CENTRE FOR EUROPEAN REFORM

THE LISBON SCORECARD VIII

Is Europe ready for an economic storm?

Katinka Barysch, Simon Tilford and Philip Whyte

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CLIFFORD

CHANCE

Clifford Chance is delighted to sponsor the Lisbon scorecard again this year. The EU's Lisbon strategy is now in its eighth year, and three years into the 2005 re-launch.

As a service business, we welcome particularly the renewed emphasis placed by the European Commission on investing in people, and substantially reducing early-school leaving and improving basic reading skills. Daniel Gros draws attention in his article to the pivotal, yet often overlooked, link between education and employment. This is of key importance to Clifford Chance. We invest huge resources in attracting the best people to our business. We need people within Europe to have the necessary skills. Getting the proportion of the EU workforce with secondary education above 85 per cent must be seen as an imperative.

The year 2007 changed the European Union in many significant ways, politically, economically and institutionally. There was a change in leadership in two of its biggest economies, agreement on a new treaty that will bring institutional changes to carry the EU through the coming years, and a credit crunch that started in the US, but quickly demonstrated once again how intertwined our economies are with the rest of the world.

This publication does a fantastic job of measuring how member-states are progressing, and invariably throws up some interesting – and unexpected – findings. We commend and support the CER for its continued work to ensure a competitive Europe.

Stuart Popham

Senior Partner, Clifford Chance LLP

Foreword

JPMorgan is a global financial services firm proud of its historical roots in Europe and its extensive engagement across the modern European Union of today. We are glad to support this year's Lisbon scorecard, which serves as an invaluable tool for measuring member-states' efforts towards creating a productive and competitive EU.

This report highlights the real progress that many EU countries have made with structural reform and market liberalisation. The results are clear to see, with the EU's growth rate noticeably accelerating since 2006. This is encouraging, but there is clearly still plenty of work to do, and against the background of a more challenging global economy in 2008.

The impact of recent financial market turbulence has been felt across the world and has highlighted how globalised and inter-connected today's economy has become. This reality, and the interest of the wealth funds of the east in western markets, might tempt some to start raising the drawbridge. What previous Lisbon scorecards have shown is that open markets, competition and effective regulation are good for Europe and its citizens. We hope that the Union will remain true to these principles, internally and in its dealings with those from beyond its borders.

Challenges posed by difficult financial market conditions, and the opportunities created by new players in the global economy require more co-ordination, not less. Regulatory co-operation between authorities around the world makes markets more effective, as well as safer, and is a priority for 2008 that goes hand in hand with economic reform.

Walter Gubert

Chairman, Europe, Middle East and Africa

Foreword

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

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

In our own business, the European Commission's Eighth Directive is a prime example of the sort of regulation that can support real integration and a properly functioning, efficient single market. The directive clarifies the duties of statutory auditors, sets clear principles for objectivity and encourages cross-border ownership of accountancy firms.

This allowed us last year to start creating KPMG Europe LLP. Clients are already starting to see the benefits of our UK, German and Swiss practices working closely together, particularly in the key international market sectors.

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

John Griffith-Jones

UK Chairman and Senior Partner, KPMG LLP

Foreword

I want to commend the Centre for European Reform on another well-researched and lucidly argued annual Lisbon scorecard. As the CER points out, the Lisbon targets have promoted policy innovation, public-private sector partnership and a stronger European consensus about the necessity of change if Europe is to stay wealthy and secure in a globalising world.

I also want to recognise the contribution of the European Commission in listening to the private sector and responding with pan-EU initiatives to promote entrepreneurship and innovation, such as the Enterprise Europe Network to support small entrepreneurs with high growth potential.

Microsoft is an active partner in a wide range of initiatives to promote growth, jobs and opportunity for Europe and its citizens – through investments and partnerships in R&D and innovation, entrepreneurship programmes to support the growth of small and medium-sized enterprises, and education and community-based skills training in information and communication technology. For example, we have helped to create the Alliance for Skills for Employability, to retrain people who are unemployed or who work in declining sectors. Our goal is to give access to technology and training to 20 million Europeans by 2010.

One of the key messages from this latest CER Lisbon scorecard is that the marketplace of the future is even more competitive than in the past decade, especially with the rise of China and India. It means all of us – in government, business, academia and civil society – need to keep pushing forward in all areas with even greater urgency and commitment.

Jan Muehlfeit

Chairman Europe, Microsoft Corp.

Foreword

Unilever is one of the world's leading suppliers of fast-moving consumer goods, and 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.

We are an international company but recognise that a prosperous and growing European economy is vital to our success. That is why we are pleased to once again support the CER Lisbon scorecard.

As this year's scorecard highlights, there is continued reason for cautious optimism that Europe's economy is moving in the right direction. The underlying investment in education, innovation and liberalisation is essential to helping sustain this longer term.

The current economic uncertainty underlines the need to further accelerate the pace of reform. It remains critical to Europe's long term prosperity that we respond positively to the challenges of globalisation.

To meet these challenges, Europe needs to reinforce and intensify its 'better regulation' and reform initiatives. From the perspective of the fast-moving goods sector, we see a wide range of legislative proposals on the horizon that will be crucial to shaping the future business climate in Europe.

This includes proposals for nutrition labelling of foods; the setting of targets for the use of biofuels; the adoption of new authorisation procedures for novel foods; the overhauling of EU rules on cosmetics; as well as the labelling of chemicals in products.

We believe that it is essential these measures take full account of the impact on competitiveness in global markets.

Miguel Veiga-Pestana

Vice President, Global External Affairs, Unilever

1 Introduction

After more than half a decade of economic gloom, the years 2006 and 2007 finally restored some much-needed optimism to the European Union. GDP growth rates in the EU-27 outstripped those in the US in both years, reaching 3 per cent in 2006 and an estimated 2.9 per cent in 2007. Even if the fast-growing East European members, as well as Denmark, Sweden and the UK, are left out, the eurozone still registered respectable growth figures of 2.8 and 2.6 per cent over the last two years.

The economic upswing is partly a cyclical recovery after five years of under-performance. But that is not the whole story. Many European countries have worked hard to improve the structural underpinnings of growth. They have opened up previously closed markets for transport and communication; they have reformed retirement systems to encourage people to work longer; they have made life easier for small companies; and they have modernised their education systems. In short, they have followed the recommendations of the EU's Lisbon agenda for growth and jobs, a set of pledges that EU leaders signed up to in 2000. As a result of these reforms, many economists estimate that the EU's trend growth – the rate at which an economy can expand without overheating – has picked up: from around 2 to 2.25 per cent or higher, depending on which calculations are used.[1]

[1] *For an optimistic view see Goldman Sachs, 'European weekly analyst 07/17', May 2007.*

A laboratory for reforms

National governments rarely give the EU much credit for higher growth and job creation. Instead, they tend to blame the EU for a plethora of economic ills, ranging from red-tape to low-cost competition, while ascribing successes purely to national policy-making. It is indeed hard to establish a clear link between the Lisbon agenda and Europe's economic performance. First, GDP growth depends on various factors that have little to do with Lisbon, such as strong demand from emerging markets, technological change, global commodity prices or new business opportunities linked to eastward enlargement. Second, the Lisbon agenda, with its soft targets and 'open method of co-ordination', leaves governments a lot of leeway over how and when to adopt reforms. As a result, there are vast differences in performance between the EU countries. These differences have been the subject of the CER's Lisbon scorecard for the past seven years.

While the EU cannot force individual member-states to reform, Lisbon has made an indirect but noticeable contribution to Europe's recovery. It has done so by helping to foster a consensus among Europeans that change – while often painful and sometimes scary – is necessary if Europeans want to stay wealthy and secure in a globalising world. Lisbon has also initiated a useful process of comparing and contrasting among countries, so that they can learn from each other what works and what does not. For example, most European countries have had a close look at the success of the Nordic countries, which manage to combine high living standards, low unemployment, fast growth and solid social security systems. Of course, no national model is perfect: the Nordic countries themselves are struggling with quite a few problems; and any attempt to transfer all of their successful policies to countries that are bigger, poorer, less homogeneous or less efficient would be far from easy.

Nevertheless, the European Commission encourages all member-states to move towards 'flexicurity' in their labour-market policies; that is to copy Denmark's successful combination of relaxed hiring and firing rules, and extensive help for the unemployed to get back into jobs. European countries have also studied with interest other economic policy initiatives around the EU, ranging from Spain's 'gas release' programme for energy market liberalisation to Austria's

'portable' severance pay and Finland's education reforms that give schools and universities more autonomy. Conversely, Europeans have also become more acutely aware of policies that are not worth copying. Rather than leading to harmonisation and homogeneity, the Lisbon agenda has helped to turn the EU into a laboratory for economic policies.

Millions of new jobs

One of the most encouraging features of the recent upswing has been the strong performance of Europe's labour markets, which economists had long regarded as the continent's weak spot. During the 1980s and early 1990s, rising unemployment and a move towards shorter working hours reduced Europe's growth rates. Since then, however, job creation has picked up and unemployment has come down – and in countries such as Estonia, France and Germany, considerably so. In 2006-07 alone, the EU economies created an estimated 7-8 million jobs. In some countries, such as Italy, the Netherlands and Spain, many new jobs were initially part-time, which limited the contribution that employment made to growth. But in many others, including Austria, Belgium and France, higher employment rates have recently gone hand in hand with longer working hours.[2]

[2] *OECD, 'Employment outlook', June 2007. The average European still worked 200 fewer hours than the average American in 2006.*

The better employment numbers partly reflect growing demand. But the fact that the biggest improvements were registered among older workers and women suggests that policy changes – pension reforms, better childcare or the move towards more flexible labour contracts – have also played a role. Another indication that something more fundamental is at play is that European unemployment keeps falling without workers demanding much higher pay-cheques. One exception is Germany. But in that country higher wage demands have come after almost a decade of stagnating salaries – and they will be needed if the country is to overcome its weak domestic consumption.

No room for complacency

Despite these encouraging numbers, Europe cannot rest on its laurels. The credit crunch and the downturn in the US will test the robustness of Europe's recovery in 2008. Towards the end of 2007, EU growth had already slowed markedly, although some European business surveys showed signs of dogged optimism, and order books across the continent were still reassuringly full. All EU countries will be affected by slowing demand for exports – the US is still Europe's single most important foreign market[3] – and by tighter credit conditions. But only a few EU member-states have been through US-style housing bubbles, most notably Ireland, Spain and the UK. And the improvement in public finances that many EU countries have achieved in recent years will leave them with a little more room to react to slowing growth in the short term.[4]

[3] *The US accounted for 18 per cent of the EU's total external trade in 2006.*

[4] *The average budget deficit in the eurozone fell to an estimated 0.8 per cent of GDP in 2007, compared with more than 3 per cent in 2003. The US recorded a budget deficit of 2.7 per cent of GDP in 2007.*

That said, most EU countries still fall well short of the Lisbon targets: only five out of 27 had reached an employment rate of 70 per cent by 2006; only two spent more than 3 per cent of GDP on research and development; and most were missing their targets for cutting greenhouse gas emissions, to give only a few examples. Even those member-states that measure up well against Lisbon's (admittedly crude) targets still often have a lot of work to do to raise their employment rates and their productivity growth.[5] At the moment, most EU countries manage to achieve one or the other, but not both (see the Lisbon scorecard VII, pages 4-5).

[5] *OECD, 'Economic policy reforms: Going for growth', 2007.*

Encouragingly, many EU countries have committed themselves to more or less ambitious programmes for further reform. Others, however, seem to be succumbing to the temptation of using the upswing to reverse budgetary tightening (Italy), tone down ambitious reform plans (France) or even roll back recent achievements (Germany). Too much of this kind of complacency, and Europe's recent economic gains may be short-lived. There are other risks to Europe's medium-term economic outlook, such as calls for protectionism in response to China's economic rise, or for new barriers to cross-border capital flows to keep out investment by sovereign wealth funds. As the ten-year Lisbon programme enters its home-straight, Europe still faces a daunting economic agenda.

The Lisbon 'league table'

The CER's annual Lisbon scorecard provides an overview of the EU's record on economic reform. It is not a predictor of short-term economic performance. Instead, it points to the capacity of member-states to flourish in a world in which high-cost countries cannot sustain their living standards unless they excel in knowledge-based industries. Since we are analysing dozens of policy areas in 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 make slow progress are designated as 'villains'.

The scorecard's 'Lisbon league table' (see page 12) provides an assessment of a country's overall Lisbon performance in 2007, and compares it with its performance in 2006 (see the Lisbon scorecard VII, 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.

Strong performers

Denmark and Sweden are once again ranked first and second in the table. Both countries score highly across indicators of social equity, labour market performance and environmental sustainability. They also do very well on measures of innovation, such as R&D spending. Both countries manage to combine high levels of taxation and comprehensive welfare provision with competitive product markets and, in Denmark's case at least, a very high degree of labour market flexibility. Neither country is perfect, however. Only Italy and Portugal have experienced weaker growth in GDP per capita than Denmark since 2000, with economic growth being held back by lacklustre productivity growth. Sweden's productivity performance has been stronger, but very low levels of business investment cast some doubt over its sustainability. Moreover, although Sweden's official rate of unemployment is low, the country has exceptionally high youth unemployment and large numbers of people on long-term sick leave. While they still top the rankings, Denmark and Sweden are not the heroes of the 2008 scorecard.

Austria and the Netherlands, ranked third and fourth, are this year's heroes. 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 these economies GDP data are rather misleading indicators of living standards. 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. The Netherlands' principal weakness is the low level of R&D expenditure, which has fallen sharply since 2000 as a proportion of GDP. However, as we discuss in the report, the level of R&D expenditure is often a poor indicator of economic growth and innovation potential.

Austria should receive more plaudits for the management of its economy. The country scores well across most of the social and

employment indicators, and successive governments have acted decisively to improve the labour market. As a result, Austria became the fifth EU country to meet the target of an employment rate of 70 per cent in 2006. The country has also been at the forefront of EU efforts to reduce the regulatory burden facing businesses. On the negative side, productivity per hour worked is low, the country's effective retirement age remains below 60 and is not expected to reach 65 for another three decades, and Austria has struggled to contain its rising greenhouse gas emissions.

Estonia is our final hero. It rose by four places in 2007 to 11th, making it the highest placed of the EU's new member-states. Estonia has enjoyed extremely rapid growth in per capita GDP since 2000, with the result that it is now the third wealthiest of the ex-communist members of the EU. A determined effort to improve the functioning of its labour market and business environment has paid dividends. The country's employment rate is not far from meeting the 70 per cent target, and when it comes to keeping older workers in employment, it ranks third in the EU. Estonian businesses and foreign firms with operations in Estonia are moving up the value-chain. Estonia also does well on some indicators of the knowledge economy, such as internet usage. The biggest challenge facing the Estonian authorities is to prevent the economy from overheating.

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 their performance will largely determine the performance of the Union as a whole. The UK remains the best performer among these bigger member-states, in seventh place. However, it has slipped three places compared with 2006. By contrast, Germany has risen from 9th to 8th place, while France has risen from 11th to 9th.

Strong growth in GDP per capita means that the UK is the wealthiest of the five big member-states (although it only ranks 8th in the EU-27). It has the most competitive product markets in the EU and one of the most flexible labour markets. However, progress in reducing the country's still high degree of social inequality has slowed, and the official unemployment rate underestimates the true level of joblessness, because the UK has exceptionally large numbers of people claiming incapacity benefit. Britain's long-term growth prospects probably remain the strongest among the big five, but only if the UK authorities move aggressively to tackle increasingly serious infrastructure bottlenecks.

France boasts easily the highest labour productivity of the five big member-states, though the flipside of this is a comparatively low employment rate. In this respect, Germany lies between France and the UK: productivity and the employment rate are both relatively high. Germany, even more than France, saw rapid improvement in its labour market in 2007. German unemployment fell by almost 2 percentage points. In part this reflected relatively rapid growth in real GDP, but also the impact of labour market reforms that have tightened eligibility for unemployment benefits. Some of the country's numerous long-term unemployed have been forced back into the labour force, albeit often on very low wages. The number of Germans living in poverty has increased significantly since 2000, whereas France has succeeded in reducing poverty rates.

German expenditure on R&D is the third highest in the EU, at an estimated 2.6 per cent of GDP in 2007. While this is considerably higher than France or the UK, let alone Italy or Spain, German R&D is highly concentrated in mature sectors such as the car industry. Moreover, the country has struggled to generate well-paid service sector jobs, which is the principle reason why it remains so dependent on exports for economic growth. The long-term growth prospects of the French and German economies are probably about the same. While it is true that the price competitiveness of German manufacturing exports has improved considerably, following years of wage restraint, the German economy has become increasingly unbalanced. The burgeoning current-account surplus is not only a sign of competitiveness but also of an excessive dependence on exports to drive economic growth. Germany needs well-paid service sector jobs, and these require more competitive and flexible labour and product markets.

The Spanish economy has expanded rapidly in recent years, and despite unprecedented levels of immigration, it has closed much of the gap in GDP per capita with the wealthier members of the EU. However, further convergence is unlikely, at least in the short to medium term. Much of the economic growth has been driven by the construction sector, which is now contracting rapidly as the country suffers from a huge glut of residential housing. This means that in the coming years productivity growth will have to be the main source of Spanish growth. To achieve this, Spain will have to speed up the diffusion of new technologies, upgrade skills and create a more conducive environment for innovation. It also needs to do much more to arrest its rising emissions of greenhouse gases.

We do not always judge the new member-states by the same criteria as the long-standing ones because most of them start from a much less favourable position. For this reason, we have put Hungary and Poland in the 'must do better' category, rather than classifying them 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.

It is a long time since Hungary was considered the star performer among the transition economies of Central and Eastern Europe. Efforts to reduce the sky-high budget deficit have been impressive. However, with a declining population, and rapidly rising costs that are eroding Hungary's attractiveness as an investment location, it urgently needs higher productivity growth. Therefore, the government needs to take steps to improve the labour market and inject more competition into protected sectors. The Polish economy is expanding rapidly and the country is running only moderate budget and current-account deficits. However, Poland needs to do more if rapid economic growth is to be sustained. Polish unemployment has fallen very sharply over the last three years, but this is in part the consequence of the mass migration of Polish workers to other member-states. Despite some laudable efforts at reform, the Polish labour market remains generally sclerotic. Moreover, the regulatory burden on business is one of the most onerous in the EU.

Bulgaria and Romania joined the EU at the start of 2007, so they have only just started to plan and present their reform efforts in the Lisbon framework. Although these countries rank close to the bottom of our league table, we considered it too early to assess their overall performance. Both countries have been growing at over 6 per cent recently, which has resulted in rapid growth in incomes. But burgeoning current-account deficits and rising inflation also hint at a risk of economic overheating. Too much red tape, low employment rates and inefficient education systems are among the structural challenges to be addressed in both countries. The Commission says that Bucharest and Sofia have credible reform plans in some areas. But they need to redouble their efforts to shake up inefficient state administrations and tackle ubiquitous corruption if these plans are to stand a chance of being successful.

Laggards

The news that the Spanish are now richer than the Italians caused a major shock in Italy when the data was published in December 2007. It provided a stark illustration of how steep the decline in Italy's relative prosperity has been over the last ten years. In 1997, the country was wealthier than France and the UK, but by 2007 it had fallen a long way behind both of them. What matters for the ranking in the scorecard is not past performance, but growth prospects. Here the evidence is decidedly mixed. There are some indications that Italian exporters in low and medium-technology

sectors are moving up the value-chain in response to the challenge posed by rapidly industrialising emerging markets. However, Italy is going to have to raise its game to avoid a further decline in its relative prosperity within the EU. It scores poorly on just about every indicator, ranking 23rd overall. Only Bulgaria, Malta, Poland and Romania do worse. The outgoing government of Romano Prodi made very tentative moves to introduce more competition in previously regulated markets and liberalise some professions. But it failed to build on the limited labour market reforms introduced by the previous government of Silvio Berlusconi.

