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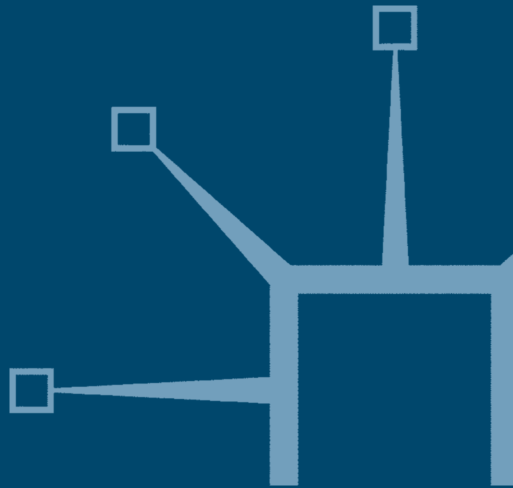
Economic Policy for a Social Europe

A Critique of Neo-liberalism and Proposals for Alternatives

Edited by

Jörg Huffschmid



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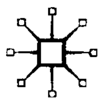

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List of Abbreviations

ASEAN	Association of South East Asian Nations
ATMs	automatic teller machines
BEPGs	Broad Economic Policy Guidelines
BIS	Bank for International Settlements
CAD	Capital Adequacy Directive
CAP	Common Agriculture Policy
CEBS	Committee of European Banking Supervisors
CEC	Commission of the European Communities
CEECs	central and eastern European countries
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
COM	Clean Development Mechanism
CRA	Community Reinvestment Act
CSOs	Civil Society Organizations
CTT	currency transaction tax
DARES	Direction de l'Animation de la Recherche, des Etudes et des Statistiques
DSB	Dispute Settlement Body
EAGGF	European Agricultural Guideline and Guarantee Funds
EBC	European Banking Committee
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECB	European Central Bank
ECOFIN	Economic and Financial Council
ECSC	European Coal and Steel Community
EEA	European Environment Agency
EEC	European Economic Community
EEG	European Economic Government
EES	European Employment Strategy
EFRD	European Fund for Regional Development
EFTA	European Free Trade Association
EIB	European Investment Bank
EIF	European Investment Fund
EIONET	European Environment Information and Observation Network
EIOPC	European Insurance and Occupational Pension Committee
EMF	European Fund for Monetary Cooperation
EMS	European Monetary System

EMU	Economic and Monetary Union
EP	European Parliament
ESC	European Securities Committee
ESCB	European System of Central Banks
ESF	European Social Fund
ESM	European Social Model
EU	European Union
FAO	Food and Agriculture Organization
FDI	foreign direct investment
FED	Federal Reserve Bank
FEER	fundamental equilibrium exchange rate
FSAP	Financial Services Action Plan
FSC	Financial Services Committee
GATS	General Agreement on Trade in Services
GDP	gross domestic product
GHG	greenhouse gas
GSM	Global System for Mobile Communication
HICP	Harmonized Index of Consumer Prices
ICPFs	insurance corporations and pension funds
ICT	information and communication technology
IEA	International Environmental Agency
IGC	Intergovernmental Conference
ILO	International Labour Organization
IMF	International Monetary Fund
IPCC	Intergovernmental Panel on Climate Change
IPRs	intellectual property rights
ISD	Investment Services Directive
JEMPoC	Joint Economic and Monetary Policy Committee
JI	joint implementation
LCCs	local centres of competence
M&A	mergers and acquisitions
Mercosur	Mercado Común del Sur
MFIs	monetary financial instructions
MIA	Multilateral Investment Agreement
NAIRU	non-accelerating inflation rate of unemployment
NAPs	National Action Plans
NCBs	National Central Banks
NEPA	National Environmental Policy Act
NGOs	non-governmental organizations
NUTS	Nomenclature des Unités Territoriales Statistiques
OECD	Organization for Economic Cooperation and Development
OFIs	other financial intermediaries
OMC	open method of coordination
OSGI	obligations to provide services of general interests

PAYG	pay as you go
PPP	purchasing power parity
PPS	purchasing power standard
R&D	research and development
RCAP	Risk Capital Action Plan
RDFP	Research and Development Framework Programmes
SEA	Single European Act
SEM	Single European Market
SGEI	services of general economic interest
SGI	services of general interest
SGP	Stability and Growth Pact
SMEs	small and medium-size enterprises
UCITS	Undertakings for Collective Investment in Transferable Securities
UMTS	universal mobile telecommunications system
UNCED	Conference of the United Nations on Environment and Development
UNCTAD	United Nations Conference on Trade and Development
UNEP	United Nations Environment Programme
WHO	World Health Organization
WTO	World Trade Organization

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1 Introduction: the European Social Model: a Contested Concept

Two historic events marked the development of the European Union (EU) in the second quarter of 2004. On 1 May eight countries from the former eastern European socialist bloc entered the EU, ending the historical East–West divide and opening the perspective of a comprehensive all-European development strategy. Less than two months later, on 18 June, the European Council in Brussels adopted the European Constitution, promising to end the hitherto unsatisfactory bias of European integration towards economic themes and to open the way to a broader, constitution-based political union. This simultaneous widening and deepening of the EU should provide a political foundation for the economic and social ambitions formulated in March 2000 at the Lisbon summit: that the Union should become the 'most competitive economic region in the world, with more and better jobs', reaching full employment with a high level of social cohesion and democratic participation of the people. Is the agenda set for the implementation of a 'European Social Model', a term which the EU adopted from the social movements and introduced into official documents at the summit of Barcelona in 2002?[1] Such a strong model would strengthen the European position in the world and help to implement strategic global projects for development, eradication of poverty and better environmental protection.

Unfortunately most of this is wishful thinking. Five years after Lisbon the average growth rate of the EU economy is about half of that required to reach the Lisbon objectives. The number of unemployed has not fallen but risen. In many cases, inequality between regions increased. Pay and working conditions deteriorated in core countries of the old EU and most new member countries.

The state of political integration is hardly better. The accession of the new members came at the end of a long process of rigorous examination and subordination to the rules of the EU, and maintained discriminatory features which are not conducive to European solidarity and political cohesion. Even the Constitution – assuming it is ratified and comes into force – will not provide the basis for a closer political union, but could rather be perverted into a battleground for nationalistic power ambitions.

While the economic and social appearance of the EU as a whole is weak, considerable differences between member countries persist. Growth has been particularly low in Germany and France, where unemployment is correspondingly high. In the UK and some smaller countries economic performance is much better and unemployment lower, but social polarization is very marked. In the Netherlands, the much praised 'Polder' model of wage moderation, with high employment growth, has recently reached a crisis. But the Danish and Swedish reforms of the welfare state and the strong labour market policies have generated much better results. Among the new members growth is higher than average but productivity and income per capita are still very low. The EU economy as a whole covers very different constellations among member countries. This should be taken into account in discussions of *the* European economy and a coherent concept of economic and social policy for the EU.

On the other hand, the EU is treated as one bloc in international relations, and her overall weak economic performance and increasing social insecurity have not strengthened but weakened her role in the world. Although in terms of economic competitiveness the Union maintains a fairly balanced position in her current and capital accounts, it does not exercise the political influence in international institutions corresponding to a leading economic trading area. Internally, it has become more alienated from citizens of member countries than ever before. The lack of transparency and the continuing democratic deficits – both in the workings of EU institutions and in the new Constitution – have reinforced this process. The contours of a European Social Model – so often invoked – are not visible for the majority of people. An alarming reflection of this disaffection is the ever-decreasing participation in the elections for the European Parliament, with a historical low participation rate of 45.5 per cent in June 2004. It is not less alarming that parts of traditionally pro-European forces of the left are being driven into anti-European positions; and that the extreme right und nationalist forces are benefiting from the consequences of current European policies.

The European Social Model is a conception under construction. There are many different models of social reproduction and regulation in Europe, ranging from strong state-controlled welfare states in the Scandinavian countries to the conflict-driven structures in southern countries like Italy and Greece, passing through corporatist arrangements such as those of Germany and Austria (see Esping-Anderson, 1990). With enlargement the spectrum of social models has been extended to include a further species of post-socialist countries. Given such diversity, are there any common features which could be the basis for a common all-European social development model? There are mainly two directions in which a positive answer to this question goes, and these are the bases for two very different meanings of the term 'European Social Model'.

The first answer, and the underlying hypothesis of this book, refers to the embeddedness of the individual in an environment of social responsibility

and solidarity (see Polanyi, 1944). In the history of all European countries, a connection has been established over the last two centuries between political democracy, social solidarity, and public responsibility for the security and social welfare of each individual in society, combined with a certain degree of egalitarianism. In the emergence of European welfare societies the development of this combination has prompted political interventions and has led to the establishment of a distinct public sector with three aims, namely to:

1. Provide social security, education and basic welfare services to all, regardless of their status and income;
2. Promote more social equality through the redistribution of income and wealth;
3. Control the main directions of economic development in order to strengthen the economy as the basis for social welfare.

The formation of such structures was the outcome of social movements and political conflicts which developed in different forms and intensities and led to the establishment of different institutional forms of European welfare states. This makes it difficult to speak of *the* European Social Model, and to find a common institutional pattern.

The second answer to the question of a European Social Model is that over more than 20 years the traditional bases of all European welfare states, namely social solidarity and responsibility, have come under heavy neo-liberal attack leading to a different concept of European Social Model. We understand neo-liberalism to be a comprehensive social and political strategy responding to the increasing complexity and difficulties of capitalist development since the mid-1970s, expressed as a body of economic doctrine, placing competition and the market as the driving forces of economic and social development. Neo-liberalism is advancing under the ideological umbrella of necessary adjustments to the all-encompassing process of globalization. Globalization, it is said, necessitates a thorough reorientation of economic and social policies in Europe, with the main objective being that of improving the competitiveness of the EU and European firms on the world market. In this context the concept of a European Social Model or European model of society to which EU institutions and officials often refer is embedded into the framework of global competition. The lasting weakness of the European economy is interpreted as confirmation that necessary adjustments have not yet, or not sufficiently, taken place. This concept of a social model is the opposite to the European Social Model which is proposed in this book, in which national and international economic relations and policies are embedded into a framework of social welfare objectives.

The attacks on the social substance of European social models follow two general paths. First, they aim to minimize public intervention and the role of the public sector in economic and social reproduction, making the establishment of open markets the main purpose of economic regulation.

Liberalization and competition promise, we are told, to achieve what governments have not accomplished over the long decades since the Treaty of Rome: the unification of Europe. This is logical in that if the market and competition are established in all countries as the almost exclusive rule of reproduction, then European unity would be one large, uniform European market economy, without frontiers and with minimal and exceptional public intervention.

The second aim is even more fundamental: it is to break up the 'encrusted' structures of social relations which are based on the relatively strong positions of workers' movements and trade unions. These social relations are regarded by mainstream ideologists and policy-makers in the European Commission and in most countries as the main obstacles to economic progress and greater competitiveness. The objective of modern politics must therefore be to break the power of workers and trade unions. In this context high and lasting unemployment seems to be tacitly accepted as a disciplining tactic against workers, although in official declarations the fight against unemployment is one of the highest priorities of the EU and most member countries. It seems that the concept of an 'industrial reserve army' has in practice returned to neo-liberal policies. Some recent political moves in member countries – for instance the pressures from employers for working hours to be extended across the whole EU – can hardly be understood in a different sense.

Under these circumstances our concept of the European Social Model cannot be developed in a straightforward way. It is bound to be a concept of contest and a contested concept, both challenging the neo-liberal strategy and being challenged by neo-liberalism. The first and immediate step towards its development is to resist attempts to destroy the substance of the welfare state. This requires powerful arguments and strong social movements. Over the last decade arguments against neo-liberal politics have been developed. The critiques have identified and exposed their general nature and their common objectives. The challenge is now to develop a European dimension of the welfare state with strong democratic intervention to prevent the uniformity of marketization and regulation through competition. This dimension cannot be an equally uniform one but must leave much room for national and regional specificities and traditions. But it should define certain common ambitions and rules, with regard to social minimum standards, social responsibility and public intervention in the economy.

The first of the two main theses of this book is that the lamentable disorganization, polarization and weakness of the EU are neither the inevitable consequence of globalization (or any other external influence) nor the result of insufficient adjustment to external changes. They are mainly the result of neo-liberal economic and social policies. What we now call neo-liberalism was one of several different possible reactions to the crisis of accumulation in the early 1970s. Neo-liberalism was chosen and enforced by the strongest capitalist

countries and corporations. They decided to cope with problems of domestic economic development through enhanced international expansion (see Chapter 2). With this aim they broke with the fragile system of international cooperation of Bretton Woods and replaced it by unfettered international competition, including currency competition and capital liberalization. This new policy triggered an international race for competitiveness and had a decisive impact on the present form of internationalization which is called globalization. It was accelerated by the competition-driven development of new technologies, particularly in the information and telecommunication sectors.

At the same time the new policy orientation served as an instrument to enforce a comprehensive roll-back attack on the domestic social achievements and reforms which had been accomplished in all countries during the first 25 years after the Second World War. It amounted to a reversal of priorities: whereas domestic employment and welfare were the leading orientations in the post-war era while international competition was mediated and in some areas such as capital flows restrained, the neo-liberal agenda defined international competitiveness – with the aim of international superiority – as the most important goal, and one to which domestic policies had to adjust. The main instruments for this were extensive liberalization, privatization and opening-up and extension of markets. In this sense macroeconomic policy was reshaped towards a very restrictive course targeting price stability as the exclusive objective of monetary policy and balanced budgets as the main rule for fiscal policies – both to strengthen competitiveness, disregarding the harmful domestic and social consequences of such policies (Chapter 3).

A major pillar of the new policy agenda was the creation of a single European financial market, in order to give Europe strength against the international financial competition and to impose discipline on those with ambitions for more social security and welfare (Chapter 4). At the same time the reduction of the public sector through the liberalization and privatization of utilities and other network industries and by outsourcing other services was and is pursued with great intensity, with the aim of creating new areas of private investment; of temporarily relaxing budgetary constraints; and for general ideological reasons (Chapter 5). In this context social policies were considerably downsized in most member countries, and the European dimension of social policy consisted strongly of encouraging the 'modernization' of social security systems. In the member countries this led to more or less comprehensive privatizations of pension systems. The result of this has been more social insecurity and the promotion of private financial markets (Chapter 6).

Amid growing unemployment since the 1970s a title on Employment was only introduced in the Treaty of Amsterdam in June 1997 and a 'European Employment Strategy' developed at the Luxembourg summit in November 1997 but reduced to labour market policies promoting employability,

flexibility and entrepreneurship of the unemployed, effected mostly through social pressure including cuts of social benefits[2] (Chapter 7). Issues of great and increasing global and regional importance, in the first place the protection of the environment, were taken up by the EU, but measures adopted were frequently vague and based on the belief that markets would eventually deal with the problems (Chapter 8). Under this regime structural policies to intervene in the very heterogeneous economic structure of the EU and to formulate strategic goals were only very insufficiently developed (Chapter 9).

The Common Agricultural Policy (CAP) as the only long-standing common policy came under pressure for radical liberalization in confrontation with conservative and protectionist conceptions which had basically remained unchanged over 40 years (Chapter 10). With regard to trade, the EU has been unable to formulate a coherent strategic approach vis-à-vis the USA, and within the GATS framework it acts as one of the main forces in favour of further liberalization (Chapter 11). Most recently, the lack of a consistent and comprehensive conception for Europe was revealed in the narrow and almost exclusively market-based approach to the most important enlargement in the history of the EU, where competitiveness was the only economic criterion which accession countries had to fulfil (Chapter 12). Although calls for better coordination and coherence between the different policy levels and approaches have been put forward over a very long time, the real advances of economic and social policy coordination are very limited (Chapter 13).

The second of the two main theses of this book is that despite the reiterated assertions from governments, the European Central Bank (ECB), EU officials and large parts of the media that there is no alternative to the present course of economic policy, such alternatives can be developed and implemented. Their bases are, on the one hand, the theoretical and empirical critique of neo-liberal policies, and, on the other, the development of social and political movements and protest against such policies. The purpose of the second part of the book is to present conceptions and proposals for such alternatives. Most of these are rather distant from the way economic and social policies are presently conducted. Most require institutional changes, some very radical ones. In that sense they are not realistic with regard to immediate policy measures. But all of them are reasonable in the sense that they would lead to higher employment and improved welfare. And the shifts in political power relations which would make such changes feasible have been regular events in history.

The alternatives proposed are based on a particular conception of the European Social Model. Its common basis has been broadly outlined above and more concrete contours have – in an embryonic form – emerged from criticism of neo-liberalism. They include much more wide-ranging and intense political intervention into the economic process. This requires a definition of the objectives of the European Social Model. It is widely

accepted that such objectives should be full employment, social security and equity, ecological sustainability and balanced cooperative international economic relations (Chapter 14). To reach the macroeconomic goals the mission and statutes of the ECB must be reformulated to encompass employment and sustainable growth (Chapter 15). Likewise fiscal policies should be empowered to contribute, via coordination and a strong EU budget, to economic growth, social cohesion and the delivery of public goods (Chapter 16). Employment and labour market policies should first be given an explicit macroeconomic dimension including working time reduction, and secondly, pushed away from putting pressure on the unemployed and towards making attractive job offers (Chapter 17). Instead of being concerned exclusively with lowering transaction costs and raising transaction speeds, financial market reform should move to dealing with financial stability and efficiency, consumer protection and the inclusion of everyone in the payment and credit system as a basic precondition for participation of the individual in social life (Chapter 18). In the European Social Model, the imperatives of financial markets should not be the basis of social reproduction. This role should be (re-)assigned to the public sector and implemented through a broad range of public services – network, social and cultural services (Chapter 19). Full social responsibility for the social security systems should be restored and they should not be delivered to the incalculable risks of financial markets (Chapter 20). Environmental policies (Chapter 21) must take priority in an alternative economic policy, and structural, agricultural and trade policies (Chapters 22–24) must be worked out in much more detail and carefully coordinated.

This book is the result of intense work and discussions of European economists, participating in the thematic network 'Improvement of Economic Policy Coordination for Full Employment and Social Cohesion in Europe' (EPOC, www.epoc.uni-bremen.de). EPOC was established within the programme 'Citizens and Governance in a Knowledge Based Society' of the Sixth Framework Programme for Research, Technology and Development of the EU. The network has organized numerous discussions with external experts in workshops, meetings and conferences. The book is also a result of exchange and interaction with the working group 'European Economists for an Alternative Economic Policy in Europe' (Euromemorandum-Group, www.memo-europe.uni-bremen.de). In these discussions we have developed and consolidated the general thrust of both our critique of neo-liberalism and our proposals for alternatives. This is not to dismiss differences and diversity concerning specific arguments and proposals. Such differences remain and are reflected in the book, for instance with regard to the role of economic growth, of competition policy or of a Tobin tax in an alternative economic and social strategy for Europe.

Members of the network have contributed different parts to different chapters. All chapters have been thoroughly discussed by the whole group,

and proposals for revision and reformulations for each chapter came from many members and external experts. In that respect, it is a collective book without genuine individual authorships for specific chapters. Nevertheless the work of final composition and formulation has fallen on the members of the network as follows: Elmar Altvater: Chapters 8 and 21; Wolfgang Blaas: Chapter 12; Miren Etxezarreta: Chapters 6 and 20; Marica Frangakis: Chapter 4; John Grahl: Chapters 7, 17 and 18; Jörg Huffschmid: Chapters 1, 5, 14, 16, 18, 19 and 25; Alfred Kleinknecht: Chapters 7 and 17; Jacques Mazier: Chapters 3, 9, 10, 11, 22, 23 and 24; Pascal Petit: Chapters 2 and 13; Malcolm Sawyer: Chapters 3 and 15. The technical organization and coordination were carried out by Jacqueline Runje.

Notes

1. First officially introduced into EU documents in the presidency's conclusions of the Barcelona summit in March 2002 (European Council, 2002, paragraphs 21 and 34) as stressed by former Commissioner Anna Diamantopoulou (2003, p. 2).
2. However, the fourth of four pillars of the European Employment Strategy is the positive objective of creating equal access for women and men to the labour market.

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Part I

Critique of Economic Policies in Europe

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2
European Integration (1974–2004): towards a Neo-liberal Zone

2.1 Introduction

The course of European integration gradually evolved as it came to concern more and more European countries with different background and history. It started from a communitarian project to ensure peace and prosperity after the Second World War to become a project mainly expressed in terms of market liberalization. This turn was induced by the outbreak of the economic crisis of the 1970s. Soon the release of market forces became the only principle of this union and regional integration was presented as a means to adjust to a more global and marketed world. This chapter shows how this turn came about.

2.2 From an inward-looking process … rejecting the conflicts of the past

By the mid-1970s most developed economies had been stricken by slow growth and rising unemployment. There followed inflationary pressures, exacerbated by the breakdown of the Bretton Woods agreements on fixed parities, soon followed by the first oil price shock in 1973 and by intense internal distributional conflicts over wages and profits.

Europe at the time was merely a union of some nine countries, centred around a common market of limited scope and preoccupied by its recent (1973) extension to the UK (with Denmark and Ireland). Although the European Communities' economic impact was limited essentially to trade in manufactured and agricultural goods, they also symbolized a new era of peace on the continent, after three major wars in a century. The UK was part of this history, but it was also most concerned to preserve its independence as well as its privileged links with the USA (for these reasons Britain had originally refused to join either the European Coal and Steel Community (ECSC) or the European Economic Community and had instead established the European Free Trade Association with non-EC members[1]).

Growing uncertainties at the world level and the outbreak of an open economic crisis in the mid-1970s meant that Britain arrived *post festum* – the high rates of growth in the original six member states[2] which had convinced the British to join became a thing of the past. Nevertheless it was not clear by then that developed economies were facing a structural crisis. The rise in inflation and in unemployment with the decline in growth rates were often seen as a transitory shock to be treated with the usual policy instruments.[3] EC countries did not attempt to coordinate their use of these instruments – what little coordination there was took place at the level of the OECD.

Only in the early 1980s did it become obvious in most countries that economies were experiencing a structural crisis, marking a real break with the 'golden age of capitalism' (Marglin and Schor, 1990). It was no longer possible to believe that the lasting combination of slow growth, unemployment and inflation was only the result of shocks in oil prices. The changes under way were not only external but concerned internal institutions and adjustment processes. In particular a decade of high inflation, along with distributional conflicts and the ensuing profit squeeze, had brought about a new balance between industrial and financial capital. This did not occur spontaneously but by way of institutional changes linked to the diffusion of new doctrines. Symbolically 1979 was the year of publication of *Free to Choose* by Rose and Milton Friedman, a work much admired by Reagan and Thatcher who would launch their neo-liberal policies in the early 1980s. The explanation of the sharp concomitant rise in both unemployment and inflation in terms of upwards shifts of the non-accelerating inflation rate of unemployment (NAIRU), a supposedly natural rate of unemployment at which inflation rates would be stable, was symptomatic of this new wave of economic liberalism.

In each economy the late 1970s also brought the challenge of adaptation to a more open world. For some firms this meant increasing their global reach, and entering new markets, for others it meant protective measures to assure survival or a shift to new fields. Structural adjustments to this new situation basically aimed to increase the flexibility of economies, meaning more flexible labour markets, exchange rates and financial markets. This search for more flexibility, resulting from the high level of internationalization reached by most developed economies, put direct pressure on labour, regardless of the position taken by individual firms on the opening of the economy. This is why the structural changes under way can be seen as a deindustrialization process whereby the share of employment in manufacturing started to decline (see Rowthorn and Wells, 1987). Increasing the flexibility of labour markets was first on the policy agenda. There soon followed the proclaimed need to privatize intermediation services (such as communication and banking), until that time highly regulated and often operated by public corporations to the exclusion of multinational firms which saw these sectors as attractive fields for investment.

In this context traditional Keynesian policies were heavily criticized as being only relevant to closed economies. Even in the case of a closed economy Keynesian economics was criticized on academic grounds for omitting the effects of rational expectations, although in reality economic changes were bringing about a much more complex, diverse, enlarged and interdependent structure of expectations.

Overall, economic debates were completely transformed by the need for developed economies to adjust to the new emerging division of labour. Large differences in unit labour costs implied some relocation of production and the development of new activities. Liberalization and the new strategies supported by the information and communication technologies were promoting this internationalization of markets (although one could only speak of globalization in a few cases).

The further promotion of European integration seemed an appropriate response to these challenges to two very different currents of opinion. A widely shared neo-liberal position was that internationalization could only be dealt with through market forces and that the only sensible political objective was to free market forces – European integration along neo-liberal lines could gradually achieve this objective and limit the conflicts inevitably involved. The other position, that of a minority which can be seen in retrospect to have been comprehensively defeated, could be described as neo-Keynesian. It saw in the process of European integration a means to coordinate government interventions in order to pursue at the level of the EC the kind of public intervention that markets require in order to achieve full employment and rising welfare.

Both sides, neo-liberal and neo-Keynesian, wanted more European coordination but different forms of coordination for different reasons. For some, integration could help to liberalize economies and to reduce the public interventionism of the past, for others a stronger union was a way of reproducing, at a higher level, and with a better adaptation to international economic developments, the type of modern capitalism they had experienced in the past. Strangely, both groups tended to take the USA as a model. For the neo-liberals, the USA represented a dynamic, continent-wide zone of free market relations. For the neo-Keynesians the scale of the USA made it possible to restore the room for manoeuvre in public policy which had been lost in small and medium-sized countries. It should be remembered, however, that in most countries these proponents of further integration remained small majorities, with large groups on the left and the right against such an extension.

Thus there was a change in the nature of European integration at the turn of the 1980s. The first steps of European integration had been aimed not just at economic objectives but at preserving the peace with first the creation in 1951 of the European Coal and Steel Community to avoid the return of Germany's heavy industry (a critical element of military capacity) to

national control, then a failed attempt in 1952 to set up a European Defence Community, rejected by the French Parliament in 1954.[4] The success of the initiative in heavy industry and the failure of the more directly political Defence Community encouraged the pioneers of integration to emphasize the economic domain. This they did through the Treaty of Rome (1957) establishing the 'common market' (European Economic Community) which began on 1 January 1958. Thus the early steps in European integration had been focused on largely internal objectives, notably the elimination of the risk of new Franco-German wars. By the 1980s this internal focus had given way to an outward-oriented process whereby similar countries attempted a coordinated response to the process of internationalization.[5]

2.3 To an outward looking union ... confronted with a globalizing world

The beginning of the 1980s were the years of stagflation. Exchange rates were especially unstable; price inflation had risen sharply, unemployment was steadily growing while economic growth slowed as well as productivity gains (see Figure 2.1). The nine members of the Union at the time quarrelled over the EU budget, with the UK refusing to pay its contribution. Comparisons of Europe with the USA turned to the advantage of the latter, reversing the previous situation and leading to the term 'Eurosclerosis'.

Although progress was made in the monetary sphere with the European Monetary System of 1979 and Greece entered as the tenth member of the EC in 1981,[6] policy-making at European level was characterised by the same conflicts between interventionists and neo-liberals as existed in most of the member states. The early 1980s are often described as years of Europessimism.

The proposal for a Single European Act was intended to revive the European project, through a large number of structural reforms aimed at completing the integration of member state markets by 1992. This was a neo-liberal response to global tensions pressing, a marked departure from the more traditionally Keynesian measures that these countries had used in the past.

Obviously this was not the first challenge to Europe from global developments. Europe as a whole had been politically structured, from the start of the post-war epoch, by the bloc confrontation between the 'socialist camp' and the 'free world'. But this tension, which would disappear after the collapse of the socialist bloc in 1989, was of a different nature. The new global tensions related essentially to economic governance, at all levels, with the related political drive for liberalization, deregulation, privatization and flexibilization (and some of the phenomena later characterized as 'globalization'). The 'Volcker shock' was a salient aspect of these new pressures. Paul Volcker (Chair of the Federal Reserve Bank from 1979) introduced a policy of high

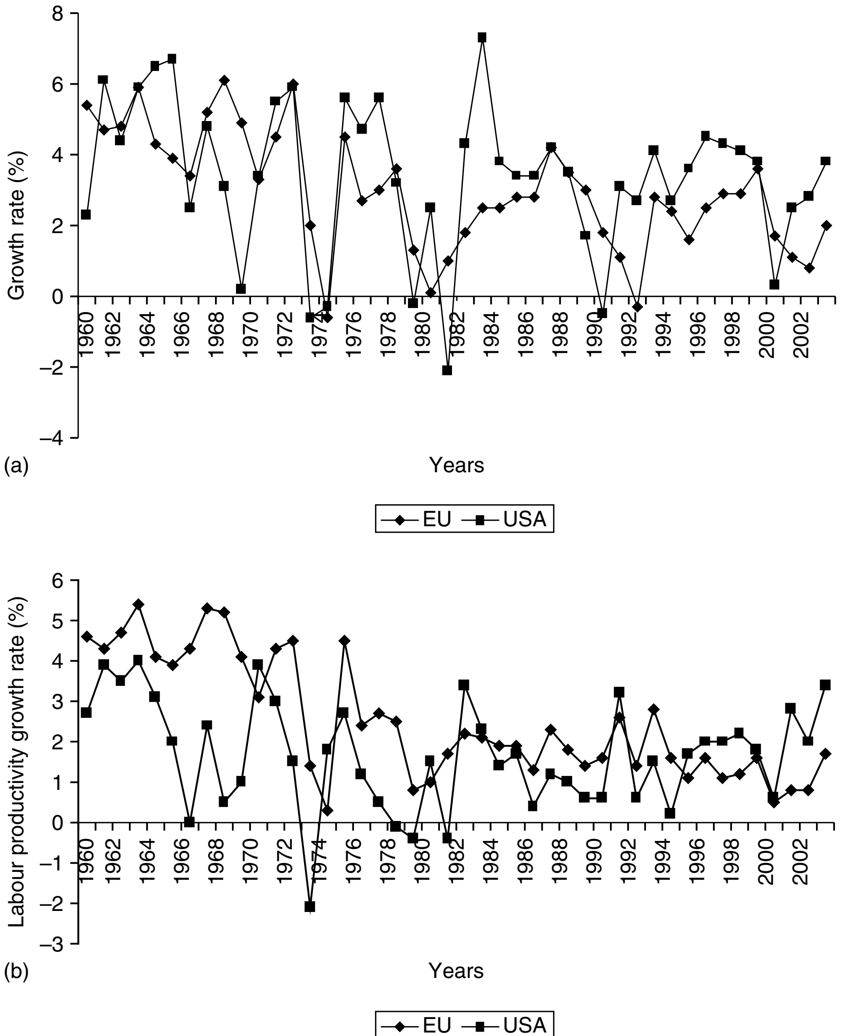
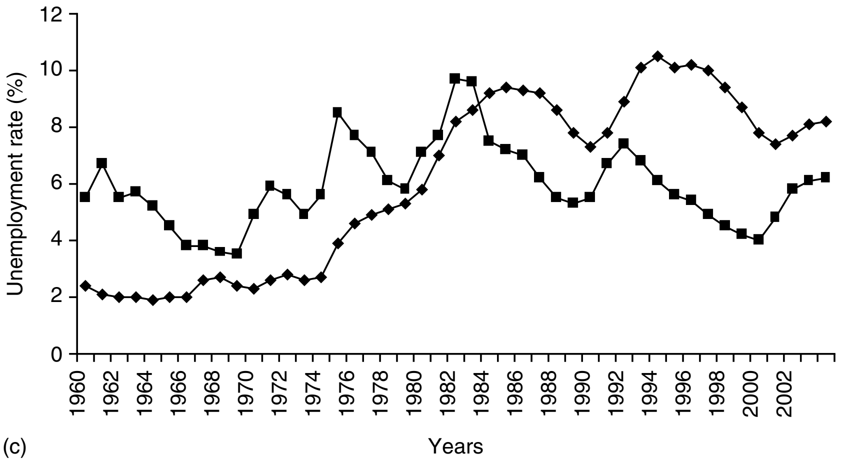


Figure 2.1 Europe (EU-15) versus the USA: (a) economic growth rates, (b) labour productivity growth rate, (c) unemployment, (d) price inflation

Source: Economic growth: European Commission (2000, 2003), statistical appendix.

interest rates which led to extreme pressures on foreign exchange markets.[7] European countries completely failed to coordinate their response to these pressures from the French experience of aborted reflation in the early 1980s to the financial crises at the end of the decade (see Boyer et al., 2004). The absence of any coordinated strategy to deal with very high dollar interest



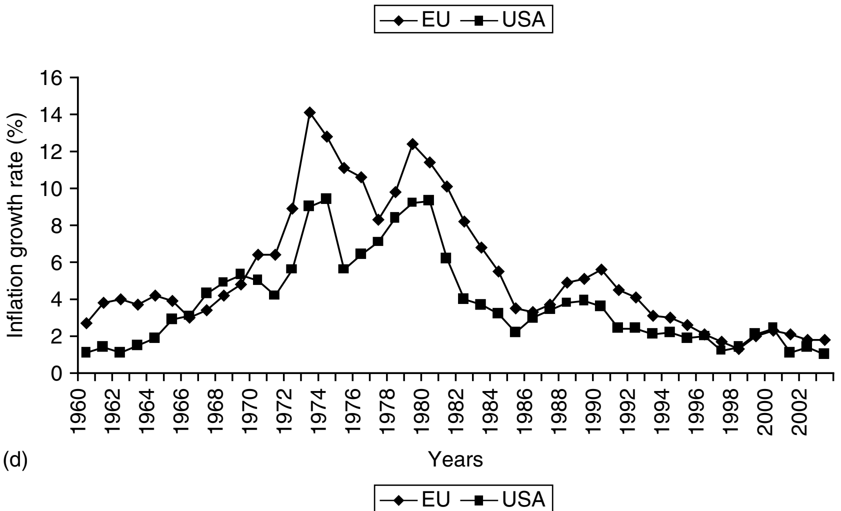


Figure 2.1 Continued

rates and large exchange rate fluctuations helped to undermine the Keynesian policies of the previous decades and to encourage a shift towards monetarism and neo-liberal 'supply-side' strategies. This U-turn was, however, accompanied by a certain scepticism and criticism even on the part of big business which was not so sure that the remedy (market-based policies) would succeed in an effective restructuring of industrial systems. This mood can be detected both in Europe and in the USA itself in such works as *Made in America: Regaining the Productive Edge* (Dertouzos et al., 1989) where

American academics wondered what had gone wrong with the US production model and when. The famous Solow paradox ('computers are everywhere but in the productivity statistics') suggested that neo-liberal restructuring strategies were not in fact successful in releasing the potential of the new technologies. Could those countries which had launched the wave of deregulation in fact compete in an open world?

The Single European Act of 1987[8] had as its central content the rapid introduction of a 'Single European Market' (SEM) to create an environment in which European enterprises could compete effectively on the new global markets. It was meant to reduce physical, technical and fiscal barriers to trade. The 1988 Cecchini report attempted to provide the economic justification for this move by assessing the 'Costs of Non Europe'. Cecchini forecasted that the Single Market would add 4.5 per cent to the GDP of the now 12 member states and create 1.8 million jobs. Most of the sectoral studies carried out to support these estimates and to justify the 300 directives backing the implementation of the SEM were never exposed to critical scrutiny. The use of these completely arbitrary results to support the Single Act simply underlines the ideological dominance of economic liberalism. A review of the process in 1996 estimated that the GDP of the EU-15 had been increased by 1.1 to 1.5 per cent and a net 300,000 to 900,000 new jobs created.[9]

The Single Act did open up very important changes in the international economy, but not so much by the increased competitiveness of EU industries as because it paved the way for a new step in the globalization of finance. The collapse of the socialist bloc further accelerated these financial developments.

In effect the Single Act did not produce the miracle that some of its proponents postulated. On the contrary, the completion of the Single Market programme in 1992 coincided with a recession. Just as important, the period following the collapse of the Soviet system opened with conflicts in Yugoslavia where Europe was very divided and unable to avoid devastating warfare.[10] The US intervention as peacekeeper in a zone so close, historically and geographically, to the EU put the seal on European weakness. Nor did the Single Act do anything to protect European currencies from speculative attacks that had become sharper because new technologies and financial deregulation had boosted the process of globalization of finance. However, although the Single Act clearly failed to meet the promises which were made for it, it did permanently alter the balance of power between the EU and the member states in the economic domain. National policies which introduced barriers to EU-wide competition were increasingly seen as illegitimate and the Commission became much more active in challenging such policies in the courts.

The political momentum arising from the ambitions of the Single Market programme made it possible to relaunch the project of monetary union. The dramatic environment created by German reunification may have helped to

bring about agreement on the project of a single currency. Mitterrand for France, Gonzales for Spain and Andreotti for Italy, in a hurry to seal closer relations with Germany at a time when the difficulties of the reunification tilted the balance of its preoccupations towards the East, proposed in Maastricht a monetary union of such a restrictive and conservative design that it was difficult for the Bundesbank to raise objections (see Kenen, 1995). Of course, this project of monetary union had been on the table since the beginning of the integration process (see Werner report, 1970, on political and monetary union), but after the collapse of the Bretton Woods system it had come to seem unrealistic. From 1972 onwards there had been several experiments in monetary cooperation, culminating in the European Monetary System (EMS) of 1979, and this had gradually become more ambitious and centralized. The apparent success of the EMS also encouraged the monetary union project. Ironically, the EMS was disrupted by huge crises from the autumn of 1992 onwards, but by this time the Maastricht Treaty, committing member states to a single currency, had already been signed. Even after the ratification of the Maastricht Treaty, there was enormous scepticism about the feasibility of a single currency. The fact that it was achieved is largely due to the fact that several member states, notably France, had been persuaded by repeated episodes of foreign exchange disturbance that it would be better to share monetary sovereignty with Germany than to continue to be subject to German monetary hegemony.[11]

The price paid for such monetary union, between currencies of very different strengths, was enormous. An agreement was reached on very stringent conditions for national policies, known as the Maastricht criteria. Originally these criteria were intended only to cover the transition to monetary union, but the 1997 Stability and Growth Pact, limiting the size of current budget deficits and public debts, turned those which related to budgetary policy into permanent constraints. Meanwhile, monetary policy was handed over to an independent European Central Bank.[12] A centralization of monetary policy is, of course, a logical consequence of the move to a single currency. The nature of that central monetary policy, on the other hand, and the fact that it was made independent of political influences at either the member state or the EU level, were not dictated by the monetary union as such – they resulted from specific decisions made at Maastricht and repeatedly confirmed thereafter. The rigid approach to monetary union came at the worst possible moment. The 'convergence criteria', meant to enable EU countries to navigate through speculative international finance, imposed a strictly deflationary discipline on the economies of member states and a dangerous transition process at a time of rapid transformations and frantic speculation within the world economy. In the second half of the 1990s the world of finance was rocked by financial crises breaking out at its periphery: Mexico, East Asia and Russia. Europe was not in the front line in these crises (except for Finland and to a lesser extent Sweden), but affected indirectly

through its trade links and through the impact on its foreign investments while the fragility of its fragmented stock markets was made even more obvious. In such harsh times the hierarchy among financial centres was made even clearer, reducing the capacity of the Eurozone to meet what came next: the speculative bubble in high technology stocks.

The financial revolution of the 1990s imposed global standards of monetary stability through currency competition. This affected most European countries, especially those planning to create the Eurozone. This is a major cause of the rigid stability policy that would be pursued by the European Central Bank and by EU governments.

This double constraint severely limited economic growth and employment in the Eurozone in comparison with the rest of the world. Figure 2.1 shows the slower growth and lasting unemployment in the EU-15; Table 2.1 demonstrates that in the 1980s and 1990s European income per head in terms of purchasing power no longer converged on USA levels – the United States maintained its advantage (although the gap did not widen). This period is strongly characterized by growing income inequality both in Europe and in the USA although much more pronounced in the latter. In Europe the old redistribution mechanisms still play an important role and

Table 2.1 Europe catching up with the USA: a pause after the mid-1970s: gross domestic product at current market prices per head of population (PPS, EU-15 = 100)

	1960	*1965*	*1970*	*1975*	*1980*	*1985*	*1990*	*1995*	*2000*	*2005*
Germany	123.7	119.3	117.4	112.1	118.3	118.4	117.2	110.0	106.4	101.7
Austria	95.7	93.5	96.3	102.7	105.8	106.5	106.0	111.6	115.5	11.8
Belgium	97.3	98.4	100.1	104.4	106.3	104.3	104.0	112.6	107.6	106.2
Denmark	125.7	127.5	124.0	115.7	112.4	115.7	106.1	117.9	117.2	113.3
Spain	59.3	69.4	73.0	80.2	72.6	71.1	75.9	78.2	82.3	87.3
Finland	86.1	89.4	89.1	97.3	97.4	102.7	102.1	97.2	103.2	101.6
France	103.0	104.8	107.3	109.1	109.0	109.4	106.8	103.8	101.4	101.3
Greece	43.7	53.9	62.9	69.6	70.0	64.0	57.8	64.8	65.5	71.8
Ireland	63.0	61.2	61.4	64.5	65.8	67.0	73.4	93.2	115.1	122.0
Italy	87.1	89.2	95.3	94.8	100.9	102.3	101.7	103.4	102.2	101.8
Netherlands	115.8	112.6	112.5	113.0	107.6	104.0	103.0	109.2	111.1	107.7
Portugal	39.5	45.2	50.7	53.7	55.7	53.1	61.3	69.8	68.3	66.0
UK	122.4	113.7	103.8	100.8	97.0	99.6	99.8	96.5	100.4	106.0
Sweden	124.6	129.1	122.8	123.6	112.3	114.7	109.6	106.1	106.6	101.0
Europe (EU-15)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Other OECD countries										
USA	163.4	159.3	146.6	141.8	141.5	147.4	142.8	144.5	142.2	142.0
Japan	58.1	69.1	93.2	93.8	99.4	106.0	113.7	119.1	106.9	104.6

Source: European Commission, European Economy, nos 71/2000 and 6/2003, Statistical Appendix Table 9.

Table 2.2 Rising inequality between the 1970s and 1990s: changes in Gini coefficients of income distribution (%)

	Years	*Market income**	*Disposable income*†
Europe EU-15			
Germany	1984–94	1.2	6.4
Denmark	1983–94	11.2	−4.9
Finland	1986–95	11.4	9.7
France	1979–90	n.a.	−1.7
Italy	1984–93	20.8	12.7
Netherlands	1977–94	14.2	11.8
Sweden	1975–94	17.3	0.9
Some other OECD countries			
Australia	1975–94	36.6	5.2
USA	1974–95	13.1	10.0

* Changes in Gini coefficient of income distribution before taxes and transfers.
† Changes in Gini coefficient of income distribution after taxes and transfers.

Sources: OECD, 1997, *Income Distribution and Poverty in Selected Countries Annex 1*, WP1 *On Macroeconomic and Structural Policy Analysis*, and OECD, 1998, *Forces Shaping Fiscal Policy*, WP1 *On Macroeconomic and Structural Policy Analysis*. Extracted from *Inégalités économiques*, p. 229, Rapport Conseil d'Analyse Économique, Paris, La Documentation Française, 2002.

the rise in the Gini coefficient (an index of inequality) is half that observed in the USA (see Table 2.2). By the end of the 1990s successive moves towards greater integration had failed both to give some autonomy to the Eurozone at world level, and to deliver the promised prosperity.

Meanwhile, the USA economy had re-established the dominant position that had seemed to be vanishing in the late 1980s. Not only did US competitiveness improve (while Japan, the success story of the early 1980s, was in trouble), but it also appeared to be the biggest winner in the new game of a worldwide market economy. Even the UK, following the US example and emphatically refusing to join the EMU, performed better than the Eurozone countries. In spite of the huge deficit in manufacturing trade of the USA and of the UK (respectively around 4 and 3 per cent of GDP in the early 2000s), and their current account deficits (respectively 5 and 3 per cent of GDP in the early 2000s), the USA and the UK seemed to reap the benefits of the financialization of the world economy, even though these benefits may prove to be short-lived if large currency depreciations put an end to the rents of their financial sectors (see Rowthorn and Coutts, 2004).

However, this financial hegemony of the USA, very different in essence from the US hegemony that prevailed in the Golden Age of capitalism period, was in a way reinforced after the 11 September 2001 events by the use of massive military force as the USA, backed by the UK, decided alone how 'globalized' terrorism should be fought, who were the enemies (the

rogue states) and how and when to get them (the Iraq war). This new posture of the USA divided Europe, with France and Germany standing out against what would rapidly prove to be a catastrophic military adventure.

By the early 2000s the balance sheet of European integration was rather disastrous. The EU had not succeeded in preserving much influence over governance at a world level. It appears divided on most global issues. Many of the themes that Europe wanted to push forward to forge a new type of governance at a world level – on such issues as preserving the environment, combining social with economic development, fighting underdevelopment – had been openly rejected by the USA (Bush's contempt for the Kyoto agreement was only one example). All these issues have been marginalized on international agendas despite the crying needs of the developing countries.

One may argue that this state of affairs in Europe would have been even worse without the various integration measures which have been taken. In the early 2000s it has tended to become clear that many of these steps and, above all, the Maastricht Treaty, have been self-defeating: too rigid, lacking both the capacity to adapt to a rapidly changing international environment and any social objectives which might have legitimated strong discipline among the member states or structural adjustments when these were needed. The EU integration process never built up such a base of legitimacy.[13]

The enlargement issue, becoming concrete in May 2004 with the entry of 10 new members, occurred at a most difficult moment. Disenchantment with the integration process among the 15 existing members did not leave much room for a generous policy of integration. This major leap forward is accompanied by an absolutely minimal effort at solidarity, with the entire EU budget limited to some 1 per cent of GDP.[14] The new member states have been kept waiting for 10 years and subjected to conditions just as harsh as those linked to the EMU. The enlargement has not proved to be particularly popular either in the new or in the old member states. Fears of further recessions are widespread, and the imperialist military moves of the USA have introduced new divisions. The problems which Germany has confronted in its reunification give some idea of the time and finance required for effective economic and social convergence between old and new members. In the face of all these problems, and in view of the costs of a solidaristic approach to them, European countries are bound to reconsider their past policies of integration. The alternative policies put forward in Part II of this book are meant to show that, whatever the difficulties, progressive policies could be designed to promote a social model for an enlarged Europe.

2.4 The main institutional steps in the integration process

We now return to the various institutional changes that took place in the 30 years under review. These institutional changes help us to understand

the key issues and the structures of decision-making at each stage. In Chapter 13 we shall return to today's structure of coordination.

The turbulence of the late 1970s and 1980s led countries to wish to deepen and widen the integration of Europe. From the Rome Treaty to the 1980s, the EU had a long story of step-by-step market integration around a core of countries. The Single Act (1987) represented an acceleration of the process, clearly intended to prepare European countries to face a greater internationalization. Of great interest in that respect are the clauses on the liberalization of financial flows and the openness of the European economy to non-European countries, and in the first place to capital flows to and from the USA. To compensate, at least in appearances, for the exclusively economic focus of the Single Act, a Social Charter was adopted in 1989, with the exception of the UK.

Before this point monetary cooperation had been limited to exchange rate arrangements (monetary snake between 1972 and 1978 followed by the EMS installed in 1979 but badly disrupted in the currency crises of 1992–93). From 1990 on monetary arrangements included the objective of monetary union and this was the main element in the Maastricht Treaty (see Chapter 15). This Maastricht Treaty (1992), elaborated by an IGC (intergovernmental conference), ratified in various countries between 1992 and 1993, was built around three pillars:

- development of the European Community,
- extension of a new field: foreign policy and common security and
- extension of another new field: cooperation on matters of justice and internal affairs.

For the structure as a whole the term 'European Union' was adopted. The role of the Parliament was strengthened by the Treaty, though modestly. Pillars 2 and 3 rely on intergovernmental cooperation.

Pillar 1 deals with economic issues and with the completion of the EMU objective. The Maastricht Treaty had thus defined the various steps towards a monetary union which would clearly separate EU members into the Eurozone and the rest, initiating a multi-speed Europe. Certain very limited social policy provisions, linked to the Social Charter, were also written into the Treaty (Britain obtained a derogation from these provisions but the Blair government accepted them in 1997).

The EMU process led first in June 1997 to the Stability and Growth Pact which defined the budgetary conditions (limited public debts and current budget deficits) which members of the EMU must observe. Coordination between central banks had been developing throughout the 1990s, leading to the creation of a European Central Bank in June 1998 to run monetary policy for all the member states of the Eurogroup.

In January 1999 the euro was introduced as a common currency, although euro notes and coin only went into circulation in January 2002.

The Treaty of Maastricht also foresaw a new IGC for 1995 to deal with the issue of enlargement to the East.

The four freedoms, asserted in the Single European Act and again in the Maastricht Treaty – freedom of movement within the EU for goods, persons, services and capital – were specified in more detail in the Amsterdam Treaty signed in 1997. This also institutionalized the Schengen agreement on free circulation of citizens between countries (again with exceptions) but did not reach any agreement on the issue of enlargement. The role of the European Parliament was again slightly reinforced.

In 1999 a charter of fundamental rights was elaborated and adopted in 2000.

The Lisbon summit of March 2000 set an ambitious strategy for the EU to become the most powerful knowledge-based economy at world level by 2010 and conversely strengthening its employment guidelines by attaching quantified objectives.

It is only with the Treaty of Nice, signed in February 2001, that a plan for the enlargement towards eastern countries was defined. Finally as a follow-up to the Nice Treaty a Convention was set up in February 2002 to elaborate a European Constitution redefining the institutional framework to take into account:

(a) the larger size of the Union (15 existing plus 10 new member countries with more to come),
(b) the existence of the Eurozone, and
(c) the need to give more weight in the integration process to national parliaments and to the European Parliament (in order to fill the widening democratic gap).

The draft Constitution was submitted to public debates in June 2003 and adopted by an IGC in June 2004, to be ratified by parliament or referendum. European citizens, be they on the left or on the right, are very divided on the ratification of this Constitution which in its third part gives constitutional status to the very rigid policies that were criticized in the previous section (though the situation might not be much better without the Constitution since very similar provisions of the Treaty of Nice would then apply).

As so often in the process of integration European citizens are not faced with positive choices but with negative ones: either a narrow and dogmatic constitutional document or a rejection of the integration process. This is the source of the democratic deficit which accumulated over the years and which has now reached worrying dimensions, illustrated by the June 2004 EU Parliamentary elections, when participation rates fell to a record low. The limited role of the European Parliament in the decision-making process does not help to reduce this democratic deficit.

Box 2.1 recalls the chronology of these various steps in the European integration process.

Box 2.1 Some key dates in European integration

PHASE I: the political emergence of the EU

1944	Benelux customs union
1948–52	Marshall Plan provided about $14 billion ($180 billion in 1995 prices) in support for reconstruction
1951	European Coal and Steel Community (ECSC) among the Six
1957–58	Treaties of Rome created European Economic Community (EEC) to develop a customs union for industrial products and Common Agricultural Policy (CAP)
1960	UK, Austria, Denmark, Norway, Portugal, Sweden and Switzerland (and later with Finland and Iceland) establish European Free Trade Association (EFTA)

PHASE II: a customs union for one sizeable Europe

1968	Customs union effective
1973	EEC enlargement begins with UK, Denmark and Ireland. Norway declines
1979	First direct elections for the European Parliament. European Monetary System
1981	Accession of Greece
1985	White Paper *Completing the Internal Market* with goals for 1992
1986	Accession of Portugal and Spain. February – draft Single Act asserting the four freedoms of movements of goods, persons, services and capital
1987	Single European Act (SEA) adopted (Cecchini report – European Commission, 1988)

PHASE III: towards a single market and a monetary union

1991	Maastricht Treaty adopts Delors Report, and establishes a timetable for adoption of single currency
1993	Maastricht ratified by members, European Union (EU) established on three 'pillars': (1) economic and social, supranational; (2) foreign policy and regional security, intergovernmental; (3) justice and home affairs, intergovernmental and reasserted the principle of the four freedoms
1995	Austria, Finland and Sweden become members. Norway declines
1997	June – Stability and Growth Pact
1997	Amsterdam Treaty
1998	June – creation of the European Central Bank
1999	January – single currency
2000	IGC in Nice outlines a new structure of governance for the enlarged EU. Lisbon summit defining a knowledge-based economy (KBE) strategy for Europe
2002–3	European convention
2003	June – Constitution draft to be debated
2004	Enlargement from Eastern countries: from 15 to 25 EU members
2004	June – Constitution adopted by an IGC

2.5 Conclusion: for ever a neo-liberal zone?

The question at the end of 2004 is clearly whether or not the process of European integration has for ever ended in the deadlock of a neo-liberal zone, where liberalization of market forces has become the dominant principle behind all the moves and policies of the EU. The debates over the constitutional treaty have brought opposite answers to this question. For some the main obstacle was the third part which attempts to perpetuate neo-liberal policies and strategies. For others what matters was in the first part, the recognition of the priority to be given to social values and to the development of a specific European Social Model. The contradictions in the text are real. In a way all these debates have the merit of calling attention to the important issues at stake.

The outcome of this clash of views is not predetermined. It will depend on what people will fight for in the various countries concerned. The worst aspect of the situation is certainly the general political disillusion which showed up in the elections to the European Parliament in June 2004 with extreme right chauvinistic parties gaining new votes.

There are alternatives to the stalemate of a neo-liberal zone as we shall show in Part II of this book, but the chances for such outcomes are clearly conditional on a broad mobilization around European issues. Such mobilization also requires radical changes in the ways in which coordination and policies are designed at the EU level. The democratic deficit of the European integration process is a real threat. One can hope that the debates around the constitutional treaty will at least help to achieve this mobilization.

Notes

1. Instituted on 4 January 1960 with Sweden, Norway, Denmark, Austria, Switzerland and Portugal.
2. France, Germany, Belgium, Italy, Luxembourg, the Netherlands.
3. In France, for instance, Chirac at first reacted to the rise in unemployment by increasing unemployment benefits in order to soften a social crisis which was obviously thought to be of short duration.
4. A project of political union soon had the same fate.
5. Such an integration process, meant to shelter economies from harsh external competition, has been qualified as defensive by Heribert and Higgott (2002). It is the characteristic of most contemporary regional processes be it in East Asia or in Latin America.
6. To be followed by Spain and Portugal in 1986.
7. Volcker's policy raised the real interest rate in 1980 from 1 to 5 per cent for the USA. However, by 1986 it was again down to 2 per cent and averaged afterwards 4 per cent, while for the EU it rose first in 1980 from 1 to 4 per cent then steadily from 4 to 7 per cent in 1993!
8. Following a White Paper of the Commission in 1985.
9. See internal update on the Single Market by the European Commission: http://europa.eu.int/comm/internal_market/en/update/impact/major.htm

10. Note that the collapse of the Soviet bloc did permit two further enlargements of the EU, bringing in the neutral states – Austria, Finland and Sweden – in 1995 and in 2004 eight of the former socialist states themselves, together with Malta and Cyprus.
11. One consequence of monetary union was that the EU, in a very roundabout way, reached the fourth of the integration phases suggested in the 1960s by Bela Balassa. His scheme (Balassa, 1961) distinguishes five phases: (1) A free trade zone; (2) a customs union; (3) a common market; (4) a monetary and economic union; (5) a political union. The European integration process rather followed this pattern up to the 1990s. The fourth phase of monetary union only concerned a subgroup of countries, and clearly the near future of the EU will more likely combine the various stages in a multi-level structure than complete the integration process.
12. This independence, and the complete priority given to price stability, are in marked contrast to the position of the central bank in the USA. The Fed is bound by its general objectives to sustain economic growth and full employment. The course of events in Europe involved a very high price in order to gain the confidence of certain member states (notably Germany) at a difficult time for the EU (with such problems as war in the Balkans, German unification and the demise of the Soviet bloc). The irreversibility of many integration strategies is an important drawback in the dynamics of European integration and growth.
13. This critique of European integration, developed in many of the memoranda produced by European Economists for an Alternative Economic Policy in Europe (Euromemorandum Group), is now widely accepted.
14. Six member states, including France and Germany, recently asked for this limit on the EU budget to be maintained until 2013, even though the limit, at a time of such enlargement, is already 'unrealistic', as Delors recently declared (in *Alternatives Économiques*, March 2004).

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3
Macroeconomic Policies: a Self-defeating Regime

3.1 Introduction

This chapter begins by outlining the road to monetary union, and the steps along the way to monetary union with the formation of the European Monetary System and attempts to secure exchange rate stability between European currencies. Attention is given to the movements in the real exchange rates between EU countries and the effects which those had on economic performance. The road to the single currency was very much shaped by the Maastricht convergence criteria. The macroeconomic policies within the Eurozone (under the Stability and Growth Pact) are closely related to the convergence criteria with respect to the constraints on budget deficits and the 'independence' of the European Central Bank. The second half of the chapter provides a critique of those macroeconomic policies which have placed such drastic constraints on the growth dynamics of most European countries. The price which has been paid for the EMU has been particularly heavy in terms of unemployment and low levels of economic activity as evident from the statistics given in the previous chapter.

3.2 The road to monetary union

The project of a European Monetary System (EMS) dates back to 1970, when the Prime Minister of Luxembourg, Pierre Werner, in his report, proposed a monetary unification that would be achieved in several stages and be completed in 1980! But the breakdown of the Bretton Woods system and the 1971 devaluation of the dollar badly affected the first attempts at coordination. The 'European monetary snake' was set up in 1972, based on the creation of the European Monetary Cooperation Fund, which sought to limit the fluctuation bands of the parities of European currencies against one another (+/−2.25 per cent). But it quickly imploded, unable to withstand the oil shock and the accelerating inflation.

The 1970s involved divergent developments in the exchange rates of the EU countries. The instability of exchange rates, and the practical difficulties which they implied, added to Giscard d'Estaing's and Schmidt's common political determination, led to a new step in 1979, when the EMS was finally set up.

3.2.1 The EMS: the first phase (1979–92)

The EMS was an exchange rate mechanism which aimed at providing greater monetary and exchange rate stability among European currencies. Its originality lay in the creation of a European Currency Unit (ECU), which corresponded to the weighted average of the currencies of the member countries of the EC. Its value was, as would be natural, more stable than that of each participating currency, but it remained a mere unit of account. Each currency was defined according to a central rate against the ECU, those central rates being used to set up a scale of bilateral central rates, with permitted fluctuation bands of +/−2.25 per cent (with the possibility of a broader band of +/−6 per cent).

The EMS had attractions in that it involved fixed exchange rates, adjustable by mutual agreement, according to the economic situation of each member country. It reduced the exchange rate volatility of participating currencies, but one of its main flaws was its asymmetric functioning. In theory, responsibilities were shared between member countries and any given participant was supposed to intervene as soon as its currency became over-depreciated (or appreciated) against the divergence level. But in practice, the Bundesbank, always intent on controlling inflation, never intervened to stop the mark's appreciation, whether by selling the national currency or lowering its interest rates, and the EMS became pegged to the German currency. The burden of exchange rate realignments was always borne by the countries whose currencies were weaker, and in several instances, they had to enforce restrictive policies in order to defend them. Given the belated nature of devaluations that never corresponded to the amount required, the weaker currencies always tended to be overvalued and the mark undervalued.

Two rather contrasting periods can be distinguished: (i) from 1979 to 1987, the EMS operated rather flexibly, with numerous realignments of exchange rates, especially for the franc and the lira. The preservation of control over capital flows by many countries also enabled monetary authorities to intervene whenever necessary; (ii) from 1987 onwards, the EMS became much more rigid, and there was only one minor realignment when the Irish punt was devalued in 1990. A 'new EMS' was then envisaged, which was supposed to work without resorting to regular devaluations which were now often seen as inefficient. The fear of inflation and the early stages of nominal convergence between European countries contributed to a more rigid functioning of the EMS. Following the 1987 Nyborg Agreements, the

Bundesbank was also supposed to participate in the coordinated interventions on interest rates and increase its short-term loans whenever weak currencies were attacked. The peseta was integrated into the EMS in 1989, followed by sterling in 1990. Divergence of prices and costs between member countries led to repeated crises of the EMS in 1992 and 1993. The UK and Italy withdrew from the EMS, Spain adopted wider fluctuation bands, and all three countries resorted to major devaluations. The franc was subjected to severe speculative attacks, with the main one in July 1993. However, thanks to the French Central Bank's massive interventions which led to the total exhaustion of its reserves, to persistently high interest rates and to the Bundesbank's support, the franc was not devalued. The preservation of the franc/mark parity, which was wrongly defended as a necessary condition of the success of the single currency project, proved particularly costly as it hampered growth in the early 1990s. The parity was seen as the reward for a decade of competitive disinflationary policy. But such a policy, relentlessly carried out since 1983, had contributed to locking the French economy into a slow growth and high unemployment process, despite the short recovery of 1989–90, even though it did improve France's cost competitiveness.

3.2.2 Misalignment against sustainable exchange rates

The particular configuration of real exchange rates, where the overvaluation of most European currencies contrasted with the undervaluation of the mark to which the system was pegged, appears as a long-lasting characteristic of the EMS in the 1980s (see Couharde and Mazier, 2001 and Table 3.1). It led to serious consequences for the countries whose currencies were overvalued and helped Germany's economic growth, to the detriment of its partners. As the German Ministry for the Economy then admitted: 'the EMS was operating as an instrument helping German exports'. The German reunification, the 1992–93 EMS crises and a deep crisis in Japan worked to reduce the size of misalignments in the early 1990s. European currencies, including the mark, appeared overvalued in 1995, but only slightly so, and to a lesser extent than in 1990. Such overvaluation was due to very high European unemployment rates which went alongside large current surpluses in many of these countries. In Germany's case, the new conditions resulting from the reunification, with rising unemployment and the end of current account surpluses, erased the factors that previously had been the cause of the undervaluation of the mark. In other words, the real sustainable exchange rate of the mark declined, bringing to an end the undervaluation of the German currency, which had been one of the main causes of imbalances within the EMS.

3.2.3 The transition to the single currency (1992–98)

A new step appeared necessary in the European monetary integration process in the late 1980s. Indeed, it had become impossible to reconcile the stability of exchange rates (as sought in 'the new EMS'), the free circulation of capital

(which had become widespread in the late 1980s) and the autonomy of national monetary policies. The 1992–93 crises were the most striking manifestation of the situation. Several solutions could then be envisaged:

- General submission to German monetary policy within the framework of an enlarged mark area. Such a solution was only possible for a limited number of economies around Germany and it faced almost insurmountable political problems, especially in the case of France.
- The reintroduction of controlled capital flows. This solution was technically possible and proposals were made in that direction, i.e. an anti-speculative mechanism installing compulsory reserves on financial intermediaries' exchange rate positions, the introduction of a Tobin tax or other 'sand in the wheels' so as to limit capital flows. But such a prospect implied the persistence of elements of instability within the framework of a strengthened EMS. It was also too much in opposition with the financial liberalization process which was driving the system.
- The adoption of a single currency which, by its nature, would eliminate every financial instability factor at intra-European level.
- Two other solutions were put forward, but never fully explored. One was the setting up of a common currency which would have been used in parallel with national currencies and allowed to compete with them. This solution was at one point advocated by the UK. The other was the creation of a single currency just to be used in external transactions, while national currencies would still have been used for intra-European exchanges. Though attractive from a theoretical point of view, this solution was deemed too complex.

The single currency project prevailed, in part as a consequence of a Franco-German compromise. Germany, which was at first very reluctant, began by giving its support to an enlarged mark area. It eventually joined the single currency in exchange for France's promise to accept its reunification. The strategy that was finally adopted in December 1991 consisted of a long transition period, from 1992 to 1998, so that the minimum nominal convergence criteria should be respected before a country could enter the single currency. These criteria were 'nominal' rather than 'real', that is, they related to the convergence of nominal economic variables rather than real ones. They related to a convergence of the inflation rate and the long-run interest rate (to close to the average of the three lowest rates), the stability of the exchange rate, and a budget deficit of less than 3 per cent of GDP (and public debt of less than 60 per cent). A further condition was the establishment of an independent Central Bank. In order to abide by those criteria, all European economies simultaneously enforced policies of adjustment to their public finances, with devastating effects in terms of growth and employment.

The years 1992–93 were particularly unstable, which led to a very flexible EMS, with extremely broad fluctuation bands. However, this instability did

not last and exchange rates soon stabilized close to their central rates. This stabilization is often attributed to the credibility of the programmes implemented, the governments' determination and the merits of an exchange policy, referred to as an 'elastic policy', which consisted in accepting a certain degree of flexibility in the defence of reference parities, without subsequent unbearable hikes in interest rates, but admitting the existence of a risk premium, which meant that other countries had to maintain interest rates rather higher than Germany's (Davanne, 1998).

Another factor in the behaviour of exchange rates seems to lie in their more fundamental determinants. The imbalances which had affected European parities until the early 1990s and which opposed an undervalued mark to overvalued European currencies had disappeared (see Table 3.1). All European currencies seemed overvalued by some 5–10 per cent in terms of effective real exchange rates. This result shows that the central rates which prevailed when the euro was set up in 1999 proved satisfactory. Several factors account for this. The successive devaluations of 1992–93, followed by a control of inflation by the countries concerned, had helped to correct the overvaluation of the lira, the peseta and the pound. France had reached the same goal by cutting unit wage costs within the framework of a competitive disinflationary policy. In Germany, the shock caused by reunification had put an end to current surpluses and caused unemployment to soar, and that trend manifested itself in the depreciation of the mark's real equilibrium exchange rate and the end of the undervaluation trend of the German currency.

These results suggest that market mechanisms, together with the realignments that followed the 1992–93 EMS crises, worked well and allowed European exchange rates to converge towards sustainable values, and this enabled the successful launch of the euro. The European currencies' conversion rates which had been announced long in advance did not cause any speculative attack because they corresponded relatively well to their sustainable values. This result is all the more surprising as the Asian crisis of 1997 was generating a general feeling of greater instability. It also enables us to

Table 3.1 Overvaluation (−) and undervaluation (+) in real terms of major industrialized countries' currencies (%)

	1979	*1985*	*1990*	*1995*	*1998*
Dollar	−6.3	−34.0	10.9	19.6	13.4
Yen	9.3	18.6	8.9	2.3	−2.2
Mark	0.2	17.7	16.1	−2.5	−1.1
Franc	−3.8	−14.0	−17.2	−7.5	−6.5
Lira	−4.3	−7.1	−17.7	−3.7	−1.8
Pound	−12.5	−20.8	−11.6	−4.7	−8.3
Peseta	4.3	−6.2	−22.0	−6.0	−4.1

Source: Couharde and Mazier (2001).

understand why southern European countries could join the euro area, contrary to what was initially expected by the authors of the project. A final lesson can be drawn from Table 3.1. There is a contrast between European currencies overvalued by approximately 5–15 per cent in terms of real effective exchange rates and the dollar which was undervalued by about 15 per cent. Although it had been reduced by comparison with 1990, a disequilibrium against the dollar continued into 1998. Despite the uncertainty inherent in calculations and the problems raised by the transition to bilateral exchange rates, the results made it clear that in 1998 the sustainable exchange rate of the dollar against the euro was near one dollar for one euro, the actual exchange rate being one euro for 1.16 dollars on 1 January 1999. The depreciation trend of the euro against the dollar in 1999 was then to be interpreted as a convergence towards its sustainable value, a positive development that contributed to the economic recovery of the euro area's economies.

3.2.4 The euro: an unfinished construction

The transition to the euro in 1999 marked the culmination of more than 20 years of efforts to move towards monetary integration. It represented a major and unique institutional change in the history of industrialized countries and only the strength of the political determination behind it made it possible. Its costs, in terms of growth slowdowns, were high in the 1980s, considering the functioning of the EMS, and even higher in the 1990s, because of the measures adopted in the Maastricht Treaty in order to achieve the transition to the euro. But those costs were accepted because of the absence of any other alternative and because of the gains that were expected from the EMU. It is certainly too early to draw a definitive conclusion from the whole process. However, a rapid assessment can be made of the advantages and costs of the single currency.

