4 Key Areas for Reform

- **Reform to create a more competitive, dynamic and knowledge-based EU economy necessarily encompasses a wide range of inter-related and overlapping policy areas. At any moment in time, however, priorities must be drawn up.**
- **In early 2003, and given the dual imperative of boosting both employment and productivity in a context of global economic uncertainty, ten priorities stand out: employment, especially among older workers; entrepreneurship; better regulation; the FSAP; corporate governance; R&D and innovation; competition policy; state aid reform; a single market in services; and effective regional policy.**
- **Economic reform at an EU level complements the Government's own efforts in the domestic sphere. The economic reforms it proposes for Europe, are reforms it is also endeavouring to put into effect at home.**

INTRODUCTION

> *"Microeconomic structural polices can make a significant contribution to achieving faster sustainable growth with high levels of employment. By extending and improving the functioning of markets, structural reforms can remove impediments to the full and efficient use of resources and allow for higher dynamic efficiency, making it easier to achieve widely accepted economic and social goals". (*EU Economy: 2002 Review, European Commission[1]*)*

4.1 The annual Spring Council provides an opportunity for Member States to look both backwards and ahead. It allows EU leaders to review what has – or has not – been achieved in terms of European economic reform, and to identify where the key priorities now lie.

4.2 Section 3 addressed the first of these issues, assessing progress to date (and especially over the past year) on the Lisbon agenda. This section looks forwards, asking where – and how – Europe's economic reform efforts should now be directed.

PRIORITY AREAS

Ten top priorities

4.3 Within the broad, interlinked policy areas encompassed by the Lisbon agenda – and from the perspective of early 2003, with enlargement imminent – the Government has identified ten priority actions for making the transition to a more competitive, dynamic and knowledge-based economy. These 'top ten' priorities are summarised in Box 4.1.

4.4 That an initiative is not mentioned explicitly in Box 4.1, in no sense implies that it is therefore not important. Some reform challenges fall outside the Lisbon agenda, and hence do not appear here; but even within this framework there is clearly much not featured which is nevertheless extremely important (e.g. eEurope). The list comprises, rather, those actions which, at the present time and under current circumstances, are at the top of a much lengthier 'to do' list of often overdue reforms.

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

Box 4.1: Ten economic reform priorities

In order to meet the dual challenge of raising both productivity and employment so as to benefit all the citizens of an enlarged EU, ten steps are particularly pressing:

1. **modern social policies that promote skills, employment and labour market flexibility, in particular among older workers;**
2. **promotion of entrepreneurship to create jobs across all ages and groups;**
3. **better implementation and enforcement of better regulation;**
4. **progress on, and implementation and enforcement of, the Financial Services Action Plan 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 for services; and**
10. **an effective regional policy which supports economic reform and addresses market failure.**

An international priority...

4.5 As is discussed in more detail in Section 5, reform is vital if the EU is to play its full role in a global economic context. This applies in particular with regard to implementing the **Doha Development Agenda** of the **World Trade Organisation** (WTO) and meeting the **UN Millennium Development Goals**. The reform priorities listed all contribute to the EU's ability to meet its international obligations; some – especially those intended to realise a more competitive Single Market, including steps on competition policy, state aids and services – are crucial to Doha's success.

...and a domestic priority

4.6 Lisbon represents as much of a challenge for the UK as for other Member States. While the UK has already achieved the Lisbon and Stockholm employment targets, it has, for example, much to do to raise productivity and improve its skills base, and much to learn from best practice in the rest of Europe and elsewhere.

4.7 As is also made clear throughout this section, economic reform at an EU level complements the Government's own efforts in the domestic sphere. The economic reforms the UK proposes for Europe, are ones it is also endeavouring to put into effect at home; on all of these issues, each Member State, including the UK, can learn from its partners. A particular challenge facing the UK, for example, is that of raising the level of productivity, which remains much lower than in France or Germany. Some analysis suggests that between half and all of the UK productivity gap with Germany can be attributed to skills differences, pointing to labour market reforms being central to reducing the gap.[2]

[2] *Britain's Productivity Performance 1950-96: An International Perspective*, M.O'Mahony, NIESR (1999); *Britain's Record on Skills*, R.Layard, S.McIntosh, A.Vignoles, Centre for Economic Performance, London School of Economics, Working Paper (2001).

(I) Promotion of skills, employment and labour market flexibility, especially among older workers

4.8 A competitive, dynamic and socially cohesive Europe needs to extend employment opportunity across all ages and groups. The Stockholm European Council of March 2001 highlighted the importance of full employment in an ageing EU population. EU leaders commissioned a report on 'active ageing',[3] and set a 2010 employment target for the EU as a whole (rather than for individual Member States) of 50 per cent for 55-64 year olds – for the EU15, the equivalent of 5 million new jobs in this age group.

4.9 The Barcelona Council of March 2002 subsequently called for measures to facilitate the retention of older workers in the labour market by, for example, more flexible or gradual approaches to retirement, and greater access to lifelong learning. It also called for a rise in the **average effective retirement age** of about five years by 2010. At 59.9 years in 2001, this implies an increase of about 7 months per year over the coming seven years – a considerable challenge.

4.10 **Encouraging more people to remain active for longer in their working lives, remains an EU-wide priority**.[4] The challenge – and the only way in which a 50 per cent employment target for older workers over 55 can be attained in 2010 – is to encourage workers now in the 45-54 year cohort to maintain high participation rates as they move into the next age bracket.

The need for a comprehensive approach

4.11 Incentives to encourage ongoing employment, and disincentives to discourage early retirement, demand a wide-ranging approach across a range of policy areas: **tax/benefit policy**; **social security systems**; **pension systems**; **regulation**; access to **flexible working patterns**; and **active labour market policies** (ALMP) such as training and lifelong learning, assistance in enterprise creation, and job-search, information and counselling services. Studies suggest that ALMP programmes not only reduce unemployment but contribute also to an increase in the labour force.[5]

4.12 Failing to take the full range of policy influences into account may mean that individuals shift around, rather than out of, worklessness. In some Member States, lower flows into early retirement have been partly offset by increased flows into long-term sick leave. Commission analysis has found that those countries which have made good progress in labour market performance (e.g. Denmark, Ireland, the Netherlands) are also those which have implemented the most comprehensive reforms, often accompanied by reform of product markets.[6]

[3] *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, COM(2002) 9 final (January 2002).

[4] For further discussion, see *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury (November 2002).

[5] *Does active labour market policy work? Lessons from the Swedish experiences*, L.Calmfors, A.Forslund, M. Helmström, IFAU Working Paper 2002:4, cited in *EU Economy:2002 Review*, European Commission (November 2002).

[6] *EU Economy:2002 Review*, European Commission (November 2002).

4.13 Some aspects of the UK's own approach to promoting participation and employment among older workers are described in Box 4.2. Welcome initiatives being pursued by other Member States include[7]:

Member State initiatives

- the **Austrian** 'Pact for older people', which provides financial incentives for part-time work and training;
- **Belgium** allows people returning to work from early retirement to keep supplementary benefits;
- early retirement schemes are being phased out in **Denmark** by 2006, and in the **Netherlands** by 2009;
- the statutory retirement age has been raised in **Sweden, Germany** and **Austria**;
- **Sweden** has responded to the rise in long-term sick leave noted above, by introducing an '11-points-programme for better health in working life'; and
- **Finland** has made provision, from 2005, for flexible entry into retirement between 62 and 68 years, or even beyond that age.

4.14 Different national circumstances, strengths and weaknesses mean that there is no single EU blueprint for labour market reform. Different countries may need to take different approaches to similar problems in order to achieve similar results; hence, the applicability to labour market policy of the **Open Method of Coordination** (within which objectives are agreed at an EU-level, but the policies to reach those objectives are set nationally).

The EU's role

4.15 Notwithstanding the need for tailored solutions to individual circumstances, the EU has an important part to play in boosting employment both among older workers and across all age groups. The '**Luxembourg Process**' – the European Employment Strategy (EES) – has, over the past five years, provided a valuable forum for monitoring, evaluation, peer review and the exchange of best practice. The present review of the EES is intended to make it an even more effective tool for delivering the Lisbon objectives, and the UK supports the joint opinion agreed between the Employment Committee and the Economic Policy Committee in September 2002, which highlighted the main priorities as:

- increasing labour force participation, especially among vulnerable groups;
- promoting active labour market policies;
- reforming tax and benefit systems (including incentives to take up and remain in work, by making work pay);
- improving lifelong learning, skills and mobility; and
- strengthening gender equality and combating discrimination.

4.16 The EU's role with respect to employment is not, however, confined to the EES. It also has important responsibilities in realising the full potential of the Single Market and the free movement of people; in applying appropriate standards of health and safety; in ensuring the consistent application of competition policy; and in helping maintain the macroeconomic stability which is the precondition of economic and social success.

[7] Commission Staff Working Paper, *Assessment of the Implementation of the 2002 Employment Guidelines, Supporting Document to the Joint Employment Report 2002*, European Commission SEC (2002) 1204/2.

Box 4.2: Employment of older workers: UK experience

People aged over 50 face many disadvantages in finding employment, and are particularly at risk of leaving the labour force if they lose their job. Furthermore, their wages on re-entering employment are, on average, 25 per cent below those of their previous employment; a much larger fall than for younger workers, and a clear disincentive to rejoin the workforce.

Introduced throughout the UK in 2000, the **New Deal for the over-50s** (ND50+) offers a package of personal advice, help with job search, and in-work training and support. Additional financial support for the first year in work (currently delivered through the **Employment Credit**) will, from 2003, be delivered as part of the **Working Tax Credit**. By end-October 2002 more than **86,000 people** had found new jobs through ND50+; evidence suggests that **42 per cent** of claimants would not have taken the job concerned without the Employment Credit.

Older members of the workforce are more likely than their younger counterparts to be disadvantaged by inappropriate skills. The Government is committed to improving training opportunities for all adults in the workforce, and has introduced a number of new policies to this end. The **Skills for Life** programme has helped over 250,000 adults to improve their basic literacy and numeracy skills, while the **University for Industry**, offering flexible and convenient learning for adults, has reached over 500,000 adults. The Government aims to improve the basic skills of **1.5 million** adults between 2001 and 2007, and to reduce the number lacking NVQ level 2 qualifications by **40 per cent** by 2010.