Greece rises by three places to 19th in this year's scorecard, but this flatters the country. Although GDP per capita has grown rapidly since 2000, there are a number of reasons to doubt the sustainability of this performance. 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. Finally, Greece does not have the human capital to flourish in a world where knowledge will increasingly determine the wealth of economies. Not only is its labour market highly restrictive, but overall skill levels are low. Unlike the new member-states, Greece has had plenty of time to take advantage of the Lisbon agenda, but it has wasted many opportunities. For this reason, it joins Italy as one of the two villains of the 2008 scorecard.

The Lisbon process = C+	
Heroes	Austria, Estonia, The Netherlands
Villains	Greece, Italy

The Lisbon league table: Overall Lisbon performance

	Rank 2007	Rank 2006
Denmark	1	1
Sweden	2	2
Austria	3	5
The Netherlands	4	3
Finland	5	6
Ireland	6	8
UK	7	4
Germany	8	9
France	9	11
Slovenia	10	12
Estonia	11	15
Luxembourg	12	7
Belgium	13	13
Czech Republic	14	10
Cyprus	15	14
Spain	16	17
Latvia	17	18
Lithuania	18	20
Greece	19	22
Slovakia	20	23
Portugal	21	16
Hungary	22	19
Italy	23	21
Romania	24	25
Bulgaria	25	24
Poland	26	27
Malta	27	26

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. There are worrying reasons why European businesses still spend too little on research and development. Japan, the United States and increasingly emerging economies such as China look set to dominate the production of high-tech products unless the EU rapidly improves its performance.

★ **Liberalisation**

In theory, the EU succeeded in creating a single market for goods and services in 1992. In practice, many barriers to cross-border business remain in place. At Lisbon 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

Many EU economies are slow to adopt and spread new technologies. This matters because differences in 'technological readiness' help explain much of the variation in productivity growth between countries.[6] The reasons for Europe's disappointing productivity growth are complex, but its weakness in using information and communication technologies (ICT) is undoubtedly part of the problem. US companies' ability to benefit from ICT, in particular in the services sector, explains much of the gap between US and EU productivity, especially in total factor productivity. (TFP is a measure for the efficiency with which labour and capital are used).[7] There is strong statistical evidence linking expenditure on ICT and productivity growth. Stronger investment in ICT, and the faster TFP this has spurred, explains much of the gap in US and EU economic growth over the last ten years.[8]

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

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

Most of the EU-15 countries that have achieved the fastest growth in per capita GDP over the last ten years, for example, Finland, Sweden and the UK, have all recorded very high growth rates in IT investment and TFP. By contrast, weak technological progress has been a key factor holding back countries that have posted the slowest growth in GDP per capita over this period – Italy in particular (see graph on page 17).

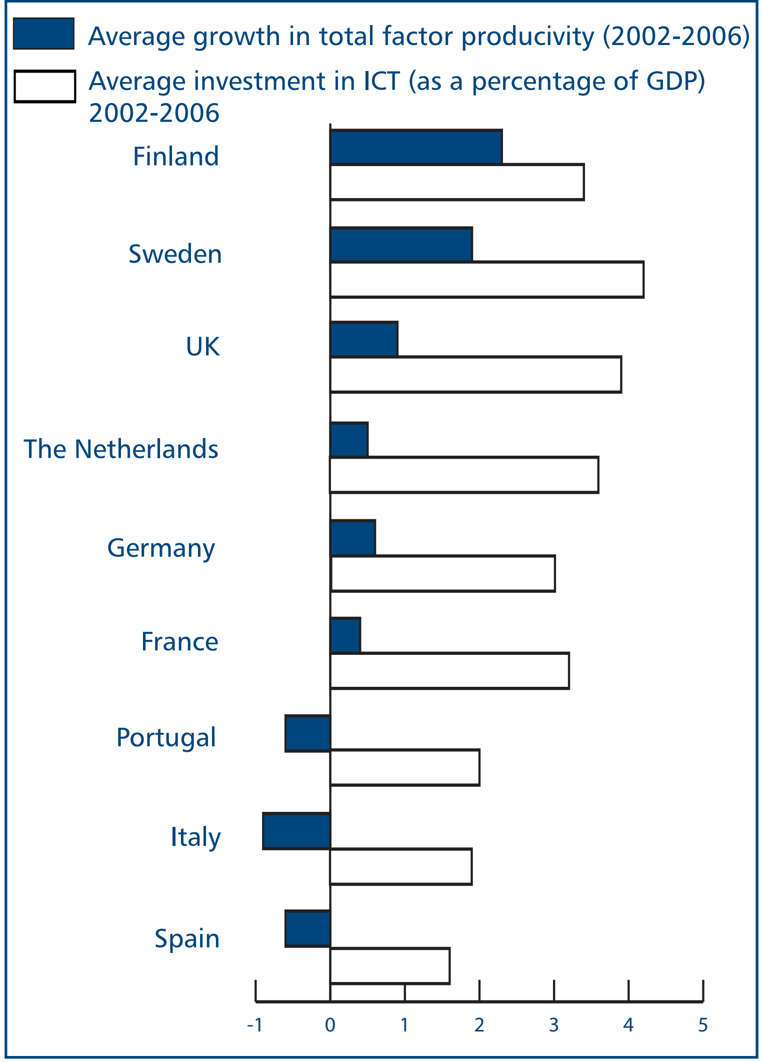
Perhaps the two most important things the EU could do to accelerate the spread of ICT would be to encourage member-states to integrate their services sectors (see section B3, page 51) and loosen employment protection legislation. Not all services are tradable by nature, but a principal reason for the low level of intra-EU trade in services is that service sectors are too fragmented to ensure the scale necessary to make innovation worthwhile. Breaking down the barriers to trade in services would encourage firms to make better use of ICT by providing greater economies of scale. Relaxing employment protection legislation could also make it less costly for firms to restructure – and hence accelerate the diffusion of new technology. Restrictive employment legislation may help to explain why growth in TFP in France has been so disappointing, despite high levels of investment in ICT in the country.

A digital divide

An advanced and competitive telecommunications infrastructure is critical to promoting the knowledge economy. Some EU countries are already very well-placed, as shown by the e-readiness ranking compiled by the Economist Intelligence Unit (EIU). The EIU's ranking assesses a country's ICT infrastructure, and the ability of its consumers, businesses and governments to benefit from ICT.[9] Five EU economies plus Switzerland are ranked among the top ten worldwide. Denmark is the global leader, ahead of the US. However, the ranking also illustrates the extent of the digital divide within the EU, with the poorest placed EU-15 country, Greece,

[9] *Economist Intelligence Unit, 'The 2007 e-readiness rankings', 2007.*

Total factor productivity and investment in ICT



Source: Economist Intelligence Unit

ranked 32nd (out of 68 countries), and the lowest ranked EU-27 state, Bulgaria, in 48th position.

E-readiness rankings, 2007

	Rank	e-readiness score (out of 10)
Denmark	1	8.88
US	2	8.85
Sweden	3	8.85
Hong Kong	4	8.72
Switzerland	5	8.61
Singapore	6	8.60
UK	7	8.59
The Netherlands	8	8.50
Australia	9	8.46
Finland	10	8.43
Germany	19	8.00
France	22	7.77
Italy	25	7.45
Spain	26	7.29
Greece	32	6.31
Bulgaria	42	5.01

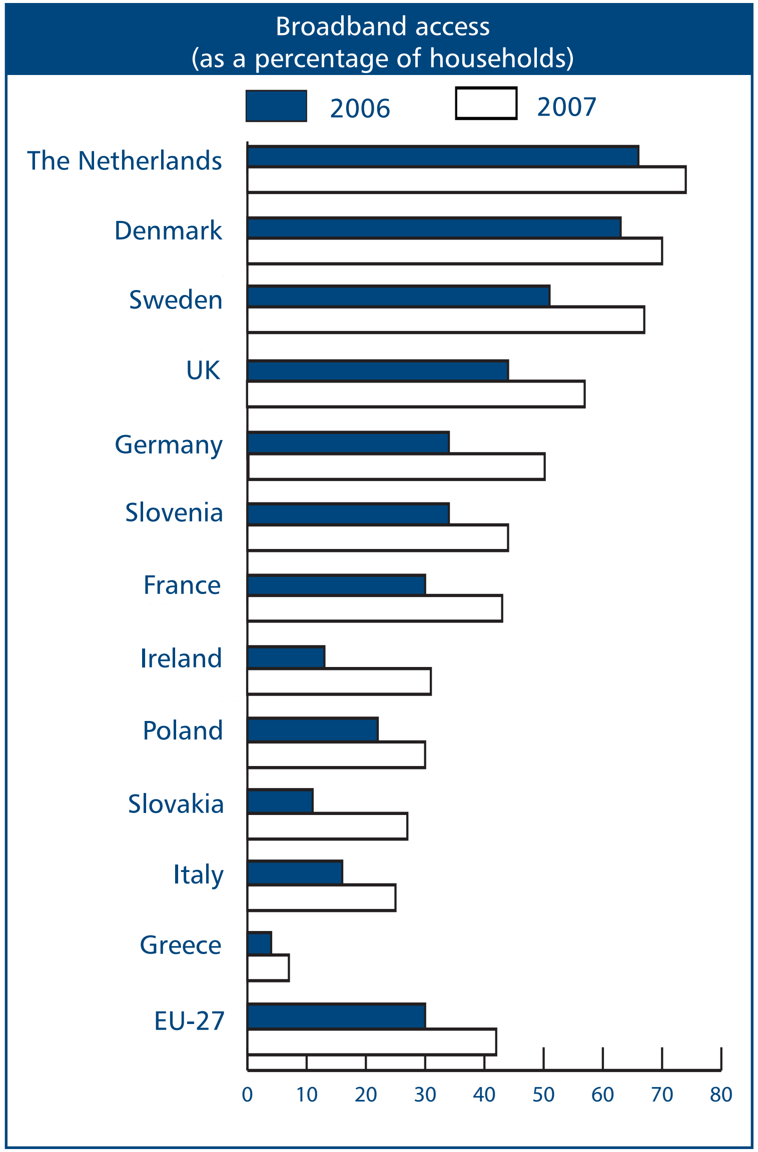
Source: Economist Intelligence Unit

Fifty-four per cent of EU-27 households now have an internet connection, although marked differences between individual member-states persist. In Denmark, Germany, Luxembourg, the Netherlands and Sweden, more than 70 per cent of all households were wired up in 2007, compared with less than a third in Bulgaria, Greece and Romania. Of the countries that have joined the EU since 2004, Estonia and Slovenia have the largest share of households

with access to the internet. Romania and Slovakia made the fastest progress in 2007, with the number of households with internet access rising by 57 per cent and 70 per cent, to 22 per cent and 46 per cent respectively.

The proportion of EU households using broadband to access the internet jumped by two-fifths to 42 per cent in 2007. Denmark and the Netherlands had the highest broadband penetration, with 74 per cent and 70 per cent, respectively. Sweden was not far behind, at 67 per cent. The biggest improvements in 2007 were registered in Ireland, where the share of households using broadband rose from 13 to 31 per cent, and in Slovakia, with a rise from 11 to 27 per cent. Greece remains the EU laggard, with a share of just 7 per cent. Broadband finally took off in Italy in 2007, with the proportion of Italian homes with broadband rising by 9 percentage points to a quarter of the total. However, this was still the fifth lowest in the EU-27, and below eight of the countries that have joined the EU since 2004.

However, basic broadband connectivity is no longer enough to ensure the potential of the internet is realised; the connections must be fast, secure and competitively priced. Nearly all domestic broadband services offered in the EU currently rely on copper-wire based telecoms infrastructure, but super-fast broadband services require fibre optic cables. In most major cities across the EU, businesses already have access to fibre-optic networks, but the roll-out of fibre-optic networks in residential areas is set to take place at hugely varying speeds. Laggards are likely to put themselves at a competitive disadvantage relative to the front-runners. The Netherlands and Sweden have taken the lead in investing in full fibre-optic networks, followed by France and Germany. In other countries, notably the UK, there is disagreement over who should pay for such a network. The UK telecoms regulator, Ofcom, has forced British Telecom (the former monopoly and owner of much of the country's fixed telecoms infrastructure) to open its network at very competitive prices. As a result, BT argues that it may not be



Source: Eurostat

commercially attractive for it to invest heavily in a full fibre-optic network (see section B1, page 35).

Much of the EU's focus has been on broadband access for households, but as important are the terms upon which businesses have access. Companies face widely different prices for broadband services across the EU. The UK offers some of the lowest prices for broadband services with bandwidth of up to 8 Mbps, which are sufficient for a small business with only moderate data requirements. Other countries with low tariffs include Belgium, France and Germany. Spain is the most expensive, followed by Ireland and Austria. The fastest speeds available to business in the EU are in Denmark and the Netherlands, Portugal and Sweden. At present, businesses that require more bandwidth than is available with standard broadband have to lease a dedicated fibre-optic line. Fees for these leased lines vary massively across the EU. Germany is most price competitive, and Spain the most expensive.

Another aspiration of the Lisbon agenda is to encourage governments to make use of technology to offer cheaper, easier and more efficient services. According to the latest figures from the Commission in 2007, 65 per cent of government services in the EU were available online, 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 and Slovakia stand out.

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

A2. Research and development

★ Agreement on a European Community patent

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

The creation and diffusion of knowledge is crucial to a country's competitiveness. The EU acknowledged this by adding a numerical target for spending on research and development (R&D) to its Lisbon agenda. In 2006, spending on R&D in the EU accounted for 1.9 per cent of EU GDP, compared with 2.6 per cent in the US and 3.1 per cent in Japan. This 'R&D deficit' is generally assumed to be a major obstacle to faster economic growth in Europe. Only Finland and Sweden currently meet the 3 per cent of GDP target, and no other member-state is on course to do so by 2010. Italy and Spain devote just 1.1 per cent of their GDP to R&D, and in Greece and Portugal the figures are just 0.6 per cent and 0.8 per cent, respectively. Europe's performance in filing patents, another widely used indicator of innovation, is similarly disappointing.

The R&D target has always been the most controversial of the Lisbon agenda's many objectives, and especially since poorer Central and Eastern European countries joined the EU in 2004 and 2007. Levels of R&D are a very imprecise indicator of an economy's growth potential or capacity for innovation. The EU is also far too heterogeneous economically and in terms of industrial structure for a single R&D target to be appropriate. Many of the new members are much further from the technological frontier than the major EU-15 economies. At their stage of development, they are still well-placed to adopt technologies developed elsewhere to drive productivity growth. In short, it is less important for the likes of Latvia or Poland to develop new technologies.

There is some relationship between levels of R&D and GDP per capita, of course, but it is not an especially close one (see the table on page 24). The more technologically advanced an economy gets, the more imperative it becomes for firms operating in that economy to be innovative. However, investment in R&D is not the same thing as innovation. For example, a wealthy economy specialising in fast-growing service industries, such as financial and legal services or advertising, usually has lower levels of R&D than one specialising in slow-growing, medium-technology industries, such as car manufacturing. But the growth potential of the former economy is likely to be higher than that of the latter.

GDP per capita and R&D spending, 2006

	Per capita GDP ($, PPPs)	R&D spending (per cent of GDP)
US	44,000	2.6
Ireland	41,300	1.3
Denmark	36,000	2.4
Canada	35,900	2.0
UK	34,400	1.8*
Sweden	34,100	3.8
Finland	33,300	3.5
Germany	32,000	2.5
Japan	31,900	3.3*
France	31,700	2.1
Italy	29,300	1.1*
South Korea	23,400	3.0
Portugal	21,000	0.8*
Poland	15,000	0.6*

*Source: OECD in Figures 2007, OECD *2005*

Governments should be wary of placing industries in a hierarchy of attractiveness, with R&D-intensive ones at the pinnacle. The crucial factor is the amount of value a business can add, and how sustainable its ability to do so is over time. It is instructive that the

US car manufacturer General Motors has invested more in R&D than any other company in the world over the last ten years, yet the firm has a very uncertain future. (See 'Is R&D a meaningful measure of innovative capacity?' by Michael Schrage, page 29).

The Lisbon agenda's narrow focus on overall R&D spending and patent activity is therefore misguided, and gives a misleading picture of the innovative capacity of the various EU member-states. The openness of firms to new technologies is as important as the R&D intensity of economies. Although much of Europe's deficit in R&D spending vis-à-vis the US reflects lower levels of R&D in information communication technology (ICT), it is Europe's relative failure to make the most of ICT that explains three-quarters of the difference in productivity levels between the US and EU.[10] (See section A1, page 15). Sweden and Finland, the two member-states with easily the highest levels of R&D (relative to GDP), have grown rapidly in recent years because of their receptiveness to new technology and their attractive business environments, not simply because of the R&D budgets of firms like Nokia and Ericsson.

[10] *European Commission's Expert Group on Knowledge for Growth, 'The EU's R&D deficit and innovation policy', April 2007.*

However imperfect R&D is as a measure of innovative capacity, the reasons for the relative lack of R&D are a real concern. European firms are big investors in R&D in sectors in which they are dominant, such as car manufacturing and mechanical and electrical engineering. But across the EU, there are strikingly few firms in fast-growing (and R&D-intensive) new sectors, with the notable exception of mobile telephony. Six US companies created within the last 30 years are among the world's top 100 firms (by market capitalisation); by contrast just one European company – Vodafone – makes the list. It is the underlying reasons for Europe's weak R&D performance that should dictate the policy agenda. Policies aimed at stimulating R&D directly, such as tax breaks and subsidies, will do little to address these problems. Similarly, increasing the availability of EU funds for R&D is unlikely to have a substantial impact. Instead, Europe needs to make it easier for firms in new sectors to expand, and must increase market incentives to make the most of existing technologies.

The way forward

In many areas, rules and regulations in Europe appear to act as a constraint on productivity growth. Although the gap has narrowed, EU product and labour markets remain highly regulated compared with the US. The EU needs more integrated and competitive markets. This 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 (see section B3, page 51). 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. If the EU is to replicate the spurt in productivity we have seen in the US, service providers must make better use of technology.

The EU also needs more harmonisation of regulatory requirements. Combined with more rapid approval procedures, this would help foster innovation of new products and services by providing companies with greater economies of scale, and by reducing the cost of regulatory compliance. The adoption of a European Community patent has been held up by governments squabbling over how many languages each application must be translated into. As a result, companies still have to file separate patents in all the main EU countries, which is both time-consuming and costly. The Commission estimates that litigating a small to medium-sized patent case in the UK alone can cost up to €1.5 million at first instance and €1 million before the appellate court. But this is just the beginning: an alleged patent violation has to be resolved in the national courts of all EU countries in which the patent has been violated.

An attempt by members of the European Patent Organisation to forge a voluntary agreement outside the formal European Union legal framework came to nothing. The aim of the so-called European Patent Litigation Agreement (EPLA) was to establish a

central European patent court and common rules for disputes and national courts. However, the Commission and a number of member-states opposed EPLA, on the grounds that it would undermine efforts on the part of the EU to pursue its own patent litigation scheme. The London Agreement, which aims to cut down the number of languages that a patent has to be translated into, did finally come into force in 2008. It will cut the translation costs associated with patenting and accelerate the whole process, but it will not remove the need to file patents in numerous jurisdictions or address the issue of litigation. The best hope is that the member-states manage to agree a community patent that borrows heavily from the rejected EPLA.

