CENTRE FOR EUROPEAN REFORM

THE LISBON SCORECARD IX

How to emerge from the wreckage

Simon Tilford and Philip Whyte

about the CER

CENTRE FOR EUROPEAN REFORM

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Foreword

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

After a period of sustained economic growth, we are now entering uncertain times where economies not just in Europe but across the world are contracting. During this time governments will come under pressure to look inwards and to introduce measures to 'protect' their domestic markets. These pressures must be resisted. In this era of interdependence where nations' economies are inextricably linked, it is important that borders are kept open and nations continue to trade.

While the Lisbon agenda is about structural reform, liberalising markets and achieving an efficient single market, it is also about restoring Europe's competitiveness and encouraging greater investment in research and development (R&D). The pharmaceutical industry invests more in R&D than any other industry. For this to continue, the European Commission must provide certainty and make clear that it values intellectual property rights. Without strong intellectual property protection, no pharmaceutical company could invest the considerable sums required to develop a medicine.

This year will be challenging. From the pharmaceutical industry's perspective we look forward to the conclusion of the European Commission's sectoral inquiry into our industry, the implementation by member-states of the recommendations of the high level pharmaceutical forum, and progress in the pharmaceutical package of legislative proposals.

If these measures are implemented with the Lisbon goals in mind, I am confident that Europe will make a significant step forward in boosting its competitiveness.

Ulf Säther

Regional Vice President, Europe

Foreword

Clifford Chance is delighted to sponsor the Lisbon scorecard for the third consecutive year. It is a reflection of the importance we place on improving Europe's competitiveness.

2009 is a pivotal year; there are elections to the European Parliament, a new Commission and – possibly – a new treaty. A lot is riding on the EU institutions' ability to pull the economy out of what is undoubtedly a very difficult time. The individuals taking over from the current Commission team must demonstrate early on that they have the expertise and drive to continue to push through reforms at a time when member-states may be struggling with other challenges. In particular, the Commission must be strong and determined in the face of any national moves to improve the situation in one EU economy at the expense of another.

This year is also notable in terms of legislation. Member-states must transpose the services directive into national law by December 28th this year, opening up the services market to true cross-border competition and bringing efficiency gains to a sector that now represents 70 per cent or more in most EU countries. A raft of new legislation will also come into force following its anticipated adoption ahead of the Parliament elections. The legislative landscape will undoubtedly be unrecognisable, but hopefully decision-makers understand that hindering competitive businesses from operating will only make this downturn longer and more difficult.

We commend and support the CER for its work in promoting competitiveness and providing a valued contribution to the debate in Europe.

Stuart Popham

Senior Partner, Clifford Chance LLP

Foreword

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

The world economy is at a critical juncture. Since the turn of the year it has become painfully apparent that the credit crisis knows no bounds and hopes that the worst of the fall-out might be confined to the US have been dashed. Europe and Asia have, if anything, been more severely affected by the collapse in world trade, exports and manufacturing than North America. Latest forecasts from the IMF suggest that 2009 will be the worst year for the global economy since the second world war, with output virtually stagnating.

Under these circumstances the temptation to revert to protectionist measures must be resisted at all costs: any apparent gains to individual countries would prove illusory as new barriers to trade would ultimately drag everyone down. Instead, everything possible must be done to preserve and extend the liberalisation of trade achieved in recent decades.

For Europe, this means continuing to promote the internal market, as well as guarding against external threats to commerce. Lisbon is all about removing barriers to the efficient working of the single market, be they structural rigidities in individual countries or the costs involved in dealing with a multiplicity of cross-border regulatory regimes.

It is only by continuing to pursue this goal that we will emerge from the downturn stronger and more able to compete in the global economy.

John Griffith-Jones

UK Chairman and Senior Partner, KPMG LLP

Foreword

Unilever is one of the world's leading fast moving consumer goods companies. Our portfolio includes some of the world's best known brands such as Lipton, Dove, Knorr and Axe. With strong local roots in more than 100 countries we help consumers to feel good, look good and get more out of life.

Last year's Lisbon scorecard was rather prophetically entitled – "Is Europe ready for an economic storm?" Since its publication, the financial crisis has spread, with severe consequences for the 'real economy'. At the same time, the world still needs to address climate change, food security and poverty alleviation.

The Stanford economist Paul Romer once famously remarked: "A crisis is a terrible thing to waste". Now more than ever we must not lose sight of the need to continue to invest in improving Europe's competitiveness. We must redouble our efforts to strengthen the EU single market and avoid measures which however well intentioned may ultimately undermine economic competitiveness.

Furthermore, the EU continues to discuss a wide range of legislative proposals that are of crucial importance to our industry (e.g. proposals for food labelling, the adoption of new authorisation procedures for novel foods and the overhauling of EU rules on cosmetics). The final results will show whether the EU will be able to deliver on its 'better regulation' promise.

The Lisbon agenda has sought to stimulate collaborative action by Europe's political leaders to ensure that Europe is well positioned to compete in a globalised world. It has sought to balance the need for environmental and social considerations which are also the cornerstones of sustainable development. It has attempted to benchmark progress. Whatever its flaws, Europe needs a Lisbon agenda which recognises that collective action by member-states is the only way forwards. The CER's Lisbon scorecard has played an important role and we are very pleased to continue to support this publication.

Miguel Veiga-Pestana

Vice President, Global External Affairs, Unilever

1 Introduction

What a difference a year makes. In 2007, the EU was still celebrating a welcome economic upswing after five years of sub-par growth. In a region long blighted by joblessness, the rate of unemployment had fallen to its lowest level since the early 1980s. And independent analysts were busy raising their estimates of the EU's trend rate of growth (that is, the rate at which an economy can grow without overheating). Back then, the Centre for European Reform worried about a growing mood of complacency taking root across the EU. Reform efforts had been weakest in several of the countries where they were most needed. And the prevailing wisdom of the time – that the EU was well-placed to weather the financial crisis originating in the US – seemed to us to be misplaced.[1]

[1] *Katinka Barysch, Simon Tilford and Philip Whyte, 'The Lisbon scorecard VIII: Is Europe ready for an economic storm?', CER report, February 2008.*

Any illusions that Europeans may have harboured a year ago have disappeared. The financial crisis has spread across the Atlantic – with devastating repercussions on the real economy. Credit has dried up. Industrial output has collapsed. Economies are contracting at an alarming rate. And unemployment is surging. Faced with the worst economic crisis since the 1930s, policy-makers are pushing through heterodox measures in a desperate bid to prop up ailing banks and stave off the threat of a full-blown economic depression. Banks are being recapitalised – and even nationalised. Traditionally conservative central banks are reaching for new tools to restore the effectiveness of monetary policy. And EU governments, having been repeatedly urged to consolidate their public finances, are now being exhorted by the International Monetary Fund to loosen their purse strings more aggressively. In December 2008, EU governments duly signed up to a co-ordinated fiscal stimulus package.

Picking through the wreckage of the past year, it is legitimate to ask what remains of the EU's Lisbon agenda. Since the agenda was launched, its implicit assumption has been that Europe's main challenges rest on the supply side – in freeing up markets for services and labour, improving skills, reforming pension systems, and so on. However, events over the past year pose several challenges to the legitimacy of the Lisbon agenda. The first is one of relevance – in the short term, at any rate. Supply-side factors are the key determinants of long-term growth and employment (and consequently of a country's prosperity). But measures to improve the supply side, desirable as they are, will do little to lift the EU (or the rest of the world) out of its current hole. The reason is that the short-term challenge rests on the demand side.[2] The Lisbon agenda provides no tools for combating the business cycle.

[2] *Paul Krugman, 'The return of depression economics and the crisis of 2008', Penguin 2008.*

Critics may even be tempted to see the Lisbon agenda as an obstacle to Europe's emergence from its current economic slump. So profound is the crisis that many of the Lisbon agenda's key targets and principles have had to be loosened or suspended. The Commission has rightly subordinated the enforcement of the Stability and Growth Pact to the short-term need for a pan-European fiscal stimulus. And it has had to show flexibility in interpreting competition policy in the face of state-funded recapitalisations of ailing banks. Inevitably, the suspension of key EU rules has provided grist to the mill of those who never liked the Lisbon agenda in the first place. Many Europeans have long seen it as an attempt to import dreaded 'Anglo-Saxon neo-liberalism' via the backdoor. The financial crisis, they believe, discredits the Anglo-Saxon model – and hence the Lisbon agenda.

So what is – or ought to be – left of Lisbon after the past year's events? The answer is: vastly more than its critics allow, but slightly less than some of its proponents assume. There is an obvious temptation to succumb to all-or-nothing logic. One response would be to argue that Lisbon is dead because the

financial crisis has exposed the bankruptcy of a reform programme with deregulation and market liberalisation at its core. This would be a mistake. For one thing, the crisis in the US did not result from weak innovation or low productivity. For another, more regulated economies in the EU, such as Spain, have suffered similar problems as the US – credit-fuelled booms, housing market bubbles and unsustainably large current account deficits. Besides, any regulatory shortcomings that may have been exposed in the financial sector have not strengthened the case for employment protection legislation, or obviated the case for increasing the effective age of retirement.

The financial crisis, then, must not become an excuse for throwing the baby out with the bath water. But it would be equally absurd to deny that the crisis has undermined some key assumptions about the financial sector. One is the desirability of allowing some of the most innovative segments of the financial sector to thrive with little or no regulatory oversight. Another is the wisdom of promoting cross-border integration by encouraging EU banks to take deposits in other member-states when their home countries do not have the financial wherewithal to bail them out (or, in the event of bankruptcy, to honour their legal commitments to compensate depositors in host countries). So the financial crisis raises awkward questions about the single market in financial services. And the financial sector will emerge from the crisis more regulated than before. But the EU needs to get the balance right. If it goes too far, it may end up with a financial system so safe that it stifles long-term growth.

In short, the Lisbon agenda is not an instrument for lifting the EU out of its current recession. And some of its features may have to be redesigned – particularly for financial services. But Lisbon's broad conceptual thrust has not been invalidated by the crisis. The fact remains that national policies and institutions which may have worked well for EU countries when they were in a phase of catch-up growth are ill-adapted now that there is a

[3] *Philippe Aghion, 'A primer on innovation and growth', Bruegel policy brief, October 2006.*

greater onus on them to innovate.[3] Countries that fail to make progress on their Lisbon targets are consequently likely to suffer from weak levels of productivity and employment. Put simply, countries which fail to reform will condemn themselves to lower living standards. Nor will they be safeguarding social values: they will be saddled with unsustainable public finances (because of ageing populations) and are likely to be more exposed to rising income inequalities flowing from globalisation and technological change.

The Lisbon agenda was originally designed to run from 2000 to 2010. This means it is now in its final stretch. So it is disappointing that most EU member-states are still so far from meeting their targets. True, most have made progress of sorts. However, this has been patchy. It has varied widely, both across countries and policy areas. For much of the period since 2000, too many EU countries have shown a lack of urgency – and some have been downright complacent. Overall, it is hard to avoid the conclusion that many governments have squandered the opportunity provided by the relatively benign economic backdrop which prevailed between 2000 and 2007. The EU has now entered what promises to be a deep and prolonged recession, and reforms are likely to become more difficult to push through in the face of rising social unrest. Indeed, there is a risk that governments will be tempted to row back, undermining the single market and the single currency in the process.

The Lisbon league table

The scorecard's 'Lisbon league table' (see page 12) provides an assessment of a country's overall Lisbon performance in 2008, and compares it with its performance in 2007 (see the Lisbon scorecard VIII, page 12). 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 impact the crisis will have on countries' scores.

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 can achieve 'hero' status, as can those that are catching up at a fast pace. Those that lag seriously behind and have made slow progress are designated as 'villains'.

Strong performers

Sweden and Denmark once again rank first and second in the table, although the positions of the two countries have reversed. This year Sweden, not Denmark, tops the ranking. The two countries are not without their weaknesses. Danish productivity growth has been weak for a number of years, holding back growth in per capita GDP. Sweden, for its part, has exceptionally high youth unemployment and large numbers of people on long-term sick leave. Nevertheless, the two Scandinavian member-states are close to what the architects of the Lisbon agenda envisaged for the whole of Europe. Sweden and Denmark show that it is possible to combine competitive markets with high levels of taxation and comprehensive welfare provision, and in the case of Denmark at least, a very high degree of labour flexibility. They score highly across indicators of social equity, labour market performance and environmental sustainability.

Sweden and Denmark are the heroes of this year's scorecard, but there is little to separate them from the third and fourth placed countries: the Netherlands and Austria. The Netherlands is in many respects the EU's most successful economy. Uniquely in the Union, it combines high levels of productivity with a high employment rate. EU countries typically have high productivity and low employment rates (such as France and Belgium) or high employment rates and relatively low productivity (such as Finland and the UK). The Netherlands is also the third wealthiest country in the EU, after Luxembourg and Ireland, and in both those economies GDP data are misleading indicators of living standards.[4] The Netherlands' principal weakness is the low level of R&D expenditure, which stood at just 1.7 per cent of GDP in 2007. However, this partly reflects the structure of the Dutch economy, which is heavily skewed towards services. Innovation in the service sector is much harder to measure than in manufacturing (see Lisbon VIII, page 24).

[4] Irish GDP is significantly inflated by multinational companies booking profits in the country, whereas Luxembourg's GDP is distorted by people working in the country but living with their families elsewhere.

Austria is rarely bracketed together with the Nordics as one of Europe's more successful economies, but arguably it should be. The country's strengths lie more in mechanical and electrical engineering than in sectors classed as 'knowledge-intensive' such as information and communication technologies (ICT) and pharmaceuticals. Nevertheless, Austria scores very well across nearly all social and labour indicators. It is one of only seven member-states to have an employment rate in excess of 70 per cent. Successive governments have acted to reduce the regulatory burdens facing business. On the negative side, productivity per hour worked is relatively low, the country's effective retirement age remains below 60, and Austria has a poor record of reducing emissions of greenhouse gases.

The Czech Republic is our final hero, rising five places in 2008 to 9th. The country has achieved relatively rapid economic growth (real GDP per capita stood at an estimated 82 per cent of the EU-27 average in 2008) without running up big budget or trade deficits. Czech business and foreign firms with operations in the country are moving up the value-chain. In 2007 R&D spending in the country was equivalent to over 1.5 per cent of GDP, and hence not far short of the EU average. Levels of social inequality are low and educational levels (at least, in terms of secondary schools) are high. However, the country's performance is not without its weaknesses. The labour market remains rigid, the business environment relatively poor and levels of internet access modest.

Must do better

Every EU member-state could do better. But for Europe's economic prospects five economies – France, Germany, Italy, Spain and the UK – matter most. Together they account for around 75 per cent of EU GDP, and what happens in these countries will largely determine the region's prospects for long-term growth. The UK narrowly remains the best performer among these bigger member-states, ranked 7th, just one place ahead of Germany. France slips one place to 10th. The performance of France, Germany and the UK is good compared with Europe's other two big economies, Italy and Spain. Spain slipped three places to 19th while Italy manages to climb just one place to 22nd. Both countries are classed as laggards (see below).

Strong growth in GDP per capita means that the UK is the wealthiest of the five big member-states (it ranks 7th in the EU-27).[5] It has the most competitive product markets in the EU and one of the most flexible labour markets. It also has a good record of reducing greenhouse gas emissions. The huge scale of the monetary and fiscal stimulus in place in the UK means that its economy will probably emerge from the downturn sooner than much of the EU. However, it is no longer clear that Britain's long-term growth prospects are better than those of France or Germany. Very slow reform of public services and a rapid increase in the size of the state will impose a drag on economic growth over the years ahead. The UK performs

[5] Measured at purchasing power parity.

relatively poorly across the social indicators included in the Lisbon agenda and the government urgently needs to address the country's increasingly serious infrastructure bottlenecks.

France has taken a succession of steps to improve the business environment and combat inequality. And it has a good record of curbing emissions of greenhouse gases. French productivity per hour is also easily the highest of the five big member-states. Unfortunately, there are plenty of negatives. The strong productivity performance is to a large extent the result of the country's dense labour laws. Employment is held back by very high labour taxes and onerous labour regulation. Although France's employment rate has risen, it still only ranks 17th in the EU. As a result, GDP per capita is now considerably below Germany and the UK. The French government, moreover, remains ambivalent towards the EU's competition rules. French moves to protect uncompetitive firms threaten to weaken France's growth prospects and undermine the single market.

Germany scores well on measures of innovation and environmental sustainability. The country also combines a relatively high employment rate with strong productivity. But Germany scores less well for social equity. It is one of the few member-states to have experienced a widening of social inequalities since 2000 and the rate of long-term unemployment is still high.

However, Germany's key handicap is the extreme weakness of domestic demand, which was masked in recent years by very rapid growth in exports. The export boom was a reflection of the strong expansion of world trade, but also the result of a big jump in the price competitiveness of German goods. This improved competitiveness was largely the result of cost cutting, not productivity improvements. Allowing domestic demand to stagnate and relying on exports for growth was never going to be a sustainable economic growth strategy. Inevitably, Germany is being hit exceptionally hard by the downturn. Demand for German exports is contracting dramatically. Moreover, with growth in the

global economy set to remain weak for several years, Germany cannot rely on exports to drive the eventual recovery. A more balanced economy would make Germany less vulnerable to shifts in demand for its key exports. But the key structural change needed in the German economy – a shift away from the excessive dependence on export-oriented manufacturing – could take a number of years to achieve.

Laggards

The Spanish economy was one of the most dynamic in Europe prior to the crisis, and easily the fastest growing of the bigger economies. However, as we noted in last year's scorecard, the Spanish 'economic miracle' was based on very shaky foundations. Spain's economic prospects have deteriorated dramatically. The collapse of the property boom has exposed Spain's underlying lack of competitiveness. With the credit bubble having burst, it can no longer rely on construction and debt-fuelled consumption to drive economic growth. Spain must rebalance its economy by boosting exports (its current account deficit was close to 10 per cent of GDP in 2008). Unable to devalue, Spain has no option but to ensure that its costs fall relative to the rest of the eurozone, and especially relative to Germany. There is a serious risk this will not happen. First, the Spanish government recently dismissed out of hand calls by the IMF to accelerate the structural reforms that are needed to boost the country's poor productivity performance. Second, it will not be easy for Spain to boost exports if the German economy remains so unbalanced. As noted above, even if the German government accepts the need for rebalancing, the process could take many years. The most likely outcome is that Spain's external deficit will act as a huge drag on economic growth, inflating the country's fiscal deficit.

