4. Ensaios: Economic Growth in the EU: Institutions and Governance issues[2♣]

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4.1. Introduction

European economic integration is at the centre of the European integration process. It is therefore fundamental for the political and economic sustainability of the European Union (EU) that the internal market be perceived as delivering (growth, employment) in today's changed market and technological environment and that economic advantage is taken of the opportunities opened up by liberalisation in the internal market, globalisation, the faster pace of technical change, the knowledge-based economy, or indeed climate change. Yet, output delivery requires doing away with structural problems that impair productivity and economic growth in European mixed economies. The capacity to do so hinges very much on governance, in particular when reforms to realise international synergies and complementarities or policy-learning with a view to common goals involve not only the EU but as well the member state level.

European economic integration and in particular the internal market condition the economic policy framework facing member states and have been instrumental in putting in motion governance patterns. The Lisbon Agenda is a case in point. Motivated by international competitiveness concerns, it came to outline an economic and social strategy meant to re-launch the EU in a changed context of worldwide competition and a knowledge-based economy. Its success ultimately depends on whether necessary coordination to implement policies with an EU rationale can be achieved in order to realise the static and dynamic efficiency properties of the internal market when increased liberalisation and market coordination by itself are not sufficient.

The Lisbon Agenda can thus be considered an exercise in policy coordination to ensure that member states' over-regulated economies comply both with liberalisation in the internal market and with an adequate Europe-wide institutional environment for sustainable growth without coordination mismatches, protectionism and market segmentation. This raises the question of the appropriate governance level and of the regulatory model to adopt (systems competition and/or European regulation). The article here summarised explores in more detail three domains – innovation, services and social models – where policy coordination promises to be beneficial with a view to competitiveness.

4.2. Liberalisation and the need for policy coordination

The EU 'club', distinguishing itself from other international organisations by being highly integrated not only economically but possessing a strong political dimension, has expanded at the expense of (and indeed prevailed over) inter-governmental models of European economic integration (such as EFTA). The process of integration and decision-making in the EU can be already regarded as a polity. Whereas the aimed at economic integration level (notably the common market and the customs union) implied some degree of coordination and sovereignty-sharing between member states from the outset, the need for policy

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coordination has since advanced, driven by the evolution of the internal market. Economic integration has progressed to monetary union, (some) economic policy coordination and aspects of a political union.

It should be noted that the attractiveness of Community membership owes much to its level of economic integration, that is, to the advantages it confers on insiders through the scale and properties of its domestic market and the abolition of internal non-tariff, frictional barriers, and the common commercial policy. The Community preference translates into a disadvantage for outsiders. At different times in history, preferential trade integration has afforded the Community an advantage that made entry for third, in particular neighbouring, countries very attractive. In the first phase the trade-led model of integration allowed for scale economies in an enlarged (albeit incomplete) domestic market in goods protected by common external tariffs. In the second phase characterised by the realisation of the internal market, the root of advantage has shifted towards regulation-based integration. Successful regulation-based integration is becoming ever important given that as efficiency-enhancing external liberalisation proceeds – through the World Trade Organisation (WTO) or preferential trade agreements – any discriminatory advantage due to tariff protection that EU members possess vis-à-vis outsiders is reduced. A well-functioning internal market can again translate into a cost advantage for member states, based on efficiency gains associated with the abolition of frictional, invisible barriers to trade and the full liberalisation not only of goods but also of services and production factors, plus the creation of a dynamic advantage through capital accumulation and innovation.

The EU's market-oriented economic constitution (the creation of a European economic area by means of the liberalisation of goods, services and production factors, that is, capital and labour) implies a need for liberalisation in less market-oriented member states. In mixed economies members states also need to reassess and possibly modify their (distinctive) balance between the provision of private and of public goods by the state. The completion of the internal market is a dynamic, on-going process (not least illustrated by the growth dynamics of EU legislation) which in addition touches upon and extends to many different policy areas. Yet, unlike the internal market, those areas are not necessarily in the EU domain. Also, to the extent that liberalisation and deregulation in the EU do not do away with market failure or that negative integration does not meet with the preferences of society, the issue turns towards how to avoid governmental (regulatory) failure and towards what regulatory model to adopt.[4] In the reality of European mixed economies, output performance of the internal market calls for a good deal of coordination between institutions and policies at the EU and the member state level and indeed for high levels of economic integration (economic policy coordination, monetary union, possibly political union), in particular when there are interdependencies.

