



REALISING EUROPE'S POTENTIAL

ECONOMIC REFORM IN EUROPE

February 2002

Presented to Parliament by the Chancellor of the Exchequer
by Command of Her Majesty
February 2002

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ECONOMIC REFORM WHITE PAPER

PRIME MINISTER'S FOREWORD

1. This White Paper is about jobs.
2. The countries of the European Union have developed societies with much to be proud of. We have unprecedented prosperity. We work together to tackle the challenges we face in trade, environment, crime, security and foreign policy. We are about to extend our stability and prosperity to the new democracies of eastern and central Europe. In different ways EU Member States have built up high quality public services. Many of the world's best universities, most advanced medical facilities, and most innovative research institutes are in Europe.
3. We want a society from which no-one is excluded, where no child grows up in poverty, and opportunity for all is matched by responsibility from all. As Europeans our social models differ but our social values are the same. But these values – and the distinctively European vision of society that goes with them – can only thrive in a dynamic and flexible economy, offering more and better jobs to all. Without sustained economic growth and the employment it brings we will find our social safety net and other achievements also under threat; we cannot afford to run that risk.
4. So we must now modernise and reform our economic structures so that we compete successfully with the best in the world and provide a strong economic base for a socially inclusive society. Modernisation is never easy. Economic and industrial change can sometimes be painful. Political decisions that speed up change in our economies are often hard. But there is no alternative if we are to build the economic success on which a genuinely inclusive society will in future depend.
5. Europe has an encouraging track record of delivery in difficult times. In the 1980s the Single Market programme removed national barriers and old-style protection of markets. The Single Market was never complete and needs constant updating. But it has already given a powerful stimulus to enterprise and jobs across Europe: around a million new jobs have been created, and GDP is higher in every Member State.
6. Throughout the 1990s European countries brought order to their public finances and industry underwent massive restructuring. All this helped pave the way for the successful introduction of the Euro.
7. And two years ago at Lisbon, European leaders agreed another bold goal: a comprehensive ten-year programme of action by the EU and Member States to make Europe the most dynamic modern economy in the world, with full employment and social justice. Since then we have made a start down the right road. Europe has created five million new jobs – an impressive start towards the Lisbon target of twenty million new jobs across Europe by 2010.
8. A lot has been achieved since Lisbon – an E-Europe programme to open up closed telecommunications markets, provide a common framework for E-commerce, and meet targets for Internet access; better focus and co-ordination of the EU's research programme; proper benchmarking of employment and enterprise policies to find out which ones work best. Member States have pushed ahead with tax, health, pensions and labour market reforms. But progress has not always been smooth. Much more remains to be done.

9. Europe's competitiveness depends on harnessing and developing all resources: a dynamic open market, the single currency and a stable economy, a skilled workforce, a world-class research base. This White Paper takes stock of how well Europe is doing, measured against the best in the world: the US, south east Asia, successful global corporations. It looks at the challenge we face to raise productivity and create more jobs.

10. This is as much a challenge for the UK as for the rest of Europe. The UK has to raise productivity levels further to match the best in Europe, through improved skills and working methods. Other countries face the challenge of raising their employment levels and reforming over-regulated labour markets. Tackling these problems is not about new rules or centralised control but effective action at a national level coordinated so that the best in Europe becomes the benchmark for each of us. Europe's diversity is a strength, and a source of new ideas.

11. In mid-March, the European Council – the EU Heads of Government – will meet in Barcelona to speed up the pace of progress. To do that we must focus on the right priorities:

- to **reform Europe's labour markets**. Barcelona should give a clear signal that Europe's leaders are determined to remove the legal and bureaucratic barriers that stop people finding the jobs they need, at home or anywhere else in the Single Market – with equal opportunities for all. All professional qualifications should be recognised across the EU, and information on job opportunities made freely available across borders;
- to **cut unnecessary and expensive regulation**. Europe's workers and businesses need regulation that will enhance opportunity, not destroy jobs. We must uphold fair standards in the workplace, but also ensure that business retains the flexibility to create new jobs. This means moving to much simpler and more cost effective regulation. The European Council should strongly endorse the recommendations in the excellent Mandelkern report – including a rigorous assessment of the impact of all legislative proposals before they are put forward by the Commission, with close and open consultation of business and other interests. The Commission and other regulators should start implementing these now;
- a more integrated financial services market in Europe will mean cheaper capital for business, especially small firms and high-tech start ups which create so many new jobs. For securities markets, we have agreed streamlined and more flexible, objective-based procedures for setting the regulatory framework to ensure they are safe for customers and efficient for companies. These principles should be extended to banking, insurance and accounting standards. All the proposals must help create a more open, competitive and dynamic market in Europe so that our firms enjoy the same chances to borrow cheaply and to grow as fast as their competitors in the United States, with more choice and better returns for savers and pensioners;
- a breakthrough in opening **energy markets** in Europe. The UK already benefits from cheaper telecommunications and energy prices thanks to a competitive and well-regulated market. We want to see these benefits spread rapidly across Europe, to deliver new opportunities and jobs as well as benefits for customers through lower prices and security of supply. There is no true single market for energy, which is a commodity like any other, and can be bought and sold freely across Europe. To get the full advantages of market opening we have to develop Europe's networks – in telecoms, transport, gas and electricity – to ensure that the cross-border capacity is there to meet future needs, including those of the UK economy;

- the **lifelong learning** we all need to make a reality of the knowledge based economy in Europe, starts in schools. We want to use Internet link ups between schools to help develop language skills and other educational priorities across the EU. We want to make Internet use faster and easier through the rapid spread of broadband technologies, and so help bridge Europe's increasing digital divide;
- Europe's **research** expertise is a hidden strength we must exploit more effectively. We should focus Europe's spending on turning research into innovation in sectors such as **biotechnology**, and help the best national researchers to work together more effectively to avoid unnecessary duplication of effort. We can increase low private R&D spending by modernising the state aids rules covering research and venture capital, and use the tax system to encourage more business spending on R&D, giving our companies a boost in the international market place.

12. We can and should make progress in all of these areas at Barcelona. And these reforms will help to boost employment across Europe. Despite the progress made in recent years an EU unemployment rate of almost 8 per cent – over 13 million people – is far too high. The recent economic slowdown makes structural reform to create jobs even more urgent. It is the launch pad for strong European and global recovery in the year ahead.

13. Full employment is not just an economic issue. A job is the best form of help for those on the margins of society. Europe's tradition of solidarity and concern for the disadvantaged and excluded challenges us to deliver the employment-based social policy at the heart of the Lisbon strategy. Social inclusion, lifelong learning and equal opportunities are good for employment. They also contribute to building a more just and fair society. This White Paper reviews how we can better achieve these goals.

14. Economic reform is important for our relations with the wider world. The world trade round opened at Doha in November is a chance to make further progress in opening markets, to everyone's benefit. There is also scope for much more open trade between Europe and the Americas.

15. Europe rightly looks to a sustainable model of development, at home and abroad. That is why we are committed to achieving the Kyoto emission targets to help defeat global warming. And why through more open trade and help for the third world we are working to ensure that the benefits of global interdependence are shared by all, particularly the poorest countries.

16. Reform and modernisation is never easy. In Europe we have taken some tough decisions; and delayed taking others. At Barcelona we have a major opportunity to show that we are determined to do what is needed for Europe to prosper. Europe's citizens deserve no less.

A handwritten signature in black ink that reads "Tony Blair". The signature is written in a cursive style and is underlined with a single horizontal line.

TONY BLAIR

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INTRODUCTION

“In Lisbon we set ambitious goals for ourselves and we established a work programme designed to achieve them. We agreed upon a reform strategy to achieve dynamism and greater openness, flexibility and response capacity. In short, we agreed to modernise our economies and our societies. This coming spring, it will be two years since we embarked upon that process. It is now time to show that we are able to deliver on our commitments.” (Spanish Prime Minister Jose Maria Aznar)¹

The goal for Europe

1.1 What happens to Europe, matters to Britain. Its prosperity is our prosperity. In this White Paper the Government sets out its vision of the EU as a dynamic, job-creating economy characterised by high living standards and full employment, and emphasises the challenging reforms of product, labour and capital markets needed to realise that goal. Each Member State, without exception, can learn from the strengths and experiences of its partners; all Member States, without exception, share a common interest in European reform and in European success

1.2 Economic reform must go hand in hand with social justice, with a clean and healthy environment, and with a successful process of EU enlargement; and it must be pursued by an open and outward-looking Europe both aware of its international obligations and ready and willing to fulfil them.

1.3 At the **Lisbon European Council of March 2000**, EU leaders committed themselves to a ten year strategy for reform of Europe’s product, capital and labour markets. Their vision was of an EU which would become the most dynamic and competitive economy in the world, combining full employment and social cohesion.

1.4 As well as legislating to open up markets to competition and enforce common standards, and in order to deliver this reform programme, Member States agreed to pursue common goals through ‘open coordination’ – using benchmarking and peer review to learn from each other what worked, and to design solutions to fit different national environments.

1.5 The **Stockholm European Council**, one year later, provided the forum for the first annual review of the Lisbon agenda. The next such opportunity comes with the **Barcelona European Council of March 2002**; a chance to assess progress on these reforms, analyse frankly what has been achieved and identify areas where further political momentum is required to keep Europe on track towards the Lisbon goal.

The Commission; promoting reform

1.6 In taking forward reform, the Government warmly welcomes the publication of the **Commission’s Synthesis Report²**; an excellent survey of the progress that has been made on reform, and of the challenges still facing the EU (see Box 1.1). The Government commends the Commission’s ongoing promotion and enhancement of the Lisbon agenda, both by urging Member States to greater efforts and by bringing forward further proposals itself. The Synthesis Report will help set an effective, focused and positive policy agenda for economic reform in Europe.