The other two villains among the older member-states – Greece and Italy – face similar challenges. In 2000, GDP per capita in Italy was broadly similar to France, Germany and the UK. Since then, the country has seen a precipitous decline in its relative prosperity. This trend would have been bad enough had the country at least managed to boost its competitiveness vis-à-vis the rest of the eurozone over this period. Unfortunately, Italy has experienced the worst of both worlds: very weak growth and a steady increase in its costs relative to the rest of the eurozone. Italy's current account deficit is running at around 2.5 per cent of GDP, despite economic stagnation (an economy growing as weakly as Italy would not normally be running a deficit). Much as in the case of Spain, it needs two things to happen. First, it needs the German economy to start growing under its own steam. Second, Italy needs to raise its game. It scores poorly on just about every Lisbon indicator. Only Bulgaria, Hungary, Malta, Poland and Romania do worse. The signs are not good. The government of Silvio Berlusconi has been doing little to build on the limited reforms of its predecessor, under Romano Prodi.

Greece ranks 20th, down one place from last year, but this flatters the country. If anything, Greece's prospects are worse than Italy's. GDP per capita has grown rapidly since 2000, but this was fuelled by excessively low interest rates. The result is an implausibly large current account deficit of around 14 per cent of GDP. Investors have started to spurn Greek sovereign debt, with the difference (or 'spread') between the yield on Greek 10-year bonds and the German equivalents ballooning to 3 percentage points (from around 0.4 per cent a year ago). In the various areas of the scorecard, Greece is classed as a villain more times than any other country. Greeks are slow to adopt new technologies, and shortcomings in the education system mean that this is unlikely to change soon. Greek governments have consistently been among the slowest in the EU to liberalise product markets, and the country has one of the least favourable regulatory environments for business in the EU. Given the febrile political atmosphere in the country, it is a moot question whether the Greek authorities will be able to push through urgently needed reforms without triggering some sort of political crisis.

In previous years we have not always judged the new member-states by the same criteria as the long-standing ones because most of them start

from a much less favourable position. We still think a degree of latitude is warranted in the cases of Bulgaria and Romania, which only joined the EU in 2007, although it is clear that they have much to do. However, we do think Hungary and Poland can now be judged by the same criteria as the EU-15 states, and as a result should be classed as villains.

Both countries need to do much more if they are to succeed in bringing about a rapid convergence in living standards with the wealthier members of the EU. Hungary's macroeconomic and currency crises have brutally exposed the country's weaknesses. Because of its dependence on foreign borrowing to cover its external and budget deficits, the drying up of international capital markets has hit Hungary especially hard. The depreciation of the forint will help improve the price competitiveness of its exports, but in the longer term it must boost productivity growth. Therefore, the government needs to take steps to improve the labour market and inject more competition into protected sectors. It will have to take these steps against the backdrop of recession and fiscal austerity, which will not be easy.

On the face of it, Poland's low ranking (24th) is hard to justify. The Polish economy has expanded rapidly over the last few years, and it has done so without building up large internal and external imbalances. But this masks a very poor record of meeting the Lisbon criteria, casting doubts over the sustainability of Poland's economic growth. Despite some laudable efforts at reform, the Polish labour market remains generally sclerotic; the regulatory burden on business is one of the most onerous in the EU; the country performs very poorly on indicators of innovation; and overall investment levels are too low to ensure strong productivity growth.

The Lisbon process = C	
Heroes	Austria, Czech Republic, Denmark, Sweden
Villains	Greece, Hungary, Italy, Poland, Spain

The Lisbon league table: Overall Lisbon performance

	Rank 2008	Rank 2007
Sweden	1	2
Denmark	2	1
The Netherlands	3	4
Austria	4	3
Finland	5	5
Ireland	6	6
UK	7	7
Germany	8	8
Czech Republic	9	14
France	10	9
Estonia	11	11
Luxembourg	12	12
Belgium	13	13
Slovenia	14	10
Cyprus	15	15
Latvia	16	17
Lithuania	17	18
Slovakia	18	20
Spain	19	16
Greece	20	19
Portugal	21	21
Italy	22	23
Hungary	23	22
Poland	24	26
Bulgaria	25	25
Romania	26	24
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

Differences in 'technological readiness' help explain much of the variation in productivity growth between countries.[6] Unfortunately, many EU economies are slow to adopt new technologies. This is most striking in regard to information and communications technologies (ICT). Not only is investment in ICT too low in many member-states, but European firms tend to derive fewer benefits from their investment in ICT than their US counterparts. The full benefits of such investment can only be realised if firms accompany it with organisational restructuring. Unfortunately, in many EU economies such restructuring is still taking too long.

[6] *Groningen Growth and Development Centre, 'Industry growth accounting database', March 2006.*

Productivity growth in the EU-15, and in particular the eurozone, has been very disappointing since 2000. Only three EU-15 member-states – Ireland, Finland and Sweden – have achieved comparable growth to the US, and this despite the fact that the US started from a considerably higher level (see table on page 17). Far from narrowing, the gap in labour productivity between the EU and US has actually increased since 2000. Nor is higher US output per worker simply a reflection of the fact that Americans work longer hours than Europeans. US working hours are long, but so is output per hour worked. France and Belgium achieve similar output per hour worked as the US but with much lower employment rates. As a result of labour market rigidities in France and Belgium, companies have a strong incentive to employ capital over labour even where this is inefficient. Only the Netherlands manages similar productivity per hour as the US with a comparable employment rate.

Adoption of ICT

Some EU countries are now among the world's most sophisticated users of ICT. The Economist Intelligence Unit (EIU) compiles an annual e-readiness ranking, which assesses a country's ICT infrastructure, and the ability of its consumers, businesses and governments to benefit from ICT.[7] Five EU economies plus Switzerland are ranked among the top ten worldwide. Sweden ranks third, after the US and Hong Kong. The top-scoring EU member-states have impressive levels of internet use: over 80 per cent of households have access to the internet in Denmark, the Netherlands and Sweden, and the proportion exceeds 70 per cent in Finland, Germany and the UK. The level of broadband internet access in the Nordics and the Netherlands exceeds that of the US by a considerable margin, and is comparable to the US in France, Germany and the UK.

[7] *Economist Intelligence Unit, 'The 2008 e-readiness rankings', 2008.*

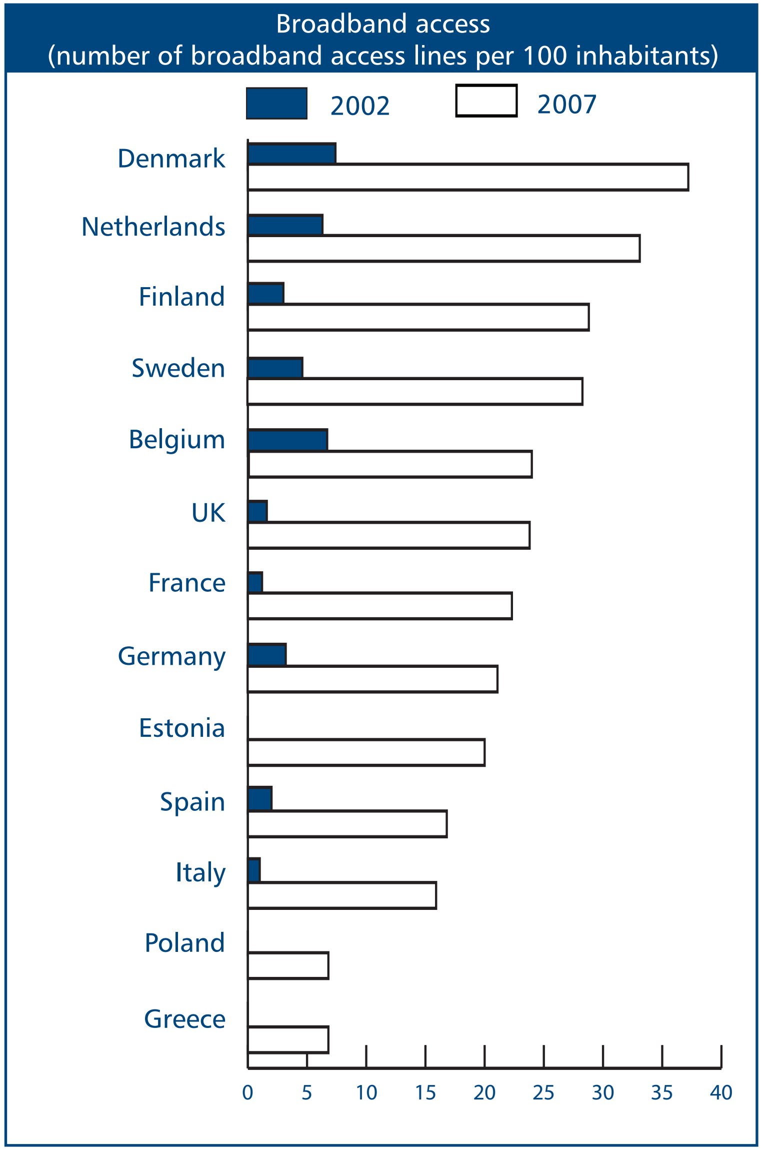
The EIU ranking also illustrates the extent of the digital divide within the EU, with the poorest placed EU-15 country, Greece, ranked 30th (out of 70 countries), and the lowest ranked EU-27 state, Bulgaria, in 48th position. Just 31 per cent of Greek households had access to the internet in 2008, and there were less than seven broadband connections per 100 inhabitants (see page 18). The figures for Italy were not much better. Forty-one per cent of households had internet access and there were 15.9 broadband connections per 100 inhabitants. The best performing of the new member-states are doing far better than the EU-15

laggards. Around half of Czech, Polish, Latvian and Lithuanian households had internet access in 2007 and almost 60 per cent of Estonian, Slovenian and Slovak ones.

E-readiness rankings, 2008

	Score (out of 70 countries)	E-readiness score (out of 10)
US	1	8.95
Hong Kong	2	8.91
Sweden	3	8.85
Australia	4	8.83
Denmark	5	8.83
The Netherlands	7	8.74
UK	8	8.68
Finland	13	8.42
Germany	14	8.39
France	22	7.92
Italy	25	7.55
Spain	26	7.46
Greece	30	6.72
Romania	45	5.46
Bulgaria	48	5.19

Source: Economist Intelligence Unit



Source: Eurostat

The readiness of EU governments to exploit ICT to make it cheaper and easier to access government services has also varied considerably. According to the latest figures from the European Commission, 68 per cent of government services in the EU were available online in 2008, up from an estimated 25 per cent in 2002. The best performing EU-15 countries were Austria, Portugal and the UK. Among the new member-states, Slovenia performs well, as does Estonia. In terms of the actual usage of e-government services, citizens in the Nordic countries and the Netherlands are the most likely to interact with the government online. In terms of business usage, Denmark, Finland, Ireland, Slovakia and Estonia stand out as strong performers.

ICT and productivity

There is robust statistical evidence linking expenditure on ICT with productivity growth.[8] The performance of EU economies appears to corroborate this. Those economies that have posted high rates of investment in ICT have generally achieved stronger growth in labour and total factor productivity (TFP). TFP is a measure of the efficiency with which labour and capital are used. Economists think that TFP is a better measure of technological progress than labour productivity, which is largely driven by rates of capital spending. Many factors influence TFP, such as labour market flexibility, education levels, regulatory frameworks, and the general climate for innovation. But the level of expenditure and diffusion of ICT throughout the economy is crucial.

[8] *Groningen Growth and Development Centre, 'Industry growth accounting database', March 2006.*

With the exception of Sweden and Finland, EU countries have not seen the same productivity gains as the US over the past five years. This is most obvious in regard to TFP. Sweden and Finland have achieved higher rates of TFP in recent years than the US. But the big EU economies – France, Germany, Italy, Spain and the UK – have lagged the US by a considerable margin. The performance of Italy and Spain raises particular concerns. The exceptionally low rates of labour productivity growth in Spain and Italy partly reflected strong growth in employment in these two countries, especially in Spain, between 2002 and 2007. But the extremely weak performance of TFP highlights how serious the underlying productivity problem is in these two countries.

ICT and productivity

	Growth in total factor productivity, 2002-07	Growth in labour productivity, 2002-07	Investment in ICT (per cent, GDP), 2002-06
Finland	2.4	2.1	3.4
Sweden	1.6	2.6	4.2
UK	0.8	1.7	3.9
Germany	0.7	1.0	3.0
France	0.5	1.2	3.2
Spain	-0.4	0.0	1.6
Italy	-0.6	-0.2	1.9
US	1.1	1.9	3.8

Source: Economist Intelligence Unit, Eurostat

Organisational change

The pace of organisational change in businesses needs to rise if EU economies are to make better use of new technologies. The reasons for the slow speed at which businesses in many member-states restructure reflect a range of factors, but three stand out:

★ **Labour market regulation.** Excessive labour market regulation makes it hard to lay-off staff or to redeploy them. It therefore reduces both the profitability of investment in ICT and firms' ability to profit fully from such investment. Relaxing employment protection legislation could also make it less costly for firms to restructure – and hence accelerate the diffusion of new technology. There has been a progressive liberalisation of labour markets across the EU since 2000, but some member-states – including France, Spain and Italy – still have very restrictive legislation.

★ **The fragmentation of the EU market.** There is a lack of service sector competition within individual member-states and between them, which reduces incentives for companies to make efficient use of ICT. Many European services markets are still a long way from being fully integrated, meaning it is harder for companies to achieve the economies of scale needed to justify investment in new technologies. The worst thing EU governments could do would be to react to the economic crisis by slowing the pace of liberalisation at both national and EU levels.

★ **Skills levels.** Many EU countries also suffer from a lack of workers with the necessary skills to make the most of new technology. In Spain, Italy and the UK, for example, too many people leave school without completing secondary education and do not go into training. All three countries will soon have to make swinging cuts in public spending, threatening investment in education.

Information society = B	
Heroes	Estonia, Finland, Sweden
Villains	Bulgaria, Greece, Italy

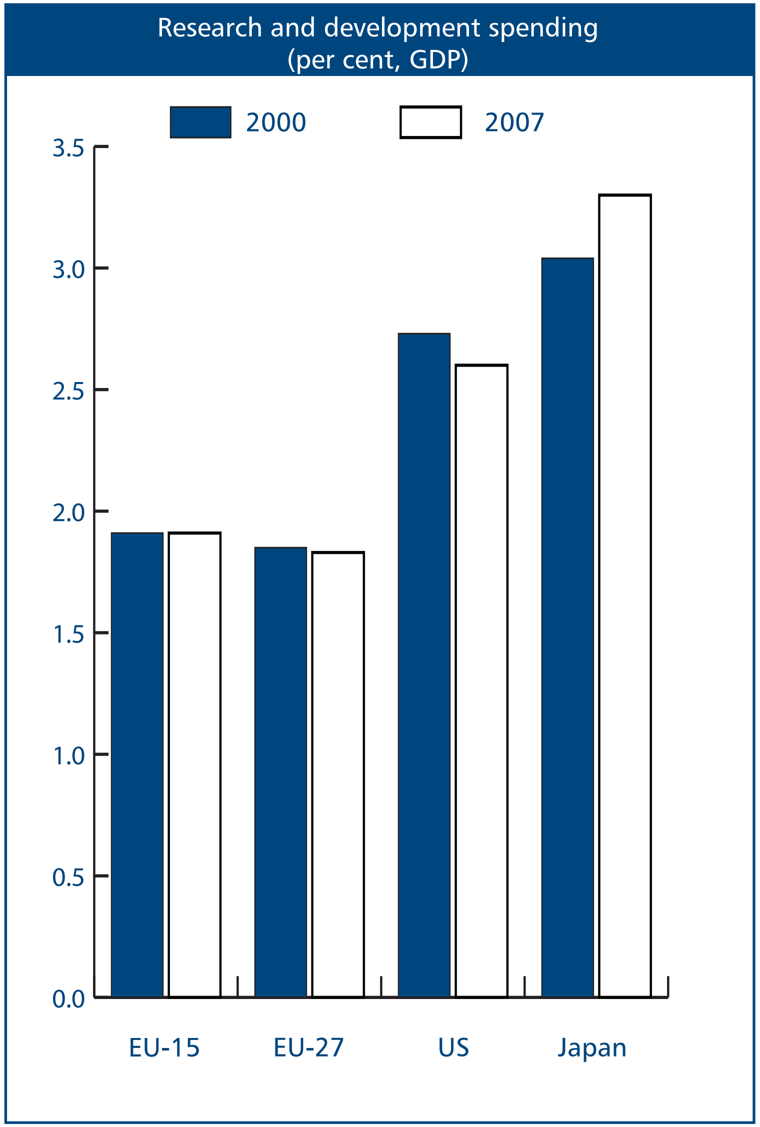
A2. Research and development

★ Agreement on a European Community patent

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

The creation and diffusion of knowledge is key to driving productivity growth. Economic growth in the EU in recent years has been heavily dependent on rising employment rather than improvements in productivity. While it is important to bring more people into the workforce (see section D1), the underlying weakness of productivity growth across much of the EU is the biggest economic challenge facing Europe. Unless productivity growth improves, governments will struggle to cope with the impact of population ageing on public finances, and living standards will stagnate or even start to fall.

The EU acknowledged the importance of raising Europe's capacity for innovation by setting a target of 3 per cent of GDP for spending on R&D. The EU as a whole is nowhere near meeting this target. In 2007, spending on R&D accounted for 1.9 per cent of EU GDP, unchanged from 2000. The EU's performance compares poorly with the US and Japan, where the proportion in 2007 was 2.6 per cent and 3.1 per cent respectively. Just two EU member-states – Finland and Sweden – meet the target of 3 per cent, and no others will do so by 2010. Indeed, 21 of the 27 EU economies devoted less than 2 per cent of GDP to R&D in 2007. Moreover, it is not just the poorer new member-states that spend little. Spain and Italy devoted just 1.2 per cent of their GDP to R&D.

