

## Supply-side policy coordination in the European Union

Guido Tabellini and Charles Wyplosz\*

### Summary

■ Europe's overall economic performance has been depressing for more than a decade. The reasons are well known, as are the solutions. The problem lies squarely with the supply side. While some countries have been able to undertake the necessary reforms, others have not. Can the solution come from outside, through more centralization, formal or informal, at the EU level of government? Our answer is negative. Centralization works by exploiting externalities and increasing returns, but it cannot substitute for domestic policy failures. With few exceptions, chiefly research and higher education, the supply side displays no significant externalities and no increasing returns.

Is the Open Method of Coordination, which lies at the heart of the Lisbon strategy, an alternative to centralization? Here again, our answer is negative. We view the strategy as misguided in its ambitions, muddled in its endless list of priorities, undercut by the illusory precision of its quantitative targets, and flawed in its reliance on improbable peer pressure.

We make three main proposals. First, in order to complete the single market, held up by powerful interest groups, we suggest increasing the powers of the Commission or, preferably setting up independent agencies. Second, in those countries where the labor markets need politically difficult reforms, we recommend that national parliaments be required to debate the conclusions of European Council meetings. Third, to overcome Europe's scientific innovation failures, we propose that the EU's research budget be primarily used to provide matching grants for setting up new universities and research centers.■

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## 1. Should supply-side policies follow the example of demand-side policies?

Having decided to centralize monetary policy and set limits on national fiscal policies, European Union member countries have gone a long way towards giving up national demand-side policies. In the area of supply-side policies, the Single Market has also achieved some degree of centralization—many competition policies are now a shared competency, but national prerogatives remain dominant. This is the case for policies concerning the labor markets, R&D, health, retirement, equality, education and several aspects of regulatory policies. Is this division of tasks appropriate, or should it be reconsidered? In which areas of supply-side policy, if any, is the need for European coordination more acute? Is the current institutional framework for coordination of supply-side policies adequate, or is there a need for reforms? These are the questions addressed in this paper.

The current framework for coordinating supply-side policies is the Open Method of Coordination (OMC), enshrined in the Lisbon Strategy. This new approach is based on the idea that there is a need for national governments to go further in the supply-side areas as well. Yet, it does not propose to centralize national policies. The strategy consists of requesting from every EU country that it annually sets and updates pluri-annual policy goals designed to boost productivity. The Commission provides a template of desirable actions in several policy areas (R&D, education, labor markets, etc.). It critically evaluates the country programs and submits its views to the Spring European Council. The intention is to promote peer pressure among

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Heads of States and Governments—sometimes referred to as a “naming and shaming” exercise. The Lisbon strategy does not include any other obligation than producing the annual action plans.

This half-way procedure may be seen as the diplomatic outcome of conflicting views between “federalists” and “nationalists”, in and out of government. The former see an increasing degree of coordination as desirable *per se*, irrespective of the economic logic, on the way to “an ever closer union”. The latter oppose further integrative steps, also irrespective of the economic logic, as they want to protect national prerogatives against what they perceive as relentless pressure to undermine the Nation-State.

Alternatively, the OMC can also be seen as a flexible approach to coordination in areas where the case for centralization is weak, yet present. This is the pragmatic approach followed in the present report. Our main purpose is to evaluate whether the need for supply-side coordination is warranted and, where it is, to ask whether the Lisbon Strategy offers an efficient framework.

A large literature now deals with the coordination of aggregate demand policies. This paper focuses exclusively on the supply side.<sup>1</sup> Thus, we do not discuss the question of whether the framework for coordinating aggregate demand policies, and in particular the Stability and Growth Pact, needs to be reconsidered. Nor do we examine the link between demand and supply-side policies. A widely held opinion maintains that expansionary demand-side policies are needed to encourage supply-side reforms, because such reforms are more likely to be implemented in good times. In fact, this opinion is contradicted by the evidence. Looking at the last 15 years, Boeri (2003) concludes that reforms enacted when growth exceeds 2 percent per year often increased the generosity of welfare systems or the protection of labor market insiders, rather than the other way around. Radical and unpopular reforms are always difficult, but sometimes they occur also because negative economic circumstances create a sense of urgency and increase the awareness that something has to give.

In the next section, we present our guiding principles, inspired by the theory of fiscal federalism. Section 3 describes the supply-side challenges faced by the EU, all of which have now been clearly identified. Section 4 contains the policy analysis, discussing the role of

<sup>1</sup> Other recent papers with a similar purpose include Begg (2005) and Alesina, Angeloni and Schuknecht (2005).

Europe with regard to labor markets, competition policy and the single market, taxation, and policies towards research and education. Section 5 then examines the Lisbon Strategy and the associated Open Method of Coordination, a potentially interesting half-way between formal coordination and full decentralization. While the strategy is clearly not delivering, it can be improved, and some proposals follow. The last section presents our conclusions.

The paper does not seek to identify all reforms that Europe needs to cure its ills. Both the ills and the medicine are well-known, as are the reasons why some countries have failed to act. These aspects are cursorily recollected only to illustrate the main aim of the paper, that of analyzing how the *process* of economic reform can be best served. The paper also includes three proposals in the spirit of the Lisbon Strategy: reinforce the centralized enforcement of the single market, possibly by setting independent agencies; exploit the OMC to bring public opinion pressure to bear on governments that balk at supply-side reforms; and use EU resources to coordinate and encourage the creation of new universities and research centers.

## 2. Principles

At a general level and from an economic effectiveness standpoint, the need for coordination of supply-side policies is not clearly established. Basic economic principles are too often overlooked in public discussions. Contrary to some popular beliefs, coordination or centralization is not desirable *per se*. The case must be based on the idea that national policymakers acting in isolation have distorted incentives. But from where does the distortion come?

### 2.1. Welfare maximizing governments

The traditional perspective views policymakers as “benevolent” and motivated only by the goal of maximizing national welfare. In this case, distorted national incentives arise from one of two problems: the presence of externalities (one country’s action affects others), or the existence of increasing returns to scale (some activities are more efficient when carried out on a scale larger than the national domain).

Demand-side policies carry externalities which, if important enough, call for coordination, whenever possible. In the area of monetary policy, for instance, a country’s exchange rate depreciation is an appreciation from its partners’ viewpoint. This has long been

seen as dangerous beggar-thy-neighbor moves that require a high degree of coordination; hence the Bretton Woods system, the EMS and eventually the monetary union. Fiscal policy triggers income flows that can be welcome but too small if the cyclical situation is similar, or unwelcome if the countries are in different phases of the cycle. Yet, these effects are usually considered as too small to justify coordination, except maybe for impulses originating in the larger countries. The only aspect of fiscal policy that justifies some effort is the risk of default on public debts; in a monetary union, one country's default could reverberate throughout the area, possibly including systemic difficulties in the financial system, at any rate provoking capital outflows and a depreciation of the common exchange rate. The Stability and Growth Pact intends to deal with that aspect.

Supply-side policies are different. In principle, one country's efforts to enhance its productivity should benefit its partners through higher purchasing power. It is sometimes feared that one country's failure to carry on effective supply-side policies, while its partners do, could lead to a loss of market share and reduced demand, thereby leading to a growth slowdown and unemployment. Similarly, if one country's actions benefit others, uncoordinated supply-side policies might be optimal at the national level but under-developed at the collective level. Both observations correspond to the existence of externalities. Do such externalities support the case for coordination or centralization? The broad answer is negative when the externalities are pecuniary and if countries are too small for this to affect their terms of trade.<sup>2</sup> Pecuniary externalities occur when they are accompanied by price changes without generating any market failure.<sup>3</sup>

It turns out that the externalities of most, but not all, supply-side policies are pecuniary.

But the assumption that countries cannot affect their terms of trade with supply-side policies may be too restrictive. If countries can affect their terms of trade, because they are large enough in the rele-

<sup>2</sup> The distinction between pecuniary and non-pecuniary externalities is established in Musgrave and Musgrave (1973).

<sup>3</sup> In contrast, by definition, demand-side policies are only justified if we accept the pre-existence of a market failure. Typically, monetary policy is justified by the existence of price and/or wage rigidity, while fiscal policy rests on the presence of borrowing constraints—failure of the Ricardian equivalence. In the presence of a market failure, second-best arguments can be invoked to argue that the externality is not adequately internalized via price adjustments.

vant markets, then benevolent governments' supply-side policy coordination is welfare improving. If factors of production are immobile, then growth and productivity-enhancing policies typically result in deteriorations in the terms of trade (through prices and wages). This means that some of the benefits of the supply-side improvements spill over abroad, and the incentives to engage in supply-side reforms are correspondingly weakened. Put differently, countries that pursue effective supply-side policies indirectly benefit others with their own effort; without policy coordination, this external benefit is not internalized, and thus, supply-side reforms might be discouraged relative to full coordination.<sup>4</sup>

Yet, there is an important exception to this general argument. If factors of production are mobile, the argument may be reversed. A country that manages to increase the productivity or the returns of its inputs may be able to attract capital from abroad. This benefits the reforming country and hurts its neighbors. Without coordination, countries might exaggerate in supply-side reforms (for instance, in reducing corporate taxes), and coordination might be needed to discourage supply-side reforms designed with the main purpose of attracting foreign inputs. Given the mobility of capital in the EU, this argument seems to be more relevant than the previous one on the terms of trade. We return to this point below, in the next subsection.

Attempts to affect the terms of trade, or attract foreign capital, are not the only reasons why coordination of supply-side policies amongst benevolent governments might be needed. Another reason concerns legislation and regulations, seen as policy interventions designed to deal with market failures. For example, anti-trust policies are needed because increasing returns to scale, where they exist, lead to excessive market concentration. In this second-best world, policy coordination is justified because most markets operate at the EU level. A good example is the Single Market that, indeed, must operate on a level playing field and requires a high degree of harmonization of commercial laws, public procurement, anti-trust policies, etc.

<sup>4</sup> Gancia and Epifani (2005) use a related argument to argue that more open economies have larger governments (because they do not fully internalize the tax distortions associated with government spending).

## 2.2. Politically motivated or constrained governments

The abstraction of “benevolent” welfare maximizing national policymakers is generally not appropriate. Often national policymakers face political constraints, and respond to electoral concerns or to the influence of organized groups who seek rents for themselves. In this case, national policymaking has distorted incentives, even in the absence of externalities or economies of scale. The question then becomes whether centralization mitigates or enhances these political distortions.

The main reason why centralization may be counterproductive, if there are national political distortions, is obvious: centralization weakens the incentive to compete. Each government acting in isolation faces a cost in pursuing politically expedient but inefficient policies, and this cost is lower if everyone agrees to remain inefficient. A well-known example is tax policy. When acting in isolation, national governments have an incentive to set low tax rates, so as to attract mobile tax bases from abroad. This so-called tax competition is inefficient if governments are welfare maximizing, because every country ends up with excessively low tax rates. But suppose instead that politically motivated governments have distorted incentives to over-spend and over-tax. Then, tax competition could be welfare enhancing, because it offsets the political distortions.

Centralization may also reduce the cost of political lobbying by foreign organized interests. This can be counter-productive or welfare improving, depending on whether domestic and foreign lobbies have the same or opposite interests (see Bordignon et al., 2003). Under decentralized policymaking, national policy is distorted only (or mainly) by the influence of the domestic lobby. With centralization, policy is also influenced by the foreign lobby. If the foreign and domestic lobbies have the same interests, they pull in the same direction and the policy is doubly distorted. If instead the two lobbies have opposite interests, they offset each other and the distortion is mitigated.

