

# Advancing long-term prosperity

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Economic reform in an  
enlarged Europe





HM TREASURY

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Economic reform in an  
enlarged Europe

February 2004

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# FOREWORD

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Two years ago we published a White Paper setting out our vision for European Economic Reform. That vision was, and still is, about jobs. Increasing the level of employment is the best form of social protection; it is the best way to make Europe's economy more productive and sustainable; it is the best way to compete in an increasingly globalised world, and, most importantly, it is the best way to tackle poverty and fight social exclusion.

In March 2000 in Lisbon, Europe's leaders committed themselves to a ten-year strategy of reform of Europe's labour, capital and product markets. The programme was and remains ambitious. We committed ourselves to becoming the most competitive and dynamic economy in the world by 2010, underpinned by a reinvigorated European social model.

We have made significant, but not sufficient, progress. I said in the foreword to our progress report in February 2002 that we had created 5 million more jobs since Lisbon. That figure has now risen to 6 million, giving us a total employment rate for the existing EU 15 of 64.3 per cent. That is progress. But at Lisbon we aimed for 70 per cent by 2010, and set ourselves an interim target of 67 per cent for 2005. So it is not good enough.

In the past twelve months, we have achieved agreements on better regulation, on modernising EU competition policy, on an Action Plan for research and development, and on reform of the Common Agricultural Policy. Germany and France have instigated reform programmes. A new Labour Market Initiative in Italy is beginning to tackle employment levels. The Innovation Council in the Netherlands and a new initiative to encourage enterprise in Spain are examples of best practice that we can all learn from.

This year, it is right to applaud also the efforts of the ten countries joining the EU on 1 May. For many of them economic reform has been the norm for the past ten years.

But whatever we have achieved, and wherever we sit on the graphs and tables, we need to go further to meet the standards being set by our competitors elsewhere in the world.

At the end of March, the EU Heads of Government will meet in Brussels. To meet our goal of increased economic dynamism against a backdrop of full employment and social cohesion, we must focus on the right priorities:

- **implementing the recommendations made by Wim Kok's Employment Taskforce** at the Member State level, to get more people into more and better jobs;
- **completing and strengthening the Internal Market**, by endorsing the Commission's approach in the Directive on the Internal Market in Services, and implementing EU legislation across the enlarged Union, at the same time ensuring that regulation is not over-burdensome;
- **promoting enterprise and innovation**, by developing policy frameworks that raise the level of private sector research and development and innovation, using existing and public sector R&D more effectively, and introducing measures to help enterprise grow and flourish;
- **becoming a more outward-looking Europe** that recognises the benefits of increased competition and co-operation in trade with the rest of the world, fulfils our commitments to international development and on climate change,

and adopts environmental technologies that can increase sustainable development. A successful WTO negotiation is a high priority; and

- **implementation and enforcement**, as we approach the half-way mark along the road to 2010, we must ensure that we have a competitive and dynamic economy in practice as well as in theory: we must implement the agreements and recommendations we have made.

Tony Blair

# OVERVIEW

At the Lisbon European Council, in March 2000, Europe's leaders committed themselves to a ten-year programme of far-reaching economic reform designed to make the European Union "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion." This report examines progress towards this ambitious goal.

Since the launch of the Lisbon strategy, the European Union has made important progress in reforming its economy; the past year bearing witness to further substantial reform. But as Europe approaches the half-way point in the Lisbon strategy, the need for further action remains as pressing as ever. Globalisation, advances in new technologies and the imminent enlargement of the European Union provide new opportunities for Europe to prosper and new challenges to overcome. This will require tough decisions; a hard look at whether the traditional approaches to economic policy-making in Europe still deliver results; and difficult choices about whether the areas in which the EU currently targets its spending are the right ones.

The occasion of the forthcoming spring European Council in March 2004 provides an important opportunity for Europe to take further strides towards the Lisbon goals, through a comprehensive programme of reform designed to:

- **promote employment and skills**, through concrete action to improve labour market flexibility in Europe;
- **strengthen competition and regulatory reform**, to deliver greater efficiency in the Single Market and to minimise unintended burdens on business;
- **advance enterprise and innovation**, to increase flexibility and deliver a dynamic knowledge-based economy;
- **achieve greater external trade liberalisation**, multilateral and bilateral, as a driver of progress toward the Lisbon goals; and
- **meet the challenge of sustainable development**, to ensure that economic and social progress is matched by progress on the environment.

## INTRODUCTION

1.1 In February 2002, the Government published a White Paper, *Realising Europe's potential: Economic reform in Europe*. The paper set out the Government's vision of a dynamic, job-creating Europe, built on full employment, high living standards and social cohesion. It underlined the importance of structural reform in labour, product and capital markets to the realisation of this ambition. This report examines the progress that has been made in delivering European economic reform. It updates HM Treasury's February 2003 review, *Meeting the challenge: Economic reform in Europe*.

### Economic reform: a European priority

1.2 At the Lisbon European Council in March 2000, Europe's leaders committed themselves to a ten-year programme of far-reaching economic reform to advance a new strategic goal for the European Union to become "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion."<sup>1</sup> The economic, social and environmental dimensions of sustainable development were integrated into this programme in June 2001, through the EU Sustainable Development Strategy.

<sup>1</sup> Presidency conclusions Lisbon European Council, 23-24 March 2000.

**Globalisation 1.3** Four years since the launch of the Lisbon strategy, economic reform remains a European priority. The backdrop to the Lisbon strategy is an increasingly interconnected global economy, characterised by rapid advances in new technologies and the continuing integration of emerging market economies into global patterns of trade and investment. Fifty years ago Europe was in the vanguard in recognising the need to look beyond national borders in the way that economic activity is organised. Today, in an age in which people, ideas and capital are more mobile than ever before, Europe must again expand its vision and look outwards, ensuring that its economic policies are rooted in the realities of the modern global economy, and in the opportunities and challenges it presents. Continued reform is needed, not only to advance the Lisbon goals, but to ensure that existing standards of living can be maintained in the face of global competition.

**Enlargement and demographics 1.4** The importance of reform is amplified by developments within Europe's borders – in particular, the imminent enlargement of the European Union and longer term demographic trends. The expansion of the Single Market that will follow enlargement offers the prospect of significant gains for the European economy – gains that will only be realised if Europe's economies adapt quickly and efficiently to changing patterns of competition, trade and investment. An ageing population, in which fewer workers will be required to support more people of beyond working age, serves only to intensify the case for reform. Sustained and wide-ranging action is needed to ensure that Europe is properly equipped to face these challenges in the years ahead.

**Flexibility 1.5** These factors make the development of policy more challenging; require of Europe's leaders greater imagination and openness to change; and mean that the Union as a whole must be ready to challenge and revitalise traditional approaches to policy-making. For the European economy, they call for greater economic flexibility in product markets, labour markets and capital markets, to advance long-term prosperity and ensure rising living standards for all. Without further action to promote flexibility, Europe's businesses and individuals will lack the means to adapt to economic change and to take advantage of new opportunities as they arise. Structural reform, which both promotes economic flexibility and ensures a fair deal for all citizens, is the key to Europe's success in the modern global economy.

## MEETING THE LISBON CHALLENGE

**1.6** The Lisbon strategy is underpinned by a series of targets, agreed at the Lisbon European Council and in Stockholm, Göteborg and Barcelona. These targets are ambitious. But the price of inaction would be high. Further reform could boost potential growth rates in the European Union by  $\frac{1}{2}$  –  $\frac{3}{4}$  of a percentage point of GDP within the next five to ten years, generating significant gains for businesses and consumers across the EU.<sup>2</sup>

## A reforming Europe

**Reform in Europe 1.7** Since the launch of the Lisbon strategy, Europe has taken important steps to improve the performance of its economy. Significant reforms have been introduced, including overhauls of the regulatory frameworks for telecommunications, energy and competition; reforms to the state aid rules; and steps to promote enterprise and innovation. The past year has seen a series of concrete steps taken, including:

- **inter-institutional agreement on the need for better regulation**, with a new system of impact assessment, consultation and regulatory simplification;

<sup>2</sup> *The EU economy: 2003 review*, European Commission.

- **modernisation of EU competition policy**, including a simpler and more economically-grounded assessment of mergers;
- **publication of the Employment Taskforce Report**, which highlighted the structural reforms needed to raise employment across the EU;
- **adoption of a new Action Plan for research and development**, to support progress towards the Union's aim to raise investment in R&D;
- **agreement on a new Action for Growth Initiative** to mobilise investment in trans-European network infrastructure and in R&D and innovation; and
- **reforms to the Common Agricultural Policy** that have the potential to reduce trade-distorting agricultural support.

**Reform in the Member States** **I.8** Recognising their responsibility to show leadership in the drive for reform, many Member States have also taken tough decisions to implement important domestic reforms aimed at improving the flexibility of their economies. Though by no means an exhaustive list, examples include:

- **the launch of Agenda 2010 in Germany**, with reforms to improve labour market flexibility and measures to promote business start-ups, and recent proposals to enhance innovation and increase research and development;
- **a package of reforms in France to promote enterprise** by simplifying and reducing the costs involved in setting up a new business. France has also significantly reformed its pension system to enhance sustainability;
- **the launch of a new Innovation Council in the Netherlands** to strengthen the innovation climate and increase business R&D, and the launch of new targets to reduce the administrative costs and burden of regulation;
- **introduction of more flexible forms of labour market contracts in Italy** and proposals to reform the pension system;
- **reforms to increase public administration efficiency in Portugal**, and the establishment of a new competition authority; and
- **reforms to encourage enterprise in Spain**, permitting new forms of finance, faster procedures for setting up a business and new guidance for entrepreneurs.

**I.9** At the same time, many of the new Member States have continued to advance their comprehensive programmes of structural reform in preparation for EU membership, while many other Member States have implemented or are considering reforms to improve the sustainability, quality and efficiency of pension and health care systems.

## The performance gap

**I.10** These reforms are a welcome step in the right direction. But the pace of reform must be accelerated if Europe is to meet the Lisbon challenge. As the OECD has concluded: *“Reaching the strategic goal set at the Lisbon summit ... by 2010 now looks very challenging, and requires that greater progress is made in implementing the structural reform agenda already laid out and attention be given to what additional efforts may be required.”*<sup>3</sup>

<sup>3</sup> *Economic Survey – Euro Area – 2003*, OECD.

**I.II** Europe's recovery from the recent global slowdown highlights the nature of the challenge. Compared with the US, the European economy has failed to recover as strongly, with several Member States experiencing recession. This cannot be explained by reference to cyclical factors alone. Rather, as the Commission has concluded, "*the fact that the slowdown has persisted for three years suggests that supply side dynamics have been important and the growth weakness cannot solely be attributed to demand shocks*"<sup>4</sup>. Underlying trends in productivity and employment growth – two important drivers of an economy's potential growth rate – confirm this assessment.