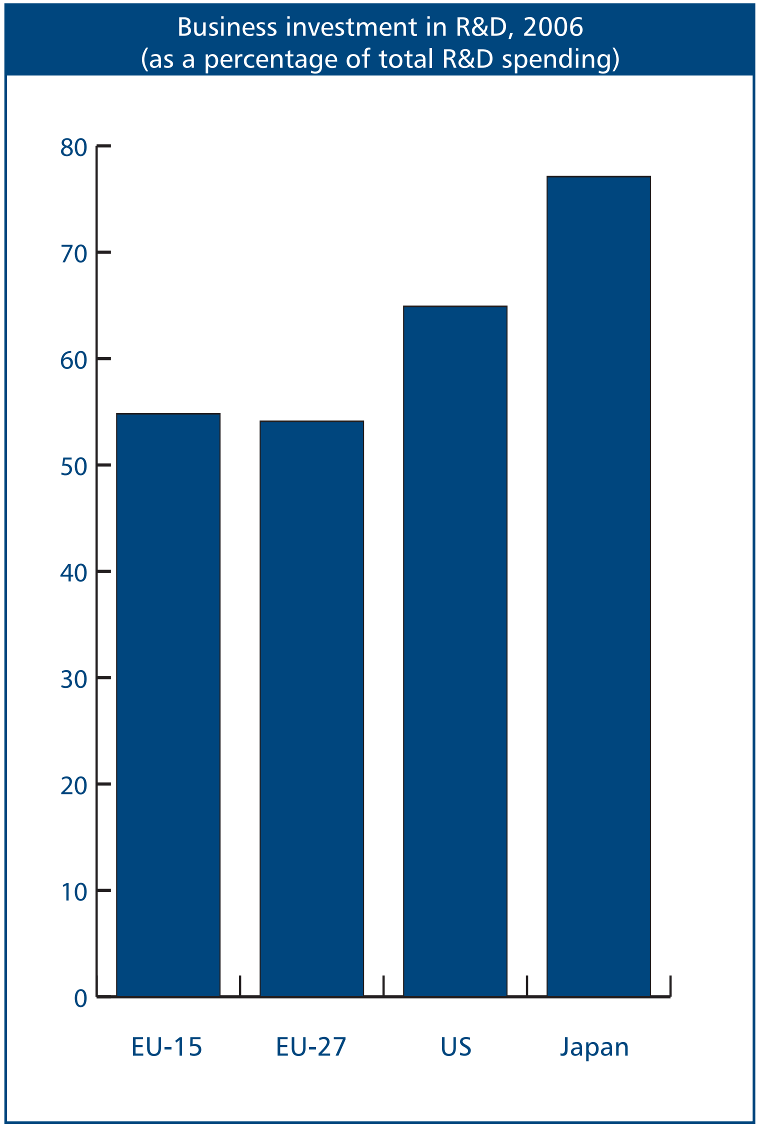


Source: Eurostat
2007 data for the US and Japan are estimates

Because of the dearth of fast-growing R&D-intensive firms in Europe, R&D spending in the EU is also heavily dependent on public spending. Private businesses account for only 55 per cent of EU investment in R&D, compared with two-thirds in the US and three-quarters in Japan. As a proportion of GDP, European companies invest little over half as much as their American and Japanese counterparts. Business spending on R&D will also fall over the next two years as the economic crisis depresses overall investment. Europe's relatively high dependence on public-funded R&D is not necessarily a problem. Public investment in R&D can be very useful, if it leads to the commercial application of new technologies. Unfortunately, Europe as a whole makes poor use of publicly-funded R&D because of generally weak links between universities and business. One of the objectives of the European Research Area (ERA), launched in 1997, was to improve knowledge transfer between the research institutions and industry.[9] The ERA performs a useful function, but more determined action to improve links between universities and companies is needed at national level.

[9] The European Research Area is a system of scientific research programmes integrating the European Union's scientific resources.

Although business investment in R&D is too low across the EU, it is important to remember that, in some industries, European firms are highly innovative. In the sectors where Europe is successful – the automotive industry, aerospace, mechanical and electrical engineering, and pharmaceuticals – European companies invest as much in R&D as their US counterparts. But these are very established industries. Europe as a whole is poor at producing new fast-growing high-tech businesses that spend heavily on R&D. Europe is not short of small high-tech start-ups, but few grow into major businesses. Across the EU, there are strikingly few big firms in fast-growing (and R&D-intensive) sectors, with the notable exception of mobile telephony.



Source: Eurostat

The EU as a whole is too slow to shift resources from mature, slow-growing industries into faster-growing, knowledge-based ones. Policies aimed at stimulating R&D directly, such as tax breaks and subsidies, will do little to address the weakness of private sector R&D spending, as they do not tackle the reasons why high-tech firms find it so difficult to grow. Indeed, the member-states with the most generous tax incentives for R&D – Spain and Italy – have among the lowest levels of R&D. Companies need market incentives to invest in innovative technologies and undertake organisational change. EU governments need to concentrate on the following:

Deepening the single market: In order to accelerate the pace at which European economies re-allocate resources, the single market needs to be deepened by further liberalising product and labour markets. In many areas, rules and regulations in Europe act as a constraint on productivity growth. Although the gap has narrowed, EU product and labour markets remain highly regulated compared with the US.[10] The need for action is most obvious in the case of services. At present, services sectors are fragmented, with the result that there is often insufficient scale to make innovation worthwhile. According to data from the OECD, services sector R&D in the EU is just a third of the US level, even though the two economies are of comparable size.[11]

[10] OECD, 'Economic survey of the European Union', 2007.

[11] OECD, 'Main science and technology indicators', 2nd edition, 2008.

Service sectors account for around two-thirds of economic activity in most eurozone states, but service sector productivity has been extremely weak for a number of years now, especially in Italy, Spain, Greece and Portugal. More competition at both national and European level would do much to change this, and boost economic growth. Sadly, there is a risk that the downturn will further increase resistance to precisely the kinds of economic reform that are needed to accelerate the pace at which resources are redeployed. The financial crisis has emboldened those political forces that have always been sceptical of the case for liberalisation and more integration. For example, faster action to liberalise and integrate service sectors across the eurozone now looks almost out of the question.

A single European patent: At present, firms or individuals have to file a patent in every member-state, a time-consuming and costly process. The total cost of an EU-wide patent is around €50,000, fives times as high as in the US and three times as high as in Japan.[12] This fractured regulatory framework poses a particular problem for small and medium-sized (SMEs) firms. SMEs file far more patents per employee than big ones, and generate the majority of employment growth. Anything that discourages these businesses from commercialising new ideas is bad for the European economy.

[12] *The Association for Competitive Technology, 'Entrepreneurship environments: Inspiring a de novo research agenda', December 2008.*

There is near unanimous support for an EU patent among the member-states, but agreement has consistently foundered on the question of which languages the patent should be translated into. To translate into all 23 EU languages would be time-consuming and expensive. The French government had hoped to make progress on resolving the issue during its presidency in the second half of 2008, but the language problem proved intractable. The EU needs to move quickly to resolve this issue. There must be full harmonisation of the approval process, and a single European patent that only has to be translated into two languages: the language of the filer's country of origin and English, the closest Europe has to a *lingua franca*.

Financing: The EU as a whole continues to lag a long way behind the US in the provision of venture capital. Even the leading EU member-states in this area – Germany, Sweden and the UK – have a poor record of providing venture capital for high-tech start-ups as opposed to mature companies. There is no European equivalent of the Nasdaq market for fast-growing firms, for example. There is also a risk that the financial crisis will reverse the growth of the venture capital industry by undermining the development of equity markets.

The alternative – bank-based financing – is ill-suited to the financing of high-tech companies, because they mostly have little in the way of collateral. High-tech start-ups need investors that are prepared to take equity.

Venture capital

	Annual investment by venture capital funds (per cent of GDP), 2007	Percentage share of high-technology sectors in total venture capital, 2007
US	0.16	87.0
Denmark	0.09	63.0
Finland	0.21	52.0
Germany	0.05	35.0
UK	0.34	30.0
France	0.09	27.0
Spain	0.12	26.0
Italy	0.02	21.0

Source: OECD, Eurostat

Human capital: Innovation and the adoption of new technologies are impossible without human capital. Overall, the EU continues to invest too little in higher education and too many Europeans lack relevant skills. While considerable progress has been made across the EU since 2000 in raising educational standards, many member-states still have much to do (See section D2). A small number – the Nordics and the Netherlands – perform very well, but the five big EU economies have a mediocre record. France, Germany and the UK perform adequately, but Spain and Italy do not. Indeed, all of the southern countries – Greece, Italy, Portugal and Spain – lag behind many of the new member-states, and need to raise their game. Unless they can improve their education outcomes, they will struggle to develop and absorb new technology and boost productivity.

Public procurement: Public procurement of goods and services is a badly used resource in the EU. Government procurement accounts for around 15 per cent of EU GDP and could play a greater role in stimulating innovation. The US has long used public procurement to create demand for advanced technologies, and many successful US technology firms have their origins in the US small business innovation research (SBIR) programme.[13] In December 2007, the European Commission launched the Lead Market Initiative (LMI), which aims to create pan-European markets for key environmental technologies: protective textiles, sustainable construction, recycling, bio-based products, renewable energy and so-called eHealth (the application of ICT to the healthcare sector).[14] By standardising legislation and encouraging pan-European public procurement, the EU hopes to promote favourable market conditions for the commercialisation of new technologies. The programme is a modest step forward, but could prove to be a blue-print for a more ambitious scheme.

[13] *SBIR was established in 1982 and is the world's largest seed capital programme for science and technology businesses.*

[14] *European Commission, 'A lead market initiative for Europe', December 2007.*

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

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 would lower prices and improve services for households and enterprises. In the energy sector, more competition should encourage investment as well as help meet a number of other EU objectives, such as security of supply and the fight against global warming. For example, suppliers of renewable energy such as wind or solar power should have better access to electricity grids in markets where ownership of electricity generation and distribution have been separated (or 'unbundled'); more links between national markets would enhance security of supply by reducing the risk of countries being held hostage by a dominant supplier.

Industrial users have had the right to choose between alternative suppliers of gas and electricity since July 2004. However, five years after the deadline, competition in wholesale energy markets remains limited in many EU countries. Former monopolies (often still with state involvement) continue to play a dominant role in many national markets. In some countries, for example Finland or Malta, the dominant position of the incumbent is the result of a tiny local market or an isolated location. But in others, such as France, slow progress in market opening and the absence of real business opportunities for newcomers appear to be the main reasons.

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. In

France just two companies, Gaz de France and Total, account for 95 per cent of all gas imports. Since these two companies also control the pipeline network, few customers have benefited from real choice. In many of the new member-states, quasi-monopolies still import, transport and distribute all natural gas. The UK, on the other hand, liberalised its gas market in the 1980s. Today there are a multitude of players, ranging from the former state-owned monopoly to the big power companies (which offer packages of gas and electricity supplies) to foreign players (including Gaz de France and the German Wintershall).

In the electricity sector, France also stands out as the least open among the big countries. Electricité de France accounts for 87 per cent of power production, owns the transmission network and directly supplies 95 per cent of customers. However, France is not alone: competition in wholesale electricity markets remains elusive in many member-states, in particular those that joined the EU in 2004 and 2007.

The picture is barely better when it comes to the retail sector. Since July 2007 all EU consumers have had a legal right 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.[15] This is partly because in many member-states it remains difficult to move between suppliers. Also, the experience from those countries that liberalised their retail energy markets long before the 2007 deadline, such as the Netherlands, Sweden and the UK, indicates that it can take years before households start changing suppliers.[16] In February 2009, the Commission announced an investigation into the EU's retail electricity market, citing the difficulties consumers have in switching and the huge variations in pre-tax domestic energy prices.

[15] *European Commission, 'Monitoring consumer outcomes in the single market: Second edition of the consumer markets scoreboard', January 2009.*

[16] *Capgemini, 'European energy markets observatory', 9th edition, November 2007.*

Competition policy is key

The Commission has been pursuing a twin-track strategy to open up energy markets, focusing on both competition policy and legislation. In September 2007, it published new draft legislation designed to make market liberalisation a reality. However, the Commission's proposal to force the large integrated energy groups to sell their transmission assets – so-called unbundling – was met with fierce opposition from a minority of EU governments led by France and Germany. They argued that only big vertically integrated groups have the necessary financial resources to invest in new capacity. In addition, they said powerful companies were needed in order to negotiate effectively with suppliers, such as Russia's Gazprom.

Energy ministers finally hammered out a compromise in October 2008. Under this agreement, vertically integrated firms will be permitted to retain ownership of their electricity and gas distribution grids, provided that these are subject to independent monitoring. A firm's grid business will have to be managed by an independent institution – a so-called Independent Transmission Operator (ITO). The body will, in turn, be monitored by a supervisory board, comprising representatives of the power company, the ITO itself and third parties such as the national regulator.

October's political compromise was not without merit. First, the requirement to establish an independent organisation to run the network infrastructure will make it less attractive for energy suppliers to hold on to their transmission infrastructure. Second, the governments of countries that have unbundled their energy assets will be able to bar vertically integrated firms based in countries that have not from buying their distribution networks. Third, individual member-states will be able to negotiate bilateral investment agreements with non-EU suppliers. In these agreements they can make investment by a third-country supplier, such as Gazprom, conditional on the firm's home country giving the same access to its markets as foreign firms have to operate in the EU.

However, 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 by the energy ministers. Indeed, competition policy has become the primary 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 found that they had used their control of networks to prevent rivals from entering the regional market they dominate. They agreed to unbundle in exchange for not having to pay fines, which in the case of E.ON could have totalled €7 billion.

The decision by the two German groups represents a big boost to the drive to liberalise the EU's energy markets. The Commission's pursuit of E.ON and RWE and their decision to compromise caused political consternation in Germany. But with unbundling a reality in the country, opposition from the German government should dissipate. The EU will not make another attempt at forging a political consensus in favour of unbundling. But a changed German stance means that the implementation of the compromise agreement may be more forceful. Moreover, the Commission is also likely to seek similar compromises with other vertically integrated groups, not least in France.

A level playing field for telecoms

The liberalisation of European telecoms markets started earlier and has gone much further than in energy. The prices of telecoms services have fallen dramatically in real terms across the EU as a result of increased competition. In some telecoms markets, such as mobile telephony, market integration is advanced. Nevertheless, some of the remaining problems are similar to those in the energy sector, such as the strong role of incumbents that own networks.

There are still too few telecoms companies able to provide single pan-European services. 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, Spain's Telefonica and Ireland's Eircom still control around 80 per cent of local calls, while in Germany and the UK the share of the former monopolies is less than 60 per cent. There tends to be a little more competition in national long-distance 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' market share in 2006 (the latest year available) was less than 40 per cent on average, and as low as 25-30 per cent in Denmark and the UK.

Market dominance tends to be reflected in higher prices: in 2006 Slovaks paid roughly twice as much for local calls as Dutch customers. Latvians got charged €6 for a 10-minute call to the US, and Greeks €3.50, but Swedes only €1.20 and Germans just €0.50. But the correlation does not hold in all cases. For example, Britons and Finns pay above the EU average for overseas calls, despite their highly competitive telecoms markets.

Although the integration of the telecoms markets has gone further than in other network industries, there are big differences in the way they are regulated across the EU. The Netherlands and the UK are deemed to have the best regulatory environments in the EU, while the Czech Republic, Greece and Poland have the worst.[17] The Commission believes that a true single market will only come about when there has been a harmonisation of regulatory frameworks.

[17] *European Competitive Telecommunications Association, 'Regulatory scorecard 2008', February 2008.*

In theory, the EU's 27 national telecoms regulators work closely together through the European Regulators Group (ERG). In practice, harmonisation and joint initiatives are rare, even in areas with clear cross-border implications. For example, in 2007 the Commission forced mobile phone operators to cut the 'roaming' charges that Europeans pay for using their mobile phones abroad, after national regulators had failed to act. Moreover, differences between member-states over how to regulate the sector create substantial barriers to competition. For example, a contentious law allows Deutsche Telekom to deny possible competitors access to its new high-speed broadband network. The Commission says that such differences are not acceptable in an EU where most big telecoms companies operate across borders.

In November 2007, the Commission put forward a telecoms reform package. Parts of this proved uncontroversial, such as making it easier for customers to keep their numbers when switching providers or making it possible to call free-phone numbers from abroad. But the two most important proposals proved highly controversial – the establishment of a European telecoms market authority with power over national telecoms regulators, and the proposal to split the management of telecoms networks from the provision of call and internet services ('functional unbundling'). The two proposals are inter-twined: a greater supranational regulatory component would make it harder for national regulatory bodies to dismiss the case for unbundling.

The Commission's proposal to empower the new EU regulatory body with the right to tell national regulators which measures they should use against recalcitrant incumbents came up against fierce resistance. Moreover, it was not just countries such as France and Germany which have resisted functional unbundling. The UK government was also opposed on the grounds that it would impose a further layer of bureaucracy and violate the principle of subsidiarity. As a result, the proposal was heavily watered down. Instead of the proposed staff of 130, the new body will have just 20 people. These will be seconded from national regulators and will have very limited influence over national bodies.

Critics of the Commission's proposals argued that functional unbundling would result in underinvestment in network

infrastructure. They stressed that the existence of different technologies for providing telecoms services already ensured that there was enough competition. It proved impossible to gain agreement on this issue. Under the compromise reached, national regulators will, in theory, have slightly greater powers to enforce functional separation. But it is unclear what this will mean in practice, as national regulators could simply opt against using these powers. As the new EU-level regulatory body will lack independence, it will not be able to request national regulators to exercise their powers.

