Growth and Opportunity

Prioritising economic reform in Europe

February 2005

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Foreword by the Prime Minister

2005 is an important year for the Lisbon strategy. It is a chance to take stock of the progress made at the European level since 2000, and set the agenda for the next five years.

The EU has achieved a lot since the Lisbon strategy was established five years ago. We have made good progress in opening markets in telecoms, network industries, and financial services. We have created millions of new jobs, delivering prosperity and opportunity to millions of families across Europe. But as Wim Kok has said, commenting on progress so far, in a world economy which is constantly changing, we need to go further and faster.

The European Commission has acknowledged this in its new plans to refocus the Lisbon strategy on promoting growth and jobs. This is the right priority and the best way to equip the EU to meet the social, environmental and economic objectives we have set ourselves.

This report is a valuable contribution to our work in pursuing these goals. It shows where we have made progress, and where we now need to concentrate our efforts to deliver growth, jobs and a sustainable future for Europe's citizens. It reaches important conclusions about how we can create more jobs, and help our businesses to seize the opportunities presented by a fast moving global economy. And it draws the right conclusions on how European leaders – acting nationally and together – can act to generate the conditions for sustainable growth.

Tony Blair

Executive Summary

At the Lisbon European Council in March 2000 Europe's leaders committed themselves to a ten-year programme of economic reform designed to make the European Union the most competitive and dynamic knowledge-based economy in the world with more and better jobs and greater social cohesion. In the past five years important progress has been made in reforming the European Economy. But the challenges ahead remain substantial:

- **globalisation, advances in new technologies and the increasing integration of emerging economies into global patterns of trade and investment are placing Europe under sustained and intensified competitive pressure and forcing Member States to adapt, and adapt quickly, to maintain growth and living standards;**
- **major demographic challenges caused by an ageing population have profound implications for long-term growth in Europe and place significant pressures on the sustainability of age-related public spending programmes across the Union; and**
- **the gap between Europe's economic performance and that of its major international competitors has widened, with economic growth, employment rates, productivity levels and living standards below those in the US economy.**

The mid-term review of the Lisbon strategy offers a vital opportunity for the European Union to address these challenges and to advance its goal of higher standards of living and social cohesion. The agenda that flows from this demands a concerted programme of structural reform, with economic growth at centre stage and urgent action by the Member States and institutions of Europe to strengthen each of the key drivers of growth – employment and productivity. In the words of the European Commission: *"the opening of international markets and the strong growth of the newly industrialising economies will make a significant contribution to growth and jobs. However, this will only happen if we can ensure a deeper and more rapid process of structural adjustment…to reallocate resources to sectors where Europe has a comparative advantage. Facilitating change to more competitive sectors and better quality jobs is therefore critical to the success of the renewed Lisbon strategy"*.

A Lisbon strategy focused on the key objective of economic growth does not mean that Europe should renege on its defining commitment to social justice and to high standards of environmental protection. These will rightly remain at the very heart of European ambition. But in a world of ever-intensifying global competition, in which adaptability and responsiveness is the key to success, policies constructed on the outdated notion of a trade-off between economic efficiency and social and environmental fairness should be reconsidered. As the European Commission has concluded *"we need a dynamic economy to fuel our wider social and environmental ambitions"*.

The UK Government strongly welcomes the work of the High Level Group chaired by Wim Kok and the European Commission's communication to the spring European Council. If Europe is to set in place the foundations for economic success in an increasingly globalised world economy, and deliver growth, jobs and rising living standards for all its citizens, the mid-term review must embrace and agree a programme of change designed to:

- **deliver a dynamic and competitive Single Market**, with liberalisation in services, and a new strategic focus to ensure that the benefits of economic integration are realised, through better implementation of existing regulation, a pro-active approach to competition policy, steps to promote competition in public procurement, and further reform of the state aids framework;
- **establish the right climate for enterprise and innovation**, through further action to strengthen and reform the regulatory framework in Europe building on the Six Presidencies' initiative, reform of Community funding for research and development, urgent action to improve the intellectual property regime in Europe, and the launch of a new European Centres of Enterprise competition;
- **promote flexibility and security in the labour markets**, by implementing the recommendations made by Wim Kok's European Employment Taskforce, and so equipping people with the skills they need to master change and to compete effectively for jobs in a rapidly changing global economy, promoting higher employment and social cohesion;
- **establish a more outward-looking Europe**, through increased EU flexibility in advance of the WTO Ministerial in Hong Kong in order to lead the Doha Development Agenda negotiations towards an ambitious, liberalising and pro-poor agreement; and through further concrete steps to strengthen bilateral trade and investment relationships, especially with the US; and
- **deliver environmental protection with competitiveness**, in particular by promoting eco-efficient innovations and ensuring that economic and social progress is matched by progress on the environment.

To underpin delivery of this ambitious programme of reform, further action is also needed to improve the governance of the Lisbon strategy, strengthening political ownership and national incentives for reform, and ensuring that wider Community policies support, rather than hinder, the process of structural economic reform across Europe. To this end:

- **Member States should prepare National Growth and Employment Plans**, summarising annually the actions they have taken to reform labour, product and capital markets, and setting out specific forward-looking commitments to further reform;
- **benchmarking of national performance should continue** and be developed to enhance political and public exposure to the results; and
- **the Community budget should be refocused** to better support the overall goals of the Lisbon Strategy, while ensuring that limited resources are directed to where they can add most value at the European level.

GROWTH AND EMPLOYMENT: A EUROPEAN PRIORITY

At the Lisbon European Council in March 2000 Europe's leaders committed themselves to a ten-year programme of economic reform designed to make the European Union the most competitive and dynamic knowledge-based economy in the world with more and better jobs and greater social cohesion. In the past five years important progress has been made in reforming the European economy. But the challenges ahead remain substantial:

- **globalisation, advances in new technologies and the increasing integration of emerging economies into global patterns of trade and investment are placing Europe under sustained and intensified competitive pressure and forcing Member States to adapt, and adapt quickly, to maintain growth and living standards;**
- **major demographic challenges caused by an ageing population have profound implications for long-term growth in Europe and place significant pressures on the sustainability of age-related public spending programmes across the Union; and**
- **the gap between Europe's economic performance and that of its major international competitors has widened, with economic growth and living standards below those in the US economy.**

These challenges call for a renewed commitment to economic reform, with flexibility and economic growth at centre stage. Crucially, they demand concerted action from Europe's policy-makers to strengthen the key drivers of economic growth – employment and productivity. For example:

- **22 million more people must succeed in finding work if Europe is to meet its employment target for 2010. This will require average annual employment growth rates of twice the level of those achieved in the past four years and necessitates a comprehensive programme of reform to improve levels of skills in the labour force and to facilitate greater adaptability to change; and**
- **Europe's productivity gap with the US has widened, with US productivity levels now substantially above those in the EU. This requires further structural reform to enhance levels of product market competition in Europe, to create the right climate for enterprise and innovation to flourish and to upgrade the skills of European workers.**

INTRODUCTION

1.1 At the Lisbon European Council in March 2000 Europe's leaders committed themselves to a ten-year programme of far-reaching economic reform intended to make the European Union the most competitive and dynamic knowledge-based economy in the world with more and better jobs and greater social cohesion. As the Union approaches the mid-point in the original timeframe envisaged for action, now is an important time to take stock of what has been achieved and, crucially, to ask what more must still be done to realise the strategic vision of the Lisbon strategy.

1.2 Since the launch of the Lisbon strategy important progress has been made in reforming the European economy. Many Member States have taken action to improve the functioning of their labour markets, to lower the obstacles faced by new and innovative businesses, and to open up markets to the rigours of external competition. The Community too has taken important strides, with reforms to competition policy and the state aid rules, and further action to extend and deepen the Single Market.

I.3 But the stark reality facing policy-makers today is that the scale of reform has yet to match the challenges confronting the European economy. Advances in technology and the rapid integration of emerging economies into global markets are putting Europe under sustained competitive pressure, while demographic developments pose a serious threat to the long-term growth and prosperity of many EU nations. As the European Commission notes in its communication to the spring European Council: *"Europe's performance has diverged from that of our competitors in other parts of the world. Their productivity has grown faster and they have invested more in research and development. We have yet to put in place the structures needed to anticipate and manage better the changes in our economy and society."*

I.4 Against this backdrop, the mid-term review of the Lisbon strategy presents a vital opportunity for the Member States and institutions of the European Union to reassess the global economic challenges that lie ahead and to unite around a common framework of action to ensure lasting economic prosperity for all of Europe's citizens in the years to come. As the High Level Group chaired by Wim Kok noted *"Lisbon's direction is right and imperative, but much more urgency is needed in its implementation – and more awareness of the high cost of not doing so"*. This chapter describes the challenges facing Europe as it prepares to conclude the mid-term review of Lisbon and assesses the scale of the task ahead.

THE LONG-TERM GLOBAL CHALLENGE

I.5 The backdrop to the Lisbon strategy is a global economy in the midst of radical transformation, with far-reaching and fundamental changes occurring to technology, production, and trading patterns. Faster information flows and falling transport costs are breaking down traditional geographical barriers to economic activity. The boundary between what can and cannot be traded is being steadily eroded and the global market encompassing ever-greater numbers of goods and services. Ever more countries are opening their economies to global trade and investment and seizing the opportunities that come from closer integration with the global economy. As set out in the UK Government's December 2004 document, *Long-term global economic challenges and opportunities for the UK*, each of these trends is set to continue, posing significant new challenges for advanced economies:

- the balance of global economic activity is likely to shift significantly, with an increasing proportion of global output produced in the rising Asian nations and other emerging economies – for example, by 2015, China and India will account for around 25 per cent of world output in real terms. These developments present advanced economies with new opportunities to trade and invest but also pose challenges to traditional industries and sectors. Structural reform and flexibility is key to harnessing the benefits;
- the integration of global economic activity looks set to intensify as international trade and investment expand, increasing competition among producers and offering increasingly diverse sources of, and destinations for, foreign direct investment (FDI). In 2003, China was the number one destination for FDI, attracting $57 billion. To attract investment flows, countries must put in place policies to create a strong investment climate;
- as communication and technology continue to improve, production chains will become increasingly specialised and dispersed across continents in search of the most productive location. This places a premium on actions to promote enterprise and productivity to ensure that businesses can compete effectively in the global market place;

- as global competition and the speed of technological change intensify there will be increasing rewards from innovation. Countries at the forefront of research and innovation will be best placed to move into high value-added, technology-driven areas which can provide new sources of growth and enhance their attractiveness as centres of economic activity;
- to harness the opportunities that come from accelerating global integration, countries will increasingly need to invest in the skills of their workforce and ensure that individuals are equipped to continually update their skills. For firms deciding where to locate different parts of the production process, the relative skills of the labour force are likely to become increasingly important, and skills that were once regarded as high-level are now increasingly viewed as basic; and
- the pace of global economic growth will place increasing pressure on energy and other resources, generating higher environmental costs. Action by governments to promote greater energy and resource efficiency and to foster new, low-carbon sources of energy supply will therefore become ever more important.

I.6 These trends point to the increasingly global scale of markets and to an accelerating pace of change in all sectors of the global economy. Responding to and benefiting from this process of change will demand greater flexibility from governments, businesses and individuals. As the High-Level Group chaired by Wim Kok noted: *"Even if every [Lisbon] target were to be hit on schedule, Europe would not be on safe ground. Competitor countries and regions are moving on as well, threatening Europe's position in the global economic league table. Europe must find its place in a global economy, which will nonetheless enable it to uphold its own distinctive choices about the social model that it rightly wants to retain …To realise this ambition, Europe needs more growth and people in work."*

THE CHALLENGE OF AN AGEING POPULATION

I.7 Along with globalisation, the EU also faces a major demographic challenge. Europe's population is ageing, its birth rates falling and its workforce shrinking, with the result that fewer people of working age are having to support growing numbers of people of above working age. According to the latest United Nations population projections, the average demographic old-age dependency ratio in the EU is set to rise from 24 per cent in 2000, to 36 per cent by 2025 and 50 per cent by 2050. This is a steeper rise than that projected for many non-European developed economies, including the US, where the dependency ratio is projected to rise from 19 per cent in 2000 to 32 per cent in 2050.

I.8 An ageing population has profound implications for long-term growth in Europe. According to the European Commission, *"if left unchecked, [an ageing population will] drag down potential growth rates to a paltry 1 per cent per year"*. The report of the High Level Group chaired by Wim Kok adds further weight to this conclusion, noting that *"the cumulative impact of such a decline would be a GDP per head some 20 per cent lower than could otherwise be expected."* Urgent action is needed to address this challenge.

1.9 Demographic trends also have significant implications for age-related public spending programmes, such as pensions and healthcare provision. In 2004, the European Commission published an assessment[9] of the long-term sustainability of public finances in EU Member States and concluded that *"…due to the growing concerns regarding the impact of ageing populations, ensuring the long-term sustainability of public finances is a key objective in the EU …. even assuming that all Member States achieve their medium-term budgetary targets, there is a risk of unsustainable public finances (measured against the 60 per cent gross debt of GDP reference value) emerging in at least one third of the EU15 Member States"*. According to the Commission's report, only six Member States have debt levels that put them in a relatively safe position: *"Ireland, the UK, Finland, Luxembourg, Denmark and Spain have a relatively low level of debt/GDP ratio. This gives some room to tackle the problem if future imbalances arise."*

CLOSING THE PERFORMANCE GAP

1.10 These challenges make the development of policy more challenging; require of Europe's leaders greater imagination and openness to change; and mean that the Union as a whole must be ready to challenge and revitalise traditional approaches to policy-making. For the European economy, they call for greater flexibility in product markets, labour markets and capital markets to ensure that Europe's businesses and individuals are equipped to adapt to economic change and to take advantage of new opportunities when they arise. Structural reform, which promotes flexibility and fairness together, is the key to success in the modern global economy. There can be no security without change.