Most inactive people in the UK aged between 50 and the State Pension age receive incapacity benefit because of ill health or disability; this age group comprises 49 per cent of all incapacity benefit recipients. While many expect to return to the labour market in due course, many fail to do so. Reforms which took effect in April 2002 aim to facilitate the transition, enabling claimants to work for up to 16 hours per week without losing incapacity benefit.

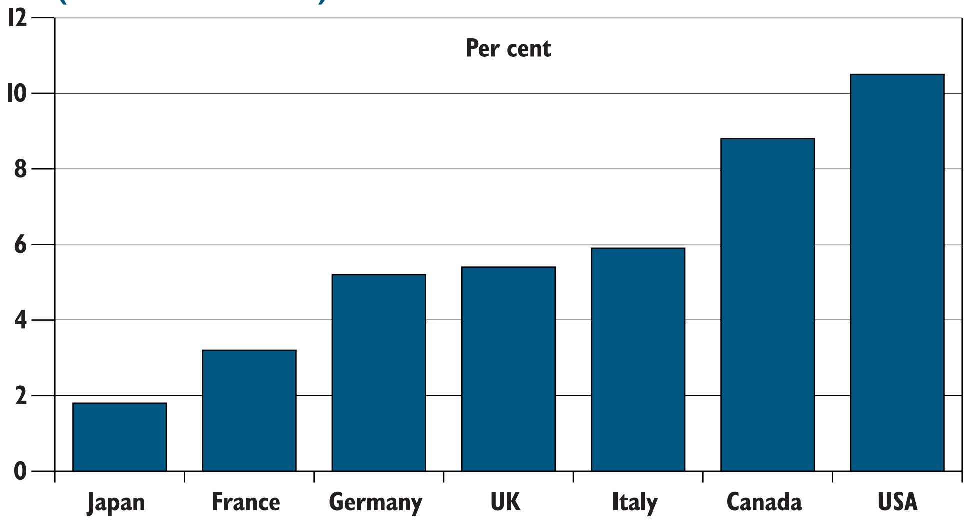
Furthermore, the Government recently published a consultation document, '**Pathways to work: Helping people into employment**', in which it announced its intention to pilot measures to help new recipients of incapacity benefits back into employment. These measures will offer people coming onto incapacity benefits, greater help and a more coherent package of choices and options, thereby encouraging those for whom a return to work is a realistic prospect, to achieve it.

(2) Promotion of entrepreneurship across all ages and groups

4.17 **Enterprise** makes a vital contribution to any competitive, dynamic economy. Not only is it a key driver of productivity growth and a source of job creation at an aggregate level but it can be an important means of generating prosperity and social cohesion in disadvantaged communities. An economic reform agenda must also be an enterprise agenda.

4.18 'Entrepreneurship' is invariably difficult to quantify but such proxy indicators that exist point to an EU which is doing better than was once the case. Nevertheless, on many such indicators Member States continue to fall short of the US, as Chart 4.1 illustrates.

Chart 4.1: The enterprise gap, 2002; share of working-age population involved in operating a new business (under 42 months)



Source: Global Entrepreneurship Monitor, 2002 Executive Report

4.19 Many groups such as women,[8] people from disadvantaged communities, some ethnic minorities, and people with disabilities are under-represented in the entrepreneurial community. Unlocking each citizen's potential would reap significant economic and social rewards; enterprise has a important part to play in delivering long-term sustainable regeneration and higher living standards in the more deprived areas.

4.20 Barriers to entrepreneurship may be very deep-rooted in culture and attitude, or they may be of an entirely practical nature such as access to information or finance. In an EU context, the main barriers to enterprise include:

- the burden of administration and legislation, whether EU or national;
- cultural and social barriers such as the fear of failure, or a low status being attached to self-employment;
- lack of access to finance, especially for disadvantaged groups, minority groups, micro businesses seeking risk capital; and
- inappropriate education and training, notwithstanding that enterprise education is a feature of almost two thirds of Member States.

[8] According to the Observatory of European SMEs, 2001 Survey, women own 22 per cent of European SMEs (ranging from 14 per cent in Greece to 30 per cent in France).

4.21 The Commission has recently published its very welcome **Green Paper on Entrepreneurship**.[9] A period of consultation is now underway. It is essential that the Commission initiative be followed up, preferably with an **Action Plan**, to transform intentions into genuine reform. Such an action plan might include:

- steps to ensure that the potential for enterprise to lead to **sustainable regeneration,** is reflected in the priorities of Structural Funds and the European Investment Fund Start-Up facility;
- targeting of EU funding towards **under-represented and disadvantaged groups**;
- a review of **bankruptcy rules** to identify best practice such that rules do not excessively penalise business failure but maintain sanctions against the unscrupulous or dishonest;
- a coherent and thorough Commission assessment of the **effect of regulation** on small firms, examining the barriers at each stage of the business cycle (e.g. start-up, growth, succession) in the context of the Commission's better regulation action plan. The Commission could also make further use of its expertise in assessing the likely impact of regulations on competition;
- a commitment by the Commission to adopting a **lighter touch** approach to the introduction of new EU legislation as it affects small firms, and even exempting small firms on a case-by-case basis; and
- **raising awareness** of enterprise among young people.

4.22 The Commission's Green Paper also refers to tax in a number of areas. The UK position here is that taxation is a matter for Member States, in keeping with the principle of subsidiarity. Fair tax competition allows governments to reflect national preferences concerning the role, structure and aims of taxation.

4.23 The UK Government has introduced a raft of measures to support and encourage enterprise. Box 4.3 summarises just some of these.[10]

[9] *Green Paper Entrepreneurship in Europe*, DG Enterprise, European Commission (January 2002) http://www.europa.eu.int/comm/enterprise/entrepreneurship/green_paper/green_paper_final_en.pdf.

[10] The full range of policy measures are set out in depth in *Enterprise Britain: a modern approach to meeting the enterprise challenge* printed alongside the 2002 Pre-Budget Report: http://www.hm-treasury.gov.uk/Pre_Budget_Report /prebud_pbr02/assoc_docs/prebud_pbr02_adenterbrit.cfm.

Box 4.3: Promoting entrepreneurship: UK experience

Measures introduced by the UK to promote entrepreneurship include:

- **regional venture capital funds**, providing £270 million investment for small businesses with growth potential across the English regions, backed by up to £80 million government funding and £53.5 million from the European Investment Fund;
- the **Bridges Community Development Venture Fund**, which provides venture capital funding to firms that can demonstrate meaningful interaction with the local economy;
- a new **Community Investment Tax Credit** to provide tax relief to investors in Community Development Finance Institutions;
- measures to **regenerate high streets** and encourage the **cleaning up of contaminated land**;
- the **Coalfields Enterprise Fund**, which provides venture capital to start-ups and developing firms in former coalmining areas in England;
- the **Phoenix Fund**, to support independent organisations that deliver business support services and provide community development finance;
- **Employer Training Pilots** to allow businesses to access free training and, in the case of SMEs, subsidies to meet the cost of staff taking time off to develop basic skills;
- support for the **Inner City 100 awards**, which raise awareness of successful enterprise in less prosperous communities; and
- reform of **Capital Gains Tax** and introduction of taper relief, cutting the effective rate to 10 per cent for business assets held over two years.

(3) Better regulation

4.24 Effective and well-focused regulation can help to correct market failures, promote fairness, ensure public safety and contribute to a better environment. Unnecessary or poorly enforced regulation, however, can restrict competition, stifle innovation and deter investment. The European Commission has put the cost to the EU of badly drafted regulation at about €50 billion per year.[11]

4.25 The quantity of regulation is no guide to its quality. A rising volume of regulation may reflect citizens' demand for greater reassurance (with respect to, for example, food safety) or governments' attempts to respond to increasingly complex challenges. Balancing these against the need for simplification and clarity is a key and very difficult challenge. At both a European and domestic level, the Government is committed to ensuring that regulation is transparent, accountable, targeted, consistent and proportionate to the problem it is intended to solve.

4.26 The burden of bad regulation can be particularly weighty for small businesses and for those who want to start an enterprise. Strict regulation of entrepreneurial activity can have a negative effect on both the entry of new firms and the rate of expansion of successful entrants. Deregulation in such circumstances results not only in increased competition and lower mark-ups, but also has a positive effect on total factor productivity, insofar as, successful entrants are more likely to employ relatively new technologies.[12] Better regulation also helps ensure a more effective outcome in addressing environmental and social policy

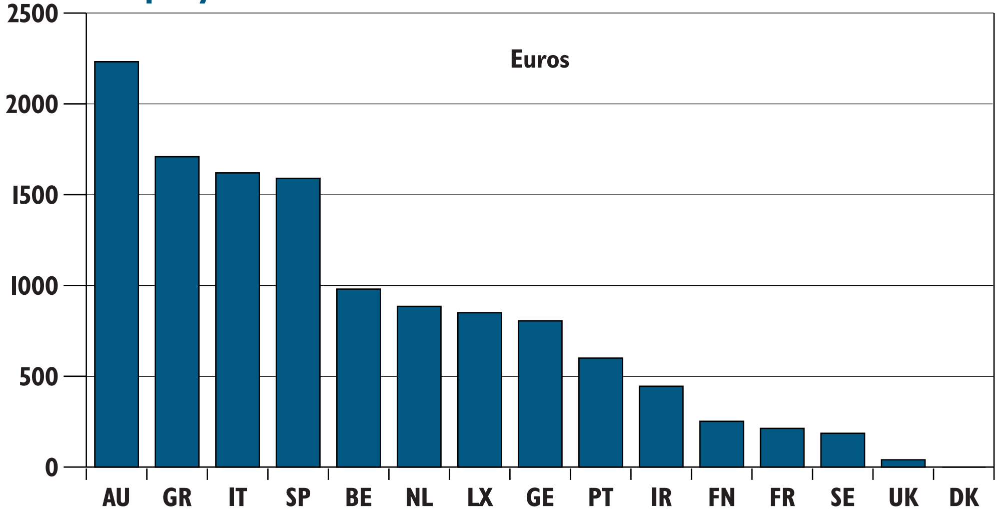
[11] *Internal Market Scoreboard 2001*, European Commission.

[12] *The role of policy and institutions for productivity and firm dynamics; evidence from micro and industry data* S.Scarpetta, P. Hemmings, T.Tressel, J.Woo, OECD Economics Department Working Paper No.329 (2002), cited in *EU Economy: 2002 Review*, European Commission (November 2002).

objectives. The use of **regulatory impact assessments** for new regulations, and the continuous review of existing regulation, are necessary and complementary aspects of the effort to improve the environment for entrepreneurs.