Overall, the compromise is a setback for a single market in telecoms. The Commission was right to put the burden of proof on those who argue that technological change and voluntary co-operation among regulators are enough to deliver open and innovative telecoms markets. Some member-states raised legitimate concerns over how new network infrastructure would be financed in the absence of vertically integrated firms. But this is hardly a compelling argument against unbundling. Investment has not been lower in countries that have spun-off network operations, such as Britain, Italy and Spain, than in France and Germany, which have not. Rather, there needs to be a regulatory solution that provides the owner of the network with sufficient incentives to make the necessary investments in new technology. The Commission should now focus on using competition policy to prevent market abuse. If vertically integrated firms are using their quasi-monopolistic positions to profit at the expense of consumers and rivals, the Commission needs to take action against them.

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

B2. Transport

★ Encourage investment in trans-European networks

★ Create a single European sky

★ Increase competition in the railways sector

The transport sector's importance to the European economy goes well beyond its direct contribution to growth and jobs. Because of the pivotal role it plays in labour mobility and in the distribution of goods and services, a modern, integrated and reliable transport system has an important influence on productivity. Transport policy at EU level has focused on two broad priorities. The first has been to improve the underlying infrastructure by developing transport links between countries (known as 'trans-European networks') and by improving connections between different modes of transport. The second has been to increase competition by liberalising the provision of transport services on air, land and water.[18] Progress on both fronts has been uneven. The EU's programme to upgrade transport connections has struggled to overcome funding problems, while the liberalisation of transport services has proceeded more sluggishly on land and water than it has in the air.

18 European Commission, 'Keep Europe moving – mid-term review of the 2001 transport white paper', June 2006.

Improving transport connections between EU countries

Many EU countries already boast some of the best transport infrastructure in the world. But there is still scope for improving connections between them. Although the member-states are primarily responsible for investing in roads, airports and railways, the EU is giving a helping hand by filling in missing cross-border links – particularly in parts of Europe where such connections are likely to boost economic development. However, most of the 30 priority axes for trans-European networks in the transport sector (TEN-Ts) identified by the Commission have fallen behind schedule.

Progress on some of these axes is being hampered by procedural and technical problems. But the principal cause of the delays is financial.

The problem is two-fold: EU funding for TEN-Ts is tiny; and it has proved hard to find national sources of funding for cross-border projects, which are complex and financially risky. The cost of completing the EU's 30 priority axes is projected to total €250 billion by 2020. If non-priority projects are added, the estimated cost for all TEN-T projects rises to €600 billion. The EU's budget for TEN-Ts for the period from 2007 to 2013 amounts to just €8 billion (of which €5.1 billion is reserved for the 30 priority projects). So even if loans from the European Investment Bank (EIB) are added, most of the onus for funding TEN-Ts still rests with national governments and private investors. The European Commission has tried to tackle the problem of co-ordination. It has appointed 'European co-ordinators' to bang heads together and to promote cross-border projects to private investors. And it has joined forces with the EIB to create a 'loan guarantee instrument for trans-European transport network projects'. The loan guarantee aims to increase private-sector participation by covering commercial risk during a project's initial phase of operation, when an operator might have difficulties paying back loans on time because of lower than expected revenues.

The Commission's efforts have been laudable, but they will be hampered by the financial crisis. Although the EU signed up to a co-ordinated fiscal stimulus in late 2008, it is unlikely that this will provide much impetus to TEN-Ts. The EU's budget for 2007-13 is fixed, so the most the European Commission can do is to bring forward future spending and use unspent funds that would otherwise be returned to the member-states. Budgetary positions in many of the member-states are weak, and fiscal stimulus packages are in any case likely to focus on national rather than cross-border projects. Finally, it is hard to see how the private sector can step into the breach when the availability of credit is so constrained.

Increasing competition in transport services

The liberalisation of transport across the EU has been a qualified success. The poster child has unquestionably been air transport, where increased competition has brought about dramatic falls in prices and a huge increase in passenger choice. Passenger numbers have surged since the mid-1990s and air transport has increased its share of intra-EU passenger transport to nearly 10 per cent of the total. The Commission has rightly tried to extend the benefits of liberalisation by negotiating agreements between the EU and commercial partners outside Europe. The agreement which it signed with the US came into force in 2008. This now allows all EU and US airlines to fly any route between a city in the EU and a city in the US. However, the agreement is not a full 'open skies' agreement because it excludes cabotage (that is, it does not allow an EU airline to offer services between US cities) and EU carriers cannot take stakes of more than 25 per cent in US airlines. The removal of these restrictions would provide an additional fillip to competition in the transatlantic marketplace – the world's largest economic artery.

The liberalisation of the rail sector has been more fitful. Successive packages of EU legislation to open railways to competition have been adopted. A first 'package' required member-states to 'unbundle' the management of tracks from transport services. A second package, adopted in 2002, provided for the full liberalisation of rail freight by 2007. And a third package, adopted in 2007, is set to open international and domestic passenger services to competition by 2010. But adopting EU legislation is one thing, implementing it is another. Encouragingly, many countries that were laggards two years ago are now on schedule: foreign rail freight operators are licensed and actively operating in most EU countries. However, the actual degree of competition on national networks varies widely, suggesting that there may still be national impediments. A number of state-owned railways have accused each other of exercising influence over their countries' rail networks to obstruct competition at home, while trying to establish footholds in foreign markets.[19]

[19] Robert Wright, 'Tensions high between rail operators', Financial Times, December 11th 2008.

Transport and negative externalities

Transport generates 'negative externalities' – that is, costs such as pollution that are borne by everyone, whether they travel or not. So building an efficient European transport network has to be balanced against other considerations. The Commission's approach to negative externalities has been the right one. Its programme for TEN-Ts is trying to promote the most ecologically sustainable modes of transport by concentrating most EU investment on the least polluting mode of transport (rail). It is also trying to ensure that the costs of pollution are borne by those who cause it. The Commission has, for example, proposed a directive to bring air transport within the scope of the EU's emissions trading scheme. And it is promoting the use of 'smart-charging' on roads, notably in the form of a directive on the charging of heavy goods vehicles, which is due to enter into force in 2010.

However, the EU faces an uphill task in containing the rise in greenhouse gas emissions from transport. The problem is that economic growth generates increased demand for transport services – and that this will fall primarily on the most polluting modes of transport (air and roads). By 2020, railways will account for an even smaller share of passenger and freight transport than they do at present. As a result, total emissions from transport are set to increase over the next decade, despite a continued fall in emissions from the rail sector.

Transport = C-	
Heroes	Germany, Sweden
Villains	Greece, Ireland

B3. Financial and general services

★ Create a single market in services

★ Complete the financial services action plan

Services tend to attract less publicity than manufacturing. This is unfortunate, because they matter more for the EU's future prosperity. Since they account for a much larger share of GDP than manufacturing – 70 per cent or more in most EU countries – a one percentage point gain in productivity in the service sector will have a greater impact on European living standards than a similar-sized increase in manufacturing. The widening of the EU's productivity gap with the US since the mid-1990s is mainly explained by trends in the service sector. And part of the reason for the transatlantic productivity gap is that the EU's services market is less integrated than that in the US: comparisons with the US suggest that services trade between EU countries is lower than would be expected in a fully integrated market.

So the EU has justifiably focused on removing the barriers that still segment national services markets. But of all the objectives set out in the Lisbon agenda, the integration of services markets has proved to be one of the most contentious. The Commission's attempts to create a single market in general services ran into such bitter political opposition that it contributed to the rejection of the EU's constitutional treaty in 2005. More recently, the financial crisis has exposed worrying fault-lines in the design of the EU's single market for financial services – and raised questions about the wisdom of continuing to promote cross-border banking integration on the basis of current regulatory arrangements.

General services

Firms find it difficult to provide services across the EU. Rules that openly discriminate against foreign providers are becoming rarer, as their existence is challenged and they are struck down by the courts.

But the existence of 27 different national regulatory regimes in the EU inevitably creates obstacles to firms wanting to provide services across borders. The effect of these national obstacles is to inhibit competition, slow productivity growth, and create interest groups opposed to change. The Commission has been pushing for many years for greater integration of the EU's services market. Initially, it attempted to apply a sweeping mutual recognition principle that would have allowed service providers operating temporarily in another EU member-state to follow the regulations of their home country. However, the proposal (the so-called Bolkestein directive) was blocked by a number of wealthier member-states, which feared that it would spark a regulatory 'race to the bottom'. So the EU settled for a less ambitious directive, which enters into force in 2010.

The services directive does not attempt to prise national markets open through mutual recognition. Instead, it reasserts the treaty's commitment to the free provision of services; and limits the number of "overriding reasons of national interest" that can be invoked to justify national restrictions. Although the directive should in theory make it easier for firms to provide services across borders, its practical consequences could be limited. One reason is that many sectors – from healthcare to urban transport and services provided by notaries – are exempted from the directive. Another is that member-states are likely to continue defending their national regulatory regimes. Regulatory barriers will therefore need to be challenged individually in each country and sector. This will inevitably be a laborious and frustrating process – not least because service providers may find it hard to prove that regulatory regimes are discriminatory, disproportionate or unnecessary. Even after the directive comes into force, therefore, the EU's market for services is likely to remain fragmented.

Financial services

Until the financial crisis broke out, the integration of the EU's market for financial services was proceeding more serenely than

that for general services. Market integration in the financial sector has been spurred by three factors: the introduction of the euro; improvements in the underlying technological infrastructure; and an ambitious legislative programme, known as the Financial Services Action Plan (FSAP), to lower the regulatory barriers that prevent financial institutions from selling their products and services across the EU. As a legislative programme, the FSAP had run its course: all of its 42 measures, including the market in financial instruments directive (Mifid), had been adopted. True, the EU's single market in financial services had still not been completed. The integration of EU securities markets 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 retail banking was still a work in progress.[20]

[20] *David Shirreff, 'European retail banking: Will there ever be a single market?', CER policy brief, December 2007.*

Overall, however, the story before the financial crisis was of a market that was making reasonable progress on cross-border integration. Since the financial crisis broke out, this can no longer be said with the same level of confidence. The financial crisis has exposed some problems with the functioning of the single market in banking. One, which was brought to light by the failure of Icelandic banks in late 2008, concerns the ability of some countries to honour their legal commitments to depositors in other member-states if one of their banks fails. Another, illustrated by Ireland in October 2008 is the lack of concern that some EU countries show for the cross-border impact of their policies when they are trying to shore up confidence in their banking systems. The third issue is the emergence of banks which have developed such large cross-border exposures that they have outgrown the capacity of their home country state to bail out. Iceland's plight highlighted the problem, but a number of EU countries could be in the same boat – particularly those whose banks have developed large cross-border exposures to rapidly contracting economies in eastern Europe and elsewhere.

Recent events have thrown a worrying spotlight on the adequacy of the EU's regulatory arrangements, and on the wisdom of promoting cross-border integration on the basis of them. Since the launch of the single market programme in the late 1980s, the EU has sought to open up financial services markets on the basis of the so-called 'passport' arrangements. These allow institutions to open branches or provide services on a cross-border basis into another EU member-state on the basis of a single authorisation from the home country regulator. But host countries are understandably becoming nervous about allowing foreign banks to take deposits on their territories if the home country is unable to protect local depositors. So the EU may face a difficult choice. Either it requires banks wishing to attract deposits in other member-states to establish separately capitalised subsidiaries in the host country – a move which would mark a retreat from the single market. Or it agrees to set up a single regulatory authority to supervise banks with large cross-border operations.

What sort of financial sector after the credit crunch?

Another assumption which the financial crisis has undermined is the belief that certain financial activities can be allowed to flourish beyond the purview of regulators. This belief is no longer tenable. Not only have financial innovations like securitisation and derivatives ratcheted up, rather than reduced, the overall level of risk in the global financial system. But failures of risk management have been catastrophic. The financial sector, whether it likes it or not, will emerge from the crisis a more regulated industry. In the EU, the regulatory clampdown has already started. Capital adequacy rules will take inspiration from Spain by requiring banks to hold more capital when lending and asset prices are growing strongly. The Commission has submitted a proposal to regulate credit rating agencies, and another that would require banks to ensure that originators "retain a material economic interest" in assets which are securitised. It is also considering forcing the trading of derivatives on to regulated exchanges, and has appointed an expert group to propose new regulatory arrangements for banks with cross-border activities.

Few would dispute that a comprehensive overhaul of financial regulation is necessary. Given the massive costs that the current crisis is imposing on the real economy and the public purse, the demand for a more stable financial system is both understandable and justified. Nevertheless, the EU should try and avoid pushing through piecemeal fixes to different parts of the system without thinking hard about the sort of financial sector that it would like to see emerge from the crisis. Tightening regulation may make the financial system less prone to crises (even if it is unlikely to legislate such crises out of existence). But a more stable, tightly regulated and less innovative financial system could also come with costs of its own. An efficient financial system makes a key contribution to economic growth by channelling savings to productive investments, reducing transaction costs and diversifying risks. The danger is that a more stable but less innovative financial system would be less efficient at channelling savings to borrowers, stifling long-term growth in the process.[21]

[21] Edward Carr, 'Greed – and fear: A special report on the future of finance', The Economist, January 24th 2009.

Financial and general services = C	
Heroes	Spain
Villains	Ireland

C. Enterprise

C1. Business start-up environment

★ Create the right environment for start-ups

★ Encourage entrepreneurship

Young firms play a key role in raising productivity and employment. They tend to be more innovative and dynamic than long-established ones. Because they are more nimble and less hamstrung by entrenched practices and attitudes, they are faster at introducing new products, working practices and technologies. Not only do they generally create more jobs than sleepy and bureaucratic incumbents, but their very existence puts pressure on established firms to innovate and become more efficient. The EU has never been short of small and medium-sized enterprises (SMEs), but it has long lagged the US in at least two respects. Establishing a business is still more time-consuming and expensive in most EU countries than it is in the US. And fledgling companies in the EU are much less likely to grow into global giants. Over the past twenty years, Europe has not produced a Google or a Microsoft.

There are numerous reasons why the environment for start-ups is less favourable in the EU than it is in the US. Cultural, linguistic, regulatory and other obstacles continue to fragment the single market. Burdensome regulations inhibit the emergence of new firms by increasing start-up costs. Tacit or explicit official support for 'national champions' in some EU 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 inefficient ones. And inadequate funding hampers start-ups and their subsequent growth. Improving the environment for start-ups in the EU is consequently a wide-ranging task. It involves simplifying regulatory regimes for SMEs, cutting red tape (see section C2, page 57), relaxing restrictive labour laws, improving the availability of seed capital and reforming bankruptcy regimes to reduce the cost and stigma of failure. Sadly, progress in many of these areas has been patchy at best across the EU.

Improving the regulatory environment for start-ups

Since the Lisbon agenda was launched, the regulatory environment for start-ups has improved – but very unevenly. The good news is that many of the countries where the obstacles to start-ups have traditionally been the most onerous appear to be making the greatest efforts to reform. Over the past two years, Italy has simplified its registration procedures, allowing a business to be started through a single electronic filing; Hungary has introduced on-line filing and, along with Greece, reduced the minimum capital requirement for starting a new business; and the Czech Republic has made it easier to start a business by merging three separate registration procedures into one and reducing the number of days needed to open a business. A small number of EU member-states have actually transformed their regulatory environments for start-ups. Take France: long a byword for stifling entrepreneurial spirit with bureaucracy, it has steadily crept up the European league table. It is now one of the easiest countries in which to start a business in the EU.

Some countries have unquestionably made progress, therefore. Even so, it remains the case that across the EU as a whole, bureaucratic requirements for start-ups remain much too onerous. 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, and so on. Its latest survey suggests that only two EU countries – Ireland and the UK – rank among the ten easiest places in the world to start a business, and only six in the top 20. In a large number of EU member-states, the bureaucratic obstacles to opening a new business remain depressingly onerous. According

to the World Bank's Doing Business survey for 2009, it is easier to start a business in Venezuela than it is in Poland – and it is easier in Argentina than in Spain.[22]

[22] *World Bank, 'Doing Business 2009', October 2008.*

Funding business start-ups

Start-ups in many EU countries suffer from a further handicap: the relative dearth of risk capital to fund their establishment and expansion. By and large, banks are reluctant to lend money to entrepreneurs with good ideas but little collateral. This is where venture capital firms come in. However, the venture capital industry is unevenly developed across the EU. In Denmark, Sweden and the UK, investments per capita by venture capital firms are actually higher than in the US. Moreover, the sector has grown strongly in France following some well-designed reforms since 2003. However, in many EU countries the sector is almost non-existent. And even where the industry is well-developed, venture capitalists tend to prefer investing in firms that are already established. Contrast this with the US, where they are more likely to provide seed capital to new ventures. Finally, EU countries do not provide enough 'exit channels', such as the US Nasdaq, for venture capitalists to turn their investments into cash.

The funding of start-ups, as the article by Nicolas Véron on pages 54-55 explains, has received less attention in the Lisbon agenda than it deserves. However, the Commission has tried to provide impetus at EU level. In late 2007, it issued a communication that aims to encourage the emergence of a pan-European venture capital industry by lowering the barriers that impede cross-border business. The Commission believes that increasing cross-border activity might alleviate funding problems for start-ups in EU countries with under-developed venture capital industries.[23] But this is unlikely to tackle the root of Europe's problem – namely, that investment is far too concentrated in mature

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

businesses at the expense of early-stage or high-tech firms. The credit crunch will exacerbate this bias. This is a shame, because the contribution of innovative, high-growth companies is every bit as important when an economy is contracting as when it is expanding.

Reforming bankruptcy laws

To foster an entrepreneurial culture, it is not sufficient simply to fix the conditions for establishing and funding start-ups. It also helps to have an appropriate legal framework for when businesses fail. Research indicates that more 'forgiving' bankruptcy regimes tend to be associated with higher rates of business creation.[24] The problem, however, is that Europeans have long frowned upon bankruptcy in a way that Americans traditionally have not – a stigma that continues to be reflected in many EU countries' domestic laws. Well-designed bankruptcy regimes should rehabilitate firms that are viable, liquidate those which are not as efficiently as possible, and maximise recovery rates for creditors. A handful of EU member-states meet these criteria. In Denmark, Finland and Ireland, failed businesses are usually wound up within a year and creditors recover on average close to 90 per cent of their investment. A host of other EU countries, however, are still saddled with lengthy bankruptcy procedures that hamper the development of an entrepreneurial culture.

