Meeting the Challenge: Economic Reform in Europe

February 2003

HM TREASURY

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Foreword

Last year we produced a White Paper about jobs. It explained our vision of what the EU needed to do, Britain included, to boost employment, productivity and growth. Here, we set out what has been achieved. And what has to happen next. There remains a daunting amount to be done. But we Europeans need to do it if we are to compete in a globalised economy.

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. It was an ambitious programme driven by the vision of a European Single Market, now underpinned and strengthened for 12 of the 15 Member States by membership of the Euro, that would become the most dynamic and competitive in the world, and a reformed European social model that would combine full employment with social cohesion. It was a vision of economic reform embedded in social justice, with a sustainable environment.

Europe has the ability to meet this challenge. In the past year, there has been important progress, including an historic agreement to open up energy markets, which will deliver genuine competition and lower prices for businesses and consumers. The reformed anti-trust rules we have agreed are an important step towards more effective enforcement of competition across the EU helping business and the consumer. The agreement on the 'single sky' should deliver real benefits through more effective management of European airspace, reducing air traffic delays. We are trying to make it as easy to buy and sell a pension across EU frontiers as it is to buy or sell anything you get in a shop.

Five million jobs have been created since Lisbon. Many countries have made impressive progress in cutting unemployment. The Dutch and Danes have particularly high levels of employment. But in some parts of the EU unemployment is rising sharply and participation levels remain desperately low.

Europe's reform process is based on a shared understanding that social protection and economic competitiveness are not opposites but complementary. Increasing levels of employment is the best social protection: having a job is for any adult, the first rung on the ladder of opportunity out of poverty or social exclusion. That is why the EU has set itself rigorous targets: 70 per cent employment by 2010, with 60 per cent of women and at least 50 per cent of older workers in employment. But the EU's Member States are still not doing enough to tackle the fundamental barriers to job creation. Of course, it is politically difficult in all countries but Europe's leaders should show that they are determined to undertake the necessary reforms with a fresh urgency. We know what has to be done – to restructure tax and benefit systems to make work pay, to remove the self-defeating incentives to retire early, and to pursue active labour market policies that match new opportunity for the unemployed with responsibility on their part to take jobs. The challenge is for Member States to do it in the next twelve months confident of EU backing for the tough decisions that have to be taken.

In mid-March, the European Council – the EU Heads of Government – will meet in Brussels. To meet our goal of full employment, we must focus on the right priorities:

- **a renewed commitment to complete the single market**, which has already boosted growth in Europe by £570 billion over the past ten years;
- **integration of financial services and capital markets**. Substantial progress has been made in the past year. The challenge now is effectively to implement and enforce the new arrangements so that they deliver better access to capital and greater choice for consumers;

- **research and development**. Europe already has a world-class science base, but we have to tackle the situation where, when European companies increase their spending on research and development, they do it outside the EU. Part of the answer lies at Member State level, for example, by using the tax system. But the EU should consider how to modernise state aid rules to provide added incentives, and how to increase the number of university business links to ensure that research is more effectively disseminated across the EU;

- **cutting red tape and lifting the regulatory burden on business**. Member States and the Commission must stick to their promises to improve the legislative process through effective impact assessment of proposals. And business and other interests must be consulted in a thorough and open way in the development of policy;

- **implementation**. When we have passed the laws, the member states must implement them to open up markets in practice as well as in theory. The Commission needs the political support to clamp down on backmarkers.

Reform on this scale is never easy. But we cannot duck it. We shall continue to work energetically and imaginatively with our partners, including the new members of the Union, and the Commission to deliver the dynamic Europe of full employment and social justice to which we are committed.

Tony Blair

1 INTRODUCTION

*'The Union has today set itself a **new strategic goal** for the next decade; 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.' (Presidency Conclusions, Lisbon European Council 23-24 March 2000[1])*

The White Paper on European economic reform

1.1 In February 2002 the Government published the White Paper: '*Realising Europe's Potential: Economic Reform in Europe*'.[2] This document set out the Government's vision of a dynamic, job-creating EU characterised by full employment, high living standards and social cohesion. It also underlined the challenging reforms of labour, product and capital markets needed to reach this goal.

1.2 Heads of government, meeting at **Lisbon** in March 2000, committed themselves to a ten year strategy of far-reaching economic reform intended *"to enhance the capacity of the EU economy to generate high rates of non-inflationary growth over a long period"*.[3] The economic, social and environmental dimensions of sustainable development were fully and explicitly integrated into this programme with the adoption of the EU Sustainable Development Strategy, in June 2001. Almost three years into the Lisbon agenda, much has been achieved but much more remains to be done: not only in terms of agreement on reform, but also in delivering what has already been agreed.

Macroeconomic stability; a prerequisite for success

1.3 A prerequisite of successful economic reform is **macroeconomic stability**. Sound macroeconomic policies provide the best framework for reaping, as quickly as possible, the full benefits of structural reform policies. Successful structural reform, in turn, contributes to more efficiently operating markets which raise potential growth and contribute to successful macroeconomic policy formation.

1.4 The Government believes that, in the UK and the EU as a whole, there is a shared commitment to economic stability based on the recognition 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 which commands public and market credibility.

Taking stock and taking steps

1.5 *"Structural reform"*, as noted by the Commission in a review of the Single Market's first decade, *"is vital – not as an end in itself, but as a means of creating the wealth to pay for an inclusive society"*.[4] In a context of imminent EU enlargement and global economic and political uncertainty, the creation of a more dynamic, resilient Europe becomes all the more important.

1.6 It is therefore appropriate, in early 2003, both to **take stock** and to **take steps** to ensure that momentum is maintained. The concept and agenda of the Lisbon programme have been agreed, targets have been set, bottlenecks and weaknesses have been identified, processes invented and streamlined, and strategies put in place. What matters now, is **implementation and delivery**.

[1] The Lisbon Presidency Conclusions can be downloaded at http://ue.eu.int/Newsroom/LoadDoc.asp?BID=76&DID=60917&from=&LANG=1.

[2] *Realising Europe's Potential; Economic Reform in Europe*, HM Treasury, www.hm-treasury.gov.uk.

[3] *EU Economy: 2002 Review*, European Commission (November 2002) ECFIN/475/02-EN.

[4] *The Internal Market - Ten Years Without Frontiers*, European Commission (2002).

The purpose of this report

I.7 This report accompanies and updates the 2002 White Paper. It evaluates **progress** on economic reform in Europe, taking into account changes in policy and circumstances over the intervening year, and it identifies **priorities** for action in the near and medium term. In so doing, it draws on a range of sources including, in particular, the Commission's important Spring Report.[5]

I.8 This report **reaffirms and underlines the UK Government's strong commitment to the Lisbon agenda**. Lisbon complements the core tenets of the UK's domestic policy approach: that economic prosperity and social justice go hand-in-hand, and that the best safeguard against poverty is a job. A more dynamic and open Europe would be a Europe of **increased employment, confidence and growth,** a Europe which would both promote and facilitate the UK's efforts to boost its own productivity and raise its own economic performance.

The report's structure:

I.9 The UK Government has, since 1997, played a key role in shaping and driving European economic reform, and will continue to do so. This report is part of its continuing contribution to the European debate, and is structured as follows.

the rationale for reform;

I.10 **Section 2**, using productivity and employment data from both the EU and the US, outlines the scale of Europe's economic reform challenge,[6] and both the challenges and the opportunities will be all the greater in an **enlarged EU**. Global economic and political **uncertainty**; the prospect of **ageing** and contracting EU workforces; and the importance of maintaining the **credibility** of the Lisbon commitments, all render tangible progress on economic reform – and in the shape of results, not processes – a pressing concern in 2003.

the track record on reform;

1.11 **Section 3** focuses on the track record to date of reform efforts. Taking key areas of the Lisbon agenda, it asks which have delivered substantive results (which does not, of course, preclude the need for further effort in these areas); which comprise work-in-progress, where momentum needs to be maintained; and which have, to date, fallen short of expectations in terms of what has been delivered. Taking each category in turn:

- **clear progress** is evident with respect to overall employment, the EU regulatory environment, the cars block exemption, research and innovation, communications and energy liberalisation;
- **work-in-progress** includes reducing unemployment, financial services, a single market for the services sector, competition policy, state aid reform, public procurement, aviation, entrepreneurship and sustainable development; while
- **limited progress** has been made regarding the employment of older workers, takeovers legislation and a business-friendly Community Patent.

the priorities for reform;

I.12 Against this background, **Section 4** then turns its attention to the most pressing reform issues on the Lisbon agenda, identifying ten top priorities for action:

1. modern social policies which boost skills, employment and labour market flexibility, in particular among older workers;
2. promotion of entrepreneurship across all ages and groups;

[5] *Choosing to grow: Knowledge, innovation and jobs in a cohesive society*, Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal. http://europa.eu.int/comm/lisbon_strategy/pdf/5_en.pdf

[6] For an overview of Europe's performance against a broader range of indicators, see *Structural Indicators of European Economic Reform: Measuring Europe's Progress*, HM Treasury (February 2003)

3. better implementation and enforcement of better regulation;

4. progress on, and implementation and enforcement of, the Financial Services Action Plan so as to deliver better access to low cost capital, and greater choice;

5. improved corporate governance;

6. boosting the knowledge-based economy via an R&D framework which better promotes innovation, especially in clean technologies;

7. stronger and more effective competition policy;

8. a modernised state aid regime;

9. a single market in services; and

10. a regional policy framework which supports economic reform and addresses market failure.

and the global imperative of EU economic reform.

I.13 **Section 5** concludes with a reminder of the global importance of European economic reform. In an increasingly interconnected world, the need for a strong, resilient and open EU is all the greater. Both in the context of the Doha trade round and with respect to other multilateral agreements and initiatives, it is vital that Europe maintain and redouble its commitment to **openness,** to **free trade** in industry, services and agricultural products, and to **sustainable development**.

I.14 A stronger Europe would also be a stronger transatlantic partner. The EU and US comprise the world's largest bilateral trading and investment relationship. The deeper and more open this relationship – delivering access to expanded product and capital markets for EU and US companies, and wider choice for EU and US consumers – the greater its contribution not just to transatlantic prosperity and employment, but also to the strength and resilience of the global economy.

I.15 **Europe's challenges, opportunities and responsibilities do not stop at its borders.** Rising to these challenges effectively, seizing these opportunities confidently and fulfilling these responsibilities wholeheartedly demands, however, ongoing economic reform at home. **Lisbon's success will be judged not by the quantity of its processes, but the quality of its outcomes.** For the benefit of all of its citizens and each of its neighbours, Europe must deliver.

2 Economic Reform – A European Priority

European economic reform was recognised as a priority by EU leaders meeting at Lisbon in March 2000. Three years on, the importance of structural reform of product, capital and labour markets has been amplified by imminent EU enlargement, greater economic and political uncertainty, and the ongoing challenges posed by an ageing and contracting working-age population.

Economic reform must focus on results, on boosting employment and on raising productivity. In both respects, the EU continues to fall short of its own aspirations and of the benchmarks set by the best of its global competitors.

It is important that – a third of the way into the Lisbon decade - the benefits already gained from the economic reform programme, and the importance of making further progress, should be recognised. EU leaders must regularly reaffirm their commitment to the Lisbon objectives, and ensure that they deliver results. Europe's citizens will judge Lisbon's success not by the quantity of its processes, but by the quality of its outcomes.

'The further implementation of the Lisbon Strategy and the Spring Summit in 2003 will take place within a new political and economic context, bringing major challenges as well as opportunities... Within such a context, it should be clear that we remain determined to achieve the goal of making the European economy the most competitive and dynamic knowledge-based economy, capable of promoting sustainable growth with more and better jobs and stronger social cohesion. This will require, however, significant reforms to enable faster growth, employment prosperity and improved quality of living'. (The Priorities of the Greek Presidency 2003)[1]

INTRODUCTION

2.1 European economic reform was designated a priority by EU leaders meeting at Lisbon in March 2000. Three years on, the importance of structural reform of Europe's product, capital and labour markets – far from diminishing – has only been amplified, in particular (though not solely) by imminent EU enlargement. Europe's weakness in the face of a global slowdown has underlined the need for structural reform. A strong and resilient EU economy matters not only for the EU itself, but also for its developed and developing country neighbours. **Europe's opportunities, responsibilities and challenges do not stop at its borders.**

2.2 Progress towards the dynamic and socially cohesive economy envisaged at Lisbon is clearly evident. Nevertheless, the EU continues to fall short of both the best in the world and its own aspirations with respect to employment and productivity. In a context of EU enlargement, and against a background of ageing populations and contracting workforces, **it is vital that the momentum for reform initiated at Lisbon be increased**. Economic and industrial change is rarely easy and sometimes, in the short term, painful. There is, however, no alternative if the EU is to build the economic success which is the only sustainable base for a genuinely inclusive society

[1] *Our Europe; Sharing the Future in a Community of Values, The Priorities of the Greek Presidency 2003*, (December 2002), http://www.eu2003.gr//multimedia/pdf/2002_12/267.pdf

Economic reform: a larger priority in a larger EU

A number of reasons contributing to the urgency of economic reform...

2.3 Several factors contribute to the urgency of the economic reform programme:

- **global economic and political uncertainty** make the creation of a stronger, more resilient and more dynamic Europe all the more important. As noted in the Commission's 2003 Spring Report, *"the vulnerability of our economy to external conditions reinforces the case for accelerating the pace of change"*;[2]
- **demographics** point to an ageing, smaller EU workforce and a rising proportion of post-working age citizens. This has significant implications for growth, consumer tastes, housing needs and expenditure on pensions and healthcare, and necessitates long-term reform to boost productivity and/or raise employment (by increased participation in the labour force, a higher effective retirement age or appropriate migration);
- **EMU**: a successful single currency within a successful single market is of benefit to Europe. To be successful in EMU, countries need even more flexibility to adjust to change and to unexpected economic events, since the ability to vary interest rates and exchange rates within the euro area no longer exists. This applies to existing EMU members and to countries which may join EMU in the future, including the new Member States. EMU membership puts a premium on ongoing reform of EU labour, product and capital markets, delivered through the Lisbon agenda. The Government will continue to argue that employability, flexibility and stronger competition policies must be a top priority, so that EMU can be a sustained success; and
- **the Doha Development Agenda of the World Trade Organisation**, launched in November 2001, and including negotiations on agriculture, services, non-agricultural goods, WTO rules and regional agreements, investment, competition and government procurement; and
- **EU enlargement**. The EU looks forward to signing a new Treaty on 16 April 2003, and welcoming ten new Member States as of 1 May 2004[3]; a substantial enlargement which constitutes a particularly pressing driver of change, as is discussed in more detail in what follows.

...and in particular, enlargement

2.4 The Copenhagen European Council of December 2002 paved the way for an EU of 25 members in 2004, taking the Single Market from its current 378.5m[4] citizens to 453m (thereby overtaking the 423 million of the North American Free Trade Area). This expansion creates considerable opportunities in terms of both supply, as the accession countries become fully integrated in the EU, and demand, as their income levels rise towards EU15 levels.