EU countries also need to redouble their efforts to remove the remaining obstacles to venture capital provision. Some EU countries are already doing well in this respect, but on the whole, Europe's venture capital industry still lags behind that of the US (see section C1, page 59). Innovation and the adoption of new technologies are impossible without human capital, however. EU skills levels are generally suited to producing capital-intensive goods, such as machinery and cars, where competition is set to intensify rapidly as firms from emerging markets such as China and India enter these markets. Europe's living standards will only be sustainable if EU companies become more successful in knowledge-intensive industries. This, in turn, depends on the availability of highly-trained researchers (see section D1, page 81).

Finally, public procurement of goods and services represents a badly used resource. If the EU is to succeed in accelerating the development and adoption of new technologies, government procurement – around 15 per cent of EU GDP – must play a greater role in stimulating innovation. The EU could do worse than learn from the example of the US small business innovation research (SBIR) programme.[11]

[11] *David Connell, 'Secrets of the world's largest seed capital fund', Centre for Business Research, University of Cambridge, 2006. See also Luke Georghiou's article on demand-side innovation policies in the 'Lisbon scorecard VII', pages 32-33.*

This was established in 1982 and is the world's largest seed capital programme for science and technology businesses. Each year it makes over 4,000 awards to small high-tech businesses. These awards take the form of contracts for the development of technologies that US agencies believe they need in order to improve effectiveness. Many of the leading US technology companies have their origins in the programme. At present, EU state aid rules make it difficult to use public procurement to stimulate innovation.

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

Is R&D a meaningful measure of innovative capacity?

What kind of media mogul believes that a $100 million blockbuster Hollywood movie will be ten times more entertaining – let alone ten times more profitable – than that skillfully marketed $10 million independent film? Are there any owners of European football clubs who believe that increasing player wages by 50 per cent will lead to a 50 per cent increase in the number of victories or goals scored?

Yet seemingly rational policy-makers across Europe seriously argue that European countries and companies would be so much more competitive if only they would increase their spending on research and development (R&D). These champions of innovation are distressed that American companies top the OECD's league tables for R&D as a percentage of sales (R&D intensity), at 4.8 per cent. Japanese companies follow at 3.7 per cent, whereas the less intense Europeans lag at 3.4 per cent.

So the dominant thinking in Europe on innovation is that unlike movie production or football championships, there is a positive linear relationship between R&D spending and commercial success. The truth is simpler. Logically, anecdotally and empirically, there is no meaningful correlation let alone actual causality between the sums invested in R&D and business success. R&D spending falls prey to the same diminishing returns that afflict other investments.

The 2006 Global Innovation 1000, compiled by Booz Allen, again confirms that there are no statistically significant relationships between R&D spending and the primary measures of financial or corporate success, including sales and earnings growth, gross and operating profitability, market capitalisation growth, and total shareholder returns.

Average R&D intensity numbers from the OECD and others may be one of those metrics that is so misleading that they are literally worse than no numbers at all. To use them to diagnose the innovative capacity of an enterprise or an industry is akin to treating caloric intake as a proxy for estimating height instead of weight. A case can be made that there is some correlation between height and weight. But building a public health policy around it would be bizarre. Why would European policy-makers look to even feebler correlations as inspiration or justification for their R&D innovation policies?

Far more damning than the aggregates and averages, however, are firm-level examples. Apple, widely and rightly regarded as one of the world's most innovative companies, has not appeared on the Standard & Poor's/Institute of Electrical and Electronic Engineers (S&P/IEEE) R&D 100 leader board in the five years the ranking has been in existence. The creator of the iPod, iTunes and iPhone had an R&D budget of $712 million in 2006, on sales of over $19 billion – an R&D intensity of 3.7 per cent. By contrast, Sony's R&D intensity was 6.6 per cent and Nokia's 9.5 per cent. Between those three rival personal electronics giants, whose R&D spending delivers the best value for money?

Google is perhaps the fastest-growing technology company of the past 50 years, but it did not make it into the S&P/IEEE R&D 100 list until 2007. The search giant entered in 79th place, with an R&D intensity of 11.5 per cent – well below Microsoft's 13.9 per cent or Oracle's 12.2 per cent. Is Google an R&D laggard?

The idea that automobile R&D is the road to global competitiveness is even more far-fetched. Five years ago, Toyota ranked 4th among the 12 leading car-makers for R&D, spending less than two-thirds of what Ford Motor spent. Toyota has since become the largest (and most profitable) car manufacturer in the world, whereas Ford is in rapid retreat.

The closer one looks at the R&D numbers, the more confidently they can be dismissed as essential ingredients of profitable innovation. The more one examines intra-industry variances in R&D spending and intensity, the more difficult it becomes to see how more money translates directly or indirectly into innovation and competitiveness.

The point is not that R&D spending is irrelevant or wasteful. That would be an equally fallacious leap. The point is that significant investment based on bad numbers is bad business and worse policy. We can do better. If policy-makers believe that sustainable innovation is key to economic growth and prosperity,

then industrial rivalry and competitive intensity are far better indicators than R&D intensity.

Increased information about the profitability of investment in R&D would be a step forward. For example, if companies disclosed, on a risk-adjusted basis, which R&D investments over the past five years yielded the greatest returns, that would be useful information for investors. If firms disclosed which research relationships with universities generated the most usable information for their business, that would be revelatory.

In essence, policies that would encourage disaggregation and assessment of R&D investment outcomes, rather than R&D budgets and inputs, would provide more information about the effectiveness of R&D spending. Would there be competitive and proprietary risks to such disclosure policies? Of course. But at least those debates would be rooted in the reality of results rather than the fictions of flawed statistics.

Michael Schrage

Senior adviser to the Massachusetts Institute of Technology's Security Studies Programme

Regaining leadership in pharmaceutical innovation

The pharmaceutical industry has long been one of Europe's most successful high-tech sectors. It is also an industry in which there is a clear link between R&D spending and commercial success. In 2005 alone, it invested about €21.7 billion in R&D on European territory – or almost a fifth of all business R&D in the EU. But there are grounds for worrying about the sector's future in Europe.

As recently as the mid-1990s, the EU was the biggest pharmaceuticals player in the world. However, R&D spending is now growing more than twice as fast in the US as it is in the EU. As a result, innovation in the pharmaceutical sector in Europe is slipping behind the US – a fact acknowledged by the Commission in its 2006 Competitiveness Report. Moreover, as Janez Potočnik, the Commissioner for Science and Research, has pointed out, Europe faces growing competition for pharmaceuticals R&D from China and India.

It is not too late to stem the shift of pharmaceuticals R&D to the US (and elsewhere), but we must act quickly. It takes between 12 and 13 years to develop a new medicine. The average medicine costs €900 million to develop, and half of all medicines that reach the last stage of clinical trials fall at that final hurdle. Those that do make it to market have only between eight and ten years of patent protection left, before facing competition from generic copies. Only 30 per cent of new EU medicines on the market pay back the initial R&D investment.

Delays over pricing and reimbursement decisions at national level can keep medicines from patients for over two years after market authorisation is granted. A recent study by the European Federation of Pharmaceutical Industries and Associations (EFPIA) showed that in 18 of the 20 European countries covered in the report, between 20 and 94 per cent of the medicines that received a marketing authorisation between 2003-06 were still not available to patients in mid-2007.

The EU needs to review its policy on 'parallel trade' – that is, cross-border trade that exists only by virtue of differences in government-administered prices. Different pricing systems in a fragmented internal market mean that over €4 billion is lost every year to parallel trade flows. By simply exploiting price differentials, parallel traders do not create value for Europe's healthcare, society and economy. But they damage the research-based industry's ability to fund new research, to the overall detriment of patients and medical progress.

The EU should adopt and implement the best policies to encourage innovation. A first test will be the implementation of the newly adopted Innovative Medicines Initiative (IMI). The IMI is a public-private partnership involving the pharmaceuticals industry and the Commission, set up to find ways of improving the research underpinning the development of new medicines.

Brian Ager

Director general of the European Federation of Pharmaceutical Industries and Associations (EFPIA)

B. Liberalisation

B1. Telecoms and utilities

★ Increase competition in telecoms markets

★ Liberalise gas and electricity markets and improve supply security

The year 2007 was supposed to be a milestone on Europe's journey towards an internal energy market: while industrial users have had the right to choose between alternative suppliers of gas and electricity since July 2004, the final deadline for opening up retail markets was July 2007. According to Commission figures, ten of the (then) 25 member-states had fully opened their markets in late 2006, in the sense that customers were entitled by law to switch suppliers.[12] However, legal rules do not give a full picture of progress with liberalisation. In practice, only around 10 per cent of Europeans eligible to choose alternative suppliers actually did so in 2006. Some countries, such as Poland, have put the EU directives on their statute books but subsequently failed to implement them properly. Moreover, 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.[13]

[12] John Goerten and Emmanuel Clement, 'European electricity market indicators of the liberalisation process, 2005-06', Eurostat 2007.

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

However, the fact that competition in wholesale energy markets has remained limited in many EU countries – more than three years after the deadline – indicates that the original directives were not strong enough to open up markets. The clearest indication of the lack of competition is the strong role that the former (often state-controlled) monopolies still play 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, Greece or Slovenia, slow progress in market opening and the absence of real business opportunities for newcomers appear to be the main reason.

Market switching: percentage of customers in each category that had changed supplier by mid-2005

		Electricity	Gas
Germany	Big business	41	*
	SMEs	7	*
	Households	5	*
France	Big business	15	14
	Households	0	0
Spain	Big business	25	60
	SMEs	22	60
	Households	19	2
UK	Big business	50+	85+
	SMEs	50+	75+
	Households	48	47

Source: European Commission, 'Internal market fact sheets', January 2007. More recent data is not available on a comparable basis. SMEs stands for small and medium-sized enterprises.

** Germany does not provide data on customer switching in the gas sector.*

There are some notable differences between the markets for electricity (mostly home-produced) and gas (which is usually imported). But what the two have in common is that when a company that produces/imports energy also controls the means for distributing it (national grids or pipeline networks), newcomers have a particularly hard time to break into the market. In France, for example, just two companies, Gaz de France and Total, account for 95 per cent of all gas imports. Since these two companies also happen to control the pipeline network, few customers have benefited from real choice so far. In Germany, five large, vertically integrated companies control the gas market, with only limited competition between them. 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 is a multitude of players, ranging from the former state-monopoly to the big power companies (which offer packages of gas and electricity supplies) to foreign players (including Gaz de France and the German-Russian Wintershall). Some governments, for example in Austria and Spain, have forced incumbents to release a certain amount of gas from their long-term contracts with suppliers. This gas is then available for trading, which should allow newcomers to gain market shares. The Commission would like many more countries to start such 'gas release programmes'.

In the electricity sector, France also stands out among the big countries as the least open. Electricité de France accounts for 87 per cent of power production, owns the transmission network and directly supplies 95 per cent of customers. In Germany, Hungary and the Netherlands, competition initially increased after market opening, but subsequent consolidation has reduced the number of suppliers again. In Denmark, Finland and Sweden, the number of suppliers in each market is limited, but generation and transmission tend to be fully unbundled; and additional competition comes from regional integration in the 'Nordic power market', which also includes Norway.

The fate of the third directive

Since 2005 – when EU leaders declared energy policy a priority at the Hampton Court summit – the European Commission has redoubled its efforts to prise open Europe's energy markets. It has conducted an enquiry into anti-competitive practices in the sector;

carried out dawn-raids on various big energy companies; consulted widely among industrial and consumer interests; and launched a comprehensive energy policy package (see the Lisbon scorecard VII, pages 38-39, for details of these initiatives).

Most recently, in September 2007, the Commission published new draft legislation that is designed to finally make market liberalisation a reality. In this latest package, it suggests the full 'unbundling' of generation/supply, transport and distribution of energy (see article by David Buchan, page 42). Since Germany, France and others are against breaking up energy companies, the Commission suggests they should at least run transmission as a separate business. This second option would be more complex and more open to abuse. Therefore, good regulatory oversight would be all the more important. Knowing that few national governments would support a new European super-regulator, the Commission instead proposes intensified co-operation among national regulators, which in turn would be made fully independent from both industry and government (something which is not yet the case in all EU countries). In addition to this 'EGREG-plus' (as the new network would be called), a new EU agency would regulate the cross-border aspects of energy investment and trade. The Commission also responded to fears that unbundled assets may be snapped up by cash-rich foreign energy companies, such as Gazprom: non-EU companies would be allowed to buy pipelines and power grids only after special government agreement, and only if the countries where these companies are based have themselves liberalised their markets.[14]

[14] *European Commission, 'The EU electricity and gas markets: Third legislative package', September 2007.*

The debate about the Commission's liberalisation proposals has been complicated by the fact that European energy policy no longer has just one objective (open markets) but three: security of supply and the fight against global warming are now considered equally, if not more, important (see also section E1, page 105). There is no doubt that in some areas, these objectives require difficult trade-offs, and that these trade-offs vary from country to country. However, the Commission is

on fairly solid ground when it argues that on balance, well-functioning markets will help to meet the other energy policy objectives. For example, suppliers of wind or solar energy should have better access to the grid after unbundling; more links between national markets would enhance security of supply; and more competition should encourage much-needed investment in new infrastructure and power plants, although this last argument remains hotly debated.

A level playing field for telecoms

The liberalisation of European telecoms markets started earlier and has gone much further than in energy. Consumers have enjoyed more choice and cheaper call charges as a result. Nevertheless, some of the remaining problems are similar to those in the energy sector, such as the strong role of incumbents that own networks. In 2005 (the last year for which EU-wide data are available), the former state monopolies still handled an average of 72 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 was virtually no competition in this market. France Telecom, Spain's Telefonica and Ireland's Eircom still controlled 80 per cent of local calls, while in Germany and the UK the share was 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 is 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: Slovaks in 2006 paid roughly twice as much for local calls as Dutch customers. Latvians got charged €6 for a 10-minute call to the US, Greeks €3.50, but Swedes only €1.20 and Germans €0.5. But the correlation does not hold in all cases. For example, Britons and Finns pay well above the EU-average for overseas calls, despite their highly competitive telecoms markets.

In many segments of the market, competition is now so well entrenched that regulation is no longer necessary. At the same time, however, EU governments handle new regulatory challenges very differently. In Germany, for example, a contentious law allows Deutsche Telekom to deny possible competitors access to its new high-speed broadband network. 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.[15] The Commission says that such differences are not acceptable in an EU where most big telecoms companies operate across borders. In November 2007, it therefore published a raft of measures to create a level playing field in the European telecoms market.[16] Many parts of the package will be uncontroversial, for example making it easier for customers to keep their number when switching provider or to call free-phone numbers from abroad. But the main proposals have attracted criticism:

[15] *European Competitive Telecommunications Association, 'Regulatory scorecard 2007', November 2007.*

[16] *European Commission, 'The EU telecoms reform proposes a single market for 500 million consumers', November 2007.*

★ **A European telecoms market authority:** 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 phone abroad, after national regulators had failed to act. The Commission insists that the new EU agency (with a staff of 130) would complement, not replace, the ERG. But it would have some formidable powers, such as telling national regulators which measures they should use against recalcitrant incumbents. Germany, claiming support from France, Spain and the UK, has complained that the new agency would create an additional layer of bureaucracy and violate the principle of subsidiarity.

★ **Functional unbundling:** National regulators will in future be entitled to request that incumbents run telephone networks as a separate business from that of providing call and internet services. Telecoms Commissioner Viviane Reding describes this as a "last resort" remedy to give newcomers access to customers in markets that are still dominated by quasi-monopolies. The UK has already spun-off BT's network operations, while Italy, Poland, Spain and Sweden are considering doing the same. The French telecoms regulator, backed by its Dutch counterpart, argues that different technologies provide enough competition, and that functional unbundling would result in underinvestment in network infrastructure. However, historically, investment in the UK's unbundled network has been twice as high (per customer) as in France's vertically integrated industry.[17]

[17] *SPC Network, 'Regulation and investment in European telecoms markets', November 2007.*

Emboldened by her 2007 success in pushing down roaming charges, Reding is unlikely to back down in the face of national opposition, and the new package should be in place by 2010. The Commission is right to be bold: in previous instances, the mere threat of tough action has been enough to make governments and companies change their ways. The Commission is also 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.

Telecoms and utilities = C-	
Heroes	European Commission, UK
Villains	France, Germany, Poland, Slovakia, Slovenia

Energy unbundling: Brussels should declare victory and move on

Energy market liberalisation has been one of the longer-running sagas in the EU's single market programme. In theory, all EU energy companies need to manage their supply (or import) businesses separately from the transport and sales of electricity and gas. In practice, many still succumb to the temptation to use their ownership of power grids or gas pipelines to discriminate against potential rivals. In the autumn of 2007, the Commission proposed to end such market abuse once and for all. Its new draft directive would put all transmission networks under independent ownership or, at the very least, independent management. The proposal for so-called ownership unbundling (OU) stirred cries of "expropriation" or "forced privatisation" from the vertically-integrated companies of Germany and France. Their governments countered in January 2008 with an alternative plan for "effective and efficient unbundling" that is backed by six other states.

The Commission quickly hit back. However, it would be well advised to declare victory, come to a compromise with the Franco-German group and close a debate that has reached its political and intellectual limits. The EU's energy policy needs to move on to the more pressing business of developing a low-carbon economy.

The reason why those in favour of unbundling can declare a victory of sorts is that France, Germany and other erstwhile refuseniks have admitted the need for further reform. They had initially disputed the need for the Commission's new draft directive, given that the previous batch of legislation (passed in 2003) had only fully entered into force in mid-2007. However, the Commission and other proponents of further liberalisation argued that the 2003 directives contained a fatal flaw. On the basis of a prolonged competition inquiry into the energy sector, the Commission decided that network operators retained such pervasive links with their parent companies that they were structurally incapable of offering a non-discriminatory service to third party customers.

However, this finding does not amount to a decisive case for so sweeping a remedy as OU, or even the second best option of independent system operators (ISOs; this would allow networks to stay in energy groups' hands but require them to be operated by independent companies). The Commission's 'impact assessment' on unbundling seeks to argue that OU produces higher rates of network investment and lower price rises, compared to countries with bundled networks. However, too many other factors affect investment (such as resource availability) and prices (such as fuel costs) for the ownership regime to be convincingly singled out as decisive.

So the EU has reached an impasse. Most MEPs appear to favour OU, as do most EU governments. But Germany, France and their six allies form a blocking minority, which will probably hold together on the basis of the third option they have now agreed. This option resorts to a considerable amount of regulatory red tape to duplicate the effective separation of network from supplier that would be so simply achieved by OU. Network companies would have in-house compliance officers to oversee separation programmes approved by national regulators. The latter could force network companies to fund new infrastructure judged to be in the general interest, or invite third party investors to do so.

Extra red tape, as the Commission rightly warned, is the price of alternatives to OU, as indeed it is with the ISO option. But France and Germany appear ready to pay this price to avoid, respectively, law suits by E.On and RWE claiming "illegal expropriation" and political rows over the networks of state-owned EdF and Gaz de France/Suez being "privatised". That will be more their problem than that of others.

A compromise directive allowing all three options would add to the complexity. There is always, too, a danger of creating in energy the equivalent of the 'takeover directive', which turned out to be more loophole than law. But a continued impasse would leave in place the current distortions between the dozen EU states that took their own national decisions on unbundling, and the rest. It could also jeopardise Commission plans to promote EU-wide co-operation among network operators, because of fears that co-operation between unreformed transmission operators might turn into a cartel.

The EU needs to reach a final and stable arrangement on the independence of its energy networks, so that they can begin delivering more renewable energy to the grid, and providing a competitive foundation for emissions trading. In sum, clear away the old issues on the energy agenda before starting on the new.