**Productivity I.I2** Despite a marked variation in the performance of different Member States, overall levels of productivity in the EU remain substantially below those in the US, one of the Union's major international competitors. In 2002, productivity in the US exceeded that in the EU by as much as 19 per cent, depending on the definition used<sup>5</sup>. Only two Member States – Ireland and Luxembourg – currently experience levels of productivity above those in the US<sup>6</sup>. Moreover, in the new Member States, levels of productivity remain far below the existing EU average, contributing to the scale of the challenge ahead.

**I.I3** A dynamic and productive economy requires an economic environment that supports the key drivers of productivity – competition, enterprise, investment, innovation and skills. Action to close the productivity gap must focus on each of these drivers, with structural reforms to enhance product, labour and capital market flexibility to the fore.

**Employment I.I4** The Lisbon strategy commits the European Union to a series of stretching targets to raise levels of employment throughout the EU – notably, to secure an increase in the overall rate of employment to 70 per cent by 2010. While the labour market performance of different Member States varies considerably, the stark reality facing the Union is that these targets will not be met without a substantial increase in future rates of employment growth. Between 1992 and 2002, the EU managed average annual employment growth of just 0.6 per cent – under half that experienced in the US. For an enlarged EU to meet the Lisbon target, average annual employment growth of around 1.5 per cent is needed between 2003 and 2010 – around three million new jobs every year.

**I.I5** Even in a more favourable global economic climate, job creation of this magnitude will be hard to deliver. Structural reform, to improve the flexibility of Europe's labour markets, will be crucial to success. While action is needed on a range of fronts, reforms to improve the employment prospects of women and older workers, both of which groups continue to suffer considerable labour market disadvantage relative to other members of the working age population, are needed in many Member States. Reform must also seek to reduce the persistently high levels of economic inactivity across Europe – at around 93 million people, the stock of those who are neither in work, nor looking for work, dwarfs the numbers of those who are unemployed.

## TOWARDS THE LISBON GOALS

**I.I6** Despite encouraging progress over the course of the past year, Europe's policy-makers have more to do if they are to deliver for the Union's citizens the rising living standards they have a right to expect. The underlying aim of the Lisbon agenda is clear. The aim of structural reform is to create more and better jobs and greater social cohesion, to benefit citizens throughout the enlarged Union and to promote sustainable development.

<sup>4</sup> *The EU economy: 2003 review*, European Commission.

<sup>5</sup> According to Eurostat, measured in terms of output per worker, US productivity in 2002 was around 19 per cent higher than that in the EU. Measured in terms of output per hour worked, US productivity in 2002 was around 14 per cent above that in the EU.

<sup>6</sup> Using a comparison of output per person employed.

**Leadership I.17** As Europe approaches the half-way point in the Lisbon strategy, the Member States and the Community must unite around a comprehensive programme of reform that is both commensurate to the scale of the task and acknowledges the opportunities and challenges of the modern global economy. Strong and determined political leadership, from the Member States and institutions of Europe, and from the highest levels down, will remain central to the success of the strategy. For its part, **the Commission should nominate a Vice-President with explicit responsibility for economic reform**, to oversee and give a vital spur to progress across the range of structural reform priorities.

**A new approach I.18** Progress itself will require tough political decisions; a hard look at whether traditional approaches to economic policy-making in Europe still deliver results; and difficult choices about whether the areas in which the EU currently targets its spending are the right ones – focused on the key economic aims of a more productive and dynamic economy. This calls for a visionary and strategic approach built upon:

- **concerted action to deliver enhanced economic flexibility**, across all of Europe's product, labour and capital markets;
- **economic reform that advances flexibility and fairness together**, to ensure that economic growth goes hand-in-hand with social justice;
- **a continued commitment to the goals of sustainable development**, with economic growth and social cohesion matched by action to protect and preserve the environment;
- **action to ensure that the benefits of reform are felt in all regions** of the European Union, including the poorest;
- **a flexible and adaptable approach to policy-making** that reflects changes in the world economy and the diversity within Europe itself, and which looks beyond regulation for the most appropriate policy instrument; and
- **a modern and flexible framework for EU budget expenditure** in support of the Union's priorities, including the Lisbon goals.

**Priorities for reform I.19** Subsequent chapters of this report describe in detail the range of structural reform priorities facing the European Union as it strives to raise both levels of productivity and employment. The occasion of the forthcoming spring European Council, in March 2004, provides an important opportunity to advance the Lisbon goals, through priority action to:

- **promote employment and skills**, through concrete reform to improve labour market flexibility in Europe;
- **promote competition and regulatory reform**, to deliver greater efficiency in the Single Market and to minimise unintended burdens on business;
- **advance enterprise and innovation**, to increase flexibility and deliver a dynamic knowledge-based European economy;
- **achieve greater external trade liberalisation**, multilateral and bilateral, as a driver of progress toward the Lisbon goals; and
- **meet the challenge of sustainable development**, through innovation in environmental technologies and improved external aid.

**Box 1.1: Economic reform: the priorities of the Irish EU Presidency**

The Government strongly welcomes the Irish Presidency's focus on economic reform and its commitment to give new impetus to the achievement of the Lisbon goals. It looks forward to working closely with the Presidency, as well as with other Member States, over the coming months to advance the Lisbon goals. The Government endorses the economic reform priorities identified by the Presidency which chime well with its own assessment as described in this report. These priorities include:

- **the promotion of growth oriented economic policies**, through investment in research and development and in physical and human capital in the context of the EU Action for Growth Initiative. Such investment is essential to support economic recovery and the transition towards a knowledge-based economy;
- **fostering competitiveness**, by ensuring that the impact of Community policies is properly assessed and through action to advance the Commission's draft directive on services in the internal market;
- **delivering more and better employment**, through action to progress the implementation of the EU's employment guidelines, taking into account the recommendations of the recent Employment Taskforce report, and steps to promote the effective adaptation to change by workers and companies, including through lifelong learning; and
- **ensuring sustainable growth**, with steps to promote greater investment in environmental technologies so that growth and social progress are delivered in a sustainable fashion, decoupled from environmental damage.

## Job-creating growth: employment and skills

**1.20** The Lisbon European Council placed labour market reform at the heart of the European agenda, recognising its importance for economic growth and social justice. In the past four years, many Member States have launched ambitious reforms to assist and encourage people back into work – partly as a result of which, six million more people are in work today than in 1999. Yet despite these successes, progress in delivering reform remains too slow, and the Union as a whole faces an uphill challenge if it is to meet the targets for employment endorsed by EU leaders at Lisbon. As Europe approaches the half-way point in the Lisbon timetable, the Member States and the Community must therefore revitalise their commitment to reform, with action to advance flexibility and fairness in Europe, through:

- **improvements to the regulatory environment**, with new legislation assessed to ensure both decent minimum standards in the workplace and the flexibility needed to encourage job creation and to facilitate flexible working patterns;
- **active labour market policies** to help the unemployed and inactive, particularly those among disadvantaged groups, find and remain in work;
- **reforms to tax and benefit systems to improve incentives to work** and advance flexibility and fairness together; and
- **action to create a skilled and adaptable workforce** that can respond rapidly to changing economic conditions, with lifelong opportunities for individuals to refresh and update their skills.

## Dynamic growth: competition, regulation and the Single Market

**I.21** Flexible product markets are an essential feature of a modern, dynamic economy, providing a competitive environment which rewards efficiency and ensures that firms have strong incentives to deliver quality and choice to their consumers. The Single Market has made an important contribution to competition and flexibility in the European economy, delivering substantial benefits to EU businesses and consumers. The Lisbon strategy has taken this further, broadening and deepening the Single Market by opening up markets that were previously subject to national monopolies or other constraints. But there is a need to go further if the Lisbon goals are to be realised. As Europe moves into the next phase of the Single Market, the challenge is to build on past successes with a new approach aimed at promoting dynamism and enhanced economic flexibility throughout the European Union. This requires:

- **a comprehensive programme of regulatory reform, building on the joint initiative of the next 4 EU Presidencies**, to promote flexibility and economic performance through better controls on the quality of new EU regulation, reforms to reduce the burden of existing legislation and active consideration of alternatives to regulation;
- **concrete action to open up markets**, such as that for energy, ensuring that agreements lead to genuine market opening and that deadlines are met;
- **action to extend the Single Market to services** – the majority of the EU economy but just 20 per cent of intra-EU trade – to deliver wider benefits to EU consumers;
- **a more pro-active approach to competition policy**, so that markets which are not working properly can be investigated and addressed; and
- **further reform of the state aid guidelines**, to tackle the most distortive aids while ensuring that Member States have the flexibility to tackle market failures effectively.

## Productive growth: enterprise and innovation

**I.22** To compete effectively in an integrated and competitive global economy, Europe needs to improve its capacity to innovate and to foster an entrepreneurial culture. By helping to generate economic prosperity and employment in deprived areas, enterprising firms and individuals can also make a positive contribution to Europe's social goals. While important steps have been taken to identify and address the barriers to enterprise and innovation in Europe, the EU as a whole continues to under-perform relative to a number of its major international competitors. It is only by learning from the best, within Europe and beyond, that the Union will realise the full potential of enterprise and innovation in creating the most dynamic, knowledge-based economy in the world. Further action is needed to:

- **adopt and implement an Entrepreneurship Action Plan, drawing on the joint initiative of the UK, France and Germany**, to identify the range of actions needed to promote enterprise in Europe, including new European Centres of Enterprise – local centres of excellence in enterprise policy;
- **develop and implement an effective Action Plan for Innovation** to help tackle the barriers to innovation in Europe;

- **support research and innovation through the Action for Growth initiative**, ensuring a focus on the most economically and financially viable projects and leveraging in private investment in research and new technologies;
- **review and reform Community instruments for research funding**, ensuring that assistance provided under Framework Programmes delivers value for money and the greatest possible impact on research and innovation;
- **further reform the state aid guidelines** to give Member States the flexibility they need to address market failures inhibiting both innovation and access to finance by businesses; and
- **implement swiftly the Community Patent** in a way that effectively addresses the needs of businesses.

## An outward-looking Europe

**I.23** In an interconnected global economy, Europe's opportunities, responsibilities and challenges do not stop at its borders. External openness, underpinned by a flexible and dynamic economy, can play an important role in advancing the Lisbon goals of growth, productivity and employment, reinforcing action taken as part of the Single Market programme. An outward-looking Europe must therefore:

- **adopt a leadership role in multilateral trade negotiations** with the aim of ensuring the most ambitious agreement possible. Europe must commit to deliver further significant improvements in access to all of its markets and offer additional flexibility to developing countries so that they may share in the benefits of global trade; and
- **take steps to strengthen the transatlantic economic relationship** – the EU's most significant trade and investment relationship – by identifying and then tackling ongoing barriers to trade and investment between the EU and the US, to the benefit of businesses and consumers on both sides of the Atlantic. The Chancellor of the Exchequer and the US Treasury Secretary have announced their support for a new OECD-led study to quantify the potential benefits of closer economic cooperation between the EU and the US, which now has the backing of an array of EU Finance Ministers.