The changes in the external environment brought about by globalisation and the new economy have obvious repercussions for the competitive pressures facing firms while economic agents' incentives and their capacity to react or take a pro-active stance are conditioned by (the design of and incentives provided by) social and economic institutions. Those (broadly defined) institutions can either smooth and facilitate or retard necessary adjustment. This raises the question as to whether the economic and institutional framework (EU and member states) is adequate for the internal market to deliver.

It is a functioning internal market that holds the key to the challenges ahead for the EU. Europe needs to adapt itself as to take advantage of globalisation and raise productivity and growth. The failure to deliver satisfactory economic performance and/or an adequate (or perceived as such) social system in a changed setting imply political risks, to the extent that public opinion might turn against internal and external liberalisation on the European internal market and in the WTO, respectively, and resist necessary

[4] This type of consideration was everything but focused upon at the time of the inception of the Single Market programme by the mid-80s, which tended to be presented as a technical, deregulation exercise to stimulate the supply side. Yet, putting in practice the four freedoms becomes highly political in the context of the reality of European mixed economies: what is at stake is the role of the state in the economy and reforming (often path-dependent) national institutional frameworks. For the reasons outlined above, reforms that bring about changes in the institutional framework in which markets and the state operate are necessary to realise the potential gains from trade.

structural and institutional change or enlargement in the name of some “European or national model”, which might eventually threaten the EU political integration project itself.

Note that member state economic policy frameworks are conditioned by the EU internal market and by external challenges (globalisation, the new economy). The internal market, which is mostly in the EU domain, has driven liberalisation and deregulation. Its output performance depends firstly on whether member states accept the functioning of the market and secondly on whether they coordinate policies (create an adequate economic and institutional framework) when appropriate so that delivery of the internal market is neither impaired by member state protectionism nor by inadequate institutions / their sub-optimal interaction. The adaptation of national institutions and policies with an impact on the internal market has been a major challenge, considering that they were not only created in a very different economic and technological environment but that they are often path-dependent and the product of country-specific factors. To the extent that deregulation requires forms of economic coordination other than through the market it ultimately raises the issue of European regulation and of the regulatory model (an issue that became highly visible in the case of the Bolkestein services directive).

4.3. The Lisbon Agenda as an exercise in policy coordination

While society as a whole stands to benefit from internal and external liberalisation through gains from trade that contribute to higher living standards, within society there are winners and losers. Whether and how these latter ones are to be compensated will be important for the political acceptability of reforms (issues of equity and distribution), but also raises the question of sustainability and of the efficiency (providing adequate incentives) of social systems.

In line with the theory of fiscal federalism, governance should take place at the EU level when there are economies involved in pooling competences and when preferences are similar, whereas it should take place at the national level when preferences and circumstances are different. Political economy reasoning also suggests that changes at the Community level, subject to qualified majority voting (QMV), tend to go through more easily than changes at the national level, more liable to be held up and resisted by political economy forces. National policy makers are more prone to give in to political economy arguments at the national level (although burden-sharing might be easier in smaller countries), while it is easier for governments to circumvent special interest groups at the EU level when there is QMV. Resistance at the national level is aggravated by the joint impact of liberalisation and restructuring in the internal market and globalisation.