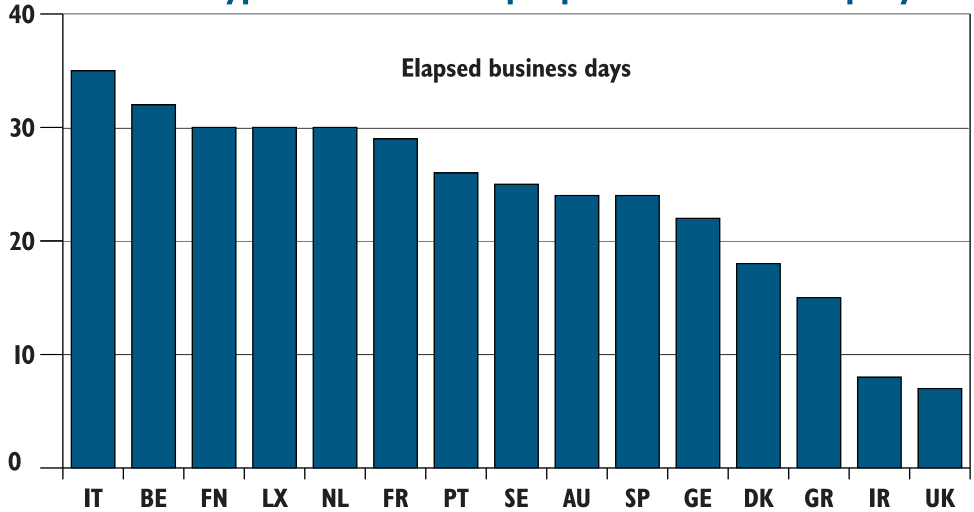
4.27 Removing unnecessary obstacles to business start-ups is an important part of the drive to create the world's most dynamic knowledge-based economy. One of the Commission's 'Target Actions' for June 2003, is that all Member States should ensure that a private limited company can be set up in 18 working days at a cost of no more than €213 and with a minimum paid-up share capital of no more than €3,000. Only Denmark and the UK have to date achieved this fully (Charts 4.2 and 4.3).[13]

Chart 4.2: Typical cost of setting up a private limited company



Source: Benchmarking the Administration of Business Start-ups, European Commission 2002

Chart 4.3: Typical time to set up a private limited company



Source: Benchmarking the Administration of Business Start-ups, European Commission 2002

[13] *Implementation Report on 2002 Review of the Internal Market Strategy – Delivering the Promise*, Commission Staff Working Paper SEC (2003) 43.

The product and labour market dimensions

4.28 Product and labour market regulation each affect both investment and employment decisions. After controlling for a range of policy and institutional factors affecting the labour market, an OECD study[14] found that anti-competitive **product market regulations** (establishing entry barriers in potentially competitive markets or unduly restricting market mechanisms) had significant negative effects on employment. The study also suggested that strict **employment protection policies** could reduce innovation activity in manufacturing, though this impact differed depending on industrial relations regimes and the technology level of the industry concerned.

4.29 Job security and fair employment rights are highly desirable **social aims**. Additional costs on businesses can be justified in terms of establishing legitimate social protection. Regulation can encourage employers to use labour more efficiently, and help improve the quality of job-matching, reducing the cost of labour turnover to firms. Decent standards in the workplace enhance, rather than subtract from, efficiency. It is important, however, to find the appropriate balance between regulation and flexibility. Workers' rights are not best safeguarded by denying access to work for those who do not have it. Regulation must both protect and promote employability and enterprise, thereby furthering the Lisbon objectives of job creation, productivity and social inclusion.

The EU dimension

4.30 The Government accordingly strongly supports the high level political commitment to regulatory reform made at the Lisbon European Council, and the Action Plan based on the Mandelkern Report and published in June 2002 (described in Section 3, above). Around 40 per cent of new legislation with a non-negligible impact on UK businesses, originates in the EU.[15] It is clearly in the national interest to ensure that such regulation meets the standards expected of domestic regulation. An **Inter-Institutional Agreement on Better Regulation** was due to be agreed by end-2002. This has not yet materialised; a speedy conclusion would be welcomed.

4.31 Measures taken by the EU go some way towards answering the challenge of fostering a more enterprising, innovative and confident society. Ultimately, however, the Government believes that getting the framework conditions right at a national level, is fundamental to the exercise. Some of the steps taken in this direction by the UK, are described in Box 4.4.

Box 4.4: Better regulation: UK experience

Measures introduced by the UK to promote better regulation include:

- steps to lift the **barriers** to enterprise imposed by inappropriate regulation;
- **Regulatory Impact Assessments;**
- a **Regulatory Reform Action Plan** that lists 260 measures of regulatory simplification; and
- giving the **Office of Fair Trading** a role in assessing the effects of regulations on competition.

[14] *Product and labour market interactions in OECD countries*, OECD (September 2001).

[15] Based on the average proportion of UK regulatory impact assessments concerning EU legislation.

(4) Progress on, implementation and enforcement of the FSAP

4.32 Progress towards completion of the Financial Services Action Plan (FSAP) has, as described in Section 3, been encouraging. There is, however, certainly no room for complacency. It is important to ensure that:

- the new 'Lamfalussy arrangements' are fully taken advantage of;
- the programme of measures already set out in the FSAP remains the focus of any legislative efforts; and
- the FSAP measures, once agreed, **are properly implemented**.

The importance of Lamfalussy

4.33 The new Lamfalussy arrangements referred to in the first of these bullet points, are particularly important. Originally introduced for securities legislation, these change the way EC legislation is made, by:

- committing the legislative process to greater openness and consultation;
- creating output-focused and principles-based legislation;
- supporting these principles with more detailed rules which are drawn up using 'comitology' arrangements – a less time-consuming process, which enables EC law to respond more quickly to market developments; and
- requiring greater cooperation between regulatory authorities to ensure that the new rules are **effectively implemented**.

4.34 ECOFIN has recently agreed to extend this framework to banking and insurance, and to set up a 'Financial Policy Committee' to provide political advice to the ECOFIN Councils and to improve delivery of results. This is a very welcome step.

4.35 As the FSAP nears completion, the focus shifts towards the enforcement, monitoring and implementation of agreed measures. This will require the Commission to take a more proactive approach towards monitoring Member States' implementation of EC legislation.

Box 4.5: Financial services: UK experience

The Government has enacted a range of measures to enable financial services markets to work more efficiently. The Financial Services and Markets Act 2000 (FiSMA) came into full effect on 1 December 2001, when the Financial Services Authority (FSA) assumed its full range of powers and functions. FiSMA establishes a single coherent regulatory regime for the financial services sector, enforced by a single regulator and backed by a single legislative instrument. The FSA has four statutory objectives aimed at making the financial sector operate effectively:

- **maintaining market confidence;**
- **promoting consumer awareness;**
- **protecting consumers; and**
- **reducing financial crime.**

In pursuing its objectives, the FSA must have regard to principles requiring that regulation be proportionate and not undermine competition, innovation or the responsibilities of those managing financial services firms.

The Government has also proposed further measures in relation to retail savings products. In July 2002 the Sandler review into the long-term savings market in the UK recommended:

- **a set of safer, good value, easy to understand 'stakeholder' investment products, and a 'lighter touch' regime for sales and advice of investment products;**
- **reform of with-profits policies to make their structure and management simpler and more transparent; and**
- **tax measures simplifying the regime for retail savings products.**

The Government has begun consultation on the proposals for a series of stakeholder products, and is considering the recommended tax measures.

The Green Paper on Pensions, published in December 2002, contained a wide range of proposals to boost choice in pensions and promote employment among older people, including:

- **a radical simplification of the pensions system;**
- **greater protection for pension scheme members;**
- **the biggest shake-up to date of the pension tax system;**
- **tailored information to help individuals plan for retirement; and**
- **an independent commission to monitor progress and explore the question of going beyond a voluntarist approach.**

4.36 The Commission will also need to assess what value has been added by the FSAP. This will require the compilation of indicators of success, the final choice of which should assist in making four assessments:

- whether EU financial markets are more accessible to firms seeking funds, and whether the cost of accessing capital is falling;
- whether retail markets offer consumers more choice and better value products;
- whether European actions are facilitating integration; and
- where future reform efforts should now be focused.

(5) Improved corporate governance

Corporate governance

4.37 Following the corporate crises at Enron and elsewhere, corporate governance, accounting and auditing arrangements have come under the spotlight. The policy response has occurred at a number of levels: Member States, the EU, and globally. The UK government's over-arching objective has been to ensure that decisive, prompt but proportionate action is taken at the appropriate levels to restore investor confidence, without reducing the impetus for greater market integration.

4.38 Corporate governance, broadly defined, is a matter for Member States. The UK has recently been undertaking an extensive review of its accounting and auditing regime. The recommendations, supported by the Government, are described in Box 4.10.

4.39 While Europe has not witnessed corporate governance problems on a scale equivalent to that seen in the US, the issue is nevertheless taken very seriously by both the Commission and individual Member States. The Commission's High Level Group of Company Law Experts (known as the **Winter Group** after its chairman, Jaap Winter) was asked, in spring 2002, to add corporate governance to its broader remit of company law. The group's final report, produced in November 2002, is expected to form the basis of a Commission proposal for a company law action plan in the first quarter of 2003. With respect to corporate governance, the report's recommendations concentrated on:

- strengthening shareholder involvement;
- looking at the role of independent, non-executive directors and how this could be enhanced, particularly with reference to board committees;
- increasing corporate transparency and disclosure;
- directors' remuneration, and sanctions (including disqualification) for wrongful trading;
- responsibility for financial statements;
- the role of audit committees; and
- coordination of Member States' corporate governance reforms.

4.40 The Government supports the development of an action plan which would identify areas of common concern and establish common high standards, for application by Member States according to their own circumstances and in their own jurisdictions. The Winter Report, recognising the rich diversity of approaches across Member States, does not recommend a common EU code of corporate governance – an approach fully consistent with UK thinking.

4.41 The EU is also working towards the adoption of international standards of auditing from 2005. These will enhance efforts to restore investor confidence and aid the integration of markets and the flow of capital. The UK Government supports the establishment of global standards in accounting and auditing, though it is important that this process does not result in a weakening of existing standards. The EU commitment is a significant step towards international integration, and particularly welcome at a time of global economic uncertainty. The UK urges the International Auditing and Assurance Standards Board to speed up the development of key new auditing standards.