The Maastricht Treaty set out, as indicated above, a number of 'convergence criteria', and these criteria were 'nominal' rather than 'real'. In the out-turn, 12 countries 'signed up' to the euro but in almost all cases the countries concerned did not meet all of the nominal convergence criteria (see Arestis et al., 2001, Ch. 3). There was no mention of criteria relating to real convergence of, for example, unemployment levels, the state of the business cycle and so on. This has meant that countries entered the euro with relatively similar rates of inflation (though with continuing differences) but with very large differences with respect to the rate of unemployment.

The single currency brings a number of economic gains to the member countries. These include:

- a significant reduction of transaction costs, which stimulates trade, and may raise GDP;
- an easing of the external constraint in the case of trade deficits linked to intra-European exchanges, since they can be settled in euros. A major

element of the growth slowdown of the 1970s and 1980s would thus disappear, more particularly for some countries like France, which had been under severe constraint, without eradicating the notion of external debt;

- the end of speculative opportunities between European currencies and of the resulting elements of instability;
- the end of the risk premium in many countries, which allowed some decrease of interest rates;
- an incentive for trade exchanges and investments thanks to reduced uncertainty, at least theoretically, and to higher competition due to increased price openness.

But along with these advantages, there are many problems raised by the EMU, and many of these arise from the policy framework surrounding the euro. The euro was introduced as a 'virtual' currency (which could be used for financial transactions) in January 1999 alongside the locking together of the exchange rates of the currencies of the participating countries. In January 2002, the euro became a 'real' currency (in the sense that euro notes and coins were now issued), at a time of sharp reductions in economic growth, rising unemployment and with most countries of the EMU moving close to or into recession. The ability of macroeconomic policy to respond to rising unemployment and slow growth was very constrained by the policy framework of the EMU. The effects of the economic slowdown have lowered tax revenues and pushed up budget deficits, towards and over the 3 per cent of GDP limit imposed by the Stability and Growth Pact (SGP).

3.3 Fiscal policies

The fiscal policies of the members of the Eurozone are (at least in principle) constrained by the conditions of the SGP, which places (subject to some 'escape clauses') an upper limit of 3 per cent of GDP on national budget deficits and seeks to secure budgets which are in balance or small surplus over the course of the business cycle. Since there is a requirement for the EU budget to be not only small but also in balance there is no role for fiscal policy at the EU level. The SGP had been agreed at the Dublin summit in December 1996 at the insistence of the German government. This Pact was widely seen as a measure to constrain national governments against 'profligate' spending. It specified procedures to be followed in cases where the limits were exceeded and outlined the sanctions that the deficit country would incur if it breached the limits, though it did provide automatic and discretion exemptions under certain conditions. The SGP allowed the operation of the automatic stabilizers to support demand during a downswing, but subject to the constraint of an overall budget balance. The SGP became interpreted as limiting the use of discretionary fiscal policy. Whereas the Maastricht convergence criteria sought the achievement of a 3 per cent of

GDP budget deficit at a particular moment in time, the SGP used the same figure of 3 per cent but now as a maximum. This shift represented a tightening of fiscal policy, and imposed limits on budget deficits which were substantially below the levels of budget deficits which have been experienced through the post-war era.

In the first years of the euro as a 'real' currency, there was an economic slowdown with slow growth and rising unemployment, and a general rise in the size of budget deficits. The impact of an economic slowdown on the budget deficits was fully predictable at least in qualitative terms, as the effects of economic slowdown on budget deficits are well known with falling tax revenues and rising social expenditures. Many countries (France, Germany, Greece, the Netherlands and Portugal) have registered budget deficits above 3 per cent of GDP, and the first two for a number of years. The rules of the SGP seek to impose initially non-interest-bearing deposits which become fines unless remedial action is taken. There are exemptions to this in the face of significant falls in output, but although growth has slowed and output fallen relative to trend there have not been significant falls in absolute output. The European Commission has frequently criticized those countries whose budget deficit have approached or gone over the 3 per cent limit, but as yet they have not imposed sanctions on countries with deficits over the 3 per cent level. But even without the actual impositions of sanctions, governments have been heavily constrained in their ability to use discretionary fiscal policy to respond to rising unemployment. It is no doubt a matter of regret for the advocates of the SGP that the commitment to 'fiscal discipline' has been undermined, and the credibility of the Pact brought into doubt. Yet the dangers of the imposition of inappropriate fiscal policies remain – if national governments continue to be pushed to cut budget deficits in the years ahead, then economic activity will be restrained and high levels of unemployment will remain.

Many have recognized the deflationary impacts of the SGP and the straitjacket which it imposes, but the opportunity presented by the drafting of the proposed European constitution to change the basis of the SGP has not been taken. The imposition of a 'one size fits all' fiscal policy prevents national governments adopting fiscal policies which are appropriate for their own country. It would be advantageous for national fiscal policies to be developed in a framework of cooperation and coordination, but not one of subordination to the dictates of the SGP and the dictates of a neo-liberalism. Further reservations relate to the requirement of a balanced budget over the cycle. Even if it is accepted that the budget should be balanced over the cycle, there is little reason to think that the extent of the swings in the budget position will be similar across countries. What reason is there to think that a swing in the deficit to a maximum of 3 per cent of GDP is relevant for all countries? Countries will differ in the extent to which their GDP varies in the course of a business cycle and in the extent to which the budget position is sensitive to

the business cycle. Buti et al. (1997) found that the budget position is negatively linked with GDP growth, but in a way which varies between countries. They estimate that for a 1 per cent slowdown in economic growth the budget deficit to GDP ratio rose on average by 0.5 per cent, but by up to 0.8 and 0.9 per cent for the Netherlands and Spain. The next question is whether there is any reason to think that a (on average) balanced budget is compatible with high levels of employment – indeed whether it is compatible with any level of employment. A well-known identity (though generally forgotten by advocates of the SGP) drawn from the national income accounts tells us that: (private savings minus investment) plus (imports minus exports) plus (tax revenue minus government expenditure) equals zero, which is in symbols:

$$(S - I) + (Q - X) + (T - G) = 0 \tag{1}$$

Individuals and firms make decisions on savings, investment, imports and exports. For any particular level of employment (and income), there is no reason to think that those decisions will lead to

$$(S - I) + (Q - X) = 0 \tag{2}$$

But if they are not equal to zero, then $(G - T)$, the budget deficit, will not be equal to zero, since

$$(G - T) = (S - I) + (Q - X) \tag{3}$$

The SGP in effect assumes that any level of output and employment is consistent with a balanced budget $(G - T = 0)$, and hence compatible with a combination of net private savings and the trade position summing to zero. But no satisfactory justification has been given for this view.

The SGP is based on the imposition of arbitrary limits on budget deficits: no justification has been given for the choice of the figure of 3 per cent of GDP as the maximum for example. The imposition of a balanced budget over the cycle requirement is based on the view that there is not any inadequacy of aggregate demand, and flies in the face of the experience of countries over the past half-century.

3.4 Monetary policy

The European Central Bank (ECB) has been set up as an 'independent' central bank with the prime objective of 'price stability' (which the ECB has interpreted as inflation between 0 and 2 per cent per annum). The mandate of the ECB is further discussed in Chapter 15. In the face of economic slowdown in the early years of the new millennium, the ECB was slow to respond by reducing interest rates, and when it did begin to reduce rates did not do so as aggressively as the Federal Reserve in the USA. Instead, the ECB resorted to renewing calls for labour market and other reforms in pursuit of so-called 'flexibility'. The perceived need to build up 'credibility' of its anti-inflation

credentials constrained its actions especially as inflation persistently broke the 2 per cent limit (albeit by a small margin). There were also divergences of inflation experience between Eurozone countries. In the face of inflation above the target level and economic slowdown and rising unemployment, the ECB was faced with an unresolvable dilemma. They have a single instrument to deploy to pursue 'price stability'. The rationale for this policy stance is that interest rates can be used to reduce demand when inflation is above target, thereby bringing down inflation. But inflation is supposed to be associated with high levels of demand, but the ECB was faced with a situation of inflation above target and low levels of demand.

The objective given to the ECB is that of the maintenance of price stability, and does not make explicit mention of employment and output levels (in contrast to the objectives given to the Federal Reserve in the USA). The official doctrine of the ECB that is based on a 'two-pillar' monetary strategy has been adopted. The 'first pillar' is a commitment to analyse monetary developments for the information they contain about future price developments. This is the quantitative reference value for monetary growth, where a target of 4.5 per cent of M3 has been imposed. Being a reference level, there is no mechanistic commitment to correct deviations in the short term, although it is stated that deviations from the reference value would, under normal circumstances, 'signal risks to price stability'. The 'second pillar' is a broadly based assessment of the outlook of price developments and the risks to price stability. This broad range of indicators includes: the euro exchange rate; labour market indicators, such as wages and unit labour costs; fiscal policy indicators; and financial market indicators, such as asset prices.

These policy arrangements suffer from a number of defects. First, if inflation is induced by a demand shock (i.e. a higher level of demand pushes up inflation) then a policy to influence aggregate demand, and thereby, it is hoped, inflation may have some validity. But such a policy is powerless to deal with cost inflation or supply shock inflation. A supply shock would lower (raise) output while raising (lowering) inflation. Thus monetary policy is unable to respond to a cost inflation coming from say a major rise in commodity prices. Second, changes in interest rates have only a limited impact on aggregate demand, and aggregate demand only a limited impact on inflation. The evidence seems to suggest that a 1 per cent increase in interest rates sustained for a year may serve to reduce inflation by 0.2–0.3 per cent, and that impact on inflation may be rather uncertain and unpredictable. Third, monetary policy is inevitably a 'one policy fits all' approach since only the Central Bank can set an interest rate common to the whole of the currency area. It is well known that the setting of that single interest rate poses difficulties – the rate which is appropriate for a country experiencing high demand and perhaps inflationary pressures is not the same as that appropriate for one facing low demand. Indeed, monetary policy may address the average inflation picture but cannot address differences in inflationary

experience across the euro area countries. It is also the case that economic activity in different regions may respond in different ways to changes in the interest rate, because of, for example, differences in their financial structures.

3.5 New forms and problems of adjustment

The problems, which partly reflect the unfinished character of the euro project, concern, on the one hand, the weakness of realignment mechanisms in the case of shocks or asymmetrical evolutions, and, on the other, the problems linked to the ECB's excessive autonomy and the difficulties to coordinate monetary and fiscal policies.

With the elimination of exchange rates as adjustment variables, realignment mechanisms, in case of shocks or asymmetrical evolutions, seem too weak. The flexibility of relative prices, i.e. wage and employment flexibility, was long the answer given by the single currency advocates. However, several reports show that it could only allow a very slow and partial realignment (Cadiou et al., 1999; Mazier et al., 2002). The contrasting ways various countries react to a similar shock should also be taken into account because of real existing structural differences. These divergences are a source of asymmetries, even in the case of shocks affecting all countries similarly, which makes it more difficult to formulate and implement an economic policy.

Labour force mobility between regions and countries has sometimes been suggested as a possible adjustment mechanism in the face of the different economic conditions in different regions. It is argued that such mobility has played a significant role in the case of the United States, with levels of labour migration between states which are much greater than the labour mobility between the regions of the EU. However, the role of labour migration as an adjustment function seems to remain very limited. Even in the United States, people's migrations essentially correspond to structural conditions. It is illusory to think that wider intra-European migration will provide a solution to the differential economic conditions of different regions and countries and as an adjustment response to economic shocks.

Federal budgets may play a readjustment function in the case of a negative shock affecting one state, since that state would pay less taxation into the central federal authorities and could receive increased transfers. Such a mechanism actually operates in the United States and the stabilization ratio is about 20 per cent (Melitz and Zumer, 1998), but it is not to be met in Europe because of the small size of the federal budget which is required to be always in balance. The proposal to create a cheap 'budget insurance' mechanism, which would play a stabilizing role for a country affected by a negative shock, has never been adopted for fear of lenient behaviour or of the redistributive biases it could generate (Italianer and Pisani-Ferry, 1992).

It is relevant to note that a report for the European Commission in 1977 (usually known as the MacDougall report – European Commission, 1977)

formulated a number of policy recommendations relating to fiscal and budgetary policy in the context of monetary union. Their recommendations implied that the EC budget had to be raised to 5–7 per cent of EC GDP for it to be compatible with monetary union. A subsequent report of experts for the EU (European Commission, 1993) foresaw EU expenditure rising over a period of 10–15 years (from 1992) to 1.75–2 per cent of GDP (as compared with 1.19 per cent of GDP in 1992). They argued for a regional stabilization mechanism whereby fiscal transfers from a central budget would be related to a region increase in unemployment (relative to the EU norm). The ECB is set up to be independent of the European Union Council and Parliament and of its member governments. There is, thus, a complete separation between the monetary authorities, in the form of the ECB, and the fiscal authorities, in the shape of the national governments comprising the EMU. It follows that there can be little coordination of monetary and fiscal policy. Indeed, any attempt at coordination would be extremely difficult to implement. There is also the constitutional requirement that national governments (and hence the fiscal authorities) should not exert any influence on the ECB (and hence the monetary authorities). Any strict interpretation of that edict would rule out any attempt at coordination of monetary and fiscal policies.

National budgets could be used for stabilization purposes, particularly if undertaken in a coordinated manner. But national fiscal policy is subject to the requirements of the SGP. The official rationale for this is twofold. The first is that a medium-term balanced budget rule secures the scope for automatic stabilizers without breaching the limits set by the SGP. Second, since a balanced budget explicitly sets the debt ratio on a declining trend, it reduces the interest burden and improves the overall position of the government budget. Underlying the approach to SGP, though, is the notion of sound public finances. The European Commission (2000) was emphatic on this issue:

> Achieving and sustaining sound positions in public finances is essential to raise output and employment in Europe. Low public debt and deficits help maintain low interest rates, facilitate the task of monetary authorities in keeping inflation under control and create a stable environment which fosters investment and growth. … The Maastricht Treaty clearly recognises the need for enhanced fiscal discipline in EMU to avoid overburdening the single monetary authority and prevent fiscal crises, which would have negative consequences for other countries. Moreover, the loss of exchange rate instrument implies the need to create room for fiscal policy to tackle adverse economic shocks and smooth the business cycle. The stability and growth pact is the concrete manifestation of the shared need for fiscal discipline. (p. 1)

A very major problem facing the EMU arises from its current inability to respond to shocks or asymmetric developments. The monetary and current

fiscal policy arrangements impose a 'one size fits all' policy which cannot cope with asymmetric developments. The nature of the shocks likely to hit the EU is much debated upon, even though several elements plead for the persistence, even the reinforcement, of asymmetrical factors. Regional inequalities tended to become stronger in the 1980s and 1990s, which constituted an element of asymmetry, despite the convergence of national economies. The concentration of activities per country measured by Krugman's specialization index for the whole of the EU rose in most cases (Midelfart-Knarvik et al., 2000). The concentration of activities in America, though declining since the 1950s, has been stronger than within the EU. The increasing specialization of economies in terms of technological content and product quality (development of quality intra-sector trade) is a cause of asymmetry, but compensated by the decline of inter-sector trade (Fontagné et al., 1998). The institutional differences existing between European countries are still important and can account for differentiated responses from each country faced with a shock that hits all of them similarly. In this context, the problem of the coordination of monetary and budgetary policies represents a formidable asset. The choice of an ECB independent from political power and whose main goal is to reach price stability poses several problems. It is, first, a worrying choice with regard to democratic principles because supranational authority has no legitimacy whatsoever in Europe. In the absence of an unattainable 'economic government' or European federal authority, the ECB's autonomy in terms of internal monetary policy and exchange policy is larger than the Federal Reserve Board's in the United States or the Bundesbank's. Besides, it has never been proved that monetary policy is the best tool for controlling inflation. The gap between monetary and budgetary policy may lead to policies that are lacking in coherence, with a risk of simultaneous rise of interest rates and public deficits, or to less efficient policies in the event of an inflationary shock (Sterdyniak and Villa, 1993). The efficiency of monetary policies varies from one country to another. Lastly, a common monetary policy is inadequate vis-à-vis countries having to deal with contrasting economic situations. It is too restrictive for the countries going through an economic slowdown, and too expansive for those that are submitted to inflationary pressures, as shown by the economic situation in 2001–3.

3.6 Conclusions

All in all, the EU appears as the neo-liberals' ideal world: a wide single market for goods and services, an independent ECB, the guardian of price stability, a single financial market gradually taking shape, a competition and trade policy which is an incentive for new liberalization measures, a community budget limited to a maximum of 1.27 per cent of GDP, and national states paralysed by budgetary constraints and fiscal competition. The complaint is made that labour markets still suffer from the same old rigidities, which

ought to be removed! Such an institutional framework does not really match the current problems and seems to be hardly compatible with the goal announced in Lisbon in 2000 to turn the EU into 'the most competitive and dynamic knowledge economy, capable of sustainable economic growth, along with quantitative and qualitative improvement of employment conditions and more social cohesion'. After the short upturn of the situation in the late 1990s, European economies are once more threatened with stagnation and seem to be unable to give impetus to growth-oriented policies and deal with the problems linked to the Union's enlargement. The euro was a major step, but the construction is unfinished and unbalanced.

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4
The Drive for Financial Integration: Stability and Inclusion at Risk

4.1 Introduction

Until recently, the regulation of the EU financial services sector concerned mainly banks. Until the late 1970s, banking in most EU states was highly regulated, with little coordination among countries. The First Banking Directive in 1977 provided a minimum level of harmonization, stipulating that bank supervisors should cooperate and that foreign identity was not a ground for refusing a bank licence. It left national regulatory differences intact. In the 1980s, there followed a period of deregulation at the national, as well as at the EU, level. Since the late 1980s, however, the tendency to deregulate has been combined with a renewed attempt at harmonizing regulation for the industry as a whole in the EU (Danthine et al., 1999).

The Single European Act gave rise to three groups of directives: the Second Banking Directive of 1989, harmonizing banking authorizations and prudential supervision systems; the Investment Services Directive of 1993 dealing with the cross-border activities of investment firms; and the Solvency Ratio and the Capital Adequacy Directives of 1989 and 1993 respectively, defining the prudential regulation of banks and investment firms within the EU.

Generally, the EU approach to the financial services sector is based on two principles: (i) mutual recognition, binding member states to recognize any financial institution licensed in another member state and (ii) home-country control, subjecting each financial institution to a single supervisor in the state where the institution has its head office, irrespectively of where it conducts its business. A financial institution can operate in any member state, subject only to the supervision of its home state regulators.[1]

Since the late 1990s, a new thrust at market liberalization and reregulation on the EU level has been based on the 'Lisbon strategy'. In the case of the financial services sector, the substitution of 'arm's length' finance for

'relationship' finance, following the US paradigm, is at the core of the EU policy initiatives.

This chapter examines (i) recent developments in the EU financial services sector, against which financial integration policy has been evolving; (ii) the main elements of EU policy in the area of financial market integration; and (iii) their implications for stability and social inclusion.

4.2 Tendencies in the EU financial services sector

4.2.1 The EU-15 financial services sector: size and structure

The EU financial services sector has traditionally been a predominantly bank-based one, with the exception of the UK, which closely resembles the USA paradigm. Table 4.1 displays certain main characteristics of the financial system in the USA, the UK and EU-14 in terms of size and structure, and the features of the financial services sector in the three geographical areas are further shown in relative terms (EU-14 and UK in relation to the USA) in Figure 4.1. As we can see, between 1980 and 2000 the EU financial system moved towards that of the USA and the UK in terms of size and structure, with stock market capitalization (relative to GDP) and equity issues (relative to gross fixed capital formation) rising in the EU-14, as compared with the USA.

The number of companies publicly traded in the EU-14 was greater than that in the USA in 2000 (see Table 4.1), indicative of the large number of small and medium-sized enterprises in the EU by comparison to the USA. It accounts for the fact that the share of both bank loans and deposits rose

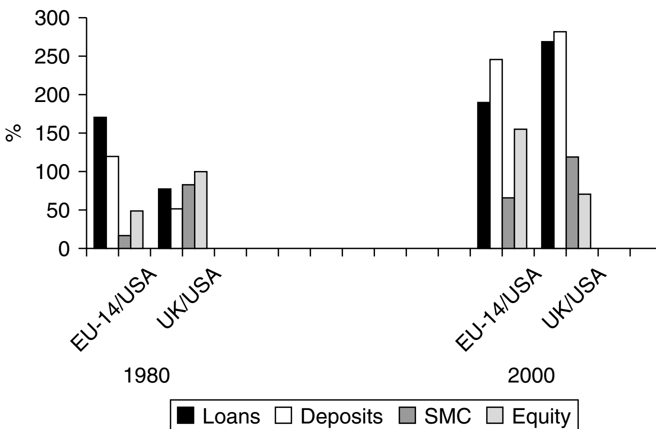

Figure 4.1 UK, EU-14 and USA financial sector – relative size and structure, 1980 and 2000 (%)

Source: Table 4.1.

Table 4.1 Financial size and structure in the USA, UK and EU-14, 1980 and 2000

Country	*Bank loans to private sector/GDP**	*Deposits/ GDP†*	*Stock market capitalization/ GDP‡*	*Equity issues/ GFCF§*	*No. of companies publicly traded/population in millions*
1980					
USA	0.354	0.540	0.460	0.040	23,110
UK	0.276	0.280	0.380	0.040	47,220
EU-14	0.601	0.647	0.078	0.020	34,422
2000					
USA	0.493	0.379	1.549	0.207	25,847
UK	1.320	1.069	1.840	0.149	32,370
EU-14	0.937	0.930	1.046	0.322	27,530

Note: EU-14 is EU members prior to May 2004 except the UK.
* Ratio of claims on private sector of deposit money banks and GDP.
† Ratio of commercial and savings bank deposits and GDP.
‡ Aggregate market value of equity of domestic companies divided by GDP.
§ Ratio of funds raised through public equity offerings (both initial public offerings and seasoned equity issues) by domestic companies to gross fixed capital formation.

Source: Rajan and Zingales (2003).

significantly in the EU-14, as well as in the UK, relative to the USA, over the same period.

According to Rajan and Zingales (2003, p. 125), the changes described above amount to a 'financial revolution', in so far as they denote a shift away from a relationship or a bank-based financial system to a market-based or arm's-length one. Such a claim may well appear exaggerated since the stock market bubble was at its highest in 2000. However, looking at developments over the period 1998–2002 would appear to confirm the observation that financial structures in the EU have indeed shifted to a new position, in which capital markets play a significantly greater role, while the size of the financial services sector has increased in relation to the economy as a whole.

Table 4.2 shows the size and structure of the euro area financial services sector between 1998 and 2002. We have adopted the ECB distinction between 'intermediated' and 'non-intermediated' assets, whereby the former are assets held with monetary financial institutions (MFIs: mainly credit institutions and money market funds), insurance corporations and pension funds (ICPFs) and other financial intermediaries (OFIs: mainly investment and mutual funds). The latter consist of direct holdings (i) of shares and other equity and (ii) of securities, other than shares (primarily bonds) (ECB, 2003b).

This is a schematic dichotomy, to the extent that investing through an institutional investor (ICPFs and OFIs) does not provide the same level of security as investing through a bank. However, an element of trust is

Table 4.2 Financial assets (acquisitions and holdings) in the form of (i) intermediated and (ii) non-intermediated instruments by sector in the euro area, 1998–2002 (% of GDP)

	1998	*1999*	*2000*	*2001*	*2002*
Acquisitions					
(i) Intermediated					
MFIs	7.2	8.5	5.0	7.9	9.2
OFIs	7.3	5.3	4.6	3.9	3.5
ICPFs	3.7	4.3	3.9	3.7	3.4
(ii) Non-intermediated					
Shares	7.0	9.7	13.2	9.3	3.7
Securities	12.1	9.7	11.9	15.1	4.0
Holdings (year-end outstanding amounts)					
(i) Intermediated					
MFIs	152.7	157.6	155.1	158.0	NA
OFIs	36.1	43.7	45.1	43.6	NA
ICPFs	46.3	50.1	51.7	52.7	NA
(ii) Non-intermediated					
Shares	150.8	197.4	197.8	172.2	NA
Securities	106.1	106.5	107.6	112.6	NA

Source: ECB (2003b).

commonly found in the relations between individual investors – mostly small – and the institutional investor they select to intermediate on their behalf. Thus, institutional investment stands in-between the two extremes – bank-based and market-based finance. However, to the extent that performance norms are largely set by the global capital markets, financial disintermediation would appear to be the main driving force in the EU's changing financial environment.

More specifically, the rate of acquisition of both 'intermediated' and 'non-intermediated' assets declined after 1999, with the exception of transactions in securities other than shares, which went on increasing until 2001. The decline was least marked in relation to assets held with MFIs, mainly banks, while the largest fall was recorded in the case of transactions in shares after the year 2000. In spite of the general downward trend in asset acquisition, however, holdings at the end of 2001 were in all cases, except holdings with investment and mutual funds, higher in relation to GDP than in 1998. Overall, securitization appears to be a rising trend in the EU financial markets. For example, by the end of 2001, the value of the euro area residents' holdings of intermediated financial assets was equal to 254 per cent of GDP, as compared with 235 per cent in 1998. On the other hand, the holdings of non-intermediated assets amounted to 285 per cent of GDP, having risen from 257 per cent in 1998. Excluding financial corporations, the financial asset holdings of the non-financial sectors of the euro area at the end of 2001

were equivalent to 162 per cent of GDP for intermediated assets and 147 per cent of GDP for non-intermediated assets, as opposed to 154 and 133 per cent in 1998, respectively.

Banks however continue to play a significant role, with their pivotal position in the payments system, and because they constitute the main source of funds for a high proportion of small and medium-sized enterprises in the EU (ECB, 2003b).

During the 1990s, banks found themselves under pressure, as a result of the liberalization of capital flows, the implementation of the European Single Market and the introduction of the euro. They responded by rationalizing their operations, cutting costs, increasing merger and acquisition activity, mostly within national boundaries, and by diversifying into new areas, such as investment banking and bancassurance.

Since the 1990s, the EU financial services sector has entered a new phase of development. Even though this process is evolving at a varying rate within the EU, the perceived threat of increased competition is believed to induce a market-type, competitive behaviour on the part of market participants (Grahl, 2002). These developments are partly the result of technological innovation and financial globalization and partly the result of political choice. Thus, the pursuit of privatization policies conceived and implemented in a fundamentally neo-liberal context by the governments of the EU member states strongly favoured the growth of market-based financial relations.

4.2.2 The financial services sector in the new member states – new challenges for policy

All of the ten states which joined the EU in May 2004 share a number of common characteristics, pertaining to the size and structure of their financial services sector, which can be described as one in which (a) the level of financial intermediation is low, (b) banks dominated and (c) there is a high level of foreign involvement (Caviglia et al., 2002).

(a) Low level of financial intermediation

The 'newness' of the financial services sector, recurring crises and the low level of confidence of depositors largely account for the relatively small size of the financial sector in the transition economies. In 2001 banking assets in relation to GDP amounted to as little as 32 per cent in Lithuania, going up to 129 per cent in the Czech Republic, by comparison with 265 per cent on average in the euro area. Malta, at 220 per cent, and Cyprus, at 245 per cent, on the other hand, were closer to the average size of the EU banking sector. The same picture emerges in relation to other banking indicators, such as loans/GDP and deposits/GDP (Caviglia et al., 2002).

Capital markets also display a low level of activity. In an international context, only the capital markets of Poland, the Czech Republic and Hungary

are of any significance. The corporate bond market is particularly small, while the government bond market is of limited importance. For example, in 2003 the general government debt of the ten acceding countries amounted to 42.4 per cent of GDP on average, as compared with 64 per cent in EU-15. Cyprus, at 60.3 per cent of GDP, and Malta, at 66.4 per cent of GDP, displayed relatively high levels (ECB, 2004).

(b) Bank dominance

A central feature of the acceding countries' financial markets is the dominance of the banking sector over capital markets. That is, the relation of domestic bank credit to stock market capitalization is approximately 2.8, as opposed to 1.8 in the euro area (Caviglia et al., 2002). In the case of the transition economies, this reflects the privatization pattern applied, which relied on the rehabilitation of their banking systems. In Cyprus and Malta, on the other hand, offshore banks have played a significant role in the development of their financial sectors. Generally, the banking sectors of the new member states are considered to be consolidated and sound, albeit small (Backé and Thimann, 2004).

(c) High foreign involvement

This is true of all segments of the financial services sector in the new member states. The high level of foreign involvement is especially evident in the banking sector, as shown in Table 4.3. In six out of the ten countries, more than 80 per cent of the total assets of commercial banks are owned by foreign concerns, much greater than cross-border ownership in the older members of the EU. In the euro area, only about 20 per cent on average of

Table 4.3 Foreign ownership of banks in acceding countries, 2001

Country	*No. of commercial banks*	*Of which foreign owned*	*Share of total assets under foreign ownership (%)*
Cyprus	13	5	13
Czech Republic	37	26	86
Estonia	7	4	99
Hungary	39	27	87
Latvia	19	12	47
Lithuania	14	4	94
Malta	13	10	99
Poland	59	45	78
Slovakia	18	15	96
Slovenia	22	6	35

Source: Backé and Thimann (2004).

the banks' capital is in foreign ownership, although there may well be significant differences across countries.

Overall, the accession of the above countries to the EU will have an immediate impact on the financial services sector of the enlarged EU, which is going to become:

- Smaller, in relation to the underlying economy;
- More heterogeneous, in terms of structure;
- With a higher degree of cross-border ownership.

In a longer-term perspective, EU financial integration policy will be faced with a new set of challenges, pertaining mainly to the stability of the financial services sector (see *European Economy*, 2002). The low level of financial intermediation in the new member states means that a rapid credit expansion into new product and customer areas, often with risky profiles, is expected, even though small and medium-sized enterprises, with low credit rating and/or collateral, may find it hard to secure external financing. Indeed, the IMF estimates that such expansion will exceed the thresholds linked to a bank crisis, leading to risks of overheating and asset price bubbles (IMF, 2004).

At the same time, the full liberalization of capital flows is expected to result in increased volatility. Thus, the monetary transmission mechanism will have to rely more on the foreign exchange market (currency channel), than on the money market (interest rate channel). Under these conditions, it is expected that open capital markets alongside relatively high interest rates will induce large and potentially volatile capital inflows (IMF, 2004).

The stability of the financial services sector in the EU is going to come under pressure. Although this concerns primarily the new member states, it also concerns the rest of the EU in view of the high level of cross-border ownership of financial assets in the new member states and the increased risks of contagion. Therefore, strong financial supervision and tight prudential standards are going to be needed. Furthermore, it may be necessary to institute administrative and tax restraints on credits or inflows, a suggestion actually supported by the IMF (IMF, 2004).

4.3 Financial market integration policy in the EU

Financial integration constitutes part of the broader process of European integration. The introduction of the single currency has acted as a powerful catalyst, by removing a major obstacle to the cross-border provision of financial services. As a result, financial integration policy came to the forefront in 1998, when the Commission submitted to the Council its first communication, putting forward the Financial Services Action Plan, which, together with the Risk Capital Action Plan, forms the basis of the EU financial integration policy. Member state governments were unanimous in adopting

these plans, a measure of the political urgency attached to the project of financial integration.

4.3.1 Financial Services Action Plan (1999–2005)

In June 1998, the Cardiff European Council invited the 'Commission to table a framework for action … to improve the single market in financial services' (CEC, 1999, p. 3). In 1999, the European Council and the European Parliament endorsed the Financial Services Action Plan (FSAP). The duration of the Plan was set at six years, 1999–2005. By comparison with the length of time the evolution of the EU financial integration policy has taken, it has been argued that 'the FSAP is an example of politics under pressure' (Frangakis et al., 2002, p. 3).

The FSAP is structured on the basis of the principal policy objectives and the relative order of priorities, as well as an indicative timescale for their achievement, as shown in Table 4.4.[2]

Progress under the FSAP – in terms of new legislation – has been impressive. In certain areas where a political impasse had been reached in the past, a breakthrough was made possible. There have, however, been cases where no such consent was achieved. The Takeover Bids Directive 2004/25 is the

Table 4.4 Areas of action envisaged by the Financial Services Action Plan, 1999–2005

I. *Wholesale – securities and derivatives – markets*
- Removing outstanding barriers to raising capital on an EU-wide basis
- Common legal framework for integrated securities and derivatives markets
- Moving towards a single set of financial statements for listed companies
- Providing legal security to underpin cross-border securities trade
- Promoting cross-border restructuring through mergers, takeovers and so on
- Creating the necessary conditions for asset managers to optimize the performance of their portfolios

II. *Retail financial services*
- Promoting information for cross-border provision of retail financial services
- Elimination of non-harmonized consumer-business rules
- Promoting the resolution of consumer disputes
- Creating a legal framework for new distribution channels and distance technologies on a pan-European scale

III. *Prudential rules and supervision*
- Adjusting prudential legislation to international standards
- Regulating the prudential supervision of financial conglomerates
- Promoting cross-sectoral and regional cooperation among authorities on issues of common concern

IV. *Wider conditions*
- Eliminating tax obstacles to financial market integration

Source: CEC (1999).

best-known example of a compromise reached after long deliberations, which does not satisfy those pressing for greater market liberalization.

> Although the European Commission tried to broker a far more ambitious agreement, there was no common opinion on how to create a new balance between the power of management and shareholders. The result is a disappointing de minimis optional outcome. The compromise does not underpin a level playing field and is a retrograde step in terms of economic reform. (CEC, 2004b, p. 3)

It is necessary, however, to distinguish the legislative programme from the actual financial integration for which it prepares the way. The latter requires not just an appropriate legal framework but also strong economic incentives. The stock market crashes of 2001, related scandals and the consequent loss of consumer confidence in many financial products have certainly slowed down integration on the ground.

Overall, the rate of financial integration, and its implications with respect to its social aspects, have not been adequately discussed, while its social provisions are either minimal or non-existent. These issues are especially relevant to the new member states, in which financial structures are weak, consumer confidence in the financial services sector is low, while banking and financial crises have been a frequent phenomenon of the recent past.

4.3.2 Risk Capital Action Plan (1999–2003)

The Risk Capital Action Plan (RCAP) was agreed for a five-year period which expired in 2003. Unlike the FSAP, a follow-up plan is envisaged. Its central objective is to develop an integrated market for equity financing – venture capital and buyouts – of SMEs, by way of eliminating the existing regulatory and administrative barriers to competition at both the Community and the national level. It includes a number of measures such as taxation, research and development, entrepreneurship and public funding through state aid and the European Investment Fund (EIF), the 'equity' arm of the European Investment Bank (EIB).

The model of equity financing adopted by the RCAP is that of the US venture capital market, which in 2002 was nearly twice as large as that of the EU – 0.20 per cent of GDP compared with 0.11 per cent of GDP in the EU. But between 1998 and 2002 the amount of funds raised by European private equity houses increased by 36.2 per cent. The main sources of funds are banks, pension funds and insurance companies.

Overall, the fifth and final Progress Report on the RCAP concludes that

> When taking the RCAP period as a whole (1998–2003) important progress can be reported. From the political point of view, risk capital issues are now at the top of the agenda in all regional, national and Community

> institutions. From the technical point of view most of the measures foreseen in the RCAP in 1998 have been completed. (CEC, 2003a, p. 18)

This is a fair summary of the RCAP from the point of view of capital market participants, to the extent that the RCAP, in the same way as the FSAP, disregards social issues.

In particular, the emphasis placed on closing the gap with the USA in the shortest possible time period can only result in increased pressures on the social relations in which the financial services sector is embedded. Furthermore, the precedence given to the elimination of all barriers to the flow of capital over the setting up of institutions to regulate such flows in a transparent way raises the issue of stability – both financial and economic – both at the European and at the national level.

4.3.3 The Lamfalussy Process

The original FSAP process ran into two kinds of difficulties. First, reaching agreement on, and then enacting, legislation proved to be a slow and complicated process. Second, other issues arose – particularly regarding technical aspects of security trading such as clearing and settlement – which had not been included in the original agenda but which would be of great importance to financial integration. For this reason a report was commissioned from Alexandre Lamfalussy on the measures necessary for more complete and effective integration, leading to the institution of a new policy-formulation process, known as the Lamfalussy Process, the basis of an interinstitutional agreement among the Commission, the Council and the Parliament.

Two new, intermediary levels of policy formulation intervene between the passing of legislation by the Council and the European Parliament on the basis of a proposal by the Commission under the co-decision procedure (Level 1) and its implementation by member states (Level 4). These involve two new committees, the Committee of European Securities Regulators (CESR) and the European Securities Committee (ESC).

The Lamfalussy Process was put into effect in the securities sector in 2002, following an agreement between the European Parliament, the Council and the Commission, known as the 'Sunset Clause', which is included in all Level 1 legislation. More specifically, this safeguards the Parliament's right to 'call-back', that is to look again at implementing legislation, in order to ensure that it follows on from the intention of the primary legislation. Furthermore, in the event of disagreement, the Parliament expects the Commission to modify the draft measure by taking account of objections, initiate a new legislative process, or withdraw it altogether.

The Lamfalussy Process has been extended to all the segments of the EU financial services sector, as shown in Table 4.5.

In addition to the above, a 'policy-shaping' committee under the name of the 'Financial Services Committee' (FSC) was adopted by the ECOFIN

Table 4.5 The EU financial services sector organizational committee architecture

	Banking	*Insurance and occupational pensions*	*Securities (including UCITS)*
Regulatory Committee (Level 2)	European Banking Committee (EBC)	European Insurance and Occupational Pensions Committee (EIOPC)	European Securities Committee (ESC)
Committee of Supervisors (Level 3)	Committee of European Banking Supervisors (CEBS)	Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)	Committee of European Securities Regulators (CESR)

Source: CEC (2003b).

Council at its meeting of 17 February 2003. This fills the gap between the political and the technical regulatory levels. In particular, the Financial Services Policy Group, set up in 1998 to advise the ECOFIN Council on financial matters, has been renamed and upgraded, with the Chair being taken by a member state. Its task is one of political oversight of financial issues, without becoming part of the legislative process.

Although the new committees are to operate within the political mandate given to them and the agreement reached by Council and the Parliament, they are to play a major role in the new phase the EU financial services sector has entered. Furthermore, they are endowed with a significant autonomy vis-à-vis the Council and the Parliament.

This is a new element in terms of European governance, whereby government officials, EU technocrats and industry representatives assume a decisive role in the formulation of policy in broad areas of EU affairs and even in drawing up legislation. Therefore, the under-representation of consumers and the absence of trade union and employee representatives from the above committee structure is a shortcoming of the EU financial services policy.

4.4 Assessing the EU financial market integration policy

Financial market integration is now at the top of the EU economic and political agenda. The faster this proceeds, the more intense are the competitive pressures on the financial services sector, as well as on the economy. In assessing the implications of financial market integration in the EU, we shall look into the areas of stability, growth and social inclusion.

4.4.1 Stability

In the 1980s and 1990s, developed countries experienced banking crises following rapid financial liberalization without adequate surveillance

Table 4.6 Selected episodes of banking distress in OECD countries

Country	*Year*	*Fiscal cost (% GDP at end period)*	*Output loss (% GDP)*
US savings and loans institutions	1980–94	2.5	–
US banks	1982–94	0.5	–
Japan	1991–2001	14.0	71.7
Norway	1989–92	3.4	27.1
Sweden	1991–94	2.1	3.8
Finland	1991–94	10.0	44.9

Source: Barrell et al. (2004).

mechanisms. Table 4.6 shows the occurrence of such crises and their estimated cost in terms of output loss. Such cost pertains not only to bank stakeholders – shareholders, depositors and creditors – but also to society at large, through the crisis resolution process.

EU financial markets are largely liberalized, but they still face sudden and unprecedented shocks, financial innovations and so on. The expanding securitization of the EU financial services sector increases the risk of contagion and the transmission of shocks, while the non-availability of monetary and exchange rate policies for the members of the EMU increases their exposure to risk. In these circumstances, the prudential regulation and supervisory framework of the EU is of crucial importance. The existing framework consists of (i) an extensive set of policy coordinating committees and (ii) adopting and adjusting to international standards and in particular to the Basle Accord and its successor, Basle 2.

(a) EU supervisory framework

The guiding principle of the EU approach in the area of financial supervision is that 'the existing institutional arrangements are appropriate, but that further enhancement of their functioning is needed, in particular through closer cross-sector and cross-border cooperation among the authorities' (CEC, 2002, p. 30). In this sense, the issue of supervision is only marginally touched upon by the present financial market integration policy. The existing institutional arrangements include the following.

National supervisory structures. Three models of supervisory structures coexist: (i) separate competencies along the borderlines of financial sectors (Greece, Spain, France and Portugal, with a variant in Finland and Luxembourg); (ii) total consolidation of supervisory responsibilities across financial sectors in a single agency (Austria, Germany, Denmark, Sweden, UK and likely to be established in Belgium); and (iii) consolidation of supervisory responsibilities by objectives across sectors (Netherlands and Italy). Generally, there is a

broad move away from the first model towards the other two, with the merger of banking and securities supervision as a possible intermediate step (ECB, 2003a).

Central banks are extensively involved in the prudential supervision of the financial services sector and especially of the banking sector in all cases, albeit the precise form of their involvement varies from country to country.

EU Coordinating committees. Their main task is to promote cooperation between national supervisory authorities. There are three in banking, two in insurance and four in the securities market. These are being replaced by the committees constituting the Lamfalussy Process, described above.

Memoranda of Understanding. These are bilateral agreements between the supervisory authorities of EU member states. They have no legal force, their main purpose being to detail the supervision of financial institutions and markets.

Role of the ECB. The ECB has not been given powers to supervise commercial banks or other private financial institutions. The narrow specification of the ECB's objectives as controlling inflation assumes that no episode of financial instability will ever happen in the European economy (Grahl, 1997). Should one occur, it is not clear whether the ECB will take on the role of lender of last resort, or how promptly it may do so.

Overall, while greater coordination among member states may eliminate some sources of financial instability, it may prove inadequate in the case of a systemic financial crisis or instability. Furthermore, to the extent that the ECB has not been granted the authority or the resources necessary to act as a lender of last resort – a function which remains within the jurisdiction of the national central banks – there remains a vacuum of authority. This could prove fatal, should the response of the various national authorities be too slow or inadequate (Frangakis, 2002).

(b) Adjusting to international standards of prudential regulation

The EU capital adequacy framework is based on existing Basle standards. This is to be adjusted to take into account the new Basle 2 agreement. Accordingly, the EU is preparing a new Capital Adequacy Directive (CAD 3), which will apply Basle 2-type standards to all EU banks and investment firms authorized under the Investment Services Directive (ISD).

The Bank for International Settlements capital adequacy guidelines for international banks constitutes the first attempt of the leading industrial countries to fight international financial instability in a coordinated way. The Basle Accord, signed in July 1988 and adopted by more than 100 countries, sets a minimum target of 8 per cent of a bank's risk-weighted

assets for its equity capital. In view of the shortcomings of this Accord, a new framework, Basle 2, has been elaborated, to be implemented as of 2006.

This is based on three 'pillars': (a) capital adequacy (or solvency) regulation; (b) supervisory review process and (c) disclosure requirements. It introduces three new elements. First, it creates a closer link between capital charges and underlying risks. Second, it gives greater reliance on internal risk management practices by sophisticated institutions. Third, it places new emphasis on market discipline by improving public disclosure, especially in relation to a bank's risk exposure.

The Basle 2 proposals have met with widespread criticism:

- *Basle 2 deals only with banks and bank-related institutions*. No specific rules are designed for other financial institutions, such as pension funds, mutual funds and hedge funds.
- *Basle 2 is designed for large banks*. These are able to implement sophisticated and costly risk management. The new guidelines are not adapted for small banks which will be under pressure to merge with large banks in order to comply with the new rules. Also, the new guidelines propose to use external credit ratings to assess the risk faced by small lending institutions. But most small business firms do not have credit ratings.
- *Basle 2 is not adapted to developing countries*. Banks in these countries are generally not in a position to build sophisticated risk management systems. Thus, they may be forced to merge with large banks in developing countries. Also, ratings do not exist for many developing countries and private sector borrowers in developing countries. For example, in November 2000, only 54 developing countries were rated by Standard & Poor's.
- *It is not clear whether the new capital charges will be lower or higher than in the earlier Basle guidelines*. But there is a strong risk that the new guidelines will have pro-cyclical effects, due to the fact that ratings are often downgraded during a slowdown or a crisis. Hence Basle 2 is likely to have perverse effects on some firms and on developing countries if the availability of credit is reduced when they are facing difficulties.
- *Quasi-privatization of supervision*. The use of private rating agencies amounts to no less than the quasi-privatization of banking supervision.

In the case of the EU, it has been estimated that the Basle 2/CAD 3 proposals slightly reduce overall bank capital requirements. On average, a fall of 5.3 per cent is expected, although a significant redistribution of regulatory capital between banks and between banking systems of different countries, depending on the composition of financing business, will occur. Where retail lending is prevalent, a decline in the minimum level of regulatory capital required to support the banking system is expected, especially where financial institutions are in a position to employ sophisticated risk models. Conversely, where lending to sovereigns, large corporations and investment

banking business is dominant, few, if any, reductions in regulatory capital requirements are expected to take place. Such a reduction is considered to be too small to endanger the stability of the EU financial services sector (PricewaterhouseCoopers, 2004).

Overall, the evolution of the prudential regulation and supervisory framework has not kept pace with the increasing rate of integration in the financial services sector of the EU. This reflects the order of priorities of current EU policy and the commitment of its economic and political elites to market liberalization. In this sense, EU policy is subject to a fundamental flaw. While its professed aim is to promote integration, it does not take full account of its implications for stability, that is, of the increased risks to which the EU financial system thus becomes exposed.

4.4.2 Social inclusion

The relationship between financial liberalization and development and social inclusion and cohesion goes through a number of channels.

(a) The growth channel

This is based on the neoclassical belief that market liberalization mobilizes savings, thus encouraging investment and growth, which eventually 'trickles down' to most of society. This methodological, as well as ideological, approach largely permeates the EU's view of financial liberalization. Thus, according to the Midterm Review of the FSAP, '… clear communication of the long-term benefits and appropriate consumer protection with a level regulatory playing field [is required]'. This view, however, tends to ignore the fact that markets often fail and when they do negative externalities, such as financial crises and social hardship, occur. Empirical studies have shown that financial liberalization gives rise to financial crises of increasing frequency and severity (Arestis, 2003).

Another aspect of the growth channel pertains to efficiency in the use of resources. The liberalization of capital movements and the Single European Market have put the member states under increasing competitive pressure. Thus, different tax regimes for corporate profits and capital incomes have become competitive parameters, leading to investment decisions based on tax differentials. While the probability of such distortions is lower for investment in production facilities, it is considerably higher for investment in financial services. Financial market taxation for regulatory purposes is, however, beyond the strategic policy concerns of the EU.

(b) The access to credit and financial services channel

The neoclassical view argues that financial liberalization also leads to better access to credit. Although greater competition may indeed increase financial options for savers and borrowers, it is not clear that it improves the access of small firms and disadvantaged social groups to credit and financial services.

Similarly, small customers and the poor may find it difficult to secure credit following financial liberalization and the resulting weakening of relationship finance. Therefore, deepening financial integration improves access to credit only where it develops the institutional structure and new instruments to satisfy the financial needs of small enterprises and the poor (Arestis and Caner, 2004).

(c) Consumer protection

The objective of consumer protection has been given some weight in the EU programme for financial integration, although hardly sufficient by comparison to the extent of market deregulation that has been introduced.

Consumer protection in the area of the EU financial services is provided by the FIN-NET network, which aims at resolving cross-border legal disputes between consumers and financial service providers, and by the FIN-USE, a newly established group, which is to deliver opinions on legislative initiatives affecting users of financial services and to identify key financial services issues affecting them. Although both initiatives represent positive developments, they are inadequate by comparison with the multiplicity and complexity of the issues involved. Also, they address computer-literate consumers – be they individuals or SMEs.

Generally, consumers of retail financial services are suspicious of enterprises in this sector. This suspicion is justified by the boom and bust pattern of financial developments in the late 1990s and early 2000s. Furthermore, the suspicions of consumers will impact not only on retail services but also on the financial markets and the general process of integration, as their concerns for safety and liquidity will hold back the development of financial intermediation in general.

Therefore, if the EU objective of an integrated financial sector is to be achieved, consumer confidence needs to be re-established. However, in the absence of a Europe-wide drive for substantively higher standards, the EU approach – involving market liberalization, minimal harmonization of regulatory standards, mutual recognition of supervisory regimes and home country control over financial enterprises – makes this difficult. The not obviously legitimate desire for rapid integration impedes the pursuit of more complete and effective consumer protection.

Overall, the ongoing transformation of European finance from a bank-based to a market-based system of financial relations represents a clear political commitment to the liberalization of EU member states' financial markets and their re-regulation along EU lines. This has profound implications for the social and economic relations in which finance is embedded (Grahl, 2003). Hastening this process will add to the pressures being felt by European society and especially by its most vulnerable sections, e.g. in southern Europe, as well as in the new member states. Even in the more developed

northern European countries, the drive towards market liberalization will have certain negative trade-offs on the social level.

4.5 Conclusion

Since the late 1990s, the EU financial services sector has come under increased pressure to liberalize and integrate across national borders. The implications of financial market integration for the stability of the sector and the economy and for the well-being of European society have not been widely discussed. In this respect, the dominant view of the EU authorities derives its origin from the neoclassical school, according to which financial liberalization and development automatically lead to increased growth and economic development. This is a one-sided argument, which underplays the frictional elements of the market mechanism. As argued in Chapter 18, a large, integrated financial services sector may be beneficial to both the economy and to society, although not automatically so. For this to happen, a policy framework explicitly designed to safeguard financial and economic stability and to promote growth and social inclusion is needed.

Notes

1. Until recently, an important qualification to these arrangements was that regulations with monetary policy motives – such as reserve requirements – remained an issue for the host, not the home country; this tended to limit the opening of bank branches across currency zones; however, with the introduction of the euro this provision ceased to be a barrier among the countries using the new currency.
2. The regulatory measures under the FSAP and the rate of implementation thereof can be found in CEC (1999, 2004b).

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5
The Attack on the Public Sector

5.1 Introduction: no mandate for privatization

The European Union (EU) has never had any formal competence with regard to private or public property in the member states. Article 222 of the Treaty of Rome of 1957 establishing the European Economic Community (EEC) states clearly: 'This Treaty shall in no way prejudice the rules in Member States governing the system of property ownership.' This provision has survived all subsequent changes and it is also present in the Constitution (art. III-425) which was adopted by the 25 EU governments in June 2004 and has now entered the ratification procedure. One could therefore assume that the stampede for privatization throughout the EU during the last two decades (see Hall, 1997; ÖGPP, 2003) has nothing to do with the specific structure and policies of the EEC or the EU. Such an assumption seems all the more justified, as privatization has not been confined to Europe or the EU but was and still is a worldwide process (see Megginson and Netter, 2001).

In most countries privatization started with the manufacturing firms, for instance in the car or shipbuilding industries. Later, major public utilities (electricity, gas, water) and other network industries (telecommunications, transport) followed. The latest wave of privatization has shifted the focus onto services. International institutions – the World Bank and the IMF – have from the beginning played a supporting and sometimes driving role in privatization, particularly in developing countries, in Russia and the Central and Eastern European countries (CEECs). For the service sector the decisive international framework since the mid-1990s has been the General Agreement on Trade in Services (GATS) within the WTO. Although GATS negotiations formally deal only with liberalization and market access, privatization is in fact often a consequence of increased competitive pressure after liberalization.

In the following we will argue that, in spite of this formal neutrality with regard to property ownership, the policies of the EU have much to do with, and in fact exert a strong bias towards, privatization in Europe. The question

is why the members of the EU, all of whom had a large and sometimes growing public sector in the first three decades after the Second World War, succumbed so quickly and completely to the dynamics of privatization. They were not under external pressure as were Latin American and African states, nor did they experience a complete systemic crisis as did the CEECs. It is argued that European construction was not the main cause of this outcome but that it provided a favourable and reinforcing framework, which accelerated the neo-liberal conquest of the EU (section 5.2). The single market project led to a wave of liberalizations and (partial) privatizations in strategic public sector segments such as the large network services. As a consequence the role of the state changed from that of a direct provider of public goods to that of a guarantor and regulator of 'services of general interest' (SGI) (section 5.3). Contrary to many assertions, the private provision of these services under public supervision did not generate the positive results in efficiency and welfare which were expected and promised (section 5.4). The response of the EU to mounting criticism against unfettered liberalization and privatization remains ambiguous: on the one hand it accepts SGI as a pillar of the European model of society with – at least in official declarations – particular emphasis on social cohesion and environmental sustainability. On the other hand it underlines and reinforces the dominance of the rules of competition in every area in which enterprises are involved (section 5.5).

5.2 Economic integration without a clear concept of the public sector

Most member countries of the present EU were 'mixed economies' with rather extensive public sectors, based on three rationales:

- The public sector has to provide legal, administrative and economic infrastructures as the basis for the private economy. Because of long time horizons for investment, the externalities involved and the difficulties of charging for the use of the infrastructure, material infrastructures could not be supplied by private firms. With the development of modern technologies and financial markets this justification for the public sector has become less important in some fields.
- The public sector should give governments political and strategic control over the main directions of economic development. With the rise of neoliberalism and the change of power relations such a perspective of democratic political control over the economy has been largely abandoned in most capitalist countries.
- The public sector should provide essential welfare goods and services beyond the market mechanism and ensure access to these for everyone regardless of his or her social status or income. The range and extent of these public goods have varied from country to country. In Europe it has generally

included social security (health, pensions, unemployment benefits and so on) and education and – although in different forms and levels – communications, energy, transport, water provision and so on. Here, too, neo-liberalism has opened a campaign for restriction and comprehensive roll-back.

Public goods and other elements of general welfare and democratic control over the economy are – with the exception of agriculture and parts of transport – completely absent from the Community level as a consequence of the narrow perspective in which the EEC was founded. After the failure of more ambitious attempts towards a comprehensive political European integration from just after the war to the early 1950s, the Community was constituted as an *economic* community with a strong bias towards regulation through markets and competition. All attempts to complement this narrow approach by a broader perspective including a fiscal and social union were subsequently rejected by most governments who were not prepared to give up national sovereignty. The hopes of the advocates of a more comprehensive perspective that economic integration would create spillovers, which would then lead to broader political harmonization, did not materialize in the 1960s and 1970s. In the subsequent two decades these spillover effects did materialize, but in an unexpected way: what happened was that the public interest was more and more integrated into a framework of market and competition rules. The Single European Market was not embedded into a common societal regulation, rather society itself has become more and more embedded in the framework of the market and exposed to the pressure of competition.

This is the background to the absence even today of any public service or public interest related equivalent to the strict and detailed competition rules of the Treaty of Rome. Only within the context of these competition rules (in the original article 90, subsequently 86 EC Treaty) can one find a reference to 'public undertakings' and 'undertakings in the general economic interest', which are regarded as exceptions within the strictly competitive framework. Throughout the history of the EC the public sector in many member states has continuously been an object of criticism and litigation on the part of the European Commission. These attacks have increased and multiplied over the last two decades in accordance with the rise of neo-liberalism in the EU.

5.3 Network services: from liberalization to privatization

With the revitalization of the Single Market process from the mid-1980s the service sector was earmarked for more intense market liberalization. Among these service sectors, network services are of outstanding importance, because they are the backbone for the functioning of every developed economy: motor-, rail- and waterways, (tele)communications, postal services, gas, electricity and water provision and so on. For the further progress of European integration it was essential to widen the national networks. In order to create

a single European area for public network services it would have been necessary and appropriate to establish a common set of public standards for the Community. But such harmonization of different rules and standards had been widely abandoned as a method of integration by the mid-1980s. This was explicitly recognized in the White Paper of 1985. Instead 'mutual recognition' and comprehensive liberalization and deregulation had become the philosophy of European integration, and this also included competition among regulatory systems. For the public network providers in the member states this approach resulted in two developments: firstly, they were exposed to strong external competition from foreign private and public network operators and service providers; secondly, to ensure the fulfilment of the public mission public regulatory bodies had to be established (see EC, 1999).

Comprehensive market opening and access for private and foreign competitors force the supplier of services into the logic and strategic behaviour of profit-maximizing private firms, even if formal ownership remains with the government. The first step in the implementation of the Single Market project was therefore the separation of public service suppliers from the state apparatus and their transformation into incorporated entities often split into several separate firms. The logic of private competition consists in cost-cutting measures and in market expansion to conquer market shares from competitors. The first happened regularly at the expense of employment and working conditions. The second took the form of a dash for size through a wave of national and international mergers and acquisitions, often resulting in collapses, overindebtedness and recourse to corruption and fraud. After a period of 'consolidation', the former public monopolies were in most cases replaced by private near-monopolies or narrow oligopolies (see Dickhaus and Dietz, 2004, pp. 98–9; von Weizsäcker, 2004, pp. 20–2; Fumagalli, 2001, pp. 22–3; Wright, 1994, pp. 33–7).

Liberalization of markets and exposure of network service provision to national and international competition endanger the public interest in universal access to these services. This was not the intention of the EU, which found itself in a dilemma: on the one hand to liberalize public services and on the other to maintain the public mission. The way out of this dilemma was the development of the concept of *universal services* (see EC, 1999). The providers of network services are subordinated to the general competition rules. At the same time they are subject to 'obligations to provide services of general interest' (OSGI). The opening of markets for postal and railway services, telecommunications, gas and electricity was therefore accompanied by European directives, which obliged the member states to take appropriate measures to ensure the public mission now under new conditions of liberalization and competition. In most cases this had to be done by setting up *independent regulators* in the member states for which certain standards were to be defined by national governments. At the same time the EU has, through various universal services directives, defined a bundle of minimum

standards for such services which the member state should take into account: universal access, quality, reliability, safety and security, affordability (see EC, 1999, 2003a, paragraph 49–74; Plehwe, 2002).

The role of the state and of the public authorities thus changed from producing and providing public goods themselves to ensuring and monitoring the provision of public goods which are produced and delivered by private firms. The European Commission asserts that market opening plus the setting up of independent regulators lead to greater efficiency of the service providers which is then carried over to the final user and results in an improved fulfilment of the public service mission. This is a highly questionable and in the last instance untenable assertion, at least when a longer time period is taken into account (see Florio, 2004; Reimon and Felder, 2003; Dickhaus and Dietz, 2004). The reason for this is the following: liberalization, deregulation and privatization lead to intensified competition. In a first phase this can often result in lower prices and a better quality of service, because during this period the competing firms can exploit efficiency reserves and lower wages. However, in a second phase when market structures are 'consolidated', high profits can only be maintained at the expense of the services. Prices tend to start rising again, quality deteriorates, safety and security are disregarded, the reliability of universal access is restricted and so on. In this situation it is the task of the regulator to intervene and insist on the comprehensive fulfilment of public service obligations. However, there are reasons to believe that independent regulators are not able to meet this challenge (see Manzetti, 1997; Thatcher, 2002). Firstly, it is very difficult to define comprehensively and in precise detail all quantitative and qualitative aspects of the services to be delivered even under changing circumstances. Secondly, there is the problem of information asymmetry, which gives the private provider a distinct advantage over the public supervisor. This advantage is, thirdly, enhanced by the fact that the technological competence and knowledge of public supervisors are usually one or several steps behind the providers who develop new technologies. In addition good and competent personnel are expensive and usually much better paid by big corporations than in the supervising institutions, and this also creates asymmetries against the supervisors. A really competent and efficient authority would be very expensive and its additional costs would probably (more than) offset the temporary relief for the public budget through privatization of public services. If, under fiscal pressure, public expenditure for regulation and supervision is reduced, then the regulator becomes powerless and the public mission will be more and more restricted and eventually abandoned.

These general theoretical doubts about the superiority of private (and supervised) provision as against public provision of public goods are confirmed by empirical evidence in various areas:

- The provision of *infrastructure* is not generally improved by privatization, and often a marked deterioration takes place. This can be studied in the

British railway system, where a severe fall in the quality of transport services – including passenger safety – has been publicly recognized (see Dickhaus and Dietz, 2004, pp. 23–6).

- In addition *social cohesion* almost inevitably suffers when public network services are privatized. This is particularly true for transport, postal and banking services. Especially in the countryside, with thinly populated regions, the regular delivery of mail and uncomplicated access to the banking and payment system at no or low cost are essential features of social networks. Since these are time consuming they are inevitably thinned out and at least partly destroyed when such services come under the pressure of competition and time compression (see de Lima et al., 2003; Dickhaus and Dietz, 2004, p. 37).
- Also, *safety, continuity and modernization* of public services are not guaranteed after privatization and deregulation. This has recently been demonstrated by the collapse, with blackouts, of electricity provision in California, New York, London and Italy (see Raimon and Felber, 2003, pp. 109–23). The main reason for these accidents is the lack of sufficient excess capacity and ability to cope with sudden surges in electricity demand. Under the pressure of competition firms tend to minimize excess capacity and this makes them more vulnerable. This applies also to state-owned producers when competitive pressures increase.
- *Prices* have in many cases fallen after privatization to make the process more acceptable to the public and to conquer market shares (see Dickhaus and Dietz, 2004, p. 99). But when markets are 'consolidated' prices regularly rise again. This can be observed in electricity, gas and water supply as well as in the privatized transport sectors (see Raimon and Felber, 2003, pp. 116–21; Fumagalli, 2001, p. 29). Privatized firms have also often developed techniques of accounting and calculating prices which – due to information asymmetry – are very difficult for public regulators, let alone the broader public, to monitor and control.
- With regard to *employment* one can safely state that privatizations have in most cases led to considerable job losses and deterioration of working conditions (see Dickhaus and Dietz, 2004, pp. 32, 101; Fumagalli, 2001, p. 29). This is not surprising because the prospect of profit has been the driving force for the investor to take over a public firm or service, and the quickest – although in the long run not the most sustainable – road to profits is to cut costs through the elimination of jobs, the reduction of wages and salaries and the tightening of working conditions.
- Privatization has contributed considerably to the rise of *inequality*. On the one hand manager remuneration usually rose steeply after privatization. Secondly, shares in privatized firms were usually bought by the richer parts of the society at a price which, thirdly, was often considerably below their value. On the other hand the poorest 10–20 per cent were the losers from privatization, having to pay higher prices, losing their jobs and earning lower wages (see Florio, 2004, pp. 362–4).

- Even in terms of internal *efficiency and profitability* the results reveal a mixed picture (see Megginson and Netter, 2001, pp. 346–56; Florio, 2004, Ch. 4; Fumagalli, 2001, p. 29). On the one hand severe cost-cutting programmes and extensive marketing have often substantially raised profitability. On the other hand most large privatized firms and private service providers have in the last five years engaged in a largely irrational merger wave and bought firms beyond any reasonable and solid business perspective. They paid prices for business licences (for instance UMTS) for which they had to take on an unsustainable burden of debt. In the stock market crash they suffered huge losses and the subsequent restructuring processes cost many thousands of jobs and will remain an economic burden for many years to come.

In the light of this performance no justification for privatization and deregulation can be found in the allegedly generally superior efficiency and better provision of public services (see also SAPRIN, 2002, Ch. 5). Other motives must be more relevant. Apart from strong ideological and political pressures there are two economic interests which drive the process and which complement each other: on the side of the government it is the desire to alleviate burdens on the public budget: to raise money through the sale of public property or to save money by contracting out public service provision. On the side of private firms it is in their interest to open up new opportunities for investment – in a general economic environment where their liquidity is high but where investment opportunities are low. Privatization meets both interests.

5.4 Services of general interest as niches in a world of competition – the position of the EU in the new debate

The Treaty of Maastricht transgressed the boundaries of exclusively economic integration and created space for closer political cooperation. In the economic and social area, however, the predominance of the rule of competition, privatization and deregulation survived and was even reinforced. It was not until the Treaty of Amsterdam that an explicit reference to 'services of general economic interest' (SGEI) was inserted into the Treaty (art. 16), as a result of growing criticism and opposition to the increasingly neo-liberal direction of the EU. The same reference was then also included in the Charter of Fundamental Rights and via this in the Constitution (art. II-96). It comes up again in the third part (art. III-122) which opens up the prospect of a European law on services of general economic interest. This law should define the 'principles and conditions, in particular economic and financial' for SGEI which 'enable them to fulfil their missions'. At the same time the Constitution reconfirms and underlines the priority of competition as the overarching approach to services when it begins the article on services of general economic interest with the

words 'Without prejudice to Art. I-5, III-166, III-167, and III-238 …', articles which all refer to the rules of competition.

Growing concerns in the member states about the future of the public sector have been recognized and to a certain extent taken up by the European Commission. An outcome of this response is the publication of several communications including one *Green Paper on Services of General Interest* (see EC, 2003a) in which the EC claims to launch a public debate on the issue, while in reality it tries to influence an ongoing debate. A year later the Commission gave an account of this debate and presented some preliminary conclusions from it in a *White Paper on Services of General Interest* (see EC, 2004a). The publication of these documents is to be welcomed because they clarify the position of the European Commission. They reveal the congenital defect of the biased development of the EC as a market- and competition-based economic community.

Both papers go rather far in the justification of services of general interest. The Green Paper asserts that the concept has to reach beyond the narrow borders of services of general *economic* interests and should where necessary be extended to 'services of general interest' (SGI), although these are not conceptualized in the document. The significance attributed to SGEI and SGI is underlined in the Green Paper by repeated reference to them as 'an essential element of the *European Model of Society*', their 'role as essential for increasing quality of life for all citizens and for overcoming social exclusion and isolation' (paragraph 2). The same line is repeated in the White Paper, which calls services of general interest 'one of the pillars of the European model of society' (p. 4).

Both papers also explicitly confirm and underscore the (exclusive) right of member states to define, organize, finance and monitor such services according to their traditions and choices. With regard to the competition rules the White Paper even asserts that 'the effective performance of a general interest task prevails, in case of tension, over the application of the Treaty rules (EC, 2004a, p. 7). Such remarks might feed the expectation that the EC has at last broadened its approach beyond the perspective of markets and competition.

However, such expectations are premature. For there remains one decisive restriction: 'However, providers of services of general economic interest, including in-house service providers, are undertakings and therefore subject to the competition rules of the Treaty' (EC, 2004a, p. 15; see also EC, 2003a, paragraph 80). In other words: once the public service has left the orbit of direct administrative provision and is managed through a separate public entity, the prevalent framework for operation is given by the competition rules. The seemingly broad range of discretion for the member states or for regional or local authorities in opting for certain ways of providing public goods is rather small and largely fictitious.

The general thrust of both papers is quite unambiguous. Even when SGI are recognized as justified, they are regarded as an exception to the general

rule of competition and/or as a small niche in the world of competition. In the view of the Commission these exceptions have to be restricted as much as possible and they must be closely monitored to see whether they are still justified. The overarching frame of reference remains the competition-driven market economy.

The White Paper announces the further procedure of the Commission regarding SGI, which can be summarized as follows. The Commission will:

- Maintain the sectoral approach to services of general (economic) interest;
- Undertake during the next two years a thorough analysis and assessment of the functioning of universal services in the EU;
- Wait until the Constitution is in force (i.e. at least until 2006) before considering steps to propose horizontal provisions or European laws for SGI.

This reluctance of the Commission to go one step further in the promotion of public services stands in strong contrast to the resolve which the same institution displays with regard to liberalization and further market opening. In 2003 the EC published a ten-point programme on the priorities for the internal market strategy for the years 2003–6 (see EC, 2003b), in which it considers among others the water sector as 'one area where new action may be required' (p. 13). This programme was followed in January 2004 by a comprehensive draft proposal on services in the internal market (see EC, 2004b) in which all services for which a fee is charged are subject to liberalization and competition. The proposal also reinforces the country of origin principle which makes the activity of a service provider in every member country subject to supervision exclusively by the authorities of the country of origin where the provider has its headquarters. The implementation of this principle will lead to a twofold regulatory race to the bottom: not only will countries loosen their regulatory framework to encourage service providers from other countries to establish themselves on their territory, but they will come under pressure to deregulate when foreign providers offer their services under the looser rules of their home countries.

