

An EU “fit for purpose” in the global age

# After the crisis: A new socio-economic settlement for the EU

Edited by Roger Liddle



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Iain Begg | Gabriel Glöckler | Anke Hassel  
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## Rescuing the European project: EU legitimacy, governance and security

Edited by Olaf Cramme



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Edited by Loukas Tsoukalis



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**After the crisis:  
A new socio-economic  
settlement for the EU**

Edited by Roger Liddle

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# About the project

Organised by Policy Network, in partnership with the European Institute of the London School of Economics and ELIAMEP (Hellenic Foundation for European and Foreign Policy), the EU “fit for purpose” project was initiated in May 2008 when Professor Loukas Tsoukalis presented to a workshop in London a substantial critique of the challenges and choices facing the EU in the 21st century.

Subsequently, a programme of study and events, co-directed by Olaf Cramme, Maurice Fraser, Roger Liddle and Loukas Tsoukalis, was organised around the central theme of this initiative: what the role of the European Union is as a political entity in a rapidly changing world and how it should reform itself, both internally and externally, in order to overcome and respond to the multifaceted challenges of the global age we now live in.

Over a period of 12 months, the project has sought to engage with a wide-ranging group of distinguished academics, policymakers and government advisers from across Europe, looking at the key clusters of policy choices facing the EU post-2009. High-level symposia and public events took place in Hydra, Paris and London.

Three publications mark the climax of this project:

- **Rescuing the European project: EU legitimacy, governance and security** (*edited by Olaf Cramme*)
- **The EU in a world in transition: Fit for what purpose?** (*edited by Loukas Tsoukalis*)
- **After the crisis: A new socio-economic settlement for the EU** (*edited by Roger Liddle*)

In addition, a synthesis report provides a compact analysis of how the EU needs to evolve and operate if it is to live up to the expectations and hopes of many of its citizens.

All of the publications are available in hard copy and online. Further information about the project and the organisers is available at:

<b>Policy Network</b>	<a href="http://www.policy-network.net">www.policy-network.net</a>
<b>European Institute at the LSE</b>	<a href="http://www.lse.ac.uk/europeaninstitute">www.lse.ac.uk/europeaninstitute</a>
<b>ELIAMEP</b>	<a href="http://www.eliamep.gr">www.eliamep.gr</a>



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First and foremost, I would like to thank the authors who have contributed to this pamphlet for engaging so positively with our initiative. I hope this publication will prove to be a suitably worthy and thought-provoking intervention in the EU debate to match the high quality of the pieces they submitted.

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Finally, I would like to thank all those who over the years have helped to harness my pro-Europeanism and develop my ideas about the future of Europe.

**Roger Liddle**

London and Cumbria, October 2009



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# Chapter 1

## From crisis to opportunity: Europe's economic choices

Roger Liddle\*

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This pamphlet is about the socio-economic challenges facing Europe after the global crisis and what political choices these entail. The global economic crisis marks a watershed in the evolution of Europe; it demands a new socio-economic settlement for our times. This chapter, by way of introduction, considers why. It asks whether the crisis has raised the urgency and profile of key strands of EU policy like financial regulation, macro-economic coordination, the governance of the Euro, EU budget reform and the Lisbon strategy, but also whether they now require a re-think.

This contribution considers whether the crisis will mark a defining moment in the process of European economic integration; whether, on the one hand, it provides a new impetus for further integration, or, alternatively, whether the crisis will lead to a sustained upsurge in economic nationalism and demands for greater member state autonomy that undermine the achievements of the Single Market. Finally, it assesses the long-term consequences of crisis for the EU's climate of intellectual and policy thinking. Is the Anglo-Saxon model of capitalism mortally wounded? But will the crisis coalesce with the long-running debate about the future of the "European social model" and strengthen its purchase as a governing idea?

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*\*I write here in a personal capacity. I would like to thank Simon Latham, my principal adviser at Policy Network, for his helpful comments on and revisions to this paper.*

## **Before the crash: the EU as a partial economic success story?**

These issues cannot be satisfactorily addressed without an overview of what EU economic and social policies had achieved in the period before the crisis broke. The decade prior to the millennium was one of much soul searching about the EU's economic record. In the aftermath of German unification, the Bundesbank's anti-inflationary squeeze led to recession across much of the Continent as other members of the Exchange Rate Mechanism (ERM) struggled to stabilise their parities against the Deutschmark. Fiscal consolidation progressed as member states sought to meet the Maastricht convergence criteria for Euro membership. Unemployment rose sharply particularly among older workers and young people (and employment participation rates fell) as companies sought to maintain their core labour force in the face of weak demand. Trade unions, in cooperation with employers, sought to alleviate the employment problem through strategies of work-sharing that involved limitations on working time and extensive early retirement. Whereas until the 1980s the EU had steadily closed the gap in output per head with the United States, there then ensued a decade of stagnation. In the mid-1990s a productivity surge in the United States (often attributed to the information technology revolution) began to generate fresh fears that Europe was being left behind.

Policy experts argued that Europe needed to prioritise "economic reform", by which bodies such as the OECD meant labour market reforms<sup>1</sup>, to create more flexibility and weaken trade union resistance to change; further opening up of product markets, especially in services and the "network" industries, traditionally dominated by publicly owned monopolies; and financial liberalisation to create a Single Market in financial services. The EU bought into an agenda of "economic reform". However, its conception of employment policy, embodied in the European Employment Strategy (EES) that grew out of the Luxembourg Jobs Summit in November 1997, was more Nordic in conception than the OECD's and focused on active labour market policy and raising employment participation. To this mix of flexibility and active labour markets, in 2000 the Lisbon strategy added a more social democratic emphasis on both new forms of public investment in growth through research, innovation and skills, and the idea that welfare states and social inclusion policies could be re-designed to have a positive impact on economic performance.

There is considerable academic debate as to whether or not policymakers' continued emphasis on the "Lisbon" agenda of economic reform

contributed much to timely and effective outcomes. Nevertheless, the first decade of the twenty-first century turned out to be a period of relative success for the European economy. A central feature of the upturn was the remarkably smooth transition to the euro. The ECB's management of monetary policy consolidated remarkable price stability across the euro area – in sharp contrast to the preceding three decades. However, the euro was only partially perceived to be a success when the financial crisis struck. Its existence prevented currency turbulence and the rounds of competitive devaluation that would have occurred without it, which, in turn, would in all likelihood have increased economic dislocation and led to more pressures on the integrity of the Single Market.

One other area of conspicuous policy success was employment. By the summer of 2008 unemployment had fallen rapidly to the lowest level seen in the EU as a whole since German re-unification: from the year 2000, jobs in the EU grew at a faster rate than in the United States. This reflected in part the success of piecemeal labour market reforms in member states. These reforms on the whole embedded a policy shift from work sharing, early retirement and limitations on working time (that had held sway in the 1980s and 90s) towards employment activation, “flexicurity” and greater flexibility.

On the other hand, the US record in R&D and innovation in terms of output per head remained stronger than Europe's. Overall, there was no real sign that the EU/US differential was narrowing. Detailed analysis showed that a large proportion of the EU's “productivity gap” with the United States could be accounted for by retail and financial services. In manufacturing the picture was more nuanced. Some sectors such as apparel and footwear were forced to restructure and downsize radically in face of new global competition, with a particularly severe impact on Italy for example. On the other hand, the success of Germany in re-establishing itself as the world's leading exporting nation demonstrated the pay off from difficult structural reforms at company level. Rather than globalisation signalling the end of Europe's ability to compete in rapidly growing world markets, as was popularly feared, it demonstrated the scale of the huge new commercial opportunities that existed for European businesses that reorganised their global supply chains, focused their European activities on high value added and exploited new market niches.

Economic integration, meanwhile, proceeded apace. Cross border mergers increased. In particular, cross border financial integration deepened as result of EU policy decisions on the creation of the euro and on financial

liberalisation. The City of London strengthened its dominance as Europe's major financial centre, apparently unaffected by the UK decision not to join the Eurozone, though benefiting greatly from the increased momentum of European economic integration. Strong catch up growth, meanwhile, took off in the new member states, particularly the Baltics, Slovakia and Poland, suggesting that the central and eastern enlargement would lead to rapid convergence as it had in the case of the Cohesion Four. The December 2005 European Council agreement on the EU Financial Perspective for 2007-13 significantly increased EU Budget transfers to the new member states to support public investment in that catch-up. Free movement of labour within the enlarged EU facilitated above trend growth in member states such as Ireland, Spain and the UK, strongly suggesting that if all restrictions on free movement were to be lifted when the current 7 year transition period comes to an end in 2011, there would be overall benefit to the Union.

As for social cohesion, enlargement profoundly altered the character of the EU without much serious analysis of the economic and social implications thereof. It greatly increased ethnic and religious diversity as well as geographical disparities between EU regions. Average income per head ranged from a high of 290% of the EU average in London to a low of only 27% in north east Romania. Within the EU15, the wage share in national income declined in many member states and measures of inequality and child poverty grew. But Europe saw nothing like the increase in inequality that occurred in the United States. Rather increases in inequality in Europe appeared member state specific and episodic rather than part of a general trend.<sup>2</sup>

Worryingly, though, within the Eurozone macroeconomic structural divergences grew. Whereas in the period up to the establishment of the Euro, the convergence criteria acted as a discipline on fiscal policy, once the euro was in being, these disciplines were relaxed and countries like Greece and Portugal began to accumulate unsustainable deficits, while Spain enjoyed an unsustainable housing boom as a result of the euro sharply loosening the domestic monetary conditions.

Despite this record of on the whole improved economic performance, with the single (though admittedly large) exception of energy policy and climate change, the momentum for policy integration slowed the entire economic and social field. Only modest progress was made in strengthening Eurozone governance. The rules of the Stability Pact underwent pragmatic revision and were made more flexible and intelligent, but it remained only

the smaller weaker member states who really felt they had to take notice. Also, the Eurogroup elected a permanent President in the person of Luxembourg's Jean Claude Juncker but still lacked effective single external representation. It was striking how in the EU's intra-institutional debates on the Constitutional and Lisbon Treaties, very little attention was paid to economic questions as opposed to improving the EU's effectiveness as a "global actor". Internally, debate focused on the justice and home affairs agenda, not economics. Governance and political will have arguably failed to keep pace with economic integration.

The Lisbon process was in part conceived as an alternative to the classical focus of integration. Yet though it was re-launched with a flourish at the start of the Barroso Commission in 2004, it failed to engage political attention or deliver high-profile results. Lisbon's bolder ambitions were clearly beyond reach, even in 2004: the 2010 deadline had always been over-ambitious, especially given the EU10 enlargement. One valid criticism of Lisbon was that the initial goals were inadequately specified or prioritised. The Barroso Commission attempted to narrow the focus to "growth and jobs" as recommended by the Kok report. However, pressures within the Council and Parliament soon widened them again. More seriously, the German refusal to contemplate the "naming and shaming" of member states failing to reach their targets meant that delivery depended on an opaque partnership between the EU and its member states that lacked real political purchase.

In terms of further market liberalisation, services have the most economic potential as they constitute some 60% or more of the EU economy. In the latter days of the Prodi Commission, Frits Bolkestein, the Dutch liberal Commissioner responsible for the Internal Market, convinced his colleagues that the way to liberalise "services" was through an omnibus measure based on codifying in EU law the founding freedoms of the Rome Treaty. This broad based approach liberalising a vast range of economic activity from sensitive "public services" such as health and social care, to high value added professional services, ran into immediate political difficulties. The Services Directive that eventually emerged was substantially amended – strict economic liberals would say watered down – by the European Parliament. This demonstrated the limits of political will to drive Single Market purism beyond goods.

Beyond that, there was sparse legislative achievement in harmonising internal rules and standards, not to mention questions of taxation, with the important exceptions of the passage of the REACH Directive and much

of the Financial Services Action Plan. The dominant spirit of the times was anti-regulatory, with the Commission stressing its commitment to “better regulation” and the legislative simplification agenda. Experts pointed to weaknesses in the EU’s system of cross-border financial regulation but there was little political appetite for doing much about it.

There also appeared to be a lack of radical ambition for future budget reform. After the dramas of the horse-trading in 2005 to achieve an agreement on the EU Budget, over 70% of the funds are still devoted to the Common Agricultural Policy and Structural Funds. This is despite the emergence of major new EU policy priorities such as climate change and the need to facilitate the transition to a low-carbon economy; strengthening controls on migration at the common EU border; research and higher education in light of Europe clearly falling behind the US; a more active and effective EU neighbourhood and external policy; not to mention new social policy initiatives. True, agriculture subsidies have largely been decoupled from production and more funds switched to rural economic development. The Structural Funds are now also supposed to be aligned with “Lisbon” policy objectives. Yet, even within fields covered by the EU Budget, the Commission still has little ability to direct spending towards its agreed policy priorities – for instance, labour market adjustment, “flexicurity”, skills, social innovation and programmes to integrate “migrants” and ethnic minorities. The Commission’s political accountability is centred instead on bureaucratic processes and financial procedures rather than better policy outcomes.

Partly as a result, “Social Europe” remained largely a rhetorical construct. Debate was polarised between on the one hand, those who interpreted anything with the label “social” on it as a burden on business and on the other, those who advocated a traditional “social agenda” centred on labour market regulation. The battles over the Working Time Directive were the best examples of this trench warfare, though the long deadlock demonstrated the difficulty of legislating across a diversity of practice in 27 member states and the substance of the issue seemed out of sync with new economic times where employees, just as much as employers, demanded greater flexibility in hours worked through the life course. As an alternative to this old debate on “Social Europe”, the Commission tried to focus attention on the “new social challenges” facing Europe – but was less clear about what new policies at EU level might flow from this. However, some political space for future European action was created by the establishment of a pale version of the Globalisation Adjustment Fund

proposed in André Sapir's 2003 report for the Commission, *An Agenda for a Growing Europe*, and the advancing debate on "flexicurity".

Until the crisis broke in the autumn of 2008, the prospects for radical policy change were poor. This reflected an intellectual consensus that the Single Market in legislative terms was near complete; that the euro had become quickly embedded in its early years without a degree of turbulence that fundamentally called its governance into question; and that social and budgetary questions were in the classically "all too difficult" redistributive category that member states had no appetite to grapple with. Given the dominance of this view, it was taken for granted that the EU's internal development would more or less proceed benignly as a result of market dynamics supplemented by the full exercise of the Commission's powers of implementation of existing legislation and the powerful liberalising instincts of ECJ jurisprudence. The focus of policy attention in EU debate shifted away from what seemed tired and stale internal questions of economics and social cohesion to new and more compelling debates about the EU's role as a global actor. Then in autumn 2008 the global crisis struck Europe with full force. A new question came to the fore: what will change as a result?

### **Has the immediate reaction to the crisis been positive or negative for the EU?**

Against this background Europe's initial reactions to the global financial crisis were unsurprisingly complacent. Its impact was deemed containable; the crisis itself a problem of "Anglo Saxon" financial capitalism, originating in the US, with limited spillovers to the continental economy. Clearly, some member states were more exposed like the UK, Ireland and Spain which had seen an unsustainable house price boom and growth in consumer spending. But the initial conventional wisdom that the EU would be able to batten down the hatches and ride the storm rather suited the ideological preferences of Continental political leaders: the interpretation of the crisis as an Anglo-Saxon debacle both distanced them politically from responsibility and strengthened the case for the different approaches Continental Europeans were perceived to take to the market economy.

This complacency did not, however, survive long as the seizing up of the world financial system shook the banking system to its foundations in Europe as much as the United States. The spread of the crisis from Wall Street to Main Street triggered a sudden collapse both in consumer

confidence and world trade, to which Germany as the world's leading exporter, has been particularly exposed. The European Union emerged ill prepared and poorly equipped with the necessary policy instruments to tackle the crisis. Few experts had predicted what could go wrong. In fairness, some had foreseen a looming problem in that financial market integration in Europe had proceeded apace without an adequate parallel development in the effectiveness of financial regulation at EU level. But, even had better cross border supervision been in place, there is legitimate doubt how far it would have mitigated the scale of the crisis. The problem for supervision may have been an inability to understand the nature of systemic risk as much as a failing of normal regulatory processes. And when the problem became one of bank solvency the absence of any European fiscal authority with the power to tax meant that member states had to take responsibility for bank rescues and recapitalisation. The essential role of the nation-state as a pragmatic necessity was confirmed – and not just in eurosceptic eyes.

However, some decisive actions were taken in common. In addition to the adoption by the October 2008 European Council of a broadly pitched, common framework for national bank rescues, there was a recognition that the sudden demand shock created by the crisis could only be countered by government fiscal stimuli, and that it would be far more effective if member states acted in harmony. The Commission produced a fiscal stimulus plan – implementation of which has been both imperfect and uneven – but nevertheless counts as a significant new move in economic policy coordination. These are important positives.

The crisis revealed however that lack of adequate policy coordination remains an area of serious weakness for the EU. First, there can be no sustainable economic recovery without a cohesive EU approach to banking sector recapitalisation, regulation and supervision. In many respects, what is required at EU level is a Treuhand agency, which famously privatized many East German enterprises during the process of the country's re-unification, to overcome the innate problems of its banking sector. But there remains a latent risk that certain member states are unwilling to address this weakness and use as an excuse, the assertion that this is still an Anglo-American rather than a European crisis.

Second, several member states in central and eastern Europe have run into such severe economic difficulties that they have had to resort to the IMF for balance of payments support. While (following the April 2009 G20 meeting in London) better placed EU member states have contributed the

increased resources to the IMF that made these interventions possible, it is striking that the leading nations of the EU have preferred to rely on the mechanisms of the IMF for this purpose rather than use the shared processes and institutions of the EU.

Third, the wider pattern of responses to the crisis have largely been national, with the consequences for the EU's established policy frameworks treated as second order issues. Governments have sought both properly and legitimately to protect their citizens against the impact of the crisis: the unprecedented risks of loss of savings due to potential bank collapse; more mortgage defaults and housing repossessions; and business bankruptcies. Emergency measures have been taken to mitigate the impact of the crisis on particularly vulnerable sectors, for example the motor industry, where orders collapsed as new car purchases were deferred. Emergency actions taken at national level inevitably lead to distortions in the Single Market. The scale of these will remain relatively uncertain until the crisis has completed its trajectory. But we know already that in banking and motor manufacturing, the provision of new state aids has been extensive.

Fourth, several instances of a nationalistic “my-citizens-first” approach have been particularly troubling:

- In the first few months of the crisis, there was the call by the President of France (although the French government later backtracked) that French firms receiving public aid should repatriate investment from new member states.
- Banks in receipt of national aid have been pressurised to concentrate their lending on domestic customers and cut back on overseas lending, even within other EU member states though. This poses considerable problems for new member states when their banking system is largely in foreign ownership and these banks withdraw funds and concentrate on their respective domestic markets. What makes it worse is that the scale of foreign ownership of banks in new member states was actively encouraged by the Commission in times past and rightly in keeping with Single Market principles.
- The free movement of labour has become a focus of increased resentment about foreigners stealing “our jobs”: the rising tide of cries for “British jobs for British workers” is not just confined to the UK. In the process of his re-appointment President Barroso conceded the case for a review of the Posted Workers’ Directive

following the ECJ's controversial rulings in the Vaxholm and Laval cases. This is a Pandora's Box that European politicians may well regret opening.

- The handling of the disposal of General Motors' European interests was notoriously left to member states to fend for themselves rather than a cohesive European view taken with accusations that Germany had designed a deal to protect domestic jobs at the expense of GM plants and jobs in other member states.

There is no certainty that these distortions will be easily unwound in the near future, unless the Commission, with strong leadership from the newly re-appointed President Barroso, is willing to make full use of its powers to take recalcitrant member states and companies to task and secures the political backing of the Council for this stance. Tackling the market distortions that the crisis has introduced will probably be a long haul slog over at least a decade. In the process of rebuilding the Single Market, there may be a need for structural measures to break up over-concentration as a result of the crisis, as maybe in the case of banks. In other sectors, there may be a case for explicit interventionism and capacity limits for example, to restructure the motor manufacturing sector. This would be an early twenty-first century equivalent of the structural policies for reshaping the coal and steel sectors in the first decades of the Community's existence.

Overall however there are grounds for optimism in that the Single Market has survived the worst of the crisis, assisted to a large extent by the stability provided by the Euro in preventing the much bigger trade distortions that would have occurred as a result of competitive devaluations. The newly appointed European Commission now has an opportunity to re-assert its powers over the Single Market. The election of a CDU-FDP coalition in Germany offers the likelihood of stronger political support for this.

### **A paradigm shift in the process of European integration?**

The crisis has cast doubt on the prevailing consensus that internal EU economic and social questions can take second place to the much bigger debate on the EU's global role. The wider impact of the crisis on the European economy is still uncertain. Even if by autumn 2009 when there are some encouraging signs of recovery underway, many experts question whether "normality" is about to be restored and, even if it were, whether European policy could conceivably return to "business as usual" as in the period up to mid-2008. Could a paradigm shift be occurring that will have

profoundly deep and long-term effects? And what will the consequences for the EU be?

In one sense this question is already answering itself – at least in part. At the time of writing, European leaders have already committed themselves to a programme of reinforced financial regulation to buttress a “more responsible capitalism” that includes not just highly technical questions of reserve ratios but the highly charged issue of regulation of bankers’ bonuses. Financial services re-regulation will be at the heart of the reconstruction of the Single Market once the worst of the crisis is over and the Commission’s new proposals, based on the earlier De Larosière report, appear well crafted to secure consensus. It is strongly in the interests of the Eurozone that the necessary strengthening of financial regulation is agreed on an EU-wide basis, involving the UK.

As the City of London is the “de facto” financial centre of the euro area, despite being outside it, this still gives the UK significant leverage in designing the detailed shape of this new regulatory regime, as long as the UK agrees to play the European game. Prior to the crisis these proposals would have been seen as a major threat to UK interests which have historically been allergic to entangling the City of London in excessive European red tape. However a significant shift in attitudes is discernible. Lord Turner, the Chair of the UK Financial Services Agency (FSA), has argued forcibly that without some element of “single” financial regulation, there can be no Single European Financial Market. There is clear questioning as to whether the best interests of the City of London are to be seen in the long run as a “light touch” regulated market operation offshore of its European home base. Should this trend be confirmed, this is a significant move in European economic integration.

Another area where the pace of integration may quicken is tax. The present pressure to be serious in tackling tax havens and abuses by the rich may result in greater tacit tax coordination. How far this will go is as yet uncertain. In order to bring down fiscal deficits and public debt, member states need to protect and restore their tax bases. With their tax bases badly weakened by the crisis (of which the UK is a prime example) member states will not want to see further leakage of tax revenues overseas to countries with less onerous tax regimes. Nor in this situation does it make sense to allow business to play off one member state against another or allow blatant tax competition. It may also be necessary to implement an EU-wide carbon tax to supplement the operation of the European emissions trading in order to ensure that the correct market

signals are in place to promote a new wave of low-carbon investment. The era and rhetoric of tax competition may well be at an end. But there will be inevitable rows and tensions between different views of how all this should be done, laced naturally enough with vested national interests.

The ratification of the Lisbon Treaty is likely to result in greater formalisation of the Eurogroup, but with what consequences for policy is unclear. At present, however, there is no sign that the crisis will result in a centralisation of fiscal authority. The French and Germans have shown little interest in such a move up to now. But the EU needs to establish a new consensus on what should be the sound principles of public finance for the period ahead. To say that there is no need for fundamental change in the EU's Growth and Stability Pact is to argue that the EU should take no effective position at all. What might be done? The issue is urgent as several member states, including Britain and Germany, are contemplating significant legislative and constitutional change to their fiscal policy regimes.

Meaningful targets for each member state could be framed on the basis of a sustainable long term debt to GDP position with much greater transparency on whether current fiscal policies are consistent with achievement of the long term target. The key requirement is to agree on rules whereby an adequate portion of the proceeds of restored growth is steadily devoted to reducing national debt, without attempting a fiscal consolidation at such speed that growth itself is stifled. In judging progress towards member state compliance with a revised set of fiscal rules, there is a strong argument to be made that the *quality* as well as the quantum of public expenditure needs to become a guiding principle. Some argue that "social investments" like research, university spending, training and early years education should be protected from fiscal restraint if they can be shown to deliver high economic and social returns. This raises the issue of whether an operational definition of what constitutes "social investment" is feasible.

But there is a bigger question of what will be the wider purpose of new fiscal rules. Leading economists argue that the Euro area, as a zone of low inflation, is one of the areas of the globe that can lead the world out of recession. In this dimension of economic policy coordination, the position of Germany is crucial. With its strong balance of payments and dominant position as the motor of the European economy, Germany needs to be persuaded that a prudent decision to expand its own economy will not lead to significant inflationary risk nor profligacy elsewhere, or

increase the chances that the German taxpayer will be expected to bail out others' mistakes. Berating the Germans about their failure to take the expansionary steps that they could afford is unlikely to yield much success. However, a grand bargain at EU level is possible whereby other member states agree reforms that Germany is arguing for. What might such a package look like? It would certainly include:

- Tougher common rules for financial regulation, including the bonus issue.
- The possibility of greater tax coordination, if not tax harmonisation in certain exceptional circumstances.
- Implementation of a radical EU budget reform to make Structural Fund payments conditional on benchmarks of progress in economic reforms that would need to be agreed individually with member states. Germany as the largest contributor to the EU budget stands to gain from such an approach.

A big political uncertainty is whether the recession will be long-lasting and as a result, whether parts of Europe will be engulfed by a serious social crisis. Much of Europe's impressive employment growth in the "noughties" was in the second tier labour market of insecure jobs with inadequate protections and employment rights. These workers are now bearing the brunt of the recession. The labour market "inner core" remain in a relatively privileged position. As a result will this seem even more indefensible than it was before? This offers the Commission the opportunity to sharpen the debate in favour of a more balanced "flexicurity", which should be the EU's counter to the risk of a reversion to a "work-sharing" psychology.

Would a social crisis – combined with populist outbursts against labour migration in parts of the Union– result in a comprehensive new look at EU social policy? There is undoubtedly a need for more social reforms at member state level, given the manifold social challenges facing Europe – the ever-present threat of protectionism and fear of globalisation; rising unemployment, especially among youths and graduates; the polarisation of labour markets between "lovely and lousy" jobs; citizens in new member states struggling to service debt as their ailing national currencies depreciate – not to mention others. Priority must be given to policies that improve life chances for children and young people to tackle emerging problems of generational inequity. New "social bridges"

need to be constructed to create access to new ladders of opportunity at different stages of the life cycle. The potential risks of polarisation between “winners” and “losers” from economic change and globalisation need to be narrowed: a new focus is needed on better labour market transitions, particularly for the low skilled. Emerging social problems, such as the social exclusion of disadvantaged and child poverty, can only be tackled through sustained social investment.

In particular there are clear policy areas where welfare and labour market systems within member states have not sufficiently adjusted to changing social conditions:

- Insufficient early years investment in young mothers and babies to overcome embedded disadvantage.
- Too many school leavers not in employment, education or training: new initiatives are needed to reduce early school leaving, make up the ground for young people whose schooling has let them down and lessen the risks of delinquency.
- Inadequate routes of progression for the low skilled into apprenticeships, technician grade skills and high quality vocational training.
- Better support for “dual earner” couples to combine bringing up their children well and sustaining their career.
- Fuller integration of migrants into European societies through targeted action to overcome language and cultural barriers and raise levels of educational achievement and labour market participation.

Member states have the main responsibility for the social policy changes that are necessary. But this does not preclude a framework of objectives, targets, incentives and mutual learning that could be set at EU level. An opportunity to strengthen EU social policy is offered by the forthcoming review of the EU Budget. EU Budget funds could be used to realise some key social objectives, including the possibility of some form of minimum income or anti-child poverty guarantee across the Union. The onus of any EU Budget reform should be on the expansion of common policies where the EU can genuinely make a difference beyond the remit of what national policy instruments can realistically achieve at national level alone in

areas such as research and innovation; mobility within higher education; cross-border energy infrastructure necessary for energy security and low-carbon transition, alongside flagship social policy initiatives. One further possibility is that if the crisis is prolonged, demand may grow for a Europe-wide recovery plan based on investment in low-carbon transition, research and skills. This might be financed by the issuing of Europe- or Euro-wide bonds.

### **A new EU political economy?**

At one level, the discourse on the future of Europe will take the shape of a reversion to a familiar pro- or anti-European debate. Lining up on one side are those who feel that in some way the EU offers a shield against the disruptive forces of global capitalism, potentially far wider and thicker than the diminished role that the nation state can now offer: the logic that persuaded the Irish to vote a second time in favour of the Lisbon Treaty and Iceland to apply for EU membership. Ranged against this position are the populists on both the right and left, who see European integration as part of the problem, not the solution. They will almost certainly see a stronger nation-state as a consequence of the crisis, whether in protecting jobs at home, controlling migrant labour, or supporting national businesses in trouble. In addition, there is the possibility that some of the newer member states may feel “let down” by the EU – if they are left to themselves and denied the possibility of early entry to the Euro. This could strengthen anti-EU feeling in some member states unless the EU acts with greater boldness and vision, though this remains highly uncertain.

Among pro-Europeans, the lessons of the crisis may be interpreted quite differently. For ease of understanding these pro-European reactions can be placed into four distinct camps, which to an extent overlap.

- First, “**integrationist interventionists**” will see the crisis as an opportunity and find support for their instincts in the argument, popular on the left, that the crisis brings back the case for a wide range of public intervention in the economy, not just a need for tighter financial regulation but Euro-Keynesianism and more interventionist industrial policies.
- In contrast, “**economic liberals**” who regard the Single Market as a central EU achievement, will only be “market-conditional integrationists”. They will want to consider whether and how EU institutions need to be strengthened as an agency of liberalisation, both internally and in the wider world, in order to better defend,

or indeed re-impose, what they regard as essential commitments to the “four freedoms” of the Rome Treaty and the centrality of the EU’s espousal of the Single Market to its work.

- There will also be some “**market redistributionists**” who would count themselves in the market liberal camp, but would be more prepared to embrace social measures aimed at strengthening political support for open markets, as long as they cause no significant damage to competition, efficiency and dynamism. Significantly, Mario Monti, the archetypal market liberal of his age, has called for a new balance to be struck between market liberalism and redistribution.
  
- Finally there will be “**better market orderers**” who in the classic German social market tradition place heavy emphasis on closer social regulation of how financial markets operate and how business conducts its affairs and exercises its wider social responsibilities. This view gives priority to getting frameworks right and frowns on day to day public interventionism: it is fundamentally about shaping behaviours in the market place not altering market outcomes.

How will these different perspectives play out in their impact on future policy? The fundamental concern that will unite all strands of pro-European thinking is the survival of the euro. For “market orderers” the euro is what binds together the social market they seek to build. For “market liberals and redistributionists” it is the cornerstone of liberalisation without which the risk of fragmentation in the Single Market would grow as member states sought to protect their economies against the consequences of exchange rate instability. For “interventionist integrationists”, the existence of the euro holds out the hope of stronger European economic government. The strength of determination to preserve the euro was demonstrated when at the height of the crisis earlier in 2009 the German finance minister signalled that the euro area should be prepared to take steps to prevent any member country being forced out of the euro by market perceptions of a risk of default on its national debt.

This is not to say that the future of the euro will be without crisis or fierce political rows. No one can tell whether the euro area will one day be confronted with a credibility crisis if the markets refuse to fund the borrowings of an overindebted member state. The Germans (with the support of other richer member states) may be prepared as a last resort to bail other countries out – but this emergency support will not be for

free. For instance, the Irish could come under pressure to phase out the tax rules that are seen to give them an unfairly favourable advantage in attracting US investment. A major uncertainty concerns the speedy enlargement of the euro to all member states (other than the UK) who see it as a safe haven of stability. “Market liberals” will tend to argue that “politics” should not determine “the economics”, though the question of what makes for sensible entry criteria has been thrown wide open by the crisis. “Market orderers” may take a longer term view of Europe’s essential interests, though on strict conditions that the central and eastern Europeans could be forced to follow a disciplined path to Euro membership and curb “social dumping”.

The crisis has strengthened the importance of the role of government at both nation state and EU level. The nation state gains in importance because of the added urgency to reform welfare states and hasten low-carbon transition. Countries like the UK and Ireland need to develop a new growth model as an alternative to their previous dependence on financial services. These are tasks that given the division of competences within the Union, only the nation-state can reasonably fulfil.

Yet, at the same time, the necessity of greater nation-state activism requires a stronger framework at EU level that will make nation state activism effective and to prevent it resulting in “beggar thy neighbour” policies. Nation-state efforts to combat unemployment will be most effective within a framework of EU policy coordination given the scale of the economic spillovers created by European economic integration and the Single Market. Similarly an effective EU framework for carbon pricing is essential if large scale low-carbon investment is to take place. And when it comes to efforts to promote economic development, nation-states and regions must operate within a clear framework of EU rules for state aids and incentives.

Similarly, the debate about regulation of “bankers’ bonuses” is symptomatic of a wider concern that the crisis has intensified: that our economies need to be governed by “fair rules”. This implies that in the years ahead there will be a continuing focus on issues of corporate governance and responsibility. The striking change is how far in the UK the mood has shifted against the “light touch” mentality of Anglo-Saxon capitalism. There is an acceptance of the need for “market ordering” across the political spectrum that simply did not exist before. Although this is as yet unrecognised in UK public discourse, this opens up new possibilities of EU consensus.