Examples of policies where foreign and domestic organized interests are aligned are consumer or environment protection—both foreign and domestic producers are likely to lobby for excessively low consumer or environment protection. When policy is decentralized, each government is influenced by the domestic lobby, but neglects the adverse effect of consumer or environment protection on the foreign lobby. Under policy coordination, instead, both governments cooperate and exchange favors. As a result, domestic policy is likely to

be even more distorted towards low consumer or environment protection, because it also internalizes the interests of the foreign lobby.

Examples where foreign or domestic organized interests are opposite are policies that protect the market share of national incumbents, or production subsidies to national producers. These policies hurt foreign competitors, either because they create barriers to entry in the domestic market, or because they create a competitive advantage for domestic producers by reducing their cost. Here, centralization or coordination also exposes the policymaking process to the influence of the organized interests that are hurt by these protectionist policies, and this is likely to lead to better policies.

So far, we have discussed the effect on policymaking incentives of strong forms of coordination (such as delegation of power to a European policymaker, or coordination to a commonly agreed policy). But some policies, in particular in the labor market, are coordinated in a softer way, through the so-called Open Method of Coordination Method (OMC)—see the previous section. Here, national policymakers basically exchange information and set performance standards for policy decisions that remain entirely national. This kind of soft policy coordination generally strengthens the incentives of policymakers to enact good policies, because it increases the transparency of public policy decisions, forces governments and statistical agencies to gather information about policy consequences, and facilitates international comparisons by voters.

The effect on voters' opinions can be particularly important, through two channels. First, if voters are more informed, governments are less likely to be captured by lobbies protecting special interests. Second, seeing that the same kind of reform is implemented by other governments irrespective of their left or right position, ideological opposition to reforms is less likely and reforms tend to be perceived as being in the general interest.

Note, however, that precisely because it entails soft coordination methods, the OMC does not change the incentives of policymakers in any important ways. These coordination methods are more extensively discussed below, and we ask how these positive effects on government incentives can be reinforced.

### 2.3. Summary

There is no general case for supply-side policy coordination, and for the specific contents of attempts to coordinate. With benevolent gov-

ernments, coordination might be needed either to restrain governments or to encourage them to engage in supply-side reforms, depending on whether factors of production are mobile or fixed. Competition via supply-side policies is a priori desirable, since countries can learn from each other's experiments and have stronger incentives to compete and enact efficiency enhancing policies. The main exception concerns policies that guarantee equal access to the Single market for all producers, such as policies that fight state aid or other competitive distortions. Here, there is a clear benefit from centralization, which alone fully exploits the conflict of interest among organized interests located in different countries.

### **3. The economic challenges**

In this section, we review the critical challenges facing European policymakers if they are to meet the Lisbon goal of boosting growth. We organize the discussion around two main headings, employment and productivity. Each section ends with a brief discussion of the main policy implications.

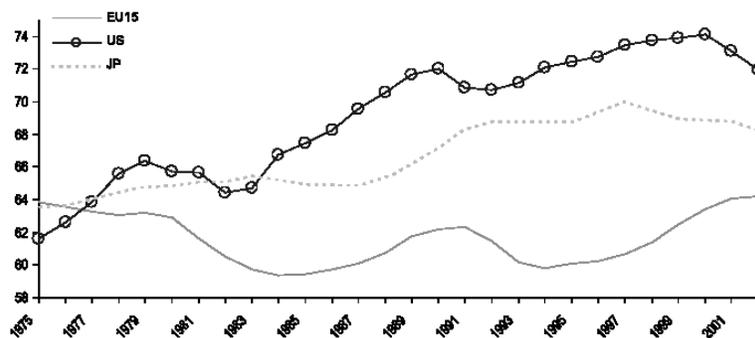
#### **3.1. Employment**

Public opinion polls routinely show that the main challenge for Europe is undoubtedly to increase employment. As shown in Figure 1, European employment has fluctuated between 60 and 64 percent of the working age population since the mid 1970's. In contrast, the US employment rate has always remained well above 70 percent since the late 1980's. The failure to provide able workers with jobs is a massive and costly failure. Not only does it result in the waste of the most precious resource—people's talent, often enhanced by extensive education systems—but it also creates social problems which affect the social cohesion and generates fears of growth-enhancing reforms in a vicious circle that is Europe's landmark.

The Lisbon strategy aims at achieving an overall employment rate of 70 percent in Europe by the year 2010 (65 percent by the year 2005). As shown in Figure 1, European employment improved significantly in the second half of the 1990's. This progress is also evident in Table 1, which compares the EU and the US before and after the onset of the Lisbon Strategy. In Europe, employment growth accelerated from -0.3 percent on average in the first half of the 1990's, to +1.4 percent on average after 1997. In the US, instead, it slowed

down from 1.7 percent before 1997, to 1 percent from 1997 and onwards—the comparison with the US is partly distorted by cyclical factors, however, since the US went through a deeper recession in 2001 as compared to the EU.

**Figure 1. Employment rates in the EU, US and Japan 1975-2000 (percent of working population)**



Source: European Commission (2003).

**Table 1. Economic Performance: EU and US**

	Annual average percentage changes			
	1991-1996		1997-2002	
	EU15	US	EU15	US
<b>GDP</b>	1.5	3.2	2.4	3.0
<b>Employment</b>	-0.3	1.7	1.4	1.0
<b>Hourly productivity</b>	2.2	1.4	1.5	2.2

Source: Kok (2004).

Although progress is evident on this front, the challenge is far from being met. First, the overall employment rate remains low (64.3 percent in 2002). Second, employment is particularly low in a few countries (Italy, Greece, Spain, but also France and Germany). Third, the employment rate is exceptionally low for specific groups in the population (elderly, young, female). Finally, employment growth slowed down in 2002 and 2003; as always, further progress becomes increasingly difficult once the first most glaring distortions have been removed.

There is no mystery about what needs to be done. The recent Kok Report (2004), for instance, restates the list of well-known measures: lengthen the retirement age and reduce the non-wage costs of labor, increase wage flexibility (particularly between different regions in the same country), reduce the employment traps due to generous unemployment subsidies and high marginal income taxes, reduce the firing costs and facilitate labor reallocation. Where these policies have been applied, at least partly, progress has been sizeable, even though slow to come by (Denmark, Ireland, Spain, and the UK, see Figure 2). Why they are not more generally and forcefully implemented is also clear: any reform of the labor markets is bound to upset the existing delicate socio-political equilibrium, often the outcome of decades of conflicts and negotiations. Few governments are ready to face the likely political turmoil head on.

### **3.2. Productivity**

The second main challenge is to increase labor productivity. This means better exploitation of the new technological opportunities that already exist, but also increasing the pace of technological innovation.

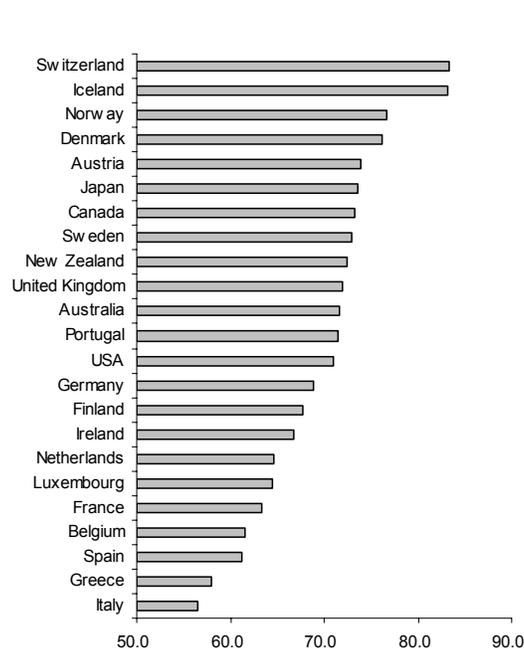
#### **3.2.1. Comparison with the US**

As shown in Table 2, productivity growth has accelerated in the US since the mid 1990's (from 1.1 percent on average before 1995, to 2.2 percent afterwards). In fact, Table 2 under-estimates the underlying acceleration of US productivity growth in recent years, because of the US recession of 2001; in 2003 US productivity accelerated further. This acceleration is entirely due the new information and communication technologies (ICT)—this is firmly established, for instance, by Oliner and Sichel (2000), Jorgenson (2003). These new technological opportunities are equally available in Europe. Hence, it should be expected that European productivity also accelerated in this recent period. But that is not what happened. As shown in Table 2, European productivity growth declined in the second half of the 1990's, from 1.9 percent on average before 1995 to 1.4 percent on average since then.

Figure 3, taken from Blanchard (2004), puts recent events in a longer term perspective. Until the mid 1990's, European productivity was catching up with the US. This was largely because of capital deepening (i.e., rapid growth in capital per worker), probably in turn

induced by high labor costs and substitution of labor with capital. But this convergence stopped in the mid 1990's, precisely when the US was reaping the benefits of ICT. Europe has not been able to fully exploit the benefits of the new ICT for productive purposes, and is now lagging behind the US. Overcoming this deficiency is the second main challenge currently faced by European economies.

**Figure 2. Employment rates in 2003**



*Source:* Economic Outlook 74, December 2003, OECD.

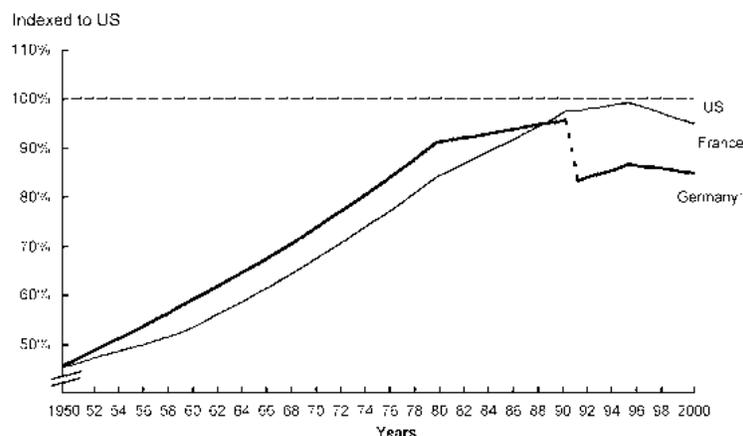
### 3.2.2. Diagnosis

Recent research has identified some of the key European weaknesses. Table 2, taken from van Ark et al. (2003), breaks down productivity growth between ICT producing sectors, ICT using sectors and the rest of the economy, in the EU and the US.

As previously noted by Cohen and Debonneuil (2000), the main difference between Europe and the US is that productivity growth in the ICT using sectors accelerated sharply in the US in the second half of the 1990's (from 1.5 percent to 4.7 percent) but not in Europe

(from 1.7 percent to 1.6 percent). ICT using sectors are mainly services, such as wholesale and retail trade, and financial services. A second, smaller, difference is that ICT producing sectors (where productivity growth is faster) are larger in the US than in Europe, and are more productive in the US.

**Figure 3. Private sector productivity for comparable workforce, 1950-2000**



Note: \* West Germany until 1989 and total Germany thereafter.  
Source: Blanchard (2004).

**Table 2. Sectoral decomposition of productivity growth**

	Productivity growth				GDP shares	
	1990-95		1995-2000		2000	
	EU	US	EU	US	EU	US
<b>Total Economy</b>	1.9	1.1	1.4	2.5	100.0	100.0
<b>ICT Producing</b>	6.7	8.1	8.7	10.1	5.9	7.3
<b>ICT Using*</b>	1.7	1.5	1.6	4.7	27.0	30.6
<b>Non-ICT</b>	1.6	0.2	0.7	0.5	67.1	62.1

Notes: EU is defined as Austria, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Spain, and Sweden. No adjustment for hours worked. \* Excluding ICT Producing  
Source: van Ark et al. (2003).