David Buchan

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B2. Transport

★ Encourage investment in trans-European networks

★ Create a single European sky

★ Increase competition in the railways sector

The transport sector accounts for 7 per cent of EU GDP, and about 5 per cent of total employment. However, like the energy and financial sectors, its importance to the economy goes well beyond its direct contribution to value added and jobs. Because of the central role that it plays in labour mobility and in the distribution of goods and services, a modern, reliable and integrated transport system has a decisive influence on Europe's overall productivity. Broadly speaking, EU transport policy has focused on two priorities. The first is to improve the underlying transport infrastructure by developing links between countries (known as 'trans-European networks') and by improving connections between modes of transport. The second is to increase competition by liberalising the provision of transport services – on air, land and water.[18] Progress to date has been patchy: efforts to improve transport connections remain beset by funding problems, while the liberalisation of service provision 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.*

Transport generates 'negative externalities': costs from pollution and congestion that are borne by everyone, whether they are travelling or not. So building an efficient European transport network has to be balanced against other considerations. But the pace of liberalisation has not been dictated by ecological concerns. Liberalisation has proceeded faster in the airline sector than in the railway sector, even though the former is a larger emitter of greenhouse gases. Nor is there necessarily a trade-off between the search for efficiency and the need to reduce pollution. A more efficient transport network should reduce congestion – and hence pollution. The EU's approach has been the right one. Its programme for trans-European networks is promoting the most ecologically sustainable modes of transport by focusing the bulk of investment on the rail and water transport networks. The Commission is also trying to ensure that the costs of pollution are borne by those who cause it. It has proposed a directive to bring air transport within the scope of the EU's emissions trading scheme. And it has promoted the increased use of 'smart charging' on roads – notably by persuading member-states to adopt a directive on the charging of heavy goods vehicles.

Connecting EU countries

Many EU countries already boast some of the best infrastructure in the world, but connections between countries can still be improved. The member-states are responsible for the bulk of investment in roads, airports and railways. But the EU is giving a helping hand by adding missing cross-border links, especially in places where such connections are likely to make a difference to local economic development. In 1996, the EU agreed on 14 priority trans-European networks in the transport sector (TEN-Ts) to better connect its member-states. Since then, the EU's membership has risen from 15 to 27 and the number of priority EU projects has been extended to more than 30. Most of these are at risk of falling behind schedule. Progress on some of the initial 'priority axes' is being hampered by procedural and technical problems, but the main cause of delays is the difficulty of raising finance.

The cost of completing the EU's 30 priority axes will total an estimated €250 billion by 2020 – or €600 billion if non-priority projects are added. The EU's budget for TEN-Ts projects for the period from 2007 to 2013 amounts to €8 billion, of which €5.1 billion is reserved for the 30 priority projects – an average of just over €1.1 billion per year. The EU is only allowed to fund 10 to 30 per cent of the costs of construction. So even if loans from the European Investment Bank (EIB) are added, much of the onus for funding TEN-Ts still rests with the member-states. However, national governments have shown little enthusiasm for investing in cross-border projects, which can be complex and financially risky. So the Commission has appointed 'European co-ordinators' to bang heads together and promote cross-border projects to private investors. It has also joined forces with the EIB to create a 'loan guarantee instrument for trans-European transport network projects' (LGTT). The aim of the LGTT is 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. By partially covering the risk of TEN-Ts projects, the Commission is hoping that the LGGT will improve their financial viability – and hence their attractiveness to private-sector investors.

Open skies

The liberalisation of air transport has been one of the great success stories of the past decade, with prices falling dramatically and the number of routes being offered rising sharply. The offer of greater choice at lower prices has spawned a huge increase in passenger numbers. Since the mid-1990s, air transport has more than doubled its share of intra-EU passenger transport, to nearly 10 per cent of the total. Unsurprisingly, the Commission is now trying to extend the benefits of the single market in air transport by negotiating agreements to free up air travel between EU member-states and non-EU countries. In 2007, the EU finally signed a landmark 'open skies' treaty with the US. The agreement will allow any EU or US airline to fly any route between a city in the EU and a city in the US. This will allow all EU carriers, for example, to compete on the London-New York route. However, it will not allow them to compete on domestic flights within the US, and EU carriers will not be able to take stakes of more than 25 per cent in US airlines. The availability of landing slots at airports will still influence the ultimate number of transatlantic flights. But the open skies agreement should still encourage new entrants and stimulate competition – even on the already highly contested transatlantic routes.

One downside to the boom in air transport has been the resulting increase in carbon emissions. Although emissions from aviation account for only 3 per cent of total EU greenhouse gas emissions, they have risen by around 90 per cent since 1990. This rise contrasts with the reductions achieved by many other sectors in recent years. On current trends, the growth in emissions from flights departing EU airports would cancel out about a quarter of the emissions reductions that the EU has to achieve to meet its Kyoto targets. Sensibly, in late 2006, the Commission put forward a proposal for a directive to bring aviation within the scope of the EU's emissions trading scheme (see section E1, page 105). Member-states should make every effort to adopt the directive in time for it to come into force by 2011. Improvements in air traffic management could also help to curb aviation emissions by reducing the incidence of planes flying in holding patterns over crowded airports. But the air traffic control modernisation programme that aims to do just this will not be operational until the middle of the next decade.

Railways

For the past decade, the EU has tried to introduce competition to the railways sector. A first railways package, adopted in 1998, required member-states to 'unbundle' the management of rail tracks from transport services. A second package, dating from 2002, provided for the full liberalisation of rail freight transport by 2007. The third and final package, adopted in October 2007, should open international and domestic passenger services by 2010.

All the legislation is therefore in place for the full liberalisation of rail transport. This is no mean feat. But adopting legislation is one thing. Implementing and enforcing it is another. Encouragingly, the most comprehensive study of the state of play suggests that most EU countries are either on schedule or in advance of the deadlines set by EU legislation. Many countries that were laggards a year or two ago are now on schedule. Only four countries – France, Greece, Ireland and Luxembourg – are still lagging. The clear front-runners, in

terms of implementing the legal framework and practical access conditions, are Germany, the Netherlands, Sweden and the UK. Foreign rail freight operators are now licensed and actively involved in most EU countries. In the market for passenger transport, there are still large variations across countries, which is not surprising, given that the relevant EU legislation only needs to be implemented by late 2009. However, the actual degree of competition on national networks still differs markedly across countries. This reflects a variety of factors, but it suggests that some countries that theoretically provide open access to their networks still have more to do to deliver proper competition on them.[19]

[19] *IBM Global Business Services, 'Rail liberalisation index 2007', October 2007.*

One residual impediment to a pan-European rail service is the existence of over 20 different speed control and traffic management systems. When a train crosses a national border, the driver needs to switch from one system to another to communicate with local controllers. So the EU has launched a multi-billion euro project, the European Rail Traffic Management System (ERTMS), to enable trains to run seamlessly between EU countries. Most observers agree that the development of ERTMS is essential if European railways are to become more competitive. But like many ambitious pan-European projects, the ERTMS has run into a co-ordination problem: how to reconcile a standardised system with different signalling rules. The decision to press ahead with the ERTMS without any attempt to integrate national signalling rules has added to the complexity of the project, slowed down its roll-out, and increased the costs associated with it.

The rail sector's share of total transport has been falling for decades. Railways currently account for only 10 per cent of freight carried and 6 per cent of passengers – compared with 44 and 85 per cent respectively for roads. One reason is that rail transport is intrinsically less flexible than road transport: railways cannot deliver goods and people to their precise end-destination. Another reason is that roads are under-priced relative to railways, given their environmental and infrastructural costs. There is little that policy can do to increase the flexibility of rail transport compared with roads – although improving connections between different modes of transport can certainly help. But policy can influence relative pricing, notably by introducing 'smart charging' for roads (such as congestion charging in city centres). It can also influence the quality of service provision by modernising the underlying rail network and introducing more competition on it.

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

B3. Financial and general services

★ Complete the financial services action plan

★ Create a single market in services

The free movement of services is one of the 'four freedoms' guaranteed by the Treaty of Rome. Yet the EU's single market for services is nowhere near as integrated as that for goods. Services account for some 70 per cent of value added and employment across the EU, but only 20 per cent of intra-EU trade. To some extent, this reflects services' lower tradability: haircuts and concerts need to be consumed where they are produced. But this does not tell the whole story. Comparisons with the US suggest that trade within EU countries is higher, and trade between countries lower, than one would expect in a fully integrated market. Services' share of total intra-EU trade, moreover, has been falling in recent years.

Services generally attract less publicity than manufacturing, but they matter. For one, they account for a much larger share of GDP than manufacturing – a percentage point gain in productivity in services will therefore have a greater impact on European living standards than a similar-sized increase in manufacturing. For another, the widening of the EU's productivity gap with the US since the mid-1990s is mainly explained by trends in the service sector. The European Central Bank has estimated that increasing competition in the service sector within the euro area to US levels would raise output by 12 per cent.[20] Given the potential gains from the liberalisation of trade in services, the progress to date has been disappointing.

[20] *European Central Bank, 'Benefits and spillovers of greater competition in Europe', Working Paper 341, 2004.*

Financial services

An efficient financial system makes an essential contribution to GDP growth by channelling savings to productive investments, reducing transaction costs and diversifying risk. In this sense, the European financial sector's importance to the economy goes well beyond its direct share of employment and value added. A decade ago, the EU's financial sector was still a patchwork quilt of largely national markets. Since then, the integration of financial markets has increased markedly, spurred by three developments: the introduction of the euro; improvements in the underlying technological infrastructure; and the EU's financial services action plan (FSAP), an ambitious legislative programme designed to reduce the legal obstacles that prevent financial institutions from selling their products and services across the EU.

The speed of integration has varied across market segments. The integration of wholesale markets is now high. In the euro area, government debt markets have all but converged: yields on Spanish government bonds are rarely more than a hundredth of a percentage point higher than those on their German equivalents. Similarly, in the corporate bond markets, yields are now primarily influenced by the credit risk of the company in question and the sector in which it operates, rather than by the company's country of origin. Equity markets have also become more integrated, thanks partly to cross-border tie-ups between stock exchanges. But progress in other market segments has been more sluggish. The two most disappointing areas have probably been clearing and settlement systems, the continued fragmentation of which raises transaction costs and exposes participants to credit risks; and retail banking, where markets still resemble a collection of 'national islands'.

The FSAP – the attempt to promote financial services integration by legislation – has largely run its course. The 42 measures identified by the FSAP have all been adopted and there is now an understandable sense of legislative fatigue, both in the Commission and at national level. The focus of the Commission's attention should now be on ensuring that member-states properly implement the legislation they signed up to. The FSAP's most important item of legislation, the market in financial instruments directive (Mifid), officially came into force in 2007 – yet several member-states have still not implemented

it. The costs of complying with Mifid have been onerous, but in the long run these should be outweighed by the directive's wider benefits, notably in the form of lower transaction costs for clients.

However, the full integration of EU securities markets continues to be impeded by the fragmentation of national clearing and settlement systems, which arrange the payment and transfer of securities between buyers and sellers. Integrating clearing and settlement systems is a complex task because barriers stem from different national laws, market practices and tax provisions. The Commission has estimated that clearing and settlement costs in the EU are up to eight times higher than in the US because of this fragmentation. In an effort to reduce national barriers, the Commission proposed a code of conduct which key players – stock exchanges, clearing houses and settlement systems – signed in 2006. The code aims to give customers a choice of providers so that they do not have to use the one selected by the exchange on which they trade. The Commission should make sure that all the relevant measures are implemented by the end of the 2008 deadline.

To date, the EU's single market legislation has had little impact on retail banking. The vast majority of retail banks remain domestic, rather than European, players. Cross-border retail bank lending is negligible. In the residential mortgage market, direct lending to consumers in other EU member-states represents just 1 per cent of total mortgage activity – and almost all of this is related to holiday homes or properties close to national borders. Transferring money from one country to another remains far more difficult than doing so within the same country. Retail banks that provide customers with a proper pan-European service have still to emerge.[21] Cross-border consolidation, furthermore, is proceeding only slowly. Cross-border takeovers have taken place, but remain rare – partly because of resistance to foreign takeovers of 'national champions'. True, the Dutch authorities allowed a consortium of European banks to take over ABN Amro,

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

one of the largest banks in the Netherlands, in 2007. But their attitude has perhaps been less representative than that of the French government, which tried in early 2008 to deter foreign bids for Société Générale.

In theory, banks have been able to compete throughout the EU on the basis of a single authorisation from their home state since 1993, when the Second Banking Directive came into force. In practice several factors have impeded the emergence of a pan-EU retail banking market. Different consumer protection rules, for example, make it impossible for banks to offer standardised products across the EU. Differences in culture, language, or savings and spending patterns have also got in the way of integration, as have anti-competitive practices. The Commission's inquiry into retail banking unearthed numerous obstacles to cross-border competition, including collusive practices between domestic banks designed to keep foreign ones at bay. It also found that fees for switching banks remain prohibitively high, and that high fees also impede access to payment card networks.[22] Vigorous competition policy at EU and national levels would not eliminate all of these obstacles, but it would reduce some of them.

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

One initiative that would give new impetus to the integration of retail banking markets would be the creation of a Single European Payments Area (SEPA). The underlying idea of SEPA is that the ability to make payments across borders – by bank transfers, direct debit, or cards – should be as straightforward as domestic payments. Establishing SEPA has been an EU objective since 1999, but progress has been slow. In early 2008, the first phase of SEPA was finally launched. However, the scope of SEPA is still limited because the first phase only covers credit transfers and because only half the banks in the EU have so far signed up to it. A proper SEPA will not exist until national payment networks become fully interoperable – and this is unlikely to be the case until around 2012. Before that date, the Commission should make sure that the legal framework for cross-border direct debits is properly established, so that companies in one member-state are able to draw funds directly from the accounts of customers in another; and it should keep a close eye on charges to make sure that SEPA does not become an alibi for raising prices.

The painful fall-out from the US sub-prime crisis in late 2007 has hit the European banking system hard – with the UK witnessing its first run on a bank, Northern Rock, since the 19th century. Northern Rock's difficulties did not result from its cross-border activities (which were negligible). But they have inevitably raised new questions about whether a system that counts over 50 supervisors is adequately equipped to deal with a pan-EU financial crisis; and whether some of the underlying rules need to be tightened up. There is little prospect of a single EU banking supervisor emerging any time soon, but the continuing credit crunch has underlined the need for national regulators to co-operate closely, particularly when supervising groups with pan-EU operations. There may also be a need to review certain supervisory rules (notably those on liquidity), but the EU should avoid a knee-jerk regulatory clampdown that stifles competition and financial innovation.

General services

The existence of 27 different national regulatory regimes makes it difficult for firms to provide services across the EU. Rules that openly discriminate against foreign providers are becoming rarer, as their legality is challenged and they are struck down by the courts. But even when national rules can be justified (for example, to protect public health or consumers), their existence still creates obstacles to cross-border providers. These are compounded by different national legal systems, as well as by cultural and linguistic barriers. The effect of all these national obstacles to the cross-border provision of services is to inhibit competition, slow productivity growth and create interest groups opposed to change.

In 2005, the Commission tried to give new impetus to the EU's single market in services by proposing an ambitious directive that would have applied an across-the-board mutual recognition principle based on the country of origin. The idea was that service providers operating temporarily in another EU country could jump over legal restrictions in the host country by following the laws of their home country. The mutual recognition principle has been the driving force behind most single market legislation. But the attempt to apply the principle in a general way, without common minimum standards, was a step too far for some of the richer member-states. Coming so soon after the admission of ten poorer countries in 2004, their fear was that the directive would spark a regulatory 'race to the bottom'.

So the EU has had to settle for a pale copy of the original. The watered-down services directive, which member-states signed up to in 2006, will come into force in 2010. It does not attempt to use the mutual recognition principle as a lever to prise markets open. Instead, it reasserts the treaty's commitment to the free provision of services; limits the number of "overriding reasons of general interest" that can be invoked to justify national restrictions; reduces the number of administrative procedures that firms have to comply with before they can offer services in another member-state; and requires host EU countries to offer service providers from other member-states a single point of contact for accessing all the relevant documentation and for completing all the necessary paperwork.

When it comes into force, the directive should, in principle at least, make it easier for firms to provide services in several EU member-states. The mutual screening process required by the directive may even result in unnecessary regulatory barriers being dismantled. Realistically, however, the practical consequences of the directive are likely to be modest. One reason is that many sectors, from healthcare to urban transport to services provided by notaries, are exempted from the directive. Another is that EU countries will continue to try and defend their national regulatory regimes.

Regulatory barriers will therefore need to be challenged individually in each member-state and sector. This will inevitably be a laborious process – not least because service providers may find it hard to prove that regulatory regimes are discriminatory, disproportionate or unnecessary.

It would be unrealistic to expect intra-EU trade in services to reach the same level as trade between different states within the US. Cultural, legal, linguistic and other barriers to cross-border business will always be higher in the EU than they are in the US. But the market for general services is more fragmented than it needs to be – and is likely to remain so for the foreseeable future. This is a pity. The fragmentation of the market for general services along national lines shields too many sectors from competition. Many regulated professions, from notaries to plumbers and taxi drivers, will therefore continue to enjoy large economic rents at the expense of European consumers.

Financial and general services = B-	
Heroes	The Netherlands, UK
Villains	France, Germany

C. Enterprise

C1. Business start-up environment

★ Create the right environment for start-ups

★ Encourage entrepreneurship

New firms tend to be more innovative and dynamic than long-established ones. They are better at introducing new products, working practices and technologies. They also create more jobs and put pressure on incumbents to innovate and become more efficient. The EU is not short of small and medium-sized enterprises (SMEs). However, Europe lags behind the US in at least two respects. First, setting up a business can still be prohibitively expensive and time-consuming in many EU countries. Second, Europe's fledgling companies are much less likely than their US counterparts to grow into a global giant like Google or Microsoft.

In part, the start-up and subsequent growth of companies in the EU is hampered by the persistence of cultural, regulatory, linguistic and other barriers that impede the integration of the EU's various national markets. But other factors are just as important. Burdensome regulations inhibit the emergence of new firms by increasing start-up costs. Restrictive labour laws interfere with 'creative destruction' by slowing the growth of new firms and curbing the exit of inefficient ones. The entry of new firms, as well as their subsequent growth, can also be impeded by inadequate financing opportunities. Most of these issues are slowly being tackled, at EU and national level. Across much of the EU, governments are taking steps to cut red tape (see section C2, page 67), introduce simpler regulatory regimes for SMEs, relax excessively restrictive labour market regulations, improve the availability of seed capital, and reform bankruptcy regimes to reduce the cost (and stigma) of failure.

Improving the regulatory environment for start-ups

The World Bank monitors many of the policies that matter for SMEs through its annual 'Doing business' survey. This measures the ease of setting up or closing a business, employing staff, registering property, and so on. The World Bank's latest survey suggests that disparities across the EU remain large. Denmark and the UK are among the easiest countries in the world to do business. But while most EU countries rank in the top 50 worldwide, five do not. The EU's worst-ranked country, Greece, barely scrapes in to the top 100 globally – behind countries such as Azerbaijan, the Dominican Republic and Swaziland.[23] In short, there is plenty of scope for some EU countries to improve their business environments.