**I.24** An outward-looking Europe must also acknowledge its responsibilities to pursue the goals of sustainable development, challenging traditional perceptions of growth to ensure that economic and social progress goes hand-in-hand with action to protect the environment, and playing a leading role in the fight against global poverty. As it strives to achieve the Lisbon goals, Europe must therefore:

- **demonstrate global leadership in the pursuit of sustainable development**, through further steps to encourage innovation in environmental technologies, and a revitalised commitment to make progress towards the Kyoto targets to reduce greenhouse gas emissions and address the problem of climate change; and
- **take further action to help tackle global poverty**, by improving the effectiveness of national and Community financing for development, supporting the establishment of an International Finance Facility to mobilise additional aid resources and continuing reform of the Common Agricultural Policy.

# 2

## ECONOMIC REFORM: A EUROPEAN PRIORITY

Four years into the Lisbon strategy, economic reform remains a European priority. Globalisation, advances in new technologies, and the imminent enlargement of the European Union, provide both new opportunities for Europe to prosper, and new challenges to overcome. Structural reform, which delivers enhanced economic flexibility, is key to ensuring that the European economy can respond quickly and efficiently to change and that higher living standards can be assured.

Over the course of the past year, the Community and the Member States have made welcome and important steps to advance the Lisbon goals. But there remains much more still to do. Productivity levels in the EU as a whole continue to fall short of those in the US, while current trends in employment growth are not sufficient to ensure that the Union's stretching targets for jobs are met. As Europe approaches the half-way point in the Lisbon strategy, the Member States and the Community must revitalise their commitment to reform, uniting around a comprehensive programme of change that is both commensurate to the scale of the task and which acknowledges the opportunities and challenges of the modern global economy. This requires:

- **continued structural reform to deliver greater economic flexibility** throughout Europe's product, labour and capital markets;
- **economic reform that advances flexibility and fairness together**, to ensure that economic growth goes hand-in-hand with social justice;
- **a continued commitment to the goals of sustainable development**, so that economic and social progress is matched by progress on the environment;
- **action to ensure that the benefits of reform are felt in all regions** across the European Union, including the poorest;
- **a flexible and adaptable approach to policy-making** that reflects changes in the world economy and the diversity within Europe itself, and which looks beyond regulation for the most appropriate policy instrument; and
- **a modern and flexible framework for EU budget expenditure** in support of the Union's priorities, including the Lisbon goals.

### INTRODUCTION

**2.1** In March 2000 in Lisbon, Europe's leaders committed themselves to a ten year strategy of far-reaching economic reform to make the European Union "*the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion*".<sup>1</sup> Four years on, the need for structural reform of Europe's product, labour and capital markets is more pressing than ever.

**2.2** In recent years, technological innovation and the integration of emerging markets into the global economy have led to a step change in competition from the rest of world. These developments have brought new opportunities for Europe to prosper. But they have also brought challenges – challenges that can only be addressed through structural reform to deliver economic flexibility and ensure that Europe's economies can take full advantage of new technologies and markets within the EU and abroad.

<sup>1</sup> Presidency conclusions, Lisbon European Council, 23-24 March 2000.

**2.3** Enlargement of the European Union intensifies the need for reform. While an enlarged Single Market heralds new opportunities for the European economy, so too will it alter patterns of competition and economic integration within the Union's expanded borders. Flexibility and continued reform are vital to ensure that Europe's economies respond swiftly to these changes and reap the full economic benefits of this historic step.

**2.4** These factors form the backdrop to the Lisbon strategy. And while progress towards the dynamic and inclusive economy envisaged at Lisbon is evident, Europe continues to fall short of its own aspirations and of the benchmarks for performance set by the best of its global competitors. The pace of reform must be accelerated if Europe is to meet the Lisbon challenge. As the OECD has concluded: "*Reaching the strategic goal set at the Lisbon summit ... by 2010 now looks very challenging, and requires that greater progress is made in implementing the structural reform agenda already laid out and attention be given to what additional efforts may be required.*"<sup>2</sup>

**2.5** As set out in Box 2.1, the Lisbon targets are ambitious. They illustrate how far Europe needs to travel if it is to improve its economic position in the world, in the face of intensified global competition and as the emerging economies of China and India forge ahead. But the price of inaction would be high. As the Commission note in their annual report to the spring European Council<sup>3</sup>, "*insufficient implementation of the Lisbon Strategy could produce significant net costs for Europe: in terms of reduced growth, delayed improvements in employment levels, and a growing gap with some of our large industrial partners in the fields of education and R&D. Studies and simulations conducted by the Commission conclude that simultaneous and integrated pursuit of these reforms can produce an increase in potential growth in the order of 0.5 to 0.75 of a percentage point of GDP within the next five to ten years.*" This chapter assesses the nature and scale of the economic reform challenge and describes a principled approach to future policy action towards the Lisbon goals.

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<sup>2</sup> *Economic Survey – Euro Area – 2003*, OECD.

<sup>3</sup> *Delivering Lisbon: reforms for the enlarged Union*, Report from the Commission to the spring European Council, January 2004.

**Box 2.1: Key targets and objectives**

The Lisbon strategy entails a variety of targets, agreed at the Lisbon Council itself (March 2000), and at Stockholm (March 2001), Göteborg (June 2001) and Barcelona (March 2002). Not all are quantified or carry a deadline, but those which are include:

**Employment:**

- an overall employment rate of 67 per cent in 2005, and 70 per cent by 2010;
- a female employment rate of 57 per cent in 2005, and 60 per cent by 2010;
- an employment rate for older workers, aged 55-64, of 50 per cent by 2010;
- an increase of 5 years by 2010 in the average effective retirement age; and
- reduce, by 50 per cent, the number of 18 to 24 year olds with only a basic secondary education, by 2010.

**Research and innovation:**

- R&D spending to approach 3 per cent of GDP by 2010, with two thirds of the total coming from business; and
- 100 per cent of schools to be connected to the Internet by 2002.

**The Single Market:**

- full implementation of the Risk Capital Action Plan by 2003, and of the Financial Services Action Plan by 2005;
- a transposition rate for Internal Market directives of 98.5 per cent;
- no Internal Market directives to be more than two years overdue in their transposition;
- open energy markets for business in 2004, and subsequently for domestic users; and
- a single European sky by 2004.

**Social cohesion:**

- halve by 2010 the number of early school-leavers not continuing with further education; and
- reduce by 2010 the numbers living at risk of poverty.

**Sustainable development and the environment:**

- visible progress towards reducing greenhouse gas emissions by 2005;
- an indicative target for electricity generated from renewable sources of 22 per cent of gross electricity consumption in 2010; and
- halt the loss in biodiversity by 2010 and recycle 55 per cent of all waste by 2008.

**THE ECONOMIC CHALLENGE**

**2.6** The backdrop to the Lisbon strategy is an increasingly interconnected global economy and faster economic change. These factors, alongside the imminent enlargement of the Union, acute demographic pressures, and the need to ensure the ongoing success of the single currency, contribute to the urgency of economic reform.

**Globalisation 2.7** In recent years, developments in the world economy have been characterised by significant advances in technology and the continuing integration of emerging market economies into global trade and investment flows. In this global age, Europe's economy is constantly undergoing a process of structural change, with the amount of labour and capital required by some industries declining, freeing up resources that can either lie idle, or be used profitably to provide new goods and services. For example:

- the pace of economic change has accelerated beyond all expectation, leading to a reduction in the typical life cycle of products as competition and innovation lead to faster renewal. As a result, firms' abilities to adapt and to take advantage of new technologies and markets are increasingly crucial to their success. IBM, for example, moved from hardware to software and services as the information technology market moved from mainframes to personal computers, while Nokia dealt with commodities before coming to dominate the market for mobile phones. The same is also true in the labour market where employees must refresh their skills more frequently than ever before and the concept of a job-for-life no longer holds; and
- the speed with which information can flow, and the increasing mobility of people, ideas and capital, are breaking down geographical barriers to economic activity. The growing integration of emerging markets with the global economy offers an important source of wealth and opportunity, but brings new challenges too. Rapid growth in a number of the world's emerging markets means that the geographical centre of gravity in the global economy is likely to change over the coming decades, with important implications for the world's major economies. For example, valued at current market exchange rates, China is already the sixth largest economy in the world, and valued at purchasing power parity it is second. Other countries are also forging ahead as the world's economic axis changes.

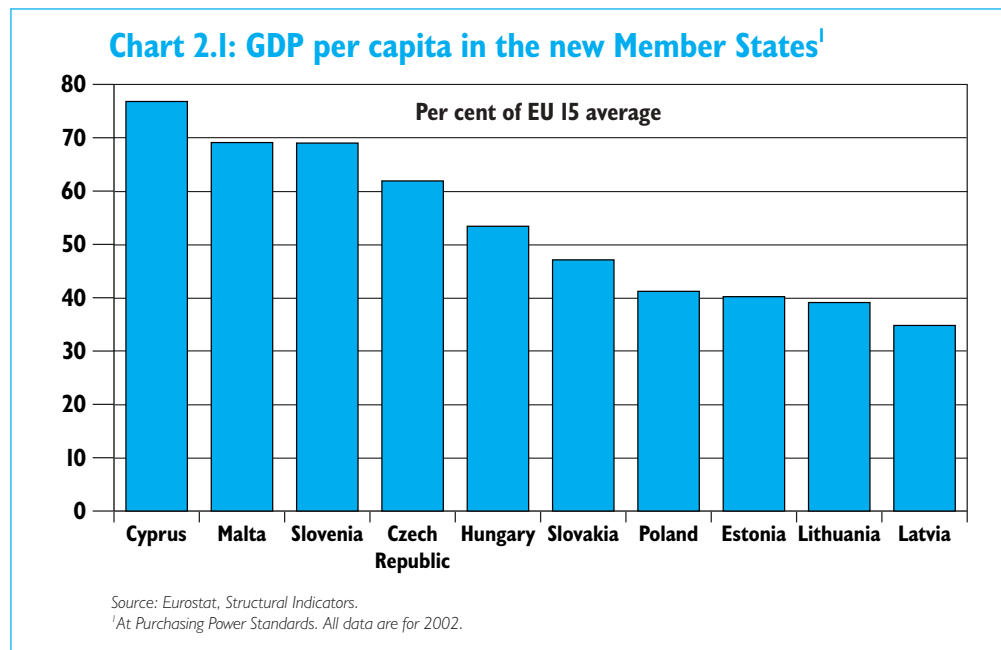
**2.8** Fifty years ago Europe was in the vanguard in recognising the need to think beyond national borders in the way that economic activity is organised. Today, Europe must again expand its vision and look outwards, ensuring that its economic policies are rooted in the realities of global competition and the opportunities it offers.