¹ Speech to Business School IESE in Barcelona, 27 November 2001

² www.europa.eu.int/eur-lex/en/com2002_0014en01.pdf

Box 1.1: The Synthesis Report

The Government views the Commission's annual Synthesis Report, prepared for the European Spring Council, as one of the most important contributions each year to the economic reform debate. The Report makes an honest and rigorous assessment of how the EU is progressing with the Lisbon reform agenda and sets out priority areas for action, along with policy recommendations as to how progress might be achieved.

This year's report notes that, while there has been progress to date, some key proposals have stalled. It calls on the EU to overcome the "delivery gap" between actions and words, and to demonstrate at Barcelona that reforms are being taken forward. Three areas in particular are highlighted for reform: labour markets, network industries and financial markets, and research and innovation.

It argues that developments outside the European Union reinforce the case for structural reform which would render the Union less vulnerable to external shocks, whether political or economic; and it highlights the importance of engaging fully in efforts to reform and reshape the international landscape, and of playing an active role in the current trade round launched at Doha.

Much achieved; much still to be done **1.7** The Single Market has, over the years since the 1957 Treaty of Rome, brought significant benefits to consumers and businesses. Increased trade and intensified competition have resulted in lower prices, greater choice and increased quality of goods and services, while the free movement of people across Member State borders has transformed both work and leisure habits.

1.8 While much has been achieved, much remains to be done, as the Lisbon objective itself makes clear. **Chapter 2** sets out the case for further reform, and underlines the urgency of progress in a context of the need to preserve the credibility of the commitment to reform, the arrival of euro notes and coins, EU enlargement, and an adverse demographic outlook.

Macroeconomic stability; a prerequisite of successful reform **1.9** The UK Government's approach to maintaining stability in the UK economy is set out in detail in the 2001 Pre-Budget Report and the 2001 Convergence Programme³. **Macroeconomic stability is a prerequisite of successful economic reform.**

1.10 The Government believes that in the UK and in the EU as a whole, a route to economic stability is being sought – and realised – based on a shared recognition that fine-tuning cannot work; that, in liberalised markets, rigid monetary targets cannot of themselves deliver stability; and that the discretion necessary for effective economic policy is possible only within a well-coordinated framework that commands public and market credibility.

1.11 As the Chancellor said in his October 1997 statement, *"a successful single currency within a single European market would be of benefit to Europe and to Britain"*. That is why, in principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. To this effect the Government has set out five economic test which define whether a clear and unambiguous case for UK membership of EMU can be made. If, on the basis of the five tests, a decision to recommend joining is taken by the Government, it will be put to a vote in Parliament and then to a referendum of the British people.

³ Pre-Budget Report, HM Treasury 2001; *Maintaining macroeconomic stability: Convergence programme for the United Kingdom*, HM Treasury December 2001.

I.12 Current **world economic conditions** pose significant challenges to policymakers. In an integrated global economy, no country or group of countries can fully insulate itself from international events.

I.13 In this situation, **monetary policy** should be forward looking and directed at ensuring inflation remains close to target. **Fiscal policy** should be aimed at achieving a healthy and sustainable position for the public finances. In the UK the fiscal policy framework, based on the golden rule and the sustainable investment rule, is ensuring sound public finances over the medium term, while supporting monetary policy over the cycle and delivering sustainable investment in public services. The Government believes a similar approach is appropriate for the EU fiscal policy framework and supports a prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). The UK continues to discuss this with its EU partners.

The economic reform challenge

I.14 Notwithstanding progress to date, the Government considers that Europe, including the UK, is not living up to its potential in terms of either productivity or job creation. While employment has shown recent improvement, the contrast with other industrialised countries and, in particular, the US, remains striking. Had the EU as a whole matched the US performance on both productivity and employment levels in 2000, its output would have been higher by the equivalent of around £5000 or €8000 per person per year. **Chapter 2** considers the scale and urgency of the challenge. **Enlargement** is just around the corner. It is vital that the EU should be sufficiently dynamic and flexible both to offer an economic model and to rise smoothly to the challenge of expansion.

I.15 Lisbon aspired to an EU which would be *“the most competitive and dynamic knowledge-based economy in the world, capable of sustaining economic growth with more and better jobs and greater social cohesion”*. The Government strongly supports these aims, which complement the core tenets of its domestic policy approach; that economic prosperity and social justice should be interlinked, and that the best safeguard against social exclusion is a job. In the absence of economic reform in Europe, the Government’s central economic objectives at home – to raise the UK’s rate of sustainable growth, and achieve rising prosperity through creating economic and employment opportunities for all – would be all the more difficult. A reforming, dynamic and open Europe would, by contrast, be a Europe of increased competitive pressure, confidence and growth; a Europe, in other words, which would both promote and facilitate the UK’s efforts to boost its own productivity and raise its own economic performance.

I.16 **Tangible improvements** have already been registered since Lisbon, as Box 1.2 illustrates. The EU has enjoyed higher employment (an extra five million jobs since Lisbon), greater choice for consumers, and larger, more open markets for business; and the UK has shared in and benefited fully from these gains. The UK Government has, since 1997, played a key role in shaping and driving European economic reform and will continue to do so, making full use of the new processes of open co-ordination and peer review to share best practice and ensure progress – processes explored more fully in **Chapter 3**.

I.17 Economic reform becomes all the more important at times of economic slowdown.

Box 1.2: The Lisbon European Council

The Lisbon European Council of March 2000 marked a radical departure for Europe. Building on the work of previous EU Presidencies, including the UK's in 1998, the European Council⁴ agreed, for the first time, a **strategic goal** for the EU; to create the most innovative, dynamic knowledge-based economy in the world by 2010, delivering both full employment and increased social cohesion through an ambitious programme of economic and social reform. This new focus was accompanied by a strong political commitment to keep this goal at the top of Europe's agenda, and to pursue new, more flexible ways of working with and learning from each other. Lisbon:

- demonstrated an acceptance that, in key areas of economic performance, the EU has to catch up with the best in the world;
- brought a strong commitment from Europe's leaders to a comprehensive agenda of reform, combining market opening with action to promote innovation, employment and social inclusion;
- established the use of concrete indicators against which to judge success, and a new system of peer review for periodic self-assessment and encouragement; and
- promised an annual review by Heads of State and Government of progress towards the Lisbon goal.

Two years on, good progress has been made. Details of what was agreed at Lisbon, and progress to date, are provided in Annex A. Notable successes include:

- opening Europe's **telecommunications markets**, the network that will deliver the knowledge-based economy to schools, businesses and homes;
- under benchmarks established by the **eEurope Action Plan**, rapid progress in increased access to the internet;
- a **Small Firms Charter**, agreed at the Feira European Council in June 2000;
- agreement on the **Lamfalussy** proposals for streamlined and more flexible, objective-based procedures to help deliver a single EU securities market;
- establishing a high speed **broadband network** that links European university research centres, enhancing knowledge diffusion and research co-operation;
- making **state aids** more transparent through a state aids scoreboard, an important tool to level the playing field for businesses in the Single Market;
- boosting **employment** through comprehensive labour market reforms. Five million jobs have already been created since Lisbon; and
- launching a **sustainable development strategy** in June 2001 during the Swedish Presidency, to ensure fairness for this and future generations.

⁴ The Presidency conclusions from the Lisbon Council can be found at 'www.europa.eu.int/council/off/conclu/'

Why reform? Barriers to cross-border trade and integration in key areas of the Single Market, combined with overly restrictive labour market institutions and product market regulation, all help explain why unemployment (and particularly long term unemployment) remains unsatisfactorily high within the EU. The temptation at times of slowing growth can be to reinforce, not reduce, such barriers. Such a counterproductive response risks only exacerbating the slowdown and dampening employment growth still further. The EU must, instead, recognise the need for ongoing dynamic reform, taking responsibility for its own interests and helping lead the world economy into a new phase of growth and shared prosperity.

I.18 To meet the Lisbon challenge, the Government urges a two-pronged approach using the agreed **structural indicators** (summarised in Box 1.3) to monitor progress and identify where further reforms might be needed:

- first, address the **five key factors which influence productivity**; competition; investment in physical capital; investment in skills and human capital; innovation; and enterprise. This requires a combination of reform at the national level and completion of the Single Market; and
- second, boost **low employment rates** with reforms and incentives, thereby tackling a major cause of social exclusion.

Box 1.3: Identifying priorities for reform: structural indicators

As set out in the ECOFIN (Economics and Finance Council of the EU) report endorsed at the conclusion of the Intergovernmental Conference at Nice in December 2000⁵, economic reform should be driven forward using a set of structural indicators which highlight areas requiring particular attention from EU policy makers. This White Paper draws heavily on these indicators, illustrating how they can be used effectively to benchmark against best performance in order to achieve the overall Lisbon goal. The accompanying paper, ‘Structural Indicators of European Economic Reform: Measuring Europe’s Progress’, provides a full list of the indicators, which cover a wide range of reform issues:

- open and competitive product markets;
- a dynamic single market for financial services;
- innovation and research;
- labour market reforms;
- new approaches to social exclusion; and
- improving the environment.

By using structural indicators in this way, the **annual spring European Council**, which allows Heads of State and Government to discuss economic reform issues in some detail, can adapt its ongoing agenda to focus on those areas most in need of reform. The indicators should therefore become a powerful tool for:

- focusing on economic outcomes as well as necessary processes;
- showing where the EU has made progress;
- taking a critical look at policy, and learning from others’ experience; and
- shaping the agenda of future European Councils.