[23] *World Bank, 'Doing business 2008', October 2007.*

Take the number of procedural hoops through which entrepreneurs must jump to establish their own businesses. Belgium, Finland and Sweden require a modest three – Greece a staggering 15. Reforms in recent years have produced changes to which many observers have not yet woken up. France now imposes fewer procedures for start-ups than the traditionally business-friendly UK. There are also large disparities in the number of days it takes to open a business, ranging from just four days in Belgium and six in Denmark to 47 in Spain and a striking 60 in Slovenia. The costs of setting up a new business also vary widely across the EU. These are negligible in Denmark, Ireland, Sweden and the UK, but still substantial in Greece, Italy and Poland. In countries where reforms have been pushed through to encourage start-ups, the benefits have been quick to materialise. Slovakia, for example, has cut the number of days it takes to start a business from 103 in 1999 to 25 in 2007. Portugal, similarly, has reduced the cost of starting a new business from 13 per cent of annual per capita income in 2005 to just 3.4 per cent in 2007. Research also suggests that such reforms pay off.

Funding for new ventures

As elsewhere in the world, European SMEs get most of their funding from their own savings, loans from friends and family, and from

retained earnings. Banks are often reluctant to lend money to entrepreneurs with good ideas but little collateral. Venture capitalists, by contrast, are more willing to make risky investments. And they can offer guidance on how to write business plans, access new markets and grow a business. Europe's venture capital (VC) industry has enjoyed strong growth since the bursting of the technology bubble in 2000-01. But it is still smaller than that in the US. In addition, Europe's venture capitalists tend to prefer investing in firms that are already well-established, while their US counterparts are more likely to provide seed capital to new ventures. Access to funds for business start-ups varies widely across the EU. In Denmark, Sweden, and the UK, VC investment is higher as a share of GDP than it is in the US. France, which was one of the laggards in the VC sector as recently as 2003, has shown how quickly a well-designed reform can transform the environment for fledgling firms for the better. But in many other countries, the VC industry is still under-developed.

The Commission has been trying to provide some impetus at EU level. In early 2008, it issued a proposal that aims to encourage the development of a pan-European VC industry by dismantling the barriers that impede cross-border business. Lower national barriers would undoubtedly help. But a successful European VC industry also needs easy 'exit channels' that enable venture capitalists to turn their investments into cash. The UK has enjoyed some success with the London Stock Exchange's Alternative Investment Market (AIM), which now lists close to 2,700 companies (many of them foreign). But Europe as a whole is still hampered by the absence of an equivalent to the US Nasdaq – as the article by Sir Ronald Cohen explains (see pages 64-66).

Bankruptcy

Europeans have long frowned upon bankruptcy in a way that Americans have not – a stigma that continues to be reflected in a number of EU countries' domestic laws. However, there is evidence that more 'forgiving' bankruptcy regimes tend to be associated with higher rates of business creation.[24] Good bankruptcy regimes should rehabilitate firms that are viable. When firms are not, they should be liquidated as efficiently as possible, and recovery rates for creditors should be maximised. A handful of EU countries boast some of the most efficient bankruptcy regimes in the world. In Denmark, Finland and Ireland, for example, failed businesses are usually wound up within a year and creditors recover on average close to 90 per cent of their investment. But a host of other countries are still saddled with lengthy and expensive bankruptcy procedures that hamper the development of an entrepreneurial culture and reduce the recovery rate for creditors. In the Czech Republic, for example, it takes an average of six and a half years to wind up a business – and the recovery rate for creditors is the lowest in the EU (at just 21 cents in the euro).

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

Few EU countries with inefficient bankruptcy regimes have taken steps to reform them. Over the past year or so, only Italy and Portugal have done so. One reason may be the inherent complexity of the issue, which sometimes entails making wider changes to the civil code and to the administration of the judiciary. Another reason may be that the issue appears dull and unglamorous – so tackling it reaps few political benefits, particularly in the short term. However, all the evidence suggests that the economic benefits in terms of boosting levels of entrepreneurship can be tangible. Countries with poorly-functioning regimes – particularly, the Czech Republic, but also Estonia, Greece, Poland and Slovakia – could reap significant medium-term rewards from reforming their bankruptcy laws.

Employment protection

Rigid hiring and firing laws pose a particular problem to SMEs. Faced with limited funding and volatile markets, they need to have enough flexibility to adjust staffing levels rapidly. Most EU countries

have moved to relax hiring and firing practices in recent years. France, for example, has been steadily relaxing labour market restrictions for the best part of the last five years – and further reforms are high on the current government's list of priorities. Although none of these reforms will give France the flexible labour markets that Denmark and the UK already enjoy, they are still steps in the right direction. Other countries should follow suit – particularly those such as Greece, Luxembourg, Portugal, Slovenia and Spain, whose labour market laws have long been among the most restrictive in the EU.

Business start-up environment = B	
Heroes	Denmark, France, UK
Villains	Czech Republic, Greece, Poland

The second bounce of the ball

To this day, European hi-tech entrepreneurs are at a serious disadvantage compared with their American counterparts because there is no European equivalent of Nasdaq. That is, there is no serious and viable market for early-stage companies.

The consequence is that European investment in early-stage companies is a lot lower than the United States, about $20 billion against $31 billion in 2006, and that Europe has fallen far behind the US in technological innovation. Entrepreneurship and technological innovation have been fundamental to global prosperity in recent decades, and a key contributor to the eventual success of the venture capital sector was the inter-twining of the sector with emerging technologies. Hi-tech enterprise and venture capital support each other's advance, like a double helix.

When the history of the last quarter of the 20th century comes to be written, I have no doubt that an important chapter will be entitled "The age of entrepreneurship and innovation". Few periods in history can compare; perhaps only the Renaissance and the 30 years spanning the last quarter of the 19th century and the first few years of the 20th, when the telephone, electricity generation, the radio, the motor car and the aeroplane were invented and introduced. Growth in the 21st century will be powered by the electronic microchip, the personal computer, the cellular phone and the internet – and the parallel discoveries arising from research into DNA, cloning and the mapping of the human genome. Technologies converge to create unforeseen opportunities.

The exploitation of technological convergence since the 1970s has resulted in products and services – in information technology, communications, entertainment and life sciences – that have transformed our lives. In the process, these products and services have given rise to some of the greatest corporate success stories in history. In the last 40 years, five new, entrepreneurial, hi-tech businesses have made it into the top 100 companies in the world as measured by market capitalisation: Microsoft, Sun Microsystems, Intel, Cisco and Oracle. All of them are American and all of them floated – and are still listed – on Nasdaq.

Europe's record, by contrast, has been dismal. The only European hi-tech companies to appear in the top 100 companies of the world, as measured by market capitalisation, are Nokia, which is an unusual example of an established European company that transformed itself from low-tech to hi-tech, and Vodafone, which, having been a successful start-up, grew after being absorbed by Racal, which was already a large British public company.

The reasons for Europe's junior stock market failures are a matter for debate. What is indisputable is that, if you look at the last 30 years, which were marked by massive commercial and entrepreneurial advances, Europe has failed to rise to the early-stage and hi-tech challenge. Although private equity in Europe has grown dramatically in recent years (from $8 billion of funds raised in 1996 to more than $100 billion in 2006), the bulk of its investment activity is in mature businesses.

For European hi-tech to thrive, we need European venture capital to thrive. If European venture capital is to thrive, we need a European stock market geared to high-growth companies, capable of funding them before they have reached profitability. Such a market needs to have a separate identity and a separate governance structure from the main stock exchanges, even if it is affiliated with one or more exchanges. It cannot be designed as merely a 'stepping stone' market that is unsuitable for high-growth companies once they have become successful. The credibility of Nasdaq has been boosted by the fact that Microsoft and others have chosen to stay on it, thereby providing powerful role models for new, ambitious ventures.

The next bounce of the ball for stock exchanges is global consolidation, going beyond the transatlantic tie-up between Euronext and the NYSE. A key question for European entrepreneurs and policy-makers is how to take advantage of this next bounce so as to ensure that the resulting exchanges properly address the needs of European early-stage, high growth companies, in the way Nasdaq does for their American counterparts. The absence of such an exchange will guarantee that Europe continues to lag behind.

Sir Ronald Cohen

Chairman of Bridges Community Ventures and Co-Founder of Apax Partners, extract from 'The second bounce of the ball', by Ronald Cohen, 2007

C2. Regulatory burden

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

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

Regulation is an integral feature of all modern market economies. It plays a key role in correcting market failures, protecting consumers and preventing market abuse. Some degree of regulatory convergence has been necessary at EU level, partly to ensure that different national regulatory standards do not obstruct cross-border trade; and partly to give European consumers the confidence to make cross-border purchases. But regulations do not always meet their intended objectives – and they can have numerous unintended consequences. Inefficient and excessively burdensome regulations can dent firms' competitiveness by imposing unnecessary costs. They can act against consumer interests by reducing choice. They can weigh on innovation and productivity growth, notably by deterring the entry and expansion of new firms. And they can hinder the creation of new jobs.

The dangers of poorly designed regulations are compounded at EU level. Reaching agreement among 27 member-states requires complex compromises, trade-offs and bargains which inevitably influence the content of the final legislation. As a result, EU regulation often bears little resemblance to the Commission's original proposals. When EU legislation is adopted, moreover, it can often remain in force long after its sell-by date. All of this matters, because half of all the laws in force at national level are now estimated to flow from EU legislation.[25] Efforts to improve the quality of the regulatory framework have featured prominently in the Lisbon agenda. The Commission has made the fight against red tape a priority at EU level. And governments across the Union have been working hard to reduce the regulatory burden at national level,

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

as well as to ensure that they take into account business and consumer concerns when new legislation is drawn up.

The EU's better regulation agenda consists of three prongs. The first requires the Commission to make improved use of impact assessments before it proposes legislation. The second is a programme to simplify legislation. And the third aims to reduce the administrative burden of regulations. Progress in each of these three fields has been mixed.

Predicting the impact of laws

Impact assessments are not new. The Commission has been assessing the impact of its legislative proposals since the late 1980s. But the system has been beefed up since the Lisbon agenda was launched in 2000. Following the publication in 2002 of a report by a high-level consultative group (the 'Mandelkern group'), the Commission adopted a new, integrated impact assessment model in 2003. In theory, the Commission is now required to take into account the likely economic, social and environmental impact of alternative policy options – including those that do not require legislation. In practice, the new model is still bedding down. The quality of impact assessments still varies widely across the Commission's directorates general; environmental and social impacts are not always assessed; and the Commission does not always consider whether its proposals meet the subsidiarity test, or whether they are proportional to the objective they are designed to meet.

The EU's new system of impact assessment has moved closer to international best practice and, in some respects at least, is now arguably superior to that in the US. The Commission withdrew 68 legislative proposals in 2006 (out of 183 pending at the Council and European Parliament), and a further ten in 2007 – either because they were inconsistent with the Lisbon agenda, or because they did not meet better regulation standards. But aspects of the new system are not yet working as well as they should. The Commission still

needs to improve the consistency and quality of its impact assessments if they are to carry greater credibility. One problem with impact assessments, both at EU and national levels, is that they tend to be conducted by the same officials who draft the laws or directives. Some may therefore lack the ability to provide a detached assessment of the legislation they are championing. Both the Commission and the member-states should consider following the examples of countries like Germany, Ireland, the Netherlands and the UK, which have set up independent bodies to evaluate the business costs of laws. The Commission should also consider carrying out systematic ex-post assessments to ensure that regulations are working as intended and that their costs do not exceed their benefits.

Simplifying existing legislation

The second prong of the EU's better regulation agenda is 'simplification'. Broadly speaking, simplification has two aspects: repealing redundant regulation; and bringing together the provisions of existing acts with all their subsequent amendments into a single text, to reduce the volume of legislation and make it clearer. Simplification does not necessarily mean deregulation. The main objective of the exercise is to improve the business environment by lightening the administrative burden that regulations impose on firms.

In 2005, the Commission launched a first three-year rolling programme for the period 2005-08, which identified 100 areas where existing legislation could be simplified. The scope of the exercise has since been extended to cover a further 43 areas for the period 2006-09, and more initiatives will follow in future rolling programmes. On the face of it, the scope of the exercise is impressive, covering rules in areas as diverse as accounting, food additives, waste, statistics, cosmetics, agriculture, construction and air transport. But identifying areas where regulations can be 'simplified' is only a first step. Unfortunately, the complexities of EU law-making have slowed the pace of progress. Despite efforts to break the logjam by improving communication and co-operation between the Commission, the Council and the European Parliament, many of the measures remain stuck in the legislative pipeline – with little prospect of emerging rapidly from it.

Simplifying legislation at EU level is only half the battle. Since most EU legislation has to be implemented at national level, businesses will not feel the benefits of simplification unless member-states give priority to a similar exercise at home. Efforts at national level are crucial, given the tendency of certain countries to 'gold-plate' EU directives – that is, to add regulations over and above those actually required by EU legislation. Encouragingly, a growing number of member-states are drawing up plans to lighten regulations at home and including them in their Lisbon-related 'national reform programmes'. However, the pace of change on the ground remains glacial in many places. It will be some time yet before EU businesses start noticing tangible changes to their regulatory environments.

Reducing the administrative burden

In 2007, the EU launched the third prong of its better regulation agenda, namely a plan to reduce the administrative burden on businesses by 25 per cent by 2012. The Commission estimates that the costs imposed on businesses by requirements such as filling in forms currently average 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.[26] The aim of the Commission's action plan is to remove unnecessary or obsolete reporting requirements on firms. There are several ways this could be done: the frequency of reporting requirements could be reduced to the minimum levels necessary; duplication across forms could be eliminated; web-based and electronic reporting could be extended; reporting requirements could be lightened for small and medium-sized enterprises or limited to companies which pose the highest risk; and so on.

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

As this latest initiative is still in its infancy, it is too early to weigh up progress on it. So far, the Commission has only tabled a package of proposals to make life easier for transport companies and small businesses such as bakers, butchers and grocers. But while the Commission's action plan to reduce the administrative burdens is laudable, it is likely to run up against the same constraints that have slowed progress in other parts of the EU's better regulation agenda, particularly the slowness of EU decision-making and the need to ensure that the programme is given priority in all member-states. A good sign is that cost-reduction programmes are no longer confined to a small group of pioneering countries such as the Netherlands and the UK. Most member-states now have their own programmes in place, so the battle against red tape should enjoy political impetus at national level. That said, evidence from the many member-states suggests that good intentions are not enough. The UK, one of the supposed pioneers, has found it particularly difficult to reduce the costs of red tape. Indeed, the British Chambers of Commerce estimate that the administrative burden on companies has increased since the government's battle against red tape was declared.

Implementation

Streamlined law-making procedures, impact assessments and simplification exercises may not help businesses much if the EU's single market continues to be hampered by uneven implementation of legislation in the member-states. Governments are often slow to transpose EU legislation into national law, or reluctant to enforce it properly. The EU as a whole has reduced its 'transposition deficit', but the single market continues to be plagued by wide disparities in individual countries' records.[27] Some countries (such as Italy and

[27] *European Commission, 'Internal Market scoreboard', July 2007.*

Portugal) have consistently poor records. Traditional laggards, such as France and Greece, have made concerted efforts to improve their records. But others, such as the Czech Republic, Poland and Portugal, are slipping ever further behind. Implementation statistics tell only half the story. Even when countries have transposed EU directives into domestic law, they may not have done so correctly or they may be reluctant to enforce them. Unfortunately, infringement proceedings for the faulty implementation or application of directives have continued to rise (see table on page 73).

Infringement cases are costly and can often take a long time to resolve. This highlights the importance of the SOLVIT system, a pan-European network that handles individual complaints about member-states' failure to apply EU rules. Since it was set up in 2002, SOLVIT has become an effective instrument for identifying problems – and resolving them without resorting to infraction proceedings. SOLVIT centres in countries such as the Czech Republic, France, Portugal and Spain have managed to resolve 90 per cent of all the problems submitted to them. However, the SOLVIT network is still not working as well as it could, partly because the national agencies in almost half the member-states are under-resourced.

Regulatory burden = B	
Heroes	European Commission, The Netherlands, Slovakia, UK
Villains	Czech Republic, Poland, Portugal

Infringement proceedings against EU member-states

	Wrong transposition	Wrong application	Total
Italy	39	66	105
Spain	27	51	78
Greece	18	44	62
France	26	28	54
Ireland	16	35	51
UK	21	22	43
Portugal	14	28	42
Germany	13	29	42
Poland	17	21	38
Belgium	21	13	34
Sweden	15	14	29
The Netherlands	8	21	29
Austria	11	16	27
Finland	10	16	26
Malta	11	9	20
Cyprus	11	9	20
Luxembourg	13	7	20
Hungary	10	9	19
Czech Republic	12	7	19
Denmark	11	6	17
Latvia	11	6	17
Slovakia	9	7	16
Estonia	8	4	12
Lithuania	8	3	11
Slovenia	6	3	9

Source: European Commission, 'Internal market scoreboard', July 2007

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

State aid and restricted markets distort free and fair competition between firms and undermine competitiveness. One of the most important things the EU can do to achieve the Lisbon objectives is to pursue an effective competition policy. In open markets, firms are constantly under pressure to cut costs and prices, to innovate and become more efficient. Competition is therefore key to productivity and GDP growth. Competition policy is also one of the few instruments the Commission can deploy against companies and governments that do not play by the rules of the single market. It allows the Commission to step in when legislation alone has failed to create a level playing field.

The Commission has taken an increasingly tough line, ensuring that member-states abide by their commitments to open up previously regulated markets, and taking governments to task for trying to protect 'national champions'. However, EU competition policy is under attack from a number of sides. Both businesses and some EU governments have criticised the Commission for damaging Europe's economic prospects by being over-zealous in its application of competition policy. The criticisms are two-fold. The first is that the Commission is undermining competition and hence innovation by placing excessive constraints on dominant firms, especially those in high-technology sectors. Critics, including many in the US, argue that the Commission should focus more strongly on consumer benefits rather than the level of market dominance; that is, it does not matter how much of a market a company controls so long as the consumer benefits. The second is that restrictive state aid rules are putting European companies at a disadvantage vis-à-vis firms based in countries such as China and India, where governments intervene aggressively in support of their companies.

Competition policy

Since 2004, the Commission has done much to modernise its competition regime, in particular its anti-trust policy.[28] Instead of asking whether a merged company would have a 'dominant' market position, the Commission now looks at mergers that could 'impede effective competition'. The new rules recognise that a merger can have a positive economic effect, by strengthening the competitiveness of the firms concerned. Despite claims to the contrary, the Commission also assesses the impact on consumers of a merger, although it takes a long-term view: what benefits consumers in the short term may not do so in the longer term. The problem is that it is extremely difficult to judge what the long-term economic impact of a merger will be.

[28] *The point of anti-trust rules is to prevent dominant companies from abusing their market power to keep competitors at bay. They also prohibit companies from striking deals that fix prices or carve up markets.*

Nevertheless, there is little doubt that the Commission has taken a different approach to large established, high-tech companies than its US counterparts. Much of the criticism of the Commission has centred on the case of Microsoft, the world's leading supplier of computer operating systems. In 2004 the Commission imposed a record fine on the company for abusing its dominant position, and in September 2007, the EU's Court of First Appeal turned down Microsoft's appeal against the fine. The Commission is sceptical that Microsoft's dominance is in the consumer's interest, or that the market for IT is fundamentally different from other markets. For their part, critics of the Commission's handling of the Microsoft case argue that the decision could undermine incentives for firms to innovate as they risk having to share their intellectual property with potential competitors.

High-tech companies need to benefit from the development of their intellectual property. But newcomers also need to be able to challenge incumbents, and spur them to innovate. Like all competition authorities, the Commission will need to regularly

assess whether it strikes the right balance, but there is very little evidence to suggest that the Commission's stance has played a significant part in thwarting the growth of high-tech companies in Europe. Others factors have been more important, including poor access to financing, skills deficits and fragmented markets (see sections C1, page 59, and D2, page 91).