## **Markets with rules**

The overall conclusion, therefore, is that the impact of the crisis will be that “market liberalism” loses out and “market orderers” gain the upper hand. This should not lead to a retreat from the promotion of competitive markets or indeed globalisation as a tool of efficiency and a driver of innovation. But it does mean a new framework of “markets with rules” for the future.

More effective coordination of the EU internal economy is the key both to a stronger economic recovery and to more European clout on the global stage. At the same time on the international stage the G20 has emerged as the major player. The main significance of the G20 is positive in that it is a recognition by the rich nations of the G7 of the necessity to embrace the world’s large emerging economies if global decision making is to be effective. But from an EU perspective it re-asserts the role of the EU’s big member states rather than making it essential to develop a single EU voice. The EU needs to become the strongest advocate of greater international policy coordination and macro-economic global governance. This requires taking bold steps so that the EU speaks with a single voice in international financial institutions.

In coming months a heavy responsibility falls on the Commission to exert its Single Market powers and propose far reaching and radical economic reforms, especially on bank failure and recapitalisation; investment-orientated fiscal rules; as well as reformed internal economic governance and the EU’s external representation. There can be no return to business as usual after the global recession runs its course: public policy cannot and will, in any case, be unable to return to status quo ante. Instead, the EU needs to focus with even more urgency on the new economic paradigms of the twenty-first century: economic globalisation, low-carbon transition and the ageing society. Overcoming these immense challenges, in tandem with coping with the long-term impact of the current recession, will require a greater steering role for government. At the same time, this must happen within a strong and credible EU framework, otherwise the EU will succumb to “beggar thy neighbour” policies.

The EU, therefore, needs a new overarching internal policy framework to replace Lisbon – a new socio-economic settlement for the future. This should be based on seven pillars:

- An enlarged euro area that is consolidated as a zone of economic and security for all member states who wish to join.

- A new determination to rebuild and strengthen the Single Market with structural reforms to strengthen competition.
- A stronger framework for macroeconomic coordination that promotes growth and facilitates strictly defined social investments that offer high economic and social returns.
- Moves to single EU external representation in the economic field.
- New EU-wide “fairness” rules for financial regulation, tax coordination and corporate governance.
- A consistent emphasis throughout on sustainability and the promotion of low-carbon transition.
- A comprehensive EU Budget reform that makes EU aid conditional on policy reforms by member states and addresses the twin challenges of demography and globalisation with modern social policies to raise the quality of human capital, increase workforce participation and better integrate migrant and ethnic minority communities.

This framework should acknowledge the need for differentiated approaches toward common goals given the EU’s increased diversity. This is a moment in the history of “Europe” as political project that will test the mettle of the EU’s leaders and challenge the principles of its *raison d’être*. Ultimately, as the recent BRUEGEL memos to the new Commission illustrate,<sup>3</sup> it is a moment that demands strong leadership from José Manuel Barroso as the newly appointed President of the Commission and assuming Lisbon is ratified, the new President of the Council. It is, quite rightly, an “exceptionally difficult task”.

A new capitalism now needs to be built and the EU should play a significant role in building it. The set of distinguished contributions that follows in this publication aims to sculpt this process, outlining its many obstacles but also its manifold opportunities.



# Chapter 2

## **Regulating financial capitalism: the EU's global responsibility**

George Pagoulatos

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The 2008 global financial crisis found Europe unprepared. The EU's regulatory equipment was intended to address different priorities and different risks. It was not designed to cope with such serious cross-sectoral financial contagion and complex cross-border systemic interdependence. The crisis spread with great intensity and speed, from the banking and financial sector to the real economy, and from the directly affected sub-sectors to a global scale. It proved the proponents of unfettered financial capitalism wrong and the critics right. Europe should now be entitled to take the lead from the US in reforming the global financial architecture. Inside the EU, the argument for a more intelligent regulation of finance has gained momentum.

The crisis has demonstrated the advantages of the Eurozone financial area being able to rely on a global reserve currency. Yet, it also reminded us that the EU and EMU institutional architecture was designed for fair-weather financial conditions, and therefore it was inadequately prepared to deal with a crisis of such proportions. Crisis-prevention and regulatory redesign are now gradually replacing crisis-reaction on the EU and global policy agenda.

## **Target financial stability**

The EMU architecture was designed with the objective of safeguarding price stability in the Eurozone, leaving financial stability aside. After a long period of excess financial liquidity flowing in and out of European financial markets, asset price inflation, imprudent accumulation of financial risks and over reliance of financial institutions on leverage, this omission invites renewed interest.

While the euro has crucially contributed to economic and financial stability,<sup>1</sup> financial stability as such has been absent from the macroeconomic models used by the ESCB, and EU central banks in general. Several economists and institutions, including the Bank for International Settlements, have long proposed the need for central banks to target asset price inflation as well, with an eye on preventing asset price bubbles. Moreover, as Paul de Grauwe suggests, since financial stability today also depends on avoiding deep recessions, stabilising the business cycle should also be of concern to the central bank.<sup>2</sup> This might be departing from the Maastricht-prescribed exclusive ECB focus on monetary stability, a field where the ECB has so far demonstrated success. Recent financial developments, however, have shown that a narrow definition of central bank success as confined to price stability is not enough. There is a case to be made for the ECB and other central banks to follow financial sector asset price movements more closely.

The “regulatory philosophy” applied on the eve of the crisis has been shown to be wrong: a systemic crisis can still occur even if bank supervisors ensured individual banks were safe. There is now a shift in emphasis from micro to macro-prudential regulation, focusing on systemic stability.<sup>3</sup> The de Larosière Group<sup>4</sup> has recommended setting up a European Systemic Risk Council (ESRC), under the ECB, comprising EU-level committees of financial and banking supervisors and the Commission, with the task of gathering information on all macro-prudential risks in the EU, and working closely with the IMF, the Financial Stability Forum and G20 at a global level. In late September 2009 the Commission proposed the creation of a European Systemic Risk Board (ESRB) along the lines recommended by de Larosière.

Some believe it is time to revise the Treaty of the EU, to grant supervisory authority and formal lender of last resort capability to the ECB, the only institution in the Eurozone able to issue unlimited amounts of a global reserve currency. Article 105.6 of the EU Treaty provides the possibility of transferring Eurozone financial supervision (except for the insurance

sector) to the ECB, following the unanimous EU27 Council decision. Alternatively, a new separate supervisory institution could be created next to the ECB. Below we briefly examine the competing alternatives.

### **Too big to supervise: integrated markets, fragmented governance**

The regulatory and supervisory status quo is weak both in terms of crisis prevention and crisis management. The structure of financial supervision in Europe is not commensurate with the degree of market integration. It thus fails to ensure the desired efficiency and stability of the financial system. Back in the late 1980s and early 1990s, when the EMU was designed, few banks in Europe had cross-border operations of significant scale. Following waves of cross-border bank mergers and acquisitions, this is no longer the case. Globalisation and financial market integration have resulted in the largest European banks becoming not only too big to fail but also too big to be saved. For example, at the peak of the September 2008 crisis, the total liabilities of the Deutsche Bank equalled 80% of Germany's GDP, Barclays almost 100% of British GDP, and Fortis 300% of Belgian GDP.<sup>5</sup> In 2007, the 46 largest EU banking groups held 68% of all EU banking assets. Of these groups, 16 held at least 25% of their EU assets outside their home country and were present in at least six other EU member states.<sup>6</sup> The failure of the Icelandic Landsbanki showed that under existing single market rules, cross-border depositors as well as taxpayers can be exposed to significant risks. In the case of Landsbanki, UK depositors were rendered dependent on the limited resources of the Icelandic deposit insurance scheme.<sup>7</sup>

European financial market infrastructure, such as clearing and settlement provision, has become increasingly internationalised. This promotes efficiency in good times but encourages contagion at times of crises. The potential failure of large pan-European financial institutions can spread across national boundaries to other member states, as a result of several transmission channels: directly via interbank markets, counterparty risk and investment in financial assets issued by the institution in question; indirectly via abrupt changes in asset prices, liquidity or credit availability, and the impact on GDP or the euro exchange rate.<sup>8</sup> Such combinations were witnessed in the latest financial crisis.

The current regulatory and supervisory fragmentation hampers the chances of effective crisis management whenever a pan-European financial group gets into trouble. Fortis illustrates the weaknesses of defending against a fully-fledged euro-area crisis. Fortis was eventually saved after

Belgium, the Netherlands and Luxemburg nationalised it by pouring in billions of euros. The bank was divided in three, with each section rescued by the corresponding government. With Fortis, this sort of cross-national geographical distribution was relatively easy, but several other large EU banking groups are much more difficult to divide between countries. In Fortis' case, no European solution was possible. The ECB can only provide liquidity against collateral to keep the money market functioning – and indeed has earned praise for the speed at which it pumped cash into a frozen financial system. But the ECB has no powers to resolve a solvency crisis. In the absence of a European Treasury, such operations can only be carried out by national authorities – who are naturally reluctant to pay for the rescue of banks abroad.<sup>9</sup> In the months that followed the outbreak of the crisis, financial protectionism was evident in the reluctance or refusal of EU national central bank authorities (such as those of Austria or Greece) to allow banks to use bailout funds to support their distressed cross-border subsidiaries.

The problem calls for Europe-wide institutional responses. To begin with, pan-European banks should be subjected to fully consolidated supervision (more on which anon). Uncoordinated national responses, resulting from a weak political centre in the Eurozone and the EU, generate negative externalities and regulatory arbitrage. The deepening of integration in the Eurozone and the further development of a single voice for the Eurogroup are obvious necessities. Moreover, in times of crisis, the European Investment Bank could be organised to undertake rescue operations at EU level, by taking up stakes in pan-European financial institutions under stress.

The implications of public debt financing difficulties following the slump underscore the tight nexus of interdependencies within the Eurozone. Southern European governments, for instance, have been hard-pressed to find buyers for their securities at times of excess global supply of government bonds. The no-bailout clause is of little use if the credibility of the entire Eurozone is to be endangered by the inability of a Eurozone member-state to sell its debt, or by a referral of a Eurozone government to the IMF. The proposed issuing of a Eurobond (promoted by President Sarkozy and Eurogroup Chairman Juncker) would significantly lower the cost of public debt financing for member-states under duress. It should rightfully be followed by Brussels-dictated conditionality, to return profligate governments to a sustainable financial position.

In an interdependent European banking system, national-level responses exercise beggar-thy-neighbor effects on neighboring EU banking systems. Such was the case in October 2008, when countries like Ireland and subsequently Greece initially announced unlimited blanket guarantees for all bank deposits, opening opportunities for regulatory arbitrage at the expense of neighboring banking systems. The rapid spread of financial contagion from the US to Europe and the world points to the highly destabilising effects that financial integration and globalisation can have when not followed by corresponding governance structures.

### **The pitfalls of regulatory fragmentation**

In the run-up to the crisis, European markets faced and continue to face a diversity of different rules and supervisory practices. The level playing field is not level at all, thus encouraging regulatory arbitrage. The issue of integrated banking supervision remains unresolved and has been stalled by cross-national differences.

The fragmentation of the EU regime of financial regulation and supervision, which is testament to the cross-national heterogeneity of political and regulatory preferences, suffers from undeniable weaknesses. Information regarding the risk situation of a financial group is not effectively shared among different supervisors. As a result, financial contagion becomes more likely and disruptions emerging in one market can potentially spill over into other markets.

The current system is not effective, and it is not efficient either. As pointed out by Deutsche Bank Research,<sup>10</sup> supervisory fragmentation creates duplication in reporting duties and inconsistent requirements for pan-European financial institutions. Rather than being rewarded for advancing the single market, pan-European banks end up carrying additional burdens. From the standpoint of the European financial market, this is counterproductive as it hinders the global competitiveness of Europe's large financial services companies as well as Europe's financial markets.<sup>11</sup>

Supervisory fragmentation is a problem not only in the cross-national but in the cross-sectoral dimension too. Market integration has blurred the borders between different financial market segments and activities. Many of the largest market players in Europe are financial conglomerates. The recent crisis demonstrated the ease with which cross-border risks accumulated by investment banks can spread to commercial banks,

mortgage banks and the insurance sector. Credit derivatives, structured products and securitisation can transmit credit risk between banking and insurance sectors. Segmentation of supervision by type of institution introduces distortions when various financial institutions perform very similar functions. In several EU countries, however, particular sectors of the financial market fall in a regulatory and supervisory vacuum. There is a strong argument to be made in support of single, integrated, cross-sectoral financial supervision, including the insurance industry, like in the case of the British FSA or the German BaFin.

### **Towards integrated financial supervision**

The existing “Level 3” committees under the Lamfalussy Process<sup>12</sup> have advanced some degree of closer supervisory cooperation. They bring together national supervisors in regular interaction, aiming to generate convergence of cross-national supervisory practices and simplify compliance with regulatory and supervisory requirements, particularly for large pan-European conglomerates. Without a stronger structure, however, such convergence would be very unlikely to emerge. Level 3 committees operate by consensus rather than majority vote, guidelines are non-binding, and tend towards lowest common denominator compromises seeking to preserve national practices. Thus, while a further deepening of Level 3 cooperation would be welcomed, there are clear limits as to the ability of Level 3 structures to overcome supervisory fragmentation.

### ***The “college” solution***

For major cross-border banks (and as an alternative to establishing a single European regulator) mandatory “colleges” of national supervisors have been proposed for European banking and insurance regulatory groups. The college, comprising all supervisory agencies in whose jurisdiction any European financial group has sizeable operations, would be chaired by a lead (i.e. home) supervisor, acting as the single point of contact for the financial group in question. However, this could only provide a solution if the head of the college (home supervisor) has the authority to ensure that its members exercise their separate sovereign powers identically so as to produce the effect of a single regulator for a cross-border group.<sup>13</sup> In other words, the “college” solution can only be effective provided that arrangements are identical in terms of supervisory practice (which would require a “hard” legislative basis such as EU-wide regulation), and that the lead supervisor is equipped with a “buck stops here” authority. However, the initiatives of the lead supervisor are not immune to generating significant cross-border externalities. Most

importantly, the “lead supervisor” regime opens the possibility for different regulatory practices across jurisdictions, violating the principle of competitive neutrality unless some central control is established. Thus the “college” solution is inadequate.

### ***A European System of Financial Supervision (ESFS)***

Regulatory fragmentation can be feasibly addressed by a gradual but speedy transition to a European System of Financial Supervision (ESFS), parallel to the European System of Central Banks (ESCB). Both the Turner Review<sup>14</sup> and the de Larosière Group<sup>15</sup> agree on the need to replace the Level 3 Lamfalussy committees with a new EU independent regulatory institution. The primary responsibility for supervision of individual firms would continue to remain at the national level.

Under de Larosière, the ESFS would transform and upgrade the Level 3 Lamfalussy committees into three new independent European Authorities (for Banking, Securities and Insurance respectively), which would be granted legal powers on the adoption of binding supervisory standards.<sup>16</sup> After a 2-year transitional period, in which colleges of supervisors would be set up under ESFS for all major cross-border institutions, the ESFS would begin to function as a fully fledged integrated independent EU institution, comprising the three authorities. In late September 2009, the Commission finally adopted draft legislation incorporating the de Larosière recommendations; it establishes a European Banking Authority, a European Insurance and Occupational Pensions Authority, and a European Securities and Markets Authority.

The boards of the latter would consist of the chairs of the national supervisory authorities. The three European Authorities would be equipped with their own autonomous budget. Their chairpersons would be appointed for an eight-year term, approved by the Commission, the European Parliament and the Council, and accountable to the EP. Their competences should include legally binding supervisory standards and mediation between national supervisors, coordination and oversight of colleges of supervisors, licensing and supervision of specific EU-wide institutions such as credit rating agencies, binding cooperation with the ESRC to ensure adequate macro-prudential supervision, and a coordinating role in crises.

The ESFS should enjoy institutional guarantees of operational independence vis-à-vis governments, regulators, and other EU institutions, thus retaining final authority for interpreting and implementing EU

financial market rules. The ESFS authority over the European financial system would guard against the inadequacies or “capture” of national regulators. Most importantly, it would ensure the sufficient scale of operation necessary to prevent or effectively confront cross-border European-level systemic banking crises.

The ESFS should be modeled as a single, integrated, cross-sectoral financial market supervisory institution, comprising banking, insurance and securities market supervision under one roof. Integrated financial supervision also makes sense in view of the process towards creating a pan-European capital markets infrastructure, with consolidated stock exchanges, clearance and settlements systems, and so on. Given the desirability of incorporating supervision of the city under a European supervisory scheme, the ESFS has the advantage of being able to play this role better than the ECB, for as long as the UK remains outside the Eurozone.

There are some good reasons for assigning financial supervision to an institution separate from the ECB. According to a familiar argument, a conflict of interest may exist between financial supervision and central banking, in that a central bank may be tempted to loosen its monetary policy in order to bolster the banking system. It is also important that each institution retains a clear and unambiguous mandate that won't lead to conflicting objectives or create risks that might undermine credibility in one area as a result of promoting the other. The information acquired by a central bank's participation in the money market and foreign exchange dealings can be shared with the financial supervisor, in a structure of close interaction between the two and the financial industry, without the central bank having to perform a supervisory function. And successful rescue operations can be performed with the ECB in a central role (coordinating private creditors and public funds) without necessitating a joint supervisory function, which can be carried out by a distinct institution. Finally, a clear division of labour between the ESCB and the ESFS would help ensure a coherent communication strategy, an institution speaking with one single voice to the markets (“one voice policy”), avoiding conflicting messages and mixed signals emitted in situations of crisis.<sup>17</sup>

As the ESFS solution leaves local supervision to national authorities, some have criticised it as an inadequate substitute to a fully-fledged central super-regulator. However, complete regulatory centralisation is not politically feasible; and probably not even desirable either. The ESFS as a structure has the potential to lead to deeper integration. By ironing out

regulatory and supervisory differences, harmonising supervisory standards and reigning on discordant national supervisors, the ESFS could gradually mature into a powerful EU-wide regulator.

### **The ECB as macro-supervisor**

A second alternative would be to assign supervisory powers to the ESCB, an option compatible with EU Treaty provisions. This would also allow the ECB to better pursue the parallel task of financial stability. Article 105.6 of the EU Treaty provides the possibility of transferring prudential supervision of banks and other financial institutions (except for the insurance industry) to the ECB. In such an event the ECB should be assigned full powers of macro supervision. The ECB would not become the sole supervisor of banks but act “within a single institution” with national market supervisors and central banks so that broader financial stability supervision is combined with the day-to-day oversight of individual banks.<sup>18</sup> The distinction between macro and micro-supervision is necessary in order to comply with the subsidiarity principle. From the ECB’s standpoint, the macro-prudential authority has to have access to micro-prudential information and vice versa; an exchange of information that can be better achieved within a single institution.<sup>19</sup> The ECB for its part would be willing to play a role in micro-prudential supervision as well but nobody should expect it to supervise markets.

One obvious weakness with this option is that it is not very favourable for countries, like the UK, who are not in the Eurozone. An additional weakness of the solution of assigning supervisory functions to the ECB according to article 105.6 is that the Treaty explicitly delimits the ECB’s new supervisory role to “specific tasks” related to banking supervision – excluding the insurance sector. This represents an inferior arrangement when compared to a full “blanket” supervisory authority which covers the entire financial system.

### **Regulatory interventions for promoting financial stability**

Regulatory and supervisory policies have a major impact on the size and nature of the information asymmetries involved in the functioning of financial markets. Disclosure requirements for securities, regulatory standards for bank capitalisation, and supervisory practices, all influence and seek to improve the risk/return characteristics of investment.<sup>20</sup> In principle, not only banks but any financial institution subject to systemic risk must be covered by regulation. Highly leveraged hedge funds when moving together as a herd generate systemic risks, thus requiring macro-

prudential regulation – though only limited micro-prudential regulation.<sup>21</sup> The need to regulate applies particularly to financial instruments that have developed systemic significance, such as credit default swaps (CDS). In cases like CDS, over-the-counter bilateral financial transactions should become regulated by a centralised clearing house, with the power to impose trading conditions aimed to ensure systemic stability.

The crisis showed how the alleged benefits of securitisation (efficiency, dispersion of risk, etc) can turn into factors of grave financial disruption. The growth of securitised credit intermediation increased systemic risk in a way that was inherent rather than just a matter of bad execution.<sup>22</sup> Therefore re-regulation of securitised credit is needed, focusing on more simplicity, transparency, and real diversification of risk. Off-balance sheet transactions have been a major source of opacity, concealing risks and liabilities and generating grave systemic instability. All transactions should be incorporated in the bank balance sheets, displaying all the risks undertaken by financial companies.

The recent crisis has offered useful insights into market failures in the functioning of the globalised financial system. Serious principal-agent problems have characterised the behaviour of banking executives. The emphasis on quarterly reporting skews their investment behaviour heavily toward short-term high-return investments, accumulating sizeable future risks for their company and the system at large. Risk management considerations should be closely integrated into remuneration decisions. Bankers bonuses should be assessed in a multi-annual framework, spread over the cycle, or even held in escrow for a certain period, to ensure that profitability is sustainable. The systemic implications of excessive banking bonuses justify regulatory authorities imposing remuneration caps.

Excessive leverage has been a major factor in the recent crisis. Maximum gross leverage ratios and new capital and liquidity requirements should be designed to constrain commercial banks' roles ("utility banking") in risky investment banking activities. Moreover, the current system operates in a procyclical manner, amplifying the effects of expansion as much as those of crises. In fair weather conditions, the evaluation of the risks is too optimistic, the assessment of asset values runs high, and the resulting exuberance leads actors to undertake even higher risks. When a sharp downturn occurs, the reverse happens, asset valuations fall steeply, market actors are led to panic sales and the effects of the crisis are magnified. The "mark to market" system exacerbates procyclicality.

For all its virtues, the Basel II framework has a tendency to function procyclically. The Basel II capital adequacy requirements should be raised by a ratio linked to the growth of the value of each bank's assets. Thus, at times of expansion the capital adequacy bar would be raised, moderating excess lending, and building up capital reserves during boom time in the event of a downturn.<sup>23</sup> Countercyclical regulation should be most constraining at the height of the bubble, breaking away from policies of regulatory laxity and neglect that led to the crisis.

Regulatory supervision must extend to include the “shadow” financial system (major investment banks, private equity and hedge funds, and sovereign wealth funds operating in Europe). The recent crisis demonstrated that a major source of instability in the US was the lack of any regulation in the derivatives industry. As a principle, there should be comprehensive regulatory coverage across the entire financial system, covering all leveraged institutions over a certain size, in order to prevent regulatory arbitrage.

Regulatory initiatives would be incomplete if they failed to tackle systematic patterns of tax evasion that distort actors' incentives and market competition. Following the G20, global government coordination should target offshore companies based in tax havens, a scandalous source of tax evasion and financial corruption, especially since taxpayers money has been invested in the banking system bailout. Offshore centers contribute to draining fiscal revenues and unfairly shifting the tax burden onto the majority of working tax payers and productive enterprises. Europe should lead the efforts of global-level intergovernmental tax cooperation, which should heavily sanction governments and authorities that insist on free-riding by retaining offshore centres. At an EU level, the effort to tackle tax-havens should lead to closer tax coordination. Indeed, the financial and economic crisis in general makes tax harmonisation a highly relevant issue.

Finally, private rating agencies have been heavily implicated in underrating the high risks of toxic investments that led to the subprime bubble and subsequent meltdown, and have also been implicated in serious conflicts of interest. As the role of rating agencies has vital implications for systemic stability and the public interest, it is important to ensure fully transparent methodologies and evaluation systems. The EC has already adopted legislation requiring all credit ratings agencies active in Europe to register with EU regulators and observe demanding rules of conduct. Regulatory

initiatives vis-à-vis ratings agencies would require closer transatlantic coordination, given that many of these firms are based in the US.

## **The global dimension and the road ahead**

Regulatory and supervisory fragmentation prevents Europe from maximizing the opportunities and benefits of its global financial position. The inefficiencies resulting from fragmentation hamper the international competitiveness of European financial services. In addition, Europe's inability to demonstrate uniformly applied supervisory standards prevents European financial companies from accessing foreign markets (such as the US) on the basis of reciprocal market opening based on mutual recognition.<sup>24</sup> Supervisory fragmentation also inhibits a more effective EU leadership role in global financial negotiations and governance.

Institutional weaknesses inside the EU lead to missed opportunities for Europe. Weak institutional structures at a global level prevent better governance of global financial capitalism. At a global level, and in close coordination with the IMF, the Financial Stability Forum (to be expanded and renamed as the Financial Stability Board) should be put in charge of converging international financial regulation to the highest level. Global-level governance must be pursued initially through establishing global colleges of supervisors. Europe should play a leading role in this new global financial architecture. Integrated financial supervision (ESFS) remains a necessary precondition.

We have learned from past financial disruptions that major crises tend to be followed by regulatory waves, with regulation often evolving in a leapfrogging manner.<sup>25</sup> Major crises offer a unique opportunity for history-making policy and regulatory interventions, though one must always guard against over-regulating. However, failing to rise to the challenge of the occasion and falling short of both what is needed and what is expected presents – under current circumstances – an even greater risk.

Europe's globalised financial system has been a source of considerable dynamism and innovation, benefiting the European economy and its position in the world. However, its governance has been left partly unresolved, with grave implications for systemic stability. Either the establishment of a European System of Financial Supervision or, as a second option, the attribution of supervisory responsibilities to the ECB, represent suitable pathways of reform. "More Europe" is needed in financial regulation and supervision, based not necessarily on centralisation but certainly on tighter coordination and integration.

At the same time, well targeted regulatory interventions must seek to align the operation of the deregulated “shadow” financial sector with the interests of the real economy. Meanwhile, imposing greater transparency in the accumulation of risk; countering procyclicality in financial system functioning; aligning the interests of managers to the longer-term interest of their companies; confronting excessive risk creation and remunerations; and preventing some of the market failures that led us into the crisis, are some of the main challenges ahead.

By regulating financial capitalism at home, Europe can offer a viable financial model which is exportable and potentially uploadable at global level, thus claiming the role it deserves in the governance of global capitalism. Financial reform is urgent and long-overdue, and a crisis is a terrible thing to waste.



# Chapter 3

## **Euro area governance and the financial crisis: new quality or flash-in-the-pan?**

Gabriel Glöckler\*

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For years prior to the move to Stage Three of Economic and Monetary Union (EMU) and soon afterwards, it had been assumed, and expected, that the introduction of the euro would lead to further integration in the sphere of economic policymaking, at least among the euro area member states.<sup>1</sup> The facts tell different story: between 1999 and 2007, the institutional and policy evolution of the euro area economic governance framework has been incremental at best.

### **From monetary union to economic union? A demand-supply analysis**

With the introduction of the euro, integration in the field of monetary policy has reached its final destination. A single central bank, the ECB – or, to be more precise: a federally-structured central banking system, the Eurosystem – conducts a single monetary policy, sets interest rates and decides on liquidity management for the euro area as a whole. For the purposes of monetary policy, euro area member countries indeed ceased to exist, effectively becoming constituent parts of a larger entity.

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\* The opinions expressed in this paper are those of the author and do not represent the views of the European Central Bank. Any errors or omissions are exclusively the responsibility of the author. Correspondence: gabriel.glockler@ecb.europa.eu. The author would like to thank Gilles Noblet, Wouter Coussens and Marion Salines for their comments.

Even if membership in a monetary union implies that the participating countries become part of a community with a shared destiny (“*Schicksalsgemeinschaft*”), and despite the fact that EMU has clearly been conceived as much as a political as an economic project, the existence of the euro *per se* has not led to a deeper political desire for further integration, or at least coordination of key management aspects of national economies at euro area or EU level. Applying the neo-functional explanation, further integration would happen “around” the euro, in the specific areas that are required to make the single currency function smoothly. For instance, there had to be common EU rules on the combating currency counterfeiting or the harmonisation of national provisions to prohibit monetary financing or the privileged access of public institutions to credit.

In the neo-functional logic, other macroeconomic policies such as fiscal policy would have been the next policy fields in which integration would progress. Indeed, the Maastricht Treaty and its subsequent revisions laid the foundations for some forms of EU cooperation in economic policy, mainly in the form of “soft” coordination of national economic, structural and employment policies. A large literature exists on the pros and cons, the methods and procedures, and estimated economic and policy outcomes of greater fiscal coordination<sup>2</sup> or even some form of fiscal federalism in the euro area.<sup>3</sup> The underlying rationale for such propositions are mainly economic, notably the need to cope with the externalities created by the sharing of a single currency, the spill-over effects of domestic policy choices across national borders and the avoidance of potential free-riding behaviour.<sup>4</sup>

In practice, macro-economic policy coordination has been limited to the more or less faithful observance of the rules of the Stability and Growth Pact (and its contested revision in 2005). Integrative progress has also been limited in other economic policies: the Lisbon strategy; the much talked-about Open Method of Coordination; the European Employment Pact/Cologne Strategy etc., all seem to have excited observers and academics more than the practitioners who are supposed to implement policies within those frameworks.

One way of looking at this evolution of the economic policy framework is to conceptualise it in terms of the demand and supply factors for integration outcomes.<sup>5</sup> Without entering into detailed explanations about why economic governance in the euro area has not evolved further (this is done more extensively elsewhere),<sup>6</sup> the demand for integration outcomes

was apparently not as compelling as anticipated by some and/or the supply was constrained by various political, institutional, economic and social factors.

The one area where tangible progress in economic integration has been achieved is the financial markets. The functional explanation for this advance lies in the fact that the introduction of the single currency removes a key inefficiency in the functioning of financial markets in Europe: the need to deal with various national currencies. However, while the existence of a single currency may be a necessary condition of integrated financial markets, it is by no means a sufficient one. Indeed, as stressed in various reviews of the state of integration of financial markets in Europe, the integration progress is very uneven across the various segments of the market, with those segments that are closest to the single monetary policy – like the money markets – displaying the most advanced degree of integration. Private sector action that created facts on the ground (e.g. through cross-border banking mergers and acquisitions) and pressure on public policy have generated demand for further integration. On the supply side, an activist pro-integration stance from the European Commission and the ECB has driven progress towards deeper financial integration. The EU's Financial Services Action Plan sought to address the existing obstacles to a truly integrated financial market in the EU.

### **A surge in demand for EU policy action: the response to the financial crisis since summer 2007**

The 2007-2009 financial crisis led, *prima facie*, to a step-change in the demand for integration outcomes, at least among euro area member states.<sup>8</sup> The stresses in the euro money market that occurred in August 2007 – by definition a fully integrated segment of the financial markets – meant that a supranational institution with a commensurate responsibility covering the entire currency zone, in this case the ECB, had to intervene to enable the continued fulfillment of its responsibilities, i.e. to ensure the orderly functioning of interbank money markets across the euro area, in order to guarantee the proper transmission of its monetary policy signal. This task is inherent in the ECB's responsibility for the single monetary policy and its price stability mandate. Problems that emanated from specific financial institutions in certain euro area countries created spill-over effects in other countries due to the integrated nature of the euro money markets, engendering a policy response at the supranational level. In that sense, the functionalist logic drove the first public policy action in the course of the financial crisis. That said, at this stage, the market tensions had

remained relatively contained to specific segments of financial markets, notably the markets for specific structured finance products, and, more importantly, interbank money markets.

This meant that the first responses from European governments were very limited. The crisis initially seemed to be felt mainly in the United States, and its fall-out had so far only affected certain specific financial institutions in Europe, and these were isolated cases. Essentially, the matter was viewed as a private sector issue. If government intervention was deemed necessary, then only in a national framework (e.g. SachsenLB, IKB, Northern Rock), and the extent of the expected macroeconomic impact was highly uncertain, and perceived to be limited.

That said, in seeking to investigate the causes of the turmoil which, via the integrated financial markets, was affecting all EU member states, and to explore possible remedial action, the ECOFIN Council became active and developed a set of “roadmaps” aimed at reinforcing the regulatory framework, financial stability arrangements and crisis coordination as well as supervisory convergence.<sup>9</sup> In addition, an updated Memorandum of Understanding between Finance Ministries, Banking Supervisors and Central Banks (this update had been in the pipeline anyway) was agreed upon to structure crisis cooperation. However, at that stage, further-reaching proposals for an EU mechanism for burden-sharing in the event of a cross-border banking group insolvency were rejected.<sup>10</sup>

All in all, however, these were incremental steps on the way to marginal improvements in EU coordination; towards the establishment of a common understanding of the root causes of the crisis; and towards the design of appropriate policy responses, all very much in keeping with the existing framework of institutions and practices, and without “thinking big” about possible institutional consequences or innovations.

On 14 September 2008, the collapse of the US investment bank Lehman Brothers ushered in a new phase in the crisis. The fact that such a large institution with systemically important links to other financial institutions across the globe was allowed to go bust led to a dramatic collapse in international equity markets, with investor confidence all but disappearing and entire segments of the financial markets becoming completely dysfunctional. The spectre of an imminent meltdown of the entire financial system became a real possibility. This spurred government action of unprecedented scale in the United States, with Congress agreeing

on a USD 800 billion “Emergency Economic Stabilization Act” (the so-called “Paulson Plan”).

Faced with this dramatic situation, European governments – especially in those countries with financial institutions that were particularly exposed to the US financial system – had to react. The Irish government started by announcing a guarantee that would “safeguard all deposits, covered bonds, senior debt and dated subordinated debt” with six Irish financial institutions.<sup>11</sup> While wholly understandable from an Irish political perspective and given the desire to avoid bank runs and a meltdown in the domestic financial sector, this measure ignored the “externalities” of this decision, notably the fact that Ireland, and the Irish financial system, are part of the euro area and EU financial market.