1.11 Important progress has been made in recent years towards realising the strategic goal set at Lisbon. As described in Box 1.1, many EU Member States have taken steps to reform their economies and to reduce the structural barriers that hold back growth and prosperity.

[1] See *Public Finances in EMU 2004*, European Commission 2004, Part 1, Section 4.

Box 1.1: Implementing Lisbon: recent reforms in the Member States

Over the past year or so many Member States have introduced important reforms, so helping to advance the Lisbon goals. Though by no means an exhaustive list, this box highlights a number of key measures throughout the EU.

Many Member States have taken steps to boost growth through higher employment:

- **Germany has reformed its benefit system and modified job placement services to boost labour supply. It has also taken action to boost labour demand, through reforms to reduce the cost of employment protection legislation and by enabling social partners to increase the use of firm level clauses in collective agreements.**
- **The Netherlands has taken further steps to make work pay, by limiting the maximum duration of unemployment benefits and integrating job search with benefit determination. Similarly, Denmark has reduced marginal tax rates and introduced an earned income tax credit to increase incentives for people to enter the labour market at lower wages.**
- **A number of countries have introduced reforms to improve skills levels, with new measures to develop vocational training in Hungary, reforms to basic education in Latvia, modernisation of education and vocational training systems in Portugal, and a new social cohesion plan in France, which extends training and apprenticeship opportunities for the young and excluded.**

Many Member States have also taken steps to boost growth through greater productivity, by promoting innovation, reducing regulatory burdens and strengthening competition:

- **The Netherlands implemented new measures to promote industry-university links, and Spain acted to raise private R&D, including through the use of tax incentives.**
- **Within the spirit of the Six Presidencies' Initiative, Belgium, France, Germany Hungary, Poland and Slovakia all acted to simplify regulation for business. The Czech Republic and Slovenia established one-stop-shops and business information centres. And Italy launched new reforms to improve access to business finance.**
- **Both Sweden and the Netherlands took steps to strengthen the implementation of competition policy.**

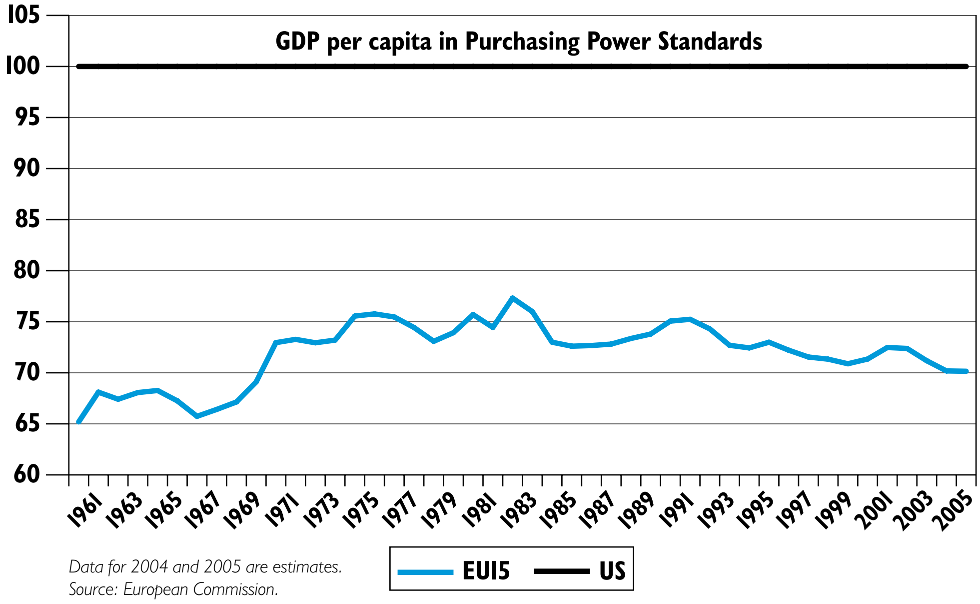
Finally, several Member States took action to increase long-term fiscal sustainability:

- **Italy's Parliament approved a pension law raising the minimum retirement age, introducing incentives to delay retirement and promoting private pensions.**
- **Slovakia increased its retirement age and, in early 2005, introduced a sizeable funded pension pillar.**

Growth and living standards

1.12 These reforms are a positive and welcome step forward. But the problems they seek to correct are deep-rooted and the task ahead remains substantial. The long-standing challenge identified by Europe's leaders at Lisbon was to close the gap between the EU's economic performance and that of its major international competitors, such as the US. During the first three decades after the war, strong growth in Europe had begun to narrow the divergence in living standards between the European and US economies. However, as shown in Chart 1.1, this process of catch-up ground to a halt in the 1980s and, since the early 1990s, the gap in GDP per capita has begun to widen once more. Since 1996, average annual growth in GDP per capita in Europe has been around one third of one per cent lower than that in the US. The resulting gap in living standards is now around 30 per cent for the EU15 and 35 per cent for the EU25.

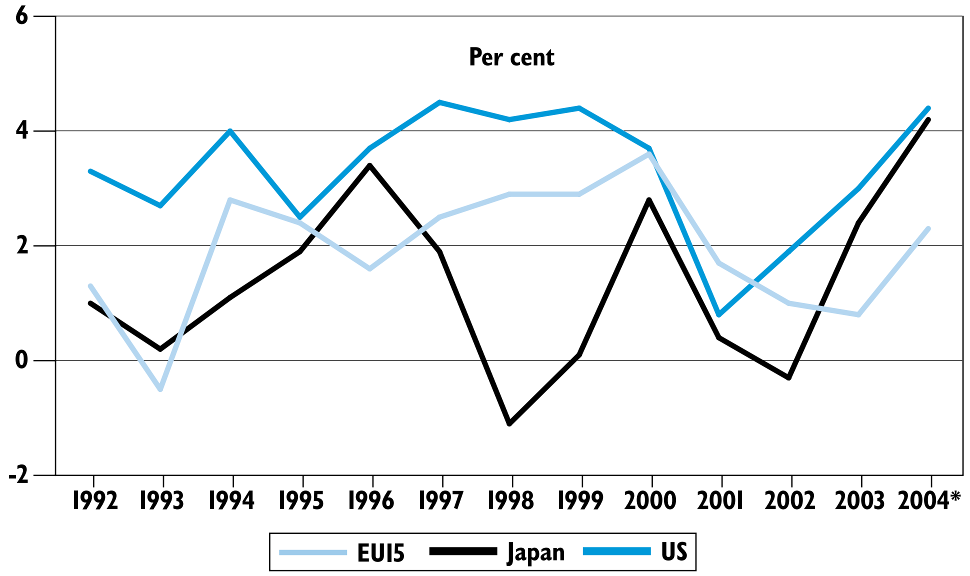
Chart 1.1: Comparison of living standards



Data for 2004 and 2005 are estimates.
Source: European Commission.

1.13 More recent economic developments offer no scope for complacency. Following a marked slowdown in the first half of 2003, the European economy has experienced a moderate recovery and the euro area now looks set to grow at around 2 per cent in both 2004 and 2005. Stronger growth in the non-euro area countries is expected to boost growth for the EU as a whole to around 2½ per cent. But even with these improvements, growth in Europe continues to lag that in its major international competitors. In 2004, growth in the euro area is forecast to have been just half of that in the US and Japan. Moreover, in the previous three years, cumulative growth amounted to just over 3 per cent in the euro area, or around 3¾ per cent in the then EU15, compared with 5½ per cent in the US.

Chart I.2: Real GDP growth



**Data for 2004 are estimates.*
Source: Eurostat structural indicators database.

I.14 Improving Europe's growth performance requires further concerted action to strengthen the key drivers of economic growth. As the European Commission notes in its communication to the spring European Council: "*faced with this challenge Europe needs to improve its productivity and employ more people*".

The employment challenge

EU employment targets

I.15 Growth accounting analysis[10] suggests that weaknesses in Europe's labour market performance explain around two thirds of the differential in living standards between Europe and the US. The importance of raising employment – to boost growth, promote long-term fiscal sustainability and safeguard the welfare of citizens – is therefore reflected in Europe's commitment to a series of stretching targets to deliver:

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

I.16 Table 1.1 depicts progress towards these targets. Compared with 1999, the number of people in work across the EU has risen by around 6 million. Moreover, in excess of 4 million more women have found work in the past four years, lending weight to the conclusion that the Union could succeed in meeting its target for female employment by 2010.

[2] See, for example, *EU Economy Review 2003* and *EU Economy Review 2004* European Commission.

Table 1.1: Jobs required to meet the Lisbon targets

	Employment rate in 1999 (per cent)	Employment rate in 2003 (per cent)	Jobs created end 1999-end 2003 (million)[1]	2010 target (per cent)	Jobs needed end 2003-end 2010 (million)
Total	61.9	62.9	6	70	21.6
Female	52.9	55	4.3	60	7.6
Older workers	36.2	40.2	2.6	50	5.3

Note: All figures are for EU25 and assume constant population.

Source: Employment in Europe 2004 and Employment in Europe 2003, Eurostat.

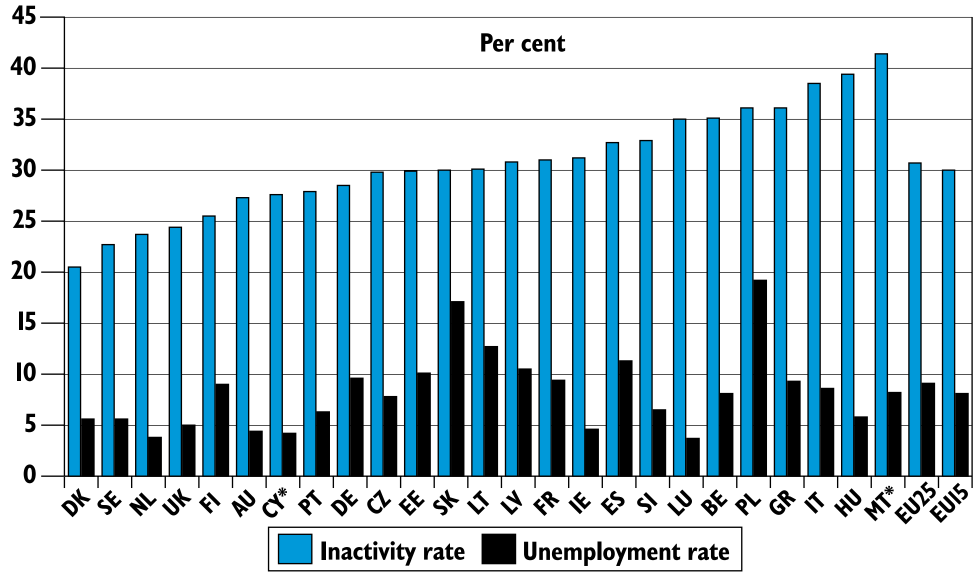
[1] For older workers, this is jobs created between end 2000 and 2003.

1.17 Nonetheless, when viewed in the aggregate, at just under 63 per cent, the overall employment rate in Europe remains far below the 70 per cent target level set at Lisbon, and the fact remains that around 22 million more people must succeed in finding work if this target is to be met. Strikingly, this requires average annual employment growth of over 1½ per cent in the coming years – twice the rate achieved over the past four years. And as Table 1.1 shows, the challenge in respect of older workers is greater still.

Unemployment and inactivity

1.18 If the increase in employment needed to meet the Lisbon targets is great, Europe's untapped pool of labour is even greater. At around 9 per cent, the unemployment rate in Europe is considerably higher than that in the US or Japan, leaving 19 million people unemployed across the Union. But even if all of these potential workers were to find employment, Europe still would not succeed in meeting its employment target for 2010. To close the gap between reality and aspiration, labour market reform in Europe must therefore also concentrate on reintroducing the economically inactive to the labour market. As illustrated in Chart 1.3, rates of inactivity are substantially greater than those of unemployment in all Member States. At 93 million people, the stock of economic inactivity in Europe dwarfs the number of unemployed jobseekers across the Union.

Chart 1.3: Inactivity and unemployment rates in the EU



Source: European Commission - Employment in Europe 2004. Data is for 2003.
**Inactivity rates for Cyprus and Malta are for 2002.*

Box 1.2: Boosting the contribution of employment to growth

Since the mid-1990s, the employment rate among the EU15 economies has risen by one per cent per year on average. While this has helped to deliver a positive contribution to growth, its impact has been lower than might have been expected as average hours worked have fallen by around one third of one per cent.

Much of the decrease in hours worked per capita reflects a decrease in hours per full-time worker, rather than an increase in the proportion of part-time workers. Since this trend has coincided with an increase in incomes, Blanchard[1] suggests that lower hours worked might be interpreted as a European preference for leisure time, rather than income.

However, many policy-makers and academics consider that the EU's policies have also contributed to the EU's reduction in hours worked. For example:

- **Cotis[2] acknowledges that falling hours worked might partly represent a conscious preference for leisure, but adds that "*it could equally be that low labour utilisation reflects European labour market and tax policies that have the effect of weakening the incentives to work and of reducing the demand to hire employees*";**
- **Nickell[3] concludes that "*tax rates are a significant factor in explaining differences in the amount of market work undertaken by the working age population in different countries. However, the evidence suggests that tax rate differentials only explain a minority of the market work differentials, the majority being explained by other relevant labour market institutions. Particularly important are probably the differences in social security systems, which provide income support to various nonworking groups including the unemployed, the sick and disabled, and the early retired*"; and**
- **EU survey evidence[4] suggests a greater desire among workers to increase their hours worked in countries with tighter statutory limits, indicating that institutional factors, including legal barriers, also play a role.**

In addition, Cotis also highlights the problem of long-term unemployment in the EU, noting that "*low labour utilisation in Europe is connected to limited labour market flexibility. Restrictive employment protection laws, for instance, tend to dampen both hiring and firing and lengthen average unemployment spells. Through time, some long-term unemployed become discouraged and permanently exit the labour market*."