This asymmetry in commitment to services of general interest and to complete deregulation of all services makes it clear where the heart of the Commission lies. It is in the world of markets and competition and not in the world of democracy and public goods. In the recent White Paper when mentioning social and health services 'which have a specific role to play as an integral part of the European model of society' (EC, 2004a, p. 16) the Commission formulates: 'While in principle the definition of the mission and objectives of social and health services is a competence of the Member States, Community rules may have an impact on the instruments for their delivery and financing.' This means that whenever member states use market-based systems to deliver social and health services they are subject to the competition rules.

5.5 Conclusion

It has been argued in this chapter that the congenital defect of the EU was that the existence of extensive public sectors in the member states was not reflected in the conception of the Community which was based instead on the rules of competition. When the thrust of the Single Market project reached the public services sectors in the member states the concept of privatization-cum-regulation was developed for universal services, which govern the strategic network areas in the EU. The assertion that this arrangement would lead to considerably improved performance of the SGI could not be substantiated. The EU meets mounting – and in our view justified – criticism from the public by attempts to assign public services the status of exceptions in a competition-dominated world. But this is thoroughly inappropriate and cannot be the end of the story. In Chapter 19 proposals to build and maintain a strong and democratic public sector will be presented.

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6
The 'Modernization' of Social Policy: a Critique of Pension Reforms[1]

6.1 Introduction

In this chapter the issue of the so-called 'crises' of the public pension systems is revised and assessed. The arguments in favour of the 'modernization' of the present public pension systems as well as those put forward enhancing the privatization of the pension systems are reviewed and evaluated. A number of counter-arguments are advanced, and an effort to disclose the true reasons for the reform is presented. The role of EU policy towards this issue is discussed. Conclusions are drawn about the fallacious nature of the arguments presented for the privatization of the pension systems.

6.2 Social policy in the frame of globalization and neo-liberal policy

Social policy should be one of the main pillars of the European project, since it constitutes one of the key elements for the welfare of the population. But since social policy systems are embedded in society, a broad framework is needed for an assessment of social policy. If the analysis of social policy systems and the definition of appropriate policies are narrowly focused on the elements of each policy the results could be seriously misleading. Because of that, social policy has to be situated in the context in which it develops.

Social policy has come under heavy attack from the neo-liberal theoreticians and policy-makers, especially during the last decade, based on three key considerations:

- First, social policy is seen exclusively as a cost. Since in order to be able to compete all *unnecessary* expenses have to be eliminated, and since social expenses increase costs, they have to be reduced. It is maintained that expenditure in the public health system and especially in public pensions is growing rapidly, that it will grow further in the future and cannot be maintained.

- Second, social expenditure has to be converted into a field for profits. Therefore the field of social policy has to be privatized in order to produce profits, and the development of private and mixed (public and private) systems is advocated.
- Third, social policy may be used as an instrument to discipline the workforce. Social policy after the Second World War reduced discipline over workers, and a more stringent social policy was sought by neo-liberals to reinforce discipline. At present, it is considered that unemployment policy and other social benefits are too generous, and that they discourage the active search for employment; therefore workfare instead of welfare is recommended. And as the labour markets become more precarious, unemployment and poverty become a real threat for significant parts of the working population, and the need to rely on public welfare services becomes bigger, the provision of public services may be linked to the *good behaviour* of workers. Mechanisms as *workfare*, control of benefits, means tests and so on are implemented.

A particularly important area of neo-liberal counter-reform is the ongoing pressure for the so-called *modernization* of social security systems, proposed by the World Bank and other international institutions. The essence of this process is the weakening and privatization of public systems, under the argument of the economic unsustainability of the present systems, which require increasing amounts of financial resources. These pressures are most obvious in the case of pension policy, but are also present in unemployment policy and in the trend to privatize more and more of the public health systems.

The EU seems to have accepted the arguments for the 'modernization' and privatization of the social systems, since the guidelines for social policy faithfully follow the recommendations of the World Bank for the *modernization of social security systems*; the direction of this modernization follows unambiguously the privatization pattern. The development of social policy along those trends is at present one of the top priorities of the enlarged EU agenda with very serious consequences for the European citizenship.

6.3 Social policy in the EU

The EU Treaty takes the economic and social cohesion as an explicit engagement and establishes that the Union has as its objective the diminishing of the differences in development in the different regions, in order to promote a harmonious development of the whole Union. Accordingly, some provisions for social policy have always been present in the Community policies.

The European Social Fund (ESF), building on a Social Fund existing even before the founding of the then Common Market was established in 1967, together with the Regional Fund (EFRD) and the Agricultural Orientation

Fund (EAGGF, Orientation), were refunded and reformed in the 1990s and now constitute the so-called Structural Funds.

The Social Fund is mainly devoted to support workers' educational and training expenses and the Regional Fund supports Regional Development Plans, very often dedicated to improving the productive structure of small enterprises, rural development and the provision of infrastructures and transport. In 1989 the Charter on Social Rights was developed, it did not become statutory and was not fully incorporated into the Community provisions. In 1992, after the Treaty of Maastricht, the Cohesion Fund was established to compensate for the negative consequences of the Treaty, the beneficiaries being the southern countries.

The social policy of the EU is explicitly left under the responsibility of the member states, and the most important pillar of the social model of the EU up to the present has been a relatively comprehensive network of national public social security regimes of its member countries.[2] Social policy remains in the hands of the member states because of national idiosyncrasies and differences, and these support the maintenance of decentralized social policies and argue against attempts to centralized social policy at the EU level.

The draft for the Constitution does not substantially change this position. In spite of some encouraging provisions, with positive and progressive formulations regarding the Union's objectives in Part I and the inclusion of the Charter of Fundamental Rights in Part II, the narrow attention given to social aspects is shown by the lack of concrete expression of this in Part III. Social policy remains the 'ugly duckling' of the Union.

Social policy is a wide subject and different classifications may be established: on the one hand social policy leads directly to improvements, in general terms, of the situation of citizens, in matters such as health, education, housing; on the other hand social policy is oriented towards supporting people in special conditions, namely unemployment subsidies, sickness benefits and pensions; besides this there is the social policy aimed at providing public services as electricity, water, waste (refuse) disposal and others. Moreover, labour and employment policy constitutes an important part of social policy. In this chapter we deal with the policy on old age pensions, both because it is a very significant part of social policy which has in the last decade been submitted to significant changes in the EU member countries, and also because some of the elements that affect pensions, mainly privatizations, are also being implemented in other aspects of social policy such as health and education.

6.4 The pension issue: the modernization of the pension systems

The issue of the *crisis of the pension systems* was launched by the World Bank in their report (World Bank, 1994) on the future of pensions, about the

alleged unsustainability of the public pension systems. It may be considered as the 'official' starting point of the present debate, even if in the 1970s important pension reforms had taken place in Latin America. Using an ambiguous mixture of arguments about the need to *modernize* the pension system and the implicit suggestion that *privatization* will solve the financial problem, the alleged crisis of the pension system and the consequent need for pension reform were declared.

The arguments of the reformers are presented as unavoidable under the threat of a *demographic time bomb*: based on the changes that are taking place in the demography and in the labour market, it is asserted that the increasing number of old-aged people and the decreasing number of the working population are leading to a situation when sometime ahead (10, 20, 30 or more years according to different studies) the public pension system will become financially unsustainable and go bankrupt. It is interesting to observe that unless they directly produce profits, the best advantages of society, like a longer life expectancy, tend to be portrayed in capitalism only as problems leading to crises.

To counter this crisis two lines of action are recommended. To maintain financial sustainability it is necessary to increase contribution rates sharply, and/or to substantially reduce the generosity of state pensions. Proposals concerning lengthening working life, or insisting on more years of contributions in order to qualify for basic entitlement or for a full pension, the recommendation to take into account the whole of the working life when calculating pension benefits, raising retirement ages and instituting penalties for earlier retirement, ignoring the fact that very often the labour career of individuals does not depend upon their will but of the employment situation of the country. All these points lead to lower replacement rates (proportion of pension in relation to working life wages), and the deterioration of the public schemes is a good way to induce people to subscribe to privately funded systems.

Private pension systems based on funding have to be developed. Many scholars and administrations argue that future retirees would be better off investing at least part of their savings in private, funded pension plans which must function through capital markets. People should provide for their future old age purely through private schemes, and only the very poor should be entitled to public provision of pensions. This trend towards privatization should be supported by substantial tax incentives for savings placed with pension funds.

The overall purpose of the proposals is to replace the present public system (pay as you go system, PAYG) by a private insurance system run on capitalization of individual savings on an actuarial basis.

It is also alleged that private pensions systems are more efficient than public financing of pensions due to the returns of the stock market, that privatization will diminish public expenditure and especially that private funding of the pension system would increase total savings and foster

economic growth. This argument has been widely used since 1990 in relation to Central and Eastern European countries because of the need to enhance rapidly the private accumulation process.

One of the features of the present PAYG system considered particularly pernicious is its embodiment of the solidarity links. It is then argued that the only sound system is the actuarial system in which everyone receives what he/she paid.

The arguments against PAYG schemes, and in favour of private funding, correspond to a very specific economic and social analysis which can be widely contested. Abundant counter-arguments have been provided, both to show that the above-presented arguments for the crisis of the public pensions may be easily refuted, and to show that private pension systems do not necessarily lead to a better system for pensioners or for the economy of the countries concerned.

The references to demographic changes which allegedly require a thorough systemic change of the pension scheme are false in two respects. First, the threats to the financial viability of PAYG schemes resulting from demographic changes are exaggerated. Several elements illustrate that exaggeration: the relevant element to consider is not the demographic dependency ratio but the economic dependency ratio, and this is forecast to increase substantially more slowly than the former (Concialdi, 2002). Second, the expected growth of old-aged people is not greater than the growth experienced in the last 50 years, and 'Moreover, demographic projections may differ considerably depending on the basic assumptions (projections made for the German Bundestag differed about 60 per cent between the lowest and highest "ageing scenario")' (Dräger, 2003, p. 10). While the predicted changes indeed raise problems and require political responses to ensure financial stability, they do not justify alarmist scenarios of an impending breakdown of such systems which are often used in the political and sometimes also in the scientific debate to underpin the alleged need for thorough systemic changes. Problems of pension financing are at present not exclusively and in many cases not even in the first place the result of demographic changes but of unemployment, low wages and a shift in the distribution of incomes to the disadvantage of the wage side, which is the financial basis of PAYG systems; and often result from the withdrawal of employers from the cofinancing of social security. Only if we assume that there will be no or only very low increases in labour productivity in the future – which seems a highly unrealistic assumption – would future financial burdens resulting from demographic changes jeopardize such systems. Continuous increases in productivity create the basis for rising real incomes both for the working population and the pensioners even under conditions of a higher dependency rate.

> For example, if the Social Security trustees [of the USA] assumed that productivity would grow at an annual rate of 2.0 per cent [instead of

> productivity growth rates of approximately 1.5 per cent as they did] – the low end of most current estimates – then the projected shortfall would be reduced by almost 25% and the program would be projected to be fully solvent until almost 2050. (Baker, 2003, p. 5)

Second, even if there were strong problems arising from demographic changes, this could be no reasonable basis for the transition from a public PAYG system to a private system based on financial markets, which is inferior to the public system in all relevant aspects.

The idea of a shrinking number of workers having to sustain a growing cohort of old people, proposed as a significant element of the crisis, is also misguided for two reasons: firstly, if the number of workers diminishes the problem would seem to be a labour market problem, and not a pension problem, and a vigorous policy for full employment would seem to be the best solution to recover the necessary contributors to the pension system. Secondly, the latter is not the important issue since the relevant variable is not the number of workers but the wealth and incomes they produce.

> Therefore the central question is not demographic but whether increases in productivity and economic efficiency can be maintained to produce higher value added with a decreasing number of people in employment – thus generating a higher proportion of value added destined to meet the needs of 'collective consumption' of a higher number of pensioners. The economic dependency ratio thus also being only a partly question, the overall issue is distributional: how do our mature industrialized societies distribute produced wealth and revenues ... . (Dräger, 2003, p. 11)

For the deterioration of benefits of public schemes two points need to be considered: (i) is it fair to go on diminishing the incomes of old people leading at least to significant numbers of them experiencing economic difficulties and even poverty, and (ii) that it may mean simply pushing the problem from one social security scheme to another, either because those who cannot retire will become unemployed, or because poor pensions will have to be supplemented by assistance for cases of poverty. 'In a context of massive unemployment and underemployment the different forms of increase in the contribution period results mainly in savings for the pension system, either by transferring costs to the unemployment insurance scheme, or because it leads to some employees retiring on reduced pensions' (André and Concialdi, 2003, p. 4). It is also important to point out the growing exclusion from social protection resulting from the expansion of informal work. Even official administrators recognize the need to find new ways to identify excluded workers and extend protection to them, but few experiments are under way. These problems are especially acute for women, many of whom do find great difficulties in covering the required number of years of

contributions and who are affected disproportionately by increases in the retirement age.

The case for the privatization of pensions has no economic rationale. The current public systems are less expensive than private sector alternatives and are relatively sound financially for the foreseeable future. The possible changes needed to keep them solvent over the very long term are not larger than changes that have been made in several prior decades.

The (macro-) economic viability and the advantages of increasingly funded systems are also usually exaggerated by their proponents. It is assumed that additional private saving through transformation of contributions to PAYG schemes into additional capital stocks will increase economic growth and thus provide a large proportion of income for the greater share of elderly people in the future. But this is by no means necessarily the case. The deflationary impact generated by private contributions to pension funds will probably not result in the formation of additional savings but will only cause a shift in the allocation of existing savings, since workers may contract their voluntary savings in order to compensate for larger mandatory savings. Further, the introduction of private pension funds will not generally increase economic growth, even if it generates additional savings. Economic growth does not come from additional savings, though it may come from additional investment. The reason for the slowdown in economic growth in the EU over the last two decades is not the absence of savings as investible funds, but the weakness of effective demand and of the desire by firms to invest. Moreover, when, after a transition period, pension funds mature, the savings decisions of the young are matched by the dissaving decisions of the old. If the shift towards capital market-based systems does not create additional growth, its only effect will be a more unequal distribution of pensions between those who could afford additional individual savings during their active lifetime and those who could not. What will happen to those workers who cannot save for the future? The Pensions Policy Institute reports for the UK

> that the gap between rich and poor pensioners has widened since 1979: the average income of the poorest quartile of single pensioners has fallen from 23 per cent to 21 per cent of national average earnings; that of the richest quartile has risen from 73 per cent to 87 per cent. The proposed tax reforms will certainly swell these subsidies. (Grahl, 2003, p. 2)

Shifting public pension systems from public PAYG schemes to privately funded capital market schemes exposes the living standard of future pensioners to the incalculable risks of financial markets, which will greatly increase the vulnerability and the risks they bear, since for most of them retirement income is an essential part of their total income. These risks, highly underestimated by the proponents of privatization, arise from the systemic instability of financial markets. The recent stock market crash and

the collapse of large corporations, in which major pension funds had invested a large fraction of employees' pension contributions, has impressively demonstrated that these markets are not a reliable basis for safe pensions and that crises can push many pensioners into sheer poverty. It is not only in the recent conjuncture but 'risk adjusted rate of return to equities ... the twenty year averages were negative for about one-third of that period and fell to zero for three twenty year periods' (Niggle, 2000). Because the ups and downs of financial markets are much more accentuated than the amplitudes of regular business cycles, pensions linked to capital markets are exposed to a much higher degree of economic and social insecurity than pensions in a PAYG system. The danger of corruption of big financial and entrepreneurial undertakings, which has been greatly facilitated following deregulation and financiarization, also adds another relevant element of risk. Overall, this is not acceptable in a society which assumes responsibility for the social welfare for its citizens.

If pensions were to be fully privatized financial market instability would increase. As each cohort reached retirement age they would want to annuitize their financial assets, which would lead to selling of these assets, reducing share prices. This money would then be handed over to insurance companies for an annuity that in a stock market with falling prices would have a lower value (as an example of what can be expected in the future, note the decline in annuity rates in the worldwide stock market downswing of the past few years). Insurance companies may decide to put part, and only part (given risk diversification principles), of this money in stocks and shares and thus shore up stock market prices. This recycling of money would not be enough to stem the secular decline of share prices with an ageing population. In short, private pension funds require similar constant flow of new money to provide for an ageing population, very much similar to a PAYG system. This new money can only come from the new generation of workers who would then have to pay more (in the same way as they have to pay more in PAYG systems) in order to ensure a decent life for pensioners.

The reasons which are regularly given to justify such shifts from public PAYG schemes to private capital market schemes are not only unconvincing but simply fallacious: if the present relative living standard of pensioners is to be maintained, an ageing population requires a larger real transfer of future production from the working population to the pensioners, regardless of the mechanism by which transfer is effected. We maintain that such transfers can be carried out more safely and with greater social equity via the public PAYG system.

Empirical evidence about the consequences of privately funded systems – in Latin America, Great Britain and some Central and Eastern European Countries – shows that they have no comparative advantage against public PAYG systems, and in many cases are clearly inferior. Macroeconomic performance has not improved through capital-funded schemes, and in some

cases they have been a factor of macroeconomic instability. Public PAYG systems are frequently much less costly and more comprehensive in their coverage – concerning for instance periods of unemployment and sickness as well as disability – than privately funded systems, which are much more selective and tend to exacerbate instead of mediating social divides and polarization. Private systems do not allow for any consideration of solidarity between different social groups or individuals; since they are actuarially based their philosophy is totally individualistic and at most each beneficiary gets back strictly what he or she has paid in. In fact since there are substantial administrative costs, every beneficiary gets less than what they pay for. There is no evidence either that the privatization of pensions improves the balance of government expenditure. Most pension benefits are financed by contributions from wages, and their net requirements on the public budget are meagre, while those financed out of public budgets mainly correspond to social assistance rather than to pensions as such. The costs of tax benefits awarded to private pension contributions also have to be considered: for instance 'Britain devotes only 5 per cent of GDP to state pension expenditure … [while] the "tax expenditures" which subsidize private pensions absorb some 2.5 per cent of GDP' (Grahl, 2003).

The administrative and management costs of private decentralized systems are much higher than centralized public systems. These costs are, of course, income to the financial industry, while less pension is paid to the working population in relation to the contributions made. The privatization of pensions implies increased risk and uncertainties for future pensioners both with regard to the size and the real value of their pensions, as well as heavily increased management cost. In addition, the privatization process undermines the financial base of the public pension systems, and imposes large transition burdens on the public.

6.5 The real reasons for the reform

The real thrust behind the shift from public to private schemes is not any objective necessity but much more the interests and lobbying power of large financial institutions and the financial markets, who will obtain command over billions of private insurance contributions to invest on financial markets. It is this prospect for profit, and not the problems of an ageing population, which propels the modernization of pension systems.

The financial institutions receive very substantial amounts of workers' contributions to private pension systems, which they can invest on financial markets and which are the basis for substantial revenues and profits and increases in their financial power. It can be argued that the privatization of pensions is aimed at generating continuous financial flows in order to enable the growth of the dominant financial players. This trend is felt more acutely where financial markets are underdeveloped and institutional

investors small (South, Central, Eastern European and Latin American countries). Banks, investment funds and insurance companies have a major interest in the transformation of public PAYG systems into capital market-based private systems. The primary aim of financial institutions is to turn the delivery of welfare into a product that generates corporate profits. It is therefore not surprising that powerful financial interests have been and are being extremely active in leading the drive towards privatization, and also in transmitting to professional and public opinion the risks of the unsustainability of the public system. Their hostility against any system based on collective solidarity is shared and supported by many other industrialists and employers' associations. They rely on their influence in the media and in the political system to carry through a course of action that would be extremely unpopular if the public were accurately informed about the situation. However, this clear interest of asset managers and the considerable power of financial institutions should not be confounded with the public interest or social welfare in general. While the prospect of privatizing pensions may include the promise of large profits to the financial industry, it is obvious that it offers little benefit to workers, citizens and future pensioners. The support that the positions favourable to the financial institutions receive from public international institutions, namely the World Bank and the OECD, raises serious questions about whose interests they are actually defending, as well as about the neutrality of their viewpoint.

In this general context, the role of the EU authorities in enhancing the diminishing of public pension benefits and the increase of private systems also has to be considered. The EU leaders seem to have accepted uncritically the arguments about the risk of public pension bankruptcy and are actively taking measures in favour of privatization in the member countries. Surely the profits that private systems may produce for the financial institutions as well as the willingness to build up an integrated financial market, which is one of the present aims of the Union, is not alien to this stand, even if it clearly conflicts with the wishes of important parts of the European populations that overtly and permanently manifest their rejection of the deterioration of the public system.

Besides the financial interests, the role of other agents in the privatization process as representatives of pension policy stakeholders may be worth considering, especially the role of the trade unions. Their role in pension reform processes is complex and union interests cannot be reduced to a simple acceptance of, or opposition to, proposed reforms. The interest of the unions regarding public policies, as well as their narrower particular interests as specific organizations, together with the 'trilemma' that pension reform entails (between the short-term interests of current pensioners in maximizing pension income, the short-term interests of current workers in maximizing wage income, and the long-term interests of current workers in maximizing deferred wage income) are likely to shape the way the trilemma is resolved.

The consequences that the new systems will have for the funds, organizational structure, membership composition and institutional context of the trade unions must also be considered. When trade unions are invited to take active part in the reform and in the future management of pensions they tend to be more likely to accept the reforms. If trade unions consider that programme changes are necessary or merely convenient for their institutional interests they have an incentive to cooperate in the policy change, and it may lead them to convince their members to accept the reforms even if the latter are rather sceptic about them. Consequently the reforms will take place with less social unrest.

6.6 Conclusion

Neither the arguments advanced about the crises of the pension systems nor those put forward favouring the change of the present public systems towards privatization are solidly proved and sustainable. Privatization is not a good way to solve the problems that the public systems may have and there is ample scope to solve them through different ways that do not require diminishing the benefits of pensioners nor privatization. The real reasons for the reform are the powerful financial interests and their willingness to profit from the vast amounts of funds that the private pensions imply. In the light of the arguments revised here public pensions may be, and should be, maintained for the welfare of the ageing population.

Notes

1. This chapter is the outcome of work done by the Social Policy Group of the EPOC Network. Four workshops and a conference were organized and regular participants included K. Anderson, C. André, M. Augusztinovics, R. Blackburn, P. Concialdi, J. Iglesias, F. Lordon, A. Marano, R. Minns and M. Sawyer.
2. It does not mean that some specific items of social policy do not exist at central level. Policies for gender equality, safety at work, work quality and other provisions established in the Single Act are part of the system of social policy of the EU.

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7

Employment through Labour Market Flexibility? A Critical Appraisal of the European Employment Strategy

7.1 Introduction

Over the last two decades, labour market policies in Europe have been strongly inspired by the doctrine that persistent unemployment mainly arises from malfunctions in the labour market itself.[1] In various ways, the *flexibility* of labour markets has been advocated as the main solution to unemployment. The call for flexibility typically includes demands for downward wage flexibility, easier hiring and firing, flexible changes of tasks and working conditions and higher labour mobility across regions, industries and occupations.

We start with a supply-side critique of the flexibility agenda. We argue that, as far as the flexibility agenda has been realized, it has been damaging for innovation performance in Europe. Finally, we examine EU labour market policies. While there are positive aspects to the coordination of these policies, current strategies are still greatly influenced by the flexibility agenda.

7.2 Flexibility versus innovation

This part develops a Schumpeterian supply-side criticism of the flexibility agenda. We critically examine the mainstream economics argument that achieving more flexible labour markets should solve the European unemployment problem. Taking the example of the USA and the Netherlands, we argue that such policies indeed resulted in impressive job growth; however, they hardly resulted in higher GDP growth and induced a crisis of labour productivity growth. Moreover, we argue that, during the 1980s and 1990s, the strong pressure towards reduction of public budget deficits and towards lowering taxes favoured a tendency towards budget cuts in the educational sector in many countries. This is counterproductive for the Lisbon agenda.

7.2.1 Lack of educational investments

Lack of adequate investment in education is likely to hamper innovation, economic growth and social coherence in various ways, for example:

- There is evidence from the Community Innovation Survey (European Commission, 2004a) that lack of adequately qualified personnel is an outstanding factor hampering innovation.
- In recent years there is strong evidence that relative demand for qualified workers is rising and the labour market position of low-qualified workers is deteriorating, resulting in widening wage gaps (see e.g. Ter Weel, 2002).
- Investments in education have high benefits, returns on educational investments varying between 8 and 12 per cent (see Groot and van den Brink, 2003).
- More highly educated people tend to have less need for medical care, are less frequently criminal, make less claims on social security, are more often active in political parties and social movements and tend to have stronger social networks (Groot and van den Brink, 2003).

In conclusion, striving for a socially coherent Europe and realization of the Lisbon agenda would first of all require higher investments in education at all levels.

7.2.2 Striving for flexible labour markets

In a neoclassical perspective (persistent) unemployment can be avoided if the price of labour is allowed to adapt flexibly to changes in demand. For example, people with low productivity can still be employed if their wages adapt in a downward direction. Such flexible adaptation of prices to relative scarcities is expected to bring the economy 'automatically' into equilibrium (at least in the long run). There are two countries in the world economy that are frequently cited as examples of the relevance of a neoclassical view of the labour market.

The first example is the United States. In the 1970s, the power of US trade unions was broken, and there is abundant statistical evidence that this translated into declining wages, notably among workers with low qualifications. In exchange, the US job machine created impressive numbers of jobs, clearly outperforming job creation in the 'rigid' economies of continental Europe. It is a standard argument by mainstream economists that, by preventing downward wage flexibility, trade unions keep certain categories of workers out of work.

The other example is the Netherlands. In response to mass unemployment (following the 'Dutch disease' of the 1970s and a severe recession in 1982/83), Dutch trade unions decided to reduce their wage claims. Between 1982 and 2002, real wages in the Netherlands grew, on average, by only 0.8 per cent per year as opposed to 1.9 per cent in the EU. This seemed to

work according to the neoclassical logic. Since the mid-1980s, employment began to rise substantially. For example, in the period 1990–2002, numbers of labour hours grew by 1.7 per cent per year as opposed to an EU average of 0.1 per cent (DNB, 2003). Within about 15 years, the Netherlands moved from mass unemployment to full employment (i.e. full employment according to ILO standards and ignoring hidden unemployment).

The Dutch example is of particular relevance here as it is often considered more attractive than the US example. In contrast to the USA, the welfare state (although partly cut back) still exists and income distribution is not excessively unfavourable for the poorer part of the nation. The Dutch model of job creation appears socially acceptable to large parts of the trade unions and to many politicians. There is a consensus in the country that all that is required to make the job machine work, is that trade unions are ready to make 'reasonable' wage claims that are in solidarity with the unemployed.

7.2.3 What is wrong about the US and Dutch job miracles?

Using different methods, and within quite different institutional settings, both models have essentially achieved the same thing: a reduction of wage cost pressures. In the USA, beating the trade unions and realizing downward wage flexibility have achieved this. In the Netherlands, trade unions voluntarily sacrificed wage increases and tolerated a wage-cost saving flexibilization of labour relations. This resulted in an increasing number of people that worked on 'non-typical' working arrangements (e.g. temporary contracts, work-on-call, 'freelance' or via temporary work agencies). Econometric estimates show that such flexible arrangements lead to substantial wage-cost savings and thus enhanced the policy of voluntary wage restraint (see Kleinknecht et al., 1997). In the following, we argue that this led to a lower overall level of innovation activity and to a decline in labour productivity growth.

Table 7.1 illustrates that, during the 1950s and 1960s, value added (that is GDP) per working hour (as a measure of labour productivity) was rising very fast. During the 1970s, productivity growth rates declined and remained at low levels during the 1980s and 1990s. Some authors have suggested that this worldwide decline of labour productivity growth has something to do with Schumpeter–Kondratieff long waves in economic growth, caused by the thrust-wise introduction of major innovations (Kleinknecht, 1990). This is not the place to discuss the realism of such theories. We confine ourselves to interpreting differences in labour productivity growth between countries. While EU-average labour productivity growth declined to about 2 per cent per year in the 1980s and 1990s, US labour productivity growth went down to 1–1.6 per cent after 1973 and seemed only to recover during the second half of the 1990s in the wake of a boom in ICT industries (Jorgensen et al., 1999). An even stronger decline of labour productivity growth rates is observable in the Netherlands during the 1980s and 1990s.

Table 7.1 Growth of labour productivity, 1950–2000 (average annual growth rates of gross domestic product *per working hour*, at 1996 prices)

	B	*F*	*D**	*I*	*NL*	*UK*	*EU-14*†	*USA*	*Japan*
1950–60	3.2	5.2	6.3	3.2	4.2	1.8	**4.2**	3.6	5.9
1960–73	5.5	5.1	5.0	6.7	4.5	3.6	**5.7**	2.6	8.4
1973–80	4.3	3.4	3.3	3.3	2.5	2.3	**3.0**	**1.0**	2.7
1981–90	2.3	2.9	1.6	2.0	**1.0**	2.2	**2.1**	**1.5**	3.0
1991–00	2.4	1.3	2.4	2.0	**1.1**	2.2	**2.2**	**1.6**	2.0
1991–95	2.3	1.5	3.2	3.1	**1.1**	2.6	**2.3**	**1.1**	1.8
1996–00	2.5	1.1	1.6	0.8	**1.1**	1.8	**2.0**	**2.0**	2.3

* Rows 1–4: West Germany; row 5: United Germany.
† Excluding Luxembourg.

Source: Computed from Groningen Growth and Development Centre data (www.eco.rug.nl/ggdc/).

Table 7.2 Employment elasticities of major OECD countries: the percentage increase of labour hours if GDP grows by 1%

	B	*F*	*D**	*I*	*NL*	*UK*	*EU-14*	*USA*	*Japan*
1950–60	−0.05	−0.13	0.19	0.48	0.10	0.31	**0.07**	−0.03	0.34
1960–73	−0.11	0.06	−0.22	−0.26	0.07	−0.16	**−0.09**	0.39	0.13
1973–80	−0.63	−0.34	−0.47	0.07	−0.05	−1.15	**−0.15**	**0.60**	0.19
1981–90	−0.22	−0.24	−0.19	0.09	**0.57**	0.18	**0.12**	**0.55**	0.25
1991–00	−0.12	0.26	−0.44	−0.27	**0.61**	0.03	**0.13**	**0.51**	−0.35
1991–95	−0.50	−0.38	−1.00	−1.44	0.49	−0.57	−0.47	0.52	−0.26
1996–00	0.09	0.54	0.07	0.54	0.68	0.37	0.41	0.50	−0.44

* Rows 1–4: West Germany; row 5: United Germany.

Source: Groningen Growth and Development Centre data (www.eco.rug.nl/ggdc/). Elasticities are computed as GDP growth minus hourly labour productivity growth divided by GDP growth.

During the 1980s and 1990s, GDP growth in the USA was above the EU average while growth in the Netherlands was almost equal to EU growth (see Table 7.3). However, in both countries GDP *per working hour* grew substantially slower than the EU average (see Table 7.1). This implied that labour hours had to grow much faster. The latter is reflected in Table 7.2. During the 1980s and 1990s, a 1 per cent increase of GDP coincided with 0.12 per cent (or 0.13 per cent) growth of labour hours in the EU; but the same 1 per cent GDP growth in the USA and in the Netherlands lead to 0.51–0.61 per cent growth of labour hours. This labour-intensive growth is just the flip side of the crisis of labour productivity growth visible in Table 7.1. In other words, the powerful and often admired job machine in the USA and in the Netherlands coincides with a severe decline of labour productivity growth. Obviously,

Table 7.3 Gross domestic product, 1996 prices (in national currencies; average annual growth rates)

	B	*F*	*D**	*I*	*NL*	*UK*	*EU-14*†	*USA*	*Japan*
1950–60	3.0	4.6	7.7	6.1	4.6	2.7	**4.5**	3.5	8.8
1960–73	4.9	5.4	4.1	5.3	4.9	3.1	**5.2**	4.3	9.7
1973–80	2.7	2.5	2.3	3.5	2.4	1.1	**2.6**	2.6	3.4
1981–90	1.9	2.4	1.4	2.2	2.2	2.7	**2.4**	3.2	4.0
1991–00	2.1	1.8	1.7	1.6	2.8	2.2	**2.5**	3.3	1.5
1991–95	1.5	1.1	1.6	1.3	2.1	1.6	**1.6**	2.4	1.4
1996–00	2.8	2.5	1.7	1.8	3.6	2.8	**3.5**	4.1	1.6

* Rows 1–4: West Germany; row 5: United Germany.
† Excluding Luxembourg.

Source: Computed from Groningen Growth and Development Centre data (www.eco.rug.nl/ggdc/).

behind this low-productivity–high-employment growth path are a lack of modernization of capital stock and a slow introduction of labour-saving technology, and questions can be raised about its long-run sustainability.

In the following, we give theoretical arguments why, in our view, reduction of wage-cost pressures are at the heart of the productivity crisis in the USA and in the Netherlands.

7.2.4 Theoretical arguments

Various parts of economic theory suggest that a causal relationship exists between wage growth on the one hand and innovation and labour productivity growth on the other, notably:

1. In standard *neoclassical theory*, an increase in the relative price of labour leads to substitution of capital for labour. Causality in this argument runs from relative factor prices to choice of technique and hence productivity.
2. In *vintage models*, wage increases lead to scrapping of old, labour-intensive vintages of capital in favour of new and more productive vintages.
3. In the theory of *induced technological change*, higher relative wages increase the labour-saving bias of newly developed technology.
4. In the *Schumpeterian theory of creative destruction*, one can argue that, due to their monopoly rents from innovation, innovating firms can live better than others with an aggressive wage policy by trade unions. Higher real wage growth enhances the process of Schumpeterian 'creative destruction' in which innovators compete away technological laggards. Conversely, slow wage growth and flexible labour relations increase the likelihood of survival of low-quality entrepreneurs. While this is favourable for employment in the short run, it leads to a loss of innovative dynamism in the long run (see Kleinknecht, 1998).

5. According to *Schmooklerian demand-pull theory* and the *Verdoorn–Kaldor law*, higher effective demand raises innovative activity and labour productivity. This implies that wage restraint or downward wage flexibility can impede innovation as far as they lead to a lack of effective demand (Brouwer and Kleinknecht, 1999).

Some of these theories point to a direct link between wages and labour productivity growth. Others, such as the 'creative destruction' argument, suggest that overall innovation activity may slow down in response to lower wage-cost pressure. These pieces of theory may contribute to explaining that, during the 1970s up to the mid-1990s, US labour productivity growth was appreciably below European standards. They also explain why, from the mid-1980s onwards, labour productivity growth in the Netherlands declined to about half of the EU average (see also Naastepad and Kleinknecht, 2004, for a more detailed empirical assessment). In the USA, the ICT boom induced a rise of labour productivity growth during the second half of the 1990s. It has been argued, however, that this rise is confined to the ICT sector itself and to closely related sectors. The broad range of classical manufacturing and service sectors (the 'old economy') continues to experience a productivity crisis (Gordon, 2000).

In addition to the above arguments about the influence of wage-cost pressure on innovation and productivity, one can argue that flexibilization of labour relations itself might have a negative impact on innovation. Of course flexible hiring and firing and a high labour turnover might also favour a firm's innovation performance: firms can more easily replace unproductive workers by more productive ones, and a larger inflow of fresh people may enrich the pool of a firm's innovative ideas and open up new networks. But highly flexible labour also has disadvantages. For example, high rates of labour turnover may diminish social cohesion and trust and increase the danger of moral hazard and opportunistic behaviour. In other words, such flexibility will diminish social capital, forcing firms to invest in extra monitoring and control. Moreover, the so-called 'hold up' problem may become more relevant: as labour relations are (expected to be) of shorter duration, employers and employees may hesitate to invest in the labour relation (for example training, investment in firm-specific knowledge, networks, trust and so on). High mobility of labour increases the probability that one cannot (fully) appropriate the benefits of such investment.

Flexible and short-run labour relations may also favour the leaking of trade secrets and of technological knowledge, thus discouraging investments in R&D and innovation. In other words, high flexibility of labour may aggravate the problem of market failure due to positive externalities. This may be particularly harmful for innovative and knowledge-intensive firms. Moreover, the quality of services may also suffer from a high personnel turnover since frequent changes of personnel may cause problems of

Table 7.4 Growth of value added (GDP) per working hour and the growth of hours worked per 1% GDP growth (average annual percentage changes)

	Growth of GDP per working hour			*Employment elasticities of GDP growth (growth of working hours divided by GDP growth)*		
	*EU-14**	*NL*	*USA*	*EU-14**	*NL*	*USA*
1950–60	4.2	4.2	3.6	0.07	0.10	−0.03
1960–73	5.7	4.5	2.6	−0.09	0.07	0.39
1973–80	3.0	2.5	**1.0**	−0.15	−0.05	**0.60**
1981–90	2.1	**1.0**	**1.5**	0.12	**0.57**	**0.55**
1991–00	2.2	**1.1**	**1.6**	0.13	**0.61**	**0.51**
1991–95	2.3	1.1	1.1	−0.47	0.49	0.52
1996–00	2.0	1.1	2.0	0.41	0.68	0.50

* EU, excluding Luxembourg.

Source: Computed from Groningen Growth and Development Centre data (www.eco.rug.nl/ggdc).

information transfer between people leaving the firm and people coming in. A firm's historical memory may become weaker. Such arguments also contribute to explaining the pattern of low growth of labour productivity in the 'old economy' of the USA and in the Netherlands as summarized in Table 7.4.

Summarizing the above, one can argue that more flexible labour markets and the reduction of wage-cost pressure may indeed work as neoclassical theory predicts: they may lead to higher job growth. However, they do so at the expense of innovation and labour productivity growth. One should remember that an economy can grow only in two ways: (1) either by working more hours or (2) by producing more value added per hour worked (that is by technical change). Hence the two parts of Table 7.4 are just two sides of the same coin: a low growth of GDP per hour worked (that is low labour productivity growth) in the Netherlands and in the USA coincides with a high growth of numbers of hours worked per unit of GDP growth. If you are not intelligent (in using technical change), you have to work harder.

Why should we be concerned about this? First, it is obvious that low productivity growth is essentially caused by a lack of modernization of capital stock, that is by a slow speed of adoption of labour-saving technology. This will make the economy vulnerable in the long run: technologically backward factories are the first to be closed down in times of prolonged recessions.

Second, the highly labour-intensive growth path may lead to labour scarcity. For example, around the year 2000, the labour market in the Netherlands became tight, causing upward wage pressure. Dutch trade unions tried to keep wage increases modest. However, employers paid many

people above the level determined in collective wage agreements. Scarcity of labour forced them to do so. This caused problems, as wage increases were not immediately matched by higher labour productivity growth. In principle, such a problem might become relevant for every development model that competes on low factor costs rather than on quality and innovation: if successful, certain factors of production will become scarce; scarcity will drive up factor prices and the model becomes self-destroying. In the future, this may become relevant for the Irish model.

7.2.5 Shorter working time

Mainstream economic think tanks again and again propagate that achieving more flexible labour markets should solve the European unemployment problem. Unfortunately, this is no free lunch. The examples of the USA and the Netherlands show that flexibilization of labour markets and sacrificing wage increases indeed have led to higher job growth, but this job growth was hardly due to higher overall GDP growth. It came mainly from lower GDP growth *per hour worked*, which required many more hours to be worked in order to achieve the same GDP growth as the neighbouring countries.

The employment elasticities in Table 7.2 indicate that there have been periods when GDP growth contributed only modestly to the growth of labour hours in Europe. In the 1960s and 1970s, labour productivity growth was even so high that high rates of GDP growth were accompanied by a slightly *negative* growth of total labour hours in various countries. In principle, jobless growth does not need to be a problem. If a high speed of labour-saving technical change allows the production of more value added with little or no extra labour input, it is an almost natural solution to use labour productivity gains for a collective shortening of standard working hours, rather than for wage increases. In principle, this does not need to cost more money to the firms than keeping labour hours constant and increasing real wages.

This requires a social pact between trade unions and employers. Such a pact might commit both parties to use large parts of the annual labour productivity gains for the financing of reduced labour times rather than for increased real wages. If the entire labour productivity gains were used for financing shorter standard working hours, we would obtain an extremely labour-intensive growth path. Each 1 per cent increase in GDP would translate into a 1 per cent increase of labour hours. This would be a more intelligent solution to the unemployment problem than the Dutch and US way: creating jobs by reducing wage-cost pressures and thereby giving negative incentives to labour-saving technical change.

7.3 Labour market policies in the EU

This second section looks at the role of the EU in helping to shape and coordinate national labour market policies. It argues that, in spite of some

positive elements, EU strategies themselves are dominated by the same negative flexibility agenda as prevails at member state level.

7.3.1 The scope of EU labour market policy

Labour market policies are a field in which most competence remains with the member states, except for those rules, such as the free movement of workers and equal treatment of all EU nationals, which are necessary for the process of economic integration. But even here there is a big gap in EU labour market rules in that migrant workers from outside the EU are not permitted to circulate freely among member states.

Beyond these market rules, the EU impacts on member state labour market policies in two main ways. There is, firstly, legislation establishing minimum standards in employment practice and secondly, an attempt to coordinate member state labour market policies through the European Employment Strategy (a key example of the 'open method of coordination'). Each of these EU interventions will be examined, but with most emphasis on the second.

7.3.2 EU employment law

Since the Treaty of Rome, the EU and its predecessors have had a certain competence in the promulgation of labour law. An important motive behind EU legislation has been to restrict competition by reductions in labour standards. One field of such legislation was gender equality; a second, reinforced by the Single European Act of 1986, has been health and safety at work, introducing EU-wide maxima for hours worked. Since the Treaty of Maastricht, more themes for labour legislation have been provided by the Social Chapter of that treaty, which permits labour legislation by unanimity and, in a few cases, by qualified majority vote among the member states. The Social Chapter also gives legal force to certain EU-wide agreements between employers and employees, although, in practice, employers' representatives have not been prepared to enter into such agreements unless they were threatened by legislation to be introduced by the classical route of the Council of Ministers and the Parliament. In recent years, EU labour legislation has focused on various aspects of the flexibility agenda and has sought to introduce minimum standards for the regulation of 'atypical' employment contracts.

In general, this body of law makes a contribution to social Europe by signalling the EU's interest in better working conditions. However, the legislation is in general weak; its standards place fewer constraints on employer practice than already exist at member state level in most northern European countries. There is therefore a danger that EU legislation may actually give legitimacy to 'atypical' work. Nonetheless, employers continue to challenge those laws. For example, under pressure from the employers, the Commission has recently sought to dilute the Working Time Directive, by amendments that would allow raising the maximum work week from 48 to 65 hours in some cases (European Commission, 2004b).

Moreover, in those countries where EU legislation does promulgate standards higher than those set by national regulation, there are problems of enforcement. In Britain, as well as in some poorer countries, serious violations of EU labour law are a matter of routine. Where trade unions are weak, such violations are difficult to avoid.

There are limits to the use of legislation to advance working conditions and labour standards that arise from the very different levels of economic development of the member states and from the diversity of their social histories. Nevertheless, the actual labour law of the EU can be criticized both for its lack of ambition and for inadequate enforcement.

7.3.3 The 'European Employment Strategy' (EES)

Since 1997 the EU has been involved in the labour market policies of member states through the 'European Employment Strategy' (EES). The EES leaves competence for policy in the hands of member states but interrogates and seeks to coordinate national policies by an iterative process: each year policies are examined at EU level; recommendations for improvements are made in the form of 'National Action Plans' (NAPs); member governments are required to report back and the cycle is then repeated. This is an example of the 'open method of coordination'.

Coordination objectives are expressed in various targets for the EU labour market as a whole, as well as for individual countries. These targets centre on overall employment rates but also include employment rate targets for women and other groups and for the levels of intervention in support of the unemployed. Several dimensions of labour market policy are included; however, a great deal of emphasis has been placed on 'active employment measures'.

In 2002, the Commission undertook a comprehensive review, which has led to certain changes (see Watt, 2004), putting less emphasis on the revision of NAPs and more on their implementation. Plans will only be subject to basic revision every three years. The number of recommendations is to be reduced, and the quantitative targets associated with the EES have been reformulated.

The first formulations of the EES were heavily influenced by the newly elected Labour government in Britain, itself influenced by US approaches to unemployment and the employment initiatives of the Clinton administration. In accordance with the flexibility agenda, improvement of employment outcomes was seen as a matter of increasing incentives for labour market participation, of reducing labour market regulation and of adapting the characteristics of job seekers to the requirements of employers.

The first specification of the EES reflected this approach. The four 'pillars' of the strategy were employability, developing entrepreneurship, adaptability and gender equality. Of course, no objection can be made to the last of these, nor to training measures related to employability. The other pillars, however, corresponded to the 'flexibility' agenda. The language used is often

deliberately ambiguous, but governments have been encouraged to tighten constraints on the unemployed, to reduce levels of social protection and to lower regulatory standards in employment. The 2003 recommendations to the Swedish government offer a particularly absurd example of this procedure. Sweden already more than meets the EU's targets for employment and female participation. Nevertheless, the Swedes are enjoined to cut payroll taxes in order to improve the incentives to work.

In spite of these biases in the EES, there have, from the start, been other interpretations of the strategy. Trade union representatives, progressive governments and some forces within the Commission, have stressed the interventionist aspects of the EES. They have emphasized the qualitative side of employment relations and challenged the deregulatory and inegalitarian thrust of the 'flexibility' agenda. Over time, these pressures have brought about significant modifications of the strategy. The four-pillar schema was replaced by ten broad principles, which give a more balanced and comprehensive view of employment policy reform. In particular, the requirement for social dialogue has been strengthened, as has also the concern with the quality of new jobs. Another generally positive feature of the EES has been a concern to improve the position of immigrant and ethnic minority workers.

One important issue is the nature and the use of 'active employment measures'. In general these consist of programmes of work experience or training which are meant to complement or replace the mere ('passive') allocation of unemployment indemnities. Although the deliberately ambivalent language used in the employment guidelines disguises the fact, 'active' policies follow two completely different logics. On the one hand there are the types of intervention found in the Nordic countries as far back as the 1960s. These might be described as solidaristic interventions in favour of the unemployed. On the other hand there are measures that derive from the Anglo-Saxon notion of 'workfare'. These are primarily modes of social discipline, or even of social punishment.

There are other signs of a more positive trend in the EES. The Commission's own empirical studies have indicated that the reduction of legal constraints on dismissals does little or nothing to increase employment (see Directorate-General for Employment and Social Affairs, 2002, pp. 57–61, 'The Role of Temporary Contracts'). Hence this theme seems to be disappearing from the strategy. On the other hand, the EES has done little or nothing to challenge the attack on labour standards, which is currently taking place in Germany (see Grahl and Teague, 2005). The Commission claimed, in its review, that the EES has had a significant impact on the formulation of labour market policies in the member states. But it is not clear that any major change in the direction of member state policies has yet taken place.

Finally, even if the EES in future takes a more positive direction (which is not guaranteed) the strategy as such cannot be a full response to employment problems in the EU. It is in fact misnamed, being a labour market strategy

rather than an employment strategy since it has no macroeconomic dimension.

The 'macroeconomic dialogue', bringing together the social partners with officials from the Commission and the ECB, offers in principle a way of correcting the macroeconomic policies of the EU and of aligning them more closely with employment objectives.[2] In practice the dialogue has not modified in any way the dogmatic conservatism of the Central Bank or the equally dogmatic commitment of the Commission to restrictive, often pro-cyclical, fiscal policies.

7.4 Conclusion

In Chapters 15 and 16, the importance of macroeconomic policies to the achievement and maintenance of higher growth is insisted on. The present chapter makes complementary arguments in a labour market context. Firstly, the employment elasticities in the above tables indicate that 'more growth' is of limited relevance to job creation. According to the Verdoorn law, higher GDP growth will coincide with higher growth of GDP *per working hour*. Historically, impressive GDP growth has been achieved with only little (and sometimes even negative) growth of hours worked. Clearly, GDP growth is still relevant for the viability of the welfare state (and for many of the proposals made in the second part of this book). However, full employment is achieved more readily by shorter standard working times. Secondly, we criticized the labour market flexibilization agenda. We argued that flexibilization of labour markets, lowering of labour standards and reduction of wage-cost pressure can be associated with impressive job creation. However, this is achieved at the expense of economic dynamism because innovation and productivity growth are impaired. Thirdly, our assessment of the EES detected some positive elements but in general it is found that the EU tends to follow the flexibility agenda.

Notes

1. Of course, besides economic doctrine, powerful economic interests have also supported these policies.
2. Such were the original interventions of Oskar Lafontaine, never realized in practice (see Dufresne, 2002).

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8 Europe's Environment in Bad Shape[1]

8.1 Introduction

During recent decades the environment in the EU has deteriorated greatly, as has the global environment. Many indicators, provided by the EU, by official international organizations and institutions and non-governmental organizations (NGOs), support this statement. The loss of biodiversity, for example, continues at an unprecedented speed. The degradation of forests, desertification and the loss of fertile soil continue. The supply of clean water declines in tandem with the pollution of the oceans and of freshwater reservoirs. The use of land for production sites, urban enlargements, waste disposal and above all transportation has increased considerably. Already shrinking natural spaces are therefore diminishing further. The main trend to individualization in transportation (cars) and housing (single apartment) has not been halted, so that formerly natural spaces are continuously and inevitably being transformed into artificial economic spaces. Last but not least, the greenhouse effect has not been stopped in spite of many endeavours to reduce greenhouse gas (GHG) emissions. In October 2004 leading scientists expressed concern about an unexpected CO_2 rise in the atmosphere measured by the Mauna Loa observatory in Hawaii for 2002 and 2003. 'The sinister aspect of the most recent peak … is that it may represent the beginnings of a feedback …' (*The Independent*, 11 October 2004).

This chapter seeks to give an overview of economic pressures on the environment and of the policy responses of the EU. It explains how EU environmental policies are embedded in global agreements. It also examines three particularly important environmental policy fields: energy supply, climate change and (agro-)biodiversity. Alternatives to current governance of the environment are addressed in Chapter 21.

8.2 Survival, inefficiency and lifestyle pressures on the environment

Economic actors, production and services (firms) as well as consumption (households) and circulation (transportation and communication), exert pressures on natural spheres, that is on the air, water, land, soils, on material, energy and living resources (the biosphere). Ecological pressures depend largely on (social) patterns of the organization of labour and life. Therefore, we should distinguish between (1) *survival pressures* on nature which can only be reduced to a minor extent, (2*) inefficiency pressures* which can be reduced by technological and organizational improvements in production, consumption and transportation, and (3) *lifestyle pressures* which grow with people's living standard and the shift to 'American' consumption patterns. An analysis of CO_2 emissions in the EU-15 clearly shows that between 1990 and 2002 CO_2 emissions due to higher income increased by 19.8 per cent, whereas CO_2 emissions due to a change of the energy mix and energy intensity decreased by 9.8 and 12.3 per cent respectively (Ziesing, 2004, p. 534).

Resources are tapped as inputs for the economic process, and they are in the course of the process emitted into the natural sphere. All production is 'joint production' because the result not only consists of the intended product, but also of the unintended side product, of 'external effects', mostly external diseconomies. They make use of the 'carrying capacity' of the 'environmental space'. This carrying capacity of the environmental space eventually shrinks. Many indicators are alarming. On to waste management, the Irish presidency of the Council in May 2004 declared that 'total waste quantities are continuing to grow across Europe and overall waste generation has been decoupled from economic growth only in a minority of European countries' (Informal Meeting, 2004). The same critical assessment could be made with regard to CO_2 emissions, the quality of water, marine fish resources, (agro-) biodiversity, the built environment, noise pollution and so on.

8.3 The precautionary principle and other guidelines of European environmental policy

An important aspect of the societal relation to nature is information about the impact of economic activities on the environment. This knowledge is in principle uncertain and incomplete. Data are often conflicting and interpretations are contested by different social groups and scientific paradigms. Only a *holistic endeavour* of integrating environmental aspects into economic policy discourse enables a coherent understanding of environmental problems and can give adequate political responses to the ongoing ecological crisis. Therefore the foundation of the European Environment Agency (EEA) in 1990 was an important step to improve environmental knowledge.

Based in Copenhagen since 1994, the EEA is the hub of the European environment information and observation network (Eionet) of some 300 European institutions, which collect and disseminate environment-related data and information. Although an EU body, the Agency is open to all nations that share its objectives.

Another major step forward is the introduction of the precautionary principle. The Rio Declaration of Environment and Development (1992) stipulates that, where there are 'threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation' (Principle 15 of the Rio Declaration). In 1989 the EC referred to this principle when it banned imports of US hormone-fed beef, and in the Lisbon strategy of 2000 the EU adopted the principle. Since then the precautionary principle has been an important guideline of European environmental policy. A central element of precaution is the application of the 'polluter pays principle' in environmental policy (Climate Protection Programme, 2004). The EU as one of the world's largest polluters therefore carries particular responsibility.

On a European level, environmental regulations date back to the early 1970s. However, a breakthrough only came in 1987 when the Single European Act added a title to the Treaty establishing the European Community specifically defining guiding principles of European environmental policy and creating a legal basis for environmental measures (art. 130r–130t). In 1992, the importance of environmental policy for the protection of natural resources, the conservation of biodiversity, and the protection of the atmosphere was underlined by the Conference of the United Nations on Environment and Development (UNCED) in Rio de Janeiro. It must be interpreted as a landmark that for the first time new mechanisms of policy coordination were set up under the label of 'global governance'. This is an attempt to overcome the incongruence between the deterioration of the global (and regional) environment and the politics of the international system of nation states and international organizations by setting up a much broader approach to politics than in the tradition of international relations (Brunnengräber, 2000). Since then, environmental policy is interlinked with other policy areas. Moreover, it includes new actors in the arena of policy formulation, private corporations as well as civil society organizations (CSOs) or non-state actors (NGOs); and it is reshaping political processes by transforming them into multi-level politics and by setting up networks of policy coordination. This is valid also on the EU level.

The growing awareness of political actors with regard to the environment has been fostered or even enforced by new social movements against the degradation of nature – from the local campaigns against the construction of motorways to international protest against trans-European transports of nuclear waste and the movements against nuclear power plants and against air pollution and acid rain causing dying woods (*Waldsterben*). At the end of

the 1970s the German Green Party was founded as a forerunner of other European green parties, which brought environmental issues to the regional and national level and lastly also to the European Parliament, the Council and the Commission. Meanwhile green parties are well established and other traditional parties after some hesitation since then have integrated 'green issues' into their programmes and activities. In July 2004 the principles of environmental protection were included in the Treaty establishing a Constitution for Europe (art. 3, 3). In part II of the Treaty 'a high level of environmental protection and the improvement of the quality of the environment' is determined to be integrated into the policies of the Union and 'ensured in accordance with the principle of sustainable development' (art. II, 97).

The *first* guideline follows from the basic assumption of a possible reconciliation of economic efficiency, ecological sustainability and social cohesion. The idea behind this 'triad' is rather simple: sustainability in a comprehensive sense cannot be defined only with regard to the economy or the environment or the social system, respectively. It has to meet, concomitantly, ecological, social and economic requirements in a balanced and coordinated manner. Contradictions between economy and ecology can be resolved by means of an appropriate economic, social and environmental policy.

The *second* basic assumption is that 'win–win solutions' with regard to the environment and the economy are possible. The environment is conceived as a key component of the economic and social policy of the EU because neglect of the environmental dimension has consequences in terms of 'hidden costs', such as health costs due to bad air quality and economic costs for filters and other devices for a reduction of pollution 'at the end of the pipe'. The Commission fears that the Lisbon objectives can be jeopardized by these costs. Therefore, environmental policy action is necessary in the framework of policies aiming at increasing competitiveness.

The *third* principle is the improvement of efficiency. The promise to resolve the environmental problem through a considerable increase in technical efficiency is a simple and broadly convincing approach. Of course, technical improvements are important to mitigate the pressures on the environment. However, a mere increase in efficiency is insufficient given the extent of ecological degradation and the rebound effects, that is the trade-offs from increasing lifestyle emissions. Although different areas of environmental policy (a higher share of biologically produced agro-products; increase in the shares of renewable energy; more awareness of ecological problems and so on) have been successful, the general state of the environment in the EU is worsening, if not precarious.

Fourthly and contrary to the principles already mentioned, there is some insight into the complexity of intertwined policy fields. The Commission correctly argues that environmental issues shall become integrated into other policy fields, from energy policy to transportation and agricultural

policies and so on. It thus acknowledges an integrated, even 'holistic' approach to environmental issues, the need for an 'integrated approach to environmental policy' in order to isolate the unsustainable environmental trends of European and global developments.

A *fifth* guideline is that environmental policy should have positive effects on employment. In a report on 'Environmental technology for sustainable development' (from 13 March 2002), the Commission asserts that the economic performance of industries related to environmental technology is better than average. Environmental industries offer 2.5 million working places. Also the quality of employment in environmental industries is above average. Environmental policy can also be considered as relevant to a progressive redistribution policy. Ecological industries are research intensive and therefore demand highly qualified labour.

The *sixth* principle is derived from the assumption that the best instruments of environmental policy are provided by the market. Therefore external effects should be internalized so that 'prices tell the truth'. The main instrument of reducing GHG emissions is emissions trading. Market-based flexible instruments, the Commission concludes, should be used in order to stop negative climate effects and other environmental evils. However, the internalization of external effects is not always possible because our knowledge on the extent of externalities is uncertain. Moreover, damage to nature can perhaps be calculated but it simply is not reversible.

8.4 The environmental implications of EU enlargement

The institutional and financial aspects of environmental policy are part of the *acquis communautaire* which new members have to fulfil in the coming years. However, the integrated environmental policy approach leaves out the negative effects of the inevitable transformation of rural areas in central and eastern Europe in the course of their modernization, enforced by the CAP or by an increase of transport due to the extension of markets and the growth of trade. The lifestyle of central and eastern European citizens will change and therefore income-dependent 'clean' lifestyle emissions will increase. On the other hand, 'dirty' survival and inefficiency pollution without any doubt will decrease. The 'rebound effect' also works in the accession countries: air pollution by old vehicles without catalysers will be reduced by an inevitable modernization of the motor vehicle fleet, whereas non-visible and therefore 'clean' CO_2 pollution will increase due to an intensification of traffic.

During the decade following the 'velvet revolutions' in central and eastern Europe and the dissolution of the Soviet Union the CEECs experienced a dramatic downsizing of their industries, with a considerable decrease of GNP. A positive consequence of this negative development was a considerable reduction of GHG emissions of on average 24.6 per cent. Manufacture, construction and energy production account for most of this reduction; the

only sectors which exhibited an increase of CO_2 emissions were transport and services (Ziesing, 2004).

8.5 Conflicts on energy security, collapsing climate, fading biodiversity

Firstly we discuss energy security. This is a main political target in Europe and elsewhere due to the importance of energy resources for economic development. Fossil energy, above all oil, is still the most important form of energy and therefore the energy question is largely the question of oil. Secondly, we discuss the implications of the greenhouse effect and climate policy as an outstanding example of the pressures exerted on natural sinks by the combustion of fossil energies and of policy responses on a global and European level, resulting in new modes of global and regional governance, respectively. Thirdly, we discuss the consequences of diminishing biodiversity and European policy responses to these challenges.

8.5.1 Cornerstones of European energy policy

Since planet Earth is limited, the stocks of mineralized energy are also limited. The limits, however, are not objectively determined. They depend, first, on knowledge about reserves and resources, second on the cost–benefit analysis of reserves to be extracted, and third on the dynamics of the market for fossil fuels and therefore on the formation of prices. The latter predominantly depends on alternative, that is renewable energies, which could replace fossil resources. However, the share of fossil fuels (coal, oil, natural gas, nuclear energy) in total primary energy supply has been nearly constant since the 'first oil price shock' of 1973 (87 per cent 1973 and 86.4 per cent 2001), and the share of renewable energies therefore stagnated during the last three decades on a low level of around 10 per cent (IEA, 2003).

Another important factor is the development of demand in industrialized countries, and above all the impact of further industrialization of those parts of the world which until today mostly relied on agriculture, such as big newly industrializing countries like India and China. In 1973 Asia (including China) had a share of total final consumption of energy of 10.9 per cent. In 2001, China alone held a share of 11.4 per cent and Asia (without China) another 11.8 per cent (IEA, 2003). Indian industrialization will probably accentuate this tendency.

The main advantages of fossil energies as against other primary energies consist in their congruence with the logics of capitalist development:

1. They can be used without considering space and place, for it is comparably simple to transport energy resources anywhere in the world.
2. Unlike solar radiation, which changes its intensity at day and at night, in summer and winter, fossil energies can be used 24 hours a day and 365 days

a year with constant intensity. They allow the organization of production processes independent of social time schedules, biological and natural rhythms.

3. Fossil energies allow extreme acceleration of processes, that is the 'compression of time and space' and thus an increase of productivity.
4. Fossil energies can be used very flexibly.

Now, managerial decisions can follow the logics of the capitalist firms without taking into account energy restrictions or spatial and temporal necessities. Therefore, accumulation and growth – and economic competitiveness – are perceived as increasingly independent of natural conditions and limitations, although the negative effects of fossil fuel combustion are more and more recognized.

Since the 1990s the peak of oil production in relation to new reserves ('peak oil') in many oil regions has been reached or even crossed: the amount of new oil reserves found is lower than the annual increase of oil production, so that the temporal reach of oil supply inevitably is declining. Nobody knows exactly when oil and gas fields will be depleted but it is sure that this will happen in a few decades.

In the long run the supply of oil cannot increase as fast as demand, if the whole world follows the production and consumption pattern of the industrialized countries. New oil consumers crowd into the market. China and India alone are responsible for three-quarters of the additional oil demand in 2004. Therefore the likelihood of increasing oil prices in the future remains high. The tendency of increasing oil prices is reinforced by high demand from the developed OECD countries as well.[2] The consumption of fossil energies is still growing because the energy hunger of the industrialized countries is almost insatiable.

The world energy demand is projected by the EU Commission (WETO, 2003, p. 3):

> The world energy system will continue to be dominated by fossil fuels with almost 90% of total energy supply in 2030. … Nuclear and renewable energies would altogether represent slightly less than 20% of EU energy supply.
>
> Given the continued dominance of fossil fuels, world CO_2 emissions are expected to increase more rapidly than the energy consumption (2.1%/year on average). In 2030, world CO_2 emissions are more than twice the level of 1990. In the EU, CO_2 emissions are projected to increase by 18% in 2030 compared to the 1990 level. …

The report of the Commission optimistically concludes that

> sufficient oil reserves exist worldwide to satisfy the projected demand during the next three decades. However, the decline in conventional oil

> reserves may constitute a preoccupying signal beyond 2030. It is only partly compensated by an increase in the reserves of non-conventional oil. The reserves of natural gas are abundant and expected to increase by around 10%. There is no constraint on coal reserves over this time horizon. (WETO, 2003, p. 3)

The latter, however, very likely is wishful thinking. In any case, oil reserves will run out in three to five decades and therefore preparations for a transformation of the energy system must be undertaken. A precautionary energy policy, therefore, is obliged to pay more attention to renewable energies, and consequently to related research and development. In the field of energy policy the Commission, furthermore, prefers energy efficiency to the massive substitution of fossil energy consumption by renewable energies. In the final report on the Green Paper *Towards a European Strategy for the Security of Energy Supply* from 2002 the Commission writes that

> The European economy, steadily demanding more and more energy, is essentially based on fossil fuels (oil, coal and natural gas), which make up four-fifths of its total energy consumption and almost two-thirds of which it imports. Natural gas from Russia alone represents nearly 20% of our consumption. The EU's own energy supply covers about half of its needs. If nothing is done by 2030 the share of fossil fuels is going to increase. Energy imports will be much higher in 30 years' time, amounting to 70% of total needs. 90% of oil is likely to be imported. [The] current energy demand is covered by 41% oil, 22% gas, 16% coal (hard coal, lignite and peat), 15% nuclear energy and 6% renewables. … If nothing is done, the total energy picture in 2030 will continue to be dominated by fossil fuels: 38% oil, 29% gas, 19% solid fuels, 8% renewables and barely 6% nuclear energy.[3] (European Commission, 2002)

A major objective of energy policy is a doubling of the share of renewables in the EU energy mix. But the predominance of fossil and nuclear fuels remains. The Commission also does not seem to believe in a 'sufficiency revolution' (European Commission, 2002, p. 2), that is in the change of consumption patterns in households and production patterns in the economy. It is very doubtful whether this self-constraint will be helpful for the achievement of the targeted improvement of the natural environment in Europe. Future dependence on increased imports of oil is highly conflict-prone, since other oil-importing countries also have to increase their import share of oil and gas (USA, China, India, Japan and so on).

In 1973 the oil-exporting countries only had one alternative when the inflation rate in the USA increased and the US dollar depreciated vis-à-vis other currencies: oil-exporting countries could not change the currency, but only increase the oil price. In oil-importing countries this increase was

experienced as a 'shock'. Thirty years on, however, the situation has changed, because an alternative currency exists: the euro. The loss of value of the US dollar vis-à-vis the euro and the huge twin deficit of the USA are factors which make the euro more attractive for oil exporters as an oil currency. Moreover, this option could also become attractive for those countries with huge US dollar reserves, particularly Asian countries. These currency reserves are threatened with losing part of their value as a consequence of a possible devaluation of the US dollar, so that the strategy of these countries will probably be to switch slowly to alternative currencies, above all the euro, without creating turbulence on currency markets. Declarations of senior officials of the People's Bank of China to increase the share of the euro in its reserves go in this direction. However, the share of the euro in reserves of Asian central banks today is only 6 per cent, so that the move to the euro should not be overstated (Solans, 2004, p. 12). The likelihood of this switch is the greater, the more the twin deficit of the US budget and of the current account rises. Thus, on the horizon of the disputes on energy security appears a harsh conflict between the US dollar and the euro, between North America and Europe.

8.5.2 Climate policy and climate conflicts

One major result of the combustion of fossil energy is an enormous increase in greenhouse gas emissions and hence the warming of the atmosphere. According to the Intergovernmental Panel on Climate Change (IPCC, 2001), the average global temperature rose by approximately 0.6 °C during the twentieth century. The average surface air temperature is expected to rise 0.4–5.8 °C by 2100 relative to 1990, and the sea level is projected to rise 0.09–0.88 m by the same year.

The consequences of global warming are serious even today. The insured losses during the tropical storm and hurricane season in the Atlantic and Caribbean in 2004 range between US$20 and 42 billion (*Financial Times*, 1 December 2004). The number of weather- and climate-related disasters in the world has more than tripled in the last decade compared to the 1960s. The average cost is estimated at around US$333.7 billion per decade (Table 8.1 – Munich Re Group, 2003).

The EEA is also collecting the numbers of natural hazards, which are not at all natural, but mostly human-made. It is quite obvious that the frequency of hazards has increased in recent years, indicating a deterioration of the environment and a resulting increase of costs. In the future it is very likely that the costs of climate-related disasters will grow. The annual costs of the greenhouse effect have been predicted to reach US$2000 billion in the middle of this century. Asia has to bear US$840 billion, the USA US$325 billion, Europe US$280 billion and so on (Kemfert, 2004).