Box 4.6: Corporate governance; UK experience

The **Coordinating Group on Audit and Accounting Issues** was established in February 2002 by HM Treasury and the Department for Trade and Industry to review the UK accounting and auditing regime. The group comprised representatives of the main regulatory bodies, and some independent members. Its final report was published on 29 January 2003, at the same time as the report of a review of regulation of the accountancy profession. The reports[1] contained a number of recommendations, supported by the Government, including:

- creating a **single authoritative regulator** with responsibility for setting accounting and auditing standards, proactively enforcing and monitoring them, and overseeing the regulatory functions of the professional accountancy bodies;
- enhancing the role of **audit committees** and ensuring larger companies disclose more information about the provision of non-audit services by their auditors. Best practice guidance for audit committees has been developed by a group appointed by the Financial Reporting Council (FRC), chaired by Sir Robert Smith. This group reported on 20 January 2003, alongside Derek Higgs' independent review of the role and effectiveness of non-executive directors;
- tougher measures to underpin **auditor independence**, including more frequent rotation of lead audit partners, the clarification and tightening of the circumstances in which audit firms can provide non audit services to audit clients, and cooling-off periods for partners and senior employees of auditing firms taking up employment with clients;
- the provision by major audit firms of much **more information** on their policies, procedures, financial affairs and management structures;
- establishing a new independent **audit inspection unit** to monitor the audits of listed companies; and
- setting up the long-delayed **Investigations and Discipline Board** with the power to remove eligibility to audit from firms and individuals.

The Higgs report on the role and effectiveness of non-executive directors recommended changes to the Combined Code to require a greater proportion of independent, better-informed individuals on boards. The new Code will require greater transparency and accountability in the boardroom, formal performance appraisal and closer relationships between non-executive directors and major shareholders. The report also calls for all boards to put in place a significantly more rigorous appointments process. The Government has warmly welcomed the proposals in the Derek Higgs' report.

The DTI is chairing an implementation steering group to take forward the changes to the regulatory structure. Changes to the Combined Code on Corporate Governance will be made in the early summer once the FRC has consulted on the precise wording.

[1] Links to all the reports can be accessed at www.dti.gov.uk/cld/post_enron.htm

(6) An R&D framework which better promotes innovation

Drivers of productivity

4.42 A recent ECOFIN study[16] identified research and development (R&D) and innovation as catalysts of productivity growth, helping open up markets and opportunities through the creation of new and improved products, services and processes. The study, however, also noted the extent to which R&D and innovation remained lacking in an EU context. This is a matter for concern, given innovation's role in realising the economic, social and environmental aspirations articulated at Lisbon; for example, in the development of more environmentally friendly technologies, or through the social benefits of better access to improved healthcare.

Linked but separate

4.43 Innovation is broader than R&D alone. However, firms with relatively high levels of investment in R&D appear also to have higher levels of productivity and innovation. The UK's R&D Scoreboard, for example, finds a positive correlation between R&D intensity and such measures of company performance as sales growth, productivity and market value.[17] Given the difficulty of measuring innovation, R&D is frequently used as a proxy. This should not, however, obscure the fact that it is only a part of the innovation process.

4.44 The Commission's latest European Innovation Scoreboard[18] highlights two particular EU innovation weaknesses. First, while the growth of EU high tech patents has been substantial over recent years, American patenting in Europe has grown even faster. Second, the rate of increase in business sector R&D continues to be slower than in the US.

The 3 per cent aim

4.45 The Barcelona Council of March 2002, responding to unsatisfactorily low expenditure on R&D and innovation in the EU, concluded that '*spending on R&D and innovation in the Union should increase with the aim of approaching 3 per cent of GDP by 2010*'. Business had a key part to play; '*two-thirds of this new investment should come from the private sector*'.

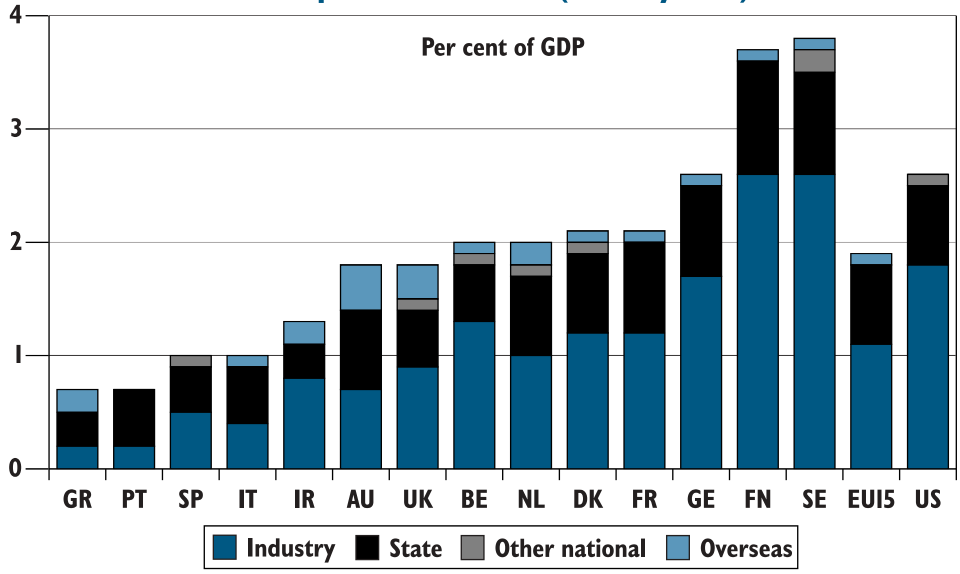
4.46 As Chart 4.4 illustrates, this represents a considerable challenge for most Member States and for the EU as a whole, and equates to devoting a larger share of GDP to R&D than is currently the case in the US. By focusing on the **input** to R&D and innovation, EU leaders hoped to generate increased **output** – greater choice, higher productivity and benefits to consumers and society in general.

4.47 Having set the target, steps must now be taken to reach it; in particular, by establishing **framework conditions** conducive to business investment in research and innovation. Efforts to this end cut across a number of aspects of the economic reform agenda, including in particular:

- high levels of **competition** to stimulate innovation;
- accessible, low cost **capital markets**;
- a supply of appropriately **skilled labour**; and
- an appropriate **intellectual property regime**, especially in the context of the lack of progress on a Community patent.

[16] Economic Policy Committee, "Report on Research and Development", EPC/ECFIN/01/777-EN Final, 22 January 2002, http://www.europa.eu.int/comm/economy_finance/epc/epc_reports_en.htm.
[17] 2002 R&D Scoreboard, http://www.innovation.gov.uk/projects/rd_scoreboard/introfr.html.
[18] European Innovation Scoreboard 2002; see

Chart 4.4: R&D as per cent of GDP (latest year*)



**UK, 2002; Germany, Spain, Austria, Finland 2001; Denmark, France, US, 2000; Belgium, Ireland, Italy, Netherlands, Sweden, 1999.*

Source: Towards a European Research Area, Science, technology and innovation – key figures 2002, DG Research, European Commission.

4.48 The urgency of reform was underlined by a report from the European Round Table of Industrialists, which concluded that '*unless there is dramatic reappraisal of Europe's approach to R&D and its framework conditions for business, the gap between the Barcelona target and the real world will not be bridged by 2010*'[19].

The 'European paradox'

4.49 The EU's poor performance on the innovation stage does not reflect its relatively strong science and knowledge base. Europe's failure to exploit that base is frequently referred to as the 'European paradox'. Measures to improve the information flow across borders and between research institutions and industry could include:

- support for knowledge transfer mechanisms between universities and business;
- enabling universities and public research organisations to better exploit their own research; and
- encouraging independent research organisations to play a larger role in knowledge transfer.

4.50 **Fiscal incentives**, and in particular tax credits, can be an effective tool for delivering additional R&D, though it is important that the system be simple, stable and well-understood. The most suitable approach to raising R&D and innovation inputs will, however, vary between Member States, and each must be able to adopt the policy mix most appropriate for its own economic structure and social model.

[19] *Is the "3% R&D for 2010" objective unrealistic?* European Round Table of Industrialists (22 October 2002).

4.51 The UK government set out some of its own thinking in a report published in July 2002 ('*Investing in Innovation – A strategy for science, engineering and technology*'[20]), and the Department of Trade and Industry is this year conducting a wide-ranging review of UK innovation policy to inform and shape policy on public support for business innovation. Some aspects of this policy are described in Box 4.7.

4.52 In addition, there is an important role for **state aid** in addressing the market failures that inhibit the effective operation of the EU innovation system. It is questionable whether the current state aid rules for R&D[21] adequately reflect this role. The Commission's intention to introduce a block exemption for state aid for R&D by small businesses (avoiding the need to notify and secure approval in advance) is a welcome move. In addition, there would be merit in the Commission instigating an independent review of the role of state aid in facilitating business R&D with a view to producing early proposals for reform of the relevant state aid rules.

Box 4.7: R&D and innovation; UK experience

The UK Government announced an R&D tax credit for SMEs in 2000 and, in 2002, introduced a further tax credit to encourage R&D by large companies.

The science budget has undergone a large and sustained increase which will help fund a number of measures, including:

- higher education **capital investment** and **infrastructure**;
- **university research departments**, through the Higher Education Funding Council for England;
- science in **schools** and establishment of a National Centre for Excellence in Science Teaching; and
- improved **career prospects** for academic scientists.

Funding for knowledge transfer through the Higher Education Innovation Fund has been increased, and fifteen 'University Challenge Seed Capital Funds' have been created.

The Department for Trade and Industry publishes an annual R&D Scoreboard, enabling businesses to benchmark their R&D expenditure against that of the most successful companies in their sector.

(7) Stronger and more effective competition policy

The importance of competition

4.53 Competition drives growth, productivity and job creation, and facilitates an efficient distribution of resources between enterprises and sectors. It promotes innovation, entrepreneurship, and efficiency; and it ensures that the benefits of these improvements are passed on to consumers through lower prices, increased quality, and greater choice. Empowered consumers drive and benefit from an effective competition regime. This is essential for a well-functioning single market, to ensure that the potential benefits of market integration are not negated by anti-competitive behaviour.

[20] Ref: "Investing in Innovation: A strategy for science, engineering and technology", DTI, HM Treasury, DfES. July 2002.