This interpretation of the difference between Europe and the US is confirmed by recent research by Jorgenson (2003) and Daveri (2003),

which sheds further light on why ITC using sectors in Europe performed worse than those in the US. Table 3 decomposes aggregate productivity growth in the US and the main European countries into its determinants: improvements in labor quality, accumulation of physical and ICT capital (capital deepening), and a residual component (total factor productivity, TFP) in ICT producing sectors and the rest of the economy. The data are those of Jorgenson (2003). ICT capital deepening refers to the accumulation of ICT capital in all sectors, and likewise for Non-ICT capital deepening. TFP of ICT producers refers to TFP in the ICT producing sectors, and likewise for TFP of Non-ICT producers.<sup>5</sup>

**Table 3. Sources of labor productivity growth**

	1989-95		1995-2000	
	EU	US	EU	US
<b>Hourly labor productivity</b>	2.30	1.34	1.44	2.11
<b>Labor quality</b>	0.45	0.36	0.34	0.21
<b>Non-ICT capital deepening</b>	1.34	0.32	0.48	0.39
<b>ICT capital deepening</b>	0.23	0.43	0.43	0.87
<b>TFP of ICT producers</b>	0.26	0.25	0.56	0.44
<b>TFP of Non-ICT producers</b>	0.01	-0.02	-0.37	0.20

*Note:* EU is defined as the simple average of France, Germany, Italy, and the UK.  
*Source:* Jorgenson (2003).

Table 3 makes clear that the deterioration of European productivity growth in the second half of the 1990's relative to that of the US is explained by three facts. First, Europe has reduced its accumulation of Non-ICT capital (row 3). This is not a bad thing in itself: it is the other side of the coin of the improvements in European labor markets described above. In previous years, capital accumulation entailed a large component of substitution of labor for capital; as labor costs recede, we should expect capital deepening to slow down. Second, Europe still lags behind the US in its accumulation of ICT capital. ICT capital deepening has doubled in the second half of the 1990's, both in Europe and the US, but the US still invests twice as much in ICT capital as the large EU countries. This is likely to be part of the reason why productivity in ICT using sectors has not improved in

<sup>5</sup> The sector definition is different from that of van Ark et al. (2003), and here (but not in Table 2) an adjustment is made for variation in labor hours.

Europe as much as in the US. Third, TFP in the Non-ICT producing sectors has declined in Europe, while it has improved in the US. This says that Non-ICT producing sectors have become more efficient in the US, but not in Europe.

### **3.2.3. Appraisal and policy implications**

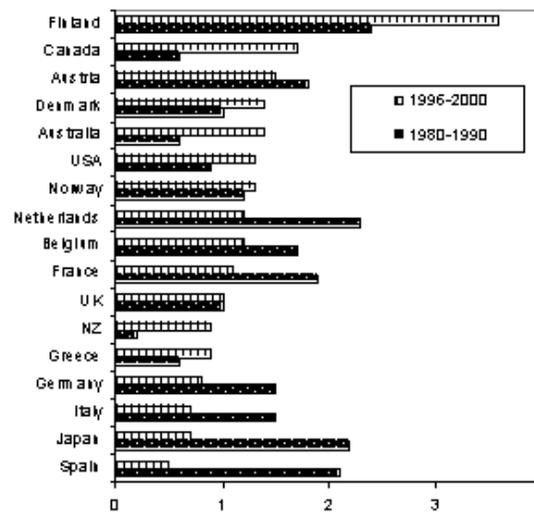
Europe lags behind the US in terms of both ICT production and ICT use. Fewer workers are employed in ICT production in Europe than in the US; this matters because these are the sectors that grow more rapidly (productivity in ICT producing manufacturing grew on average almost 24 percent each year between 1995 and 2000 in the US). Overall spending in ICT is also lower in the EU than in the US. These differences between the US and the EU have not increased significantly over time, they already existed in the mid 1990's. But the EU was certainly not able to catch up and, if anything, the distance between the US and the EU in ICT production and employment has increased.

In addition, even though ICT spending in Europe has accelerated since the mid 1990's, Europe has not been able to benefit from this investment: labor productivity in ICT using sectors stagnated despite the additional ICT spending (Table 2), and this is confirmed by the decline in TFP outside ICT production (Table 3).

So far, we have looked at the situation in the whole of Europe, but the continent is far from homogeneous. As shown by Figure 4 (countries are ranked according to their performance over 1996-2000), productivity is currently growing faster in the Northern European countries than in the Southern countries, often even faster than in the US, in many cases a reversal from the 1980's. The mediocre performance of the UK is also noticeable.

The policy implications of this analysis are more complex than in the case of employment policies, as they involve several largely unrelated aspects: distortions in the labor market, distortions in the product and financial markets, and the acquisition and production of knowledge. As a result, the productivity challenge can only be met through a combination of reforms and supply-side policies.

**Figure 4. Average annual growth in total factor productivity**



Source: Nicoletti and Scarpetta (2003).

#### *Labor market*

New productive technologies have an important labor savings component. To enhance overall productivity, labor must move within the firm, across firms and across sectors. The rigid European labor markets—in particular firing protections—hamper the reallocation of labor needed to take advantage of new technologies. Removing these rigidities is thus an important priority.

#### *Product and financial markets*

Lack of competition in product and financial markets, and segmented markets, also contribute to explain why the large European countries did not benefit much from the availability of the new ICT. Suppose for a moment that the pace of innovation potentially usable in production is exogenously given. Then, the rate of economic growth only depends on how fast new technologies are adopted and disseminate throughout the economy as they become available. A large and well functioning market for goods and services increases the rate of adoption and dissemination of new productive technologies. This happens

through two channels: stronger competition and a larger scope for market exchange.

Stronger competition in the product market forces incumbent firms to speed up the adoption of innovations to avoid succumbing to their competitors. The adoption of productive innovations often entails an intertemporal tradeoff, just like an investment in R&D. In the short run, it is costly (the corporation has to overcome internal oppositions of stakeholders, or acquaint employees with the new technology or with new work practices). In the long run, it increases efficiency and reduces costs. The threat of competition from other producers can force incumbent firms to change sooner rather than later, as the option of postponing adjustment becomes too risky. Moreover, a well-functioning market for goods and services speeds up the dissemination of innovation through the entry and exit of firms. Inefficient firms which are unable to survive the foreign competition have to close down, freeing up resources for new and more productive initiatives. Empirical evidence by Nicoletti and Scarpetta (2003) supports this conclusion: OECD countries with more competitive and de-regulated product markets have a faster productivity growth.<sup>6</sup>

A well-functioning financial market is crucial in this respect. Financial development determines the extent of competition in the rest of the economy. Limited financial resources act as a barrier to the entry of new firms; thus, imperfect financial markets end up protecting inefficient incumbent firms in all sectors of the economy. Rajan and Zingales (2003) discuss several examples. They point out that the de-regulation of US banking in the 1970's and 1980's led to a significant increase in the degree of financial development and, as a result, in the rate of creation of new enterprises in the US states that deregulated. Similarly, there is direct evidence that differences in financial development among Italian regions affect competition at the local level: the profit margin of small-medium size Italian firms is much higher in less financially developed regions (Guiso, Sapienza and Zingales, 2002).

But stronger competition is not the only beneficial effect of a well functioning market for goods and services. The scope of the market is also relevant. A large market expands the assortment of intermediate

<sup>6</sup> The idea that competition is beneficial to growth because it forces incumbent firms to adopt more efficient productive technologies has been particularly stressed by Parente and Prescott (2002).

inputs available for production which in turn raises total factor productivity. International trade is the channel for expanding the size and scope of the market. Through international trade, innovations introduced in one country raise the productivity in its trading partners as well. Moreover, international trade expands the scope of the so-called “knowledge spillovers”. Trading partners can learn from each other, simply because trade exposes domestic firms to a variety of business practices and organizations. Under autarchy, learning-by-doing in France is limited by the cumulative experience of the French industry. Trade enables French producers to benefit from the experience accumulated by other countries as well.<sup>7</sup>

In many European countries, and particularly in the large countries of continental Europe, product market competition and trade in services are hampered by regulatory barriers and other government induced distortions. Removing these product market distortions and achieving a well functioning and integrated European market for goods and services is another important priority to meet the goal of faster productivity growth.

#### *Knowledge*

As discussed above, the sectors at the forefront of technological innovation are smaller in Europe (and in particular in the large countries of continental Europe), compared to the US. This reflects a more general trend: Europe seems to be falling behind the US in terms of its ability to shift the technological frontier.

A first symptom is that, according to a variety of indicators, basic and applied scientific research appears to be much less successful and productive in Europe as compared to the US. This is true for research with immediate or prospective economic value, as measured by the number of patents, but also of base research as measured by publication records, scientific impact, and the like—see, for example, data and references in Aghion and Cohen (2003). In addition, Europe on average devotes fewer resources to R&D investment and tertiary education. The US spends about one third more than Europe on R&D, and more than twice on university education. In both cases, the deficiency concerns private spending: government spending is about the

<sup>7</sup> The analysis of how international trade impacts on growth through the dissemination of productive innovations is mainly due to the work of Grossman and Helpman (1995)—see also Helpman (2004).

same in Europe and the US (this also applies to university education). There is also a large variation within Europe, with the countries in Northern Europe faring much better on both indicators.

The two symptoms are related: Europe is less productive scientifically also because it spends less. But lack of financial resources is not the whole story, as suggested by the fact that government spending does not differ to any considerable extent between the US and Europe. The organization of research inside European universities and research labs is also responsible for the European failures. Although the specific details differ between European countries, the heart of the problem is the same throughout Europe: lack of competition. The budget of European research institutions mainly relies on government grants and subsidies at the national level. These financial resources are given on the basis of need and equality, with little regard for scientific merit. Hence, resources are often wasted or misallocated. The lack of appropriate institutional incentives trickles down to the level of the individual researcher, who also lacks adequate career or pecuniary incentives. The best and more mobile researchers leave for the US, and those who stay often lack motivation and are underpaid. In many European countries, the problems are then aggravated by conservative bureaucracies inside ministries and government agencies and inadequate corporate governance rules for universities.

A third important priority for many European countries, and in particular for the large countries of continental Europe, is to remedy these deficiencies. This means increasing the resources devoted to research, improving the allocation of these resources, and improving the rules for the governance of European research institutions.

#### **4. The role of the European Union**

The list of challenges faced by Europe is daunting, and many governments have found it difficult to make important strides in the necessary direction. This does not mean that centralization is a solution, however. Centralization must be justified on its merits, the EU should not become a scapegoat for the failures of member governments. In addition, the subsidiarity principle, which holds that decentralization should be retained in the absence of a clear case for centralization, lays the burden of the proof on the advocates of centralization. This section reviews the case for an increased EU role in five areas: the single market, the financial markets, the labor markets, taxation and

research. With the main exception of the single market, it concludes that centralization is more likely to harm Europe's growth potential than to boost it.

#### **4.1. The Single Market**

Barriers to trade in goods and services within Europe have now been almost completely removed. In this sense, the single market has been a reality for several years, achieving most of its aims. What remains to be done is to eliminate the distortions left in specific sectors and, of course, make sure that new barriers or new distortions are not introduced. Each area poses specific problems, and we will not attempt to provide a detailed analysis. Instead, we briefly discuss three policy areas, state aid, regulation of public utilities, and financial markets.