[24] *John Armour and Douglas Cumming, 'Bankruptcy law and entrepreneurship', University of Cambridge Centre for Business Research, working paper No 30, July 2007.*

Reforming bankruptcy laws is an unforgiving task. The issue is dry, unglamorous, and often horribly complicated. All the evidence suggests that the medium-term returns from such reforms are significant. But governments that undertake them rarely attract many plaudits, let alone political rewards. Unsurprisingly, only a small number of EU countries with inefficient regimes have undertaken to reform them. The Czech Republic, which has long had one of the most inefficient bankruptcy regimes in the EU, introduced a reform which came into force in January 2008. The

intention is to shorten bankruptcy proceedings and improve recovery rates for creditors. The World Bank, however, is more sceptical: it still rates the Czech Republic's regime as one of the least efficient in the EU. Other EU countries to have reformed their bankruptcy regimes over the past two years include Italy and Portugal. Few others have done so, however. Those which would benefit the most from reforming bankruptcy laws include Greece, Hungary and Slovakia.

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

The challenge of financing Europe's high-growth firms

Before the onset of the financial crisis, Europe's system of corporate finance was biased in favour of large, well-established companies. By and large, these firms had access to the best financial services available. By contrast, potentially high-growth enterprises with few assets and not much of a track record were poorly served, particularly outside the UK and Scandinavia.

Although there is a lack of fully comparable data, most available indicators suggest that the specific forms of financing best suited to young, fast-growing firms are much less developed in the EU than they are in the US. This is true of players such as the venture capital industry, as well as instruments such as subordinated debt. So small, potentially high-growth companies in the EU have suffered from a twin handicap. They have not had access to the form of capital they have needed the most. And their more limited access to capital vis-à-vis larger, more established firms has often hampered their ability to fulfil their potential.

It is striking, therefore, that corporate finance should be such a blind spot in the Lisbon agenda. Of the 24 integrated guidelines for growth and jobs adopted in 2005 and reaffirmed in 2008, none focuses specifically on improving the framework for financing innovative firms. It would be wrong, to suggest that the European Commission has ignored the subject altogether. It has attempted to lower the barriers that impede the emergence of cross-border venture capital funds. It has repeatedly advocated making greater use of the European Investment Bank and the European Investment Fund to provide financial support to SMEs. And it has rightly identified the dearth of mezzanine finance (typically subordinated, unsecured debt) as a key impediment to the growth of SMEs.

By and large, however, it is fair to say that the subject of funding innovative start-ups has taken something of a back-seat. EU policy in financial services over the past decade has been dominated by two related concerns: cross-border integration and financial stability. Enhancing the financial system's ability to fund start-ups and support the growth agenda has barely featured.

Sadly, the financial crisis will probably reinforce this imbalance. Governments and regulators are currently more preoccupied with securing the survival of banks than with promoting competition among them. Witness the British government's encouragement of the merger between Lloyds TSB with HBOS. The inevitable emphasis on stability and risk reduction will hit the youngest and most dynamic firms hardest, because the companies most in need of capital benefit the most from competition between banks. Preserving the financial system will take a higher priority than correcting its biases.

It is tempting to believe that emerging firms stand little chance in a downturn anyway. But this is not the case. Some high-growth firms may actually thrive even in the worst of economic climates, as entire industries are brutally restructured and new business models supersede failing older ones. However, young firms stand little chance of seizing such opportunities if they are hamstrung by a shortage of funding.

What could Europeans do to make the financial industry that emerges from the credit crunch friendlier to emerging firms? First and foremost, they should enforce more effective competition among banks, including on a cross-border basis. They should also eliminate biases in prudential rules that deter pension funds and insurance companies from investing in financial instruments that fund the growth of SMEs; correct tax distortions that unduly favour debt over equity; and reform insolvency laws to make them more harmonised and more protective of subordinated creditors (a crucial if fiendishly difficult area).

Europe's financial systems had built-in biases against emerging companies well before the crisis. The financial crisis has made it all the more important that European governments take steps to correct them.

Nicolas Véron

Research Fellow, Bruegel

C2. Regulatory burden

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

★ Member-states to implement 99 per cent of all single market legislation by 2009

No market economy can function without an appropriate regulatory framework. Regulations play a key role in correcting market failures, protecting consumers and preventing market abuse. At EU level, some degree of regulatory convergence has been necessary to ensure that different national standards do not impede cross-border trade and that European consumers have the confidence to make cross-border purchases. But regulations do not always meet their objectives, and they can sometimes have unintended consequences. By imposing unnecessary costs, they can dent firms' competitiveness. And by reducing choice, they can damage the consumer interests they are designed to protect. 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, burdensome regulations can ultimately damage the two determinants of a country's prosperity: productivity and employment.

Around half of all laws in force at national level are now estimated to flow from EU legislation.[25] The complex compromises and trade-offs which are necessary to reach agreement among the EU's member-states inevitably impact on the quality of EU legislation – and not always for the best. Once they have been adopted at EU level, many laws need to be transposed into national law before they take effect. However, some countries are more assiduous than others at implementing them. EU rules, moreover, often remain in force long after their sell-by date. So it is not surprising that the Lisbon agenda should have identified the improvement of the regulatory framework as a key objective. The Commission has pursued a two-pronged

[25] *OECD, 'Economic survey: European Union', 2007.*

strategy. On the one hand, it has sought to improve member-states' records at implementing EU legislation. At the same time, it has fleshed out a 'better regulation' agenda – a collection of principles and processes designed to reduce the amount of unnecessary red tape to which companies are exposed.

Implementation and enforcement of EU laws

One of the greatest blights on the single market has long been the unevenness with which EU directives are 'transposed' into domestic law by the member-states. Governments can be slow in implementing EU legislation. And once they have done so, they are sometimes reluctant to enforce it – or comply with its spirit. The good news is that the member-states have become more assiduous at implementing single market legislation into national law. Faced with improving records, the European Council agreed in 2007 to set member-states a more ambitious goal of implementing 99 per cent of all single market legislation by 2009 (up from an original target of 98.5 per cent). By mid-2008, 18 EU countries had already met this new target. Only five countries (Cyprus, Czech Republic, Luxembourg, Poland and Portugal) had not met the Lisbon agenda's original target of 98.5 per cent. Three countries (Malta, Slovenia and Spain) posted their best implementation records ever, while eight others achieved their best scores since 1997.[26]

[26] *European Commission, 'Internal market scoreboard', July 9th 2008.*

However, implementing legislation is one thing, adhering to it quite another. Uneven adherence by member-states to EU rules means that firms do not always compete on a level playing field. The energy market, for example, is supposed to have been opened to competition. Yet it continues to be undermined by political and other obstacles. As a result, energy companies in some member-states have been able to hide behind barriers at home even as they have taken advantage of EU legislation to expand into other markets. A good measure of national adherence to EU law is the number of infringement proceedings that the

Commission initiates against individual member-states (see table on page 60). The worst culprits by far are Italy and Spain, followed by France, Greece and Germany. Among the countries that have joined since 2004, the worst offender is Poland. The areas in which compliance is the lowest are the environment (297 infringement cases outstanding in April 2008), taxation and customs union (237) and transport and energy (140).

Infringement proceedings can be costly and take a long time to resolve. So the EU has established an imaginative instrument – a pan-European network of centres, known as SOLVIT, which handles complaints about individual member-states' failure to adhere to EU rules. The SOLVIT network has been a success. Since it was set up in 2002, it has become an effective instrument for identifying problems and, just as importantly, for resolving them without resorting to infringement proceedings. To date, the SOLVIT network has managed to resolve 83 per cent of the cases it has taken up. SOLVIT centres in the Czech Republic, Germany, Austria, the Netherlands, Italy, France, Portugal and Romania have been particularly effective, resolving over 90 per cent of all problems submitted to them. The SOLVIT centres in Austria and Germany work particularly swiftly – handling cases in just three weeks on average. But not all SOLVIT centres are equally effective. And some suffer from staff shortages which hamper their ability to deal with the case load.

Open infringement proceedings against EU member-states

	Directives	Other sources of EU law	Total
Italy	88	39	127
Spain	67	41	108
France	60	34	94
Greece	51	37	88
Germany	50	37	87
Portugal	31	37	68
Belgium	29	35	64
Poland	44	14	58
UK	37	20	57
Austria	22	32	54
Ireland	43	10	53
The Netherlands	26	22	48
Malta	28	17	45
Sweden	24	19	43
Finland	19	14	33
Czech Republic	20	11	31
Luxembourg	17	14	31
Latvia	22	6	28
Hungary	13	13	26
Estonia	17	9	26
Denmark	14	11	25
Slovenia	16	7	23
Slovakia	16	6	22
Cyprus	9	9	18
Lithuania	13	5	18
Bulgaria	7	7	14
Romania	3	6	9

Source: European Commission, 'Internal market scoreboard', July 2008.

Improving the regulatory environment

In addition to improving member-states' levels of compliance with EU rules, the Commission has tried to reduce the amount of red tape associated with such rules. The 'better regulation' agenda which it has developed consists of three prongs. The first is to avoid the adoption of unnecessary rules by improving the quality of the Commission's impact assessments. In theory, all proposals for new legislation must now pass certain tests before being submitted: alternatives to legislation must be explicitly considered; the likely economic, social and environmental impact of proposed regulations needs to be assessed; and if new legislation is proposed, it should be proportional to the objective it is designed to meet. The second prong is a programme of simplification. Broadly speaking, this entails repealing redundant legislation and consolidating laws with their subsequent amendments into one text to make EU rules easier to understand. The third prong, which was launched in 2007, is a plan to reduce the administrative burden on business by 25 per cent by 2012.

The system of regulatory impact assessments has improved since the Lisbon agenda was launched and is starting to deliver results. Since 2005, the Commission has withdrawn 78 legislative proposals – either because they were inconsistent with the Lisbon agenda or because they did not meet the better regulation tests. The Commission has also set up an Impact Assessment Board, staffed by senior officials, to exercise quality control. Impact assessments have improved since the board was established. But problems remain. The board's powers are limited. The quality of impact assessments still varies widely across the Commission. Stakeholders are not always properly consulted. And an outside report found that too many impact assessments were fig-leaves to justify a predetermined policy choice.[27] The Commission carried out a consultation process in 2008, with a view to improving its impact assessment guidelines. It could consider following the example of some member-states and set up an independent body to evaluate the business costs of proposed laws.

[27] The Evaluation Partnership, 'Evaluation of the Commission's impact assessment system', April 2007.

The EU is also making progress on simplification. In 2005, the Commission launched a three-year rolling programme which identified 100 areas where existing EU legislation could be simplified. The scope of the exercise has since been extended to cover a further 43 measures for the period 2006-09, and more initiatives are set to follow in future rolling programmes. The scope of the exercise is impressive, covering laws in areas as diverse as accounting, food additives, waste, statistics, cosmetics, agriculture, construction and air transport. Although it may be some time before businesses start to notice a difference, the simplification programme is starting to deliver results. The Commission has identified and is repealing 2,500 obsolete acts that are still in force. And it is reducing the volume of legislation – and hopefully making it easier to understand – by consolidating (or, in EU jargon, 'codifying') 400 original laws and their subsequent amendments into single texts. The Commission expects to have completed its programme of codifying legislation some time in 2009.[28]

[28] *European Commission, 'Second strategic review of better regulation in the European Union', January 2008.*

Ultimately, the central objective of the Commission's better regulation agenda is to reduce the administrative burden on EU businesses. The Commission estimates that the costs imposed on businesses by requirements such as filling in forms currently average around 3.5 per cent of GDP across the EU. It predicts that reducing these burdens by 25 per cent would lift EU GDP by 1.4 per cent, or €150 billion, over the medium term.[29] In 2007, it presented an Action Programme, a key part of which is to measure the reporting burden that EU rules (and the national laws that implement them) impose on businesses. By mapping out all the obligations stemming from EU legislation, the Commission hopes to identify areas where the reporting burden might be reduced. The Commission has also held a consultation exercise to solicit suggestions on how administrative burdens might be reduced. And it has identified (and pushed through) a number of 'fast track' measures, entailing minor changes to EU legislation, which it hopes will generate benefits worth €1.3 billion.

[29] *European Commission, 'Action programme for reducing administrative burdens in the European Union', January 2007.*

Is the better regulation agenda delivering?

The regulatory burden on business cannot be lightened just by simplifying and consolidating legislation at EU level. Since many EU laws need to be implemented into national law to take effect, the national dimension is crucial. Businesses will not see the full benefits of better regulation unless member-states give priority to parallel exercises at home. Efforts at national level are particularly important, given some countries' tendency to 'gold-plate' – that is, to add national requirements over and above those required by an EU directive when implementing it. Encouragingly, most member-states have now drawn up plans to lighten regulations at home and have included them in their Lisbon-related 'national reform programmes'. Nevertheless, the pace of change in some countries remains glacial. And even pioneering countries such as the Netherlands and the UK, which have long had their own programmes in place to fight red tape, have found it difficult to ease the regulatory burden in practice. The British Chambers of Commerce estimates that red tape has actually risen since the government's battle against it commenced.

Regulatory burden = B	
Heroes	The Netherlands
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 is key to productivity and GDP growth. In properly contested markets, firms must strive to be innovative and to maximise their productivity if they are to flourish. But competition needs to be protected and promoted; it does not arise spontaneously. There are two important reasons why competition policy must be free of political interference. First, firms must be unable to earn monopoly profits by preventing potential competitors from entering markets. Second, governments are unable to undermine competition by providing state aid. Competition policy is one of the few instruments the EU can deploy against companies and governments that do not play by the rules of the single market and attempt to protect 'national champions'.

The current Commission has a very good record of facing down recalcitrant governments and championing economic openness. It has consistently argued that any dilution of competition policy would harm the competitiveness of EU firms. State aid has continued to decline as a proportion of GDP. The amount of state aid paid out by EU governments fell from 0.71 per cent of GDP in 2002 to 0.53 per cent in 2007. There has also been a continued shift in the emphasis from bail-outs and aid for corporate restructuring to aid targeted at meeting the EU's so-called horizontal objectives: environmental efficiency, regional economic development, the growth of SMEs and R&D. The share of state aid accounted for by horizontal objectives was 80 per cent in 2007, up from 74 per cent in 2004 and around half in the mid-1990s. In 15 member-states, 90 per cent of aid was allocated to horizontal objectives. As a result of this shift, the share of aid paid to SMEs has risen steadily since 2000.

State aid, 2007

	Total state aid (per cent, GDP)		Horizontal aid (per cent, total aid)	
	2002	2007	2002	2007
EU-15	0.71	0.51	73	80
EU-27	0.71	0.53	66	80

Source: European Commission

Worryingly, EU competition policy now faces unprecedented challenges. Even before the current economic downturn threw a whole raft of industries into turmoil, critics argued that Europe's economic prospects were being undermined by the over-zealous application of competition policy. The severity of the economic downturn and the pressure on governments to alleviate its impact on hard-hit industries raises a serious threat to the single market. Various governments have long been hostile to the rigours of EU competition and state aid policy and could attempt to use the crisis to dilute what they see as a damaging constraint on their freedom to pursue an activist industrial policy. In the interests of the long-term health of the European economy, they must be resisted.

The credit crisis and the ensuring recession have led to a resurgence of state intervention across the EU. The landscape of European banking has changed fundamentally over the past year and competition policy in this sector has effectively been suspended. A number of the biggest EU banks have been nationalised in all but name and governments have moved to provide public guarantees for bank loans. The shot gun marriage of Britain's Lloyds TSB with another high street British bank, Halifax Bank of Scotland (HBOS), has left the combined group controlling around a third of the entire UK market for consumer banking services. The German, Dutch and Belgian governments have bailed out financial institutions, while governments across the EU have recapitalised banks. The Commission has had no

option but to sanction the various national bail-outs of the banking sector. The collapse of one country's banking sector would have triggered collapses elsewhere, with devastating consequences for the real economy.

Despite the Commission waving through massive programmes of state support, various EU governments have criticised it for being too slow to sanction state support for stricken banking sectors. This criticism is unfair. The Commission has been very quick to endorse any action being taken to prevent a systemic threat to the financial system, such as measures to prevent the bankruptcy of a major bank. However, it has been slower to approve measures to guarantee credit lines. The Commission's caution is justified. Programmes of state guarantees are doubtless required to free up lending, but the Commission is right to assess them carefully to ensure that they are being implemented in a way that minimises the potential impact on competition. After all, state guarantees potentially provide firms in one country with an unfair competitive advantage by reducing the cost of investment funds.

The dramatic increase in government influence over the lending process will need to be reversed if potentially serious distortions are to be avoided. For example, there is a risk that pressure will be put on banks to maintain funding for national champions and to avoid lending to foreign companies. Such politicised lending would undermine the efficient allocation of capital throughout the EU by protecting inefficient companies and reducing available funds for more competitive firms. Once the financial sector has stabilised and normal levels of financial intermediation have been restored, the Commission will have to get serious about ensuring that the EU does not retreat into such 'capital protectionism'.

However, the most serious fall-out from the bank bail-outs could be elsewhere. The huge expansion of the role of government in the financial sector has set an awkward precedent. A look at the car industry highlights the risks. EU governments have rushed to provide support for car manufacturers on the grounds that the downturn in car sales is a product of the financial crisis. Cars tend to be bought on credit, and the crisis has reduced the availability of consumer credit. If those responsible for the financial crisis – the banks – have been bailed-out, why should blameless car manufacturers be denied government support? It is a seductive argument, but a fallacious one. A collapse of Europe's banking sector would have devastated the real economy. By contrast, the bankruptcy of a number of the weakest car manufacturers would be positive for the industry's future.

The car industry is burdened by huge excess capacity. Car firms have aggressively expanded production in a number of the new Eastern European members of the EU in recent years, in order to reduce their production costs. There have been some plant closures in the older member-states, but not enough to prevent a rise in overcapacity. This problem of excess supply has been masked in recent years by the availability of cheap credit, which inflated car sales in a number of key EU markets, especially Spain and the UK. The Commission needs to ensure that any support for car companies does not prolong uncompetitive production and exacerbate the industry's long-term problems.