⁵ Council doc 13217/00

Reform of product markets

I.19 To match the dynamic, job creating performance of the US and to meet the Lisbon goals, EU Member States need to intensify their efforts both to complete the Single Market and to reinvigorate their national economies. **Chapter 4** argues that, to meet this responsibility, further widespread structural reforms are needed in a range of sectors, focusing on the five factors driving productivity growth. Such measures must be implemented in the context of consistent and transparent market rules and a reformed state aids regime that helps tackle market failure, thereby creating a level playing field and **stimulating competition** while simultaneously protecting and promoting **social justice**. EU economic reform must lead to, and be seen to lead to, real improvements for EU consumers and businesses.

Enterprise, innovation and job creation: the virtuous circle I.20 Chapter 5 considers the important topics of **enterprise and innovation**, and what Member States might do to promote (or remove barriers to) company start-ups and expansion, and the dynamic process by which ideas are generated, refined, financed and then transformed into output, jobs and greater consumer choice. The UK Government strongly believes that economic dynamism and social justice go hand in hand. An innovative, enterprising economy is the surest guarantee of maintaining and enhancing the high level of social justice expected by European citizens, and of constructing a fairer and more inclusive society in which all can contribute to and benefit from rising prosperity. This principle is at the heart of the Government's, and the EU's, reform agenda.

Investment and capital markets: actions not words I.21 Chapter 6 focuses on the dynamic role of investment, both public and private. The Government believes that there is a key role, within the context of sustainable public finances, for productive **public investment**. High quality public services – a sustainable transport system, modern schools and hospitals – complement **private investment**, enhancing the overall productive potential of the economy and delivering social justice. Encouraging private investment requires ongoing reform so as to realise the full potential of the Single Market, not least in **financial services**. This demands action not words; in practice it means living up to the wide-ranging commitments already made at the Lisbon and Stockholm European Councils. While steps have been taken, progress in some areas has been slow and deadlines have been missed. It is important not to lose sight of the original objectives of the action plan; to open up markets and to reduce the cost of access to capital for EU firms.

Setting sights high at Barcelona I.22 The EU must demonstrate that throughout the reform agenda, it is not content simply to follow the timetable agreed at Lisbon, but aims to set its sights high and pursue as ambitious a programme as possible. At the **Barcelona Council of March 2002**, EU Heads of Government will assess progress to date on the reform agenda, and set out next steps. The EU needs to take this opportunity to demonstrate that it is serious both about delivering on the commitments made at Lisbon and Stockholm, and renewing its reform agenda so as to address new issues. Making progress will mean tough decisions; reform can present complex and difficult challenges for all Member States, including the UK. For an EU with justifiably high social and economic aspirations, however, and which aspires to be the best in the world, these are challenges which must be met.

Labour markets: the centrality of full employment I.23 The best means of combating social exclusion and enhancing individual dignity is to boost employment. **Labour market reform** must be an overriding priority for an EU seeking to combine high rates of non-inflationary growth with low levels of unemployment. **Chapter 7** addresses the key issues of **skills and education**, and the importance of measures to enhance occupational and geographical mobility, both within and between Member States. If economic reform is to be to the benefit of all, European workers must be in a position to take advantage of the opportunities opened up by an integrating, dynamic Single Market.

The EU in the wider world: responsibilities and opportunities I.24 Finally, **Chapter 8** considers the EU in the wider world. The EU is part of an increasingly interconnected and interdependent global economy marked by rising trade and investment flows. **Europe has a responsibility to pursue economic reform**; not only for its own benefit, but also for the good of its neighbours – helping drive global economic growth, and promoting international cooperation beyond its own borders to ensure that globalisation works for the benefit of all. The Government will look to make progress in particular:

- by **breaking down barriers to trade** between the EU and the rest of the world, and keeping the multilateral trading system on a track towards growth, development and improved global governance. The WTO's Doha Development Agenda promises a positive boost to the world economy, and major gains for developing countries;

- by promoting a stronger commitment from the EU and Member States to meeting the **Millennium Development Goals**. The Government supports further reform of the EC's own development budget, and has encouraged further increases in Member States' aid levels;
- by joining with our European and other partners in **supporting international financial stability** through reform of the international financial architecture and institutions, and by constructing sound and sustainable macroeconomic frameworks to protect against destabilising financial flows and economic slowdown; and
- by working with other Member States to protect our common environment and contribute to **sustainable development** in both the EU and the wider world, improving the quality of life for current and future generations.

Spanish priorities **I.25** The Government welcomes the priorities for the Barcelona Council set out by Sr Aznar, Prime Minister of Spain (and summarised in Box 1.4). The Government believes these highlight the issues demanding further attention if the EU is to meet its Lisbon goals, and is fully committed to making the efforts in these areas necessary to ensure that Barcelona is a success.

Box 1.4: Spanish Presidency Priorities for Barcelona

- 1) Transport and Communication, including: a renewed impetus for broad-based trans-European transport networks; the creation of a single European sky; rail liberalisation; and the development of broadband networks.**
- 2) Single Energy Market, including: completing gas and electricity markets for companies and then consumers as soon as possible; greater transparency and clear rules for third party access to networks; introduction of rules with respect to setting of rates and management of cross border flows; and a revision of the guidelines on trans-European energy networks and the announced Infrastructure Plan for Interconnections.**
- 3) Single Financial Market, including: the importance of the Financial Services Action Plan (FSAP); the integration of the securities markets in 2003; and ensuring successful implementation of the Lamfalussy Report.**
- 4) Employment, including: fostering the mobility of workers across Europe; adapting the European Employment Strategy – the Luxembourg Process; and removing structural barriers to job-creation within tax and benefit systems.**
- 5) Education, including a policy focus to achieve the objectives of improved quality, universal access, and the opening of education systems.**

Next steps **I.26** Some would argue that in the current economic climate the EU should rein back on its reform ambitions; that now is not the time for rapid change. The UK Government disagrees. By pressing ahead with economic reform the EU can increase confidence in the EU economy, dampen the impact on EU growth and employment of a global slowdown, and create the conditions for stronger growth. In the coming year, the economic reform agenda must be pushed forward. The EU must agree action plans which both signal intent and focus on the outcomes and benefits delivered. More concretely – and building on Prime Minister Aznar's priorities detailed above – the next steps should include:

- a reform of **labour market policies**, especially in the context of the five-year review of the Luxembourg Process, to help Europe regain the conditions for full employment;
- to encourage enterprise and not stifle it, a lighter and better targeted approach to **regulation**. The Mandelkern report's recommendations now need to be implemented to ensure that the impact of new regulations is fully assessed through effective consultation, and to promote the consolidation and simplification of existing regulations;
- **liberalisation of capital markets by 2003**, and a transparent framework of core standards and principles for a **single financial services market by 2005**, to ensure consumers are protected and companies can access capital cheaply and efficiently. Greater competition will lead to a better deal for consumers and businesses, and especially for small and medium sized enterprises (SMEs) which are so important for job creation;
- **the opening up of energy markets**, creating more competitive gas and electricity markets across Europe with better cross-border connections;
- **more generally, developing the EU's networks** in telecoms (including broadband), transport, gas and electricity to ensure that the capacity is there to meet Europe's future needs;
- pursuing strong, pro-active, independent and economically rigorous **competition policy**, and less but better targeted **state aid**, based on a clearer recognition of what constitutes market failure;
- a focus on **life-long learning**; a flexible approach tailored to national needs and differences, while being firmly directed at the common Lisbon objective of full employment and opportunity for all;
- enhanced professional cross-border mobility, with **mutual recognition of professional qualifications**;
- making more of European **research and development and innovation** efforts, especially in areas such as biotechnology and eEurope, with steps to foster more effective dissemination of ideas across borders and between the academic and business communities, and to boost private R&D investment; and
- a review and reminder of the importance of **openness and trade**, including a Cecchini-style assessment of the economic benefits to the EU of the transatlantic relationship.

1.27 The Barcelona European Council and the months and years that follow, offer an opportunity to make substantive progress on economic reform and to take concrete steps towards a new, fully employed and socially cohesive European economy. Ahead of Barcelona, the Government presents this White Paper as a positive contribution to the Presidency's efforts to take forward the Lisbon agenda.

- **European economic reform matters.** It matters to consumers, businesses and investors in the EU and elsewhere; it matters to the UK as a large, open and integrated European economy; it matters economically and socially; and, most importantly, it matters now.
- **Two years on from the Lisbon European Council which aspired to create a dynamic, competitive and socially inclusive Europe, much has been achieved.** Much more, however, remains to be done.
- **Employment and productivity continue to disappoint,** especially in comparison with the US. The challenge is not simply to close the gap, but to do so within a framework which delivers the resulting benefits to all sections of society, combining economic gain with social justice.
- **EU enlargement,** the credibility of Europe's commitment to economic reform, the arrival of the euro, and demographic change all lend current reform efforts a **new sense of urgency.** The challenge for governments is to combine Lisbon's breadth of vision with a succession of concrete steps to its realisation. Europe's citizens expect no less. At Barcelona and over the months and years that follow, Europe's leaders must demonstrate that they can deliver.