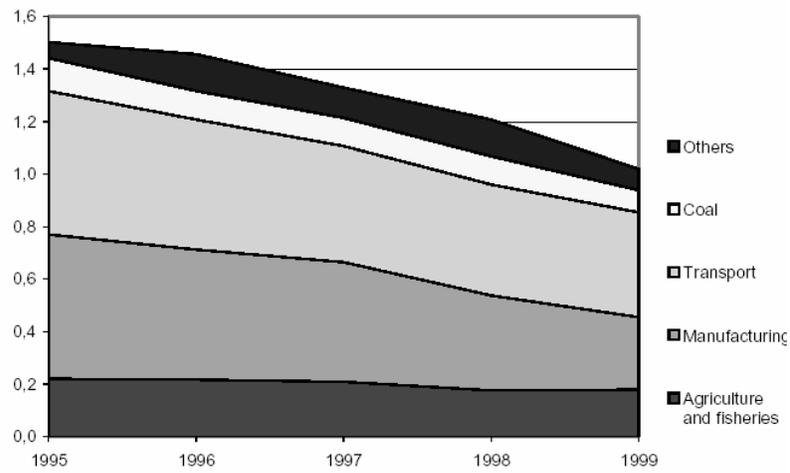
##### **4.1.1. State aids and industrial policy**

State aid as defined by the Commission is now a relatively small and declining portion of EU GDP (over half of which goes to agriculture, fisheries and transport)—see Figure 5. Article 87(1) of the Treaty provides that State aid is, in principle, incompatible with the common market. Under Article 88, the Commission is given the task to control State aid and each member state has to notify the Commission in advance of any plan to grant new aid.

The Treaty allows a number of exemptions, to be approved by the Commission.<sup>8</sup> In practice, the Commission very seldom blocks State aid. Over the period 2000-2002, only 7 percent of the cases resulted in a negative Commission decision for the EU as a whole—Figure 6. A benign interpretation of the Commission's record is that it is credible; the threat of a veto is sufficient to discourage member states from putting forward proposals that are likely to be turned down. But it could also be that the Commission lacks enforcement power, and if it tried to be stricter, it would be over-ruled by the Council. This second, less favorable interpretation is particularly plausible in the politically more difficult cases of restructuring of firms in difficulty.

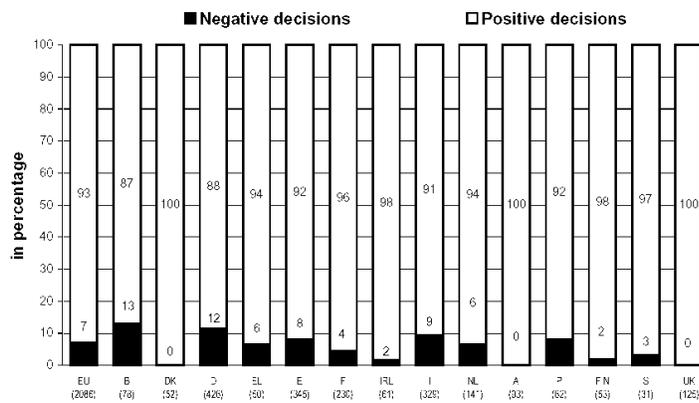
<sup>8</sup> Examples of these exemptions are: aid given to specific regions in need of assistance, aid to small and medium-sized enterprises, aid to research and development, aid to specific sectors such as agriculture and fisheries, and several other cases.

**Figure 5. State aid in percent of overall EU GDP 1995-1999**



Source: Ninth Survey on State Aid in the EU, European Commission, 2001.

**Figure 6. Share of negative decisions by the Commission, 2000-2002**



Figures in brackets show total number of decisions 2000 - 2002

Source: European Commission, State Aid Scoreboard, spring 2003.

#### 4.1.2. Is industrial policy needed?

The central argument in favor of state aids is the presence of market failures. Indeed, advocates of an active industrial policy often argue that specific productive activities induce positive local externalities, for instance because of technological spillovers to downstream or upstream producers in the same geographical area.<sup>9</sup> Such activities should be subsidized, the argument goes, because the free market does not internalize these positive external effects. Alternatively, even if there is no economic externality, the firm that is being subsidized might perform a socially valuable public service, or have an obligation to do so (as in the case of postal services or transportation). All this assumes that industrial policies are carried out by benevolent governments.

A different picture emerges if governments are politically captured by organized interests. By and large, it is not at all clear that externalities and market failures are the main motives for disbursing public funds to support ongoing economic activities. Redistribution to private interests also weighs heavily. In this case, the subsidy is likely to be inefficient even from the point of view of national welfare.

#### **Box 1. Innovations and state support: The US case**

It is sometimes said that the US productivity booms and technological improvements have been facilitated by federal spending in transportation or defense (for instance, railway construction in the 19<sup>th</sup> century, military support for chemical research during World War II, or more recently for the development of the ARPANET, the predecessor of the Internet). But, as argued by Ferguson (2004), in the US most technological breakthroughs had their genesis in the private sector, and led to aggregate productivity improvements as firms sought to exploit new opportunities for cost reduction or for selling new products at a profit. Even for investments in railroads, government funding played a small role (less than 10 percent of the nominal investment after the Civil War—Ferguson, 2004; Fishlow, 2000). And careful empirical studies on the effects of US federal spending on infrastructure generally conclude that their growth effects are nil—see, for instance, CBO (1998).

<sup>9</sup> See Krugman (1991), or Baldwin and Wyplosz (2003).

Irrespective of the true motivations for disbursing state aid, identifying sectors and firms that induce valuable externalities in the rest of the economy is not an easy task. The empirical evidence supports this skepticism—see Box 1. Overall, therefore, the case for industrial policy calls for a careful case by case examination, with the awareness that good economic arguments may conceal damaging private interests.

#### **4.1.3. Should industrial policy be centralized?**

The question of whether or not to centralize industrial policies, where they are justified, is controversial. National production subsidies may distort the allocation of resources within the EU and entail costs for competitors located in other member states. Moreover, a national policymaker would only consider local externalities that benefit his country, neglecting the question of whether similar positive externalities might be stronger in other member states. Each government has an incentive to defend his “national champions”, forgetting that the “champions” might be even stronger and generate stronger positive externalities in other member states. These are the arguments in favor of centralization.

The opposite argument, in favor of national control, rests on the comparative disadvantage for the European policymaker in assessing the benefits of externalities accruing to each member state. This disadvantage is most evident in the case of the provision of essential public services, such as the provision of mail or other facilities to a secluded location, while it seems negligible for externalities that are purely economic (for instance, assessing the knowledge spillovers induced by a large firm operating in a high-tech sector).

While, all in all, there is no general presumption that favors either centralization or decentralization, and the subsidiarity principle then argues for decentralization, the suspicion of political capture by private interests provides a clear argument in favor of centralizing policy decisions at the EU level. Redistribution is a zero sum game, and the gains for one member state are the losses of another. A European policymaker would internalize both gains and losses, and would not engage in this kind of redistribution. The argument in favor of centralization applies even if both national and European policymakers are captured by political lobbies, as long as the interests of producers in different countries are opposite (since they tend to offset each other). Judged from this perspective, the procedure for controlling

State aid envisaged by the Treaty is appropriate. If anything, the powers of the Commission ought to be reinforced and the exemptions reduced.

Currently, the Commission essentially has veto powers but it cannot formulate or implement an industrial policy. No European policymaker has the responsibility of identifying European priorities, assessing economic externalities with a European perspective, and taking initiatives. The result, it is sometimes alleged, is that important externalities remain unexploited and neglected. The development of transportation infrastructure provides a case in point. Transportation systems have largely developed on a national basis, with little concern for creating major transportation routes across member states. Recent efforts to coordinate public investments in transportation networks in Europe seek to remedy this problem.

#### **4.1.4. Conclusion**

The existence of market failures is a necessary condition for industrial policies, but it is not a sufficient one. Two additional conditions are required. First, the authorities in charge of carrying out such policies must not be captured by private interests. Even if they are not, they must have the ability to identify market failures and the appropriate remedies. It is unlikely that all three conditions are generally met, but that case should not be ruled out. Industrial policies may have a role to play, but the exception is likely to be the rule.

National industrial policies, carried out in the form of state aids, are quite likely to be triggered by private interests. In addition, they are bound to create distortions elsewhere in the single market or undermine better policy opportunities in other member countries. This provides a strong case for fully centralizing industrial policies. In that event, the Commission should be given positive powers of initiating policies, beyond its current negative powers of blocking state aids.

## **4.2. Financial markets and corporate governance**

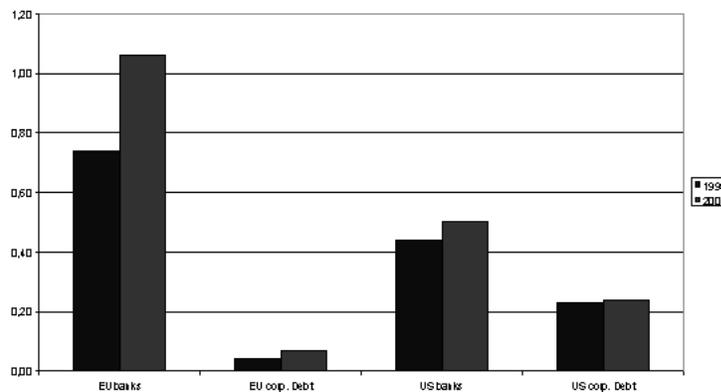
### **4.2.1. Bank loans vs. arm's length financing**

Despite the changes over the last two decades, the financing of European firms remains dominated by banks, as opposed to "arm's length" investors (creditors or shareholders). This is an important difference to the US, where the market for corporate debt has tradition-

ally played a larger role (see Figure 7), and where stock market capitalization (the value of the stock market over GDP) is much higher than in Europe (about 1.5 in the US vs. 1.0 in continental Europe in 2000).

The predominance of banks in Europe is important, because banking remains much segmented. This segmentation will probably not be overcome in the medium-short run, since it is due to a variety of deep-seated reasons and not just to remaining differences in national regulations: the local nature of retail banking, differences in taxation, high set up costs in entering a new market (see the discussion in Dermine, 2003; Cabral et al., 2002; Angeloni et al., 2003).

**Figure 7. Banks and markets: EU vs. US**



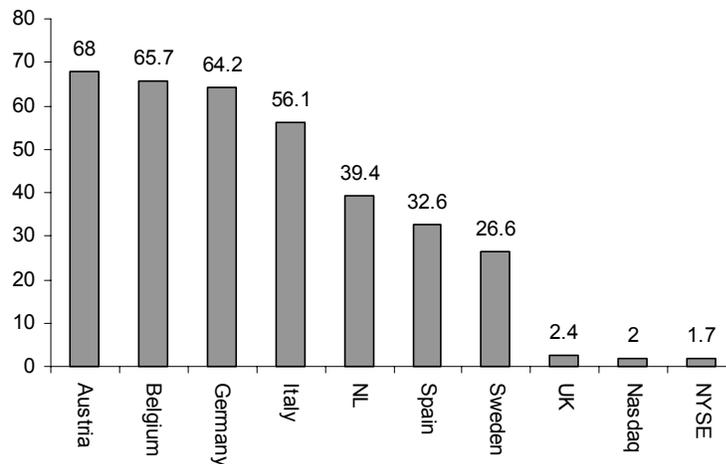
*Notes:* Banks: claims of deposit money banks on the private sector as a ratio of GDP. Corp. debt: domestic corporate bank outstanding as a ratio of GDP  
*Source:* Rajan and Zingales 2003.

This is why “arm’s length” financing by anonymous markets better stands to exploit the full benefits of European integration and the economies of scale associated with the birth of the Euro. In addition, as argued by Rajan and Zingales (2003), in periods of rapid change and revolutionary innovations, banks’ information more quickly becomes obsolete. Banks are less likely to risk their money to finance new products or new entrepreneurs, and tend to discriminate against outsiders in favor of mature incumbents. This bias towards stability is not always undesirable, but may delay the exploitation of new opportunities in times of exceptional innovation and structural change.