One of the worst scenarios of climate change paradoxically has been presented in a study commissioned by the Pentagon and carried out

Table 8.1 Costs of natural disasters related to the greenhouse effect. Damage in billion US$ (in values from 2002)

Decade	*1950–59*	*1960–69*	*1970–79*	*1980–89*	*1990–99*	*1993–2002 last 10 years*	*Increase from the 1960s to the 1990s (%)*
Number of events	13	16	29	44	74	58	360
Economic damage	41.1	54.0	81.5	128.4	432.2	333.7	620
Insured damage	–	6.0	11.9	23.6	99.7	60.1	1000

Source: Munich Re Group (2003).

by P. Schwartz and D. Randall (2003) of the Global Business Network. Since global warming does not have equal effects in all parts of the world, the regions of the world may exhibit different patterns of climate change. Thus, some regions may even be hit by colder periods in the near future because of the changing global air and water circulation. When the temperature rise causes a melting of the Greenland ice sheet the Gulf Stream may change its direction due to the lower density and salination of waters in the North Atlantic. The time period of this deviation is assumed to be very short. The resulting collapse of the thermohaline circulation is 'disrupting the temperate climate of Europe. … Ocean circulation patterns change, bringing less warm water north and causing an immediate shift in the weather in Northern Europe and eastern North America …' (Schwartz and Randall, 2003, p. 9). Europe would heavily be affected in the event of abrupt climate change:

> it's likely that food, water, and energy resource constraints will first be managed through economic, political, and diplomatic means such as treaties and trade embargoes. Over time though, conflicts over land and water use are likely to become more severe – and more violent. As states become increasingly desperate, the pressure for action will grow. (Schwartz and Randall, 2003, p. 16)

Even if climate change will not be that dramatic and not occur as suddenly as assumed in the Pentagon scenario (this is the opinion of the majority of climate researchers), it is obvious how conflict-prone the use of fossil energies actually is, on both sides: the 'input side' of energy provision and the 'output side' of GHG emissions. Even if the scenarios are in reality less dramatic than presented, the precautionary principle which is inscribed in the environmental policy of the EU requires preventive measures, that is a considerable reduction of GHG emissions.

This is the aim of the Kyoto Protocol,[4] a reduction of the emissions of six different greenhouse gases.[5] For this objective it has defined concrete but country-differentiated reduction targets. The group of developed countries and countries in transition (Annex B[6]) has to reduce emissions by at least 5 per cent below 1990 levels. The EU is required to achieve a reduction of 8 per cent by the 2008–12 commitment period. However, under the 'burden-sharing' agreement differentiated reduction targets have been set for each member state (EEA, 2003, p. 7). In March 1997, before the Kyoto Protocol was adopted, the Environment Council had actually set a preliminary common reduction target of 15 per cent and much higher targets for different member countries. Following the Kyoto Conference reduction targets were reduced to a legally binding target of 8 per cent in June 1998.

Most of the real reduction of GHG emissions in the EU-25 has been a consequence of the crisis following the transition to a market economy in CEE-accession countries (see Table 8.2). Germany has also performed well mostly due to the deindustrialization of the eastern regions. Some EU countries have considerably increased their GHG emissions so that compliance with the Kyoto target is uncertain.

The sector most responsible for the increase of CO_2 emissions is transportation. From 1990 until 2002 GHG emissions of transportation increased in the EU-25 by 19.4 per cent, whereas in energy (−6.6 per cent), industry and construction (−14.1 per cent) and other sectors including services (−22.7 per cent) the impact of GHG emissions was reduced (Ziesing, 2004). However, the fact that the EU target of 8 per cent has so far been overaccomplished is a mere consequence of deindustrialization in central and eastern Europe where emissions have dropped by 38 per cent since 1990. In the industrialized OECD countries, emissions increased by 8 per cent between 1990 and 2000. The Commission therefore is fully aware of the gap between the 2010 reduction target of 8 per cent compared to the 1990 GHG emissions and the overall achievement of expected 0.5 per cent, leaving a gap of 7.5 per cent (EEA, 2004, p. 17; European Commission, 2003).

Policy instruments to achieve the Kyoto target include emissions trading, promotion of renewable energy and of combined heat and power (CHP), improvements in the energy performance of buildings and energy efficiency in large industrial installations, and promotion of the use of energy-efficient appliances (EEA, 2003). While both the EU renewable energy target (22 per cent of gross electricity consumption) and an 18 per cent share of CHP in total electricity production for 2010 are unlikely to be achieved, the success or failure of the Emissions Trading Scheme will have to be evaluated after its entry into force in January 2005.

The Emissions Trading Scheme (Directive 2003/87/EC) covers some 12,000 companies in the energy and energy-intensive industrial sectors of the EU.[7] The aim of the Trading Scheme is to create an EU-wide market for CO_2 emission allowances.[8] Companies are assumed to make decisions regarding

Table 8.2 Greenhouse gas emission targets relative to the base year 1990 under the EU burden-sharing decision, and real changes 1990–95 until 2002 (%)

	Reduction target 2008–12	*Real reduction between 1990–95 and 2002*
EU-15	−8.0	−2.9
EU-25	−7.8	−9.2
Belgium	−7.5	2.1
Denmark	−21.0	−0.8
Germany	−21.0	−18.9
Finland	0.0	6.8
France	0.0	−1.9
Greece	25.0	23.4
Great Britain	−12.5	−14.9
Ireland	13.0	28.9
Italy	−6.5	9.0
Luxembourg	−28.0	−15.1
Netherlands	−6.0	0.6
Austria	−13.0	8.5
Portugal	27.0	40.4
Sweden	4.0	−3.7
Spain	15.0	39.4
Accession countries	−6.8	−33.5
Estonia	−8.0	−55.2
Latvia	−8.0	−62.8
Lithuania	−8.0	−63.5
Malta	−9.0	−8.7
Poland	−6.0	−33.3
Slovakia	−8.0	−29.3
Slovenia	−8.0	−1.1
Czech Republic	−8.0	−25.6
Hungary	−6.0	−31.0
Cyprus	−8.0	59.8
USA	−7.0	13.1

Source: Ziesing (2004).

their emissions on the basis of a comparison of prices of buying emission allowances on the one hand and reduction costs on the other. The overall number of emission allowances is determined by the Kyoto target (−8 per cent of GHG emissions) and therefore limited. Allowances or certificates will only be available in the market if companies reduce their emissions and are able to sell a share of their allowance. These emission allowances are to be allocated nationally to every participating company while the latter can trade certificates in the entire EU.

While it is estimated that the targets can be achieved at an annual cost of €2.9–3.7 billion, which is less than 0.1 per cent of GDP in the EU, the

industrial lobby won an opt-out scheme for certain installations until 2007 as long as the member states can assure that these installations reduce their emissions in other ways. A study commissioned by the EU Commission has found that without the Emissions Trading Scheme costs of fulfilling the target could reach €6.8 billion. Thus, opt-out options for certain companies could not only hamper the reduction of emissions but also raise the cost of meeting the Kyoto target (European Commission, 2004; EEA, 2004).

The Emissions Trading Scheme suggests that the Kyoto targets can be achieved by market mechanisms. However, transport is one of the major polluters and hence requires lifestyle changes and government regulation beyond a market-based trade in emission certificates. Furthermore, the linking of the Trading Scheme with the flexible mechanisms of the Kyoto Protocol – Joint Implementation (JI) and the Clean Development Mechanism (CDM) – may undermine the potentially positive results of emission trading within the EU in the near future. Several problems can arise from this link between the flexible Kyoto mechanisms: allowances that are later traded in Europe may result from questionable sink projects which only shift CO_2 emissions into the future, or the international trade in emission allowances may support dangerous (nuclear energy) or old (coal) technology which complies neither with modern European standards nor with the Kyoto Protocol.

A major issue, moreover, is the question of equity between North and South. While the wealthier North produces most of the emissions, the South will carry most of the burden of climate change. Addressing climate change will have to take this disparity and limited resources for adaptation measures in the South into account. 'Mitigation is [of course] the best form of adaptation' (Climate Protection Programme, 2004, p. 2). The *South–North Dialogue* of the Climate Protection Programme (2004, p. 3) proposes a country-differentiated abatement approach which is based on the criteria of responsibility, capability and potential to mitigate. Resulting from this differentiation between countries, the EU remains highly responsible for a reduction in GHG emissions. Rather than trading European emissions with low-emission projects in the South or transition countries, the EU needs to limit the allowances that companies can obtain from these schemes so that climate policy in the EU effectively contributes to mitigating emissions worldwide.

8.5.3 The threats to biodiversity

There is a whole array of factors which contribute to the loss of species, the reduction of genetic variability and the degradation of ecosystems. Especially when climate change occurs faster than endemic agricultural crops, other plants or animals can adjust to it, the effect on the life on earth will be dramatic. Not only will agricultural biodiversity be affected. Due to rising temperatures, plants already flourish earlier, migrant birds do not leave in northern winter for warmer regions any more, and marine animals

change their migration routes. In complex ecosystems environmental changes are all-encompassing and therefore affect nearly all species. In Europe also 42 per cent of native mammals, 15 per cent of birds, 45 per cent of butterflies, 30 per cent of amphibians, 45 per cent of reptiles and 52 per cent of freshwater fish are threatened (Commission, Press Pack of 9 February 2004). Consequently, the Commission committed Europe to significantly reducing biodiversity loss by 2010. By April 2002, Special Protection Areas – 2827 sites, covering 222,480 km^2 – had been created, covering 7 per cent of the EU territory. Another 17 per cent of the territory (more than 18,000 sites) are part of the 'Natura 2000 network'.

Although only two of the world's 25 so-called 'hot spots' of an extraordinary endemic variety and richness of wild species are partly located in Europe, that is the Mediterranean basin and the Caucasus region, the European continent is home to almost half of the world's recorded livestock diversity. Nearly half of the 2576 breeds registered with the Food and Agriculture Organization (FAO) are at risk of extinction and approximately half of the breeds that existed at the beginning of the twentieth century are already extinct.

Agricultural biodiversity is essential for securing the world's food supply. Industrialized agriculture in Europe seemingly has overcome dependence on natural constraints by the large-scale use of pesticides, fertilizers and irrigation. This development has been pushed by the Common European Agricultural Policy (CAP). Meanwhile, however, the negative effects of the prevalent 'agro-industry' have sharpened awareness of the advantages of a 'green' ecological agriculture. It is based on crop rotation and mixed cropping and integrated farming with animal breeding and plant cultivation. However, the share of 'green agriculture' is still small, reaching from 4 to 10 per cent in the member countries of the EU. Most farms are still characterized by uniformity of mass production. A major consequence of the loss of diversity is that animals and crops become more susceptible to micro-organisms and other disease-causing agents (foot and mouth syndrome, mad cow disease, chicken pests and so on).

Food, water and many other resources can only be provided by coherent and self-reproductive ecosystems. For example, wetlands provide a natural device of flood regulation; marine and coastal ecosystems enable fisheries or aquaculture, but also provide oil or sand and gravel; and Europe's mountain ecosystems are estimated to host over 7000 plant species. Wetlands have been declining for decades and today cover approximately 4.4 per cent of the EU territory. Major threats to the conservation of sensitive environments, for example the marine and coastal environment, include industrialized agriculture, industrial pollution, water regulation, human habitation, construction, tourism, fishing industries or waste disposal, and once again climate change. Due to their particularly vulnerable physical conditions, mountain ecosystems face the same problems. The consequence is a loss of environmental security and above all of food security and safety.

Furthermore, trade exerts a major impact on wild species and natural habitats and thus on biodiversity. Europe is one of the world's three largest consumer markets for wild animals and plants. In the Russian Federation and in central Asia the reproduction and even the survival of many native species have become endangered, because they are captured or killed for consumers in the richer parts of the continent, that is in the EU. The conversion of virgin land into land for the production of cash crops, for timber-logging, or for resource mining is also destructive for biodiversity.

The EC is a member of many international conservation agreements, such as the Convention on Wetlands of International Importance (Ramsar – 1971), the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES – 1973), the Convention on the Conservation of Migratory Species of Wild Animals (Bonn – 1979), and, of course, the Convention on Biological Diversity (CBD – 1992). At the European level many Conventions have been adopted that protect particular areas or ecosystems, such as the Baltic Sea or the Danube estuary. Member states are obliged to implement the EU Biodiversity Strategy as well as the birds, habitat and water framework directives. The target of achieving by 2010 a significant reduction in the current rate of loss of biological diversity, however, can only be reached if the basic causes of the loss of biodiversity are addressed: in the first instance economic pressures. It is, thus, a major challenge for the EU to integrate biodiversity protection into other policy fields. Regional policies and spatial planning are an important policy area influencing biodiversity. Forests, energy and transport, tourism and last but not least development and economic cooperation also are included in the list of policy areas with an important impact on biodiversity (see http://europa.eu.int/comm/environment/nature/biodiversity/useful_info/key_speeches/index_en.htm).

During the last 12 years the CAP of the EC has adopted many environmental and biodiversity-friendly measures (European Commission, 2002). The most important change in agricultural policy was to decouple the amount of subsidies from the quantity of production. This change could support extensive farming and thus foster the development of biodiversity. The WTO Agriculture Agreement, however, can exert adverse effects on European agriculture. It will continue to dominate agricultural policy because of sharp competition from southern countries, especially when tariffs and subsidies are cut.

Biotechnology has not, however, only been accompanied by a privatization of life forms but also by a redefinition of biodiversity in general. Whereas in traditional breeding the morphological characteristics of a plant made up a large part of the selection criteria today's genetically based breeding and cultivation can even recombine different species through the transfer of genes. The biotechnology industry therefore often argues that it actually helps create more agro-biodiversity instead of reducing it. The possibility of genetic recombination subjugates the societal relationship with nature to mere human dominance over nature.

8.6 Conclusion

It is necessary to soberly assess the state of the environment. Although much has been done in recent decades to protect the environment and to establish ecologically sound economic mechanisms, the environment in Europe has deteriorated. Probably, the basic assumption underlying environmental policy of the EU has to be challenged: that it is possible to reconcile an industrial economy and enforced growth on the one side with ecological sustainability in the long run. On the other side following the aim of conservation of nature, a radical restructuring of the economy, of consumption patterns as well as of production technologies and of its energy basis and last but not least of lifestyles seems to be necessary. To continue with present environmental policies will lead the European peoples into a deep ecological crisis which also in economic terms will be extremely expensive – more expensive than timely policy measures based on the precautionary principle.

Notes

1. Corinna Heineke and Achim Brunnengräber, Free University of Berlin, contributed helpfully to this chapter.
2. It is not possible here to discuss the influences of oil speculation on financial markets and on the development of prices, although this is an important factor explaining a good part of the price increases in 2004.
3. The Green Paper and the web page on the debate are accessible on the Internet at the following address: http://europa.eu.int/comm/energy_transport/en/lpi_lv_en1.html
4. [The Protocol] shall enter into force on the ninetieth day after the date on which not less than 55 Parties to the Convention, incorporating Annex I Parties which accounted in total for at least 55% of the total carbon dioxide emissions for 1990 from that group, have deposited their instruments of ratification, acceptance, approval or accession. (http://unfccc.int/resource/convkp.html). In the meanwhile Russia has signed the agreement so that it has entered into force on 16 February 2005.
5. The six greenhouse gases are carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF_6).
6. Annex B to the Kyoto Protocol includes all OECD countries except for Turkey, South Korea and Mexico, as well as countries in transition, excluding Belarus.
7. The system covers the power sector (all fossil fuel generators over 20 MW), oil refining, cement production, iron and steel manufacture, glass and ceramics, and paper and pulp production. The Commission will initiate a review in 2006 which may come to a proposal to include additional sectors. Cf. Climate Action Network Europe, http://www.climnet.org/EUenergy/ET.html.
8. The other greenhouse gases can be included in the Trading Scheme in 2008.

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9
Structural Policies: Weak and Market Biased

9.1 Introduction: from the Treaty of Rome to the Single Market

Structural policies had an ambiguous position during the first stages of the European construction. No provision had been made in the Treaty of Rome, except for the agricultural sector. The only policy mentioned was competition policy, as the result of a Franco-German compromise. The rules of competition policy applied both to businesses, where the Common Market was concerned, and to national governments, in order to avoid state interventions that would alter the nature of the competition game on the market as a whole. In practice, Community monitoring worked relatively pragmatically. From the 1960s to the 1970s, the number of state interventions was greatly increased following the economic crisis. Apart from the CAP, at Community level, numerous structural interventions were decided, most often under the pressure of events concerning:

- Declining sectors such as the steel or shipbuilding industries, where restructuring policies were carried out under the Commission's control from the mid-1970s; but also the clothing–textile sector where the Commission often exerted its nit-picking control of national aids and had difficulty in stimulating common actions.
- The high-tech sectors where practices and results were very uneven, from the nuclear industry where the failure of Euratom was obvious in the 1960s to the aerospace industry where results have been generally beneficial thanks to the setting up of agencies with their own budgets and carrying out their own projects, without forgetting the failures in the computing industry.
- R&D, where results only became really concrete in the early 1980s (FAST, ESPRIT, BRITE, EUREKA with a different status and an intergovernmental procedure) but have remained modest (1.6 per cent of the total R&D budget in the 1980s).

- The regional dimension, with the setting up of the European Fund for Regional Development (EFRED) in 1975, the importance of which increased with the successive enlargements.

By the mid-1980s, the belief that European construction would work around a harmonization and European space-structuring process implemented through common policies had largely disappeared. Each year the Community budget was the occasion of fierce bargaining, particularly with the UK. The successive CAP reforms were strongly fought over. In spite of occasional obvious progress, technological policies could only mobilize very modest amounts of money and had great difficulty promoting efficient cooperation patterns.

The 1986 Single Act was intended as a refoundation. The market was presented as the only way to overcome the deadlocks of the European construction, with a real 'European-style supply-side policy' as a counterpart to the 'American-style supply-side policy' launched by the Reagan administration. The logic of competition was strengthened at all levels. All the advantages expected from the Single Market resulted from the scale economies and cost reductions due to increased competition. Innovation was also to be stimulated by this competition, which would contribute to amplifying the virtuous circle of growth and productivity. In practice, the results were far from those expected.

Growth did not happen and the very questionable estimates of the Cecchini report[1] (a 7.5 per cent GDP increase and the creation of 5.7 million extra jobs in the medium term) were not borne out by events. Some major industrial changes occurred in the second half of the 1980s which accentuated the polarization of activities in the European area. Though inter-branch specialization did not increase, the extent of quality intra-branch exchanges rose, gradually leading to a qualitative division of labour. The technological content of the products highlights the reinforcement of the asymmetry between the 'heart' of Europe, specializing more in technological-intensive products, and the periphery, specializing in less technology-intensive ones. Lastly, the boom of intra-European foreign direct investment (FDI) which followed the implementation of the Single Market reinforced the polarization between the countries in the centre of Europe, because of the effects of geographical proximity, the intensity of exchanges and the attractiveness of the 'potential market' represented by those countries. European integration through FDIs reinforced the hierarchical organization of the economies around a vertical specialization based on quality and technology, instead of product specialization.

The mere abolition of non-tariff barriers did not manage to create a Single Market. National markets continued to be characterized by the strong specificities that usually underpin private behaviours. To a certain extent, barriers have subsisted, and econometricians have rediscovered the 'frontier effects' which have remained strong, even if attenuated (Head and Mayer, 2000).

Because the Single Market was too much oriented towards the issues of economies of scale and the stimulation of intra-European competition, it failed to grasp the new stakes in international competition. Conversely, one of the main assets of the European productive system, i.e. the large variety of its markets as far as tastes and culture are concerned, has not received enough attention.

Financial liberalization had some major consequences. In the face of the danger of capital flight, capital revenues were less heavily taxed, which reduced budget resources and increased the non-egalitarian aspect of the growth process. Financial markets became the main reference, if not the only one, to assess the validity of economic policies.

The Commission's monitoring of state aids was reinforced in order to eliminate those interventions likely to alter the competition mechanism. A few aids only were allowed, to R&D, regional development (in certain cases) and, more generally, general-purpose aids aimed at improving the business environment. The restrictions that were introduced to national interventions were not compensated for by a sufficient enlargement of the Community's own interventions. Technological programmes were developed in the 1980s and 1990s, notably at the level of intra-European cooperations, but have remained too modest. The reform of the Structural Funds that are destined for the less developed regions had the effect of doubling them between 1987 and 1993, but they only account for 0.3 per cent of GDP and suffer from the multiplicity of protagonists as well as from a lack of coordination.

9.2 The insufficiency of innovation and industrial policies

9.2.1 An inadequate research and innovation policy

The European paradox is well known. Europe's scientific excellence, notably in terms of publications, contrasts with its weaknesses in terms of patent registrations and new product development. The difficulty of turning scientific breakthroughs into industrial and commercial successes had already been pointed out in the White Book on employment and competitiveness in 1993. The deterioration of exterior performances was noticeable in the 1980s and 1990s, notably in the two key sectors of information and communication technologies and biotechnologies. The reasons for this are many but essentially lie in the inadequacy of research policy, both at Community and national levels. Compared with America's policies in the same sectors, national policies based on very diversified national innovation systems have lacked homogeneity and coordination. In general budgets have been inadequate. In Europe, the average R&D effort accounts for approximately 1.9 per cent of GDP against 2.5 per cent in the United States and in Japan, and no country, except for Sweden, exceeds the American level.

The RD Framework Programme (RDFP) has suffered from several handicaps:

- the inadequate commitment of big companies, who have been reluctant to cooperate on major projects and have often limited their contribution to second-level projects;
- the complexity of the procedure which has represented an obstacle for medium-sized firms;
- the multiplicity of objectives which is incompatible with regulation uniqueness;
- the perversity of the need to reach unanimous decisions, which has prevented the concentration on priority projects and lead to a multiplicity of minor interventions;
- the inadequate nature of the pre-competitiveness notion;
- the use of the RDFP by some countries as a substitute for national budgets;
- its own low budget: 15 billion euros for the fifth RDFP from 1998 to 2002 and 17.5 billion euros in the sixth RDFP.

As for the EUREKA programme, it is an intergovernmental cooperation mechanism whose flexibility is often acknowledged, based on the initiatives of laboratories and companies, and with variable configurations. Yet it has been underdeveloped because of the lack of engagement of some states, the reduction of the size of funded projects and a loss of financial credibility.

Several improvements have recently been made. Since the removal of the rule on unanimous decisions in June 1999, there has been more selectivity within the RDFP. It is now possible to exceed the pre-competitiveness criterion, and this should allow projects that are nearer to industrial application to be financed.

At the 2000 Lisbon summit, member states asserted their willingness to catch up in the knowledge-based economy, but the allocated budget seems extremely limited (in spite of the possible use of the European Investment Bank, EIB). The overall strategy remains essentially liberal, while preserving some social objectives.

In the sixth RDFP (2002–6) community research will be focused on excellence networks and large integrated projects. Such an approach, which is sometimes justified when it is necessary to concentrate the means of action, is on the other hand likely to marginalize innovative – but more specific – projects which will not be financed by the Community.

9.2.2 A lack of industrial policy at Community level

There is no real place for the notion of industrial policy at Community level and many member countries are not familiar with it. This question had, however, begun to be considered in 1992 when it was stated in Article 130 of the Maastricht Treaty that creating the conditions for 'the competitiveness of the industry of the Community' is a task of the Community and of

member states. Official reports of the Commission (1993, 1994b) afterwards confirmed this first step, at least at the level of principles. The most significant of these reports has been the Bangeman Communication *Industrial Policy in an Open and Competitive Environment*, which was adopted by the European Council of Ministers of Industry in 1994. The notion of 'industrial competitiveness policy', to which it is referred, is rather restrictive. Theoretically, it is limited to horizontal measures aimed at improving the firms' environment. In practice, these measures are rarely explained. Furthermore, industrial policy is subject to the constraints imposed by the all-powerful competition policy.

In the high-technology fields, research and innovation policy has been the only instrument to be implemented at Community level within the RDFP framework. The lack of an overall policy in this field is illustrated by several sensitive cases where decisions have been taken erratically:

- It concerns specific programmes, such as the Galileo GPS project which was reintroduced at the 2002 Barcelona summit. These projects could have decisive driving effects on many European research groups and labs, provided a more favourable institutional environment was set up.
- The absence of a European policy for high-speed telephone services (UMTS) and the mere recourse to national tenders have had particularly harmful consequences. Conversely, a well-designed European standardization has been a powerful instrument for strengthening the positions of European businesses, as illustrated by the GSM standard for mobile phones.

National regulatory agencies were set up in several service sectors (telecommunications, electricity) within the framework of liberalization policies. These regulatory agencies do not pay enough attention to the interests of consumers. Their operating methods raise problems with regard to democratic principles and the respect of public service activities. European regulatory bodies and their links with national agencies remain to be determined. These problems are even more serious when it comes to the large public programmes, which often appear as the necessary complements to the liberalization policies implemented in public services. The traditional instruments of national industrial policies, based on large projects and public procurement logic, have been thoroughly challenged by liberalization policies and technological changes. The accumulated experience and the results that were obtained are significant but they have not been transposed at European level.

The most striking example is that of public infrastructure investments, and more particularly trans-European transport networks. The 1993 Delors Programme was never implemented since it had been opposed by the Council of Ministers of Finance. Only 14 projects of trans-European transport were decided in Essen in 1994. Out of these 14 projects, only three have been

completed in 2004 and two have not even started. The deadlocks can partly be explained by the fact that those projects were merely juxtapositions of national projects that did not take the cross-border links into account, therefore leading to poorly coordinated efforts. In addition, infrastructure investments were slashed for budgetary reasons and road transport continued to be privileged. Yet rail freight transport is little developed in Europe, as opposed to the situation in America, and represents a major source of congestion and pollution.

Several new orientations were recently decided on within the framework of a trans-European transport scheme, including the definition of an element of 'community interest' as a contributing factor for the selection of projects, and the awarding of a 'European label'. The work should no longer be coordinated at intergovernmental level, and each project will be piloted by a single appointed operator having the status of a European business, as is already the case for Galileo. Although in this particular area progress has been made in the field of design, it still shows many shortcomings if a wider goal is to be decided. The budget is too low, even for projects that only concern trans-European transport networks (23 billion euros between 2003 and 2006). Some key areas in terms of long-term growth are not covered, such as telecommunications, research and education.

As far as these various fields are concerned, the Constitution project proposed by the last European Council brings no real improvement. Competition rules are reasserted in the Constitution with repeated references to the principles of an open market economy and unbiased competition. National aids are specifically mentioned and aids compatible with domestic markets are confined within narrow limits. The interventions likely to be undertaken at European level in order to boost supply in the fields of R&D, education, industry-oriented aids or large infrastructures are very modest. Coordination, evaluation and exchange of best practices remain the keywords.

9.2.3 The pre-eminence of the competition policy

Four distinct areas are affected, as detailed below.

(a) The control of national aids is too rigid

National state aids are banned in order to ensure that unilateral practices do not lead to distorting effects and affect competition. In theory, only general purpose aids that do not help particular firms or sectors are allowed. In practice, some dispensations have already been accepted for those aids intended to help areas experiencing the greatest difficulties, namely small and medium-sized firms, as well as for those aids in favour of the environment or R&D. The existing control devices correspond to a unilateral strategy of national aid reduction, based on assessment criteria that are overly macroeconomic (annual assessment in GDP per cent of effective reductions). These

lack coherence and do not try to articulate national aid control and existing Community policies, for instance in the area of regional aids financed by Structural Funds or regarding the aids in favour of research.

In the case of the USA, individual states actively intervene with aids to encourage inward investment, research, technological parks and so on, and in support of industries in difficulties. These practices vary between individual states but are not regarded as distorting competition within the USA. There is a kind of inter-state competition, but within a strong federal framework, notably in the case of research and innovation policies.

(b) The opening of public services to competition

Public services can be defined as the supply of services that are essential to people's daily lives and to each individual's fundamental rights. They can be provided either by administrations, public companies or private companies, under certain conditions. They have been at the heart of the policy of liberalization and the opening-up of competition since the 1990s. In Chapter 5 a broad treatment is done of the subject. Therefore we shall only add a few comments.

Several factors are put forward in order to justify this evolution. Some activities, like telecommunications, which were considered to involve increasing returns to scale, are now characterized more by constant returns to scale because technological change has enabled many firms to operate in the industry without increasing unit costs. The segmentation of activities, as in rail transport or electricity, has allowed the division of public companies into several parts, and some of these have been subjected to competition or privatized. The narrowing of the public service scope has been accompanied by a change in the criteria that justify public intervention. Traditional criteria (such as increasing returns, externalities) have tended to disappear in favour of criteria based on asymmetric information.

All these 'theoretical' reasons serve, in many respects, as an image to hide the decline of the 'public service' concept under the pressure of the liberal trend in a context of economic and budget austerity. Such an approach underestimates the difficulties linked to the dismantling of network companies into distinct profit-making centres. By going too far in the division of activities (infrastructures and operation, but also production, distribution and trade) the companies' technical culture as well as the quality and safety of supply may be put in danger. The network companies that have remained public are torn between the preservation of their general interest mission and the emergence of a new form of competition in the profitable segments of their activities. Avoiding the drifts of privatized systems and the risks of deteriorating public services has become a major stake for regulating authorities. The solutions that they are currently trying to bring about, notably through the promotion of competition and the preservation of a 'universal service', remain very incomplete.

Three points ought to be noted because they allow some flexibility for more active interventions. The fact that the Commission's directives mention the notion of 'network', characterized by increasing returns in some segments of activities, justifies the maintaining of monopolies in the corresponding sectors, and allows public interventions without clearly defining their nature. The 'universal service' obligation is also mentioned in sectoral directives, with the following definition: 'a cluster of minimum services of a given quality, accessible to everyone at an affordable price'. Lastly, the 'general interest economic services' mission has been reasserted in recent documents and in the Constitution project. These documents have so far been little enforced, but the principle of a 'European law' inscribed in the Constitution project may open a new framework.

In addition, the WTO, with the General Agreement on Trade in Services, represents a more general perspective, which appears particularly constraining and worrying for public services. This will be examined further in more detail (see Chapter 11).

(c) The control of anticompetitive agreements

The control of anticompetitive agreements aims at sustaining a high level of competition, which is supposed to contribute to greater efficiency. Little consideration is given to the economic dimension, but it ought to be acknowledged that in many sectors companies' competitiveness is based on the narrow and sustainable links which may exist between the different firms. This prevailing approach is too doctrinal, and does not provide national control bodies with sufficient room for assessment.

(d) A narrow-minded interpretation of the rules on concentrations

Prior to the key merger control regulation of 1989, it was very difficult for the Commission to intervene in mergers and acquisitions, although it tried in some cases to do this by defining a merger as the establishment of a kind of cartel.

Since the early 1990s the definition of a 'pertinent market', on which the risk of a dominant position is assessed, has often been limited to the European level, or sometimes to the national level. This was a static approach, taking into account only the impact on effective competition, without integrating the future evolution of markets. Recently the Commission has taken world market perspectives into account.

Concentration in the manufacturing sector is generally less in European countries (and in the EU as a whole) than in the United States, and medium-sized firms are weaker. Cross-border mergers and acquisitions between European firms are few. The Aérospatiale–DeHavilland case, which was shortly followed by the Boeing–DouglasMcDonnell merger and more recently by the refusal of the Volvo–Scania and Schneider–Legrand agreements illustrate the problems at stake. Lastly it must be underlined that the

performance of mergers is not always convincing: from Vivendi to Daimler–Chrysler and BMW–Rover.

According to the Commission, its credibility is at stake; and its rigorous attitude vis-à-vis European firms gave it the means to refuse the Honeywell–General Electric merger in September 2001. In practice, refusals are extremely rare (18 merger refusals over the last ten years out of 1900 notified mergers), even in the case of the Elf–Total merger where only marginal adjustments were required. The fear that second-rate European firms might fall under foreign control ought to be put into perspective when considering the takeovers achieved abroad by European companies. With the recent reform of European merger policy and regulation in 2004, the attitude of the Commission seems to have changed towards a slightly more pro-merger stance.

9.3 The limited efficiency of the regional policies and their planned reduction

In the EU-15 regional disparities, measured in GDP per capita in PPS, are roughly twice as high as the number observed in the USA (Barro and Sala-I-Martin, 1995). Whereas a catching-up process has been observed since the beginning of the 1980s regarding the income per capita at the national level, the regional configuration is more diversified. The poorest regions, but also the richest ones, have a higher rate of growth than the intermediate ones. Within each country, a general trend cannot be observed. Since the 1990s, the increase in regional disparities is more pronounced.

Recent empirical studies (Lallement et al., 2002) show that innovation activities are more geographically concentrated than production activities at any regional level and with any innovation indicators (R&D, patents, R&D employees). The southern European countries, France included, seem to be where both innovation and production activities are the most concentrated, by contrast with the northern European countries where the regional development seems to be less unequal. The R&D concentration indicator shows that in 1997, Germany, France, the UK and Italy represented 75 per cent of the European R&D expenditures.

Regional policies in the EU are implemented at three different levels, local, national and European. In a restrictive sense, they are only concerned with public interventions with a regional dimension. But the regional impact of national policies (fiscal policy, social transfers, education, public services) and European policies (agricultural policy and competition policy) may be greater and cannot be ignored.

9.3.1 The local and regional policies

The different local authorities (cities or regions) conduct active policies to sustain economic activity and promote employment, following specific ways

in each country. The policies of attractiveness focus on the improvement of infrastructure, training, strengthening of the technological potential and development of networks to increase cooperation and spillover effects (Begg, 2002).

Tax cuts, decrease of social charges and wage pressures are also used to attract investments, sometimes at the level of a whole country like in Ireland. Such a strategy is more open to criticism, as it leads to a ruinous competition between the sites to the detriment of labour skills, without contributing to the development of stable employment or a strong economic system.

Regional aids, like subsidies or investment aids, must also be criticized because these would alter competition, and might finance investments which would have been realized even without aids. Moreover regional aids might detract from regional balance, as richer regions would be able to offer more important aids. These criticisms are unequally significant. The possible adverse effects depend on the concrete forms of implementation. Actually, all the regional policies could be criticized, as their importance depends directly on the level of development of the region and, in that sense, contributes to increasing regional disparities.

The regional policies properly so-called are twofold: explicit policies of fiscal transfer in favour of the poorest regions, and the public expenditures with a regional dimension.

The explicit interregional fiscal transfers in favour of less advanced regions are more or less developed according to the countries (Davies and Hallet, 2001). They are at their most advanced in Germany and work between the federal state, the *Länder* and the cities, according to a complex mechanism which is periodically adjusted. The German reunification has been a major shock in that respect. Some western *Länder* are also receiving a net transfer, but most of them are now net contributors. In Spain the process of decentralization and transmission of expenditures to the regions has not been accompanied by an equivalent increase of their capacity to raise taxes. Consequently, the regions depend on transfers from the central government, but a fiscal decentralization procedure is in progress. In Italy an Equalization Fund has been created between the 15 ordinary regions but its implementation is very progressive.

Public interventions with a regional dimension take the form in each country of public infrastructures, investment in education and research or aids to private investments, often with a co-financing from the European Structural Funds. The efficiency of these interventions to stimulate regional growth and reduce disparities is uncertain. The investment programmes must be sufficiently lasting but may be established on too permanent a basis to promote endogenous dynamics. Development strategies may lack consistency.

This kind of system sets a problem of balance between equity and efficiency. Equity allows the poorest regions to benefit from sufficient resources

to finance public services, while efficiency allows the richest regions to keep resources through the fiscal autonomy. Too much equity creates a system which cannot induce either the rich regions or the poor ones to improve their performance. Too much efficiency, which implies more resources for the rich regions, can prevent the poor regions from having sufficient public resources to catch up. Moreover these problems become more complex as the fiscal decentralization is generally more advanced for the expenditures than for the taxes, which remain dependent on the repartition of those collected at the national level. Consequently, regions are not accountable enough at the fiscal level.

State aids with a regional dimension are more specifically criticized by the Commission, mainly because of their ability to alter competition. They used to be important in Germany (0.6 per cent of GDP), in Italy (0.9 per cent of GDP), in Greece (0.8 per cent of GDP) and in Portugal (1.2 per cent). They have been reduced under the pressure of the European Commission and have been brought to roughly 0.3 per cent of GDP in 1999, in line with the mean of the other countries. These criticisms are again of an unequal value. The concept of regional state aids is less clear than it seems. If subsidies are directly accused, it remains true that many of the research or training aids, which are better accepted in principle, are not of a fundamentally different nature.

9.3.2 The European regional policy

Since the accession of the southern European countries, the European regional policy has reached a relatively important level, as the Structural Funds and the Cohesion Funds represent yearly 0.45 per cent of the EU GDP between 1994 and 1999, with financial contributions far higher for the southern countries (4 per cent of GDP in Portugal, 3.7 per cent in Greece, 2.8 per cent in Ireland and 1.7 per cent in Spain). A decrease has been planned, however, for the period 2000–6, with 260 billion euros for the whole structural measures (0.4 per cent of EU GDP each year), 195 billion for the Structural Funds, 18 billion for the Cohesion Funds and the rest for the applicant countries. Three objectives have been retained for the Structural Funds:

1. Promotion of the development and structural adjustment of regions whose development is lagging behind (with a GDP per capita less than 75 per cent of the EU average) and which would receive an amount of 70 per cent of the total Structural Funds;
2. Support of the economic and social conversion of areas facing structural difficulties;
3. Support of the adaptation and modernization of policies and systems of education and employment (long-term and youth unemployment, persons excluded from the labour market).

The efficiency of Structural Funds in reducing regional disparities is questionable. According to some authors, they have not had a great impact (Fagerberg et al., 1999) or, though econometrically significant, they have had only a limited impact. For others, they could explain half of the convergence observed between 1989 and 1993. According to the results of national modelling, they might have significantly increased the growth of the southern countries during the years 1994–99 (Cour and Nayman, 1999). Structural Funds invested in infrastructures would have contributed to a third of the reduction of productivity gaps between the Spanish regions during the 1980s. Their impact on private investment seems also to have been positive for the Cohesion countries. But public infrastructures have strengthened convergence between countries by accelerating the growth of the most advanced regions of the poorest countries, without reducing internal intraregional inequalities (Martin, 1999). The efficiency of Structural Funds is generally more marked in cases where the concerned region is rich.

The elaboration and implementation of projects financed by Structural Funds suppose complex interactions between the regional, national and European institutions. In many countries the management of the projects appears to be too centralized. Due to the complexity of the European documents, the control requirements at the national level and the co-financing recourse, the use of the Structural Funds is often very slow.

The eastern enlargement of the EU brings new challenges (Begg, 2002). With the entrance of the new countries, the average EU GDP per capita has fallen dramatically. This means that many regions in southern Spain or eastern Germany up to now under the 75 per cent eligibility threshold and receiving Structural Funds (Objective 1), will move above the threshold and have their support eliminated, without any change in their absolute GDP per capita.

According to the Third Cohesion report (European Commission, 2004), the number of backward regions (Objective 1) in the EU increased from 50 in the EU-15 to 69 in the EU-25, and the share of total population living in such regions rose from 19.2 to 27.1 per cent. But these overall figures conceal the dramatic character of the development. Since the average per capita income of Objective 1 regions fell from 65.5 per cent of the EU-15 average to 56.2 per cent of the EU-25 average, the number of officially backward regions in the EU-15 fell from 50 to 33, with a population of 11.9 per cent of the EU-25, while 36 regions from the new members, covering 92 per cent of the population of these countries or 15.2 per cent of the EU-25 population, are below the 75 per cent threshold.

A distinction can be made between those countries with a weak fiscal capacity, and the richest ones, who believe that they pay too high a net contribution to the EU, and regard the Structural Funds as one of the channels through which they can recoup some of their net contribution. The poorest countries, measured with an aggregated indicator, regroup Greece, Portugal

and the new entrants. Some countries are not relatively poor, but contain regions which are below the threshold, sometimes significantly so, like Spain, Italy and Germany. In the other cases, neither the country nor the region is below the threshold, but there are structural and specific problems which permit Structural Funds to be awarded (mainly Objective 2). As there is a Treaty commitment that obliges the EU to act to reduce regional disparities, the political challenge in the perspective of enlargement would be to raise the threshold, for instance at the level of the Cohesion Funds (90 per cent of EU GDP per capita). This, however, would raise difficult budgetary constraints with a EU budget limited to 1.27 per cent of the EU GDP.

Regarding the new entrants, the current proposals have put a ceiling of 4 per cent of GDP on the transfers due to the limited absorption capacity. This would give a cost estimated between 0.18 and 0.38 per cent of the EU GDP, depending whether the estimation is made in current prices or in PPS. On the whole, this cost would be bearable.

9.4 Conclusion

The European structural policies have been gradually implemented since the middle of the 1970s, at first in a rather pragmatic way, but making more and more concessions to liberal logic from the second half of the 1980s. The research and innovation policy has suffered from the complexity of the procedures, the inadequate commitment of the biggest companies, the weakness of its own budget and from a lack of coordination with national research policies. The 'industrial competitiveness policy' was only recognized at the beginning of the 1990s at the European level and is reduced to horizontal measures aimed at improving the environment in which businesses operate. In the high technology sector no overall policy was launched except for the RDFP, which remained very limited. Large public programmes and public procurement, which were at the basis of many national industrial policies, have not been transposed to the European level, especially in the fields of trans-European infrastructures. The competition policy has occupied a pre-eminent position, with a too rigid control of the state aids, an opening of public services to competition – which has led to a decline of the public service concept – and a difficulty in finding an appropriate regulation. The control of anticompetitive agreements has been carried out with little consideration given to the economic dimension. The merger regulation has often adopted too static and too narrow-minded an interpretation.

The European regional policy has reached a rather important level at the end of the 1990s with the Structural Funds and the Cohesion Funds, but its efficiency at reducing the regional disparities is questionable. The regional impact of national policies (fiscal policy, social transfers, public services) and European policies (research, CAP, competition policy) is often greater, but is not well integrated. Since 2000 a reduction of the Structural Funds has been

planned to take place when the EU enlargement increases the regional disparities. On the whole, the European structural policies appear too weak and too market biased.

Note

1. According to Table 10.2 of *Cost of non-Europe* (Cecchini report) the effects of the Single Market programme alone would amount to +4.5 per cent of GDP and 1.8 million additional jobs. It would also create a public budget surplus and a current account surplus. It is only through additional public expenditures using these surpluses that the whole effect of the programme would be +7.5 per cent of GDP and 5.7 million extra jobs.

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10
Agricultural Policy: the Need for Reform[1]

10.1 Introduction

The Common Agricultural Policy (CAP) is criticized by pro-free trade liberals and supporters of developing countries' farmers, as much for its agricultural productivism as for absorbing an excessive share of the EU budget. Its advocates are often presented as backward-looking supporters of corporatist interests and declining sectors. However, although no one today questions the need for radical reforms, the situation is quite complex and not as clear-cut as is often claimed. Agricultural policies have proved their efficiency, even if pernicious effects began to appear (and to be corrected). It is usually suggested that the market is the only way out of the current difficulties; this does not provide a satisfactory answer, however, and provides hardly any solution for the problems of agriculture in developing countries.

10.2 The foundations of agricultural policies

One of the justifications of agricultural policies is that unsatisfactory management of agricultural markets can lead to highly unstable agricultural prices. This volatility is well known and can have very serious effects, not so much for consumers in rich countries as for producers, particularly in developing countries. The impact of fluctuating prices is considerable, as farmers, particularly in poor countries, are risk averse, especially when linked to price fluctuations. When faced with such risks, they reduce their production. A price hike can often lead to a production increase – although this is not an automatic outcome.

The macroeconomic consequences of such phenomena are noticeable (Boussard, 2003). The development of cereal yields in France and the USA over centuries shows quite clearly the increase that took place in the late 1930s due to the fact that in the USA, from 1935 onwards, prices were guaranteed by the Roosevelt administration – as they were in France by the Wheat Office in 1936. More stable prices allowed farmers to increase their

income, to invest and to improve their productivity substantially. Two theories account for the volatility of agricultural prices. The first relates this volatility to exogenous factors, essentially the unpredictability of the weather and seasonal changes. The second theory refers to the inefficiency of agricultural markets. Demand remains rigid for basic food products. In the case of shortages, consumers are ready to pay very high prices in order to meet their needs. In case of surpluses, they are never willing to increase their consumption, even when prices are slashed. It is thus difficult for the market to find its equilibrium. Prices are unstable and no longer reflect production costs. These questions have fuelled an abundant literature on the nature of agricultural products' prices (Burton, 1993; Boussard, 1996). These strongly suggest that in order to reduce fluctuations it will be necessary to change the price-setting mechanism.

This was confirmed by history: the American policy adopted in 1935 of administering agricultural prices literally boosted output, and wheat prices in the USA in real terms have fallen to a quarter of what they were in the 1930s. American consumers and taxpayers have largely benefited from this situation, regardless of the huge amounts of money spent by the Treasury to subsidize the US agricultural policy. Most countries in the world imitated the US model after 1935 and decoupled their agricultures from the market. The CAP was inspired by this American policy, but also took specifically European aspects into consideration, notably by seeking to ensure the independence of the EU's food supply. These policies, which are still enforced despite the rise of liberalism, have largely been successful, despite today's numerous difficulties. These difficulties are as follows.

1. *Prices that are guaranteed at near production cost level lead to agricultural surpluses and resource waste*. This can be observed in both Europe and the USA in the case of cereals. A reasonable solution would seem to be the implementation of administered prices in conjunction with a regulation of supply, including individual production quotas, so that global controlled output should remain slightly lower than domestic consumption. The market would then impose marginal adjustments. Past experiences testify to the feasibility of such a scheme, which essentially applies to basic products. This method is often criticized because it links economic surpluses to the existence of quotas. However a fine-tuned management of quota-controlled product prices would limit the economic surpluses.

Faced with rising surpluses and increasing budgetary costs, the CAP has undergone several changes increasingly since the early 1980s. In 1984 quotas were introduced for dairy produce; then in 1992 a wide reform was instituted which deeply changed the system for farmers of cereals, oilseeds and beef. Financial support was granted according to the number of cultivated hectares or head of cattle in exchange for a significant decrease in guaranteed prices and the obligation to leave fields fallow for agreed periods.

2. *Agriculture does not only produce basic products but also semi-luxury products (flowers, spring vegetables …)* for which the regulations are more complex. The notion of product 'quality' plays an increasing role. There are no major agricultural policy problems for these products because they are generally not highly subsidized; also, the market is more efficient when demand is elastic.

3. *More basically, agriculture has effects on other areas (landscapes, pollution …).* The market has little effect in this sector which means the problems are completely different (no one will pay for attractive landscapes, for example). Democratic procedures are hard to implement. However, collective decisions play a role (in cleaning up a river or preserving a scenic area, for example) even if these are costly. But what is an acceptable cost? Which institutions could be devised so that a collective will might be able to give voice on possibilities for the management of rural space?

The public goods produced by a multifunctional agriculture (and, more specifically, the effects on the landscape) are hard to assess (Allaire and Dupeuple, 2003). For pollution a reliable system of administered prices, for inputs as well as outputs, might encourage farmers to adopt non-polluting techniques. Would such an incentive be sufficient?

These questions have been partially addressed in the CAP reforms which have been under way since 1999. Under pressure from Germany, Agenda 2000 stressed the importance of reaching 'fair agricultural practices'. In France the agricultural sector is expected not only to produce as much as possible, but also to take care of the environment and produce rural amenities. State-funded 'regional development contracts' to help those farmers committed to environmentally friendly practices or to the production of rural amenities were meant to further this process, but in reality little was achieved. The recently adopted CAP reform of June 2003 followed the same logic in so far as it was aimed at increasing financing of both rural development and environmental protection.

A shift from a narrowly sectoral view to a combined view of sectoral and territorial interests has taken place. Rural development has now been recognized as a policy objective: rural problems cannot be solved only through agricultural policy, standards of living and welfare of the rural population must be addressed, and the diversification of rural productive structure needs to be encouraged. The European policy for rural development was in its origin conceived as a policy accompanying the CAP rather than as a policy with its own autonomy and objectives, although at present these two sides of policy exist side by side in the CAP. However, their relative importance is very unequal, and the territorial function is still too often perceived as responding to the constraints influencing farming. Examining the budget shares involved, the asymmetry is very clear. For the period 2000–6 the agricultural sector will receive around 45 per cent of the total EU expenditure: 40 per cent provides market support and a little less than 5 per cent goes to

rural development programmes and the LEADER initiative. Since a ceiling on total agricultural expenditures has been established, increasing the expenditures for either pillar will require diminishing the amount of funds for the other, establishing competition between the two pillars with some negative consequences as we shall see below.

Another element also makes for strong competition between the two pillars. Beneficiaries of both pillars are not the same, and neither is their relative power. The CAP over its long history has established powerful interest groups. Big farmers and their lobbies are well organized and very powerful, as are ministries of agriculture, which are in general production-minded but tend to consider rural development as a marginal and irrelevant objective. Rural lobbies, on the other hand, are almost non-existent (even if some present programmes like LEADER are developing the conscientiousness of rural populations about the convenience of pressuring).

4. *Major income inequalities are pervasive in the agricultural sector*. The CAP, by linking financial support to output and then to cultivated hectares, has undoubtedly rewarded big farms. Should those problems be addressed by the CAP or by other instruments such as redistribution policies?

This concern was partially addressed in the 1999 CAP reform and member countries were offered the possibility of adjusting their subsidies according to farm sizes. Portugal, the UK and France made a very moderate use of this opportunity. Quite significantly, however, one of the first measures taken by Raffarin's government in France in May 2002 was to suspend these arrangements for European subsidies.

5. *The CAP's protectionist nature is said to be detrimental to developing countries*. For instance, sugar beet producers in Europe are said to be hindering the full development of sugar cane in Brazil and elsewhere. In the Euro-Mediterranean agreements agricultural goods were not included, thus limiting the comparative advantages of Mediterranean countries. The CAP is not the only one to be concerned, since American subsidies to cotton producers caused a fall in cotton prices, which lead to the ruin of small individual African producers.

This argument, however, ought to be dealt with carefully. The comparative advantages of the developing countries ought to be increased and exploited through structural policies that are well adapted to those countries. These advantages are not 'natural' and do not result only from favourable factors such as climate or labour conditions. The full integration of agriculture in developing countries into international trade requires specific instruments of regulation, and cannot rely on free trade alone. The Cairns-led liberal crusade, that seems to defend developing countries' agriculture, advocating trade liberalization is very hypocritical. Since this group brings together not only emerging countries with high agricultural potentialities, but also developed countries like Australia and Canada, if liberalization was implemented it would actually reinforce the extensive agriculture of richly endowed

emerging countries like Brazil and Argentina, but not really small individual farmers in Brazil's north-east or in Africa, who would be wiped out. Let us also recall that while the EU's agribusiness has posted important trade surpluses against the USA since 1999, it has also shown a deficit against the rest of the world. This deficit is particularly important (and rising) with Brazil, Argentina, Mexico and other Latin American countries and in a smaller way Africa (Pouch, 2003; Pouch and de Lorgeril, 2004). The agriculture of the poorest countries stands no chance if the market mechanisms are given even more freedom.

If agricultural and food products are different from other goods, two further points should be raised. Firstly, in the poorest countries it would then be necessary to sustain an agriculture at a level which would generate sufficient income to maintain non-agricultural activities in rural areas, while linking such a policy to a more global development strategy. In developed countries, by contrast, limiting the production and export of goods (for example using quotas) would be essential. This latter point underlines the need for reform of the CAP.

10.3 Reform proposals

Such problems have led to radical proposals for reform, and the CAP has been substantially altered since the 1980s. Increasing budgetary constraints have led to pressures for a more radical reform, as have the new issues linked to the eastern enlargement and the international negotiations of the WTO. The general trend has been towards the reintroduction of free trade, while correcting its drawbacks. A return to free trade would have devastating effects: the basic instability of agricultural prices would certainly not provide a satisfactory solution for developing countries. There have been hopes that futures markets could bring some relief (Carfantan, 2002), but they do not match the depth of the problem. Futures markets may allow individual farmers to protect themselves, but they certainly do not remove the risks of price fluctuations or their drawbacks at macroeconomic level.

In practice, four series of proposals may be distinguished, as follows.

1. *The CAP's renationalization*, that is to say its suppression, is particularly tempting in the UK, but not only there. It is also to be found in Sapir's latest report (2003). In this perspective it is proposed to free imports of agricultural products in conjunction with a system of guaranteed prices for farmers, the difference between guaranteed and market-determined prices being compensated for by subsidies that would be renationalized and autonomously managed by each state. Such a position seems a clever one, as it is both open to developing countries' imports and coherent with free trade principles.

It poses several problems, however. Consumers would have to bear the effects of the strong instability of agricultural prices. If production levels are

not limited, the risk of overproduction can be serious. Defining individual quotas would be preferable, but this poses evaluation and management problems. Compensatory payments are incompatible with the philosophy of the WTO. Finally, the countries currently exporting agricultural products which stand to gain the most from such reforms could not really be described as developing countries.

2. *The Commission* is trying to reform the CAP with several aims in view: that of reducing its cost in view of the recent enlargement; that of renewing with budgetary margins within a community budget limited to 1.27 per cent of GDP (the problem being that the CAP is the only true common policy); and to make it acceptable in international negotiations. The Commission's position is that the nature of existing subsidies should be changed by putting an end to subsidies linked to surface areas or head of cattle and that instead a new kind of subsidy should be instituted related to agricultural practices and the production of amenities. Subsidies would thus no longer be linked to production; and production itself, as well as prices, would become market-oriented.

Such a position, which is not unlike that of Germany, will encourage 'fair practices'. However, the Commission's insistence that the market should be central in regulating the agricultural sector poses certain problems since the market has historically been unable to fulfil this role. Moreover, as a counterpart to this decoupling and return to free trade, those farmers who were lucky enough to still be working would receive a sort of guaranteed lifelong income, which seems a bit strange.

The compromise reached by the agriculture ministers in June 2003 is a strange mixture, lacking coherence and essentially aimed at making a better impression at the next WTO meetings. The decoupling will start in 2005 or 2007, depending on country. It will be only a partial decoupling for certain products (beef, mutton and cereals), while others will not be concerned at all (olive oil, sugar). Intervention prices for cereals will not be lowered.

The present framework for *rural policy* was defined in Berlin in 1999. The first and most important regulation reassembled under one single heading various existing measures of heterogeneous nature for rural development. Few of the measures included in this regulation are new. They are made up of the historical accumulation of the direct interventions which have taken place since the CAP was launched. A second form of intervention in rural areas concerns the Structural Funds. A third instrument is the LEADER initiative, an experimental programme. These policies are managed by national and regional administrations and co-financed by the EU, by member states and by separate regions. The 2003 reform did not establish any significant change in this system.

These three forms of intervention represent quite different approaches to rural development, and are not necessarily coherent as a package. The Rural Development programmes have a sectoral function and appear weak as

instruments of diversification; they are still perceived as a sort of undesirable, but necessary, alternative for 'inefficient' farmers who might be pushed out of their activity. The Structural Funds programmes and the LEADER initiative address the territorial function with a multi-sectoral and integrated approach, perceiving the diversification of activities as a positive strategy for economic development. Since interventions are fragmented, the coordination between them is weak and mostly left to member states' preferences (Saraceno, 2002). Discussion about this system began after Agenda 2000 was approved. Specific problems arising from the enlargement negotiations, the new WTO round and the issues raised by multifunctionality and the food safety crisis led to continuous debate.

3. *With a view to the eastern enlargement*, agricultural problems play a key role. A cost (the reduction of agricultural employment without compensating for this in other sectors, rising normalization-related costs and prices, increased competition, environmental risks) and benefit (modernization and productivity gains, aids) assessment suggests that costs might prevail over benefits. Community subsidies have been limited to 25 per cent of today's amounts per hectare or head of cattle, and will gradually increase to reach 100 per cent in 2013. This ceiling, which is frowned upon by applicant countries, is justified, in the Commission's opinion, by the constraints imposed by the current budget (only a community budget increase could ease the situation), the fear of an uncontrolled rise of agricultural surpluses if subsidies were more important (the setting up of quotas could be a solution) and lastly by the problems linked to the redistribution of internal revenues in applicant countries if subsidies were too high compared with average national incomes.

4. *The international negotiations taking place within the WTO with the USA and developing countries* raise a final series of questions. The debate made a bad start during the WTO discussions, with the Anglo-Saxon countries seeking to preserve and promote their interests under the cover of attractive proposals (the acceptance of subsidies encouraging 'fair practices', the gradual reduction of subsidies with distorting effects, the defence of developing countries by the Cairns group countries). Following the failure of the 1996 Farm Act, which had introduced the decoupling of subsidies and output, and led to a significant decrease of American agricultural incomes, the USA within the 2002 Farm Bill framework reaffirmed a policy of guaranteed prices. Meanwhile they were asserting, quite hypocritically, their willingness to reduce their agricultural subsidies and return, in the long run, to free trade.

The failure of the Cancun summit in 2003 has shown the new ability of the main emerging countries efficiently to face the Euro-American couple by federating a rather heterogeneous coalition of Southern countries (the G21 which has since split). The American refusal to remove subsidies to cotton producers, and the rigidities of the European positions on other subjects, have also contributed to the blockage. However, the implication of the

central demand of the G21 (the suppression of all subsidies to Northern farmers) must be considered. A full liberalization of agricultural products would be favourable neither to most of the agricultural producers in the South nor to those in the North. The Geneva deal in July 2004 did not significantly alter the global outlook. The main point was the agreement between the EU and the USA progressively to eliminate export subsidies and other forms of export support in the agricultural sector, but with many exceptions and no precise agenda.

10.4 Conclusion

Agricultural policies are based on solid foundations and have demonstrated their efficiency. Their main justification is that of the major instability of agricultural prices. However pernicious effects have appeared, including agricultural surpluses, major income inequalities and the conflict with developing countries arising from the protectionist nature of the CAP. Although several reforms have been implemented since the 1980s, pressure for more radical reforms (renationalization of the CAP, propositions of decoupling) have been reinforced by the increasing budgetary constraints, the new stakes of the eastern enlargement and the negotiations of the WTO.

Critics are often too quick to cite the protectionist nature of the CAP, even if there are some grounds for this. There is a risk of having a European agriculture in which a productive and performing agriculture (theoretically better controlled as regards its practices) and a more specialized one ('farm products' and other labels) would coexist, without solving the problem of the poorest nations. A badly handled dismantling of the CAP within the WTO would have grave consequences for European farmers and more generally for European countries, without bringing solutions to the traditional agricultures of developing countries.

Note

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11
European Trade Policy: Weak and Too Liberal[1]

11.1 Introduction: from the Treaty of Rome to the WTO

The common trade policy was initially given great importance within European politics: it was seen as a contributing factor to the smooth running of the Common Market (through the suppression of trade barriers) and a way of allowing the Community to express a single viewpoint in international negotiations. The main goal was the promotion of international free trade. However the progressive dismantling of the common tariff barrier meant that one of the essential instruments of trade policy disappeared. It also proved extremely difficult for the Community to control the non-tariff interventions of the different member states; these proliferated in the late 1970s in the context of economic crisis and industrial restructuring.

In the early 1980s, with no clearly expressed position, Europe found itself in a position of weakness when faced with the protectionist policies and proliferation of unilateral measures that were beginning to be instituted by its two major partners, Japan and the USA. The climax came with the USA's adoption of the 'Super 301' within the 1988 Trade Act framework, which has been consistently renewed since then. The Community had a certain number of instruments at its disposal (anti-dumping and anti-subsidies procedures, a safeguard clause and a 'new instrument' of its trade policy set up in 1984) which, until recently, were not used or were used with extreme reluctance. Following the implementation of the Single Market, there was a unilateral move to open the public markets and begin to liberalize services, without any parallel action from our non-European partners, notably the USA. In the GATT negotiations, the European Community became trapped in a confrontation with the USA over their bilateral disagreements, while the latter were carrying out their own bilateral negotiations, particularly with Japan, over the opening of foreign markets.

The lack of will to change in the field of trade policy reflected some deeply rooted differences in attitude between European nations that were difficult to overcome. Unlike the USA and Japan, there was little solidarity between

European firms. The presence of firms with foreign capital (essentially American at first, but also Japanese later on) and the strategic alliances between European and non-European firms added to the existing divergences. The UK and northern European countries had long been used to free trade practices and were more deeply penetrated by non-European capital. Ireland resorted to large-scale foreign investment as part of its catching-up strategy. Germany, taking advantage of its competitive industrial activities, was always in favour of free trade despite the gradual erosion of its positions worldwide. Differences in specialization have also played a key role. Northern countries, which specialized in quality, sophisticated goods, were more favourable to free trade. Southern countries, which specialized in more commonplace products, such as clothing, were more tempted by protectionism.

Considering the risk of dilution of the European economic area and the noticeable structural weakening of exterior European positions since the early 1980s (notably in the high-technology sector), the proposals aimed at strengthening the trade policy have been much debated. Elaborating a central document similar to the American Trade Act seemed an unlikely way to outbid America; so did a more simple reformulation of the existing texts (to incorporate reinforcement of anti-dumping procedures, retaliatory measures in case of illegal or discriminatory practices, relaunching of the 'new trade policy instrument', and so on). The EU did not have the same political and strategic influence as the USA: non-member countries would have been less sensitive to European retaliatory measures. Nor did the EU have strong enough assets to take full advantage of a strategy of opened markets. Lastly, the divergences among European countries were such that the extension of bilateralism, notably in the USA and Japan, would have meant an additional source of conflicts between member countries. There are very few sectors (the aerospace industry being one) where the EU has been able successfully to maintain an efficient and proactive policy alongside a strategic industrial policy. Another reason for the weakness of Europe is the lack of connection between trade policy, which falls within the remit of the Commission, and foreign policy, which is intergovernmental, with a high representative who is devoid of any real existence or means. The difference is obviously crucial when comparing Europe with the United States, where trade and foreign policies are closely linked.

A new economic order was established with the setting up of the WTO. Theoretically, unilateral instruments could no longer be used. The 'Super 301' was renewed in the USA, but was actually unenforceable. The remaining instruments (anti-dumping measures and protection clauses) could only be used under special conditions, at the risk of judicial proceedings. The USA, however, have never given up unilateral actions (increased tariffs on steel in March 2002 or, prior to that, subsidies to sustain exports within the Foreign Sales Corporations' framework), but were condemned

within the Dispute Settlement Body's framework and had to find compromises.

The failure of the September 2003 Cancun summit was a turning point, with the emergence of a serious conflict between North and South. Southern countries thought they had come off worse in the Marrakesh agreements. They had given in on the Intellectual Property Right Agreement, which proved a more costly move for them than expected, in exchange for more liberal practices in the agricultural and industrial (notably textile) sectors. Yet the EU, and mostly the USA, failed to honour their commitments. The USA largely increased subsidies to its own farmers and reached a compromise with Europe on the agricultural issue. The EU did not carry out the gradual dismantling of the textile sector that had been planned and in fact has postponed it until 2005. There are strong pressures in the USA to maintain quotas even beyond 2005. In such a context, developing countries have been able to form coalitions, which although lacking in homogeneity are likely to have a decisive influence in discussions: first of all within the G20, where many emerging countries, among which Brazil, India and China are gathered, and then within the G90, where a larger number of developing countries are gathered. The EU made a series of mistakes during negotiations by betting on the heterogeneity of the G20 (which was then the G22) coalition and overemphasizing the 'Singapore issues' discussed at the 1996 Singapore meeting which were related to competition, international investment, access to public markets and the facilitation of exchanges. Who won and who lost? Developing countries have appeared as new protagonists in international negotiations, but the USA do not seem embarrassed by this new configuration. They can reassert their commitment to multilateralism while continuing to be actively addicted to bilateralism.

Although the Geneva deal in July 2004 was presented as a 'historical moment', it did not have serious global effects. Deadlock in the trade talks was released. The most important result was the agreement of the EU and the USA to progressively eliminate export subsidies and other forms of export support in the agricultural sector, but without a precise agenda and with plenty of exceptions. The discussion on tariff cuts was more controversial, with opposition between the main agro-exporters like Brazil and Argentina and the poorest countries who prefer to protect their domestic markets.

On the whole, four groups of protagonists can be distinguished in trade negotiations: the EU, the USA and other industrialized countries, the G20 and G90. Four main topics are discussed, three of them being essentially related to market access, agriculture, industrial goods and services, and the last one, that is the 'Singapore issues', dealing with standards. The EU's trade policy will be analysed from three complementary angles: the North–North relationships (mostly related to strategic trade policy), the policy towards Southern countries, and sectoral issues dealing with agriculture and services.

11.2 Strategic trade policy and North–North relations

The EU's trade policy towards other Northern countries, notably the USA, is essentially a matter of trade strategy policy. Standards, public procurement and intellectual property rights have long been used by developed countries in order to promote and protect their own industries. Thanks to their large, unified market and their powerful administration, the USA have a more favourable position than Europe. The impact of American military and space programmes in high-technology sectors (aeronautics, telecoms, computing and electronics) and the role of normalization in protecting the US market are well-documented issues. Europe, with its partitioned markets and competitive programmes, found itself in a weak position by comparison.

The completion of the Single Market made the enlargement of markets possible, in compliance with the original goal, but without the necessary accompanying measures to benefit from this new advantage. The opening of public markets was achieved unilaterally without any negotiated counterpart from the USA. The actual proposals came close to a self-parody: in 1998, the EU in its communication on competitiveness could suggest nothing more than the setting up of a Public Procurement Observatory. There have been very few European programmes relating to public contracts and likely to stimulate demand in high-technology sectors. As far as normalization is concerned, there have been uneven results such as the failure of high-definition television, but successful ones like mobile phones, for which the unification allowed by GSM standards at European level has furthered the development of Europe's industry in this sector. More generally, Europe's weaknesses in terms of strategic policy have increased since the 1990s due to the excessive confidence placed in market forces and the logic of competition.

In 1980 the USA launched a new offensive, this time in the field of intellectual property rights (IPRs) and aimed at recovering their international supremacy (Coriat, 2002a, b). The 1980 Bayh–Dole Act instituted a system of licences for public research products and declared the American preference for them. The USA, drawing on the 'Special 301 Section' of the Trade Act on property rights, then gradually imposed the recognition of American companies' IPRs through the negotiation of successive bilateral agreements. After IPRs had become part of the Uruguay Round agenda, the 1994 Marrakesh Agreement on IPRs compelled the signatories to abide by the new American standards. This agreement standardized, generalized and extended patent rights. From a system in which there were major differences between national situations on account of important discrepancies in development levels, the Marrakesh agreement formalized the transition to a very standardized system, largely serving the interests of the United States. Since the 1980s, the USA have also built up a decisive advantage in the taking-out of patents, which guarantees long-lasting protection and covers a very wide range, with an extension of patentable areas and a certain incentive to

patent everything. Catching-up strategies through imitation have become riskier and more costly on account of the increased penalties imposed on imitators.

The EU, already handicapped by its global weakness in terms of research, has a cumulative backwardness in the field of IPRs, with less developed patenting practices, the absence of a unified patent at European level and a higher cost for patenting. A European patent was first introduced in 1977 but the name has somehow been usurped. Indeed, although a patent is examined by all countries when it is taken out, the name when issued becomes national and peculiar to each country, and duties are paid to each National Office. The genuinely European in scope patent, although announced in 1973, still does not exist. The weak and blurred legal outlines of emerging technologies have helped to hamper the R&D efficiency and to limit the private sector's research efforts. They have also prevented the EU from acting as a significant counter-balance to the USA in international negotiations. Such basic problems as the ethical considerations linked to the concept of patenting a living entity or environmental safety have never been clearly debated.

11.3 Trade policy towards Southern countries

Developing countries fear the rules imposed on them within the WTO framework might be ill-adjusted to their development level and appear too constraining. As underlined by Rodrik (1998), they consider that Asian countries would never have been able to gain sufficient momentum at the start of their development process, if the WTO's current rules had been forced on them. They plead for more flexibility in the enforcement of those rules in order to take each country's particular circumstances into consideration. On this aspect the EU, as well as the USA, have appeared to be too favourable to the enforcement of across-the-board rules and turnkey institutions. IPRs and the 'Singapore issues' are two illustrations of this situation.