[1] *The Economic Future of Europe*, Olivier Blanchard, February 2004.

[2] *Growing Pains: Dissecting the causes of Europe's lagging economic performance*, Jean-Philippe Cotis, in Finance & Development (IMF), June 2004.

[3] *Employment and taxes*, Stephen Nickell, July 2003.

[4] See the *Third European Working Conditions Survey*, the European Foundation for the Improvement of Living and Working Conditions, 2000.

1.19 Tackling the causes of under-performance in European labour markets remains central to the Lisbon strategy. Chapter 2 describes the priorities for reform. But the need for action is urgent. Demographic changes place a premium on the need for faster growth in employment, while globalisation, increased international competition and rapid technological change call for greater labour market flexibility. The overarching objectives of labour market reform in Europe are therefore:

- to facilitate the efficient reallocation of labour between sectors in response to changing patterns of global demand. In particular, those employed in declining sectors that are losing market share to new sources of international competition need swiftly to be re-employed in new and growing sectors, where the EU can compete on quality;

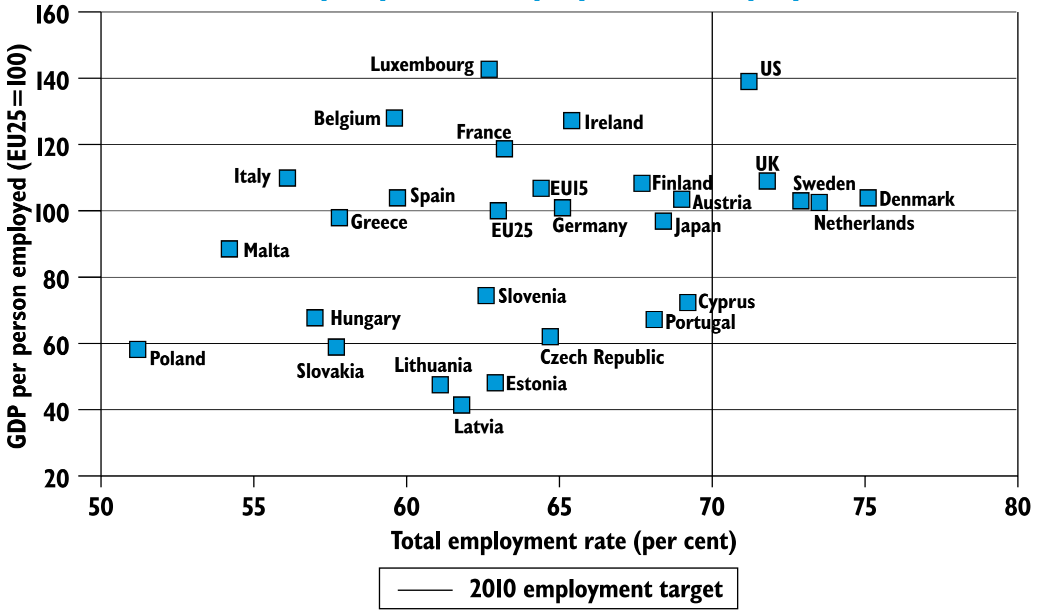
- in this context, to ensure that workers have access to the training opportunities they need to upgrade their skills, and to find and succeed in higher value-added employment;
- to minimise any adverse social consequences flowing from international competition to European businesses, providing opportunity for all and security for the most vulnerable; and
- to absorb structural change and other shocks, including by facilitating the growth of wages in line with productivity and local labour market conditions.

The productivity challenge

The productivity gap

1.20 To achieve Europe's strategic goal of stronger economic growth, high and rising employment must go hand in hand with greater productivity. As shown in Chart 1.4, despite a marked variation in the productivity performance of different Member States, when measured in terms of output per employee, only Luxembourg enjoys higher productivity than the US, while the overall level of US productivity remains substantially above that in the enlarged Union.

Chart 1.4: GDP per person employed and employment rate



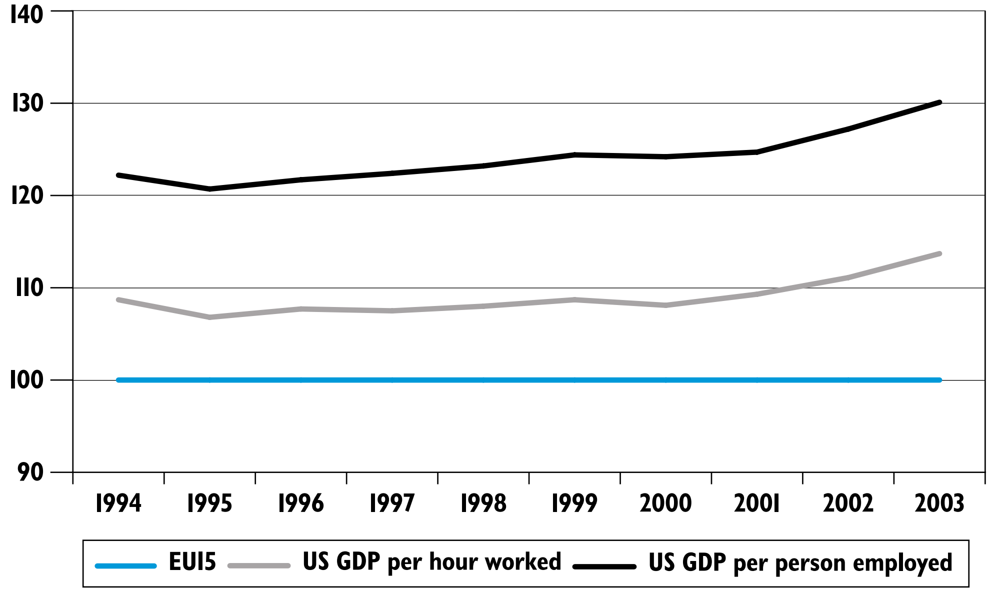
All data for 2003.
Source: Eurostat structural indicators database.

1.21 Recent trends in Europe's productivity performance are a particular cause for concern. As shown in Chart 1.5, the differential between EU and US productivity levels, on the basis of both hours worked and employment, has widened since the mid-1990s, reversing the period of catch-up that characterised the three decades following the war. Indeed, the contribution to EU growth from productivity has fallen by about 1 per cent since the mid-1990s, at a time when productivity growth rates in the US increased. Analysis suggests that:[11] "*fully one fifth of the European catch-up [in productivity] …over the previous half-century has been lost over the period since 1995*". Moreover, the European Commission[12] estimates that weaker labour productivity now accounts for as much as one third of the gap in EU living standards with the US.

[3] *Why was Europe left at the station when America's productivity locomotive departed?*, Robert Gordon, NBER Working Paper 10661, August 2004.

[4] See, for example, *Second Implementation Report on the 2003-2005 Broad Economic Policy Guidelines*, Commission staff working paper, January 2005.

Chart I.5: Labour productivity in the EU and the US



All data is in Purchasing Power Standards.
Source: Eurostat structural indicators database.

I.22 Various arguments have been put forward to explain the recent deterioration in Europe's relative productivity performance. For example, it has been suggested that some of the relative deterioration might reflect the temporary impact of the economic cycle and the recent increase in employment among marginally less productive individuals. Others have questioned the compatibility of trying to raise employment and productivity simultaneously.

I.23 However, these objectives are mutually reinforcing, rather than inconsistent. The US has combined high levels of employment and labour productivity, while some Member States, including Finland and Ireland, have also managed to achieve increases in both. Moreover, analysis[13] also suggests that only a small share of the deceleration in productivity growth since the mid-1990s can be attributed to rising employment and that there is limited evidence to support the claim that the differential reflects cyclical differences. Rather, the gap appears largely structural, reflecting a failure to boost service sector productivity – particularly in wholesale, retail and securities – which in turn relates to use of ICT and its impact on total factor productivity, as well as the EU's larger share of low productivity non-ICT-using or ICT-producing manufacturing industry. Other research[14] has concluded that regulatory barriers and land-use regulations in Europe inhibit the development of US retailing formats, and that persistent cultural factors *"inhibit the development of ambition and independence by teenagers and young adults, in contrast to their encouragement in the US".*

I.24 In its communication to the spring European Council, the European Commission argues that *"reversing this trend [in productivity performance] is the major competitiveness challenge facing the Union".* Urgent action is therefore needed to strengthen the key drivers of productivity, including by:

[5] For a comprehensive study, see *EU Productivity and Competitiveness: An Industry Perspective – Can Europe resume the catching up process?* edited by Mary O'Mahoney and Bart van Ark, published by the European Commission, 2003.
[6] *Why was Europe left at the station when America's productivity locomotive departed?*, Robert Gordon, NBER Working Paper 10661, August 2004.

- enhancing the level of product market competition in Europe, by reducing regulatory barriers, extending and deepening the Single Market in services, and increasing external openness to trade and investment;
- creating the right environment for enterprise and innovation, by developing the Union's knowledge base and supporting the creation, diffusion and utilisation of new technologies; and
- upgrading the skills of new entrants, re-entrants and those currently in the labour force, to enable workers to adapt to new production or service delivery techniques.

CONCLUSION

1.25 Five years after the launch of the original Lisbon strategy, the case for economic reform in Europe remains compelling. The challenges that the Lisbon strategy was designed to address – of increased global competition and an ageing population – have merely intensified in recent years, while the Union's economic performance has diverged further from that of its major international competitors. The challenge now is to strengthen the Union's international competitiveness in the years ahead, through concerted and immediate action to promote both employment and productivity growth. As the European Commission note in their communication to the spring European Council: *"the costs of not doing so are large and quantifiable … [and] can be found in the widening gap of Europe's growth potential compared to other economic partners"*. Against this backdrop, Chapter 2 describes the policy priorities for the mid-term review of the Lisbon strategy.

2 Seizing opportunity: Economic Reform in Europe

The mid-term review of the Lisbon strategy presents a vital opportunity for the nations and institutions of the European Union to address the structural economic challenges that continue to hold back growth and productivity in Europe and to set in place the foundations for economic success in an increasingly integrated world economy. The UK Government strongly welcomes the recent work of the High Level Group chaired by Wim Kok and the European Commission's communication to the spring European Council. If Europe is truly to master the opportunities and challenges of the global economy, and deliver growth, jobs and rising living standards for all its citizens, the mid-term review must embrace and agree a programme of change designed to:

- **deliver a dynamic and competitive Single Market, with liberalisation in services, and a new strategic focus to ensure that the benefits of economic integration are realised, through better implementation, a pro-active approach to competition policy and further reform of the state aids framework;**
- **establish the right climate for enterprise and innovation, through further action to strengthen and reform the regulatory framework in Europe building on the Six Presidencies' initiative, reform of Community funding for research and development, urgent action to improve the intellectual property regime in Europe, and the launch of a new European Centres of Enterprise Competition;**
- **promote flexibility and security in labour markets, by implementing the recommendations of Wim Kok's European Employment Taskforce, and so equipping people with the skills they need to master change and to compete effectively for jobs in a rapidly changing global economy, promoting higher employment and social cohesion;**
- **establish a more outward-looking Europe, through increased EU flexibility in advance of the WTO Ministerial in order to lead the Doha Development Agenda towards an ambitious, liberalising and pro-poor agreement; and through further concrete steps to enhance bilateral trade and investment relationships, especially with the US; and**
- **deliver environmental protection with competitiveness, in particular by promoting eco-efficient innovations and ensuring that economic and social progress is matched by progress on the environment.**

To underpin delivery of this ambitious programme of reform, further action is also needed to improve the governance of the Lisbon Strategy, strengthening political ownership and national incentives for reform, and ensuring that wider Community policies support, rather than hinder, the process of structural economic reform across Europe. To this end:

- **Member States should prepare National Growth and Employment Plans, summarising annually the actions they have taken in labour, product and capital markets, and setting out forward-looking commitments to further reform;**
- **benchmarking of national performance should continue and be developed to enhance political and public exposure to the results; and**
- **the Community budget should be refocused to better support the overall goals of the Lisbon Strategy, while ensuring that limited resources are directed to where they can add most value at the European level.**

INTRODUCTION

2.1 As described in Chapter 1, the backdrop to the mid-term review of the Lisbon strategy is one of increased global competition, an ageing population, and a widening performance gap between the European economy and that of its major international competitors, including the US. This chapter builds on this assessment of the challenges facing policy-makers in Europe, and identifies the priority reforms needed to revitalise the Lisbon strategy and to deliver growth and rising living standards in the years to come.

2.2 The UK Government strongly endorses the conclusion of the High Level Group and the European Commission that growth must be centre stage in the renewed Lisbon strategy. It agrees with the Commission that *"renewed growth is vital to prosperity, can bring back full employment and is the foundation of social justice and opportunity for all. It is also vital to Europe's position in the world and Europe's ability to mobilise the resources that tackle many global different challenges"*. A Lisbon strategy focused on raising Europe's long-term growth potential, through higher employment and productivity, provides the foundation upon which high standards of social cohesion and environmental protection can be built and maintained. As the Commission note in their communication to the spring European Council: *"we need a dynamic economy to fuel our wider social and environmental ambitions"*.