#### 4.2.2. Corporate control

The segmentation of European financial markets is worsened by a second feature common to all countries in continental Europe: the dominance of strong controlling national shareholders who, typically, only own a fraction of the firm. The separation of ownership and control is achieved through a variety of devices that vary across European member states, such as shares with special voting rights, Chinese boxes or other arrangements of share pyramids. As shown in Figure 8, instead, the Anglo-Saxon model is one of diffuse ownership, with control and ownership being jointly traded in the equity market.

**Figure 8. Percentage of listed companies under majority control**



*Source:* Barca and Becht (2001).

A priori, both systems of corporate governance have pros and cons—see Box 2. But an important byproduct of the European system of corporate governance is that it makes the transfer of control across national borders much more difficult. Well protected European block shareholders cannot easily be challenged by new prospective owners, particularly if they come from a different member state. This lack of contestability reduces the pressure to efficiently manage European corporations and adopt new business practices when new opportunities arise. The problem is particularly evident where the

controlling shareholder is a non-profit organization or an entity in the public sector, as in the banking sectors of some European member states.

**Box 2. Pros and cons of strong controlling shareholders (the European model) vs. diffused ownership (the Anglo-Saxon model)**

The European model overcomes the free rider problem of diffuse ownership: the controlling shareholder has a strong incentive to monitor the management and impose his long-run vision on the firm's strategic decisions. On the other hand, the European model gives rise to a serious conflict of interest between minority and controlling shareholders, with minority shareholders being under-represented. In the Anglo-Saxon model, minority shareholders are less exposed to the risk of expropriation, both because their interests are better protected by legislation and because there is no dominant shareholder who can abuse his control to divert corporate funds.

Which point is preferable depends on the external environment and the nature of the corporation. The European model of corporate finance fits well with the dominance of banks in providing external finance to firms—the personal relationships between bankers and corporate owners guarantee a stable environment and a steady flow of credit. Conversely, the Anglo-Saxon model of diffused ownership is well suited to an environment of well functioning financial markets, where effective regulations guarantee transparency and adequate information, and where risks can easily be diversified away by holding a portfolio of claims on a variety of corporations. The Anglo-Saxon model tends to be better in times of rapid technological innovation, when diversifying risk, identifying corporate winners and losers and financing innovation gain relevance.

**4.2.3. Policy responses**

All this argues for facilitating the integration of European financial markets and encouraging the evolution of corporate governance towards arm's length investing, diffused ownership and greater contestability. As argued by Rajan and Zingales (2003), the first major challenge is to improve the legal, supervisory and regulatory infrastructures inside each member state. Financial markets thrive when

the rights of “arm’s length” investors are effectively protected, information is properly disclosed, and fraud and abuse are extremely rare. Much remains to be done to achieve these goals, particularly in Southern European countries. Regulation does not adequately protect the rights of minority shareholders. Law enforcement to protect creditors’ rights is often inefficient. In several countries, widespread tax evasion, corruption and lax accounting standards undermine the quality of information that is disclosed.

#### **4.2.4. What role for centralization?**

These challenges are mainly up to the member states. In countries that fail to develop adequate institutions, borrowers will not have access to the European financial market, so that the penalty for failure is largely confined within the national borders. Decentralization enhances the incentives to reform. Moreover, the specific reforms that need to be enacted vary across countries, since each member state has its own peculiarities and its own system of corporate governance—another argument in favor of decentralization.

Still, there is an important role for centralized European intervention: that of establishing a truly level playing field in order to increase the contestability of corporations across national borders. Without an active role by the EU, there is a risk that each member state will try to retain control over its “national champions”. This form of protectionism would induce a misallocation of capital inside the EU. More importantly, it would reduce the contestability of the large corporations, making it more likely that “national champions” become the vehicle of opportunistic political agendas and create little economic value added. Examples of where the EU could play an important role are:

- Establishing common and demanding principles for disclosure (to avoid a harmful race to the bottom and achieve some simplifications).
- Establishing common ground rules for takeovers, to insure that the ultimate decisions of whether or not to transfer control rests with shareholders and not managers.
- Improving the ability of shareholders to vote, particularly across borders.
- Discouraging excessively complex pyramids of control. This seems to be the approach currently taken by the Commission and the European Court of Justice.

### 4.3. Labor markets

That the labor markets lie at the heart of Europe's major economic failures is the main conclusion from Section 3. That conclusion is backed by a considerable amount of research. The remedies are well known, and have been applied with success in a number of countries. But labor market reforms remain highly controversial because of the powerful and politically-sensitive interests involved. This sensitivity is testimony to the fact that governments are under substantial pressure to serve the public interest, even assuming that they are not captured by the organized pressure groups that shape labor markets.

The political sensitivity also suggests that any solution has to be national, based on an understanding of the collective interest and an arrangement with the private interests that are bound to suffer from reforms. The European level of government does simply not have the political legitimacy that would be needed to act in these areas. This does not rule out policy coordination, but it suggests that any European coordination ought to be "soft" and motivated by the goal of bringing foreign examples to weigh onto national public debates, rather than imposing a common and pre-packaged solution.

This section examines some generic aspects of labor markets to illustrate the differences characterizing existing national institutions.

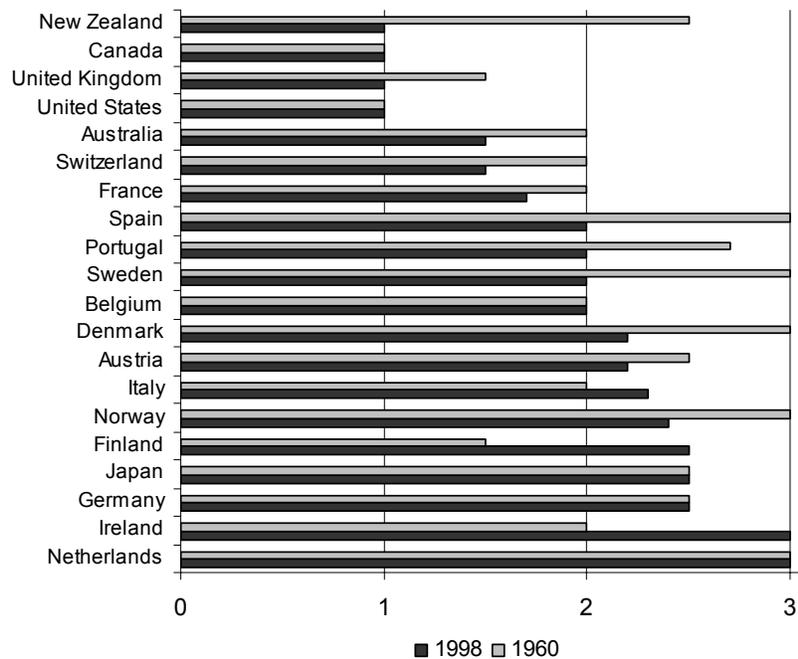
#### 4.3.1. Labor market institutions: Considerable diversity

Labor market negotiations typically bring together large players, employers and trade unions. These players seek to apply pressure to tilt the sharing of profits in their direction. While profits are determined in markets, labor negotiations rely more on power than on market logic. Even the goods markets are not entirely driven by adequate market rules, since many of them are of a monopolistic nature. As noted by Blanchard and Giavazzi (2003), monopolistic competition generates rents that employers and employees struggle to capture. National legislations frame the allocation of power and influence the outcome, which is typically less efficient wherever power relations dominate more. Should this legislation be coordinated throughout Europe?

Labor market negotiations vary considerably from one country to another. One aspect is the way they are conducted, another is what they deal with, and yet another consideration is the degree of state involvement. For example, negotiations can be conducted at the na-

tional level, or at the industry level, or at the establishment or plant level. Figure 9 illustrates the diversity of existing situations. It shows an index that captures the degree to which labor market negotiations are coordinated, taking a value that ranges from 1 (no coordination) to 3 (full coordination). Much the same can be said about the objects of negotiations: wage agreements are always negotiated but the duration and applicability of the agreements vary, minimum wages are sometimes set through legislation and sometimes bargained over, as is the case for safety, working time, overtime salaries, etc. Obviously, reforms cannot be conducted in the same way across countries with sharply different institutions.

**Figure 9. Index of coordination of labor market negotiations (1960 and 1998)**



Source: Nickell (2003).

The power of trade unions also varies considerably from one country to another. This may be superficially associated with membership but membership rules themselves differ. For example, nearly

all employees in Sweden are union members because unemployment benefits are paid by the government but through the unions. At the opposite end, union membership is lowest in France because officially recognized unions are deemed to represent all workers, which means that the benefits from trade union memberships can be had without paying the fees. Yet, overall, union membership and its influence has declined throughout Europe over the last two decades.

Finally, the unions' own views of their role are at sharp variance. To simplify, Nordic unions see themselves as partners of both employers and governments, while Latin unions have a more militant slant and harbor an adversarial view of employee-employer relationships. German unions are deeply involved in co-determination with wide powers, but their use of that power varies across industries. This is sometimes reflected in formal or informal links with political parties, although these links have now disappeared almost everywhere.

#### **4.3.2. Policy responses**

The need to improve labor market performances has led to numerous attempts at reform. A common challenge is that any reform has to redistribute power among players and hurt the interests of one group or another. Resistance to change is everywhere strong and calls for a specific treatment. Given the wide diversity of labor market institutions, it is no surprise that policy responses have differed greatly, both in substance and in process.

Regarding substance, the aim is to make labor markets more responsive to changes. This means that employment protection must be adjusted to encourage both firms and employees to shift to higher value added activities instead of attempting, in vain as it usually turns out, to maintain obsolete production. It also means that room must be made to bring low-qualified workers into employment, through a combination of retraining schemes—active labor market policies—and a better matching of wages to productivity. Finally, employability must be enhanced, which requires “making work pay”, i.e. eliminating the unemployment subsidies that deter accepting jobs. The diversity of starting positions means that each country needs to focus on a particular mix of measures.

These are wide-ranging requirements, which entail substantial concessions by all parties involved. Protected employees must give up some protection, firms need to take more risks and be more transparent about the implications, and governments have to shake up their

practices (e.g. their employment agencies), streamline their own ranks and offer transitory financial compensations to affected individuals. There are three main ways of proceeding. The “Thatcher way” consists of offering no compensation, instead focusing on a consistent set of reforms and using raw political power to impose them.<sup>10</sup> The “package way” implies forging wide-ranging deals that combine comprehensive reforms with compensations that can be financial or political. Examples of such deals include the Wasenaar agreements in the Netherlands and the Moncloa agreements in Spain. The “piecemeal way” resorts to gradual changes, each of which is the object of detailed negotiations, which must each include some compensation to be politically viable. The main difference between the package and piecemeal ways is that the former seeks to partially provide compensations by balancing some reforms against others while, in the latter, each reform must politically stand on its own. Put differently, the package way seeks to build up a broad consensus, while the piecemeal way works through “divide and conquer”. In general, smaller countries are better able to operate on a consensus and implement package deals than large countries, although exceptional circumstances may offer opportunities as was the case in Spain. Quite clearly, the choice among these three processes is deeply related to each country’s social and political situation.

#### **4.3.3. What role for centralization?**

Given the importance of heterogeneities and information asymmetries, the case of decentralization is overwhelming. Yet, faced with intense pressure from all interest groups involved in labor markets, most governments find it difficult—and some find it close to impossible—to implement the necessary reforms. The question is whether involving the European level of government can help meet this challenge by overcoming political resistance to labor market reforms. There are three ways in which this could be done.

First, stronger product market competition reduces the rents over which firms and workers bargain. Smaller rents, in turn, reduce the incentives to retain distorting labor market practices that increase the bargaining power of unions. Through this channel, European integra-

<sup>10</sup> Mrs. Thatcher described her own approach as TINA (There Is No Alternative), having framed her election as a mandate to carry out historical changes.

tion can be seen as an agent of change, as noted by Blanchard and Giavazzi (2003). This calls for a strengthening of the single market.