[21] *Community Framework for State Aid for Research and Development*, Official Journal C45, 17/02/1996.

[22] OECD Economic Outlook No.7, OECD 2002, finds that if the competition position for the EU economy as a whole were to reach the standard of "best practice" it could yield multi-factor productivity benefits equivalent to several years

4.54 Research suggests that Europe could achieve significant productivity benefits from increased competition; sustained progress in opening up markets is vital if the levels of dynamism of the best performers elsewhere in the world are to be achieved.[22] For instance, while price dispersion – which can be linked to competitive pressures – has shown some signs of declining in the EU, it remains significant and varies across sectors and countries in a way consistent with impediments to competition. The Government has consistently reaffirmed its belief in the importance of strong, independent and proactive competition regimes, both across the EU and within Member States.

EU level reform;

4.55 At an EU level, progress has been seen on two major initiatives to improve further the competition regime: modernisation of the rules implementing the competition articles of the Treaty, and a proposal for reform of the mergers regime.

modernisation

4.56 Competition policy is a shared competence between the Community and Member States; national competition authorities also have a key role to play in ensuring that the EU playing field remains level. The Commission's **modernisation** plans promise greater consistency in this sphere, proposing the application of Community law in all cases affecting cross-border trade. This should not only lead to a significant "levelling up" of competition regimes across the EU; but should also do much to promote a stronger competition 'culture' in Europe, and facilitate a better exchanges of information and best practice between Member States.

4.57 Modernisation also removes the system of compulsory notification, which created incentives for companies to provide large amounts of information and unnecessary work for the Commission. The change should remove from the Commission a large amount of reactive work and leave it well-placed to develop an increasingly proactive role.

mergers...

4.58 The proposed changes to the **mergers** regime include:

- measures to increase the transparency, predictability and accountability of decisions, including greater independent oversight;
- greater recognition of the benefits of efficiency improvements to consumers; and
- a more practical and effective process for identifying the correct level of jurisdiction in merger cases.

...and beyond

4.59 Commissioner Monti has also announced proposals for **changes which go beyond the mergers regime**. He has reiterated his commitment to strengthening the Directorate's economic expertise, in particular by creating the high profile post of Chief Economist. The Government welcomes these reforms as consistent with its own vision of competition policy as strong, proactive, independent and grounded in economic analysis. It looks forward to working closely with the Commission in order to continue making the European competition regime **more effective, enhancing competition** in all Europe's markets, and **promoting understanding** of the effects of anti-competitive policies. The Government continues to regard an economically-based "substantial lessening of competition" test for mergers as the best means of achieving reliable and credible decisions.

4.60 The Government has also pioneered new ways of extending competition in the delivery of public services through innovative Public-Private Partnerships, and will look for new opportunities to share best practice across the EU.

Competition and consumers

4.61 Some of the UK's own initiatives in competition policy are summarised in Box 4.8. The UK reforms have been founded on the Government's belief that competition and consumer policy are intrinsically linked. Consumers must have sufficient confidence to take advantage of the opportunities offered by more open markets. Informed and empowered consumers are an important driver of productivity and competitiveness. Just as a vigorous competition regime is the best way to ensure that consumer receive a good and fair deal, so active consumers are the most effective way of ensuring that the best firms are rewarded, and resources allocated in the most efficient manner. Tackling Internal Market barriers will empower consumers to seek the best deals, and enable businesses to offer them regardless of internal borders. This in turn will drive competitiveness and contribute to economic reform.

Box 4.8: Competition policy; UK experience

In 1998, the UK modernised its competition regime with the introduction of a **Competition Act**, moving into line with best practice on articles 81 and 82 of the EC Treaty.

In 2002, the UK introduced the **Enterprise Act**, improving the ability of the competition regime to increase the competitive intensity of the UK economy and bring down barriers to enterprise and innovation. The Act:

- gives the **Office of Fair Trading** a clear proactive role in keeping markets under review;
- modernises the **merger regime**, including the introduction of a substantial lessening of competition test;
- introduces a new regime for **market investigations**; and
- allows for **criminal sanctions** to be imposed on those engaging in hard-core cartels.

(8) A modernised state aid regime

More state aid reform needed:

4.62 While progress to date on state aid reform has been welcome, further effort is required to complete the process. The key is to build on this momentum by:

- tackling effectively the **market failures** that hold back the productivity and employment performance of countries and regions across the EU;
- **streamlining** the state aid procedures, in particular to deal much more quickly and simply with state aid that is not economically significant; and
- **focusing** the greatest Commission and Member State attention, and the most rigorous processes, on the most significant state aids.

targeting market failures...

4.63 It is essential that the state aid rules enable governments to tackle market failures wherever they occur, to the extent that they occur, and in a proportionate way. While progress has been made in better targeting the state aid rules on identified market failures, there are still areas where state aid has an important role to play in addressing market failures that are not currently covered by the state aid rules. In particular, the UK is committed to securing more effective state aid rules to address the market failures around regeneration, by way of a new regeneration state aid framework.

4.64 Targeting state aid rules on market failure also has an important **regional** dimension. Meeting the EU's productivity and employment objectives requires every country and region to reach its full potential. This process may include, where appropriate, the use of state aid. (The regional dimension is covered in more detail below.)

...and streamlining processes

4.65 The key priority for reform over the coming year is the **radical simplification and modernisation of the state aid regime**. At both a Commission and Member State level, effort must be focused on state aid that is economically significant. This could be state aid which:

- has a significant impact on trade or competition across the EU;
- exceeds certain thresholds (analogous to antitrust thresholds); and/or
- has significant spillovers impacting on other Member States.

Box 4.9: State aid reform: UK experience

A growing share of UK state aid is directed at horizontal objectives. In 2000, 60 per cent of UK state aid (excluding agriculture, fisheries and transport) was devoted to horizontal objectives, and much of the remainder was regional aid which also often addresses horizontal objectives.

UK state aid is increasingly targeted on identified market failures; for example, in the areas of access to finance for small companies, the regeneration of deprived communities, and in pursuit of environmental objectives.

The UK has expanded the resources devoted to the state aid dimensions of policy measures; both centrally in the Department for Trade and Industry, in lead policy departments and in devolved administrations.

4.66 Such steps would need to be complemented by a less onerous and much swifter process for dealing with aid that is not economically significant. Taken together, such reforms have the potential to embed robust economic criteria at the heart of the state aid regime, substantially speeding up the state aid processes and, by focusing on the key information relevant to each case, reducing the compliance burden on individual Member States. This latter is a particularly important consideration for an enlarged EU.

(9) A single market for services

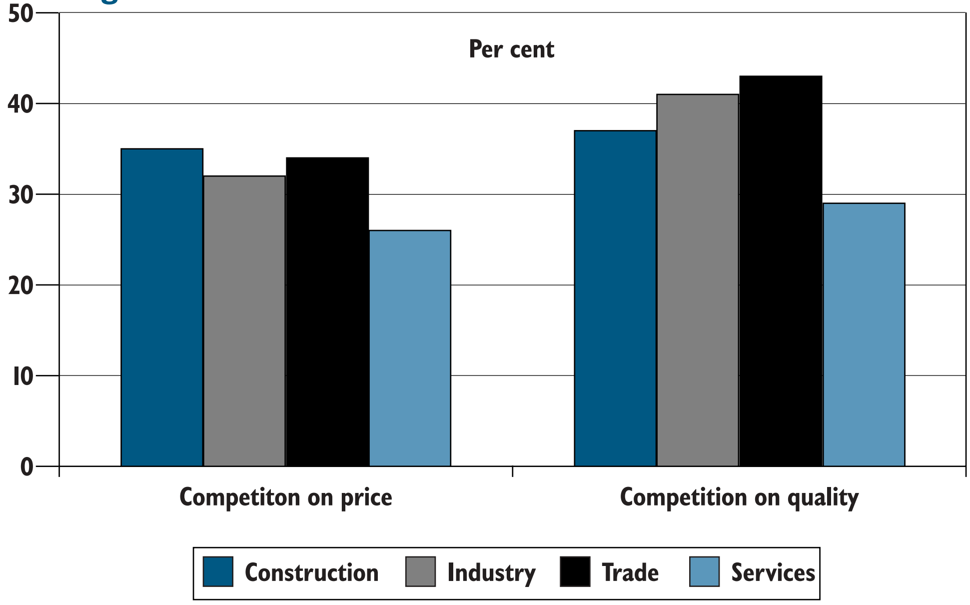
An uneven Single Market

4.67 The Lisbon objectives are, in the words of the Commission, not achievable without the creation of a single market in services: '*the creation of the Internal Market for services is perhaps the most important mid and long term goal for reforms...the development, adoption and implementation of the service strategy is therefore becoming increasingly urgent*'.[23] Greater competition and openness would not only allow consumers to obtain services at cheaper prices, but also reduce the cost of manufactured goods, thereby creating further consumer gains. The poor performance of services, and in particular service industries which affect business competitiveness (e.g. distribution, transport, energy, business services, financial services), may explain part of the difference in competitiveness between the EU and the US.

4.68 Services have, to date, been less exposed to the effects of the Single Market than has the goods sector. As Chart 4.5 illustrates, the proportion of firms reporting increased competition from firms elsewhere in the EU as a result of the Single Market, whether with respect to price or to quality and choice, is lower for service sector enterprises than for their counterparts in construction, industry or trade.

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

Chart 4.5: Proportion of firms reporting increased competition from elsewhere in the EU, as a result of the Single Market



Source: Internal Market Scoreboard No. 11, November 2002.

4.69 As noted in Section 3, the Commission is engaged in a two stage programme aimed at redressing the balance. The first stage, just completed, comprises a comprehensive inventory of the remaining Internal Market barriers to services.[24] This provides the basis for action to be launched in 2003 as part of the second stage of the programme, as well as for a closer analysis of the cost of these barriers to consumers.

4.70 Analysis of the effects of barriers to cross-border service provision will help identify the priority areas, paving the way for policy proposals that are proportionate to the scale of the problem. Particular consideration should be given to, for example, the use of **mutual recognition** rather than harmonisation. The free provision of services under the original professional title, subject to certain conditions to protect consumers, is an important part of creating a more dynamic, knowledge-based economy, and of improving public services. Discussions to produce a genuinely more flexible and automatic procedure, based on home state recognition and taking advantage of the opportunities offered by common platforms established by EU professional associations, are ongoing. Also of importance in this context is the potential of e-commerce to untie the provision of services from their location, enabling transactions without a physical presence and opening up markets to imports.