Financial incentives to purchase new cars, such as those already in place in France, Italy, Spain and Germany, pose a limited threat to the single market, so long as the subsidy is available on any new car irrespective of where it is built. The problem arises when companies are given access to subsided credits or loan guarantees. Unco-ordinated programmes of support for national car industries risk seriously distorting competition in the sector. There is also a threat to the free flow of capital. For example, the French government's proposal to support French car companies in return for a commitment to keep production in France contravenes one of the EU's four freedoms.[30] The Commission has initially ruled against it and must stick to its guns.

[30] These are the free movement of goods, the free movement of people (including workers), the free movement of services and the free movement of capital.

The Commission will have few friends

The Commission has so far struck the right balance between the need to respond to the economic crisis and the longer-term requirements of the single market. In addition to accepting emergency support for the banking sector and credit guarantees for various industries, the Commission has also temporarily increased the amount of state aid EU governments are permitted to give a company without it triggering an enquiry. Until the end of 2010, this will stand at €500,000, up from €200,000. Moreover, in an effort to prevent the financial sector paralysis from undermining the growth of start-ups, the Commission has also raised the level of risk capital a government can provide to a firm to €2.5m a year, up from €1.5m. It has simultaneously reduced the proportion of total funds to the company in question that must come from private investors – from 50 per cent to 30 per cent.

But the Commission must now resist what is likely to be ferocious lobbying for a further dilution of competition policy and state aid rules. A number of EU member-states have always been ambivalent about the need for an independent EU competition policy. For them, competition policy should be as much about defending the interests of national champions as it is about ensuring a level playing field. Against a backdrop of very weak economic growth, they will be even more determined to use state aid in an attempt to bolster the competitiveness of their firms. This, in turn, will prompt retaliatory action by other governments. A return to the high levels of state aid of the 1980s would hinder the efficient allocation of resources and undermine Europe's competitiveness. Indeed, an erosion of EU competition rules would be every bit as debilitating as the impact of the financial crisis and the resulting recession.

State aid and competition policy = C	
Heroes	The Commission
Villains	France, Italy, Poland

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, a central objective was to raise the level of 'labour utilisation' across the EU. In 2000, around two-thirds of the difference between US and EU living standards was explained by two factors: fewer Europeans had jobs than Americans; and those Europeans with jobs did not work as hard (partly because of shorter working weeks, and partly because of longer holidays). To some extent, the disparity in living standards across the Atlantic reflects a legitimate preference of Europeans for leisure over income.[31] However, economic inactivity in the EU cannot be explained by a cultural preference for leisure. Many people across Europe who are not working would like to be employed. And a depressingly large number have become so discouraged by long-term unemployment that they have given up looking for work and dropped out of the labour force.

[31] *Olivier Blanchard, 'The Economic future of Europe', NBER working paper No. 10310, March 2004.*

How has the EU fared since the Lisbon agenda was launched? Superficially, the answer is: not too badly. Since 2000, the employment rate has risen in all but two member-states (Portugal and Romania). Across the EU-27 as a whole, it has increased from 62.2 per cent in 2000 to 65.4 per cent in 2007. Seven EU countries already exceed the Lisbon agenda's target of 70 per cent. The unemployment rate, meanwhile, fell to just 7.1 per cent in 2007 – its lowest level since the early 1980s. Employment increased in all the EU's wealthiest member-states between 2000 and 2007 – a period when 12 poorer countries were admitted to the EU's ranks and imports from China surged. The fact that employment in the old EU-15 expanded at a time when factories were moving eastwards and imports from China were soaring should at least puncture a persistent myth about globalisation: namely, that the growth of trade and 'offshoring' condemn the developed world to rising unemployment.

Sadly, the brief period of buoyant employment growth which the EU enjoyed between 2006 and 2007 has now come to an end. With economies shrinking throughout the EU, unemployment – which usually lags the cycle – is likely to rise sharply in 2009 and 2010. This will provide an unfavourable backdrop to labour market reforms. There are two risks facing the EU. One is that demands to strengthen employment protection legislation will increase. The other is that globalisation will be blamed for job losses, sparking demands for trade protection.

The limits of the EU's 'employment miracle'

Even before the global financial crisis worsened dramatically in late 2008, it was already clear that EU countries' records in creating new jobs were less impressive than appeared at first sight. The spectacular rises in employment in countries such as Spain and Latvia were driven by unsustainable booms in construction (which have now turned to bust). Despite several years of strong economic growth, the EU in late 2007 was still a long way from meeting its target of a 70 per cent employment rate by 2010. Three quarters of the EU's member-states had not met the target – and about half were nowhere near doing so. Greece and Italy, traditional laggards on the jobs front, had managed to increase their employment rate by respectable amounts. But progress in many other countries with historically low employment rates had been disappointing. In Hungary, the employment rate had barely moved since 2000, while in Romania it had declined sharply. The brutal recession now engulfing the continent will inevitably push most EU countries even further away from their targets.

Employment rates in the EU (percentage of labour force)

	2000	2007	Change
Denmark	76.3	77.1	0.8
The Netherlands	72.9	76.0	3.1
Sweden	73.0	74.2	1.2
UK	71.2	71.5	0.3
Austria	68.5	71.4	2.9
Cyprus	65.7	71.0	5.3
Finland	67.2	70.3	3.1
Estonia	60.4	69.4	9.0
Germany	65.6	69.4	3.8
Ireland	65.2	69.1	3.9
Latvia	57.5	68.3	10.8
Portugal	68.4	67.8	-0.6
Slovenia	62.8	67.8	5.0
Czech Republic	65.0	66.1	1.1
Spain	56.3	65.6	9.3
EU-27	**62.2**	**65.4**	**3.2**
Lithuania	59.1	64.9	5.8
France	62.1	64.6	2.5
Luxembourg	62.7	64.2	1.5
Belgium	60.5	62.0	1.5
Bulgaria	50.4	61.7	11.3
Greece	56.5	61.4	4.9
Slovakia	56.8	60.7	3.9
Romania	63.0	58.8	-4.2
Italy	53.7	58.7	5.0
Hungary	56.3	57.3	1.0
Poland	55.0	57.0	2.0
Malta	54.2	54.6	0.4

Source: Eurostat

Did the rise in the employment rate between 2000 and 2007 reflect an improvement in the long-term performance of the EU's labour market, or was it just an ephemeral cyclical event? Some countries do appear to have enjoyed modest improvements as a result of reforms. Germany's labour market performance, for example, seems to have improved thanks to the various Hartz reforms – particularly Hartz IV, which cut benefits for the long-term unemployed and forced job-seekers to show greater initiative and flexibility. France, which has gradually watered down the legislation on the 35-hour working week, saw its unemployment rate fall in 2007 to its lowest level since the early 1980s. Austria introduced a number of reforms which pushed its labour market closer to the Danish model of 'flexicurity' – a combination of flexible employment rules, generous but conditional social safety nets, and active support for those who lose their jobs. In other words, reforms do seem to have made some EU countries' labour markets slightly more flexible.

Sadly, reform efforts have been weakest in the very countries where change is most urgent. Not only are a number of EU member-states saddled with rigid labour markets and under-performing education systems, but they also happen to be reform laggards. Most of the culprits are to be found in Southern Europe and parts of Central Europe – countries such as Greece, Hungary, Italy, Malta, Poland, Portugal and Romania. All of these countries suffer from under-performing education systems, with poor records at both secondary and tertiary levels. In some, high payroll taxes discourage job creation. In others, social security is poorly targeted. And in all of these countries, reforms have been disappointing. Romania, for example, appears to have no coherent plan to reform its labour market. And Greece has made little progress in easing labour market laws or reducing non-wage labour costs – and its spending on active labour market policies has fallen.

Overall, then, few EU member-states can claim to have pushed through particularly radical reforms to their labour markets since 2000. Even so, the overwhelming majority (25 out of 27) enjoyed

increases in their employment rates between 2000 and 2007. Why? The answer may be that Europeans have become more employable because they have become more educated. It is often assumed that many EU countries have lower rates of employment than the US because they have less flexible labour markets. This is partly true, but it cannot be the only explanation. The reason is that employment rates among groups with similar levels of skills are about the same on both sides of the Atlantic. The greatest transatlantic difference is that a higher proportion of the workforce in the US has tertiary education.[32] The correlation between employment rates and education is equally striking within the EU. Countries with good education systems have comparatively high employment rates; in countries with poor education systems, the reverse is generally the case.

[32] *Daniel Gros, 'Employment and competitiveness: The key role of education', The Lisbon scorecard VIII, CER report, February 2008.*

The insider-outsider problem persists

The two segments of the labour market that have benefited most from job creation since the Lisbon agenda's launch in 2000 are women and older workers. Among women, the rate of employment in the EU-27 has increased from 53.7 per cent in 2000 to 58.3 per cent in 2007. Some countries have posted particularly large increases in female employment – notably Estonia, Latvia, Germany and Spain. In others, by contrast, female employment has stagnated at low levels. This has been the case in Malta, Slovakia and Romania. Older workers (aged 55 to 64) have been the other great beneficiaries of employment growth. The EU-27's employment rate in this segment has risen from 36.9 per cent in 2000 to 44.7 per cent in 2007. Despite the respectable progress recorded in many countries since 2000, the recession will prevent Europe from reaching the Lisbon target of a 60 per cent employment rate for females and of a 50 per cent rate for older workers by 2010.

The great blot on the EU's labour market record continues to be the exceptionally high rates of unemployment among the young. True, the unemployment rate among those aged under 25 has fallen slightly in the EU-27 – from 17.4 per cent in 2000 to 15.3 per cent in 2007. However, in the old EU-15 it has barely moved. And across the EU-27 as a whole, the rate of unemployment among those aged under 25 is two and a half times higher than among those aged 25 to 64. In a number of EU countries, moreover, young people in work are condemned to taking on a succession of fixed-term contracts. Many have to wait years before they are offered permanent contracts. Part-time contracts tend to make up a larger share of total employment in member-states where rules on hiring and firing are strictest. In Spain and Sweden, for example, part-time contracts account for 20 per cent or more of total employment, whereas in the UK and Denmark, they account for less than 10 per cent.

In a number of EU countries, therefore, labour markets are split between 'insiders' and 'outsiders'. Insiders enjoy full-time contracts, high levels of employment protection, and generous pension provisions. Such privileges are denied to outsiders (usually the young) who, supposing they can find a job, have to get by on short-term contracts with few perks. Breaking the dual structure of labour markets has proved politically difficult. The problem is not just that insiders are reluctant to give up their privileges to improve the lot of outsiders. As France discovered in 2006 (when the government was forced to ditch the introduction of a new working contract for young employees), it is that outsiders can resist reforms designed to help them. The explanation for this paradox is that outsiders aspire to insiders' privileges. Permanent jobs are essentially like flats in cities with rent control: regulations unwittingly limit their supply, but everyone wants to have one.

The impact of enlargement

The last two rounds of EU enlargement, in 2004 and 2007, do seem to have increased labour market flexibility in one important respect: by encouraging greater mobility. Central and East Europeans have proved less sedentary than many of their West European counterparts.

Although their chances of finding jobs in wealthier member-states have been limited by transitional restrictions in some of them, the three countries that opened their borders immediately experienced much larger influxes of migrants than either they or the European Commission had projected. Central European migration helped fill vacancies in Ireland, Sweden and the UK – and reduced unemployment in their home countries. Few of these migrants have come to settle in the host countries for the long term, however. With recession reducing job opportunities in host countries, many have already returned home. So host countries have been revolving doors through which migrants have entered and exited.[33]

[33] *Naomi Pollard, Maria Latorre and Dhananjayan Sriskandarajah, 'Floodgates or turnstiles? Post-EU enlargement migration flows to (and from) the UK', Institute for Public Policy Research, April 2008.*

Bringing people into the workforce = B-	
Heroes	Austria, Denmark, The Netherlands
Villains	Hungary, Malta, Portugal

D2. Upgrading skills

★ Halve the number of early school leavers

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

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

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

International comparisons show that a country's wealth is highly correlated with the quality of its human capital. This should come as no surprise. Highly-skilled populations tend to raise an economy's level of productivity, partly because they spur technological breakthroughs, but also because they accelerate the integration of new technologies into working practices. Skills also raise employability. Employment rates for people with university-level education are markedly higher than those for people who only complete secondary education (let alone those who do not). Skilled workers, moreover, command higher wages. Two underlying forces have been exacerbating disparities in the employability and income of skilled workers relative to unskilled ones: technological change and globalisation. Countries which fail to raise their skills levels can therefore be expected to suffer on three fronts. They will struggle to raise their productivity. They will tend to have lower employment rates. And they will usually have higher levels of income inequality.

Improving skills is consequently a key objective of the Lisbon agenda. So it is disappointing that the EU as a whole will miss its targets on skills. Some progress has certainly been recorded. More Europeans are graduating with university degrees than a decade ago. The share of students graduating in maths, science and technology exceeded the Lisbon target of 15 per cent as far back as 2004 and has continued to rise since. The numbers completing secondary education, moreover, have risen in almost every EU member-state. But the EU as a whole still has a long way to go. Not only are drop-out rates from secondary education still unacceptably high, but also the disparities across the EU remain large. Most Northern European countries are strong performers, with good schools and universities and high graduation rates at both secondary and tertiary levels. But some countries in Southern and Central Europe remain weak links, with under-performing schools and universities and low graduation rates at secondary and tertiary levels.

Secondary education

A child's chance of a good education in the EU depends on where he or she grows up. If the child is educated in one of the EU's three Nordic states, there is a 90 per cent chance that he or she will leave school with at least an upper secondary education. This falls to 50 per cent if the child is raised in Portugal. True, Portugal has made huge strides in reducing drop-out rates from school over the past two decades: more than twice as many Portuguese aged 25-34 have completed their upper secondary education than those aged 45-54. But the comparison with the Nordics shows just how much ground Portugal still has to cover. Nor is Portugal alone. Other EU member-states with strikingly high drop-out rates from secondary school include Italy, Poland, Spain and the UK. The UK is an interesting case. Despite large increases in public expenditure on education in recent years, it has made much less progress than many other EU countries in lowering drop-out rates from secondary education. The UK's long history of high drop-out rates at secondary level is an important reason for its persistently high levels of income inequality compared with the Nordic countries.

Length of education is, of course, only one aspect of a country's educational performance. The other is quality. Every three years, the OECD carries out its PISA survey in which it asks countries to test 15 year-olds for numeracy, literacy, problem-solving and other skills. Again, the results of the OECD's work show a marked north-south divide. The EU's star performer is Finland, which is ranked first in the

world. But the performance of many other EU countries is, at best, pedestrian. Only three rank in the world's top ten for scientific competence or numeracy. The EU's three largest member-states – France, Germany and the UK – achieve only average scores. And the Southern European countries – Greece, Italy, Portugal and Spain – are among the worst performers in every single test. The performance of many of the new member-states from Central and Eastern Europe is respectable. Estonia, for example, ranks sixth globally for scientific competence, while Latvia and Poland have both posted big improvements in literacy.[34]

[34] *OECD, 'PISA 2006', December 2007.*

It is tempting to believe that differences in EU countries' performances at secondary education are attributable to differences in funding. But international comparisons do not really bear this out. Portugal spends a higher share of its GDP on primary and secondary education than the EU average, but it is one of the worst performers in the OECD's PISA tests. A more important influence on school performance is autonomy: the best schools generally have a free hand when allocating their budgets, hiring teachers and dealing with students. Greater autonomy encourages more efficient administration and spending, as well as better results: it is no coincidence that Finland's secondary schools, the best in the EU, enjoy high levels of autonomy. Nor is it a coincidence that over-centralised systems are inefficient and that the worst-performing schools in Europe suffer from too much state intrusion. In weak-performing countries such as Greece and Romania, for example, most teachers are hired by education ministries rather than by schools.

University education

EU member-states are unquestionably making progress in increasing the number of young people that pass through universities. Across the EU as a whole, around 30 per cent of those aged 25 to 34 now have a university degree, compared with just 16 per cent for those aged 55 to 64. Over the past decade, France, Ireland, Poland, Spain and Sweden have recorded particularly large increases in the number of people aged 25 to 34 graduating with a university degree. In Germany, however, the share of the population with a degree has barely moved in the past two decades – and at 26 per cent it is now below the EU average. Once again, variations across the EU are stark. In Finland, Denmark, Ireland and Sweden, 40 per cent of young people graduate with a university degree. In the Czech Republic, Hungary, Italy, Portugal and Slovakia, fewer than 20 per cent do so. So despite the progress achieved, there is no room for complacency. And the EU still lags way behind countries such as Japan and South Korea, where more than 50 per cent of the population graduates with a degree.

Too few European graduates, moreover, emerge from world-class universities. A survey carried out by Shanghai Jiao Tong University ranks only two European universities – Cambridge and Oxford – in the world's top ten, and only 33 in the top 100.[35] One can question the survey's underlying methodology. The Shanghai index has a bias towards science and therefore omits some of Europe's best specialist institutions in subjects like economics. Nor does the survey capture the quality of research in countries like France and Germany, where excellent work is often carried out in institutions like the Centre National de Recherche Scientifique (CNRS) and the Max Planck Institut. Even so, the broad picture that the Shanghai index paints reflects some inescapable realities: the world's best universities are overwhelmingly concentrated in the US; Sweden and the UK are the only EU countries that compete with the US on a per capita basis in the top tier; and most of Europe's universities are in the second or third tier (that is, they rank in the world's top 200 or 500).

[35] *Shanghai Jiao Tong University, 'Academic ranking of world universities 2008', August 2008.*

Why do European universities struggle to compete with American ones? Partly, it is a question of funding. As a share of GDP, the US spends two and half times more on higher education than the EU average. Most of the difference is accounted for by much higher private spending in the US. But public spending in the US is higher too – in nominal terms and as share of GDP. The US, moreover,

concentrates public research funds on its elite institutions, whereas in the more egalitarian EU, public spending is more evenly distributed. Lower spending, allied to large increases in the numbers going through university, mean that the average spend per student is much lower in the EU than in the US. Too many universities suffer from 'massification': rising numbers of students are being pushed through their doors with no commensurate increases in funding. Spain may have made huge progress in raising its number of graduates. But the quality of the education they are receiving may be suffering, because the average spend per student is exceptionally low.