Second, identifying employment as a common goal, the EU may exert a counter-pressure on governments that face intimidating resistance. This calls for a soft method of coordination—pressure but no obligation. Governments face internal costs when adopting reforms opposed by powerful pressure groups, they could also face external costs for not reforming their labor markets.

Third, in labor markets as in many other areas, one reason for resistance to reforms is uncertainty about their effects. The combination of a clear understanding of their shorter run costs and doubts about the longer-run benefits can be lethal to reforms, a point made by Fernandez and Rodrik (1991). Given that a number of European countries have successfully reformed their labor markets, and that the results are becoming increasingly obvious, disseminating this information throughout the union may be very helpful.

All this assumes that the EU level of government is more likely to be benevolent than the national levels, at least in countries that make little headway. This is generally plausible, as argued above, but there is no guarantee. In the area of labor markets, many discussions currently conducted under the heading of “Social Europe” seem to suggest that the EU level of government could well be captured by the private interests that block reforms at the national level. Calls for harmonizing social minimum protection and avoiding “social dumping” within the EU amount to a collusion of already captured national governments that seek to extend the inefficiencies of their labor markets to the other countries.

It is by no means certain that this process of creeping capture will succeed, but the current state of affairs suggests that any move toward centralization has to be conducted with great care. Of the three potential directions described above, the first calls for centralization of enforcement of the single market, the two others envision the soft version of coordination. This latter idea is now incorporated in the Open Method of Coordination (OMC) that lies at the heart of the Lisbon Strategy. The strategy is examined in Section 5, which observes that, so far at least, it has not been successful. Should we then go further and harden the OMC? This would be dangerous. The OMC can very well fail in the end, leaving the responsibility for labor market policies in national hands. Given that at the national level, the incentives are well oriented toward reforms, this would be a better

outcome than one which would transfer distorted incentives to the EU level.

#### 4.4. Capital taxation

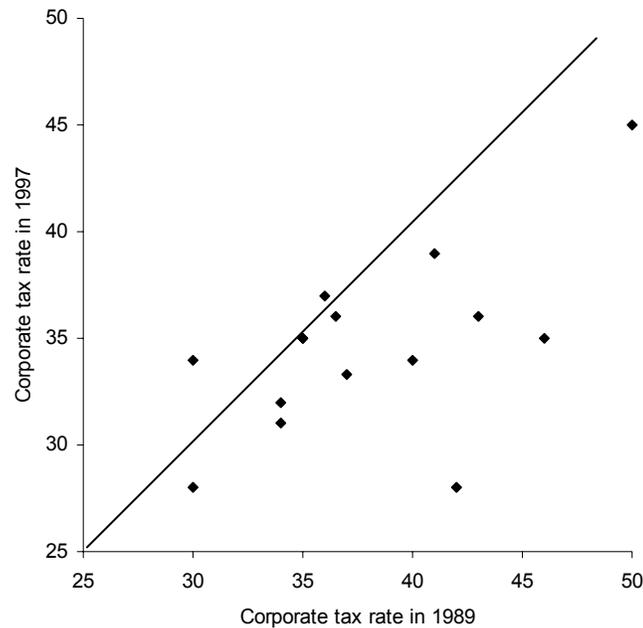
With the exception of the VAT tax, the power to tax resides almost entirely with Europe's national (and local) authorities. Is this decentralization excessive and if so, how can Europe play a larger role?

The argument in favor of tax policy coordination is well known. Since mobile factors of production will move to where tax rates are lowest, national governments have an incentive to engage in tax competition, producing a race to the bottom. Tax competition puts excessive downward pressure on the funding of government programs, while shifting the tax burden onto the more immobile factors of production (labor) and away from the more mobile factors (capital).

This argument is mostly relevant for financial and physical capital. Since financial capital is very mobile and responsive to tax incentives, tax competition in this area has the potential of being very disruptive. The current approach is to force all Member States to exchange information on assets held by individual residents of other Member States, in order to enforce the "residence principle" of taxation (individual financial income is taxed by the country of residence, irrespective of where the financial assets are held). But non-EU countries such as Switzerland have so far refused to comply, and this has blocked progress inside the EU as well.

Physical capital—means of production—is less mobile. Tax rates are only one of several factors that companies consider when deciding where to locate manufacturing plants and undertake other activities. The desire to attract such activities may encourage some tax competition among jurisdictions (some tendency to race to the bottom), but it is unlikely to be intense. This is evident in the US, where states compete for factories by offering tax breaks and holidays, but destructive competition has not led to the centralization of all fiscal decision making at the federal level. Nevertheless, capital mobility has created pressure for at least some convergence of corporate tax rates, and therefore at least some rationale for coordination. As shown in Figure 10, there is a tendency for rates of corporate taxation in Europe to fall and converge during the 1990's, the period following the creation of the Single Market and a decade of rising capital mobility. Enlargement is bound to strengthen this tendency, since the countries of Central and Eastern Europe tend to have much lower corporate tax rates.

**Figure 10. Corporate tax rates in the European Union  
(1989 and 1997)**



*Source:* OECD.

All this assumes that tax competition is undesirable. But is it? Not always and everywhere. If tax competition limits the tendency for governments to become over-large, this may be welcome. International comparisons hardly suggest that the growth of the public sector in Europe is stunted by obstacles to revenue. Moreover, heterogeneity of preferences remains an important reason to oppose centralization in tax matters, since different Member States are likely to have significant differences of opinion concerning the role and the appropriate size of government or the structure of taxation.

The main cost of tax competition is that it shifts the allocation of the tax burden against the immobile factor (labor). Concentrating taxation to a subset of the tax base increases deadweight loss and reduces economic effectiveness. Since labor markets are far from competitive in Europe, high labor-income taxes reinforce other distortions that produce inefficiently high labor costs and high unemploy-

ment. Also in this case are there counter-arguments, however. Governments lacking credibility may have an incentive to over-tax capital and under-tax labor (the so-called capital-levy problem). In this case, tax competition and the discipline offered by the threat of capital flight can actually help governments solve difficult commitment problems.

The previous discussion suggests that some form of European policy coordination might be needed for the taxation of income from financial assets. In matters of corporate taxation, a standardized definition of the tax base could also be desirable. But the arguments for extending policy coordination also to corporate tax rates are weaker: heterogeneity in preferences is bound to be high, and governments may have distorted incentives to over-tax corporate income. The burden of proof here lies with the advocates of more coordination.

#### **4.5. Research and human capital**

As argued in Section 3.2, research and innovation in Europe lags behind the US. Europe achieves less in terms of patents and scientific discoveries, spends less on research, and loses some of its best researchers to the US.

The cost of these common European failures largely falls on the individual Member States, which are less competitive and less productive as a result. There are nevertheless some important externalities. The knowledge frontier has no national borders, and everyone benefits from scientific progress. Moreover, mobility and communication within the research community implies that a more productive scientific environment in the universities or firms of a specific region is likely to benefit neighbors. Finally, even abstracting from these externalities, the political distortions responsible for the national policy failures may be less prominent at the European than at the national level. For all these reasons, the EU has a role to play. In the next subsection, we briefly review the European approach so far and then we evaluate it.

##### **4.5.1. Current policies**

So far, the EU action has concentrated on three main fronts. First, steps have been taken to reduce the compartmentalization of public research and university systems throughout Europe. This means agreeing to common educational standards, increasing the mobility of

students and researchers, coordinating the implementation of national research policies, and moving towards a European patent system.

Second, a small fraction of the EU budget is spent on direct support for research.<sup>11</sup> Two criteria guide the allocation of these scarce resources. First, the EU supports European research networks and collaboration among national research institutions. Second, the EU has privileged a top-down approach, identifying specific research priorities and then evaluating research proposals in the light of the chosen priorities—in the social sciences, the thematic priority concerns “Citizens and governance in a knowledge based society”, whatever that means.

Third, the OMC has been actively pursued in this area. As explained in Commission (2003), for instance, this method is designed to help Member States progressively develop their own policies towards the common goal of improving European research capabilities. In practice, this approach to policy coordination entails the following steps:

The Union sets some common guidelines and a timetable for achieving specific goals (such as increasing R&D spending for the EU as a whole from the current 1.9 percent of GDP to 3 percent by 2010, 2/3 of which to be funded by the private sector).

The Union establishes quantitative indicators and benchmarks, to compare best practice and performance of individual Member States.

Member States translate the European guidelines into national policies.

The Union periodically monitors and evaluates the policies and the performance of Member States against the chosen indicators.

Of these three European initiatives, the first is clearly the most important and promising. Creating common standards is essential to have an integrated European system of advanced education based on the mobility of students and researchers within Europe. Mobility is not only a good in itself, but fosters competition among the EU research institutions. This, in turn, can be a stimulus for improvements of national policies and organizational structures.

The second stepping stone of the European Research Area, namely direct support to research according to the 6<sup>th</sup> framework program and the like, is badly flawed. There are two problems. First,

<sup>11</sup> The 6th “Framework program” was launched in 2003. Its budget is 17.5 bn Euros over five years, or about 4 percent of the EU budget.

as others have pointed out (e.g., Alesina and Perotti, 2004), the top-down approach is based on the faulty premise that bureaucrats know better than scientists what are the most promising research areas. The results of new research are hard to predict and the best judges of new research efforts are peer researchers. As recently advocated by Sapir et al. (2003), the current system of European research grants should be replaced by an open ended and bottom-up system, like the American NSF, where peer scientists establish the criteria for fund allocation. Ideally, such a new funding system would be run as an independent agency, rather than by a political body like the Commission, with the participation of highly respected and independent scientists. Scientific excellence and scientific merit should be the only criteria guiding the allocation of funds, without any regard for distributional or geographic implications. Redistribution in favor of the disadvantaged regions should occur through other means, without corrupting the criteria for funding scientific research.

The second problem with the current system of European research grants is that it is designed to encourage collaboration among European research institutions. But what European research needs is more competition, not more collusion. Collaboration is not an end in itself; sometimes it is helpful, sometimes it is a mere waste of time. Again, the best judges of whether or not collaboration can be fruitful are the scientists themselves, not the bureaucracies. In general, collaboration of researchers separated by geographic barriers is unlikely to be very helpful. Rather than spreading thinly small amounts of funding, what Europe needs is to build more “centers of excellence”, namely a critical mass of outstanding researchers in the same locations. To achieve this goal, European funding should be concentrated to the few institutions that are more likely to be successful. “Networks” of centers of excellence will not have high payoffs, except to please bureaucracies. Competition among these centers of excellence for European funds is bound to be much more important.

Finally, the OMC may not be harmful, but it is unlikely to succeed in this area. Its main purpose is to enable countries to learn from each other through experimentation, and keep up the pressure for gradual and piecemeal reform. But experimentation and gradualism are not what Europe needs. We know very well what works and what does not, and how to organize successful research oriented university systems: we just need to look at the other side of the Atlantic. The American university system, its structure of corporate governance, its

career profiles, its funding arrangements, constitute a benchmark that could be successfully implemented in other industrial countries. We also know the objection: the American system is too different from the European model, it will never be accepted. This is true, and it is precisely our point. Gradual and piecemeal reform will never take us where we need to go.<sup>12</sup>

#### **4.5.2. A new strategy is needed**

To achieve something in the not too distant future, a radical change of perspective is needed. Europe must acknowledge that its public university system is by and large malfunctioning and cannot be reformed from within. The failures of European universities and research institutions are too daunting, particularly in the large countries of continental Europe, to imagine that they can be overcome by gradual reform from within each national system. Europe needs more competition within the research community; it also needs to concentrate resources in a few very productive institutions. Both goals are strongly opposed by vocal groups of students and researchers, and undermined by the hidden opposition of national bureaucracies. These oppositions will not be overcome.