4.71 The free movement of services is, it should be remembered, already guaranteed by the Treaty[25]. That barriers persist, is partly explained by **ineffective and insufficient enforcement**. Attention must be paid not only to developing new ways in which to tackle these barriers, but also to better enforcement of measures already in place (a process required also at a national level, as described in Box 4.10 with respect to the UK). Only then will businesses and consumers be able to realise the full benefits of a genuinely single market across the EU.

[24] *Report from the Commission to the Council and the European Parliament on the State of the Internal Market for Services* COM(2002)441 Final, July 2002.
[25] Articles 49-55 of the Nice Treaty.

Box 4.10: A single market for services; UK experience

Private sector services account for almost half of UK gross value added and employment, and have benefited particularly from an increasingly effective UK competition regime (see Box 4.8, above).

The UK also continues to take steps to make trade in services easier; by, for example, including proposals in the Planning Green Paper to facilitate business establishment, and consulting on the Office of Fair Trading report into competition in the legal, accountancy and architectural professions. In the absence of any compelling arguments to the contrary, the Government is committed to reforms which improve competitiveness in these sectors.

(10) An effective regional policy which promotes economic reform and addresses market failure

4.72 Regional policy is not just about the poorest regions. A high productivity, high employment Europe can only be built on improved productivity and employment in all of its constituent parts. That is why a modern regional policy must focus on enabling every nation and region to improve their economic performance, by tackling the diverse market and social failures that are hindering their performance. Notwithstanding the progress that has been made, drawbacks in the current EU framework for regional policy continue to limit the contribution it has made to the Lisbon objectives.

European regional policy

4.73 The UK's approach to regional policy (see Box 4.11) is to devolve power substantially to enable regions to tackle local problems. Scotland, Wales and Northern Ireland have freedom over their policy design and, through the block grant arrangements, freedom over the associated allocation of resources in support of regional development and regional priorities. This approach is complemented by action at the European level. The Community has various instruments of regional policy for working towards these aims, of which the **Structural and Cohesion Funds** (SCF) are the most prominent. However, the policies of the **European Investment Bank** (EIB) are also important, as is the wider economic framework set by the rules on **state aid**.

4.74 These individual policies have many good elements. The SCF rules, for example, place a strong emphasis on using appropriate local and regional partners; cross-border co-operation between Member States formalised under the *Interreg* programme has promoted partnerships across borders encouraging balanced development; and state aid rules emphasise strong and fair competition to constrain inappropriate aid and funding.

Meeting the cohesion challenge – evidence of convergence

4.75 Although EU regional policies have delivered benefits, there have also been significant problems with their implementation. For example, existing EU regional policies have not proved sufficiently flexible to provide efficient delivery of the UK's regional development objectives and, in their current form, cannot meet Europe's cohesion challenge or effectively contribute to the Lisbon agenda. Current arrangements all too often have a bureaucratic "one size fits all approach", that does not adequately reflect the differing needs across the Union, particularly in the more prosperous Member States where Community aid is a comparatively small proportion of spending on regional development. Furthermore, the current system of state aid does not allow all clearly identified market failures to be tackled effectively and places an unnecessary constraint on the freedom nations and regions need in order to pursue their own locally determined and delivered policies.

4.76 The evidence on cohesion over the last two decades is mixed. Economic disparities between Member States have diminished substantially since 1988, thanks to the convergence of the cohesion countries (Ireland, Portugal, Greece, Spain).[26] Between regions of Member States, however, the improvement is much less marked.[27] Of particular concern is that the worst performing regions tend to be characterised by persistently low performances in terms of employment, unemployment and productivity.[28]

4.77 While there is scope to learn from policies that have contributed to substantial income convergence in particular instances (e.g. the Italian North-East, Metropolitan Lisbon, Inner London), EU regional policy is not, as currently deployed, delivering improvements for all.

A modern regional policy

4.78 If the Community is to achieve its Lisbon objectives – including those for social and economic cohesion – there is a need for an EU framework for devolved regional policy: so that regions have the resources and flexibility to meet local needs, within a framework of clear accountability, common principles and shared objectives, and with delivery of these policies substantially devolved. In particular, such a framework for devolved regional policy will require reform of the state aid regime and reform of the structural funds.

State aid reform and regional

4.79 The state aid disciplines have two important roles in the achievement of these regional policy objectives. First, they promote **strong and fair competition** – ensuring less prosperous regions can compete on an equal footing with wealthier areas by continuing to constrain inappropriate or economically undesirable aid. Second, they enable Member States to address the causes of **regional disparities**. There has been good progress in developing horizontal state aid rules (that apply across the whole of the economy) focusing on particular market failures, but the current rules prevent empowered local institutions from adequately tackling these causes of relative regional disadvantage.

4.80 The challenge now is to build on this progress to deliver a reformed state aid regime that is suitably efficient, proportionate and responsive to meet the needs of a modern regional policy. As has already been noted, while progress has been made, there are still several gaps to be addressed: in particular, ensuring the relevant market failures can be addressed wherever they occur across the EU, and that local and regional measures with little impact on the wider EU economy can be approved quickly and with minimum compliance costs.

Structural and Cohesion Funds

4.81 With a budget of €213 billion for the current members of the EU over the period 2000-2006, the structural funds represents the largest Community budgetary instrument for promoting social and economic cohesion, and constitutes a third of overall Community spending. It is, however, far from clear that this money is being spent to best advantage. Reform of structural funds is needed, so that Member States can pursue a range of effective policies for regional growth, within a framework that has sufficient flexibility to meet their differing needs.

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

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

[28] *Employment in Europe 2002*, European Commission.

4.82 Reform of regional policy poses a major challenge for an enlarging Europe. It is also a challenge which must be met, if the EU is to reach the goals it set for itself at Lisbon.

Box 4.11: Regional policy; UK experience

Regional policy is not just about the poorest regions. For the Government to meet its central economic objective of achieving high and stable levels of growth and employment, it is essential that every nation and region of the UK performs to its full economic potential. That is why the Government has rejected the failed policies of the past, which maintained huge differences in prosperity between and within regions, to the exclusion of sections of society. In their place it has developed a modern regional policy focussed on improving economic performance in every nation and region, by tackling the diverse market and social failures that are holding them back.

This new strategy for regional development is based on robust analysis of the evidence, and set out in *Productivity in the UK: 3 – The Regional Dimension (November 2001)*. The key elements are:

- **macroeconomic stability**, providing a stable basis to plan and invest following decades of under-investment;
- **microeconomic reforms to tackle market failures** at the national, regional and local level, focused on the key drivers of productivity; and
- a **regional policy framework of devolution and decentralisation** so that regions have the resources and flexibility to deliver locally-led policies, within a framework of clear accountability.

The Government believes that building on this approach across the EU will help Europe realise its potential, facilitating the wider reform objectives set out at Lisbon.

5 European Economic Reform in a Global Context

The competitive, dynamic and knowledge-based EU economy envisaged at Lisbon must, by definition, be an open economy. As the EU reforms inwardly, it must continue looking outwards.

Progress is now underway on the Doha Development Agenda launched in November 2001. The next milestone will be a stocktaking meeting at Cancun, Mexico, in September 2003. This will herald a second stage of negotiations: bringing together the existing programme, focused on market access, agriculture and services liberalisation, and opening the door for substantive talks on new issues such as investment, competition, trade facilitation and transparency in public procurement.

Agriculture is a key element of the Doha negotiations, and one of the most difficult. Progress on agriculture would not only bring significant benefits in its own right but would also increase the potential for success on other aspects of the World Trade Organisation (WTO) agenda.

At a bilateral level, the most significant global trade and investment relationship is that between the EU and US. An important contribution to bilateral liberalisation came with the Positive Economic Agenda of May 2002 – a rolling programme of cooperation in specific sectors. The potential gains from a deeper and truly open transatlantic relationship remain vast; a detailed analysis of the potential benefits of further liberalisation would help ensure that the momentum for further progress in this direction is maintained.

INTRODUCTION

5.1 The EU is part – and an important part – of an increasingly interconnected world. It accounts for 6 per cent of the world's population but a fifth of global imports and exports. The EU15 is[1]:

- extremely 'open', with a ratio of external trade to GDP of 11.3 per cent in 2001 (compared with 9.2 per cent for the US and 8.9 per cent for Japan);[2]
- the world's leading exporter of goods; over €973 billion in 2001, or almost a fifth of the world total;
- the world's leading exporter of services; €290 billion in 2000, or almost a quarter of the world total; and
- the world's leading source of foreign direct investment (€362 billion in 2000) and the second largest destination for foreign investment after the US (€176 billion in 2000 into the EU, €305 billion into the US).

5.2 **A reforming, stronger and more dynamic Europe** therefore benefits its neighbours substantively, both directly and indirectly: **directly**, through stronger import demand, more competitive exports, and improved access to large markets no longer unfairly protected by inappropriate state aid or legislation; and **indirectly**, insofar as other countries are encouraged to reform their own social, economic and environmental frameworks in the light of EU lessons learned.

[1] Unless otherwise stated, all figures in this paragraph are from *Making globalisation work for everyone; the European Union and world trade*, European Commission (November 2002).

[2] Eurostat.

5.3 A reforming, stronger and more dynamic Europe can play a leading role in **breaking down barriers** to trade and investment[3]; in fostering the application of effective competition policy; in supporting and promoting **sound, sustainable macroeconomic frameworks**; and in reform of the **international financial architecture**. Such a Europe is also better placed to meet, and to encourage others to meet, the challenge of the **Millennium Development Goals**; agreed in 2000 by 189 countries and a range of supranational institutions, which target substantial improvements in the quality of life of the poorest communities in the world.

5.4 For an enlarged EU, the obligations and the challenges are larger still, both in a global and European sphere. 'Enlargement', in the words of the Greek Presidency, "*serves as a point of departure for building stronger relations in the wider European space from Russia to the Mediterranean, based on common values and economic interests*".[4]

5.5 This section addresses the EU's external relationships at both the multilateral and bilateral level. It looks first at the Doha Development Agenda, with a particular focus on agriculture and sustainable development; and, second, at the transatlantic dimension – the EU-US relationship.

