have been older workers. Across the EU-27 as a whole, the employment rate among workers aged 55 to 64 rose from 36.9 per cent in 2000 to 45.6 per cent in 2008. But the gap between the best-performing country and the worst-performing remains huge. While Sweden has an employment rate of 70.1 per cent among those aged 55 to 64, in countries like Italy and France it is still well under 40 per cent. The scale of this difference partly reflects variations in the effective age of retirement, but it also reflects the extraordinarily low rates of female employment in the 55 to 64 age group in some countries. In 2008, the employment rate for women in this particular age group was just 12.5 per cent in Malta and little over 20 per cent in Italy, Poland and Slovenia. In Sweden, by contrast, it stood at almost 67 per cent.

Why Europe must not be complacent

Does the rise in employment rates between 2000 and 2008 point to an improvement in the long-term performance of EU countries’ labour markets? The answer is: yes, but only up to a point. Since 2000, countries like Austria, France and Germany have all pushed through reforms which have made their labour markets more flexible. Improvements in levels of education, moreover, have made the working-age population more employable: Europeans with tertiary education are more likely to be in work than those without it (and are just as likely to be in work as their counterparts in the US). But the improvement has not been uniform across the EU. Many countries continue to be saddled with rigid labour markets or under-performing education systems (or both). And the countries where reforms are most needed are those where they are least likely to occur – the worst culprits being Greece, Hungary, Italy, Malta, Poland and Romania.

In aggregate, then, there probably has been an improvement in the performance of the European labour market. But the nature of that improvement needs to be kept in context. To start with, it has been modest. The EU as a whole will come nowhere near meeting its employment targets by the time the Lisbon agenda concludes in 2010. It will be tempting, of course, to explain away that failure by laying the blame on the global financial crisis. That temptation should be resisted. Yes, the crisis will have pushed most countries backwards. But two-thirds of EU member-states would not have hit their targets for employment even in the absence of the crisis.

Another reason why few EU countries should congratulate themselves is the persistence of alarmingly high rates of unemployment among the young. Even before the global financial crisis intervened, the rate of unemployment for those aged under 25 was two and a half times higher than that among those aged 25 to 64. In 2008, it was above 18 per cent in Belgium, France, Greece, Hungary, Italy, Romania, Slovakia, Spain and Sweden. This already depressing picture will have worsened in 2009, because the young have borne the brunt of a savage recession. The young continue to be the main victims of the dual nature of many countries' labour markets. When times are good, the best that many can hope for is a succession of jobs on short-term contracts. And when times turn, the short-term nature of their contracts means that they are the first to be laid off.

Employment rates in the EU (percentage of labour force)

	2000	2008	Change
Denmark	76.3	78.1	1.8
The Netherlands	72.9	77.2	4.3
Sweden	73.0	74.3	1.3
Austria	68.5	72.1	3.6
UK	71.2	71.5	0.3
Finland	67.2	71.1	3.9
Cyprus	65.7	70.9	5.2
Germany	65.6	70.7	5.1
Estonia	60.4	69.8	9.4
Latvia	57.5	68.6	11.1
Portugal	68.4	68.2	-0.2
Slovenia	62.8	68.6	5.8
Ireland	65.2	67.6	2.4
Czech Republic	65.0	66.6	1.6
EU-27	**62.2**	**65.9**	**3.7**
Spain	56.3	64.3	8.0
Lithuania	59.1	64.9	5.8
France	62.1	64.9	2.8
Bulgaria	50.4	64.0	13.6
Luxembourg	62.7	63.4	0.7
Belgium	60.5	62.4	1.9
Slovakia	56.8	62.3	5.5
Greece	56.5	61.9	5.4
Poland	55.0	59.2	4.2
Romania	63.0	59.0	-4.0
Italy	53.7	58.7	5.0
Hungary	56.3	56.7	0.4
Malta	54.2	55.3	1.1

Source: Eurostat

Bringing people into the workforce = C+	
Heroes	Austria, Denmark, Germany, The Netherlands
Villains	Hungary, Malta, Romania

D2. Upgrading skills

★ Early school leavers to average no more than 10 per cent

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

★ Raise the share of graduates in maths, science and technology to 15 per cent

★ Foster a culture of life-long learning and provide training to 12.5 per cent of the workforce

The quality of a country's 'human capital' – or the education and skills level of its population – has a large bearing on its prosperity. It is not hard to understand why. Highly-skilled populations tend to boost a country's level of productivity, because they spur technological breakthroughs and accelerate their integration into working practices. And skills raise employability: people who have a university degree enjoy much higher rates of employment than those who only complete secondary education (let alone those who do not get that far). On average, Europe's human capital is high by global standards. But its relative advantage is being eroded as other countries become better educated. And there is a massive gulf between the EU's best performers (mainly in northern Europe) and its worst performers (mainly in central and southern Europe).