The current agreement on IPRs seems costly for imitating developing countries and overtly favourable to industrial countries – even though the 40 less advanced countries will not be concerned by this agreement until 2016. The case of drugs is an illustration of the problem at stake while representing, to a certain extent, an exception (Jennar, 2003). The 2001 Doha Declaration admitted the impact of patent regulations on the price of drugs and the necessity of enforcing the agreement on IPRs so that everyone could have access to drugs. As regards 'public health crises', emerging countries with pharmaceutical industries were thus allowed to produce generic drugs without the patent holders' authorization, and the other developing countries could, for their part, import those generic drugs. The 2003 Geneva Agreement made the conditions under which developing countries could resort to such imports of generic drugs more drastic, that is the 'right to' has been replaced by 'the obligation to prove the existence of a public health

crisis'. The EU ostentatiously aligned itself with America's position, that is to say a determination to protect the interests of the pharmaceutical industry.

The EU and Asian countries reintroduced the 'Singapore issues' in the Cancun negotiation, which constituted a deadlock vis-à-vis developing countries. The 'Singapore issues', in their 'international investment' section, essentially took up the terms of the Multilateral Investment Agreement (MIA), which had been promoted by the OECD and abandoned in 1998. The purpose of the MIA was to remove most remaining barriers to, and controls on, the mobility of capital. Developing countries considered that given their own belated development, they should be entitled to give preference to their own economies, favour their national champions, protect their public markets and compel foreign investors to accept joint ventures and facilitate the dissemination of new technologies. Similarly, they feared that 'easier trade', that is the reduction and harmonization of the administrative procedures linked to international trade, might mean very high implementation and compliance costs for them. Even though the EU ultimately backed two points (competition and international investment), it took too rigid a view throughout the negotiation and was too favourable towards the idea of enforcing the same rules for everyone, without taking the developing countries' specific needs into consideration.

Developing countries still think they are marginalized within the WTO but in Cancun the balance of power started to take a new turn. The penalty system within the Dispute Settlement Body (DSB) framework is meant to solve conflicts between developed countries, but is ill-adjusted to developing ones. Trade sanction threats do not have the same weight when they come from developing countries or emerging ones like Brazil or India. In case of conviction, there is no provision for prejudice compensation, but only the possibility of increasing tariffs proportionately to incurred losses, which leaves little margins for developing countries. Conversely, this system is a means to protect one country from another that would be condemned but unable to pay. The condemned country must also lower its tariffs on the corresponding goods; but here again this sanction may be more difficult to impose when a small country is in dispute with a big one. This asymmetry in sanction mechanisms is problematic.

Social standards are another major issue in the relations with developing countries (Cling et al., 2003). The debate on this issue has calmed down somewhat since the failure of the 1999 Seattle Conference, where the EU and the USA proposed to analyse the links that could be made between social standards and trade policy. This proposal was rejected by developing countries, which saw it as a way of disguising protectionist instruments. According to several studies, there is a link between the respect of social standards and development, but the causality relation plays both ways and these studies often tend to be somewhat reductive. Although this question is no longer on the discussion agenda, the failure by many countries to respect basic labour

standards remains a serious problem. Those basic labour standards relate to the 1989 ILO Declaration, that is the principle of free association and the effective recognition of the right to collective bargaining, the elimination of any kind of forced labour, the abolition of child labour and the suppression of recruitment and professional discrimination.

The multilateralism/bilateralism/regionalism debate has important implications for developing countries. On the whole bilateralism is unfavourable to small countries, which have to make larger concessions. For this reason the EU decided in 1999 to apply a moratorium on free trade bilateral agreements, unlike the USA where these have proliferated. Multilateral liberalization is not favourable to developing countries either, because they lose the preferential treatments they could take advantage of.

The EU has widely developed regional agreements and is in favour of a regional integration process. The latest agreements to date are the Cotonou Agreements of 2000 which followed the Euro-Med and Mercosur Agreements. The drawback with those agreements is that they call into question the asymmetries that developing countries could take advantage of and benefit processes in which parallel liberalization takes place on both sides (reduction of tariffs in return for an easier access to Northern markets). But this so-called symmetry is actually detrimental to the Southern countries, and the Euro-Med Agreements may thus be the origin of serious imbalances. Mediterranean countries are opening their markets to European products that will increasingly penetrate them, while agriculture, which could have represented a potential element for a return to a balanced situation, is not included in those agreements. Moreover the planned dismantling, in 2005, of the Multifibre Agreement which gave an advantage to small producers, who were thus protected against big producers by their quotas, is going to play largely in favour of China and other Asian countries, to the detriment of Mediterranean countries, especially in the textile and clothing sector.

11.4 Sectoral problems

Two main sector problems may be identified in terms of trade policy; one is linked to the CAP (Common Agricultural Policy) and the other to the liberalization of services within the General Agreement on Trade in Services (GATS).

11.4.1 The negotiations on agricultural policy within the WTO framework

This question has already been discussed in the previous chapter. The failure of the September 2003 Cancun summit illustrated the new capacity of the larger emerging countries to efficiently oppose the Euro-American axis by federating a rather heteroclite coalition of Southern countries (the G22 which then became the G20). One must, however, give some consideration

to the extent of the G20's central claim, that is the suppression of export subsidies and financial support to Northern farmers. The total liberalization of agricultural products trade would be far from favourable to most Southern and Northern farmers. It would first benefit the emerging countries' big farmers, like Brazil and some members of the Cairns group. The less advanced developing and Mediterranean countries' farmers, whose export capacities are limited, would be eliminated; and the same would apply to those in north-east Brazil. In order to modernize their agricultures, which still guarantee a minimum income to a large part of their population, these countries need structural policies and specific subsidies that are far removed from the sole principles of liberalization.

The CAP's protectionist aspect is often too hastily denounced in spite of its objective foundations. A badly handled dismantling of the CAP within the WTO may not solve the problem of low-priced exports and the resulting pressure on the poorest nations. It would have different implications for each country. It would highlight the antagonism among Northern countries according to each one's interests in agricultural activities, the losers being Europe's farmers, and the winners the Cairns group members. No solution would be found for developing countries with traditional agricultures.

11.4.2 The negotiations within the GATS framework

After the liberalization of goods trade, which is already well under way in most sectors, the liberalization of services trade represents the new stake in the future negotiations with the GATS which was signed in 1994 within the WTO framework. The stake is essential as many services are socially produced in accordance with specific national standards that are the very foundations of our societies. All services are concerned, including education and health, with the exception of regalian ones. The negotiation process is progressive but all sectors will be affected by the liberalization trend through successive bargaining waves.

This general framework is particularly constraining and worrying for public services and the European social model (Jennar, 2003). In terms of the global liberalization of services, no reference whatsoever is made to the specificity of public services. The participating nations jointly determine which sectors should be liberalized on the basis of mutual concessions, but all exceptions and restrictions must be re-examined every five years. The WTO must then decide whether the conditions that justified those restrictions are still acceptable. In the case of disputes and if a complaint is lodged by an 'operator', the WTO's Dispute Settlement Body – a court whose validity with regard to democratic principles may be questioned as it is composed of private experts without official mandate – will be the only one to judge, on last appeal. The WTO is ruled by a British 'common law' principle according to which the law is empirically established through the DSB's judgments. The extent of the DSB's competences thus remains uncertain.

The Commission, negotiating on behalf of the EU, has appeared as a zealot of the liberalization process. The liberalization proposals of March 2003 on highly sensitive subjects were not submitted to any democratic consultation, and remained top secret. Besides the horizontal commitments which, among others, pave the way for short-stay work permits for non-Europeans working in highly skilled sectors (computing, engineering, consulting, architecture), the proposals for sectoral liberalization are considerable: in postal and environmental services, transport and telecommunications. If the right to impose universal service goals in postal or telecommunication services is maintained, the procedure will allow the speeding up of the liberalization process and will foist the policy of liberalization on reluctant member states. Most of all, liberalization within the GATS will become non-reversible and the remaining obstacles are likely to be removed at a later stage in negotiations. Although education, health and cultural activities are not affected at the moment, there is no guarantee of what the future might hold.

11.5 Conclusion

On the whole European trade policy must be assessed as only very partially successful. Regarding strategic trade policy, the EU has been in a weak position in using traditional tools like norms, public procurement and IPRs. The completion of the Single Market has not been used to implement the accompanying measures in order to benefit from the enlargement of market sizes. The EU has been impotent when faced with the efficient strategy of the USA in using the IPRs to strengthen their comparative advantage in the high-technology sectors.

Regarding the Southern countries, the EU, as well as the USA, has appeared to be too favourable towards the enforcement of across-the-board rules, which are too constraining for developing countries. This has been the case with the IPRs and with the 'Singapore issues' relating to competition, international investment and facilitation of exchanges. Social standards are another sensitive point. Behind their apparent symmetry, the regional agreements signed by the EU often hide mechanisms detrimental to the situations in Southern countries.

Lastly the agricultural policy and the liberalization of services are two major issues. A badly handled dismantling of the CAP could have negative effects on European farmers without contributing towards helping the poorest countries. The negotiations within the GATS represent a very constraining framework for public services and for the European Social Model.

Note

1. This chapter and Chapter 24 are the outcome of a workshop organized within the thematic network EPOC with the following participants whom we gratefully

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12
Enlargement: Not Enough Support for the New Members[1]

12.1 Introduction

There is no doubt that the 2004 enlargement was justified by a number of very good reasons: (1) the intention to take up the original European agenda to unite the countries for a more peaceful and prosperous future; (2) the ambition to create a large and powerful economic area able to compete with the United States in economic terms; (3) the will to balance the increasing hegemonic behaviour of the United States by a second superpower; (4) the hope that integration of eastern European countries would make it very difficult for a further 'Yugoslavia' to occur, that is another regional war among former Soviet-dominated states and neighbouring countries in Europe. On the other hand in the accession countries the issue of EU membership was associated with contradictory and vague expectations, with fear and hope. But the specific constellation of economic, political and ideological powers during the accession years resulted in an institutional framework conducive to a suboptimal development in the CEECs. It will be argued that the economic evolution in the former socialist countries[2] exhibits a number of severe deficits which partly have their origin in EU policies.

After presenting a short picture of the economy of the CEECs, we focus on three areas of EU policies: first, the imposition of neo-liberal structures onto the CEECs; second, the self-blocking effects of the Stability and Growth Pact in conjunction with asymmetries of monetary and fiscal policies; and third the implementation of the 'club approach' in the process of enlargement.

12.2 Main economic indicators of CEEC development

12.2.1 Production and growth

The end of the socialist system marked a significant downturn in the volume of production in all the eight countries. Between two years in a row (Poland) and five years in a row (Lithuania) the volume of total production fell

Table 12.1 Real growth in the CEECs

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
Czech Republic (CZ)	−1.2	−11.6	−0.5	0.1	2.2	5.9	4.3	−0.8	−1.0	0.5	3.3	3.1	2.0	2.9
Estonia (EE)	−8.1	−13.6	−14.2	−8.8	−2.0	4.3	3.9	9.8	4.6	−0.6	7.3	6.5	6.0	4.7
Hungary (HU)	−3.5	−11.9	−3.1	−0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.3	2.9
Latvia (LV)	10.4	−10.4	−34.9	−14.9	0.6	−0.8	3.7	8.4	4.8	2.8	6.8	7.9	6.1	7.4
Lithuania (LT)	−3.3	−5.7	−21.3	−16.2	−9.8	3.3	4.7	7.0	7.3	−1.8	4.0	6.5	6.8	9.0
Poland (PL)	−7.5	−7.0	2.6	3.8	5.2	7.0	6.0	6.8	4.8	4.1	4.0	1.0	1.3	3.7
Slovakia (SK)	−2.5	−14.6	−6.5	−3.7	5.2	6.5	5.8	5.6	4.0	1.3	2.2	3.3	4.4	4.2
Slovenia (Sl)	−4.7	−8.9	−5.5	2.8	5.3	4.1	3.5	4.6	3.8	5.2	4.6	2.9	2.9	2.3

Sources: wiiw Handbook of Statistics (2002, 2003); wifo databank.

Table 12.2 GDP per capita and PPP, 2003 (in euro and % of EU-15 average respectively)

CZ	*EE*	*HU*	*LV*	*LT*	*PL*	*SK*	*SI*	*EU-15*
14.600	10.320	13.400	9.330	10.290	10.360	11.710	16.540	24.300
60	42	55	38	42	43	48	68	100

Sources: wifo; wiiw databank; Eurostat.

(see Table 12.1). The following recovery in the second half of the 1990s started from a considerably lower level of GDP.

Since the mid-1990s, the CEECs have shown some strong increase in production volumes, notably in Poland and the Baltic countries. Notwithstanding the relatively good growth performance since then, it is important to remember that the CEECs are still far away from the average level of GDP per capita in the EU-15. Even if we compare the GDP per capita at purchasing power parities, these economies arrive only at about 40–60 per cent of the EU-15 average, with the exception of Slovenia with 68 per cent (see Table 12.2). There is still a significant gap in the level of economic development between the CEECs and the EU-15. This gap will continue to play an important role, and it will need favourable growth conditions over a longer period of time in the CEECs to effectively catch up with higher levels in western Europe.

12.2.2 Unemployment and productivity

Although growth gained momentum from the mid-1990s onwards, a number of severe economic problems continue to exist, in particular unemployment. Over the six years 1998–2003 only two of the eight CEECs under consideration, namely Hungary and Slovenia, managed to keep their unemployment rates below average EU-15 levels (see Table 12.3). The majority of the CEECs experienced higher unemployment than on average in the EU-15, with some few years of exceptions in Estonia and the Czech Republic. For the year 2004 unemployment rates of 19 per cent were forecast for Poland and 17 per cent for Slovakia.

Unemployment will not recede quickly. The persistent efficiency reserves and the enormous catching-up process in labour productivity will lead to further increases in unemployment despite considerable real growth. The speed of the catching-up process is clearly represented by the development in manufacturing industry (see Table 12.4). During the years 1995–2002, (the weighted average of) labour productivity increased annually by 6.4 per cent in the CEECs and by 2.1 per cent in the EU-15. Cumulated for this eight-year period, labour productivity grew by almost 80 per cent in the CEECs vis-à-vis just above 16 per cent in the EU-15. The downside of this remarkable achievement was not only that real growth was too weak to

Table 12.3 Unemployment rates (total unemployment)

	CZ	*EE*	*HU*	*LV*	*LT*	*PL*	*SK*	*SI*	*EU-15*
1998	6.4	9.2	8.4	14.3	13.2	10.2	n.a.	7.4	9.4
1999	8.6	11.3	6.9	14.0	13.7	13.4	16.7	7.2	8.6
2000	8.7	12.5	6.3	13.7	16.4	16.4	18.7	6.6	7.8
2001	8.0	11.8	5.6	12.9	16.4	18.5	19.4	5.8	7.4
2002	7.3	9.5	5.6	12.6	13.5	19.8	18.7	6.1	7.7
2003	7.8	10.1	5.8	10.5	12.7	19.2	17.1	6.5	8.1

Source: Eurostat, 2004.

Table 12.4 Labour productivity catching up in the CEECs vis-à-vis the EU-15 in manufacturing industry, 1995–2002

	CEECs' growth rate (%)		*CEECs' growth differential against EU-15 (percentage points)*		*EU-15 growth rate (%)*	
	Cumulative	*Annual average*	*Cumulative*	*Annual average*	*Cumulative*	*Annual average*
Production	54.0	6.4	38.6	4.3	15.4	2.1
Employment	−14.0	−2.1	−11.9	−2.1	−0.9	0.0
Productivity	79.1	8.7	62.7	6.5	16.4	2.2

Notes: Gross production and productivity in real terms; central and east European first-round accession countries, weighted average.

Source: Havlik et al. (2003, p. 11).

create additional jobs ('jobless growth') in the CEECs. The cumulated loss of manufacturing jobs amounted to 14 per cent in the CEECs, while the number of these jobs did not fall significantly in the EU-15 (−0.9 per cent).

12.2.3 Price stability and interest rate levels

Inflation is no longer a problem in transition countries, since a persistent trend towards disinflation has been observed in the majority of them, although the Baltic countries, Slovenia and Poland in particular had to cope with extreme price increases at the beginning of the transition process (see Table 12.5). In some countries like for example the Czech Republic, Lithuania and Poland, the tendency to deflation in the years preceding the accession might be a matter of concern. However, the annual rate of inflation in Poland has jumped from 1.6 per cent in the first quarter of 2004 to 4.6 per cent in the second quarter. That increase is even more impressive if compared with 0.5–0.8 per cent in the first three quarters of 2003. The recent

Table 12.5 Inflation rates: consumer price index changes against preceding year (%)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
CZ	9.7	56.6	11.1	20.8	10.0	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	−0.1
HU	28.9	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.2	5.3	4.3
PL	585.8	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1	5.5	1.9	0.6
SK	10.4	61.2	10.0	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.2
SI	551.6	115.0	207.3	32.9	21.0	13.5	9.9	8.4	7.9	6.1	8.9	8.4	7.5	5.8
EE				89.8	47.7	28.8	23.1	10.6	8.2	3.3	4.0	5.7	4.6	1.5
LT				410.2	72.2	39.7	24.6	8.9	5.1	0.8	1.0	1.3	0.3	−1.2
LV				108.8	35.9	25.0	17.6	8.4	4.7	2.4	2.7	2.5	2.0	2.8

Source: Österreichische Nationalbank, CEEC Research Platform; wiiw Handbook of Statistics 2003.

Table 12.6 Official lending rates (%), end of year (for 2003: October)

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
CZ	11.30	12.40	15.75	9.50	5.25	5.25	4.75	2.75	8.50
HU	28.00	23.00	20.50	17.00	14.50	11.00	9.80	8.50	9.50
PL	25.00	22.00	24.50	18.25	19.00	21.50	14.00	7.50	5.75
SK	9.75	8.80	8.80	8.80	8.80	8.80	8.80	6.50	6.25
SI	13.75	6.07	9.84	6.26	6.05	9.86	7.30	7.30	12.26
EE	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
LT	n.a.	n.a.	13.00	13.00	13.00	9.60	7.80	7.99	5.13
LV	24.00	9.50	4.00	4.00	4.00	3.50	3.50	3.00	3.00

Source: Österreichische Nationalbank, CEEC Research Platform, 2004.

trend towards currency appreciation has also supported price stability. After excessive devaluations at the beginning of the transition process, appreciation seems now only a return to normality.

In line with the gradually vanishing inflation danger, nominal interest rates have shown a falling trend (see Table 12.6). However, for a number of reasons, the credit markets in most transition countries are still not functioning properly. Therefore loans for business investments are hard to obtain irrespective of the level of interest rates, posing a crucial barrier to expansion and growth. A further obstacle might be the partial reversal of the trend with interest rates rising again in some of the CEECs (Czech Republic and Hungary, see Table 12.6).

12.2.4 Current account

One of the most serious problems of the CEECs is the huge and lasting negative balance in foreign trade. This problem is caused by insufficient levels of international competitiveness, but also by excessively high ratios of foreign ownership in the industries of some of the acceding countries, which tend to deteriorate the current account balance and increase economic uncertainties.

In the period of 1998–2004, the current account in per cent of GDP

- has deteriorated from −2 to −7 in the Czech Republic
- has 'improved' to −6 at the end of the 1990s, but then worsened again to −15 in Estonia
- has oscillated between −3 and −6 in Hungary
- moved up and down between −7 and −11 in Latvia
- 'improved' from −12 to −6 in Lithuania
- improved after almost −8.3 (in 2000) to about −3 in Poland
- oscillated between −4 and −9 in Slovakia and
- is only now approaching equilibrium in Slovenia after −4 in 1999.

These deficits are the source of continuous macroeconomic adjustments, of fiscal and monetary austerity measures and of slowing down economic

growth. A typical example is Poland, where the external deficits had particularly negative consequences. The restrictive policy, applied since 1998 to cool down the economy and improve the current account, resulted in a growth crash from 6–7 per cent in 1995–97 to 1.0–1.3 per cent in 2001–2, while the unemployment rate nearly doubled between 1998 and 2001 (Dymarski, 2001, 2003).

12.2.5 Summary

The data reveal some positive signs of the economic development of the eight CEECs in the last ten years or so (economic growth, falling inflation rates), but also a number of difficult problems (unemployment, current account deficit). There is no reason to believe that the new member countries are already on a stable path to catch up economically with the EU-15.

12.3 Imposing neo-liberal structures

While some policies with the latest enlargement of the EU may be deemed positive (environmental policy, human rights and so on), the enlargement policy pushed forward by the Commission had for several reasons a number of negative economic consequences for the accession economies. The enlargement policies observed in the last decade or so *continued* the neo-liberal free market trends of the transition strategies (Kregel et al., 1992) that have so disadvantaged the majority of the CEECs. They have resulted in increased inequality, unemployment, declining levels of real income, growing poverty and significant regional economic disparities.

The neo-liberal core of the suggested policies is characterized by the dogma of free trade, economic deregulation and privatization, therefore leaving the main burden of structural adjustments and the impact of economic liberalization to the candidate countries themselves (Bohle, 2002). This kind of *negative integration*, perfectly in line with EU policy prescriptions, has posed a crucial barrier to growth and employment in the CEECs.

12.3.1 Deregulation of trade and financial markets

Deregulation at large and deregulation of international trade in particular have been said to be the key to global prosperity. The proponents of free trade seem to have history on their side. However, a closer look at the history of capitalism reveals a completely different story (Chang, 2002). When the rich countries of today were developing countries themselves, virtually all of them did not practise free trade. Rather, they protected and supported their national industries through tariffs, subsidies and other measures. In particular, Britain and the United States were frequently the most ardent users of *interventionist* trade and industrial policy measures in their early stages of development. The same holds for the so-called 'Asian tigers'. Hence, for a successful economic development, both history and well-designed theory

demand a cautious approach to the opening-up of domestic markets to foreign competition.

In stark contrast to such a well-balanced opinion the ideology of free trade has played an important role in the transition process (Kregel et al., 1992) and also in the accession process. Consequently, from the end of the socialist system onwards, a steady progress of opening up integrated the CEECs gradually into the 'European market'. Nearly 70 per cent of CEECs' exports and 60 per cent of their imports are now (2003) traded with the EU (Havlik et al., 2003).

This integration process was accompanied by a *structural deficit* in the current accounts of the CEECs. This deficit follows logically from deregulating international trade in goods, services and capital between less developed and more developed countries (Matzner, 2002). The less developed economies have a high demand for both consumer and investment goods, and their competitive position is by definition such that they are less able to sell their industrial products and services to the richer economies. The result is a permanently recurrent deficit in the balance of payments.

Foreign trade statistics of the CEECs confirm this conclusion. The trade balance of all the CEEC-5 countries (the Czech Republic, Poland, Hungary, the Slovak Republic and Slovenia) was permanently negative from 1998 to 2003, although in recent years the excess of imports over exports grew smaller (Havlik et al., 2003), in particular due to improved product quality of export goods and a remarkable increase in productivity.

12.3.2 Privatization effects

A typical example of privatization can first be considered with the case of the *rail sector in Slovakia* (Lucas and Hines, 2000). With a staff of approximately 50,000, the Slovak Railway Company (ZSR) was the biggest employer in the country. In 1998 the Slovak government prepared for the layoff of around 25,000 employees, and signed a loan agreement with the European Investment Bank (EIB). The agreement envisaged a rise in fares of 30 per cent for passengers, a cut of two-thirds in both state subsidies and in staff payroll over eight years, a reduction in rail freight, and a drop in the overall number of lines in the railway network. These conditions were not a matter of negotiation. The EIB made it quite clear that if the government agreed to meet them, the bank was ready to immediately provide the loan. As the president of the EIB recognized it, 'the proposed restructuring measures in this case mirror those agreed over recent years between the Bank and virtually all railway companies in the 10 Central and Eastern Europe countries which have applied for EU membership' (Lucas and Hines, 2000).

On the other hand, public money was abundant for private transport industries. The scale of financial inducements offered by the Slovak state to encourage the expansion of Volkswagen in Bratislava was considerable. One industrial zone built to attract foreign suppliers for the nearby Volkswagen

plant was supported by the government, which was paying the costs of the infrastructure of about $6.4 million to create 1200 jobs. The question has been raised why such huge incentives have been offered to a foreign manufacturer in the first place, when for example they could have been granted to the domestic manufacturers of buses, of which there is an acute shortage in the country. Alternatively, they could have been used to strengthen the crumbling public transport sector. This would have saved thousands of jobs: Volkswagen Slovakia employs approximately 6000 workers (in 2000), while the railways, short of investment funds, laid off about 20,000 in the same year.

The case of Slovak railways is but one example of a more general pattern in transition countries of the effects of privatization on welfare and employment levels. While studies of the impact of privatization on the company level ('restructuring') reveal the positive effects on cost reduction and efficiency on the micro-level (Megginson and Netter, 2001), the effects on the macro-level are generally much less positive. A report for the International Labour Organization (Martin, 1997) states that privatization can make an important contribution to creating the conditions for employment growth and social justice, but that these outcomes are, by no means, inevitable. The report underlines that 'if privatization is to yield strong benefits to society as a whole, it needs to be managed to ensure transparency, equity and fairness and consideration must be given to its impact on workers, employers and investors, consumers, managers and all other stakeholders'.

The *employment effects* of privatization were rather negative in the transition countries. Using detailed studies in Bulgaria, the Czech Republic, former East Germany and Hungary, the report states that

> In most Eastern European countries privatization … has resulted in large-scale job losses. This has created a pool of unemployed workers, which often cannot be absorbed by other privatized firms or new firms. Furthermore many workers never appear in the unemployment statistics because, either before or after the privatization process, they are sent on leave without pay or with very much reduced pay. (ibid.)

The following numbers are quoted to substantiate these findings: a government survey of 572 companies revealed a 'significant decline in employment' in the *Czech Republic*, with engineering showing the sharpest drop (−12 per cent), manufacturing and construction cutting jobs by 10 per cent and the food sector by 4 per cent.

Heavy job losses are also reported for *Hungary*. Between 1989 and 1997 almost 30 per cent of employed people lost their jobs[3] (that is about 1.5 million job losses). A particular case was the lighting company Tungsram, where 35,000 people had been employed. In preparation for the sale to General Electric this number was halved to 17,640, and the new owner soon almost halved again the number of employees to 9500.

The numbers in employment fell from 9 million before transition to 6.3 million by the end of 1992 in *former East Germany*. Employment in companies under the privatization agency Treuhandanstalt fell from 4.1 million to 1.2 million in that period. Government research in *Poland* into 130 companies who employed 285 workers on average, showed employment reductions of 15 per cent in the first year, 25 per cent in the first two years after privatization, levelling off in the third year with a drop of a further approximately 2 per cent.

The true scale of unemployment has been concealed in some cases by practices of enterprises to keep workers at home on some proportion of their pay. However, even where unemployment levels have remained low, long-term unemployment has emerged. A typical case is the Czech Republic, where low levels of unemployment prevailed until the mid-1990s. But by the end of 1994 over a third of job applicants had been out of work over more than a year.

There have been further crucial effects of privatization. Considering the impact on *pay and conditions of work*, the average real net wages and salaries fell by 28.8 per cent between 1989 and 1993 in Poland. According to a study of ten privatized Polish companies, on the other hand, wages showed a tendency to sharply increase immediately after privatization, but they stopped doing so soon afterwards in favour of performance-related pay incentives. Foreign owners have been reported to block pay increases in Estonia. While a law, which took effect in 1993, forbids new private owners from scrapping collective agreements, it allows them to renegotiate. In Hungary, while some privatization contracts have obliged foreign companies to retain employment levels for a specified period of time, there have been cuts in *training*. There have also been opposite experiences, however. In the already mentioned case of Tungsram, jobs and pay cuts were associated with the introduction of a number of safety and health measures, accompanied by comprehensive worker training programmes.

Furthermore, it seems to be open to debate what the effects of privatization on *economic democracy* will be in the end. The case of the Czech Republic may serve as a typical example for contradictory experiences in the CEECs. Mass privatization brought ownership to about 6 million shareholders without leading to a widespread democratic influence on company decisions. Quite the contrary, economic power became concentrated in the hands of investment funds. After the first wave of privatization, 14 investment funds held 70–80% of all investment fund shares. On the other hand it seems that workers have gained a more powerful position via the emergence of institutionalized industrial relations in the Czech transition process. In Poland free or discounted shares have enabled Polish employees to obtain ownership stakes. However, there has been a post-privatization tendency for ownership to concentrate with inside management or outside institutions within three years or so.

Further effects of privatization have been analysed, for example on social services and on the access to public utilities (Martin, 1997). In some cases, utility prices have soared to hitherto unknown levels. In Lithuania, to give just one example, the average electricity bill for domestic consumers went up by 400 per cent between 1991 and 1995.

In summing up, it may be quite difficult at times to empirically separate the effects of privatization from other sources and causes of social and economic change. However, since privatization is at the core of transition strategies as they have been advocated by neo-liberal ideology and followed in the CEECs, it seems appropriate to associate a large part of the social and economic effects dealt with in this section with privatization. Furthermore, detailed studies suggest exactly such a causal relationship.

12.4 Self-blockade by programmes and structures

In terms of growth and employment policy, the EU-15 has immobilized itself by a combination of economic policy programmes and institutional arrangements. It has already been argued in detail (see Chapter 3) that the Stability and Growth Pact (SGP) is one source of the general slowdown in European growth and of the increase in unemployment in recent years. The inflexibility and simultaneity of the deficit rules led to a general reduction of domestic demand, which reinforced itself by the close integration of European economies. The asymmetry between a highly centralized monetary policy and a largely decentralized fiscal policy in conjunction with the independence of the ECB and its singular orientation towards monetary stability are at the core of an institutional arrangement which is inefficient in promoting growth and employment in Europe.

In the context of increasingly integrated CEECs, the insufficient effective demand *within* the EU was bound to have *multiple negative effects* on the transition economies. Firstly, weaker economic activity in the EU-15 translates into weaker export demand for the CEECs. Secondly, unfavourable economic prospects within the EU lead to an even stronger reorientation of sales towards the new markets in the east, stepping up competitive pressure and company failures in the CEECs. And thirdly, high and increasing unemployment in the west increases workers' fears of low-wage competition from immigrants. Therefore, there is a tendency for populist and workers' movements to ask for barriers to immigrant workers from the CEECs (and other low-income countries). Consequently, income chances for CEEC migrants are possibly reduced.

Empirical findings substantiate the correlation between EU-15 growth and industrial production in the accession countries. The increase in industrial production, mainly driven by expanding exports, dropped sharply after 2000 in most CEECs. For example, in the CEEC-5 (Poland, the Czech Republic, the Slovak Republic, Hungary and Slovenia), the growth of industrial production was almost halved at the beginning of the new century from 5.8 per cent

Table 12.7 Real growth of EU-15 and growth of industrial production in the CEEC-5 (%)

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Industrial production growth, CEEC-5	5.1	8.5	4.6	2.3	8.4	3.2	3.0
Real growth, EU-15	1.6	2.5	2.9	2.9	3.6	1.7	1.0

Sources: wifo databank; Havlik et al. (2003, Table 3, p. 7).

(1996–2000) to 3 per cent (2001–2), when the average growth rates made a parallel movement from 2.7 per cent (1996–2000) to 1.3 per cent (2001–2) (see Table 12.7).

12.5 The club approach to enlargement

The club approach to enlargement means that there was an asymmetry in the relation between the 'club of the powerful', who make the rules for joining the club, and the poor petitioners who want to get in. This club approach suffers from at least two significant weaknesses (Huffschmid, 2002). First, the club approach assumes that the EU has a genuine democratic basis and a strong economy with appropriate rules and institutions, and that therefore it needs no fundamental changes. This assumption is not validated by empirical facts. The EU economy has gone through a decade of slow growth with high and growing unemployment. Unemployment rates and social exclusion were higher at the end than at the beginning of the decade. Furthermore, the democratic character of the EU may be questioned, at least to some extent. The European Parliament is only partially involved in legislative processes, and democratic accounting in essential economic policy areas like monetary policy is not existent. The decisions taken by the Council are often not transparent enough to the common public.

The second flaw in the club approach is the assumption that after enlargement, the EU will be larger but not substantially different. But even if all the conditions for joining the EU are met by all the new member countries, the 'new' Europe will be quite different. On the positive side, the cultural and historical diversity and richness of the EU will be much larger, which is an asset in itself. On the other hand, the economic disparities between member countries and regions will be much larger than before. These disparities may develop into a crucial problem for the future of the EU.

12.5.1 Increasing regional disparities meet decreasing means to offset them

Already the former enlargement rounds (see Chapter 2), in particular the two 'south enlargements' in 1981 and 1986, have widened considerably the

spread of economic wealth, and the 2004 enlargement has further increased economic disparities. Measured in 2002 GDP per capita (PPP), economic wealth in the EU-15 ranged from a minimum of €15.840 (Greece) to a maximum of €45.490 (Luxembourg), that is a range of €29.650 and a coefficient of variation of 26 per cent. With the same measure, the EU-25 span starts from a minimum of €8.390 (Latvia), spreading the span to €37.100 and amplifying the coefficient of variation to 43 per cent.

Disparities are of course even more pronounced on the subnational level. Using the figures for NUTS-2 regions in the year 2001 (Krueger, 2004a), regional GDP per capita (PPP) ranged from €12.308 (Dytiki, Greece) to €61.316 (inner London, UK) before the last enlargement, which represents a span of €49.008. By the same measure (Krueger, 2004b), this span has now grown to €54.558 after enlargement, with the least developed region arriving at a GDP per capita of €6.758 (Lubelskie, Poland), that is almost one-tenth of the top region in London, even taking into account the quite different price levels.

However, in contrast to former enlargement rounds, the 'club' does not seem to have the ambition to substantially elevate its funds for regional adjustment. If we take the Community's expenditures within the structural policy chapter (B2) as an indicator of the Community's preparedness to deal with regional disparities, the situation today is quite different from that in the second half of the 1980s (south enlargement). From 1984 to 1990, Structural Funds expenditures increased from €3.220 to €7.324 million in real terms (1984 prices). In other words, these expenditures have been raised by *more than 100 per cent in real terms*. Over the same number of years, from 2000 and 2006, these expenditures are subject to a *decrease in real terms* (from €32.678 to €30.343 million at 2000 prices). From 2006 to 2007 an increase of 23 per cent (in real terms) is planned according to current budget provisions, but from 2007 onwards there will be only marginal real term increases (Europäische Kommission, 2000, p. 30). Therefore, facing growing regional disparities in the process of the 2004 enlargement, regional funds are downsized in real terms, at least until the year 2006.

12.5.2 Trade and industrial specialization patterns

Enlargement leads to a redefinition of core and periphery. Some regions and countries in the EU-25 will now broaden the periphery, while others will come closer to the core. The core–periphery location is important for trade and industrial specialization. Dupuch et al. (2004) have shown that periphery economies tend to be significantly more specialized in trade than core economies, and that there is a risk for peripheral regions to specialize heavily in traditional sectors associated with lower levels of productivity and value added. Hence, the authors favour a 'regulatory framework at the EU level' preventing or diminishing these risks, so that potential economic and political tensions may be kept from emerging in peripheral areas. Again, strategies of positive integration would be needed, entailing appropriate

regional development measures to set off the possibly negative effects of core–periphery polarization.

If the EU does not manage to set the countries and regions on a development path of converging living standards, and the disparities are growing, the economic and political stability of the EU itself is endangered. However, the reduction of these large disparities will not be possible under a neo-liberal regime which is bound to increase rather than to decrease inequalities.

12.5.3 The ambiguous role of FDI

It is rarely questioned that 'FDI are explicitly and even more implicitly considered a kind of panacea for problems of transition countries which is indicated also by their efforts to get as much FDI as possible' (Mencinger, 2002, p. 62). The common expectation is that foreign firms are likely to bring with them technology, know-how and management structures that support the transformation towards a more competitive market-based economy. In fact, FDI has played an important role in terms of its share in overall investment and GDP.

However, empirical evidence gives rise to substantial doubts whether FDI is a net benefit, in particular to transition economies. For example, Mencinger's findings in an econometrical study suggest a negative correlation between the level of FDI and the rate of economic growth (Mencinger, 2002, p. 62). This result is important per se, even if more detailed studies conclude that it is not possible to isolate the channels through which FDI affects growth, and that therefore one has to revert to firm-level data.

This issue is normally analysed under the heading of spillover effects of multinational firms to host countries, an issue which has attracted much attention in the literature since the 1960s. Notwithstanding the very large number of studies on this matter, there is no clear answer to the question whether in the end multinationals have positive or negative effects on local firms. This ambiguity is even biased towards the negative in transition economies. Barba-Navaretti and Venables (2004) list five studies on firm-level spillovers in transition countries. For none of the eight countries included was it possible to establish a statistically significant positive relationship between FDI and local firm performance.[4] The bottom line is that for countries in a catching-up process it seems at least questionable whether they should try to attract foreign capital by all means, and in particular by subordination to the deregulation rules of free capital markets.

In conclusion, the club approach to enlargement poses a formidable threat to the long-term viability of the European Community and has therefore to be abandoned and replaced by a much more integrative development approach.

12.6 Conclusion

After presenting the main stylized facts of economic development in the CEECs since their transition to market economies, we have pursued three

lines of argument to substantiate our hypothesis, that the EU-15 policies have not been sufficiently supportive to a progressive and viable economic development in the CEECs during their accession period.

The first argument deals with deregulation and privatization as core elements of neo-liberal policies. A wide variety of empirical evidence is used to show the adverse effects of these policies on the accession economies. Secondly, the self-blockade to expansion by the Stability and Growth Pact in conjunction with a deflationary monetary policy may be seen as a barrier to CEEC economic upswing due to multiple feedback effects of international trade. Finally, we have identified the 'club approach' as being a further source of past and future deficits in the catching-up process of the CEECs. The main argument is that the negative integration set in motion by neo-liberal policy patterns would need much more active cohesion strategies to offset growing regional disparities and unfavourable specialization processes. In order to set the CEECs on a stable path of catching-up with the EU-15, a number of measures are urgently needed:

- to ensure sustainable growth, the EU has to design policies that would assist the improvement of the competitiveness of the (national) firms in the new member countries; a special institution should be established with the tasks to (1) study the reasons for unbalanced foreign trade and current account deficits, (2) evaluate the competitiveness of the new member economies vis-à-vis that of the old EU economies, (3) examine the long-term capital flows, (4) benchmark the components of competitiveness;
- the ambition of some new member countries to enter the Eurozone as soon as possible has to be met with extraordinary caution; since there is the danger of repeating the deflationary experiences which have bedevilled the existing Eurozone countries when they prepared to meet the Maastricht criteria, it is recommended to use the flexibility of the EMS2 over an extended period in order not to fall into the convergence trap (see Chapter 15);
- to prevent the re-emergence of monetary instability, a European Fund for Monetary Cooperation Mark 2 (EMF) could be established with the task of mitigating the impact of sudden money movements within and outside the Union and to help the new member states' efforts to reach a balanced economic growth; in order to protect themselves against foreign exchange speculation, the new members countries should have the right to use temporary capital controls until they join the Eurozone;
- in line with the Council decision of 20 December 2000, an institution should be established to address the particular problems of small and medium enterprises (SMEs) in the new member states;
- the catching-up process will be a long and difficult process accompanied by many economic and social tensions; in order to anticipate the main problems and to better understand the complexities of the process, a monitoring activity would be helpful to evaluate the progress and to assess the foreseeable economic and social problems.

Notes

1. The author is grateful to Karoly Lóránt for a number of important suggestions. Further comments have been received from Wlodzimierz Dymarski.
2. In this chapter we concentrate on the eight CEECs of the ten 2004 accession countries, i.e. on Poland (PL), Hungary (HU), Czech Republic (CZ), Slovakia (SK), Slovenia (SI), Estonia (EE), Latvia (LV) and Lithuania (LT). This in no way implies that the economic development in Cyprus and Malta is of lesser importance. However, the focus in this chapter is on former socialist economies, having a particular history of economic development and of accession to the EU.
3. Source: personal information from K. Lóránt.
4. For Romania, two studies are quoted, one reporting a positive and the other a negative relationship (Barba-Navaretti and Venables, 2004, Ch. 7).

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13
Policy Coordination: Legitimate and Effective?

13.1 Introduction

The policy coordination mechanisms in the EU form a *complex*, *multi-level* and *segmented* system. There are two main reasons for this. Firstly, the general customs union is combined with a partial monetary union: the monetary union has its own requirements in terms of coordination and it runs in parallel with a customs union of countries which have kept their own currencies and possess more or less autonomy in their exchange rate policy. Secondly, the whole process of construction of the Union has continuously produced specific arrangements in different domains, be they trade, investment, finance, labour mobility, social affairs, defence. Coordination is therefore highly segmented by domain and by subgroups of countries, and this raises the problem of the consistency of policy overall. Moreover this complexity does not avoid major coordination failures which call into question the legitimacy of the whole system when its segmentation obstructs democratic control of the overall process.

13.2 What do we mean by policy coordination? The theoretical background

Let us firstly present a broad definition of policy coordination to avoid a loose use of the term where 'coordination' is said to exist whenever we have exchange of information of any kind on the issue under view.

A core definition of effective policy coordination might contain three elements:

- The first element is the willingness of the policy-makers concerned actually to modify their policies, at least to some extent, in the light of the process. This implies that they are aware that their actions will have spillovers (externalities).
- The second element is the existence of a shared model of action and interaction. A common vision (or model) of the real world makes it possible for the partners to define common objectives.

- The third element is the establishment of a formal scheme of coordination. This procedure helps to frame the learning process underlying a coordination scheme and to fix the commitments of the participants.

In practice of course, not all the conditions of this core definition will be fully satisfied. For example, there may be differences in the models used by various partners or disagreements about the procedures to be followed. But the most important problem in policy coordination is perhaps the first element – the willingness to modify policies and the recognition of interdependence (spillovers or externalities) on which this willingness rests. This willingness has to be grounded on some political legitimacy. Only then can the model referred to in condition (2) make sense. We shall see that the democracy of the procedures may well be the major condition of success when the coordination required concerns complex and lasting issues. So far our definition gives rise to two kinds of problems.

In the first place in a more open world and with the expansion of information and knowledge interactions are more numerous and more likely to be acknowledged. Interdependencies become common knowledge. This recognition of external effects is also a matter of debate between politicians. Ecological issues are good examples of such a battle for the internalization of external effects. Even more worrying is the fact that coordination in one domain may interfere with coordination in another. This raises the crucial problem of overall consistency.

Even if partners in the EU were willing to coordinate their policies (condition 1), as some express it, the intricacy of the coordination required reacts back on the second and the third conditions. With growing interdependencies it becomes difficult to model these, to agree on causal linkages and to define objectives. For example, the problem of macroeconomic coordination and stabilization has led to endless, highly antagonistic, debates because there is no shared model of macroeconomic interactions. Growing complexity also makes it difficult to establish clear rules for policy coordination: faced with uncertainty, agents want to be able to adapt their behaviour as the situation changes. In consequence, even when they are ready to modify their policies to some extent they may refuse to bind themselves to strict procedures. We might then find only 'indicative' (non-binding) coordination. A good example of such a cautious approach is given by the open method of coordination (OMC) that was introduced at the Lisbon summit. In the OMC, common objectives are agreed in a specific field of policy, indicators are selected and outcomes are followed up, without the partners being constrained to follow fixed rules. But the lack of a shared model (condition 2) severely hampers the process.

It can be concluded that the very notion of policy coordination is bound to remain rather loose. If coordination is too tight it amounts to a rule which will either be accepted or enforced by some legitimate authority. If

coordination is too loose and informal it amounts, at best, to a signal of cooperation, at worst to a mere disturbance in the policy-formulation process.

We can illustrate the relativity of the notion of coordination with two opposite situations. The first is that of the European Central Bank[1] which denies the need for any direct policy coordination with member states on the pretext that this would go against its status as an independent body. The ECB also argues that for governments to follow good policies there is no need for coordination and that the pursuit of good policies at national level will still be optimal at the level of the Union.

The other example, totally at odds but interesting, refers to the personal experience of Alan Greenspan, director of the Federal Reserve, and as such, an important player in the world governance. During a visit to the Bank of England on 27 September 2002[2] he praised the coordination between the Federal Reserve and the Bank of England that occurred on many occasions through the regular meetings of the Bank of International Settlements (BIS), the OECD, the IMF, the World Bank and of the G7 (which led to the creation of the Financial Stability Forum within the BIS). In this case coordination refers to a certain disposition to exchange information over current subjects, supported by a common brand of neo-liberalism adjusted to the specific practices of central bankers, with varying procedures and few commitments. It is clear that such coordination can only be understood if one takes into account the long-term relationships gradually established through all these meetings.

The provisional conclusion is that in practice our approach to coordination should allow for uncertainty and for the complex fabric of long-term relationships in which any specific case of coordination is bound to be embedded. The definition of the objectives of coordination is a strategic issue, certainly marked by these unequal positions.

13.3 The complex system of EU policy coordination: the historical background

The Community has developed many coordination schemes in the various domains where it has gained competence. Some of these schemes involve fixed rules or institutions. Others remain more open and adjust to changes in the environment. All such schemes either take place or are issued and in all cases supervised within the governance frame of the EU (see Box 13.1), with its institutional triangle (Council, Commission and Parliament) and its judiciary arm (Court of Justice). The process of decisions within this frame defines what is called the Community Method.

The coordination schemes produced within this governance structure leave open the possibility of coordination failure. Problems may also arise from the fact that these schemes are independent and that the above governance structure does not produce the equivalent of a central government able to resolve inconsistencies.

Box 13.1 The governance scheme of the EU and its institutional triangle: at the core of the Community Method

(1) *The Council of the European Union*, composed of the ministers of the member countries, decides by unanimous agreement on questions falling within national competence and by qualified majority vote on questions within EU competence. It normally acts only on proposals from the European Commission. Presidency of the Council of Ministers alternates every six months. The Council of Ministers is supplemented by the European Council three times a year – this is essentially a summit conference of heads of state and heads of government of member countries.
(2) *The European Commission* composed of 30 members, commissioners (20 before the 2004 enlargement), one or two per country according to size, designated for five years by their national governments and agreed by the European Parliament. The Commission makes the propositions of laws to the Council and sees to their implementation. It has the monopoly of taking initiatives.
(3) *The European Parliament* (732 members elected directly for five years), co-decider with the Council over those decisions where the Union has competence, has to agree the budget of the EC.

This celebrated triangle of the European governance corresponds to the legislative and executive powers of the EU, to which should be added the *Court of Justice* for the judiciary power. The Court sees to the enforcement of the Treaty and to the respect of the four freedoms. It is an important body to which nation states have transferred part of their sovereignty as it prevails over all national judiciary institutions which have to assist the Court in enforcing EU-wide law.

The *European Central Bank*, since it is fully independent of national and EU-level instances, must be regarded as a fifth fundamental institution and is treated as such in recent EU legal documents.

Questions on coordination issues arise when new situations create new interdependencies which are not fully accounted for and where a new balance has to be set. Two major changes of this kind have placed coordination issues on the EU's agenda. The first is the creation of a monetary union by a majority of 12 out of the 15 members of the Community. The second is the enlargement of the EU to 25 member states.

The EMU, as it stands, is liable to coordination failure if one or several member countries are either subject to some adverse external shocks or experience internal economic recession.

To reflate the economy of these countries standard economics suggests three kinds of adjustment: mobility of workers to find a job in the other countries; cuts in the level of wages, providing this increases employment; or finally budgetary transfers that help the countries in depression to run large budget deficits. Depending on the overall size of the shock, these adjustments will be more or less feasible. However, these various national-level policies

are not easy to implement in the Eurozone. The mobility of labour cannot be compared with that in the USA, which is a fundamental trait of that country. The Schengen process which authorizes full mobility of persons in all the countries which are party to it, is not enough to overcome the drawbacks of different histories, languages and employment systems. As for wages, they are basically determined at the national level (as are most social issues) and in most Eurozone countries labour markets are not particularly responsive to wage cuts. Budget transfers would thus remain the only possibility. But euro member countries have explicitly eliminated the possibility of any solidarity budget beyond the standard Community budget. The SGP does not permit any exceptions to the basic rule limiting the public sector deficits of member countries.

There is no mechanism of coordination to escape from such a trap, even though a 'qualified' majority of member countries agree that a derogation from the Maastricht criteria could be allowed for a given period. The European Council made such an arrangement for six member countries with 'excessive' deficits in 2003. But the Court of Justice then invalidated this breach of the SGP, on the grounds that the arrangement should have been proposed by the Commission which has the monopoly of such initiatives. Even though the last head of the Commission, Mr Prodi, heavily criticized the rigidity of the SGP, one cannot hope that the Commission will accept its responsibility to systematically adjust the SGP according to the needs of member countries. Such adjustment has to take place at another level.

The Central Bank itself, in charge of monetary policy, has no obligation to take into consideration the danger that the shock may represent for a subset of countries of the EMU and therefore it can neglect the issue. This rigidity is a deadlock in the EU governance structure which has been forcefully criticized by many commentators.

Jacquet and Pisani-Ferry (2000), for instance, argue that in the case of an external negative shock, not only should there be some coordination between the monetary policy of the ECB and the budgetary policies of the member states, but also that the structural policies of the partners should also be coordinated as they aim to support economic growth and are all the more efficient if they occur simultaneously (risk of prisoner's dilemma). Another rationale for a coordination with the ECB is that de facto the Bank is bound to take into account growth prospects to fix its policy.[3]

Part of the problem is also that any coordination on such issues should involve not only the ECB but also the countries which are not in the Eurogroup which have their own currencies and could therefore launch policies with pro-cyclical or anti-cyclical effects, especially as in the EU-25 the Eurogroup becomes a minority.

This is why some advocate that macroeconomic policy cooperation should take place at the level of the Macroeconomic Dialogue[4] which gathers together all member countries plus the ECB and the social partners (see Watt

and Hallwirth, 2003). So far the Macroeconomic Dialogue, which takes place for one day twice a year, represents a very soft non-binding mode of coordination through the exchange of information. What might have become a central mechanism for macroeconomic coordination is in practice too weak to fill the gap.

This lack of central coordination is not the only problem with existing coordination methods in the EU. The EU governance structure has led to a lot of arrangements in specific policy fields, providing that they fall within the competence of the EU. Coordination within each such field may have important consequences for other fields or may be conditioned by them. This is very clear as far as budgetary issues are concerned: coordination of research policies clearly impinges on budgetary choices and therefore on the coordination of the latter. But these interactions also arise between specific policy fields such as labour market policies and pension policies or research policies. These interactions are not in practice taken into account. Only a central coordination could deal with mismatches of this kind.

Similar coordination problems may appear in fields which are outside the scope of the Commission. The EU may benefit in the long run from closer policy coordination even in fields where the subsidiarity principle applies.

It is unlikely that all the 'sectoral' governance systems will somehow finally converge into one central pattern (Boyer and Dehove, 2001). It is also implausible to suggest that such convergence is desirable. The relevant question is to see which limited changes could transform the present inefficient configuration into a more coherent mode of governance in the EU.

The so-called Community Method (see Box 13.1) seems to make reform initiatives extremely difficult. The topics that the Commission can deal with are strictly defined and controlled by the Court of Justice. The Commission can put forward new proposals in specified areas, but it cannot call into question any decision which has been given Treaty status.

The control of the Commission by the Council of Ministers is decisive and leads one to qualify EU governance as essentially intergovernmental and all the more so in that this primacy is not strongly balanced by the European Parliament.

The problems arising from intergovernmentalism are aggravated by the relative irreversibility of past decisions. The Constitutional Treaty presented in June 2004 could have opened up ways to change rules, such as those of the SGP. But, far from that, it seems to make things worse with its third part inscribing in stone just those rules which are today most irrelevant. Coordination may thus lead to common rules which then become obsolete and need to be scrapped. Failure to do so may be in the EU the most frequent form of coordination failure.

One should add in that respect that coordination may in some cases be delegated to specific agencies. At EU level 16 agencies have so far been created at various summits.[5] Checking that these delegated tasks are effectively

done and keep their relevance should then remain part of the coordination procedure.

13.4 Critical issues in coordination practices

We are confronted with a wide variety of coordination schemes. In some cases the objective is to respect some criterion (budget deficits should not go beyond 3 per cent), in other cases the objective is to come up with a single policy (as in monetary policy for the euro area). Very often it is only to promote some loose concertation. The schemes may also differ as to the actors involved: sometimes the concertation takes place at one level (the Commission, for example), sometimes at two or more levels as in the case of wage policies in the Macroeconomic Dialogue. These examples of coordination have few features in common. Nevertheless, the whole set of coordination schemes constructs a context in which a certain form of geopolitical coordination takes place. The key point is that coordination schemes may not be separable, whether we take a dynamic time perspective (diachronic) or a comparative static perspective (synchronic). Over time there are certainly cycles through which loose coordination gives way to more constraining arrangements and then to a fixed rule or a single policy. Conversely, when looking at all the coordination schemes in a given geopolitical area at one point of time, one is forced to observe that they interact: for example the existence of strict rules in competition policy affects not only wage determination but also the scope which exists for wage policy coordination. Both effects, the path dependency of institutional changes and the complementarity between various institutional fields, account for some persisting diversity of capitalist systems. Despite the opening of all capitalist economies to international transactions, one does not observe a complete convergence towards a unique pattern of open market economy. Differences remain which still matter in a much more sensitive economic environment.

We have to look at the present pattern of policy coordination within the EU with the two perspectives, diachronic and synchronic, in mind. In the early 2000s a certain framework for policy coordination was developed in the EU, based on the Broad Economic Policy Guidelines (BEPGs) as a core set of recommendations. These are established annually in spring after discussions between the Commission, the Council and the member states on the basis of the past year's outcomes. These policy guidelines serve in turn as inputs to four 'specialized' coordination schemes, concerning respectively budgetary issues (the Stability and Growth Pact), product and capital markets issues (the Cardiff process), employment issues (the Luxembourg process) and the macro-social and economic dialogue issues (the Cologne process), to which one could add the Lamfalussy process to coordinate the changes in the regulation of financial services (see Chapter 4 in the present

volume) and the Göteborg process (1997) on environmental regulations. This structure is the result of a decade of evolution whereby the BEPGs (four pages in 1993) became more comprehensive and started to address the specific situations in individual member states. This also led to distinct EU policies in such fields as employment (from the Luxembourg summit of 1997), reform of market structures (from the Cardiff summit in 1998) and the Macroeconomic Dialogue (from the Cologne summit of 1999). Procedures have evolved, becoming more precise (quantified) and having more impact on national policy. However, the four schemes referred to are not consistent with each other, nor do they have the same legal force. Only on budgetary issues are sanctions clearly specified in the SGP. The others vary in their legal status. The reform of market structures can be a binding requirement as regards liberalization of financial markets or of public services by virtue of the competition rules. Employment guidelines remain indicative while the Macroeconomic Dialogue is even more vague in its recommendations.

It is clear that this structure is potentially inconsistent, in that, for example, recommendations regarding employment may conflict with budgetary rules or recommendations for the reform of product markets. Such conflicts may in practice be avoided by the fact that some implicit neo-liberal priorities are in effect ranking the determination of these various policy objectives.

It would be much more democratic and satisfactory to put at the core of the reform process debates on the central model underlying the coordination schemes. In that respect for instance a greater role could be given to the Macroeconomic Dialogue, putting its debates on central options at the centre of the coordination process and deriving the BEPGs from these discussions (see Watt and Hallwirth, 2003).

The Macroeconomic Dialogue has no real impact and the only policy recommendations which are really binding are those which call for ever more market liberalization and, of course, for ever smaller budget deficits.

For the time being this neo-liberal dominance seems well established. This does not mean that a hybrid system of policy coordination, drawing on the experience of both the liberal market economies such as in Britain and the more organized systems such as in Germany, would not be sustainable.

But the whole framework described above, with the BEPG and its four sub-coordination schemes, has, since the completion of the EMU, been completely subordinated to the single monetary policy where the ECB wants to act in full independence. This position of the ECB, as in a sense over and above the general coordination scheme, may be a legacy from the past,[6] but it is nevertheless shockingly undemocratic and unsustainable. Even the US Federal Reserve has as an explicit objective the welfare of the US people and their full employment. To gain some legitimacy, the ECB has been forced to engage in some hidden coordination,[7] but this far from fills the democratic gap. It leaves it up to the ECB to decide whether or not the European

economy should be restricted or reflated. Moreover the asymmetry represented by non-EMU member states is not dealt with in a clear way. The countries in question do not explain how they will use their room for manoeuvre, with their independent currencies.

The unsustainability of the present arrangements has become even more obvious with the enlargement. It will be interesting to see what will be the outcome of the entry of new currencies. Another challenge will come from the recent replacement of the Commission by an even more neo-liberal set of country representatives.

The core result of this overall coordination framework, centred on the BEPGs, is a dogmatic adhesion to the rules of the SGP and the excessive deficit procedure. Existing cooperation procedures are so dominated by the Maastricht Treaty that they focus only on net budgetary balances and not at all on the uses of public funds. Some argue that spending on investment which expands the productive potential of member states (for example on R&D) could be taken out of the budgetary targets.

We still have so far only mentioned the coordination schemes linked to core policies and the BEPGs. Associated with these, but without formal linkages, we find all the coordination schemes concerning such specific fields as pensions or innovation policy. These are obviously related to labour market and product market issues but they constitute autonomous processes.

The Lisbon summit has pushed forward a method of open coordination which is emblematic of this trend to decompose the overall process of coordination, on the assumption that, at all levels, a process of benchmarking will help to identify best practices and to construct, piecewise, an optimal pattern of structural policies.

This is far from the truth. Since countries follow different development paths regarding their institutional fabric,[8] piecemeal adjustments do not lead to an overall convergence of the various modes of capitalism. Such distinctions assume there is a systemic aspect to the institutional fabric of countries, which implies that one cannot bring about effective change in these contexts by isolated adjustments to the working of particular institutions. These open coordination practices may prove to be a handicap for some types of capitalism. They either prejudge discussion against some models or attempt to bring about a damaging convergence to a single model (Scharpf, 2002).

This domain of weak coordination is by definition rather vague and difficult to follow beyond the wording of the various dialogue committees set up for the purpose. It is difficult to assess the effectiveness of such bodies because they have to compete with many less formal mechanisms such as lobbies, trade unions, employer associations, NGOs, media, … It is also important to see that neither the European Parliament nor the national parliaments have a strong presence in these 'open coordination' schemes. The open method seems to rest on the influence of theories, ideologies and

'expert' opinions which associate integration with a uniform reinforcement of the market in all domains, and are shielded in that respect from critical scrutiny and political debate.

Two opposing dangers result: on the one hand these procedures may prove to be weak and ineffective, on the other they may impose lines of future development in an undemocratic way.

Moreover some important domains, especially regarding external relations of the EU, are left without any coordination. Although a common representation of the EU exists regarding trade negotiations with the WTO or other international partners (be it other countries, or regional blocks such as Mercosur or ASEAN),[9] representatives of member states, even though they have no external negotiation powers, are still very active and pressing on the EU representatives (from Doha to Cancun). The coordination of EU positions with those of other important international agencies, be it United Nations organizations or other institutions such as the IMF, remains informal. The cooperation is weak in such important fields as aid to developing countries, access to raw material sources or intellectual property rights issues, all of which are long-term strategic issues. On such global issues, it is, in the long run, self-defeating to split up the negotiating power of the EU.

13.5 Coordination in urgent need of democratic reform

By the early 2000s the structure of policy coordination in the EU had developed in significant ways. Within a decade, very much advanced by the Single Act and the EMU among a large majority of member states, the coordination structure had become more specific, with a clearer division of labour between the various EU bodies. But the process of development did not involve a critical study of existing coordination schemes or proposals for coherent reforms. Rather, we see an accumulation of procedures and a proliferation of coordination mechanisms. It follows that, despite this development, the coordination structure continues to display many weaknesses and inconsistencies. Beyond the fact that the system is viewed as bureaucratic, rather inefficient[10] and above all non-democratic, it has shown a critical weakness precisely where coordination was supposed to be the most effective: that is, with regard to the constraints put on excessive budgets deficits. In 2002 and 2003, when it turned out that some countries including Germany and France would not be able to keep their current budget deficits under the 3 per cent threshold, criticisms of the rigidity of the SGP came from all sides. Despite ongoing criticism, even limited suggestions to reconsider the way in which deficits are calculated have not led so far to serious change.

The coordination of budget deficits in the EU has become a major failure, from many points of view.

The 1990s have also seen pressure for coordination in many other fields where the open method of coordination has become more and more

specific. One of the major issues in this respect has been labour market policies. The loose coordination around the employment policy guidelines (only distinguished from the BEPGs since 2001) did have the advantage of reintroducing the objective of full employment (which had disappeared from the BEPGs), but on the other hand it linked this objective with a list of selected criteria, pre-empting the labour market strategies which would be used to attain full employment. The criteria in question corresponded largely to the road map of active labour market policies (see Barbier, 2004). The Commission is largely responsible for producing the policy framework in this field but all policy decisions are taken by national governments. In that sense the open method of coordination leaves national governments in control, yet with little involvement of social partners.

However, the European Single Act of 1986 already suggested that the Commission should develop dialogue and collective bargaining between social partners at EU level. A social protocol was added to the Maastricht Treaty, which was integrated as a social chapter for Europe in 1997 at the Amsterdam summit. From then onwards, social partners have to be consulted, whenever the Commission wants to take an initiative on social issues. This collective bargaining, however, has had little effect (only three agreements were reached between 1995 and 2001). Then from 2002 on the initiative was left to social partners leading to one agreement on teleworking. A programme has been defined and bargaining engaged on the subject of restructuring. Overall, social bargaining has been very slow and labour laws remain quite different within the EU. The enlargement, by increasing the range of differences, is not going to speed up the process.

The absence of a bridge between open coordination practices and the 'will' to integrate social partners in the coordination structure reveals a lot about the segmented nature of the overall system. It does not mean that various social and economic forces have no say in all the above mechanisms; lobbying of all kinds is highly developed in Brussels. But although it is difficult to appreciate its impact (if only because the same interests are also defended at national level and thus integrated into the positions defended by member states) there is no doubt that business lobbies, dominated by large corporations whether European or not, undertake the vast bulk of lobbying activity and have the greatest impact on EU decision-making, if only via the networks of consultative and advisory committees.

Beyond the actions of lobbying organizations, which could be categorized as the informal part of the EU governance system, one finds at a third level the role of ideologies. In all decision-making processes, the conception of the world, of what is good and bad, that the deciders share is of the greatest importance. In that respect most of the lobbying by firms converges at least in promoting the neo-liberal credo. The role of the media is also important in this process, as well as that of all the technical studies which surround the decisions.[11] Most of these studies are not widely and publicly discussed.

13.6 Conclusion

The broad conclusions that one could draw from this review of coordination methods in the EU is that much is left to governments because coordination is constrained:

(a) by the rigid framework built around the EMU;
(b) by rules of unanimity when situations are very diverse;
(c) by proposals for policy measures which underestimate the intricacies of institutional change;
(d) and, last but not least, by the lack of political demand in member states from seemingly uninterested citizens.

In such conditions initiatives of subsets of member countries for reinforced cooperation, in one domain or more, may appear to be a valid way of relaunching the process of integration. The possibility of reinforced cooperation was included in the Treaty at the Amsterdam summit of 1997, reassessed in Nice (2001) and included again in the proposed Constitution.

Such a multi-speed process has its pros and its cons. European integration has often followed this path, starting with the initiative of a subset of countries, then after some time bringing in other partners. The value of reinforced cooperation procedures depends on:

(a) how public and open the conditions of entry are at the point at which a subset of countries launch an initiative;
(b) how the initiative is then related to other policies and procedures within the EU and
(c) above all, on what conditions other countries can participate.

A lot depends on the particular policy domain and on whether there are strong positive or negative externalities among EU members. Some degree of adverse selection is possible in that a subset of countries may choose to launch an initiative just because there are large and widespread effects on other countries in the policy field in question. The defence issue is certainly a good example and the Balkan crisis has clearly raised the issue; 11 September 2001 pushed it a step further with the creation of European forces of intervention, even though countries remain divided.[12] Other important domains are eligible such as environmental issues, fiscal regimes, intellectual property rights regimes, not to mention labour laws.

Multi-speed processes might thus be essentially divisive or capable of launching a positive dynamic across Europe, depending on the policy field and the precise nature of the initiative. Clearly some issues can only be decided by democratic political debate. But there is not much point in calling for political debates to establish the legitimacy of European initiatives, whether EU-wide or multi-speed, if citizens have no interest in the activities and projects of the EU.

We have identified up to now three situations where the lack of involvement of the citizens of the member countries tends to block the dynamics of EU integration:

(a) National governments are not pushed by local political demands for an EU project; therefore intergovernmentalism, which remains the major driving force, has little impetus.
(b) The absence of political debate around EU issues prevents critical scrutiny of, and effective change to, open coordination procedures.
(c) Alternative coordination methods such as negotiations between social partners at European level are not facilitated.

One should add the limited role, so far, of the Parliament in the decision process, which in turn leads to low turn-outs in European elections. A recent White Paper of the Commission on European Governance[13] correctly identified this lack of interest and the corresponding democratic deficit as a major shortcoming in the EU process of integration. The reform of EU governance was adopted as one of the major strategic objectives in 2000, in the hope that the foreseen Constitution might move towards a less top-down integration process. But a few years later, with a proposed Constitution which simply consecrates the existing deadlocks in EU policy-making, one can doubt that an effective reform of EU governance will be achieved.

Notes

1. Often reassessed in particular by its chief economist Otmar Issing (2002).
2. For the opening of the new HM Treasury Building in London on 27 September 2002.
3. Following the Taylor rule according to which monetary policies tend to be based on a mix of inflation and growth perspectives.
4. The Macroeconomic Dialogue was established in 1999 at the Cologne summit. It gathers the ECB, the central bankers of non-EMU countries, the social partners, the European Commission and the Council.
5. Cf. on all these agencies http://europa.eu.int/agencies/index_en.htm
6. The strict independence of the ECB is often presented as a precondition set by the Bundesbank to accept the EMU, somehow a price to pay by the other countries to achieve the EMU.
7. It has exchanges with a specific commission of the EU Parliament but the minutes of these meetings are not public, and the same secrecy surrounds the internal meetings of the ECB as well as its participation in the Macroeconomic Dialogue process. The question is whether this initially built-in isolationism of the ECB will last or adapt with the circumstances.
8. Authors thus distinguish various types of capitalism, from two in Hall and Soskice (2002) to five in Amable et al. (1997) for instance.
9. See Chapter 11 for trade policy issues.
10. With some contending that policy coordination has at best no effect. Scheide (2003) thus argues against the consensus, that soft coordination as done by the

BEPGs is useful, … on the basis that central banks can do it better … and that by all means uncertainty is too big.

11. Each step of the integration process has been preceded by debates around various reports. We mentioned the Cecchini report for the Single Act (with the whole series on the 'Costs of Non-Europe') which appear to have been based often on wrong assumptions; see 'The 1996 Single Market Review', Commission staff working paper, Brussels 16/12/96 SEC (96) 2378.
12. The Council appointed in 2004 a defence minister (J. Solana) if only to bridge the gap between member states on these issues.
13. CEC, 'European Governance: a White Paper', Brussels 25/07/01, COM(2001)428, presented at Laeken European Council.

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Part II

Proposals for Alternatives

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14
The European Social Model: Basis for a Strategy

14.1 Introduction

In the first half of this book we analysed and criticized the dominant neo-liberal approach to economic and social policy in the EU. The critique refers to both the theoretical foundations and the practical consequences of this approach. It can be summarized by the statement that the combination of market radicalism plus monetary and fiscal austerity is a harmful policy framework, which has led to economic weakness, persistently high unemployment, growing social inequalities and insecurity, and environmental degradation in the EU. Such developments are harmful for the majority of the population in the EU.