**Enlargement 2.9** Enlargement of the European Union places a further premium on the need for structural reform. From 1 May 2004, membership of the Union will be expanded to include the ten new Member States of Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia, increasing the size of the Single Market, in population terms, beyond that of the North American Free Trade Area.

**2.10** The expansion of the Single Market that will follow enlargement will create new opportunities for the European economy, increasing supply-side competitive pressures and generating new demand for goods and services. However, these benefits will only be realised through further reform to ensure that income levels in the new Member States converge rapidly on those in the existing Union, and that all Member States in the enlarged Union are able to adapt quickly and efficiently to changes in competition and comparative advantage. Continued reform will be essential if such adjustment is to be achieved without disproportionate economic and social cost.

**2.11** While the challenge is one for all Member States, that for the new Member States is particularly acute. The new Member States have already implemented significant reforms in preparation for EU membership. These reforms have centred on the creation of new public institutions and agencies, the removal of obstacles to the free movement of goods and the progressive liberalisation of capital markets. Many have also begun to put the Lisbon programme into effect through their Pre-Accession Economic Programmes. These reforms have helped to deliver significant improvements in economic performance – aggregate annual growth in the new Member States has exceeded 3 per cent over the past five years. Nonetheless, as shown in Chart 2.1, living standards in the new Member States remain significantly below those in the existing Union.

**2.12** While greater economic integration between the new and existing Member States should provide a further boost to economic growth and prosperity in the new Member States, EU entry alone will not be sufficient to ensure rapid economic convergence. Box 2.2 shows that a failure by the new Member States to pursue growth-promoting policies and to respond flexibly to enlargement would delay convergence and the time it takes to catch-up with living standards in the existing Member States. Without further structural reform, not only would the new Member States miss out on the full benefits of enlargement, but all Member States would be disappointed in their ambition to create a more dynamic and competitive Single Market.



### **Box 2.2: The new Member States: catching up**

Even small changes in growth rates can significantly affect the speed of economic convergence. Based on an average GDP per capita growth rate in the existing Member States, assumed at 2 per cent for this exercise, it is possible to estimate the year at which the new Member States would, on average, attain 75 per cent of the average GDP per capita in the existing Member States.

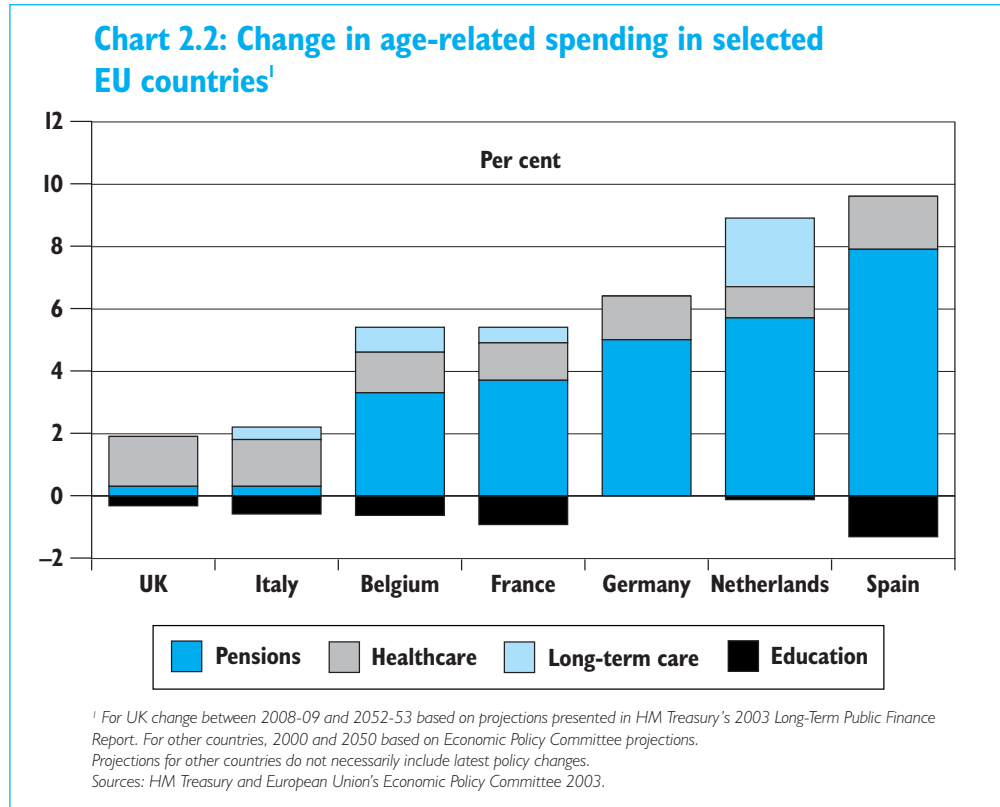
As future growth rates are uncertain, different scenarios are estimated. The baseline scenario assumes that the new Member States attain GDP growth of 4.6 per cent from their accession until 2009, in line with a European Commission projection, and that growth then slows to 4 per cent. This implies a considerable acceleration in GDP growth compared with the past five years, during which time growth has averaged around 3.1 per cent. The baseline scenario implicitly assumes that the momentum of reform is at least maintained. In this scenario, convergence to 75 per cent of EU GDP per capita would take place around 2025.

The variation in the speed of convergence resulting from differences in growth rates is, however, striking. On average, it would take the new Member States an additional 19 years to reach 75 per cent of existing EU GDP per capita if growth in these countries were to end up 1 per cent slower than assumed in the baseline. However, in a more benign scenario, in which the new member states grew 1 per cent faster than the baseline, convergence could take place some seven years earlier, in around 2018.

**Demographics 2.13** As with globalisation and enlargement, demographic pressures in Europe also reinforce the case for structural reform. Europe's population is ageing and its workforce shrinking, with the result that fewer people of working age will have to support more people above working age in the years ahead. According to the latest United Nations population projections<sup>4</sup>, the average demographic old-age dependency ratio in the EU is set to rise from 24 per cent in 2000, to 36 per cent by 2025 and 50 per cent by 2050. With the exception of Japan, this is a steeper rise than that predicted for many non-European developed countries, including the US which is expected to see its dependency ratio rise from 19 per cent in 2000 to 32 per cent by 2050.

**2.14** These trends have significant implications for growth, the future sustainability of pensions and healthcare provision, and intergenerational fairness in Europe. The Economic Policy Committee recently published its findings on the impact of ageing populations on the public finances. As shown in Chart 2.2, these findings suggest that age-related spending, especially on pensions and healthcare, is set to rise markedly in many Member States over the coming decades. Additional long-term reform, to pensions and healthcare systems and to increase employment, especially among older workers, is urgently needed to address this challenge. Recent reforms, though a positive step in the right direction, must be followed up with further action.

<sup>4</sup> World population prospects: The 2002 revision, United Nations, 2003.



### Economic and Monetary Union

**2.15** Ongoing structural reform is also vital to ensure the continued success of the single currency. The need for economic flexibility is enhanced in a single currency, once the ability to adjust interest and exchange rates is lost at the national level. In such circumstances, labour, product and capital markets must be able to respond dynamically to shocks, so as to avoid putting at risk growth, employment and social cohesion. This is true both for existing EMU members, and for those countries that may join the single currency in the future.

## MEETING THE CHALLENGE: EUROPE'S PERFORMANCE GAP

**2.16** Significant progress has been made in recent years towards realising the strategic goal set at Lisbon. As described in Box 2.3, many European Member States have taken important steps to reform their economies and reduce the structural barriers to growth and prosperity. The EU as a whole has also introduced a series of significant reforms, with further progress made during the last twelve months.

**Box 2.3: Meeting the challenge: recent reforms in the EU**

Over the course of past year, the Community has taken a number of important steps to advance the Lisbon goals. As described elsewhere in this document, these include:

- **inter-institutional agreement on the need for better regulation**, with a new system of impact assessment, consultation and regulatory simplification;
- **modernisation of EU competition policy**, including a simpler and more economically-grounded assessment of mergers;
- **publication of the Employment Taskforce Report**, which highlighted the structural reforms needed to raise employment across the EU;
- **adoption of a new Action Plan for research and development**, to support progress towards the Union's aim to raise levels of investment in R&D;
- **agreement on a new Action for Growth Initiative** to mobilise investment in trans-European network infrastructure and in R&D and innovation; and
- **reforms to the Common Agricultural Policy** that have the potential to reduce trade-distorting agricultural support.

However, the Lisbon goals will only be met if all Member States accept and share responsibility for reform. Though by no means an exhaustive list, the past year has seen a number of important developments in several Member States, including:

- **the launch of Agenda 2010 in Germany**, including reforms to improve labour market flexibility and measures to promote business start-ups, and recent proposals to enhance innovation and increase research and development;
- **a package of reforms in France to promote enterprise** by simplifying and reducing the costs involved in setting up a business. France has also significantly reformed its pension system to enhance sustainability;
- **the launch of a new Innovation Council in the Netherlands** to strengthen the innovation climate and increase business R&D, and the launch of new targets to reduce the administrative costs and burden of regulation;
- **introduction of more flexible forms of labour market contracts in Italy** and proposals to reform the pension system;
- **reforms to increase public administration efficiency in Portugal**, and the establishment of a new competition authority; and
- **reforms to encourage enterprise in Spain**, permitting new forms of finance, fast track procedures for setting up a business and new guidance for entrepreneurs.

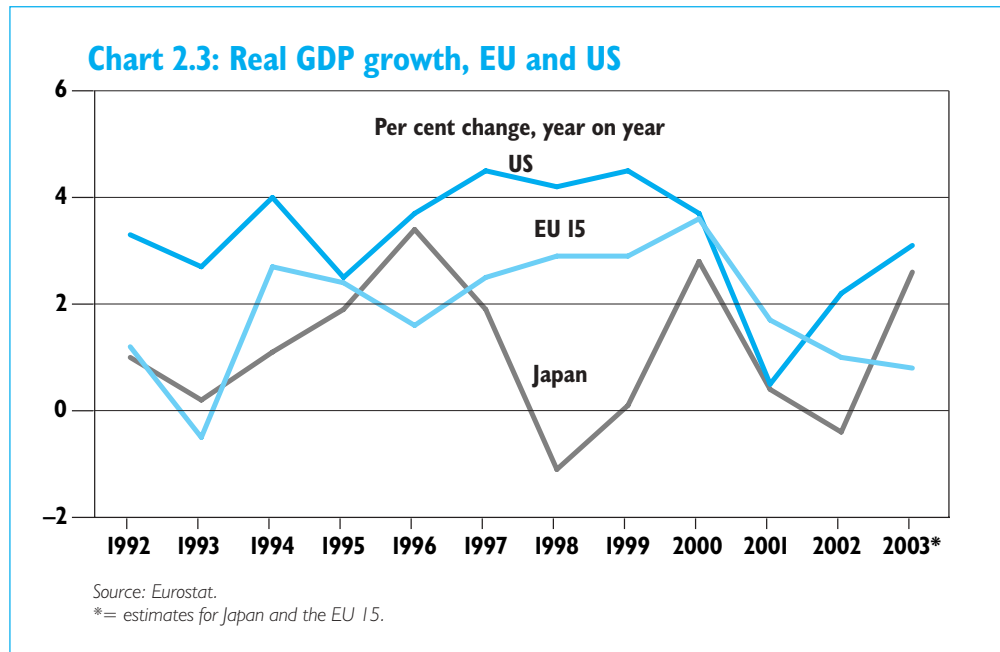
At the same time, many of the new Member States have continued to advance their comprehensive programmes of structural reform in preparation for EU membership, while many other Member States have implemented or are considering reforms to improve the sustainability, quality and efficiency of pension and health care systems.