2.3 The challenge now is to make Lisbon work – to unite around the priority actions needed to ensure that Europe can prosper in the new global economy, and to reinforce commitment at every level to the implementation of reform. As the Commission note, this will require *"rigorous prioritisation"* within the existing Lisbon agenda and *"new arrangements for governance of the Lisbon strategy … to encourage real debate and genuine political ownership"*. The 2005 spring European Council presents Europe's leaders with a vital opportunity to address these fundamental issues and to embrace a comprehensive programme of change designed to:

- deliver a dynamic and competitive Single Market;
- establish the right climate for enterprise and innovation;
- promote flexibility and security in labour markets;
- establish a more outward-looking Europe;
- deliver environmental protection with competitiveness; and
- strengthen and improve the governance of the Lisbon strategy.

A DYNAMIC AND COMPETITIVE SINGLE MARKET

2.4 The creation of the Single Market has been one of the central economic achievements of the European Union. By removing cross-border barriers to market entry, it has helped to increase competitive pressure in Europe, promoting productivity and growth, creating incentives for innovation, and ensuring that resources are allocated swiftly towards more productive uses. The European Commission's own analysis suggests that, as a result of the Single Market over the past ten years, around 2.5 million jobs have been created, and extra EU prosperity to the value of around €875 billion has been generated – around €5,700 per household.[1] This amounts to almost 10 per cent of the EU potential growth rate on an annual basis.

[1] *The internal market – ten years without frontiers*, European Commission, 2003.

2.5 The Lisbon strategy has developed further the Single Market, by opening up markets that were previously subject to national monopolies or other constraints. Nonetheless, against a backdrop of increased global competition and the ever greater need for efficiency this entails, additional action is needed to extend and deepen the Single Market and to unlock the greater economic potential it provides. As Europe enters the second phase of the Lisbon Strategy, it must therefore focus on:

- extending the Single Market to the hugely important services sector;
- ensuring that the economic benefits of liberalisation are realised, including through the pro-active enforcement of competition policy; and
- tackling persistent distortions through the proper control of state aid.

Liberalisation in services

2.6 With globalisation, trade and investment in services has grown significantly in importance. Between 1970 and 1990 the share of services in the global stock of foreign direct investment (FDI) grew from one quarter to almost a half, and by 2002 it had risen further to around 60 per cent. Today, services constitute some 70 per cent of EU GDP and the majority of European employment. Yet they make up only 20 per cent of EU trade. Estimates suggest that the removal of national regulatory barriers could increase trade in commercial services by between 15 and 30 per cent, delivering substantial economic benefits to the European economy. As the High Level Group chaired by Wim Kok has noted: *"Largely because of a wide range of legal and administrative barriers, Europe remains fragmented into separate national markets. Many of these markets are effectively closed for business to potential competitors based elsewhere in what should be a single market. As a result, prices are too high, productivity growth is too low and levels of intra-EU trade in services are lower than a decade ago."*

2.7 In January 2004, the European Commission produced draft proposals for a directive on services in the internal market. The draft directive is a wide-ranging and radical attempt to open up services markets, tackling the barriers to business establishment across the EU by removing many of the restrictions to licensing and authorisation systems that currently prevent such action. The directive also seeks to promote cross-border trade in services through rigorous application of the country of origin principle which establishes that transactions between countries are to be regulated by the authorities where the service provider is located.

2.8 The UK Government strongly supports the market opening nature of the draft directive and shares the objectives of the European Commission to make the Single Market a reality for services. It is committed to ensuring that rapid progress is made on the proposal and believes strongly that **the Commission and the Council should work swiftly to develop the Commission's proposals with a view to agreeing a package of reforms to liberalise trade in services across the EU, ensuring that the economic impact of agreed measures is maximised.**

2.9 The Government recognises that further work is needed to refine the draft Directive, in particular to ensure an exclusion for taxation and publicly funded healthcare, and to maintain high standards in areas such as health and safety, working conditions, environmental protection, and the care extended to the most vulnerable people in society.

Financial services

2.10 A Single Market in financial services would bring considerable benefits to the European economy, by reducing the cost of capital, providing firms with increased opportunities to access markets in other Member States and giving customers access to a wider range of competitively priced products.

2.11 For the past five years the Financial Services Action Plan (FSAP) has been the vehicle for developing the Single Market in financial services and 39 of the 42 FSAP measures have now been adopted. Looking ahead, the priority is to ensure the effective, proportionate and consistent implementation of these measures throughout the EU. This will pose a considerable challenge for financial services firms and supervisory authorities in Europe and is why, in May 2004, the UK authorities published *The EU Financial Services Action Plan: Delivering the FSAP in the UK*[2], to give advice and guidance to UK industry on implementing the FSAP.

2.12 With the adoption of the FSAP nearly complete, policy makers, industry practitioners and users of financial services have been discussing the future approach to creating a Single Market in financial services in the EU. The UK Government, along with many other Member States and industry practitioners, firmly believes that a second raft of new legislation – or a second FSAP – is neither necessary nor desirable and therefore welcomes the commitment in the Commission's communication to the spring European Council that further legislative action will *"be taken only if broad consultation with interested parties and impact assessment demonstrates a clear value-added"*. In line with this commitment, **the Commission's forthcoming communication on the further integration of financial services markets in Europe should set out an alternative strategic approach to developing the Single Market in financial services** built on five priorities, all of which have been emphasised and endorsed by the four independent expert groups[3] set up to advise the Commission on this issue, as well as by the Financial Services Committee in their Report on Financial Integration:[4]

- improving implementation and enforcement of existing measures affecting the financial sector. A significant number of FSAP measures that have been adopted have still to be implemented nationally. This must be the top priority, together with their subsequent enforcement;
- more pro-active use of alternatives to regulation. In general, EU legislation should be a last resort, and alternative approaches to policy-making, such as the pro-active use of competition policy, market-based solutions and initiatives at national level, should be considered first;
- better regulation. In some specific cases, market failure analysis may demonstrate that further legislation on financial services could be necessary. However, when new EU legislation on financial services is being considered, a proper consideration of the costs and benefits should be undertaken, and financial market participants should be fully consulted;
- making the Lamfalussy arrangements work well. These new regulatory arrangements are now in place to supervise financial services across the EU. They have been shown to work for securities markets and have now been extended to banking and insurance. The effective and efficient functioning of these arrangements now needs to be optimised; and
- recognition of the global nature of financial services markets. A global perspective is needed when considering the impact of EU financial services regulation on the competitiveness of EU-based firms and financial centres. International action will sometimes be needed to tackle global issues.

[2] *The EU Financial Services Action Plan: Delivering the FSAP in the UK*, HM Treasury, FSA and Bank of England, May 2004.
[3] See, for example the May 2004 reports: *Expert Group on Banking Final Report*; *Securities Expert Group Final Report*; *Expert Group on Insurance and Pensions Final Report*; *Asset Management Expert Group Final Report*. See also *After the EU Financial Services Action Plan: UK response to the reports of the four independent expert groups*, HM Treasury, FSA and Bank of England, September 2004.
[4] *FSC Report on Financial Integration*, Report of the Financial Services Committee to the Council, FSC4156/04, 17 May 2004.

2.13 The UK Government supports the call by the High Level Group chaired by Wim Kok for further research into how retail financial markets might be integrated into the Single Market. However, it believes it premature that proposals for action should be developed at this stage or that target dates should be set for agreement. The barriers to a single retail market, given information asymmetries, language, and cultural differences, are not generally amenable to legislative solutions in the same way that wholesale markets are. Rather, what is needed are non-legislative measures including, but not limited to, more effective use of competition policy, Commission support for voluntary arrangements between market participants, consumer education and an examination of closed distribution networks.

Developing the Single Market: a strategic focus

2.14 While legislative agreements have delivered genuine progress towards the establishment of a truly open and dynamic Single Market, wider action is needed to ensure the full realisation of its potential economic benefits. **As Europe moves into the second stage of the Lisbon Strategy, this calls for the development of a strategic approach to the Single Market, focused on ensuring that the benefits of open markets are translated into improved economic performance on the ground.** Such an approach must encompass a wide range of non-legislative actions, with a focus on:

- improving the implementation of existing market-opening legislation;
- the pro-active enforcement of competition policy, including through the use of sectoral enquiries; and
- developing further the state aid regime to minimise competitive distortions while ensuring Member States have the flexibility to tackle market failures.

Improving implementation

2.15 The implementation of existing market opening measures is crucial to the success of the Single Market. As the High Level Group chaired by Wim Kok noted: *"every Directive that is late in being implemented by a Member State reduces the competitiveness of the entire Union"*. Efforts to ensure more effective implementation of existing Single Market legislation should therefore be a central strand of further action to strengthen the Single Market and be prioritised in the second stage of the Lisbon strategy. **The Commission and the Member States should work together to promote the timely and effective implementation of internal market legislation, through more systematic comparison of transposition practices and sharing of best practice, building on the Commission's existing scorecard of implementation.**

Promoting competitive markers

2.16 Despite various agreements to liberalise European markets, many studies have shown that competitive pressures remain weak in a number of key sectors across the EU. Indeed, the OECD estimate that restricted competition could be reducing productivity by double-digit percentages in some EU markets. The pro-active enforcement of competition policy is key to unlocking these benefits. Such enforcement activity must focus on making the Single Market work by removing existing impediments to competition and preventing incumbents from raising new barriers to entry or pursuing restrictive strategies to insulate themselves from more innovative competitors. Enforcement actions should be prioritised on the basis of economic significance.

2.17 The High Level Group chaired by Wim Kok underlined the importance of pro-active competition policy to the future development of the Single Market and identified the importance of sectoral enquiries: *"In order to foster further liberalisation and open more sectors to EU-wide competition, the European Commission should carry out sector-wide enquiries to identify barriers to competition, including the effect of State aid. This should ensure that effective competition exists not only on paper but also in practice, especially where local rules have the effect of preventing competitors from entering into the national market."*

2.18 The European Commission's communication to the spring European Council reinforced this conclusion, noting that: *"competition rules must be applied pro-actively"* and that *"sectoral screenings of the barriers to competition will be launched in sectors such as energy, telecoms and financial services"*. The UK Government strongly supports these conclusions and believes that **the European Commission should now set out the practical steps it will take to pro-actively enforce competition policy, building on its 2004 communication on competition policy[5], and based on economic significance, in support of the Lisbon strategy.**

2.19 The Government also believes that further action is needed to strengthen the competition regime in Europe and to increase the positive contribution it can make to achieving the Lisbon goals. Building on the Commission's 2004 communication, it believes that **the Commission and the Council should work together to identify future priorities for reform of competition policy**, including to:

- strengthen the role of private actors in enforcing competition policy, while ensuring that this does not lead to excessive rent-seeking behaviour;
- improve the interface between competition and consumer policies to ensure that consumers are empowered to provide an effective stimulus to competition in Europe; and
- deepen the extent of transatlantic cooperation between competition authorities, building on existing arrangements.

[5] *A pro-active competition policy for a competitive Europe*, COM(2004) 293 final.

Box 2.1: Promoting competition in European public procurement

Public procurement currently accounts for around 16 per cent of EU GDP. Given its importance to the EU economy, the UK Government commissioned a report into the experiences of UK businesses in gaining access to public contracts in other EU Member States. The Wood Report, published in November 2004, identified significant obstacles to competition in EU public procurement markets, to the detriment of both UK and EU businesses. Despite the existence of Single Market rules in awarding public contracts, the review found evidence of complex public procurement procedures, unfair national preference, and a wavering commitment to competition and market liberalisation. The report proposed steps to improve the functioning of EU public procurement markets, including:

- **action to identify and spread best practice among Member States, including the use of scorecards of performance where appropriate; and**
- **action by Member States to open up more markets to public procurement, so as to remove barriers to effective competition, raise the skills of procurement practitioners and eliminate bad practice.**

The Commission and Member States should commit to further action to improve competition in public procurement by promoting best practice in the field of procurement policy and developing improved tools for monitoring and comparing national performance, including the use of scorecards.

Reforming state aid

2.20 Globalisation and the challenges created by new sources of international competition place a premium on the need for effective control of national state aids. Businesses that are sheltered from competition in their domestic markets are unlikely to be able to cope effectively with the rigours of international competition, and misplaced concerns over the impact of de-industrialisation must not be managed through the inefficient misuse of public subsidy to create national champions. The EU state aid regime has a vital role to play in preventing payments of distortive aids and preserving the integrity of the Single Market. It must also ensure that Member States are able to intervene swiftly to tackle market failures that hold back economic progress.

2.21 The European Council has made repeated commitments to reduce state aid and redirect it towards horizontal objectives in support of the Lisbon goals. In line with this, the annual level of state aid in the EU15 decreased by 27 per cent between 1997 and 2002 to €49 billion, or 0.56 per cent of EU GDP. In the new Member States, state aid over the period 2000 to 2003 averaged €5.7 billion per year, or 1.42 per cent of GDP. This figure falls to 0.67 per cent once measures currently being phased out are excluded.

2.22 The UK Government welcomes the European Commission's recent commitment to set out a new strategy for delivering less and better-targeted state aid to help advance the Lisbon goals. In defining this new strategy, **the Commission should propose a further tightening of the controls over distortive state aids to reduce obstacles to competition, and further modernisation of the wider state aid framework to facilitate national reforms to address market failures.** This requires action to:

- ensure that the guidelines for regional aid allow Member States to target regional assistance effectively in the most under-performing areas, while strengthening controls over the largest investment aids which have the greatest potential to lead to inefficient investment decisions and undermine competition;
- introduce a significant impact test to allow small non-distortive aids to be introduced quickly; and

- modernise further the horizontal state aid guidelines to improve the ability of Member States to tackle market failures in the areas of regeneration, innovation and environmental technologies.