As the Lisbon agenda reaches the end of its term, what progress have EU member-states made in meeting their targets on education and skills? The answer is: some, but less than might have been hoped for. Raw data certainly point to a welcome rise in the number of people completing secondary and tertiary education across the EU. But the numbers in some countries remain well below their Lisbon targets: drop-out rates from secondary education, for example, remain too high in some countries (see below). In addition, there is evidence that in some member-states, the rise in numbers reaching secondary and tertiary levels has been accompanied by a decline in the quality of education provided. The result is that Europe increasingly resembles a two-tier region in which a person's economic prospects are strongly influenced by the country he or she happens to be born in.

The numbers in education have risen

In almost every EU country, more of the population is completing secondary education now than in 2000. In 2007 (the last year for which data are available), 81 per cent of 25 to 34 year-olds had at least an upper secondary education, while among 35 to 44 year-olds it was only 75 per cent. Portugal, the country with the most ground to cover in 2000, has made good strides: 44 per cent of 25 to 35 year-olds had at least an upper secondary education in 2007, compared with 27 per cent of 35 to 44 year-olds. But Portugal still has a huge distance to cover: it remains way behind the Nordic countries, where 90 per cent of children finish secondary education. Other EU member-states where drop-out rates have fallen but remain much too high include Italy, Spain and the UK. The poor performance of the UK is striking, given the huge increases in public spending committed to education over the past decade.

The number of students completing tertiary education has also risen. Across the EU, around 30 per cent of those aged 25 to 34 had a university degree in 2007, compared with 25 per cent among those aged 35 to 44. In recent years, particularly large increases in university graduation rates have been posted in countries such as France, Ireland, Poland, Spain and Sweden. One notable exception to this trend is Germany, where a smaller share of students aged 25-34 have completed tertiary education than those aged 45 to 54. Variations in graduation rates across the EU remain stark. Fewer than 20 per cent of young people graduate from university in the Czech Republic, Hungary, Italy, Portugal and Slovakia, compared with 40 per cent in Finland, Ireland and Sweden. But even the latter remain way behind countries like Japan and South Korea, where the proportion is more than 50 per cent.

Large variations in quality persist across the EU

Length of education is only one measure of a country's performance. The quality of the education provided is harder to measure – and not strictly captured by the Lisbon agenda's numerical targets. Nevertheless, a number of reasonable proxies for quality exist. One of these is the PISA survey carried out every three years by the OECD, which tests 15 year-olds for their numeracy, literacy, ability to solve problems and other skills. The surveys have consistently pointed to a sharp north-south divide within the EU, and to a pedestrian performance overall. Only three EU countries rank in the world's top ten for scientific competence or numeracy. The EU's largest member-states – France, Germany and the UK – achieve only moderate scores. And the EU's southern member-states (Greece, Italy, Portugal and Spain) are among the worst performers in every single test.

Similar variations in quality exist at university level. Regular surveys carried out by the Times Higher Education Supplement and Shanghai's Jiao Tong University both reach a similar conclusion: too few Europeans graduate from world-class universities, with only two European universities (Cambridge and Oxford in the UK) in the world's top ten. It is, of course, possible to question the methodology of these surveys. The Shanghai index has a strong bias towards technology and science and omits some of Europe's best universities in subjects like economics. Nor do the surveys capture the quality of research in countries such as France and Germany, where excellent work is often carried out in institutions like the Max Planck Institutes and the Centre National de Recherche Scientifique (CNRS). To correct these biases, the EU is developing its own rankings of world universities, based on what it believes to be a better methodology.[9]

[9] *Helena Spongenberg, 'EU to test new university ranking in 2010', EU Observer, January 6th 2010.*

The EU's own rankings may show universities from certain EU counties in a slightly better light. But it would be surprising if they fundamentally altered the picture painted by existing surveys:

namely, that the world's best universities are overwhelmingly concentrated in the US; that only a tiny number of European universities can compete with them; and that most European universities are concentrated in the second or third tier (that is, they rank in the world's top 200 to 500). Broadly, there are two reasons for this under-performance. One is that the US spends two and a half times more on higher education than the EU average. The other is that US universities have more freedom than their EU rivals to set their budgets and hire and pay their own staff. Research suggests that such autonomy doubles the effect of extra money on their research performance.[10]

[10] *Philippe Aghion, 'Higher aspirations: An agenda for reforming European universities', Bruegel Blueprint 5, 2008.*

The importance of education and the future of reform

The Lisbon agenda recognised the need for EU member-states to raise their game on skills and education. But this goal never quite achieved the prominence it deserved. Given its centrality to employment, productivity and social cohesion, it will have to loom larger in the EU's successor agenda, EU 2020. Education levels are rising worldwide – so much so that some countries in Asia have now overtaken even the best performing countries in the EU. All EU member-states consequently have room to improve. But the challenge in parts of Southern Europe – where far too many people never finish secondary or tertiary education – has become as urgent as it is daunting. Unless these countries improve (and fast), they will suffer from chronically low productivity; have lower rates of employment; and will almost certainly have to endure rising levels of income inequality and social disharmony.