**2.17** These steps are a necessary contribution to achieving the Lisbon goals. But by themselves they are not sufficient. Notwithstanding the variation in economic performance between Member States, the economic evidence points to a significant gap between the overall performance of the European economy, and the targets set at Lisbon and elsewhere. This is the subject of the next section.

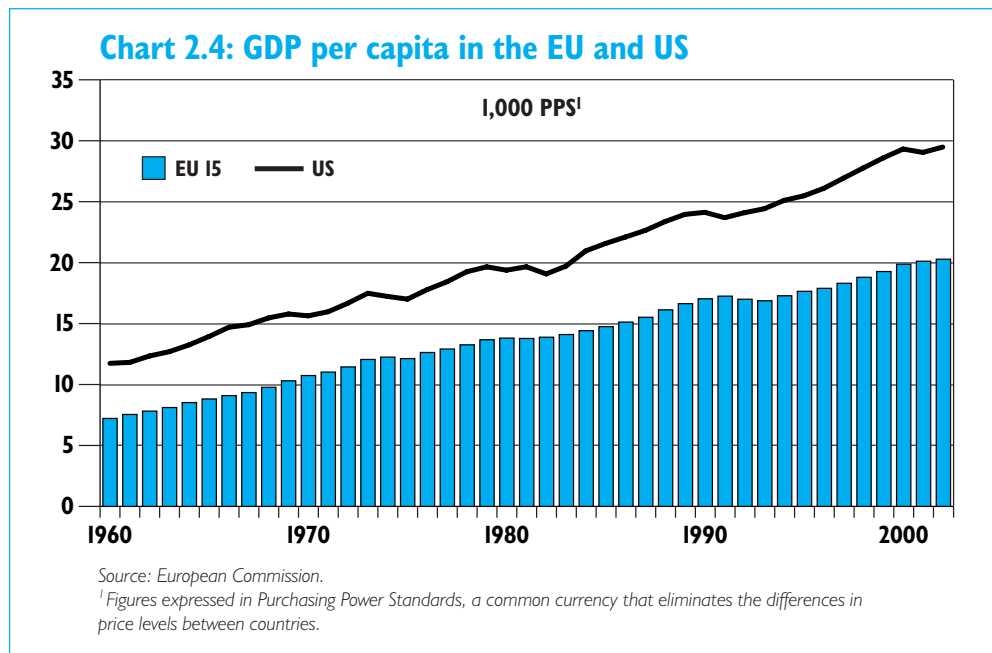
## The performance gap

**2.18** Following strong growth in the late 1990s, the world's major economies slowed significantly and simultaneously in 2001, world growth falling to just 2.4 per cent – the sharpest slowdown since 1974. The synchronised nature of the slowdown provides ample demonstration of the global nature of economic activity. Equally, the pattern of global recovery highlights comparative weaknesses in the EU economy.

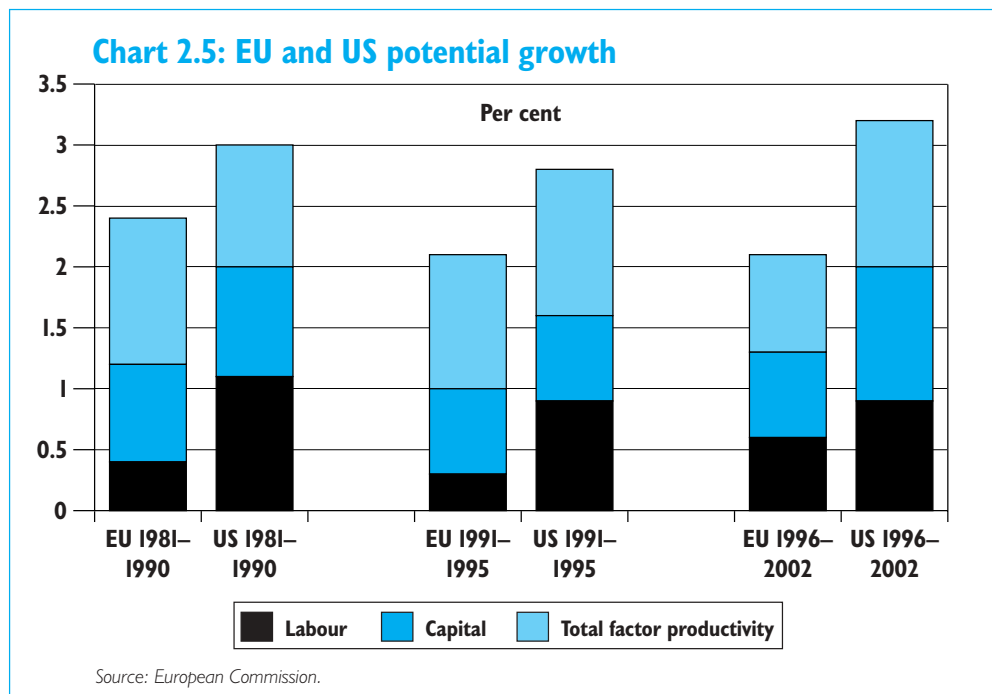
**2.19** Economic recovery since 2001 has proceeded at an uneven pace. Growth in the US, despite falling sharply during 2001, has since picked up and reached 3.1 per cent in 2003. Though initially affected to a lesser degree, the EU has not recovered as strongly, with several economies falling into recession and the strength of the euro weighing heavily on export growth in early 2003. Growth in the EU is expected to have been less than 1 per cent in 2003, significantly below that in the US. Moreover, this is not a recent phenomenon – as Chart 2.3 shows, EU growth has been stronger than that in the US in just one of the past ten years. Japan is also expected to have exhibited stronger growth in 2003 of around 2.5 per cent, outstripping the EU for the first time since 1996.



**2.20** In part, this trend reflects demographic factors such as stronger historical growth in the US population of working age. In terms of growth in GDP per capita, the recent divergence between the US and the EU is much less pronounced. But demographic factors do not account for the historical and persistent gap between overall living standards in the EU and US. As shown in Chart 2.4, EU GDP per capita, a broad measure of living standards, is currently around 70 per cent of that in the US – a shortfall which has been apparent since the 1960s and has widened since that time. A continued commitment to the Lisbon agenda is needed to close this gap and deliver rising living standards for all of Europe's citizens.



**Potential growth 2.21** Cyclical or demographic factors cannot therefore fully explain Europe’s relatively weak economic performance. Structural factors have also had an important role. As shown in Chart 2.5, a comparison of potential, or trend, growth rates – that is, the growth rates an economy can maintain over the long term without creating inflationary pressures – show that potential growth in the EU has lagged that in the US in recent decades. Indeed, the Commission has also concluded that “the fact that the slowdown has persisted for three years suggests that supply side dynamics have been important and the growth weakness cannot solely be attributed to demand shocks”<sup>5</sup>.



<sup>5</sup> The EU economy: 2003 review, European Commission.

**2.22** Potential growth can be broken down into contributions from labour, capital and total factor productivity. Labour input measures employment, taking into account the working age population and participation rates. Capital input measures the amount of capital stock available to workers and firms. Total factor productivity measures the efficiency with which labour and capital are used. It depends crucially on the amount and quality of capital available and the ability and skills of workers and firms to utilise it effectively.

**2.23** Chart 2.5 demonstrates that the US has consistently out-performed the EU in terms of labour input to potential growth. It also shows that the acceleration in US potential growth in the late 1990s was driven primarily by capital formation and increased productivity, both of which outstripped developments in the EU where the impact of a rising labour contribution was largely offset by declining productivity. This does not, however, imply that there is a trade-off - the US has combined both high employment and strong productivity growth in recent years.

**2.24** Achieving the Lisbon goals therefore requires further effort to raise the potential growth rate of the European economy to deliver rising living standards and greater social cohesion. This in turn necessitates a dual approach focused on raising the EU's productivity performance and delivering higher levels of employment.

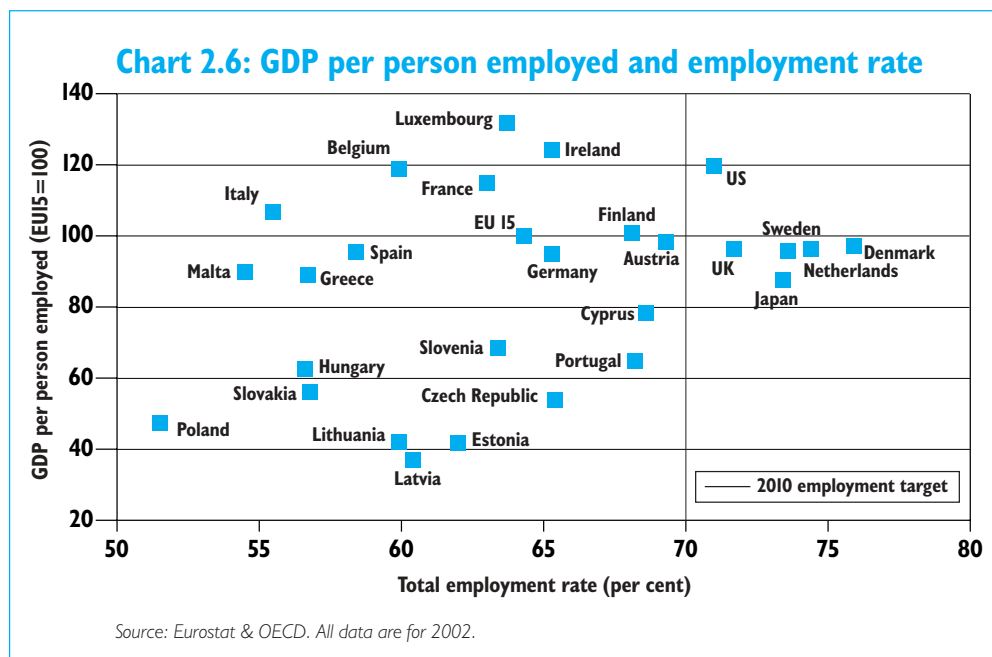
## Raising productivity

**2.25** Alongside high and stable levels of employment, productivity growth is central to long-term economic performance and rising living standards.