The consequences of this analysis are that a more equitable and more sustainable development requires better economic strategy and stronger political intervention to correct the errors and failures of the last two decades. It is made all the more necessary following the most recent enlargement of the EU, which has made many aspects of a progressive development more difficult. Part II of the book presents some proposals for this intervention. This introductory chapter discusses briefly the conceptual framework (Section 14.2) and the multiple objectives (Section 14.3) of alternative economic policies in Europe.

14.2 The European Social Model: re-embedding the economy into a context of democratization

Stronger political intervention, as such, is of course no guarantee of better economic results, more welfare or a healthier environment. History is full of the errors and bureaucratic failures of economic policy. If we refute the simplistic belief that the markets will best regulate the economic reproduction of society with a minimum of political interference, we must then consider the problem of the objectives and criteria for an alternative, more interventionist framework. It is a question of economic expertise and of

political options. This inevitably leads to the question of democracy. The re-embedding of the economic process into a democratic social context is a basic requirement for alternative economic policy. At the same time, it is the basis for the identification and correction of errors, and for the development of the political strength necessary to implement a different course of economic and social policies. Public discussion, and increased democratic control and participation, must be key principles of an alternative economic policy.

This general postulate is already difficult to meet on the national level – and in fact is often missed. It is even more complicated and difficult to establish for the EU, that is above the national but below the global horizon. The European dimension of economic and social policy must include new institutional arrangements and new forms of cooperation, coordination and also centralization of policy areas and decision procedures. Without strong democratic involvement, the new arrangements will be unable ever to reconcile the interests and aspirations of the European people with the procedures and decisions of the EU institution.

In recent critical discussions about the direction of economic and social policy in the EU the concept of a 'European Social Model' has been invoked as a frame of reference for an alternative to neo-liberal policies. As noted in Chapter 1, the term was not invented by the EU but was taken over from the social movements and has by now even entered official publications and missions of European institutions.[1] The concrete content of such a model remains vague, and practical economic and social policies have mostly been conducted in the opposite direction – namely towards the US pattern. The objective of 'more and better jobs' for instance can hardly be achieved through participation rate targets and pressure on the unemployed to accept jobs regardless of pay, working conditions and qualification. It is also contradictory to declare that provision of services of general interest is a 'pillar of the European model of society' (Commission, 2004, p. 4) and insist that these service firms must follow the general competition rules (ibid., p. 15). The same is true for environmental policy, which cannot rely mainly on market mechanisms. The way the EU uses the term 'European Social Model' or 'European model of society' is very vague and rhetorical because this conception is too embedded in a framework of markets and competition.

The concept of European Social Model which we propose envisages the opposite ranking: the re-embedding of the market into a democratic context implies strong conceptual changes in the relationship between means and ends in economic and social policies. The European Social Model should not be regarded only as an instrument to enhance economic strength and competitiveness in the world. Indeed it is the other way round: the European Social Model is the objective and end of economic and social policy, and to reach this objective a certain strength and competitiveness are required. The strength of the European economy should not be measured by its external

superiority over the rest of the world but by its capacity to fulfil social goals. The basis for this is a high and continuously (and sustainably) rising level of productivity and technological progress, but also a fair distribution of the results of this progress. The market should not be the overarching instrument to regulate economic and social development in the EU, where any other regulation has the status of a – usually strongly contested – exception to this rule. The public sector should not be an exception from but both alternative and complementary to the private sector.

A serious pursuit of the European Social Model as overarching framework of reference will require strong and persistent changes in the way in which western European capitalism has operated during the last two decades. Because such changes generate winners and losers they are not uncontroversial. They will be resisted by those groups and forces who benefit from the present structures of market dominance. These groups are powerful, they dominate the media and try to create a public belief that there is no alternative to neo-liberal policies. To counter such false allegations, not only good arguments but also strong social movements against the prevailing policy patterns will be necessary.

14.3 The cornerstones

In the following we propose five objectives which we regard as cornerstones for the European Social Model: full employment, social welfare and security, social equity, ecological sustainability and balanced and cooperative international economic relations.

14.3.1 Full employment

By full employment we mean that every person who is able and willing to work should be able to find a job at wages or salaries sufficient for decent living, and enabling further development of his or her productive capabilities. Social responsibility for full employment does not simply mean providing a job for everyone, but the provision of good work opportunities and choices for everyone.

Full employment in this sense is more than the absence of unemployment, registered or not. It is an enormous economic, social and political asset, laying the basis for citizenship and the sustainability of diversity in lifestyles in our societies. In *economic* terms full employment enhances welfare by allowing full exploitation of the productive potential of society. It is a major contribution to a strong public budget because it generates tax revenue and reduces public expenditure on unemployment and poverty benefits. *Socially*, full employment is a major factor in social inclusion, enhancing the individual's potential for development, flexibility and self-respect, strengthening the basis for social cohesion. Full employment also strengthens the positions of workers and trade unions and can partly offset the systemic disadvantages

of labour against capital. Finally, full employment is an important factor for *political* stability and is an effective response to all kinds of political extremism and fundamentalism.

Since the summit of Lisbon full employment is again an objective on the EU agenda but devoid of the social substance which makes full employment a desirable goal. In formal employment relations the following basic principles should remain valid:

- Employment must be voluntary and not compulsory.
- It must correspond to the qualification and preferences of the person employed, and it should offer opportunities for further learning and job improvement.
- Employees should have the right to job security (which is not the same as the right to stay permanently on the same job) and should not be compelled to accept casual work.
- Wages or salaries of persons working full time should allow them to lead an independent life without the threat of poverty.
- Employees should enjoy full work protection and should have rights against sudden dismissal, discrimination and other arbitrary measures on the part of the employers.
- All arrangements concerning flexibility in working hours and working conditions should require the consent of the employees.

14.3.2 Social welfare and security

Social welfare and security mean that old age, sickness, accidents or other adverse circumstances should not force anyone into a state of poverty or helplessness. It includes the *unconditional right* for all residents to a level of material resources which afford a dignified life and access to all basic social and cultural institutions, and a broad range of other public goods. The definition of 'public good' should be flexible and follow the development of productivity and material wealth of the society. Essential for the achievement of comprehensive social welfare are a strong and publicly maintained network of social security systems (like pensions and health care) and the provision of public services like education and child care. The eradication of homelessness and poverty must be made a social responsibility.

The existence of fairly comprehensive social security systems can be regarded as one traditional achievement in all EU countries – although they have been developed in very different forms in different countries. However, over the last few years public systems have come under heavy attack and have been undermined to varying extents. The 'modernization' of social security which is high on the agenda of the EU emphasizes the responsibility of the individual for his or her health or living standard in old age and places more financial burdens upon the individual for these purposes. Correspondingly, social security systems are increasingly privatized and their

management delegated to corporate actors on financial markets. Against this trend we maintain that welfare, social security and protection for everyone are essentially social responsibilities and the best way to meet them are public systems.

14.3.3 Social equity

Social equity means the absence of social discrimination and excessive inequality in the distribution of income, wealth, and access to material resources, institutions and channels of democratic public discussion and decision-taking. It has a class-specific, an interpersonal and a regional dimension. Social responsibility for class-specific equity requires the reversal of three general trends of the last two decades: first, the distribution of income in favour of profits at the cost of wages; second, the shift of the tax burden from capital to labour and consumers and, third, severe reductions or abolishment of financial support to low-income and poor groups in society. Interpersonal equity refers most importantly to measures to end the lasting discrimination against women with relation to career opportunities and wages. Other dimensions of personal discrimination which must be overcome relate to the ethnic or religious status of people. Regional equity invokes a public responsibility in support of weak and underdeveloped regions in the EU.

Social equity is on the agenda of the EU only in the second and third sense. Efforts are made to cope with gender discrimination and to establish equal employment opportunities for men and women. But real successes have been few. Gender discrimination in payment and in access to higher positions in corporations and public administration is still very strong. In most other areas the call for more gender-related equity remains largely rhetorical, because the EU has no real competence in social policy and cannot deal efficiently with growing inequalities. Regional policies have been successful in that they have moderately diminished the variations in per capita incomes between member countries of the EU. But they have not prevented the increase of disparities between *regions* in the EU. Therefore stronger efforts and new approaches are required, particularly after the recent enlargement which has been accompanied by great increases in disparities of productivity, income and wealth.

14.3.4 Ecological sustainability

The objective of ecological sustainability aims at the preservation of the natural basis of individual and social life. It relates to the exploitation of natural resources and the pollution of the natural environment and includes a most careful approach to unknown risks in physical, chemical and biological technologies.

Achieving ecological sustainability requires a far-reaching restructuring process in core areas of economic and social reproduction. Measures such as

energy saving, greater use of renewable energy sources, attractive public transport infrastructures, less use of chemical fertilizers and other pollutants in agriculture, construction of low-energy housing, and so on should all be politically promoted.

Ecological sustainability requires strong administrative measures and public sector activities, not subordinate to the imperative of market competition. In the past, environmental degradation has been linked to energy- and waste-intensive industrial growth. The necessary shift to a more sustainable development pattern does not necessarily mean that economic growth must be removed from the economic policy agenda altogether. But it should not be pursued at any price, regardless of its environmental consequences. Instead it should go along with, and take the form of, economic restructuring in an environmentally sustainable direction and it should be governed by the principle of precaution with regard to the natural resources and environment. This is for instance the case if development takes place as expansion of private and public services which are less energy-consuming and waste-producing sectors than industrial production or mining.

14.3.5 Balanced international economic relations and efficient development aid

This objective envisages a European contribution to stop the increasing polarization between rich and poor countries and to initiate a fair international division of labour for developing countries. Measures in this direction include the increase of official development aid and the waiving of debt for highly indebted poor countries. Another important element is a radical change of position in the trade negotiations within the framework of WTO and GATS, and particularly opening EU markets for products from developing countries (although this alone will not solve the problems of the Third World, see Chapter 24).

The pursuit of balanced international economic relations must replace the current endless efforts to increase international competitiveness through dismissals, relocations, aggressive cost-cutting and endless attempts to conquer market shares at the expense of competitors. Imbalances of current and capital accounts between developed and developing countries are to a certain extent reasonable in order to provide development finance to countries with insufficient saving rates and/or weak credit institutions. However, such imbalances can also reflect speculative capital flows, or they can lead to unsustainable positions on the side of debtor countries. To avoid both, the EU should support a dynamic catch-up process of developing countries through extended official financial and technical development aid. It should at the same time accept protective measures against financial speculation. In the long run balanced international relations should avoid the cumulative accumulation of external debt of the weaker countries – which is unsustainable in the long run. Such balanced relationships are fully compatible with

intense international trade and investment relations. They are also compatible with international competition if this is contained in a politically stable macroeconomic framework. They are incompatible with massive speculative capital flows which lead to financial instability and crisis. Therefore measures to promote international financial stability are a further element of balanced international economic relations. These also include the capacity to protect the European economy against external attacks through unfair trade practices or the destabilizing of financial flows.

14.4 Conclusion

This list of the essential objectives of economic and social policies of the EU is still general and undeveloped. Specific historic situations require not only more detailed elaboration of these objectives but also the analysis and reconciliation of possible contradictions between them. Under concrete circumstances these 'multiple objectives' cannot all be achieved at the same time, and in most cases they cannot even be pursued with the same political intensity (for which resources – human and material – are needed). Priorities must be decided and political and material resources allocated to specific projects. It is likely and normal that differences of assessment and interest will emerge even in a context of generally progressive policies. There is only one way to deal with such problems: transparent public discussion and democratic procedures of decision-making. The establishment of an appropriately open institutional framework for information, general and professional education and participation is an essential part of change towards a more democratic and at the same time more efficient economic policy; and this will ensure that the above processes are not only formal voting mechanisms, but are based on solid information and understanding.

This short discussion of objectives for an alternative economic and social strategy towards the European Social Model is incomplete without at least a brief glimpse on the perspective for further progress. None of the goals presented above will be attained without strong social movements and political pressures. Therefore every success and achievement on this way is a contribution to the transformation of social relations and power structures. As certain key thresholds are passed in this process, new perspectives of more comprehensive change can be opened up. Their essential achievement would be that democracy would become something more than an instrument to restrain and control private property, capital and profit as the basis of economic reproduction in a capitalist society. Instead it would be a comprehensive political and social framework for the social reappropriation of the material basis of reproduction, in which the respective roles of public and private economic activity would be determined. The perspective for such a framework reaches beyond capitalism, even in its mildest and most mediated form of the European Social Model.

Note

1. The mission statement of the Directorate-General for Employment and Social Affairs states the task of 'contributing to the development of a modern, innovative and sustainable European model with more and better jobs in an inclusive society based on equal opportunities' (http://europa.eu.int/comm/dgs/employment_ social/index).

Reference

Commission of the European Communities, *White Paper on Services of General Interest*, Com (2004) 374.

15
More Active Monetary and Exchange Rate Policies

15.1 Introduction

This chapter, following from the critical evaluation of current policies in Chapter 3, proposes alternatives for monetary policy in terms of its objectives, its instruments and its institutional form. The possible effects of interest rates on exchange rates leads to a consideration of exchange rate policies, first between member countries of the EU and then between the euro and other currencies, notably the dollar.

15.2 Monetary policy and the European Central Bank

Monetary policy has become the only macroeconomic policy which can be operated at the EU level, and its objectives have been set solely in terms of low inflation. Although the EU has set targets for employment in terms of the participation rates to be reached by 2010, this is an objective to be pursued through the European Employment Strategy rather than through macroeconomic policy (or through a combination of the two). No employment objective (or equivalent) has been formulated for monetary policy, or even for macroeconomic policy.

The objectives for monetary policy should be derived from the overall macroeconomic objectives, and these objectives for macroeconomic policy should include securing high levels of demand to promote high levels of employment and economic growth. The only objective of the ECB relates to price stability, and in effect this means that the only objective of EU macroeconomic policy is price stability. The objectives of macroeconomic policy should be reformulated to make a clear commitment by the EU to the pursuit of full employment and sustainable growth. Accordingly, the objectives of the ECB should include a target for growth and full employment alongside the price stability objective, following the model of the US Federal Reserve. The reformulation of the objectives would be an important signal that the EU does attach importance to the achievement of full

employment. Further, the achievement of multiple objectives requires multiple instruments: the one instrument of monetary policy cannot be geared to the achievement of multiple objectives. Thus additional policies are required, and fiscal policy and exchange rate policy are particularly important in this regard.

The 'independence' of the ECB raises issues of democratic control over an important element (indeed in the present situation the only element) of macroeconomic policy. We reject the notion that politicians cannot be trusted to make 'good' macroeconomic decisions and that unelected bankers can be trusted to do so: both politicians and bankers will no doubt make mistakes but there is no inherent reason for bankers to make better decisions. While there can be some delegation of decision-making to a body such as the ECB, it must be within a framework which sets the relevant objectives for that body, enables coordination of various parts of macroeconomic policy and ensures accountability to democratic bodies.

The independence of the ECB and the national central banks places heavy constraints on any coordination of fiscal and monetary policies. Coordination requires discussion and agreement between the bodies responsible for fiscal policies and for monetary policy. The present legal framework within which the ECB operates appears to heavily restrict coordination. For example, 'neither the ECB, nor a national central bank, nor any member of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member States or from any other body' (art. 7 of the Statute of the European System of Central Banks and of the European Central Bank).

The statutes then require significant changes to ensure that the Central Bank is accountable and that it can fully participate in the coordination of macroeconomic policy. The problem of the absence of any democratic control over macroeconomic policy-making is more difficult to resolve, because there is no supranational economic policy authority with a clearly established legitimacy. But it is possible to enhance the responsibility of the ECB to the European Parliament and to the Council and to broaden and intensify the dialogue with the national political authorities. The ECB would maintain an operational independence in day-to-day activities but with a much broader set of objectives with democratic accountability, and the obligation to coordinate policy decisions with other EU institutions and national governments. Further, the statutes must be changed so that there is no hint that the ECB cannot discuss and agree upon macroeconomic policy with other bodies.

The current approach of the ECB is based on a 'two-pillar' monetary strategy, with one 'pillar' being a commitment to analyse monetary developments for the information they contain about future price developments, with a quantitative reference value for monetary growth, where a target of 4.5 per cent of M3 has been imposed. The other 'pillar' is a broadly based

assessment of the outlook of price developments and the risks to price stability. Price stability is defined by the ECB as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2 per cent, and the aim of the ECB is to maintain inflation rates below, but close to, 2 per cent over the medium term. A 'reference level' is set for the growth of M3 (at $4^1/_2$ per cent of GDP, derived from the inflation target rate, perceived trend growth rate of the EU and presumed change in the velocity of circulation). The rationale for the adoption of this 'reference level' seems to be based on the monetarist notion that the growth of the money stock can be controlled by the Central Bank and that growth of money stock governs the rate of inflation. These are rather outdated notions when it is recognized that money is endogenously created by the banking system, leaving the Central Bank without the ability to control the growth of the money stock (see, for example, Arestis and Sawyer, 2003, 2005). Thus, we would argue for this 'reference value' for the growth of the stock of money to be dropped as irrelevant.

Monetary policy inevitably suffers from the 'one size fits all' problem – that is, a single interest rate is set by the Central Bank which applies across many economic regions and cannot be differentiated to accommodate the individual circumstances of each economic region. In the context of the Eurozone, there are substantial differences between regions in terms of the level of unemployment, per capita income and so on, and of the general structure of demand, and the general level of interest rates appropriate for one region may be not be appropriate for another. Further, the lack of synchronization of economic business cycles and the difference of inflation experience between countries (at the time of writing a difference in national inflation rates of the order of 3 per cent per annum exists across the Eurozone) can mean that a change in interest rates which is apposite for one region will not be so for another. Finally, differences in the financial structures and institutions are likely to mean that the response (in terms of output, inflation and so on) to a change in interest rates will differ across countries. Within the framework of monetary policy, there is nothing which can be done to differentiate policy and to meet these problems. But it does mean that other ways have to be found to differentiate macroeconomic policy in order for it to meet the varying needs of the different economic regions. Fiscal policy is a prime contender in this respect, but that requires the removal of the confines of the Stability and Growth Pact (SGP) so that national fiscal policy can be set in a way appropriate for the needs of the national economy.

Monetary policy has come to take the sole form of variations in the interest rate, which have an uncertain effect on the rate of inflation and economic activity. Alternative forms of monetary policy should also be considered. Explicit forms of credit control implemented by the Central Bank, or other government agencies, could be used to supplement interest rate policy.

There are well-known difficulties with the use of credit controls. They can be evaded (legally or otherwise) through switching from regulated to unregulated forms of credit, including the development of products which fall outside the range of regulation and the switch of lending to overseas sources. Credit controls may have some effect in restraining credit and thereby expenditure, but the relaxation of credit controls may do little to stimulate expenditure during a downswing.

Credit controls may have a role to play in slowing down the development of asset-price bubbles, which may be worthwhile in so far as the extent of the subsequent downturn is a function of the extent of 'irrational exuberance'. These are circumstances which we see as better tackled by controls over the volume of credit rather than attempting to prick the bubble through traditional monetary policy measures that use the price mechanism of interest rate increases. Appropriate forms of credit control may be focused on sectors where 'overexuberance' is developing, rather than use the blunt instrument of interest rate changes which impacts on all sectors of the economy. Credit controls may be implemented in a variety of forms, and those which operate through reserve ratio requirements would appear to be feasible (Arestis and Sawyer, 2005). An example of this would be an asset-based reserve requirement (for example Palley, 2003), which could have the added advantage of seeking to cut short the development of asset-price bubbles.

Monetary policy, whether in the form of interest rate, credit controls or otherwise, tends to be asymmetric with regard to its effects on the level of demand and economic activity – that is, monetary policy may be able to constrain high levels of demand but not able to stimulate economic activity in the face of low levels of demand. Monetary policy may constrain expenditure by making credit more expensive or unavailable but may be unable to stimulate expenditure by making credit less expensive or more available. Monetary policy then has to be complemented by more effective policies, such as fiscal policy.

There must be a move away from the *sub*ordination of national fiscal policies to the artificial budgetary limits imposed by the SGP and to the dictates of monetary policy and the ECB. The strengthening of the status of the Eurogroup would transform the latter into the main partner of dialogue for the ECB with regard to the conduct of monetary policy.

The reformulated ECB should be required to act as lender of last resort and not merely possess the potential to act as such. One notable feature of the operation of the ESCB is the apparent absence of the lender of last resort facility. The Protocol under which the ECB is established enables, but does not require, the ECB to act as a lender of last resort. The relevant article of the Protocol suggests that

> In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may: operate in the financial

> markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in Community or in non Community currencies, as well as precious metals; conduct credit operations with credit institutions and other market participants with lending being based on adequate collateral. The ECB shall establish general principles for open market and credit operations carried out by itself or the national central banks, including for the announcement of conditions under which they stand ready to enter into such transactions. (from Protocol, No. 3)

The lender of last resort function requires that base money is essentially provided on request to the banking system by the Central Bank, and in particular would be supplied if reserves were low following an expansion of broader money. More generally, the lender of last resort function recognizes the role of a central bank in securing a stable financial system, but that a specific objective of the stability of the financial system is not included in the remit of the ECB. It is clear that on occasions, the lender of last resort function may require base money to be supplied when pursuit of a price stability target would point in the opposite direction.

Our proposals are in summary:

- The reformulation of the objectives of the ECB to include high and sustainable levels of employment and economic growth, and dropping any 'reference level' for growth of money stock;
- The ECB be made accountable to the European Parliament, and involved in the coordination of fiscal and monetary policies;
- The ECB undertake the role of lender of last resort and accept responsibility for the stability of the European financial system.

15.3 European Monetary System Mark II

With the expansion of the EU in May 2004, the nature of the exchange rate regime EMS Mark II in which the new member countries find themselves is of considerable importance, as the situation arises that the majority of the EU countries will be for some time outside the Eurozone. Most of the new member countries have ambitions for early entry into the Eurozone. The macroeconomic implications of the exchange rate system and of preparation for entry into the euro will have significant impacts on the economic prospects for the new member countries. There is a clear danger that they will suffer from the same deflationary experiences which the existing Eurozone countries had as they prepared to meet the Maastricht convergence criteria, striving to fulfil budget deficit and government debt requirements. Unnecessary restraints on budget deficit and level of public expenditure would stifle the level of aggregate demand and economic activity, and also

harm the construction of infrastructure in the new member countries. There is then the danger that the economic prospects of those countries will be harmed rather than helped by their membership of the EU.

The setting of an appropriate exchange rate which is compatible with high levels of economic activity and a sustainable current and capital account position is not straightforward especially in shifting circumstances. But entry into the EMS at too high an exchange rate would bring considerable economic difficulties to the new members, undermining their ability to export. It is important that there is a target exchange rate set which is favourable to the prosperity of the new member countries and which can be adjusted in the light of changing economic circumstances, including not only inflation differentials with other EU member countries but also the changing competitiveness of exports and productivity levels.

An alternative exchange rate regime is for a prolonged continuation of the EMS which enables accession countries to enjoy a degree of exchange rate stability but without the deflationary effects of potential Eurozone membership and the ability to adjust their exchange rate as their economic conditions change. This should be supported by the establishment of a body along the lines of the European Monetary Cooperation Fund which has funds available to support the exchange rates in the short run and to provide medium-term loan facilities to assist in balance of payments adjustment.

A fixed or quasi-fixed exchange rate regime can be undermined by large capital flows pushing the exchange rate away from its target level. It is now widely recognized that capital controls have a role to play in supporting exchange rates and in limiting financial crises: 'the lessons from the 1997/98 Asian Financial Crisis show that a premature liberalization of capital controls would expose the financial system to substantial stress and risks' (Kato, 2004). The Treaty of the European Union article 59 permits capital controls:

> Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the ECB, may take safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary.

To protect themselves against massive short-term currency speculation the new members should have the right to impose temporary capital controls. Furthermore, to avoid currency crises in the new countries a common governing body – an economic government – should be responsible for exchange rate policy with the purpose to smooth the necessary and ongoing adjustment in the productive structures of the central and eastern European countries (CEECs).

15.4 Exchange rate policy for the euro

The creation of the euro has confirmed a situation in which three major world currencies can be identified, the dollar, the euro and the yen. It is not only the case that these currencies are those of the major world economies, but also that many other currencies are linked with one of those major currencies (whether in the form of currency boards, of fixed exchange rate systems or targeting of value of own currency against one of the major currencies). The volatility of exchange rates has been one of the outstanding features of the post-Bretton Woods exchange rate system, with substantial swings in the value of currencies arising. The volatility of exchange rates is not just a matter of day-to-day variations in the exchange rate, but also swings over several years (often of the order of +/−30 per cent). The volatility of the exchange rates not only discourages trade but also exacerbates the vulnerability of national economies to external events. As the exchange rate fluctuates, imports and exports, and then the distribution of employment and output between countries, are subject to ups and downs.

The importance of the exchange rates between the dollar, euro and the yen, and the harmful effects of the volatility of exchange rates strongly point towards the development of mechanisms which could help to stabilize the trilateral exchange rates. The potential for a Tobin tax on financial transactions as a means of revenue raising and reducing exchange rate volatility is discussed in Chapter 18.

A major reduction in the volatility of the major exchange rates could come from the establishment of an agreed zone of stability for the (relative) values of the exchange rates. Around the target exchange rates, fluctuations within a band (say +/− 10 per cent) would be permissible (with the aim of narrowing the band over time), with intervention by governments and central banks in the exchange markets as necessary to ensure that the exchange rates stay within the band. The target exchange rates may be adjusted over time in so far as the economic conditions of the three major blocs change, but provided the three blocs experience similar inflationary experiences the adjustments are likely to be infrequent and small.

The establishment of a zone of stability for the exchange rates between the three currencies faces a range of problems. The first, major difficulty relates to the agreement over the central values of the exchange rates between the three currencies. There are at present no clear policies on the part of the USA, Japan or the EU as to what would be the desired exchange rate between their currency and one (or more) of the others. For example, there is no clear statement from the American government as to what value of the dollar it would see as sustainable or desirable, and indeed many obfuscating statements have been made on the value of the dollar. While countries often promote the notion of a 'strong currency', it is clear that different interests (for example importers, exporters) are served by different values of the exchange rate.

However, it may be appropriate to think in terms of the so-called fundamental equilibrium exchange rate (FEER). This equilibrium exchange is viewed as one which corresponds to a sustainable current account position. Since the current account plus the capital account sum to zero, this would also involve the notion of a sustainable capital account position. A current account deficit which would involve as its counterpart an inflow of capital from abroad may not be sustainable in so far as continual borrowing may not be possible and/or the interest payments on that borrowing mount.

However, in order to calculate the FEER assumptions have to be made on the sustainable capital account position, the interest rate differential (presumed to affect the capital account), the levels of income in the countries concerned (as well as the income flows). There is then not a single FEER but many arising from different assumptions on, for example, sustainable capital account position.

But there are also clearly political difficulties as well: an economic bloc which secures a relatively low value for its currency may well gain in terms of export performance. Each bloc may have different perceptions as to what would be a desirable exchange rate and within an economic bloc there are gainers and losers from a particular exchange rate.

There is the question of the degree of variation around the central values which would be permitted. We suggest something of the order of +/−10 per cent. This would be a range which significantly reduces the degree of year-to-year variations in the exchange rates which have been observed over the past three decades, and which should be achievable.

The major question, though, is the mechanism by which the stabilization of the exchange rates would be attempted. It is here that coordination between the member central banks becomes particularly important. Interest rates may be used to some degree, but noting that it is interest rate differentials which are particularly relevant, and hence the need to coordinate interest rate decisions in order to arrive at the desired interest rate differential. But interest rates are used for a variety of other objectives as discussed above, and the unreliability of the effect of interest rate changes on the exchange rate weakens the usefulness of interest rates in this regard. Interest rates are currently used to target the rate of inflation, though much of the effect of interest rates on inflation may come through the exchange rate. The policy indicated here requires a broadening of the remit of central banks to clearly include an exchange rate target. The interest rate instrument is likely to be rather ineffectual in this regard, and hence direct intervention by central banks in the exchange markets would be required. The ability of a single central bank to intervene in the exchange markets is limited by its own reserves. The combination of central banks is in a much stronger position to intervene, in part as they have a greater volume of reserves. But the main reason is that while a central bank is limited by its own foreign reserves, the

central bank of the currency which is not under pressure can buy to an unlimited extent the currency under pressure. The major requirement in this respect is the continuing agreement among the central banks on the target exchange rates and a willingness to intervene to protect those rates.

A policy which seeks to establish stable exchange rates between the major currencies requires some significant institutional changes within the EU: indeed a range of changes would be required for any policy which seeks to achieve a target exchange rate for the euro, whether or not in cooperation with other countries. The target exchange rate would be set by the Council of Ministers of the Eurogroup, and the ECB would be required to support that policy (through its interest rate policy and through interventions in the foreign exchange markets). Thus the objectives of the ECB would have to be changed to include that of support of the external value of the currency, and interest rates would have to be set with regard to their effects on the exchange value of the euro. The overall responsibility for the pursuit of an exchange rate policy should lie with the Council of Ministers of the Eurogroup. International negotiations would be in the hands of that group of ministers, and this could be aided by the creation of a permanent apparatus to support those negotiations and their implementation.

15.5 Conclusions

This chapter proposes that the macroeconomic objectives of monetary policy should be reformulated to include the pursuit of full employment and sustainable growth. The policy instruments of monetary policy should also be broadened, and the ECB made accountable for its policy decisions, and changes made to the institutional arrangements to enable full coordination of macroeconomic policies. The importance of the exchange rates between the dollar, euro and the yen strongly point towards developing mechanisms to help to stabilize the trilateral exchange rates.

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16
Fiscal Policies: Stronger Coordination and Higher EU Budget

16.1 Introduction

There are at least three reasons why fiscal policies must be considerably strengthened at the EU level. Firstly, the current internal state of persistent macroeconomic weakness and increasing social polarization can only be overcome through strong political intervention. Secondly, the close interlinkages between member states have the dual effect of making isolated actions by individual member countries increasingly ineffective and of reinforcing the effectiveness of joint action. Thirdly, such joint action is also required to strengthen the external position of the EU in the world and helps to shape the profile of the EU as an attractive alternative to the US development model.

From an institutional point of view the necessary development of fiscal policies in the EU relates directly to the budget of the EU as a supranational organization and indirectly, through coordination at European level, to the budgets of the member countries. The existing framework of, on the one hand, a very low EU budget, and on the other the straitjacket of the Stability and Growth Pact (SGP) must be overcome, and new rules of coordination must be developed. In a narrower economic view, European fiscal policies must include the expenditure, the revenue and the deficit side on both the national and the EU levels. In the following we discuss proposals to improve coordination of budgetary policies of the member states (16.2) and to reform the size, structure and use of the EU budget (16.3). In the subsequent section (16.4) the question of a European economic government (EEG) is taken up.

16.2 Coordination of national fiscal policies

16.2.1 Public expenditure

For technical, economic and political reasons, the greatest part of public expenditure in the EU will and should be spent on the national, regional or local

level. Moreover, most of the decisions on, and implementation of, fiscal policies should remain within the political forum of national debates. However, two facts must be acknowledged. Firstly, in an increasingly integrated European economic area, national budget policies may have negative or positive spillover effects on other national economies in the EU. Secondly, with regard to the envisaged formation of a common European identity, goals and interests will increasingly be formulated and implemented in interaction among member states, and one major instrument for this is coordinated budgetary action.

(a) Coordinated stabilization policies for growth and employment

In a large common market like the EU, total demand effects of coordinated fiscal policies are substantial as leakages to outside countries are small within an integrated economic area. The growth path of the European economy should be influenced with the aim of diminishing the amplitude of recessions. For this purpose coordination of national policies and activity on the EU level – via the European stabilization fund discussed further below (see 16.3.1) – must go hand in hand.

Coordination of national policies should include the preparation of contingency plans (in connection with general fiscal policies in order to secure democratic involvement) and a common agreement in the Commission and ECOFIN council on bringing these contingency plans into effect for all or a specific number of member countries. Conclusions from the common assessment should take the form of binding decisions. This would amount to the reintroduction of a policy tool which was available – though never used – for common action in the old EEC Treaty (art. 103) until it disappeared in the Treaty of Maastricht. These programmes should be financed through low-interest loans from the European Investment Bank (EIB), which would be refinanced through EIB bonds on the capital market.

(b) Coordinated infrastructure policies

In an integrated economic area there is a need for common, or at least, compatible structures in large infrastructure patterns like telecommunications, motorways, railway and waterway development, air traffic and big research projects. Scattered patterns of infrastructure in these areas pose substantial obstacles to a united Europe. After enlargement the concept of a common European infrastructure must be extended further to include the new members and this requires additional effort. Privatization, which is currently a major way of dealing with these issues, will in the long run not be viable, because it tends to preserve the internationally divergent structures and will then be more expensive for the potential users. International coordination of such large infrastructure projects is therefore preferable. It is not identical with the coordinated stabilization policies discussed in the preceding section, which must be flexible so that programmes can be activated and deactivated according to the current economic phase of the cycle.

(c) Coordinated policies for social welfare and cohesion

More than any other area, social policy has developed along specifically national lines and is still structured in distinctly national patterns. There is no need to make substantial changes. However, across the different European societies there are similar traditions and features related to concepts like solidarity and social responsibility which have resulted in highly developed social welfare systems. These features should be maintained and extended. They are the substance of the European Social Model as an alternative to the American model of society with its much more individualistic approach, emphasis on private property and aversion against federal welfare regulation. Therefore it is recommended that the EU should coordinate national welfare policies with the aim of ensuring that certain minimum levels of social achievements – for instance social security, workers' protection, education and health – should be improved. In terms of public expenditure such coordination could take the form of an agreement to spend a certain share of GDP on social welfare. Such general agreements could then be broken down into specific categories – health, education and so on – for which minimum standards should be set. Benchmarks and standards do not have to be identical for all countries. Coordinated public expenditure planning following such long-term guidelines would certainly be much more 'sound' and 'sustainable' than public expenditure which is subordinate to the imperative of balanced budgets, which are currently seen to be the only yardstick for the sustainability of public finances.

(d) Coordination of environmental policies

The agricultural and climate irregularities in Europe during the last few years have impressively demonstrated the need for a coordinated policy for ecologically sustainable development. The greatest part of an ecological turnaround will not consist of large public expenditure projects but of changes of behavioural patterns. Public money must be used not only to support this change, but also to manage important tasks like environmental clean-ups of polluted areas or the restructuring of transport or energy provision systems.

16.2.2 Coordination of national tax policies

The coordination of national tax policies is essential in order to recover the room for manoeuvre within national expenditure policies, which many member states have lost during the past two decades, due to the increasing pressure on taxes, and to tax competition. The harmonization of taxation throughout the EU would be the most thorough way of coordination. However, for the foreseeable future this is no option because tax systems in the member countries have evolved in very different ways. But below the threshold of full harmonization of entire tax systems, many coordination solutions are conceivable.

(a) VAT

The current VAT system in the EU with a tax base which since 1977 has been largely harmonized, a range of tax rates (from 15 to 25 per cent) and a very complicated procedure of individual identification and accounting requirements, should be radically simplified. The prevailing principle that value added taxes should not be paid in the country of origin but in the country of destination (or use) of a good or service requires payments between countries to take account of export and import flows and different sizes of and consumption patterns in member states. The method of calculating these payments should be transformed from the current individualized system to a system based on national accounts. This would put an end to large bureaucratic structures and complicated procedures. It would also remove the wide windows of opportunity for fraud and corruption.

(b) Capital income (interest, dividend) and capital gains

These are taxed as personal income and cannot be harmonized due to the very different income tax systems. For interest income the proposal which the EU has adopted[1] is reasonable and should be extended to all categories of capital income: all EU countries should join a system in which information about capital income realized by foreign investors can be exchanged, so that the national financial authorities can control whether all incomes are declared for income taxation. The large financial markets of the EU give the Union enough bargaining power to ensure the cooperation of third states in this matter (see also Section 18.3.1).

(c) Taxation of corporate profits

In theory, the full harmonization of tax bases and tax rates within the EU would be by far the most efficient means of taxation of financial income. This would remove incentives for tax competition and for relocation for reasons of tax arbitrage. As intermediate steps towards this long-term objective we propose three measures:

- Firstly, the *harmonization of the corporate tax base* (including accounting and valuation standards) which is currently pursued by the EU should be accelerated.
- Secondly, a *minimum regular tax rate of 40 per cent* should be imposed in order to make tax competition less attractive. To support catch-up processes and regional cohesion a temporary lower rate of 30 per cent could be set for countries with a per capita income of less than 50 per cent of the EU average (currently most countries who entered the EU in 2004).
- Thirdly, the EU should introduce the *world income principle* in the form that worldwide profits of a corporation would be taxed in the 'value basis' country (at the domestic rate) where the main operating basis of this firm lies, that is, where the largest parts of value are created. Taxes paid in

other countries would be deductible from the tax obligation in the value basis country. Under such a regime, 'double taxation conventions' would have to be revised, with the likely effect that most of them would become pointless and would be terminated.

Even with complete harmonization of corporate taxation there still remains the problem of unequal tax treatment of different legal forms of enterprises: taxes on profits of incorporated firms differ substantially from (that is are usually much lower than) taxes on the revenues of non-incorporated individual firms which are subject to income tax, usually at the top rate. To avoid this disadvantage the idea of a *conduit tax* should be reconsidered: this is a tax which transfers corporate taxes to the individual owners of a corporation (see Schratzenstaller, 2000, pp. 15–16). Such a regime would eventually amount to the abolition of corporate taxes as separate taxes of their own. Corporate profits would be treated as income of the owners and would be subject to the individual income tax of said owners. Under this tax system, actually paid corporate tax is regarded as a *provisional* withholding tax on the income of the owners.

The *coordinated introduction of energy taxes* is an important instrument to underpin and complement national climate protection policies. With regard to the targets stipulated in the Kyoto Protocol, energy taxes – especially on carbon dioxide – are essential in order to influence both production decisions by the energy-producing sector and consumption decisions by the private sector. The coordination of carbon dioxide taxes between member states is necessary in order to avoid international competitive distortions. Moreover, external negative effects connected with the production and consumption of energy are often not restricted to the single national states but are cross-border externalities: this is true for carbon dioxide emissions as well as for potential dangers connected with the production of nuclear energy. Therefore, from an efficiency point of view, international coordination is desirable.

A further measure which could increase the financial room for manoeuvre at the member state level would be the *coordinated introduction of a domestic securities transaction tax* (this aside from its function to stabilize financial markets in Europe, as discussed in Chapter 18). In 2003 the trading of equities on European stock exchanges – almost all secondary trading because almost no new share issues occurred in 2003 – amounted to a little over €8 trillion (FESE, 2003, Table 4c). A securities transaction tax of 0.5 per cent would lead to revenues of €40 bn; and even if as a response to the tax the velocity and yearly volume of trade fell, the tax revenue would remain substantial.

16.2.3 The future of the Stability and Growth Pact

It is obvious that in such a differentiated approach to fiscal policy coordination there is no room for the very rigid rules of the SGP. These have, therefore, to

be abandoned. Of course the financial situation of member countries, including size of indebtedness and budget deficits, must be taken into account when the general policy orientation is discussed for member countries and for the EU as a whole. But the setting of a prior limit cuts off such discussion. The primary direction for suitable rules for fiscal policy coordination would be the objectives of full employment, stable growth, social cohesion and ecological sustainability and the establishment of benchmarks and action plans which are set up to achieve such goals.

The most important tasks in the next few years will be the development of common standards for such objectives, benchmarks for assessment of achievements and agreed orientations for further action. This process will take considerable time, particularly with regard to the fact that enlargement poses additional challenges to fiscal policy coordination, including the prevention of tax competition. The main task will be the development of mutual trust, understanding and solidarity between all member countries; this carries with it the associated responsibility of each individual country not to abuse this common trust through lax policy enforcement or free-riding behaviours.

The question of public deficit and debt is one of the most misunderstood in the public and also in the mainstream scientific discussion. Firstly, at least for developed economies, there is no scarcity of capital and therefore no crowding-out effect of government deficits at the cost of private investment which could not be financed on the capital markets because the public authorities have absorbed the resources. On the contrary, if public money is used to strengthen for instance the economic infrastructure, this may lead to additional private investment and thus create a crowding-in effect. Secondly, a particularly misleading argument in this context is the assertion that public deficits equal the use of present resources at the cost of future generations. This is not even true for the most unfavourable case when government spends the money which is financed through public deficit for consumptive purposes without any further economic consequences. Even then the burden which the obligation of the government to serve and repay the debt creates for the future generation would be matched by the entitlements of the future generation to receive these payments. But usually government deficits are incurred to finance expenditure which has positive economic consequences, be it to raise employment or to strengthen the infrastructure or productive potential of the economy. In this case future generations will benefit twice from present public deficits. On the one hand the future holders of the public debt will receive interest on and repayment of government debt. On the other hand the next generations will inherit from the present one a stronger and more productive economy at a higher level of employment. This is a situation which is certainly more favourable for future generations than if they inherited no government debt, no entitlements to interest payments and a weaker economy with high unemployment. Thirdly, even the

assertion that high public debt is unsustainable because it restricts the room for manoeuvre for fiscal policies is not tenable as long as the rate of growth of the economy is at least as high as the rate of interest on public debt (see Arestis and Sawyer 2004, pp. 66–7).

Therefore, it makes good economic sense to regard public budget deficits as part of a group of regular economic policy instruments which should regularly be applied in order to achieve particular purposes. It is also reasonable to agree that in general, public expenditure which will have a long-term effect on the productive capacity and strength of an economy can be financed through loans. Such expenditure is included in the current definition of public investment, which refers only to expenditure on material structures like roads or hospital buildings. But expenditure on research and education has at least as high an impact on the future performance of an economy as expenditure on buildings does. Therefore it is appropriate to reformulate the concept of public investment in order to include these categories. Even then, however, deficit financing should not be exclusively reserved for such cases of long-term productivity-enhancing expenditure. It is also required when, for instance, a rapid increase of public demand is necessary to offset a shortfall in private consumption or investment expenditure or a fall in exports.

In this context one must mention that the coordination between fiscal and monetary policy is as important as the coordination of national public expenditures and tax policies. The strong institutional obstacles discussed in Chapter 3 will ultimately necessitate a revision of the whole construction and mission of the ESCB. In the mean time, however, there are some possibilities which could be explored by the member countries and by public political pressure. The ECB is obliged to support the economic policies of the Community and the member countries, so long as these do not affect the main goal of price stability. The ECB has interpreted the statutory independence in a very broad and excessive way, which is by no means the most plausible way of understanding it. Neither the definition of price stability nor the assessment of the situation and potential dangers for price stability are necessarily covered by the independence provision in the Treaty. Therefore we propose to shift these two tasks to a Joint Economic and Monetary Policy Committee (JEMPoC) discussed further below (Section 16.4) in which the EP, ECOFIN, the ECB and – via the Economic and Social Committee – the social partners are members. With regard to monetary policy this JEMPoC will have a twofold mission: firstly, to define price stability (possibly in a flexible way with different targets for different economic situations), and secondly, to assess the current situation with regard to price stability. The results of such a procedure would be the starting point for coordinated fiscal action on the one hand and for independent (in the operational and technical sense) monetary policy on the other.

16.3 The budget of the EU

If the EU is serious about its declared objectives to become the most competitive region of the world and to strengthen the specific European model, it needs a much larger budget than the present one and a more active budgetary policy than it currently carries out. This need was acknowledged by the MacDougall report of 1977 which estimated an amount of 7 per cent of EU GDP to be the necessary amount required in order to manage a monetary union with a common foreign and defence policy (Commission, 1977, vol. I, p. 14; see also Goodhart and Smith, 1993, pp. 438–44). This is in sharp contrast to the upper limit of 1.27 per cent which was fixed at the summit in Berlin 1999 for the period 2000–6 and to current intentions to reduce this limit further to 1.0 for the forthcoming financial period 2007–13, in spite of the additional problems and requirements which have appeared following the recent enlargement. It is well known from experience and from scientific literature that fiscal policies are a strong unifying element if they contribute to the classical goals of providing public goods, stability and social cohesion (see for instance Bayoumi and Masson, 1995; Kenen, 1995, pp. 80–90). In the light of these experiences an increase of the EU budget to 5 per cent of EU GDP in the medium term is a reasonable requirement in order to make the EU a community which can act to reach its declared objectives. This increase cannot be effectuated in one big leap, but it is conceivable by steps, reaching 5 per cent in 2012.

16.3.1 EU expenditures

Central EU resources must be used to support policies which enhance the European content of economic and social policies. In a rough approach one could assign the following proportions of the enhanced EU budget to the various areas.

(a) A stabilization fund

This should be created out of small contributions from the EU budget, amounting to 0.5 per cent of EU GDP, which will correspond to 10 per cent of the EU budget in its final 5 per cent of EU GDP stage.[2] The risk of asymmetric shocks will not decrease even with the ongoing economic integration, and there will be additional risks of spillovers of asymmetric shocks into other countries.

Therefore the old idea of a 'European Stabilization Fund' which could supply transfers of financial funds to countries affected by an economic crisis (see Italianer and Vanheukelen, 1993) should be re-established. This fund should function as an automatic stabilizer against asymmetric shocks on the EU level. Whenever unemployment rises more rapidly in certain countries, short-term resources should be released automatically and

transferred to the respective countries to enable them to react quickly in curtailing the rise of unemployment through setting up temporary programmes. Resources would be given as short-term loans at low or even zero interest and they could be limited to a maximum percentage of GDP. To reach the necessary size for economic stimulation the transfer from the EU level should also trigger the activation of the specific contingency plan of the member under pressure.

(b) Common Agricultural Policy (0.8 per cent of EU GDP)

Although the role of the CAP should be downsized in the development of the EU budget, it remains an important policy field, which requires a great deal of public financial support in the future. This is justified, and a concrete proposal for a necessary reform of the CAP is given in Chapter 10. In the final stage of a budget of 5 per cent of EU GDP, a share of 20 per cent for the CAP would still be relatively larger than it is today (0.5 per cent).

(c) Regional policies (1.6 per cent of EU GDP)

This is four times larger than the present share of GDP for structural policies through the Structural Funds (0.4 per cent). This steep increase is necessary to support a dynamic catch-up process by the new members without disregarding the continuing needs of the poorer regions in the old EU member states. This raises certain problems of absorption in the new countries which must be solved during the transition period up to 2012.

(d) Social policies (1 per cent of EU GDP)

While social policies clearly remain a domain of member countries, the EU can, through social transfers out of the budget, help to fulfil commitments for the maintenance of minimum standards which poorer countries have difficulty meeting. This would also have the effect of establishing a popular awareness of the concept of European solidarity. On the basis of the 2004 GDP for the EU-25 (= €10.1 trillion) the amount of 1 per cent spent on targeted social policy transfers through the EU budget (= roughly €100 bn) would have very visible effects in reducing social emergency problems like poverty and homelessness.

(e) Other public goods (1.1 per cent of EU GDP)

In addition to the above, there are three major fields which should be matters of public policy at the EU level: a common research policy; Trans-European Networks (TENs) in the fields of transport, energy and telecommunications; and environmental policy. In all three areas EU budget allocation complements the necessary policy coordination of member countries. These policies are discussed in Chapters 21 and 22.

16.3.2 EU revenues

On the revenue side of the EU budget there are several important aspects. First of all, the system of own resources has to be reformed. Secondly, the Union should exploit additional revenue sources in order to finance a larger budget. Thirdly, the EU must be allowed to incur its own public debt.

(a) Reform of the system of own resources

The current system of revenues (or 'own resources') of the EU consists of the traditional revenues stemming from tariffs and agricultural levies, plus a VAT-based and a GDP-related pillar. The traditional resources have fallen to below 15 per cent of the budget and are likely to decrease further. Most problematic are the VAT-based revenues which are commonly regarded as interregionally regressive: they put a disproportionately high burden on the poorer countries which have comparatively high consumption shares of GDP. Therefore this revenue source should be abandoned and be replaced by financial sources reflecting the ability to pay of member states, measured in income per capita.

The GDP-based own resources are calculated as a percentage of a country's GDP and are currently seen as a residual financial source to cover gaps between EU expenditures and the other revenues. They have become the most important revenue source of the EU: in 2002, they accounted for almost half of the EU's income. They do not violate the ability-to-pay-principle, if it is accepted that GDP is an adequate indicator of financial strength. They do, however, disregard differences in per capita incomes across countries and have been criticized for this reason by the poorer member countries. We propose to activate and further develop the initiative taken by Spain in 1998 to reform the current GDP-based own resources so that interregional progressiveness can be achieved across the member countries (see European Commission, 1998, pp. 14–16 and annex 7).[3] So-called national 'modulation coefficients', reflecting the relative positions of individual member countries' per capita income in comparison to that of the EU, would be applied to the GDP-based own resources. Thus countries whose per capita income is above average would pay more, countries with a per capita income below average would pay less than under the current system. The introduction of such a redistributive tax system would of course require that current tax competition between member states is stopped. The modified GDP-related EU tax would leave it to member countries to decide how the additional contributions to the EU budget should be raised. Table 16.1 shows the revenue potential of this tax for different tax rates (TR), and the country-specific tax rates based on the member states' relative income positions, as well as the contributions for each country.

16.3.3 European public debt

The EU should primarily rely on transfers from member states (GNP-based own resources) to finance its regular expenditures. In addition it should have

Table 16.1 Effects of a progressive GDP-related EU tax: tax rates and tax burdens for EU members

	GDP 2005[1]	Population	GDP per head		EU-25 TR = 1%		EU-25 TR = 2%		EU-25 TR = 5%	
	(bn €)	*(million)*[1]	*1.000 €*	*EU-25 = 1*	*CSTR*[2]	*CSTB*[3]	*CSTR*	*CSTB*	*CSTR*	*CSTB*
Belgium	284	10.4	27.3	1.19	1.19	3.4	2.38	6.8	5.75	16.3
Denmark	204	5.4	37.8	1.65	1.65	3.7	3.3	6.7	8.25	16.8
Germany	2,261	82.7	27.3	1.19	1.19	26.9	2.38	53.8	5.75	130
Greece	178	11	16.2	0.71	0.71	1.3	1.42	2.53	3.55	6.32
Spain	841	41.2	20.4	0.89	0.89	7.5	1.78	15	4.45	37.4
France	1,662	61.8	26.9	1.18	1.18	19.6	2.36	39.2	5.9	98.1
Ireland	154	4	38.5	1.68	1.68	2.6	3.36	5.2	8.4	12.9
Italy	1,407	58.3	24.1	1.05	1.05	14.8	2.1	29.5	5.25	73.9
Luxembourg	26	0.5	52.0	2.27	2.27	0.6	4.54	1.2	11.35	2.9
Netherlands	476	16.4	29.0	1.27	1.27	6	2.54	12.1	6.35	30.2
Austria	238	8.1	29.4	1.29	1.29	3.1	2.58	6.1	6.45	15.4
Portugal	143	10.6	13.5	0.59	0.59	0.8	1.18	1.7	2.95	4.2
Finland	154	5.2	29.6	1.29	1.29	2	2.58	4	6.45	9.9
Sweden	293	9	32.6	1.42	1.42	4.2	2.84	8.3	7.1	20.8
United Kingdom	1,702	60.2	28.2	1.23	1.23	20.9	2.46	41.9	6.15	104.7
Cyprus	14	0.7	20.0	0.87	0.87	0.1	1.74	0.2	4.35	0.6
Czech Republic	82	10.3	8.0	0.34	0.34	0.3	0.68	0.6	1.7	1.4
Estonia	9	1.3	6.9	0.3	0.3	0.03	0.6	0.05	1.5	0.14

Hungary	89	10.1	8.8	0.38	0.38	0.34	0.76	0.67	1.9	1.7
Latvia	10	2.3	4.3	0.19	0.19	0.02	0.38	0.04	0.95	0.1
Lithuania	18	3.4	5.3	0.23	0.23	0.04	0.46	0.08	1.15	0.21
Malta	4	0.4	10.0	0.43	0.43	0.02	0.86	0.03	2.15	0.09
Poland	200	38.6	5.2	0.23	0.23	0.46	0.46	0.92	1.15	2.3
Slovakia	32	5.4	5.9	0.25	0.25	0.08	0.5	0.16	1.25	0.4
Slovenia	27	2	13.5	0.59	0.59	0.16	1.18	0.32	2.95	0.8
	10,508	459.3								
Total EU budget revenue						118.95		237.1		587.56
EU-25 budget[4]						1,105.09		2,210.18		5,545.45

Note: The total amount of country-specific budget revenues differs from the EU budget based on the application of the tax rate on the aggregate EU GDP. This is due to the higher weight accorded to the countries with above-average per capita income. The difference can be corrected by subtracting from the tax burden of each country a percentage corresponding to the relative difference between aggregate EU revenue and revenue based on country-specific tax payments to the EU, i.e. 11.7% for the 1% rate, 11.4% for 2% and 7.2% for the 5% overall EU tax rate.

[1] Estimates of the EU in the 2003 review.

[2] Country-specific tax rates.

[3] Country-specific tax burden.

[4] Calculated by application of the tax rate to the aggregate EU GDP.

Source: European Commission, *European Economy*, No. 6/2003, Statistical Annex, Tables 1 and 5, own calculations.

the option of incurring public deficits and public debt, as the member states do. Article 269 of the Treaty and article I-53, section 2 of the Constitution, which explicitly prohibit a deficit of the EU budget (by stipulating that expenditures must be covered by own resources) should therefore be changed accordingly. The most important situations where deficit finance of EU expenditure is appropriate are as follows:

- Transnational public investment, research or technological development projects which will have the effect in the long term of improving the infrastructure or other elements of economic strength and productivity of the EU, and therefore the revenue basis of the EU. Such projects have self-financing effects. According to the pay-as-you-use-principle formulated by Musgrave (see Musgrave, 1963, p. 372), shifting a part of the financial burden incurred by long-term infrastructure to the following generation by debt financing is justified on the basis of intergenerational equity.
- Unforeseen exogenous shocks which require rapid reaction from the member states as well as from the EU. In cases of asymmetric shocks like above-average unemployment in one or several countries, funds must in the first place be transferred from the European Stabilization Fund. Other asymmetric shocks like catastrophes in one or several member states may require additional funds. Yet more important would be a large symmetric shock such as an EU-wide recession or sudden rise in oil prices. In such cases the resources from the EU budget could be insufficient or might not be quickly enough available. Therefore the EU should have access to uncomplicated financial resources on the capital market.

16.4 Which institutional structure for European fiscal and economic policy?

There are at least three axes along which common concepts and structures must be developed. Firstly, the European dimension of *member states'* expenditure and tax policies must be developed through tight coordination which nevertheless leaves enough room for member states to act according to their specific needs and priorities. Secondly, the role of the *EU budget* as the core of fiscal action on the EU level must be considerably enhanced, and must at the same time be coordinated with member states' policies. Thirdly, *fiscal policies on both levels must be brought in line with other policy areas*, the most important one being monetary policy.

With enlargement, matters have become even more complicated. For an indeterminate time the majority of EU members will not be members of the EMU, although except for the UK, Sweden and Denmark they are obliged – and some also want – to become members as soon as they meet the convergence criteria. The Eurogroup will therefore only represent a minority

of EU member countries. However, in the Constitution its position has been upgraded through the 'Protocol on the Eurogroup' annexed to the Constitution. This stipulates that the ministers of the member states of the Eurogroup should meet informally to discuss 'questions related to the specific responsibilities they share with regard to the single currency' and that they shall 'elect a president for two and a half years'. The endeavours to strengthen this group through a 'Mr Euro' can be understood as an attempt to enhance efficiency of economic policy and to ensure closer cooperation in the matter of monetary policy (and other policies) between the members of the EMU. On the other hand this increases the risk of widening the gap and generating conflicts between different groups of EU members. Even the emergence of a core–periphery structure between a minority group of powerful countries and the rest who make up a weaker majority cannot be excluded. Such a structure will make the EU procedures less democratic and will in all probability enhance the potential for political conflict between member countries or groups of member countries.

The institutional problems of economic policy in the EU would be easier to solve if all EU members would enter the EMU and a 'European economic government' (EEG) were formed as a counterpart to the monetary government of the ECB.[4] This economic government cannot be the ECOFIN because this institution is, partly together with the EP, the legislative body of the EU. Nor can the EEG be identical with the Commission, because of the role of the Commission as the guardian of the Treaty and because of its monopoly of legislative initiatives (at least as long as this monopoly is not abolished). The EEG must rather be a body of its own, similar to the 'centre of decision for economic policy' which the Werner plan of 1970 had proposed as the corresponding institution to the European Central Bank[5] (see Werner report, 1970, p. 12; see also Kenen, 1995, pp. 3–6). This economic government would develop and discuss economic policy of European relevance on the basis of legislative acts and orientations given by ECOFIN. In order to make ECOFIN viable in acting as a legislative body for the enlarged Union, the unanimity requirement for certain substantial economic policy decisions – for instance in tax and matters of workers' rights – would need to be removed, and a system of simple or qualified majority voting in the Council would have to be widened. Although this would be difficult to achieve it would appear to be – under the current circumstances of self-imposed stagnation – the best solution and should therefore be pursued as a matter of high priority in the institutional reform of the EU. If this is not achieved a number of countries would probably take recourse to the method of 'enhanced cooperation' – either within or outside the Treaty – and proceed with policies which would no longer be under control of the European institutions. This would almost inevitably deepen the economic gap and lower the threshold for political conflict within the larger EU.

Given these points, the following structure of economic policy in the broader sense, including monetary and fiscal policies as main pillars,

seems to be plausible:

1. ECOFIN and the EP adopt in co-decision procedures and on the basis of qualified majority voting all main legislative acts and orientations for monetary and fiscal policies of European relevance. For fiscal policies this includes policy coordination and the EU budget.
2. The ECB and EEG develop monetary and fiscal policies within the political framework given by EU legislation and are *independent in their day-to-day operations*. Both bodies should have the right to bring initiatives for legislation to the Council and to the EP.
3. Coordination between the ECB and EEG takes place in a *Joint Economic and Monetary Policy Committee of ECOFIN and EP* (JEMPoC) in which – via the Economic and Social Committee – the social partners also participate.

16.5 Conclusion

Policies aimed at achieving a progressive European Social Model require strong public intervention in the economy, and such intervention must include the active use of public budgets. Since the great majority of public expenditure and revenues is and will remain a domain of national parliaments and governments, the implementation of a European dimension requires tight and binding policy coordination. On the expenditure side coordinated national programmes for macroeconomic stabilization, for social welfare and for the protection of the environment are recommended. On the revenue side the most important step will be that of putting an end to tax competition and the adoption of a common direction in the taxation of profits and capital income. But beyond an improved coordination of national budgetary policies the EU needs an enhanced central budget, which should rise from the present 1 per cent level to 5 per cent of the EU GDP by 2012. This should be financed largely through a progressive, GDP-related, EU tax.

This is an outlook which is far from realistic while neo-liberal thinking continues to dominate economic theory and practice. But the current course of tax competition and austerity policy in the EU is not only obviously unsuccessful; it has also been exposed for some time to increased theoretical criticism and political and social opposition. In this situation the consideration of a thoroughly different proposal which claims to be not only more reasonable in economic and social terms but also feasible, under a changing balance of political forces, may be helpful to achieve this change: it may encourage people to act to change the political situation.

Notes

1. For Luxembourg, Belgium and Austria an exemption from the system was granted, and these countries collect a withholding tax from foreigners' interest income.

2. In order to avoid contractionary effects the contributions could either be paid in times of budget surplus or be provided by the ECB (as a kind of special drawing right).
3. The Commission refers to a Spanish proposal which is supported by Greece and Portugal and demands that with regard to the Protocol on Economic and Social Cohesion the EU should take 'greater account of the contributive capacity of individual Member States in the system of own resources' (European Commission, 1998, p. 14).
4. However, from an economic point of view an early accession to the EMU would probably prove harmful for new members unless the course of monetary and fiscal policy is considerably relaxed.
5. Point D of the conclusions of this report says:

   > On the institutional plane, in the final stage, two Community organs are indispensable: a centre of decision for economic policy and a Community system for the central banks. These institutions, while safeguarding their own responsibilities, must be furnished with effective powers of decision and must work together for the realization of the same objectives. (Werner report, 1970, p. 26)

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17
Labour Market Policies: Higher Standards

17.1 Introduction

As was argued in Chapter 7, labour market policies (the regulation of, and intervention in, labour markets and the employment relationship) cannot on their own resolve the problem of European unemployment. The main instruments for addressing that problem are those of macroeconomic policy, together with a genuine social dialogue relating wage outcomes to improvements in the quality and quantity of employment, and in the way in which working hours are distributed among the population. Nevertheless, labour market interventions are needed to promote full employment because the inequalities and imbalances generated in market economies mean that even in a favourable macroeconomic climate some social groups (notably people with low qualifications) will face difficulties in obtaining employment.

The view that more economic growth in the longer term will guarantee fuller employment may be an illusion (see Chapter 7). Given that, in the long run, in most developed countries, the total number of working hours is hardly growing (and in many countries even falling), a redistribution of the remaining working hours over a larger number of people appears desirable. In other words, in solidarity with the unemployed, a collective shortening of standard working times should be high on the agenda of European trade unions and social movements.

Further, there are serious questions of ecological sustainability, which call into question the objective of a long-run increase in the rate of growth. Major investments are certainly needed to render the economy more sustainable; but at the same time a change in the nature of economic growth towards sustainability requires the limitation of other forms of investment.

In addition to increasing employment, labour market policy has other important economic and social objectives: to raise the level of skills and qualification of the workforce and to open opportunities for workers to improve their qualifications; to improve working conditions and establish minimum levels of pay; to contribute to industrial democracy and the ability

of workers to influence key economic decisions. As was argued in Chapter 7, the wage gap between people with high and low qualifications is widening, pointing to the problem that notably the labour market position of low-qualified people is under pressure. A large literature on 'skill-biased technical change' suggests that, increasingly, simple work can be more easily automated. This asks for stronger efforts towards education and training, notably among people in the lower range of the educational system. The educational system should not continue to produce large numbers of people with poor qualifications.

Since the early 1980s, broader objectives have been obscured by the doctrine that persistent unemployment results from rigidities and distortions in the labour market itself. In the pursuit of 'structural' solutions to unemployment, labour market policies have been misdirected towards reducing employment rights, undermining social protection and intensifying competitive and administrative pressures on the most vulnerable groups in the labour market. Such policies serve the interests of the most powerful groups in the economy, and their continuing failure to improve employment outcomes often only leads to a demand for more of the same. The proposals discussed here aim to break this vicious circle so that economic and social progress become mutually reinforcing, rather than seen as contradictory.

Very complex questions of competence and coordination arise in the field of labour market policy. Economic policies are highly centralized in the EU with competition rules heavily restricting economic interventions at member state level. For those countries using the euro, the macroeconomic regime involves a common monetary policy and places tight constraints on budgetary policy. However, social policies are essentially a question for each member state. This is because, firstly, the most powerful interest groups, linked to the big corporations, reject the notion of social Europe and wish to enjoy the benefits of the four freedoms while being able to 'regime shop' among the differing member state social systems, which necessarily implies regime competition and pressure on the most advanced social systems. Secondly, member state governments jealously guard their autonomy in the field of social policy just because European integration, and internationalization in general, have impaired their ability to respond to political problems with economic instruments. However, some populations, such as those of the Nordic countries, often support this defence of national autonomy because they are concerned that centralization in the social sphere would undermine their historic achievements.

In these circumstances, labour market policy, as a key intersection of economic and social policy, is necessarily a field of divided competence: to leave it entirely in the hands of the member states would be to risk compromising economic integration itself because labour market measures could be used as surrogate forms of economic intervention; but unified labour market regulation would be a big step towards the social Europe which is unacceptable

to economic and political elites. Labour market policy not only involves divided competences; it is also highly contested as different conceptions of economic and social advance come into conflict at both member state and EU levels.

In the long run, the formula, 'international economy, national social policy' is a prescription for the divorce of society and economy and thus for a comprehensive loss of social control over economic life. However, in the immediate future, the situation may be exactly the reverse – the important elements of social control that actually exist are embedded in specific national societies and attempts at international integration might threaten to dismantle them.

There may be immense advantages in a strategy of *coordination* – preserving member state competence in the social sphere while seeking collective advantages and enhanced control over economic processes. The proposals address firstly the role of a European Employment Strategy (EES), which is, despite its weaknesses, an important experiment in enhanced coordination among autonomous systems; secondly, they stress the need to give real meaning to the macroeconomic dialogue; and finally they deal with European labour legislation, where a certain transfer of competence to the EU has already taken place.

17.2 The European Employment Strategy

Although workers' representatives, some Commission officials and some member states have, from the beginning, challenged the main lines of the strategy, the EES has largely worked to reinforce the general drive for 'flexibility' which has been a theme of labour market policy in many EU countries over the last two decades (without producing the promised benefits in terms of employment; see Watt, 2000). However, following the major review of the strategy in 2003, there are signs that a wider and more practical approach to labour market policies is being encouraged.

It must be recognized that the 'open method of coordination' does represent a promising and constructive innovation in the integration process. Conflicts over competence are avoided but there is a continuing effort to improve and coordinate policies on an EU-wide basis. In practice, however, it seems useful to improve the procedures of the strategy in two ways. Firstly, the wide-ranging comparisons and interactions around member state policies, which are implied by the open method, have not been sufficiently developed in practice. The actual iterative process of recommendations and reviews has tended to narrow down to a simple dialogue between Commission and each member state government in turn. This reduces the pressure for collective policy appraisal, for cross-fertilization between policies in different countries and for discussions with social actors at both member state and EU levels. Only if an effective policy community emerges will open coordination achieve its full

potential and the emulation of successful initiatives in member state labour market policies be encouraged.

Secondly, formulations of the employment policy guidelines have been subordinated to the very different objectives of the EU *Broad Economic Policy Guidelines* (BEPGs). In principle, of course, it is extremely desirable for the EU to pursue consistent policies in the economic and social spheres. However, the BEPGs at present embody a very restrictive notion of economic policies. Thus labour market policy recommendations are constrained to conform with general pressure to reduce public expenditure, to suppress wage growth and so on. What is required is an integrated approach in which the economic policies of the EU are oriented towards social objectives as much as the reverse and where social constraints are placed on the choice of economic instruments and on the way they are used. This in turn requires the effective presence of the social partners in the process of economic policy formation.

These procedural changes would work to support the necessary substantive changes in the EES. For the objectives of the strategy, ambitious targets for the reduction of unemployment should certainly be maintained, although it is necessary at the same time to recognize that labour market reforms in themselves are insufficient to achieve such targets. However, the objective of the EES should no longer be formulated in terms of simple targets for employment. There needs to be a recognition that, when people do not participate in the labour market, this occurs in various ways and for various reasons. EES targets have usually been set in terms of employment growth rather than unemployment reduction. Employment targets have the merit that they discourage the excessive use of early retirement, when what is needed are better employment prospects for older workers, and an excessive resort to sickness and incapacity benefits, when what is needed are effective programmes of rehabilitation.

Non-participation for other reasons, such as education or the provision of care to the old and infirm, has a completely different social significance and may often be something to be encouraged by social policies. Considerations of work–life balance may also make periods of non-participation desirable. As some recent changes in the EES in fact recognize, quantitative employment targets abstract from the qualitative considerations which impact on welfare and well-being. The objective, in most cases of unemployment, must be to improve the circumstances of the individuals concerned, not to drive them into any job available.

Similar considerations apply to the targets for female labour market participation. A statistical increase in female employment may represent a genuine improvement in the economic position of women. But it may signal increased pressure on low-income families. Only more complex assessments of changing labour market outcomes and more carefully specified policy objectives can guarantee that rising employment reflects a real improvement in the status of women workers.

Legal problems seem to inhibit explicit discussion of wages in the formulation of NAPs, although there have often been implicit recommendations that wage differentials be widened. Such suggestions, apart from their adverse social consequences, are invalidated by evidence that greater equality in rewards goes together with greater equality in employment opportunities and that the two objectives are not in conflict. Given that the EES works on the basis of continuing member state control over the policies in question, it is important to address the issue of intra- and inter-country wage differentials in the policy debate, as an aspect of both social and economic integration. A decent wage is the central measure of the quality of a job.