It is tempting to define the challenge facing EU countries as simply one of funding. Funding obviously matters. It is surely part of the explanation for the difference in standing between American and European universities. But there is more to improving educational standards than simply throwing money at the problem. Portugal, after all, spends a higher share of GDP on primary and secondary

education than the EU average, yet it is one of the worst performers in the OECD's PISA tests. The evidence suggests that countries where schools and universities enjoy high levels of autonomy from central government – particularly with regard to hiring their staff and managing their budgets – perform better than those where the state interferes in such matters.

Upgrading skills = C+	
Heroes	Finland, Poland, Sweden
Villains	Greece, Portugal

D3. Modernising social protection

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

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

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

Ever since it was launched, the Lisbon agenda has suffered from the perception in some quarters that it is an assault on the social model to which many European citizens remain attached. This perception is largely nonsense. For one thing, the countries which come closest to meeting their Lisbon targets – the Nordic countries, Austria and the Netherlands – happen to produce the best social outcomes in the EU. For another, many national welfare systems work less well than their supporters claim: some produce very poor social outcomes (in terms of high levels of poverty, income inequality and long-term unemployment); others are little more than inter-generational Ponzi schemes that are destined to collapse owing to population ageing. The Lisbon agenda is therefore right to have stressed the need for social welfare systems to be modernised. And critics are largely wrong to see reforms of national social welfare models as an attack on the European way of life – much of which is well worth defending.

Reducing poverty and social exclusion

When it was originally conceived, the Lisbon agenda contained two prongs: a wide-ranging programme of reforms to improve the supply-side of the economy; and a social dimension that aimed, among other things, to reduce the number of people at risk from poverty and social exclusion. Many critics believe that these two dimensions are fundamentally incompatible; and that the social dimension has been subordinated to the economic one, particularly since the agenda was revised following the report written by a group led by Wim Kok in 2005. It is not hard to see why this belief has taken hold. The Lisbon agenda was conceived as a programme to close the EU's wealth gap with the US. And since the US had higher levels of poverty and social exclusion than the EU, it was not unreasonable to fear that the price of greater dynamism would be a deterioration of social outcomes towards US levels. Many Europeans therefore think that they face a binary choice between dynamism and social solidarity.

A glance at the table on page 83 suggests that this belief is not really borne out by the evidence. It is certainly true that the UK, whose product and labour markets bear some resemblance to those in the US, suffers from higher levels of poverty and inequality than the EU average. However, the lowest levels of poverty and income inequality are in the Nordic region, where high levels of competition generally prevail in markets for goods and services. And the countries with the very worst social outcomes in the EU – Greece, Italy and Portugal – are countries whose markets for goods, services and labour are more highly regulated than anywhere else in the EU. In short, equitable social outcomes are not necessarily threatened by market liberalisation. Nor are they guaranteed by high levels of regulation. The Lisbon agenda, with its emphasis on competition and innovation, does imply a recalibration of existing social models. But it does not require them to be swept away.

Much of the European Commission's attention has focused on promoting the merits of Denmark's model of 'flexisecurity' – that is, liberal labour laws allied to generous but conditional social welfare payments. There is certainly much that other EU countries can learn from the success of Denmark's model (even if cultural and institutional factors mean that its results may not be easily reproducible elsewhere). But the enviable social outcomes in Denmark rest on more than just the interaction of its labour laws with its tax and benefits system. They are also the result of its excellent education system. Countries which adopt their own versions of flexisecurity

without raising the skills levels of their populations' are highly unlikely, therefore, to emulate Danish employment rates or social outcomes. As EU leaders ponder the shape of Lisbon's successor agenda, they would do well to pay more attention to the role played by education in producing socially cohesive societies.

Reforming pension systems

Europe's long-term pension problem is so well-known it scarcely needs restating. In many EU countries, state-run pay-as-you-go (PAYG) pension systems rely on people in work to pay the pensions of people in retirement. But populations across the EU are ageing owing to declining fertility rates and rising life expectancy. The result is that the ranks of pensioners are set to surge at a time when the number of people of working age will be declining. On current trends, the EU will have two people of working age for every pensioner by 2050, down from four at present. The European Commission has estimated that in the absence of reforms, the burden of supporting an ageing population with a shrinking workforce would push the ratio of government debt to GDP for the EU as a whole above 200 per cent by 2050.[11] These projections are optimistic, because they predate the financial crisis – and so take no account of the explosion of government debt resulting from it.

[11] European Commission, 'The long-term sustainability of public finances in the European Union', 2007.

All EU countries face the same problem to a greater or lesser degree, although national differences in demographic trends and pension arrangements mean that reforms are more urgent in some countries than in others. The largest increases in age-related government expenditures are projected to be in Belgium, the Czech Republic, Hungary, Ireland, Italy, Luxembourg, Portugal, Slovenia and Spain. Sizeable increases are also expected in Denmark, Finland, France, Germany, the Netherlands, Slovakia and the UK. The challenges posed to the public finances by population ageing are not insuperable. In essence, they require action on two fronts. The first is to mitigate the impact of a smaller working age population by making sure that a greater share of it is actively participating in the labour market. The second is to raise the age at which people retire. This may be an unpopular move but it is a good test of a government's courage and responsibility.