Funding is part of the explanation for the transatlantic gap in higher education, but it cannot be the whole story. The UK, for example, spends a slightly lower share of GDP on higher education than the EU average, yet many of its universities are among Europe's best. Why? Much of the answer rests with the way universities are governed. In general, the greater the autonomy universities enjoy, the better they tend to perform. Three factors seem to be particularly important in determining universities' performance: their ability to control their own budgets; their freedom to hire staff; and their ability to set their own wages. On all these dimensions, British universities enjoy higher levels of autonomy than most of their European counterparts. In Germany, by contrast, universities are subject to extensive and detailed control by the state: they have the freedom to hire their own staff, but they have no budgetary autonomy and cannot set their own wages. Research suggests that budgetary autonomy doubles the effect of additional money on universities' research performance. In other words, universities that control their own budgets get a bigger bang for their buck.[36]

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

Why the resistance to greater autonomy?

The evidence at secondary and tertiary level is overwhelming: the greater the operational autonomy that educational institutions enjoy from the state, the better they tend to perform. Some countries have learned the lesson and are reforming accordingly. Parts of the UK have introduced student tuition fees to improve university funding. And in 2007, France introduced a law to give universities greater freedom to manage their affairs. But few other countries have followed suit. Why such resistance to change? Part of the answer may be governments' fears of taking on vested interests. Reforms have a nasty habit of bringing students out on the street – as France and Greece can testify. Another reason is philosophical. It is the widespread belief across Europe that the only way of delivering fair social outcomes is to fund universities from the public purse, place them firmly under the control of the state, and oppose anything that might remotely smack of selectivity and competition.

The result is widespread mediocrity, with rigid curricula, de-motivated teaching staff, high drop-out rates and few incentives for university students to complete their studies quickly.[37] Nor is it even clear that highly centralised systems produce fairer outcomes. For one thing, relying mainly on taxes to fund universities tends to be regressive because the beneficiaries are primarily children from better-off families. Besides, education systems in many EU countries seem to be producing social outcomes totally at odds with the officially stated objectives. Indeed, evidence suggests that social background plays a greater role in determining students' performance in egalitarian Germany than it does in the inegalitarian US.[38]

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

[38] *Andreas Schleicher, 'The economics of knowledge: Why education is key for Europe's success', Lisbon Council Policy Brief, 2006.*

Upgrading skills = B-	
Heroes	Finland, The Netherlands, 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

Critics on the European left like to portray the Lisbon agenda as a 'neo-liberal' assault on the social model to which citizens remain attached.[39] Moderate critics acknowledge that some of the reforms identified by the Lisbon agenda may be necessary, but argue that the social objectives have been subordinated to the economic ones – particularly since the agenda's mid-term revamp in 2005, when the EU gave increased emphasis to growth and jobs. Other critics go further. The Lisbon agenda, they argue, is a Trojan horse for globalisation and business interests: it is fundamentally incompatible with social justice. Such views are misguided. For one thing, many national welfare models have worked less well than their supporters acknowledge. For another, many of the pressures for reform have come from domestic trends (notably population ageing), rather than external forces such as globalisation. Reforms would have been necessary whether European countries were integrating in the world economy or not.

[39] *Sandy Brian Hager, 'The Lisbon agenda and neo-liberal communitarian citizenship', Multicultural Center Prague, March 2007.*

Reforming pension arrangements

Many European countries' pensions systems have become inter-generational Ponzi schemes. They rely on people in work to pay the pensions of people in retirement. However, populations across the EU are ageing because of declining fertility rates and rising life expectancy. So the ranks of pensioners are set to swell at a time when the number of people of working age will be declining. The EU will go from having four people of working age for every pensioner, at present, to just two in 2050. If countries with state-run pay-as-you-go (PAYG) pension systems do not reform them, their public finances will be unsustainable. 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 average ratio of government debt to GDP above 200 per cent by 2050. These projections, moreover, assume an impossibly favourable starting position, because they predate (and so take no account of) the sharp rise in public debt that will result from the credit crunch.

All EU member-states are, to a greater or lesser extent, faced with the same challenge. However, national differences in demographic trends and pension arrangements mean that reforms are more urgent (and daunting) in certain member-states than in others. The long-term impact of ageing on the public finances is most marked in Cyprus, where, in the absence of reform, age-related government expenditure is projected to increase by more than 11 per cent of GDP by 2050. No other EU member-state faces such a large increase. But in Belgium, the Czech Republic, Hungary, Ireland, Italy, Luxembourg, Portugal, Slovenia and Spain, it is still projected to exceed 5 per cent of GDP. And these countries have made only modest strides towards reforming their pension systems. The impact of ageing on the public finances should be weaker in Denmark, Finland, France, Germany, the Netherlands, Slovakia and the UK, where it is forecast to be between 2 and 5 per cent of GDP. In the remaining member-states, the impact is projected to be less than 2 per cent of GDP.[40]

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

One of the simplest solutions to the EU's demographic problem is to increase the age at which people retire. This is why an important objective of the Lisbon agenda is to raise the effective age of retirement. This goal is not a gratuitous attack on social

rights, but an inescapable element of any solution to the long-term impact of ageing populations on the public finances. The Lisbon agenda is right, in the short term, to focus on increasing the effective age of retirement, because people across the EU generally retire at a much younger age than the official retirement age (at which people can draw a full pension). In most countries, the official retirement age varies between 60 and 65 for women, and between 62 and 65 for men. However, the average age at which EU workers retire in practice is 60.4 for women and 61.4 for men – still a long way from the Lisbon objective of 65. In Ireland, Sweden and the UK, the effective age of retirement is now between 63 and 64. However, in countries such as Austria, France, Hungary and Italy, it is still 60 or below.

Countries must not only discourage early retirement, but they must also gradually increase the official age of retirement. Some countries have already started to do so. Since the Lisbon agenda's launch, France has pushed through courageous reforms gradually to increase the age of retirement and to align the treatment of private and public sector workers. The UK, by contrast, has only gone half way. The age of retirement for private-sector workers is set to rise to 67, but existing public-sector workers are exempt from the reform. So the UK's reform has entrenched the privileges of workers in the public sector (whose pensions, unlike those in the private sector, are not even exposed to market risk). The official age of retirement is also being raised elsewhere, but in many cases reforms have been too modest. In Italy, the minimum retirement age is being raised to 61 (based on 36 years service) by 2013, but this is too little given its rate of ageing and the state of the public finances. Austria, meanwhile, is raising its official retirement age to 65 – but not before 2033.

The design of pensions systems is also being reformed. All the member-states have embarked on more or less ambitious programmes to place their pension systems on a more sustainable footing. Since countries have very different systems, there is no single path of reform across the EU. But reforms have generally contained one or more of the following elements: less generous tax-funded pension entitlements; an increased onus on individuals to save for their retirement; and a greater role for private-sector providers, notably to supplement retirement savings. However, private-sector schemes in countries which have traditionally relied on state-run PAYG systems have been slow to take off. Some countries, such as the Nordics, have tackled the problem of inadequate savings by obliging people to save for their retirements. The UK has shied away from compulsion. It has tackled inertia by providing a 'liberal paternalistic' nudge[41] – in this case, enrolling people automatically on retirement savings schemes, so placing the onus on them to opt out.

[41] *Richard Thaler and Cass Sunstein, 'Nudge: Improving decisions about wealth, health and happiness', Yale University Press, 2008.*

Poverty and social exclusion

The Lisbon agenda enjoins member-states to reduce the number of people at risk from poverty and social exclusion. The target raises a key question: is the social dimension of the Lisbon agenda compatible with the strategy for jobs and growth, or is there a trade-off between the two dimensions? To put the matter differently, is an economic system better geared to innovation condemned to higher levels of social inequality? Many opponents of the Lisbon agenda believe that its growth and social dimensions are incompatible. The Lisbon agenda, they reason, was conceived as a programme to close the EU's wealth gap with the US. The US has long had higher levels of poverty and social exclusion than most EU countries. So the price for emulating the US's record on productivity and employment must be a rise in poverty and social inequality. Europeans, it follows, face a choice. They can either free their product and labour markets and accept the downsides, or defend social solidarity.

Selected social indicators for EU-27 countries, 2007

	At risk of poverty after social transfers	Long-term unemployment rate	Income inequality	Gender pay gap
Austria	12	1.2	3.8	25.5
Belgium	15*	3.8	4.2*	9.1
Bulgaria	14*	4.1	3.5*	12.7
Cyprus	16	0.7	4.5	23.1
Czech Republic	10	2.8	3.5	23.6
Denmark	12	0.6	3.7	17.7
Estonia	19	2.3	5.5	30.3
Germany	13*	4.7	4.1*	23.0
Finland	13	1.6	3.7	20.0
France	13	3.3	3.8	15.8
Greece	20	4.1	6.0	20.7
Hungary	12	3.4	3.7	16.3
Ireland	18	1.4	4.8	17.1
Italy	20*	2.9	5.5*	4.4
Latvia	21	1.6	6.3	15.4
Lithuania	19	1.4	5.9	20.0
Luxembourg	14	1.2	4.0	10.0
Malta	14	2.7	3.8	5.2
The Netherlands	10	1.3	4.0	23.6
Poland	17	4.9	5.3	7.5
Portugal	18	3.8	6.5	8.3
Romania	19*	3.2	5.3*	12.7
Slovenia	12	2.2	3.3	8.3
Slovakia	11	8.3	3.5	23.6
Spain	20	1.7	5.3	17.6
Sweden	11	0.9	3.4	17.9
UK	19*	1.3	5.4*	21.1

*Source: Eurostat. * = 2006. Income inequality = ratio of total income earned by the top 20 per cent of the population relative to the bottom 20 per cent. Gender pay gap = difference between the average gross hourly earnings of male paid employees and of female paid employees, expressed as a percentage of the average gross hourly earnings of male paid employees. At risk of poverty after social transfers = share of the population whose income is less than 60 per cent of national median disposable income (after social transfers).*

The belief that freeing up markets increases social inequalities is not supported by the evidence. The table on page 89 shows that the country with the lowest levels of long-term unemployment, income inequality and poverty in the EU is Denmark – a country with some of the most liberalised markets for goods, services and labour in the EU. Equally, many of the countries with the worst social outcomes in the EU (notably Greece, Italy and Portugal) have highly restrictive product and labour markets. So liberalisation does not threaten social justice, and high levels of regulation do not guarantee it.[42] There is no fundamental tension between the Lisbon agenda and social welfare. But the Lisbon agenda is incompatible with some countries' unreformed social welfare models. Its emphasis on competition, flexibility and skills means that welfare systems which try to protect workers through employment protection legislation and limits on competition must reform. However, the Lisbon agenda requires social systems to be recalibrated, not swept away.

[42] *Philip Whyte, 'Why free markets have little to do with inequality', Financial Times, June 2nd 2008*

How? Much of the European Commission's attention has focused on promoting the virtues of Denmark's model of flexicurity – a combination of liberal labour laws and generous but conditional social welfare provision. The Danish model has produced enviable results from which other EU countries can draw inspiration. But social outcomes in Denmark are not just the product of the interaction of its labour laws with the tax and benefits system. They are also the result of its excellent education system. Countries which adopt their own versions of flexicurity without improving skills levels will not achieve Danish social outcomes. Nor is enough attention being paid to the timing of state interventions. Too many countries still spend too much on ineffective palliatives relatively late in a person's life – remedial training for the unskilled, social transfers and so on – and not enough on interventions earlier in life. This is a mistake because low skills are usually rooted in social and family conditions that

people face very early in their lives – and the rate of return on state interventions is higher on children than it is on adults.[43]

[43] *James Heckman, 'Coping with the accident of birth: The case for early childhood intervention', May 2008.*

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

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 has made more progress towards meeting the environmental objectives of the Lisbon agenda than any of the other targets. The EU-15 countries will not meet their target of an 8 per cent cut in emissions of greenhouse gases by 2010. But a reduction of 7 per cent is now within reach, partly as a result of the recession. Similarly, the proportion of EU electricity derived from renewable sources will fall short of the target of 22 per cent. However, it should reach 19 per cent, and this will be an impressive improvement on the 2000 level, which stood at just 13.8 per cent. The link between economic growth and traffic volumes remains as strong as ever, but average car emissions are set to fall rapidly from 2015. Of course, performance varies enormously between the member-states, with some set to miss their targets by huge margins. But the EU has done much more than the US or Japan to put its economy on an environmentally sustainable footing.

At present, each member-state has an individual emissions target, which takes into account levels of economic development, energy mix and exceptional circumstances (such as the closure of inefficient communist era industrial capacity). These targets range from a reduction of 21 per cent by 2010 (from 1990 levels) for Denmark and Germany, to a rise of 25 per cent for Greece and 27 per cent in Portugal. Despite this so-called 'burden-sharing', the countries that have met their targets or are close to doing so are those that were set some of the most demanding targets. The UK and Sweden have already met theirs and Germany is close, while Belgium and the Netherlands have also done relatively well. The worst performers are Spain and Portugal. Although they were given the least demanding targets (along with Greece) they will miss them by the biggest margins.

On the face of it, the performance of the new Central and East European member-states looks impressive. All have seen very large cuts in their emissions since 1990. However, these were largely the product of the closure of inefficient communist industrial capacity rather than the result of a progressive reduction in emissions. Indeed, the new member-states continue to use energy very inefficiently compared with the EU-15.[44]

[44] *Energy intensity (the amount of energy needed to produce a given sum of GDP).*

The national renewables targets were set with reference to geography, GDP per capita (richer countries being given more ambitious targets) and countries' starting points. Most of the increase in the use of renewables by 2010 will take place in the electricity industry. By 2010, renewable sources must account for 10 per cent of energy use, but 22 per cent of electricity generated. The use of renewable energy sources varies massively across the EU. This partly reflects geography (Sweden, for example, is ideal territory for hydroelectric power), and partly public policy. The worst performer among the EU-15 is Belgium, which generated just 3.9 per cent of its electricity through renewable means in 2006. The UK and the Netherlands fare little better, at 5.1 per cent and 7.6 per cent respectively (in 2007). By comparison, the Austrian figure was 56.6 per cent and the Swedish one 52.1 per cent. In terms of progress towards meeting their targets, Denmark and Germany are the best performers and France, Italy and the UK the worst.

Total greenhouse gas emissions
(1990=100)

	2000	2006	2010 (target)
Germany	82.7	81.5	79.0
UK	86.3	84.0	87.5
Sweden	94.6	91.1	104.0
Austria	102.6	115.2	87.0
The Netherlands	100.3	97.4	94.0
Finland	98.3	113.1	100.0
Denmark	98.0	101.7	79.0
Spain	132.9	149.5	115.0
France	98.5	96.0	100.0
Italy	106.9	109.9	93.5
Poland	69.1	71.1	94.0
Czech Republic	75.7	76.3	92.0
Hungary	67.2	68.1	94.0
EU-15	96.5	97.3	92.0
EU-27	90.9	92.3	n/a

Source: Eurostat

In contrast to the rest of the Lisbon criteria, there is no doubt about what will replace the environmental targets post-2010. There are already robust, legally binding commitments in place and credible policies to meet them.[45] EU governments agreed that by 2020 the Union will cut emissions of greenhouse gases by 20 per cent (rising to 30 per cent if EU action is matched by other countries); improve energy efficiency by 20 per cent; and draw on renewable sources for 20 per cent of its total energy consumption. In December 2008, they agreed on a raft of policies to meet these targets, despite mounting concerns in a host of member-states that Europe cannot afford such an ambitious environmental agenda.

[45] *European Commission, '20 20 by 2020: Europe's climate change opportunity', January 2008.*

Share of renewable energy in gross electricity consumption
(per cent of total)

	2000	2006	2010 (target)
Belgium	1.5	3.9	6.0
Denmark	16.7	29.0*	29.0
Germany	6.5	12.0	12.5
Finland	28.5	24.0	31.5
France	15.1	13.3*	21.0
Italy	16.0	13.7*	25.0
The Netherlands	3.9	7.6*	9.0
Austria	72.4	56.6	78.1
Poland	1.7	3.5*	7.5
Portugal	29.4	29.4	39.0
Slovakia	16.9	16.6*	31.0
Spain	15.7	20.0*	29.4
Czech Republic	3.6	4.9	8.0
UK	2.7	5.1*	10.0
Sweden	55.4	52.1	60.0
EU-15	14.6	15.3	22.0
EU-27	13.8	14.6	21.0

*Source: Eurostat. *2007*

The timing of the negotiations could not have been worse. Despite the EU's impressive record in the field, the European consensus in favour of ambitious action on climate change has always been fragile. Many EU governments believe Europe should only act when (and if) there are corresponding commitments by all the major emitters of greenhouse gases. Their scepticism had been strengthened by the dramatic deterioration in economic conditions since the targets were agreed in 2007. Several member-states claimed that unilateral EU action to cut emissions would endanger economic growth and jobs in

the Union. The Italian government even threatened to use its veto over the Commission's package. The fact that the Commission's proposals emerged largely intact owed much to the determination of the French presidency of the EU, and in particular to the determination of the French president, Nicolas Sarkozy.

Emissions trading

The most controversial element of the Commission's package was reform of the EU's emissions trading scheme (ETS). The EU ETS was established in 2005 and is the core of the EU's strategy to curb greenhouse gases. Emission trading involves putting a price on a gas or pollutant by establishing a cap on annual emissions. Allowances are allocated to businesses and other emitters, either free of charge or by auctioning them to the highest bidder. 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. The rationale for this is that it is cheaper to cut emissions in these sectors than from buildings or road transport.