The real challenge confronting Europe's competition authorities does not come from Chinese subsidies or the impact of an overly-restrictive treatment of dominant firms. Rather, it is the growing struggle between the Commission and national regulators, some of whom work for governments that still own stakes in the monopolies they regulate. In the energy market, vertically integrated firms in a number of member-states, notably France and Germany, control pipelines and transmission grids and can discriminate against new entrants. They also lack the incentives to provide adequate interconnection capacity across borders. In the telecoms sector, some national regulators, such as those in France and Spain, have done too little to promote access to existing networks, with national regulators often seeming beset by conflicts of interest (see section B1, page 35).

State subsidies

Under current EU rules, governments are not supposed to pay out more than €200,000 over a three-year period to an individual company, unless it is in support of R&D, regional development, environmental protection or training – the so-called block exemptions to horizontal aid. Aid in excess of this must be referred to the Commission for approval. Where aid is paid without such approval, the Commission can demand it to be repaid. Spain has the highest number of pending recovery cases, representing around 30 per cent of the total. Taken together, France, Germany and Italy account for a further 50 per cent of cases, although the share accounted for by Germany has declined significantly since 2000.

The EU as a whole has made considerable progress in reducing state aid and in applying it in ways that distort markets less. The amount of state aid paid out by EU governments fell from 0.71 per cent of GDP in 2002 to 0.58 per cent in 2006.[29] The Commission deserves credit for the progress made towards meeting the targets. By taking an uncompromising line with illegal aid, it has deterred governments and forced them to allocate aid in ways that are less distorting of markets. Nevertheless, there are still large variations across the EU, with some governments much more willing to fall back on subsidies than others (see table opposite). Even stripping out agricultural subsidies – which tend to vary enormously between countries – the differences are still large.

[29] *European Commission, 'State aid scorecard: Autumn 2007 update', 2007.*

The vast majority of member-states also continue to shift the emphasis from bail-outs and aid for corporate restructuring to aid targeted at meeting the EU's so-called horizontal objectives: energy savings, regional economic development, small and medium-sized enterprises (SMEs) and R&D. The share of state aid accounted for by horizontal objectives was 84 per cent in 2006, up from 63 per cent in 2002.[30] In 13 members, 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. The EU has also worked hard to make it easier for small companies to benefit from government subsidies. It has modernised its rules for innovation and R&D, as well as venture capital, so that small businesses get a better deal.

[30] *European Commission, 'State aid scorecard: Autumn 2007 update', 2007.*

The EU's increasingly restrictive state aid regime is not without its critics, however. The French and German governments have argued that these rules do not take sufficient account of today's global economy, and that Europe risks losing out to countries that are more generous with their aid. Germany has regularly criticised the Commission for its alleged failure to appreciate the particular challenges faced by manufacturing companies. And in April 2007,

the German government even called on the EU to change its state aid rules, to allow member-states to 'match' financial incentives offered by states outside the EU.

State aid, 2006

	Total state aid excl. rail (€ bn)	Per cent of GDP	Total state aid for industry and services excl. agriculture and transport (€ bn)	Per cent of GDP
Malta	0.1	2.3	0.1	1.8
Hungary	1.4	1.6	0.8	0.9
Finland	2.6	1.5	0.6	0.4
Germany	20.2	0.9	16.0	0.7
Latvia	0.3	1.8	0.0	0.2
Poland	2.3	0.9	1.2	0.5
France	10.4	0.6	7.4	0.4
Italy	5.5	0.4	3.8	0.3
The Netherlands	1.9	0.4	1.3	0.2
Spain	4.9	0.5	3.9	0.4
UK	4.2	0.2	3.1	0.2
Luxembourg	0.1	0.3	0.0	0.1
EU-15	61.1	0.56	44.7	0.4
EU-25	66.7	0.58	47.9	0.4

Source: European Commission

There is no doubting the challenge posed by fast emerging economies like China and India, because of their size and the speed at which their goods and services are becoming more technologically advanced. For an economy at China's stage of development to be running a huge trade surplus is almost unprecedented. But for one the size of China to be doing so requires huge adjustments on the part of other economies. Nevertheless, raising state aid for European companies on the grounds that the Chinese, or anybody else, subsidise theirs would damage Europe's economic prospects by compromising the single market.

State aid for so-called national champions nearly always comes at the cost of another European firm. Companies rarely choose between a location in the EU and one outside of the EU when deciding where to invest. More often than not, the choice is either between various EU countries or cheaper locations outside the EU. If EU governments were allowed to 'match' state support provided elsewhere this could trigger damaging subsidy wars between member-states. Moreover, loosening state aid rules would threaten the Union's cohesion. Big, wealthy member-states can afford aid; poor ones cannot. Rather than complaining about 'unfair subsidies' by foreign governments, European politicians should concentrate on boosting Europe's presence in high-technology sectors. Increased investment in education and skills, together with more support for scientific research, would be a much better use of public resources than more state aid.

State aid and competition policy = B	
Heroes	European Commission, The Netherlands, UK
Villains	France, Germany, Hungary, Spain

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

For Europe's job markets, the years 2006 and 2007 were the best ones since the launch of the Lisbon agenda in 2000. The EU economies created around 4 million jobs in 2006 alone, and probably another 3.5 million in 2007. Average unemployment across the EU-27 dropped to 7 per cent in the course of 2007, its lowest rate since the early 1980s. Some economists are already talking about a "European employment miracle". However, countries such as Spain, with unsustainable economic growth rates, accounted for much of the employment creation. And many of the new jobs are temporary or part-time. There is no doubt that Europe needs further labour market reforms to sustain its current employment trends.

The good performance in recent years has brought the EU closer to its Lisbon employment targets, with the average employment rate across the EU reaching 64.3 per cent in 2006, from 63.4 per cent a year earlier (2007 figures were not yet available when we wrote this).[31] However, even on current trends, the EU will not meet its overall target of getting 70 per cent of the working age population into jobs by 2010. Since much of the recent improvement has been caused by women taking up paid jobs and older workers staying on longer, the EU is getting closer to its two subsidiary targets: more than 57 per cent of women were in employment at the end of 2006, only 3 percentage points short of the 2010 target. The gap for older workers (55-64) is bigger – 6.5 percentage points at the end of 2006 – but progress in recent years has been faster than in any other segment of the labour market (see table on page 82).

[31] European Commission, 'Employment in Europe in 2007', December 2007.

An employment miracle?

The EU can and should be proud of its improved employment numbers. Labour market reforms in many European countries have paid off in terms of job creation and lower unemployment. In Germany the so-called Hartz reforms, pushed through by the previous government under Gerhard Schröder, seem to have had a positive impact on the labour market. German companies report that the 2005 curtailment of benefits for the long-term unemployed (under the controversial Hartz IV law) has forced job-seekers to take the initiative and to become more flexible.[32] After years of declining employment, Germany saw net job creation of around 250,000 in 2006 and 650,000 in 2007. However, in 2007 the grand coalition of Chancellor Angela Merkel decided to undo a part of the Hartz reforms, for example by giving more generous unemployment benefits to older people.

[32] *Anja Kettner and Martina Rebien, 'Hartz-IV Reform: Impulse für den Arbeitsmarkt', Institut für Arbeitsmarkt- und Berufsforschung, October 2007.*

Job creation in the EU-27, 2000-2006

	Million	Percentage change
Total	11.6	5.7
By gender:		
Men	4.2	3.7
Women	7.4	8.5
By age:		
15-24	-0.7	-3.0
25-54	7.1	4.5
55-64	5.3	27.6
By employment type:		
Full-time	5.7	3.3
Part-time	5.9	18.1
Permanent	7.1	4.9
Fixed-term	5.0	24.8

Source: European Commission

The Commission encourages all EU countries to copy the Nordic model of 'flexicurity', a combination of flexible employment rules, solid social safety nets and active support for those who become unemployed.[33] Austria has made more progress in this respect than most. It does not impose too many restrictions on employers, but offers workers solid social benefits, training and job-search assistance. In 2003, it introduced an innovative system of 'portable' severance pay, where employers pay a small sum into each worker's severance account, which provides cash in the case of dismissal or else gets added to a worker's pension. This measure encourages labour market flexibility while at the same time providing a sense of financial security for workers. More recently, Austria has tightened eligibility for jobless benefits and stepped up efforts to cut unemployment among low-skilled and foreign workers. It is also planning measures to lift its low employment rate among older people.

[33] *European Commission, 'Towards common principles of flexicurity', July 2007.*

Most other EU countries, however, have made much less progress towards flexicurity. And despite the recent encouraging job statistics, there is no room for complacency. A lot of the job creation since 2005 has been the result of faster economic growth rather than underlying improvements in labour markets. Spain – where rapid growth has been driven by an unsustainable construction boom – accounted for almost 40 per cent of jobs created in the EU since 2000. A closer look at the figures reveals how much the various EU countries still have to do.

Although all 27 EU members created jobs in 2006, there are still huge differences among them. Some EU countries (Denmark, the Netherlands, Sweden and the UK) already exceeded the target of a 70 per cent employment rate when the Lisbon programme was launched in 2000. Austria surpassed the bar in 2006 for the first time, while Cyprus, Estonia, Finland, Germany and Ireland came close that year, and some have surpassed it since.

The Baltic states have enjoyed particularly fast employment growth in recent years, and so have several other new member-states. Poland's unemployment rate, which stood at almost 20 per cent until as recently as early 2005, fell to 11 per cent at the end of 2007. Slovakia saw a similarly precipitous fall. However, in both countries, a large-scale exodus of (mostly skilled) workers contributed to the lower unemployment rate. And in both countries, employment rates remained below 60 per cent in 2006, as did those of Bulgaria, Hungary and Romania. Hungary's employment rate has hardly increased since 2000. Only a third of older workers have a job in that country, and unemployment is very high among disadvantaged groups. Promising plans to cut payroll taxes and offer more active labour market policies had to be put on ice because of the urgent need to reduce the budget deficit. Romania's labour market presents huge challenges: 30 per cent of workers are still in the farm sector; only 1.5 per cent of Romanian workers have access to training; and high payroll taxes discourage job creation. Yet the government has no coherent plan for reforming the labour market.

Job markets have finally started to improve in Greece and Italy, but in both countries employment rates remain well below the EU average, mainly because fewer than half of Greek and Italian women work. Italy has made some progress with tackling employment in the black market. But other problems, such as punishing tax rates on labour, a badly targeted social security system and the absence of training opportunities, have hardly been addressed. In Greece, young people (even well educated ones) and women find it harder to get jobs than in most other European countries. Yet the country has made no progress with easing labour market regulations or cutting non-wage labour costs, and its spending on active labour market policies has fallen in recent years.[34]

[34] *European Commission, 'Annual progress reports' 2007. World Bank, 'Doing business in 2008'.*

Of the 13 million jobs created in 2000-06, more than half could be classified as 'precarious': part-time or fixed-term contracts, often without job protection or entitlement to social security (see the

Lisbon scorecard VII, pages 84-85, for a discussion of the labour market split into protected, full-time workers, or insiders and precarious outsiders). However, several countries, including Spain and Austria, have started to give part-time and temp workers better rights and access to social security, in an attempt to mitigate the 'insider – outsider' gap in their labour markets. Moreover, there is some evidence that since 2005, the growth in precarious jobs has slowed. This was perhaps to be expected: at the beginning of an economic upswing, companies tend to remain cautious about hiring, preferring temps and part-time workers. As growth picks up, they start feeling more confident about putting people on the payroll. Labour market reforms (or promises thereof) could also have made companies more confident about hiring.

One in five youngsters is unemployed

One segment of the labour market that has not benefited from the upswing so far is younger people (those aged 15 to 24). This is both odd – younger people are scarcer and better educated than in the past – and alarming, because European economies will not be able to cope with ageing unless more younger people are in productive employment.

Across the EU, youth unemployment remains more than twice as high as that for the labour force as a whole. In France, Italy, Sweden and some of the new member-states, more than one in five young people is looking for a job. The employment rate for young people has actually fallen a bit since Lisbon was launched (to 36 per cent in 2006), although that is at least partly the result of more youngsters getting higher education and therefore entering the labour market later (this is why the EU focuses its efforts on reducing the share of young people who are neither in education nor have a job; see next section).

While prime-age workers are now a little more likely to get a full-time regular job, the same does not hold true for younger ones. In

Poland, Slovenia, Spain and Sweden, more than half of all young workers are on temporary contracts, with France and Germany not far behind. In some countries (for example, Denmark and Germany), youngsters choose flexible employment contracts to better combine work and study. However, in Belgium, France, Poland and Spain, the majority of youngsters in fixed-term employment say they would prefer a permanent job.[35] Temporary contracts are not a problem if they are the first step towards a regular job, as is often the case in Belgium for example. In Spain, on the other hand, too many young people go from one short-term contract to the next for years.

[35] *European Commission, survey in 'Employment in Europe 2007', December 2007.*

The Commission says that the EU's general move towards 'flexicurity' would particularly benefit young people.[36] Research shows that in countries with strict hiring and firing laws, young people take a lot longer to find a job, in particular a permanent one. Also, youngsters are not usually eligible for unemployment payments, so they will gain more from 'active' labour market policies, such as (re-)training, make-work schemes and job-search assistance. But such policies may have to be specifically tailored to those who struggle to enter the labour market, which is what many EU countries are doing now.

[36] *European Commission, 'Promoting young people's full participation in education, employment and society', September 2007.*

Denmark, Finland and Sweden, have had 'guarantees' to find unemployed youngsters either a job or a training place for decades. But these programmes did not work well initially because there were no corresponding obligations for the job-seekers. When the UK launched its 'New deal for young people' in 1998, it made it compulsory for young people who have been unemployed for more than half a year to look for a job and attend training. This appears to have been rather successful.[37] However, when EU governments made a joint pledge in 2005 to offer all young unemployed people either a

[37] *Glenda Quintini and Sébastien Martin, 'Starting well or losing their way? The position of youth in the labour market in OECD countries', OECD 2006.*

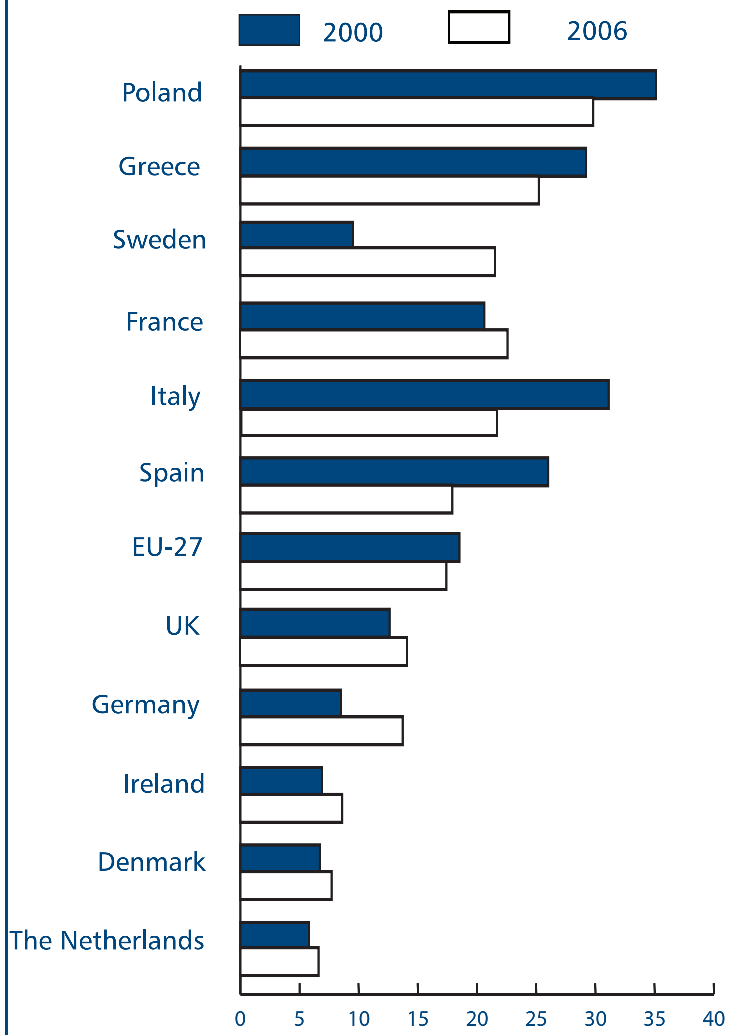
job, a training course or some other form of education within six months, they did not mention compulsory participation in such programmes. Some 'stick' may be needed, however: when Germany made a big push to cut the number of youngsters who had not yet been assigned a job or training place towards the end of 2007, more than a third simply did not show up for their appointment.[38]

[38] *Bundesagentur für Arbeit, 'Monatsbericht', December 2007.*

Most European countries have only gone part of the way towards preparing their labour markets for ageing populations and increased global competition. High youth unemployment and the persistence of insider – outsider problems in many countries show much remains to be done. Although labour market institutions cannot be easily copied among countries, the fact that the EU contains some of the world's best functioning labour markets does provide an invaluable opportunity for learning and benchmarking.

Bringing people into the workforce = B-	
Heroes	Austria, Denmark
Villains	Greece, Hungary, Italy, Poland, Romania

Youth unemployment in selected EU countries, per cent
2000 and 2006



Source: European Commission

Employment and competitiveness: The key role of education

The most visible Lisbon target remains the goal of reaching an employment rate of 70 per cent by 2010. Between 2000 and 2006 the EU-15 employment rate did indeed increase, by almost 3 percentage points, from around 63 per cent to 66 per cent. But progress has been too slow to put the Lisbon target within reach by the end of the decade.

One key aspect that is often neglected when discussing the evolution of the employment rate is the link between skills and employment. It is usually assumed that the best way to increase employment rates is to eliminate labour market restrictions. The strong push by the new French president, Nicolas Sarkozy, for example, has been motivated by this idea. Eliminating or at least reducing labour market rigidities certainly remains a key problem for most continental members of the EU, but there is another aspect, which is at least as important. This is the link between employment and education.

The implicit benchmark for the EU in setting the goal of an employment rate of 70 per cent was the US, where it already stood at 74 per cent in 2000. It was almost universally assumed that this gap was due to the near absence of rigidities on the US labour market. This might be partially true, but it cannot be the entire story since employment rates among groups with similar skills are about the same on both sides of the Atlantic. The big transatlantic difference lies in the skill level of the population: in the US the proportion of the workforce without secondary education is only 15 per cent, against almost 35 per cent in the EU; and conversely the proportion of the workforce with tertiary education is much higher in the US. This leads to a simple conclusion: if the European workforce had the same skill composition as the US, the employment rate in Europe could reach the US level, and thus the Lisbon goal.

Even a superficial look at the data reveals the importance of education for employment: on average, across the EU-15 the employment rate for people that failed to complete secondary education is about 50 per cent, against 70 per cent for those with secondary education and more than 80 per cent for those who attended university. Indeed, employment rates for people with university education are uniformly above 80 per cent, even in countries like Italy which has otherwise lower employment rates. Most of the improvement in the overall employment ratio (of the EU-15, but also of the EU-27) that has taken place since 2000 can be explained by an ongoing change in the skill composition of Europe's labour force rather than decreasing labour market rigidities.

The fact that labour market outcomes are determined to a large extent by the skill level of the population does not mean that nothing can be done to improve them by decreasing labour market rigidities. However, the most pressing challenge facing Europe is to increase the level of education of its workforce. Efforts should focus on the lower skilled and the young, eliminating obstacles to their employability. Some progress is visible on this front as a result of the gradual increase in the number of Europeans completing secondary and tertiary education. However, this ongoing improvement in skill levels is proceeding very slowly. There has been virtually no acceleration since 2000 and almost none of the more specific benchmarks set in the context of the Lisbon agenda is likely to be reached by the end of this decade.