Opportunities for both new and incumbent Member States

2.5 As well as generating opportunities, however, enlargement also poses challenges to established patterns of production, employment, finance, consumption and trade. Realising the full potential of an expanded EU will demand considerable effort on the part of all Member States. As Chart 2.1 illustrates – though aggregate data conceal substantial national variations – the 10 new Member States (New MS) are structured somewhat differently from the incumbents; agriculture and industry account for a greater share of output and, in particular, of employment. GDP per head in the new Member States was, in 2001, 45 per cent of that in the EU15, ranging from 33 per cent in Latvia to 77 per cent in Cyprus.[5]

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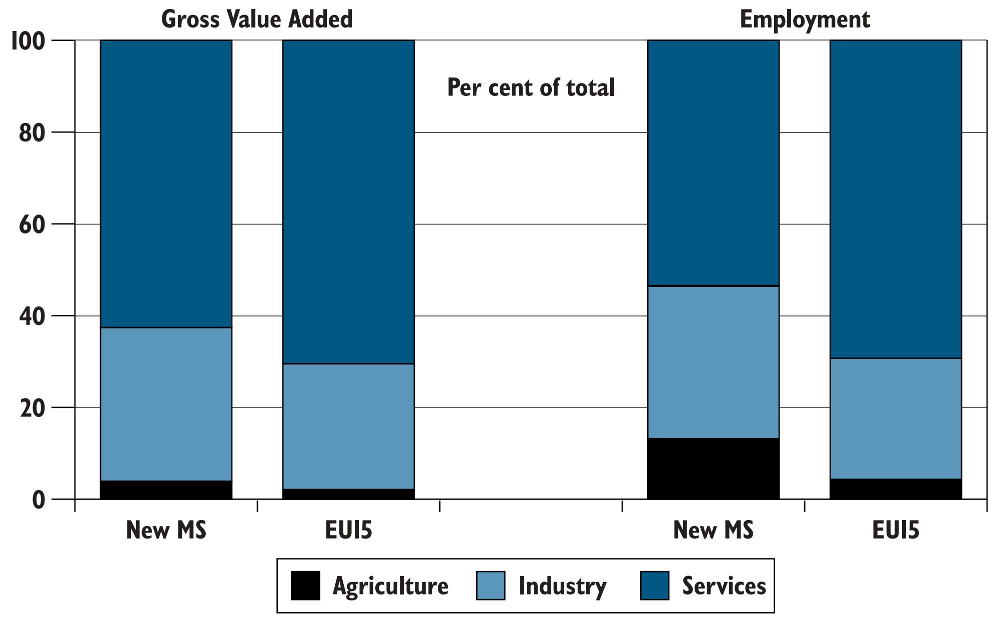
[2] *Choosing to grow; Knowledge, innovation and jobs in a cohesive society*, Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal. European Commission COM (2003) 5 final

[3] Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia.

[4] First estimates for EU and new Member States as of 1 January 2003, Eurostat

[5] The GDP of the Candidate countries, Statistics in focus, Theme 2 - 59/2002, Eurostat

Chart 2.1: Sector share in gross value added and employment, 2001



Source: Eurostat

2.6 To meet the challenges and realise the opportunities of enlargement, it is vital that both the current and new Member States are able to respond quickly and smoothly to changes in competitive pressure and comparative advantage. Ongoing reform is vital if such adjustment is to be achieved at minimum economic and social cost.

The structural challenge

2.7 EU entry alone is not sufficient to ensure economic convergence of the accession countries with the EU15. Without further addressing the need for fiscal discipline and structural reform, not only will the new Member States be disappointed in their economic ambitions, but current Member States will miss the opportunity to benefit from a more dynamic and competitive internal market.

2.8 The new Member States have, to date, been guided primarily by the Copenhagen criteria of *"establishing a functioning market economy and having the capacity to withstand competitive pressure and market forces within the Union"*. Reform has been impressive, and has included the privatisation of state-owned companies, trade and price liberalisation, and changes to institutional and legal systems to raise the standards of financial discipline and corporate governance and to allow market mechanisms to operate efficiently.

Enlargement and the Lisbon agenda

2.9 Substantial challenges now lie ahead with respect to raising both employment rates and productivity. The Economic Policy Committee's Annual Report (2002) on Structural Reforms noted that the *"continuation and acceleration of the structural reform process – interacting with growth and stability orientated macroeconomic policies – is necessary to facilitate economic recovery as well as further improvements in the economic performance of Member States"*.[6] This is no less true, and is if anything still more important, for the new Member States which will soon be full participants in the Lisbon process. The Lisbon programme is already being put into effect in many accession countries through their Pre-Accession Economic Programmes, and follows naturally from the economic reforms undertaken since 1989.

[6] *Annual Report on Structural Reforms 2002*, Economic Policy Committee (March 2002)

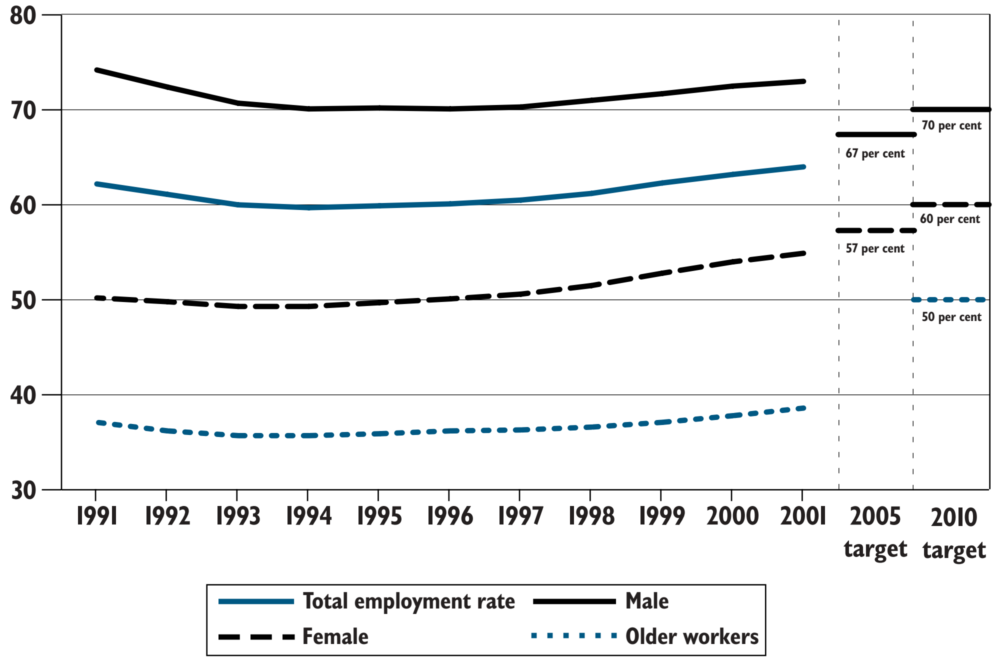
2.10 The benchmarking and peer review intrinsic to the open method of coordination enable the rapid dissemination of best practice across national borders.[7] This flexible and cooperative approach to policy-making is particularly appropriate in the context of an enlarged and even more diverse EU. The shared policy challenge for all Member States, new or incumbent, is to equip individuals to adapt as their economic environment changes, enabling all to benefit from the increased prosperity that results from a more efficient allocation of resources in an EU25.

The performance gap

The gap with EU aspirations

2.11 Lisbon aspired to an economy which would be the most dynamic and competitive in the world, while retaining its social cohesion. To this end, quantified targets have been agreed for a range of measures (Box 2.1), among the most important of which are targets for total, female and older workers' **employment**. Chart 2.2 shows the 2010 targets for each of these groups in the context of the actual performance of the past decade.

Chart 2.2: EU employment rates, 1991-2001



Source: Eurostat

[7] The 'open method of coordination' combines EU-level agreement on guidelines and objectives, with national determination of the policies most appropriate to realise these objectives. Quantitative and qualitative indicators and benchmarks are used to compare best practice, and mutual learning facilitated by periodic monitoring, evaluation and peer review. See para.37 of the Presidency Conclusions of the Lisbon European Council, at http://ue.eu.int/Newsroom/LoadDoc.asp?BID=76&DID=60917&from=&LANG=1

Box 2.1 Key Lisbon targets and objectives

The Lisbon strategy entails a variety of targets and objectives, agreed not only at the Lisbon Council itself (March 2000), but also at Stockholm (March 2001), Göteborg (June 2001) and Barcelona (March 2002). Not all are **quantified** or **time-specific**, but those which are include:

Employment:

- an overall employment rate of 67 per cent in 2005 (Stockholm) and 70 per cent in 2010 (Lisbon);
- a female employment rate of 57 per cent in 2005 (Stockholm) and 60 per cent in 2010 (Lisbon);
- an employment rate for workers aged 55-64 of 50 per cent in 2010 (Stockholm);
- an increase of 5 years by 2010 in the average effective retirement age (Barcelona); and
- available childcare by 2010 for 90 per cent of pre-school children over three, and 33 per cent of children under three (Barcelona).

Research and innovation:

- R&D spending of 3 per cent of GDP by 2010, with two thirds of the total coming from business (Barcelona); and
- 100 per cent of schools to be connected to the Internet by 2002.[1]

The Single Market:

- full implementation of the Risk Capital Action Plan by 2003, and of the Financial Services Action Plan by 2005 (Lisbon);
- a transposition rate into national law for Internal Market directives of 98.5 per cent (Stockholm);
- no Internal Market directives to be more than two years overdue in their transposition (Barcelona);
- open energy markets for business customers in 2004, and subsequently for domestic users (Barcelona);
- cross-border energy transmission capacity equal to at least 10 per cent of installed production capacity by 2005 (Barcelona); and
- a single European sky by 2004 (Barcelona).

Social cohesion:

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

Environment/sustainable development:

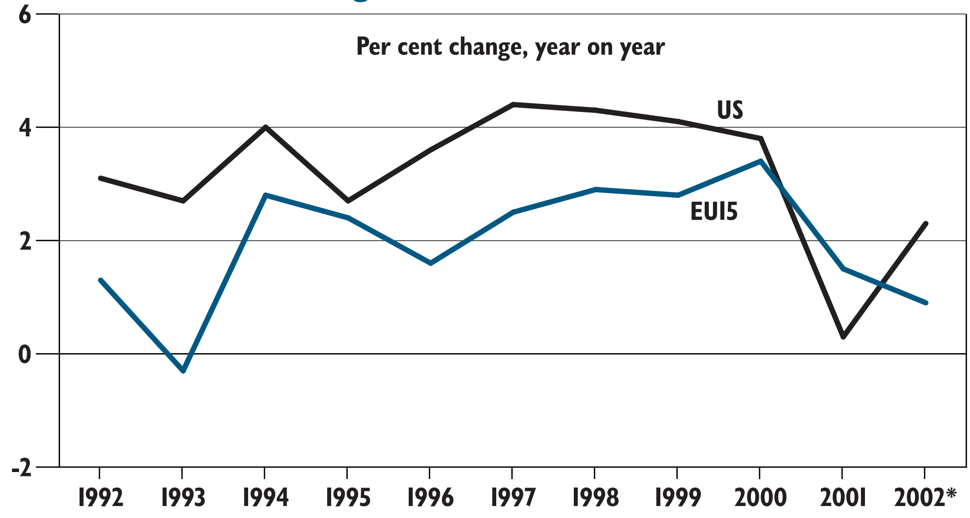
- visible progress on reducing greenhouse gas emissions by 2005 (Göteborg); and
- an indicative target for electricity generated from renewable sources of 22 per cent of gross electricity consumption in 2010 (Göteborg).

[1] 93 per cent in February 2002

The EU-US gap in GDP growth...

2.12 The Lisbon agenda entails benchmarking not only against the EU's own objectives, but also against the performance of the best in the world; in particular (though not solely) the US. As Chart 2.3 shows, the growth of the EU economy has surpassed that of the US in only one of the past ten years – 2001, when US growth decelerated in a context of weak and volatile financial markets and in the wake of the events of 11 September 2001.

Chart 2.3: Real GDP growth, EU and US



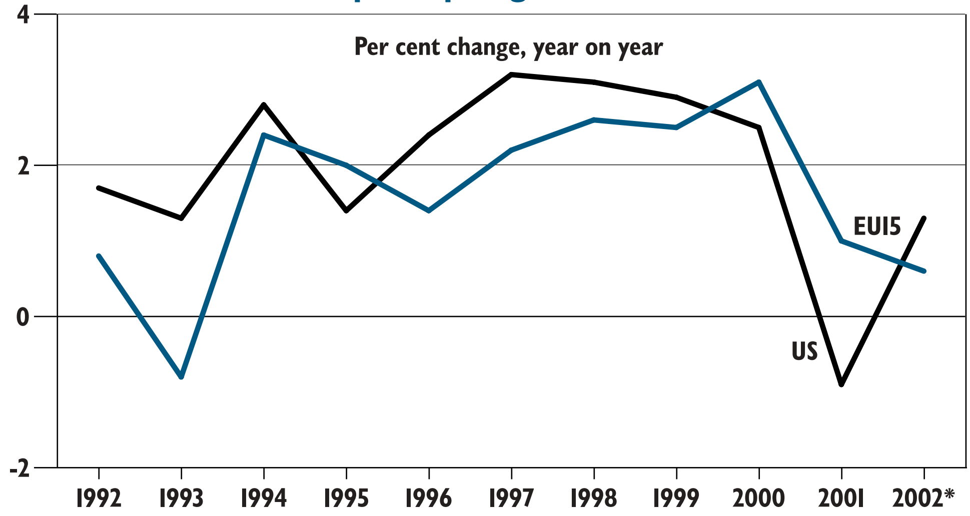
**Estimate*

Source: Eurostat

...in GDP per capita...

2.13 Some of this growth gap reflects the faster expansion of the working age population in the US. Even had the EU and US productivity and employment performances been identical, EU GDP would have expanded more slowly than US over the past decade due to the latter's faster labour force growth. In terms of **GDP per capita**[8] rather than GDP growth, the transatlantic difference is smaller though still evident (Chart 2.4).