In today’s more uncertain and fast-changing technological and market environment and in order to take economic advantage of globalisation and the knowledge society, innovation needs to be a wide-spread phenomenon and be encouraged, financial markets need to function and institutions need to promote change (flexible adaptation) for competitiveness. While it is measures at the EU level that condition the expected benefits from the internal market and from a single currency, the successful implementation of the Lisbon goals hinges on the coordination of many (reformed) policies and institutions at the EU and/or the national level and on governance patterns conducive to innovation and change. Among others, (reformed) institutions in Europe need to facilitate factor mobility, namely of labour out of unprofitable businesses and sectors into competitive areas as well as of capital mobility, hereby including well-functioning markets for corporate control.

The issue is then not only to avoid a policy mismatch but to realise synergies and complementarities and to facilitate policy-learning. Coordinated efforts make sense when there is interdependence between member states, such as in the case of synergies (for instance spillovers in the case of research and development (R&D) or complementarities (for example regarding liberalisation and reforms in the product and in the labour market), or when there is scope for policy-learning with a view to common goals (the case of social systems). Coordination would then take the form of joint action and of benchmarking in the light of structural differences and of policy differences, respectively. This translates into a rationale for EU involvement in the Lisbon process in many policy areas relevant for an EU growth strategy. Yet, despite the potential benefits from coordination, in many of those the EU cannot act by itself or only if the member states give their consent. However, a coordination mismatch can be expected to negatively affect the performance of the internal market cum EMU (and any growth dividend).

With a view to the implementation of the Lisbon goals, policies whose coordination is vital involve different governance levels (EU and the member state) and coordination modes. Still, it is noteworthy that EU market integration has set in motion governance levels and modes and has meant that the competitiveness issue has gained ground. For instance, in the case of competition policy, industrial restructuring has led to more delegation to the EU level (merger regulation) but also the decentralised, parallel application by national competition authorities of EU competition law. Here EU market integration led to a different evaluation of the centralisation vs. decentralisation trade-off, notably access to information vs. regulatory capture. Also, to the extent that production factors become more mobile (in particular capital, whereas labour tends to be rather immobile within the EU and at national levels) the discussion of direct taxes with a view to competitiveness/localisation of investments and of an eventual harmonisation of direct taxes has become an issue. For instance, the Commission is trying to form a consensus on firms' tax base in the light of different member state regimes. The regulation of labour markets and of social systems has remained at the national level since the Treaty of Rome, but has become subject to benchmarking at the EU level. This reflects the fact that the question of wage and price flexibility assumes particular importance in a monetary union where there are larger interdependencies (thus the rationale for EU coordination is reinforced in the Euro-zone), given that there is a single monetary policy with only fiscal policy commitments, and also the need for innovation and productivity in the EU that puts emphasis on the adjustment capacity of the industrial fabric and of the labour market (and of institutions in general). National labour markets (and employment policies and social systems) hence are being ever more measured against their performance in terms of flexible adaptation, high levels of human capital (qualifications and skills) and a high participation rate. Adequately designed social policies can be efficiency- enhancing. Social systems as well have a bearing on labour mobility in the EU.

Against this background, the Lisbon Strategy can be considered an exercise in policy coordination. It is often identified with soft coordination through the Open Method of Coordination (OMC). Underlying the OMC is the recognition that policy coordination is a necessary condition for internalising international spillovers and complementarities. The OMC's weak point reportedly is its reliance on benchmarking (that is, peer pressure and public opinion) in the absence of formal sanctions. The fact that the implementation of national action plans that were to stimulate R&D investments, as to translate EU goals through national targets, has been slow is a case in point. Moreover, the fact that the OMC seems not to have worked as a commitment device for the Lisbon strategy contrasts with Economic and Monetary Union (EMU) where there was a timetable and there were conditions that had to be met by member states.

The 2005 mid-term review of the Lisbon Strategy was to address an excessive agenda and the shortcomings in the governance structure. It led to sharpening the Lisbon objectives to focusing more narrowly on employment and growth and also suggested the need for changes in governance in particular to ensure the coordination of national reform programmes (NRPs, substituting the previous national action programmes) which are member states' responsibility. The institution of NRPs in the refocused Lisbon strategy aims to involve stakeholders and thereby increase commitment. Both commitment in governance and acceptance of the market by member states are fundamental for attaining the common goals (growth and jobs).