The Lisbon agenda rightly focused on the need for EU countries to increase the effective age of retirement, because people across the EU generally retire at a younger age than the legal retirement age. The good news is that the effective age of retirement has risen in almost every member-state since 2000. The bad news is that the EU will come nowhere near meeting the Lisbon target of 65 by 2010. In 2008 (the latest date for which data are available), the average age for the EU as a whole stood at 61.4 (up from 59.9 in 2000). The average for the EU concealed large variations between countries, with the effective age of retirement standing above 63 in the Netherlands, Sweden and the UK, but below 60 in France, Malta, Poland and Slovakia. Some EU countries have also been raising the legal age of retirement. In many cases, however, reforms have been too modest – either because their entry into force has been deferred too far into the future, or because public-sector workers have been exempted.

The need for a new social consensus

Reforms to welfare systems are not gratuitous attacks on 'acquired social rights', as they are often portrayed. They are a condition for the very survival of European welfare systems. Ever since the Lisbon agenda was launched, organised interest groups opposed to change have been allowed to portray themselves as spokesmen for 'social justice'. If EU 2020 is to be a greater success than Lisbon, political leaders will need to do a better of job of explaining why changes to welfare systems are necessary. They could do worse than start putting some of the forces opposed to change on the back foot. One of the great wonders of Europe's political economy is the way workers who have enjoyed the most success in getting others to pay for their retirement have been allowed to cast themselves as spokesmen for social justice. One place such workers are not entitled

to occupy is the moral high ground – particularly as their rights are effectively paid for by others who do not or will not enjoy them.

Selected social indicators for EU-27 countries, 2008

	At risk of poverty after social transfers*	Long-term unemployment rate	Income inequality**
Austria	12	0.9	3.7
Belgium	15	3.3	4.1
Bulgaria	21	2.9	6.5
Cyprus	16	0.5	4.1
Czech Republic	9	2.2	3.4
Denmark	12	0.5	3.6
Estonia	19	1.7	5.0
Germany	15	3.8	4.8
Finland	14	1.2	3.8
France	13	2.9	4.2
Greece	20	3.6	5.9
Hungary	12	3.6	3.6
Ireland	16	1.6	4.5
Italy	19	3.1	5.1
Latvia	26	1.9	7.3
Lithuania	20	1.2	5.9
Luxembourg	13	1.6	4.1
Malta	15	2.5	4.0
The Netherlands	11	1.0	4.0
Poland	17	2.4	5.1
Portugal	18	3.7	6.1
Romania	23	2.4	7.0
Slovenia	12	1.9	3.4
Slovakia	11	6.6	3.4
Spain	20	2.0	5.4
Sweden	12	0.8	3.5
UK	19	1.4	5.6

*Source: Eurostat. *Disposable income below 60 per cent of the median national average. **Income inequality = Ratio of total income received by the top 20 per cent of the population relative to the bottom 20 per cent (a higher number means a more unequal society).*

Modernising social protection = C+	
Heroes	Denmark, The Netherlands, Sweden
Villains	Greece, Italy, Portugal, UK

E. Sustainable development

E1. Climate change

★ Reduce greenhouse gases by 8 per cent from 1990 levels by 2010 (for the EU-15), 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 was right to include environmental targets in the Lisbon agenda. There is no trade-off between economic growth and ambitious environmental standards. Anything that encourages European businesses to adopt energy-efficient technologies will stand them in good stead in a world of increasing energy scarcity. Tight emissions caps and stringent energy efficiency standards will also help European businesses to carve out leadership positions in markets for low-carbon technologies. Unfortunately, the Lisbon agenda's environmental targets were neglected from the start, and especially so since 2005 when the agenda became more narrowly focused on growth and employment. There has been little attempt to integrate the environmental targets into the overall strategy and to demonstrate the economic benefits of a move to a low carbon economy. This will need to change in the EU 2020 programme.

The EU as a whole will meet the first Lisbon target – an 8 per cent reduction in emissions of greenhouse gases by 2010 (from their 1990 level). But this is to a large extent down to one-off developments: the collapse of communist-era industry in East Germany, the switch from burning coal to gas in the UK, and more recently, the economic crisis. The EU economy shrank by around 4 per cent in 2009, with industrial emissions falling by around 10 per cent. But the EU will not meet the second Lisbon target (increasing the proportion of electricity derived from renewable sources to 22 per cent by 2010) or the third (breaking the link between economic growth and traffic volumes).

Total greenhouse gas emissions
(1990=100)

	2000	2007	2010 (target)
Germany	81.8	77.6	79.0
UK	86.8	82.0	87.5
Sweden	94.5	90.7	104.0
Austria	102.6	111.3	87.0
The Netherlands	100.7	97.4	94.0
Finland	97.9	110.3	100.0
Denmark	97.8	96.1	79.0
Spain	133.1	132.6	115.0
France	98.7	94.2	110.0
Italy	106.3	106.9	93.5
Poland	69.0	70.8	94.0
Czech Republic	75.8	77.6	92.0
Hungary	67.6	65.8	94.0
EU-15	96.3	95.0	92.0
EU-27	90.8	90.7	n/a

Source: Eurostat

It has long been clear what would replace Lisbon's environmental targets, because there are already robust, legally binding commitments in place. In 2008, EU governments agreed that by 2020 the Union will cut emissions of greenhouse gases by 20 per cent from 1990 levels; improve energy efficiency by 20 per cent and increase the proportion of total energy consumption met by renewables to 20 per cent. The challenge for the EU is to make sure

that the policies needed to meet the targets are in place. A combination of price signals and regulation is needed.