Another important aspect of quality is job security. The 'flexible' employment promoted by orthodox policies has all too often been insecure employment. Yet the Commission now recognizes that deregulation to make dismissals easier and cheaper for employers has not in fact made them more ready to expand their payrolls. Employment has been made more unstable by these measures but there has been no lasting increase in the number of jobs. In these circumstances the EES should include job security as a key objective. Recommendations to member state governments should take this into account.

From the start, various forms of active employment policy have been central to the concerns of the EES. But 'activation' measures in practice are of very different kinds, ranging from the solidaristic interventions in favour of the unemployed to 'workfare' schemes, which are essentially mechanisms for social discipline or even social punishment. The ambiguous language used in EES documents has tended to conflate these two, quite opposed, types of intervention, and activation targets have been set without any clear demarcation between them. The 'workfare' philosophy is unacceptable because it breaches European norms of social solidarity and because it limits the autonomy of disadvantaged individuals. The Nordic activation measures certainly have a disciplinary aspect, but this is within a framework designed to expand the range of choices and opportunities open to unemployed individuals. It is a key substantive requirement on the functioning of the EES that it follows this solidaristic path in the design of active employment measures.

Effective active policies necessarily have a contingent and ad hoc character – they are often responses to emergencies, such as plant closures, or to the problems facing particular groups, such as migrant workers (Dares, 1997). This is perfectly rational but it means that it is inappropriate to constrain such measures to follow prescriptive or standardized formulas. In particular, general training and workforce qualification systems should be separated from the functioning of these schemes.

An issue linking substantive and procedural reform of the EES is the organized representation of workers. Social partnership and social dialogue are central to conceptions of social Europe. But effective employee representation

is also a necessary condition for the successful implementation of labour market reforms aimed at enhancing the quality of working life. The 'flexibility' agenda has tended to undermine representative structures in the workplace by destabilizing employment and disaggregating employee interests. In so doing, it has also contributed to the grossly excessive dominance of employer groups in the formulation of policy at both EU and member state levels. The EES should challenge these political and economic imbalances by insisting on the active involvement of workers and their representatives in the implementation of every aspect of labour market policy.

17.3 For a genuine dialogue

A genuine macroeconomic dialogue, bringing the social partners together with representatives of Commission, Council and ECB, could help to make macroeconomic policy decisions both more effective and more transparent. In a comprehensive view of macroeconomics, three policies are involved: monetary policy, fiscal policy and incomes policy. There is neither a need for, nor any possibility of, a Europe-wide incomes policy in the foreseeable future. Nevertheless, the incomes strategies adopted by social partners at national level and the monetary and budgetary decisions taken at EU and national levels are mutually interdependent. The dialogue could help to make this interdependence clearer and to avoid inconsistent strategies. In addition, it could make for a more coherent relationship between macroeconomic and labour market policy. The ECB demands endless 'structural reforms' in the form of labour market deregulation and reductions in social protection and makes the absence of such 'reforms' an alibi for macroeconomic failure. A renewed dialogue, in which the social partners had more real responsibility for the ends and means of labour market policies, would work to eradicate this imbalance.

17.4 European employment legislation

Besides the important attempt to coordinate labour market policies represented by the EES, there also exists a significant body of employment legislation at EU level, corresponding to issues in which a certain degree of sovereignty has been ceded by member states. In recent years this legislation has been directed especially to the regulation of atypical employment relations. Directives in such areas as part-time working set minimum standards for employment conditions when such contracts are used and thus help to prevent a deep segmentation of the workforce according to contractual status. At the same time, employment directives in general work to set a floor to employment conditions in the EU labour market. Examples are the legislation governing working time and the information and consultation of workers. In principle, both aspects of EU legislation are highly

desirable: they contribute to the defence of European social models and to the integration of European labour markets.

One weakness of the legislative structure lies in the field of *enforcement*. It is usual for employment directives to be very permissive as to the ways in which the promulgated standards are achieved: in countries with strong labour market institutions this will involve bargaining and dialogue between the social partners, and employees' representatives supervise compliance by employers; elsewhere, enforcement depends entirely on the national legislation and tends to become, in practice, a matter for individual workers. This is difficult and costly and in many cases workers as individuals will be extremely reluctant to instigate legal proceedings against those on whom they depend for their incomes. These problems of enforcement are likely to become more severe with the entry of new member states, in several of which effective constraints on employer behaviour are very weak and representative institutions for employees are underdeveloped.

Failure to enforce EU employment norms is a form of social dumping. Although member state governments should be required to implement these norms more stringently, the only satisfactory solution is to enhance the role of the social partners and of social dialogue in those states where they are weak or absent. Such an approach is in any case necessary to prevent a division of the EU workforce into two groups each with a fundamentally different status – those protected by effective representative institutions and those without such protection. Labour market institutions develop out of the specific experience of different countries and cannot simply be imposed from above. But EU legislation can encourage a move in the right direction by requiring the involvement of democratically chosen employee representatives in the implementation and enforcement of its employment norms.

A more general problem with the EU's employment legislation is that the standards introduced are low, and do little more than try to limit downward divergences on the part of those member states with the lowest national standards (see, for example, Streeck, 1997 and Falkner, 2000). This minimalism results from political pressure for deregulation and 'flexibility' and it has been conceded by trade unions anxious to establish even weak forms of social dialogue at European level. However, it is in conflict with the Treaty requirement to promote upward convergence in working conditions.

Thus, although aspects of EU employment legislation have brought some potential improvements for British workers (in terms of gender equality for example) the legislation has almost no direct impact on employment practices in France, Germany, the Netherlands or Scandinavia because national regulations are usually more stringent than those of the EU. One danger of this situation is that the EU legislation, instead of constraining the use of atypical contracts, will act to legitimate the lowering of labour standards in these countries by suggesting that they have been set too high.

To respond to these problems, it is important to associate the EU with improvements in conditions for all European workers. It is no doubt impractical to attempt this across the whole range of standards and working conditions. But one possibility might be to reinforce the legislative structure in the field of education, training and workforce qualification. There exist wide disparities in the level and the comprehensiveness of member state systems for workforce qualification, disparities that certainly inhibit economic convergence. The introduction of EU rights to retraining and qualification, applicable to all workers (not just the unemployed) and aimed at an ambitious increase in standards, would signal a return to the Treaty objective of an upward convergence in working conditions. The attractive slogan 'lifelong learning' has tended to cover simply an obligation placed on the unemployed to prepare themselves for different types of work. It would contribute to both economic and social advance in the EU to establish rather an entitlement, for all working people, to retraining and educational opportunities throughout their working lives.

It is necessary to make it clear that EU legislation is intended to bring about substantive improvements in the conditions of workers on part-time, agency and other types of non-standard contract and is not simply a means of legitimizing the use of such contracts by the employers. To the extent that atypical contracts really add to economic efficiency and are not merely a way of reducing wages and employment standards this should be acceptable to all parties. This requires that two types of convergence are brought about: a convergence of the status, rewards and conditions of workers on non-standard with those on standard contracts; and an upward convergence in working conditions and employment rights across the member states.

In the Social Chapter of the Amsterdam Treaty, some themes are explicitly excluded from EU competence – these include *wages*. This provision may be obsolete because of the entry of new member states with very low incomes and because of continued labour market differentiation and fragmentation in the older member states. Some trade union movements have in the past opposed statutory minimum wages because they might undermine union organization in low-wage sectors. However, such a rejection can no longer be justified if trade union movements are unable to protect the vast majority of workers through collective bargaining. A legal floor to wages has the obvious direct advantage of raising the incomes of the weakest and most vulnerable sections of the workforce.

From the point of view of convergence and cohesion within the EU it would be useful to have a clear wage floor in every member state. The upward convergence of these standards would then be a useful indicator of the progress being made towards the improvement and levelling out of living conditions which are stated in the Treaties to be an explicit goal of the EU. For this reason the present exclusion of wages from EU competence

should be abolished and provision made for EU legislation on this issue, using the qualified majority vote.

17.5 Conclusion

It is an essential characteristic of the European social models that they attempt to combine successful economic performance with high labour standards and ambitious social objectives. In this respect, both aspects of European labour market policies can be found wanting: the legislative programme has often failed to establish substantively higher standards, and original formulations of the EES were heavily influenced by mainstream advocates of labour market flexibility. Debates around these policies point to the possibility of a more constructive agenda. The latter would include a high priority to overcoming unemployment not by sacrificing working standards but by enhancing the quality of working life and strengthening the social and economic position of European workers. Considering the low long-run employment elasticities of GDP growth reported in Chapter 7, a reduction of standard working hours is the most efficient way of overcoming European unemployment.

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18
Taming European Finance: Stability, Efficiency and Inclusion

18.1 Introduction

A large and well-functioning European financial market could be a considerable achievement for the European economy and beneficial for the European Social Model. It promotes financial stability, facilitates access to the payment and credit system for individuals and enterprises and contributes to efficient economic development while giving better services to consumers. But integrated financial markets do not automatically generate these positive effects. As argued in Chapter 4, the current, almost exclusive, concentration of financial market policies in the EU on size, speed and the reduction of transaction costs is working in the opposite direction – towards instability, economic inefficiency and social exclusion. To ensure the positive effects of a single financial market in Europe a political framework for, and political intervention into, the market mechanism are required. This applies to all EU members, and especially to the new members of the EU, whose financial systems are comparatively underdeveloped and largely in foreign hands, increasing their vulnerability (see Cavaglia et al., 2002, pp. 15–30). Financial stability needs strong supervision of financial institutions and safeguards against both monetary chain reactions and excessive financial speculation. Efficient economic development requires the continuous provision of credit to a broad range of firms and to public institutions pursuing regional and structural development goals not served by markets. Social inclusion in financial markets needs efficient European rules and instruments to guarantee universal access to basic financial services, consumer protection against fraud and overly risky activities of financial institutions; it also requires workers' protection against the deterioration of their working conditions caused by the emphasis on shareholder value and by takeovers.

18.2 Financial stability

Financial stability is an important national and international public good, albeit not a 'common good', because individual actors on financial markets

do not take into account the risks to other actors, and to the system as a whole, resulting from their actions. Therefore the pursuit of international financial stability raises the problem of how to coordinate private choices so as to counteract the short-sightedness of markets and private players. It must also be the subject of deliberate political measures against the interests and resistance of actors who benefit from the existing instability. The present financial system does not provide efficient safeguards against the sudden outbreak of a financial crisis with very high costs and strong contagion effects, although it must also be seen that the greater role of securitization can contribute to financial stability to the extent that the supply of funds does not go through banks and therefore an asset-price collapse is less threatening for the system as a whole (see Boyer et al., 2004). Improvement and introduction of new elements are therefore necessary. Such measures can be divided into four groups:

(a) macroeconomic supervision and emergency plans;
(b) improvement of capital requirements for financial institutions;
(c) special measures against excessive financial speculation;
(d) national consolidation and tighter European coordination of financial supervision.

18.2.1 Macroeconomic supervision and emergency plans

Macroeconomic financial stability is based on a well-functioning monetary and credit system. The responsibility for this should be clearly assigned to the European System of Central Banks (ESCB), which is currently not equipped to fulfil this task (see Grahl et al., 2002, Section 3.2). The exclusive focus of the ESCB on price stability should therefore be broadened so as to include not only employment and growth (see Chapter 15) but also systemic financial stability. It is necessary to reinforce the EU's central capacity to confront issues of systemic stability and to undertake active, macro-prudential, measures in response to malfunctions in the increasingly integrated European financial sector. Mechanisms for the collective supervision of financial actors and markets – such as the European Committee on Banking Supervision – should be strengthened and the role of the ECB as a lender of last resort should be clear and unambiguous. Clear contingency plans are needed to deal with possible banking crises and collapses of asset prices. In the formulation of monetary policy and of interest rates asset markets should play a greater role, because there are interactions between credit and securities, which in a case of crisis can run in both directions – for example a shortage of bank credit can impair the functioning of stock markets, while a collapse in asset prices can provoke a wave of bad debts, undermining the balance sheets of the banks. In both cases the crisis could have an impact on one member country only and thus lead to very sharp asymmetries in the effects of common policies. But a crisis might also exceed the intervention capacities of

individual countries and trigger an EU-wide process of contagion. In either situation, confusion as to responsibilities for intervention or delay in taking emergency measures could have the most serious consequences.

18.2.2 Capital requirements

The Basle 2 conception was criticized in Chapter 4 for its pro-cyclical and structurally polarizing implications and for the quasi-privatization of banking supervision by the introduction of private risk assessment procedures – both internally (through the use of the banks' own risk assessment models) and externally (through reliance on private credit-rating agencies). As an alternative we propose the following three measures.

1. The system of standardized risk weights for particular *groups* of debtors should be maintained and be complemented for particularly risky kinds of loan recipients, for instance hedge funds or offshore institutions. Risk weights should be externally determined by the financial supervision authorities. Such a standardized pattern has two advantages compared to the individualized approach envisaged in the Basle 2 framework. First, it implies a certain degree of cross-subsidization: within each group of debtors capital requirements are the same for loans to all members of the same group regardless of their individual financial status. Although this – very moderate – cross-subsidization of the weaker by the stronger debtors contradicts the logic of a single firm it will – if not excessively extended – improve systemic stability because it works against the polarizing mechanism of an individualized approach. Second, the rigid pattern of capital requirements operates as a kind of automatic stabilizer, because as far as external requirements are concerned credit conditions do not deteriorate in a recession and do not improve in a boom.

2. For the determination of the group-specific risk weights the financial supervision authorities should use the national central banks (NCBs) as *public rating agencies*. NCBs dispose of large and detailed statistical databases, long experience and highly qualified personnel. This makes them the natural basis for rating procedures which are not driven by private profit considerations and conflicting interests and loyalties – as is often the case with private rating agencies. In developing rating standards NCBs should cooperate closely with each other within the ESCB, while taking account of the national specificities of the groups of debtors which they are evaluating. Where NCBs fulfil functions of national financial supervision, rating activities must be strictly separated from these to avoid conflicts of interest, through outsourcing and the setting-up of separate public entities.

3. The range of risk weights should be extended to more than 100 per cent. For particularly risky loans – which are for instance used for investment in hedge funds or trades in derivatives – coefficients of 150 per cent or more should be set.

18.2.3 Specific measures against financial speculation

Although a certain degree of financial speculation is necessary to enable hedging activities which have a stabilizing effect, excessive speculation, driven by herd behaviour, has often led to cumulative processes, increased volatility and turbulence and bubbles on financial markets which can cause severe financial crises (see Kindleberger, 1996, Ch. 2). Some safeguards against excessive financial speculation can be provided through monetary policy and capital requirements, others through enhanced transparency and reporting requirements both for institutions such as hedge funds and for risky positions in certain derivatives. But more is needed. Particularly, very short-term trading and selling on secondary equity markets is more harmful than useful for the smooth functioning of the economy and should therefore be constrained. A soft way of doing this is the introduction of a *securities transaction tax*, which could be differentiated according to holding periods. It should apply only to trades on secondary markets, and not be levied on the issue and first buying of shares and comparable securities. Therefore it would not be an obstacle to external financing for firms and governments. Such a tax is already levied on the London Stock Exchange. Government bonds could be excluded from this tax in order to avoid obstacles to the liquidity management of financial institutions. For stronger waves of speculation this transaction tax should be complemented by a high *capital gains tax*, the rate of which should fall as the holding period of the security lengthens.

As to currency speculation we take up the proposal for a moderate *currency transaction tax* (CTT), following the concept developed in the 1970s by James Tobin. The intense discussion of this proposal has come to the general conclusion that it would be feasible even if introduced only by the EU, and that it would gather a substantial amount of revenue. Other aspects such as the impact on financial markets in general remain more controversial.[1] However, it seems clear that in times of strong turmoil in the foreign exchange markets a low Tobin tax would be rather ineffective. It has therefore been proposed that this low fixed rate be complemented by a *second flexible rate* which would serve as a circuit breaker against massive short-term currency flows (see Spahn, 2002). Although it is desirable that such a two-tier system be set up on a worldwide level its unilateral introduction would also be possible and effective – although to a lesser extent. The tax, even if it is levied at a lower rate (for instance 0.1 per cent) than Tobin proposed (1 per cent), would yield considerable revenues. The proceeds from the CTT can be used to promote economic and social development in poor Third World countries.

Another way to deal with currency speculation is a coordinated exchange rate policy with target zones, an exchange rate stabilization fund and intervention on the currency markets, already discussed in Chapter 15.

In the case of destabilizing capital inflows or outflows the EU could and should reintroduce and apply temporary *capital controls*, an instrument which was never completely relinquished by the Community. It is – at least in indirect form – present in article 59 of the current EU Treaty which is maintained – as article III-159 – in the Constitution.[2] The cost of such capital controls can be lower and their efficiency much higher than the costs of other forms of market intervention. Although the size of the Eurozone is so great that such measures would only be needed in exceptional circumstances, smaller monetary systems, including those of the new member states before adopting the euro, are more likely to face this kind of emergency and the EU should uphold their right to use capital controls as an effective response.

18.2.4 National consolidation and tighter European cooperation in financial supervision

To strengthen the European dimension of financial supervision it is in the first place necessary to expand the stock of common harmonized rules for the structure and behaviour of the financial services sector. Two models are conceivable:

(a) A European institution corresponding to the centralization of monetary policy. However, the centralization of European financial supervision can only be conceived as a last step in a long process of ever closer coordination and harmonization. But even then a centralized financial supervision institution on the European level would hardly be in a position to take into account the specific structures, problems and needs of national financial sectors and deal with them in an appropriate way.

(b) The second model assigns the implementation of the common harmonized rules to national supervisory authorities which can also best take account of the particular national specificities. In this case a tight European coordination is needed, which should lead to a set of common binding rules, and eventually result in a set of European directives (or European laws), while legislation should remain in every stage under the full control of the Council and the European Parliament.

18.3 Economic efficiency

One major function of financial markets is to channel financial resources into their most profitable use which mainstream economics identifies with the most efficient use. This function can be undermined in two ways – in addition to excessive speculation. First, capital can be diverted from its most efficient economic use by tax considerations. Second, the dynamics of financial markets may lead to short-term operations to raise asset prices, not compatible with long-term sustainable economic development. Against the first

danger a tightly coordinated tax policy with regard to corporate and capital taxes is necessary. To correct structural distortions driven by financial market short-termism, the public authorities should be able to intervene in the structure of finance via public banks.

18.3.1 Tax policy

We do not share the view of the EU authorities that tax competition in general is to be welcomed and that only discriminatory treatment of corporate or capital profits is harmful and to be eliminated. Tax competition via reduction of tax rates and tax bases can lead, even when it is not discriminatory, to harmful consequences. To constrain tax competition and thus enhance economic efficiency the following measures are viable in the area of capital income, that is of interest income, dividends and capital gains.[3]

As long as income taxes are not harmonized throughout the EU – and this is still more unrealistic than the harmonization of corporate taxation – *full mutual information about the capital income of EU citizens in other EU countries and cooperation in enforcing national income tax regimes throughout the EU* is the best way to deal with capital income. The EU should extend this regime which, for most countries from 2005 onwards, will operate only for interest income to dividends and other forms of capital income. It should do so even if the US, Swiss and other financial centres do not cooperate. If the EU is determined to apply this rule there are instruments to enforce cooperation and to limit the damage of non-cooperation. A model for such enforcement could be the USA: the tax authorities in 2000 wrote letters to major financial institutions throughout the world, requesting them to provide regular information about the capital incomes of US citizens and threatening to complicate or cut financial relations between US firms and non-cooperating banks. Subsequently the US Internal Revenue Service concluded contracts with the same content with several European banks (see Bach, 2001, pp. 120–1; *Handelsblatt* of 26 October 2000, p. 1). This unilateral measure could be the model for a corresponding response from the EU as long as no multilateral agreements are reached.

The problem of the EU is not that there are no means to implement strong tax rules. The problem is the lack of political determination to apply them. In this context, the requirement of unanimity for all legal steps with regard to taxation is a real obstacle to progress and should eventually be removed. But even before this happens if there were political consensus among the main financial centres to proceed in the proposed way it would hardly be possible – and in any case not very efficient – for other EU members to openly offer opportunities to circumvent such measures.

18.3.2 Public banks

The main orientations and directions of economic development – infrastructure, utilities, basic research and the provision of other public

goods – should in a democratic society not be left exclusively to market forces but be in the last instance determined by democratic discussions and decisions as to the appropriate framework. If the markets do not follow these public guidelines, governments must have the instruments to provide finance through public financial institutions. This applies to the national and – often even more so – to the regional level. Public banks can be necessary instruments to implement regional, industrial and technological development strategies and to pursue social objectives such as the provision of affordable housing or universal access to the financial system. Most national and regional governments still own such financial institutions. They should be explicitly acknowledged as instruments to provide public goods or services of general interest and therefore be exempt from the European competition rules. On the EU level, the roles of the European Investment Bank (EIB) and the European Investment Fund (EIF) for the implementation of development priorities inside the EU should be reinforced.

18.4 Inclusion

18.4.1 Universal access to basic financial services

In modern societies participation in social life is not possible without access to basic financial services. This access is therefore an essential requirement for social inclusion and for democratic life itself. It includes two dimensions.

The first dimension is the unconditional right of every *individual* to basic financial services. Regulations to this effect exist in different member countries, but they are often rather vague and differ substantially from each other.[4] Guidelines as to the minimum content of basic financial services should be elaborated and adopted on the EU level through directives or European laws. They should include the right to a bank account, to a bank card to withdraw money from ATMs of a certain network, to make and receive payments, and to a number of free money transfers per month. For welfare recipients and other low-income individuals these services should be granted without charge by all credit institutions. To avoid an unfair distribution of the costs involved in meeting these obligations a fund should be created to which all credit institutions contribute according to their financial assets and from which they are reimbursed according to the number of free low-income accounts.

The second dimension of the universal access to financial services is the *regional* one. Credit institutions must be within a reasonable regional reach of users to realize the right of access for everyone. Traditionally this function was very often fulfilled by the national postal services. However, these are increasingly being transformed into legal corporate entities, and subsequently deregulated and privatized. During this process the financial services branch is downsized, and often outsourced and sometimes sold to private banks without any infrastructural mandate. It is therefore necessary to counter the

tendency to regional desertification with regard to the availability of financial services. This can be done through public savings banks which play an outstanding role in Germany. Where such banks do not exist private commercial banks should be obliged to set up a minimum number of service points in every region. They could consist of networks of different density for ATMs (high density) and other financial services (lower density). To cover the costs of maintaining such a network for financial inclusion a fund solution similar to the one for basic bank services for low-income groups is conceivable. An alternative would be to subsidize banks to the extent to which they take part in such networks. As a part of providing services of general economic interest such subsidies should not be regarded as conflicting with EU competition law.

18.4.2 Consumer protection

It has been shown (in Chapter 4) that consumer protection is a subordinated and widely neglected aspect of the EU's policies for financial markets. Financial liberalization and deregulation have caused widespread damage both to households (particularly those with modest incomes) and to the social fabric. Only the reassertion of different priorities can restore the legitimacy of EU actions in this field. Nor would this reassertion have a negative impact on growth and investment. In the present context of financial disorder, the subordination of consumer interests to 'market-creating' integration may even be self-defeating because consumer suspicion will hold back financial development and deprive many financial companies of new resources. On the other hand, the gradual restoration of confidence in financial institutions would tend to support a socially responsible integration project and to make for a wider and more stable supply of financial resources. To this end, consumer protection must regain greater weight than it currently has. It must go beyond the setting up of a European network FIN-NET which deals with complaints with regard to financial services but has no formal competence nor power.

Therefore it is necessary to introduce high, Europe-wide, minimum standards of consumer protection, summed up by the *caveat venditor* rule: the seller is responsible. Provisions to this effect should be integrated into the directive proposal for consumer loans currently under discussion (see European Commission, 2002), replacing article 9 of this proposal about 'responsible lending'. In retail markets where individuals confront large and sophisticated companies, and where a single decision – on borrowing and lending – can have enormous implications for long-run welfare, the most effective regulatory principle is to oblige the providers of financial services to investigate thoroughly the interests (and not only the ability to pay) of their customers. Credit advanced to households without such investigation should be irrecoverable; savers should be indemnified if a failure to consult their interests leads to losses. It may be desirable to leave much of the

detailed regulation of financial products and practices to national authorities. In general the adoption of minimum standards is preferable to full harmonization, because it allows countries with higher standards to maintain these.

More concretely, European consumer protection in financial services should include the following.

(a) Standardization of certain retail services

Frequently, enterprises in the financial sector engage in excessive and spurious product differentiation usually presented as 'financial innovation'. This is made possible by the marked information asymmetries between suppliers and customers. The outcome corresponds to the classical analysis of monopolistic competition: excess capacity; wide margins between costs and prices; a loss of scale economies; heavy and dysfunctional marketing expenditures. In such situations the authorities should be empowered to require a simplification of product descriptions. This again implies that regulators should have power over *products*, not just over marketing procedures.

(b) Enforcement of socially responsible behaviour by commercial enterprises

Similarly, profit-making financial actors themselves should be constrained to respect social objectives in their commercial activities, for example to avoid discrimination against lower-income customers. German and French enterprises which close production facilities are required to draw up 'social plans' in the interests of their employees. Similar rules should apply, on a Europe-wide basis, to the withdrawal of financial services from communities with inadequate alternative provision. This kind of constraint is found in the USA, although it has not attracted the attention of EU elites. The Community Reinvestment Act (CRA), enacted in 1977, aims to ensure a flow of credit to low-income communities, and all banks above a certain size are required to participate. The CRA – something of a dead letter under the Reagan administration – was reinforced in the 1990s, so that there is now an effective, if imperfect monitoring system to ensure compliance (see www.ffiec.gov/cra/default.htm).

(c) Protection of non-profit and publicly owned enterprises

In many countries, mutual and other non-profit-making enterprises in the retail financial sector, as well as publicly owned financial enterprises, have come under pressure – from deregulation and liberalization, monetary incentives for demutualization (the British building societies) and from the European competition regime (the public Sparkassen and Landesbanken in Germany). Such institutions provide important public goods such as financial services for low-income households and communities, while they support local initiatives and certain forms of redistribution and collective insurance which would not be provided by purely commercial enterprises and help develop the 'social sector' of European economies. In consequence,

the competition regime for European retail financial services must permit national, regional and local governments to subsidize the provision of such services, or themselves to provide them.

(d) Constraints on GATS negotiations

The liberalization of financial services is a prominent issue on the GATS liberalization agenda of trade in services in general. In the financial sphere as elsewhere, such liberalization can threaten important aspects of public provision. The EU is the best-placed trading bloc to resist the introduction of liberalization rules which compromise consumer protection and to ensure that financial companies entering the European market observe the highest possible standards. Such conditionality for the liberalization of the financial sector in the long run reinforces European competitiveness and attracts customers to European financial services.

18.4.3 Workers' protection

Workers are often the victims of increasingly deregulated financial markets. On the one hand they feel the pressure which a shareholder value orientation introduces into all aspects of industrial relations. On the other hand financial takeovers of firms by institutional investors are often followed by closures and/or plant relocations with severe consequences for workers.

Remedies against this exclusion of workers should consist of strengthening their right to participate in the control of the firm with a veto right in matters of employment and work conditions. This is of course difficult to implement because structures and provisions are very different among member countries and because the resistance of management and owners will be strong and adamant.

In the case of takeovers specific rules for the protection of workers' interests can be conceived. The EU has recently adopted a takeover directive (see Directive 2004) which very largely leaves it to member states to decide how far companies are allowed to protect themselves against hostile takeovers. In this area the effort of the Commission to promote financial expansion without any constraint was not successful and there remains room to shape conditions for takeovers which take account of interests and concerns of the target firm. The main concern in the discussion preceding this directive has been the protection of the interests of minority shareholders. But it is reasonable to extend this protection to the interests of workers as well. This could be done by imposing social obligations upon the buyer, above all to guarantee – at least for a certain time – the number of jobs and refrain from tightening pay and work conditions. There should be strong vetoing powers against closures and plant relocations after a takeover. Where they are clearly shown to be unavoidable – in the context of a corporate strategy about which workers' representatives must be fully informed – there should be

adequate compensation to dismissed workers and to the region affected by the measure. Again it is necessary to give these rules concrete expression in each national legal system. The EU should adopt a directive with three clear mandates: first, it should oblige the parties concerned to elaborate and take the measures mentioned above. Second, there should be certain minimum standards in each of these areas. Third, European minimum standards should not lead to the reduction of standards where they are already higher than the required minimum.

18.5 Conclusion

In this chapter proposals for the reform of financial market policies in the EU were presented. The main idea behind such proposals is that the creation of an integrated European financial market should not be governed by the exclusive aim of reducing costs and increasing the speed of financial transactions. Instead integration should be embedded in a social and economic environment in which financial stability, economic efficiency and social inclusion are the guiding principles. To ensure financial stability the mission of the ESCB must be broadened, the Basle 2 framework should be changed, special measures against excessive financial speculation should be taken and tight cooperation among financial supervisors in the EU is necessary. Economic efficiency in financial markets can be enhanced when distortions caused by different tax systems and tax competition are removed and special financial instruments for the implementation of public development objectives are retained. In the area of social inclusion proposals for the guarantee of universal access to the financial system, for high minimum consumer protection standards and for the inclusion of workers' interests into the framework of a European financial market were formulated.

Many, although not all, of these proposals are in more or less sharp contradiction to the ongoing formation of a European financial market which is reflected in the nearly completed Financial Services Action Plan. Therefore the task of creating an integrated European financial market is by no means completed. To embed the integrated market into the framework of the European Social Model, the FSAP needs to be corrected to make it compatible with this model and it needs to be extended where issues of stability, efficiency and inclusion have not been covered.

Notes

1. Perhaps one could make the proposal more acceptable to critics of the concept by exempting foreign exchange swaps from the tax. The reason for this is that such swaps do not establish open positions and are frequently used as instruments for liquidity management. For a detailed discussion of the arguments in favour and against the CTT, see New Rules (2003).

2. Article 59 of the Treaty on European Union and art. III-48 of the Constitution: Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, on a proposal from the Commission, may adopt European regulations or decisions introducing safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary. It shall act after consulting the European Central Bank.
3. The taxation of corporate profits is discussed in Chapter 16 and does not play a major role in the context of financial market problems.
4. In France for instance, where since the 'loi Aubry' of 1998 against social exclusion every individual has a right to a bank account, about 5 million persons are, according to a report of *Le Monde* of 10 June 2004, p. 18, in fact excluded from bank services.

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19
A Strong and Democratic Public Sector

19.1 Introduction: dimensions of a new debate about public goods

The development and implementation of a European Social Model (ESM) require the construction of public services on a European scale. In Chapter 5 it was shown that the progress of competition-led integration has paralysed the traditional public service structures of member states without establishing a genuinely European public space. The absence of any functioning European social networks is a contributing factor in the current weakness of the European economy. Stagnation and tax competition undermine public revenues and are leading to the destruction of the traditional welfare systems. The balance between private competition and public regulation has been severely distorted towards the rule of competition and it needs a comprehensive re-evaluation of the status of the public sector within the EU. This revision should abandon the a priori assumption of the general superiority of the market.

Public goods are social constructions which reflect on the one hand the stage of economic, social and technological development and on the other political choices about the 'general interest'. In a comprehensive approach, four main ways of looking at public goods can be identified.

Firstly, the *institutional* dimension of security and safety for everybody is reflected in the rule of law, protection of individual rights and reliable procedures of administration. These cannot be taken for granted in modern capitalism. On the contrary: in times of instability and global insecurity these issues demand increased political efforts. Traditional approaches aimed at strengthening public authority and the power of the state in general are not sufficient to ensure political and institutional stability and in some cases can even be counterproductive, if they are not accompanied by new forms of public dialogue and mediation.

Secondly, the *economic and technological* dimensions of infrastructure, utilities and other network services are the basis for development in every

society. Policies concerning public networks have a great influence on the structure and direction of economic development, and conversely dynamic economic development makes it necessary to establish an equally dynamic policy for networks and other infrastructure.

Thirdly, the *social* dimension of public goods guarantees universal access for every individual to certain material goods and services as a basis for the exercise of individual rights and for social welfare and cohesion. Education, health, housing and cultural services belong to this group. The provision of these services should not be confined merely to meeting, in a uniform way, *basic* needs to protect individuals from sickness, homelessness and illiteracy; for developed societies such as EU members high standards for the level, quality and diversity of public services should be expected and guaranteed. The public welfare system should not be a gift to the poor but a reflection of the wealth of a society as a whole and of its determination to extend this wealth to all members.

Fourthly, the *political* dimension reflects the procedures which shape the relationship between the private and the public sector. It is obvious that providing public goods in an authoritarian and paternalistic way is not appropriate in a democratic society. But even in a democratic society public services can degenerate and produce bureaucratic rigidities which isolate them from the changing needs of the people. To avoid this, continuous democratic participation is needed, and this requires that public goods and services become a matter of permanent *public* debate on all levels of society.

In the following some systematic ideas are presented for consideration concerning the approach that should be taken towards establishing a new balance between public and private regulation (Section 19.2). Section 19.3 takes up and extends the issue of European network services from Chapter 5. This is followed by a discussion of different steps to extend the concept of public good from the national to the European level (Section 19.4). Section 19.5 deals briefly with the different options for the finance of public services.

19.2 A new balance between private and public consideration

We propose a scenario in which private and public economic activity is re-embedded into a social context. It is a question of 'res publica', of establishing a public space which can be used for intense discussions of the main orientations of economic and social development. Three kinds of economic activity can be broadly identified.

19.2.1 *Private* production and distribution of goods and services as *private commodities*

The public interest in this area relates to the behaviour of private firms. Here the promotion of the public good requires the promulgation of *rules* to

which private firms must comply in their business activities. Such rules are concerned with areas such as worker and consumer protection, environmental standards, transparency of accounting, competitive behaviour and so forth. European legislation in such areas varies widely: from strong and binding regulations on competition to the weak or absent regulations of workers' rights, environmental protection or cultural standards.

19.2.2 *Public* production and provision of *public* goods, which are directly regulated through political decisions and control

Some of the most important sectors in this area of 'government services' are education, health, defence, justice and others. Public production and distribution can take place through national state monopolies, regional and local administration, or other public bodies such as schools, universities, hospitals or local public firms. The focus here must be on avoiding bureaucracy and assuring democratic and efficient governance of the public service provision. It is increasingly questioned whether the production of such services should necessarily be confined to the public sector.

19.2.3 *Private* provision of *public* goods, which over the last decade has emerged as the most frequent way of delivering public services

The provision of communication services, electricity, water or waste disposal remains a public task and these services must fulfil the criteria applicable to universal services (access, reliability, affordability and so on). But the production and delivery of such services are – partly or completely – delegated to private firms. This can take various forms: contracts, public–private partnerships, private finance initiatives, leasing and so on. Independent regulators are set up as quality control measures and in order to ensure the continuing provision of these services (see Chapter 5).

19.3 European network services: proposals for improvement

Europe-wide regulation of public services is most advanced in the area of regulation of universal services organized in a liberalization-privatization-cum-regulation pattern. However, as was shown in Chapter 5, this arrangement often does not work satisfactorily. In the light of these experiences, the following steps are proposed towards a coordinated approach to the further improvement of European network services.

A first step should be a thorough and independent *stocktaking and evaluation of previous liberalizations and privatizations* of network services in the EU. Such an assessment should not only examine the efficiency and microeconomic performance of privatized sectors, but should also take into account their

impact on social and regional cohesion, employment and working conditions and the costs and efficiency of the accompanying regulatory structures and practices. Until this evaluation has been publicly discussed a *moratorium on further liberalizations and privatizations* should be adopted.

As a second step *private network operators should be retransferred* back into national or municipal ownership and management in all cases where liberalization and privatization have produced negative effects and where regulation of private operators has been inefficient and costly. This process has already begun in France, where several municipalities took over water provision from private corporations (see Hall, 2001, p. 11) and in the UK, where the private company Railtrack, after filing for insolvency, was taken over by Network Rail, a not-for-profit company with a broad range of stakeholders ranging from the operating companies to trade unions and consumer groups.

With regard to the European-wide network services and related questions on their privatization and regulation, it must be recognized that if European unity is to be taken seriously – and if enlargement is to be understood as a serious project aimed at stretching the European Social Model to encompass the new member countries – much more must be done, in terms of both the size of the European public sector and regulation on a European scale. Therefore as a third step it is proposed that the basis of public European infrastructure should be strengthened, particularly in the areas of transport (railways, roads and waterways) and communication. This would include on the one hand *large public investments* and on the other the implementation of *common European rules and standards*. Such infrastructure programmes could be financed partly from an enlarged European budget and partly through loans from the European Investment Bank (EIB) and the capital markets (see Chapter 16). For European regulation it is proposed that a *horizontal universal services directive/law* should be developed, which would be based on the experience of sector-specific liberalization directives. Its content would generalize the regulations currently in existence concerning general access, quality, safety and security, reliability and so on which were established in the postal, electronic communications and other network services directives. It would also establish rules for the continuous participation of users and consumers of these services in the governance of the sectors concerned. It should take note of the lessons of past experience and make a clear distinction between the operation of the core network structures and the provision of services through this structure. On the basis of past experience, preserving the material network structure (railway tracks, channels, transmission lines) in public ownership or at least under public management seems reasonable in order to avoid private monopolistic positions and to ensure safety, reliability and continuous modernization of the services.

At the same time, and as a fourth step, European network policy should begin to explore the possibility of developing a *new, more demand-led, concept*

of public services which would respond to the increasing differentiation of the needs and demands of individuals. Such a new concept would offer a solution to the problem of the hitherto often prevailing uniformity of supply, which sometimes taints the idea of public services with a certain suggestion of inferiority in comparison with private services. Public regulation to ensure universal access and affordability should not preclude a product differentiation strategy based on the varied and changing needs of individuals and groups of users and consumers. On the contrary, a public framework which protects public services from worldwide competition (and from the pressure to expand at any price with the consequent situation whereby a company spends more resources on marketing than on product development) will make such demand-led innovation and differentiation far easier. In this context even a moderate policy of price differentiation according to individual purchasing power might be envisaged. On the basis of cross-subsidization within large public complexes, the viability of providing a broad range of public services can be maintained, whereas in private firms loss-bearing services are not subsidized but terminated.

In a fifth step the European regulation of network services should be taken beyond the current level of European directives which are implemented on the national level. This could be done in two subsequent steps: firstly, through a closer and more binding cooperation of national supervisory authorities (instead of the current legally informal structures); secondly, through a European supervisory authority which would have the responsibility for setting and regulating European standards. Such centralization could strengthen the economic performance and social cohesion of the European economy; but it must be based on a process of transparent public debate. The development of such a debate, and the establishment of democratic procedures, are in this context specific challenges which will need intense attention.

19.4 Towards a broader European framework for public services

The Constitution explicitly acknowledges – in articles II-96 and III-122 – a special role for services of general interest. It offers the possibility of legislation at a European level on such issues as the economic and financial principles of these services. However, the operation of these services is quite narrowly restricted, and the formulations in the Constitution cannot serve as the constitutional basis under which we might understand a comprehensive public sector to be an essential pillar of the ESM. These restrictions should be replaced by a broader approach to the public sector, giving it equal weight to the private sector and embedding both in a framework of democratic regulation. The following formulation is proposed to be inserted into article I-3 of the current version of the Constitution: 'The Union shall

maintain and develop a strong and democratic public sector through which it provides to its citizens a broad range of public services as a basis for social cohesion and solidarity and for sustainable economic development.' In part III of the Constitution a chapter should be inserted about the principles and rules of the public sector in the EU.

In this context the problem of compatibility with WTO rules and particularly with the current round of General Agreement on Trade in Services (GATS) negotiations arises. In the WTO and GATS frameworks social responsibility and public interest do not play any role apart from the assertion that both free trade in everything and competition in open markets are in the public interest. Therefore the EU must refuse to be put under external pressure from such free market institutions; social responsibility and solidarity should figure as core elements of the ESM. The EU should insist in the GATS negotiations that all public services – including those supplied by public and private corporations – should be exempted from the GATS framework. Consequently it should withdraw all offers for liberalization of public services which it has already made during the ongoing negotiations. Liberalization may occur nonetheless, but only as a voluntary choice. As long as there is no common European standard for public services, the Commission, which conducts the GATS negotiations on behalf of the EU, should insist on the freedom of member states (who should be able to delegate this freedom to regional and local authorities under the principle of subsidiarity) to define their own public services and the way in which they are delivered (how the services are to be financed, whether the enterprises involved will be public or private). It should also refuse to allow the WTO to regularly re-examine the continuing necessity of such definitions or to allow the Dispute Settlement Body of the WTO to take decisions on these questions.

Apart from anchoring a broad concept of public services in the Constitution – which for the foreseeable future is not politically realistic – the following, not mutually exclusive, ways of dealing with public services other than network services on the EU level are conceivable.

The most modest approach would be to guarantee in the Constitution the freedom of each member country to implement its own concept of public goods and services. In order to strengthen the principle of subsidiarity the opportunity given in article III-122 of adopting a European law for services of general interest would not be taken. However, if this approach were adopted there would still be no common standards and no joint institutions to provide a core element of a coherent European structure of public services. This absence would tend to lead to continuing economic disorganization in Europe. This option should be disregarded.

A much more ambitious project would be the adoption of a European law/directive on public services which would go beyond the reach of universal network services and would constitute a counterweight to the competition rules. Such a directive could be regarded as the predecessor of an eventual additional corresponding chapter on public services in the Constitution. This

chapter would refer on the one hand to the *public sectors of the member states* and on the other would establish the concept of *Europe-wide public services*.

As part of the general perspective for public services in the separate member states, the following procedure is proposed. In a first step a European directive should oblige member states to define clearly their areas of public services and to reveal the rules for their organization. Clear and comparable information about the concept and the extent of public services and the regulatory structures would be available for all member states. Because of differences in historic and political development between states the pictures would differ considerably throughout the Union, and this would probably stimulate intense political discussion.

A second step should be the development and adoption of certain European *minimum standards*, referring to:

(a) The areas and sectors which should be regarded either as the exclusive domain of public provision – 'government services' such as education, health, water, social security, justice, defence, basic research – or as domains in which private provision should be publicly regulated (gas and electricity, transport, housing, other infrastructure, pharmaceutical production).
(b) Qualitative criteria such as universal access, safety, affordability, participation of users and consumers, work conditions and so on.
(c) The structures and procedures of management and implementation (regulatory authority, voluntary negotiations and so on, *ex-post* or *ex-ante* regulation).

A directive or European law of this content should also establish that the introduction of agreed minimum standards should be no reason for lowering existing higher standards in certain member states.

A third step which would have in mind the outlook for further long-term progress would be a *common European platform of public services* which would then become obligatory for all member states, with common objectives, common minimum standards and joint interventions by EU and national regulators. Such a scenario would provide a clear framework constraining the workings of competition and halting the drive towards privatization.

The idea of a *European* concept of public services is currently mainly discussed in the areas of internal and external security, asylum policy and other administrative regulations. In the economic and social field the prospect for public services should be enhanced, through development of large European networks. More should be done, particularly in the areas of research and development, economic stabilization and cohesion. The establishment of a European stabilization fund, as proposed in Chapter 16, and the strengthening of activities promoting social cohesion should also be regarded as part of European public services. The possibility of enabling the EU to ensure some real contribution to the welfare of people, for instance through a contribution to the pension or the health systems in Europe, should also be considered.

Proposals for such reinforcement of European public services immediately raises the question of how to finance them.

19.5 The financing of public services

A strong public sector cannot be established at no cost. The provision of high-quality public services requires large resources, and effective regulation is also expensive. To be serious about a strong public sector therefore presupposes the willingness to pay for it. There are in principle several sources.

The most important financial basis for the public services is the public budget. All government services which are provided free of charge must be financed from the public budget. The concept of a strong public service sector is therefore inseparably linked to a concept of taxation which would ensure a sufficient revenue basis to bear the cost of public services (see Chapter 16). Tax competition must be ended and taxes on corporate profits and capital income must be raised. Wealth and property taxes should also be introduced, where these do not already exist. At the same time it should be ensured that tax revenue is assigned to those public levels (national, regional and local) which provide the services. Similarly, the concept of stronger *European* public services can only be realized if the *budget of the EU is considerably extended*. In order to strengthen the Europe-wide conception of public services, the introduction of special European taxes going directly to the EU, as proposed in Chapter 16, would be a useful measure.

Another financial basis, particularly for the financing of social security systems, are *mandatory contributions*. The cost of strong pension, health, welfare and unemployment insurance schemes could be borne by a system of mandatory contributions as a fraction of the income of the active population, and not only employees. Income from capital, rents and other incomes could be liable for contributions as well as income from wages. In a public pay-as-you-go system the revenue from these contributions is immediately spent to finance the expenditure of the respective systems. Such contributions can be regarded as a special tax; in some countries social security expenditure is mainly financed out of taxes, in others taxes complement contributions. Although the latter are the basis for individual entitlements and claims against the community, they cannot be regarded as private savings which can be invested on capital markets. The privatization of social security systems does not solve any of the problems of these systems; but it does increase the risk and insecurity to which they are exposed (see Chapter 6).

Sometimes a reasonable way to finance public services is through *intra-firm cross-subsidies*: where public services are paid for by the end-user, prices must follow the imperative of affordability and of uniformity for the said end-user. Where costs of delivery vary for different groups of recipients, volume and regions of delivery, service providers can cross-subsidize high-cost recipients (for example households in remote rural areas) through the proceeds from

low-cost recipients (for example industry in agglomeration areas). Such cross-subsidies are strongly rejected by proponents of privatization and deregulation, but they make sense as a potentially efficient way of combining economic efficiency with social redistribution. While they can be implemented without particular difficulty within large public service complexes, such cross-subsidies contradict the logic of private enterprises, which generally terminate non-profitable activities. In order to prevent this, much stronger regulatory control than is presently in place in most countries is necessary. As was pointed out in Chapter 5, such efficient control is difficult and expensive, possibly to an extent that provokes doubts about the rationale of transferring a public service task to a private corporation which must then be supervised.

A special way of financing the provision of public services is through *contributions by market participants*. This is feasible when public services are delivered by public and private firms, or exclusively by private firms under public control. In this case a fund could be established and financed by the firms in the market. Its purpose would on the one hand be that of covering the cost of regulation. On the other hand it could be used to spread in a fair way the costs of keeping high public service standards even in regions or for groups for which provision is expensive. While all firms would have to contribute to this fund depending on the volume of their activity, those firms engaged in cost-intensive activities fulfilling the public purpose would receive subsidies from this fund.

19.6 Conclusion

To establish a strong ESM, a thorough rebalancing of the roles of the private and the public sectors is necessary, as well as a thorough re-evaluation of the status of the public sector. This process should be based on the specifically European traditions concerning private property, social responsibility and the role of the state. For network services, the only area of public services which the EU has hitherto dealt with, a horizontal law on universal services should draw conclusions from the widespread experience that there are great difficulties in maintaining a high level and quality of service provision through public control of private service providers. Stronger minimum standards should be combined with the option of retransferring privatized network operators and service providers back into public ownership and management. But it is also necessary to go beyond network services and to establish a comprehensive and transparent concept of public services at both the member state and the EU level, which should eventually become part of the Constitution.

Reference

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20
A Secure Future for Pensions

20.1 Introduction

This chapter deals with proposals for an improvement of the pension systems, and seeks to devise some sort of *alternative pension systems*.[1] The first and main objective is to consider improvements of the present public pension systems and to explore the possibilities of expanding them to cover new situations and needs. Nevertheless, since private systems are being developed and expanded, it is worthwhile to discuss the ways in which it may prove possible to defend and improve the interests of pensioners and other stakeholders where private systems are developed.

The EU should build up social policy at the level of the Union, complemented by a positive and active attitude towards the development of the social policy of the member states and enhancing the convergence of social policy among them. However, that position should not be interpreted as a desire to replace the social policy of the member states. Social systems have been developed in the various countries in different ways and they differ considerably from each other in their concrete structure and ways of operation, and homogenization of those systems is not recommended. Nevertheless, in spite of their differences they have several features in common – their structure is relatively egalitarian and their financing in most countries is based on pay-as-you-go (PAYG) arrangements by which payments to beneficiaries are financed by public revenues (contributions or taxes) of the same period – and therefore diversity does not preclude that recommendations for general principles, the pursuit of common objectives and even some similar specific measures may be established and implemented within each country.

20.2 Some basic principles

The proposals that are presented here spring from the following premises and principles. The objectives of a pension system should be clearly and explicitly defined. Pensions have to be adequate for the well-being of pensioners who

Box 20.1 Fundamental principles for pension systems

Member states should safeguard the capacity of pension systems to meet their social objectives. To this end, against the background of their specific national circumstances, they should:

1. Ensure that older people are not placed at risk of poverty and can enjoy a decent standard of living: that they share in the economic well-being of their country and can accordingly participate actively in public, social and cultural life;[2]
2. Provide access for all individuals to appropriate pension arrangements, public and/or private, which allow them to earn pension entitlements enabling them to maintain, to a reasonable degree, their living standard after retirement; and
3. Promote solidarity within and between generations.

Source: Joint Report from the Social Protection Committee and the Economic Policy Committee on objectives and working methods in the area of pensions. Presented at the Laeken European Council, December 2001.

have to share in the productivity gains of society. Even minimum pensions have to allow for a dignified standard of living (Box 20.1).

In order to maintain and improve the social protection systems, they have to be able to adjust rapidly to new circumstances, such as the increasing number of old-aged persons, unemployment situations, precarious employment and so on. Equity, solidarity and decommodification are also well established as further basic principles for any socially fair pension system (Box 20.2).

Pension systems should be based on transparency and democracy. The public has to understand and support the public system in order to increase wide support for it, and efforts should be made in this direction.

20.3 Improving conditions of the present public systems

In the short run, it is necessary to safeguard the existing public pension systems and, in some cases, to reinstate previous public systems that have been changed through so-called reforms. There are no sound economic and social reasons to advance towards the dismantling of the present systems; they are feasible from the economic point of view and may be maintained with little additional effort. Table 20.1 provides information justifying the idea that increased social transfers may be absorbed with little effort.

The best instrument for a substantial advancement in the financial situation of pensions systems would consist in improvements in the labour markets situation with a powerful policy for full employment leading to a real increase in activity rates, the promotion of activity by people who would voluntarily like to work, and a more open immigration policy. Only quite modest improvements in productivity would be necessary to absorb increased future social

Box 20.2 Basic elements for any fair pension system

Equity. 'Intergenerational equity: a sustainable fair distribution of the costs of future retirement between workers and retirees', and intergenerational justice: 'safeguarding the welfare of the weakest, both in working life and in retirement' (Esping Andersen, 2002, p. 24). The first part of this definition is rather narrow since it only refers to the cost of pensions and 'fair distribution of costs between workers and retirees', that is, the costs of pensions should not negatively affect those of the workers who pay for them. However, the redistribution of income necessary to pay for pensions should not affect only the workers but society as a whole (especially capital revenues and incomes other than wages). That would make for greater solidarity and also ensure that the negative effects, if any, would not be so significant for workers.

Also, not only costs, but equity between the standards of living of the active population and of pensioners should be added; equity seems to require that elderly people share in improvements in the standards of living made possible by growth and redistribution. Often, when referring to intergenerational equity the efforts that present pensioners have made in the past to achieve economic growth which allows for the present wealth and income and favours younger generations are ignored.

Solidarity. This should be an important pillar of any alternative economic system as point 3 of the EU goals for pensions recognizes. However, a position often invoked is the necessity of keeping the status of the pensioners commensurate with that they had when in activity. In fact the question of in what measure the differences in status must be kept or smoothed is an important social option that has to be resolved and made explicit without forgetting the question of solidarity.

Decommodification. 'Decommodification occurs when a service is rendered as a matter of right, and when a person can maintain a livelihood without a reliance on the market' (Esping Andersen, 1990, p. 22). However, decommodification should not be interpreted as meaning that the pensioner should not be entitled to a personal income that would enable him/her to take part in the market to satisfy his/her needs, but that the entitlement to an income should not ultimately depend on his/her past labour life (from contributions to public schemes or from purchase of private pensions). It is interpreted in the sense that some basic services – such as personal or home assistance – should be available without recourse to the market.[3] Only a public system will be able fulfil even partly this requirement.

transfers. Table 20.1 indicates the increases in productivity necessary to cover additional social transfers, which should be compared with the average rate of growth for the EU which, even corresponding to a period with a low rate of growth, for 1975–2000 gives an average annual rate of 2.0 per cent.

A number of specific improvements to the existing public systems can be readily made.

20.3.1 Replacement rate

Replacement rates should in general be increased. It seems quite reasonable that the replacement rate for lower-paid workers should be higher than for

Table 20.1 Annual productivity gains necessary to absorb increased social transfers over the next 40 years

Country	%	*Country*	%
Sweden	0.06	Belgium	0.24
Greece	0.08	European Union	0.25
Austria	0.09	Italy	0.26
Portugal	0.18	Denmark	0.28
Luxemburg	0.19	Spain	0.28
Finland	0.23	United Kingdom	0.31
France	0.24	Netherlands	0.35
Germany	0.24	Ireland	0.40

The figures show the average annual increase in productivity necessary to finance increased expenditures for the dependent population (pensioners, unemployed, children) during the period 2000–40. The ratio of average current transfers per dependant to the average wage is assumed to remain constant.

Source: Concialdi (2004, p. 6).

people with higher incomes, for otherwise those on low incomes during their working life will be condemned to considerable poverty in retirement.

The existence of a floor on the level of public pensions for all pensioners such that it avoids poverty among pensioners, especially those who had low wages as workers, is of paramount importance. Specific percentages of some variables that could fix the minimum level for pensions could be established: for instance, a percentage of GDP per capita, or of the average wage or of the level of minimum wages or any other quantitative parameter about pension benefits.

The distribution of the levels of pensions has also to be taken into account. The highest level of pensions provided by the public schemes should be capped, and the gender dimension should be particularly taken into account: lowering the requirements for specific levels of pension benefits for women or increasing their replacement rate or other ways of positive discrimination should be considered. The pension system cannot be expected to completely reverse the extent of inequality which results from other elements of the economic system, notably the inequality of earnings and employment opportunities. But the possibility of contributing to income convergence among social groups should not be rejected outright, since the necessity of maintaining a redistributive element between different sections of the population constitutes a major argument in favour of PAYG systems. The pension system has to be redistributive because the system itself redistributes perversely in the sense that rich people live longer than poor people and therefore obtain higher benefits, implying a redistribution from poor to rich people. Moreover, since the shares of wages in national income have

diminished in the last two decades, there is a need to recover and increase that share in the future.

A concern over the distribution of income and economic welfare means that the issue of pensions cannot be considered in isolation but rather that pension policy has to be integrated with other policies. We have already stated that a social security system, which obviously encompasses pensions, should not be considered in isolation but within the frame of the whole social and economic system. It may, and does, happen that measures at the different levels may be complementary or either highly contradictory. For instance, the pension system might be designed in such a way that those who have been unemployed during long periods or devoted a long period to care would receive a higher pension than would be actuarially justified by their contributions.

It is necessary to secure a sufficient revenue not only to satisfy the fundamental needs of pensioners but also to allow a real integration of the elderly into society. Diminishing benefits may simply push the problem from the social security scheme to social assistance, when the income of poor pensioners will have to be supplemented by poverty assistance. Besides, consideration of the insurance principle, if included, should be such that it should make adequate allowance for the principle of solidarity: the difference between market-based insurance – operating on a profitability basis – and social insurance, which may include solidarity, should be stressed and the second should be chosen.

20.3.2 Indexation of pensions

In order for pensioners to share in the improvement of the standard of living of the country, pensions have to be indexed to the rate of increase in wages, earnings or growth rather than to the increase of consumer prices.

20.3.3 Retirement age

There are several reasons to recommend that the retirement age should not be raised, especially given the present situation of the labour markets where many enterprises are compelling workers to retire long before the statutory age and where in many cases people are not allowed to choose their retirement age. In those cases, the statutory increase of retirement age implies that if people are not allowed to retire they will either become unemployed or experience a reduction of benefits due to retiring before the statutory pensionable age. Also, it does not seem to make sense to compel older workers to work later into life when younger people may be unable to get a job; similarly, since there is an excess supply of labour there is no reason to prevent older people from enjoying more leisure. Moreover, although we know that people are living longer, we may not be equally certain that their capacity and resilience for work have increased, and wage working is a heavy burden above a certain age, except for very privileged jobs. In contrast, the option of

an earlier retirement age may be convenient for people in particularly hard jobs or special circumstances.

20.3.4 Contributions

The contribution period needed to get a full pension should be indexed to the average length of the career, and should take into account the inequalities faced by various groups on the labour market (women, atypical employment), clearly incorporating some solidarity principles. No increase in the period of contribution necessary to qualify for a full pension should be contemplated. Equally, the number of years which are taken into account in order to calculate the amount of pension benefit should not be increased. For the cases in which computing for pensions for a number of the last years of the working career punishes the workers (as for those that become unemployed in the last few years before they reach pension age) alternative systems should be devised (for instance allowing the worker to choose the required period all along his/her working life).

20.3.5 The gender issue

In spite of the increase in female activity rates, women have less favourable careers than men: lower wage levels, often part-time or precarious jobs, periods of child rearing or caring for relatives, and so on. Therefore there is the increased need to take into account non-contributive periods.

The question of different life expectancy for men and women arises: should different actuarial coefficients be established for defined contribution schemes or should pensions for women be lower? The responsibility of all members of society to share in care tasks, and the lower opportunities of a full working life for women because of the asymmetry in fulfilling them could justify an equal treatment in spite of longer lives. The system by which pensions are awarded to a surviving wife or husband, whether or not they have their own pension, must be considered.

Overall, two major advantages of PAYG schemes have to be maintained: the first is its very high degree of flexibility: PAYG systems can adapt very rapidly to changing economic situations, and the social consequences of these changes can be carefully managed. This is in contrast to funded systems that might adapt very rapidly, but without being able to deal with the social consequences of these changes. The second is a very gradual implementation of changes. In comparison, capitalization is much more rigid. It may require a big increase in contributions (defined benefit schemes) or a very large drop in pensions (defined contribution schemes).

The impact of changes in the labour markets on the pension systems also deserves special consideration. Although more about this problem will be said below, the changes experienced over the last decades in the economic and social environment and the transformation and deterioration of the

labour markets create new problems that deserve special consideration and make it necessary to contemplate ways of supporting the welfare of citizens and the pension systems even within the present systems.

Precariousness of the labour markets, and new patterns of careers that break up the regularity of work, make it increasingly difficult for workers to qualify for pension benefits, due to growing non-contributive periods: periods of unemployment, temporary jobs, fixed-term contract jobs, non-voluntary part-time jobs, time off for child rearing or taking care of elderly relatives and so on. There is the need to improve the entitlement to pensions for atypical jobs and increase the level of pensions for those categories and for low-wage workers. For instance, in some countries (for example the Netherlands), in the second pillar, part-time and full-time workers have been given parity of treatment since 1996.

Time credits should be given to workers in any of the above circumstances to enable them to qualify for pension benefits. However, the problem of young people in precarious employment who cannot even qualify as workers for many periods may not be solved by that procedure. It seems that the only way to solve this kind of problem is through a citizenship-based system (see below).

All the schemes and plans must be compatible with labour mobility, making portability easier (particularly between EU member states), for instance, for people covered by several schemes or pension funds because they have several employers. There are also growing forms of remuneration for labour other than wages and salaries such as profit-sharing schemes, *épargne salarial*, stock options which are not generally subject to social security contributions and which do not give a right to pensions. There seems to be no reason why those payments could not be submitted to contributions to public pensions. Since it is generally highly paid workers who are paid in these ways, this may improve financing of public pension systems.

20.4 European convergence

Although it has already been said that national systems vary very widely and that no homogenization should be aimed at, even within the general orientation of allowing for different national systems, the Union should aim at convergence towards the best social policies and should actively contribute towards the achievement of this aim. Therefore some recommendations for convergence in the social protection systems may be of interest. In particular, establishing a set of minimum statutory requirements for all member countries, both for social and pension expenditure related to the wealth of the country, and for specific individual entitlements would be useful and would increase at least relative convergence. For instance, ensuring that the percentage of GDP devoted to pensions be the same in every country, and that a floor for individual pensions in terms of the same percentage of some national income variable – average wage, national per capita income,

minimum wage, and so on – or a relation between pension benefits and average wage, or other similar conditions could be statutorily established.

A small *European pension* financed by a small European levy unrelated to labour income may be useful. This would complement national pensions and enhance and legitimate the European dimension. Although the proposal may not be too realistic for the time being given that the EU budget is likely to be diminished rather than enhanced and the national political pressures are for a reduction in the EU budget, in terms of the financial resources required it would be quite realistic as a levy of 1 per cent of GDP could be part of an increased EU budget.

20.5 Towards citizenship-based systems?

The difficulties in qualifying for pensions related to the evolution of the labour markets, as well as the changing patterns of labour careers and of the family structure and the relationships between their members, seem to lean increasingly towards decoupling the pension issue from the labour markets and relating it to citizenship as the basic reason for entitlement to a pension. The idea that production is a social undertaking reinforces that view. Citizenship-based systems enhance the rights of the individual rather than being based on increasingly changing household structures. The convenience of advancing towards universal pension systems – every person should be entitled to a pension in old age regardless of the past labour situation – seems well established. The possibilities of a system that would consider the citizen rather than the worker as the subject of pension entitlement seem worth exploring.

One of the best-known formulae as a means to advance towards a public citizenship-based system is the basic income system, by which every citizen would be entitled to an unconditional basic income during the whole of his or her life. This could solve the problem of new irregular types of work (since it would cover rights regardless of the labour contribution of individuals), its financing should not directly affect employment, it would avoid many of the present and future problems of computing for pension rights, would be highly egalitarian and would greatly simplify the administrative burden.

Obviously the introduction of such a citizenship-based entitlement implies a radical and broad-based transformation of the pension and the whole of the social protection systems. It is a very ambitious and rather controversial proposal, but it seems there might exist in it the potential to devise an entirely new social system for pensions which makes it worthwhile carefully exploring and thoroughly assessing it.

Obviously if pensions become universal entitlements, their financing cannot be based on individual contributions. Financing by general taxation seems to be the most obviously viable way of financing, but new ways of financing pensions need to be explored.

The discussion between the convenience of more egalitarian systems – citizen-based – or systems that allow for the maintenance of the previous standard of living – contributions based on labour – has to be solved. Equally, in the transition to citizenship-based systems account has to be taken of the rights of workers presently entitled to pensions higher than the basic income.

A combination of a basic pension based on residence, combined with a system of supplementary benefits related to contributions based on labour, could be an adequate solution. It will mean a system at two levels:

- a universal allowance (basic income) allowing for a decent standard of living;
- a supplementary system linked to work, with a reduction/bonus depending on the age and/or number of contribution years, and taking into account several non-contributive periods.

Nevertheless both in citizenship-based systems or in combined ones, it must be assured that the universal allowance (basic income) for residents is enough to provide them with a decent standard of living, since if not the whole purpose of separating the system from labour will be defeated.

20.6 Financing of public pensions

Present public systems currently seem financially sound; even if financial problems were to arise further in the future, these can be solved by improvements in the labour markets. If new, better public systems (such as residence-based systems) are to be devised, however, the question of financing must be examined. A number of points may be considered.

20.6.1 Contributions

The issue is how much contributions paid by current workers would need to rise to pay for the current pensions when the number of pensioners is rising. The limit on social contributions is not known and growth may give ample scope for increased contributions. However, the increase in the rate of contributions to finance pensions is not considered the best measure in the short run, but if that were necessary, there are indicators that the population is not reluctant to increase them, provided good benefits are guaranteed.

20.6.2 Taxes

Since our societies are producing increasing income and wealth, it should be possible to increase taxes. However, in the short run and given the present trends towards decreasing taxation, the problem of the budget limits imposed by the Stability and Growth Pact crops up. The more the trend for diminished taxation is enhanced the more difficult it will be to raise taxes in order to finance pensions. As a general principle it has to be asserted that if

better welfare systems are desired there is a need to argue energetically against the present trend towards the reduction of taxation, which is often supported by all political parties.[4]

There are other ways of increasing taxation besides income and value added tax such as capital tax, wealth taxes, the so-called *Meidner proposal* (companies required to issue new shares to be given to European *wage earner funds* to finance pensions), or taxing rents (for instance 'a betterment levy' on commercial land) or inheritance tax, and so on.

20.7 Improvements of private systems

Private systems are not the solution to the problems that could arise in the realm of public systems; and the best policy would be that of eliminating mandatory private pensions, since improving private pensions seems to require a return to the financial market logic that is at the heart of the present problems of pensions. However, since at present these systems affect many workers and citizens, it may be useful to evaluate these systems to see if they may be improved. In the same way in which the position regarding pensions of workers facing new risks in the labour markets have been dealt with, at present they also face risks in the financial markets – as long as they invest, privately or collectively, in capitalization schemes – and there is a need to cover these new risks.

Firstly, different types of pension systems should be identified, since their consequences may be different: (i) collective mandatory private pension systems constituted by the workers, which place their pension contributions in their own enterprises; (ii) collective mandatory pension systems where contributions for pensions are placed in private financial institutions; (iii) individual or collective voluntary private pension schemes managed by financial institutions.

There are several elements that may be analysed in relation to the private systems: *private schemes, if any, should be collective and compulsory*. If they are collective there should be some space for the socialization of conditions; they must be compulsory because voluntary schemes are associated with adverse selection. The public systems could assume management of these funds.

20.7.1 Risk and uncertainty of benefits

It has already been noted that in the last decade dramatic financial crises have been experienced which have put in a stark light the private pension system and the fall in the balance sheet value of pension funds. There is no good solution to protect workers from the risk of private pension systems and the instabilities of capital markets and, in any case, nothing that can be suggested is anything other than a second-best policy. The need for strict regulation of private funds – financial guarantees, portability, and so on – and monitoring

the allocation of capital to diminish the instability of capital markets seems undeniable.[5]

Fiscal policy could also be used to gain some control over financial markets: it may be considered whether establishing the Tobin or some sort of similar tax in the trading of shares could lead to some improvement in stability among the assets of the pension funds, but it is difficult to accept that this type of tax could address the problem of the stability of pension funds since they may be able to reduce somewhat very short-run volatility in the share prices, but the problems of pension funds would seem to be a combination of inadequate contributions by companies and long-run movements in share prices.

For pension funds that consist of investments in their own enterprises, the requirement to externalize investments to other placements represents a fruitful development, leading to a safer system. Companies with schemes that insure each other may partly diminish uncertainty, but some uncertainty still remains since there is no guarantee that a joint financial crisis might not take place.

The introduction of a more holistic approach to the management of pension funds may be advocated, such as the establishment of requirements to invest in specific categories of assets in order to improve the social role of pension funds. The possibility of qualifying for tax advantages as pension funds only if a part of investments go to specific placements may be recommended. For instance, requirements for a percentage of investments to take place in local communities or where workers contributing to that pension fund live; or in specific sectors; in a word, giving a social dimension to investment of social funds. However, too much should not be expected from capital allocation properties since the problems of risk and uncertainty do not come from capital allocation but rather from changes in stock prices. Bad effects of financial markets come from global pressure which has little relationship to the monitoring of the circulation and fixing of stock prices.

20.7.2 Subsidies and tax relief for private pensions

In order to enhance private systems most public administrations provide substantial tax rebates to contributions to private pensions, mainly under the argument that contributions to public pensions are not taxed, and that tax allowances are lower than they seem due to the fact that pension benefits are taxable when they are received. Tax rebates are highly appreciated by would-be private pensioners and it is likely that without subsidies the private systems would not be able to operate on current levels.