Europe will succeed in improving the quality of its research, only if it sidesteps the hurdle of national universities. Concretely, this means creating new research institutions outside the national university systems. These institutions could mainly focus on research and advanced training, leaving undergraduate teaching to national university systems. New institutions will not be bogged down by implicit contracts with unproductive and older researchers. They could acquire additional resources with more flexibility and without giving the impression that they are subtracted from existing beneficiaries. And they could acquire new and more efficient organizational forms, imitating their US counterparts, without forcing change into the whole national

<sup>12</sup> A concern is that European academic traditions would stand in the way of an efficient allocation of resources. It could well be so but there is little evidence that European leading researchers share different values from their US colleagues. The experience in the UK over the last decades, whereby formal criteria determine the funding of universities, has shown how a competitive allocation of resources can be effective. At any rate, if there is a suspicion that European researchers do not have the right “culture”, the grant-allocating committees could include non-European scholars of international reputation.

university system. A recent initiative by the Italian government provides an example of how this might be done—see Box 3.

### **Box 3. The Italian Institute of Technology**

In the fall of 2003, the Italian government created a new research institution, the IIT. Completely outside of the Italian University system, the IIT will be located in Genoa. Initially, it will only focus on a few research areas in the natural sciences, but gradually the research areas could be broadened. The IIT will be a research institution, and its teaching and training activities will be confined to the post-university level. Its statute and organizational structure are still being formulated, but the idea is that the IIT will seek to attract the best researchers from all over the world. Thus, its contractual arrangements with prospective researchers will be unconstrained by Italian university regulations and will seek to match those of top US research institutions. Financing is provided by the Italian government, with a budget of about 1 bn euros spread over a period of 10 years. But active fund raising from the private sector through donations or joint ventures is planned.

#### **4.5.3. The role of the EU level of government**

Setting up new research institutions outside the national university systems can and should be done unilaterally by Member States, as illustrated by the Italian example. The incentives operate in the right direction as it is in every country's best interest to host leading universities and research centers. In fact, financing the creation of new research institutions out of the common European budget would be a nightmare: just imagine the fights over where the new institutions would be located.

The main risk is that every country attempts to have, say, the top biochemistry department in the world. On the other side, it is entirely reasonable that two of the top five biochemistry departments in the world be located in Europe. This can be achieved through competition, but much costly fixed investment stands to be lost until the winners emerge. A much cheaper way is to coordinate at the EU level, with three objectives:

The positive externalities and synergies within Europe would be more fully exploited.

For frontier research and education, the competition for resources must take place at the European level, since the national dimension is too small even for the larger European countries.<sup>13</sup>

The example of a successful initiative in one country should induce others to follow suit.

While the OMC can be used to achieve the third objectives, some degree of centralization is required for the first two. Not all universities need to be at the frontier of innovation, so national governments will retain control of and responsibility for a large part of higher education. Leading universities and research centers might require special treatment.

A simple solution is for the EU to use its research budget, possibly raised to more than its current one tenth of CAP's budget and 0.04 percent of EU GDP, to provide incentives for national governments to start new universities and research institutions outside their national university systems. The procedure would be to collect bids and provide a limited number of large matching grants to those countries that offer the best chances of success, keeping an eye on avoiding the duplication of efforts. The allocation of funds would not be politicized, instead being delegated to an independent international jury of researchers.

## 5. The Lisbon Strategy

The Lisbon Strategy reflects an ambition, that the EU becomes “the most dynamic, knowledge based economy in the world by 2010, an economy that can create sustainable economic growth with more and better jobs and greater social cohesion.” It recognizes that Europe has fallen, and is still falling, behind the US in many supply-side aspects. The diagnosis seems to be that structural rigidities hinder Europe's potential dynamism and that education and R&D need to be improved for the economy to better incorporate the latest technological developments with some weight on ICT. Three pillars—economic, social and the environment—are identified.

The strategy itself is based on the Open Method of Coordination.<sup>14</sup> This soft form of coordination eschews the kind of binding

<sup>13</sup> CERN is a good example of a domain where no single European country could have hoped to match the collective achievements in nuclear physics.

<sup>14</sup> For a discussion of the open method of coordination, see Hodson and Maher (2001) and Morelli et al. (2002).

commitments that have so far characterized common actions; this is presumably why it is called “open”. Rather, the strategy intends to adopt the benchmarking approach, fashionable in the industrial world, and to apply peer pressure through a mutual analysis of each country’s position vis à vis 102 chosen benchmarks that cover six areas: general economic background, employment, innovation and research, economic reform, social cohesion and the environment.<sup>15</sup> For each benchmark, the strategy sets a Europe-wide target to be reached by 2010.

Each year, the Spring European Council is mainly dedicated to the examination of a report from the Commission that presents individual country performances on the benchmarks.<sup>16</sup> This discussion is preceded by work conducted by the Economic Policy Committee. The Commission’s report includes a table that evaluates each country’s performance, summarized in the 2003 report as the number of times a country appears in the top and bottom three on a rating of the benchmarks, see Appendix A.<sup>17</sup> The Commission’s comments, which closely follow the benchmarking procedure, do not refrain from identifying stars (typically the Nordic countries) and laggards (the larger and Southern countries). The European Council invariably issues a communiqué congratulating itself on the progress accomplished but acknowledging that more efforts are needed to meet the Lisbon objectives.<sup>18</sup> Table 4 shows a less rosy independent appraisal.

The review procedure also focuses on the remaining barriers to competition. Instead of letting the European Commission alone face recalcitrant states, and occasionally take them to the European Court for breach of law, the strategy moves these conflicts to the inter-governmental level. The hope is that collective peer pressure may be more subtle and politically more difficult to resist than formal demands from “Brussels”.

<sup>15</sup> It brings together the Cardiff, Luxembourg and Cologne processes that focus, respectively, on structural reforms, the labor markets and the social dialogue.

<sup>16</sup> The latest report is European Commission (2003).

<sup>17</sup> The “hall of fame and shame” is not presented in the Commission’s 2004 report.

<sup>18</sup> The Brussels March 2004 communiqué states: “The Union set itself ambitious goals in March 2000. Four years later, the picture is a mixed one. Considerable progress has been made and the European Council reaffirms that the process and goals remain valid. However, the pace of reform needs to be significantly stepped up if the 2010 targets are to be achieved. The European Council is committed to demonstrating the political will to make this happen.”

### 5.1. Economic principles and the political economy of reform

The OMC offers a number of advantages over other coordination strategies. First, it is better adapted to policies where the case for centralization is weak. Indeed, with the exception of the environment, most policies under the strategy display limited externalities and strong heterogeneities regarding initial conditions and institutions. Moreover, the areas covered by the Lisbon strategy, in particular labor markets, are politically very sensitive and touch powerful political interests. The European level of government would lack the political legitimacy to impose its own decisions on member states. This is why the strategy is less than coordination.

Second, it is hoped that the OMC will strengthen the political resolve of national governments to reform. Economic reforms are inherently difficult and conflictual because they usually aim at removing existing rents<sup>19</sup> and often result in income redistribution.<sup>20</sup> Existing arrangements reflect a political equilibrium with economically inefficient features. Reforms aim at raising efficiency and, to that effect, they usually have to disturb existing equilibria. This is why governments are often reluctant to open up a process that can be politically costly. The hope is that peer pressure in the Council of Ministers can strengthen political incentives to reform.

A third view, defended by Dermot and Maher (2001), is that the OMC is a first step towards future transfers of sovereignty. In this view, once the member countries have developed a common understanding and agreed on common approaches, they will find it easy, if not natural, to go the next step. It is far too early to judge whether this evolution will materialize, but it is important to ask whether the strategy itself fits the general principles regarding supply-side coordination.

<sup>19</sup> Rents are defined as income in excess of social returns. This includes obvious cases such as subsidies to, or protection from competition of inefficient firms. It may also include welfare programs that provide transfers to individuals in excess of the social costs for which they are meant to compensate.

<sup>20</sup> Drazen (2000), Persson and Tabellini (2000), Saint-Paul (2000).

**Table 4. The Lisbon Scorecard for 2004**

Policy domain	Average performance	Heroes	Villains
Information society	B-	Denmark, Estonia, Sweden	Greece, Luxembourg
Research and development	C	Finland, Slovenia, Sweden	Greece, Italy, Portugal
Telecoms and utilities	C+	Netherlands, Sweden, UK	Greece, Italy
Transport	C+	European Parliament	Belgium, France, European Parliament
Financial and other services	C+	European Parliament, UK	Italy, Poland
Business start-up and environment	C	Ireland, Slovenia	Bulgaria, Romania
Regulatory burden	C	Denmark, Finland	Italy, France
State aid and competition policy	C+	Greece, Luxembourg, Netherlands	France, Germany, Portugal
Bringing people into the workforce	C-	Cyprus, Czech Republic, Netherlands, Sweden	Belgium, Italy, Poland
Upgrading skills	C	Czech republic, Finland, Slovakia, Slovenia, Sweden	Greece, Portugal
Modernizing social protection	B-	Austria, France, Sweden	Belgium, Ireland, UK
Climate change	C-	France, Sweden	Austria, Ireland
Natural environment	C+	Austria, Belgium, European Commission	Ireland, Spain

*Source:* Murray (2004).

## 5.2. Can the Lisbon Strategy be repaired?

### 5.2.1. Why is the strategy failing?

Nearly halfway since the strategy was adopted in 2000, the general assessment is that Europe will not be “the most dynamic, knowledge based economy in the world by 2010”.<sup>21</sup> It is very tempting to see the

<sup>21</sup> See e.g. Alesina and Perotti (2004) and Murray (2004).

whole exercise merely as grand, ritual declarations with little practical impact. True, the objective of the strategy is overly ambitious and many of its aspects were doomed from the start, but others may be useful. Why is the strategy failing?

One reason is that the objective was never taken seriously, neither by the authors of the declaration themselves, nor by public opinions. This anticipated failure has much to recommend. The Commission is invited to scold governments, with no effect since the domains concerned by the strategy are not shared competencies. Economists, national and European technocrats, members of the EU Parliament and other observers can vent frustration at politicians in a well-rehearsed fashion. It also provides governments with the possibility to ritually rededicate themselves to spirit-lifting intentions during their Spring meetings, a more pleasant exercise than hard bargaining on burning decisions. In the larger countries at least, i.e. those in most need of peer pressure, the public does not take any notice.

Another reason for failure is that quantified objectives are bound to be unmet, especially as they fail to take into account the different starting positions and varied abilities to meet them.<sup>22</sup> Quantified objectives bear a painful resemblance to the Soviet plans: they impart a deceptive sense of precision, they are set as ambitious objectives so that they are expected to go unmet and, when they are, it is unclear whether the government did not try hard enough or whether the objectives were unrealistic. More importantly, the Lisbon objectives concern outcomes, not policy measures. We may know what is to be done to raise the employment rate, but not how to achieve a particular target. Ex post, it is difficult to determine whether a failure to achieve the target is due to insufficient efforts or disappointing effects.

Yet another reason for the strategy's failure is that the 102 benchmarks are a hodge podge of characteristics, some important, others less so. Knowing fully well that not everything can be done, governments may freely pick some benchmarks—preferably the mundane ones—and drop others—the critical ones. This creates perverse incentives. Governments want to show that they have done something, and yet nothing of substance is affected. It seems a joke, but it is not. According to a recent study—Boeri (2003)—over the last 18 years, there have been on average 1.6 reforms per year *and* country. How-

<sup>22</sup> For discussion of this aspect, see Alesina and Perotti (2004).

ever, most of the reforms have been marginal, and their direction is mixed. Not infrequently, a reform corrects the mistakes or undoes the effect of a reform enacted just a few years before. This hyperactivism in reforms is not just useless: it can also be counter-productive because it increases the institutional complexity of European labor markets. Boeri (2003) counts that in Italy alone there are now over 40 possible types of employment contracts!