However, governance changes fell short of the recommendations made in the 2004 Kok report. The report had advocated improving the governance of the Lisbon strategy by a three-legged approach, namely NRPs coordinated by EU guidelines, an EU budget with adequate resources and priorities with respect to the Lisbon objectives, and benchmarking as a coercion mechanism for poor performers. In the event, the governance system of the reformed Lisbon strategy fell short of recommendations and came to rely on NRPs, with EU budget reform postponed and benchmarking through comparative performance indicators watered down. Coordination of reforms rests on the Integrated Guidelines for Growth and Jobs which establish numerous objectives which should be the basis for evaluation of NRPs by the Commission. Stakeholder involvement in NRPs should augment national ownership of reforms so as to help overcome national resistance to reforms with an EU rationale.

Yet, Lisbon priorities and common goals are not reflected or implemented through the EU budget and "naming and shaming" as a coercion mechanism was further weakened. It remains to be seen to what extent NRPs will trigger a national debate in poorly performing countries and whether national ownership proves sufficient to overcome national resistance to reforms with an EU rationale and increase commitment as to successfully implement reform programmes.

Still, and despite those possible governance weaknesses, it might be important to not lose sight of the fact that the very discussions prompted by and facilitated within the context of the Lisbon Agenda have meant that Lisbon has in practice already moved on beyond the OMC and makes use of a range of instruments. Increasing EU market integration is having an impact on governance, leading to new coordination needs, making coordination requirements and mismatches more visible and their resolution more pressing in the light of competitiveness considerations. On the one hand, the Lisbon process has made shortcomings more visible and led to more similar preferences and possibly circumstances. Furthermore, issues have been pulled to a European level and institutions were created, it has resulted in the application of the normal legislative process (EU directives that are the result of discussions within the Lisbon strategy), or in EU regulations.

4.4 Lisbon goals and coordination of reforms

Accepting that it would be important for the EU to grow faster - for reasons that rest on the sustainability of European varieties of the social model in the face of unfavourable demographics (an ageing population), the need to facilitate catching-up of the new and of future members, and the fact that low growth makes the political task of reform more difficult or the EU's international political influence negligible, its capacity to do so hinges on the ability to adjust flexibly in order to be able to take advantage of globalisation.

4.4.1 Innovation and international spillovers

The European Council recognised in 2003 that the potential of any R&D policy within the Lisbon Strategy rested on global and coordinated reforms. The benefits from innovation and a knowledge-based economy can only accrue provided that multi-dimensional adjustment is allowed to take place. This encompasses functioning product and financial markets (focussing attention not only on firms' incentives to invest in innovation and technological development but also on financing those investments), effective public support for R&D of various kinds to foster synergies and provide the right incentives for firms (research infrastructures, training, patent system) but as well competition policy enforcement (notably the absence of state aids and restrictive practices) and labour markets and social systems that encourage and smooth adaptation.

The case for the EU to coordinate and/or take measures to promote knowledge investments rests on international spillovers (promoted by geographical proximity) between member states, while the need for large-scale investment is importantly related to Europe's proximity to the technological frontier so that productivity growth depends more on (the accumulated effect of) domestic European R&D and its commercial exploitation rather than on imitation or assimilation of knowledge from abroad. Yet, the EU budget is small compared to member state budgets and moreover inconsistent with Lisbon priorities (agriculture and structural funds account for about two thirds). EU budget spending on Community R&D

policies is also rather small in absolute terms compared to national R&D. As a consequence, EU innovation performance is strongly conditioned by the member states' innovation policies and their commitment to agreed targets. Member states' insufficient and not sustained investment can be taken as an indicator of their (in)capacity to reform and insufficient commitment towards creating a dynamic knowledge economy, and by that way as a critical impediment to higher EU long-run economic growth.