2.23 Member States also need to take further steps to ensure that payments of state aid are effective and deliver value for money, helping to achieve a better use of public finances while safeguarding against distortions to competition. Performance in this respect could be improved through the exchange of national experiences and new opportunities for learning from one another. **The Commission and the Member States should explore options for sharing best practice and for strengthening existing mechanisms for ensuring value for money in the design and delivery of state aid.**

PROMOTING ENTERPRISE AND INNOVATION

2.24 While the Single Market is a good example of the benefits of economic integration, globalisation means that the pace of economic change is greater than ever before. The increased integration of emerging markets into global trade and investment flows offers an important source of wealth and opportunity but brings new competitive challenges for European businesses. Increased competition and rapid technological change has led to a reduction in the typical life-cycle of products and services and is challenging traditional relationships between customer and supplier, forcing businesses to innovate and become ever more responsive to change.

2.25 To compete effectively in the global economy, Europe must improve its capacity to innovate and increase levels of entrepreneurial activity, promoting investment in research and development and encouraging new and high-growth innovative companies. This requires action at all levels – regional, national and European – and with a particular focus on:

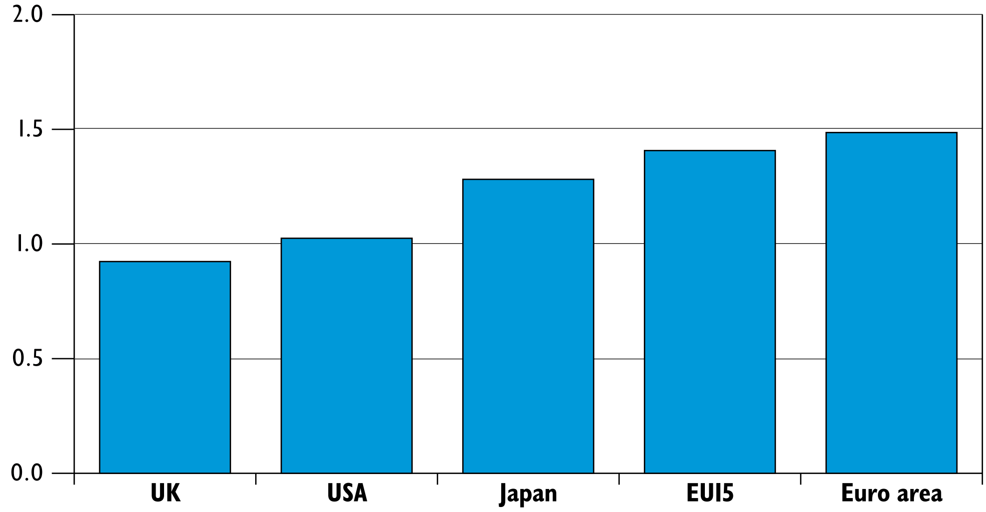
- improving the regulatory framework in Europe to reduce administrative and competitiveness burdens on business;
- stimulating entrepreneurial activity, through actions to develop an enterprise culture in Europe and to increase access to affordable finance for new and innovative companies;
- promoting research and development activity, including through a more efficient use of EU expenditure;
- reforming the intellectual property regime to enable better exploitation of research and diffusion of knowledge; and
- encouraging greater take-up and effective use of ICTs across the EU.

Regulatory reform

2.26 Regulation can play a key role in helping to tackle market failures, and well-designed and proportionate regulatory intervention is essential to underpin the operation of markets. However, poorly designed or excessive regulation can impose significant economic costs. In addition to the potential compliance and administrative burdens it may impose, inflexible, over-complex or out-of-date regulations can have the unintended consequence of raising barriers to entry in markets, reducing competition, or discouraging firms from employing new workers, thereby hindering employment growth. Research by both the OECD[6] and the IMF[7] has concluded that the regulatory framework in Europe inhibits the performance of EU economies. According to the OECD[8], improvements in the regulatory regime could increase productivity levels by up to 6 per cent in many EU economies. As shown in Chart 2.1, levels of product market regulation vary, but the EU on average remains more heavily regulated than either the US or Japan.

[6] *The sources of growth in OECD countries*, OECD, 2003.
[7] *When leaner isn't meaner: measuring benefits and spillovers of greater competition in Europe*, IMF, 2003.
[8] *Product market competition and economic performance*, OECD, 2002.

Chart 2.1: Overall levels of product market regulation



Note: a lower value implies a less restrictive level of regulation (on a scale of 0-6).

Source: Product market regulation in OECD countries: 1998 to 2003, forthcoming OECD working paper. Data is for 2003.

2.27 In January 2004, the Finance Ministers of Ireland, the Netherlands, Luxembourg and the UK launched a new initiative to promote regulatory reform in Europe. Building on the European Commission's 2002 Better Regulation Action Plan, the Four Presidencies' initiative set out a programme of actions designed to strengthen the assessment of new regulatory proposals and to tackle regulatory burdens inherent in the existing acquis. The March 2004 spring European Council welcomed the initiative and called for a programme of work to take forward its principal recommendations. Significant progress has already been made:

- fifteen priority areas of regulation have been identified by the Council for simplification, marking an important step towards reducing burdens in the stock of existing EU legislation;
- agreement has been reached on the principal elements of competitiveness testing, to ensure that all new regulatory proposals are properly scrutinised for their impact on jobs and competitiveness; and
- work is now underway to develop a methodology for measuring the size of administrative burdens imposed by new and existing regulations, so that such assessments may be included all future impact assessments.

2.28 The UK Government strongly welcomes these developments, made possible by the constructive engagement of all Member States and the European Commission. To build further on this success, in December 2004 the Finance and Economics Ministers of Ireland, the Netherlands, Luxembourg, the UK, Austria and Finland launched an updated and extended initiative, *Advancing Regulatory Reform in Europe*, highlighting the important steps taken during the course of 2004 and establishing regulatory reform as a key priority of the six EU Presidencies through to the end of 2006. The initiative presented a series of concrete proposals and strategic objectives for ongoing reform of the regulatory regime in Europe, including action to:

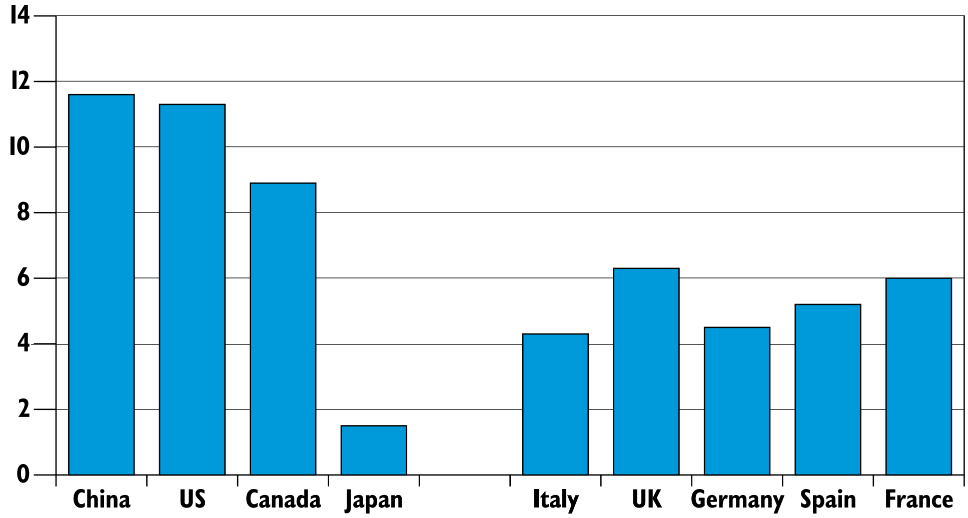
- further develop the competitiveness dimension of impact assessments, through rapid implementation of the European Commission's revised guidelines for impact assessments and an enhanced and cross-cutting role for the Competitiveness Council;
- exercise stronger and more effective control over the administrative burdens associated with EU regulation, including a target to ensure that measurement of administrative burdens becomes a standard feature of all Commission impact assessments by the end of 2005;
- implement swiftly the simplification priorities identified during the course of 2004, including through reform of the working methods of the Council and the European Parliament, and to identify further priority areas for simplification during the course of 2005;
- establish, at the European level, clear and measurable objectives for monitoring and controlling the economic impacts and administrative burdens imposed by EU legislation;
- strengthen business input into the process of regulatory development and reform in Europe, for example by establishing a new, standing, business taskforce to assess progress, identify where further reform is needed, and report annually to the EU institutions;
- develop and implement new arrangements for external ex-post audit and quality control of EU regulatory impact assessments, highlighting examples of good and bad practice;
- enhance pre-legislative consultation in the policy-making process, by ensuring that substantive consultation methods, including the use of Green and White Papers, are used more widely and systematically; and
- ensure that non-legislative approaches are afforded proper consideration at the EU level.

2.29 The UK Government strongly endorses the European Commission's conclusion in its report to the Spring European Council that *"better regulation should be a cornerstone for decision making at all levels of the Union"* and its commitment to *"ambitiously pursue this objective and launch a major new initiative before the Spring Council".* It looks forward to continuing to work with the European Commission and other Member States to develop the proposals set out in the Six Presidencies' initiative and in the Commission's forthcoming regulatory reform initiative, with a view to delivering a more effective regulatory framework in Europe. **The spring European Council should welcome and endorse the initiatives of the Six Presidencies and the European Commission on regulatory reform and call for decisive action to drive forward implementation of this programme in the coming years.**

Promoting enterprise

2.30 Improvements in the regulatory regime in Europe could play an important role in stimulating and encouraging new entrepreneurial activity, promoting employment and productivity growth. As shown in Chart 2.2, evidence suggests that much of Europe's entrepreneurial activity remains untapped, with levels of business start-ups far below those in the US and Canada. The Lisbon strategy must address this weakness, with additional steps to improve access to finance and to encourage and promote pro-enterprise policies.

Chart 2.2: Entrepreneurial activity[1]



[1] Proportion of 18-64 year olds involved in starting a new business, or who own or manage a business that is less than 42 months old. All data is for 2004, except China which is for 2003.

Source: Global Entrepreneurship Monitor, 2004 Executive Report.

Access to finance

2.31 Access to finance remains a key issue for European enterprises, particularly new and innovative SMEs. However, levels of venture capital investment in the EU remain around half those in the US. The Government welcomes the progress made in dismantling the regulatory and administrative barriers to the development of a single risk capital market in Europe through the Risk Capital Action Plan, but believes that further action is needed to improve access to finance for small firms and to raise overall levels of risk capital investment in the EU to match those of the US. To this end, **the Commission should ensure that the financial instruments proposed in its forthcoming Competitiveness and Innovation Programme provide an effective stimulus to risk capital investment in Europe. The Commission should also work with the Member States to develop a new strategy for risk capital by the end of 2005, with a focus on improving the availability of capital for new and innovative firms with high growth potential.**

Box 2.2: European Centres of Enterprise

Promoting a more enterprising culture throughout Europe is key to improving the entrepreneurial performance of the EU. In February 2004, the UK Government therefore proposed the establishment of a European Centres of Enterprise competition with the aim of raising the profile of successful enterprise policies and entrepreneurial activity.

A European Centres of Enterprise competition would identify local centres of excellence in enterprise policy and performance across the EU, spotlighting and championing best practice in policy-making and implementation, and highlighting the contribution that enterprise can make to business development, employment, regeneration, social inclusion and education. A UK competition, *Enterprising Britain*[1], was launched in June 2004.

The UK welcomes the European Commission's pledge at the November 2004 Competitiveness Council to develop a European Centres of Enterprise scheme and looks forward to working closely with the Commission and other Member States to develop the substance of the scheme. **The Commission and the Member States should work together to ensure the launch of a European Centres of Enterprise competition by the end of 2005.**

[1] See http://www.hm-treasury.gov.uk/media/158/D5/enterprising_britain.pdf

Financing research and development

2.32 Investment in the knowledge economy, and in particular in research and development, is critical to Europe's long-term economic success. As the High Level Group chaired by Wim Kok has pointed out *"studies demonstrate that up to 40 per cent of labour productivity growth is generated by R&D spending and there are powerful spillover effects into other areas of the economy, depending on the way in which the money is spent"*. Despite this powerful conclusion however, average EU expenditure on R&D amounts to just under 2 per cent of GDP, compared with 2.64 per cent in the US and more than 3 per cent in Japan. Urgent action is needed to close this funding gap.

2.33 The European Commission will shortly present a proposal for its 7th Research Framework Programme (FP7), effective from 2007. To have maximum impact on Europe's global competitiveness, the fund should be focused on raising the EU's capacity to conduct the very best research, underpinned by a dedicated funding stream for basic research. Decisions on allocation should be driven by the research needs of business, with a particular focus on engaging SMEs, and resources should also be used to ensure that EU policies are properly supported by research. FP7 should also provide funding for horizontal activities, in particular to support knowledge transfer and the development of key research infrastructures.

2.34 In line with the strategic objective of raising the quality of basic research in Europe, the UK welcomes the Commission's plans to create a European Research Council (ERC) as part of FP7. The ERC should enable systematic competition between the best research teams in Europe, and allocate funding on the basis of scientific excellence as determined by peer review. To ensure the transparency and credibility of the ERC, it should be independent from the Commission.