The principal price signal is provided by the EU's emissions trading scheme (ETS), established in 2005. The ETS involves putting a price on carbon dioxide by establishing a cap on the amount that businesses can emit annually. Allowances to emit the gas are allocated to businesses and other big energy users of fossil fuels, either free of charge or by auctioning. Despite being responsible for just over 40 per cent of the EU's total emissions, the industries covered by the scheme will have to deliver two-thirds of the targeted reduction in overall emissions between 2005 and 2020.

Unfortunately, carbon prices under the ETS are far too low to make investment in new technologies worthwhile. In February 2010, the carbon price stood at €13 per tonne. Although this represented an improvement on the low of €10 reached in February 2009, it is far below the €30 level of July 2008. Nor is the price likely to recover any time soon. The EU economy will not grow as fast between 2008 and 2020 as was assumed when the caps were set, which means that emissions will be considerably lower than forecast. Economic growth is unlikely to exceed 1.5 per cent a year, instead of the 2.5 per cent the Commission had assumed when it set the caps. The cumulative impact of much weaker growth on emissions, and thus on the price of carbon, will be huge. Although the target of a 20 per cent reduction in EU emissions by 2020 could be met, it will be for the wrong reasons. An underlying fall in emissions (one that will not be reversed once the economy recovers) requires investment in new technologies, which is much less likely to take place if carbon prices remain very weak.

The Commission should intervene in the carbon market to ensure that carbon prices rise. It should tighten the post-2020 (phase four) emissions cap, which is not yet set in stone. Given that emitters can retain allowances from phases two and three (2008-12 and 2013-20) of the ETS for use in phase four, reducing the number of allowances available in the post-2020 period would help to prevent further falls in prices in the short term. The Commission should also announce that from 2013 auctions will be subject to a minimum price of €30. Those allowances that do not meet the reserve price would then be withdrawn from the market. Such a move would increase carbon prices and reassure firms that prices will remain high enough to warrant investment in new technologies. One argument against intervention is essentially ideological: namely, that it would interfere with the working of the market. Another is that intervention would create uncertainty: investors would come to fear that the Commission would interfere in the market whenever it was unhappy about the price of carbon. Both fears are exaggerated. The carbon market, like many others, is the product of regulation, so altering the frame of that regulation in the light of changed circumstances should not be considered problematic.

Price incentives on their own will not suffice to bring about the needed investment in low-carbon technologies; the EU also needs to put in place stronger regulatory signals. The Commission was wrong to rule out including carbon dioxide in the EU's forthcoming Industrial Emissions Directive (IED). Including CO_2 in the IED would have effectively set maximum CO_2 limits for power stations and other industrial plants. The Commission's argument against doing so – that it would undermine the effectiveness of the carbon market – is unconvincing. First, it is far from clear that the ETS will work as desired; in the absence of intervention in the market it is just as likely that carbon prices will remain too low to stimulate investment in low carbon technologies. Second, it is unclear why setting emissions standards for industrial plants would undermine the ETS, whereas the EU's existing targets for renewable electricity apparently do not. The Commission's opposition to member-states going it alone and setting more stringent emissions standards for industrial plants on the grounds that it would distort competition is similarly problematic. It makes no sense that California has the right to set an Emissions Performance Standard but an individual EU member-state does not. EU governments need to challenge the legality of this.

Stronger regulation will also be needed in order to meet the emissions targets for the sectors not covered by the ETS, which are targeted to reduce emissions by 10 per cent between 2005 and 2020. The EU has made a good start at addressing the problem of car emissions, which after air travel is the fastest rising source of emissions. By 2015, the range of cars produced by each car manufacturer will on average have to emit no more than 120 grams of carbon dioxide per kilometre, falling to 95 grams in 2020. This target has spurred a lot of innovation, and is a good example of the kind of integration between the environmental and innovation targets that is desirable. The EU's emissions targets have effectively become a source of competitive advantage.

But much more will have to be done to promote energy efficiency, in particular in buildings, which account for about 40 per cent of the EU's energy use. Improving the efficiency with which they use energy offers the cheapest way of cutting emissions. In November 2009, EU governments finally agreed that all new buildings would have to comply with tough energy-performance standards by 2020. This deadline is far too distant; there is no justification for waiting a decade to introduce such a requirement. Moreover, no standards were laid down for the energy performance of existing buildings. If substantive progress is to be made in reducing emissions from buildings, the target for new buildings needs to be brought forward, and standards gradually introduced for existing buildings. This is unlikely to increase building costs by much – competition has quickly brought down the cost of energy-efficient housing in Germany and Austria, the two EU economies that lead in this field. And the ongoing benefits in terms of much lower running costs and emissions would be enormous.