It is member states which will have to finance the largest share of R&D investments to ensure implementation of the Lisbon targets (three per cent of GDP), only part of which can come from the Community budget. The fact that the implementation of productivity-raising R&D investments thereby depends crucially on member states raises two issues. Firstly, to ensure commitment at the member state level when coordination relies on the OMC to internalise international spillovers from R&D. Secondly, apart from R&D spending targets it is necessary to consider effects on the private sector (tax policy is at the national level) and the output efficiency of R&D spending. Cost effectiveness could be promoted by the opening-up of national R&D funding to EU-wide competition – as happened with public procurement in the past - hence putting an end to the segmentation that in practice still exists along national lines. Thereby the public research efforts could contribute to creating better scale, avoid duplication and promote excellence by channelling the funds to the best researchers or research institutes at the EU level.

4.4.2 Services liberalisation and regulation

Notwithstanding its potential for employment creation, the service sector lags behind the goods sector with respect to European market integration. Liberalisation has been slow and the services sector in the EU is still segmented along national lines by national regulations with intra-EU trade in services low. The lack of competition is problematic in the light of unrealised efficiency gains to raise productivity and the need for the internal market to deliver, in particular since the weight of the services sector in the economy is so large (over 60 per cent of EU GDP). Services liberalisation brings to the forefront the issue of EU regulation and of the regulatory model. The Bolkestein services directive of 2005 that aimed at liberalising the sector by means of resorting to the home country principle was rejected. It gave way to a watered-down compromise version that does away with competition between national regulatory systems.

Deregulation in the internal market raises the question as to the regulatory model when pure market coordination is beset by market failure or regarded as not sufficient. There are various styles of complex, country-specific domestic regulation in EU member states and different degrees of tightness of regulation. In this setting, different regulatory systems are likely to contribute to the segmentation of the internal market. However, national regulations that constitute invisible barriers to trade are incompatible with the common market and market integration and the goal of services liberalisation already enshrined in the Rome Treaty. So, the question is not whether but how liberalisation will take place in Europe: by simply letting the market work (negative integration) or through positive integration, notably European regulation, harmonised European essential rules in conjunction with the mutual recognition of national regulation, or just mutual recognition. Far from constituting a mere technical deregulation exercise the liberalisation of the services sector and more specifically the fate of the services directive has illustrated that the choice of the regulatory model happens to be highly political.

In the light of different national circumstances and/or preferences and the difficulty to have European regulation on the one hand and the need to guarantee non-discrimination on the other, the Bolkestein services directive had initially embarked on the third option, mutual recognition of home country regulation for the provision of services in the internal market. Opposition to the directive was directed importantly against the home country principle which implies competition between national regulatory systems. The resistance owed much to political economy reasons, that is to powerful lobbies in (often relatively small but well protected) service sectors protected by high barriers who stood to lose most, such as liberal professions and public sector services and which managed to mobilise public support. An economic agent's competitiveness would to an important degree depend not on own efforts, but on the – more or less – favourable regulatory framework provided by his/her home country. Firstly, it is questionable whether this is politically acceptable in the internal market, as in that case a country's regulatory system would be part of its comparative advantage (or disadvantage). Secondly, it might as well be debatable whether there would have been any race to the bottom or whether countries would not have tried to compete by means of more efficient and better quality regulatory frameworks. In the event, the discussion became focused on the defence of social models and turned against Europe (the European Constitution).

Under the compromise version of the services directive[5] which abandoned the home country principle and thus regulatory competition, member states preserve the right to fix general obligations applicable to the service providers on their territory. This will also create more legal uncertainly that will have to be sorted out by the European Court of Justice in due time.