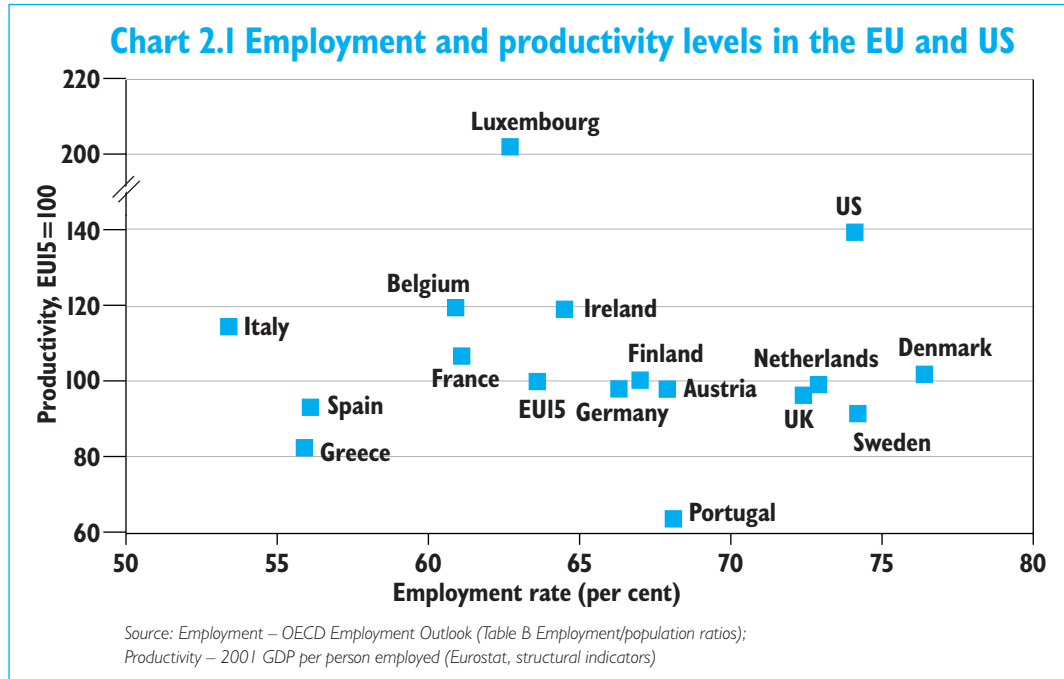
INTRODUCTION

"The rapid and accelerating pace of change means it is urgent for the Union to act now to harness the full benefits of the opportunities presented. Hence the need for the Union to set a clear strategic goal and agree a challenging programme for building knowledge infrastructures, enhancing innovation and economic reform, and modernising social welfare and education systems." (Lisbon Economic Council conclusions, March 2000¹)

2.1 Why a White Paper on European economic reform, and why now? Because progress on reform matters for consumers, businesses and investors, in the EU and elsewhere; it matters to the UK as a large, open and integrated EU member state; it matters economically and socially; and it matters now.

Minding the gaps 2.2 The case for economic reform is made clearly by Chart 2.1. Output per person employed is lower in the EU and in the majority of individual Member States than in the US; so too, is employment. While Denmark and Sweden enjoy equivalent or higher employment rates, each falls well short on productivity; Luxembourg has higher productivity, but lower employment. Had the EU matched US levels of both employment and output per employee in 2000, its output would have been higher by the equivalent of around £5000 per person per year, or €8000. The challenge for reform-minded EU policy-makers is to close the gap in economic performance without sacrificing Europe's high levels of social justice.

¹ The Presidency conclusions from the Lisbon Council can be found at www.europa.eu.int/council/off/conclu.



TRYING TO EXPLAIN EU UNDERPERFORMANCE

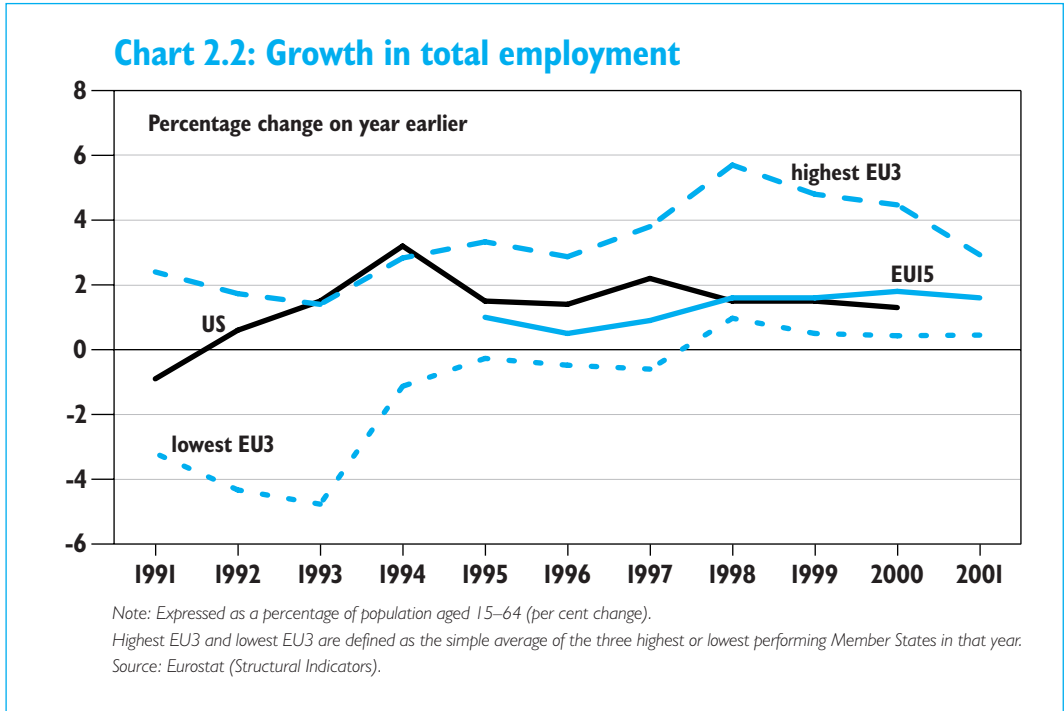
2.3 Why is EU performance so much lower than that of the US, and what policies might be required to close the gap? Research commissioned for this White Paper from Mary O'Mahony explores the variations in output per person across the EU and examines possible underlying causes.

Lower employment levels. . . **2.4** Part of the explanation lies with the low rates of **employment** already highlighted in Chart 2.1. Employment in the US is, on average, 10 percentage points higher than in the EU, though there is substantial intra-EU variation.

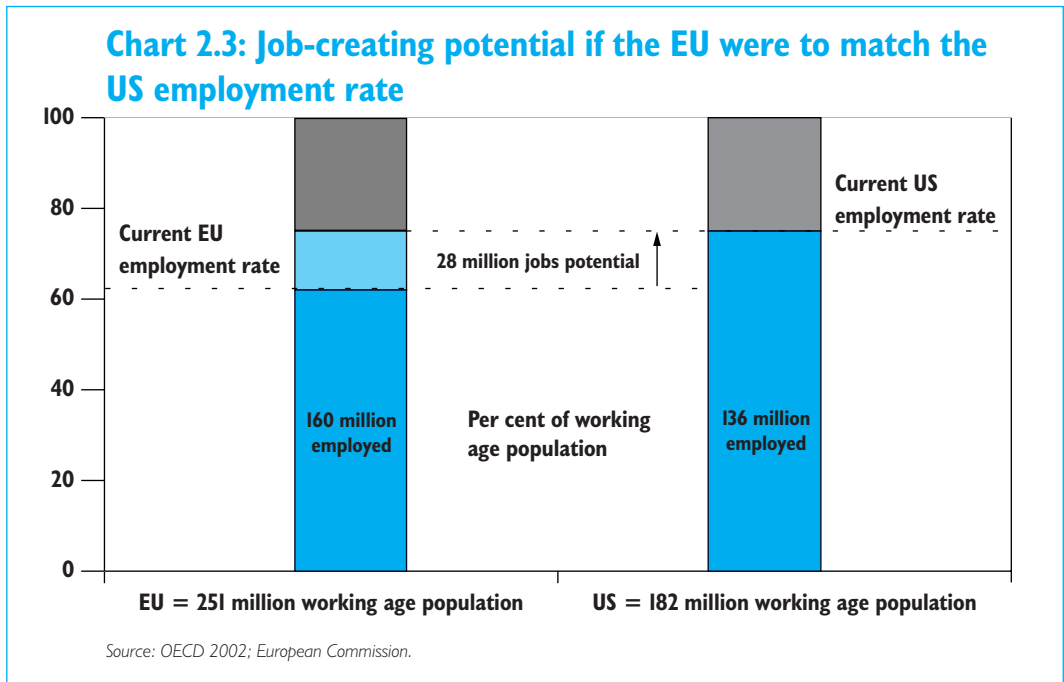
. . . and slower employment growth **2.5** Chart 2.2, using one of the several structural indicators developed by ECOFIN to monitor progress on reform, shows not employment rates but employment growth. EU employment – as well as being well below the US as a proportion of the working age population – grew more slowly through much of the past decade. Only towards the end of the 1990s did EU job creation again begin to rival the pace of its transatlantic neighbour.

2.6 As the chart also makes clear, there have been substantial differences in performance within the EU in any one year. The best performers² enjoyed employment growth some 5 percentage points above that of the lowest, where employment was frequently contracting.