2.35 **The Commission and the Member States should agree the key principles of reformed Framework Programme funding by December 2005, to raise the EU's capacity to conduct the very best basic research, improve industrial competitiveness and ensure that EU policies are properly supported by research. The FP7 proposal should also call for the establishment of an independent European Research Council, founded on the principles of excellence in research programmes as determined by peer review.**

2.36 The UK Government published its ten-year Science and Innovation Framework in July 2004, setting out a comprehensive strategy to raise public and private investment in R&D towards 2.5 per cent of GDP by 2014. As part of that strategy, the UK seeks to encourage business investment in R&D through the use of a tax credits scheme. The UK Government believes that **Member States should share best practice in the use of tax incentives for promoting R&D while recognising that the operating environment for businesses varies between countries and that the design of such tax incentive schemes should remain a matter for Member States.**

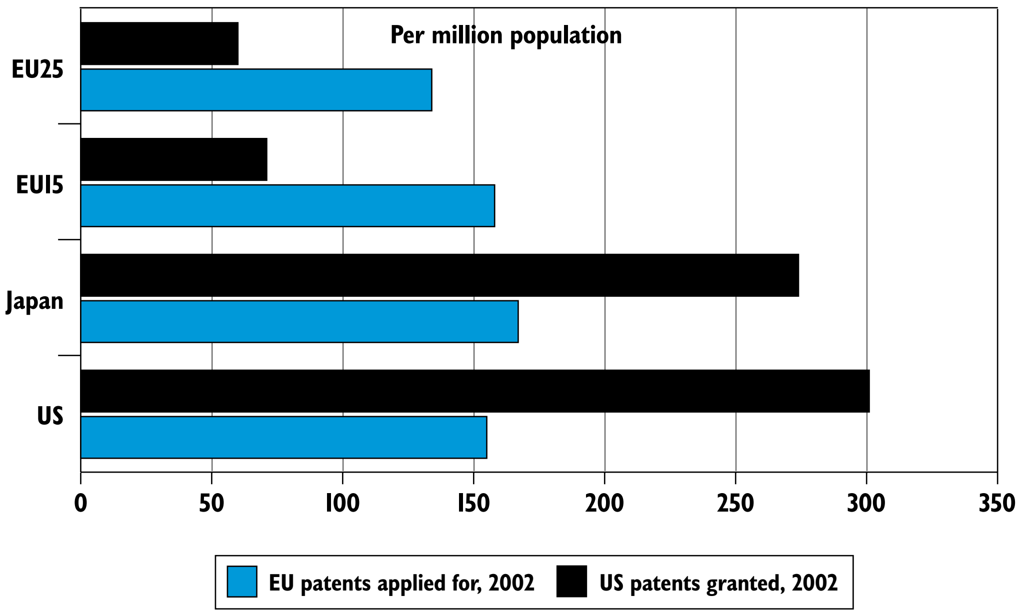
Intellectual property

2.37 While public funding can play an important role in promoting R&D across an economy, ultimately it is investment by business that is the key to success. The overwhelming majority of Europe's shortfall in R&D expenditure relative to its major international competitors can be explained by a lack of private sector investment. In 2002, EU business expenditure on R&D amounted to just 1.18 per cent of GDP, compared with 1.87 per cent in the US and 2.32 per cent in Japan[9]. Wider action is therefore needed to increase the incentives for private businesses to invest in R&D and, in particular, to address the distortions and disincentives created by the existing system of intellectual property protection in Europe.

[9] Source: OECD. Data is for 2002.

2.38 An effective and efficient system of intellectual property rights is increasingly critical to the success of European businesses. Patents provide incentives to innovate, create market opportunities for science-based firms and facilitate technology diffusion through licensing. However, patenting across the EU through the European Patent Office is currently up to five times more expensive than under the US system, and twice as slow, contributing to a shortfall in innovative activity, as illustrated in Chart 2.3.

Chart 2.3: Patent activity



Source: Eurostat structural indicators database.

2.39 In order to develop the competitiveness of innovative industries across Europe, further reform is needed to ensure that the intellectual property regime is made more cost effective, accessible to business, and adequately enforced when business rights are infringed. Intellectual property rights have been made more accessible to business through measures such as IP Europe and the IPR Helpdesk, although more effort is needed to increase accessibility to SMEs. Action has also been taken to strengthen the enforcement of the existing regime. Such initiatives, however, remain insufficient to address the concerns of European businesses. In this context, the lack of agreement on a Community Patent, the implementation of which is often cited by EU businesses as fundamental to improving innovation performance in Europe, is highly regrettable.

2.40 In view of the significant importance attached to patenting regimes by European businesses, it is now imperative that urgent and constructive action is taken by the Commission and the Member States to resolve the differences that have hitherto prevented agreement from being reached on a Community Patent regime, or that urgent work is undertaken to identify, evaluate and agree alternative mechanisms. **The spring European Council should resolve existing problems in the intellectual property regime, or set out a timetable and clear steps for delivering an alternative solution.**

Information and communication technologies

2.41 The rate of innovation in information and communication technologies (ICT) remains a critical driver of economic activity. In Europe, approximately 43 per cent of productivity growth from 1995 to 2000 can be attributed to the use of ICTs.

2.42 The report of the High Level Group, chaired by Wim Kok recognised the importance of the ICT sector, noting that *"in order to ensure future economic growth, the EU needs a comprehensive and holistic strategy to spur on the growth of the ICT sector and the diffusion of ICTs in all parts of the economy"*. The e-Europe initiative forms an important part of the EU's ICT policy objectives and **the Commission should bring forward an innovative and forward-looking e-Europe Action Plan for 2006-2010 during the first half of 2005.** The diffusion and application of new technologies will be particularly important in determining the pace of Europe's economic growth.

ADVANCING EMPLOYMENT

2.43 Globalisation and advances in communication and technology have brought new opportunities for businesses to modulise production, transferring business processes outside the EU in search of lower costs and intensifying the competition for jobs within Europe. At the same time, increased global competition and the rapid development of innovations and new technologies have increased the demand for higher-skilled workers who can move swiftly between firms and sectors and compete for higher value-added jobs. These challenges, combined with that of an ageing population, place a premium on efforts to reform Europe's labour markets.

2.44 In the modern global economy, flexibility and skills are central to ensuring high rates of employment in the face of changing patterns of global demand. Adaptability is the key to participation in the modern labour market, with 'employability for life' replacing the old notion of a 'job for life'. And because globalisation brings not just new opportunities but new insecurities too, national welfare systems must be modernised to support individuals through periods of change while providing protection for the most vulnerable. As the High-Level Group chaired by Wim Kok noted, European labour market reform must be based on the foundations of *"agility, adaptability and employability for which the key is the ability of workers constantly to acquire and renew skills, and for a combination of active labour market policies, training and social support to make moving from job to job as easy as possible"*.

The need for reform

2.45 As described in Box 2.3, many Member States have taken important steps in recent years to reform their labour markets. But further action is required. As noted in Chapter 1, if Europe is to meet its targets for employment by 2010, it must succeed in helping 22 million people into work and in recording average annual employment growth rates of double the average in recent years. On any measure, this is a substantial task. Against a backdrop of rising global competition and an ageing population, it is all the more challenging. Europe must work hard to stand still.

Box 2.3: Important reforms underway in Member States

Many Member States have begun to undertake potentially far reaching reforms:

- **the Dutch Government has agreed a new 'Work and Social Assistance Act' with social partners to deliver moderate wage increases in the future, consistent with productivity growth;**
- **France has introduced a 'Social Cohesion Plan' to raise youth employment through tax incentives for both employers and apprentices. To raise employment and reduce unemployment, France has also increased cooperation between job centres and the administration of unemployment benefits, and introduced measures to reduce non-wage labour costs;**
- **in Germany, the Hartz V reforms to benefit systems and the role of employment agencies will be fully implemented in 2005, providing greater incentives to those out of work to re-enter the labour market, and giving jobseekers the support to help them to find work;**
- **the UK has a National Minimum Wage supplemented by a system of tax credits to ensure that work pays. Tax credits provide in-work financial support to ensure that taking up employment, even at low starting wages, is also financially more rewarding than remaining on benefits;**
- **the Finnish Government has launched a 4-year reform programme targeted at 30-59 year olds who lack vocational qualifications. Employees can attend vocational schools or adult education centres, or take computer courses, in order to meet the demands of new technology; and**
- **in Denmark, the Youth Effort has been addressing youth unemployment and low skills, giving young people under 25 who have received unemployment benefit for more than 6 months and who have little or no basic education the right and obligation to start training or education.**

Priority areas for reform

2.46 The EU cannot ignore change and the resulting need for reform, nor that the creation of jobs in high value-added sectors may be accompanied by a reduction in employment in declining sectors. Provided change reflects genuine economic forces – the fact that some businesses and activities are today more productive than others – then change will drive wealth and the creation of jobs. Not to reform would mean that productivity would lag behind and opportunities for greater prosperity and growth would be missed, harming the most vulnerable in society. There can be no security without change.

2.47 In November 2003, the European Employment Taskforce[10] set out a clear strategy for labour market reform in Europe, the principle recommendations of which have now been integrated into the Union's own guidelines for employment policy. Rapid and effective implementation, by Member States and on the basis of shared experience and learning, remains the key to success. The goal must be to increase:

- opportunities and incentives for the unemployed and economically inactive to find and succeed in employment;
- skills and adaptability in the workforce, so that individulas have access to retraining and new avenues for learning; and

[10] *Jobs, Jobs, Jobs: Creating More Employment in Europe*, European Employment Taskforce, November 2003.

- flexibility and security together, with employment and social policies working in tandem to open up opportunities for employment while supporting those who need it most, and the regulatory environment geared towards job creation.

Increasing opportunities and incentives

2.48 Opportunity and incentives are central to any well-functioning labour market. **Member States must implement the necessary policies to ensure that people have the financial incentives they need to take up and remain in employment, and offer the practical assistance and tools people need to find and take up work.** While there is no single solution that will work for all, Member States must each use a combination of policies to promote opportunity and incentives, including:

- policies to make work pay, for example through reform of tax and benefit systems and by ensuring that where minimum wages are in place they are set at a level which provides security without discouraging job creation;

- active labour market policies which target the obstacles that prevent people from gaining employment, for example through training and improved work-search. Member States must also extend the use of active labour market policies to open up opportunities for the economically inactive; and

- reform of employment services to provide assistance with job search activities, through tailored guidance and advice that responds to the specific requirements of individual job seekers. Member States need to complete the modernisation of employment services to provide the right incentives and support to move people into jobs.

2.49 Patterns of work, and in some cases the nature of work, are also changing radically. More people want to work flexible hours in order to combine work with family responsibilities or to avoid a cliff-edge into retirement. Businesses that seek to support more flexible patterns of working will help to ensure an inclusive labour market, by helping those with caring responsibilities or who wish to pursue further education, or combine this with work. Such flexibility can also help the inactive or unemployed return to work, particularly those with low skill levels or with no recent experience of work.

Promoting skills

2.50 Alongside action to promote opportunity and incentives to work, **Member States must also invest more, and more effectively, in the skills of their workforces, focusing on the demands of the knowledge economy and on their specific skills gaps.** Changing patterns of global demand place a premium on efforts to ensure that workers are equipped with the skills they need to adapt to change and to compete for higher value-added jobs. Skills that were once regarded as high level, such as ICT literacy, are now increasingly viewed as basic skills. The challenge for Member States is to improve the skills of people entering the workforce from the education system, and to improve and update the skills of those already in the workforce.

2.51 Member States need to respond to this challenge with an approach that is tailored to their own particular circumstances, as the nature of the skills gap varies across Europe. For example, while the UK and Germany both compare favourably by international standards in terms of higher-level skills, less than a third of UK workers have intermediate skills, compared with over half in both France and Germany[11]. Similarly, the precentage of early school leavers varies dramatically across the Union. According to Eurostat, the proportion of 18 to 24 year-olds leaving school with at most a lower secondary education and not in further education or training ranges from over 40 per cent to under 5 per cent depending on the Member State examined[12].

[11] *Skills in the global economy*, HM Treasury, Department for Education and Skills, Department for Work and Pensions, Department of Trade and Industry, December 2004.
[12] Eurostat, Structural Indicators. Data is for 2003.

2.52 Individuals also need to update and extend their skills regularly during their working life, so that they can move quickly between firms and sectors in response to changing economic circumstances. The UK Government therefore welcomes and strongly supports the recommendation of the High Level Group, that **Member States should adopt national strategies for lifelong learning to address national skills shortages and demands in the face of rapid technological change,** facilitating increased labour market participation, through reductions in unemployment and with people working longer.

Combining flexibility with fairness

2.53 As economies respond to globalisation and move into different areas of economic activity, adjustment can have significant impacts. Capital and labour may need to move from traditional to expanding industries and at any point in time the impact can fall disproportionately on particular individuals and activities. For the individuals concerned this may entail considerable challenges in adapting to change, acquiring new skills and finding new employment. It is therefore vital that flexibility in the new global economy is accompanied by measures that ensure fairness and enable individuals to make the transition from traditional activities into expanding areas.

2.54 As the High Level Group chaired by Wim Kok noted, flexibility and security can and should be achieved together. Inflexibility can be a key cause of opportunity missed. Unemployed and inactive people without the skills they need to gain employment and without access to retraining and avenues for learning, risk becoming marginalised at the edges of the labour market, facing uncertainty over their long-term employment prospects or long spells out of work. Policies constructed on the notion of a trade-off between economic flexibility and social cohesion must be reassessed.

2.55 Europe's defining commitment to social justice must remain a core value. The question is how best to deliver this in a world of ever intensifying global competition. The role of the modern social model cannot be to protect people against change and to freeze frame. Rather, employment and social protection systems must have at their heart the need to manage uncertainty by equipping people to cope with change, while providing a foundation of security and support for those most vulnerable.

2.56 Minimum standards in the workplace are essential to protect the health and safety of workers and ensure equal pay. They can also boost commitment and productivity and avoid unfair treatment and discrimination. Today, Europe rightly has in place a solid foundation of minimum standards to protect the rights of workers and support the integrity of the Single Market. Such minimum standards have served the Union well, and have helped to make a reality of Europe's shared commitment to social cohesion.

2.57 But globalisation and the growth in competition and markets beyond the EU's borders calls for a reappraisal of Europe's traditional approach:

- research shows that poorly designed employment protection legislation can increase the risk and duration of long-term unemployment by making employers reluctant to fill job vacancies. It also shows that long-term unemployment tends to be higher and forms a larger share of total unemployment in countries with higher employment protection levels than in those with more flexible labour markets[13]. By the same token, and as identified by the European Employment Taskforce, regulation that places excessive burdens on business can act to discourage employment growth, harming the very people it was designed to protect; and

[13] OECD Employment Outlook 2003 and 2004.