Chart 2.4: Real GDP per capita growth, EU and US



**Estimate*

Source: Eurostat

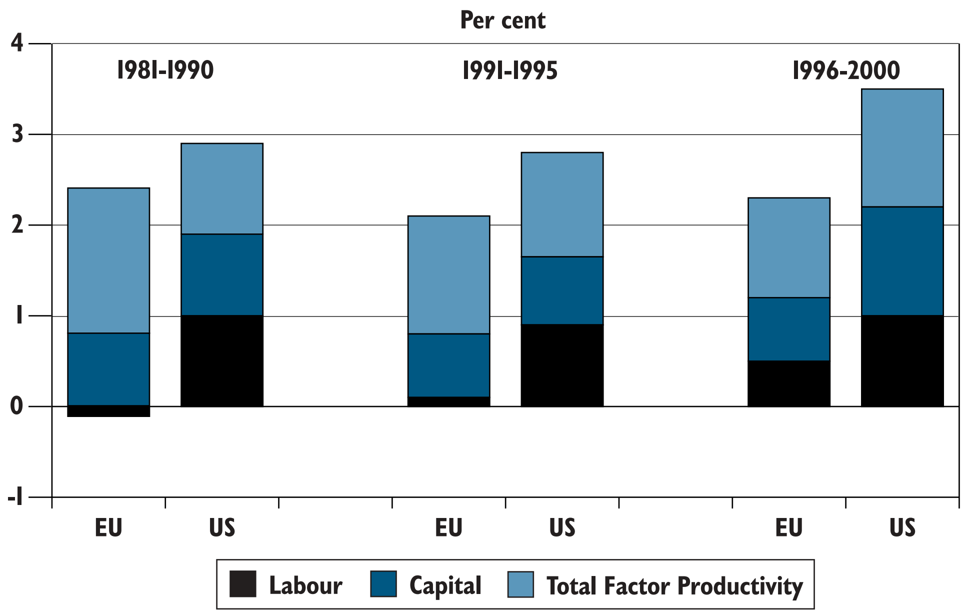
[8] GDP per capita growth comparisons avoid distortions caused by differential population growth rates, but not by shifts in the relative shares of the working age population in the total population.

...and in trend growth

2.14 Actual GDP growth in any one year may exceed or fall short of **potential or trend growth** – the economic growth rate which is sustainable over the long term without creating inflationary pressures. This trend growth rate can be thought of in two ways: as the sum of labour input, capital input, and total factor productivity (TFP) – the efficiency with which these inputs are used; or as the sum of potential employment growth and the growth rate of labour productivity (this latter, itself a function of technology and social institutions).

2.15 Chart 2.5, drawing on a recent paper from the Commission,[9] takes the first approach and describes trend growth during the 1980s and 1990s in terms of its labour (adjusted for changes in hours worked), capital, and TFP components. The acceleration in US potential growth in the latter half of the 1990s was driven primarily by both capital formation and TFP growth. EU potential growth, in contrast, showed little change, the boost from a rising labour contribution being largely offset by a declining contribution from TFP (a relative weakness which underlines the importance of efforts to make EU markets work more efficiently, and to encourage EU innovation, entrepreneurship and competition).

Chart 2.5: EU and US potential growth (labour*, capital and TFP contribution)



**including change in hours worked*

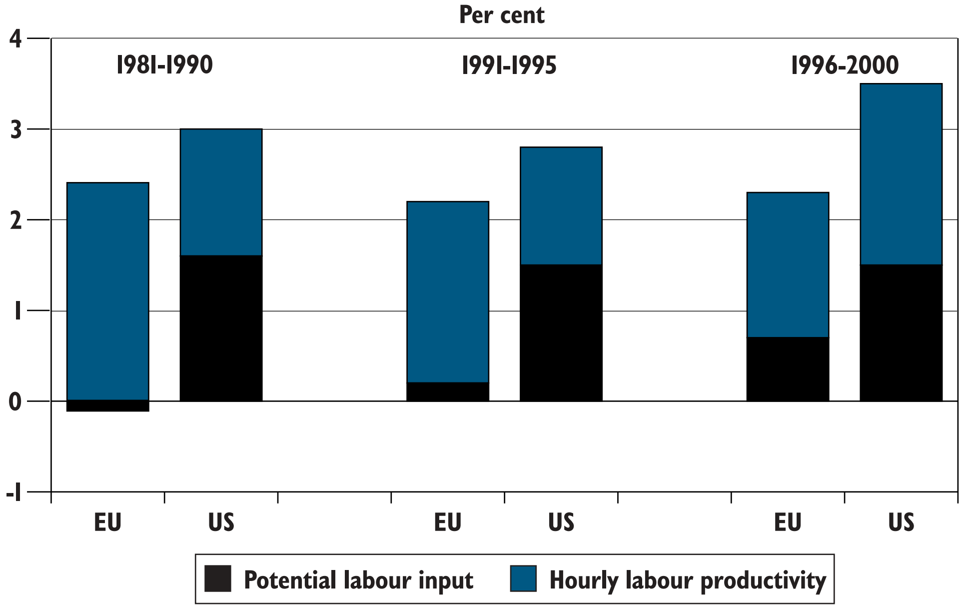
Source: McMorrow et al, DG ECFIN Economic Paper No. 176 (Sept 2002)

2.16 Chart 2.6 describes EU and US trend growth rates over the same period, but now in terms of its **potential labour supply**[10] and **labour productivity** components. The benefit derived by the US throughout the 1980s and 1990s from strong labour supply growth is clear. Also evident, however, is the extent to which recent US out-performance reflected accelerating labour productivity, even as the contribution of labour productivity to EU potential growth declined.

[9] *Production function approach to calculating potential growth and output gaps* – estimates for the EU Member States and the US, C.Denis, K.McMorrow, W.Röger, Economic Papers No.176 (September 2002), Directorate General for Economic and Financial Affairs, European Commission

[10] A function of the population of working age, the participation rate, hours worked and the non-accelerating inflation rate of unemployment.

Chart 2.6: EU and US potential growth (potential employment change* and hourly productivity)



**Potential labour input in hours*

Source: McMorrow et al, DG ECFIN Economic Paper No. 176 (Sept 2002)

Realising and raising trend growth

2.17 An EU aspiring to greater economic and social dynamism faces, therefore, two challenges: realising actual economic growth which is consistently closer to the potential growth rate, and boosting the potential economic growth rate to the benefit of all of its citizens. This **dual challenge** demands itself a **dual response**: higher productivity growth, and higher employment growth.

Raising productivity...

A statistical heath warning

2.18 Gauging a country's productivity performance over time is difficult; comparing productivity across different countries even more so. As Box 2.2 shows, **different methodologies can paint very different productivity pictures** and the Government's usual measure is that of the Office of National Statistics (ONS). As, however, the ONS does not publish data for all EU Member States, the Chart 2.7 necessarily draws on Eurostat data.

GDP per person employed

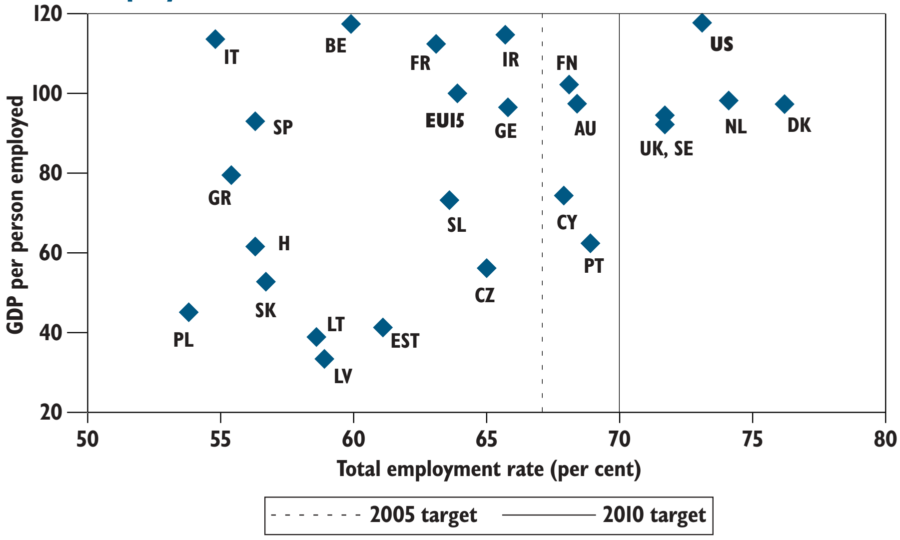
2.19 The chart provides a snapshot of Eurostat estimates of GDP per person employed (in terms of PPS1[11]) and employment[12] in 2001. US GDP per worker was, on Eurostat estimates, some 17 per cent greater than its EU15 counterpart. Some Member States such as Belgium, Italy, France and Ireland could perhaps claim productivity levels comparable to the US, but not employment (and ONS data would suggest a larger US productivity advantage over France in particular, than indicated by Eurostat[13]). Productivity in the new Member States, while having improved markedly in recent years, remains below the EU average and varies substantially.

[11] Purchasing Power Standards; a fictive currency 'unit' that eliminates differences in purchasing power, i.e. different price levels, between countries, and fixed such that the average purchasing power of one euro in the EU equals one PPS. Figures expressed in PPS are derived from national currencies by using Purchasing Power Parities (PPP) as conversion factors. PPPs are obtained as a weighted average of relative price ratios with respect to a homogeneous basket of goods and services. For more detail, see
http://europa.eu.int/comm/eurostat/newcronos/info/notmeth/en/theme1/strind/ecoref_rp_sm.htm

[12] The working age employed as a percentage of the working age population

[13] ONS figures for output per worker in 2001 (UK=100) put France at 115.3 and the US at 137.5. See http://www.statistics.gov.uk/cci/nugget.asp?id=160

Chart 2.7: GDP per person employed (EU15=100) and employment rate, 2001



Luxembourg excluded for reasons of scale: GDP per person employed (2001), 192.5; employment rate (2000) 62.7 per cent.

Sources: GDP per employee, Eurostat; employment rates, European Commission 'Employment in Europe 2002' except for US (OECD Employment Outlook, July 2002)

Box 2.2 International comparisons of productivity

Different methodologies can paint very different pictures of comparative productivity.[1] The Government's usual measure is that produced by the Office of National Statistics (ONS)[2]. As, however, ONS productivity data are available for only a few Member States, the analysis in this document necessarily draws heavily on Eurostat data.

As Table 2.1 illustrates with reference to GDP per worker and GDP per hour worked in 2001, the differences between alternative data sources can be substantial.

In terms of GDP per worker, both ONS and Eurostat find productivity to be higher in the US than in the UK, Germany or France. The ONS series, however, points to a larger US productivity advantage in each case.

In terms of GDP per hour worked, the US productivity advantage shrinks but, on ONS estimates, remains in the US's favour. The Eurostat series, however, suggests that US is performance is exceeded by both Germany and France.

Table 2.1 Productivity comparisons, 2001 (US=100)

	US	UK	Ger	Fra
GDP per worker				
• ONS	100.0	72.7	79.1	83.9
• Eurostat	100.0	80.1	81.9	95.4
GDP per worker hour				
• ONS	100.0	77.4	98.2	99.7
• Eurostat	100.0	85.4	101.7	113.5

Sources: ONS, Eurostat

[1] For discussion of different methodologies and estimates, see '*International Comparisons of Productivity*', Craig Richardson, Economic Trends 577, December 2001, ONS

[2] Following a detailed investigation by the ONS, improvements have been made to the methodology used for the International Comparisons of Productivity. The comparisons are now consistent, and based solely on comparable OECD data, and the output per worker series now has the National Statistics 'kitemark' of quality. (The output per hour series is marked 'experimental', and will remain so until ONS are satisfied that OECD hours worked data are sufficiently comparable.)

GDP per hour worked

2.20 Part of the US's high level of GDP per person employed reflects the relatively high number of hours worked by US employees. Data on **GDP per hour worked** are, however, particularly open to interpretation and inaccuracy owing to the difficulty of finding a reliable and internationally comparable measure of hours worked.

2.21 Eurostat data show that the hours worked total is higher in the US than in most Member States; a function not only of weekly hours and holiday entitlements in comparable jobs, but also of the high proportion of part-time employment in some Member States, e.g. the Netherlands. As Box 2.1 shows, the EU-US productivity gap, while still in the US's favour, is smaller than was the case in terms of output per employee. However alternative methodologies suggest that it may not be quite as small as Eurostat indicates.

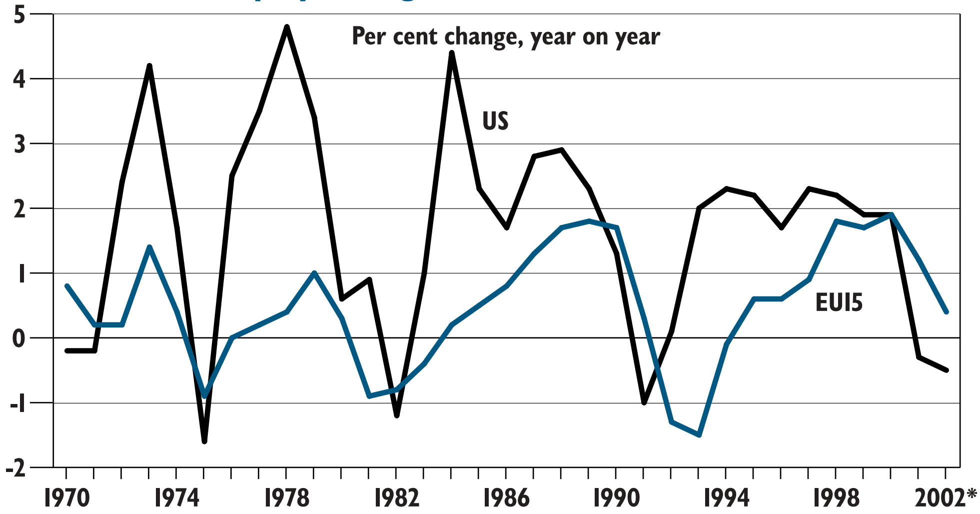
2.22 Caution must, therefore, be exercised in all international comparisons of productivity. What is clear, however, is that it is the combination of **high productivity and high employment** – and not just either in isolation, or any particular level of individual hours worked – which sets the goal for the EU. Lessons can be learned in this context not only from the US, but also from high performing Member States such as Denmark and the Netherlands.

2.23 The EU will not achieve its productivity and employment objectives – and hence the economic, social and environmental goals set out in the Lisbon agenda – unless every country and region within it is able to realise its full potential. This demands a clear focus on **tackling the barriers and market failures** which constrain national and regional performance, and becomes particularly important in the context of an enlarged EU. Delivering the Lisbon goals means delivering results to **all EU citizens** across **all of the EU's regions**.

...and raising employment

2.24 A goal of higher productivity goes hand-in-hand, in the Lisbon reform programme, with one of higher employment – of *'more and better jobs'*.[14] As Chart 2.8 illustrates, employment growth in the EU15 has consistently lagged that of the US except during years marked by a sharp US downturn.

Chart 2.8: Employment growth rates, EU and US



**Estimate*

Source: Eurostat

Lisbon's ten year goal; a 70 per cent employment rate overall...

2.25 Once again, however, demographic differences must be kept in mind. Employment growth may be faster in one country than in another, simply because working age population growth is faster in the former. A better comparison is between employment rates – the percentage of the working age population which is actually in work. As noted above, the 2000 Lisbon Council agreed a specific ten year target for the **EU employment rate** of **70 per cent**.