### The productivity gap

**2.26** Throughout the 1990s, productivity levels in the EU were persistently weaker than those in the US. As shown in Chart 2.6, measured in terms of output per employee, US productivity in 2002 was around 19 per cent higher than that in the EU. EU productivity was, however, higher than that in Japan in the same year.

**2.27** Chart 2.6 also shows a marked variation between the productivity performance of different Member States. Only two Member States – Ireland and Luxembourg – currently enjoy higher levels of productivity than the US, with others, including Belgium, France and Italy, not far behind. The new Member States, though having experienced some improvement in recent years, still have a considerable way to go to reach average productivity levels within the existing Union. Productivity in the UK also remains just below the EU average.



**2.28** There are many ways of measuring productivity. Chart 2.6 uses output per person employed, which does not adjust for the amount of hours worked by each employee. As European workers tend to work fewer hours and receive longer holiday entitlements than US workers, when measured in terms of output per hour worked the productivity gap between the EU and US narrows somewhat to around 14 per cent. Nonetheless, on either measure the gap remains significant, lending further weight to the conclusion that strong productivity gains have been key to the relatively superior performance of the US economy in recent years.

**The drivers of productivity** **2.29** A productive and enterprising economy requires an economic environment that supports the key drivers of productivity – competition, investment, innovation, enterprise and skills. These drivers are interdependent and complementary – for instance, strong competition will provide greater incentives for firms to innovate and improve efficiency, while skilled workers may encourage firms to invest in more technologically advanced capital. **Improving the drivers of productivity growth is therefore crucial to achieving the Lisbon goals** – a point recently highlighted by the European Commission, who concluded that “analysis confirms the importance to the EU’s long-run productivity performance of a forceful implementation of a comprehensive reform strategy. It should aim at reducing the regulatory burden, further integrating markets, promoting human capital investment and enhancing the innovation potential of the economy.”<sup>6</sup>

**The contribution of ICT** **2.30** Recent advances in technology have also placed a premium on the ability of economies to adapt quickly and efficiently to new technologies so that they may reap the full benefits of investment in them. Research by the OECD<sup>7</sup> shows that a key factor explaining strong US productivity growth in recent years has been the development and uptake of ICT technology. The US has experienced sharp increases in ICT investment and there is evidence that this has stimulated multi-factor productivity growth.

<sup>6</sup> Op Cit.

<sup>7</sup> The sources of economic growth in OECD countries, OECD, 2003.

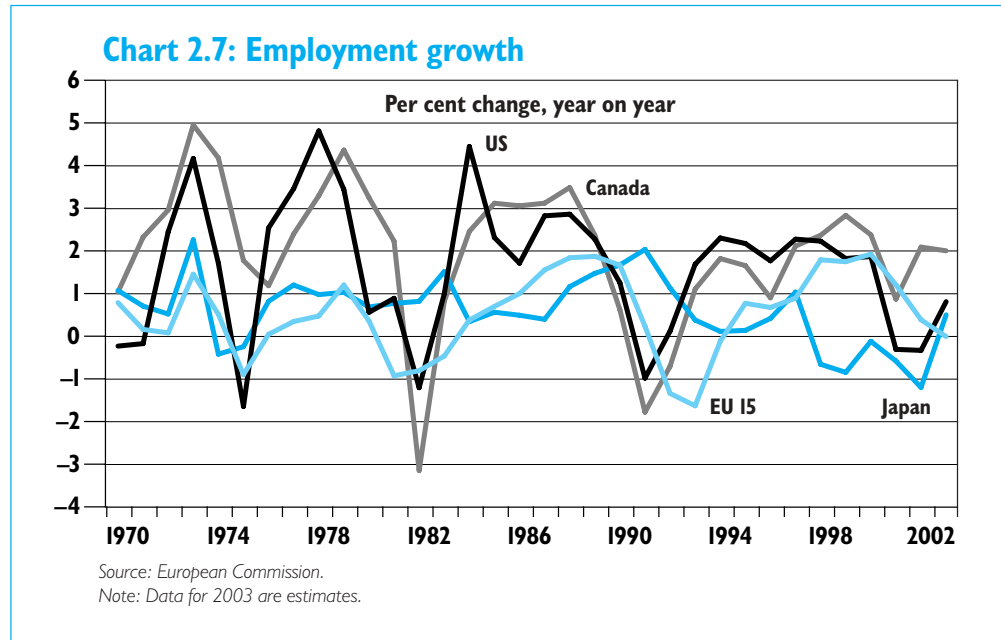
**2.31** Again, analysis by the European Commission confirms the important role of ICT in explaining strong US productivity growth<sup>8</sup>. The US outperforms the EU in ICT-producing industries, such as firms making semi-conductors, and in ICT-using industries, such as wholesale trade, retail trade and financial services. However, the Commission also notes that ICT differences only explain part of the productivity gap between the EU and the US. Rather, traditional non-ICT sectors in the EU, such as services, have also experienced a deterioration in capital intensity and overall efficiency in recent years, weakening the contribution to productivity growth from these sectors. The key to achieving the Lisbon goals is therefore to improve performance on all of the drivers of productivity, improving the incentives for, and ability of firms to, increase efficiency and adopt new technologies and processes.

## Raising employment

**2.32** To achieve the Lisbon goals, a goal of higher productivity must go hand-in-hand with one of higher employment. A well functioning labour market makes a positive contribution to potential growth in an economy, improving overall competitiveness. It also helps safeguard the welfare of individuals, since, as noted at Lisbon, the best safeguard against social exclusion is a job. Raising employment is therefore at the heart of the Lisbon agenda.

### EU and US employment growth

**2.33** While the labour market performance of different Member States varies markedly, international comparisons show that employment growth in the EU as a whole has, with few exceptions, consistently lagged that in the US over the past thirty years. Chart 2.7 shows relative employment growth in the EU and US since 1970. Between 1992 and 2002, the EU achieved average annual employment growth of just 0.6 per cent – under half the average annual US employment growth rate of 1.4 per cent.

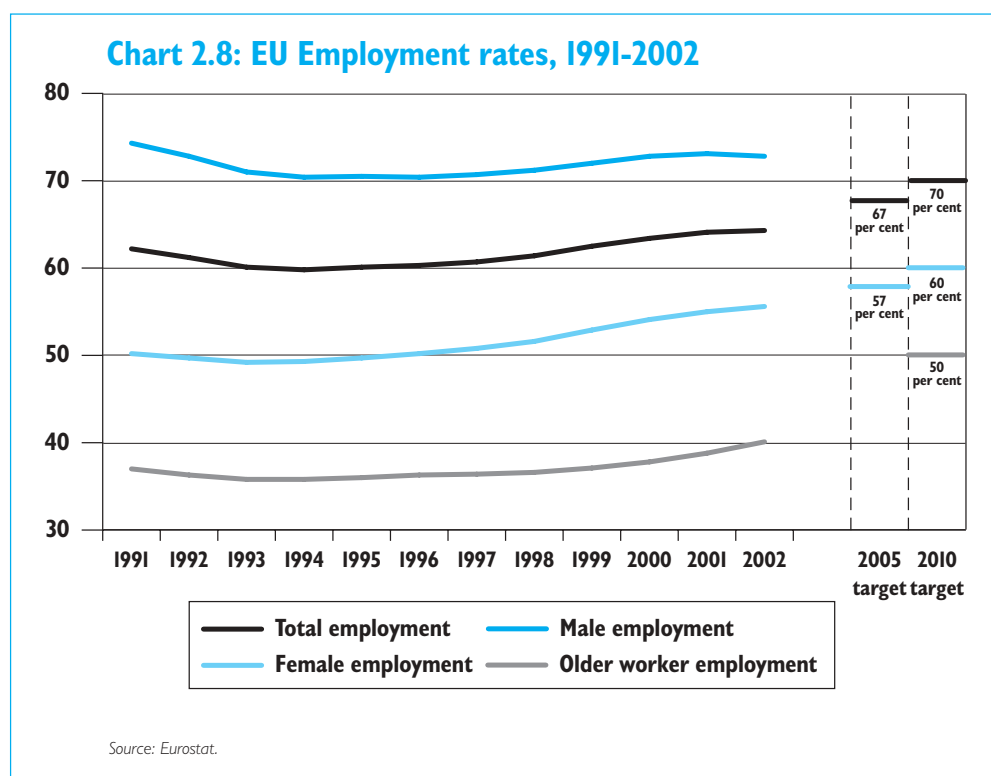


<sup>8</sup> The EU economy: 2003 review, European Commission.

**EU employment targets 2.34** As a signal of their commitment to improve the performance of European labour markets, at the Lisbon and Stockholm European Councils EU leaders set new targets to increase the number of people in work. These targets are challenging but are key to advancing the Lisbon goals.<sup>9</sup> They comprise

- an overall employment rate of 67 per cent by 2005, and 70 per cent by 2010;
- a female employment rate of 57 per cent by 2005, and 60 per cent by 2010; and
- an employment rate for older workers, aged 55-64, of 50 per cent by 2010.

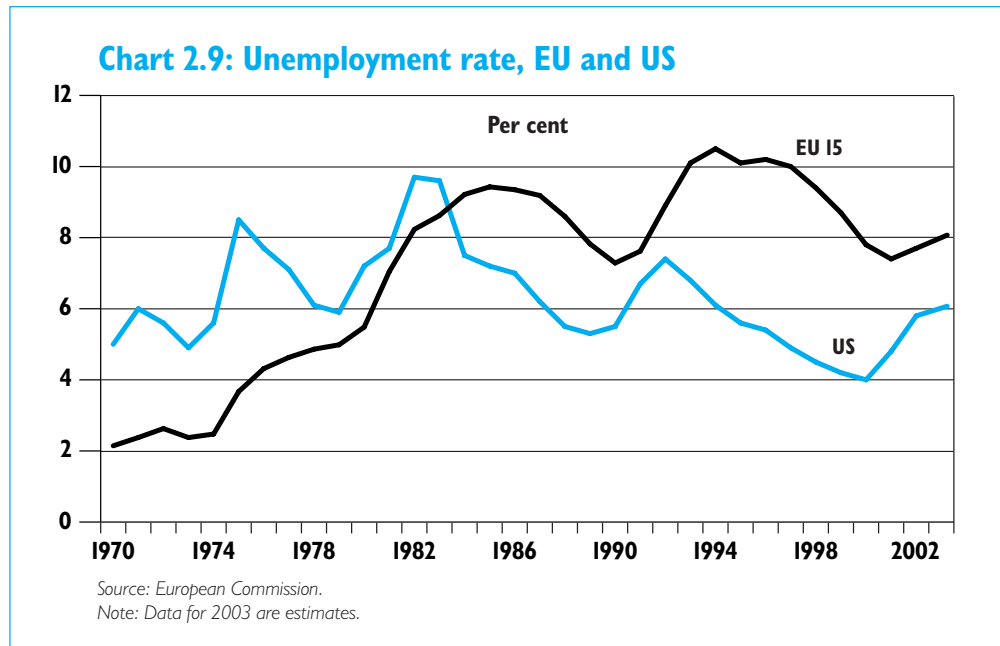
**2.35** Chart 2.8 depicts progress towards these targets. The reality facing the Union is that current trends in employment growth are not sufficient to ensure that the targets are met by 2010, and the 2005 interim targets also look set to be missed. **To meet the 2010 target for total employment, an enlarged Europe must create an average of three million new jobs each year.** As described in Chapter 3, the scale of the challenge for female and older workers is particularly acute, suggesting that efforts to improve the labour market position of these groups must be a priority for many Member States.