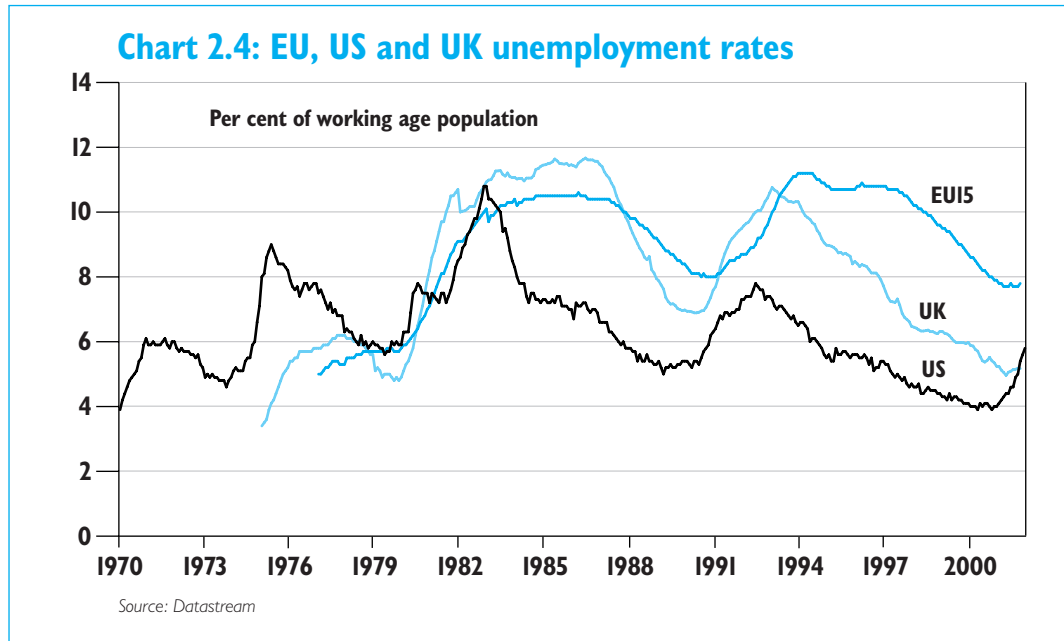
² Measured as the average of the best three. Note that the composition of the 'highest' and 'lowest' categories may change over time; Chart 2.2 does not imply that some EU countries have consistently outperformed US employment growth.



2.7 Chart 2.3 asks what the implications would be for EU employment if the 64 per cent EU employment rate (about 160 million employed out of a total 251 million of working age, in 2001) were to be raised immediately to the 75 per cent rate of the US. The answer is an extra 28 million jobs. Lisbon’s targeted 70 per cent employment rate - ambitious from a European starting point - implies a smaller increase from the present base, of about 16 million jobs.

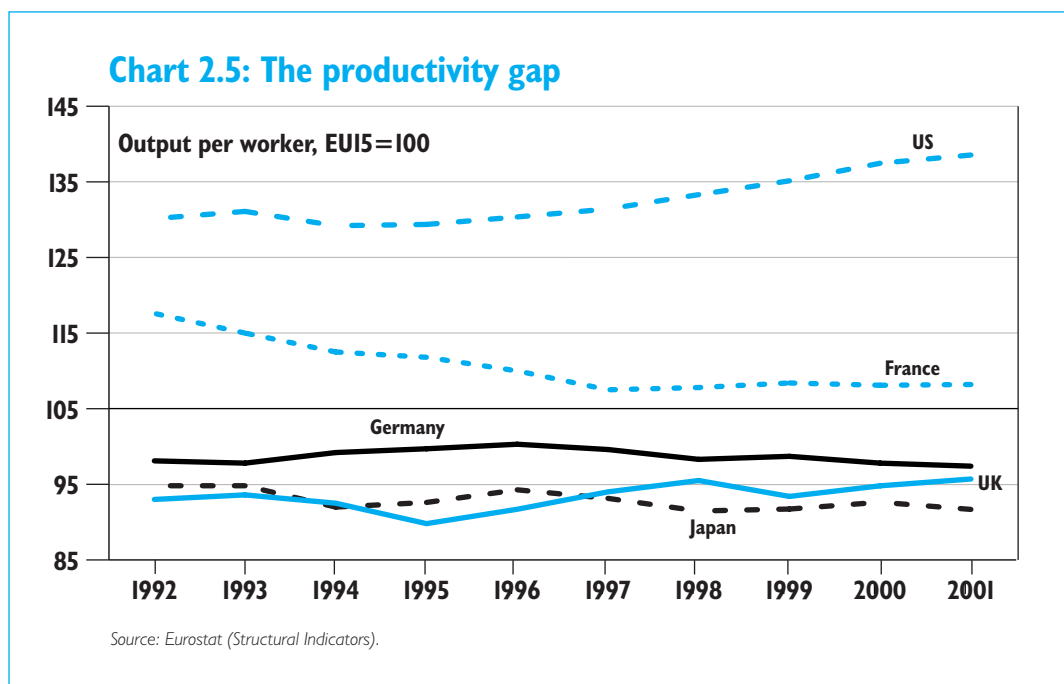


2.8 Low employment rates have been accompanied by relatively high unemployment rates. As Chart 2.4 shows, one of the more worrying aspects of the EU's overall performance is that it has not, over the course of two decades (including periods of relatively strong economic growth) managed to push unemployment sustainably below 8 per cent. Even allowing for such sharp and unique shocks as German reunification, Europe's unemployment track record is disappointing, and contrasts sharply with the 4 per cent lows touched in the US prior to the recent economic slowdown.



Lower levels of productivity

2.9 Another part of the explanation for EU underperformance may lie with **labour productivity**. The amount that each employed person produces is over 30 per cent higher in the US. This partly reflects hours worked in the EU; but even allowing for this, output per hour worked in the US is 15 per cent higher. Furthermore after a lengthy period of post-war catch-up, the productivity gap with the US has, on both measures, once again begun to widen. The EU needs to intensify its efforts, simply to hold its ground.



2.10 Another possible explanation is **investment**: more capital per employee generally makes employees more productive. There are clear differences in investment between Member States; France, Belgium, the Netherlands and Luxembourg all have considerably higher levels of capital per hour worked than does the US. On average, however, capital per employee hour is about 7 per cent higher in the US than in the EU.

Box 2.1: Is increased employment a correct objective?

The value of a policy which sets out to boost employment is sometimes questioned on the grounds that workers in the EU may attach a greater value to leisure than do workers in the US, and therefore prefer to work shorter hours. Lower GDP per capita in the EU relative to the US might therefore reflect a greater preference for leisure over work, rather than a weakness in the labour market.

Encouraging employment is not, however, the same thing as encouraging employees to work longer hours. Overall rates of participation and employment are higher in the US than in the EU, and the much higher rate of registered unemployment in Europe indicates a substantial element of involuntary inactivity. This does not take into account ‘discouraged’ workers who, failing to see any prospect of gaining work, do not register as job-seekers and hence fail to show up in the unemployment statistics. Furthermore, US experience illustrates that, in buoyant labour markets, people choose to remain active for longer in their working lives, and are more easily able to agree working times and patterns which allow them to do so. While it cannot be assumed that European workers would like to work as many hours as their US counterparts, it can reasonably be assumed that many European residents who are not in work, would like to be.

A slightly different criticism of the full employment objective focuses on the way ‘employment’ is defined. People may consider themselves to be more than fully employed without being paid employees; in voluntary or community work, for example, or as full-time carers. Certainly, not all work is paid work. Is an employment objective of the sort set at Lisbon therefore somehow misguided? No. First, because those countries with low employment rates tend also to have high official unemployment rates, suggesting that many of those not in paid work are actively seeking it. Second, because the question of the definition of ‘employment’, is different to that of the validity of an employment target; and third, because a 70 per cent employment target still implies that almost a third of the working-age population is not in work as officially defined. Experience in the US, Scandinavia and elsewhere suggests that the proportion of people who would prefer not to have some form of paid employment, given the option, is actually much lower than this.

Different individuals and different electorates will clearly have different social and lifestyle preferences. An employment target such as that set at Lisbon not only allows ample scope for this; it also ensures that governments pursue strategies which enable those choices to be exercised.

2.11 Another factor behind the productivity shortfall is the efficiency with which the different inputs are combined, or total factor productivity. Total factor productivity is about 12 per cent higher in the US than in the EU. Such a differential reflects a combination of factors including **competition, innovation, enterprise** and **skills**.

2.12 Table 2.1 contrasts the performances of the EU in aggregate, and the UK in particular, with the US in terms of output per person employed, output per hour, capital per hour and total factor productivity.

Table 2.1: Breakdown of US, EU and UK productivity differences (1999)

	US	EU	UK
Output per capita	151	100	101
Output per person employed	132	100	95
Output per hour	115	100	92
Capital per hour worked	107	100	81
Total Factor Productivity	112	100	99

Source: O'Mahony (2002).

2.13 O'Mahony's work also sheds some light on productivity differences between different sectors of the economy. The US-EU gap in manufacturing, for example, is greater than that in market services³, as Table 2.2 illustrates. While the EU underperforms the US in both sectors, it does so by much less in market services. The same is also true of the UK, though to a much smaller extent. The result is that the UK productivity gap with the EU is greater in market services than in manufacturing (though O'Mahoney's work suggests that this gap narrowed during the latter half of the 1990s). Market services account for a much larger share of the US and EU economies than does manufacturing; and while US manufacturing growth has outpaced European, the relative growth of US market services has been even faster.

Table 2.2: Relative labour productivity performance in manufacturing and market services (1999)

Value added per worker engaged	US	EU	UK
Manufacturing	159	100	95
Market services	123	100	85

Source: O'Mahony (2002).

Increasing employment and labour productivity

2.14 Both increased employment and labour productivity boost total output. However, employment growth and productivity growth are far from independent of each other. As employment grows, so the level of output per head of population increases, but there may be a one off reduction in output per worker if people entering the workforce have below average productivity.

2.15 Evidence on UK labour markets suggests that new entrants into the labour force are between one half and two thirds as productive as existing workers⁴. This is broadly consistent with findings that entry wages are around half of average weekly wages. Higher employment may, in the short-run, dampen labour productivity, and a fall in employment may boost it. The most impressive aspect of the US achievement is that it has combined high productivity with high employment; a goal to which the EU must also aspire.

2.16 The Government therefore does not accept that the EU should focus only on employment or on productivity. Rather, it believes that there are structural factors which shape both productivity and employment to different degrees and in different ways. Further reforms are needed to tackle such structural weakness and put the EU in a position to sustain the desired combination of high growth, high levels of employment and high standards of social justice.