If other EU countries were to announce measures of that type, it would lead to fragmentation of the integrated financial and money markets: savers would naturally withdraw their savings from banks in countries where these are not guaranteed by the state and channel them to banks in countries where they are. This type of government action would also spill over to other segments of the financial markets beyond retail banking, because banks whose deposits are backed up by a state guarantee exhibit a different risk profile, and thus differentiate themselves from other counterparties in financial transactions.

This, in turn, could lead to financial institutions selecting their counterparties on the grounds of nationality, e.g. banks only lending to Irish banks (as these had a state guarantee), and shunning counterparties from countries which did not provide such guarantees to their banks. The latter banks, in turn, would run into problems, and ask for guarantees from their governments. If this example were to be repeated – thus unleashing a vicious spiral of financial sector “beggar-thy-neighbour” measures – the integrated financial market would re-fragment and renationalise into individual national financial markets.

This was, then, the first channel of functional spill-over, engendering a coordinated response: the proper euro area-wide functioning of money markets had to be ensured so as to shore up EMU – what was needed was a defence of the state of financial integration already achieved. In other words, it was a matter of safeguarding the degree of negative integration attained, rather than any proactive integrative steps to tackle the crisis (positive integration).

The second channel of functional spill-over derived from the specificity of cross-border financial institutions: in situations of distress, it becomes exceedingly difficult to determine whether financial institutions are temporarily illiquid but fundamentally solvent, or whether liquidity problems are a reflection of underlying insolvency. Whereas the former can be remedied by emergency liquidity provision by central banks, the latter is a matter for national governments: propping up ailing banks requires taxpayers' money, and therefore a quintessentially national task. Bank rescues are, however, a form of state aid and hence might undermine the level playing field in the internal market and therefore require a policy response from the centre.

The third channel was the sheer size of the liabilities of the financial institutions concerned, making them not only “too big to fail”, but also “too big to rescue” for those banks' home countries alone (the liabilities for Fortis, for example, amount to a multiple of Belgium's GDP). The budgetary resources allocated to the supranational level (EU budget) were way too small, meaning that the affected governments needed to seek a cooperative EU-level solution as the only way out.

In recognition of these functional necessities, the ECB and the Commission called for a coordinated response on the part of EU governments. In fact, no matter what the precise measures were, and without judging their specific merits, it was clear that whatever EU governments did, they had to do it together. Or as Commission President Barroso put it, it was a matter of “either swimming together or sinking together.”<sup>12</sup>

The first Paris summit, convened by French President Sarkozy on 4 October 2008 and involving the European G7 countries (Germany, France, the UK and Italy) as well as the European Commission and the ECB, sought to devise a European position before the G7 meeting on 10 October 2008. However, little in the way of a substantive agreement beyond declaratory politics was achieved.<sup>13</sup> In fact, an earlier, more substantive Dutch proposal for a so-called “European Stabilisation Fund” (mirroring, to some extent, the US initiatives), which would consist of contributions of individual Member States, and amounting to 3% of EU GDP, was explicitly rejected. In other words, the demand for a coordinated EU-level policy response was not seen as sufficient to engender supply.

This changed with the further intensification of the crisis in the week prior to the G7 meetings. On 12 October 2009, a second Paris summit was called by President Sarkozy, this time involving the heads of state of all euro area

countries, the presidents of the European Commission and the ECB as well as the British prime minister (for parts of the meeting). This time, a European response was agreed upon.<sup>14</sup> There are several reasons why, within the span of a week, the demand for a coordinated EU response had risen:

- First, it was obvious that financial markets did not distinguish between national markets any longer – especially not in the euro area. The relevant indices across euro area countries were plummeting in sync, regardless of the specific situations in individual countries.
- Second, after the bold US government action (the “Paulson Plan”), the financial markets expected “the Europeans” to come up with an answer to the problems generated by the market tensions for the financial institutions in Europe.
- Third, there also was a clear understanding among EU governments that the confidence effects of a common approach were significant, and that these effects would be larger the more “Europe” a package of measures contains – a sort of “shock-and-awe” strategy for financial markets through the sheer size of the joint action. In other words, the effects of a common EU package would be larger than that of the sum of its (national) parts.

The answer provided by the Paris Summit was a euro area umbrella of guiding principles and common intentions for the design of national responses with a view to upholding the common market and level playing field.

But was it a genuine EU response? On the one hand, the set of measures that was agreed upon can be called an EU response because the French Presidency managed to stick the EU label on the outer wrapping of a package that mostly contained a collection of national policy measures. On the other hand, however, the package was not actually an EU response that would conform, strictly speaking, to the *méthode communautaire*, involving a Commission proposal which is thoroughly discussed by the various layers of the Council machinery, or possibly even seen by the European Parliament. Rather, the measures of the Paris Declaration were very much driven by national governments. The Commission was essentially sidelined in this initiative, though it provided support via its existing infrastructure for cooperation among governments.

But even so, the depth and intensity of the cooperation among EU, and especially euro area, governments in designing the measures outlined in the Paris declaration, and the recognition of the necessity of a common response and the willingness to achieve agreement testify to a new quality of cooperation in the EU.

As the financial crisis deepened and broadened and affected the real economy, the cooperation mode that had its start with the Paris Declaration continued, even if the immediate stress level and crisis management context abated. In their efforts to deal with the fall-out of the crisis, in designing policy measures tailored to national needs and domestic financial institutions (e.g. in the form of government guarantees, recapitalisations or asset relief schemes), and in spending their own taxpayers' money, the member states accepted a considerable limitation of their national sovereignty. In other words, the interdependence created by the financial markets, especially during the period of turmoil, has created a demand for a new level of economic policy coordination thus far not seen in the EU, which – lest governments were willing to risk a financial meltdown – needed to be met by a new quality of economic governance in the euro area and the EU.

### **Beyond the crisis response: permanently deepened integration or back to “business as usual”?**

Is this unprecedented level of cooperation and coordination across euro area countries in dealing with the fall-out of the crisis a step change in European integration, leading to a permanently higher level of integration and policy interconnectedness? Or is it merely a flash-in-the-pan, a crisis-induced peak in intergovernmental cooperation, after which levels of EU interaction will fall back to more “normal” levels? After all, as Lord Turner lucidly exposed, the answer to the challenges thrown up by the crisis is “either less Europe, or more Europe”.<sup>15</sup>

### ***Why “more Europe” could be here to stay***

The arguments in favour of “more Europe”, i.e. that the new level of EU integration is here to stay, can be supported, *inter alia*, by six reasons related to the demand for, and supply of, more integrated policy outcomes. On the demand side, various factors call for coordinated EU responses:

### ***It isn't over yet***

It is premature to speak of a crisis-related peak in EU economic integration, because the crisis is not over; and, in all likelihood, will not be over for a considerable period of time. Recently, in fact, the heightened

intensification of the crisis in the wake of additional massive losses by banks, which led to the design of asset relief schemes (e.g. “bad banks”) with large budgetary repercussions, has led to further coordination on how to design such a scheme.

### ***Markets call for a coordinated macro-response***

The financial markets continue to call for a pan-European response to economic and market developments. The co-movement of share prices and interconnectedness of financial sectors as well as the synchronisation of business cycles are evident facts which lead market participants, analysts, observers, and the media to view purely national solutions as suboptimal, and pan-European policy responses as superior outcomes. After the announcement of the Paulson Plan in the US, the markets called for a “European” rescue plan, thereby de facto treating the EU – or, at any rate, at least the euro area – from the perspective of market expectations, as a political entity that should be capable of decisive and unified action in ways comparable to a nation-state.

### ***Crisis resolution measures require further coordination***

The follow-up to the coordinated response to the crisis – notably the measures necessary to implement the decisions of the Paris Summit, require a similarly coordinated response at the EU level to sustain a level playing field. Certain aspects of the national rescue packages, like the pricing of government guarantees for banks’ new debt issuance or the features – and especially the pricing – of national governments’ recapitalisation measures for their own troubled institutions call at least for common guiding principles in order to avoid distortions to competition or other detrimental effects on financial stability which are easily felt across national borders. At the same time, there seems to be a permanently increased willingness to supply coordinated responses.

### ***Acceptance of the joint management of the consequences of the crisis***

It could be argued that the acceptance of the purely functional argument about exchanging more information concerning the economic and financial situation in the various Member States – in view of their manifest or expected cross-border impact – has created a new culture of cooperation, in which certain ideas for common action which previously would have been complete taboos, like a EU-wide fiscal stimulus package, or summit meetings of euro area Heads of State or Government, increasingly become acceptable, or at least joined the mainstream discourse about economic

governance in the EU and the euro area. For example, the European Commission's proposal for a coordinated EU-wide fiscal stimulus programme worth € 200bn – an unthinkable suggestion only a few years ago – found the support of the European Council.

### ***Learning processes for national policy design***

Despite notable differences across member states concerning:

- the starting positions and structures of national financial systems;
- the features of national financial market instruments and conventions;
- the degrees to which financial institutions and national economies are affected by the turmoil; and
- the extent of public support for government intervention in the financial sector.

Domestic policymakers have been part of a mutually beneficial learning process in designing the measures to resolve the crisis. One clear example is Gordon Brown's rescue plan of October 2008, which served as a blueprint for the EU-wide consensus on how to address the crisis. Also more recently, national measures in a number of member states have evidently only been designed after some countries have "shown the way" (e.g. guaranteeing bank deposits) or EU bodies have laid down common principles which have informed and guided national policy measures (e.g. pricing of recapitalisations).

### ***Demonstration effect shows the benefits of coordinated EU response***

The vigorous and effective response of the one financial authority with the responsibility and capability to act within, and for the euro area as a whole – the ECB – has undeniably demonstrated what unified supranational decision-making, combined with real leadership and adequate resources can achieve in the face of the worst financial crisis in decades. Similarly, the obvious and measurable confidence effect of using the common EU label for the set of coordinated national rescue packages outlined at the Paris and Brussels Summits confirmed the beneficial impact of bringing national policy initiatives under the EU umbrella. Against the background of this experience, the notion of a similarly effective and forceful EU-level framework for financial supervision is now clearly an idea whose time

has come. The convocation by the Commission of an expert group led by Jacques de Larosière,<sup>17</sup> which fed into a set of Commission proposals<sup>18</sup> to reform financial stability arrangements in the EU, by creating a European System of Financial Supervisors (ESFS), as well as a European Systemic Risk Board (ESRB) under the auspices of the ECB, and which has since been accepted by the European Council of June 2009,<sup>19</sup> bear witness to the willingness to pursue further significant institutional innovation.

### **Why it might be back to “business as usual”**

That said, there are also a number of factors which suggest that the crisis was indeed a high-point in European economic cooperation, and that once the crisis abates, “business as usual” will return to economic governance in the euro area and the EU as a whole. It could even be argued that “less Europe”, i.e. a reaffirmation of national policy action over EU-level responses is the answer to the challenges of the crisis. At least six arguments could be made why the elevated level of cooperation will not last:

#### ***Leadership mattered but was coincidental***

Most observers agree that it has been a case of serendipity for Europe and the world that the intensification of the financial crisis fell into the period of the French EU presidency. The actions – and activism – of the French presidency attached the formal EU label to the various national policy responses and brought them under the EU umbrella. It would seem likely that if the crisis had happened under a different presidency, the policy response would probably not have been very different in substance. It would in all likelihood have been a big power (European members of the G7) or a euro area response; it would have happened anyway – just simply not under the EU label. It has been a fortunate coincidence for the EU, but should not be mistaken as a reflection of the EU’s enhanced strength, the relevance of its institutions or inherent capacity of action.

#### ***Ad hoc responses worked***

It is fair to say that the EU, with its current structures and procedures, fared reasonably well in dealing with the crisis. Existing institutions, fora and cooperation methods functioned relatively smoothly and reasonably effectively. Nevertheless, the ad hoc solutions created within the EU framework all demonstrated that the EU is capable of handling extraordinary situations. If that line of argument is accepted, then there should be no need for a permanent increase in the supply of enhanced integration outcomes, especially once the “normal” times return. Indeed, as the discussions on the review of the financial supervision framework

in the EU show, authorities at the national level – which are set to lose power and influence within a more supranational setting – are engaged in a broad rearguard action and continue to advocate national solutions combined with some strictly limited EU-level coordination as a sufficient and workable response to the problems thrown up by the crisis.

### ***The “EU label” on the box, national measures inside***

A closer scrutiny of the measures agreed at the Paris Summit reveals that the supposedly European measures were little more than a set of rather general framework principles, within which the Member States were free to devise their own measures. In some cases, not even basic elements of common agreement, e.g. a common minimum guarantee of depositors’ funds, could be achieved. Even the initial (Dutch-inspired) idea of an EU-wide recapitalisation fund was in fact a misnomer, since it merely represented a compilation of national commitments, which – in their totality and enhanced by the EU label – were to be “sold” as an “EU rescue package”.

### ***The policy substance – “tax & spend” – remains quintessentially national***

Regardless of the EU coordination processes that might have had an impact on the timing and presentation of national policy responses to the crisis, the very substance of government interventions to reign in the crisis remains fundamentally a national prerogative: the spending of public money. Whether it concerns state guarantees for emergency liquidity assistance for illiquid, but overall solvent, financial institutions; or the assistance to otherwise troubled banks via recapitalisation or other measures, or fiscal stimulus packages for the macro-economy: the policy responses call for public expenditure – taxpayers’ money. The public discourse on such spending remains quintessentially national. Indeed, the explicit exclusion of fiscal burden-sharing in the event of serious problems of particular financial institutions has been made the sine qua non of any British agreement to the (limited) reforms of the European supervisory framework agreed at the June 2009 European Council.<sup>20</sup>

Moreover, also on macroeconomic policy, the appetite to spend public money for European causes remains distinctly limited, even if certain not insignificant amounts were made available to Member States in need via the EU financial instruments (the so-called Medium-Term Financial Assistance and special lending from the European Investment Bank). The aforementioned initial proposal for an EU-recapitalisation fund, by simply combining national contributions, was based on the underlying premise that national funds should not be spent on rescuing other countries’

financial institutions. More recently, the Commission's proposal for an EU-wide fiscal stimulus has been shot down by finance ministers who insist on national measures, which, at most, should be aligned to an EU wide "menu of options."

### ***Financial crisis was special, other policy areas are different***

The nature of the financial system – its increasing interconnectedness across borders, and its fundamental importance for the functioning of the modern market economy – mark it out as a special sector of the economy. Financial globalisation in general, and European financial integration in particular, created increasing vulnerabilities and mutual dependencies between financial institutions, markets and infrastructures across national borders. In addition, the contagion effects created by complex structured finance products that are capable of transferring risk across financial institutions and markets, and the immediate impact of systemic pressures across countries all implied that the fall-out of financial market pressures or the failure of a systemically important institution in one country was rapidly felt across other countries. The result was a congruence of direct and indirect pressures on policymakers to (re)act, and to do so in a coordinated manner. Incidentally, similarly common shocks in other sectors that seemingly affect all member countries equally do not inescapably engender similar pan-European responses. The debate over the EU ambitions on climate change (and, crucially, their financing) provides a case in point. Precisely because financial markets are "special", the European cooperation experience from the ongoing crisis cannot be generalised.

### ***Crisis showed limits of European solidarity***

The various government and central bank actions to stem the detrimental impact of the financial crisis, while purportedly demonstrating the capacity of the euro area – and other advanced economies – to look after themselves, also revealed the limits of the willingness to extend such solidarity to other parts of the EU, notably the new Member States. The slow response in extending assistance to countries in particular distress, such as Hungary, Latvia, Bulgaria, Poland, but also EEA member Iceland, and the insistence on joint actions with other international institutions (like the IMF), clearly displayed that the scope and depth of European cooperation has its limits.

All these arguments relate, mainly, to the supply side of coordinated policy responses at EU or euro area level, which shows that this supply is evidently limited. It is, however, reasonable to forecast that demand

factors will remain prevalent and become increasingly pressing. It is this assessment which informs the answer to the concluding question: on balance, which set among the above 12 factors are likely to have a greater impact on the future development of economic governance in the euro area and the EU?

### **“More Europe” in practice: *ad hoc* intergovernmental cooperation or institutionalised deeper integration?**

Developments in the financial markets and the real economy over the past months suggest that the demand for coordinated economic policy action at EU or euro area level is likely to remain a persistent pressure. In other words, the centripetal forces in European integration are alive and their dynamics will push in the direction of more integration outcomes. Even if the supply side presents more question marks – and certain centrifugal forces, for instance, in relation with the preservation of the level-playing field in the internal market are clearly discernable – there are reasons to believe that supply will eventually catch up, not least for functional reasons.

The evolution of integration outcomes is likely to manifest itself in two dimensions, notably the well-known categories of deepening and/or widening of integration. Specifically, the financial crisis is set to have a lasting effect on the *content* of the euro area governance framework (in terms of deepened, institutionalised integration in specific policy fields such as financial supervision, or changes in the decision-making processes). At the same time, the crisis is set to have an effect on the *widening* of the scope of deeper monetary integration, that is, the membership of the euro area. In one word, “more Europe”, and not just in economic governance, is likely because:

### ***Dealing with the new “inconsistent trio” is a structural necessity***

First, financial integration in the EU and in the euro area in particular, has created a new (functional) “trilemma”.<sup>21</sup> Integrated financial markets in the EU/euro area, a stable area-wide financial system and maintaining national tools and competences for supervision and crisis management and resolution, are mutually incompatible. Attaining all three objectives simultaneously seems impossible, as the current crisis has amply manifested: whenever national measures attempt to restore financial stability, they risk re-fragmenting the common financial market; integrating financial systems at European level without concomitant Europeanisation of supervisory and crisis management tools risks financial instability; and

the stability of a truly integrated European financial system cannot be safeguarded as long as supervision and crisis management is fragmented along national lines.

This “inconsistent trio” is structural – it is here to stay – and its resolution will require “more Europe”, lest the benefits of stable and integrated financial markets will be renege. In fact, the increasing inadequacy of existing arrangements and the underlying centripetal dynamics at work are already evident when looking at the evolution of the EU financial regulatory and supervisory framework over the past years: from little or no cooperation among national authorities at the beginning of the millennium, to the Lamfalussy procedures and Level-3 Committees<sup>22</sup> set up in 2003, which essentially served as consensus-driven discussion fora to the 2009 Commission proposals turning these Committees into European Supervisory Authorities within an European System of Financial Supervision.

### ***Creating solid institutions is better than ad hoc arrangements***

Second, the argument in favour of structural, i.e. institutional, change (such as the ones to be introduced by the Lisbon treaty) has been reinforced. For instance, the crisis has revealed benefits of a more permanent EU presidency, especially with a view to the Czech presidency in the first half of 2009 which was anticipated with a certain degree of nervousness. The creation of the new financial crisis management cell, the agreed framework for more integrated European financial supervision to prevent future crises, all provide evidence that the *status quo ante* in economic governance is not perceived to be a viable option. Moreover, the Lisbon Treaty, once it enters into force, will offer further possibilities to reinforce economic governance both for the euro area and the EU as a whole.<sup>23</sup>

A key question remains how these possibilities are used – for integration along the lines of intergovernmental cooperation or supranational centralisation. More specifically, this question also hangs over the coming institutional reinforcement of European financial supervision: what will be the precise nature of the new bodies? The new ESRB under the auspices of the ECB, for instance, could in practice turn out to be a cacophonous talking shop of parochial national interests; at the same time, the ESRB can be designed to have the potential to produce policy recommendations with real consequences by building on the supranational routines of the central bankers (who are also members of the ECB’s decision-making bodies) and by leveraging the reputation of the ECB as an effective

centralised decision-maker. Similarly, the new European Supervisory Authorities may risk yielding only incremental improvements compared to the functioning of the existing Lamfalussy Committees, although they also have the potential to develop into effective, if at that stage embryonic, EU-level regulators and supervisors.

### ***Being inside the euro area is an insurance policy***

Third, the single currency has shown its ability to shield the economies and financial systems of the participating countries from the storms of the financial crisis. This has raised the attractiveness of euro area membership for a number of countries still outside the single currency zone.<sup>24</sup> The option of “staying out” revealed its inherent economic costs, which became tangible and measurable in terms of higher interest rates, more elevated risk premia, or exchange rate volatility. As these concrete costs of “splendid isolation” start to show-up in monetary terms, they seem to be accelerating a rethink of euro area entry not only in Denmark but also in other non-euro area EU countries.

A case in point is the complete turnaround of Icelandic opinion on EU and euro area membership and that country’s recent formal application for EU membership. The realisation that the combination of “small country, small currency, big financial sector, small fiscal firepower” (such as the cases of Iceland, and to a certain extent, also Britain) is unsustainable<sup>25</sup> is likely to find its way into public debate and policymaking. In other words, when the sea gets rough, it is better to be on a big boat than a small vessel. Thus, “more Europe” in the sense of wider coverage of complete monetary integration is likely. Therefore, in the medium to longer-term context, the distinction between euro-ins and -outs is likely to become increasingly obsolete. For instance, the debate as to whether any institutional innovation – such as the new framework for financial supervision (ESFS/ESRB) – should be exclusively geared towards the needs of, and apply to, euro area countries, might be pressing, for reasons of political advantage in the immediate future, but, in a longer-term perspective, it is a temporary one. Within the coming decade, it can be expected that almost all current (and some future) EU member states will have joined the euro area, leaving the United Kingdom and a small number of countries outside.

## ***Putting a European “stamp” on the new global financial architecture***

Fourth, the current global reform agenda to reshape the regulatory architecture of the world economy can only be effectively influenced by the Europeans if they speak with a stronger voice, that is, with a single voice. At a moment when the institutions of global economic governance are being redesigned to take into account the rebalancing of the world economy in favour of emerging markets, a cacophony from the European side in discussions would condemn the EU to a spectator role that is not commensurate with its economic weight, its political clout and the intrinsic interests not just of the EU as a political entity, but of each of the Member States individually. The G20 process launched by the Washington Summit in November 2008 laid out a broad reform agenda, EU countries – and particularly the euro area countries – now need to agree on a common position to make sure this G20 negotiations stay on track and progress in line with their preferences.

### **“More Europe” is here to stay**

It is apparent that “more Europe” is the likely answer to the current economic and financial crisis. And this answer can be expected to involve – and indeed necessitate – structural institutional change. Of course, whether or not the new quality of integration outcomes in Europe will have a distinctly intergovernmental feel to it – i.e. a continuous and dominant involvement of national authorities – or increasingly follow, in the long run, the supranational route – with stronger central institutions and majoritarian decision-making, remains to be seen. On this, the jury is out. But whatever the outcome, the future is “more Europe”, not “less Europe”.



# Chapter 4

## **The EU budget: “not fit for purpose” but change is afoot, gradually**

Alan Mayhew

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The European Union budget is “not fit for purpose” in the global age. Its critics are numerous, from the European Parliament, across government and amongst economists, lawyers and political scientists. The criticisms are clear: First, instead of supporting new policies tackling future challenges, the budget supports a low productivity sector, agriculture, and relatively poor regions in rich countries; Second, large budget rebates to relatively rich countries, together with side payments, agreed to obtain unanimity in the Council, severely limit transparency and equity in the budget; Third, policymaking in the Union is plagued by the net budget balance concerns of member states; Fourth, the Union’s own resources are in fact transfers from the member states, which divorce the budgetary authority from the taxpayers, and which, in the electoral process, therefore divorce European parliamentarians from responsibility for expenditure; Finally, the medium-term financial framework of the Union is not subject to influence from the European Parliament and severely limits flexibility in the budget to tackle rapidly changing policy requirements.

Identifying these problems is naturally far easier than curing them. The great difficulty is the need for unanimity amongst the 27 member states to make serious changes to the annual budget and the financial framework. While the overall budget is less than 1% of EU Gross National Income

(GNI), the interests of the member states are so divergent, that negotiation exhaustion frequently sets in before changes can be agreed.

Some critics argue that the size of the European Union budget is simply too small for its ambitions of political union. However in the middle of the greatest financial crisis since the Second World War, this particular criticism has largely been put on ice.

### **The characteristics of the EU budget**

The European Union budget, unlike the budgets of its member states, cannot project either deficits or surpluses; budget revenue is raised simply to equal budgetary expenditure. Even investments are treated as current expenditure, which has to be met by own resources.

The only budget recognised by the current treaties is the annual budget. However, the annual budget has to conform to the medium-term financial perspective, which is usually decided for a period of seven years. The financial perspective therefore establishes a degree of financial discipline in the annual budgets, because, unlike many national medium-term financial plans, it creates legally agreed ceilings for the different categories of expenditure which are identified. While the negotiation of each financial perspective takes around two years and is accompanied by loud contestation between member states, its existence appears to have made the agreement of annual budgets a rather smooth operation.

Institutionally the financial perspective and the annual budgets are dealt with in radically different procedures. The financial perspective is decided unanimously by the Council. The European Parliament always tries to influence the decisions on the financial perspective but in the past it has had little impact. However the implementation of the financial perspective is governed by an inter-institutional agreement through which the Parliament, the Council, and the Commission agree on the rules of its operation. The annual budget is proposed by the Commission and then passed to both the Council and the Parliament, with the Parliament having the decisive vote on non-obligatory expenditure and the Council on obligatory expenditure (expenditure on the CAP, on international agreements and pensions). The EP's role in the approval of the annual budget is one of its most important powers in the Union's institutional arrangements. Ratification of the Lisbon Treaty would increase the power of the Parliament both through the abolition of the distinction between obligatory and non-obligatory expenditure, and through the requirement

that the Council obtains the consent of the Parliament for the approval of the financial perspective.

The overall limit to the size of the budget is decided by unanimity in the Council, without the participation of the other Community institutions. The current limit is 1.24% of the Union's GNI. However the present size of the budget, in payment appropriations, is less than 1% of GNI (0.89% in 2009), leaving a considerable amount of head-room below the own resources limit. In fact the annual budget has declined in size as a proportion of GNI since 1993 when it was 1.21%, and actual spending has been considerably lower than that foreseen by the annual budgets. In nominal terms of course there has been a steady increase in the size of annual budgets, reaching €134 billion in 2009 (commitment appropriations). The EU budget is therefore at the same time small in relation to public spending in the Union (approximately 2%) but quite substantial in nominal terms.

The resources required to implement the agreed expenditure, so-called "own resources", consist mainly of transfers from the member states based on the size of their gross national incomes. Traditional own resources, that is to say customs duties and certain agricultural duties as well as the VAT-based own resource, now account for only 33% of the required resources, the remainder coming from the GNI-based resource. Thus only a relatively small proportion of the resources needed to meet planned expenditure come automatically to the Union and are therefore "own resources" in the strict sense.

## **The current structure of the EU budget**

### ***Expenditure***

It is a well-known fact that, however the budget figures are presented, around 80% of the budgetary funds go to finance agricultural spending and cohesion policy. In the 2009 budget, agriculture, fisheries and rural development accounted for 42% of commitment appropriations. Cohesion policy amounted to a further 36%.

It is certainly true that the Union has made an attempt to reduce spending on the Common Agricultural Policy over several years. In the 2008 budget for instance narrow agricultural expenditure was the only major budget line to decrease over the previous year. Indeed, expenditure on agriculture in the current financial framework is expected to increase in nominal

terms only very slowly and as a percentage of total commitment appropriations is expected to fall from 36% in 2007 to 32% in 2013. However a large part of the expenditure on rural development, the second arm of the Common Agricultural Policy, goes to farming. This expenditure has increased rapidly over the last few years as it has been realised that the development of rural areas is a key to a healthy farm economy.

Cohesion policies, designed to support the less prosperous regions and member states, account for around 36% of total budget commitments throughout the whole period 2007 to 2013. This allocation still contains a large proportion of funding for regions in the EU-15, some of which is transitional funding which will run out before the end of the current financial perspective. This suggests that cohesion policy funding could fall in the next financial perspective, both in nominal terms and as a percentage of total funding, although the accession of Turkey would undoubtedly lead to a move in the opposite direction. Spending on cohesion, like that on the CAP, has come under attack from some of the net contributors to the budget, because a large share of the funding is still going to regions in rather rich member states.

Around 6% of the annual budget is spent on administration, including staffing and pension costs.

The most important policy areas for the future of the European Union share the remaining 15% of the budget. This includes those policies considered essential for the future competitiveness of the Union, such as research and development, education and training and energy and transport networks, the burgeoning area of freedom and security and justice, EU foreign and neighbourhood policy and of course climate change. Union activity in all of these areas is increasing at a considerable rate, but this is not reflected in the budget. These policies are also those for which majority support can be found amongst the citizens of the member states.

The structure of the budget and of the financial framework depend partly on the rules under which they are drawn up, some of which are extremely complex. Apart from the normal distinction between payment and commitment appropriations, until the Lisbon Treaty is ratified, the budget still differentiates between compulsory and non-compulsory expenditure. This insulates CAP spending from effective parliamentary criticism. The budgetary treatment also is conditional on the competence of the Union to act in certain fields. The Common Foreign and Security Policy is an

example. As the policy is essentially the competence of the member states, there is only limited EU budget support. Interestingly when a joint action is agreed, the member states prefer to use the EU budget line rather than making the logically more correct charges on national budgets!

There is little rationality to the budget structure; claims on it have arisen over the years without any serious thought to the logic of budgetary support.

### ***Own resources***

The resource side of the budget is even more complex thanks to the way in which contributions are raised and to the compensation mechanisms for member states which feel that they are contributing too much. The vast bulk of the resources are not “own resources” in the strict sense of the term. Indeed there are many who feel that the budget does not respect the Treaties in this respect. After the true own resources have been assessed, a share of VAT is transferred to the EU budget and the remaining requirement is contributed through a GNI key as explained above. These national resources are transferred by the member states to the EU budget through the specific decision-making processes in force in the member states.

However those countries which do not benefit from EU policy expenditure but contribute in a major way due to the GNI resource are unwilling to exceed a certain net contribution. The British budget rebate (abatement) was the first of these reductions in contributions, but subsequently Germany, the Netherlands, Austria and Sweden have also benefited from a rebate on their contributions to the British rebate. This makes the resources side of the budget extremely complex.

### ***Net budgetary positions***

Whatever budgetary system is used, member states will calculate their net positions – the difference between what they contribute to the budget and what they receive from the expenditure side. For many years the Commission attempted to make this calculation difficult and certainly did not speak about it in public. Today the Commission publishes figures annually as a matter of course and the figures are used by different member states to berate the Union because either their net position is too negative or not positive enough.

Net balances are however a problem because they often determine policy outcomes in the Union. Each member state when confronted with a new

policy proposal asks itself what the budgetary impact of that policy will be for its net contribution to the Union budget. This means that policy which may be important for the future development of the Union is voted down because it has negative net budgetary implications for a few member states.

## **A critique of the current EU budget and financial framework**

Budget expenditure goals have been criticised by a large number of independent economic institutions, most particularly by the “Sapir Report” which was commissioned by the EU Commission itself and which has come to be a point of reference for those interested in budget reform.<sup>1</sup> The basic criticism is that the EU budget supports mainly a sector, agriculture, which is one of the least dynamic in the Union and cohesion funds go to countries which are not poor – roughly 45% of the funds allocated in the period 2007-13 will go to the EU15. On the other hand the sectors and the policies which are important for the future of the Union are barely supported.

Logically the EU budget should support European public goods and the principle of solidarity established by the Treaties. In budget-speak, expenditure through the EU budget should also show “EU value added”. It would also be sensible to deal with current expenditure separately from investment expenditure.

European public goods are those goods and services which benefit the whole European Union even if the expenditure takes place in only a subset of member states. A typical example is the protection of the external frontier, which serves all member states not simply those with an external frontier. There is for instance a strong argument that Poland should not be expected to bear the whole cost of controlling its eastern frontier because this action is basically protecting Germany, the Benelux countries and the rest of the Community from illegal migration and international crime.

Where it is economically more efficient to support actions at the EU level rather than at the member state or regional level then these actions may best be financed through the European Union budget. This is often a question of scale – an example would be certain forms of research and development, which only make sense if they are carried out on a large enough scale, jointly with the support of all the member states.

There is also little serious controversy about the fact that economic cohesion and solidarity should lead to a redistribution function in the budget. The aim is to ensure that regions which are economically backward should be helped to close the gap with richer and more dynamic regions in the Union. The debate here is less about the principle of solidarity but more about the way in which the principle is being interpreted. Redistribution which is passing money from the EU budget to the richer member states can hardly be considered as a function of the principle of solidarity.

The EU budget should also treat current expenditure separately from investment. At present an EU investment in a project such as Galileo or in the trans-European networks is treated in the same way as a direct income subsidy to farmers. This ignores the fact that the investment will bring a stream of returns over the medium and long term.

Structural weaknesses in the way in which the financial framework is determined are also frequently criticised. Many observers feel that the budget of the European Union should be constructed from the bottom up. This means that the budgetary requirements of agreed policies of the Union should be calculated and the overall level of the financial framework should simply be the addition of these necessary budgetary expenditures. In reality however, recent financial frameworks have been limited by the net contributors to the budget, who have set an upper limit to the expenditure prior to the negotiation taking place—in other words a top down approach.