2.26 That the EU remains some way short of a 70 per cent employment rate, is scarcely surprising in the context of a programme with seven years still to run. There are, however, only two years in which to meet the interim target (agreed at Stockholm in 2001) of **67 per cent** by **January 2005**, and in a less than helpful economic environment. As recognised in the Commission's 2003 Spring Report, additional efforts are required if the EU is not to miss its 2005 employment target.[15]

a 60 per cent employment rate for women;

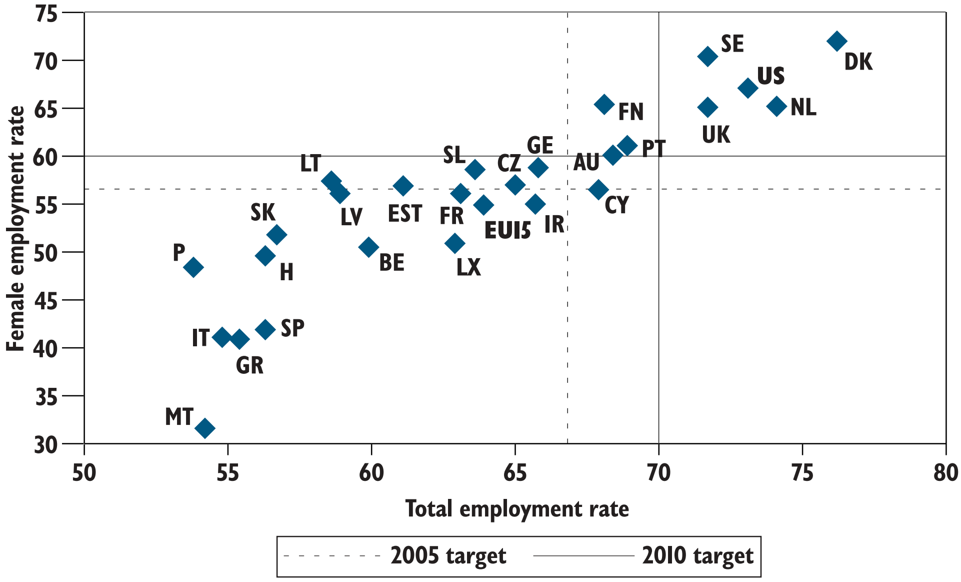
2.27 Lisbon also recognised the particular importance of boosting employment opportunity for women, and therefore set an additional target for the **female employment rate** of **'more than 60 per cent' by 2010**. This was supplemented, at Stockholm, by an interim target of **57 per cent** by **January 2005**.

[14] Presidency Conclusions, Lisbon European Council (23-24 March 2000)

[15] *Choosing to grow; Knowledge, innovation and jobs in a cohesive society*, Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal. European Commission COM (2003) 5 final

2.28 Chart 2.9 shows both total and female employment rates for new and incumbent Member States, and for the EU15 and the US. While some individual Member States have very high rates of female employment, the performance of the EU15 as a whole remains disappointing. Most new Member States (bar Cyprus and the Czech Republic) have total employment rates which are below the EU15 average. Six of the ten, however, are above the EU15 average in terms of female employment, and nine outperform several EU15 incumbents.

Chart 2.9: Total and female employment rates, 2001



Sources: European Commission 'Employment in Europe 2002', except for US (OECD Employment Outlook, July 2002)

2.29 Clearly, such a chart says nothing about the type of work undertaken, the status and income it carries, or the extent to which it is full-time, part-time, permanent, fixed term or agency. Over 33 per cent of employed women work part-time in the EU, compared with just over 6 per cent of employed men.[16] Gender pay gaps remain all too evident; in the UK, for example, average hourly full-time earnings for women in 2002 were 81 per cent of men's, reflecting differences not only in pay levels per se, but also in the mix of occupations, job tenure etc.[17] The EU 2002 Employment Guidelines urge Member States to adopt a 'multi-faceted' strategy to tackling the gender pay gap by reviewing job classification and pay systems; improving statistical and monitoring systems; raising awareness, and improving transparency.

2.30 The quality of employment, the hours worked and the rewards gained can vary substantially between countries with equivalent employment rates. Nevertheless, the employment gap between the EU15 and the US, especially in terms of female employment, points to a substantial economic and social cost to the EU. Employment is not solely a matter of income; it also carries immense social benefits. As recognised at Lisbon, the best safeguard against social exclusion is a job. Chart 2.9 suggests that the EU has some way to go if it is to meet the needs of all of its citizens.

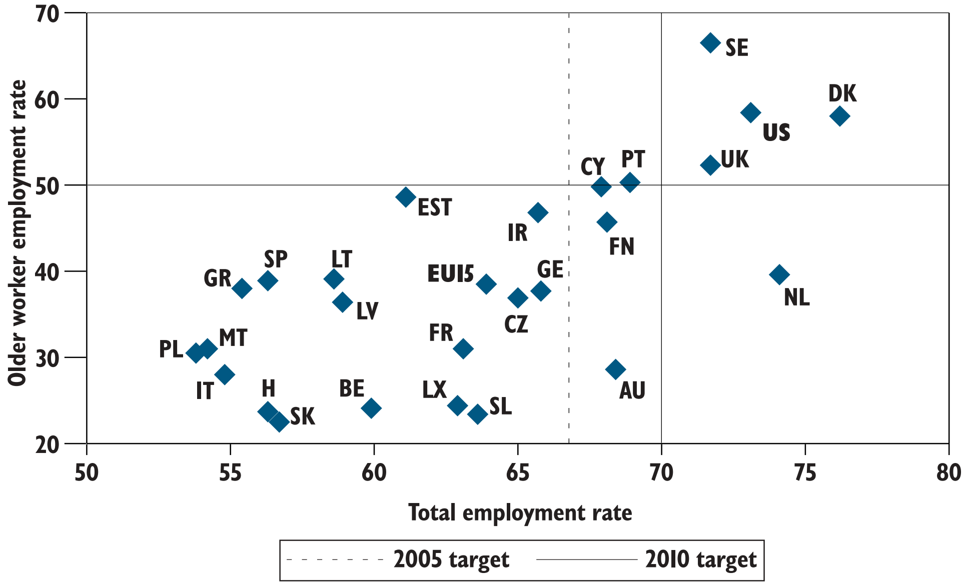
[16] *Employment in Europe 2002*, European Commission

[17] National Statistics; see http://www.statistics.gov.uk/CCI/nugget.asp?ID=167

and a 50 per cent employment rate for older workers

2.31 Employment among **older workers** also comes under the Lisbon spotlight, the Stockholm Council having agreed a 50 per cent employment target for 2010. As Chart 2.10 suggests, this is an ambitious objective. While employment growth in this age group has recently picked up to almost 2 per cent,[18] this pace is not yet sufficient to meet the 2010 goal, underlining the need for further reform.

Chart 2.10: Total and older worker employment rates, 2001



Sources: European Commission 'Employment in Europe 2002', except for US (OECD Employment Outlook, July 2002)

2.32 Employment rates decline sharply in the decade leading up to statutory or 'normal' retirement age. The average effective EU retirement age in 2001 was 59.9 years, but this conceals substantial national variations. In Belgium and Luxembourg, for example, only a quarter of people aged 55-64 remain employed; a sharp contrast, as Chart 2.10 shows, not only with Sweden and Denmark, but also with some new Member States (e.g. Estonia) and with the US. As the chart also illustrates, some countries with relatively high overall employment rates, such as the Netherlands and Austria, nevertheless perform poorly in terms of older workers.

2.33 In an EU context of **ageing populations, contracting workforces, pressure on pensions systems and longer and healthier life-spans**, reversing the hitherto declining effective retirement age, and maintaining access to the social and economic interactions of the workplace throughout the working life, is important for both the individual and society.[19]

[18] Employment rate growth for the 55-64 age group was 0.83 per cent in 1997-1998, 1.34 per cent in 1998-1999, 1.89 per cent in 1999-2000 and 1.85 per cent in 2000-2001. *Source: European Commission, Supporting Document to the Joint Employment Report 2002* [COM(2002)621 final]

[19] For detailed discussion of the fiscal consequences of long term economic and demographic developments, see the *Long-term public finance report; an analysis of fiscal sustainability*, HM Treasury (November 2002)

Enlargement and the employment targets

2.34 The Lisbon agenda employment targets, framed in the context of an EU15, will represent also the aspirations of an EU25. As the Commission's Spring Report[20] notes, *'Enlargement does not...require a wholesale rewriting of the Lisbon strategy or the relaxation of its key targets – those are targets for the whole of the Union rather than for individual countries.'* While the incorporation of the ten new Member States will reduce the EU25 employment rate relative to that of the EU15, the impact will be relatively modest due to the new entrants' combined working-age population being only a fifth of that of the EU15[21]. Table 2.2 shows EU15 and EU25 employment rates in 2001, relative to all three 2010 targets.

Table 2.2: Employment Rates for EU15 and EU25, 2001 (per cent)

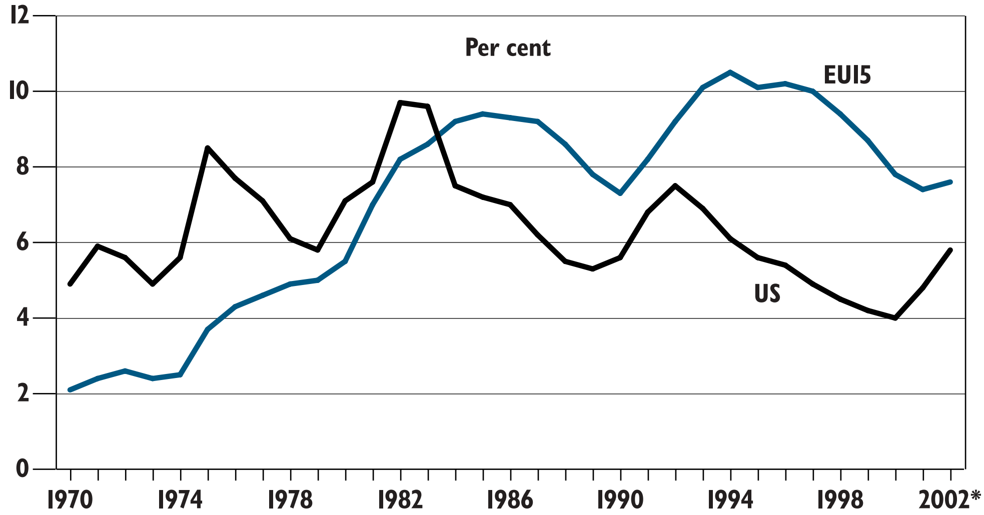
	Total aged 15-64	Women aged 15-64	Older workers aged 55-64
EU15	63.8	54.7	38.2
10 New Member States	56.8	51.1	31.0
EU25	62.6	54.1	37.2
2010 Targets	*Close to 70.0*	*More than 60.0*	*50.0*

Source: Eurostat; Employment in Europe 2002, European Commission

Unemployment; not targeted, but not overlooked

2.35 That Lisbon targets **higher employment** rather than **lower unemployment**, does not imply that the latter is somehow unimportant. As Chart 2.11 illustrates, unemployment was uncomfortably high through much of the 1990s and, while it has fallen in recent years, remains of ongoing concern in many Member States.

Chart 2.11: Unemployment rate, EU and US



**Estimate*

Source: Eurostat

2.36 The decision to target employment rather than unemployment signalled that the focus was to be on creating jobs rather than on reshuffling the composition of the non-employed. Around **77 million** working-age adults are estimated to be **inactive** in the EU; almost a third of the working-age population.[22] Even excluding the 15-19 year old age group, many of whom are in education or training, this still leaves **53 million**.

[20] *Choosing to grow; Knowledge, innovation and jobs in a cohesive society,* Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal. European Commission COM (2003) 5 final

[21] Over half of the combined working-age population of the new Member States is accounted for by Poland.

[22] 2001 data; *Increasing labour force participation and promoting active ageing*, Report from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions (January 2002) COM(2002) 9 final

2.37 The unemployed – 13.8 million in the EU, at the end of 2002[23] – comprise only a fraction of this total. Others may have been discouraged from seeking work, be ineligible for unemployment benefit, or be recipients of other types of benefit. In the 1980s and early 1990s, for example, macroeconomic instability proved deeply damaging to the UK labour market. Many unemployed people drifted into economic inactivity, often on disability-related benefits, and never returned to work even as the economy recovered and the registered unemployment total declined.

UK experience

2.38 A target framed in terms of the unemployment rate might be met if, for example, those on the jobless register simply switched to other types of benefit.[24] Achieving the economic and social benefits of greater employment and reduced inactivity is a much greater challenge. Since 1997, the UK Government has pursued a reform strategy that involves maintaining macroeconomic stability; investing in education; Welfare to Work policies, that help the unemployed achieve a successful return to work; further help and support for the most disadvantaged areas and groups; and improved work incentives. Only by such comprehensive reform efforts can the Government's domestic goal of ensuring a higher proportion of people in work than ever before by 2010,[25] be achieved; and only by similarly comprehensive reforms, tailored to national circumstances, will the more dynamic and socially inclusive Europe envisaged at Lisbon be realised.

Maintaining credibility

2.39 Lisbon agreed a set of objectives which were highly ambitious and widely publicised. As discussed in Section 3, the period since then has seen both major successes and some setbacks. The latter, naturally, tend to have the greater impact on public perceptions of the EU and its policy-makers.

2.40 It is important that, a third of the way into the Lisbon decade, the benefits already gained from economic reform should not be overlooked or forgotten. The momentum of reform must neither slip nor be perceived as slipping. Such a development would damage the EU in the eyes of voters, investors, businesses and governments; and as public expectations of what was likely to be achieved on economic reform were scaled back, so the pressure on Member States to meet those expectations would itself weaken, making further disappointment more likely.

2.41 Avoiding such a cycle of cynicism and underperformance demands that **reform be implemented, that it be seen to be implemented, and that it produce results**. As highlighted by the Commission in its 2003 Spring Report: *'the credibility of the Lisbon reforms depends most on transforming policy declarations into action, allowing Member States to be judged by what they do and not just by what they say'*.[26]

2.42 Maintaining the credibility of the Lisbon agenda becomes more important with each successive year; not least, at a time of slow economic growth and after a period when several Member States have seen changes of government. It is vital that EU leaders regularly and publicly **reaffirm their commitment** to the Lisbon objectives, both at the annual Spring European Council and through national policy decisions throughout the year.

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[23] Eurostat

[24] While registered unemployment would fall in this scenario (if only temporarily), employment would remain unchanged and the participation rate (the employed plus the officially unemployed) would decline. The individuals affected by the shift in benefits, having officially withdrawn from the labour force, would risk finding it all the more difficult subsequently to obtain employment.