Against a backdrop of weak economic growth, poor public finances and frustration at the EU's failure at Copenhagen, there will be no shortage of opposition to taking action to boost carbon prices or tighten regulation. In order to maintain the consensus in favour of ambitious unilateral action, the EU must demonstrate that these targets will be a source of competitive advantage and that failing to meet them would cause long-term economic damage. It must challenge the misleading portrayal of regulatory standards as a 'cost' to be borne by business rather than as an incentive to use energy more efficiently and to invest in new technologies. What matters is the impact of environmental policies on overall economic performance, rather than the short-term implications for the price competitiveness of a narrow range of industries.

Climate change = B	
Heroes	Germany, Sweden
Villains	Poland, Spain

4 Conclusion

The Lisbon agenda was launched at the height of the dotcom boom in 2000 – a time of exuberant (and, in hindsight, utterly unrealistic) optimism. In 2010, when Lisbon comes to the end of its term, EU leaders will launch a successor agenda – 'EU 2020' – against the backdrop of a region trying to recover from the steepest decline in economic output since the 1930s. One can take two views on the intention to replace the Lisbon agenda. The first is that doing so is a self-defeating waste of time. Why renew something that most observers agree has been a disappointment? As EU countries showed insufficient commitment to reform during a relatively benign period (2000-07), why expect them to do so in harder times? Nothing, after all, does more to damage the EU's image than the announcement of grandiose ambitions that no member-state is really committed to meeting.

The alternative view – the one favoured by this report – is that the intellectual case for reforms is not undermined by the weakness of certain countries' practical commitment to them; and that a roadmap and peer group review process is desirable to try and keep policy heading in the right direction. Indeed, the need for such a roadmap is all the more necessary when the financial crisis has raised doubts about the direction of reform, and when governments face growing pressure from organised interest groups opposed to change.

EU 2020: What should be the broad contours?

So what should EU 2020 look like? The only plausible reasons for replacing the old agenda with something entirely new would be if the original design was flawed, or if developments in the wider world had rendered it obsolete. Developments since 2000 call for modifications to the Lisbon agenda, but they do not justify a root-and-branch overhaul of it. The global financial crisis, for example, may have raised questions about the way in which the financial sector is regulated. But it has not strengthened the case for subjecting European labour markets to even more regulatory burdens. The weakness of the Lisbon agenda was not its underlying diagnosis of the economic challenges facing EU countries, so much as its lack of focus and the dearth of instruments available to meet the objectives that it set. EU 2020 needs to be given a sharper focus than the Lisbon agenda, as well as better instruments.

A credible reform programme cannot be an inventory of everything the EU happens to do. The central focus of EU 2020 must be on growth, jobs and sustainability (social and environmental). The EU's traditional answer to 'Eurosclerosis' is to deepen the single market. This should remain an important objective. But it will not be enough: it will be largely irrelevant, for example, to the increasingly urgent, and largely national, task of improving European workers' education levels. EU 2020 will also need to embrace a more sophisticated conception of innovation than that which informed the Lisbon agenda – with less emphasis on misleading input measures like R&D spending. Finally, if the EU 2020 programme is to exert a greater influence on member-states' reform efforts than the Lisbon agenda, the EU will need to equip itself with a better method of governance.

★ Improve the method of governance

The relative failure of the Lisbon agenda is often ascribed to shortcomings in process – particularly to its reliance on the 'open method of co-ordination' (broadly speaking, a peer group review system) and to the absence of any mechanisms to ensure that member-states take their commitments seriously. While there is some truth in this criticism, the weaknesses in governance merely reflect the 'constitutional'

division of responsibilities: in many policy areas, the Commission cannot enforce compliance for the simple reason that it has no authority to do so. Barring an extension of EU competence to areas like education or pensions – which will not happen – EU 2020 will suffer from similar constraints. Does this condemn EU 2020 to failure? Not necessarily. 'Soft law' need not be weaker than 'hard law': the OECD's PISA tests, after all, have arguably had a greater influence on countries' education policies than the EU's Stability and Growth Pact has had on their fiscal policies.

So how can governance mechanisms be improved upon in EU 2020? To start with, the EU should have the courage of its convictions and agree to turn EU 2020 into a proper benchmarking exercise. One reason the OECD's PISA tests had such a galvanising effect was that their results were published, shocking many governments into action. If governments do not want the Commission to 'name and shame' (or even to 'name and praise'), responsibility for carrying out the benchmarking could be given to an independent council of experts.[12] The EU could also give itself a better instrument if it reformed the EU budget, so that less money is spent on agriculture and more on policies that promote innovation (a change that admittedly cannot enter into force before 2014, even if its agreed). Finally, EU 2020 could eschew Lisbon's crude, 'one size fits all' approach and set different priorities to reflect individual countries' specific challenges and starting positions.