While the bottom up approach has a clear logic, the reason for the dominance of the top-down approach is obvious. Two of the Union institutions, the European Parliament and the European Commission, have a clear interest in having as large a budget as possible, because both of these institutions are in effect spending authorities but without the need to raise the funding for the expenditure themselves. In the Council of Ministers the net beneficiaries of the budget also have less reason to restrict the size of the budget than the net contributors who will bear the greatest pain from a larger budget. It is therefore clear why the main net contributors stated clearly before the negotiation of the 2007-2013 financial frameworks that they were not prepared to agree a budget above 1% of GNI.

On the own resources side of the budget, there are two major areas of criticism. The first concerns the system of budgetary rebates, which aim to

ensure that a ceiling is put on the net contributions of certain member states. The second is that the “own resources” of the EU budget are not at all own resources but require the agreement of member states which transfer gross contributions to the Union.

The system of budgetary rebates began with the agreement to reduce the contribution of the United Kingdom, because that country benefits only marginally from the main spending instruments of the budget, namely the CAP and cohesion spending, and, at the time of the decision to grant the rebate, the United Kingdom was one of the poorer member states. Later Germany, Austria, the Netherlands and Sweden were given rebates on their contributions to the British rebate. In addition the UK rebate was not applied to most spending on enlargement countries when they joined in 2004. This lack of transparency in the budget is added to by its use to make side payments to countries in order to get them to agree to policy innovation or additional budgetary resources. The result is an incomprehensible and ill-justified mess, which cannot be explained simply to normally intelligent EU citizens.

The argument on providing the Union with real “own resources” (“an EU tax” in Eurosceptic language) is that this would make the budgetary process more democratic, because the Council and above all the Parliament would be held directly responsible by the voters for the use made of EU budget resources. This would mean that both institutions would become more responsible and some of the silly spending would be eliminated, with a consequent rise in the efficiency of EU public spending.

### **How might the EU budget be reformed?**

The criticism of the EU budgetary process is well-founded. However as usual identifying weakness is easier than curing it. What steps are necessary to reach a budget fit for purpose in an EU fit for purpose?

### ***Net budget balances***

There is general agreement that one of the fundamental problems is the question of net budget balances. Clearly one of the first changes which could be made is to create a gross contribution system, which would eliminate this sort of calculation, and the very complex system of budget rebates.

The Commission made a proposal for a system of generalised budgetary compensation during the negotiations of the last financial perspective. This would have set a cap on the net contributions of individual member states; when the level of deficit exceeded 0.35% of GNI, the net contributor

would have received a rebate of two thirds of the excess above this level, the cost being spread across all member states. The proposal was not however adopted by the Council.

Other proposals have been made which attempt to remedy some of the lacunae in the Commission scheme. A proposal by de la Fuente et al. suggests linking net balances rigourously to prosperity.<sup>2</sup> This would have the advantage of separating budgetary proposals from distribution issues. It would mean that all member states' transfers to the Union budget would be increased by a decision to spend additional funds, so that it would attack not only the problem with excessive deficits but also excessive receipts. Such a scheme should make it easier to make a radical assessment of EU policies which have a budgetary impact and where desired to make changes. Under such a system a sharp reduction in expenditure on the CAP would not have an excessively negative effect on the budgetary situation of those countries which benefit from this policy.

The problem with such a proposed radical change is mainly the practical problem of its negotiation. The move to a fairer system, which would allow significant changes on the expenditure side of the budget would mean that some countries would be faced with considerable increases in net contributions; in the case of the "de la Fuente" system for instance, if the same level of redistribution was maintained as at present, Ireland would be a major loser, as would Greece, the UK and several of the new member states, while the big winners would be Italy, Germany and France. And of course any change would have to be supported unanimously. The system might also not appeal to the European Commission and Parliament, which might find it more difficult to persuade the member states to accept the financing of EU wide programmes.

The problem of policy being partly driven by net budget balances must be tackled in the longer term: and the solution like that proposed by de la Fuente et al. is certainly worthy of further work. However at present there seems to be no enthusiasm in the Union to consider such fundamental reform in the short-term.

The problem which led to the introduction of budget rebates in the Union was the very large expenditure on the Common Agricultural Policy; in other words it was a problem on the expenditure side of the budget. An easier route to reform, though a far less satisfactory solution, might be to tackle a reform of EU expenditure.

## ***Reform of EU expenditure***

Spending 40% of the Union budget on supporting agriculture, at a time when agricultural prices have risen sharply and profitability in agriculture has also increased, appears bizarre. It should however be remembered that the EU budget is part of total public spending in the Union and that, in some areas, member states have decided to finance their policies through the EU budget rather than national budgets. This is the case in agriculture which throughout the EU attracts only 1% or less of total public funding while absorbing between 40% of the EU budget.

This is of course not a defence of the CAP. It is however an important argument. Many of the contributors to the discussion of the budget appear to want it to be a financial showpiece of a modern, future oriented and deeply integrated European Union. Yet where some policies are delegated to the Union, and others are the competence of the member states, it is obvious that the Union budget is going to be “unbalanced”, unless seen as a part of total public spending in the Union.

One of the key problems with agricultural spending is that it is not progressive in the same way that cohesion spending is. It therefore exacerbates the problem of net balances, without meeting the priorities and values of the Union treaties. In spite of the serious question of food security, the subsidisation of low productivity activity in the Union does seem perverse.

This situation could be changed in several ways. Subsidies, notably direct income subsidies, could simply be reduced over a number of years. On the other hand the individual member states could take over some of the financing of agricultural subsidies, although this would hold dangers for the common market in agricultural products.

A considerable reduction in CAP spending is expected to allow the British government to agree to a gradual elimination of the British budget rebate, and therefore of the other distorting rebates in the budget.

While almost everybody agrees that cohesion policy is a fundamental pillar of solidarity within the Union, there is much criticism of the way in which it has come to be considered rather as a permanent subsidy for regions in relatively rich member states. It will therefore be important in any major overhaul of the Union budget that the temporary nature of cohesion spending should be underlined and that complex and well endowed transitional arrangements should be kept to a minimum.

As there is unlikely to be agreement to increase the size of the budget in the next financial framework, creating additional headroom for new policies and rapidly expanding policies is essential. Increased financing will almost certainly be needed in the policy areas of justice, liberty and security as well as in the common foreign and defence policies; policies providing essential European public goods. These are rapidly growing areas for which there is considerable support in the member states of the Union.

However while it is easy to state the obvious, like the importance of increasing spending on research and development in the Union or additional support for European foreign policy, whether it is desirable to redirect spending in the EU budget to these issues depends partly on the efficiency and effectiveness of the instruments used to disburse the available finance. Many people believe for instance that a condition for radically increasing spending on research and development at the Union level would be changes in the institutional setup for supporting research and development. The effectiveness of financial support distributed through the Framework Programmes is considered to be rather low. This was almost certainly one of the reasons why the member states in the last financial perspective negotiation did not support the Commission's proposal for a very large increase in R&D spending. This emphasises the need to consider the means of implementation at the same time as the budgetary allocations.

### ***The “own resources” system***

The own resources system has been frequently criticised because by far the larger part of these resources are contributions of the member states and not taxes which are automatically transferred to the Union budget. It is argued that if there was a type of EU tax, which automatically was collected by the Union, this would ensure that the budgetary authority would become more responsible in its expenditure decisions because these would have to be defended in elections subsequently.

This is probably the least likely change to be made to the EU budget system. Politically it would be difficult to get agreement from certain member states. As the current system works quite well, it is unlikely that anyone is going to trade a system which delivers the required financing for a new system, which may well not have any of the benefits which its proponents propose.

Finally, the budget rebates, which are part of the resources side of the budget, should be progressively eliminated, as measures are taken to ensure that the pain of budget contributions is more justly distributed.

## ***The medium-term financial framework***

The medium-term financial framework provides a stable, usually seven year, planning horizon for the EU budget. To alter the detail of a financial framework during its life is a complex procedure, subject to unanimity, and therefore only usually undertaken in the face of absolute necessity. This system gives comfort to net contributors because it places an upper limit on expenditure in the medium-term, it also gives comfort to net beneficiaries because it guarantees to a large extent expenditures over the same period.

However the financial framework freezes expenditure in wide policy chapters at a time when needs are changing rapidly. It does therefore make sense to think about increasing the flexibility within this system. One positive change would be to reduce the length of the financial framework to 5 years and bring it in line with the lifespan of the Commission and elections in the European Parliament. This does not require a Treaty change. However increasing the role of the European Parliament, which would also be desirable, does require a Treaty change.

## **The mid-term budget review and the outlook for budget reform**

The negotiation of the medium-term financial perspective of the European Union is usually one of the most highly contested negotiations that take place in the Union. Decisions on the annual budget of the Union can also be contentious.

At the end of the negotiation of the Financial Perspective for the years 2007-2013, it was agreed that there should be a mid-term review of the financing of the Union, in which both the future financing of the Common Agricultural Policy and the British budget rebate would be included. These two subjects have traditionally fired up even the most moderate of the EU member states.

The European Commission published its consultation paper on the mid-term review in September 2007. Since then the public has been invited to make representations to the Commission on the future of the budget. A large number of contributions have been received and published on the web and a major conference was held in November 2008 during which the results of the consultation were discussed.

However, in spite of this apparent hectic activity, EU budget reform has dropped completely out of the political debate on the future of the

European Union. Budget reform does not appear amongst the priorities on the Commission President's website, a trawl across the main thinktanks in Europe also brings little on the budget, and it is a subject which is practically absent in the media. It is worthwhile asking why this subject today is so uninteresting both to the politicians and to the general public. Surely the budget should be a core element of the reform to make the EU fit for purpose in the global age.

The simplest reason is of course that there are very many important subjects on the agenda of the Union today. Climate change, energy security, the world financial crisis, economic reform in the member states and the future of the euro, and foreign relations, including the relationship with Russia and the situation in Iran, are just a few of the complex problems the Union is currently dealing with. The negotiation of the next financial perspective after 2013 will not get under way until the second half of 2010, long after the current Commission comes to an end and a year after the elections to the European Parliament. Several member states will also have elections between now and then. Why then should today's politicians get involved in a subject which their successors will have to deal with?

There are however more complex reasons. For the European Commission there seems little reason to disturb the relatively smooth cooperation with the member states by pushing a budgetary reform which is bound to create major problems between them. For the member states, there is little interest in unnecessarily introducing a subject which will cause domestic problems-this is of course particularly true for the United Kingdom. Indeed several of the member states appear to have concluded that the current financial perspective is not such a bad deal after all. One might for instance expect Poland to be in favour of negotiating the end of budget rebates for the net contributors to the budget, towards which it has to pay. However if reform of the British budget rebate implies thorough reform of the CAP, and perhaps the introduction of member state co-financing, then it is best for Poland not to force the pace on budgetary reform.

Finally for the European Parliament, the ratification of the Lisbon Treaty would be a significant change to its budgetary power. The distinction between obligatory and non-obligatory expenditure would disappear allowing the EP to seriously consider agricultural expenditure for the first time. Lisbon would introduce the medium-term Financial Perspective into the Treaties and while the Council remains in charge, it would have to obtain the consent of the European Parliament before agreeing itself by

unanimity. The need to obtain the consent of the European Parliament opens of course an avenue for the Parliament to influence future financial perspectives.

### **Slowly, change must surely come**

The conclusion must be that, in spite of the European Union having a budget and a medium-term financial perspective which do not reflect the key challenges of the future, the diversity of interests in the Union will mean that reform remains a slow process. However as pressure grows for the European Union to tackle more effectively those problems crucial for its future well-being – climate change, sustainability, energy security, migration and relations with its neighbours – change will have to come, even though it will be delayed by the fiscal problems arising from the current deep financial and economic crises. With the size of the budget remaining largely in the hands of the net contributors, these changes can only come about with a gradual reduction in agricultural spending and perhaps a reorientation of the cohesion funds.

# Chapter 5

## **The fourth dimension: financial supervision and economic governance**

Carlos Mulas-Granados

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Since the early days of monetary union, the debate on the economic governance of Europe has always focused on the need for a better system of coordination between different member states. This discussion always revolved around the governance of monetary, fiscal and economic policies. The recent financial crisis has now added a fourth dimension to this discussion (financial supervision), and has changed attitudes towards further integration.

When the financial crisis started in 2007, the debate still struggled around the need to agree on a new institutional Treaty that could overcome the Dutch and French blockage to the Constitution. In this context, any discussion around economic governance referred to the economic barriers that the EU would face as a result of poorly functioning economic and fiscal coordination within a monetary union. Many of us agreed that this was provoking asymmetric fiscal deficits, interest rates that did not respond to the real economic situation and a negative divergence in unit labour costs. In addition, we all complained that economic reforms were not being applied, in all probability because the institutional design favored inaction and “a wait and see attitude”, particularly if the measures to be taken were unpopular. As a result, the European economy was responding slowly and weakly to the challenges of globalisation and,

therefore, was weakening the European project in the eyes of Europe's citizens.

In the spring of 2008, the European Commission tackled some of these issues in its report on 10 years of EMU,<sup>1</sup> but its prudent approach to reforming economic governance in the euro area, was quickly put under scrutiny by the need for stronger action in response to the threat of financial collapse. The events of October and November 2008 will therefore be seen as a turning point in this soft approach to economic governance. During this period, European leaders first acted in isolation but then had to concede to the need for a much stronger coordinated response, which ultimately soothed the financial panic that consumed Europe.

Since then, the debate on economic governance has increasingly departed from aspects of joint structural reform, and has focused on other important aspects such as the role of the European Central Bank, the need to harmonise banking regulation, the future introduction of a financial regulator, and most importantly, the need to reinforce coordinated responses led by the Eurogroup or the European Council itself. It is still early to extract conclusions, but it certainly seems that the financial crisis has managed to shift the existing debate on economic governance in Europe from issues related to coordination to those linked to further integration.

This chapter analyses the criticisms and the solutions put forward for economic governance in Europe over recent years, and offers a brief reflection on the slight advances that were introduced under the Lisbon agenda. It ends with personal reflections on what lessons we might learn from the current financial crisis, offering some proposals for the road ahead.

### **Debating the governance of monetary policy**

Of the three elements that compose the system of economic governance, monetary policy is the one which has received least criticism in recent years. The main objections that have been raised regarding the independent monetary policy of the ECB can be summarised into two points. On one hand, the ECB, by focusing exclusively on price stability, could heighten growth problems in the most important economies of Europe. On the other hand, it has acted “too independently” of Eurogroup finance ministers political viewpoints, and also from the opinions of markets regarding the value of the euro and its exchange rate. In addition, it has

been unable to accommodate monetary policy with its fiscal stance, and to fulfill a role which makes structural reforms easier.<sup>2</sup>

Basically, the solutions that have been proposed aim in the direction of including growth and employment within the objectives of the EU (and perhaps within the statutes of the ECB), and maintaining price stability, similar to the Federal Reserve in the US. There have also been some proposals to modify the method of selection of the Executive Board of the ECB as a result of the growing nationalisation to which the bank is being subjected.<sup>3</sup> Some authors have also defended the possibility of establishing an institutionalised mechanism for dialogue between the economic ministers of the EU (that meet in the Ecofin) and the ECB, so that they can agree every three years on the ideal inflation objective for the euro zone.<sup>4</sup>

### **Fiscal fortitude: creating good governance**

This is the area where most scholars have expressed criticism in recent years. In some cases, the immediate implication of this criticism was that the monetary union would never work perfectly without a fiscal union. To fully understand these arguments, it is necessary to take a brief look at the original design of the fiscal policy pillar in the EMU.

The negotiations which led to the Maastricht Treaty were dominated by the alternative visions of France and Germany regarding the role that fiscal policy should play in the monetary union. While France defended the creation of an “economic government” that would ensure the “essential” coordination of fiscal policies within the EMU, Germany put its emphasis on maintaining price stability through strong mechanisms of fiscal discipline. In fact, both positions were included in the Delors Report (1989) that stressed both the need to determine in a coordinated manner the fiscal stance of the EMU, and the need to limit the size of budget deficits. Finally, both requirements became the base of the two pillars (the pillar of coordination and the pillar of fiscal discipline) of the Maastricht Treaty signed in December 1991.

Nevertheless, it is worth noting that the legal force of the pillar of fiscal coordination was much weaker than the legal force of the fiscal discipline pillar.<sup>5</sup> While article 104 of the Maastricht Treaty included a specific objective (the limit of 3%) and detailed a concrete procedure for sanctions for infringement (later reinforced by secondary legislature contained in the SGP), article 99 reduced the strength of the pillar of coordination by means of a general proposition.<sup>6</sup> Later, the creation of the Eurogroup in 1997 (only as an informal forum for discussion and under the Ecofin) to compensate

for the signing of the strict and detailed Stability and Growth Pact, deepened the imbalance between the two pillars to an even greater extent.

The experience of economic governance and the euro since its creation has demonstrated that, paradoxically, the pillar of fiscal discipline has not worked as well as expected, while that of coordination has worked better than expected. In reality, the reform of the SGP in 2005 was inspired by this initial experience, but there are still many academics who continue to criticise the SGP as an instrument obsessed with fiscal discipline, but completely useless for fiscal coordination in good times or fiscal prudence in bad times.

Proposed solutions in this area take several different approaches. The most pro-European seem a poor fit with the current political situation in the EU, but they do aim to resolve various problems in one go. On the contrary, less ambitious solutions may enjoy greater acceptance, but they would need several simultaneous legislative modifications which would complicate their implementation.

The most obvious option to improve the functioning of the pillar of fiscal discipline would be to improve the reformed SGP of 2005 by incorporating positive incentives to comply with established limits, and strengthening the sanction mechanisms for infringement. To generate positive incentives, access to certain European funds (perhaps those related to the Lisbon Strategy) could be tied to compliance with fiscal discipline. In addition, a mechanism could be established in which fines are paid by those who don't comply with the SGP. In turn they can be used to finance a new specific fund destined for Lisbon policies in complying countries. This would eliminate the temptation for countries to collude in the Council (as we saw when France and Germany joined their powers to veto in the Council the Commission's proposal to punish them for excessive deficit in 2003). Finally, to improve sanction mechanisms all the proposals are geared towards giving the Commission a greater role in this area.

The most significant initiatives for resolving the problem of coordinating the fiscal policies of the different member states refer to the creation of a truly European fiscal policy designed and implemented by a supranational fiscal authority independent of member states, similar to the ECB in regards to monetary policy.<sup>7</sup>

It seems obvious now that the EU would have been much better off at the end of 2008 had it been equipped with a supranational European fiscal

authority capable of bailing out the cross-border banks at the heart of Europe who went bankrupt. During 2009 we witnessed a strong asymmetrical form of economic crisis having a severe impact on eastern Europe, Ireland or Spain, while other countries like Germany or France suffer much less. The EU as a whole would have been much better off with a fiscal authority capable of redistributing funds and compensating for the deceleration of consumption and private investment by taking public action through a centralised fiscal impulse. Instead, Europeans had to limit their action to a coordinated small fiscal expansion approved by the European Council in December. This followed the Commission's proposal but left the composition of the expansion to each member state.

It is in this type of scenario (which was only theoretical until the present crisis) that the idea of pushing further towards a fiscal Europeanisation, which is capable of balancing full monetary union, became less utopian. However, today the situation stands as follows: on the one hand, the need to coordinate a European fiscal response to spend out of the recession has garnered support for the introduction of a new European fiscal authority or another form of economic government.<sup>8</sup> But on the other, the need to develop an economic government (maybe as the first step towards a political union) that will legitimise the actions of this European fiscal authority, and the subsequent Treaty modifications, prevent most from firmly defending this idea.

### **Knock, knock, it's Mr./Mrs. Lisbon: realising effective reform**

Since the launch of the Lisbon Strategy in 2000, the agenda for economic reform in Europe has run in parallel, and sometimes in contradiction, with agendas for social cohesion and sustainable development. In addition, the confusion generated by the proliferation of reform objectives and the weakness of the Open Method of Coordination (OMC) contributed to the revision of the Lisbon Strategy in 2005. At that time, the decision was made to reinforce the economic aspects of the Lisbon Strategy, since all agreed that the EU could guarantee the long term sustainability of its social and environmental model through growth and employment. In this strategy renovation the decision was also taken to group all the monitoring reports of the previous distinct agendas under one umbrella (the National Reform Programmes - NRP). This would be coordinated in member states through the creation of a new figure (a Mr. or Mrs. Lisbon) who would give public visibility to the process.

Since then, member states have named Lisbon coordinators and elaborated their NRPs annually. The Commission has then assessed the programmes – with a greater forcefulness each year. Without any doubt, the new process, since 2005, has improved the poor level of coordination which exists between the different reform agendas, but it has not managed to provide the highly visible strategy that was hoped for. In addition, the advances made in many areas continue to be limited.

Despite of the advancements, the risk that all the reform processes will again lack coordination is considerable for two reasons: from the Community point of view, responsibility for the areas of labour and microeconomic reforms (the core of the Lisbon Strategy) is in the hands of member states, and the Commission does not have sufficient instruments to lead them; and from the intergovernmental point of view, the actual overlap produced in many areas between the distinct formations within the council induces dispersion rather than aggregation.

To solve some of these weaknesses a series of minor technical measures have been devised, almost all to reinforce the role of the Commission in this process and to avoid the contradictions that are generated in the Council itself around its own role.<sup>9</sup> Based on the work of Murray<sup>10</sup> and Mulas-Granados,<sup>11</sup> and also incorporating other studies, the proposals can be placed into four groups:

- Finance ministers who meet in Ecofin should select their own president.
- Ecofin should be transformed into a “supercouncil” and should possess greater authority over all economic affairs than the General Affairs Council.
- The EU should integrate the Industry, Internal Markets, Energy and Telecommunications Councils into one Business Affairs Council, with the participation of the industry ministers of each country.
- And finally, the Commission should name its own Mr. or Ms. Lisbon from among its commissioners and he/she should be given the rank of vice president of the Commission. The whole process of National Reform Programmes should be improved with additional rankings that support naming-and-shaming.<sup>12</sup>

## **Sharpening economic governance under the Lisbon Treaty**

Having developed all the problems and proposals for improvement in previous sections, it is evident that an ambitious reform of the system of EU economic governance would have required a complete section in the Inter Governmental Conference launched in June 2007, a meeting that six months later led to the final agreement in Lisbon.

However, things did not work out that way. Given the need to save crucial aspects of the Constitution – such as the distribution of votes in the Council and seats in the Parliament, the division of responsibilities between the EU and member states, the presidency of the EU and the figure representative for foreign affairs – the fundamental questions of economic governance were postponed. Despite all of this, and although there were no modifications made regarding the governance of monetary policy, some improvements were introduced in the governing of fiscal policy and in the processes of economic reform which are worth pointing out.

Firstly, regarding fiscal policy, the modification which was introduced to reinforce the role of the Commission in applying the Stability and Growth Pact is important. To achieve this, article 104, section 6, was modified by substituting the word “recommendation” with the word “proposal”. With this small modification, unanimity will be needed (everyone with the exception of the country to be sanctioned) to reject any proposed fine of the Commission. In this way, from now on when the Commission proposes (and not only recommends) fines in applying the procedures for excessive deficits, the probability of applying the sanction will be much higher and will avoid situations like the Franco-German veto of 2003.

Secondly, in matters relating to economic policy coordination, the new Treaty has included a modification of article 99 to reinforce the role of the Commission in this aspect.<sup>13</sup> In addition, coordination has been strengthened with the drafting of a new article 114, that among other things, confers on the Council the responsibility to “strengthen the coordination and surveillance of budgetary discipline,” as well as “to formulate broad economic policy guidelines” for member states, assuring that they are compatible with those adopted by the rest of the Union. It also assures that they are effectively monitored.

Finally, another important advance has been the inclusion of measures which give legal standing to the Eurogroup as contained in two new articles (115 and 115bis). The goal here is to provide one voice for the euro

in the world monetary system. It also recognises that the Council might designate (after a proposal from the Commission) “unified representation within financial institutions and conferences”. Or, in other words, there is a serious possibility that a Mr. or Mrs. Euro may be assigned responsibility for representing the single currency internationally.

## **Reform after the financial crisis**

More so than the issues relating to traditional aspects of economic, fiscal and monetary policies that have been discussed until now, the debate on economic governance has dramatically shifted focus during the last year as a result of the financial crisis.

The crisis has shown that the current system of governance may be more appropriate for good times – because it is stable, foreseeable, and has the necessary incentives – than for bad times.<sup>14</sup> In times of crisis, the current system lacks crucial properties such as speed of reaction, discretionary powers and centralised processes of decision-making in key areas of financial and fiscal policy.

For this reason we have seen a new area of discussion opening and developing around the need for a stronger more coordinated system of financial supervision, capable of preventing sudden cross-border systemic crises. In past months, many have defended the need to introduce a new European Financial Supervisor,<sup>15</sup> whereas others have pushed for a new role for the European Central Bank. While the introduction of a new financial authority will require a modification of existing treaties (with all the political difficulties that it implies), the activation of Article 105.6 in order to entrust the ECB with new tasks in supervision would not require a Treaty change, but would need unanimity in the Council of Ministers and assent by the European Parliament to come into force. However, entrusting the ECB with more powers has been opposed by many for two reasons: first, the UK would be left out of the core decision-making body of financial regulation when the City of London is the largest financial market in Europe; and second, investing more power in one institution in the absence of any political counterpart may exacerbate the existing institutional asymmetries.

In the midst of this debate, the De Larosière report released in February 2009 gave support to a third-way approach, proposing an overall reform based on two new institutional elements<sup>16</sup>:

- A new system of market-wide risk supervision. Setting up a “European Systemic Risk Council” (ESRC) to be chaired by the

European Central Bank president, and establishing an effective risk warning system under the auspices of the ESRC and the existing Economic and Financial Committee, which is made up of national treasury officials.

- A new day-to-day system of financial supervision. Creating a European System of Financial Supervisors and a decentralised network, with existing national supervisors continuing to carry out day to day supervision.<sup>17</sup>

The De Larosière report has been welcome by all parties in the debate because it finds a middle point between intergovernmental and communitarian proposals for financial framework reform in Europe. The probability that it will serve as the basis for coming reforms was further strengthened with the release of the Turner Review in March 2009, which indicated a change in the UK's traditional opposition to any type of pan-European regulation in the financial sector.<sup>18</sup>

But again, any attempt to improve the existing governance structures (even in the field of financial supervision) will end up in confrontation with the need to solve the fiscal debate at the European level. It is obvious that the existing national jurisdictional domain of the fiscal authority provides significant problems for proposals to grant financial supervisory powers to any EU body (either the ECB or any new regulator). Macro-prudential supervision could be granted to a European body if it only had a limited advisory role, but in the current framework governments would be unwilling to cede national micro-prudential supervisory powers to an EU body whilst they hold the responsibility for bailing out financial institutions. If crisis management is to be at the European level rather than at the national level, there needs to be a federal source of money. Until the EU has fiscal powers which permit it to raise the funds needed to rescue distressed banks, or until there is a system of mandatory burden sharing between member states for fiscal support, supervision will remain the responsibility of member states. In this case, the real role of any new EU financial body will be very limited.

### **Focusing on a future framework**

Clearly, serious advances on the path to an improved system of economic governance were put off in the Lisbon Treaty. However, while this treaty was being ratified the financial crisis exposed all of its weaknesses. In turn, the crisis has added a new area of debate to the traditional discussion on governance of the single market and the single currency. Now we have

a Treaty that not only ignores traditional debates about the imbalances between the governing structures of monetary, fiscal and economic policies, but also imposes strong limitations on the introduction of a new financial authority that might solve the problems which led us into the current systemic crisis – the complete absence of financial supervision and regulation at the European level.

Despite the reluctance to promote any initiative in the field of economic governance that implies Treaty modifications, the events of this past year have shown European leaders and public alike that individual responses to global crises are useless. The situation only began to stabilise in Europe after European leaders met in Paris in early October 2008 and decided to coordinate a common framework to solve the financial crisis. In my view this has definitively legitimised the political role of the Euro group in times of distress, and has offered the first taste of what a European economic government might look like.

Even if this did not lead to breaking point, it at least served to change the tone of the previous debate, allowing us to reconsider some vetoed aspects of European integration. Whatever happens in the field of economic governance in the near future will depend on the political will of the leaders to push for major reforms, even at the expense of a new Treaty reform. Under both scenarios there are several options at hand:

***Minor reforms (no Treaty reform needed):***

- The Eurogroup should become the leading body for economic policy coordination in the euro area, even more so when sudden shocks require immediate and strongly coordinated fiscal policies.
- The Eurogroup should have single voice representation in the IMF and other international economic and financial institutions.
- The Ecofin Council should then be reoriented to the discussion of broader legislation affecting the Single market at EU27 level. It could incorporate some of the current Council formations, in order to focus on the competitiveness of Europe.
- A new European Fund for deep shocks in the Euro area could be established inline with future financial perspectives (similar to the current Globalisation Fund) to facilitate joint fiscal responses to systemic crises.

- A formal mechanism of permanent dialogue between the ECB and the Eurogroup could then be introduced, in order to better coordinate monetary and fiscal policy.
- The ECB could assume additional financial supervisory powers, under the current treaty provisions.

***Major reforms (Treaty reform needed):***

- A new harmonised regulation for the financial sector, which could require a stronger supervisory role for the ECB, or the introduction of a new European Financial Authority under a new European System of Financial Supervision.
- A new European Fiscal Authority (or a European Treasury) could be considered in the medium term. The European Fiscal Authority would have the capacity to bail-out major European banks, would lead the coordinated responses to systemic economic crises, and would play a complementary role to help national authorities during asymmetric shocks.
- A new EU Federal Budget. Increasing in size from its current level of 1% to 5% of EU GDP; it would be financed by pan-European corporate taxes and other sources of supranational financing (such as taxes on carbon emissions). The new federal budget would finance new supply-side transnational programmes (on R&D, education, energy, environment and infrastructures) that increase the EU's growth potential. This new budget would include new mechanisms to link financial perspectives, Lisbon reforms and compliance with SGP.

Over the past 50 years, all areas of European union and governance have been constructed in a step by step process. The case for a new system of economic governance will not be an exception. Yet, in reflection, it was not so long ago that, during the previous European recession of the early 90s, many questioned the very viability of the monetary union itself. But, here we are today in a situation where the euro has protected its members from major financial turmoil. Full economic integration will only come about in stages based on a joint political effort. Preventing future financial crises from happening should be an important motivation to push that joint effort forward in the years to come.



# Chapter 6

## **Do we need the Lisbon strategy after all? Lessons from the (recent) past; issues for the future**

Nikos Koutsiaras<sup>1</sup>

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Despite its US origins, and irrespective of its alleged precipitation by the Anglo-Saxon economic model, the financial and economic crisis has probably hit Europe harder than the US. The downturn in economic activity has rapidly expanded across economic sectors and member states, resulting in declining employment opportunities and rising unemployment rates. The immediate effects of the crisis on the productive capacity of Europe will be sizeable, whilst its longer term impact on the potential output of the European economy is likely to be unfavourable. Therefore, in addition to managing the crisis, whilst fully appreciating that a swift return of fiscal and monetary policy to their business-as-usual, pre-crisis position is simply not possible, governments should also aim to eliminate the output gap induced by the crisis and thus avert a permanent loss of potential output.

### **Bringing the long-term outlook back into the (post-crisis) economic policy agenda**

Given this challenge, strengthening the supply side of the European economy should be prioritised and structural reforms should figure prominently in the policy agenda. Furthermore, implementation of structural reforms needs to gather pace as fiscal stimulus is progressively withdrawn. Structural reforms should comprise of three types of measures.

Firstly, they should include policy actions aimed at correcting past policy and regulatory failures. Secondly, they should include measures designed to reinforce “policy success stories” associated with earlier reforms. Thirdly, they should address the long-term challenges facing European economies and societies.

The question is whether the economic crisis has produced a politically sustainable reform dynamic, thereby making the Lisbon strategy superfluous, or, on the contrary, whether implementation of structural reforms has now been linked in a much tighter way to the revival of the Lisbon process. In that case, what might the revival of the Lisbon strategy involve and how could its effectiveness be raised? These issues are discussed in the following sections, where there is an analysis of the rationale of the Lisbon strategy and an account of its inherent weaknesses and its likely strengths.