**Unemployment and inactivity 2.36** The Lisbon targets were framed in terms of employment, rather than unemployment, because employment is the key to a dynamic and socially inclusive economy. Focusing on employment also avoids the risk that governments seek to meet unemployment targets simply by reshuffling non-working individuals between different categories of non-employment.

<sup>9</sup> Employment rates provide a better measure of an economy's utilisation of labour resources in that they allow for demographic developments such as growth in the working age population. Employment growth may be faster in one country than in another simply because working age population growth is faster in the former.

**2.37** This does not, however, mean that unemployment is over-looked in the Lisbon strategy. As Chart 2.9 shows, at no point since the early 1980s has the EU unemployment rate been lower than in the US. Moreover, while the gap with the US has shown signs of closing since 2001, this may well reflect the fact that the US economy initially slowed more sharply than the EU economy, with most of the shocks at that time originating in the US. More recently unemployment has started to rise in the EU and is expected to continue doing so in 2004. This lagged response may be due to firms initially hoarding labour due to uncertainty about the length of the slowdown.



**2.38** Europe's unemployed – some 18.6 million people across the new and existing Member States – also comprise just a fraction of the total number of people not in work. As described in Chapter 3, a significantly higher proportion of the working age population – around 93.3 million working-age adults – are estimated to be economically inactive across the enlarged Union<sup>10</sup>. Many of these may have become discouraged from looking for work or be ineligible for unemployment benefits, putting them at a distance from the labour market. **To achieve the EU's employment targets, further efforts are therefore needed to tackle inactivity and to make greater use of this substantial pool of untapped labour.**

<sup>10</sup> *Employment in Europe 2003*, European Commission. Data for 2002.

**Box 2.4: An agenda for growing Europe: the Sapir Report**

In July 2003, a High-Level Study Group of independent economic experts, chaired by André Sapir, published a new report, *An agenda for a growing Europe*. Commissioned by Romano Prodi, the report reviewed the entire system of EU economic policies and made proposals for a new strategy to deliver faster economic growth together with stability and cohesion in an enlarged European Union.

The Report views the EU's growth problem as a symptom of an economic system stuck in an economy of mass production, large firms, existing technology and long-term employment patterns that is no longer relevant to the modern global economy. It concludes that Europe needs to develop an innovation-based economy, focused on R&D, technology and human capital. The Report concludes that growth must be Europe's top priority. It argues that current low growth rates and high levels of public expenditure are not sustainable and will become even less so in the future, given Europe's ageing population and the resulting burden on pensions and healthcare. Economic stability and social cohesion are vital, but neither can be assured with a stagnating economy. Implementation of the Lisbon agenda is among the keys to Europe's success.

The Government welcomes the important contribution made by André Sapir and his co-authors to the debate on structural reform. It particularly welcomes a number of the report's conclusions, including that:

- further steps are needed to make the Single Market more dynamic, with strengthened competition policies, a substantial reduction of entry costs for new firms, consistent action against anti-competitive activities by incumbents, and greater availability of risk-capital for start ups and high growth companies;
- additional effort is required to boost investment in knowledge, including through the use of tax credits to stimulate private investment in R&D and innovation. Public support for innovation should also be enhanced, provided this is combined with competition for funding, peer review and ex-post evaluation to ensure that funds are directed to where they will add most value; and
- the EU budget should be refocused to give greater support to the Lisbon objectives. The Report proposes three separate funds - a fund to promote growth through expenditure on R&D, education and training, and infrastructure; a convergence fund to help low-income countries catch-up; and a fund to support economic restructuring.

## THE APPROACH: FLEXIBILITY AND FAIRNESS FOR ALL

**2.39** The preceding section has shown that, despite encouraging signs of reform over the past year, Europe has more to do if it is to achieve the goals set out at Lisbon. As the Commission<sup>11</sup> have argued, "*the economic upturn and enlargement ... offer the Union a potentially favourable situation which it must exploit to the full. This means that both the current and new Member States must commit themselves more firmly to implementing the Lisbon Strategy and achieving its aims.*"

**2.40** This requires a strengthened and renewed commitment to reform, with hard choices and long-term decisions to deliver for Europe's citizens the rising living standards and high levels of social justice they have a right to expect, wherever they live. As the EU approaches the halfway point in the Lisbon timetable, the Member States and the Community must unite

<sup>11</sup> *Delivering Lisbon: reforms for the enlarged Union*, Report from the Commission to the Spring European Council, January 2004.

around a comprehensive programme of reform that is both commensurate to the scale of the task and which acknowledges the opportunities and challenges of the modern global economy. This calls for a visionary and strategic approach built upon:

- **concerted action to deliver greater economic flexibility in Europe's product, labour and capital markets;**
- **economic reform that advances flexibility and fairness together,** and which meets global responsibilities to the environment;
- **a commitment to ensuring that the benefits of the Lisbon agenda are felt in all regions** of the European Union, including the poorest; and
- **a flexible and adaptable approach to policy-making** that reflects developments in the world economy and the diversity within Europe itself, and includes a more developed policy framework for EU budget expenditure.

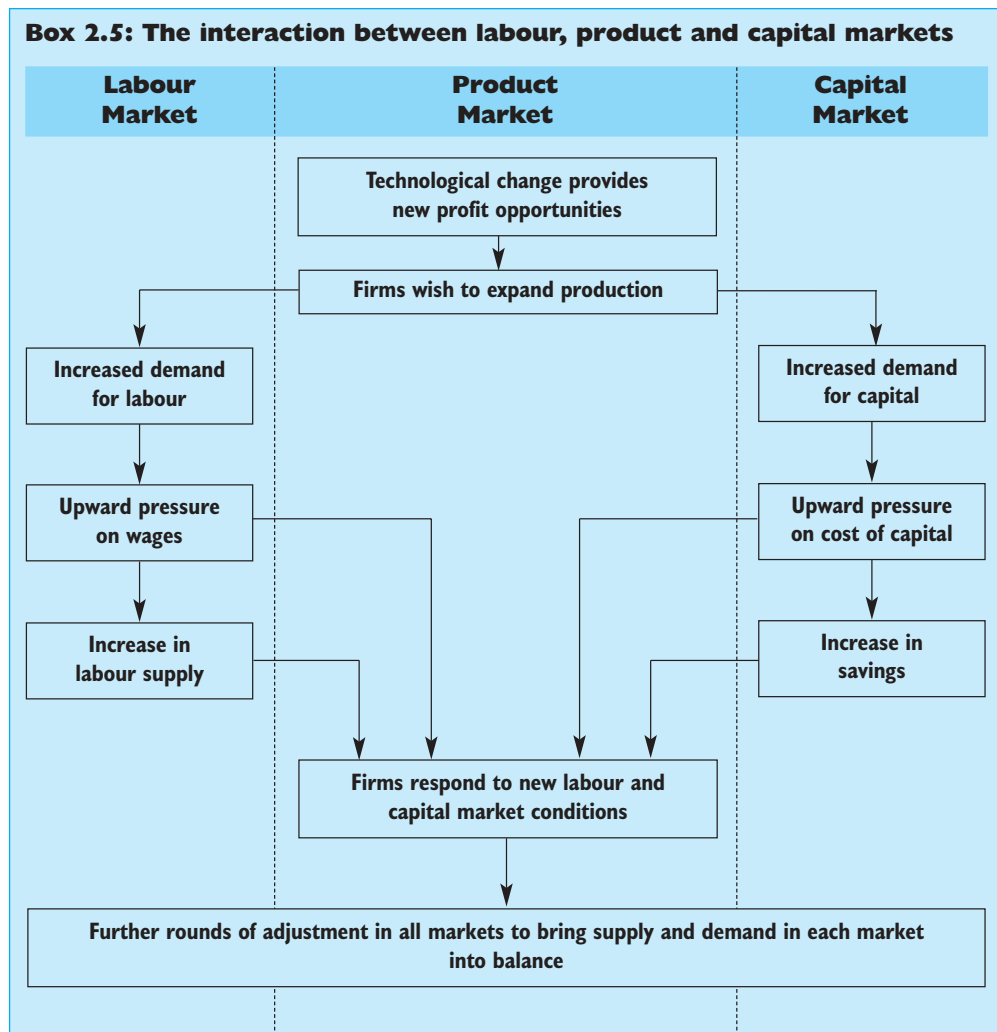
## A flexible EU economy

**2.41** To compete effectively in the global economy, and achieve the Lisbon goals, Europe's economies must become more flexible. A flexible economy is characterised by the ability of firms and individuals to adjust smoothly and rapidly to economic change so that the economy may sustain high rates of productivity growth and employment. In contrast, in an inflexible economy, weak adjustment capacity increases the likelihood that adjustment will be slower and the impact on individual and social cohesion, will be more disruptive. If Europe is to satisfy the legitimate expectations of its citizens for rising living standards, it must do more to deliver:

- **flexible product markets,** in which firms can respond quickly and efficiently to changing market conditions, taking full advantage of new technologies and opportunities in order to maintain their competitive edge. As described in Chapter 4, flexible product markets provide a competitive environment which rewards efficiency, discourages waste and provides firms with strong incentives to deliver quality and choice to their consumers. As noted in Chapter 5, flexible product markets are also characterised by a strong capacity for enterprise and innovation, with low barriers to entry allowing new firms to challenge incumbents and incentives for firms to develop and implement new processes and products ahead of their competitors;
- **flexible labour markets,** which have the ability to adapt to changing patterns in demand in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes. This means ensuring that the labour force is equipped with transferable skills, that tax and benefit systems provide incentives for people to enter and remain in work, that firms have the capacity to create and vary employment, and that there is an institutional environment that encourages labour market participation and delivers tailored and practical support to help those without employment, enabling them to remain active participants in the future; and
- **flexible capital markets,** which ensure that capital is employed effectively and that businesses, entrepreneurs and innovators have ready access to the funds they require to develop their ideas, as described in Chapter 5. Flexible capital markets ensure that borrowers have a range of competitive financing options available to them and play an important role in balancing the risks and

returns of different uses of capital, screening out projects that have an unacceptably high level of risk. They can play an important role in underpinning flexibility on both product and labour markets.