It should be added that the liberalisation of network industries (infrastructures and services) is beset by a similar problem. Network industry liberalisation in the internal market is one of the goals of competition policy. Liberalisation is based on a two-legged approach that involves on the one hand the regulation of network infrastructures (based on natural monopoly reasoning) notably in terms of pricing and access conditions and on the other hand the application of competition policy to the services based on those infrastructures. National regulatory authorities regulate network infrastructures and they are part of a European Regulatory Network meant to ensure necessary coordination. However, there is no European Regulator to oversee the Community dimension, whereas there is in the case of competition policy. As national regulation authorities are meant to create *ex ante* the conditions for the good functioning of the market (while the competition authorities basically enforce it *ex post*), if they limit themselves to their national market they are unlikely to create the conditions for the good functioning of network industries at the level of the single market. Governance in the EU so far has not tackled this problem. The present discussion around proposals concerning utilities, in particular the energy sector, illustrates the issue of protected national markets and lacking EU-wide competition.

4.4.3 Social models and policy learning

The Treaty of Rome, very ambitious indeed with respect to economic integration, had omitted any harmonisation of social policies as they would not distort competition. The Lisbon Strategy entails the recognition that social policy can be efficiency-enhancing.

A social system can actually encourage adjustment and thereby facilitate adaptation and relocation of production factors (labour and capital) with a view to higher efficiency, but also promote cohesion, another Lisbon goal. In fact, classifying member states' social models along two dimensions, efficiency and equity, it can be argued that the evolution of European social models towards higher efficiency is an imperative for their future sustainability, whereas equity is a matter of preference of society but also has an impact on the adjustment capacity. Adopting a dynamic perspective, social systems – more precisely their capacity to adapt and promote restructuring and more efficient resource deployment - are important from a competitiveness perspective and for realising the benefits of the internal market.

Having taken stock of these differences between the efficiency/equity properties of social systems in the EU and their ramifications for their sustainability and for the good functioning of the internal market, it is important to note that European social models are proving not to be monolithic. They are open to different efficiency/equity constellations, with fundamental welfare reform in member states being characterised by a very large variety of social and economic policy redirection and the elaboration of new principles of social

[5] Approved by the European Parliament on 15 November 2006 and adopted by the Council on 11 December 2006 by qualified majority, and to be implemented within three years. Also note that labour law (which protects insiders and may slow down restructuring unlike social protection that can facilitate adaptation by protecting against unemployment) does not fall under the scope of the services directive.

justice. It is the very process of European economic integration that conditions social systems through EU regulation and coordination and there has been an on-going and dynamic reform process in recent decades that revealed the adaptive capacity of the European welfare states.

4.4.4 Some conclusions on Lisbon and governance

The internal market and the defence of a level playing field is at the basis of any European model. Hence it has to deliver for the model to be sustainable, as the Lisbon Agenda recognises in particular in its 2005 refocus. For the internal market to deliver in the context of globalisation and the knowledge economy, the EU needs adequate institutions that promote change and flexible adaptation in today's more uncertain and changed market and technological environment. The Lisbon Agenda sketches out something like a European model of society that envisages making compatible economic imperatives with social and economic concerns and values. The Lisbon Agenda can be considered an exercise in policy coordination in the light of European mixed economies. Its capacity to unleash the efficiency potential of the internal market hinges very much on governance, in particular when reforms to realise international synergies and complementarities or policy-learning with a view to common goals involve not only the EU but as well the member state level, while coordination mismatches can be expected to impair performance. However, liberalisation *cum* regulatory competition might not be politically acceptable in the internal market, as illustrated by the compromise on the services directive, and not do away with protectionism and market segmentation.

Efficiency is a necessary condition with a view to the sustainability of any European model albeit not sufficient, as equity considerations and ownership of reforms seem important for successful implementation (services directive, reformed Lisbon Agenda) and not necessarily contradictory (social models). The realisation of the benefits from EU market integration and the way deregulation is conducted (regulatory model) is not an apolitical process in European mixed economies.

Still, reforms do take place and institutions evolve (albeit somewhat scattered) at the European and at the member state level, and they have done so notwithstanding the absence of a constitution and/or before the ratification of the recently-approved Lisbon Treaty. There is also some evidence that competitiveness objectives are becoming more widely entrenched, not only in regard to the wider recognition of the potentially efficiency-enhancing properties of the internal market, EMU and the Lisbon Agenda, but also within European institutions (the Commission, the European Parliament).