### **Why are we still concerned about EU-level coordination of market policy and institutional reforms?**

The Lisbon strategy was meant to narrate, shape and frame the EU’s response to a relatively weakening economic performance. Since the mid-1990s, this dip in performance has put an end to 25-years of almost stable relative per capita output and therefore led to a widening gap in average living standards between Europe and the US. The relatively slow level of output growth in Europe has been associated with relatively slow labour productivity growth, which has no longer been sufficient to offset Europe’s relatively deficient labour input. This labour input is largely a function of Europe’s lower rates of employment and shorter working year compared to the US. Growth accounting has revealed that the post-1995 slowdown in European productivity growth has been driven less by lower capital deepening in information and communication technology and more by much slower growth of multifactor productivity – multifactor productivity being directly or indirectly related to the use of information and communication technology (ICT). The total contribution of the so-called knowledge economy to productivity growth has therefore been much lower in Europe compared with the US. This has resulted in the relatively slower growth of European labour productivity.<sup>2</sup> Moreover, the shift in risk aversion and reductions in R&D and innovation that followed the financial and economic crisis resulted in lower multifactor productivity growth. It is conceivable this may lead to a permanent loss of Europe’s long-term output potential, particularly if policy responses amplify those risks and/or fail to address structural deficiencies that may prolong the impact of the crisis on labour markets.<sup>3</sup>

Europe's relative loss of efficiency in the production process has been largely attributed to overly restrictive regulation of product and labour markets, leading to lower market entry rates and reduced competitive pressures on incumbent firms, as well as inhibiting industrial restructuring. This has discouraged investment and innovation<sup>4</sup>, but also given rise to hysteresis effects. These are primarily associated with long spells of unemployment which lead to severe losses in human capital endowments. The implication is that the crisis may therefore result in a reduction in labour utilisation. Besides, Europe's relative shortfall in labour input, particularly its shorter working year, has been related to the distortionary impact of taxation or to work-sharing practices<sup>5</sup>. Such practices are mostly induced by trade unions' demands,<sup>6</sup> although genuine preferences for increased leisure time have also been invoked as an explanation.<sup>7</sup>

Some academic economists have urged European governments to embrace comprehensive structural reforms, effectively emulating the US model of market flexibility, or otherwise risk the decline of Europe.<sup>8</sup> Having underpinned economic growth for most of the second half of the twentieth century, European economic and social institutions may have become less relevant in economies which have reached the technological frontier, where instead of importing technology and accumulating capital, they have now come to increasingly rely on knowledge and innovation. Consequently, reform must be systemic in character. It must deal with the complementarities and network-type dynamics associated with thick and complex institutional structures, whilst aiming to facilitate mobility and change the once privileged stability and continuity.<sup>9</sup>

Yet this hardly implies that the European economic and social model should be dismantled. Asymmetric information, coordination failures and, probably above all, the fact that preferences for redistribution are stronger in Europe than in the US "land of opportunity",<sup>10</sup> all cast doubt on the desirability, let alone political viability of radical deregulation. Instead they call for the "recalibration" of the welfare state.<sup>11</sup> Complete deregulation of the European economic and social system may, following the crisis, seem to be even less justified and politically feasible, with the blame being put on market failures and/or excessive market optimism on the part of policymakers.

Market policy and institutional reform has dominated the Lisbon process, its rationale being not only that economic performance might improve, but that the European economic and social model might also increase its relevance and better withstand the financial pressures which mostly

emanate from demographic trends. However, this is where the consensus just about ends. Intense debates about the breadth and depth of institutional reform, largely informed by the variety of national institutional configurations and fed by a divergence in economic performance and social welfare, have precluded the emergence of a more concrete policy agenda. And they have left little, if any, room for binding coordination of national market policy and institutional reforms at the EU level, merely allowing for their soft “Lisbon-style” coordination.

Regardless of institutional and other divergence, those taking a pessimistic if somewhat cynical view of government policy have pinned their hopes for supply-friendly reforms to policy competition among national governments. In effect they think of coordination as a means of entrenching institutional inertia and maintaining meagre economic performance. However, their case has been considerably weakened as the crisis has fully unfolded. Consequently, expectations for comprehensive unilateral structural reforms have been undermined.

The absence of binding coordination at the EU level would probably have hurt the effectiveness of market policy and institutional reforms, had cross-border policy spillovers been important. However, empirical estimates of the expected effects of coordinated supply-friendly institutional reforms have been modest, probably implying the incidence of small cross-border policy spillovers. Yet, estimates of the expected gains from joint action have been bigger when simulated policy coordination at the EU level also entailed budgetary consolidation in addition to market policy and institutional reforms.<sup>12</sup> Therefore, challenging national policy preferences and institutional heterogeneity might have been less justified, let alone politically tolerated. For this reason, it may not be surprising that the Lisbon process has lacked a strong normative dimension, that is, it has been short of legal obligations and sanctions, having instead relied mostly on a strategic and a cognitive dimension.

Thus, with regard to the strategic dimension, it has been suggested that joint action in the area of market policy and institutional reform may give rise to political economies of scale. A government may appeal to its citizens’ “pride” in order to take measures that bring the economy on an equal footing with the other member states’ reformed and revitalised economies. Alternatively, it may attempt to give its own reform initiatives a universal, ideologically unbiased quality, drawing attention to the fact that the same or similar reforms are also implemented by governments

which hold different ideological convictions.<sup>13</sup> Also, it has been said that the existence of a common reform agenda, coupled with institutionalisation of a procedure for reporting and monitoring national economic reforms, may effectively provide governments with a lever to use in order to counter opposition to reforms. That lever arises out of the commitment to softly coordinate national policy with the policies of other member states, thus it essentially takes the form of an external constraint to national policymaking.<sup>14</sup>

Finally, on the strategic front, it has been argued that the Lisbon agenda allows for the realisation of policy complementarities between reforms in product and financial markets, for which the EU often bears responsibility, and labour market reforms, responsibility for which mostly belongs to member states. This can increase the gains from soft policy coordination at the EU level.<sup>15</sup> Yet, the case partly rests on an assumption that the appropriate sequence of reforms has already been put in place, whereby deregulation in product and financial markets, following the establishment of the internal market, has paved the way for implementing labour market reforms. Nevertheless, the return to more activist industrial policies and the development of somewhat protectionist attitudes in financial markets following the outbreak of the crisis, has obviously dealt the case a blow but presumably not a permanent one.

### **“National prestige” is a loser**

However respectable those arguments may be, they may not be very convincing, and the strategic importance of the Lisbon process for the implementation of domestic supply-friendly institutional reforms may not have been adequately argued. Therefore, given that market policy and institutional reforms often have significant redistributive effects, those losing from reforms may obviously be less inclined to appreciate an increase in average welfare, whatever the implications of that increase may be for “national prestige”. And, of course, it is hard to believe that “national prestige” may strengthen the winners’ voice, let alone political influence, in supporting reforms. For the same reason, “naming and shaming” would probably have little bearing on the domestic politics of reform, whilst unnecessarily politicising the process of monitoring national action plans; wisely the proposal was never endorsed. Political scale economies may also be rendered irrelevant in view of profound differences among national political systems, implying different dynamics of policy change and policy inertia, but also in view of asymptotic electoral cycles. This implies that chances for electorally unpunished policy changes may seldom arise in unison across member states.<sup>16</sup>

Furthermore, the Lisbon agenda may hardly serve as a credible external constraint to national policymaking. The reasons for this are its entirely reasonable lack of legally binding sanctions and/or rewards, as well as the lack of attention paid to it in national parliaments and in the media. On the other hand, blame avoidance is an important aspect in the politics of reform, particularly in the case of welfare state reform.<sup>17</sup> Therefore, shifting the blame onto the Lisbon process may be a convenient choice for national governments. Arguably, that choice misrepresents reality and although it may fail to have an impact on policymaking, it may add to citizens' disillusionment with European integration. All told, one may suggest that the re-launched 2005 strategy's focus on advancing national ownership of the Lisbon process may partly imply that the importance of political scale economies and the external constraint for implementing economic reforms has been relatively downgraded. Yet, one may also doubt that national ownership of the Lisbon process may be strengthened by mere procedural changes, as attempted with its 2005 re-launch.

Finally, the issue of policy and institutional complementarities may not be as simple as advocates of the Lisbon strategy are eager to acknowledge. Thus, rigorous identification and measurement of complementarities may often run counter to widely received views<sup>18</sup>, whilst empirically strong institutional complementarities may frequently favour resistance to change, as mostly argued in the Varieties of Capitalism (VoC) literature.<sup>19</sup> Also, the likelihood for complementarity-driven institutional reform may be higher in cases where change has already occurred in a hierarchically dominant institutional domain, although the direction of that complementarity-driven change may be hard to predict. However, changes in subordinate institutional domains may have few knock-on effects.<sup>20</sup>

If one subscribes to the VoC view that product and financial market regulation constitutes a hierarchically dominant institutional domain,<sup>21</sup> one may reasonably expect that following changes in EU product and financial markets, reforms of labour market institutions may also be implemented. Nevertheless, one may hardly predict the quality and direction of institutional change in European labour markets. Economists have argued that in a world of lower rents, brought about by product market deregulation and liberalisation of financial markets, the resistance of trade unions to labour market reforms will probably diminish.<sup>22</sup> However, that may not apply to the whole range of labour market institutions, nor entail wholesale changes in non-competitive arrangements. In fact, one may contemplate that trade unions or groups

of insiders may fight hard to avert institutional reforms that have an effect on rent-seeking activity and a bearing on the security and distribution of even lower rents, albeit at the cost of inefficiency.

Therefore, the strategic dimension of the Lisbon process is likely to have little impact on the domestic politics of economic reform. In other words, the Lisbon process may barely allow for favourable changes in the incentives and constraints facing policy actors, particularly governments. Several commentators have argued that the impact of the Lisbon process and especially of the soft policy coordination processes on national policy fields may mostly be felt at the cognitive level. Although perhaps later, that impact may be traced in policy outcomes too.<sup>23</sup> The cognitive dimension of the Lisbon process has specifically entailed mutual learning and exchange of experiences among member states, associated with benchmarking and comparison of economic performances, and has implied a change in national discourses.

The alleged importance of the cognitive dimension of the Lisbon process may not be empirically confirmed. Notwithstanding its scope, coverage and density, the Lisbon process of mutual learning may claim neither exclusivity, nor unrivaled influence. Besides, there is enough evidence to suggest that informal learning processes have played a bigger role than formal ones with regards to shaping policymaking and institutional reforms.<sup>24</sup> The best example of this is the emergence of independent central banking across the globe.<sup>25</sup> In addition, formal policy learning processes may often fail to take into consideration informal norms and long established conventions that may crucially impact on policymaking, yet they may not readily be taught, let alone exported.<sup>26</sup> Lastly, institutionalised policy learning processes may often adjust slowly to rapid changes in the broader policy environment. In that case, policy advice should favour diagnosis and experimentation over prescription, benchmarking and identification of best practices.<sup>27</sup> Yet, there is an obvious trade-off between the stability of the process and state-of-the-art policy advice, the former being indispensable for a policy strategy, but the latter being readily supplied by other equally authoritative sources (for example the OECD).

Therefore, major doubts may be raised about the effectiveness of the Lisbon strategy in facilitating economic reforms. Are those doubts empirically sustained? And how might the effectiveness of the Lisbon strategy be increased? Those issues are dealt with in the following section.

## **Strengthening, if not really crafting, the strategic dimension of the Lisbon process** <sup>28</sup>

Reform of the European economic and social model may entail no less than a thorough overhaul of the regulatory framework and institutional organisation of product, financial and labour markets. It may also involve restructuring of public finances, conditioned on keeping them solvent and sustainable. Those reforms may, arguably, pose a daunting task for democratic and electorally non-suicidal governments and national political systems. The principal reason for this being that the benefits and costs of the reforms are unevenly distributed among individuals, socio-economic groups, geographical regions and, also, over time, albeit in ways that differ across policy areas. Nevertheless, quite a few analysts and, most certainly, the architects of the Lisbon strategy, have argued that those reforms may be both achievable and sustainable.

The logic underlying the Lisbon strategy has been much inspired by the so-called “There-Is-No-Alternative” view of market policy and institutional reforms. This itself reflects a systemic view of the European economic and social model, whereby simple linkages and/or complementarities between policy areas are deemed functionally indispensable and politically crucial. Reformist governments may, therefore, need to vigorously confront regulatory failures and institutional rigidities in one policy area. Reforms in other policy areas may then be considerably easier to make.

However, there has been sufficient evidence to cast doubt on the effectiveness of the Lisbon process for policy coordination with regards to motivating supply-friendly institutional reforms. For example, the pace, intensity and commitment towards reforms has varied considerably across member states, whilst progress across different policy areas has also been uneven. It has also been found that implementation of the Lisbon process has barely influenced national attitudes and efforts towards reforms; hence there has been little change in the rankings of member states with regards to policy quality and economic performance. Interestingly, a sort of reform or Lisbon “fatigue” has impinged on both the pace and content of Community policies to complete the internal market for services and remove obstacles to labour mobility, but less so with regard to initiatives to simplify regulation and reduce burdens on business.<sup>29</sup> Nowhere have those observations been more relevant than in the field of labour market policy and institutional reform.

European labour market performance has, since the beginning of the present decade, been constantly improving. This has included a significant

reduction in rates of unemployment and a notable increase in employment rates. However, a trade-off between employment and productivity growth has been noteworthy, though it has been most pronounced in member states experiencing stronger employment growth and more frequently observed in low-growth “old Europe” than in fast-growing “new Europe”. Obviously, those developments have been causally related to reforms that have, especially since the mid-1990s, been implemented in European labour markets.<sup>30</sup> Yet, despite their increased pace and frequency, those reforms have seldom been comprehensive. Instead, they have been largely marginal in scope and scale. They have also encompassed measures almost equally split between those reducing levels of protection and those providing for increased protection, whilst occasionally comprising contradictory policies undoing one another over a short period of time.<sup>31</sup>

In particular, marginal reforms have often only entailed partial relaxation of employment rules, leaving the entitlements of those already employed under permanent contracts virtually untouched, hence resulting in two-tier labour market institutions and dual labour markets. Therefore, strong rises in the shares of so-called flexible forms of employment, especially fixed-term employment and temporary agency work, have been observed in several EU member states. Consequently, the frequency of low-wage employment has increased, along with an increase in volatile employment and lack of training for those working under flexible job contracts, thereby negatively affecting labour productivity.<sup>32</sup>

Reforms, furthermore, have also involved changes in active labour market policies, unemployment benefits and labour taxation, regular employment protection and wage-setting institutions. However there has been little change to early retirement policies.<sup>33</sup> Interestingly, the implementation of labour market reforms has not proven to be easier amidst weak economic conditions associated with a higher risk of job losses, whilst comprehensive supply-friendly labour market reforms have seldom been carried out under unfavourable economic conditions.<sup>34</sup> Therefore, one may doubt that the current severe economic crisis may, in itself, allow for the implementation of comprehensive reforms.

The need for comprehensive reform of labour market regulations has probably been made clear. It has also been formally acknowledged by national governments. Indeed, the Council of the EU has called for a “sustained reform effort”, *inter alia* conceding that only limited progress has been achieved with respect to reform of employment protection legislation and pointing to the need for reforms that improve work

incentives in the welfare schemes and allow for increased labour utilisation by raising both employment and the average number of hours worked.<sup>35</sup> What is more, the need for comprehensive reforms has further been stressed by the asymmetric incidence of the labour market effects of the crisis, especially the huge contraction of fixed term employment, often associated with a disproportionate increase in youth unemployment.<sup>36</sup>

Yet, no matter what the collective pronouncements of national governments are, comprehensive reform of European labour markets may still be practically unattainable. Labour market reforms have largely been shaped by political considerations which have, initially, been prompted by the uneven distribution of benefits and costs from reforms and, subsequently, influenced by shared perceptions of fairness and distributive justice<sup>37</sup> and, often, by interest group politics.<sup>38</sup> Arguably, assertions of fairness and equity may occasionally offer ideological legitimacy to interest group demands and may even galvanise the opposition to reform on the part of politically decisive labour market participants. Therefore, proliferation of flexible employment contracts may have nothing to do with inclusiveness, employment and income security or fairness in the labour market, but it may effectively reduce competitive pressures on core labour market insiders whilst increasing the number of employees at the risk of poverty.

The chances of comprehensive labour market reforms being implemented may therefore largely depend on improving their distributive effects, particularly increasing the benefits from reforms and bringing them forward, whilst also decreasing their costs and providing for adequate compensation to those bearing most of the burden. Comprehensive labour market reforms may, however put an end to the proliferation of flexible job contracts, thereby also disassociating employment growth from low-productivity, low-wage jobs. Moreover, comprehensive labour market reforms may also reduce the influence of interest group politics in the labour market, thereby allowing for bolder and faster rent-reducing, productivity enhancing product market reforms. A higher employment and productivity growth path for Europe may therefore be within reach. The crucial issue then becomes how to attain a better, fairer and politically sustainable distribution of benefits and costs from market policy and institutional reforms, especially reforms of labour market institutions.

Macroeconomic policy may be of little practical help. Fiscal policy may cushion temporary increases in the output gap associated with institutional reforms, thereby averting short-term, yet politically undesirable increases

in unemployment. The budget may bear the direct cost of certain reforms,<sup>39</sup> whilst also footing the bill of compensation packages granted to reform losers so that they stop resisting policy change. Yet, governments' room for manoeuvre is effectively, and often wisely, reduced by the Stability and Growth Pact. On the other hand, an accommodating monetary policy stance may, in principle, be conducive to labour market reforms, by bringing employment gains forward, thereby allowing for short-term budget improvements too. Yet, in practice, a monetary stimulus to labour market reforms may not be available, as it would likely entail an inflationary deal of monetary easing to cater for divergent equilibrium and actual rates of unemployment and output gaps. Obviously, the eventual return of both monetary and fiscal policy to their pre-crisis, long term path, most probably associated with increased vigilance with regard to asset price inflation and rigorous fiscal consolidation respectively, may further preclude macroeconomic stimulus for reform, at least for a long period of time.

### **Discouraging governance**

It therefore appears that comprehensive labour market reform is discouraged by governance arrangements which fall short of producing adequate incentives for that purpose, most notably carrots, sticks being institutionally, and indeed reasonably, precluded. That goes to the heart of an effective reform strategy and, thus, should partly be addressed by a strategically vibrant Lisbon process that may favourably impinge on the domestic political economy of reform. That goal may be better achieved via a system of financial incentives; in effect transfers of EU funds aimed at rewarding implementation of comprehensive labour market reforms, whilst alleviating domestic political economic constraints. EU financial support may entail backing national government policies and supplementing national budgetary resources in order to attain a socially tolerable and politically acceptable distribution of gains and losses from labour market reform, which might often imply compensating those incurring most of the burden.

In particular, EU transfers may support reforms seeking to solidify competition in the labour market and remove or offset distortions, including compressed wage distribution, which reduce effective labour supply and make the search and matching processes lengthier and costlier than they would otherwise be. They may also be used in the case of institutional reforms which cater for asymmetric information in the labour market and lack of access to financial and credit markets. Such reforms can improve job quality and increase labour productivity, as well as income

security, yet at a lower cost than would have been obtained had the reform at hand not been implemented. However, EU financial support may not be given for policies which may increase labour market segmentation and, possibly, put long-term labour market performance at risk. In general, EU financial aid may be granted to labour market reforms which may allow for an improvement in the terms of relevant trade-offs, or to put it differently, may provide for a movement towards “efficient redistribution” and away from inefficiency in the labour market.

For instance, EU financial support may be granted for reforms aimed at substituting higher unemployment insurance for stricter employment protection legislation, thereby increasing flexicurity in the labour market and allowing for an increase in the level of employment and a reduction in the rate of unemployment, especially among certain groups of workers. EU financial transfers may also be awarded to policies aimed at making work pay, or increasing job search incentives for disadvantaged groups, or linking unemployment insurance to the state of the labour market. For these purposes, EU financial resources may directly contribute to the national budget, thereby allowing for lower spending cuts and/or tax increases than would otherwise be the case. Alternatively, they may be added to national resources so as to finance targeted wage subsidies in order to increase the employment of less employable workers, or they may be allocated to social protection systems, thereby helping to provide for compensatory measures for those left worse-off following reform.<sup>40</sup>

While drawing on the experience of the European Globalisation Adjustment Fund, the scheme proposed here goes many steps further and even gets into the sacred area of redistribution, albeit not unconditionally. In fact, this scheme could replace the European Globalisation Adjustment Fund, which may be barely thought of as a successful policy.<sup>41</sup> Although the fund’s detailed scrutiny, assessment and funding may be part of the debate in the review of the Community budget. Yet, the strategic dimension of the Lisbon process may thus be considerably strengthened and its national ownership may accordingly be substantially increased, thereby raising expectations for comprehensive market policy and institutional reforms, whilst also addressing social anxieties and equity concerns associated with economic reforms.

This would certainly remove pressures for “social modifications” of the Lisbon strategy,<sup>42</sup> which may add little real value and may only lead to unnecessary complications in policy coordination processes. It may

effectively put an end to demands for politically unfeasible, largely because of their indirect cross-border redistributive effects, and practically unattainable Euro-Keynesian solutions.<sup>43</sup> And it would probably weaken the political habit of blaming the EU for domestic economic ills and policy failures, thereby running counter to the recently observed, crisis-induced EU citizens' loss of trust in the European institutions.<sup>44</sup>



# Chapter 7

## **In search of socio-economic reform and innovation: making “Social Europe” stronger**

Xavier Prats-Monné\*

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European institutions have been remarkably consistent on the values and declamatory aspects of Social Europe, at least since the Maastricht Treaty of 1992. The argument in a nutshell is that preserving the “European Social Model” is essential for the sustainability of the European project (e.g. the Berlin Declaration of March 2007), and that economic, employment and social policies are mutually reinforcing. In order to achieve higher rates of employment and economic growth, the Union must promote social integration and combat discrimination: this rationale is at the heart of the EU strategy for jobs and growth.

### **Europe in search of a social role**

So, taken at face value, the answer to the question “is there (or rather should there be) a Social Europe” is a resounding “yes”. In practice, nowadays, the shared sense of identity is less consistent than it seems: it would be difficult today to define a single European Social Model in operational terms. Furthermore, EU employment and social policies have never been a homogeneous set of objectives or instruments. Some elements were born in 1957 with the original EC Treaty, and have evolved through qualified majority voting, the European Single Act, free movement, health and safety, and the European Social Fund. Other policies acquired a Treaty

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*\* This paper is a personal contribution and does not represent the views of the European Commission.*

basis only in the 1990s, and over the last ten years, with the European Employment Strategy and the Lisbon Strategy, the traditional regulatory approach has been abandoned in favour of the soft law of the Open Method of Coordination (OMC). In fact, the focus of Social Europe has shifted dramatically over time: it once stressed regulation as opposed to outcomes, whereas now it focuses on processes as opposed to substance – not surprisingly perhaps, given that all matters of process at 27 are a Herculean task in themselves.

The cumulative result of a half-century of Social Europe is a panoply of legal, financial and policy instruments that are perhaps not entirely coherent but certainly not negligible either. Social Europe has many achievements to its credit – from focusing member states on labour market modernisation to establishing common objectives in the field of social inclusion and social protection, to a strong body of anti-discrimination legislation; it is challenged not in theory but in practice, by Polish plumbers and Laval's Swedish electricians; not by differences over European values but by the starkly different realities of the enlarged Union; not by lack of common financial instruments but by the impact of the crisis on public finances.

All these instruments of Social Europe, painstakingly built over 50 years and 6 successful enlargements, are now being put to the test by an unprecedented financial and economic crisis which is slowly turning into an employment and social one. Even if the most optimistic forecasts for recovery come true, unemployment and social exclusion will merit a place at the core of the EU policy and political agenda for years to come. This, at a time when constraints on public spending and therefore on the funding of national and EU policies will sharply increase, while the cost of not investing in the right employment social policies, in human capital and skills, would be dramatic given the key role of people and knowledge in Europe's future prosperity.

### ***The limits of Social Europe***

Beyond exhortation and declamatory statements, Social Europe has its limits. When it comes to employment and social issues, national policies have greater political legitimacy and wider breadth and depth than the EU. And while the views of member states differ significantly, as the long debate over the Lisbon Treaty comes to an end there seems to be no scope for further transfer of legal and constitutional powers to the EU in the social field. The German Constitutional Court in its recent judgment on the Lisbon Treaty drew a clear line in the sand, stating that the competences

of the EU in social matters have been reinforced by the Lisbon Treaty (article 3.3.1. and the new horizontal clause in art. 9 TFEU); that political initiatives and programmes give concrete shape to this legal framework; and(...) that this should be enough: in the future, “(...) *the essential decisions in social policy must be made by the German legislative bodies on their own responsibility. In particular the securing of the individual’s livelihood (...) must remain a primary task of the member states (...). This corresponds to the legally and factually limited possibilities of the European Union for shaping structures of a social state*”.

But policies, not Treaties can address today’s EU challenges: beyond these constitutional limits, any discussion on the future of Social Europe should take into account three obstacles, which make consensus on policy particularly difficult and impose a limit to the social role of the EU.

The first obstacle stems from the very nature of social policy. Forging a European approach on, say, energy security requires an analysis of complex economic realities and technical issues, a debate about common goals and a difficult compromise between national interests. Social Europe requires all of that – and still must make room for the expression of strong personal and cultural values, for redistribution and its vested interests, for ideology and political belief. Social policies, national or European, are about politics and well-being: their inherent subjectivity and political nature should not be underestimated.

The second obstacle that makes Social Europe so elusive is that, on the one hand, social change is mostly internally driven and follows the patterns of different European welfare regimes; and on the other hand, the crisis and globalisation increase the demand for meaningful EU and international cooperation. For all the emphasis on globalisation, trade openness is neither the source of all happiness nor the cause of all evil, and the main challenges for Social Europe are only indirectly related to globalisation: maturing welfare provisions, low fertility and ageing, changing family structures and technologies. Social structures are changing – yet national social protection policies and public expenditure are still often organised around a stable nuclear family model, ignoring the impact of immigration, new family types, female unpaid work or life-long learning needs. The response of national governments and international organisations to the crisis has fallen short of expectations, not least because nation states remain the dominant players even as governments steadily lose control over information flows, technology, migratory patterns and indeed financial transactions. While EU achievements have been mostly internal,

in an increasingly global age the “subsidiarity test” cannot be just a choice between national and EU level, but rather between national, European and global action.

The third obstacle and perhaps the most important in the long run, is the giant leap from 15 to 27 member states. The current crisis shows that the impact of enlargement on the prospects of European integration, and on Social Europe specifically, has been seriously underplayed. If today’s 27 member states had to start from scratch they would never reach the level of consensus and policy development of the *social acquis*: the crisis comes as a reminder of the striking resilience and achievements of European integration and welfare regimes, but also of the deep cleavage in political views, and of the radically different starting points and performance of EU economies.

The real significance of the German Court ruling on the Lisbon Treaty is not legal but political: it signals the extent to which the biggest EU country is now as assertive of its national interests as any other. As I write this paper, amid increasing signs that the Eurozone is slowly sailing towards lukewarm recovery rather than great depression, some EU economies are thrilled by an earlier-than-expected return to growth, just as others suffer a crippling 20% contraction of their GDP. Some countries struggle to keep their unemployment rates below 5%, others would be very happy to have rates of three times this figure. From the employment rate of women and older workers to school drop-outs, one would struggle to find a relevant social indicator that doesn’t vary radically from country to country. Ignoring the impact of this diversity was probably politically necessary when doubts about the trade-off between EU widening and deepening would have been interpreted as unsubtle obstruction against enlargement; but today it would be disingenuous to assume that EU policies can be deepened no matter how many members join the club, or how diverse they are.

### **The need for Social Europe today**

Looking at all these obstacles and constraints, one could be forgiven for seeking refuge in the safety of declamatory statements on Social Europe, long on good intentions and short on operational content: as how can Europe speak with one voice in the midst of the deepest economic crisis since its inception, when its 27 national economies, social situations and political realities sing such different tunes?

And yet, as it seeks an exit to the crisis, the EU must find a social role, and a stronger one than in the past.

## ***The impact of the crisis***

The sudden arrival of the crisis has settled at least one argument: economics is not a predictive science. So we know little about the long-term impact of the crisis, or to what extent it forebodes a paradigm shift – but if there is one prediction about Europe in the next decade that is likely to come true, it is that elections will still be won and lost over jobs and pensions, and that therefore employment and social issues will still be at the core of public debate, at national and EU level.

Ask European citizens from Riga to Athens what they expect from public authorities in these times of crisis, what the biggest challenges of our societies are, what would make Europe and its member states “fit for purpose” – and you know the answer you’re likely to get: keep people in work; raise the poor; and preserve the social services, pension and health systems of our rapidly ageing societies. Surveys consistently show that Europeans are strongly attached to the welfare state, and that the legitimacy of the EU in the eyes of its citizens depends largely on the preservation of the values, of the “social model” Europeans have built over the last 50 years.

For EU citizens, if not for specialists, the current crisis sheds new light on the state of the Union, highlighting that, for the last twenty years, inequality in our societies has been steadily growing and that wages have grown more slowly than productivity; that de-regulation and market flexibility have not been sufficient in themselves to promote growth, competitiveness and employment; but also that strong social protection systems do not necessarily reduce individual incentives or the market’s ability to provide jobs: it is surely not a coincidence if the countries that are tackling the employment and social impact of the recession most effectively are also those with the strongest social protection regimes.

The downturn has brought the spectre of rising public debt, higher income inequalities, lower labour participation, and increased labour segmentation and structural unemployment. Europe’s future depends on its capacity for reform and modernisation, on its willingness to innovate and embrace change – but none of this will be achieved if critiques of market openness and globalisation are ignored or brushed aside. Globalisation obviously has its losers: its benefits are spread while its costs are concentrated, and fears of globalisation and technological change may be exaggerated but they are nonetheless real and must be addressed, mainly by member states but also by the EU as a key facilitator of trade liberalisation.

So what kind of social role for the EU? Governments, policymakers, academics, trade unions and businesses generally agree that, operating on unchanged policies, the EU will grow at a dismally low pace which could lead to social tensions and protectionism; that human capital and skills, social investment and innovation, employment and welfare state modernisation are indispensable to meet the challenges of the global age; that uncoordinated action by individual member states, within the EU as well as in the global arena, is the worst possible course of action. The problem is that while the diagnosis is clear, there is remarkably little consensus on the specifics of a (national or European) cure. Even the widespread critiques of financial capitalism that the crisis has engendered have failed to produce a common view on national social policies, or a consensus on the social role of the EU, whereas the European Social Model of the 1990s, synonymous with Continental welfare states and social protection regimes, appears as an unsatisfactory answer to the new challenges of EU27.

### ***The added value of the EU***

EU integration tends to blossom in times of growth and hibernate during economic downturns: it will have to do the opposite now. The new European Parliament and the Commission begin their five-year mandates with an acute awareness that the credibility of the EU will rest on its capacity to forge a narrative and an exit strategy from the crisis. This is difficult, but not impossible: if managed well, the crisis can serve as an opportunity to ensure that growth outcomes go hand-in-hand with environmental, employment and social outcomes, leading to a more balanced approach where quality of life and distributive aims have a more prominent role in the European project and in its global impact.

Each of the key challenges for the EU in the next decade has a strong employment and social dimension: exploiting the job potential of a greener economy; shaping globalisation by increasing productivity and competing for talent in a knowledge-based society; and adapting Europe's employment and social structures to demographic ageing. The crisis has not changed any of these challenges, but it has added a sense of urgency to the need for socio-economic reform and innovation: the severe constraints in public spending require more efficient public services; economic restructuring calls for more flexible and inclusive labour markets and a massive increase in people's skills and employability.

EU institutions and policies will not be the main actors in addressing these issues: the core responsibility for employment and social policies, for

tackling income inequalities and preventive welfare will continue to rest with the member states, and the diversity of situations between and within countries will require if anything a more differentiated approach. But there is a European dimension to national reform policies: the EU, and the Commission in the first place, can help define the implications of the crisis for EU and national public policies, make the social justice case for economic reform, and pave the way for sustainable growth.

Today, the main way for European institutions, policies, processes and financial instruments to contribute added value is by helping member states focus on key common policy priorities. The focus of the EU 2020 strategy for the next decade should be to steer policy development, innovation and coordination, particularly as concerns the emerging social risks and challenges which are outside the traditional scope of most national welfare regimes and require a high degree of social innovation: managing economic migration and integrating multi-cultural communities; maximising the employment and social impact of climate change and policies; and addressing urban/rural cleavages and labour mobility.

In turn, the most effective way to promote these key strategic goals is to strengthen the links and conditionality between EU policy priorities and financial instruments, and to shift the role of EU funds from mere redistribution tools to incentives towards the achievement of agreed objectives. The added value and credibility of Social Europe and the European Employment Strategy (EES) on the one hand, and of the European Social Fund (ESF) and European Globalisation adjustment Fund (EGF) on the other, can be mutually reinforcing – as long as these policy and funding instruments are also clearly perceived as being mutually reinforcing.

### **Strengthening Social Europe in the next decade**

For 50 years the EU has developed a wider range of instruments than this paper can discuss: from legislation to enforce a level playing field in the single market to preventing gender and other forms of discrimination. The EU Social Agenda and OMC have proven their worth by supporting mutual learning; promoting the wider involvement of stakeholders; giving impulse to the modernisation of social protection systems; increasing awareness of the multi-dimensional nature of poverty and social exclusion; and by forging a shared approach to the common challenges and bringing to the fore emerging common issues.

Time will tell, as the social impact of the crisis unfolds, whether member states and EU institutions will have the strength to establish and enforce

effective common policies in areas of limited EU competence such as social protection or child poverty. However, the best social policy and the best road out of social exclusion remains a (good quality) job – and all the key policies to promote both jobs and the social role of the EU are already present and recognisable in the current Lisbon Strategy for Growth and Jobs. What is required, above all, is not brand new policy objectives or a reshuffle of the old ones, but clarity and simplicity – because the past failures of the Lisbon Strategy occurred not in the formulation of the right priorities, but in focus, ownership and implementation.

This pleads for clearer links between the post-2010 Lisbon strategy and the Social OMC – but above all for a straightforward, simple architecture focused on common EU thematic priorities. One possibility would be to establish just three broad EU priorities and guidelines encompassing employment and social policies: *more jobs; better jobs; more social equity and opportunities*. More jobs to ensure that Europe's growth potential and financial sustainability are not dragged down by demography and a shrinking labour force. Promoting the efficient use of skills and nurturing human capital to create better jobs which can tackle the social impact of the transition to a low-carbon economy and the effects of globalisation and ageing on the labour market. More social equity and opportunities, to provide a stronger emphasis on inequalities, modernise social protection systems, and strengthen the enabling and preventive welfare systems that will sustain the European social market economy.