**2.42** The overall flexibility of the EU economy depends on the interaction of flexibility in Europe's labour, capital and product markets, as illustrated in Box 2.5. This interdependence implies that the overall flexibility of the EU economy depends on each market working as effectively as possible. The diagram illustrates how changes originating in the product market are transmitted to the labour and capital market and back to the product market. Further rounds of adjustment and feedback will occur until the balance of supply and demand is restored in each market. Changes originating in labour and capital markets, for example as a result of tax and benefit changes which affect labour supply, or a change in risk aversion affecting the cost of capital, will similarly be transmitted to other markets, with the economy's overall adjustment reflecting the interactions between all three markets.



## Flexibility and fairness in Europe

**2.43** Flexibility in labour, product and capital markets provides the key to economic success in a globally competitive environment - the success that is vital for ensuring social justice and high standards of environmental protection. Economic flexibility can deliver the growth needed to generate revenue for social or environmental programmes, and provides the employment opportunities that are important for social cohesion.

**Social justice 2.44** Europe rightly aims for high standards of social cohesion, but must avoid being over-protective of inflexible social policies in the face of economic change. In the past, labour market policy in Europe has often been designed to mitigate, rather than adapt to, the effects of change. Generous benefit systems have helped to insure households against labour market shocks, but have at times reduced incentives for claimants to return to and progress within work. And overly restrictive legislation, while seeking to establish fair conditions of employment, has at the same time placed significant constraints on employers, restricting the creation of new jobs and flexible working patterns.

**2.45** **The Government firmly supports the Lisbon goal of greater social cohesion in Europe, but believes that flexibility and fairness must be advanced together.** There are many different ways of combining efficiency and social justice. But as Europe's policy-makers confront the challenges of the modern global economy, policies built on the assumption of a trade off between economic efficiency and social cohesion should be reconsidered. The UK's structural reforms have shown that by putting opportunity at the centre of the labour market, economies can move beyond this old trade off. Reforms to the UK's tax and benefit system, including the introduction of a National Minimum Wage and tax credit system, combined with high quality services, such as Jobcentre Plus, provide incentives and practical support to help people re-enter the labour market rapidly. Flexibility in Europe is the key to economic success and full employment, and full employment is the route to social justice with everyone sharing the benefits of greater EU prosperity.

**Sustainable development 2.46** **Europe's shared commitment to economic growth and social cohesion must also be matched by commitments to the environment.** Europe's ambitions for sustainable development continue to challenge and stretch traditional perceptions of economic growth. Recognising that an inefficient use of resources and the costs of environmental degradation act as a potential drag on the European economy, the EU has led the world in understanding that economic growth must go hand in hand with environmental protection. But it is only through innovation and by adapting its policies that the EU will be able to meet these objectives in an increasingly competitive world economy. Europe cannot afford to stifle innovation and entrepreneurship with disproportionate regulations, but neither can it meet its social and economic objectives without regard to environmental sustainability. Economic growth that results in environmental damage, such as climate change, merely jeopardises living standards and prosperity in the long run. The EU must continue to work through the market, using economic instruments such as emissions trading, to address this important challenge.

## Enhancing regional performance

**2.47** **Meeting the Lisbon goals also requires action to improve the economic performance of all Europe's regions, and particularly the poorest.** A high productivity, high employment Europe can only be built on improved productivity and employment in all of its constituent parts. A modern regional policy must therefore focus on enabling every nation and region to improve their economic performance, by tackling the diverse market failures that are hindering their performance.

**2.48** Notwithstanding the progress that has been made, drawbacks in the current EU framework for regional policy continue to limit the contribution it has made to the Lisbon objectives. Economic disparities between Member States have diminished substantially since 1988, due to the convergence of the cohesion countries – Ireland, Portugal, Greece and Spain<sup>11</sup>. However, within Member States, the improvement in regional performance is much less marked<sup>12</sup>. The worst performing regions of the EU continue to be characterised by persistently low employment and productivity<sup>13</sup>.

**2.49** In March 2003, the Government published its proposals for a new regional policy framework in Europe<sup>14</sup>. If the EU is to achieve its Lisbon objectives – including those for social and economic cohesion – it must embrace a new EU framework for devolved regional policy, giving regions the resources and flexibility they need to meet local needs within a framework of clear accountability, common principles and shared objectives, and with delivery of these policies substantially devolved. EU support should be focused on the new Member States where it can have the greatest effect. A process of peer review, under the open method of coordination, could facilitate an exchange of best practice, helping to ensure that all of Europe's regions have the opportunity to share in the prosperity that successful structural reform could bring.

## A flexible approach to policy-making

**2.50** *Just as Europe pursues greater flexibility as the route to economic success, so too must it adopt new flexibility in the policies it chooses to deliver that success.*

**2.51** The size, diversity and cultural richness of an enlarged Union means that the context for structural reform varies across Member States, reflecting local histories and traditions. While the Member States of the European Union share common ideals, reflected in agreed targets and aspirations, the Union must increasingly adopt a pluralist approach to reform, in which Member States have the flexibility to tailor reform to suit local social and institutional conditions. Europe must also ensure that its approach to economic policy-making is fit for a modern world economy. Many of today's policies had their roots in the more structured and settled post-war economy and may not be well-adapted to a more fast-moving and flexible world in which responsiveness and the ability to identify and maximise opportunities are the keys to success.

**2.52** In the context of the Lisbon strategy, this means that:

- **the open method of coordination offers the right approach**, because it promotes sharing of best practice and allows solutions to adapt to local conditions, but within a clear framework of common objectives and shared political commitment;
- **Europe must adopt a more outward-looking approach to reform**, recognising that opportunities, responsibilities and challenges do not stop at the Union's borders, and that policies for reform must equip the economy to thrive in an environment of global competition; and

<sup>12</sup> Ireland led the way, its per capita GDP rising from 64 per cent of the EU average in 1988, to 119 per cent in 2000. The other three cohesion countries also improved, their per capita GDP rising over the same period from 68 per cent of the EU average to 79 per cent.

<sup>13</sup> The ratio between per capita incomes of the richest and poorest 10 per cent of regions decreased from 2.8 to 2.6 between 1989 and 1999, and between the richest and poorest 25 per cent remained unchanged at 2.0. Disparities between regions, in contrast, widened in all Member States except Germany (including the Eastern Länder from 1991), France and Austria.

<sup>14</sup> *Employment in Europe 2002*, European Commission.

<sup>15</sup> *A modern regional policy for the United Kingdom*, HM Treasury, the Department of Trade and Industry, and the Office of the Deputy Prime Minister, March 2003.

- where action at the EU level is appropriate, the Union must look to use a range of policy instruments, selecting the best instrument to deliver the desired policy outcome. Ten years after the completion of the Single Market, it is increasingly recognised that it does not make sense to look automatically for regulatory solutions. As described in Chapter 4, non-regulatory approaches will often work at least as well, if not better. Moreover, as described below, forthcoming discussions on the EU's policy and spending priorities for the next Financial Perspective, from 2007, present an important opportunity to embrace a modern and flexible framework for EU level action in support of the Union's priorities.

**A flexible framework for EU budget spending**

**2.53** The Agenda 2000 negotiations in Berlin in March 1999 determined the expenditure ceilings for the EU budget for the period from 2000 to 2006. The next Financial Perspective will be the first one decided by an enlarged Union of 25 Member States. Although the challenges faced in negotiating the next Financial Perspective will be considerable, it represents a unique opportunity to increase both the effectiveness and transparency of expenditure and to consider how allocations within a limited EU budget can best be refocussed in support of the Union's Lisbon strategy.

**2.54** Currently, the link between objectives and Financial Perspective headings and annual budget allocations is often unclear, making it difficult to judge whether expenditure is actually delivering desired policy outcomes. The new Financial Regulation, which took effect from the start of 2003, introduces a better emphasis on objectives and evidence for spending policies, but will need more work and greater commitment to operationalise it in all areas of EU spending.

**2.55** Since the Berlin financing round, a major innovation in EU policy-making has been the Lisbon process itself. This has introduced a number of new elements which are relevant to EU financial planning:

- a focus on outcomes not inputs, through the setting of long-term policy targets with shorter-term indicators to back them up;
- a better understanding of where there can be added value through Union-level action, and where Member States are best placed to achieve policy objectives; and
- through the open method of co-ordination, sharing of best practice, to ensure that policy is informed by evidence about what works.

**2.56** These principles, applied to the EU's expenditure policies, would complement existing strategic budget planning and provide an enhanced overall framework for considering priorities. A more developed policy framework for EU expenditure would:

- be objectives-focussed, with the emphasis on outcomes not inputs. There should be no automatic assumption that a certain level of spending is needed to meet the Union's objectives. Under the new Financial Regulation, the annual budget is set by activities and with reference to objectives. This activity-based budgeting has the scope to improve the budget decision-making process by ensuring that budget allocations more closely reflect pre-defined policy priorities and objectives. In future, this approach should be extended to the Financial Perspectives, which should be set with reference to explicit high-level, evidence-based objectives to meet the EU's strategic direction established by the European Council;

- **be evidence-based, with evaluation of the impact of budgetary policy.** EU taxpayers expect the EU and its Member States to apply at least the same rigour in evaluating EU policies and spending as they do for Member States' policies and spending, whether at national level, through the Treaty multilateral surveillance procedures, or through peer review under the open method of co-ordination. Strategic EU budget planning should be based on clear evidence of what works, and what doesn't, and poorly performing programmes should be displaced or redirected;
- **examine, for existing as well as new areas of spending, whether the Union budget is the best instrument for adding value,** or whether action would be better addressed at Member State level or through other, non-spending, policy measures. Even where a case for spending to meet objectives has been made, that does not mean that spending should be carried out at the EU level. Areas where the EU budget is likely to add most value include trans-national action, where there are spill-over effects as the impact and benefit of spending crosses national borders, for example on research or transport; administrative spending, to deliver EU objectives such as ensuring the effective operation of the Single Market; cohesion, where the EU budget can be used to support improvements in those Member States where needs are greatest; provision of information exchange between Member States to encourage learning and best practice; and collective action, where the EU and its Member States can act more effectively by pooling resources, such as through development spending in support of the Millennium Development goals;
- **ensure sound financial management and budget discipline.** Sound public finances are an essential prerequisite for improvements towards the Lisbon goals of growth, employment and cohesion. The EU's budget, no less than those of Member States, needs to be set within a framework of financial stability, with proper controls to minimise fraud and financial irregularities. It should be limited to a level appropriate to EU value-added. The Government believes that the EU's goals can be fully pursued within an EU budget envelope stabilised around one per cent of EU gross national income; and
- **ensure an equitable distribution of spending across the EU,** consistent with value-added principles and objectives. The current distribution of spending is inequitable, with some Member States disproportionately benefitting from EU programmes – including the largest spending programmes – the Common Agricultural Policy and the Structural Funds – through EU spending which provides little or no evidence of EU value added towards the Union's Lisbon strategy.