[25] See Section 4 of the *Pre-Budget Report*, November 2002, HM Treasury Cm 5664

[26] *Choosing to grow; Knowledge, innovation and jobs in a cohesive society*, Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal. European Commission COM (2003) 5 final

Delivering results

Delivering results, not processes

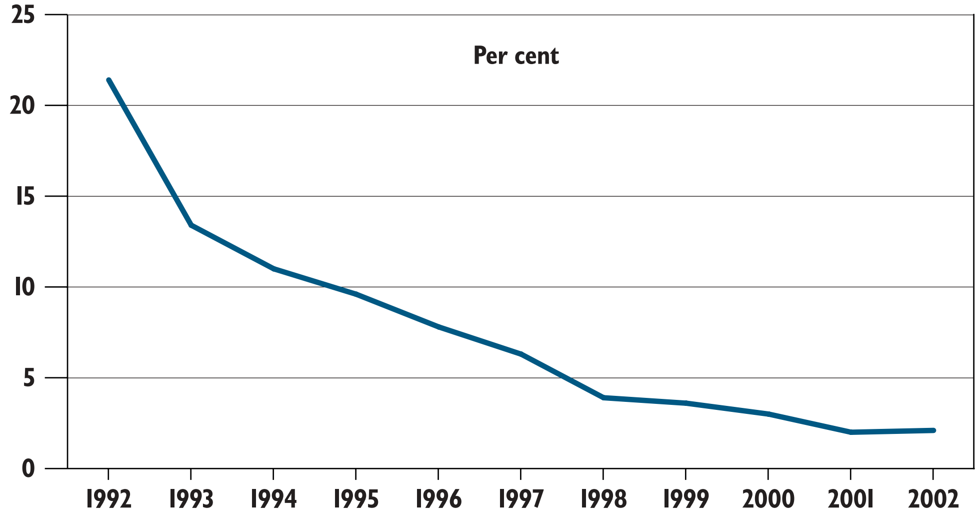
2.43 Europe's economic reform efforts must focus on **results**; on boosting employment and on raising productivity. Again, the Commission's latest Spring Report does not mince its words; '*The greatest risk – in contrast to last year's European Council at Barcelona – is not the lack of decisions at a European level, but the failure by Member States to ensure that agreed rules and new policies are effectively implemented and applied. This means that in key areas the Union has yet to unleash the full potential of the internal market. Each Member State must do much more to ensure that agreed measures are implemented properly and on time*'[27]

2.44 Policy necessarily requires processes. The latter must, however, fit the former, and not vice versa. The Government welcomes the steps initiated at Barcelona (March 2001) and agreed at Copenhagen (December 2002) to **streamline** the EU's reform processes with the aim of avoiding overlap, increasing effectiveness and giving greater weight to **effective implementation and evaluation**.

Implementing what is agreed

2.45 To ensure that the Single Market exists in practice as well as in theory, Internal Market legislation – an important part of the picture – must be not only agreed, but implemented. The average transposition deficit (the percentage of EU law not yet implemented) has declined sharply from the 20 per cent levels of a decade ago (Chart 2.12). Nevertheless, even a 2 per cent rate is no cause for satisfaction,[28] especially given the simultaneous increase in infringement proceedings.[29] The average delay phase nearly doubles the total time required for adoption and legal transposition.[30]

Chart 2.12: Transposition deficit* (November each year)



**Percentage of EU law not yet implemented*

Source: Internal Market Scoreboard No. 11, November 2002

[27] *Choosing to grow; Knowledge, innovation and jobs in a cohesive society*, Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal. European Commission COM (2003) 5 final

[28] The Stockholm European Council set a target transposition rate of 98.5 per cent of all Internal Market Directives; Barcelona targeted zero tolerance of measures which were more than two years overdue – a target met in November 2002 only by Finland. See *Choosing to grow; Knowledge, innovation and jobs in a cohesive society*, Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal. European Commission COM (2003) 5 final

[29] Legal proceedings launched by the Commission against a Member State where EU law is incorrectly transposed or applied; these rose from just under 700 in 1992, to over 1500 in 2002. See *The Internal Market – Ten Years Without Frontiers*, European Commission

[30] The average time for adoption and legal transposition of Internal Market directives between 1993 and April 2002 was 2.28 years; transposition problems beyond the due deadline extended this by an average 2.21 years. *Economic Reform: report on the functioning of community product and capital markets*, Report from the Commission, COM (2002) 743 final (December 2002)

A Greek Presidential priority

2.46 The emphasis placed by the Greek Presidency to delivery and results is to be strongly welcomed. The Presidency programme notes that *'the Lisbon Process has achieved its initial goal of mobilising and supporting Europe's efforts towards economic and social reform…but there is still an implementation deficit in a number of areas'*[31] The six economic reform areas highlighted by the Greek Presidency – and supported by the UK government – are described in Box 2.3.

Box 2.3 Greece EU Presidency Priorities, January-June 2003

The Greek Presidency's focus on the Lisbon reform agenda is to be strongly welcomed. Six key themes are highlighted as priorities: [1]

- **entrepreneurship and small businesses;**
- **the European knowledge economy;**
- **interconnecting Europe;**
- **more and better jobs;**
- **strengthening social cohesion; and**
- **safeguarding future prosperity through sustainability.**

[1] Our Europe; Sharing the Future in a Community of Value, The Priorities of the Greek Presidency 2003

The measure of success

2.47 Lisbon's success will be judged not by the **quantity of its processes**, but the **quality of its outcomes**. Adopting legislation is not sufficient to create a European single market; **implementation, monitoring and enforcement** are also required.

2.48 Furthermore, legislation may not always be the most **appropriate** tool for pursuing reform; and when it is, it should be pursued more efficiently and effectively than has occasionally been the case. In the words of the Dutch State Secretary for European Affairs, earlier this year, *'I know it took Europe ten years to decide upon the definition of chocolate, but that shouldn't set our standards'.*[32]

2.49 On some areas of the Lisbon agenda, substantial progress has already been made; on others, the improvement is less marked and, in some cases, seriously lacking. Section 3 examines the track record to date and, in particular, over the past year.

[31] *Our Europe; Sharing the Future in a Community of Values, The Priorities of the Greek Presidency 2003*, (December 2002), http://www.eu2003.gr//multimedia/pdf/2002_12/267.pdf

[32] *Delivering the promises; creating a competitive Europe is now more important than ever*, Atzo Nicolai, State Secretary for European Affairs, Clingendael seminar on the Greek EU Presidency, The Hague, 14 January 2003

3 Progress Towards the Lisbon Goals

The annual Spring Council affords a valuable opportunity for a periodic stocktake of economic reform. It offers a chance to review what has been achieved; where the major challenges now lie; how well the processes are achieving the desired outcomes; and whether priorities have shifted.

Three years into the ten year Lisbon agenda, there are clear signs of success: on employment; regulation; competition in the cars market; research and innovation; communications; energy liberalisation; and public procurement. As emphasised by the Commission in its Spring Report, however, success can be no reason for complacency. The challenges which remain are, in some cases, even greater than those already met.

Meanwhile reform continues to progress on a range of issues: reducing structural unemployment; financial services; creating a single market for services; competition policy; state aid reform; public procurement; aviation; entrepreneurship; and sustainable environmental development. Results have, however, been slower to materialise in areas such as employment among older workers, takeovers legislation and a business-friendly Community patent.

INTRODUCTION

3.1 The Lisbon programme is now nearly a third of the way into its ten year plan. It would be unrealistic, at this stage, to expect every objective to have been met. Were this in fact to be the case, the objectives themselves would then merit serious criticism as having been extremely deficient in ambition.

3.2 A lack of ambition is certainly not something of which the EU leaders who met at Lisbon could be accused, aspiring as they did to an EU which, in the space of a decade, would become the world's most dynamic and competitive economy. The negotiation, implementation and evaluation of far-reaching economic reform takes time. Ten years is, if anything, a relatively short period during which to achieve such a transformation.

3.3 For this very reason, however, there is no time to waste. Section 2 outlined the importance to an enlarging EU of meeting its **employment** and **productivity** challenges. The annual Spring Council offers a valuable opportunity for a periodic stocktake; a chance to review what has been achieved; where the major challenges now lie; how well the processes are delivering the desired outcomes; and whether detailed policy priorities have shifted. Three years of reform effort should be sufficient to provide evidence of success in some areas, and of progress in all. This section explores the extent to which this is the case.

Varying degrees of progress

3.4 Table 3.1 summarises the key challenges on the European economic reform agenda. It highlights those areas where clear successes have been registered (though considerable challenges nevertheless remain); those which might be described as constituting work-in-progress; and those where reform efforts have, to date, delivered less than would have been hoped.

Table 3.1: Recent progress in key areas of the Lisbon agenda

Clear progress

- **Employment**
  The EU has created 5 million jobs since the beginning of 2000, taking the 2001 employment rate to 64.1 per cent (but see also 'limited progress' below).
- **EU regulatory environment**
  The Mandelkern Report (2001) paved the way for the Commission's Action Plan (June 2002) and potential major improvements in developing EU regulation.
- **Cars block exemption**
  New rules which became law in October 2002 will, from October 2003, allow dealers of new cars to market their services throughout the Single Market.
- **Research and innovation**
  The 6th Community Research Framework Programme has been adopted. Efforts continue towards establishing a European Area of Research and Innovation.
- **Communications**
  Adoption of the EC legislation forming the new regulatory framework for electronic communications, and a new e-Europe 2005 Action Plan.
- **Energy liberalisation**
  Member States have agreed to open fully electricity and gas markets to competition by 2007.

Work-in-progress

- **Unemployment**
  While job creation has been strong, the rate of unemployment remains unsatisfactorily high.
- **Financial services**
  31 of the Financial Services Action Plan's 42 measures are now completed but much remains to be done on implementation and enforcement.
- **Single market for the services sector**
  The Internal Market Strategy for Services has got off to a good start with a Commission report identifying intra-EU barriers to trade in services, though measures to tackle these have yet to be introduced.
- **Competition policy**
  Recent reforms such as the modernisation regulation are welcome but further effort is required to boost EU competition.
- **State aid reform**
  Member States have made a clear commitment to moving towards less and better state aid, with a policy focus on tackling market failure.
- **Public procurement**
  Political agreement reached on updating, clarifying and simplifying the public sector directives (May 2002) and the utilities directive (September 2002).
- **Aviation**
  Single Sky shows that real benefits can be delivered for consumers. Reform of slot allocation mechanisms now requires sustained effort.
- **Entrepreneurship**
  Ongoing work to create a friendlier environment for small and medium sized enterprises (SMEs), and a Green Paper on Entrepreneurship, leading perhaps to an Action Plan.
- **Sustainable development**
  Considerable progress at the World Summit on Sustainable Development in Johannesburg in August/September 2002.

Limited progress

- **Employment among older workers**
  While the employment rate of older workers (55-64) increased from 37.1 per cent in 1999 to 38.6 per cent in 2001, this is not yet on track to meet the 2010 target of 50 per cent, with large variations in Member State performance.
- **Takeovers**
  The latest draft of the Takeovers Directive may allow progress towards a more consistent EU approach to takeovers but agreement is proving difficult to reach.
- **Community patent**
  Despite the clear commitment of the Council to achieving a Community patent, negotiations have proceeded at a snail's pace; the EU remains a patchwork of inconsistency with respect to Intellectual Property Rights.

Clear progress

Employment

3.5 The European Employment Strategy, now five years old, has succeeded in focusing policy on creating jobs and increasing employability. In 1999, just prior to the launch of the Lisbon agenda, EU employment among the working-age population totalled 153.9 million. Two years later, this figure had risen to 158.7 million; an increase of almost **5 million new jobs,** resulting in a 2001 employment rate[1] of 64.1 per cent.[2]

3.6 As with all of the policy areas highlighted in Table 3.1, however, success should not encourage a sense of complacency. **The employment challenges still to be tackled are considerably greater than those already addressed.** As Table 3.2 illustrates, reaching the 2010 Lisbon employment target of 70 per cent requires, on the basis of the EU15 population in 2001, the creation of a further **15 million jobs**.[3]

3.7 Around six in ten of the jobs created during 2000 and 2001 went to women.[4] Female employment rose by **3 million** over the period to 68.2 million, pushing the employment rate up to **55 per cent**. Meeting the 60 per cent Lisbon goal for female employment would, on the basis of the 2001 population, require a further **6 million** jobs for women.

3.8 The **older workers employment rate** kept pace with the increase in overall employment, rising to **38.8 per cent** in 2001. While the trend has improved, employment among 55-64 year olds remains disappointing (as is discussed later in this section). Furthermore, given that demographic trends point to an expansion of this age group, meeting the 50 per cent target arguably represents an even greater challenge in terms of job creation than the 5 million suggested by Table 3.2.

Table 3.2: EU15 job creation 2000-2001, and jobs required to meet the Lisbon targets

	2000 emp. rate (per cent)	2001 emp. rate (per cent)	Jobs created in 2000 and 2001 (million)	2010 target (per cent)	Jobs required 2002-2010 (million)*
Total	63.4	64.1	4.8	70	15
Female	54.1	55.0	2.8	60	6
Older workers	37.8	38.8	0.7	50	5

** Estimated on basis of 2001 working age (15-64 years) population*

Source: Eurostat; Employment in Europe 2002, European Commission

[1] The percentage of the working age population (15-64 years) in employment. Not all jobs are taken by people within this age group. In 2001, for example, working age employment accounted for 158.7 million out of total employment of 167.6 million.

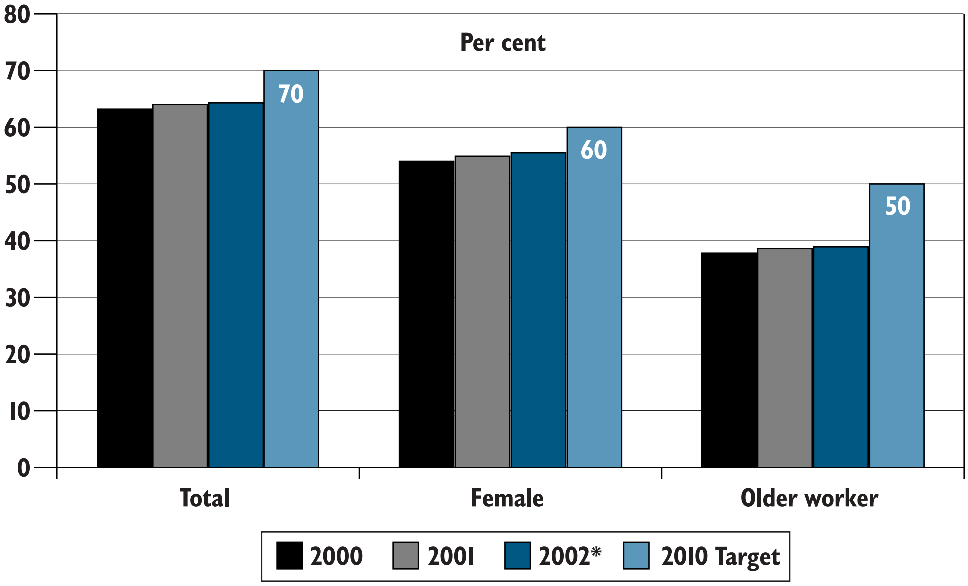
[2] Structural Indicators, Eurostat.

[3] For EU25 and on the same 2001 population basis, a 70 per cent employment rate would require an additional 22 million jobs.

[4] Employment among men rose by just over 2 million between 1999 and 2001, to 90.5 million. This took the male employment rate from 71.7 per cent to 73.0 per cent, resulting in a further small decline in the gender employment gap.

3.9 Chart 3.1 shows that the 2010 target for each group alongside actual performance in 2000, 2001 and (on present Commission estimates) 2002. While part of the employment improvement of the late 1990s was cyclical, there have also been structural changes thanks to labour market reforms of the type encouraged at Barcelona (Box 3.1). Notwithstanding the economic slowdown, EU employment is estimated to have risen in 2002 by around 500,000.