Three policy areas look especially promising at EU level: flexicurity, skills, and innovation; none of them will have a serious EU impact without strong financial incentives.

### ***Modernising labour markets: flexicurity***

As the Union's agenda increasingly focuses on tackling globalisation and the impact of the crisis, the challenge is to find a coherent policy which can simultaneously address the need for change and the need to preserve Europe's welfare. Such a policy must find a balance between, on the one hand, flexibility of labour markets, work organisation and labour relations and on the other hand, security (in employment as well as social) and non-discrimination.

This is concisely what flexicurity is about. Originally conceived as a means to stimulate productivity and employment, it should become the overarching policy framework for the modernisation and preservation of

the European Social Model in the next decade. Flexicurity is indeed the right policy instrument to address both core and emerging challenges at EU level. It can widen the discussion from security on-the-job to security in employment through policies favouring transition and human capital investment; provide inter-generational solidarity through a lifecycle approach to youth, gender and ageing; and ensure compatibility between short-term responses to the downturn (e.g. reduce working time to keep people in employment) and long-term structural reforms (increase labour supply in response to demographic changes).

True, flexicurity is now more of a challenge in a time of public spending constraint, and some see it as facilitating a race to the bottom on EU wages and working conditions. But in reality it represents consensus among member states on how to modernise and adapt labour markets to the structural changes brought by the crisis and globalisation. The policy framework is there: the EU common principles of flexicurity proposed by the Commission have been agreed by all member states, supported by the EU social partners, and endorsed by successive European Councils. This common ground is no small achievement and should be built upon.

### ***Addressing inequalities through skills upgrading***

The policy framework of flexicurity should be buttressed by a massive emphasis on upgrading skills, on anticipation and adaptation to change, and on combining active labour market policies with life-long learning. Skills upgrading is critically important for Europe's growth and productivity, for its jobs and its capacity to adapt to change, and indeed for equity and social cohesion: it is in fact the only economically sound and socially sustainable exit strategy from the crisis, and the best way to facilitate people's transition from unemployment and inactivity into a sustainable job.

Yet upgrading skills is not enough: ensuring a better long-term match between the supply of skills and labour market demand is just as important. With the right skills, the transition to a low-carbon economy and the increasing importance of healthcare in our ageing societies can be achieved and facilitated, resulting in "green" and "white" jobs to meet the needs of Europe's changing industrial and demographic structures.

The process for skills upgrading must be underpinned by a substantial improvement in the member states' and the Union's capacity to forecast, anticipate and match future skills and labour market needs. The EU can

help by ensuring a thorough audit and continuous assessment of EU skills and labour market needs up to 2020, building upon the Commission's New Skills for New Jobs initiative. Skills shortages and mismatches in the labour market can also be partly offset by increased labour mobility: more transparent information on labour market trends and skills requirements across the EU would contribute to the promotion of occupational, sector and geographical mobility.

### ***Promoting innovation through financial incentives***

The crisis will change the economic and social landscape of the all 27 EU member states in unexpected ways – and it will affect them all very differently. This gives the EU institutions, policies and processes the chance to prove their added value, to find out what works and bring it up, to formulate and implement innovative policy solutions and to ensure that the positive experience in one country is not lost to others.

The most effective way of facilitating this process of adding value is by providing real financial incentives. There will be no credible social role for the EU in the future without money – but money is scarce and should be demonstrably well spent on common priorities, i.e. with a better link and conditionality between policy priorities and financial instruments. The forthcoming EU budget review serves as an opportunity to enhance the role of funding – especially for marking out the European Social Fund (ESF) as a key provider of financial incentives for the implementation of core EU objectives and for the promotion of social innovation.

Three simple principles for policy design and delivery are needed: conditionality and the concentration of resources exclusively on key common EU policy priorities, framed by flexicurity and skills; the systemic impact of interventions; and clear management structures. The main obstacle is that the current system of EU funds delivery is so extraordinarily cumbersome that policymakers focus only on the verification of expenditure as opposed to verification of outcomes, thus EU citizens lose faith in the entire policy. EU institutions treat member states on a par with the most destitute developing countries – administrations so unreliable that they cannot be entrusted with the management and delivery of international assistance. It is extraordinary that the EU can transfer 50 million euro to a developing country's national budget for structural adjustment with just a broad policy conditionality attached, and yet the transfer – from the same EU owned resources – of 50, 000 euro to a member state's budget from the Structural Funds requires iron-fisted rules for the financial verification of expenditure but no real policy

conditionality! EU funds will not be truly effective as financial incentives without an outcomes-based system, underpinned by policy conditionality rather than the verification of expenditure. This implies the devolution, to a certain extent, of financial management and control from the Commission to the member states.

### **Implementing Social Europe at 27: differentiation and governance**

The credibility of Social Europe rests on the better delivery of reforms and innovation, and on meaningful mutual learning. Although past successes are undeniable, there is also considerable room for improvement. Policy development of Social Europe at EU27 is possible – but only by accepting that implementation and progress in European integration requires some form of differentiation. It is difficult to formulate policies – or even policy statements – that are meaningful for 27 member states and that at the same time represent neither a banality nor a vague middle ground. For example, what is the operational value of an EU objective of 60% female employment rate by 2010, if today's rates range from 37% to 73%?

Addressing this problem to date has involved formulating, ambivalent, increasingly general and convoluted opinions, guidelines, and declarations. A method which might possibly ensure both a common framework and the acknowledgement of different realities could be to follow more openly, formally and systematically the steps of the flexicurity approach as spelled out by the Commission: a) establish broad common strategic goals on social policy with qualitative and/or quantitative targets; b) agree common principles or a common framework of broad policy issues for member states to take into account when formulating their national policies; c) establish a limited number of pathways/clusters that take the situations and challenges of the different types of welfare regimes of member states into account in policy formulation and sequencing.

Similarly, while the merits of common EU targets are undisputed, more attention should be given to member states' starting positions and rate of progress.

### **Social Europe in the global age**

In the midst of the Great Depression, Simon Kutznets, Nobel laureate and pioneer of development economics, stated before the US Congress that “*the welfare of a nation can scarcely be inferred from a measure of national income*”. Three quarters of a century later, GDP is still widely used as a definition of growth even if it measures activity and transactions

irrespectively of benefit and costs, only because transactions can be measured without quarrel and well-being can't. But well-being, not economic transactions is what matters in the end: the real challenge for Social Europe is to improve the material conditions of the lives of Europeans through a model that doesn't rest on the illusion of naturally efficient world markets and plentiful natural resources.

There is no intrinsic contradiction between an efficient, dynamic economy and one that places social justice at its core. The achievement of the former rests on the latter. But economic growth alone does not automatically lead to a reduction in income inequalities, in-work poverty or regional disparities and not everybody can be incorporated in the labour market. Investment in labour market modernisation, skills upgrading and innovation can provide high returns in growth, productivity and employment – but strengthening Social Europe also implies difficult choices between efficiency and equity, and a meaningful degree of (financial) solidarity between member states. In this respect, the case for Social Europe and for a stronger Union in the next decade remains to be made, and progressive political parties still have to find a coherent narrative for the role of the State and welfare in the XXI century.

There is more. While Europe sometimes tends to preach and irritate its global partners on a range of issues, it has to be reiterated that in the employment and social field, more than in any other perhaps, the EU represents the aspiration for a world governed by law. The current crisis offers an opportunity to strengthen the Union's sphere of influence in an increasingly interdependent and multi-polar world, and shape globalisation in a sustainable manner. While recognising the diverging employment, social and economic realities, the EU strategy for 2020 should push for the exchange of experience and cooperation towards a common international agenda for sustainable development, focused on free and productive employment with a rights-based approach and access to minimum social protection; on social dialogue; on antidiscrimination and gender equality. In return, the EU may gain some of the vitality and confidence about the future that is so pervasive in emerging economies from Brazil to Turkey and China - and so conspicuously absent in Europe.

# Chapter 8

## **Lisbon through the looking glass: Europe's knowledge economy and the Varieties of Capitalism**

Dermot Hodson and Marco Simoni

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The European economy has undergone unprecedented turmoil as a result of the global financial crisis. The collapse of the US subprime mortgage market in mid-2007 and its after effects have been keenly felt on the other side of the Atlantic with banks in the euro area alone expected to lose US\$649 billion over the period 2007-10 (ECB, 2009: 103). The financial crisis has already taken its toll on the real economy with gross domestic product (GDP) in the European Union set to contract by 4% in 2009 while unemployment is likely to rise above 9%.<sup>1</sup>

The global financial crisis has put paid to EU leaders' promise at Lisbon in March 2000 to deliver "sustainable economic growth with more and better jobs" by the end of the decade. In truth, however, the dream of Lisbon faded well before the current round of economic and financial turmoil. In 2007, the unemployment rate in the EU15 was at 7%, i.e. marginally lower than 2000.<sup>2</sup> GDP growth in the EU15 averaged 1.9% over the period 2000-08, which is disappointing by historical standards and compared with key trading partners: in 2008 GDP per capita in the EU15 stood at 74% of the US level, which is only fractionally better than in 2000.

The Lisbon Strategy has also fallen far short in its efforts to build the world's most competitive, dynamic knowledge-based economy. According

to the European Innovation Scoreboard, the US is outperforming the EU in 11 out of the 15 most important drivers of innovation.<sup>3</sup> The EU may be producing more science and engineering graduates than the US and employing more workers in medium-high- and high-technology manufacturing, but expenditure on R&D in the US is far greater than it is in the EU. According to the latest figures, gross domestic expenditure on R&D in the EU15 was around 71% of US level, which is roughly the same level as in 2000.<sup>4</sup>

These conditions are made more problematic by fading political momentum for the Lisbon reform agenda. The early formulation of the Lisbon strategy, with its emphasis on social inclusion, was inspired by a modernised, centre-left vision which, at that time, resonated with a majority of member states. Since 2005, this was replaced by a conservative counterpoint focused on growth and competitiveness, reflecting the emergence of a centre-right majority in the Council. However, neither of these approaches managed to win the confidence of the general public, which remains unsure about whether the EU is having a positive impact on employment and social affairs.<sup>5</sup> This point is crucial since an economic governance strategy must be legitimate in the minds of the public as well as the member state governments if it is to bear lasting fruits.

This paper seeks to understand the Lisbon Strategy through the lens of a stylised version of the Varieties of Capitalism (VoC) literature. This stream of political economy emphasises the importance of institutional complementarities for national economic performance.<sup>6</sup> Its central finding is that there is no one path to economic success and that the effectiveness of economic policies will vary from one country to another according to the underlying model of capitalism. The theoretical and empirical insights of the VoC paradigm are very useful, we think, for understanding the Lisbon Strategy's achievements and shortcomings over the last decade. The VoC approach also offers food for thought regarding the direction of EU economy policy beyond the current economic and financial crisis.

## **A stylised presentation of the Varieties of Capitalism approach**

Peter Hall and David Soskice set out the central tenets of the VoC approach in an introduction to their edited book in 2001, which rapidly became one of the main paradigms for political-economy analysis.<sup>7</sup> To put it (very) simply, the VoC can be understood as an attempt to build a new framework for understanding capitalist economies. In Liberal Market Economies (LMEs, e.g. the US or the UK), coordination among economic

actors happens through hierarchical and market mechanisms, while in Coordinated Market Economies (CMEs, e.g. Germany) coordination happens primarily through non-market mechanisms, which include, for example, relational or incomplete contracting, networks cooperation, and monitoring. LMEs and CMEs are two stylised configurations in which the highest degree of coherence between different institutions such as the labour market, the financial sector, and corporate law, is reached. As a consequence, firm relations and corporate strategies vary systematically across these ideal types of capitalism. In the real world, most countries are situated in the space between these two archetypes, clustering around one or the other.

An important corollary of this theory is that seemingly distinct spheres of the economy, such as for example labour law and financial regulation, are closely connected. Under ideal conditions, there will be a high degree of complementarity between these spheres. For example, if investors have access to information about the internal operation of firms, thus basing their decisions on networking, reputation and long-term relations, their decisions are likely to be less influenced by short-term performance and profitability. A “patient” model of corporate finance allows firms to support expensive vocational training programmes for their employees, which in turn increases productivity levels. A highly specialised workforce is likely to generate incremental, small-scale innovation on processes and products. The protection of employees against dismissals, under this framework, complements the other institutions because long-term relations with employees reduce the chances that other firms poach a well-trained worker. In other words, in CMEs, employment protection legislation is not a source of rigidity generating higher-than-optimal wage levels. On the contrary, it becomes a way to insure the investment in human capital undertaken by firms.

If investors do not have access to information networks, as is the case in LMEs, firm financing will happen primarily through the stock market. Balance sheets and short-term performances will drive investor decisions and a fluid labour market will allow employment to follow capital allocation. Firms will tend not to provide vocational training, and the state will have a lesser role in vocational training and education. Employees will tend to develop general skills, more widely adaptable, rather than industry-specific skills, which prevail in CMEs. This logic of institutional complementarities is confirmed by empirical observations. Data show that countries with a comparatively higher value of stock market capitalisation, such as for example Denmark, and the United Kingdom, have more

flexible labour regulation than countries like Finland or Germany, where the value of capitalisation is less and information networks between banks and firms' management are more dense.<sup>8</sup>

Different institutional complementarities, however, do not imply a different capacity to cope with globalisation pressures. On the contrary, different economies will develop responses depending on their country-specific comparative advantage. In other words, the VoC predicts that countries will react differently to similar pressures, meaning that globalisation is unlikely to result in convergence towards a single economic model.<sup>9</sup> Another important result of the VoC is that there appears to be no systematic difference between LMEs and CMEs in terms of overall income levels and growth rates. However, LMEs tend to have higher participation rates in the labour market and a more unequal income distribution, compared to CMEs. Additionally, the two ideal-types of capitalist economies will tend to specialise in different patterns of innovation and competition and therefore in different industrial sectors.

In LMEs, the higher degree of flexibility and mobility with market-based modes of firm relations incentivises radical forms of innovation, and strategies based on price competition. In CMEs, in contrast, cooperation between capital and labour lends itself to incremental forms of process and product innovation, as well as quality-based competition strategies. These diametrically opposed incentives result in different comparative advantages so that, in the traded sector, CMEs and LMEs tend to specialise in different industries and to develop patents on different categories of goods.

Under this framework, policymakers must pay due regard to the implications of economic reform for different spheres of the political economy. To put it simply, the interplay between institutions implies that a limited number of combinations are both feasible and optimal.

### **Lisbon through the looking glass**

The VoC approach, it is important to recognise, would be ambivalent about the very idea of the Lisbon Strategy. According to this school of political economy, the competitive advantage of economies blossoms from the bottom up rather than thriving from the top down, leaving little room for government intervention. As such, attempts by EU policymakers to “build a knowledge-based economy” and, latterly, to foster “growth and jobs” would smack of government overreach for proponents of VoC. Similarly, the focus on national economies as a key unit of analysis means that

the EU is treated by the VoC as an important but essentially exogenous factor, akin to the impact of globalisation on national trade-offs. For this reason, the internal machinations of EU policymaking are of second order importance for most VoC scholars.

Fiorettes makes a rare attempt to explain the formation of EU policies through the VoC lens.<sup>10</sup> Using the negotiation of the Maastricht Treaty as a case study, he argues that national preference formation, under EMU can be linked, in many cases, to the underlying model of capitalism. Specifically, he views the UK's opposition to the Social Charter as an attempt to protect the institutions of a liberal market economy. Likewise, Germany's reticence towards financial market deregulation is explained by a desire to preserve its "patient" model of corporate finance.

This line of reasoning might help to explain some of the Lisbon Strategy's limitations. If incentives are derived by politicians from the comparative advantage of their own country, they should refrain from adopting common reforms. Indeed, the varying roles played by governments in different models of capitalism underline the dangers of developing a uniform mode of EU governance. Thatcher hints at this conclusion, when he suggests that the regulatory approach to governance implied by the Single Market Programme suits the UK, but not Germany and France.<sup>11</sup> Similarly, Amable warns that developing a common approach to economic reform, disregarding national differences, could lead to a political backlash.<sup>12</sup>

Some VoC scholars would appear to be more open to the idea of an EU reform agenda than others. Iversen, for one, argues that in "sectors of the economy and the labour market where trade and the division of labour has traditionally been limited", different models of capitalism might experience pressures for convergence that result in adopting common policies across countries.<sup>13</sup> In this way, national economies can experience simultaneously both convergence and divergence in different sectors of the economy. This view opens more room for shared EU programmes and may help to explain the broad consensus among member states on the need to complete the liberalisation of services within the single market.

On a more general note, there is also some commonality between the Lisbon Strategy's treatment of globalisation and that which underpins the VoC. The European Council's concluded at Lisbon in March 2000 that the EU "is confronted with a quantum shift resulting from globalisation and the challenges of a new knowledge-driven economy".<sup>14</sup> In review of the VoC debate, Hancké, Rhodes, and Thatcher argue that the question of how

to cope with change is germane to all European countries, irrespective of their underlying model of capitalism.<sup>15</sup>

Even if there is some overlap between their fundamental diagnoses of Europe's economic ills, the prescriptions offered by the Lisbon Strategy appear, at first glance, to be quite different from the basic precepts of the VoC. Hall for one, criticises the EU's attempt "to find a new legitimating ideal in a commitment to open markets".<sup>16</sup> He notes that "over the past twenty years, the powers of its Commission, Court and Council have increased, and a Union once dedicated to the ideal of political integration has become an agency dedicated to market liberalisation. As a result, its member states now face a supranational agency that puts continuous pressure on them to deregulate protected markets, eliminate industrial subsidies and promote free flows of capital. Across its member-states, the European Union imparts a liberal-bias to initiatives for institutional reform".<sup>17</sup>

Ironically, the governance structure underpinning the Lisbon Strategy was devised, in part, to overcome this line of criticism. In March 2000, EU leaders unveiled a new Open Method of Coordination, which was assigned a key role in the realisation of the Lisbon Strategy. The Open Method begins with the setting of overarching goals for the EU as a whole, which are then translated into guidelines for national and regional policy. Member states take the lead in the transposition of these guidelines and have considerable latitude to tailor reform packages to the institutional specificities of their own economies. There is little scope for supranational policymaking in this set-up. The role of the Council of Ministers and the European Commission is to monitor the design and implementation of national economic policies. Viewed from this perspective, the Lisbon Strategy's rejection of the one-size-fits-all and essential intergovernmental approach to economic reform should resonate rather than rankle with the VoC approach.

### **The limits of policy learning**

The idea that national policymakers can learn from one another is central to the Lisbon Strategy. Indeed, the Open Method of Coordination aims at "spreading best practice and achieving greater convergence towards the main EU goals".<sup>18</sup> This is essentially a voluntary approach to policy transfer by leaving primary responsibility for the design and implementation of economic policies to the member states and imposing neither legal nor financial penalties in the event of non-compliance.<sup>19</sup>

Policy transfer would presumably receive short shrift by proponents of the VoC approach. Under different sets of institutional complementarities, economic reform must be “incentive compatible” in the sense of being consistent with the functioning of the underlying economy. However, as it happens, wholesale attempts at policy transfer under the Lisbon Strategy have been a relatively rare occurrence. Although EU policymakers may have stepped up their monitoring of member states’ reform efforts in recent years, they have grown more reluctant and less prescriptive in their approach to this task. This tendency is reflected in the increasingly neutral language employed in the conclusions to the annual Spring European Council and in the European Commission’s aversion to naming, shaming and blaming member states that fail to deliver on their reform commitments.

Perhaps the most ambitious attempt at policy transfer concerns the EU’s efforts to promote collective learning from the Scandinavian experience of labour-market reform.<sup>20</sup> The Spring European Council in Brussels in March 2006 explicitly called on member states to outline “under an integrated flexicurity approach” and, to this end, invited the Commission to work with member states and the social partners to draw up common principles.<sup>21</sup> On the basis of this mandate, the European Commission held a stakeholders meeting in April 2007, which was attended by over 400 representatives of the social partners, NGOs and member states. The results of this meeting served as an input into the June 2007 Communication setting out common non-binding principles on flexicurity. The Spring European Council in March 2008 adopted these principles and asked member states to implement them in their National Reform Programmes for Growth and Jobs.

The impact of the flexicurity debate on the reform process has been far from trivial. According to the Commission’s Annual Progress on Growth and Jobs, around half of the EU’s 27 member states “have now developed or are developing comprehensive flexicurity approaches, and combining efforts on contractual arrangements, lifelong learning, active labour market policies and social security systems” compared with only a “handful of member states in 2007”.<sup>22</sup>

From a VoC perspective, attempts to transfer the Danish flexicurity model to other EU member states could have disastrous consequences. The “original” Danish strain of flexicurity combined a very high degree of flexibility in hiring and firing (in a country that has one of the shortest

average job tenure figures in the EU) with universal income protection. If applied to countries with an underdeveloped vocational training system, such policies would lose their “security” dimension and lead to social (and budget) un-sustainability.<sup>23</sup> If applied to CMEs, where high productivity depends also on labour protection from dismissal, such policies could also have the unintended consequence of triggering incentives to pursue cost-cutting strategies in lieu of a quality-competition strategy in mature industrial sectors leading to output and employment losses. The flexicurity experiment could dampen productivity and comparative advantage in sectors characterised by incremental innovation, without generating alternative sources of competitiveness.

Upon closer inspection, however, there is little evidence to suggest that Danish labour-market practices are being transferred lock, stock and barrel to other EU member states. For example, Germany has reached increased flexicurity within its economy by flexibilising marginal jobs, mostly concentrated in the non-traded service sectors, and retaining protection at the core. A dual labour market might have detrimental effects on income distribution,<sup>24</sup> but it seems that this form of flexicurity can develop within a CME-type production regime.

The Lisbon Strategy’s promotion of flexicurity reforms appears to be promising for a number of related reasons. First, it is an interesting attempt to unite the economic and social strands of economic reform. Second, it resonates with a deeply rooted conception of the European social model as a framework where a well-functioning market economy is combined with a high degree of social protection. Third, it illustrates the potential of the “openness” of the Lisbon Strategy in its capacity to foster policy solutions that coexist with country-specific models of capitalism, and divergent societal preferences (such as preferences for more or less leisure time, and differentiated rates of labour market participation among social cohorts).

### **An overly general innovation policy**

While mainstreaming flexicurity provides a positive example of the EU’s ability to address socio-economic concerns, a counter-example comes from EU strategy for innovation. In September 2006, following the 2005 re-launch of the Lisbon treaty, the Commission issued a communication on “Putting knowledge into practice: A broad-based innovation strategy for the EU” in order to identifying EU-wide programmes to reach higher innovation rates. For example, the Commission argues that potential for innovation must be fostered by the intervention of public authorities. In

particular, “Through the Open Method of Coordination the Commission will help to facilitate the modernisation and restructuring of education systems so that they provide the necessary competences to foster innovation”.<sup>25</sup>

There are two ways to interpret this objective. A first interpretation would suggest that the Commission is arguing that the education systems within the EU should keep pace with the rapid technological changes that the world is experiencing, particular in the ITC sector. If this is the case, it is unclear what value added the EU could play apart from dispensing common sense to national policymakers, for example by calling for schools to be provided with computers. On the other hand, if this programme is suggesting that each member state should aim at endowing the population with the same kinds of skills, then this directly clashes with the logic of the VoC, and is likely to result in very little policy learning at all.

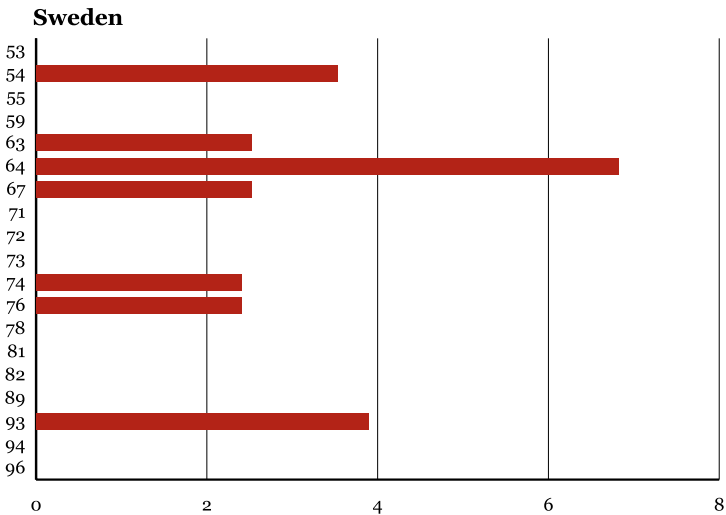
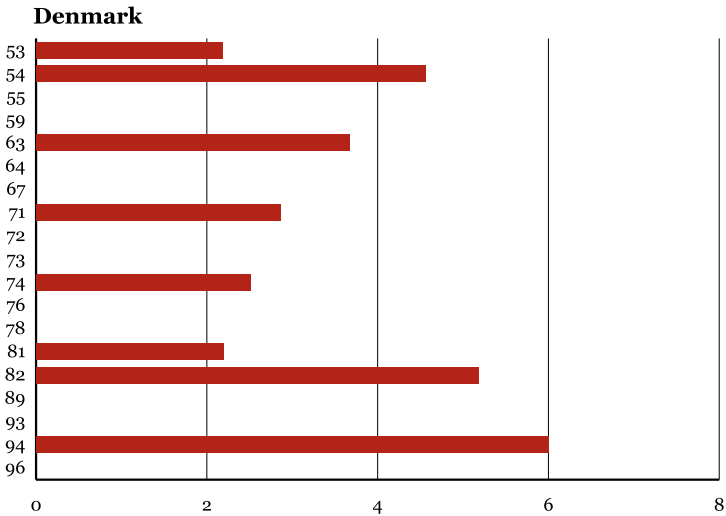
As recalled earlier, patterns of innovations are one of the key aspects of divergence between LMEs and CMEs. This is not to say that one has more innovation capacity. Rather, because of their different institutional configurations, LMEs tend to favour radical innovation in products and processes, while less dynamic CMEs develop innovation patterns that express themselves in marginal, but steady, increments.<sup>26</sup>

To offer stylised EU-focused evidence to corroborate this story, Figure 1 compares four EU countries: Germany and the UK are archetypal Coordinated Market and Liberal Market Economies respectively. Denmark and Sweden are more intermediate cases, with the former leaning towards the LME cluster, and the latter towards the CME cluster. These countries are the overall EU leaders in innovation (together with Finland),<sup>27</sup> and therefore they represent the model that other less dynamic countries should emulate.

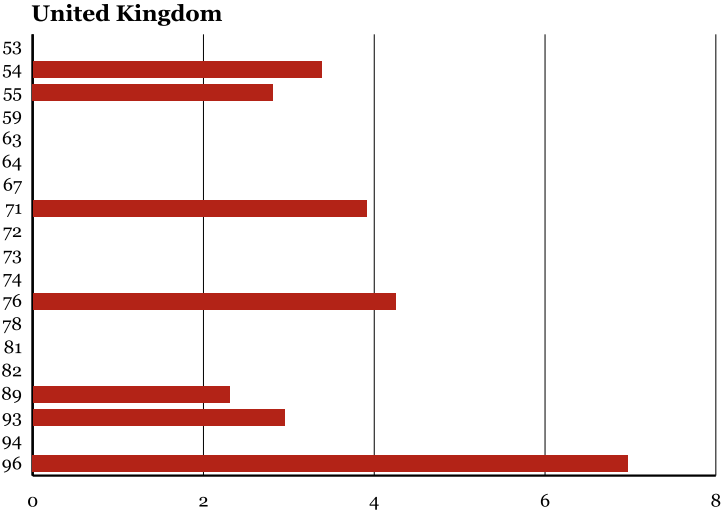
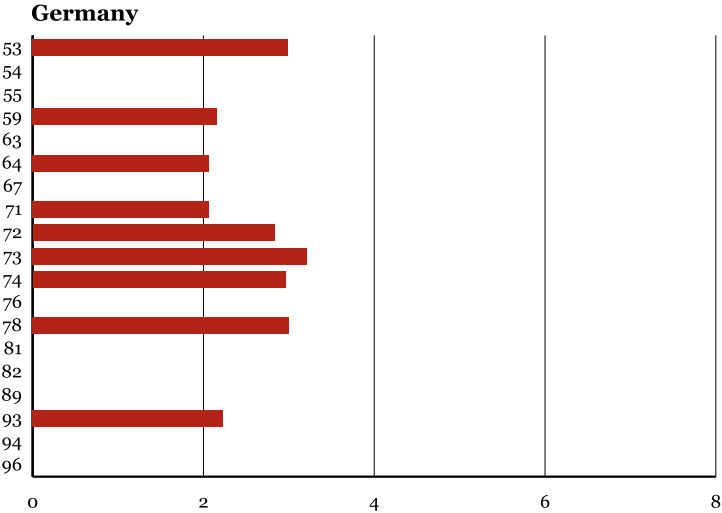
The bars in each graph show the industrial sectors in which those countries hold a strong comparative advantage. The bars identify the category of goods that are leaders in export performance within each country vis-à-vis all the other countries in the world.<sup>28</sup> The widest difference in comparative advantage is between Germany and the UK. They share a strong comparative advantage only in one category, i.e. power generating machinery and equipment (SITC 71), in which arguably both radical leaps of innovations and incremental small-scale improvements are likely to play a role. For the rest, Germany specialises in the production of goods such as metalworking machinery (SITC code 73), general industrial machinery

(74), and road vehicles (78). On the other hand, leading sectors in the UK include medical and pharmaceutical products (SITC code 54), power generating machinery (71), and telecommunication and sound recording apparatus (76). These are sectors where innovation tends to happen in leaps rather than increments, or where increased returns to scale allow for exploiting price-competitive strategies. Sweden and Denmark represent

Revealed Symmetric Comparative Advantage by SITC Code



two intermediate configurations, and this is reflected in the mixed specialisation patterns. Denmark shares more sectors of specialisation with the UK, while Sweden does so with Germany. On the basis of this evidence, the design of a “Broad-based Innovation Strategy for the EU”, aimed at mainstreaming policies across different models of capitalism seems too broad to be effective.



Data refer to 2006. Source: authors' calculation from OECD data.

## Towards a less dogmatic approach

What lessons can be drawn for the future of the EU's economic reform agenda? A general lesson is that the identification of a clear "socio-economic frame", such as flexicurity, appears to be more conducive to policy coordination than anodyne references to enhancing innovation. An excessively broad and comprehensive approach to issues of economic reform at the EU level may be difficult to disagree with, but it can also be too vague to translate it into policy action. Instead, EU policymakers should strive to identify further "socio-economic frames", perhaps with similar features to flexicurity. These features include: (1) a recognised degree of success; (2) a clear foundation in the traditions of the European Social Model; (3) the adaptability to different models of European capitalism.

We think that, *prima facie*, three broad sub-fields of European political economy could be subject to the same procedure of inclusive debate and scrutiny that was applied to flexicurity: entrepreneurship; health care; and the environment. Exporting the method adopted to flexicurity to other fields could help to flesh out the EU's reform agenda in substantial terms.

A central theme of this chapter is that the EU should enhance the economic credibility of its reform agenda by striving for more pointed and analytically-robust reform recommendations. There have already been some positive developments in this regard. In December 2005, the Commission launched LABREF, an annually-updated database of labour-market reforms. In 2007, the EU-KLEMS database was presented, including a wealth of information on growth and productivity at the industry level. Commission officials have also worked with their national counterparts on the Lisbon Methodology (LIME) working group to develop more economically robust methods for measuring structural-reform progress.<sup>29</sup>

We think that these efforts should be intensified with a view to identifying different reforms patterns and exploring the effectiveness of individual reforms more thoroughly both post-hoc empirical verification, and ex-ante plausibility tests. Against the backdrop of the VoC approach, we can identify two broad areas for further work for improving European innovation patterns. First, more knowledge is required regarding the functioning of institutional interactions both at the sub-national level, and at the level of recently acceded member states. Recent research has shown that some of the EU's newest member states are showing patterns of CMEs, of LMEs, as well as less clear ones.<sup>30</sup> Anecdotal evidence, such

as the emergence of high-tech start ups in countries such as Estonia, and hints of tripartite agreements in Romania, confirms the view according to which a differentiated pattern of development is present among the least developed EU countries. At the same time, the importance of regional differences in countries like the UK, Italy, Spain, and Germany, suggest that patterns of institutional complementarity are not only a feature of the national level, as suggested by the first formulation of the VoC, but are developing also at the sub-national level. It is possible to hypothesise that the completion of the single market and the increased economic integration of EU countries has increased the relative importance of local institutions as sources of comparative advantages. An increased knowledge of these patterns, carried out through cooperation between research units within EU institutions, academia, and member states, can point not only to a more refined understanding of the economic reforms that are likely to succeed, but also to a more specific set of criteria to orient EU cohesion funds.



# Chapter 9

## Towards a European safety net

Anke Hassel

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Compared to other world regions, the EU is a forerunner in combining free market economies with a social agenda. No other region in the world has achieved both high rates of income equality and social protection for the poor. Similarly, no other region in the world has a similar level of social public spending. The social reality of Europe has traditionally included a premium of social inequality. At the Lisbon European Council in March 2000, the European Union explicitly set itself a new strategic goal for the next decade: *“to become the most competitive and dynamic knowledge based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”*.<sup>1</sup> Since the summit the EU has used the Open Method of Coordination (OMC) as a framework to coordinate policies at the national level in order to attain the goals of simultaneous economic progress and social inclusion.