Daniel Gros

Director of the Centre for European Policy Studies

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

The relationship between a country's wealth and the quality of its human capital is well established: international comparisons show that variations in the quantity and quality of schooling are strongly correlated to differences in countries' living standards. Highly-skilled populations tend to raise an economy's productivity, partly because they spur technological breakthroughs, but also because they speed up the adoption of new technologies. Education also plays a pivotal role in the Lisbon agenda because of its impact on other areas of the EU's reform programme. The EU's ambition to increase R&D spending, for example, serves little purpose if EU countries do not have enough good researchers to develop new technologies. And education has a decisive influence on the employment and social dimensions of the Lisbon agenda. Not only are university graduates more likely to be employed than non-graduates, they are also likely to earn more.

Despite the critical role of education in the Lisbon agenda, progress in many countries has been limited. As a result, the EU as a whole is unlikely to meet many of its education targets for 2010. Progress at secondary education level, for example, has been modest. Although the numbers completing secondary school education have been rising, most countries are still well short of their Lisbon targets: in 2006, only 77.8 per cent of school-leavers had completed secondary education, still well short of the Lisbon target of 85 per cent. Meanwhile, the share of adults participating in training has remained stuck at 9.8 per cent. Perhaps most strikingly, the disparities in educational standards between the EU's best-performing countries and the rest remain stark, at both secondary and university level.

Secondary education

Across the EU, educational outcomes are still heavily influenced by the member-state that children happen to be born in. Every three years, the OECD carries out its PISA survey in which it asks countries to test 15 year-olds for literacy, numeracy, problem-solving and other basic skills. The results show a marked north-south divide in the EU. Finland does outstandingly well, ranking first in the world. But the performance of most other EU member-states is pedestrian at best. Only three EU countries rank in the world's top ten for scientific competency or numeracy. The EU's three largest countries – France, Germany, and the UK – achieve mid-table mediocrity in the PISA tests. And the southern European countries – Greece, Italy, Portugal and Spain – continue to be the EU's worst performers in every single test. The performance of the new Central and East European member-states is respectable, particularly given the resources at their disposal. Estonia, for example, ranks sixth globally for scientific competency, while Latvia and Poland have both recorded strong improvements in literacy between 2000 and 2006.[39]

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

National variations in educational performance at secondary level are compounded by stark differences in drop-out rates. Many Northern European countries, as well as some of the Central and East Europeans (notably the Czech Republic), already exceed their Lisbon targets for completing secondary education. But in much of Southern Europe, the comparatively low levels of attainment for children aged 15 are exacerbated by the large numbers that never even complete secondary level education. In Spain, only 72 per cent of school-children finish upper secondary education. In countries such as

Greece and Portugal, drop-out rates are even higher. Sub-standard secondary education systems have worrying social implications for Southern European countries, because people without basic qualifications are at much higher risk of unemployment and poverty. This risk is rising, moreover. As emerging economies, such as India and China, move up the value chain, Europeans will face less competition from low-skilled workers there, and more from higher-skilled workforces on what are still comparatively low wages.

Although the percentage of the population that has attained at least upper secondary education has risen across the EU, long-term productivity growth will be crimped if a large share of the working-age population lacks basic skills. Further efforts are therefore needed to raise the standards of secondary education (notably in Luxembourg, Portugal, Slovakia and Spain) and to reduce the proportion of young people that leave school without at least upper secondary education (notably in Italy and the UK). Adult training cannot be relied on to correct the shortcomings of countries' secondary education systems, because those who need it the most are the least likely to receive it: evidence suggests that European adults with a degree are six times more likely to receive training than the low-skilled.

University education

At first glance, recent trends in higher education look encouraging. One reason is the steady increase in the number of young Europeans graduating with a university degree. Across the EU, almost 30 per cent of those aged 25 to 34 now have a university degree – compared with just 16 per cent for the cohort aged 55 to 64. Another positive development is the growing share of university students graduating in maths, science and technology, which passed the Lisbon target of 15 per cent in 2004 and has risen further since.[40] As with secondary education, however, closer inspection reveals that the

[40] *European Commission, 'Progress towards the Lisbon objectives in education and training: Indicators and benchmarks', 2007.*

disparities in member-states' performances are enormous; and that most EU countries lag way behind Japan, Korea and the US – three of the world's best in producing university graduates.

Graduation rates vary widely across the EU. The strongest performers are the three Nordic members, where around 40 per cent of 25 to 34 year-olds now have degrees. Once again, Southern Europe tends to fare poorly: while the share of 25 to 34 year-olds with a university degree is high in Spain, it is very low in Greece and Portugal. The numbers graduating in Austria and Germany are also realatively low. Intra-EU disparities exist not only in the numbers of graduates produced, but also in the quality of universities, as shown by international surveys. One of the most respected surveys, carried out by Shanghai University, ranks only two European universities – both British – in the world's top 20, and only 29 in the top 100. Over a third of Europe's top universities, moreover, are British.[41] In short, many European countries are still not producing enough graduates. And few of those who do graduate emerge from world class universities.

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

Higher spending or increased autonomy?

Why do some EU countries' secondary education systems perform so poorly? It is common to blame lack of funding, but international comparisons do not bear this out. The Czech Republic, for example, spends $4,000 per student on primary and secondary education, but scores better on the OECD's PISA tests than Spain (which spends $6,000). By the same token, Portugal spends a higher share of GDP on primary and secondary education than the EU average, but is one of the worst performers on PISA tests. So there is little correlation between levels of spending and educational outcomes. More important is that schools should be given a free hand when allocating their budgets, hiring teachers and dealing with students.[42] In Finland, schools can set their own curriculum, within certain parameters.

[42] *Nick Clegg and Richard Grayson, 'Learning from Europe: Lessons in education', CER working paper, May 2002.*

Greater autonomy encourages more efficient administration and spending, as well as better results. Over-centralised education systems are less efficient and do worse in international tests. In Portugal, for example, over 90 per cent of total spending on secondary education is absorbed by teachers' salaries. And in weak-performing countries such as Greece and Romania, most teachers are hired by education ministries rather than by schools.

European universities do seem to be under-funded compared with those in the US. As a share of GDP, the US spends two and a half times more on higher education than EU countries. Since public spending on higher education takes up a similar share of GDP in the EU as it does in the US, the transatlantic difference is accounted for by higher private spending in the US. The US, moreover, concentrates research funds on a handful of elite universities, whereas scarce resources are spread thinly among Europe's 4,000 institutes of higher education. Yet resistance across much of Europe to shifting the burden for funding higher education from taxpayers to students remains high. Funding is not everything. Universities in many European countries are also suffocated by the over-bearing control of the state. The result is widespread mediocrity, with rigid curricula, de-motivated staff, high drop-out rates and few incentives for students to complete their studies quickly.[43] Some countries are moving in the right direction. Parts of the UK have introduced tuition fees. France adopted a law in 2007 to give universities more autonomy. But many countries have done little to give universities greater freedom in budgets, hiring and remuneration.

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

Why such resistance to change? The answer is a widespread belief that the only way of delivering fair social outcomes is to fund universities from the public purse and place them under the direction of the state. Yet there is little evidence to support this belief. Relying solely on taxes to fund universities tends to be regressive, because the beneficiaries are overwhelmingly children from better-off families. In any case, there is little evidence that European countries that claim that their education systems are more equitable produce fairer outcomes. If anything, social background plays a greater role in determining students' performance in countries such as France and Germany than it does in the US.[44] The reason is that social inequalities are exacerbated by the structure of the French and German systems, where variations in performance between schools are large and where only a low share of students from less privileged backgrounds attend university. In short, education systems in many European countries seem to be producing the opposite outcomes to the officially stated objectives.

[44] *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

Educational indicators for selected EU countries

Czech Republic	Finland	France	Germany	Italy	Spain	UK
Annual expenditure per student on all levels of education, $, 2004						
6,752	12,505	10,668	12,255	7,723	9,378	11,484
Average score in PISA science test (OECD average = 500)						
513	563	495	516	475	488	515
Variation between schools' PISA test scores (OECD average = 33%)						
62.4	4.7	n/a	66.2	52.6	12.7	23.5
Percentage of population aged 25 to 64 with tertiary education, 2005						
13	35	25	25	12	28	30
World Economic Forum higher education and training score						
4.85	6.01	5.38	5.33	4.55	4.75	5.42
Number of universities in the world's top 200						
0	2	5	11	2	1	32

Sources: OECD, World Economic Forum, Times Higher Education Supplement

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

Aside from turning the EU into "the most competitive and dynamic knowledge-based economy in the world", the original Lisbon programme was also supposed to meet social objectives. In 2000, EU heads of state and government made it clear that economic reforms needed to be compatible with "European values and conceptions of society". Since that date, the relationship between Lisbon's economic objectives and its social ones has been hotly debated. Many critics of the Lisbon agenda believe that the social objectives have been subordinated to the economic ones, or that the two sets of objectives are incompatible. Indeed, there is a widespread perception that the Lisbon agenda is a Trojan horse for globalisation – and consequently a threat to the welfare models to which most Europeans remain attached.

Widespread as it is, this view is largely misguided. For one thing, many cherished national welfare systems have worked less well than their supporters have been prepared to acknowledge. After all, many welfare systems in Europe have been associated with exceptionally high rates of unemployment. For another, reforms of welfare provisions have come in response to pressing domestic trends, such as population ageing and changing family structures, rather than to external challenges, such as globalisation. In other words, such reforms would have been necessary whether the countries concerned were integrated in the world economy or not.

Reforming pension arrangements

European populations are ageing rapidly on the back of declining fertility and rising life expectancy. The average fertility rate in the EU-27 stood at 1.5 children per woman in 2005, compared with 2.7 in 1965. In no EU country is fertility above the rate of 2.1 which is needed to keep the population constant. And in many countries, particularly in Southern and Central Europe, the fertility rate has fallen well below replacement levels. At the same time, life expectancy keeps rising: it now stands at 80 for women and over 74 for men across the EU, and by 2050, it is expected to have risen by another five years. So the ranks of pensioners are set to swell at a time when the number of people of working age will start to decline. Europe will go from having four people of working age for every pensioner at present, to just two in 2050.

The rise in the ratio of pensioners to people of working age has important economic consequences – not least for the long-term sustainability of countries' public finances. The European Commission has estimated that in the absence of reforms, the burden of supporting an ageing population with a shrinking workforce could push the average ratio of government debt to GDP above 200 per cent by 2050 – over three times its current level. All EU member-states are faced with the same challenge. But differences in age structure and pension arrangements mean that it is more daunting in some countries than in others. The long-term budgetary impact of ageing is most marked in Cyprus, where the rise in age-related government expenditure is projected to exceed 11 per cent of GDP by 2050. The increase will be 5 per cent of GDP or more in Belgium, the Czech Republic, Hungary, Ireland, Luxembourg, Portugal, Slovenia and Spain. Most of these countries have made only modest strides towards reforming their pension systems. In a second group of countries – which consists of Denmark, Finland, France, Germany, the Netherlands, Slovakia and the UK – the budgetary impact of ageing is between 2 and 5 per cent of GDP. In the remaining member-states, the impact is less than 2 per cent of GDP.[45]

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

Confronted with such numbers, it is easy to become downhearted. But there is much that countries can do to alleviate the economic impact of ageing.[46] Conceptually, one of the simplest solutions is to increase the age of retirement – which is why the Lisbon agenda sets member-states a target to raise the age at which workers can retire on full benefits to 65 by 2010. But raising the age of retirement is politically difficult, and many countries that have done so will still fall short of the Lisbon target. One reason is that increases have been deferred, or will only kick in incrementally over a period of years (or decades). In Austria, for example, the age of retirement will not reach 65 before 2033. Another reason is that some countries have found it harder to raise the age of retirement for public-sector workers. The French government finally plucked up the courage in 2007 to tackle its so-called 'special regimes' that allow public-sector workers like train-drivers to retire on full benefits aged just 50. But some countries have still not aligned the ages of retirement for private and public-sector workers. The British government tried to do so, but backed down at the first sign of protest. So many public-sector workers in the UK can retire on full benefits aged just 60, against 65 for the private sector – with no prospect of change any time soon.

[46] *Alasdair Murray, 'Growing old gracefully: How to ease population ageing in Europe', CER essay, January 2008*

The design of many countries' pension systems also needs reforming. All the member-states have embarked on more or less ambitious programmes to place their pension and welfare systems on a more sustainable footing. Since EU countries have very different systems, there is no single reform path. But reforms have generally contained one or more of the following elements: a reduction in the generosity of tax-funded pension entitlements; an increased onus on households to save for their own retirement; and a greater role for private-sector providers, notably to supplement retirement savings. A number of countries that have traditionally relied heavily on state-run pay-as-you-go (PAYG) schemes have now opened their systems to private-sector providers. However, such schemes have sometimes been slow to take off – and have often needed tax incentives to do so. Some countries, notably in the Nordic region, have sought to address the risk of inadequate savings by obliging people to save for their own retirements. The UK has shied away from compulsion, but it has tried to tackle inertia by enrolling people automatically on retirement savings schemes, placing the onus on them to opt out.

It would be wrong, therefore, to suggest that EU countries are doing nothing to reform their pension systems. All have introduced reforms of some kind or another. And no fewer than 24 of the EU's 27 member-states have registered an increase in the effective age of retirement since the Lisbon agenda was launched. But in most cases progress has been too slow. Across the EU as a whole, the effective age of retirement has increased by only one year since 2000. And in a third of the member-states (including Austria, France, Hungary, Italy, Luxembourg, Malta, Poland, Slovenia and Slovakia) it is still below the age of 60.

Poverty and social exclusion

The Lisbon agenda is not just about competition, innovation and productivity. It also sets targets for poverty and social exclusion. The status of these targets has been open to debate, particularly since 2005, when EU leaders followed the advice of the Kok report and narrowed Lisbon's focus to growth and jobs. But one thing is clear: contrary to a widespread perception, there is no inevitable trade-off between the growth and social dimensions of the economic reform agenda. An economic system that is better geared to innovation does not have to be associated with high levels of social inequality. Many of the countries that score highly on Lisbon's economic targets do well on the social ones too – witness the Nordic countries, which combine liberal product markets with high levels of education, low long-term unemployment and low income inequalities. Similarly, many countries that score poorly on the social indicators do badly on the economic ones too – witness the Southern European countries which combine restrictive product and labour markets with low levels of educational attainment and high levels of income inequality.

The Lisbon agenda is almost certainly incompatible with some countries' unreformed social models. Its emphasis on competition, flexibility and education requires changes to national systems that try to protect workers through strict employment laws, state support for big corporations and other limits to competition. But the Lisbon agenda requires national welfare models in Europe to be recalibrated rather than swept away.

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

Selected social indicators, 2006 (per cent)

	At risk of poverty after social transfers	Long-term unemployment rate	Income inequality*	Gender pay gap
Austria	13	1.3	3.7	20
Belgium	15	4.2	4.2	7
Bulgaria	14	5.0	3.5	14
Cyprus	16	0.9	4.3	24
Czech Republic	10	3.9	3.5	18
Denmark	12	0.8	3.4	17
Estonia	18	2.8	5.5	25
Germany	13	5.5	4.1	22
Finland	13	1.9	3.6	20
France	13	4.0	4.0	11
Greece	21	4.8	6.1	10
Hungary	16	3.4	5.5	11
Ireland	18	1.4	4.9	9
Italy	20	3.4	5.5	9
Latvia	23	2.5	7.9	16
Lithuania	20	2.5	6.3	15
Luxembourg	14	1.4	4.2	14
Malta	14	2.9	4.2	3
The Netherlands	10	1.7	3.8	18
Poland	19	7.8	5.6	12
Portugal	18	3.8	6.8	9
Romania	19	4.2	5.3	10
Slovenia	12	2.9	3.4	8
Slovakia	12	10.2	4.0	22
Spain	20	1.8	5.3	13
Sweden	12	1.1	3.5	16
UK	19	1.2	5.4	20

*Source: Eurostat *Ratio of total income received by the top 20 per cent of the population to the bottom 20 per cent.*

E. Sustainable development

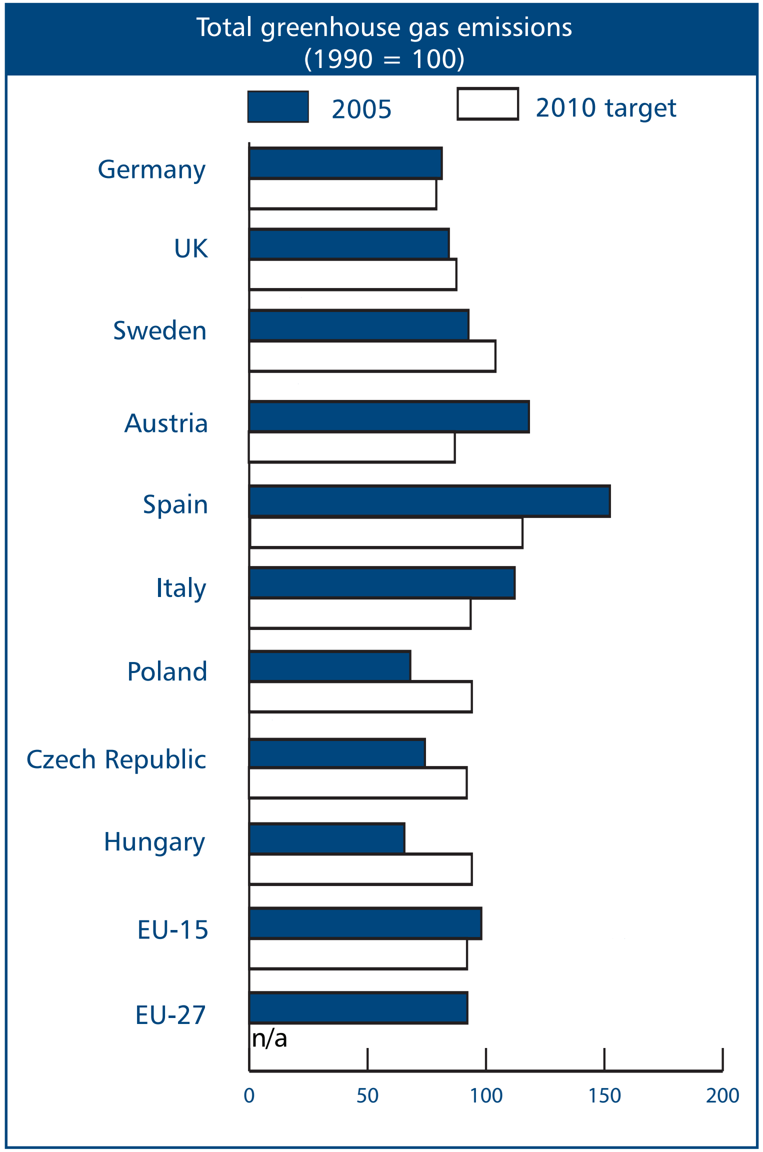
E1. Climate change

★ 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-15 countries will not meet their target of an 8 per cent cut in emissions of greenhouse gases by 2010. Emissions fell by 2 per cent between 1990 and 2005, and the maximum likely reduction by 2010 is 5 per cent. The strongest performers have been Germany and the UK (see table on page 106), although in both cases exceptional circumstances have played a part. The closure of inefficient East German industry reduced German emissions, while the UK saw a big shift away from coal to gas, which emits much less carbon dioxide. The less developed EU-15 countries, such as Spain and Portugal, have posted big rises in their emissions. This is a poor model for the global challenge we face: to stabilise emissions in emerging economies at a low level by decoupling them from economic growth. All of the new member-states saw big declines in their overall omissions between 1990 and 2005, reflecting the closure of inefficient plants and heavy investment in more modern generating capacity, but their emissions are now rising rapidly.