The Doha Development Agenda

5.6 Trade liberalisation has brought enormous benefits in the post-war era. The average industrial tariffs of developed countries have, through eight rounds of multilateral negotiations, fallen from nearly 40 per cent to less than 5 per cent. This reduction has gone hand-in-hand with a twenty-fold increase in world trade and a more than six-fold increase in world income.[5]

5.7 The World Trade Organisation (WTO) launched a new round of trade talks, the **Doha Development Agenda**, on 14 November 2001, with a target end-date of 1 January 2005.

5.8 The WTO estimates that the impact of the last trade round, the Uruguay Round (which ended in 1994), was an increase in world income of between $109 billion and $510 billion.[6] With respect to the current round, a 1999 study published by the European Commission[7] concluded that an across the board halving of protection could boost world prosperity by nearly $400 billion per annum. Gains to the EU would be in the region of $90 billion, or about 1.4 per cent of GDP, each year – equivalent to an average income boost of nearly £500 per annum for each UK household. Gains to developing countries would be still greater, at around $140 billion per year.

5.9 The Doha agenda is ambitious and wide ranging. It includes negotiations on agriculture, services, non-agricultural goods, improving WTO rules, regional trade agreements, clarifying the relationship between WTO rules and international environmental agreements, and new framework agreements on investment, competition, transparency in government procurement and trade facilitation. It will also look at: enhancing technical cooperation; special and differential treatment for developing countries; links between trade, debt and finance; trade and the transfer of technology; and the specific circumstances of small economies.

[3] Article 131 of the Nice Treaty commits the EU to a common commercial policy which contributes, '*...in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers*'.

[4] *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.

[5] *Trading into the future*, WTO (1995), WTO Annual Report, various issues: *Open markets matter; the benefits of trade and investment liberalisation*, OECD (1998).

[6] *The Uruguay Round: A Numerically Based Quantitative Assessment*, J. Francois, B. MacDonald and H. Nordstrom in *The Uruguay Round and the Developing Countries*, editors W. Martin and A.Winters (1996).

[7] *The millennium round; an economic appraisal*, N.Nagarajan.

5.10 The negotiations can only be concluded as a single undertaking: nothing is agreed until everything is agreed. Progress in one sector has to be matched by progress in others, in order that an overall balance of gains can be struck.

Mixed progress to date

5.11 While the January 2005 end-date appears comfortably distant, progress has been uneven. Some parts of the negotiations are progressing well but deadlines are also being missed.

5.12 Procedural hurdles delayed the start of substantive negotiation on various issues. These problems have, however, now been overcome, and negotiating groups, councils and committees put in place. An informal meeting of the WTO in Sydney (November 2002) delivered strong backing for the ongoing negotiations, particularly with regard to improved market opening for industrial goods, agricultural products and services. Only slow progress is, however, being made on new rules to give poorer countries access to cheaper medicines, and on a package of special and differential treatment concessions for developing countries across the full range of WTO rules. Neither of these was agreed by the Doha agenda deadline of 31 December 2002.

5.13 The question of access to medicines, relates to compulsory licensing for those countries with insufficient production capacities to combat diseases such as AIDS/HIV, malaria or tuberculosis. To break the negotiating deadlock, the EU has proposed that the World Health Organisation be invited to advise on the diseases to be covered by the proposed solution. On special and differential treatment for developing countries, the WTO's General Council has accepted a proposal for work continuing into 2003. Informal sessions resumed in Geneva on 15 January 2003.

5.14 The next milestone will be a stocktaking meeting of WTO ministers at Cancun, Mexico, on 10-14 September 2003. This will be the launch pad for a second stage of negotiations bringing together the existing programme, which is focused on **market access, agriculture and services liberalisation**, and opening the door for substantive talks on new issues **(investment, competition, trade facilitation and transparency in public procurement)** and certain **trade** and **environment** topics.

5.15 Efforts and progress to date have centred on market access. Both the EU and US have proposed far-reaching reductions in tariffs, and their elimination for industrial goods. In the negotiations on services, WTO members have exchanged liberalisation requests and are considering what offers to make in response by March 2003. While it is expected that some countries will not be able to meet this deadline (the EU does expect to meet it), this can be accommodated flexibly. Consultation exercises are underway in the UK and the EU to inform the process.

Agriculture

5.16 Agriculture is a core part of the WTO negotiations. Opening up the EU market to agricultural produce from developing countries is central to the aim of reducing world poverty (see Box 5.1). As the Chancellor noted in a speech to the UN General Assembly in May 2002, "*[Global] subsidies to agriculture run at $1 billion a day – six times development assistance – and the UK is committed to push for significant reform of the Common Agricultural Policy to allow developing countries to take full advantage of domestic and international market opportunities.*"[8]

[8] Speech given by the Chancellor of the Exchequer, Gordon Brown, at the United Nations General Assembly Special Session on Children (10 May 2002); http://www.hm-treasury.gov.uk/Newsroom_and_Speeches/Press/2002/press_46_02. cfm.

Box 5.1: Trade and EU agricultural reform

CAP reforms have largely put an end to food mountains and lakes but farm products remain an expensive, protected and managed market. Giving farmers incentives to increase production through subsidies, and then protecting them from external competition, distorts trade.

The level of agricultural tariffs is ten times higher than for manufactures. Because it is the most heavily protected, the EU has most to gain from liberalising farm trade. One study* estimates that halving agricultural trade protection would provide global welfare gains of $27 billion a year, of which more than $17 billion would accrue to the EU.

Developing countries which cannot compete with heavily subsidised agricultural exports have a particular stake in establishing a level playing field. They will be especially hostile to negotiations if they see OECD countries maintaining their subsidy programmes. Trade preferences give some developing countries limited access to the EU market for some agricultural produce at higher prices than on the world market but this is a poor substitute for a liberal trade regime for all.

The WTO negotiations cover: market access (substantial reductions); export subsidies (reductions with a view to phasing out); domestic support (substantial reduction of trade-distorting support); and non-trade issues (e.g. animal welfare).

* *The Next WTO Round: North-South stakes in new market access negotiations*, J. Francois Center for International Economic Studies, Adelaide, and Tinbergen Institute, Amsterdam

5.17 Three quarters of the world's poor live in rural areas, and agriculture accounts for about 27 per cent of developing countries' GDP. Latest estimates from the World Bank show that agricultural liberalisation on the part of the developed countries would lead to static gains of up to $31 billion (in $1997) for developing countries. If dynamic effects are taken into account, this gain would rise to $99 billion.[9]

5.18 There remain wide gaps between those seeking rapid and fundamental reform of farm trade, and those advocating a gradual approach. Progress in this area has slowed. The 'modalities' for negotiation (effectively the outline terms of a new agreement) must be agreed by 31 March 2003, with final agreement scheduled for **Cancun** in **September**. Most WTO members have submitted liberalising proposals.

5.19 The EU proposals, submitted on 30 January 2003, make a commitment to further reform. The key elements are that import tariffs should be cut by 36 per cent; that export subsidies should be slashed by 45 per cent; and that trade-distorting domestic farm support should be reduced by more than half (55 per cent). Special treatment is included for developing countries, and emphasis placed on the importance of non-trade concerns such as the environment, rural development and animal welfare. The final shape of the proposals, however, remains conditional on the outcome of the Mid-Term Review of the Common Agricultural Policy (CAP).

[9] *World Development Report 2002; Building Institutions for Markets*, World Bank (2002).

5.20 In January 2003 the Commission published its Mid-Term Review legislative proposals for reform of the CAP. These recognise the need for change to ensure the future of a competitive, market orientated, sustainable agricultural sector in Europe, and contain three main proposals:

- decoupling direct payments from production;
- transferring funding from direct payments to generate additional money for rural development and savings to fund future reforms; and
- cuts in guaranteed prices for cereals, rice and dairy.

5.21 The Government has welcomed these proposals as a positive step in the right direction and consistent with its own efforts (Box 5.2), though would prefer them to go further and cover a wider range of sectors (most notably sugar).

Box 5.2 UK agricultural reform

Following the Foot and Mouth Disease crisis of 2001, the Government set up the independent Commission on the Future of Farming and Food, to examine how a sustainable, competitive and diverse food and farming sector could be created. The commission made 105 recommendations, including that of urging the Government to press for substantial CAP reform as quickly as possible.

On 12 December 2002 the Government published its response and the Strategy for Sustainable Food and Farming, setting out how government and industry can work together to achieve their aims. While CAP reform plays a key role in this, the strategy includes a range of measures such as:

- **a pilot entry-level agri-environment scheme;**
- **the development of a new 'whole farm' approach to management and regulation, to help farmers run their businesses to meet commercial and regulatory needs; and**
- **measures to improve cooperation, farm assurance and the spread of best practice.**

Together with CAP reform, the Government believes that these measures will help farmers to become both more market orientated and better able to deliver valuable environmental outputs.

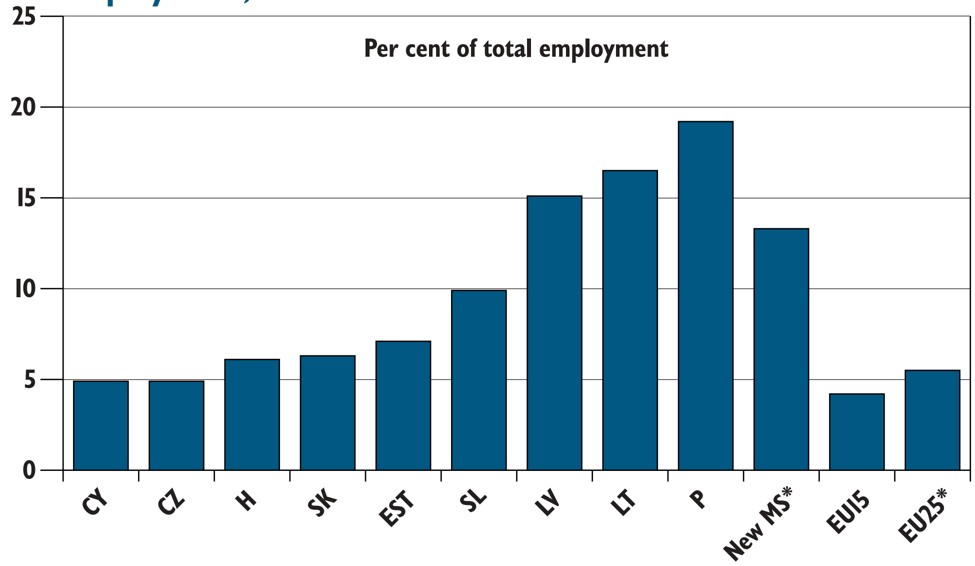
5.22 Decoupling is especially important, as it would significantly reduce the economic distortions in the agricultural sector and enable farmers to respond directly to market signals. Indeed, EU enlargement makes these changes all the more necessary. Agriculture plays a much larger role in the new Member States than in the EU15, as Chart 5.1 illustrates with respect to employment.[10] In the absence of reform, the CAP will impose significant economic costs on new Member States, attracting resources away from more productive uses into agriculture, and thereby holding back economic development.