Chart 3.1: EU employment rates and 2010 targets



European Commission projections

Source: Eurostat; Employment in Europe 2002, European Commission

3.10 The past year has seen some important steps taken by Member States in the direction of labour market reform; for example, the **Hartz Report** in Germany, which addressed ways of facilitating the shift from unemployement into work and providing new employment opportunities. This approach – commissioning a team of experts to focus on what are often the more politically sensitive areas of labour market reform – could perhaps be used more frequently and widely, and to even greater effect.

3.11 While all job creation is to be welcomed, employment clearly needs to grow at a pace closer to that of 2000 or 2001 than of 2002, if the 2010 targets are to be met. The EU needs labour markets which encourage job creation, allowing firms to respond to changing economic circumstances, while ensuring decent minimum standards for those in work; providing, in other words, both **flexibility** and **security**.

3.12 A key rationale for the Lisbon employment targets, is **social justice**. Increased participation in the labour market, especially among vulnerable groups, is an important means of combating social exclusion. Labour markets which encourage job creation and flexibility are best placed to provide opportunities for those on the margins. Conversely, labour markets which are less able to respond to changing conditions are more likely to deny the chance of work to those in the more vulnerable groups.

Box 3.1 Barcelona Presidency Conclusions: employment

The Barcelona European Council of March 2002 identified a number of priorities for labour market reform:

- **reduce the tax burden on low-wage earners;**
- **reform tax and benefit systems so as to make work pay and encourage the search for jobs (reviewing, for example, conditionality of benefits, eligibility, duration, the replacement rate, the availability of in-work benefits, tax credits, administrative systems and management rigour);**
- **ensure that wage bargaining takes account of the relationship between wage developments and labour market conditions, allowing wages to evolve according to productivity and skills differentials;**
- **strike a proper balance between flexibility and security; review contract regulations and (where appropriate) costs, with a view to promoting more jobs;**
- **remove disincentives to female labour force participation, including those related to childcare; and**
- **reduce early retirement incentives and increase opportunities for older workers to remain in the labour market, the aim being that by 2010, the effective average retirement age has risen by 5 years.**

EU regulatory environment

3.13 An EU aspiring to become the most competitive and dynamic knowledge-based economy in the world, needs an effective and appropriate regulatory regime. Effective and well-focused regulation can help to correct market failures, promote fairness and ensure public safety. Unnecessary or poorly enforced regulation, however, can restrict competition, stifle innovation and deter investment and employment.

3.14 The Mandelkern Group was established to develop an appropriate regulatory reform strategy. Its November 2001 report formed the basis for the Commission's Action Plan, published in June 2002 and welcomed by the Seville European Council. Central elements of the Action Plan are:

- the introduction by the Commission of a **two stage impact assessment process** covering the economic, social and environmental impacts of policy proposals, to be implemented gradually from early 2003;
- a commitment by the Commission to **establish and adhere to minimum standards of consultation** so as to improve the openness and transparency of the policy-making process, again from the start of 2003;
- the establishment of an **internal better regulation network** within the Commission, involving all Directorates-General and coordinated by the Secretariat General;
- the establishment of a **simplification programme** to address the existing stock of Community legislation;
- the introduction of **impact assessment within the legislative process**; and
- greater use in Commission proposals of **alternatives to traditional legislation** such as co-regulation and self-regulation.

3.15 As a first stage, the Commission has identified in its 2003 Work Programme, 43 proposals which will be subject to **extended impact assessment**. Minimum standards for external consultation have also been adopted by the Commission, with a minimum consultation period of eight weeks. The European Parliament, Council and Commission are negotiating an Inter-Institutional Agreement on Better Regulation. This will provide for impact assessment at each stage of the legislative process, the use where appropriate of alternatives to traditional regulation, and accelerated procedures for regulatory simplification.

3.16 Taken together, these changes represent **a major potential improvement** in the way that the EU develops legislation. There has been a decisive shift towards evidence-based policymaking, ensuring that legislators will in future have to take account of the costs as well as the benefits of worthwhile objectives (e.g. the development of the Single Market, a cleaner European environment). The benefits for European competitiveness should be considerable.

Cars block exemption

3.17 A major pro-competition reform of the new cars market was achieved in July 2002, with the announcement of a new European Commission cars block exemption. The block exemption[5] has hitherto allowed the car industry to act selectively with exclusive distribution of cars. Pre-tax prices of new cars vary greatly across the EU; the same models and specifications can differ by up to 70 per cent. Empirical evidence suggests that taxes, exchange rates, dealer margins and right-hand drive surcharges account for only part of these price differentials. The marketing power generated by the old block exemption appears to have allowed manufacturers effectively to segment the Single Market.

3.18 The new rules, which became law on 1 October 2002, will tackle these barriers to competition. They will allow dealers to market their services freely across the Single Market and sell multiple brands of car through their showrooms. Internet sales will also be made easier. Significantly, the new rules also open up the after sales service and repair markets to greater competition. All car owners should benefit from independent garages gaining greater access to parts and information.

Research and innovation

3.19 Quantifying 'innovation' is invariably difficult. The **European Innovation Scoreboard** takes an annual look at a range of inputs (e.g. R&D spending) and outputs (e.g. patents). In only one of the ten areas for which comparable EU and US data are compiled – new capital raised as a per cent of GDP – does the EU lead the US. The latter's advantage is particularly evident with respect to **high technology European registered patents** and **business R&D** given the importance of these to technological innovation.

3.20 Individual Member States, however, frequently outperform not only their peers but also the US. These tend to be smaller Member States, though; as the Commission notes, *'the innovative leaders in the EU are concentrated in the Nordic countries plus the Netherlands, while the larger economies, with the exception of the UK, perform only near the average or are lagging behind'*.[6] The larger EU economies are, of course, more likely by definition to be closer to the EU average. Nevertheless, if the EU as a whole is to raise its innovatory game, all Member States must boost their performance.

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[5] From article 81 of the Treaty.

[6] European Commission Staff Working Paper, 2002 European Innovation Scoreboard SEC(2002) 1349, Economic Studies No.33 (2001).

3.21 Recent OECD work supports the view that innovation, proxied by R&D intensities, has a clear positive effect on output.[7] Bassanini and Scarpetta[8] suggest that a 0.1 percentage point increase in the share of business sector R&D spending in GDP, boosts the level of GDP per capita by 1.25 per cent in the long term. Certainly, such results need to be interpreted cautiously; equally, they confirm the concerns raised by the poor innovation performance of the EU compared to its global competitors.

3.22 Lisbon called for the creation of a 'European Area of Research and Innovation', to be established by stimulating private sector investment in R&D, encouraging networking, removing barriers to the mobility of researchers in Europe, and establishing a Community patent. The Stockholm European Council built on this agenda, inviting the European Investment Bank to step up its funding for R&D, and urging the adoption of the **Sixth Framework Programme** (FP6).

3.23 Adopted in June 2002 (and its specific programmes in September 2002), FP6 has an overall budget for 2003-2006 of €17.5 billion, and introduced two new funding instruments (Networks of Excellence, and Integrated Projects) intended to deliver greater impact from European research efforts through building critical mass. FP6 resources are concentrated on three key areas:

- **focusing and integrating Community research**, with seven research areas (e.g. life sciences and sustainable development) prioritised in order to produce a more coherent and consistent Community research effort;
- **structuring the European Research Area** by tackling issues in, for example, transforming research into commercial success; developing world class human resources; facilitating the mobility of researchers; providing appropriate infrastructure; and developing a more harmonious relationship between science and society; and
- **strengthening the foundations of the European Research Area** by enhancing the coordination of research and innovation-related policy.

3.24 The Barcelona Council in 2002 added a new dimension to the R&D agenda by urging the EU to raise spending on R&D and innovation towards 3 per cent of GDP by 2010, with two thirds of this from the private sector. This goal has served to focus the attention of the Commission and Member States on the reforms necessary to deliver not only higher but also more productive business investment. The Commission has published a Communication setting out the broad objectives and areas it intends to tackle. A proposed Action Plan is expected in 2003.[9]

3.25 Europe has gone a long way towards addressing the R&D and innovation concerns registered at Lisbon. It has, for example, established the fastest and most extensive **broadband network** in the world to link European university research centres. In the area of life sciences, meanwhile, the Competitiveness Council endorsed in November 2002 a Road Map for the implementation of the Commission's **Action Plan for Life Sciences and Biotechnology**, calling for the responsible development of biotechnology in Europe. What is important is that such initiatives be not only agreed, but followed up and implemented. As successive Spring Councils have recognised, there is still a long way to go.

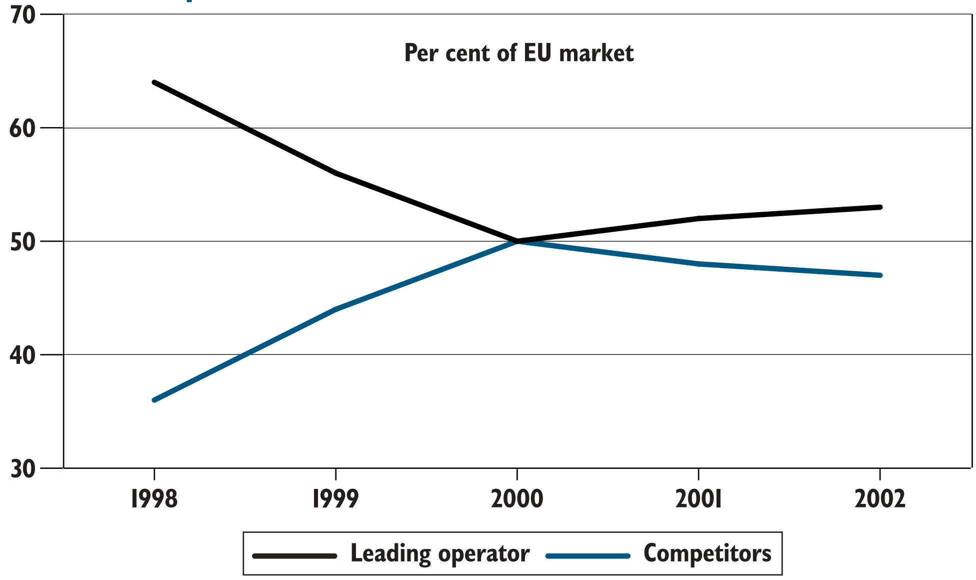
[7] This does not preclude the possibility that high levels of GDP per capita induce high R&D spending. For further discussion see *Product Market Competition and Economic Performance* in OECD Economic Outlook December 2002, No.72.

[8] *The driving forces of economic growth: panel data evidence for the OECD countries,* A.Bassanini, S.Scarpetta, OECD Economic Studies No.33 (2001).

[9] *Choosing to grow: Knowledge, innovation and jobs in a cohesive society*, Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal. European Commission COM (2003) 5 final.

Communications **3.26** Developments in the communications sector demonstrate that liberalisation and competition deliver the best results in terms of consumer choice, lower prices and extended access. Consumers now have a wider choice of operators; the number of infrastructure-based fixed access operators, for example, increased by 42 per cent between August 2001 and August 2002. Since 1998, prices in the EU for calls on fixed lines have fallen by around 50 per cent for national calls and 40 per cent for international calls. Competition in the retail mobile call market brought down average monthly consumer charges by 23 per cent between 2000 and 2002.[10] Chart 3.2 illustrates the ongoing increase in competition in this sector.

Chart 3.2: EU market share of leading mobile operator and competitors



Source: Eighth Commission Report on the implementation of the Telecommunications Regulatory Package

3.27 As well as reducing prices, competition has spurred innovation and the delivery of more advanced and reliable services. The final report on progress under the eEurope 2002 Action Plan[11] put household access to the Internet in November 2002 at 43 per cent compared with 28 per cent in October 2000. More than 90 per cent of EU businesses had Internet access by the end of 2002, compared with just over 70 per cent the previous year.

3.28 Early 2002 saw the adoption of a package of EC legislation comprising the basis of a **new regulatory framework** for communications. In a sector where the distinctions between technologies are increasingly blurred, the legislation takes a technology neutral approach with a clear focus on promoting competition. *Ex ante* regulation will be permitted only in specific defined circumstances; where, for example, an operator is deemed to have significant market power. The challenge now facing Member States is to implement the legislation by July 2003; in the UK, the Communications Bill is currently making its way through Parliament. At the same time, the EU will be looking at the development of effective spectrum management across the EU, on which leading work has taken place in the UK following an independent review which recommended the wider use of market-based mechanisms to promote efficiency and innovation in spectrum use.[12]

[10] Eighth Commission Report on the Implementation of the Telecommunications Regulatory Package, December 2002.

[11] *eEurope 2002 Final Report: Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions. Available at http://europa.eu.int/information_society/eeurope/news_library/index_en.htm*

[12] *Review of Radio Spectrum Management*, M.Cave (March 2002) . For both the report and the response, see http://www.spectrumreview.radio.gov.uk.

3.29 In June 2002, the Seville European Council endorsed the objectives set out in the eEurope 2005 Action Plan, aiming for widespread availability and use of **broadband networks** across the EU by 2005. A key theme of the 2005 plan is the role of the private sector in developing communications services and building infrastructure, with emphasis placed on creating a favourable environment for private investment.

3.30 eEurope has been a major success in delivering the Lisbon strategy, especially considering the difficult situation the information and communications technology (ICT) sector has faced recently. The eEurope 2002 Action Plan has achieved almost all of its 64 targets for getting Europe online. In June 2002, the Seville European Council endorsed the objectives set out in the eEurope 2005 Action Plan, building on the level of Internet access achieved, by aiming for widespread availability and use of broadband networks across the EU by 2005. Already, penetration rates for broadband in several European countries are near the top of the international league. eEurope 2005 aims to create a favourable environment for private investment in developing communications services and building infrastructure, to address the risks of difference across Europe, and make up the continuing lag behind the best in the world.

Energy liberalisation

3.31 The importance of the energy sector to the EU economy is well recognised. Energy accounts for 3-4 per cent of Community GDP, and represents a key input to other industries. The Government believes that evidence from liberalised markets provides a clear, strong argument that, with the appropriate regulatory and competition framework, the liberalisation of energy markets can bring significant economic benefits whilst meeting wider objectives. In the period 1998-2001, household customers were able to choose their electricity supplier in only five Member States, and their gas supplier in only three.

3.32 The March 2002 Barcelona European Council, building on the conclusions reached at Lisbon in 2000, prioritised the opening up of EU energy markets. A major breakthrough was achieved at the meeting of Energy Ministers on 25 November 2002, when a firm decision was reached on full liberalisation. The November Energy Council agreed new drafts of Directives governing electricity and gas markets, which require:

- non-household customers to be able to choose their supplier by 1 July 2004, and all gas and electricity customers by **1 July 2007**;
- vertically integrated companies to legally separate transmission and distribution businesses from production and supply;
- access to be given to grids and pipelines on published, non-discriminatory terms; and
- independent regulatory authorities to be established by Member States.