However two recent trends have had adverse effects on social cohesion within the EU: first, the access of the new member states has widened the economic and social inequality within and between member states and second, within the majority of member states, income distribution, wage inequality and in particular the share of in-work poverty has tended to widen over the last decade. Rather than achieving greater social cohesion, social cohesion has become more brittle. While it is likely that these trends

will be reinforced rather than contained by the financial and economic crisis, the issue of social cohesion and inequality has now become political priority in most EU member states.

Given the new inequalities and pressures on the low-paid/low-skilled in most European states, the idea of a “European safety net” is now on the agenda. This idea is, however, confronted with world-wide trends towards an increasing social inequality driven by a combination of economic liberalisation, internationalisation and the demise of protective institutions, particularly trade unions. It is also hampered by the vast variety of welfare and labour market structures in the European member states. Welfare states, transfer payments and labour market regulations interact at the national level, and European regulations/policies may not be appropriate for preserving high levels of equality in Europe. Should there be a European policy agenda on ensuring a general safety net? Has the Lisbon agenda sufficiently articulated the challenges and policy options of achieving economic progress and social cohesion? Or do we need a new and more radical approach towards social equality in a globalised world?

As we will see in the following, the EU has in the past successfully helped to shift the debate from welfare rich inactivity towards activation, liberalisation and flexibility through the Lisbon agenda. The post-Lisbon agenda should now advocate a recalibration of the EU policy agenda towards a “high-employment, high equality society”<sup>2</sup>, in which activation policies are embedded in measures containing widening social inequality.

High employment remains on the policy agenda for several reasons. First, only high employment levels enable European societies to cope with ageing and new economic competition in the world economy. Second, rising skill expectations and investments in education depend on the use of these skills in the labour market. And third, only high employment levels generate sufficient tax returns to finance large welfare states.

The policy problem of simultaneously pushing for employment growth and social cohesion lies in the increasing gap between productivity levels of the low and high skilled. This gap is exacerbated by increasing globalisation which allows for the off-shoring of low skilled tasks in the value chain. For workers in advanced industrial economies and extensive welfare states, this means that pushing up transfer payments and wage levels for the low skilled in order to reduce poverty runs the risk of reducing employment

opportunities. If transfer payments are too high and exceed market wages for the low skilled, low skilled workers will not try hard to look for work. If wage levels for the low skilled are set too high, employers might not offer jobs to the low skilled. There is, therefore, a dilemma between work incentives and labour costs, which is not easily solved. The win-win solution is to increase the productivity of the workforce as a whole, which allows for higher wages and transfer payments. However, in the past, raising overall skill levels has not been easy. Many countries have experimented with various forms of subsidies for low productivity employment by either creating a larger public sector or by giving tax credits to employees or subsidies to employers.

While all industrialised countries face the dilemma, the answers often vary. Countries with lower levels of social equality and flexible labour markets find it easier to foster employment growth by letting wages and transfer payments drop. Others accept lower levels of employment in exchange for higher levels of welfare provision.

High equality is the second component of the post-Lisbon agenda. High equality is an asset in its own right - not for political or ideological reasons. In contrast to policy discussions in the US, the European debate never entirely shifted the emphasis from a concern over equality to a concern over poverty but has traditionally given social equality an equal footing with the fight against poverty. Inequality is linked with poverty, as highly unequal societies also have higher poverty levels. In other words, fighting poverty is far easier in more egalitarian societies than in unequal ones. This view should be reinforced by the EU's post-Lisbon agenda, since poverty and social inequality are closely linked with more unequal societies also having higher incidences of poverty.

This policy agenda towards high employment and high equality should keep the emphasis on high levels of labour market participation and flexibility but should also more seriously push towards employment friendly social policies and sustained labour market institutions ensuring low levels of wage and income inequalities. Flexicurity – which has become the key concept of the EU Commission for guiding labour market reforms – is a good first step towards combining economic growth and social cohesion but has been seriously lopsided in its focus on flexibility and neglect of social equality. Flexicurity needs to be complemented with equality oriented policies and institutions.

## **Where do we come from? The EU agenda on employment growth and social inclusion**

It seems important to remember that the old member states of the EU originally consisted of a set of mature welfare states that during the 1970s and 1980s had achieved high levels of social equality – unmatched in other regions of the world. In the golden years of welfare expansion up until the 1980s, most member states had tended to respond to economic shocks and industrial restructuring by taking people out of the labour market and thereby reducing the employment rate. In contrast to other OECD countries, western Europe had relatively high shares of workers going into early retirement but also joining the ranks of the long-term unemployed. As has been well documented, Europe had developed a problem of employment creation while the liberal labour market of the US created many jobs but many with poor quality.

The single European market programme of the 1980s – while liberalising many sectors of the European economy – initially even relied on the functioning of the mature welfare state during the process of restructuring, which was induced by the liberalisation of markets. Moreover, Jacques Delors framed the social agenda as a form of compensation for economic liberalisation and thereby implied that the EU would stand behind the role of the welfare state. While the EU did not have any responsibility in the area of welfare, the Commission well understood that welfare played a key role for the legitimacy of the Single European Market.

In this light, first discussions on regulation and standards of minimum incomes started at the EU level in the early 1990s. In May, 1991, the Commission proposed a recommendation on minimum incomes in the follow-up of the Community Charter of Fundamental Social Rights of Workers (1989) and the affiliated action programme. This resulted in a “Minimum Income Recommendation”<sup>3</sup> enacted by the European Council which focused on the acknowledgment of the fundamental right to access resources and social assistance and on agreement of common principles for the enforcement of this right within the framework of national social security systems.

The 1992 recommendation applies to all member states in the sense that governments generally should set minimum incomes, but – like all recommendations – it is not a legislative obligation. It has prompted a more comprehensive social security approach at least in some member states such as Portugal and Italy.

The Lisbon Agenda changed the European approach towards welfare and the labour market: In the context of mature welfare states ensuring high levels of social equality, the Lisbon Agenda and the renewed European Employment Strategy – now renamed the “Partnership for Growth and Employment” ultimately shifted the focus of the debate away from welfare provision towards activation and labour market participation. It set itself strong targets – maybe too strong, since the Kok-Report, which was commissioned in 2004, criticised that “an ambitious and broad reform-agenda needs a clear narrative, in order to be able to communicate effectively about the need for it.”<sup>4</sup> Moreover, the report complained that the employment goals set for 2010 were far from realisable and recommended an increasing focus on “naming, shaming and faming” in order to enhance the activities in the member states to increase employment.

The clear narrative and focus was found with the flexicurity agenda, which can now serve as the most natural starting point for fostering both employment growth and social cohesion in the EU. Flexicurity is currently the most sophisticated policy approach at the EU level which aims to combine change, flexibility and the protection of workers. It has recently moved to a highpoint on the agenda of the European Commission through its endorsement by the European Council of Ministers in December 2007. In the words of the Commission, it “involves the deliberate combination of flexible and reliable contractual arrangements, comprehensive lifelong learning strategies, effective active labour market policies, and modern, adequate and sustainable social protection systems.” The flexicurity agenda is therefore the single most important point of reference for the modernisation of the European social model. The various debates on the European Social Model have also made it virtually impossible to separate the debate on minimum incomes from terms like active labour market policy, flexicurity or social inclusion.

Moreover, the flexicurity approach has also taken into account the complexity of the interaction between social policy and the labour market. As the recent report on Employment in Europe points out: “Everything considered, there is no single combination of policies and institutions to achieve and maintain good socio-economic results, but rather there are different pathways to good performance that are, to a large extent, the result of distinct historical trajectories. Respecting the principles of subsidiarity (and the Open Method of Coordination), this allows scope for tailor-made policy packages to suit national preferences with respect to distributional aspects, risk-taking and other national objectives.”<sup>5</sup>

However, so far the flexicurity approach has worked better in achieving flexibility than in ensuring social cohesion. Social cohesion has remained focused on the workings of national security systems and the preservation of minimum incomes. Flexicurity puts a premium on job creation and flexible adjustment. In particular, the approach has not addressed the question as on how to choose between the components of flexicurity – flexibility and security – when facing a trade-off. While in some areas, both elements can be easily reconciled, in other areas policies and institutions, which seemingly inhibit flexibility, might be important pillars for social equality and cohesion.

The connection between combating poverty, fostering social inclusion and minimum incomes has already been realised by the EU Commission and emphasised in the communication on the social agenda.<sup>6</sup> The Commission took the persisting level of poverty as a reason to start consultation with the social partners on measures via the labour market and to forward the idea of a European Year of combating poverty and social exclusion in 2010.<sup>7</sup>

This reflects that throughout Europe, solidarity and cohesion have been and still are important shared values that economic and social policies are built upon. The relationship between employment, work, poverty and social exclusion is an integral part of the Lisbon Strategy. In the Employment Guidelines, EU member states agree to work towards substantially reducing segmentation, gender pay gaps and in-work poverty. The link between quality and quantity of employment thereby becomes increasingly important, given the atypical and precarious work patterns augmenting the risk of polarisation within society. Europe should remind itself of the institutions and policies on which social equality has rested in the past. These include comprehensive welfare states and poverty relief but also the notion of social partnership and strong labour market institutions.

### **The post Lisbon Agenda: combining equality and employment**

The Lisbon agenda and the flexicurity approach have certainly helped to raise labour market participation and to facilitate the activation of the long-term unemployed. It was an important step towards creating a more dynamic economy and society. It was less successful in solving or even addressing the problem of social inequality and the low wage trap. Rather the opposite, liberalisation and activation have sharpened the problem of social cohesion rather than tackling it. The reasons for an increase in social inequality within countries are closely linked to changes in the

labour market. Movements of labour and capital after EU enlargement have increased. Migrant workers are often hired on lower wages and put existing wages under pressure. Since the late 1990s, new forms of employment contract such as part-time work, self-employment and temporary employment have spread. They helped to boost employment but also led to more precarious employment conditions often associated with lower wages. Also, the progressive decline in trade union membership and collective bargaining coverage observed in most EU countries contributed to a further polarisation of wages.

In particular, the pressure has been applied on the low skilled and low paid at the bottom of the labour market. While mid-level incomes have more or less remained stable over the last two decades, incomes at the lower end of the labour market have dropped. The in-work poverty risk in the EU has increased in all countries for which data is available (see graph on in-work poverty). In some countries, the increase has been substantial. This has to do with the trend towards activation of the low skilled, that previously have not been able to find work. Social inequality is therefore strongly connected with issues of activation, and employment of the low-skilled.

The complex interaction between minimum wages, subsidies for the low-skilled, minimum incomes and other forms of redistribution needs to be at the centre when considering a new social safety net for the EU. It should focus on the reasons and dynamic of the rise of in-work poverty in Europe. This interaction is highly country-specific and cannot be “Europeanised” easily. But we have learned from Lisbon and the ensuing agendas and approaches that benchmarks can serve as point of orientation for national policymakers. In this case, the combination of high employment levels and strong measures of activation with relatively generous forms of redistribution through social policy should guide European policymaking. Some of these benchmarks, such as high employment levels, are already included in the Lisbon Strategy. Others, such as family friendly social policy and other forms of redistribution, should be included as well. Moreover, social partners and wage bargaining institutions as one of the main pillars of ensuring wage and income equality should continuously be encouraged and fostered, rather than reliance on statutory measures of wage setting.

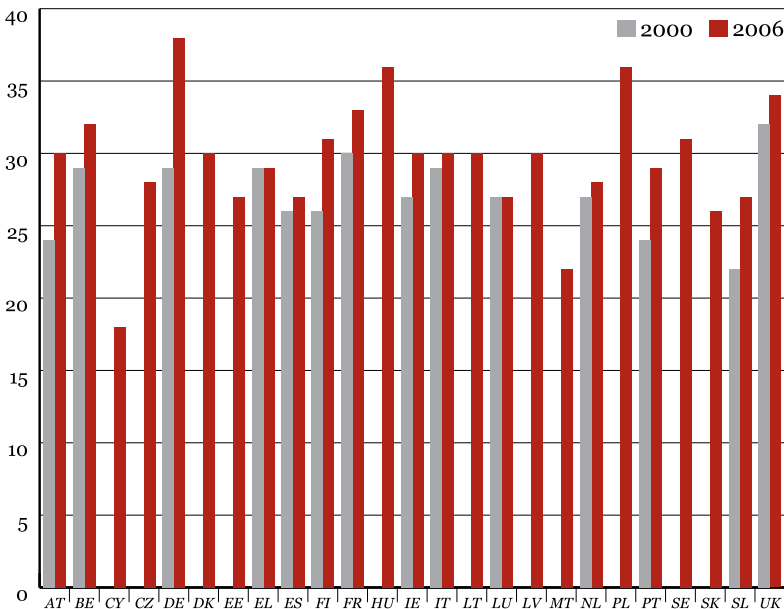
### **Minimum wages, minimum income and tax credits – how to combat in-work poverty in Europe**

Discussions about minimum wages, minimum incomes and subsidised employment need to be placed into a context of employment effects,

existing practices of wage subsidies and benefits as well as their effects on skills. Not all interactions are clearly understood and some are still debated.

For instance, it is still debated as to what extent there is a trade-off between wage and employment levels at the lower end of the labour market. While some economists assume that higher wages will always lead to a loss of employment, the empirical evidence for this is shaky. Well known research results in the US have shown that an increase in minimum wages did not lead to employment losses but rather to firms easily adjusting to higher pay rates. Others have argued that employment losses occur with a time lag. In a cross country comparison testing the effects of higher wages in different economic sectors, Lane Kenworthy comes to the conclusion: “There is reason to suspect that higher wages reduce employer demand for labor in low-productivity service jobs. But in practice they may not reduce it by very much and perhaps not at all”.<sup>8</sup> Research on the employment gap in services in different countries has come to the conclusion that it is not wages which are the main factors explaining lower levels of employment in low paying service sectors in various countries, since wages tend to be roughly equivalent even though the wage structures overall were more egalitarian.

Figure 1. In-work poverty risk in the EU



Source: Eurostat No data available for BG/RO

Nevertheless, the combination of activation policies and placing the low skilled in the labour market has generally led to an increase of low paid employment, particularly in the service sector. While this has contributed to a steady rise in employment levels throughout the EU, the question remains whether low pay can be contained or reduced by minimum wages without detrimental effects on employment, or whether policies should focus on guaranteeing minimum incomes which consist of a combination of pay and transfer payments. In any case, it is important to stress that first, both low pay and in-work poverty are highly related and second, that there is no direct connection to employment levels. In other words, countries with high numbers of workers in low paid employment and at in-work poverty risk can also be countries with relatively low employment levels. Or put the other way round: it is possible to achieve both high levels of employment and relatively well paid jobs at the lower end of the labour market.

### **Do statutory minimum wages diminish in-work poverty?**

The debate on minimum pay and standards of living has been resumed at the EU institutional level as well as at the national levels with various successes. While from an academic perspective, the demand for a European minimum wage has been discussed more thoroughly<sup>9</sup> there is also an increasing number of voices at the European level asking for a European minimum wage, such as Jean-Claude Juncker. This topic was resumed during the German presidency in January 2007 and put on the agenda of the EU Ministers for Employment and Social Affairs. The concluding document entails a call for fair and adequate wage setting mechanisms.

Statutory minimum wages are primarily a sign of the weakness of collective bargaining systems. Countries with comparatively weak collective bargaining institutions and weak social partner organisations tend to have statutory minimum wage policy. The EU member states without statutory minimum wage are also among the countries with the highest collective bargaining coverage rates, which leads to the conclusion that in these countries, the majority of employees are covered by a sectoral minimum wage agreement.<sup>10</sup> Moreover, minimum wages that are determined by collective agreements tend to be higher than statutory minimum wages.

While collective bargaining institutions, particularly the coverage of employees by wage agreements, have a dampening effect on the in-work poor, the effects of the statutory minimum wage on the incidence of low pay are harder to establish. In any case, countries with a statutory

minimum wage tend to have higher proportions of in-work poor, not lower.<sup>11</sup> Therefore the statutory minimum wage can be seen as an effect of the decline of collective bargaining and the strength of trade unions in Europe but not necessarily as a solution to the growing problem of the in-work poor. The better policy solution would be to foster collective bargaining in order to extend coverage to those areas where the in-work poor are located.

### **Minimum incomes, the tax wedge and in-work benefits**

Social assistance and poverty relief schemes guaranteeing at least a subsistence income are developed throughout the EU, although huge differences exist in the amount given, the applicable eligibility criteria and the duration of possible support.<sup>12</sup> In many cases, the complexity of the system poses specific problems to claimants, who are hindered in receiving their benefits, especially when transfer schemes are scattered and uncoordinated, as in Greece.<sup>13</sup> In some countries, discussions about a basic income have entered the policy agenda, which propose general transfer payments to all citizens regardless of need. The basic income is, however, unlikely to become a reform paradigm within the EU, given the detrimental effect it has on work incentives and therefore incompatible with the goal of high employment levels.

Rather, in the context of the recent activation policies in the EU member states, more emphasis should be put on keeping the low skilled in the labour market, even if the market wage does not provide a living wage. This is often rendered difficult through “inadequate ‘activation’ policies” – especially high tax wedges in combination with unemployment benefits leading to institutional features that tend to create or enhance disincentives to participate in the labour market and thus realise the goals set in the Lisbon strategy.<sup>14</sup> Here, the process of streamlining existing institutions and policies for fostering and reconciling work and social equality has not yet been finalised.

This also applies to various forms of tax credit systems. On the one hand, different working tax credits are created as an incentive for low wage earners to work more hours. This is the case in the UK or Poland, where tax credits count as income in means tested benefits. Other countries have tax credit systems for workers, independent of their household situation. But only in some countries, such as Slovakia and Hungary, have these reforms had a positive impact on the employment rate.<sup>15</sup> Another form

of tax credits are created for families with children, which are prevalent in a number of countries. In some countries, low paid employment is subsidised through lowering pay-roll taxes for employers and both – tax credits and reduced pay-roll taxes – are applied simultaneously. The member states currently offer a whole laboratory on how to enable high levels of labour market participation while providing living wages for the low skilled.

The EU should evaluate these experiments carefully and systematically address the whole area of pay-roll taxes, tax credits and low pay with the aim to create employment friendly but equality oriented regulations which lead to higher incomes at the bottom of the labour market. Employment subsidies should not only aim to boost employment for the low skilled but also take into account its effects on income levels and income inequality.

### **The challenges of the financial crisis**

The discussions on a European safety net have been recently put to test as the global financial and economic crisis has reached the EU. The crisis unsheathes the prevailing substantial differences with regard to welfare and social policies among the EU member states.

In the crisis, the demand for a social safety net has focused on the protection of existing jobs. In November 2008, the EU introduced a European Economic Recovery Plan (EERP) to enhance coordination among the member states in tackling the crisis and “alleviating the human costs of the crisis”.<sup>16</sup> The recovery package, as well as the scope of the European Social Fund and the European Global Adjustment Fund have been redefined to primarily focus on the safeguarding of jobs, as well as on fostering skills and social security for the most vulnerable participants in the labour market.

The goal of the Employment Summit in May 2009 was to improve coordination between the member states and their social partners when dealing with the social dimension of the crisis and the protection of the labour force. The results of the summit underlined the need for enhanced cooperation between the member states in the maintenance of jobs as well as the stimulation of employment increase and qualification and mobility.<sup>17</sup> While the involvement of EU institutions in the management of the economic and social consequences of the crisis has been low so far, the issue has moved onto the agenda of the European Council meeting in June 2009. The EU Commission thereby puts emphasis on the “shared

commitment for employment”,<sup>18</sup> underlining the need for cooperation between the social partners as well as the governments to protect and promote employment and mobility within and between the member states.

Recent reports highlighting the excessive rewards paid to the top management of failing firms has raised public awareness with regard to the issue of income inequality.<sup>19</sup> The discussion about managerial pay as well as who should bear the burden of the crisis and the cutbacks of the economic downturns makes policy actors vulnerable for accepting the fast rising gap between minimum wages and the top 1% of incomes. The debate about the introduction of pay ceilings for bonus payments to managers of firms which rely on government support will give further support for political claims for social equality.

### **The way forward**

Placing people in jobs certainly remains the most important policy goal when it comes to the social agenda, followed closely by improving jobs and pay for those in work. The increase in in-work poverty was partly prompted by the turn towards activation and higher labour market participation rates in Europe. It is partly connected to the threats and incidences of job relocation in a globalised economy.

A European safety net should start by promoting both high employment and high equality. Social equality is a goal in its own right and should not be confused with or replaced by poverty relief. In more equal societies the poor are better taken care of, education levels are generally higher and more opportunities are created. Flexibility will remain on the agenda, since more- not less- structural adjustment will be required in the future. But the security side of flexicurity needs to be spelled out more strongly and institutions and policies fostering security need to be protected and safeguarded.

# Chapter 10

## Rethinking social and regional cohesion: the need for a renewed policy

Simona Milio\*

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The EU has long set itself the task of ensuring “economic and social cohesion” among member states – it was first mentioned in the 1957 Treaty of Rome - but the most recent enlargement has given new relevance to this objective. For instance, Luxembourg is seven times richer than Romania, in terms of per-capita income, illustrating huge economic disparity between member states. Even more pronounced differences are evident at a regional level, with the richest region being central London (290% of the EU27’s per-capita income) and the poorest region being north-east Romania (23% of the EU-27’s per-capita income). In addition to regional disparities, social inequalities have also deepened in the enlarged EU, and problems related to growing internal and cultural diversity have become more apparent. The entry of 12 new countries into the EU, all rather ethnically diverse, has reinforced the need for the inclusion and protection of often vulnerable minority groups.

The next section starts by surveying today’s frame of reference for “cohesion” in the EU, highlighting the regional emphasis of the EU cohesion policy, as well as the prioritisation of economic inequality at the expense of social cohesion. The paper then narrows its focus on European

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provisions for minority protection, a necessary step to ensure social cohesion in EU27. Practices of minority protection vary greatly among member states, but the EU has yet to adopt a comprehensive minority policy. This lack of EU standards has arguably undermined the promotion of minority rights in new member states during the accession process. The conclusion of the paper stresses the need for the EU to include minority groups within its approach to economic and social cohesion, and formulates recommendations for the adoption of EU instruments of minority protection.

## **The frame of reference for “cohesion” in the EU**

### ***An emphasis on regional cohesion...***

The main objective of the cohesion policy is to narrow the gaps in development between different regions, more precisely between less-favoured regions and more prosperous ones, reducing structural disparities and promoting equal opportunities for all individuals. The 1957 Treaty of Rome mentioned regional disparities in its preamble, but it is only in the 1986 Single European Act (SEA) that an explicit reference to “economic and social cohesion” is made.<sup>1</sup>

In practical terms, regional cohesion is achieved by means of a variety of financial instruments, but principally through the Structural Funds (SFs) and the Cohesion Fund. The four SFs are: 1) the European Social Fund (ESF) created to prevent and combat unemployment; 2) the European Agricultural Guidance and Guarantee Fund (EAGGF), a financing tool for the Common Agricultural Policy (CAP); 3) the European Regional Development Fund (ERDF) aimed at reducing imbalances between regions of the Community by financing development projects; 4) the Financial Instrument for Fisheries Guidance (FIFG) which supports the adaptation and modernisation of the sector’s facilities.

The 1988 reform<sup>2</sup> provided both a financial and a legal basis for the Cohesion Policy and allowed for the four SFs to act together in a coordinated fashion. Regulation (EEC) 2058/88 clearly established principles for the coordination of SF activities between themselves and with other existing financial instruments on the basis of the objectives of the policy. Since then three more reforms, in 1992, 1999 and 2005, have improved the legal framework of funding implementation and their objectives, along with constantly increasing their share of the EU budget to reach a level of € 308 billion for 2007/2013.<sup>3</sup>

So far, the Cohesion Policy's original objective of "economic and social cohesion" seems to have had a strong economic element but a weak social dimension. Indeed, if we look at the measures implemented through the Cohesion Policy, the main "social" related intervention financed by the EU budget is the European Social Fund (ESF), which has always received a minor allocation of funding compared to the large share collected under the ERDF.<sup>4</sup> The latter was created in 1957 to promote employment and make Europe's workforce and companies better equipped to face global challenges. It is only recently that a reference to minorities was incorporated in the ESF regulation,<sup>5</sup> but no specific actions on how to address the problem were mentioned. In fact, little has been done under the Cohesion Policy to ensure the economic and social inclusion of vulnerable minority groups.

### ***... at the expense of social cohesion***

The current frame of reference for EU cohesion focuses on the ongoing aim of reducing regional economic inequality and has largely neglected any social aspect related to diversity, i.e. social cohesion.

The Council of Europe (CoE) in its Revised Strategy for Social Cohesion (2004) describes social cohesion as the capacity of a society to ensure the welfare of all its members, minimising disparities and avoiding polarisation. A cohesive society is one that has developed satisfactory ways of managing its internal diversity in a democratic manner. In practical terms, ensuring social cohesion means guaranteeing access to the same rights for all, respect for dignity of others, the right for all individuals to have the opportunity for personal development and participation in the democratic process.

This conceptualisation therefore frames a wider understanding of cohesion than mere convergence in income or GDP *per capita* among regions. The latter is nevertheless the preferred criterion to measure the achievement of "cohesion" in the EU. If economic and social cohesion is to be achieved, social inequalities are just as important as regional disparities. Furthermore, poverty, long-term unemployment, segregation and marginalisation are issues which more harshly affect the most vulnerable groups in society, among which are minorities.

The EU has recently redefined the scope of its Cohesion Policy with an emphasis on reducing inequality. At the European councils of Lisbon (2000), Nice (2000) and Stockholm (2001), member states made a commitment to reduce the risk of poverty and social exclusion. This is

reflected in the objective of the Lisbon agenda which concerns the modernisation of the European social model. The Commission's new Social Agenda (2005-2010) is focused on providing jobs and equal opportunities for all and ensuring that the benefits of the EU's growth reach everyone in society.

Since the last EU enlargement, questions of minority protection and accommodation of diversity have become even more prominent and challenging. What does the EU do to ensure the rights and protection of minorities within Europe, and thereby ensure its social cohesion?

## **The role of the EU in ensuring the rights and protection of minorities**

### ***Varied practices among member states***

The experience of the 15 old member states reveals a considerable lack of consistency in policies directed at minorities. While some EU member states are very progressive in their accommodation of internal diversity, others remain uneasy and reject the concept of minority rights altogether, jealously guarding their right to deal with minorities in their own way. Practices range from constitutional and legal protection for minorities through institutional power-sharing mechanisms (e.g. Spain or Belgium), to complete aversion of the recognition of minorities even in principle (e.g. France). The question of what constitutes a minority is debated in international politics and the lack of common standards further complicates dialogue on the issue. As a matter of fact, there is a fundamental disagreement among states as to the appropriate form and content of minority rights. Some countries will invoke collective rights<sup>6</sup> and self-government as the necessary political response to minority demands, while for others the priority remains the territorial integrity of the sovereign state. The latter are grudgingly prepared to accept minority rights defined only in terms of individual human rights.<sup>7</sup>

France and Greece are notoriously the EU's "black sheep" when it comes to minority protection. Both of these countries have so far resisted recognising minorities and adopting collective rights.

Despite demands for the self-government of Corsica dating back to the 1960s, as well as serious episodes of political violence<sup>8</sup>, French authorities have refused to depart from the principle of unity and indivisibility of the French nation. Corsica does have a unique institutional status<sup>9</sup> but it

amounts to no more than administrative devolution. In contrast, neighboring Sardinia has enjoyed regional autonomy since 1948.

Similarly, Greece has been reluctant to ensure effective protection for its minorities. The Turkish-speaking Muslims of Thrace have traditionally been viewed with suspicion by the Greek state and have suffered gross human rights violations. Through Article 19 of the Greek Citizenship Code,<sup>10</sup> the citizenship of some 60,000 non-ethnic Greeks was arbitrarily revoked until international pressure led to its abolition in 1998.<sup>11</sup> Despite some improvements,<sup>12</sup> Greece continues to officially deny the Turkish identity, often persecuting it.

In terms of good practices, the Aland Islands are an example of the accommodation of minorities which can serve as a model for social inclusion. The question was negotiated after the First World War by the League of the Nations. The result was a balanced compromise that, while satisfying Finland's claim to sovereignty, protected the Alanders' interests and identity<sup>13</sup> - with a positive impact on the stability of the Baltic Sea region.

As for central and eastern Europe, there is a general fear of separatism but with differences among member states reflecting a different conception of minority rights as collective or individual rights. Some have demonstrated significant political will in favour of minority protection (e.g. Hungary) while others have tended to perceive minorities as threats to national identity and sovereignty (e.g. Romania, Estonia, Latvia).

### ***The lack of EU minority policy***

The discrepancies in minority practice between member states and the reluctance of some countries to adopt minority rights have so far prevented the development of EU norms of minority protection. European Treaties refer to the respect of human rights, such as articles 6 and 14 of the EU Treaty which refer to the European Convention for the Protection of Human Rights and Fundamental Freedoms. Article 128 of the Maastricht Treaty mentions respect for the regional diversity of member states. Lastly, article I-2 of the draft Constitutional Treaty of 2004 mentioned respect for the rights of persons belonging to minorities as being among EU values.

Consequently, European documents of minority protection have not been developed by the EU but by the Council of Europe and are contained in the Framework Convention for the Protection of National Minorities<sup>14</sup> and European Charter for Regional and Minority Languages.<sup>15</sup> However, both

instruments have been criticised for their lack of a definition of “minorities”, which allows signatory countries to selectively identify their own minorities.

Internally, the EU normative attitude to cultural diversity has focused essentially on non-discrimination. The instrument most relevant to minorities is the 2000 Race Directive.<sup>16</sup> While it fails to bring any clarity to the definition of “racial and ethnic origin”, the Race Directive uses a comprehensive notion of discrimination, prohibiting both direct (difference in treatment) and indirect discrimination (neutral treatment creating disadvantage). Yet, non-discrimination is insufficient in itself to address the spectrum of minority rights, as treating everyone under the same conditions is not enough to guarantee a total equality in practice.

### **Minorities and the enlargement process**

The potential for ethnic conflict in the CEE region formed the rationale for a greater international attention to the minority issues of candidate countries in the 1990s. The EU faced difficulties in defining and transmitting standards of minority protection for various reasons: first, there was no provision for minority rights in EU law and, second, the existing international regime of minority rights amounts more to guidelines than concrete legal measures.<sup>17</sup>

Minority protection was included in the 1993 Copenhagen criteria for accession to the EU. Given the absence of an EU minority policy, in order to operationalise the Copenhagen criteria, the Commission based its approach on a series of non-EU documents and the international body of minority rights developed by the CoE, the OSCE and the UN.

The EU conditionality on minority protection was rather effective in influencing public discourse on minority issues and in motivating formal policy changes in candidate states. However, the role of the EU itself in monitoring the efforts made by candidate countries - through the publication of annual Reports - has been criticised by many. EU reports came out as being inconsistent and lacking emphasis on the actual implementation of the provisions adopted by candidate countries. Although eight of the ten accession countries had significant minority populations, only two minority groups were consistently addressed in the EU Reports: the Russophone minority in Estonia and Latvia, and the Roma minorities of Bulgaria, the Czech Republic, Hungary, Romania and Slovakia. Two other sizeable minority groups (the Hungarians of Romania and Slovakia, and the Turks of Bulgaria) have been mentioned in the

Reports, though considerably less attention was paid to them. Instead of addressing all minority issues in accession countries, the EU has concentrated on those minority groups representing a risk for the security and stability of the CEE region. This suggests that minority protection has been used by the EU as a problem-solving approach suited only for those countries where nationalism and the dissolution of multi-national states have been identified as a major source of conflict.<sup>19</sup>

To some, it is clear that the EU has only been “half-heartedly” committed to respect for minority rights within its borders.<sup>20</sup> In effect, the European Commission has promoted standards of minority protection in accession countries without showing any willingness to adopt an EU minority policy. This gave way to accusations of a “double standard”: candidates were to be measured against norms of minority protection for which there was no basis in EU law, no agreed definition, no established monitoring mechanisms and no consistency in practice among member states.<sup>21</sup> These accusations and the questionable minority records of certain old member states have considerably limited the authority of the EU in assessing and enforcing minority protection in new member states. The long-term effects of the EU shortcomings have yet to be seen, but it is doubtful that this half-hearted response has provided a lasting solution to minority issues previously deemed severe enough to potentially transform into ethnic conflicts.

### **Funding possibilities for minorities issues under the EU budget**

The EU has devised financial instruments dedicated to minorities in accession and candidate countries, but not those in member states. Some of the funding for pre-accession instruments has been used to ensure the effective implementation of the EU framework for combating discrimination in accession countries.<sup>22</sup> The PHARE programme<sup>23</sup> specified the integration of Roma minorities as an Accession Partnership priority for Bulgaria, the Czech Republic, Hungary, Romania and Slovakia. Over the period of 1999-2003, the largest share of resources (ME 95.77), some 60%, was spent on education related<sup>24</sup> and infrastructure development activities.

For the years 2007-2009, the new instrument for pre-accession countries,<sup>25</sup> IPA (Instrument for Pre-accession Assistance), includes a reference to cross cutting issues like equal opportunities and non-discrimination, as well as the protection of minorities and vulnerable groups. For this period, €3.5 billion of IPA is targeted to effective assistance to each country.