However, the most contentious issue relating to the ETS was not the target for the industries covered by the scheme. It was the Commission's call to introduce full auctioning of permits for energy generators and a progressive shift to full auctioning for all other industries. So far, most permits have been allocated for free under the ETS. The argument for auctioning is that forcing energy users to pay upfront to emit carbon dioxide maximises their incentives to use energy more efficiently. However, critics claimed that Europe's manufacturing sector as a whole would cut back on investment in the EU and gradually shift production to other jurisdictions if saddled with these extra costs. Nevertheless, a compromise was reached, which allows for a gradual introduction of auctioning. Aside from some temporary allowances for very coal-dependent new member-states, energy generators will have to buy all their permits from 2013. All emitters (with the exception of a small number of very energy-intensive industries) will have to purchase 20 per cent of their permits from 2013, rising to 70 per cent in 2010 and 100 per cent in 2027.

The move to introduce auctioning more gradually than originally proposed is not without its costs. It will delay the time when carbon emissions will be just another cost in the production process. However, the speed at which full auctioning is introduced will not substantively undermine the effectiveness of the ETS, because the overall emissions target remains unchanged. Energy users will still have an interest in curbing emissions, because they will have to purchase additional permits if they exceed their allowances, and because they will be free to sell any they do not use.

A potentially bigger problem is the move to allow almost half of the targeted reductions in CO_2 under the ETS to be met by so-called 'offset credits' from outside the EU. Energy users can invest in projects to cut emissions in developing countries such as India – where such reductions can be made more cheaply – and put these credits towards their ETS target. The argument in favour of offsets is that they enable firms to cut emissions where it is cheapest to do so and hence will limit the impact on competitiveness. However, there are two risks. The first is that the EU will find it harder to persuade emerging markets to curb their emissions as long as the EU is seen to shy away from making big cuts at home. Second, the recourse to so many offset credits could undermine carbon prices within the ETS and hence incentives to curb emissions.

The non-ETS sectors

The sectors not covered by the ETS – principally buildings and transport – will have to reduce emissions by 10 per cent between 2005 and 2020. Under a burden-sharing deal, poorer member-states will have to reduce their emissions by less than this (and in some cases will be permitted to increase them), whereas wealthy member-states will have to cut emissions by more than 10 per cent (but by no more than 20 per cent). EU-wide energy efficiency standards for a

range of products, including road transport (see below) will contribute to meeting the targets, but intensive action will be needed at national level, in particular to improve the energy efficiency of buildings. Member-states will be allowed to use imported credits equivalent to 3 per cent of their total 2005 emissions to help them meet the targets for their non-ETS sectors.

Road transport poses a big challenge for the EU's climate change objectives. High fuel taxes combined with voluntary emissions targets for the car industry have failed to arrest the rise in the sector's emissions. As a result, in 2007 the Commission proposed compulsory targets requiring car manufacturers to reduce average emissions per kilometre to 120 grammes of carbon dioxide by 2012, with heavy penalties for manufacturers that fail to comply. A number of governments opposed this on the grounds that firms had insufficient time to comply. However, they reached a compromise whereby the target of 120 grammes will apply to 65 per cent of each car firm's EU sales in 2012, rising progressing to 100 per cent in 2015. Although this is less ambitious than the Commission's original target, it is still a very positive outcome in light of the crisis engulfing the car industry, and will lead to a significant reduction in emissions from transport by 2020.

The EU's target of increasing the use of renewables by the transport sector to 10 per cent is more controversial because it effectively means much greater use of biofuels. Making biofuels often produces a lot of emissions even if the actual burning of the fuel does not. Although the EU is introducing tight controls to ensure that only biofuels that meet strict environmental criteria will be recognised, it is far from clear that greater use of biofuels will provide a sustainable route to lowering transport emissions.

Competitiveness gains

In the furore over the costs of cutting emissions, the huge economic benefits of a move to a low carbon economy are often ignored. The

Commission is right to carefully assess the impact of carbon pricing on energy-intensive industries. But the key factor is the impact of environmental policies on overall competitiveness and not just that of a narrow range of sectors. Europe already derives considerable economic and security benefits from its efficient use of energy.[46] Anything that encourages European businesses to adopt energy-efficient technologies will stand them in good stead in a world of increasing energy scarcity, while reduced imports of fossil fuels will lessen Europe's vulnerability to political instability in energy exporting and transit countries. Tight emissions caps and stringent energy efficiency standards will also help European businesses to capture markets for energy-efficient technologies. For example, ambitious emissions targets for cars should boost the competitiveness of European producers by forcing them to develop low-emission vehicles. If governments fail to stress the benefits of policies to curb energy use, they will struggle to maintain support for the EU's climate agenda. Climate change policies need to be shown to be a source of competitiveness rather than a drag on it.

[46] *OECD, 'The benefits of climate change policies', 2004. Carbon Trust, 'EU ETS impact on profitability and trade: A sector by sector analysis', January, 2008.*

Climate change = B+	
Heroes	Sweden, UK
Villains	Italy, Poland, Spain

4 Conclusion

The Lisbon agenda has attracted criticism from many quarters. Critics on the left see it as a poorly-conceived attempt to ape the US and dismantle the 'European social model'. Traditional integrationists disparage the Lisbon agenda as a toothless process based on little more than benchmarking and peer group pressure. Even observers who share the agenda's underlying diagnosis often liken it to a Christmas tree – a list of disparate and sometimes inconsistent objectives which get added or withdrawn according to prevailing fashion. And the agenda's original ambition – to turn Europe into nothing less than the "the most dynamic and competitive knowledge-based economy in the world" – has been a source of derision from the outset. As the Lisbon agenda reaches the end of its original 10-year term, three questions need to be answered. What has it achieved? Should it be renewed? And, if so, in what form?

The Lisbon agenda: an overall assessment

No honest assessment of the Lisbon agenda can ignore two inconvenient facts. The first is that the EU as a whole will not meet any of the targets it set itself in 2000. The second is that the gap between the best and worst performing EU countries is arguably larger now than it was when the Lisbon agenda was launched. It is, of course, impossible to tell how economic reforms would have fared in the absence of the Lisbon agenda. But it is hard to shake off the nagging suspicion that most EU countries' reform paths would not have been much different if Lisbon had never existed. Why? Because there is as much variance within the EU as there is between EU countries and other members of the OECD. The fact that differences across countries have widened in some areas suggests that neither Lisbon nor EU membership have had much influence on the path of reform in most member-states.

Lisbon's influence seems to have been particularly peripheral in the larger member-states. For the UK, it is tempting to claim that Lisbon may as well not have existed. True, it was an early reformer – so it started from a more favourable position than many other EU countries in 2000. But the UK has been guilty of complacency: it is not a star performer and its reform efforts since 2000 have been modest. France and Germany began from a less favourable position than the UK, but both countries have since pushed through important structural reforms. But in France, key changes to labour markets and pensions were driven by domestic political dynamics rather than the external pressure of the Lisbon agenda. Of the EU's four largest member-states, only Germany appears to have drawn an explicit link between Lisbon and its domestic reform programme (known as Agenda 2010).

The Lisbon agenda seems to have had slightly more influence on developments in some of the smaller member-states, where national reform programmes (NRPs) have sometimes been debated in parliament. But it would be hard to argue that the EU's efforts to strengthen the 'ownership' of Lisbon objectives at national level have been a success. Since the Lisbon agenda was revamped in 2005, governance has been beefed up. EU governments have been required to identify their own priorities within the renamed 'strategy for growth and jobs', and to draw up programmes setting out how they intend to achieve them. The Commission, meanwhile, now carries out annual assessments of governments' progress on their NRPs. However, political constraints have prevented the Commission from 'naming and shaming' poor performers (notably in policy areas of national competence), so its criticisms have tended to be coded and anodyne.

The Lisbon agenda, then, has struggled to live up to the (admittedly unrealistic) ambitions that were originally set in 2000. Does this

mean that the exercise has been a waste of time? Not necessarily. Although there are wide variations in performance between EU countries, there has been some convergence in the direction of change. Most countries have made some progress towards most of the targets – and few have moved away from them. Lisbon-related benchmarking has also clarified thinking and challenged widely-held assumptions about policy trade-offs. One common myth that really should have been discredited by now is the belief that countries which free up their markets for goods, services and labour are condemned to worse social outcomes than countries which do not.

Should the Lisbon agenda be renewed?

As the Lisbon agenda approaches the end of its term, attention will inevitably turn to whether it should be renewed. The argument is finely balanced. Even among those who broadly support its objectives, there are some who argue that the agenda should be abandoned. Sceptics reason that nothing is more corrosive of the EU's image and legitimacy than the practice of announcing ambitious objectives which its members have no intention of trying to meet. In the absence of a new and more constraining method of governance, they believe, the Lisbon agenda is not worth the paper it is written on. The 'open method of co-ordination' – that is, the agenda's process of benchmarking and peer group pressure – has its roots in the EU treaties, which leave responsibility for labour markets, social security, education and other Lisbon-relevant policy areas in the hands of the member-states. Since the EU cannot force change in areas for which it has no responsibility, critics argue, the Lisbon agenda may as well be quietly abandoned.

It is, of course, difficult to make a strong case for continuing with a reform programme that most informed observers believe has proved a disappointment. Nevertheless, there is a counter-argument. It is that the weakness of some countries' commitment to reform does not invalidate the intellectual case for the Lisbon agenda; and that at a time when some countries may be tempted to backtrack, the Lisbon targets provide an indispensable guide to the desirable direction of reform. It cannot be stressed enough that the need for reform does not arise just because business happens to support it. It is necessary for EU member-states to tackle the three key challenges they face: ageing populations, increasingly rapid technological change and globalisation. Countries which fail to reform will not, as many believe, be preserving their social models. They will be exposing them to growing long-term strains.

The shape of a renewed Lisbon agenda after 2010

What might a renewed Lisbon agenda look like after 2010? It would be odd to move beyond a reform agenda whose targets had not even been met. The only plausible reasons for doing so would be if the original design were flawed, or if developments in the wider world had rendered it obsolete. The world has certainly changed since 2000. When it was launched, the Lisbon agenda was motivated by an ambition to emulate the US. Now, the dominant concern seems to be a fear of failing to 'compete' with China and other emerging economies. The EU has also changed. Its membership has almost doubled, making it a more heterogeneous place. The admission of 12 poorer member-states since 2004 may have called into question the relevance of imposing uniform targets across the EU. But neither the rise of China nor the EU's enlargement has weakened the case for the original agenda's broad thrust; if anything, the reverse.

This report has argued, however, that the financial crisis will require some aspects of the Lisbon agenda to be rethought. The EU will have to think hard, for example, about the way the single market for financial services is currently designed. The financial sector, moreover, is bound to emerge from the crisis as a more tightly regulated industry than it was before. But the EU's response should be carefully thought through. It would be a mistake if the logic of re-regulation in financial services were allowed to spread indiscriminately to other policy areas. The financial crisis has not strengthened the case for

subjecting the EU's already highly regulated labour markets to new and more constraining rules. It has not invalidated the case for increasing competition in sectors that were previously not exposed to it. And it has not disposed of the need to update and recalibrate social welfare systems. Countries which fail to reform will not just be saddled with lower living standards. They will also suffer from rising levels of social and income inequality.

One of the most urgent tasks facing many European countries is to improve education and skills. Upgrading the overall skills level of the population is not only crucial if EU countries are to raise their productivity and employment. It is also essential if they are to maintain their social cohesion. The reason is that globalisation and technological change are increasing the demand for skilled labour relative to unskilled labour. Against this backdrop, a number of EU countries – particularly in Southern and Central Europe – look ill-equipped. So does the UK (where drop-out rates from secondary education remain far too high). Early intervention is key, because the economic and social returns from public spending are higher when they occur early in a person's life. Social transfers and remedial training rarely compensate for a poor education.

Improving education and skills is good economic and social policy, and should feature prominently in any successor to the Lisbon agenda. A post-Lisbon agenda could also seek to ensure that its objectives and instruments are better integrated. It could, for example, try to tighten the relationship between its objectives on innovation and climate change. And it could make greater use of a reformed EU budget to do so. The question is whether new policy themes should be added in a new reform programme. On balance, we believe not. If unrelated objectives are allowed to proliferate, the programme will lose its focus, and it will become increasingly difficult to gauge countries' progress. A credible reform programme cannot simply be an inventory of everything the EU happens to do. A 'Lisbon II' should consequently remain a reform agenda that focuses mainly on growth and jobs.

One criticism of the Lisbon agenda is that it lacks an 'external dimension' and that this constitutes an obvious gap at a time when the growth of emerging economies is posing profound questions about the economic and social organisation of the developed world.[47] The importance of the external environment is made all the more salient by the fact that some of these countries do not share European conceptions about property rights and the rule of law – and that they often have little hesitation about using state-owned economic actors to pursue geopolitical ends. So the growing international integration of emerging economies is not just influencing jobs and income distribution in the developed world. It is also increasingly raising concerns about security. This is notably the case with regard to investments in EU firms by state-owned vehicles from potential geopolitical rivals like China and Russia.[48]

[47] *Laurent Cohen-Tanugi, 'Beyond Lisbon: A European strategy for globalisation', P.I.E. Peter Lang, 2008.*

[48] *Katinka Barysch, Simon Tilford and Philip Whyte, 'State, money and rules: An EU policy for sovereign investments', CER essay, December 2008.*

Although there is scope for integrating an external dimension into a post-Lisbon strategy, the EU should tread carefully. One area which might benefit from an explicit external dimension would be the 'better regulation' agenda. For example, there might be a case for making the EU's regulatory convergence talks with the US an explicit part of a post-Lisbon strategy.[49] But the EU must make sure that the development of an 'external dimension' does not become the thin end of a protectionist wedge or an excuse for failing to reform internally. Globalisation provokes lazy thinking. All too often, it is invoked, by proponents and detractors alike, as the reason for pushing through reforms which have little to do with it. The truth is that many of the most pressing challenges facing EU countries are prosaically domestic. And it is illusory to hope that these will go away if the EU takes steps to shield itself from its external environment. The problems arising from population ageing, to cite an obvious example, will not be resolved by trade policy.

[49] *Philip Whyte, 'Narrowing the Atlantic: The way forward for EU-US trade and investment', CER report, March 2009.*

How could EU countries be persuaded to take the Lisbon agenda more seriously? In truth, there is no magic bullet. Some observers believe that the EU needs a more constraining mode of governance. But apparently tough external legal constraints are no guarantee of member-states' compliance, as the EU's Stability and Growth Pact demonstrates. Anyway, there is no prospect of responsibility for labour markets and education being transferred from national to EU level. So the Commission is not in a position to force member-states to change in many of the areas covered by the Lisbon agenda – and never will be. But it might be able to make a difference at the margin. It could improve its methodology for assessing NRPs. And it could be less reticent about publishing comparative tables tracking the member-states' progress towards some of the key targets.

In the end, however, responsibility for reform rests overwhelmingly with the EU's member-states. With the EU facing the worst economic downturn since its creation, the greatest short-term risk is that countries start rowing backwards in an attempt to placate domestic interest groups opposed to change. This would have disastrous repercussions, not just for the EU's single market but also for some countries' ability to prosper within the eurozone. Even in a relatively benign scenario, countries may be tempted to follow the path of least resistance – implementing reforms in areas where the perceived political costs are low, but avoiding them where they are potentially high. This would be a shame because product and labour markets are more interconnected than is often recognised: the benefits of reforms in superficially unrelated areas often amount to more than the sum of their parts.[50]

[50] *Alberto Alesina and Francesco Giavazzi, 'The future of Europe: Reform or decline?', MIT press, 2007.*

Overall assessment of results: C

★

The scorecard table

★

Issues	2009	Heroes	Villains	2008	2007	2006	2005	2004	2003	2002	2001
A. Innovation											
Information society	B	Estonia, Finland, Sweden	Bulgaria, Greece, Italy	B+	B+	B	B	B-	B-	C+	B+
Research & development	D	Austria, Finland, Sweden,	Greece, Italy, Spain	D	D+	C-	C-	C	C-	C+	B-
B. Liberalisation											
Telecoms & utilities	C	The Netherlands, UK	Germany, Poland, Slovakia	C-	C	C+	C+	C+	B-	B-	B+
Transport	C-	Germany, Sweden	Greece, Ireland	C-	C-	C+	C+	C+	B-	D-	D
Financial & general services	C	Spain	Ireland	B-	B-	C-	B-	C+	B-	B-	C+
C. Enterprise											
Business start-up environment	B	France, Ireland, UK	Greece, Poland, Spain	B	B	B	C	C	B-	D	D
Regulatory burden	B	The Netherlands	Greece, Italy, Spain	B	B	B+	C+	C	C+	C-	D+
State aid & competition policy	C	The Commission	France, Italy, Poland	B	B-	B-	C+	C+	C+	B-	B+
D. Employment and social inclusion											
Bringing people into the workforce	B-	Austria, Denmark, The Netherlands	Hungary, Malta, Portugal	B-	C+	C	C	C-	C	B-	B-
Upgrading skills	B-	Finland, The Netherlands, Sweden	Greece, Portugal	B-	B-	B-	C+	C	C	C-	D
Modernising social protection	C+	Denmark, Sweden	Greece, Italy, Portugal	C+	C	C	B-	B-	C	B-	C+
E. Sustainable development											
Climate change	B+	Sweden, UK	Italy, Poland, Spain	B+	B-	B	C-	C-	C+	C	N/A
Conclusion											
The Lisbon process	C	Austria, Czech Republic, Denmark, Sweden	Greece, Hungary, Italy, Poland, Spain	C+	C+	C	C	C	C+	C-	B+
Overall assessment of results	C			C+	C	C	C	C	C+	C	C+

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NEW IDEAS FOR A NEW EUROPE

THE LISBON SCORECARD IX

How to emerge from the wreckage

Simon Tilford and Philip Whyte

EU governments are taking increasingly unorthodox measures to prevent the economic crisis from overwhelming their economies. They are right to intervene, but their policies must not undermine Europe's long-term economic growth prospects in the process. The Lisbon scorecard IX argues that the financial crisis should not be used as an excuse to go slow on economic reform. The European Commission needs to resist what is likely to be ferocious lobbying for a dilution of competition policy and state aid rules. A retreat from the liberalising agenda of recent years would cause as much damage to the European economy in the long term as the financial crisis is doing in the short term.

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

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