- legislation designed and implemented at the EU level can often be a blunt and overly prescriptive instrument. In a Union of 25 different labour markets, where the nature of social challenges varies considerably from Member State to Member State, single solutions based on common regulation may not always be appropriate.

2.58 In practice, Member States have long pursued national social protection programmes aimed at providing security and opportunity for those in and out of the workforce. As the examples in Box 2.4 show, such programmes have made use of a wide range of policy instruments and have been tailored to tackle priority challenges at the national level. As Europe moves into the second phase of the Lisbon strategy, policies which reflect national social and institutional conditions and promote flexibility and security together are increasingly the most appropriate means of promoting employment and social cohesion. The open method of coordination, and the development of existing mechanisms for peer review and the sharing of best practice should support Member States' efforts in this area.

Box 2.4: Flexibility and Fairness: a variety of approaches

The UK's approach to increasing female employment is based on a combination of supply side policies, including tailored support under the New Deal, improvements to the provision of affordable and accessible childcare, alongside improving maternity leave and flexible working arrangements for parents and measures to make work pay. UK lone parent employment is now over 54 per cent – the highest rate on record.

In Denmark and Sweden, the Governments' approach to encouraging female employment includes providing state subsidised childcare places. In Denmark, for low-income earners a free place in a childcare facility is provided, while Sweden has a system of highly subsidised state-provided childcare for working parents. Sweden and Denmark have the highest female activity rates in the EU.

In Spain, the Government is seeking to improve incentives for female employment – for example, by offering a tax credit for employed and self-employed women with children under 3 years of age. Female activity rates have increased from 45.5 per cent in 1997 to nearly 55 per cent in 2003.

AN OUTWARD-LOOKING EUROPE

External openness

2.59 The 2004 spring European Council called for the mid-term review of the Lisbon strategy to include an assessment of the external drivers of growth and productivity. External openness to trade and investment has the potential to make a vital contribution towards advancing the Lisbon goals[14], reinforcing the drivers of productivity growth by:

- encouraging a more efficient allocation of resources across countries;
- providing greater opportunity for economies of scale;
- improving incentives for, and rewards from, innovation;
- fostering more competitive markets;

[14] The 2004 spring European Council noted that *"increasing external openness globally and improving the dynamic economic relationships between trading partners will enhance growth prospects"*.

- providing access to new technologies; and
- reinforcing incentives for investment and encouraging Foreign Direct Investment.

2.60 The dynamic benefits for countries from trade and investment stem as much from openness to imports as from greater market access for exports[15]. The evidence from the Single Market shows that greater intra-EU openness has significantly boosted productivity and growth in the Union. But, estimates suggest that existing barriers to external trade and investment, such as tariffs, quotas and restrictive standards could cost consumers up to 7 per cent of EU GDP, or around €600-700 billion a year[16]. The EU therefore needs to develop more outward-looking policies[17], and in particular to:

- lead the way in achieving an ambitious, liberalising, and pro-development outcome to the Doha Development Agenda (DDA) Round of WTO negotiations; and
- enhance its bilateral economic relationships with near neighbours, emerging markets and its largest trading partner, the US.

2.61 Growth in world trade has been outstripped in recent years by a rapid acceleration in foreign direct investment (FDI) flows. The EU has played a significant role in this, accounting for 35 percent of global inflows and nearly half of all FDI outflows between 1985 and 1999. Nonetheless, the EU could do more to attract inward investment. Between 1992 and 2002, the EU15 received a cumulative $780 billion of inward FDI from non-EU15 countries – an annual average inflow of around 0.9 per cent of GDP – compared with the US, where annual average inflows amounted to 1.4 per cent of GDP, or $1.4 trillion. The EU has potentially forgone the potential benefits of greater FDI, including higher productivity, higher wages, the transfer of know-how and integration into worldwide production networks.

The cost of continuing protection

2.62 Although many barriers to trade have fallen over the years, protection in certain sectors of the economy remains high, imposing substantial costs on both consumers and taxpayers. It has been estimated that the cost of safeguarding employment in the EU's 22 most protected sectors is eleven times the average wage – 244,000 jobs were saved (only 3 per cent of employment in these sectors), at an average consumer cost of €211,000 per job each year[18]. Barriers to trade are often put in place with the aim of encouraging investment, or safeguarding employment in specific sectors. But providing shelter from international competitors is typically an inefficient, costly and ultimately ineffective way of achieving these goals, and provides weak incentives to improve productivity.

[15] *Trade and the global economy: the role of international trade in productivity, economic reform and growth*, HM Treasury and DTI, May 2004.
[16] *The real cost of European protectionism*, Patrick A. Messerlin, Institut d'Etudes Politiques de Paris and Group d'Economie Mondiale de Science Po, 2001.
[17] *Trade and the global economy: the role of international trade in productivity, economic reform and growth*, HM Treasury and DTI, May 2004.
[18] *Measuring the costs of protection in Europe: European commercial policy in the 2000s*, P.A. Messerlin, Institute of International Economics, Washington DC, 2001.

Protectionism in agriculture

2.63 The EU's Common Agricultural Policy (CAP) is a clear example of an area of heavy protection. The EU provides around €100 billion support to farmers annually. The CAP is the EU's most expensive single policy with an annual budget approaching €50 billion. On top of this, consumers pay another €50 billion a year through higher food prices[19]. Production is significantly distorted: the CAP is estimated to have led to levels of production of crops and dairy products which are over 50 per cent higher than would have been the case without protection[20].

2.64 As for domestic support, the EU has recently taken measures to reduce the trade-distorting impact of the fiscal transfers it provides by beginning to break the link between production and receipt of payments for many important products, a process known as 'decoupling'. Further reform is still necessary to address domestic support which affects production but it is the other two pillars – export subsidies and border protection – which are now in most urgent need of reform.

2.65 Export subsidies allow excess produce to be sold on world markets at prices well below EU internal prices and often below the cost of production. Border protection – using high tariffs and other barriers to keep international produce out – is also very significant. Together, these three pillars of agricultural protection give rise to a number of harmful effects, both to non-farmers in the EU and to efficient farmers elsewhere, including many in developing countries.

Multilateral trade liberisation

2.66 The gains from liberalisation will be greatest if trade barriers are reduced in a multilateral context. The framework for continuing the DDA negotiations agreed in July 2004 offers a vital opportunity to make real progress in global trade liberalisation and significant progress towards an ambitious agreement is needed at the Ministerial meeting to be held in Hong Kong in December 2005. An agreement must offer real improvements in market access, while recognising and addressing the specific constraints on developing countries. A study for the European Commission estimated that the Doha Round could benefit the EU by $92 billion[21].

2.67 The UK Government welcomes the commitment made by the European Commission in its communication to the spring European Council to *"press hard for completion and implementation of the Doha Development Round."* The EU played a key role in reinvigorating negotiations with an early offer in May 2004 to eliminate all export subsidiaries. Looking ahead, **the EU must now show increased flexibility in advance of the WTO Ministerial in Hong Kong in December in order to lead the Doha Development Agenda negotiations towards an ambitious, liberalising and pro-poor agreement, that builds in particular on existing reforms to the Common Agricultural Policy to reduce the distortions in agricultural markets.**

2.68 An ambitious agreement in the DDA that reduced distortions and increased market access to developed country markets, as well as South-South trade, would also provide a significant boost to long-term economic growth and development in developing countries, lifting millions of people out of poverty and making an important contribution towards the achievement of the Millennium Development Goals. However, developing countries must have the flexibility to appropriately sequence trade reforms into their development and poverty reduction strategies and need assistance to build trade capacity so that they can benefit from greater market access – the UK has proposed that this be financed through the International Finance Facility. Action is also needed to address seriously the short-term transition costs that some countries will face to ensure that the most vulnerable people are protected as they adjust to more open markets.

[19] OECD (2003): Agricultural Policies in OECD Countries: Monitoring and Evaluation 2003, Paris.

[20] Borrell, B. and Hubbard, L. (2000): 'Global economic effects of the EU Common Agricultural Policy', Institute of Economic Affairs, Oxford.

[21] *The millennium round: an economic appraisal,* N. Nagarajan, European Commission Economic Papers, Number 139, 1999. Based on a 50 per cent cut in agricultural protection, manufacturing tariffs, and services, plus liberalisation of trade facilitation.

Near neighbours

2.69 As set out by the European Commission in its communication to the spring European Council, the EU must also seek to make *"progress on other bilateral and regional economic relationships"*. The historic process of enlargement of the European Union has liberalised further trade within Europe and increased the economic benefits of the Single Market. However, while the overall effect of enlargement has been liberalising, in some cases it has generated new barriers between the new Member States and third countries – notably, the EU's new Eastern and Southern neighbours. A combination of tariff and non-tariff barriers means that the potential for trade and economic integration with these countries is unfulfilled[22].

2.70 The EU must continue to strengthen economic links with its neighbours. Economic reform is an important part of the European Neighbourhood Policy (ENP); economic reform benchmarks should be included in Action Plans developed with partner countries under the ENP, and support for reform should be a key element of EC assistance programmes in the region. Barriers to trade and investment links should also be eliminated further, advancing EU cohesion objectives by providing a boost to many border regions of the new Member States that rank among the poorest in the enlarged EU.

2.71 The conclusion in May 2004 by the EU and Russia of bilateral market access negotiations for the accession of the Russian Federation to the WTO is a welcome development and the Government looks forward to the implementation of the bilateral aspects of this, possibly in the context of further progress towards the creation of a Common Economic Space with Russia.

Emerging markets

2.72 The increasing integration of Asian markets into the world economy has been one of the most important manifestations of globalisation. Their share of world trade has risen from 13 per cent in 1990 to 20 per cent in 2002. As noted in Chapter 1, China, in particular, has grown in importance, among the EU's external trading partners, the share of extra-EU trade with China more than doubling since 1990. Nonetheless, the evidence suggests that EU companies could take greater advantage of opportunities to invest in fast-growing Asian markets. For example, 12.3 per cent of US foreign investment between 1999 and 2002 was directed at Asian emerging markets compared with only 5.2 per cent in the EU.

EU-US economic cooperation

2.73 Increasingly, the most significant impediments to doing business with major economic partners such as the US are behind-the-border barriers arising from differences in regulatory approaches and standards. Overcoming these obstacles, and ensuring new barriers are not created, requires cooperation among policy-makers and regulatory bodies. International regulatory cooperation in areas such as financial services is an important challenge if Europe is to realise the benefits of globalisation.

2.74 The transatlantic economic relationship far outstrips any other in terms of size and depth of integration. Dominated by FDI, often in high-tech sectors, the relationship is an important source of prosperity for the EU and supports 12 million jobs on both sides of the Atlantic. It has been estimated that closer cooperation to remove barriers could boost EU GDP by as much as 2 per cent per year[23]. The OECD is currently undertaking a detailed analysis of the potential gains from closer economic integration between the EU and the US, the results of which will be available in March 2005 and will help to identify priority sectors for closer cooperation.

[22] For example, the expiry of the free trade agreement between Slovenia and certain countries of the former Yugoslavia is estimated to have had a 0.1 percentage point negative impact on growth in Slovenia.

[23] *Enhancing economic cooperation between the EU and the Americas*, CEPR, 2003.

2.75 The importance of strengthening the EU-US economic relationship was recognised at the June 2004 EU-US Summit which called for the development of a new forward-looking strategy for closer cooperation. The Government welcomes this opportunity to inject new momentum into EU-US cooperation, by setting clear priorities for regulatory cooperation and developing new dialogues on growth and economic reform issues, engaging key policy makers and regulators on both sides of the Atlantic. **It believes that the spring European Council should highlight the contribution that stronger economic ties with the US would make to achieving the Lisbon goals and look forward to an ambitious new forward looking strategy to strengthen cooperation, due to be launched at the 2005 EU-US summit, and building on contributions to the recent stakeholder consultation.**

Flexible tax systems in a global Europe

2.76 The challenge and opportunity that globalisation presents for Member States require flexible and competitive tax systems. With competitiveness key to the success of EU businesses in the global economy, EU governments must structure their tax systems to enhance that competitiveness.

2.77 Given the diverse economic challenges that Member States face, and different preferences for the size and nature of the public sector and the role of the tax system in funding it, the UK Government believes that fair tax competition is the right approach for a global Europe. Where Member States unanimously agree that coordination of some aspects of tax policy is necessary for the effective operation of the Single Market – for example in relation to aspects of the VAT regime – or where there may be an overriding environmental or health reason for a common EU approach, it is right that Member States should work together. But in other areas of tax policy – for example, the rate and base for corporation tax – continued national control is needed to ensure that Member States have the tools they need to support specific economic reforms and ensure competitiveness in the global economy. This is the most effective way of carrying forward the Government's agenda of fair tax competition.

ENVIRONMENTAL PROTECTION

2.78 Europe's responsibilities in the global economy extend beyond its role in promoting open markets and free trade. It has a role in promoting sustainable consumption and production both within the EU and internationally, and the UK Presidency will address these issues when it takes forward revision of the EU Sustainable Development Strategy. But, at the EU level there is also scope for synergies between the Community's environmental protection aims and its competitiveness and growth agenda. The report of the High Level Group chaired by Wim Kok rightly recognised the potential for innovation to create new markets and increase competitiveness through greater resource efficiency and new investment opportunities and called on Europe to pursue *"policies which lead to long-term and sustained improvements in productivity through eco-efficiency"* noting that *"in this sense environment policies can help achieve the core Lisbon strategy objectives of more growth and jobs"*.