However, the countries' planning documents fail to specify the budget and terms for the financing of initiatives aimed at supporting the protection, social inclusion and representation of minorities in public life.

Similarly to the legal framework, financial instruments have also seemed inconsistent and their effectiveness has been difficult to assess. Even if pre-accession instruments have underlined the importance of government intervention in addressing the social exclusion of minorities, the lack of evaluation and the ambiguity of monitoring reports on minority funding indicate the lack of a real engagement by the EU.<sup>26</sup> Arguably the most significant shortcoming of these EU initiatives has been the absence of a mechanism ensuring the participation of minority groups themselves in programmes aimed at improving their situation.

### **Overcoming the economic and social exclusion of minorities**

This paper has presented evidence suggesting that the EU has had a different approach to regional cohesion when compared to that of social cohesion. Whereas the former issue has been addressed with a coordinated policy and great financial effort, the latter seems to lack both a policy agenda and harmonised financial instruments. Without undermining the importance of reducing regional disparities, the EU cannot leave aside social inequalities and in particular the problems experienced by vulnerable minority groups in old and new member states.

In order to meet the objective of “economic and social cohesion” among its 27 member states, the EU will have to start taking a more assertive position on minority rights. Minority protection in the EU needs to be structured with a stronger policy agenda, demonstrated through (1) legal provisions for collective minority rights and (2) stronger financial instruments targeting minority groups.

So far, the EU's approach to internal diversity has revolved around a comprehensive framework for anti-discrimination, whose provisions must be transposed into domestic law by member states. Although the Race Directive is a promising instrument for the protection of cultural diversity, anti-discrimination provisions – essentially individual rights – cannot alone ensure the protection of minorities. Rather, non-discrimination and minority rights should be seen as complementary, respectively ensuring equality and preserving diversity. Social cohesion cannot be achieved without legal provisions tailored specifically to vulnerable minority groups and ensuring their participation in the

democratic process. Even more so, bearing in mind the conflicting relations between minority rights and national sovereignty – which have played a major role in the weakness of the international body of minority rights – it is the EU’s role as a supranational organisation to lead the way towards the adoption of collective rights for minority groups. By taking a position on the issue through the formulation of a minority policy, the EU would contribute to the harmonisation of member states’ approaches to minority rights.

The EU must develop coordinated and effective financial instruments aimed at reducing the inequalities experienced by minorities in current member states. While they are now EU citizens, many minorities in new member states still face social exclusion and discrimination. In light of the SFs, the effectiveness and coordination of EU financial instruments would be increased if they were to be divided in policy areas (such as education, political participation, employment, etc) rather than geographical zones. Such reorganisation would ensure that financial aid reaches all minorities in need throughout the EU. Equally, it would facilitate the creation of a framework to measure and assess the effects of EU funding on the situation of minorities. Last but not least, a mechanism must be provided for a structured and systematic involvement of minority groups themselves in all aspects – formulation, implementation and evaluation – of the EU minority policy.

The economic and social aspects of cohesion need to be brought into a much closer relationship with one another than has been customary in the EU Cohesion Policy. It has been increasingly recognised that continued economic development depends upon sustained social development as well as a sustainable environment. More specifically, as illustrated by the adoption of a “minority criterion” for EU membership in the last enlargement process, one of the challenges facing the EU27 is to overcome the economic and social exclusion of minorities. In any case, the EU will not be able to sustain a policy of double standards with regards to minority protection for much longer. In the words of Landau, “[T]he more groups that are incorporated under EU auspices and the more diverse the EU becomes, the more difficult it will be to ignore the gap between minority rights rhetoric and state’s obligations to uphold minority rights”.<sup>27</sup>



# Chapter 11

## Reconciling Europe's competitiveness with sustainable development

Iain Begg

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The idea of sustainable development resonates widely with policymakers and the public alike, and is often found in documents or vision statements mapping the way forward for both developed and developing economies. It is one of the fundamental aims of the European Union, prominently set out in article 2 of the Treaty on European Union and the Lisbon Treaty. In 2006, the EU agreed a revised Sustainable Development Strategy (SDS) which not only updated the aims of the strategy that had been established five years earlier, but elaborated the governance mechanisms intended to advance these aims. Yet despite the enthusiasm for the concept and the spread of initiatives and strategies, it is far from obvious either that the current trajectory of economic development is sustainable or that inroads are being made into global sustainability problems. An especially critical view is offered by David G. Victor<sup>1</sup> who observes that “even as sustainable development has become conventional wisdom over the past two decades, something has gone horribly wrong”, and he notes the proliferation of largely meaningless checklists and targets, rather than substantive policies, whether in the environmental or social dimensions.

Since the Brundtland report (1987) first set out a comprehensive view of sustainable development, the concept has been narrowed towards environmental – especially climate change – and quality of life issues (a

rich developed country pre-occupation), although the original conception was as much about economic development. However, the EU has a distinctive approach which defines three dimensions that are meant to be pursued in an integrated manner: competitiveness, social cohesion and environmental objectives, with international development having been added in 2006 as an external objective. These objectives could be seen as constituting a socio-economic model for the EU, captured in the SDS and in the Lisbon strategy, launched in 2000. The trouble though is that this strategy has had a chequered history. Early drift resulted in strongly critical reports, notably from the Kok Committee,<sup>2</sup> and culminated in a re-launch in 2005. What can be labeled Lisbon II plainly became more than a loose variation on the open method of co-ordination, since it brought together hard and soft law instruments. It has contributed to a greater commitment to structural reform and exposed the gaps in governance that need to be dealt with in certain member states.

For the Barroso Commission, the Lisbon strategy has appeared to be the core “project”, often giving the impression that competitiveness is the over-arching goal to which all others have to defer. The open question which this chapter addresses is whether that orientation can be maintained in the years to come. Responses to energy and climate change challenges have risen up the policy agenda in the last three years, adding an Energy Policy for Europe to the range of EU-level co-ordination processes which already included one covering social protection and social inclusion, as well as the Lisbon strategy and the SDS. There is clearly also a need for improved and co-ordinated responses to the debilitating recession that is now affecting every member state and threatens to call into question many of the policy ambitions that seemed to have secured a political consensus as recently as the summer of 2008.

The fact that these other processes and demands on policymakers now compete for policy attention raises the vexed question of whether coherent over-arching goals for EU economic and social governance can be articulated. There are also continuing uncertainties about whether the governance of the strategy enables it to yield convincing results. One verdict, from Laurent Cohen-Tanugi,<sup>3</sup> (emphasis in original) is that “*Lisbon is neither the success story the Commission declares it to be, nor the manifest failure it is sometimes wrongly depicted as being*. It has had mixed results, depending on country and objective, and its success has been largely tempered for the whole European Union by the mediocre performances of the major euro-zone economies (France, Italy, Germany).”

## **Defining sustainable development**

Most people have an intuitive understanding of what the term “sustainable development” encompasses, and would tend to associate it with variations on the definition, first adopted by the Brundtland report, that sustainable development implies meeting the needs of the present without compromising the ability of future generations to meet their own needs. There are three distinct facets of this definition that should be stressed. First, a balance has to be struck in depleting scarce resources so that today’s generation can enjoy an adequate quality of life without depriving successor generations. “Scarce resources” in this context comprise a mix of those that are lost irretrievably once consumed (such as oil stocks), those that can be recycled (many materials) and those that can be regenerated with competent management. An argument can also be made that social policies that promote life-long learning and engage those more distant from the labour market are, similarly, about maintaining the stock of human capital.

Second, the present generation has to avoid leaving a legacy that is detrimental to the well-being of future generations. Environmental degradation is the obvious example here, with extreme forms associated with contamination of industrial sites that will take centuries to recover naturally. However, it is important also to recognise that there are social and economic dimensions to legacies. Extreme poverty or endemic disease are just as debilitating as a poisoned environment or a denuded rain-forest, and will often be seen as more immediate political challenges. In so many African countries, the loss of a high proportion of the prime age population to AIDS is having a devastating effect, not just on economic potential but on social relations. At a political level, actual or perceived inequalities or social injustices can give rise to reactions that may culminate in terrorism. For the EU, as for other richer countries, the inter-generational transmission of social disadvantage risks entrenching divisions in society that will be at odds with the aim of social cohesion central to the SDS.

Third, there are the obligations to provide infrastructure and social capital for the future, just as previous generations have provided capital from which today’s benefits.<sup>4</sup> A specific element here is putting aside enough resources for pensions and care for the elderly which, in ageing populations such as the EU (as well as others such as Japan and China), raises complex questions about the sustainability of inter-generational arrangements domestically, although there is also an international dimension. For many in the developed world, capitalised pension funds imply investment in

emerging markets (indeed the rules in many countries *oblige* fund managers to seek the highest returns consistent with a level of risk). Such investment improves the availability of funding for developing economies that might struggle to finance investment, but also creates governance challenges to do with the volatility of investment and the management of interest and profit flows. Equally, immigration is canvassed as one of the ways in which ageing populations can sustain their work forces, raising complex inter-country challenges around social provision for migrants and the burden of investing in human capital – “brain drain” for some; “brain gain” for others.

### **Sustainability and competitiveness: conflicting or complementary?**

Critics argue that the supposedly tighter focus of Lisbon II on growth and jobs has been at the expense of social and environmental aims. There is a strong presumption that dealing with negative externalities, such as climate change, or advancing social cohesion will be at odds with competitiveness, because they imply adding costs, with no immediate return. According to this narrative, countries which act to abate carbon emissions or to cut other pollutants, to improve social standards, or to support economic development in poorer parts of the world will place themselves at a competitive disadvantage.

Certainly, social policy has not been absent from Lisbon II. Many commentators espouse the view that a job is still the best route to social inclusion, so that the emphasis on jobs in Lisbon II has social benefits. There is also supposed to be “feeding-in” from the separate social policy co-ordination process to the Lisbon strategy and, in turn, “feeding-out” from the latter to social inclusion objectives. The trouble is that the channels through which the “feeding” takes place are not that well developed and, even if they can be shown to work rather better than is sometimes asserted, there is considerable scepticism among representatives of social Europe that the social dimension of Lisbon is given sufficient weight. An example is the joint submission to the 2007 spring European Council from the European Trade Union Confederation, Social Platform (representing various social NGOs) and the European Environmental Bureau which calls for more than “a business-friendly agenda of internal market and simplified regulation.”<sup>5</sup>

Rather than dwelling on possible incompatibilities between competitive and social aims, perhaps a more useful breakdown would be between what might be called wealth creating objectives (such as the single market,

monetary union, and the promotion of scientific and technological advance) and *wealth distributing and quality of life* ones (sustainable development, cohesion and quality of environment). A modernised socio-economic model has to encompass both and, in doing so, various “justices” will have to be confronted:

- *Social* in the contemporary senses elaborated in previous Policy Network studies (see, for example, Giddens et al)<sup>6</sup> encompassing new balances of risks and an emphasis on incentives and empowerment, as well as distributive transfers.
- *Carbon* as increasingly discussed by NGOs that are deeply skeptical about the demands from richer countries that others should reduce their emissions.
- *Inter-generational* when thinking about the underlying definition of sustainable development.
- *Developmental* in balancing the evident priority that emerging economies give to reaching the higher income levels needed to make progress and to alleviate mass poverty, while cajoling them into accepting environmental commitments.
- *Knowledge* in recognition of the imperative of more rapid innovation and its implications for the spread of intellectual property. In particular, is there a case for knowledge aid, as opposed to cash and technology transfers?

### **Towards a low-carbon paradigm**

There is a growing consensus around the proposition that the imperative of carbon abatement should become the over-arching theme for EU economic governance in the next two decades. Effecting a transition to a low-carbon economy, as a response to the threat of climate change, has now become recognised as perhaps the greatest governance challenge of the 21st Century. At one level it is beguilingly simple. Accepting the growing scientific consensus that it is emissions of anthropogenic (man-made) greenhouse gases that are to blame for global warming, the solution is to cut them radically. But that is where the problems start. Who pays for the vast investments that are needed? How should the distributive consequences of higher energy costs, possibly accentuating “fuel poverty” be managed? Among the diverse scientific, engineering and economic approaches, which should be preferred and in what sequence?

Energy and carbon use depend on four components (the so-called Kaya identity): population, GDP per capita, the energy intensity of GDP and the carbon intensity of energy use. The first component is usually assumed to be exogenous to policymaking, and it is also salient that the bulk of the projected population growth in the coming decades will be in low income countries. If only for this reason, lower per capita growth rates – the second component of the identity - would imply that the poor of the world would be condemned to remain in poverty, so that any attempt to curb growth would be contrary to social justice, not to mention incompatible with commitments to development in the Millennium Development Goals.

It is therefore in the energy intensity of GDP and in the carbon intensity of energy that the scope for change lies. It is well established that energy consumption and GDP are strongly correlated: as countries grow, so too does their consumption of energy for transport, production, heating and cooling, and other quality of life purposes. These rates of consumption have increased steadily over the last two hundred years, especially for the countries which have grown most, and, today, the richest countries consume amounts of energy several times those of the poorer countries. The solution is, again, obvious: the relationship between GDP and energy used needs to be “decoupled”. The trouble, though, is that the countries which, over the next fifty years, are expected to add most to GDP (above all the most populous emerging economies in Asia) tend to see economic development as the primary goal and will be reluctant to forgo growth in the interests of lower emissions.

Even though demand for energy has proved not to be very responsive to price changes, rising prices will have some effects, notably on the well-being of low income households. For public policy, the result may be calls for compensatory social transfers, especially for social groups at risk of “fuel poverty”. To the extent that rising oil prices create windfall gains for government revenues, such compensation is affordable. Energy mix is partly about whether to favour renewables or nuclear power, but can also refer to using hydrocarbons in ways that emit less. In all of this there are tricky trade-offs: nuclear safety against the uncertainty of renewables; the unintended consequence that bio-fuels crowd out food production, raising the price for basic foodstuffs, and so on.

But it is also clear that sizeable commitments of public resources will be needed to develop the necessary technologies of the future, such as carbon capture and sequestration, which will require burden-sharing at the global

level. It is reasonable to expect richer regions, such as the EU, to pay more, but there will be tricky political compromises about sharing of technologies, the extent to which consumers should pay, and what contributions to expect from business. Burden-sharing also has an inter-generational dimension that echoes many of the debates about future pension arrangements.

There is often also a substantial self-interest in following policies that are “sustainable”. Consider a low-carbon strategy. Europe is increasingly dependent on imported hydrocarbons and, if only for this reason, is vulnerable to the political instability and foreign policy machinations of the major producer nations on which it relies. Also, it should not be overlooked that many shorter-term means of reducing carbon emissions can be implemented by acting on demand, bearing in mind that there are expenditure cycles measured in months (replacement light bulbs – with large savings in energy consumption) or years (more fuel-efficient cars), as well as over longer time spans (carbon-neutral buildings). At the risk of stating the obvious, energy saving potentially reduces expenditure. There is, consequently, considerable scope for a *double dividend* from investment that both achieves climate change objectives and reduces dependence on unreliable producers or lowers consumption. Business opportunities arise not only from the direct provision of investment goods that are needed to replace energy intensive capital stock, but also by conferring first-mover advantage in global markets on those companies (and countries) which are quickest to develop the new products.

### **The quality, not just the rate of growth: bringing “social” back in**

It is worth looking more closely at how aims for the *quality* as distinct from the rate of growth could be elaborated, especially in response to emerging determinants of what European societies expect. Manifestly environmental concerns constitute a key change in the policy context, notably the imperative of countering climate change, with several implications for the policy mix. Other facets of the quality of growth also need to be considered, notably the link between the chosen strategy and equity considerations. Income inequality has increased noticeably in several (though not all) member states over the last two decades, while poverty and social exclusion are prominent on the policy agenda in connection with globalisation.<sup>7</sup>

It is easy to portray social aims as being the sort of luxury that can only be countenanced once sufficient competitiveness has been attained – to

concentrate on the size of the cake, rather than how it is sliced. But such a stance overlooks the many ways in which a well thought-out social policy complements and supports a growth strategy. Equally, social systems that are out-dated or afflicted by perverse incentives need to be modernised. The flexicurity approach goes some way towards reconciling these imperatives, but needs to be elaborated. In particular, it is not clear that flexicurity yet goes far enough in taking account of inequality and pathways out of social inclusion other than through employment. Nor is it evident that the approach has convincing solutions for coping with the recession and its aftermath, although it is instructive that leading advocates of flexicurity stress that the flexibility and security elements should not be seen as in conflict.<sup>8</sup> Plainly, social policies that boost the employment rate by activating more people and encouraging active ageing, while reducing the budgetary cost of social protection, are not just progressive, but also good economics. Increases in “green jobs” also show that the presumed trade-off between jobs and environmental or social improvements may well be a false one.

Putting these different strands together suggests the need for a *smart growth* strategy in which a qualitatively different model of development is pursued. This should recognise that, while the three points of the “Lisbon/Sustainable Development” triangle (comprising competitiveness, social inclusion and a sustainable environment) remain valid, what matters just as much is the manner in which they are combined. Different configurations of policy and strategic investment decisions in the coming years can lead to very different outcomes that, over a longer-term horizon, result in a radically changed economic model. Economies will differ in the means available to them to abate carbon emissions, but the strategic imperative should nevertheless be part of a smart growth strategy. Plainly, investment in human capital or in new technologies will be costly, although a persuasive case can be made that the cost of action will generally be lower than the cost of doing nothing.<sup>9</sup> Adaptation to a sustainable growth trajectory also raises awkward questions, not least if rising energy prices impose disproportionate costs on poorer groups. Seen from this angle, the politics of climate change is also a politics of (in) equality.<sup>10</sup>

Manifestly a coherent approach at EU level is needed, embracing not just policies directly aimed at curbing emissions, but also setting the tone for what the EU budget funds, the next wave of structural reforms and the articulation of an EU response to globalisation. Nor can a low-carbon agenda be seen purely as an economic problem, because it both requires the building of a social consensus and has social effects that have to be

managed. Even if the world's leaders start to act as decisively over climate change as they did in the autumn of 2008 over the financial crisis, the sheer timescales involved in dealing with the underlying causes of global warming mean that temperatures will rise before they can be stabilised. The effects may be unpredictable, albeit relatively moderate and short-lived, but they will not be negligible and will tend to hit those least able to cope.

### **The post-Lisbon strategy**

As the original 2010 deadline for the Lisbon strategy draws close and the new Commission and Parliament start to grapple with over-flowing in-trays, a critical question will be what the underlying narrative for post-Lisbon economic governance should be. Clearly, the intensity of the economic crisis radically alters the demands on policy-makers and it may be that several years of a post-Lisbon strategy will have to be devoted to under-pinning the recovery rather than the forward looking goals that were the priorities over the last decade, that is fostering the knowledge economy and equipping Europe to prosper under globalisation. However, even before the recession struck, it had become apparent that sustainability would be to the fore and that much more emphasis would be needed on the quality of growth. It should be recalled, in this regard, that the adjective “sustainable” is prominent in the second half of the famous sentence from the Lisbon 2000 European Council articulating the strategic goal, which states that the EU should be “... *capable of sustainable economic growth with more and better jobs and greater social cohesion*”.

One clear route is offered by Laurent Cohen-Tanugi who argues that the EU has to go beyond simply adapting to globalisation (arguably the thrust of the Lisbon strategy since 2005) to try to shape globalisation in a manner consistent with EU aims.<sup>11</sup> He therefore advocates a division between a reinforced (“Lisbon-plus”) approach inside the EU, to be largely in the hands of member states, accompanied by an external dimension that would be largely at supranational level. The latter would involve common policies, building on these already settled, but adding new ones to cover energy, the environment, migration, development aid and diplomacy. He argues that this dual approach is needed because Europe now faces a new phase in its development that will require a paradigm shift.

The social pillar of sustainable development also warrants fresh thinking and must be expected to loom larger as a result of the 2008/9 recession. In all probability, the post Lisbon strategy will have to strike a (possibly uncomfortable) balance between longer-term objectives and short- to medium-term responses to the recession and its aftermath. Avoiding a

resurgence of long-term unemployment, preserving vulnerable human capital and forms of job-sharing will be back on the policy agenda, yet the trick this time will be to avoid the pitfalls such as early retirement schemes that reduced labour supply and ramped up social protection bills.

### **Purposes fit for the times: EU competitiveness and climate action**

In confronting the actual or perceived trade-off between sustainable development and competitiveness, the EU has a pivotal role to play, but it is one that calls for careful definition. Under any plausible scenario, the EU will have neither the political capital nor the administrative or financial resources to expand its governance activity greatly, and must therefore make some hard choices. By orientating its co-ordinating role around a low-carbon leitmotif, the EU could project itself as having a purpose fit for the times and one that could, moreover, be expected to resonate with citizens. The underlying challenge will be to overcome the false dichotomy between the wealth creating and quality of life/distributive aims of the various EU level economic governance processes.

More generally, a question central to this Policy Network initiative of whether there are pros and cons of further EU integration in promoting sustainable development has to be confronted. In this regard, a central underlying issue is how and to what extent a co-ordinated process adds value. The benefits from an organised process at EU level stem from diverse elements such as the strength of common goals, the salience and even the constitutional position. Climate change is an area that ticks many of the boxes for the sorts of challenges for which the EU should play a prominent co-ordinating role. So too does offering a supportive framework for recovery from the recession.

Putting in place a convincing smart growth strategy will require innovation in a range of policy domains and implies a search for policy synergies. One of the principal synergies that a strategy for the next decade can develop is between competitiveness and action to counter climate change. Such a smart growth strategy can help to generate new markets in which the EU can aspire to lead in producing low carbon goods products, in much the same way as EU companies benefited from the GSM standard for mobile telephony. Improved energy productivity can, in parallel, lower costs in a world in which the price of energy seems certain to remain higher than in earlier decades, whether because of policy choices to increase the cost of carbon or because regulatory interventions steer demand to higher cost alternative energies. In either case, an economy which is able to raise

substantially the proportion of low energy-use assets will gain. To end on an optimistic note: sustainable development and competitiveness are not condemned to be incompatible. Over to you, President Barroso.



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- 10 "Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability" of 1 June 2008, published, *inter alia*, at <http://www.ecb.de/pub/pdf/other/mou-financialstability2008en.pdf>
- 11 "Government decision to safeguard Irish banking system", statement issued by the Irish Ministry of Finance on 29 September 2008.
- 12 Speech of Commission President José Manuel Barroso at the Seventh Asia-Europe Meeting, Beijing 24/25 October 2008.
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- 19 See Presidency conclusions of the European Council of 18/19 June 2009 ([http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/108622.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/108622.pdf))
- 20 In this regard, the Presidency Conclusions state unambiguously that “decisions taken by the European Supervisory Authorities should not impinge in any way on the fiscal responsibilities of Member States” [emphasis added].
- 21 Schoenmaker, D. (2008), *Resolving the stability trilemma*, *The Financial Regulator*, Vol 13(3), December.
- 22 The three so-called Level Committees are the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).
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- 24 For an in-depth discussion of the effects of the financial crisis on euro adoption, see European Parliament (2009), *The Financial Crisis and its impact on Euro Adoption*, Presentations and Briefing notes for a workshop held on 17 February.
- 25 Buiter, W. (2008), *The Overwhelming Economic Case for the United Kingdom Adopting the Euro*, in: Bishop, G. et al. (2008), *10 years of the Euro: New Perspectives for Britain* <http://www.lse.ac.uk/collections/pressAndInformationOffice/PDF/10yearsoftheEuro.pdf>. Here he identifies for countries like Britain (or Iceland) an “inconsistent quartet”: (i) a small country with (ii) a large internationally exposed banking sector, (iii) a currency that is not a global reserve currency and (iv) limited fiscal capacity relative to the possible size of the banking sector solvency gap. This combination makes them more vulnerable to a triple financial crisis – a banking, currency and sovereign debt crisis.

## Chapter 4

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## Chapter 5

- 1 (EC, 2008)
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- 3 See Pisany-Ferri (2006)
- 4 Michel Barnier, former European Commissioner and advisor to Sarkozy stated (Ricardi, 2007): “We need to reform immediately economic governance in an effort to create a more balanced dialogue with the European Central Bank (ECB). Independence of the ECB should not be challenged but the Euro should be both a shield and a tool, and the currency should help us growth while maintaining price stability”. See Goodhart (2006) for a deeper look into the idea of inter-institutional dialogue.
- 5 Regarding exchange rate policy the results were the same. France defended the possibility of avoiding overappreciation of the single currency, and including devaluation if it was necessary to confront possible economic crises. But Germany firmly opposed the possibility of exchange-rate intervention since it could endanger its objective of price stability. The result was closer to the German postulates and is drawn up in Article 111 in the following manner: “the Council may formulate general orientations for Exchange-rate policy (...) but in consultation with the ECB and without prejudice to the primary objective to maintain price stability”.
- 6 The general formula chosen was the following: “Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council”. In fact, the carrying out of this article took place through the Broad Economic Policy Guidelines (BEPG), which carry no potential fines and only involve potential recommendations from the Council.

- 7 This idea is not new. The 1970 Werner Report said that in a European monetary union the margins within which fiscal policy should move each year should be decided at the community level. The McDougall Report (1977) also advocated a partial centralisation of the budget, suggesting that a monetary union would need a common budget that would cover at least 5% of the European GDP. In spite of these initial references, the Delors Report (1989) – on which the Maastricht Treaty was finally based – abandoned these ideas and embraced what is known as the Brussels-Frankfurt consensus. See Mulas-Granados (2009) for a deeper discussion on the underlying economic theories on which this consensus was based, and how alternative theories are questioning the validity of this approach in current times.
- 8 See for example the joint statement made by Zapatero and Sarkozy at the end of the summit held on April 24, 2009. (<http://euobserver.com/9/28030>)
- 9 See Tabellini and Wyplosz (2006) for a series of proposals to improve supply-side policy coordination. They argue in favour of the creation of independent agencies that can be isolated from lobbies to move forward in the integration of financial markets, services, public utilities and energy. Nevertheless, they think that for labour market reform, the Commission should take a stronger coordination role to push national authorities forward, but reject the possibility of creating a European Employment Agency, as suggested by Saint-Paul and Wasmer (1999).
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- 13 To do this, the following resolution has been added: “Where it is established, ... that the economic policies of a Member State are not consistent with the broad guidelines...or that they risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned.”
- 14 (Pisani-Ferry and Sapir, 2009)
- 15 Pagoulatos (in an earlier version of his chapter in this volume) proposed the introduction of a European Financial Supervisory Agency under a new European Systems of Financial Supervision (ESFS). According to his proposal, and similar to the DeLarosiére Report: “The ESFS would supervise the pan-European financial groups, smaller financial institutions remaining under the jurisdiction of national supervisory authorities.”
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- 17 Three new European authorities would be set up to replace the existing three pan-EU committees of banking, insurance and securities supervisors known as CEBS, CEIOPS and CESR. Colleges of supervisors would be set up for all major cross-border institutions.
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## Chapter 6

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## Chapter 10

1 Article 158 SEA: the Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the Community shall aim at reducing disparities between the levels of development of the various regions.

2 On 24 June 1988, the Council agreed on a regulation 2052/88 which put existing EU funds into the context of 'economic and social cohesion'.

3 Previous periods allocation: € 65 billion (1989-93); € 159 billion (1994-99); € 213 billion (2000-06). See EC (2001), *Working for the region, Luxembourg: Office for Official Publications of the European Communities*.

4 Division of Funds allocation:

Period	Total Allocation	ERDF	ESF	EAGGF	Others/FIFG
1989-1993	71368	34312 (49%)	20784 (29%)	11799 (16.5%)	4474 (6.3%)
1994-1999	162129	71488 (44%)	41975 (26%)	22059 (14%)	27150 (17%)
2000-2006	212061	123220 (58%)	65417 (31%)	20502 (9.6%)	2921 (1.4%)

5 Article 3 of regulation 1081/2006, states: "Within the framework of the Convergence and Regional competitiveness and employment objectives, the ESF shall support actions in Member States under the priorities listed below: f) pathways to integration and re-entry into employment for disadvantaged people, such as people experiencing social exclusion, early school leavers, minorities, people with disabilities and people providing care for dependent persons, through employability measures, including in the field of the social economy, access to vocational education and training, and accompanying actions and relevant support, community and care services that improve employment opportunities

6 Minority rights are an essential part of the fundamental human rights. But compared with the classical individual human rights there are specific features of minority rights that can only be exercised collectively (religious activities, cultural, education facilities, language rights, etc.).

7 Jackson Preece, J. (1997), "National minority rights vs. state sovereignty in Europe: changing norms in international relations?", *Nations and nationalism*, vol 3, n. 3, pp. 345-64

8 On 6th February 1998, Claude Erignac, the regional prefect of Corsica, i.e. the most important French government official on the island, was shot dead in the streets of Ajaccio. Yvan Colonna, a Corsican nationalist linked to the FLNC, has been convicted for his assassination on 13 December 2007.

9 Law 2002-92 of 22 January 2002 in relation to Corsica.

10 The Greek Nationality Law N.3370, enacted in 1955, states in Chapter B, Section VI, Article 19: "A person of non-Greek ethnic origin leaving Greece without the intention of returning may be declared as having lost Greek nationality . . . The Ministry of Interior Affairs decides in these matters with the concurring opinion of the National Council."

- 11 Sitaropoulos, N. (2005), "Freedom of Movement and the Right to a Nationality v. Ethnic Minorities: The Case of ex Article 19 of the Greek Nationality Code", *European Journal of Migration and Law*, 6, pp. 205.
- 12 After article 19 of the Greek Citizenship Code other similar discriminatory laws have been repealed, such as those that deprived ethnic Turks of basic rights of property and occupation (see the Human Rights Watch World Report for Greece, 1993).
- 13 The 1920 Autonomy Act was followed by laws in 1951 and 1991 that expanded the scope of autonomy. The Islands have autonomous legislative and executive bodies; the Finnish government controls foreign affairs, customs and currency and the judicial system, with the Islands having autonomy in all other areas.
- 14 All ten CEECs have signed the convention; whereas Belgium, Greece, Luxembourg and Netherlands have signed, but not ratified it. France has not even signed it. See <http://conventions.coe.int/Treaty/Commun/ChercheSig.asp?NT=157&CM=&DF=&CL=ENG>.
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- 16 European Council, Directive 2000/43/EC Implementing the Principle of Equal Treatment between Persons Irrespective of Racial or Ethnic Origin, 2000.
- 17 Visi, B. (2008) "Minority rights in the new member states after enlargement", in "Democracy, populism and minority rights", H. Suoboda, J. Wiersma (eds.), Renner Institut, p.79.
- 18 They state that "membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and the respect for and protection of minorities".
- 19 Kymlicka, W. & Opalski (2001), M., *Can Liberal Pluralism Be Exported?* Oxford : Oxford University Press.p 374.
- 20 Hughes, J. and Sasse, G. (2003), "Monitoring the Monitors: EU Enlargement Conditionality and Minority Protection in the CEECs", *Journal on Ethnopolitics and Minority Issues in Europe*, 2003. p12.
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- 22 EC (2004), "Equality and non-discrimination in an enlarged European Union" Green Paper
- 23 PHARE was the main instrument to support the accession of Eastern Europe countries in the last two EU enlargements of 2004 and 2007.
- 24 Two examples of programmes financed by the PHARE are the following: a) € 17 million, co-financed by the Hungarian government, were allocated to improve the level of participation in education for Roma/Sinti under the 1999 and 2001 programme for Hungary; b) A minority tolerance programme, co-financed by the Slovak government and totaling €2.3 million, was financed to train 450 local Slovak public administration representatives and opinion-makers on minority issues and conflict resolution. See EC (2004), "Review of the European Union Phare Assistance to Roma Minorities" Interim Evaluation of Phare Support Allocated in 1999-2002 and Implemented until November 2003, European Commission Directorate-General Enlargement, Directorate E – Evaluation Unit.
- 25 The IPA's countries are Croatia, Former Yugoslav Rep. of Macedonia, Turkey, Albania, Bosnia and Herzegovina, Montenegro, Serbia, Kosovo.
- 26 Hughes, J. and Sasse, G. (2003), "Monitoring the Monitors: EU Enlargement Conditionality and Minority Protection in the CEECs", *Journal on Ethnopolitics and Minority Issues in Europe*, 2003
- 27 As quoted in Guglielmo, R. and William Waters, T. (2005), "Migrating Towards Minority Status: Shifting European Policy Towards Roma", *Journal of Common Market Studies*, Volume 43. Number 4. pp 763–86

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- European Social Funds: [http://ec.europa.eu/employment\\_social/esf/discover/esf\\_en.htm](http://ec.europa.eu/employment_social/esf/discover/esf_en.htm)
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## Chapter 11

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# An EU “fit for purpose” in the global age

Over the next decade the EU must be ready to redefine itself: what its role is as a political entity in a rapidly changing world and how it should reform itself, both internally and externally, in order to overcome and respond to the multifaceted challenges of the global age we now live in. In short, the challenge of making the EU “fit for purpose”.

Needless to say, this is where controversy begins: what exactly is the EU’s “purpose” in the 21st century and what kind of reforms are required to render it “fit”? In this volume, leading thinkers and experts provide compelling answers to issues of economic governance, financial regulation, budget reform, social policy and sustainable growth.



This pamphlet is one of a series of three emanating from the EU “fit for purpose” project organised by Policy Network, in partnership with the European Institute, LSE and ELIAMEP.

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