3.33 These measures – essential to achieving a properly functioning internal market – will bring large benefits to consumers in terms of prices, efficiency, choice and levels of service. The Government looks forward to working with the European Commission and other Member States to ensure that the agreement is implemented effectively.

Work in progress

Unemployment

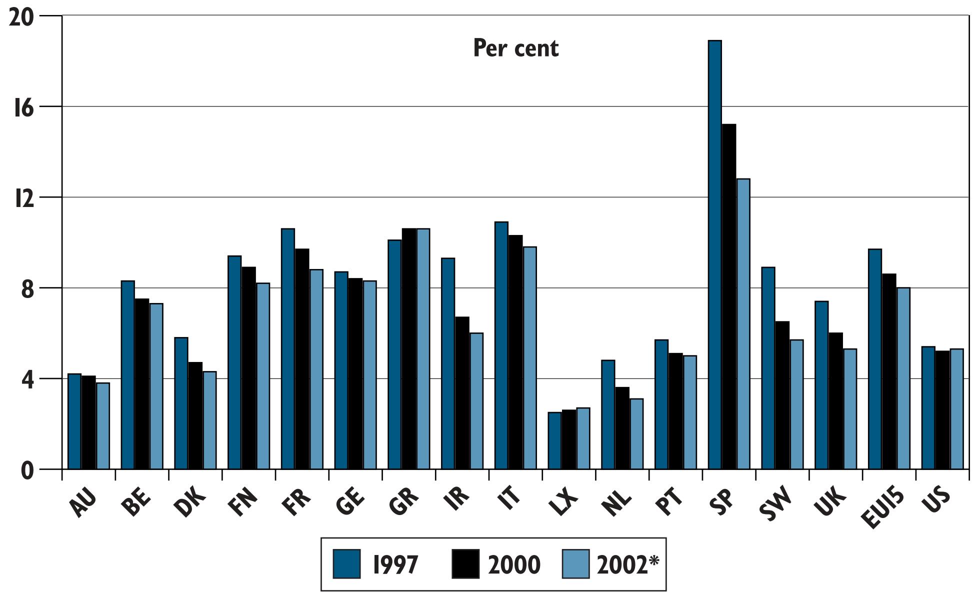
3.34 A rising employment rate does not necessarily imply a proportionate decline in unemployment. As noted earlier, the unemployed form only a proportion of the overall inactive: and while unemployment is a short-term experience for many of those affected, those who do not return to work rapidly are at risk of prolonged disadvantage.

3.35 **EU unemployment** declined from over 15 million in 1999 to below 13 million in 2001, pulling the unemployment rate down from 8.7 per cent to 7.4 per cent at the end of 2001. A sluggish 2002, however, saw the rate tick back up to 7.6 per cent (with a year-end rate of 7.8 per cent or 13.8 million in total[13]). Among women, the unemployment rate fell from 10.2 in 1999 to 8.5 per cent in 2001; an improvement which was largely sustained in 2002, when female unemployment averaged 8.6 per cent.[14]

3.36 The EU15 female unemployment rate remains considerably higher than its male equivalent; the 8.6 per cent female unemployment rate for 2002 compares with one of 6.8 per cent for men. This gap is not only considerably wider than in the US, but the opposite way around. A US unemployment rate of 5.8 per cent in 2002 reflected one of 5.7 per cent for women and 5.9 per cent for men.[15]

3.37 The **structural rate of unemployment** – illustrated in Chart 3.3 by the non-accelerating inflation rate of unemployment[16] – fell, on Commission staff estimates[17], from a peak of 10 per cent in 1994 to about 8 per cent in 2002. This decline has, however, been very unevenly distributed among Member States and, notwithstanding the recent improvement, remains unsatisfactorily high. For reasons of both economic and social justice, delivering further reductions remain a central rationale for ongoing reform of product, capital and labour markets.

Chart 3.3: Structural unemployment rates



**Estimate*

Source: McMorrow et al, European Economy Economic Papers No. 176 (2002)

[13] Compared with 7.4 per cent in December 2001, seasonally adjusted; Eurostat.

[14] Though ended the year at 8.8 per cent, seasonally adjusted, from 8.5 per cent in December 2001; Eurostat.

[15] Structural indicators, Eurostat.

[16] The non-accelerating inflation rate of unemployment is a stock equilibrium concept defined as the level of unemployment compatible (in the absence of shocks) with a stable inflation rate. Structural unemployment may also be analysed with respect to flows in and out of work. The Beveridge curve describes the combinations of vacancies and unemployment consistent with labour market equilibrium: improved job search and matching, reduce equilibrium unemployment and induce an inward shift of the curve.

[17] *Production function approach to calculating potential growth and output gaps – estimates for the EU Member States and the US*, C.Denis, K.McMorrow, W.Röger, Economic Papers No.176 (September 2002), DG Economic and Financial Affairs.

Financial services

3.38 Integration of financial services across the EU is an important factor in boosting productive investment. A recent Commission report suggested that full integration of EU financial markets would result in: a 0.5 per cent reduction in the cost of equity capital for EU business; a 0.4 per cent reduction in the cost of corporate debt financing; and a one-off increase in EU15 GDP over ten years of about 1.1 per cent (equivalent to €130 billion in 2002 prices), and in EU15 employment of 0.5 per cent.[18]

3.39 The Financial Services Action Plan (FSAP) is intended to create just such a single European capital market. Adopted in 1999, the FSAP aims to:

- create a single wholesale financial market to allow companies to raise capital on an EU-wide basis;
- complete a single EU retail market, ensuring consumer choice while maintaining consumer confidence and protection; and
- underpin all of this through state-of-the art prudential rules and supervision.

3.40 The Commission's latest communication on the subject identifies 31 of the FSAP's 42 measures as having been completed, with progress underway in many others. The eight priorities identified at the Barcelona European Council were substantively agreed by the end of 2002.[19]

3.41 The 2002 White Paper on European economic reform highlighted four FSAP measures as particular priorities. Substantial progress has now been made on three:

- a Council common position has been reached on the **prospectus directive** (which would allow companies to raise capital across the EU on the basis of a single prospectus);
- a new **collateral directive** has been agreed that will provide increased legal certainty as to the validity and enforceability of collateral in cross-border securities markets; and
- agreement has been reached on a single set of **accounting standards**, allowing financial reports to be produced on a consistent and comparable basis across the EU.

3.42 Work on the fourth priority – agreement on the **definition of a professional investor**, to enable proportionate regulation of inter-professional business – is ongoing, in the shape of reform of the Investment Services Directive.

3.43 As the FSAP nears completion, it is important that the work devoted to agreeing individual measures be followed by equivalent effort on implementation. Financial market integration is not an end in itself but a means. The underlying objective of the FSAP – as the Government has always emphasised – is a **reduction in the cost** to EU firms of accessing capital, accompanied by increased consumer **choice** at lower prices. EU institutions and Member States must ensure that legislation and other policy tools, including enforcement, are consistent with these objectives. Policy action must be proportionate and economically justified; open consultation and transparent decision-making are vital in delivering such outcomes.

[18] *Quantification of the Macro-economic Impact of Integration of EU Financial Markets*, London Economics (November 2002).

[19] Six adopted; one common position; one political agreement.

Single market in services

3.44 The service sector accounts for almost 70 per cent of EU15 employment[20] and just over 70 per cent of gross value added.[21] During 1995-2001, four service sectors (other business activities, health and social work, computer activities and education) created 6.7 million net new jobs; the equivalent of 58 per cent of total net job creation. While cross-border trade in goods has grown by around a third since the creation of the Internal Market in 1992, service sector trade has been static. While this partly reflects the 'non-tradability' of some services, it is also a function of barriers to cross-border service provision between Member States. Given the importance of services to the EU economy, the potential benefits of removing such barriers could be enormous.

3.45 Conscious of this potential, the Lisbon European Council called on the European Commission to develop an Internal Market Strategy for Services. In July 2002, the European Commission completed phase one of this strategy with a report outlining the barriers to intra-EU cross-border trade in services.[22] The report does not set out to determine whether these barriers are compatible or not with Community law; nor does it discuss measures intended to address them. This is the subject of phase two of the strategy. Proposals are due in 2003 after extensive economic and legal analysis, and consultation with business leaders.

3.46 The Commission's analysis of the state of the Single Market in services takes a horizontal rather than sectoral approach to an extremely difficult issue, addressing barriers at various stages of the business cycle.[23] Many service providers rely on other services as business inputs. Barriers to one type of service can consequently have significant knock-on effects on others, which then multiply throughout the supply chain. Careful analysis and well designed policy will be needed to ensure that the measures proposed are both sufficient to deal with sector complexities and proportionate to the problems tackled. Any read-across to the provision of public services will need particularly careful thought.

Competition policy

3.47 Competition is a key driver of growth and productivity. Competitive pressures promote innovation and entrepreneurship, encourage an efficient allocation of resources, and ensure that the benefits of greater efficiency are passed on to consumers in the form of lower costs, increased quality and greater choice. A lack of competition tends to provide little incentive for firms to pursue technological innovation and slows down its diffusion.[24]

3.48 The Government believes that competition authorities should be strong, proactive and independent, and capable of informed economic assessment, and its domestic competition agenda reflects these aims.[25] The UK therefore welcomes steps taken by the European Commission, since Lisbon, to:

- set out proposals for **reform of the mergers regime**, and raise the profile of economics within DG Competition; and
- implement reforms under its **modernisation plans**, working with Member States to 'level up' competition policy across the EU.

[20] 67 per cent in 2001; *Employment in Europe 2002*, European Commission

[21] 71 per cent in Q3 2002; Eurostat

[22] The Commission's report covers consultancy, certification services, estate agents, engineering and construction,

[23] Difficulties establishing a business; problems relating to the use of inputs, such as labour; problems with the promotion of services (e.g. advertising restrictions); obstacles to distribution; difficulties encountered when selling services; and complications providing after-sales service.

[24] For further discussion, see *Competition, innovation and productivity growth: a review of theory and evidence,* S.Ahn, OECD Economics Department Working Paper No.317 (2002), cited in *EU Economy: 2002 Review,* European Commission (November 2002).

[25] See Section 4 for more detailed discussion.

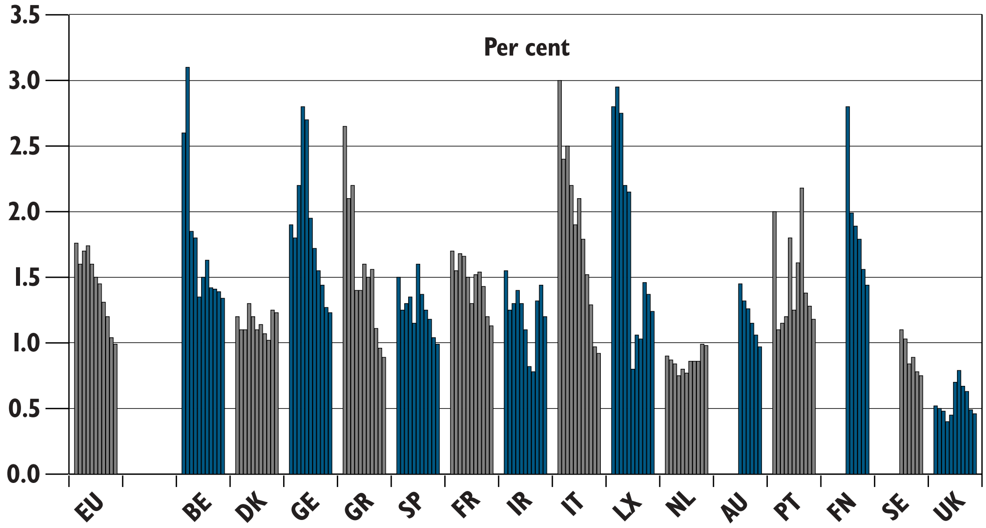
3.49 These steps will further improve competition policy within the EU. Best practice, however, continues to develop, and the Government strongly supports the Commission in its efforts to maximise the contribution that effective competition policy can make to growth, productivity and prosperity.

State aid reform

3.50 **Less and better state aid** is a key component of the Lisbon agenda, helping to create the strong and fair competition that drives higher productivity. State aid reform has been endorsed at the highest level; the Barcelona European Council agreed in March 2002 on the need for less and better state aid to promote effective competition, and to better target state aid so as to tackle identified market failures.

3.51 The EU has made good progress in reducing state aid levels over the last decade, with state aid for the EU as a whole falling from 1.8 per cent of GDP in 1990 to 1.0 per cent of GDP in 2000. As Chart 3.4 shows, this has been driven by reductions in state aid levels for most member states.

Chart 3.4: State aid as a percentage of GDP, 1990-2000

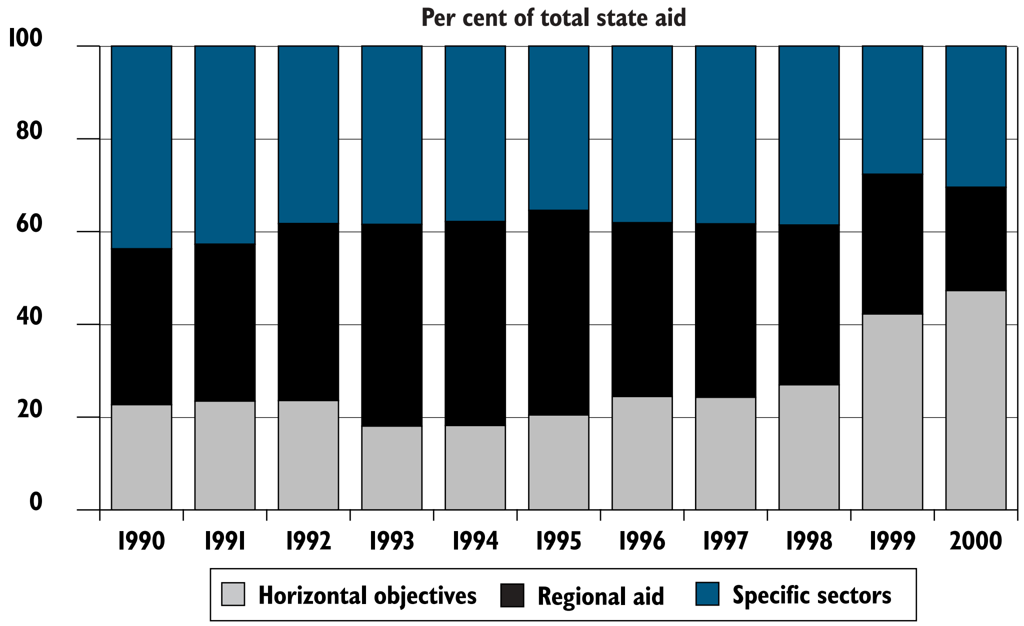


Bars show data for 1990-2000, except for Austria, Finland and Sweden 1995-2000.

Source: European Commission, State Aid Scoreboard.