³ Market services consist of transport & communications, distribution, repairing, hotels and catering, financial intermediation and business services.

⁴ *Mind the gap please. The changing nature of entry jobs in Britain*, Gregg and Wadesworth (2000), Centre for Economic Performance WP, LSE 2000.

TACKLING THE WEAKNESSES

2.17 Following the framework suggested by much of the academic literature, and drawing on the work of O'Mahony, five key factors can be identified as having a strong influence on productivity at both a national and a regional level, and hence as focal points on which policy-makers should concentrate their reform efforts^{5,6}. Such factors are, inevitably, easier to identify than to manipulate, but include:

- **competition;** stimulated by the completion of the Single Market, and prompting innovation, cost reduction, quality enhancement and greater consumer choice;
- **investment;** facilitated by efficient and integrated financial markets, and complemented by public investment in public services;
- **enterprise;** encouraged by a friendly environment for start-ups (and tolerance of failure), a culture open to risk-taking, and a financial system granting appropriate access to funding for SMEs and companies operating in new sectors;
- **innovation;** unlocking the potential of new technologies and processes, identifying those with scope for practical implementation, and promulgating the dissemination of ideas; and
- **skills;** life-long training and education which maximises the contribution of human capital to growth and enhances individual self-worth and dignity.

2.18 These factors are clearly interdependent; strengthening one may help alleviate weaknesses in another. A more skilled workforce may, for example, encourage firms to invest in more technologically advanced machines which require a higher level of expertise, which in turn encourages greater investment and innovation on the part of the suppliers of that machinery.

Flexibility; an employee benefit

2.19 As this one example shows, the link between product, capital and labour markets is multi-faceted. An EU endeavouring to raise its productivity must also concentrate on its labour force and, in particular, on the latter's flexibility. '**Flexibility**' is a broad term. It encompasses geographical and occupational mobility and skills, as well as the ability of wages and working hours to adjust to different economic circumstances; and it applies to employers as much as to employees.

2.20 What it does **not** equate to, and should not imply, is worker exploitation or the absence of employee rights; nor does its use with respect to employees in any sense sanction 'inflexibility' on the part of employers. A flexible, skilled workforce is, at the end of the day, the best guarantee of the rights and prosperity of each of its members. A flexible, responsible business sector is the best guarantee of long term success. Burdensome restrictions, whether in labour or in product markets, can protect one sector only at the expense of the broader community.

⁵ See, for example, *A Perspective on UK Productivity Performance*, O'Mahony and Crafts, Fiscal Studies, 2001.

⁶ These are detailed in *Productivity in the UK: The Evidence and the Government's Approach* HM Treasury, November 2000.

2.21 A flexible labour market is not a guarantee against rising unemployment during a downturn. It does however, mean that any **increase in unemployment is likely to be shorter-lived**, avoiding the long term joblessness which is so detrimental to the skills base, and so costly to society, localities and individuals. That EU unemployment has not only been relatively high, but persistently high, reflects in part the effects of overly restrictive institutions and regulations in both labour and product markets. Tackling these underlying rigidities must be a key priority for EU policy makers. The rewards, as discussed below, could be substantial.

COMPLETING THE SINGLE MARKET - THE BENEFITS OF REFORM

The Single Market; setting reform in motion

2.22 Economic reform as a concept is not a novelty in Europe. The Treaty of Rome in 1957 set in motion a reform process which has been underway for over forty years; a transformation of the European economy centred around the four basic freedoms of the Single Market - the free movement of **goods, services, people** and **capital**.

2.23 The biggest impact has been on trade. Physical, technical and fiscal barriers restricting trade were removed, and greater use made of mutual recognition and of the 'country of origin' principle. The initial impetus was reinforced in 1985 by the **Single Market programme**, and complemented by Member States' own efforts. Such efforts have been encouraged throughout by the European Commission; more recently, they have been rendered even more effective by the sharing of best practice policies between Member States (discussed further in Chapter 3 below).

Trying to quantify the benefits: Cecchini

2.24 One of the most significant attempts to quantify the benefits of the Single Market was the Commission's 1988 **Cecchini report**⁷ which argued that the elimination of remaining barriers to the Single Market (such as frontier controls or differing technical standards) would reduce costs and prices. Industrial restructuring, increased competition and a lower cost of borrowing from liberalised financial services would boost investment. This would lead to improved competitiveness and domestic purchasing power, and hence to higher aggregate demand, job-creation and an improved fiscal position. Cecchini concluded that, on a conservative scenario, the Single Market would lead to a one-off increase in output of 4.5 per cent, a reduction in prices of 6 per cent, and an increase in employment of 1.75 million (Table 2.3). The report also argued that, insofar as this contributed to a more stable macroeconomic environment, governments would have greater scope to pursue economic policies aimed at boosting both growth and employment, meaning that the long term benefits of completing the single Market could be greater still.

Table 2.3: Cecchini: the benefits of completing the Single Market

	GDP (per cent)	Prices (per cent)	Employment (millions)
Change resulting from completion of single market	4.5	-6.0	1.75

Note: Margin of Error +/- 30%.

Source: Commission of the EC, 1988.

⁷ Commission of the European Community, 1988

Confirmation of the gains **2.25** Almost a decade on from Cecchini, the **European Commission** in 1996⁸ undertook a significant evaluation to ascertain the extent to which such gains had been realised in practice. This study found clear evidence of efficiency gains stemming both from greater trade within the EU and from higher levels of competition. By 1994 (using the most recent data available to the Commission at the time), EU GDP was estimated to have been 1.1–1.5 per cent higher than would have been the case in the absence of the Single Market, and inflation 1.0–1.5 per cent lower. 900,000 more jobs had been created than would otherwise have been the case, and EU manufacturing trade was estimated to have been boosted by 20–30 per cent.

2.26 Academic computations of the welfare gain for individual countries confirm the Commission's findings (Table 2.4)⁹. Smaller countries, in which trade carries a high weight in overall economic activity, have unsurprisingly been the main beneficiaries of the removal of trade barriers (an indication, perhaps, that EU accession countries may be well placed to capture further gains on full membership of the Single Market).

Table 2.4: Gains from the Single Market by country

Extra consumption as a per cent of GDP	Country
2–3	France, Germany, UK, Italy
2–5	Denmark
3–4	Netherlands, Spain
4–5	Belgium, Luxembourg
4–10	Ireland
5–16	Greece
19–20	Portugal

Source: 'The competition effects of the Single Market in Europe', C. Allen, M.Gasiorek and A. Smith, Economic Policy, 1998.

The importance of the dynamics **2.27** While the Cecchini report provided a comprehensive examination of the costs and benefits of the Single Market, it did not capture all the gains. Its view of the world was essentially static. Cecchini himself was only too aware of this limitation, recognising that **dynamic, non-price factors** stemming from the removal of trade barriers and accompanying reforms would, over the longer term, have far greater consequences than any static 'step change' for EU productivity, employment, growth, and economic and social stability.

2.28 Taking into account both its static and dynamic implications, the Single Market clearly does more than just provide EU businesses with a large consumer base. It also injects competition into the economy, stimulating not only cost and price reductions but also enterprise and innovation. The mechanism by which this works can take several forms:

- **increased competition between producers** in the supply of goods and services. For consumers, this results in lower prices, enhanced quality and/or increased choice;
- **increased competition in the provision of finance** to both consumers and businesses. For the latter, this reduces the cost of capital investment and expansion. It also facilitates the growth of smaller, innovative and job-creating companies which, in less competitive circumstances, might find access to external funding difficult;

⁸ *Single Market Review 1996*, European Commission.

⁹ *The competition effects of the Single Market in Europe*, C.Allen, M.Gasiorek, A.Smith, Economic Policy, 1998.

- **economies of scale** in a larger market for businesses able to sell on the basis of common EU standards, to produce in and source from an EU-wide range of suppliers, and to raise capital in an integrating EU financial market. Increased competition means that reduced costs are passed through to consumers in the form of lower prices and/or improved quality;
- **a more efficient allocation of resources** as remaining restrictions are eased on the free movement of goods, services, capital and labour; and
- **greater innovation** thanks to the larger consumer market, the improved availability of funding and the more rapid flow of new products and processes between Member States in an integrating EU economy.

FEELING THE BENEFITS

The UK as beneficiary of EU economic reform

2.29 Economic reform to complete the Single Market benefits both the EU as a whole and the UK. Over three quarters of a million UK companies now trade with the rest of the EU. When the UK joined the then EC in the early 1970s, trade with the rest of the bloc accounted for less than 40 per cent of the UK's total exports. This has since risen to over 50 per cent, and affects around 3 million UK jobs.

2.30 Tangible benefits of the Single Market include:

- **lower telephone charges.** A liberalised EU telecommunications market, combined with an effective domestic regulatory framework, has reduced prices and increased choice. The cost of a three minute call between the UK and Italy halved over the decade to 1999 from £1.86 to £0.91;
- **lower energy costs.** Since the UK gas market was opened to competition in 1997/98, prices have fallen for consumers and new suppliers have been offering savings of around £50 on an average gas bill of £315;
- **cheaper air fares.** Competition and liberalisation in the Single Market has cut prices with the result that promotional fares, for example, were on average 24 per cent lower during 1993-1998 than before deregulation;
- **better consumer protection.** The Toy Directive means that all toys sold in the EU must be safe for children. The Fourth Motor Insurance Directive makes it easier for motorists involved in accidents in other Member States to make an insurance claim in their country of residence;
- **mutual recognition of standards** allows UK manufacturers to sell across the EU without expensive re-testing in every country;
- **reduced export bureaucracy.** The removal of time-consuming border checks and paperwork has reduced transport times across Europe;
- **public purchasing** has been rendered more open and transparent, and hence subject to greater competition and delivering better value for money to taxpayers;
- **environmental benefits.** The EU's Auto Oils programme has set common emission standards for vehicles, significantly improving air quality, and EU partners working together in international negotiations helped produce a much more effective **Kyoto Protocol**; and

- the right to **work, study or retire** in any other EU Member State. Around 100,000 UK citizens currently work in another EU country, 200,000 draw pensions elsewhere, and 450,000 live in another Member State¹⁰. Since 1995, 95,000 UK young people have studied, worked or trained in another Member State with support from EU education, training or youth programmes.