Exploiting win-win opportunities

2.79 There are many ways in which Europe can successfully combine environmental policy with action to advance the Lisbon goals. For example, effective regulation which stipulates required environmental outcomes can give the market some certainty that particular technologies or skills are likely to be in demand due to the environmental criteria that they fulfil. Similarly, Europe could gain a first-mover advantage by focussing investment on resource efficient technologies that other countries will eventually need to adopt. This would not only advance Europe's climate change objectives but would contribute also to the achievement of wider environmental objectives such as reducing levels of waste, improving air quality, reducing the environmental and human health impact of chemicals and meeting the Water Framework Directive. The UK Government believes that it is important that effective policy levers are in place and that barriers are removed to encourage the development and commercialisation of new eco-efficient technologies and products, and to that end welcomes the Environmental Technologies Action Plan.

Climate change

2.80 Member States also have a responsibility to tackle trans-boundary environmental problems, such as climate change and air quality. Recent Commission projections suggest that once additional measures yet to be put in place are taken into account, the EU could reach its Kyoto target. Nonetheless, the performance among Member States remains variable and the Government believes that further action will be needed by all Member States to ensure that the EU, as a large emitter of greenhouse gases, pulls its weight in tackling climate change and remains in a position to present credible international leadership on this issue.

2.81 Member States have a range of levers that can help them to reduce their emissions. The key instrument from January 2005 is Phase One of the EU emissions trading scheme (ETS) which will enable emissions reductions to be made at the lowest cost and should help Member States meet their Kyoto targets. The UK Government welcomes the EU ETS which provides an effective market-based instrument for reducing emissions and rewards those that find innovative ways of doing so. Looking forward, with the introduction of the EU ETS and the entry into force of the Kyoto Protocol, the EU should consider establishing longer-term greenhouse gas emission reduction targets. Moreover, in view of the significant contribution that aviation emissions make to total greenhouse gas emissions, the UK Government strongly supports the inclusion of intra-EU aviation into EU ETS and will also continue to press for the development and implementation of an international emissions trading regime.

SUPPORTING LISBON: TOWARDS BETTER GOVERNANCE

2.82 Many of the reforms needed to advance the Lisbon goals of growth and employment are the responsibility of Member States. The size, diversity and cultural richness of the European Union means that the context for reform varies considerably between countries, reflecting local histories, institutions and traditions. The Lisbon Strategy must continue to permit a pluralist approach to reform, in which Member States have the flexibility they need to adapt policy responses to suit local conditions.

2.83 At the same time, the Member States and institutions of Europe share the responsibility to take action within their realms of responsibility and to contribute on an equal basis to the process of economic reform. Member States that fail to deliver in their own economies, fail not just their own citizens but the citizens of Europe too. The mid-term review of the Lisbon Strategy must therefore embrace a new partnership for reform, in which all those responsible for the development and implementation of reform are made accountable for the contribution they make to the achievement of the Lisbon goals.

2.84 The High Level Group correctly identified the implementation of reform as key to Europe's future economic prosperity and described the extent of action to date as *"inadequate"*. The European Commission's communication to the spring European Council reiterated this message, noting that *"delivery will be critical and improvements of the existing delivery mechanisms are urgently required"*. The UK Government supports this conclusion and believes that such reform must:

- strengthen national incentives to reform, through stronger transparency and accountability for the implementation and success of national economic reform programmes; and
- ensure that wider Community policies support rather than hinder the overall goals of the Lisbon Strategy.

Promoting incentives to reform

2.85 In the context of the Lisbon Strategy, the open method of coordination continues to provide the right approach to policy-making and delivery in many areas of structural reform, promoting the sharing of best practice and ensuring that policy solutions can be tailored to suit local conditions within a framework of shared objectives, targets and political commitment. However, in the second phase of the Lisbon Strategy, reform is needed to strengthen accountability and reform incentives within the context of the open method, including through:

- National Plans for Growth and Employment, presented annually by Member States at the highest political level; and
- strengthened benchmarking of national performance to identify successes and delivery gaps in the Member States.

National Plans and Growth and Employment

2.86 The High Level Group chaired by Wim Kok and the European Commission's communication to the spring European Council both recommended the introduction of national Lisbon Action Programmes, focussed on growth and employment, to improve the governance of the Lisbon strategy. The UK Government fully supports the objectives behind this proposal and believes that **the mid-term review of the Lisbon Strategy should agree that Member States should present annually National Plans for Growth and Employment summarising the actions they have taken and intend to take to improve flexibility in labour, product and capital markets.** The aim of such Plans should be to:

- streamline existing reporting processes, thereby reducing bureaucracy and overlap, and better recognising policy inter-linkages;
- strengthen political ownership and accountability for national reform programmes at the highest level;
- preserve the integrity of existing peer review mechanisms pursued in the areas of labour market and wider structural reform; and
- improve transparency and allow the Commission and the European Council to monitor and draw conclusions on national reforms.

2.87 In order to meet these objectives:

- ECOFIN and the Employment Council should, in line with the Commission's report, continue to adopt the Broad Economic Policy Guidelines (BEPGs) and Employment Guidelines, thereby providing strategic direction for the National Plans for Growth and Employment. The BEPGs, as the overarching economic policy co-ordination instrument covering the whole spectrum of macroeconomic, microeconomic and employment policies, ensure the consistency between the different aspects of structural reform;

- Member States should present, annually, a single consolidated document summarising the reforms undertaken in labour, product and capital markets, consistent with Broad Economic Policy Guidelines and Employment Guidelines, and setting out forward-looking commitments to further reform. In practice, this would involve merging existing national reports on labour, product and capital market reforms;

- in preparing their reports, Member States should engage with and consider the views of social partners and other key stakeholders, to gain wider political buy-in, in accordance with national traditions;

- reports should be personally owned and presented by Heads of State and Government. They should be pre-faced with a short statement setting out a limited number of specific and forward-looking policy commitments, consistent with the main body of the report;

- existing peer review discussions, in the ECOFIN and Employment Councils should continue, and be based on the consolidated report, with ECOFIN continuing to ensure consistency between macroeconomic, microeconomic and employment policies. Such mechanisms, which enjoy the active participation of national policy experts, provide an effective means of sharing best practice and learning from one another; and

- though multi-annual in their context, reports should be presented each year to maintain the momentum for reform and to meet the Treaty requirement for annual peer review of the employment policies of the Member States.

2.88 The UK Government believes that a system of National Plans for Growth and Employment configured along these lines would allow the European Council and the European Commission, as well as the media and domestic stakeholders, to monitor the implementation of key reforms through a light touch approach, which would serve to streamline existing processes; preserve the effectiveness of peer review; help the Commission to play a supportive role in advancing the Lisbon goals; increase political visibility and commitment; and more effectively align appraisal of past performance with future actions. Box 2.5 sets out a possible timetable for the production, dissemination and discussion of such reports.

Box 2.5: National Plans for Growth and Employment: a possible timetable

The timetable below sets out possible milestones in the production of National Plans for Growth and Employment:

- **following the 2005 spring European Council, the Commission and the Council agree updated Broad Economic Policy Guidelines and Employment Guidelines, prioritising growth and employment as key aims of the Lisbon Strategy;**
- **the Commission produce guidance to Member States on the format and drafting of National Plans for Growth and Employment by summer 2005;**
- **Member States present initial National Plans for Growth and Employment in autumn 2005, ahead of the 2006 spring European Council;**
- **country examinations in the ECOFIN and Employment Councils take place before the end of 2005 on the basis of National Plans for Growth and Employment;**
- **the Commission takes into account the content of National Plans and the outcome of country examinations in its reports for the spring European Council;**
- **the 2006 spring European Council discusses progress on economic reform and priorities for coming year; and**
- **National Plans for Growth and Employment are updated in autumn 2006.**

Benchmarking success

2.89 In its November 2004 report, the High Level Group chaired by Wim Kok proposed that the European Commission present *"an annual league table of Member State progress towards achieving … key indicators and targets"*. This recommendation mirrored that of many other external observers, including the IMF. While the results of such benchmarking should not be treated mechanistically, the UK Government believes that a more transparent and publicly accessible system of ranking and benchmarking could usefully seem to highlight examples of good practice in the Member States and help facilitate the process of reform.

2.90 Existing work by the European Commission to monitor national performance against core structural indicators already provides an effective snapshot of the reform challenges faced by Member States and provides a useful signal of where countries can learn from one another. **The spring European Council should endorse a continuation of benchmarking and invite the Commission to develop its current approach so as to increase the degree of political and public exposure to the results.** As now, such assessments should form but one part of a wider, qualitative assessment of reform, and reflect initial starting points as well as absolute achievements.

Supporting the Lisbon strategy

2.91 While most of the instruments of structural reform belong to the Member States, Community policies also have an important role to play in advancing the Lisbon goals. As described above, action at the Community level to regulate, investigate and address competitive distortions in the Single Market can make a vital contribution to improving productivity, employment and growth in the EU. Likewise, Community spending on R&D can help to ensure that Europe is able to compete internationally in the development of high-tech products and services. This section considers the role of the Community budget and the Stability and Growth Pact in advancing the Lisbon goals.

A modern and flexible Community budget

2.92 Negotiations on the next Financial Perspective represent an important opportunity to realign the Community budget in support of the Union's political priorities, including the Lisbon strategy. The UK Government believes that the budget should be reformed to reflect the Lisbon priorities while ensuring that it is subject to the same levels of budget discipline and efficiency that Member States are expected to deliver at home. Community spending must therefore be limited to those areas in which action at the EU level adds clear value over and above that which would be delivered by Member States acting alone.

2.93 **The view of the UK Government – which is shared by a number of other Member States – is that these goals can be achieved with a commitments budget of no more than 1 per cent of EU GNI.** This amounts to a budget of €815 billion in 2004 prices and would represent a 6.5 per cent real terms increase in spending compared with the current Financial Perspective. It is both realistic and affordable.

2.94 In line with the principle of subsidiarity, responsibility for meeting the vast majority of the Lisbon targets remains primarily with Member States and should be funded at the national level. This includes expenditure in areas such as education and social policy. Nonetheless, in a limited number of areas, spending at the European level can deliver more than at the national level. There is a particularly strong case, for example, for increasing Community spending on basic research and development given its significant spill-over effects and the large economies of scale associated with such projects. In order to maximise the benefits of such expenditure however, funds must be allocated on the basis of excellence and the level of spending must be consistent with the ability of stakeholders to manage and absorb funds. In this context, the Commission's proposals to triple expenditure on all aspects of competitiveness spending in support of the Lisbon Strategy in the next Financial Perspective are unrealistic.

2.95 Spending on the Common Agricultural Policy and the Structural and Cohesion Funds together accounts for over two thirds of the existing EC budget. The UK Government supports further reform in these policy areas to complement and better support delivery of the objectives of the Lisbon Strategy.

Box 2.6: Reform of the Structural and Cohesion Funds

Reform of the Structural and Cohesion Funds in the next Financial Perspective is essential if they are to become more effective, sustainable and affordable, and are to make a more positive contribution to achievement of the Lisbon goals. The UK Government believes that all Member States should sign up to common objectives for regional policy in support of the Lisbon and Gothenburg agendas, but that delivery of these objectives should be devolved to Member States. Community funding should be focused on those countries that are eligible for the Cohesion Fund – those with a GNI per capita of less than 90 per cent of the EU average – and hence which are in most need of assistance. This would ensure that Community resources are targeted where they have greatest effect. Richer Member States should take primary responsibility for funding their own regional policies from national resources. This model retains the benefits of the current system while increasing the quality of EC expenditure. It also gives Member States the flexibility they need to design and implement their own regional development policies.

While the UK Government welcomes some elements of the Commission's proposals for the future of the Structural and Cohesion Funds, including the need for a greater strategic focus, decentralisation and simplification, it believes that the Commission's overall proposals are unrealistic and unacceptable. For example:

- **despite a significant increase in disparities between the richest and poorest Member States, less than 50 per cent of the funds would go to the new Member States. The EU15 would continue to receive the majority of SCF receipts through to 2011, a full seven years after enlargement;**
- **the proposals fail to add value at the EU level. Some €56 billion would be targeted exclusively at the richest parts of the Union; and**
- **the budget would rise by 30 per cent in the next Financial Perspective to €370 billion, or one third of the EC budget. This is incompatible with a financially-disciplined approach to the budget and is unsustainable.**

2.96 The report of the High Level Group called for an analysis of the possibilities for introducing budget incentives to encourage Member States to achieve the Lisbon targets. The UK Government believes such a system is unlikely to be workable in practice for several reasons:

- rewards for achieving the Lisbon goals would discriminate against those Member States who had already taken action to meet the goals, creating perverse incentives;
- it could encourage Member States to focus on the wrong priorities;
- given the complex relationship between reform and results, it would be difficult to agree on objective criteria for determining such rewards; and
- the size of any such rewards would be unlikely to overcome the wider obstacles to reform in many Member States.

The Stability and Growth Pact

2.97 The High Level Group noted that the framework for macro-economic policy in Europe should be as supportive of growth as possible, and that in this context, reform of the Stability and Growth Pact was desirable. The UK Government agrees that the Stability and Growth Pact must contribute to growth and not impede it. It therefore supports a prudent interpretation of the Pact, grounded in a sound economic rationale, which is applied symmetrically throughout the cycle; distinguishes between high and low debt countries; and permits borrowing for public investment within prudent limits. A prudent interpretation would lock in long-term fiscal discipline and sustainability; enhance credibility across the economic cycle, by allowing the automatic stabilisers to operate fully and symmetrically to smooth fluctuations in output; and allow appropriate increases in investment in public services to deliver strong and sustainable growth. **The European Council should agree on the reforms needed to realise a prudent interpretation of the Stability and Growth Pact.**

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