Clearly, the Lisbon strategy itself needs to be reformed, and some steps have been taken, but they do not go to the heart of the failure. A distinction must be drawn between two broad policy areas. One area is the single market in goods and services. As argued at length in the previous sections, the main challenge here is to complete the integration of the single market in services, public utilities, energy. This means dismantling barriers that achieve market segmentation along national borders, opening up markets for services to foreign providers, facilitating cross-border mergers, shutting down state aid and regulations that prevent foreign entry; in some cases forcing divestitures and privatizations. Here, peer pressure and the open coordination method will not do. To make progress, this policy area must simply be taken out of the hands of national governments by increasing the prerogatives and the enforcement powers of the European Commission or other European policymakers.

The second policy area concerns labor markets. As discussed above, the challenge here is not to achieve market integration, but rather to remove specific distortions from each national labor market. The EU can only have a limited role, both because there are no or few externalities, and because policy decisions entail delicate tradeoffs between efficiency and redistribution that can only be made through the national political process. Here, the OMC can be useful, but it should be simplified and refocused. The emphasis should move away from peer pressure, in the direction of increased accountability to national parliaments and national citizens.

### **5.2.2. Strengthen the EU institutions in charge of the single market**

The open coordination method relies on the intergovernmental approach. The Commission briefs the Council meetings, but has no concrete decision-making powers. This “soft” approach makes sense in areas such as labor markets, that are politically charged and where technical criteria alone cannot inspire policy decisions. But the inter-

governmental approach is much less appropriate in most areas related to the single market, such as state aid, public utilities regulation, and regulation of services. Here, the main opposition to reform comes from national lobbies of state monopolies, public employees, or protected private firms. Peer pressure alone in the Council of Ministers will not overcome this opposition, and the intergovernmental method is bound to fail.

A better approach to complete reforms in the single market is to strengthen the prerogatives of a European policymaker. A single European policymaker is less likely to be captured by national lobbies, because it will face countervailing pressures from a variety of producers.<sup>23</sup> Moreover, its mission can be easily defined according to technical or efficiency criteria, so that one of his main goals is to strengthen and enforce the integration of segmented national markets.

The European Commission is, of course, the prime example of how this can be achieved. In most areas relating to the single market, the Commission already has the required technical expertise and is already playing an essential role. But this role can be strengthened and its mandate can be expanded. For instance, if it were felt that Europe lacks an industrial policy, it would be much better to give the Commission some new positive powers in that direction, rather than relax the current negative powers of the Commission over state aids.

The Commission is not the only supranational institution that could be given the role of enforcing or regulating specific aspects of the single market. In the case of financial markets, expanding the role of the ECB at the expenses of national bank supervisors could be a step in the right direction. In the case of research policy, we already pointed to the desirability of creating a new European Research Agency in charge of awarding grants directly to European researchers or to national university institutions. In other areas, new regulatory agencies could be created and given specific tasks currently retained by the European Commission.

What is important at this stage is not so much who is the European policymaker in charge. The really crucial issue is that the tasks of enforcing and regulating the various facets of the single market be taken away from national governments, and put in the hands of a sin-

<sup>23</sup> For example, the Commission has been attacked by the German government over its imposition of a fine on Volkswagen, only to be supported by other car manufacturers and their governments.

gle European policymaker with a strong mandate of eliminating all remaining barriers to a truly integrated market.

### **5.2.3. Labor market reform: Realistic ambitions and political accountability on observable actions**

In the case of labor market reform, however, a single European policymaker will not do. The specific and politically charged distortions that hinder the functioning of labor markets inside each nation must be removed or, at least, alleviated, and that challenge can only be met by a national policymaker. Here, the OMC can fill a potentially interesting niche between shared competencies and national sovereignty, in areas where reforms are opposed by powerful interest groups. But to give the method a chance of working, the objectives for labor market reform must be few and realistic.

Multiplying the objectives and their associated benchmarks dilutes the whole undertaking. More ominously, it betrays the government's ability and/or willingness to identify clear priorities, heralding the ultimate failure. The first change to the strategy should therefore consist of agreeing on a limited number of essential objectives. The quantified targets must be replaced, in each case, by a clear and precise statement of what policy actions must be undertaken country by country.

While a small number of carefully chosen benchmarks for labor market reform can help concentrate policymakers' minds, we need to acknowledge that peer pressure does not work on matters of national sovereignty. Declarations inside the European Council carry little weight at home and no head of state or government will publicly—and even privately—lambaste his/her colleagues for failing to deliver on promises that do not affect him/her directly.

Political leaders only care about their citizens' opinions, and this is right for political accountability in democracies. This is why peer pressure must be replaced by the pressure of domestic public opinion. A simple way of proceeding in this direction is to require that the Commission's report on the labor market benchmarks be discussed by each national Parliament. The normal interplay of majorities and oppositions will undoubtedly reveal the policy failures. This will inform public opinions and reveal where special interests stand in the way of desirable reforms.

## 6. Conclusions

Europe's overall economic performance has been depressing for more than a decade. Yet, not all countries are equally affected and some countries are actually among the world's best economic performers. The problem is concentrated to a few countries, in fact the larger ones, which seem unable to extricate themselves from a decade of poor growth and high unemployment and are struggling to remain on the technology frontier.

The reasons for this depressing situation are well known, as are the solutions. The problem lies squarely with the supply side, which suffers from a number of inefficiencies in the labor markets, inadequate financial markets, heavy tax burdens and misperforming research and development. In each instance, deep reforms are needed but are politically unpalatable. Some countries have been able to overcome this hurdle, though, and now enjoy a renewed dynamism. Others have not and sometimes hope that the solution can come from outside, through more centralization, formal or informal, at the EU level of government. Is such a strategy the way out? Our analysis leads to a generally negative answer, with some important exceptions.

Centralization should not, and cannot substitute for domestic policy failures. It has a vital role to play to take advantage of important externalities and increasing returns. This is why the Single Market has been established, complete with a single currency, and why it has been so successful. It is by now nearly complete. A few more steps are needed to reap all its benefits. In particular, various distortions remain in the utilities sector and the service industry. What remains to be done is mainly to fully apply existing agreements. This might also require some institutional changes, reinforcing the prerogatives of European policymakers. Elsewhere, with the important exception of research and higher education, there are no significant externalities and increasing returns, hence no case for centralization.

The domestic policy failures that hinder the supply side originate in the power of interest groups that have managed to capture or intimidate their governments, usually irrespective of their political orientation. This could provide another argument in favor of centralization. Indeed, if the interests of national pressure groups are not well aligned across countries, the EU level of government could exploit their conflicts of interest to push through measures that are blocked

at the national level. This is a valid argument, but it faces two important counter-arguments.

If the problem lies with benevolent governments' weakness in the face of entrenched interests, the first best solution is to bolster their resolve. If the governments are fully captured, the solution is to alert and inform the public opinion of the costs. In either case, supply-side policy failures generate their own antidote: the affected country's economic decline provides the government with potentially large political rewards if it succeeds in pushing a vigorous reform agenda.<sup>24</sup> Put differently, competition among governments' reform actions sets the incentives straight. Centralization, on the other hand, may take the form of collusion and generate perverse incentives.

The second argument notes that failures to reform inefficient economies originate in the political sensitivity of the required policy actions. Attempting to bypass this hurdle by importing measures crafted at the EU level of government is bound to fail for two reasons. First, dealing with political sensitivities requires an elaborate understanding of national politics and calls for an astute design of policies. Second, the European level of government does not have the political legitimacy needed to arbitrate among opposing interests.

All in all, the case for the centralization of supply-side policies is weak. Yet, centralization need not be an all-or-nothing process. Soft methods of coordination can be useful in some instances and, fortunately, this is precisely what the Open Method of Coordination is designed to achieve. It is currently framed as part of the Lisbon strategy, but that strategy is misguided in its ambitions, muddled in its endless list of priorities, undercut by the illusory precision of its quantitative targets, and flawed in its reliance on improbable peer pressure.

This paper makes three main proposals that combine centralization where justified and soft coordination in a few selected areas. More precisely:

- Completion of the single market requires opening up some markets that are still protected (mainly utilities, energy and financial services). This is a case for centralization. It is highly unlikely that peer pressure or other forms of soft coordination will succeed in

<sup>24</sup> It is true that the positive effects of supply-side reforms are very slow to set in, while the political costs are front-loaded. But policy coordination in itself cannot remedy this difficulty. And, as argued in the introduction, the evidence suggests that expansionary aggregate demand policies do not help either, perhaps because they foster the illusion that reforms are not urgent.

breaking powerful interests. This calls for increasing the powers of the Commission or, preferably, for setting independent agencies with the power to enforce existing rules. The reason for preferring independent agencies is that the EU level of governments is likely to be captured by the very same private interests that block progress at the national level.

- In several countries, the labor markets need politically difficult reforms. Soft cooperation has a role to play but peer pressure exerted through the Lisbon strategy has not yet delivered, and is unlikely to deliver. Where peer pressure fails, public opinion pressure is called forth, and has a vastly superior legitimacy. So far, however, public opinion pressure has not been effective in several countries either. Combining the two ought to be tried. A simple solution would be to require that the conclusions of peer discussions—as currently conducted at the Spring meeting of the EU Council—backed by the annual Commission report be debated in national parliaments once a year. This would lead both the majority and the opposition to publicly take position on recommendations informed by other EU experiments.
- Europe's failure in intellectual and scientific innovation is all the more shocking since Europe does not lack human capital. The failure is due, again, to the power of insiders. The solution is to abandon so far ineffective attempts at gradual reforms by creating new universities and research centers. This is an area where the responsibility mainly lies with national governments but some coordination is needed to exploit some returns to scale and avoid wasteful duplication of efforts. EU's research budget—currently misused in dispersing a large number of small grants according to an ill-conceived top-down approach—should be used to provide matching grants for setting up new universities and research centers. To avoid obvious turf battles, these grants should be awarded by an independent jury of education and research experts on the basis of bids submitted by the member states.

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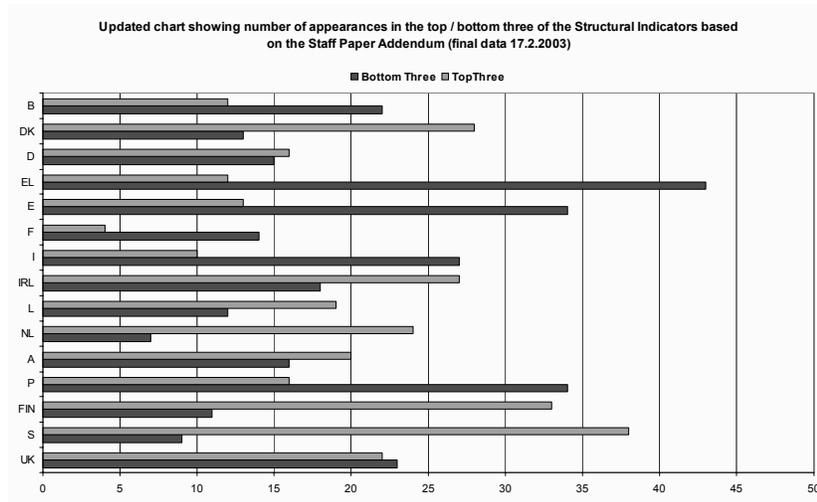
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## Appendix A. Spring 2003 evaluation of country performances



*Source:* European Commission (2003).