2.31 In a recent study, Pain and Young¹¹ attempted to quantify the potential impact of withdrawal from the EU on the UK economy. They concluded that this “...would mean that the level of output in the UK economy would be 2.2 per cent lower permanently than it otherwise would have been.” The authors comment that the result is broadly equivalent to the gains estimated to have been made by other large EU economies participating fully in the European integration process. Some might also argue that the costs of EU withdrawal will increase, the further down the economic reform path the EU progresses.

2.32 Recognising the extent to which it has benefited from an increasingly integrated Europe, the UK has frequently been in the forefront of those urging the early implementation of the measures needed to bring the Single Market to fruition. The strength of the trading, investment, financial and legislative links between the UK and its European partners means that the EU necessarily features prominently in the thinking of a Government committed to raising the rate of sustainable growth, and achieving rising prosperity through the creation of economic and employment opportunities for all. **Reform at the EU level** to remove the rigidities in capital, labour and product markets which restrict growth and job creation, and which constrain an economy’s ability to adapt to changing circumstances, complements the Government’s own efforts in the domestic sphere.

TIME FOR ACTION

2.33 As the experience of the past four decades illustrates, the case for EU economic reform is not new. Change has been demanded, urged and implemented - with varying degrees of determination and intensity - since the Single Market was first established. As noted at the outset, however, the message of this White Paper is not simply that **economic reform matters**, but that **it matters now**, with four factors contributing to the urgency.

Added urgency: credibility **2.34** First the **credibility** of Member States’ commitment to economic reform. As discussed in the next chapter, the **Lisbon Council of March 2000** agreed a set of reform objectives and targets that were both highly ambitious and widely publicised. The intervening two years, which have included the **Stockholm European Council**, have seen much in the way of progress, with agreement to open important telecoms markets one of the most notable success. They have also, however, contained some disappointments (for example, in energy). It is, inevitably, these latter which have attracted the greater publicity, and had the larger impact on perceptions of the EU’s performance and its policy-makers.

2.35 It is vital that, only two years into the ten year programme launched at Lisbon, the momentum of economic reform is not perceived to be slipping. Such an occurrence would damage the EU in the eyes of domestic voters and overseas investors, businesses and governments. It would undermine the willingness of firms, whether EU-based or not, to locate and expand in the EU; and as expectations of what was likely to be achieved were scaled back, so the pressure on Member States to meet those expectations and implement reform would itself weaken, making further disappointment more likely. This risks producing a vicious circle of cynicism and underperformance. Reform must be implemented, and it

¹⁰ *What has the EU ever done for us?*, Foreign and Commonwealth Office
<http://www.fco.gov.uk/news/dynpage.asp?Page=10382&Theme=19>

¹¹ *The Macroeconomic Impact of UK Withdrawal from the EU*, Nigel Pain and Garry Young, February 2001. National Institute

must be seen to be implemented; not least at times of economic slowdown, or at difficult points of the electoral cycle. The Lisbon process cannot afford to be seen to drag its feet.

Added urgency: **2.36** A second factor is **the introduction of euro notes and coins**. A successful single **EMU** currency has the potential to produce greater price transparency, reduced transaction costs, and greater competition in both product and financial markets.

2.37 **The dynamic benefits of such developments do not, however, accrue to EMU members automatically.** Economic reform is required in a range of areas. Increased competition in providing finance for companies, or in offering services to savers or individual borrowers, is of little benefit if legal, professional, banking or accountancy barriers, or high transaction charges, prevent customers from taking advantage of the new opportunities. Similarly, price transparency may be of little relevance if consumer safeguards are not such as to give consumers the confidence to try out unfamiliar suppliers.

2.38 At the same time, the existence of a single monetary policy throughout the euro area, and the loss of some exchange rate flexibility, renders the need for flexibility in those Member States' labour, product and capital markets all the more important. In the IMF's words, "*the greatest pay-off to Euro area performance would be stepped-up (goods and labour market) reforms*".¹² Member States across the EU, whether participating in EMU or not, cannot afford to ignore it on either count.

Added urgency: **2.39** Twelve countries are presently negotiating to join the EU. Up to ten may be ready to accede as soon as 2004, taking the Single Market from 370 million consumers to 450 million **EMU** (compared with 390 million in the North American Free Trade Area). It is vital that, in the interim, the EU15 pursue economic reform with renewed vigour; both to identify and establish best practices in a range of policy areas, thereby giving a lead to candidate countries, and to ensure that the EU which these countries join is a dynamic, thriving entity.

Enlargement

2.40 At the Copenhagen European Council of 1993, the EU established three criteria for accession which have helped guide reform in the candidate countries and establish the conditions for eventual membership of the EU. Membership requires that the candidate countries meet the following criteria:

- political: stable institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;
- economic; a functioning market economy, with the capacity to withstand competitive pressure and market forces within the Union; and
- incorporation of the Community *acquis*: adherence to the various political, economic and monetary aims of the European Union.

Reform **2.41** The existence of a functioning market economy requires that prices, as well as trade, **demanded of the** are liberalised, and that an enforceable and transparent legal system is in place. A properly **applicants...** functioning legal system is a precondition to ensuring that the mechanisms of a market economy function smoothly; that contracts are enforceable, property rights are respected, and adequate legal protection of creditors' rights is provided. Macroeconomic stability, a well-developed financial sector and the absence of any significant barriers to market entry and exit are all indicators that these mechanisms are working and that a market economy is functioning.

¹² *Monetary and Exchange Rate Policies*, IMF, Country Report No. 01/200, November 2001.

2.42 The Government hopes that engagement with the EU's own economic reform agenda will provide an additional stimulus for candidate countries. The Lisbon programme puts the focus of reform on raising productivity and employment by improving the efficiency of labour, product and capital markets. Work on this agenda is already underway in many candidate countries, and follows naturally from the economic reforms they have already undertaken since 1989. The shift from a centralised regulatory approach towards more flexible but cooperative policy-making will be even more appropriate within the increased diversity of an enlarged EU. The Lisbon methods of benchmarking and peer review will enable the rapid dissemination of best practice across the enlarged European Union, thereby enhancing the dynamism of the enlarged Single Market.

...but not solely of the applicants

2.43 Reform is not, however, solely the task of applicant countries. An enlarged EU will put an even greater onus on each Member State, whether new or longstanding, to demonstrate a combination of macroeconomic stability and microeconomic flexibility. Change is often disruptive. EU enlargement, however, should be seen not as a threat but as an opportunity. The challenge for EU public policy is to implement policies that equip individuals to adapt as the economic environment changes, enabling them to share in the increased prosperity that will result from a more efficient allocation of resources in an enlarged European Union.

2.44 The Government believes that the Lisbon agenda can help the EU to better respond to the shifting patterns of trade and production prompted not just by enlargement but also by expanding relations with the rest of the world. In both the EU and the candidate countries, the response to change needs to be not a reversion to protectionism, but policies that ease the adjustment process by promoting a more flexible and rapid reallocation of resources within a larger Single Market.

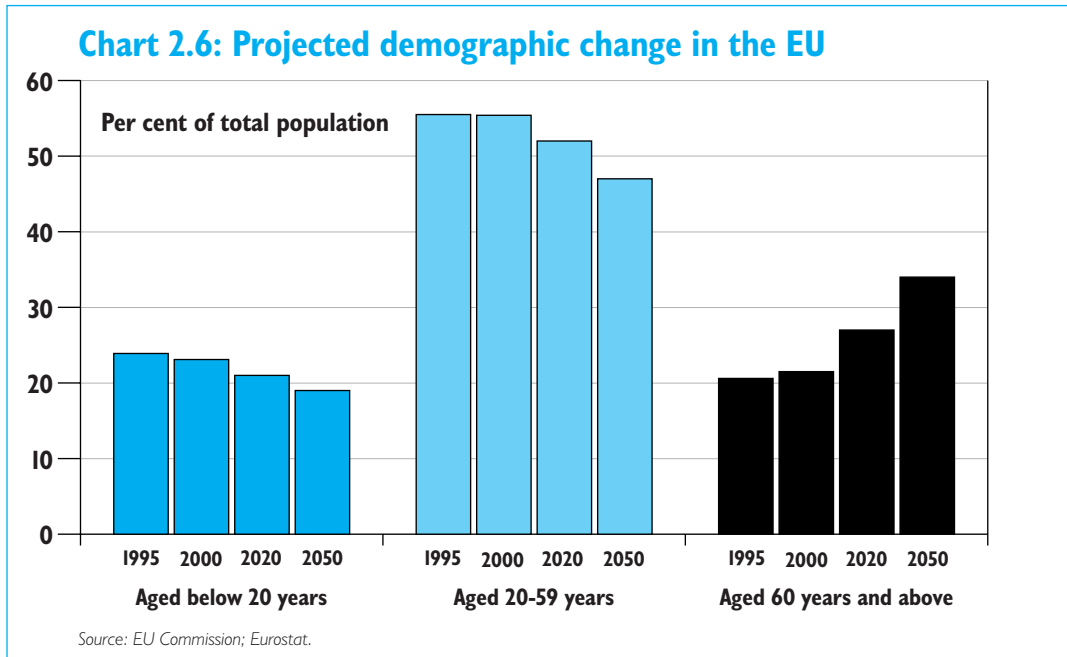
CAP reform

2.45 While not a precondition of enlargement, the prospect of the latter renders reform of the CAP even more necessary. The cost to developing countries of EU agricultural support is discussed in the broader global context of Chapter 8. It should be noted that the candidate countries are more economically dependent on agriculture than existing Member States, with agriculture accounting for around 6.5 per cent of gross value added and 20 per cent of employment. The cost to consumers is likely to be much more crucial for the candidates. Not only are prices in candidate countries significantly lower for key commodities such as sugar and milk, but the share of income spent on food is much higher than in the EU. This implies a disproportionate impact of higher food prices, particularly on the poorest consumers.