[12] Joachim Fritz-Vannahme et al, 'Lisbon – a second shot', Bertelsmann Stiftung, February 2010.

★ Provide renewed impetus to the single market

The single market remains one of the EU's great achievements. It ensures that trade is freer within the EU than between the EU and third countries. Its existence, moreover, almost certainly dampened protectionism during the brutal downturn of 2008-

09. But the single market is not in rude health. Member-states' commitment to extending it was flagging well before the financial crisis – as is illustrated by the reluctance of some countries to extend the single market to services, or to live up to their obligations in notionally liberalised sectors like energy. The crisis has dealt further blows to the single market. The arrangements for cross-border banking have been exposed as unworkable without root-and-branch reform. And public support for open markets and competition has been dented, making it harder for reticent governments to extend the single market to new areas, or simply to comply with existing rules.

The EU's single market will never be complete so long as member-states prevent goods, services, people and capital from moving as freely across their borders as they do within them. Strengthening the single market must therefore be a priority for EU 2020. A report on the single market will be submitted to the European Commission by Mario Monti in April 2010. It should recommend three tasks. The first is to carry out urgent repair work to the single market for cross-border banking. The second is to extend the single market to new areas such as e-commerce. The third is to secure a political commitment from the member-states to support the European Commission's role in enforcing the commitments that they enter into. Maintaining the integrity of the single market will be a challenging task at a time when anxious workers are likely to see increased competition as a threat to their jobs.

★ Place a greater emphasis on improving human capital

Modern economies – under the twin influences of globalisation and technological change – are placing a growing premium on skilled labour relative to unskilled labour. Yet too many EU countries are not adequately equipping their populations with the skills that they need to thrive in the modern world. The stakes are high. EU member-states that fail to improve their

human capital will suffer from lower productivity and employment, as well as increased income inequality and social tensions. The Lisbon agenda rightly exhorted EU countries to improve the quality of their human capital. But the objective never quite received the prominence that it deserved: though vastly more important, it attracted less attention than, say, the objective of meeting the target for R&D spending. Education must therefore occupy a far more prominent role in EU 2020 than it did in the Lisbon agenda.

It will be hard to improve human capital when governments will be facing acute budgetary pressures. The pressures to cut spending, particularly in the short term, will be acute – not least as the economic and social costs of doing so will only become apparent in the distant future. To ensure that the supply side of the economy is not sacrificed to short-run considerations, it might help if EU leaders committed themselves to discussing the issue of human capital at least once a year at one of their summits. The task of raising educational standards is not straightforward, irrespective of budgetary pressures. But it is critical that education policy over the next decade be guided by two lessons. The first is that modest improvements in a population's education levels can have a large impact on economic growth further down the line.[13] The second is that society gets a far better return on its investment if it educates people earlier, rather than later, in their lives.

[13] *OECD, 'The high cost of low educational performance', Programme for International Student Assessment, 2010.*

★ Base reforms on broader understanding of innovation

Because they are already close to the 'technological frontier', the EU's wealthier countries cannot rely on 'catch-up' growth – that is, advances in productivity driven by the adoption of ideas, technologies and working practices developed elsewhere. They must rely on innovation at home. The Lisbon agenda rightly recognised the importance of innovation. But it placed too much emphasis on R&D. European politicians often conflate R&D with innovation. R&D is a key driver of innovation in manufacturing sectors such as pharmaceuticals and automotive. But it is a poor proxy for innovation in the service sector, which is less research-intensive (and accounts for some three-quarters of EU GDP). In many sectors, the sorts of innovation that drive productivity growth are not determined by discoveries in research laboratories, but by less tangible changes (such as the way in which businesses and governments organise themselves to work more efficiently).

EU 2020 should not neglect R&D. But it must move beyond Lisbon's obsessive focus with numerical R&D targets and embrace a broader conception of innovation. The most important things that the EU and its member-states can do to promote innovation are to encourage greater competition, reduce support for national champions and improve the business environment for start-ups. A harder question is whether the EU should replace the Lisbon agenda's R&D target with something else, such as a broader range of innovation indicators. The best argument in favour of targets is that they can encourage a degree of competitive emulation among countries.[14] But the limitations of targets in areas like innovation must be recognised: they should not give governments the illusion that they have more control than they do in practice over output measures like productivity growth.

[14] *Ann Mettler, 'Innovating indicators: Choosing the right targets for EU 2020', The Lisbon Council, 04/2009.*

★ **Repair the financial sector without damaging its ability to fund growth**

Europe needs a less leveraged and more stable financial sector. It also needs major improvements to the way cross-border banks are supervised if the single market in financial services is to survive. The EU is pushing through a raft of measures that

should help on both counts. But as it overhauls the way the financial sector is regulated and supervised, it must keep an eye on the end-goal. The objective of reforming prudential rules is not to abolish risk or to legislate all future crises out of existence. Such a goal could probably only be achieved by neutering the financial system's ability to fulfil the task for which it is designed (which would be absurd). The objective of reform must be to contain the scale of future crises (which are probably inevitable); and to ensure, as far as possible, that the risks are borne by those who take them, rather than offloaded on to the taxpayer.[15]