5.23 By removing the incentive to over-produce, decoupling would also reduce the trade-distorting dumping of surpluses on the world market, thereby greatly strengthening the EU's negotiating position in the Doha Development Round.

[10] Enlargement will, however, have little effect on the share of EU GDP derived from agriculture (around 2 per cent for the EU15). See *Employment in Europe 2002*, European Commission.

5.24 As the Prime Minister noted in September 2002, in Mozambique; "*Trade liberalisation was set in motion afresh at Doha last year in negotiations designed to help the poorest nations. It is essential we maintain that momentum. It means recognising that free trade is not a one-way street; it will involve serious reform, for example of the EU Common Agricultural Policy, which works to shut out the products of developing world farmers while dumping food on the South. It can't continue. Enlargement of the EU makes it in any event frankly unsustainable.*"[11]

Chart 5.1: Agricultural employment as per cent of total employment, 2001



**Malta not available.*

Source: Employment in Europe 2002, European Commission.

5.25 That the European Commission's proposals were not published until January 2003 means that the timing with respect to Doha is very tight. The EU risks not being in a position to negotiate credibly in the WTO until later in the year. The current position falls short of WTO members' expectations; without some movement, the whole trade round may be delayed, and a setback at Cancun could weaken confidence in the entire multilateral system.

5.26 Making substantive progress towards meeting the Doha commitments over the coming months is crucial. Progress on agriculture would not only bring significant benefits in its own right but would also increase the potential for success on other aspects of the WTO agenda such as services and investment.

[11] Prime Minister's speech at the World Summit on Sustainable Development (2 September 2002); http://www.number-10.gov.uk/output/page5987.asp.

Sustainable development

5.27 Trade liberalisation, if done in a 'pro-poor' manner, should lay the foundations for long-term sustainable development through both economic and social improvements and increased trade in cleaner technologies and technology transfer. It is important that the EU delivers on its commitments under the WTO's Doha Development Agenda, particularly with respect to market access and the reform of agriculture market distortions. A May 2000 study published by the Tinbergen Institute estimated that the potential benefits to the developing world of a new round in agriculture alone, would be three times what it received in development aid each year.[12]

5.28 Important progress in this direction was made at the **World Summit on Sustainable Development (WSSD)** which took place in Johannesburg in August/September 2002. For the EU, the key advances included:

- agreements on **poverty eradication**, reaffirming the importance of the Millennium Development Goals, the Monterrey Consensus on Financing for Development, and the Doha Development Agenda. Highlighting the importance of good environmental and natural resource management for sustainable livelihoods;
- new commitments on **access to water and energy** and a new target to halve by 2015 the **proportion of people living without basic sanitation**;
- a commitment to urgently and substantially increase the global share of **renewable energy sources** with the EU leading a coalition of around 60 other countries in making a strong informal commitment to renewable energy;
- agreements on reversing the current trend in **natural resources degradation** as soon as possible, with specific targets on reducing the current rate of loss of biodiversity, minimising the adverse effects of chemicals and restoring depleted fish stocks; and
- a strengthening of the way the **United Nations** deals with sustainable development issues, particularly by following up the outcomes of Monterrey[13] and Johannesburg in a co-ordinated manner.

5.29 Follow-up to the WSSD is now vital, especially with respect to making patterns of consumption and production more sustainable, international capacity-building, and action to protect fisheries and oceans.

The transatlantic dimension

5.30 Openness to international competition is a key strand of the European economic reform agenda. Just as barriers to trade within Europe have dampened productivity and constrained employment growth, so barriers to trade within the world economy have contributed to global underperformance. Free trade and investment is the best way of spreading best practice and knowledge around the world's economies and corporations. Only a Europe open to trade and investment can play its full part in driving global growth.

5.31 The most significant bilateral trade and investment relationship is that between the EU and US. In 2001:

- around a fifth of EU goods imports were sourced from the US, while almost a quarter of EU exports were to the US;[14]
- around a fifth of US imports and exports came from or went to the EU;[15]
- EU direct investment in the US totalled over $800 billion in 2001; and
- US direct investment in the EU came to $640 billion.[15]

[12] *The Economic Impact of New Multilateral Trade Negotiations: Final Report*, J. Francois, Tinbergen Institute and the Centre for Economic Policy Research (May 2000).

[13] The Monterrey Conference on Financing for Development, 18-22 March 2002.

[14] DG Trade, European Commission.

[15] US Department of Commerce.

5.32 The two-way trade and investment flows support an estimated seven million jobs.[16] Given this volume of trade, the emergence of occasional trade disputes is unsurprising. Notwithstanding, the ability of such disagreements to generate headlines, the amounts of trade involved are very small (less than 2 per cent).

5.33 Recognising the importance of the transatlantic relationship, the EU/US summit of May 2002 made an important contribution to bilateral liberalisation with the launch of the **Positive Economic Agenda** (Box 5.3) – a rolling programme of bilateral cooperation in specific sectors. This was an extremely welcome step, exemplifying the benefits of bilateral engagement, and reflecting the dispute-free nature of most transatlantic trade.

5.34 The scale of the EU/US relationship means that there remain vast potential benefits from further liberalisation efforts on a bilateral basis. Preliminary studies show that removing bilateral tariff and non-tariff barriers in goods and services could raise employment by 1.3 million in the EU, and cut EU prices by at least 2.5 per cent.[17] The dynamic effects of liberalisation on labour and total factor productivity could mean that the benefits for the EU would be greater still.

5.35 The UK remains strongly committed to deepening and broadening transatlantic relations. The Chancellor has called[17] for a detailed analysis of the potential benefits arising from a **more open transatlantic relationship**; an exercise mirroring the important Cecchini report which assessed the benefits to Europe of completing the Single Market.[18]

5.36 Only by highlighting the benefits of liberalisation to date, and demonstrating the potential benefits of further liberalisation, can the momentum for progress be maintained. That is why the UK strongly supports the recommendation made by the Transatlantic Business Dialogue (TABD) at its annual conference in Chicago in November 2002, for an expert study into the benefits of a **single transatlantic capital market**.[19]

5.37 The competitive, dynamic and knowledge-based EU economy envisaged at Lisbon, must by definition be an open economy. **As the EU reforms inwardly, it must continue looking outwards**. A deeper and truly open transatlantic relationship would have a positive impact in terms of growth, jobs and prosperity for Europe, the US and the global economy as a whole.

[16] Speech by Pascal Lamy to European American Business Council, Washington D.C., 14 October 1999.

[17] Speech made by the Chancellor of the Exchequer to British American Business Inc., New York (19 April 2002). Available at : http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2002/press_36_02.cfm.

[18] Commission of the European Community, 1988.

[19] TABD 2002 Chicago Conference Report. Available at: http://www.tabd.org/recommendations/Chicago02.pdf.

Box 5.3 The Positive Economic Agenda

At the 2 May 2002 Summit in Washington D.C., the EU and US agreed to a rolling programme of initiatives in specific sectors, known collectively as the Positive Economic Agenda. The Agenda began with the following sectors (though it is expected that, as progress is made, further areas for cooperation will be addressed):

- **financial markets**; developing a regulatory dialogue;
- **regulatory cooperation**; following the adoption of guidelines on regulatory cooperation between the EU and US (April 2002), the implementation of pilot projects is under consideration;
- **sanitary and phyto-sanitary issues;** focused to date on the resumption of exports of Spanish clementines to the US, and of US poultry exports to the EU;
- **insurance**; explore possible new approaches in this field;
- **organic farming and products**; exploring, for example, mutual recognition of organic farming standards and controls;
- **electronic tendering**; cooperative efforts to increase access by both the EU and US to each other's on-line tendering processes for government procurement; and
- **electronic customs**; cooperation to define and develop prototypes in this area.

The Agenda allows for progress to be made now in areas where reforms are a priority. Thanks to discussions held under the auspices of the Agenda, the US has, for example, agreed to resume imports of Spanish clementines. The UK strongly supports efforts to broaden the scope of the Agenda, and address new areas of potential cooperation.

List of Abbreviations

Countries

EU	European Union
EU15	The EU as currently constituted, i.e. 15 Member States
AU	Austria
BE	Belgium
DK	Denmark
FN	Finland
FR	France
GE	Germany
GR	Greece
IR	Ireland
IT	Italy
LX	Luxembourg
NL	Netherlands
PT	Portugal
SE	Sweden
SP	Spain
UK	United Kingdom
EU25	The EU post-enlargement (i.e. 25 Member States)
New MS	The 10 new Member States expected to join the EU in 2004
CY	Cyprus
CZ	Czech Republic
EST	Estonia
H	Hungary
LV	Latvia
LT	Lithuania
MT	Malta
P	Poland
SK	Slovak Republic
SL	Slovenia
US	United States of America

Other

CAP	Common Agricultural Policy
DfES	Department for Education and Skills
DG	European Commission Directorate-General
DG ECFIN	Economic and Financial Affairs Directorate-General
DTI	Department of Trade and Industry
EES	European Employment Strategy
EIB	European Investment Bank
EMU	Economic and Monetary Union
EPO	European Patent Office
Eurostat	Statistical Office of the European Commission
FiSMA	Financial Services and Market Act 2002
FP6	Sixth Framework Programme
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSAP	Financial Services Action Plan
GDP	Gross Domestic Product
NAIRU	Non-Accelerating Inflation Rate of Unemployment
New Cronos	Eurostat database
OECD	Organisation for Economic Cooperation and Development
ONS	Office of National Statistics
PPS	Purchasing Power Standards
R&D	Research and Development
RCAP	Risk Capital Action Plan
SCF	Structural and Cohesion Funds
SMEs	Small and medium sized enterprises (< 250 employees)
TFP	Total factor productivity
WSSD	World Summit on Sustainable Development

List of Charts

List of Tables

List of Boxes