3.52 There has also been progress in shifting the balance of state aid away from specific sectors and toward 'horizontal objectives' more likely to target specific problems or market failures (e.g. training, R&D, small and medium sized enterprises etc). As Chart 3.5 shows, the share of horizontal aid in total aid has increased, the gains being particularly marked in recent years; from 23 per cent of all state aid in 1990, to 27 per cent in 1998 and 47 per cent in 2000. This shift in the use of state aid is a helpful step. Sectoral aid tends to carry a greater risk of undermining competition, while horizontal aid tends to be more targeted at specific problems (including, though not solely, market failures).

Chart 3.5: EU state aid by objective, 1990-2000



Source: European Commission, State Aid Scoreboard.

3.53 Further reform is needed to achieve the goal of less and better state aid. With this in mind, the Competitiveness Council[26] has agreed a further programme of actions to take these objectives forward, addressing the three main dimensions of state aid reform:

- **reducing state aid** that undermines competition (focusing especially on the most distorting aids);
- **targeting state aid** to promote structural reform, address clearly-identified market failures, and increase efficiency; and
- ensuring an **effective state aid regime**.

3.54 The Commission is also committed to radical modernisation and simplification of the state aid regime: focusing efforts on the state aid that is most economically significant, dealing much more swiftly with aid that is not significant, and developing a more robust economic basis for approving aid. This will build on the recent reforms of the regime, recorded in the Commission's recent progress report;[27] for example, introducing training aid and employment aid block exemptions to address labour market failures, and venture capital guidelines to address failures in capital markets.

[26] Conclusions of Competitiveness Council, 26 November 2002, Press:360 Nr:14365/02, pp 10-12; http://ue.eu.int/Newsroom/LoadDoc.asp?MAX=1&BID=88&DID=73375&LANG=1.

[27] *Progress report concerning the reduction and reorientation of state aid*, Commission Communication COM(2002) 555 final, 16 October 2002.

Public procurement

3.55 Ensuring the suppliers have access to open, pan-European procurement markets is an important aspect of the Lisbon agenda. While the share of total public procurement in GDP has declined slightly, it remains – at 16.2 per cent of EU GDP in 2001, from 17.3 per cent in 1995[28] – a substantial share of the economy.

3.56 Greater transparency and competition would mean better value for tax-payers and consumers, more opportunities for business, and better safeguards against corruption. A saving of even 1 per cent would have reduced EU procurement expenses by more than €14 billion in 2001 – equivalent to around a third of the total financing needs of public administrations in that year.[28] In this context it is disappointing that the percentage of public procurement published in the Official Journal remained stable in 2001 at just under 16 per cent, and that the increase in contract award notices published has not kept pace with the growth in invitations to tender (meaning that fewer details are known about the results of procurement competitions).

3.57 Political agreement has been reached within the Council on two directives: one merging and updating the three directives on supplies, services, and work contracts; and the other, revising the rules for utilities procurement. Final adoption is hoped for this year, with implementation within the following 21 months.

Aviation

3.58 The Government is committed to achieving liberalisation and normalisation of the aviation industry by ensuring that regulation is effective, that competition policy is vigorously applied; and that market distortions are minimised.

3.59 The process of airport slot allocation, governed by European Regulation No. 95/93, affects the efficient use of existing airport infrastructure. The Commission's first proposal for amending this regulation was published in June 2001 and has been the subject of discussion by EU Member States at Council Working Groups over the past year. The Commission has appointed consultants to study the possible use of market methods of allocation, and the Government hopes that this will result in a more radical proposal being put forward by the Commission next year.

3.60 **Single European Sky** is a Community initiative in the aftermath of the record European air traffic control-related delays in the first half of 1999. Following detailed work by a High Level Group composed of state experts, the Commission introduced its legislative proposals at the October 2001 Transport Council. These included four draft regulations on the framework to create Single Sky (including the setting up of the proposed Single Sky Committee); the provision of air navigation services; the organisation and use of the airspace; and the interoperability of the European air traffic management system.

3.61 Negotiations on the Single Sky package began in January 2002 and, following substantial amendment, the four draft regulations were ultimately approved by Transport Ministers at the December 2002 Transport Council. The initiative now passes to the European Parliament, which is expected to have its second reading on this dossier in early spring 2003. The regulations are likely to come into force in autumn 2003. The full impact of the Single Sky legislation will, however, take a number of years to be realised, particularly with respect to achieving technical interoperability across Europe's many air traffic service providers.

3.62 The UK has supported Single Sky from its inception, as it offers the potential for significant benefits to the industry in the medium to long term - such as reducing delays by around 25 per cent, reducing aviation fuel emissions by 5-10 per cent, enhancing Europe's air traffic management structure and reducing air traffic service costs. The regulations provide an important framework that can be developed and offer the possibility of substantial market liberalisation in the provision of Europe's air traffic services.

[28] *Economic reform: report on the functioning of community product and capital markets*, Report from the Commission COM(2002) 743 final (December 2002).

Entrepreneurship

3.63 A number of steps have been taken towards creating the friendly environment for starting up and developing innovative businesses, and for small and medium sized enterprises, called for at Lisbon. These include:

- the **Small Firms Charter** agreed in June 2000 (see Box 3.2);
- steps to **curb and cut red tape** for start-ups. Some Member States have set quantitative targets such as halving the time and costs of setting up a company (Spain and Portugal) or reducing the overall administrative burden by 25 per cent by the end of the legislative term (Belgium and Portugal); and
- **impact assessment** of new and existing legislation is now undertaken in many Member States.

3.64 The **Risk Capital Action Plan** (RCAP) was initiated under the UK Presidency in 1998 – prior to the launch of the Lisbon agenda – with a deadline for implementation of end-2003. It merits, however, mention in any assessment of the changing entrepreneurial environment, in that it aims to create a more liquid and integrated market for risk capital and thereby reduce the cost of capital to small businesses. RCAP comprises a series of Member State actions to promote enterprise. Since its launch, risk capital markets in Europe have both grown and matured, though the level of investment remains considerably below that in the US.

3.65 The Commission has recently published a Green Paper on Entrepreneurship in Europe,[30] addressing two key issues: why so few people start a business, when so many express an interest in entrepreneurship; and why so few European enterprises grow (and, when they do grow, expand only modestly). Finding the answers to these questions, and thereby furthering the construction of a more entrepreneurial EU, will be anything but easy. Asking the right questions is, however, a welcome step in the right direction.

Box 3.2: The European Charter for Small Enterprises

The European Charter for Small Enterprises was approved by EU leaders at the Feira European Council of 19-20 June 2000. The Charter calls on Member States and the Commission to take action to support and encourage small enterprises in ten key areas:

- **education and training for entrepreneurship;**
- **cheaper and faster start-up;**
- **better legislation and regulation;**
- **availability of skills;**
- **improving online access;**
- **getting more out of the Single Market;**
- **taxation and financial matters;**
- **strengthening the technological capacity of small enterprises;**
- **making use of successful e-business models and developing top-class small business support; and**
- **developing stronger, more effective representation of small enterprise interests at Union and national level.**

[30] *Green Paper Entrepreneurship in Europe*, Enterprise Directorate–General, European Commission (January 2003) http://www.europa.eu.int/comm/enterprise/entrepreneurship/green_paper/green_paper_final_en.pdf.

Sustainable development

3.66 The EU Sustainable Development Strategy was adopted by the Gothenburg Council of June 2001. The Lisbon reform programme explicitly recognises the importance of taking the environmental, economic and social dimensions of sustainable development into account, and of integrating sustainable development into the economic reform process.

3.67 The Government is a strong supporter of sustainable development, both within the EU and globally. Important progress in this direction was made at the World Summit on Sustainable Development (WSSD) which took place in Johannesburg in August/September 2002 (discussed further in Section 5). The Government is also a firm believer in: the importance of analysing cost and benefits of policies; comprehensive impact assessment of proposals; and using market based instruments, where appropriate, as the best way to advance sustainable development within the EU. The EU's new programme of impact assessments, which is being rolled out in 2003, is very welcome, though its success will depend on the available resources and the extent to which the assessments lead to the development of better regulation.

3.68 Combating climate change is an important part of sustainable development, since such change potentially involves considerable environmental degradation and high economic and social costs. Those most severely affected are often those least well equipped to deal with the consequences. One of the most notable successes in this area, and warmly welcomed by the UK Government, was the agreement on a common position in the Environment Council on the **EU Emission Trading Scheme Directive**.

3.69 The Directive is a central part of the EU's strategy for fulfilling our commitments on climate change under the Kyoto Protocol, and will help to do so in a cost-effective manner. Using a market-based approach should serve both to internalise the cost of carbon, thereby driving emission reductions where they can be done most cheaply, and could have the beneficial side effect of stimulating innovation in less carbon intensive technologies.

3.70 **Environmental technologies**, already a €180 billion market worldwide,[30] are a key factor in decoupling environmental pressures and economic growth. It is important that the market sends the correct signals, so that clean technologies can develop further. Increased demand for and trade in environmental technologies is beneficial not only for EU businesses and citizens, but also for the EU's trading partners in that it offers all countries a wider range of options with which to tackle environmental problems. The Commission will shortly publish a progress report on its forthcoming action plan, addressing the diffusion of clean technologies.

Limited progress

Employment among older workers

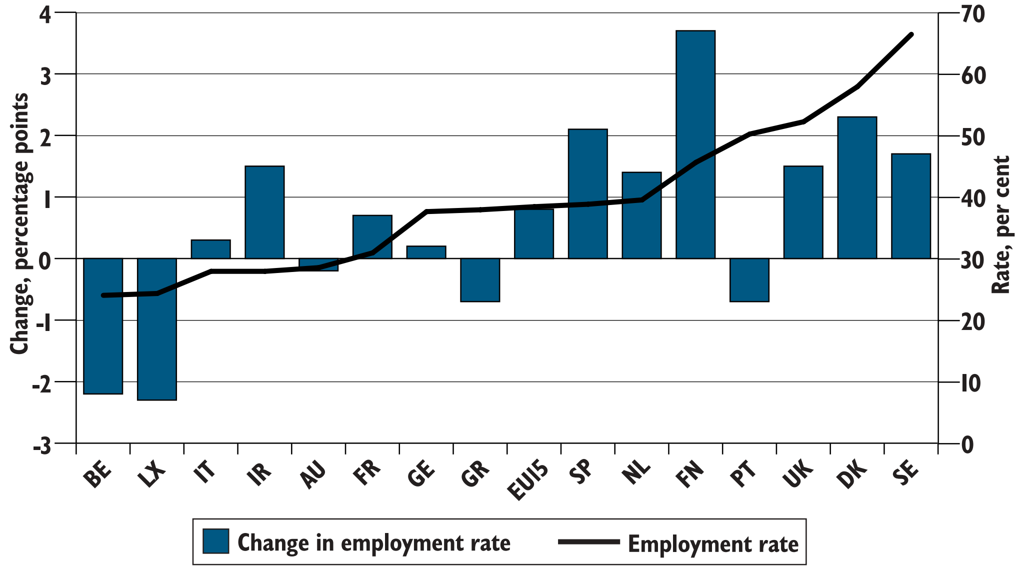
3.71 Older workers constitute a major labour reserve in the EU. Boosting overall employment requires higher participation and employment rates among older age groups, thereby helping offset the impact on labour supply and potential output of a declining and ageing working-age population.

3.72 The EU employment rate for workers aged 55-64 increased from 37.1 per cent in 1999 (the year before Lisbon) to 38.6 per cent in 2001. While this marked an acceleration from previous years – and while any improvement is welcome – the pace remains far from sufficient to meet the Stockholm target for 2010 of 50 per cent. The lack of substantive change, and the tendency in some Member States to continue to use early retirement schemes, remain causes for concern.

[30] *Choosing to grow: Knowledge, innovation and jobs in a cohesive society*, Report to the Spring Council, 21 March 2003 on the Lisbon strategy of economic, social and environmental renewal, European Commission COM (2003) 5 final.

3.73 As noted in Section 2, employment among older workers varies considerably between Member States[31]; as Chart 3.6 shows, the same is also true of the change in the employment rate. Employment in the 55-64 year old cohort **rose by more than 2 percentage points** in 2001 in Denmark, Spain and Finland. It **declined**, however, in Belgium, Luxembourg, Austria, Greece and Portugal. The first three of these are among the four Member States with the lowest employment rates for 55-64 year olds. Those countries which fell further behind the EU employment target in 2001 were, in other words, also among those with the most ground to make up.

Chart 3.6: Change in employment rate of older workers, 2001



Source: European Commission

3.74 While their National Action Plans show that all Member States give priority to increasing employment among older workers, national targets or objectives are set in only five: **France** (35 per cent in 2006); **Finland** (53 per cent in 2005, 55 per cent in 2010); **Italy** (40 per cent in 2005); the **Netherlands** (an increase in participation of older people of 0.75 per cent, per year); and the **UK** (to narrow by 2004 the gap in employment rates for the over-50s, as well as for ethnic minorities, disabled people and other disadvantaged groups and areas).

Takeovers

3.75 An earlier version of the Takeovers Directive failed in 2001 to be passed by the European Parliament. The Commission subsequently asked a group of company law experts to look at a number of issues raised by the European Parliament, not least the issue of the 'level playing field' for shareholders across the EU.

3.76 The group reported in early 2002 and proposed, in particular, a solution known as 'breakthrough' whereby, certain defensive share structures would be overridden following a successful takeover. The Commission launched a new proposal in October 2002 building on, but not adopting in full, the group's suggestions. The concept of the 'level playing field' remains elusive and, while negotiations continue, agreement is once again proving difficult to reach.

[31] The same is true of the new Member States. Only 30 per cent of 55-64 year olds are employed in the ten new Member States, though this also conceals wide variations. In 2001, Cyprus and Estonia were already close to the Stockholm target of 50 per cent, while less than one in four older workers were employed in Latvia, Slovakia and Slovenia. *Employment in Europe 2002*, European Commission.

Community patent

3.77 An appropriate intellectual property regime is vital if the private sector is to face the right incentives to invest in R&D and innovation. Patenting across the EU through the European Patent Office (EPO) is five times as expensive as in the US and twice as slow, with translation costs a major burden. Furthermore, in order for protection to be obtained across the EU, patent rights must be enforced separately in each Member State. As different national courts may rule differently on similar cases, equal legal treatment is not guaranteed.

3.78 Little surprise, therefore, that a recent report from the European Round Table of Industrialists called on the EU to *"urgently agree a quality, cost-efficient Community patent so as to strengthen protection and reduce bureaucracy, costs and litigation"*.[32] What is required is a Community patent which falls under just one jurisdiction – that of the Community – and requires the use of a minimum number of languages. At the same time, reform of the EPO needs to continue so as to enhance the speed and efficiency of processing, providing EU firms – in particular, across an enlarged EU[33] – with the same incentives to invest in R&D as their US counterparts.

[32] *Is the '3% R&D objective for 2010' target for R&D realistic?* European Round Table of Industrialists, October 2002.

[33] Low R&D expenditure in the new Member States (below 1 per cent of GDP) is reflected in low patent activity; around 8 EPO patents per million inhabitants, compared with 161 per million in the EU15 in 2001. See *Progress on the Lisbon Strategy*, Commission Staff Working Paper in support of the Report from the Commission to the Spring European Council in Brussels *COM(2003)5 final).