[15] *Philip Whyte, 'How to restore financial stability', CER report, January 2010.*

So the EU must reform the financial system to make it more responsible and to increase its resilience to future shocks. However, since there is a trade-off between safety and economic growth, it is vital that policy-makers strike the right balance. As they redesign the way the financial sector is regulated and supervised, they should not lose sight of the importance of finance in supporting the EU's growth agenda. Well before the crisis, for example, few EU countries had financial systems that were practised at funding start ups – one of the many reasons why innovative firms have struggled to grow as rapidly as they have done in the US. The need for EU countries to improve the way that start-ups were funded attracted surprisingly little attention in the Lisbon agenda (none of the integrated guidelines for growth and jobs dealt with the issue). This oversight should be rectified in EU 2020.

★ **Promote a broader conception of sustainability**

EU 2020 would perform an invaluable function if it helped Europeans to accept the responsibilities that they owe to younger (and future) generations – and provided some impetus in discharging such responsibilities. The two greatest inter-generational issues are environmental (making sure that the climate is still tolerable a few decades hence) and social (making sure that future generations are not saddled with unbearable pension liabilities built up by those currently in work). In their minds at least, Europeans have made great headway over the past decade in accepting the first responsibility. Even if they struggle to meet them, governments have at least felt able to set challenging targets on emissions reductions which their populations support (in principle, at any rate). What many Europeans still seem reluctant to accept is the second dimension of sustainability: the social one.

Europeans often think of ‘social rights’ as sacred cows that cannot be touched. The trouble is that some of these rights are effectively exercised at others’ expense. A large number of people currently in work, for example, think of their pension entitlements as ‘acquired’ social rights – despite the fact that these impose huge unfunded liabilities on future generations who will certainly never enjoy comparable rights. EU 2020 should help to spread a more responsible and sustainable conception of social justice which recognises the crucial importance of the inter-generational dimension. Interest groups who present themselves as spokesmen for social justice should be made to explain the consequences of their positions for future generations. And those who cannot provide a satisfactory answer to the question should not be allowed to occupy the moral high ground.

Overall assesment of results: C

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The scorecard table

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Issues	2010	Heroes	Villains	2009	2008	2007	2006	2005	2004	2003	2002	2001
A. Innovation												
Information society	B	Finland, The Netherlands, Sweden	Greece, Italy, Spain	B	B+	B+	B	B	B-	B-	C+	B+
Research & development	D	Finland, The Netherlands Sweden	Greece, Italy, Spain	D	D	D+	C-	C-	C	C-	C+	B-
B. Liberalisation												
Telecoms & utilities	C	The Netherlands, Sweden, UK	France, Germany, Poland	C	C-	C	C+	C+	C+	B-	B-	B+
Transport	C	Germany, Sweden	Greece, Slovenia	C-	C-	C-	C+	C+	C+	B-	D-	D
Financial & general services	C	None	Too many to mention	C	B-	B-	C-	B-	C+	B-	B-	C+
C. Enterprise												
Business start-up environment	B-	Ireland, UK	Greece, Spain	B	B	B	B	C	C	B-	D	D
Regulatory burden	B-	Denmark, European Commission, Finland	Greece, Italy, Spain	B	B	B	B+	C+	C	C+	C-	D+
State aid & competition policy	C+	European Commission, The Netherlands, UK	France	C	B	B-	B-	C+	C+	C+	B-	B+
D. Employment and social inclusion												
Bringing people into the workforce	C+	Austria, Denmark, Germany, The Netherlands	Hungary, Malta, Romania	B-	B-	C+	C	C	C-	C	B-	B-
Upgrading skills	C+	Finland, Poland, Sweden	Greece, Portugal	B-	B-	B-	B-	C+	C	C	C-	D
Modernising social protection	C+	Denmark, The Netherlands, Sweden	Greece, Italy, Portugal, UK	C+	C+	C	C	B-	B-	C	B-	C+
E. Sustainable development												
Climate change	B	Germany, Sweden	Poland, Spain	B+	B+	B-	B	C-	C-	C+	C	N/A
Conclusion												
The Lisbon process	C-	Austria, Denmark, The Netherlands, Sweden	Greece, Italy, Spain	C	C+	C+	C	C	C	C+	C-	B+
Overall assessment of results	C			C	C+	C	C	C	C	C+	C	C+

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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 X
The road to 2020

Simon Tilford and Philip Whyte

The EU's Lisbon agenda has failed to deliver what it promised. Although most member-states have made some progress towards the targets they set themselves in 2000, their commitment to reform has been half-hearted. This leaves few EU countries well-placed to thrive economically. With public finances in a parlous state following the financial crisis, population ageing kicking in, and strains emerging in the eurozone, the EU must provide new impetus to supply-side reforms. The new EU 2020 agenda needs a stronger method of governance – with public rankings of countries' performance – and should pay greater attention to skills and innovation.

Simon Tilford is chief economist and **Philip Whyte** is a senior research fellow at the Centre for European Reform.

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