2.46 Furthermore, incorporation into an unreformed CAP would risk locking candidate countries into a structure which might divert resources away from more productive uses into agriculture, thereby constraining their economic development. This would imply a cost not only to the candidate countries themselves, but also to current EU Member States. Financing enlargement is an enormous challenge for the EU. Making that challenge all the larger by failing to deliver economic reforms which would be necessary even without enlargement, but are rendered all the more so by its presence, would represent a lack of both vision and economics which EU policymakers cannot afford to contemplate.

Added urgency: an ageing population

2.47 Fourth, and finally, **demographics**. The EU's working age population is ageing and contracting, a trend set to continue over the coming half century. Chart 2.6 gives Eurostat's projections for the EU15¹³. An enlarged EU has a similar profile: while many candidate countries have at present younger populations, they tend to be ageing on aggregate even more rapidly, underlining the need to reform.



2.48 The combination of an older, smaller working age (as currently defined) population, and a larger group of citizens aged over 60 - and with very rapid growth expected in the 85+ age group - carries significant consequences for potential economic growth, as well as for pension and healthcare expenditure (Box 2.2). It also contrasts sharply with the US, where demographics points to a largely stable working age population over the same period. In the absence of reform to boost employment and raise productivity, the EU's long term economic performance risks disappointing its businesses and consumers in both absolute and relative terms.

¹² Eurostat Demographic Statistics Data, <http://europa.eu.int/comm/eurostat>

Box 2.2: Pension Reform

The UK Government's domestic pension policy is based around the following aims:

- i) for today's pensioners, tackling pensioner poverty, rewarding saving, and ensuring all pensioners share in rising prosperity; and
- ii) for today's workforce, providing the opportunity to make decent provision for their own retirement.

The UK ensures that pension provision is set at a firm floor through the Minimum Income Guarantee, and that incentives to save are maintained through the Pension Credit. The Government's Stakeholder Pension provides a product aimed specifically at helping people on modest incomes save for their own retirement.

Within Europe, and in the face of an ageing population, **pensions are a key element of the economic reform agenda**. In the absence of changes to current policy, spending on public pensions in the EU will peak at almost 14 per cent of EU GDP in 2040, from just over 10 per cent in 2000. This reflects primarily changing demographics, though large differences between the public pensions projections of individual Member States also reflect differences of policy.

In the UK, where private schemes make a relatively large contribution to pensioner incomes, the proportion of GDP needed to fund public pension provision should remain stable. In Spain and Greece, by contrast, unchanged policy suggests increases of 8 per cent and over 12 per cent of GDP respectively.¹⁴

Although pensions policy is the prerogative of Member States, there is also a shared recognition that a rising EU pensions burden has major implications for **the sustainability of public finances**. Member States have therefore decided to exchange views and good practice in this sphere, with three aims in mind: safeguarding the capacity of pension systems to meet their social aims; maintaining the financial sustainability of pension systems; and enhancing the ability of pension systems to respond to the changing needs of society and individuals. More portable pensions might be one means to the latter end; or allowing cross-border management of pension schemes (which the Commission estimates could save a medium sized company about € 1.5 million per year on non-wage labour costs¹⁵).

Promoting pensions reform by removing barriers to the development of funded pensions is also an important goal. This would alleviate the impact of ageing populations on the sustainability of public finances¹⁶. Pensions are a significant part of non-wage labour costs. Delivering affordable pensions would therefore also make an important contribution to the delivery of flexible labour markets and help to put in place the economic conditions necessary to encourage job creation. Such schemes will only develop if the regulatory regime strikes the right balance between security and costs. An approach that limited the freedom for individual pension schemes to pursue an investment and funding policy appropriate to the circumstances of the scheme would not be in the interest of pension scheme members.

¹⁴ *Budgetary Challenges posed by ageing populations*, Economic Policy Committee Report, October 2001.

¹⁵ *Economic Reform; Report on the functioning of Community product and capital markets*, Commission Report (2000).

¹⁶ As Europe's population ages, so funded pensions schemes are likely to become increasingly important savings vehicles, it is important that efficient allocation of these funds is not unnecessarily restricted, and the potential for continued

MEETING THE CHALLENGE

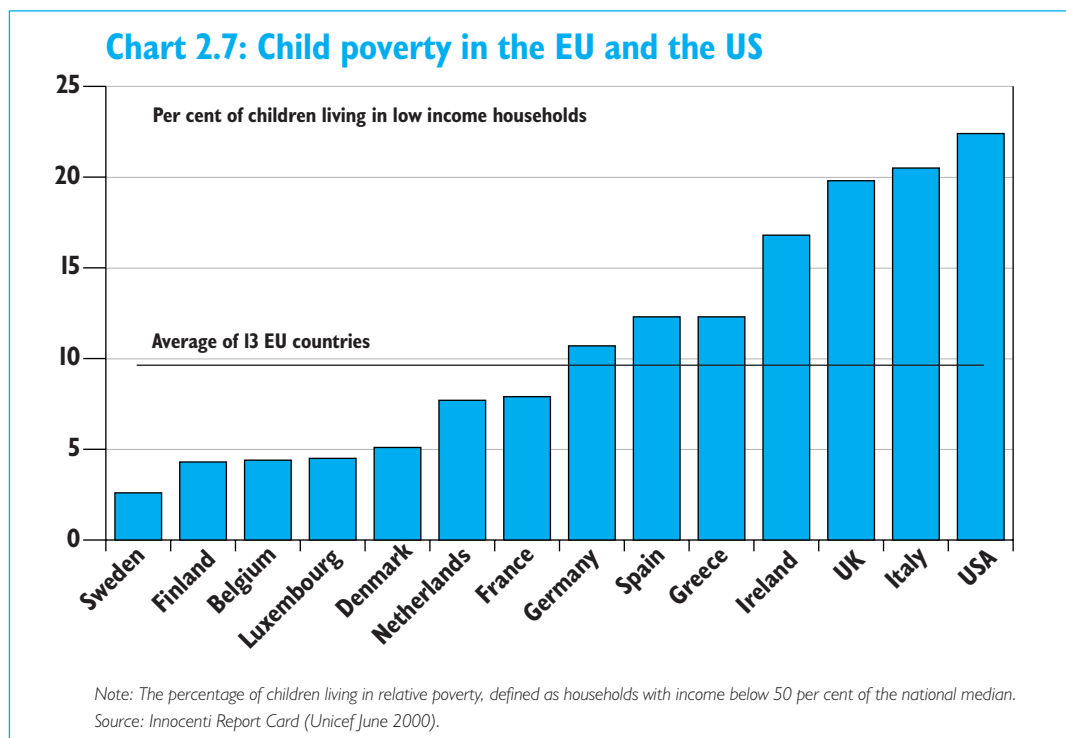
Motivating, facilitating and necessitating reform

2.49 Much has been achieved in the way of EU economic reform, and much remains to be achieved. The UK has been a significant beneficiary of the integrating Single Market, and the Government is keen to ensure that the full potential of this exercise is realised.

2.50 Approaching EU enlargement, the arrival of euro notes and coins, the delicate state of confidence in the EU's commitment to reform, and an unhelpful demographic outlook: each of these in isolation should be sufficient to encourage Member States to take European economic reform seriously. Taken together, they make the task urgent; motivating, facilitating and necessitating change in order to realise the economic dynamism and social stability targeted two years ago at Lisbon (the focus of Chapter 3).

Choice and fairness; an ambitious objective

2.51 That Lisbon explicitly targeted both economic growth and social cohesiveness, was not accidental. Economic reform invariably has **social implications**. Responsible policy makers cannot consider one without the other, and meeting social and environmental goals lies at the heart of the Treaty. Likewise, the UK Government targets not simply growth and employment, but also opportunity for all and social justice, in a context of sustainable development and environmental protection. **Economic and social issues go hand in hand**. The stability and dynamism of an economy influences the stability and health of its society, the distribution and level of poverty, the quantity and quality of employment and, at root, the dignity of its citizens.



Macro-ambition, micro-imagination

2.52 One of the EU's major achievements has been to **combine rising living standards with high levels of social justice**; a record it can be proud of (Chart 2.7, for example, shows levels of child poverty across the EU and in the US). As is illustrated throughout this paper, economic reform at both a Member State and EU level has not only supported, but has

frequently been a prerequisite of, social justice. Further change is needed to ensure that economic gains are delivered to all sections of society. Only a dynamic, efficient economy can produce the choice *and* fairness which its consumers and citizens so justifiably demand.

2.53 Successful reform requires not only debate and agreement on processes and benchmarks, but also – and essentially – action. The challenge for the EU is demonstrate both macro-ambition and micro-imagination; to combine breadth of vision with concrete steps. Over the coming months and years, Europe’s governments must demonstrate that they can deliver.