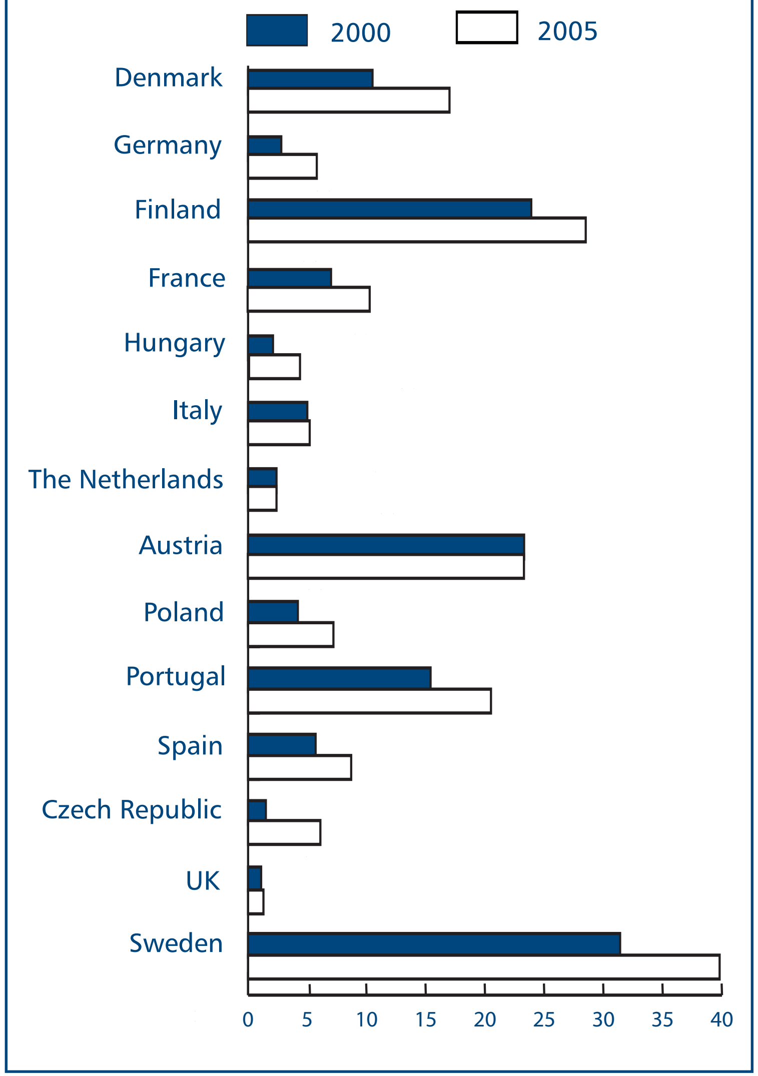


Source: Eurostat

Despite this disappointing performance, the EU is justified in claiming leadership on environmental policy. The Commission has set ambitious targets for energy efficiency, renewables and car emissions. Although the Union will not meet its targets for renewable energy – 12 per cent of gross energy consumption and 21 per cent of electricity generation by 2010 – progress has been considerable. The proportion of overall EU energy from renewable sources is set to reach 10 per cent by 2010 (up from 5 per cent in 2000), while the proportion of electricity generated sustainably should reach 19 per cent (compared with 13.8 per cent in 2000).

The use of renewable energy sources varies massively across the EU, however. The worst performer is the UK, which generated just 1.3 per cent of its energy needs from renewable sources in 2005. By comparison, the Swedish figure was 40 per cent. The large differences between countries partly reflect topography (Sweden, for example, is ideal territory for hydroelectric power), but also public policy. Each member-state has a specific target for renewable electricity generation, reflecting its specific starting conditions and topography (see table, page 109). Strong performers since 2000 include Denmark, Germany and the Netherlands, whereas the biggest disappointment has been the UK. Despite having the third lowest target of the EU-15 member-states – 10 per cent by 2010 – the country will miss it by a substantial margin. The principle problem in the UK is that it is extremely difficult to get planning permission to build wind farms, which is the renewable energy source best suited to the country. Other disappointing performers include France and Italy.

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



Source: European Commission

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

	2000	2005	2010 target
Belgium	1.5	2.8	6.0
Denmark	16.4	28.2	29.0
Germany	6.5	10.5	12.5
Finland	28.5	26.9	31.5
France	15.2	11.3	21.0
Italy	16.0	14.1	25.0
The Netherlands	3.9	7.5	9.0
Austria	72.0	57.9	78.1
Poland	1.7	2.9	7.5
Portugal	29.4	16.0	39.0
Slovakia	16.9	16.5	31.0
Spain	15.7	15.0	29.4
Czech Republic	3.6	4.5	8.0
UK	2.7	4.3	10.0
Sweden	55.4	54.3	60.0
EU-27	13.8	14.0	21.0

Source: European Commission

In January 2008, the European Commission finally published its Green Energy Plan.[47] In addition to setting out the Commission's recommendations for reform of the EU emission trading scheme (ETS), it put forward proposals for how to distribute the Union's overall target of a 20 per cent reduction in emissions of greenhouse gases by 2020 among the member-states (this target was set at the March 2007 European summit). The allocation will be determined by reference to the existing energy mixes, topography

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

and GDP per capita (poorer member-states will be given more time to increase their reliance on renewables). The Commission's national targets have proved contentious, but agreement is expected at a Council meeting in March 2008.

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. In the face of fierce opposition from the German government, the Commission retreated from its plan to enforce a mandatory target of 120 grams of carbon dioxide per kilometre by 2012. Instead, it now proposes a target of 130 grammes, with some allowances made for makers of bigger (and hence thirstier) vehicles. Under the proposals, manufacturers that fail to meet their targets will face heavy financial penalties. Together with an ambitious plan to force oil companies to blend biofuels with petrol, the Commission still hopes to be able to deliver the objective of 120 grams by 2012, which would be enough to stabilise emissions from this source.

Emissions trading

Emissions trading is the key element of the EU's drive to cut greenhouse gases. The EU's ETS is the first international emissions trading scheme, the world's largest trading permit system for carbon dioxide, and the cornerstone of the EU's strategy to meet its Kyoto emissions target. It is a downstream scheme covering the iron and steel, cement, glass, ceramics, and pulp and paper sectors, as well as power generators. These comprise around 50 per cent of EU emissions of carbon dioxide and 40 per cent of the EU's overall greenhouse gases. The scheme does not include road transport, which is one of the fastest growing sources of carbon emissions, although air transport will be brought into the system by 2011, and possibly marine transport shortly thereafter.

Emissions trading works by setting a limit on emissions of carbon dioxide and by distributing permits to emit the gas to polluters. If

a firm emits more than its allowance, it has to buy additional permits, while unused allowances can be sold. Companies, therefore, have a financial incentive to use energy more efficiently. The first stage of the EU's emissions trading scheme, from 2005 to 2007, was associated with exceptionally low carbon prices because emissions caps were too generous.[48] When negotiating national caps for the second phase of the scheme (from 2008-2012), the Commission adopted a much tougher line with EU governments. Nevertheless, the combined caps represent only a 5 per cent decline compared with 2005, and there is a risk that member-states will be able to meet most – if not all – of the reductions in their emissions simply by investing in projects abroad.[49] As a result, there is a risk that prices will be too low to stimulate investment in low-carbon technologies. Moreover, only half of the member-states intend to auction any permits and only one – Denmark – is expected to auction the maximum 10 per cent allowed. As a result companies in sectors where there is little competition, such as power generation, will continue to earn windfall profits.[50]

[48] Simon Tilford, 'How to make EU emissions trading a success', CER pamphlet, October 2007.

[59] Under the Kyoto protocol, developed countries can buy emission permits from other signatories to the Kyoto protocol and use them towards meeting their emissions targets.

[50] In the absence of effective competition in the power market, power companies can add the cost of carbon permits regardless of whether they actually paid for them.

The Commission's recommendations for reform of the ETS address many, though not all of these concerns. The Commission proposes that:

★ National caps should be replaced by an EU-wide cap that is consistent with the Union's overall target for emissions reductions. The EU-wide CAP will then be allocated among the member-states.

★ The third phase of the ETS should run for eight years until 2020, in order to provide security for investors.

★ The coverage of the scheme should be extended to include the petrochemicals, ammonia and aluminium sectors as well as nitrogen oxide emissions from the production of various chemicals. Carbon capture and storage will also be covered, though not nuclear power.[51]

[51] *This technology, still in the development phase, captures the CO_2 released by coal-fired power plants and buries underground.*

★ There should be greater harmonisation of monitoring, reporting and verification rules.

★ Two-thirds of all allowances should be auctioned in the 2012-2020 period.

★ Steps should be taken to facilitate links between the EU ETS and other carbon markets, although the Commission provides little detail on this point.

If adopted, these steps would improve the functioning of the ETS considerably. However, they do not go far enough. The EU's overall emissions targets, and the allocation of emissions permits under the trading scheme, should be decided on objective and scientific criteria – not by political horse-trading. Only then will the EU scheme provide a model for the kinds of global institutions that will be needed to achieve a global carbon market. The EU should establish two fully independent institutions to run and oversee the scheme. The first, a European Environmental Board, should distribute national emissions caps to the 27 member-states; allocate emissions permits under the emissions trading scheme; carry out the auctioning of emission permits; and establish strict guidelines for the use of auction revenues. The second institution should be a fully independent EU-wide regulatory body to oversee the carbon market, a European Carbon Market Authority. This would ensure that trading is transparent and that the market operates efficiently.

The EU can afford to cut emissions

Can the EU afford to take action to cut its emissions if others do not? The threat to the EU's overall competitiveness should not be exaggerated. The EU does all kinds of things that impose costs on certain industries. For example, EU countries impose extensive pollution standards and rigorous health and safety regulations, as well as comprehensive regulation governing working hours and quality standards. Some of these measures arguably boost the competitiveness of European companies by forcing them to apply the most up to date technologies and by encouraging them to make the most efficient use of labour. Policies aimed at curbing emissions of greenhouse gases should be seen in the same light.

Research by the OECD shows that the potential negative effects of carbon prices, even on energy-intensive industries, are smaller than feared and that the overall effect on the economy is, on the whole, positive. The OECD argues that a more climate-friendly economic framework can improve cost efficiency.[52] Anything that encourages European businesses to adopt energy-efficient technologies will stand them in good stead in a world of increasing energy scarcity, and strengthen the EU's energy security. Tight emissions caps and stringent energy efficiency standards would enable Europe to consolidate its existing lead in many energy-efficient technologies, as well as help European companies to set global technical standards.

[52] OECD, *'The benefits of climate change policies'*, 2004.

Concerns about competitiveness cannot be dismissed entirely, however. The competitiveness of some energy-intensive European industries could be impaired if other countries do nothing to control their emissions. For example, it could be counter-productive to increase the energy costs for internationally-exposed sectors such as steel and aluminium, if this led to EU producers relocating production to other continents, rather than investing in reducing their emissions in the EU.[53] If Europe's

[53] Carbon Trust, *'The European emissions trading scheme: Implications for industrial competitiveness'*, 2004.

trading partners refuse to take action, the EU will have to consider various measures to maintain a level playing field and prevent energy-intensive industries from migrating to countries with less demanding environmental regulations. These could include using revenues from auctioning to help hard-hit sectors through reductions in taxes or other types of compensation, or imposing so-called border tax adjustments (BTAs). BTAs would compensate EU producers for the higher costs they incur as a result of carbon pricing and penalise companies importing goods into the EU from countries that refuse to put a price on carbon emissions.

Climate change = B+	
Heroes	Denmark, Germany, Sweden
Villains	Austria, Italy, Spain

4 Conclusion

Since its launch in 2000, the Lisbon process has attracted numerous brickbats. Some observers have assailed the agenda as a shopping list of crude and sometimes inconsistent objectives. Other critics have argued that Lisbon-related reforms should have been accompanied by looser macro-economic policies.[54] Old-style integrationists have condemned the 'open method of co-ordination' as a toothless process, based on little more than benchmarking and peer group pressure. As for the Lisbon agenda's unrealistic ambition to turn Europe into "the most dynamic and competitive knowledge-based economy in the world", it invited widespread derision before a single reform had even been adopted.

[54] *Philippe Aghion, Elie Cohen and Jean Pisani-Ferry, 'Politique économique et croissance en Europe', Conseil d'Analyse Economique, 2006.*

These criticisms cannot be dismissed lightly. But they risk overlooking some of the more positive developments for which the Lisbon process can take credit. To start with, Lisbon has helped to foster a broad, Europe-wide consensus on what needs to be done to secure the continent's future prosperity. The underlying diagnosis from 2000 remains valid today: if European countries aspire to close the gap in living standards with the US, they must raise their rates of employment and productivity at the same time. Lisbon's original 'shopping list' of over 100 targets may have obscured this underlying message. However, the agenda's mid-term revamp in 2005 has refocused reform efforts on creating jobs and fostering growth.

As we have pointed out in these pages, there is plenty of good news on this front. Employment has been rising across Europe – for which labour market reforms can take some of the credit. The reforms have been underpinned by a growing consensus surrounding the benefits of 'flexicurity' – the combination of flexible labour markets, generous unemployment benefits and active labour market policies pioneered by Denmark. The rise in employment across almost all EU countries belies the oft-repeated claim that eastward enlargement and globalisation have been bad for European workers. It also supports those who argue that the best way to cope with globalisation is extensive reform, rather than protectionism. It is certainly no coincidence that people in less open countries, such as France, fear globalisation a lot more than those in Denmark, Finland or Sweden.[55]

[55] *European Commission, 'Eurobarometer 64', June 2006.*

However, while there has been a growing consensus on how to improve Europe's job markets, the same does not hold true for productivity. Since the mid-1990s, the EU has lagged the US in terms of productivity growth. And although recent European data look a bit better, there is still plenty of room for improvement. In too many European countries, there appears to have been a trade-off between job creation and productivity growth, as less skilled workers have been drawn into the labour force. The revamped Lisbon strategy is therefore right to pay particularly close attention to innovation, education, market liberalisation and other changes that have the potential to improve Europe's productivity performance.

If we did not have Lisbon…

It has become customary to dismiss the influence of the Lisbon agenda on member-states' national reform efforts. But this conclusion is a little crude. The simple fact that within the EU's single market, world-class economies such as Austria, Denmark and the Netherlands co-exist with less successful ones, such as Greece or Italy, has focused the minds of policy-makers – particularly in the lagging countries. The Lisbon agenda has also drawn attention to the fact that liberalisation is not incompatible with the welfare state – it can retain a 'European face'.

Academics and officials involved in the Lisbon process report that some EU countries have engaged with Lisbon more than others.[56] In general, the Lisbon agenda appears to have played a limited role in the national reform debates of large member-states such as France, Germany, Italy and the UK. These countries tend to have their own structural reform programmes that have few explicit links to the Lisbon process. In those areas where reforms are lagging, the soft targets of the EU's reform agenda do not seem to have done much to spur governments into action. But the situation is very different in small countries and in many of the new member-states. In these countries, governments have discussed their Lisbon-related 'national reform programmes' (NRPs) in parliament, as well as with trade unions, business federations and other parts of civil society. Some of these countries only developed innovation and research policies as a result of the Lisbon process. And some are known to have revised their labour market policies after having studied the EU's emerging consensus on flexicurity.

[56] *For example Iain Begg, 'Lisbon II, two years on: An assessment of the partnership for growth and jobs', Special CEPS report, July 2007. Laurent Cohen-Tanugi, 'A European strategy for globalisation', Centre d'Analyse Stratégique, January 2008.*

When it revamped the Lisbon agenda in 2005, the EU tried to strengthen the 'ownership' of Lisbon objectives at the national level. The adoption of NRPs was central to this effort. The underlying idea was that in an EU of 27 diverse countries, giving the same strict numerical targets to all governments was of limited value. So EU governments were asked to identify their own priorities within the growth and jobs agenda, and to draw up detailed programmes on how they intend to achieve them. The EU's institutions have also been asked to play a key role in the Lisbon process. The Commission annually assesses governments' reform efforts on the basis of their NRPs. It then suggests a number of priorities, as well as 'points to watch' in areas that are considered a little less urgent or where progress is already being made.[57] The Commission also

[57] *The annual assessments, as well as strategy documents, are on http://ec.europa.eu/growthandjobs/european-dimension/200712-annual-progress-report/index_en.htm.*

draws up its own list of measures to be taken at the EU level. The Council – where national ministers meet to reach agreement on EU policies – adds its own views to this surveillance exercise. The EU's spring summit then adopts a set of recommendations for each country and for the Union as a whole. Although these hint at some of the specific shortcomings of individual member-states, they do not 'name and shame' countries that have not lived up to their promises. That is unfortunate. All EU countries agree that in the Union's integrated single market, they cannot be indifferent to each others' reform efforts. They should therefore have the courage to discuss their successes and failures openly.

EU countries need to keep going

Such openness will be particularly important in 2008, when the risk of complacency and reform set-backs appears to be growing. In this pamphlet we have argued that many EU countries have made significant progress towards their Lisbon targets – but that there is still much further to go. Having enjoyed a strong economic upturn in 2006-07, some policy-makers may feel that further changes are unnecessary. They risk repeating the mistake that some EU countries made in 1999-2000, when they mistook short-run economic upturns for improvements in their long-term growth rates. Many economists assume that Lisbon-related reforms have improved the long-term structural performance of some EU economies. The structural rate of unemployment, for example, does appear to have fallen in recent years. But it is not at all clear whether many member-states have succeeded in lifting their long-term growth rates by much: reforms have probably not been sufficiently deep or wide-ranging to do so.

Another risk is that governments will follow the path of least resistance – that is, push through uncontroversial reforms but avoid them in areas where the perceived political costs are high. This would be a shame, because the benefits of reforms in superficially unrelated areas often amount to more than the sum of their parts. Product and labour markets are more interconnected than is often

recognised. A lack of competition, for example, tends to create easy profits for firms and security for workers – so creating a powerful lobby against change. One way of increasing labour market flexibility may therefore be to increase competition in goods and services markets.[58] Research suggests that the success of the Nordic economies owed much to the opening of their economies and their decision to liberalise energy, telecoms and other markets early on.[59] Such studies hold important lessons – notably for France, which has been pushing through some courageous labour market reforms while trying to shield national champions from competition.

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

[59] *European Economic Advisory Group, 'Scandinavia today: An economic miracle?', EEAG Report on the European Economy, 2007.*

The Lisbon process now only has two years left to run. There have been some encouraging improvements in recent years. But it is already clear that many EU countries will miss key Lisbon targets, on employment, climate change, education, and so on. The Commission is right to put the focus for the last two years on the implementation of commitments already made, rather than asking EU governments to draw up yet another list of national targets. But governments themselves need to have the courage to hold each other to account if these promises are not met.

Overall assessment of results: C+

★

The scorecard table

★

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

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CENTRE FOR EUROPEAN REFORM
NEW IDEAS FOR A NEW EUROPE

THE LISBON SCORECARD VIII
Is Europe ready for an economic storm?

Katinka Barysch, Simon Tilford and Philip Whyte

After more than half a decade of economic gloom, the years 2006 and 2007 restored some much-needed optimism to Europe. Faster GDP growth and falling unemployment were at least partly due to the implementation of structural reforms. But governments must not become complacent, especially at a time when a global downturn is set to test Europe's economic resilience. The Lisbon Scorecard VIII shows how much EU member-states still have to do to encourage innovation, bring people into the workforce, cut greenhouse gases and meet their many other Lisbon targets.

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