However, for collective mandatory private systems, tax rebates, if any, should be related to the provision of a certain level of social services by these funds (in the sense of priority investments such as those suggested above), while tax rebates for private individual voluntary systems should be eliminated. Obviously tax rebates for phoney retirement schemes need to disappear.

However, due to the low level of public pensions in some countries at present (for instance, the UK), eliminating tax rebates for individual complementary pension schemes may be rather a tough procedure. Therefore different income levels could be related to tax rebates, and the latter eliminated for above-average levels. However, a much better solution for this situation would be to strengthen public complementary pensions.

20.7.3 Management procedures. The question of representation

The composition of the trustees of private funds may be significant. At the least, equal representation of workers and of financial managers should be contemplated. Moreover, if private collective mandatory funds are financed, as usually they are, by the income resulting from the remuneration of labour (even if directly from the enterprise) it seems only logical that the representation of employers should be reduced. Some degree of workers' representation on the boards of the private funds might be considered, under the assumption that they will look after the interests of the workers who are stakeholders in the funds. Workers' representatives are more frequent in the pension funds for public sector workers. Often the representatives of the workers in those boards are trade union officials. It is reasonable to organize some kind of representation of the pensioners, depending on the fund.

However, the adequacy and efficiency of these representations seem worthy of careful consideration because although it might be useful to take part on the boards and exercise control of private funds wherever this can be done, it is impossible not to regard with the highest scepticism the possibilities of achieving anything relevant through this participation because of the representation bias and also because of the difficulties in taking a significant part in the decision-making of the board.

The validity of the role of trade unions as representatives of the workers for pensions presents different views: it could be argued that they take decisions on the basis of very reduced membership and more with the interests of the trade unions in mind rather than those of the would-be pensioners. But it may be argued that it is important to have trade unionists representing the interests of stakeholders as workers, in contrast to the danger of defending wage earners as savers. If the representatives of pensioners, or of those contributing to pensions, have to be elected among them it is necessary that the election procedure is based on 'one person one vote' and not on possible contributions or benefits.

20.7.4 Administrative costs

Although not all the private pension systems have the same costs – collective funds have lower costs than individual ones – the costs charged by private funds are in general very high, especially compared with the costs of public funds. They may reach such a level that most of the tax relief allowed for pensions account for little more than their managing costs, implying that in

fact tax relief will go towards increasing the revenues of financial institutions. Administrative costs may even be higher than 20 per cent of their income.

Such high costs may be due to very high competitive marketing among pension funds leading to high marketing and publicity expenditures. In that case placing an upper limit on the marketing expenses of those funds might be a good procedure in order to lower administrative costs; although how this limit may be enforced must be considered. Better information and transparency may also be another procedure, since funds may be charging high costs and obtaining very high profits. Therefore setting up a well-funded and truly independent public body regulating abuse of the administrative costs area could be helpful, although it seems difficult to reduce the level of administrative costs as long as their management is in private hands.

20.7.5 Need for information

The alarms raised about the hazards of social protection have shaken the degree of confidence that European citizens have about the future of the pension system; although these alarms should not be overestimated, the information process constitutes a key issue in assessing the sustainability of social transfers. The importance of reforms of the welfare state and their implications for the lives of all citizens are so great that there should be a full social debate about this issue. The participation of citizens in the debate should be promoted and enhanced.

Moreover, people are often puzzled by the diversity of pension funds and find it difficult to understand their actual conditions. There is obviously a need for some *alternative* information, providing stakeholders with a broad set of indicators that would clearly link the issue of financing pensions (and its consequences on wage increases) to the issue of pension levels (for instance in terms of replacement rates). Also, standardization of financial products would be useful in order to facilitate knowledge about them and also to prevent spurious differentiation of products.

20.7.6 Private systems as mechanisms for social participation

Some arguments can be found in favour of private pension systems on the basis that the accumulation of assets under the management of representatives of the workers will lead to an important social role for pension funds. They argue that workers gain power, establish new constraints for management and may even become important owners directing wealth towards collective aims. There is even a *left-wing version* of this argument that maintains that it could lead to a new historical compromise where the role of labour would be greatly enhanced. The proponents of this position have made big new promises with the intention of getting political support from wage earners and their leaders. Although the weakness of this argument has been presented in many debates it may be of interest to review it briefly.

The argument is very weak and even fallacious due to several issues:

- Workers would have to bear the high uncertainty of investments.
- Controlling the financial world of pension funds is extremely difficult for workers and their representatives: information may be deliberately very scarce, financial management requires special knowledge and skills, and top managers tend to agree with the corporate logic and have few incentives to leading a corporate strategy biased in the direction of social targets.
- That approach develops a twofold identity for workers: as savers and *financiers* instead of labourers; financial profits replace the aim of higher wages and better labour conditions, workers rally to management logic rather than workers' logic. Thus employers find it easier to minimize wages and ensure the control of workers and *harmony* in the firm.
- Workers as owners are unequal within the firm (because wages and therefore shares are unequal); political participation within the firm depends therefore on the financial capacity of the individuals concerned.
- The question of power in the firm arises. Does power in the firm come from property or from the division of labour?

Nevertheless, the main point for rejecting the question of the *financial power of the workers* seems to be the fact that it implies a deepening of the logic of financial capital which is not considered conducive to the well-being of workers or citizens. It does not seem there is much hope of improving the well-being of workers and the population through the ownership of contributions to pension funds.

20.8 Conclusion

It is obvious that most of the principles and proposals that are very tentatively described here go against the main current trends of economic and social policy. Therefore advancing towards them will only be possible if through argument and persuasion the outlook of social and political forces changes. In other words, the problem is not technical but ideological and political.

Notes

1. We use *alternatives* in the broad sense of improving the present system and where necessary introducing new elements.
2. In this respect, benefits and tax advantages other than pensions should also be taken into account where appropriate.
3. Personal clarification from Dr Esping-Andersen.
4. The question of convergence of social protection in Europe is closely linked to the tax system and its harmonization. Taxation and fiscal policy have also to be taken into account because of the public cost of private systems and also because of the difference between gross and net pensions.

5. Note that the World Bank approach considers risk as a *production factor* supporting the view that risk and efficiency go hand in hand (greater risk is associated with greater efficiency). This approach makes it impossible to cover or reduce risks without reducing efficiency.

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21
Pathways to a Sustainable Europe

21.1 Introduction

The difficulties of articulating and implementing environmental policy in the EU (and elsewhere) demonstrate the dilemma of an economy and of a society dependent on the supply of fossil energy to achieve productivity increases, to improve competitiveness and to stimulate economic growth. Given the dominant technological trajectory, it is very likely that alternative renewable energies and technical devices will only permit slower growth, with more decentralized economic structures and smaller units of production. The transition to renewable energies requires the establishment of a new time-and-space regime. Therefore ecological sustainability is not simply compatible with economic sustainability, taking the dominant paradigm of production and consumption, of labour and life conditions for granted. The 'win–win' constellation, centrepiece of the environmental policy of the EU Commission, will therefore not be easily achieved and may turn out to be impossible. The basic assumption of a reconciliation between environmental requirements and economic necessities has to be replaced by a policy concept which aims in the long run not only at increasing the efficiency of ecological transformations ('efficiency revolution') but also at the transformation of production and consumption patterns ('sufficiency revolution'), including transport systems, urban structures, agricultural systems and – last but not least – day-to-day human behaviour. Such a deep change can only be achieved by stimulating the active participation of civil society. Therefore, environmental policy is not an additional policy field of European or national *government* actions but a new and comprehensive mode of *governance* of the economy and society.

Solutions exist for most environmental challenges. The appropriate measures for a reduction of CO_2 emissions or for protection of biodiversity are known. Nevertheless environmental policy is involved in the mess of never-ending international negotiations, leading to inappropriate rules on a regional and national level with the frustrating outcome of further

deterioration of the environment, notwithstanding serious efforts undertaken by the EU Commission and national governments to achieve ecological improvements. Thus the environment in Europe deteriorated to the point of posing serious threats to human health (mad cow disease, rabies, air and water pollution, dioxins and PCBs in food and livestock feedstuffs and so on). 'Worldwide, and probably also in Europe', the European Environment Agency writes, 'one quarter to one third of the burden of disease is attributable to environmental factors' (EEA, 2003, p. 55). The Kyoto target will very likely not be reached by the EU, although the Russian Federation in October 2004 signed the Protocol and thus removed the last obstacle for its transformation into binding international law. The main reason is that fossil energy consumption will dominate the energy regime in the course of the next decades so long as this primary energy is available at affordable prices. According to the *Financial Times* of 27 October 2004 the International Energy Agency (IEA) in the *Outlook* of October 2004 calculates that in principle there is enough oil to satisfy even a growing demand for fossil fuels (from currently worldwide 82.4 million barrels per day to 90 million barrels per day in 2010 and 121 million barrels per day by 2030). Yet the costs and risks of production and transportation are rising substantially. Between 2008 and 2030 about US$16,000 billion must be invested in oil extraction and refining. But the problem is that more and more 'oil will come from fewer and fewer countries, primarily the Middle East members of Opec …' (*Financial Times*, 27 October 2004). Moreover, transport has to pass 'through vital chokepoints, sharply increasing the possibilities of a supply disruption …' (ibid.). Therefore on the one hand dependence on oil remains high, and on the other the supply of oil becomes more and more insecure. This contradictory development, therefore, is one more very good reason for increased efforts to develop an alternative energy regime.

The dominant policy approach, however, cannot bring about the necessary transformations of the societal relation of human beings to nature, that is reduction of the pressures of human activities on natural resources and sinks. A new long-run trajectory of environmental policy, aiming at a transition to renewable energies, is only possible by abandoning basic premises of European environmental policy, particularly its reliance on market-based instruments, and on voluntary environmental commitments by economic actors, that is by private corporations. Economic instruments such as an ecological tax reform, pollution charges or the reduction or even cancellation of environmentally negative subsidies and emissions trading are surely useful. But, first of all, the progress made in an ecological tax reform, in internalizing 'social costs of private enterprise' (Kapp, 1950), or in reducing ecologically harmful subsidies in agriculture or mining, in air transport or street transport has not been very promising. Secondly, economic instruments and the establishment of guidelines or codes of conduct, that is of 'soft law', are not sufficient for a successful improvement in environmental

regulation. The ingredients of European environmental policy, outlined in Chapter 8, have to be recomposed and completed by more mandatory instruments.

The most important aspects of an alternative environmental policy are firstly the choice of a development path leading to a non-fossil regime of renewable energies, and secondly the transition from the uniformity of mass production (particularly in agriculture) to the promotion of biological diversity. The first strategic orientation is possible because renewable energies are inexhaustible and abundantly at the disposal of mankind, especially in those parts of the developing world which are poorly endowed with fossil energy. The importance of the latter aspect has been underlined by the international community, since biodiversity conservation has been defined as an official millennium development goal to be reached by the year 2015. The EEA also stresses the importance of biodiversity protection by arguing that Europe has a 'global responsibility to preserve the character of its varied ecosystems and landscapes' (EEA, 2003, p. 52).

Before discussing the possibilities of a transition to renewable energies, a more efficient climate policy and biodiversity promotion, it is necessary to consider the political dimension of a regime of ecological sustainability. For, in the policy fields of energy, climate and biodiversity policy it is obvious that the political system either produces lock-in effects or guides policy in a direction away from the ecological sustainability constellation. Why is this so?

21.2 Lessons to be learned from a neglect of the precautionary principle

The first answer is: because of the fundamental contradiction between economic and ecological sustainability under a fossil energy regime. The second answer points to a social dilemma known from game theory. The introduction of new non-fossil technologies only makes sense for individual economic actors when other actors also respect the rules of the new game. In environmental policy the collective actor problem, that is the collective irrationality of individually rational decisions and the individual irrationality when individual decisions follow the collective rationality (which however is not respected by all actors), is always present, especially in those cases where infrastructure ('the spatial fix') has to be adjusted to the new requirements of the renewable energy regime. Economic actors follow their microeconomic rationality and not the necessities of macroeconomic and social rationality. It is expensive to write off fixed capital and to invest in a new infrastructure. This dilemma can only be resolved by a 'third actor', who sets rules of the game which all individual actors are obliged to follow. The role of the third actor can only be played by the state (by the nation state and/or by international institutions). This is one of the fundamental reasons why market-based instruments are poor instruments. They are not suitable for

a regime change of environmental policy, for the transition to an alternative path of (sustainable) development.

But the actions of the state, represented by government institutions, do not necessarily guarantee an efficient and timely environmental policy. The EEA has undertaken a long-term study of the application of the precautionary principle (which has been adopted by the EU at the Amsterdam and Gothenburg summits). The 14 case studies between 1896 and 2000 presented as 'late lessons from early warnings' (Harremoës et al., 2002) show how difficult and therefore how seldom early warnings about dangers to the natural environment and human health triggered by human (mostly economic) action are translated into political advice, and how difficult and therefore unusual it is to politically implement the advice. In many of the cases studied the warnings (by scientists or social movements) came in time, the advice, however, already belated, and the implementation much too late. It is therefore important to improve the interface between science (natural as well as social sciences) and politics, and to include civil society agency and lay people (that is not only experts) in the process of transforming the warnings into political action. The officially declared intention of the EU to follow the precautionary principle (see Chapter 8) can only be realized by learning from the 'late lessons'. Twelve lessons are distilled and summed up by the authors of the EEA study as a generalized consequence of different case studies:

- Acknowledge and respond to ignorance, as well as to uncertainty and risk, in technology appraisal and public policy-making.
- Provide adequate long-term environmental and health monitoring and research into early warnings.
- Identify and work to reduce blind spots and gaps in scientific knowledge.
- Identify and reduce interdisciplinary obstacles to learning.
- Ensure that real-world conditions are adequately accounted for in regulatory appraisal.
- Systematically scrutinise the claimed justifications and benefits alongside the potential risks.
- Evaluate a range of alternative options for meeting needs alongside the option under appraisal, and promote more robust, diverse and adaptable technologies so as to minimise the costs of surprises and maximise the benefits of innovation.
- Ensure use of 'lay' and local knowledge, as well as relevant specialist expertise in the appraisal.
- Take full account of the assumptions and values of different social groups.
- Maintain the regulatory independence from interested parties while retaining an inclusive approach to information and opinion gathering.

- Identify and reduce institutional obstacles to learning and action.
- Avoid 'paralysis by analysis' by acting to reduce potential harm when there are reasonable grounds for concern. (Harremoës et al., 2002)

The catalogue of 'late lessons' underlines the importance of including civil society actors in the regulation of the human–nature relationship. The role of science is also a crucial one. Environmental reporting is an important task in order to create transparency over the feedbacks between human activities and nature in the framework of the societal relation of mankind to nature.

This societal relation has to be taken into consideration as a highly complex system (or totality) with many as yet unknown feedback mechanisms. The United Nations Environmental Programme (UNEP) describes some of the feedbacks by explaining the environmental reporting system:

> The reporting system on the state of the environment was made a global activity in the declaration adopted at the Stockholm Conference on the Human Environment in 1972. In the early years, the focus was on the state of the biophysical environment – land, freshwater, forests and wildlife, for example. People were generally reported as a threat to the environment. But SOE reporting has over the years become more integrated and now takes into account the complex human–environment interactions in assessing and reporting on the changing state of the environment. Subsequently, SOE reporting has been established at virtually every level – local, national, sub-regional, regional and global. Many approaches have been used. … These different approaches have served their purpose but their inherent weakness is a linear approach to complex ecological processes and human–environment interactions. The reports often downplayed the fact that people not only have an impact on the environment but also that the environment has an impact on people. Over time, therefore, a more integrated environmental assessment and reporting framework has emerged; one that aims to show the cause and effect of human–nature linkages. It seeks to connect causes (drivers and pressures) to environmental outcomes (state) to activities (policies and decisions) that have shaped the environment over the past three decades, and the impacts such changes now have on people.
>
> The analysis is first by theme – socio-economic trends, land, forests, biodiversity, freshwater, coastal and marine areas, atmosphere, urban areas and disasters – but the holistic nature of the environment is emphasized where necessary. These thematic issues are analysed from first the global level then at GEO regional level … . (UNEP, 2002, p. 30)

For Europe UNEP identifies environmental key issues with regard to all the themes mentioned above: land use has led to soil degradation, sealing and contamination, forests are suffering from degradation and the loss of natural

forests, biodiversity is under stress due to genetically modified organisms and agricultural intensification. Fresh water and coastlines suffer from continuing pollution. The air is affected by stratospheric ozone depletion and greenhouse gas emissions, urban areas are affected by air pollution, solid waste, noise pollution. In addition to this catalogue of environmental degradation, human-caused natural disasters have to be mentioned (UNEP, 2002, p. 31). Compared with other geo-regions identified by UNEP, Europe is better off. This, however, is no reason not to pursue environmental policy alternatives. A key issue, without any doubt, is the choice of an alternative energy regime and strategies aiming at realizing it in the near future.

The scientific underpinning of the precautionary principle is not a simple issue. Modern economics in particular has difficulties with respect to the precautionary principle because the growth postulate contradicts it, unless some assumption is introduced about a possible 'win–win' constellation between environmental requirements and the improvement of competitiveness. The High Level Group, chaired by Wim Kok, in the 2004 evaluation of the Lisbon strategy explicitly defend the necessary and possible reconciliation of the precautionary principle and the growth postulate, of environmental sustainability and economic competitiveness (Kok, 2004). At the end of the day, however, the implied compatibility will turn into a preponderance of economic interests over ecological requirements as has always been the case in the past with environmental policy in the EU.

The incongruence of the spatial and temporal reach of political and economic action and our limited knowledge about direct and indirect consequences widens with economic growth and increased productivity. This has been stressed by Hans Jonas in his ethics of the 'responsibility principle' (Jonas, 1979). Because of this incongruence, the paradoxical situation arises that, while we always know more and while therefore our decisions are becoming ever more 'rational', at the same time our knowledge becomes more insecure with regard to the consequences of our deeds in time and space. The responsibility principle is the ethical foundation of the precautionary principle in environmental and social policy.

21.3 Modes of political regulation of the societal relation of humankind to nature

The 'late lessons' do not comprehensively address the *problématique* of conflicting interests in environmental (or health) policy. Governments are very often unwilling to play their indispensable role in asserting collective rationality and the common interest, partly because the costs of environmental protection or of investing in a new infrastructure seem to be too high (given dire fiscal constraints), partly because of the contradictory economic interests of producers and consumers, of different industries and so on and the pressures exerted by them, partly simply for ideological reasons.

The dominant neo-liberal discourse includes the assumption that the private sector, and the market mechanism, will find optimal solutions for environmental problems as well as others. According to the Hayekian dictum on competition as the most effective method of innovative discovery, environmental policy should also rely on market-based instruments. When such an interpretation is adopted, government interference in social and economic processes inevitably leads to inefficient and suboptimal solutions of environmental problems. In such an ideological framework the most powerful economic actors have the best chance to promote their own interests. Therefore respect for the precautionary principle also requires a greater critical distance with regard to neo-liberal ideology and the belief in market instruments.

Furthermore, the energy regime is very comprehensive and all-encompassing. It follows a single trajectory which comprises technologies as well as social organization, invested fixed capital, human qualifications, consumption patterns, patterns of mobility and so on. This is a major reason why (objectively) the energy regime is very persistent and inertial and why (subjectively) the main actors generally prefer conservative solutions vis-à-vis the energy regime and reject the possibility of a profound change.

The former head of Greenpeace, Th. Bode, drew the conclusion that in the past century the growth principle and the accompanying social formation and energy regime have always been victorious over precaution and that environmental movements should give up the easy assumption of a possible reconciliation between economic interests in perpetual growth (and accumulation) and the requirements of natural reproduction (*Tageszeitung*, 27 October 2004). The contradictions between precaution and growth, between ecology and economy, are fundamental ones and therefore have to be transformed into political conflict. This means that the environmental movements have to put the question of power on the political agenda in a much more radical way than in the past. In this approach the question arises of whether in the long run an improvement in the natural conditions of human life is compatible with the workings of a capitalist system. In the past development of capitalism the 'wealth of nations', without any doubt, increased. However, the natural environment, again without any doubt, deteriorated. The point has been reached where the deterioration of the environment is greater than the increase in material wealth.

The transition to a regime of renewable energies is very difficult to achieve, not least because several strategic options are possible (even when overcoming the capitalist system is not taken into account). Environmental policy – ignorance vis-à-vis environmental grievances not taken into account – can aim at (1) protecting nature against human deeds or at (2) the protection of human beings and societies against nature in general and especially against natural disasters. Of course, mixtures of these strategic choices are also possible.

1. The first option is based on the protection of the environment against man-made degradation by a strategy of nature conservation. Nature and its constraints are the centre around which social life, economic activities and political decisions have to be structured. This option follows from concepts such as 'deep' ecology and ecological fundamentalism (Dingler, 2003). The societal human–nature relationship is unequivocally nature-centred. This choice, however, inevitably requires a lower level of material wealth and spatial mobility.

2. A second strategic option is that of the mitigation of ecological degradation as far as possible. This option also is nature-centred. However, it follows the logics of 'politics as the art of the possible', and since the human–nature relationship *is* a relationship, human (individual and social) needs also have to be taken into consideration. The Kyoto Protocol is a good example of the mitigation approach. This option is also contained in biodiversity policy which claims to reduce the degree of the extinction of species. Mitigation is not a method of halting ecological degradation, it is aimed at reducing environmental grievances and possibly at prolonging the time span in which more radical measures for the protection of the environment can be taken. Mitigation is different from the first choice; it follows the assumption that there is a zone of compromise between economic and social requirements and the constraints exerted by the natural environment.

3. A third strategy aims at the adaptation and adjustment of societies to natural changes. The degradation and even destruction of the natural environment as a by-product of the creation of wealth are taken for granted. Theoretically, this assumption is in the background of the concept of externalities in economics. Modern societies dispose of many levers to adjust to new man-made environmental constraints and to adapt technologies and political institutions or social rules to new environmental challenges. Here, society is the centre of concern; nature is an external reality against which human societies have to protect themselves by means of adjustment and adaptation. Against the rise of sea level people build higher dams, against the consequences of harmful weather conditions an adjustment of the architecture of buildings and of urban planning can be helpful. It is obvious that rich societies have much greater capacities of adjustment than poor ones. In the current global situation the victims of natural disasters in poor regions of the world are much more numerous than in the richer regions. Thus a strategic choice of adaptation and adjustment creates new contradictions and conflicts between the rich and the poor in the world, unless a material and financial flow of assistance from the rich to the poor is agreed.

All three strategic approaches are not only difficult to realize but also insufficient. Mitigation policy only helps to reduce environmental degradation to a minor degree. Protection and conservation without changing the energy and natural resources regime are a regressive option in so far as it does not recognize the necessity for mankind to reduce considerably the use of nature

as a resource and as a sink. Adaptation and adjustment for their part are attempts to insulate societies against natural disasters and to protect society (and *not* to protect nature) against the consequences of human action on resources and sinks. This strategy, however, is very conflict prone because it is dependent on the wealth of nations and this wealth is unevenly distributed in the globalized world.

4. Therefore, an alternative environmental policy is only possible in so far as it transforms the societal relation of mankind to nature based on fossil energy. The transition to renewable energy is the principal item of an alternative environmental policy. It has to address the different dimensions of societal change, efficiency as well as sufficiency and a new 'alliance' between society and nature.

21.4 The transition to a renewable energy regime

The transition to an alternative energy system is broadly acknowledged as a necessity because the use of fossil energies in the long run is destroying the life conditions of mankind on earth (especially through the greenhouse effect). Only renewable energies can help to reduce the energy poverty of developing countries which already today have difficulties in paying the oil bill (see Chapter 8). Last but not least, conflicts over oil and over logistic networks are actually threatening world peace, so that the transition to alternative energies is also good for world peace (WBGU, 2003). Since a change of the energy regime cannot be brought about in a short period, it is politically necessary to determine a path of development for the next decades which requires a reduction of fossil energies and an increase of solar energy in the energy mix for the time being.

Renewable energies are abundantly available for human use. The radiant energy of the sun arriving on earth is 200 times superior to the daily use of reserves of fossil fuels. Unlike fossil fuel there exists no limit in the foreseeable future. But solar energy comes in as low- and high-temperature solar heat. The problem is that transformation of energy into useful products and services presupposes new infrastructures, technologies, qualifications and human practices. This is why the transition to renewable energies is a long-lasting endeavour.

The EU Commission is aware that renewable energies are a decisive way of mitigating pressures on the environment and hence the negative feedback processes of a damaged environment on the living conditions of people, especially on their health. In a Staff Working Document commissioned for the EU Commission it was declared that

> the promotion of renewable energy has an important role to play in addressing the growing dependence on energy imports in Europe and in tackling climate change. Since 1997 the Union has been working towards

> the ambitious target of a 12 per cent share of renewable energy in gross inland consumption by 2010. In 1997, the share of renewable energy was 5.4 per cent; by 2001 it had reached 6 per cent. (European Commission, 2004)

The EU, therefore, has set up sophisticated programmes to promote renewable energy. In 1995 the Joule-Thermie programme was launched to support the use of non-nuclear energy. In 1998 there followed an 'Action Plan on Renewable Energy Sources'. Five years later, in 2003, a support programme for non-technological actions in the field of energy ('Intelligent Energy – Europe' 2003) was developed, including strategies to save energy by increasing efficiency (Save), the promotion of renewable energy sources for electricity generation (Altener), support for initiatives relating to all energy aspects of transport (Steer), and support for the introduction of renewables in developing countries (Coopener). Between 1989 and 1998 electricity generation using renewable energy sources increased by 29 per cent. However, the share of renewables in total energy production remains modest. The share of renewable energy in the EU energy mix of between 9 and 12 per cent by 2010 is a realistic target only if member states initiate more vigorous policies on heating, and if they fulfil the requirements of the green electricity directive and of the biofuels directive.

An evaluation of the Lisbon strategy by the High Level Group in 2004 (Kok, 2004) came to the same conclusion for the need to increase the share of renewable energies to meet the 12 per cent target. The share of renewables in electricity consumption should even increase to 22 per cent in the coming years. The basic assumptions guiding the recommendations of the High Level Group, however, are deeply dependent on the traditional approach which characterizes environmental policy in the EU and in most of the member countries: the first principle underlined by the High Level Group is: 'exploit win–win opportunities' by promoting eco-efficient innovations, increasing energy efficiency and by 'greening public procurement' and establishing an appropriate regulatory framework. The latter explicitly relates to market institutions (and not to social and political institutions applying non-market instruments) in order to improve processes of price formation fostering efficiency solutions. Environmental policy is conceived as a 'source of competitive advantage for Europe' (Kok, 2004, p. 35). This position fits into the fundamentally neo-liberal policy model which was discussed above.

Another widespread view is that of nuclear energy as an alternative to fossil energy sources. But nuclear energy cannot function as an alternative. The main reason is the immanent insecurity of nuclear power stations and the insecurity of waste disposal and the dangers of proliferation. It must also be considered that nuclear power plants require a high degree of protection against misuse so that nuclear energy is not compatible with an 'open' and

democratic society. Therefore a central objective of an alternative environmental policy in the short run is a significant reduction in nuclear energy production and in the long run a complete closure of all nuclear power plants, in Europe and worldwide.

Thus the new energy regime is based on the following objectives: (1) a strong reduction in the consumption of fossil energies, (2) a complete abandonment of the use of nuclear energy, (3) a considerable extension of the use of solar energy, (4) a decisive increase of energy efficiency beyond its historically normal growth rates (WBGU, 2003, p. 2). It is only possible to reach the envisaged objectives by institutionalizing European and international cooperation, and by supporting and strengthening the regional and global governance structures which only exist in an informal and rudimentary manner. A more efficient and radical environmental policy is only possible if environmental movements push it through against the passive and active resistance of those who stick to the fossil regime.

The institutionalization of environmental policy has a history which can be traced back to the late 1960s (although environmental agreements were already negotiated in the nineteenth century). The OECD played an important role; newly established conventions and programmes, such as the convention on biodiversity, came in as part of more than 500 international agreements which affect national and regional environmental regulation (Braithwaite and Drahos, 2001, p. 261). The WTO, since its foundation, has been negotiating environmental clauses in international trade. The EU included environmental policy in the Single European Act and in the new Constitution (see Chapter 8). However, this institutionalization is weak, because it oscillates between strengthening of economic competitiveness, deregulation, the best practice approach and environmental regulation. Therefore institutionalization will only provide the expected results if the institutions are firmly rooted in civil society, that is if environmental NGOs play an important role on the transition path to a regime based on renewable resources. But, as was noted, the NGOs must avoid simply becoming involved in the mess of environmental negotiations. The power of civil society lies in its independence from the embodied and sometimes petrified interests of corporate power and from the political interests of parties.

Moreover, more mandatory rules are a sine qua non for an alternative environmental policy. This is because it is rather unlikely that the favoured market-based instruments (such as emissions trading) are effective enough to achieve the reduction of CO_2 emissions to a level which at least satisfies the Kyoto Protocol. New rules must also include all economic sectors, because climate-relevant emissions are not only produced by the energy sector and transport (the main polluters), but also by households, by most manufacturing and by agriculture. The same applies with regard to biodiversity. Protection is not only a task for agricultural policy. It has to be integrated into all policy fields. A transition to renewable energies only succeeds if

environmental policy is understood as part of a much broader, 'holistic', approach to structural policy.

Many ecologists and also the WBGU stress the great urgency of pushing through the transition to renewables over the next 10–20 years (WBGU, 2003, p. 2). Due to the already mentioned inertia of the energy regime the change to renewables will take many years if not decades. A 'solar revolution' is no short-term event, it has to be prepared as a long-term strategy (Scheer, 1999; Altvater, 1992; Altvater and Mahnkopf, 2003, pp. 443–77). The longer the delay in starting the change in the energy regime and in the associated economic and social relations, the more expensive it will finally be.

21.5 Conclusion: the window of opportunities is open now

Alternative environmental policy does not consist of a catalogue of single measures, but of a comprehensive, 'holistic' endeavour to restructure the energy regime and in general the societal relation of human beings to nature. It is therefore inevitable that it also includes deep changes of consumption and production patterns and of regulations – from international trade to local water distribution. Because of its all-encompassing character a radical change needs a favourable political, economic and social environment. The window of opportunity is especially widely open in a historical period in which large parts of the infrastructure of the fossil energy regime (power plants, parts of the built environment) have to be replaced by new ones. Under these circumstances the burden of fixed capital is less pressing and it is easier to realize new options and to take the renewable energy path.

Another factor which holds the window of opportunity open at present is the high oil price. High costs of fossil energies enhance the search for renewables and increase the readiness for a substitution of devices powered by fossil fuel by those using renewable energy. In the case of a considerable increase of oil prices the pathway to an ecologically more sustainable energy regime is also economically a rational choice. So it is clear that the insinuated reconciliation between economy and ecology, between economic principles and ecological sustainability, only acquires practical relevance when fossil energy (and nuclear energy, too) become more expensive than they are today.

But economic processes alone do not suffice in order to perform the change of the energetic pathway successfully. Civil society must be supportive of this change, scientific communities as well as environmental organizations and other social movements. Europe only turns out to be sustainable when the Europeans are convinced by the advantages of environmental precaution.

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22
Structural Policies: Wider and More Ambitious

22.1 Introduction

Structural policies are almost nowhere to be found in the Broad Economic Policy Guidelines aimed at defining the main goals of member countries' economic policies: these are essentially focused on budget and, more recently, on employment policies. However, structural policies do have an influence on mid-term growth potential, and on the more or less non-egalitarian nature of the growth process, notably as regards the polarization of activities. Innovation and knowledge are major growth factors. Regional policy intervenes or is supposed to intervene dynamically in the reduction of regional inequalities.

European structural policies essentially focus on four areas: competition and trade policies, which play key roles with a small cost for the European budget, regional policy, and the CAP, which absorb the main parts of this budget. Structural policies need to undergo a complete revamp with the aim of promoting sustainable growth, creating more jobs, and becoming more egalitarian and more environmentally friendly.

22.2 A more comprehensive innovation and industrial policy

Industrial policy is a largely unknown territory, as far as the culture of the Community and of many member states is concerned. Competition policy is seen as all-powerful and research policy still in its embryonic stages. The very restrictive notion of 'industrial competitiveness policy', as acknowledged in 1993 and 1994 by the European Commission, is to be found again in the European Constitution project which includes only the coordination, evaluation and exchange of best practices. The European economy is also handicapped by its backwardness in high technology, notably in information and communication technologies, as well as in biotechnology. Its relative failure to turn its research efforts into solid industrial and commercial advantage is a major handicap. A more comprehensive conception of a European innovation

and industrial policy would include three complementary approaches: a dynamic research policy, a progressive elaboration of a European industrial policy and a more pragmatic use of competition policy.

22.2.1 A dynamic research and innovation policy

To progress in this matter, it will first be necessary to reorganize and rationalize the European mechanisms aimed at encouraging research, to develop a better coordination with national policies and above all to set up new instruments at the European level. All this will inevitably have consequences on regional policy, as will be shown later.

(a) The rationalization of Community procedures aimed at encouraging research

The Community-funded measures aimed at encouraging innovation in small and medium-sized firms ought to be delegated to regional intermediaries in order to ensure greater efficiency. These regional intermediaries would be closer to the firms and better informed on their potentialities.

Some of the financial aids awarded by the Research and Development Framework Programmes (RDFP) are in fact aimed at increasing cohesion within the EU by promoting the interests of lower-income countries. These funds ought to be included in the regional aids policy which is financed by Structural Funds.

The RDFP procedures have become too complex, and specific rules ought to be implemented according to the nature of the activities that are financed:

- in the case of long-term upstream research, more freedom should be offered in the matter of proposals;
- as far as industrial research is concerned, the industries concerned should be involved in setting priorities, with a real commitment from bigger firms;
- the benefits from the EUREKA programme ought to be mobilized for rapidly executed projects and also in order to bring more specific help to small and medium-sized firms.

National measures aimed at promoting innovation ought to be rationalized; this would involve a certain integration of Community activities and taking measures to avoid duplication, as well as the sometimes stale intra-European competition. Support of development ought to be carried out with refundable aid that would be repaid in the case of successful projects.

(b) The implementation of new means

Lastly, it is essential that various new means be implemented, both regarding the budget policy and the instruments that are mobilized:

- At budgetary level, increasing the size of the European budget appears essential, and the supplementary effort proposed would represent around

0.4 per cent of the EU's GDP. The financial resources of the RDFP could thus be significantly increased within such a new framework.

- Cooperative scientific programmes, backed by more permanent budgets and autonomous structures, could be initiated in large areas.
- Technological European agencies aimed at promoting and coordinating activities in the fields of information and biotechnologies could be directly set up at European level.
- Public European research bodies could be established to perform similar functions, which were already suggested among Sapir's report proposals (2003).
- Because of the major social stakes relevant to this area (the emergence of an information society and the ethical and sanitary stakes linked to biotechnologies), this policy ought to be debated in a more democratic framework at European and member state levels, and not limited to research and development issues alone.

22.2.2 A progressive elaboration of a European industrial policy

An enlarged conception of a European industrial policy could include at least four main points: the rehabilitation of large state programmes, the strengthening of regulatory instruments, incentives for greater cooperation between firms and the renewal of sectoral interventions, and a dynamic policy of standards and patents.

(a) The rehabilitation of large state programmes at European level

The experience that has been built up at national level, thanks to traditional instruments based on large projects and public procurement, ought to be partly transposed to the European level in several directions.

Technology-intensive programmes in the energy, telecommunications and aerospace sectors have powerful impacts on the firms and laboratories that are involved. The development of such programmes at the European level, together with an increase of the corresponding budget, would reduce duplications and permit a better development of synergies. It would also encourage the establishment of research/industry and private/public cooperation networks giving rise to externalities.

Infrastructure programmes, representing higher budgets, have major structuring effects on participating firms and also play a key role in the growth process through the externalities they generate. Lastly, if well defined, they can contribute to environmental improvements and to the reduction of social inequalities. In many cases they appear to be the essential complement to the liberalization policies that are implemented in network services. Competition is not the only answer and a joint effort at infrastructure programming is necessary.

Europe could set up master plans in the fields of rail transport, utilities, telecommunications or postal services. The financing of such programmes would once more necessitate a large budget increase, either at European level or resulting from new instruments that would be devised by the European Investment Bank (EIB). It would also be possible to envisage contributions from private financial institutions in some cases.

The actual carrying-out of projects should no longer be reserved for intergovernmental coordination, but in many instances would be entrusted to a single body, at European level, in charge of an individual project, in order to avoid the numerous deadlocks that have been observed in the past. Technological and large infrastructures programmes would amount to a global budget of approximately 0.4 per cent of the EU's annual GDP.

(b) The implementation of regulatory instruments

The liberalization of network services must also be accompanied by a regulation policy in order to control the distorting effects apparent in the relations between private and public companies. Once again competition cannot be the only answer. The national regulation agencies that have been set up in various sectors (telecommunications, electricity) ought to be strengthened by giving more room for consumers and making clearer the constraints on public service activities. Regulation should not be limited to price levels, but should include matters such as guarantees of universal access, level and composition of investment.

In order to control competition in those sectors at European level, the setting up of European regulatory bodies seems to be another necessity – it would, of course, be necessary to clearly define links between these bodies and the national agencies. Beyond this, European regulation agencies in the sanitary, food and financial sectors are likely to be set up.

(c) The promotion of cooperation and the renewal of sectoral interventions

Sector-oriented policies, aimed at promoting specific infrastructures, helping innovation and making the establishment of inter-firm links easier (but without providing individual firms with specific support), could be developed jointly with firms in the sectors involved. The textile sector is one area where such policies could be implemented following the projected Euro-Med agreement and the end of the multifibre agreements. Renewable energies and technologies aiding sustainable development could be other important sectors to support. An initiative to promote clean technologies and products would be a way of encouraging sustainable development, offering the firms committed to such goals a considerable advantage for the future. To this end, a whole array of instruments ought to be mobilized (financial aids to innovation, standardization).

(d) A policy of standards and patents

A well-designed policy of standards at the European level might represent a powerful instrument for strengthening the position of European companies, as illustrated by the case of the GSM standard for mobile phones. Such a policy would rely on standards of European dimension with minimum requirement and homogeneity. The reinforcement of all-European standardization bodies, like the European Telecommunications Standard Institute, ought to be encouraged.

The setting up of a European patent is another crucial stake in order to protect intellectual property in key sectors like biotechnologies or information technologies. In Europe, the cost of patents is much higher than in the USA, and this constitutes a major handicap. A European patent would limit the complexity of the patenting procedure as well as reducing translation and examination costs.

22.2.3 A more pragmatic use of European competition policy

Changes could be introduced at four levels: the control of anti-competitive agreements, the monitoring of concentrations, the control of national aids and lastly the taking into account of public services activities, which is studied more specifically in Chapter 19.

(a) The control of anti-competitive agreements with more emphasis on the economic dimension

The current policy aimed at controlling anti-competitive agreements promotes the view that competition among a large number of firms necessarily leads to beneficial outcomes. This view is one we do not accept. Competition may contribute to efficiency and should be maintained and monitored. But preserving a strong competition should not be the only argument to be considered by the European mechanism aimed at controlling anti-competitive agreements. The competitiveness of a business is often based on the close and sustainable links that are established between different protagonists, and more attention should be paid to this dimension. However, strategic alliances should be examined cautiously in order to avoid pure marketing alliances aimed at dominating the market without improving technological efficiency. A less doctrinal approach ought to prevail, with the offer of standard contracts for cooperation agreements and permission for alliances in some cases. Depending on the individual circumstances, more scope for assessment might be left to national controlling bodies, which have a better knowledge of individual cases.

(b) A more flexible interpretation of the competition rules

The changes suggested by the Commission in this matter are limited to an improvement of the existing appeal procedures against decisions, in order to speed them up. This is welcome, but seems insufficient.

On two particular aspects, evolution over time suggests that some positive developments can be observed. A more dynamic approach, not restricted solely to the effects of current competition, tends also to integrate the future evolution of markets. The definition of the 'pertinent market', on which the risk of a dominant position is considered, is enlarged to encompass the whole world and not restricted only to the European or even to the national dimension, as was occasionally the case in the 1990s. These evolutions must be reinforced.

A last point has been raised by the latest attempt by France and Germany to jointly create European business champions. The cases in debate (Sanofi-Aventis, Alstom-Siemens and the possible creation of a naval European Aeronautic Defence and Space Corps – EADS) correspond to very different economic contexts and there is no simple answer. Strong opposition appeared from the European Commission, which has underlined the necessity of respecting the European rules on free movement of capital and on competition. The past experiences of national or European champions have been very unequal. They can work pretty well in some circumstances, as in the case of Renault or Air France. But this cannot be considered a general law. It depends on the environment and on the national traditions. The objectives of these cross-border mergers have also to be considered. Reinforcement of the European military industry (as is partly the case with the naval EADS project) comes in for more criticism than the improvement of the European biotechnology or mechanical sectors. As a general statement and according to the circumstances, European firms could be authorized to reinforce their positions in relation to their non-European competitors without being penalized. The development of 'European champions' in some major sectors of activity could be considered a reasonable objective.

(c) Improved links between national subsidies and Community interventions

The current control mechanisms of national aids ought to be relaxed and made more coherent. Increased relaxation should not mean, as is currently the case, the promotion of a unilateral strategy of national aids reduction. More coherence would imply better links between the control of national aids and existing Community policies, notably as regards those regional aids financed by Structural Funds, or those to promote research efforts. The search for a better level of intervention ought to be continued in order to encourage more Community interventions in certain cases and the continuation of national aids whenever they seem most suitable.

22.3 A continued regional policy in the context of eastern enlargement

22.3.1 The opposition between 'technopoles' and 'local centres of competence'

The knowledge-based economy does not only involve the 'technopoles' in the European regions. It also concerns the 'local centres of competence' (LCCs),

which are less technology-intensive and which concentrate their efforts on their specific competencies and on the local protagonists' innovation behaviour. Technological innovation activities are generally geographically more concentrated than other economic activities (Lallement et al., 2002). The regional concentration of technological innovation activities seems to be most pronounced in France and the other southern European countries. Technological innovation activities are more concentrated in some large regions because knowledge-intensive activities benefit from large increasing returns and from knowledge spillover. Then, it seems necessary for a region to be quite large in order to efficiently organize those activities and to develop intense relationships between actors within the firms and between firms and their partners.

Although major 'technopoles' are much more efficient when concentrated in some large agglomerations, there exist centres of local excellence which are widely dispersed within European countries. Those 'local centres of competence', sometimes described as 'local systems of production' or 'clusters', are based on specific competencies in different fields: technology, production organization and related activities such as marketing. Those clusters are focused on a specific sector agglomerated to the activities associated with such a sector. The LCCs' competitiveness is based on non-price competition advantage factors (innovation, quality, marketing, differentiation, labels …) which allow them to withstand the pressure of global competition.

The main policy recommendation is that, instead of a laissez-faire policy leading to a geographical concentration of economic activities, *an alternative European region-oriented policy is possible*, consisting of helping and consolidating local centres of excellence and the local competence and knowledge which cannot be reduced to just technological expertise.

22.3.2 Local policies

The local policies of cities or regions must not be reduced to policies of attracting investments by offering funding or tax cuts; this will lead to a devastating competition and a risk of deadlock in low-range specialization, which is not adapted to the new forms of international competition. The target must be to take advantage of the specific competencies of the local systems (labour skill, know-how, networks) through:

- strengthening the local scientific base (links between universities, research centres and firms, technological parks);
- promoting brands and labels with a strong territorial specificity (label policy, quality improvement and diversification, aid to inter-firm cooperation and to trading);
- a training policy and help with the diffusion of new technologies;
- improving the quality of the environment (infrastructures and way of life).

Each single region is not supposed to be a scientific and technological pole. The increase of the R&D effort contributes to the catching up of a region, provided it already possesses a minimum level of infrastructure. Technological diffusion occurs between regions, but with a threshold effect for regions which are not lagging too far behind at the start. But each region can form, in its specific fields, a 'local competencies centre' by identifying and progressively building its own advantages. The attractiveness of each region will thus be gradually increased for local, national or foreign investors. In this general framework, which is adjustable to each specificity, local policies can be consistently implemented and supported by national and European policies.

22.3.3 Regional policies at national level

The main scientific programmes and infrastructure expenditures can promote those technological poles which are strong enough to have European or national significance in order to avoid dispersion and to allow scale economies and spillover effects. National financing and human resources can sustain local strategies, but this policy increases the polarization of technological innovation activities. In contrast, more selected and specialized technological programmes, innovation or investment aids and training policies can support the specific competencies which have been identified at local level. Such public interventions should become ever more scattered over the whole territory.

The preservation of quality public services, regarding transport, postal services, telecommunications and energy supply, are necessary conditions to help the less developed regions restructure and find new growth factors. The improvement of the education system for initial and permanent training, with national support, is also a necessary condition.

22.3.4 European regional policy

European regional policy faces traditional problems due to the complexity of the procedures and the difficulty of management and monitoring of the projects financed by Structural or Cohesion Funds. In some cases, the endowment is underused because of problems of definition and coordination between the different participants; in other cases, the usefulness of projects can be debated. In this context, three scenarios can be considered:

1. If the EU budget limit were to remain at its present level (1.27 per cent of the EU's GDP), there would be a strong temptation to reserve the Structural Funds, for the main part, for the use of the new members. In the EU-15 regional policies would be *re*nationalized, which would accord with the fact that regional policies are already mainly financed by national and local budgets. Moreover neo-liberals consider that regional problems should largely rely on market mechanisms and on private capital flows. However, this

prospect raises two kinds of issues. The current EU members, especially the richest ones, would be excluded from any European financing. This situation would be difficult to manage in the long term, the richest countries becoming more and more reluctant to finance a solidarity mechanism from which they would be permanently excluded. On the other hand, the new members, who have made clear their doubts regarding the implementation of any European economic government, would be in a rather paradoxical situation where they would benefit from transfers without accepting a political counterpart.

2. In a more favourable perspective, the EU's budget could be progressively raised to around 5 per cent of GDP in the medium term. This would give more room to manoeuvre, for instance by raising the eligibility threshold for Structural Funds to 90 per cent of the EU's GDP per capita. A larger number of less developed regions could benefit from transfers, including some regions in the more advanced countries of the EU-15.

3. Neither of these first two scenarios are very likely, due to the political environment. A new compromise might be sought in two directions at once. As for the previous institutional changes, new Structural Funds could be created and dedicated to the new members, which would be financed by borrowing through the EIB and the European Reconstruction Development Bank (ERDB). The present Structural Funds could be shared between the EU-15 members and the new entrants, with a renegotiation of the eligibility threshold, in order to give both groups of countries sufficient funds. Lastly, the procedure of the Structural Funds could be reformed in order to improve their efficiency. More autonomy could be given to the local, regional and national development plans with the Structural Funds playing a complementary role, without too tight an examination by the Brussels bureaucracy. High levels of support for lagging countries would be linked to broad public investment strategies. Objectives for eligible EU-15 regions would be determined by country and regional indicators in order to increase the consistency. In the short term two proposals could be presented in order to reduce the regional policy conflict between enlargement, budget problems and ongoing cohesion in the EU:

1. A 0.5 per cent approach (equivalent to 380 billion euros in 1999 prices for the EU-25 over the period 2007–13). The EU's 15 regions would get as much as in the 2000–6 period, and there would be another 22 billion euros for the accession countries. In this case the 4 per cent limit which was set due to the limited absorption capacity would be eased.
2. A 1 per cent approach (equivalent to 760 billion euros in 1999 prices for the EU-25 over the period 2007–13). In this case it would be necessary to change the funding process by abolishing the 4 per cent limit and strengthening global support for accession countries' national budgets rather than controlling all projects in the 'single programme documents'

which nowadays have to be presented by the regions and accepted by the European Commission. In this perspective more appropriate ways of control would have to be defined.

22.4 Conclusion: a coherent programme for European structural policies

The overall cost of all the proposed measures regarding the European structural policies can be estimated at 1.3 per cent of the EU's annual GDP in the medium term (0.4 per cent for research, 0.4 per cent for main projects and 0.5 per cent for regional policy).

Those measures make up a coherent programme. As far as the European industrial policy is concerned, technological programmes, as well as the renewal of sectoral interventions along with standardization and patent policies, are linked to the research policy. Regulatory policies and main infrastructure programmes are complementary with liberalization and service networks policies. Research policy and large infrastructure are linked to regional policies. The CAP plays a key role in the preservation of regional balances. National aids ought to be rationalized, not with a view to slashing them, but in order to define the best level of intervention (regional, national, European) and to achieve more effective coordination with European policies.

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23
Common Agricultural Policy: a New Governance Regime

23.1 Introduction

Reform of the CAP has been a major issue for the Commission for some time, but since the late 1990s, pressure for change has increased greatly following changes in budgetary constraints, negotiations with the WTO and the enlargement eastwards. Given the current situation and the inadequacy of the reforms proposed by the Commission and Sapir's report (2003), there seem to be certain advantages in returning to Roosevelt's theory whereby we might admit the existence of an 'agricultural exception'. Agricultural products cannot be governed just by the laws of international trade. Following the traditional distinction between the first and the second pillar of the CAP, two kinds of proposals can be made regarding firstly the price support mechanisms, and secondly the rural development policy.

23.2 A guaranteed prices system with individual quotas

The instability of agricultural markets increases risks, which has negative effects on all agricultural activities. In the medium term, this can largely counterbalance the gains resulting from the exploitation of comparative advantages (the risk of desertification and disintegration in the rural regions of European countries, the absence of any short/medium-term alternative activity in the poorest countries). The positive effects of trade development can only be effective if the perverse effects of the free market are corrected by agricultural policy measures, in both developed and developing countries. The past shows us that this requires price-supporting measures, as long as production control mechanisms can be used to avoid production surpluses.

Guaranteed price systems, therefore, ought to be linked to production quotas. These prices must be high enough to encourage farmers to produce. Quotas must be tailored to individual circumstances and fixed so that the sum of individual (and national) ones is slightly lower than the EU's total consumption. Overproduction would thus be avoided and the market itself

would be able to make the necessary adjustments between European domestic demand and domestic and international supply. In this case imports would therefore be free. If such a mechanism were set up within the whole EU, it would help to stabilize the international system.

Consumer prices would be determined according to international prices and consumers would have to bear the consequences of international markets' fluctuations. Public subsidies could then make up the difference between consumption prices and farmers' guaranteed prices.

Guaranteed prices would differ between regions according to development and productivity levels. Production quotas could be exchangeable, but not between different regions, in order to avoid geographical concentration problems, as was the case abroad (milk in Quebec). Lastly, individual quotas could be used to reduce production, particularly in the case of big farms.

Production quotas generate economic surpluses that can be estimated through the variation of quota prices (since those quotas are tradable). Regular negotiations can be a means of limiting excessive economic surplus increases.

Within such a framework, *the integration of eastern European countries* might take place on a far more balanced basis, without introducing any distorting effects between countries since the same rules would apply (guaranteed prices with production quotas so that the sum of quotas should remain lower than the EU's total domestic consumption). The evaluation of quotas would take place on a historical basis in each country, limiting the future growth potential of production; this would eliminate fears about overproduction. Guaranteed prices should be high enough to ensure a significant improvement in farmers' income and permit modernization of their methods of production. They should not, however, be too high in order to avoid a situation where agricultural and non-agricultural revenues increase at different rates.

Similarly, a more balanced solution could be reached where the *Euro-Mediterranean Agreements* are concerned. The principle of free imports would make new opportunities available for the agricultures of these countries. The importance of this move should however not be exaggerated, since European farmers would continue to benefit from substantial subsidies as a result of the system of guaranteed prices. The agricultural potentialities of the Mediterranean countries, with the exception of Turkey, should also be put into perspective. Those countries tend to have a deficit of their agricultural trade due to population increases which necessitate increasing cereal imports. They have to begin considering the possibility of moving towards self-sufficiency in the area of food, which would necessitate setting up dynamic agricultural policies which would not quite match free trade principles. The CAP reform would then appear as a rather secondary matter.

However, this rather balanced proposal raises two types of problem:

1. Setting guaranteed prices is always a difficult exercise, which due to the numerous pressures involved requires complex negotiations. Experience

of the 40-year history of the CAP, however, suggests that all necessary adjustments would be feasible. The existence of periodic negotiations is a guarantee that the necessary adjustments could be realized.

2. This proposal is also out of tune with the rules of the WTO, which is not surprising as it is based on the idea that agricultural products cannot be governed solely by the laws of international trade. Within the WTO framework only restrictive agricultural subsidies are generally allowed. Some are acceptable ('the green box': environmental subsidies, rural development subsidies, ...) but are based on the 'decoupling' principle (removing any link with output levels or with current prices). Others are unacceptable ('the orange box': measures to sustain prices or subsidies that are linked to production levels), or should be progressively reduced. The 'blue box' category is intermediate and corresponds to the situation where farmers have to limit their production, which may be considered the case with quotas.

23.3 Improve the rural development policy

The second pillar should address the structural needs of the agricultural sector within the context of a reformed CAP, while addressing the development of rural areas with an integrated, multisectoral approach. Environmental concerns should be taken into account both in agricultural policy-making (water, soil, production practices) and on the territorial side (sustainability, impact of tourism and industries, energy production and consumption ...). There is the need to combine decentralization – at regional and local level which are likely to be more efficient and effective – with coherent rules of a overall character. Both the territorial and sectoral functions should be regulated at European level, establishing general principles, eligibility of areas and rules of the game. In a word 'the sectoral and territorial functions should both be *stable and complementary* components of rural policies, be kept *distinct* from each other and be *decentralised and adapted* to specific rural conditions' (Saraceno, 2002).

The calculation of compensation allowances to farmers in less favoured or environmentally sensitive areas still fails to take into account the existence of other sources of income opportunities. Defensive policies based on generically defined disadvantages are by far predominant over proactive ones for specific and well-delineated situations. Diversification of activities has already spontaneously taken place in many areas, and far from becoming a threat to farming activities this has provided an opportunity for providing contract services and for alternative jobs for farming families; new markets and technological opportunities have appeared and the attractiveness of rural areas as places to live in has greatly increased. Therefore a more positive and forward-looking rural policy should be encouraged rather than maintaining a generally defensive thrust with an emphasis on compensation.

Farming is no longer the main material support in rural areas. Rural development policies will therefore have to be formed in association with policies concerning other areas. The sustainability of rural areas does not depend on the farming sector alone but on the diversity and attractiveness of the rural resource base in relation to other types of areas, both rural and urban. Regional policy and policies for specific localities should take into account the diversification of activities which are adapted to the specific resources available in the rural area, an integrated and multisectoral approach which addresses social problems of employment and human capital and the provision of services for the population as well as infrastructures which link the area to the external context. Also, the local (LEADER) and regional (structural) programmes need to be better coordinated while still maintaining a decentralized decision-making process and a 'bottom-up' approach. Environmental concerns should also be present in regional and territorial strategies, not just in sectoral strategies.

The instruments of rural policy must rely on an area-based approach, with close links to regional and local policy. Rural areas at present vary greatly and policies must be spatially differentiated. Some instruments of rural development policy, i.e. the LEADER programme, have already adopted this differentiated approach, but it should be enhanced and deepened.

The question of who should be the relevant actors to implement these policies must also be raised. There is a wide debate about whether the management of sectoral and territorial policies should be separated or integrated. The main argument in favour of separation seems to be the existence of a danger that one of the two functions (very likely the territorial one) might become distorted or pushed to a marginal role. It seems more sensible to isolate rural development policies from tough productive agriculture; but on the other hand it seems difficult to consider rural policies in isolation from agricultural ones. In our view, however, independence but cooperation among both of them would be better than integration under a single decision-making structure.

The financing of agricultural policy is clearly another area that needs to be addressed. Since there is a ceiling on agricultural expenses, a procedure for obtaining new funds for rural development has been established through modulation programmes in the guarantee section of the European Agricultural Guideline and Guarantee Funds (EAGGF). However, the modulation of the original proposals is rather limited, and in such a way that many farms will remain out of it, and funds obtained by this procedure will not be very high. Also, support for the new members will necessitate a restructuring of the way funds are distributed, which will have negative effects predominantly for the countries that now receive the larger share. However, in spite of the very significant difference of funds applied to the sectoral objective from those applied to the spatial objective, Saraceno (2002) considers at present there is no scarcity of funds. It would be better to

start by defining what kind of measures would be most effective to achieve the objectives of each function and only then to identify the expenditure needs, rather than starting with the budget claims on the basis of past receipts and only afterwards making up any difference needed to achieve the final objectives.

With regard to enlargement, it seems that rural development may be a very interesting strategy for new member countries with substantial rural and agricultural areas. Because of this, special care should be taken to incorporate the lessons of the past into the application of policy to these new areas. In the philosophical conception of these proposals, special care should be taken clearly to distinguish between the agricultural and rural functions of policy, so that policy is not limited to traditional productivist strategies for agriculture but, from the very start of integration, is aimed at rural development in the broadest sense.

23.4 Conclusion

Based on the idea that agriculture products cannot be governed only by the laws of international trade, two kinds of proposals have been made for a complete reform of the CAP.

A guaranteed price system with individual quotas would be fixed, so that the total of the individual quotas be slightly below the EU's consumption. Overproduction would be avoided and the market would make the adjustment. Individual quotas might be used to reduce production, especially in the case of big farms. In this framework the integration of eastern European countries and the relations with Euro-Mediterranean countries would take place on a more balanced basis.

A more proactive and forward-looking rural policy, dealing both with agricultural and territorial problems, would be encouraged, instead of maintaining its defensive character. A multisectoral and integrated approach, including environmental concerns, would be developed, combining decentralization and coherent rules at the EU level.

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24
Trade Policy: towards a New Concept of Fairness

24.1 Introduction

Redesigning European trade policy is essentially a question of defining a new orientation for the WTO. In this new conception the WTO would become more democratic, more respectful of fundamental rights, and would treat subjects with a more differentiated approach: taking into account specific national situations and levels of development. In this perspective new negotiation lines could be drawn between both developing and other industrialized countries. The Dispute Settlement Body (DSB)'s functioning would be completely overhauled, which would have important implications in two sectoral matters: the agriculture policy, which has already been analysed, and the services with the General Agreement on Trade in Services (GATS).

24.2 New orientations for the WTO

Developed countries see the WTO as a place of negotiation with a main aim of building a framework for regulated international trade based on the respect of competition. Concessions may be made in order to limit counter-productive conflicts, but the general processes of the WTO should result in outcomes that are mutually beneficial for all. Functioning as it does today, it is one of the best instruments for the dissemination of liberal policies as it imposes across-the-board liberalization measures without taking specific national circumstances (such as the specific social model) or unequal development levels into consideration. The WTO is largely dominated by big powers, notably the USA and the EU, which contribute to fixing in advance the main directions of negotiation. This way of functioning is increasingly criticized by large and often diverse coalitions that have the power to lead to deadlock situations during negotiations. Yet the apparatus remains intact, with its heavy and complex procedures, and the liberalization process continues to serve prevailing interests.

24.2.1 Another conception of the WTO

The EU could propose three changes: the democratization of the WTO, the reintroduction of a more differentiated treatment of subjects and the respect of fundamental rights:

- The democratization of the WTO is necessary in order to put an end to the de facto control exerted by the strongest countries and to establish a more balanced way of functioning. This would necessitate a strengthening of the power of the developing countries within the WTO, going further than the current rule of one country, one vote. The fixing of agendas ought to be the result of global negotiations carried out with greater openness. The conferences and working committees ought to be chaired in a more balanced way. The DSB's functioning ought to be completely overhauled.
- The liberalization rules should no longer be across-the-board decisions with regard to developing countries and should take their unequal development levels into consideration. The principle of differentiated treatment lost a great deal of status following the liberalization wave. It ought to be restored within the WTO while still taking into account that constraints can no longer be exerted as before because of the existing obstacles to development. Redistribution mechanisms at global level could be included in the WTO's principles according to the level of development. Developing countries could thus benefit from a more flexible management of intellectual property rights (IPRs), similar to the systems already beginning to be put in place for drugs, or could maintain some protection in terms of the opening-up of new markets, public market policies or foreign capital investments.
- The respect of fundamental rights (the right to health, the respect of fundamental labour laws, the defence of the public services that are acknowledged as a means for everyone to exert his or her fundamental rights) should be put beside the preservation of the environment which has already been recognized by the WTO. It should not be considered as an excuse to rekindle protectionist attitudes that would put the free trade principle into question, as often denounced by the WTO's experts.

24.2.2 Some new negotiation lines

The current situation might lead the EU to suggest new orientations within the WTO vis-à-vis developing and other industrialized countries. The DSB's functioning then ought to be completely overhauled.

With regard to developing countries, Northern countries should negotiate favourable asymmetries to permit them to make up for their backwardness in development within the next 20 years. Several areas would be affected by this prospect. Temporary protection could be accepted jointly with the pursuit of Northern countries' opening-up. In contrast to its current position, the EU should stop forcing some countries to open their markets more widely and opposing those who refuse to lower their tariffs. A more flexible, less

arrogant approach should prevail, which would take more into consideration each country's or each area's particular circumstances.

A similar asymmetry should also be established for the 'Singapore issues' (see Chapter 9). As was already decided in July 2004, the EU should cease to advance such proposals, not even in the more limited spheres of access to public service markets and trade facilitation. A break should be made with the past; negotiations with countries that are willing to accept these issues within the framework of multilateralism should not be promoted.

The recent regional agreements, like the Cotonou or Euro-Med Agreements, ought to be similarly altered. While intra-area liberalization must be encouraged in order to increase regional integration, some asymmetries favourable to less developed regions ought to be negotiated.

IPR agreements ought to be made more flexible to help developing countries and encourage the development of national industries: reduction of the length of patents, introduction of special dispensations concerning the law concerning imitations. Transfers should be made towards the countries that provide temporary skilled labour, as a compensation for the educational costs incurred by those countries. This type of transfer would make Europe's current policy concerning the acceptance of temporary skilled labour more acceptable.

Lastly the support brought to developing countries, which is currently insufficient and ill used, ought to be increased, provided its management is completely overhauled.

With regard to other industrialized countries, and particularly the USA, the EU's trade policy ought to reflect the specific nature of the European model, which ought to be defended in all its key aspects, not only in the limited field of the 'cultural exception'. The main aspects involved are the 'European Social Model' and its implications in terms of health policy and redistribution policies, as well as the public services that do not consist merely of basic 'universal' services. This question also refers to the renegotiation of the GATS that will be dealt with later on. The EU should also aim for a return to a situation in which the positions of its various partners are more balanced, particularly in three sectors: European public service and financial markets, which were opened up to outsiders without any compensating concessions on their part (here the EU should insist on reciprocity) and IPRs, where the EU has been increasingly on the defensive.

The shortcomings of European research regarding IPRs are a key question. Europe's inability to set up a patent genuinely European in scope that would be valid for the whole Union must also be overcome. The involvement in this question of various national patent offices is partly responsible for the current situation, as well as the poor standard of some national courts responsible for this area, as well as the absence of a European patent court. Besides these typically European weaknesses, the excessively dominant position of the USA ought to be more strenuously opposed, particularly on the

question of the patenting of living things (Coriat, 2002). The DSB's functioning ought to be completely overhauled to make it more favourable to developing countries. While guaranteeing the multilateralism principle, the DSB ought to be deprivatized and placed under the control of the United Nations Organization. The sectors or areas likely to be the subject of unrestricted negotiations within the WTO ought to be clearly separated from those to be placed under the aegis of the United Nations' competent bodies so that rules and standards might be fixed. The WTO should then be in charge of applying trade sanctions within this framework. In the case of IPRs on drugs for instance, rules concerning IPRs and trade ought to be decided upon in the World Health Organization (WHO), taking into account the populations' needs and sanitary situations. On the question of agricultural products, a distinction ought to be made between natural products and genetically modified ones, whose trade regulation should be fixed in agreement with the Food and Agriculture Organization's (FAO) competent bodies. As far as more general industrial goods and services are concerned, negotiations would be unrestrictedly integrated within the WTO framework. As for social standards, the support brought to development is undoubtedly the most efficient means to ensure that the importance of these are respected in developing countries. However, trade sanctions could be imposed within the WTO framework on countries that do not abide by basic labour laws, in order to allow the ILO to fulfil its controlling function in this sector. Lastly a global institution coming under the United Nations would cover and coordinate the various sectoral bodies of the WHO, FAO or ILO contributing to the fixing of those standards and regulations. This would ensure both better coordination and greater political legitimacy (Cling et al., 2003).

In the long run one might see the United Nations Conference on Trade and Development (UNCTAD) gaining importance and influence in international trade affairs in general, where the WTO would be challenged by important non-Western countries like Brazil or India. As a long-term goal the subordination of the WTO to the governance of a reshaped UNCTAD could be considered.

On a more operational basis, the sanction mechanisms set up by the WTO ought to be reconsidered with the aim of reinforcing their efficiency by providing compensation for incurred prejudices, and by calling upon the participation of the sectors concerned by the sentence, which does not happen today. Lastly, because of the complex issues dealt with by the DSB, the less advanced countries ought to be entitled to benefit from specific technical support.

As regards their form, negotiations ought to be conducted on behalf of the EU, not by a Commissioner who makes proposals and is then mandated by the Council to act as negotiator, but rather by a Council representative, a 'Mr or Mrs Trade' who would benefit from a clearer political legitimacy as the representative of national governments.

24.3 Renegotiating the GATS

The 2003 Commission's liberalization proposals were, in its own words, 'significant and substantial'. Though education, health and culture were not affected and the goal of a universal service was preserved for the postal and telecommunication services, no real guarantee was given for future negotiations within the GATS framework. The principle of the GATS is the encouragement of a process of gradual and general liberalization. Various statements show that education and health will eventually be threatened (Jennar, 2003).

In order to avoid such a drift, it is essential that the EU's mandate to negotiate for the whole of Europe should lie on a clear idea of public service at the European level, going beyond the mere notion of a universal service. Public services can be defined as the supply of goods and services that are essential to everyday life and to the exercise of a human being's fundamental rights (the guarantee for all to have equal access to energy, health care, transport, communications or education anywhere on the territory and without any discrimination). They make an essential contribution to the economic and social cohesion of the territory. They should be given a specific status in negotiations in order to be clearly kept out of any future liberalization proposal.

24.4 Conclusion

The new design of the European trade policy is based on another conception of the WTO with a more democratic way of operating and would mean an end to the de facto control by the strongest countries. The liberalization rules should be applied less uniformly and should take into consideration levels of development and the particular circumstances of different countries. Fundamental rights (the right to wealth, the defence of public services, the respect of fundamental labour laws) should be reaffirmed.

In this perspective new negotiation lines should be proposed by the EU, offering favourable asymmetries to the less developed countries in such matters as trade openness, regional agreements and IPRs. With regard to the other developed countries, and in particular the USA, the EU ought to propose the specificities of the European Social Model in its trade policy. The functioning of the DSB must be completely reformed. The DSB should be put under the control of the United Nations with the creation of a new global institution or the reshaping of UNCTAD. At a formal level, for the European side, negotiations should be conducted by a representative of the Council with a clearer political legitimacy than a simple Commissioner.

Lastly, to avoid the current liberal drift within the GATS framework, the mandate of the EU within the negotiation procedure has to be redefined, reinforcing the idea of a public service at the EU level.

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25
How to Get from Here to There?

25.1 Introduction: political hegemony amidst economic weakness?

The economic potential of the neo-liberal agenda in the EU is limited. It is unable to organize long-term growth in the EU and increasingly the strategy simply amounts to the redistribution of income and wealth from the bottom and middle ranges of society to the top. This has high and increasing costs and is not sustainable in the long run. The destructive impact of neo-liberal policies in the EU was demonstrated and criticized in the first part of this book. There are reasonable economic and social policy alternatives to this harmful strategy. Some of these alternatives were outlined in the second part of the book within the framework of the European Social Model.

But, in spite of its failures, the political and ideological potential of neo-liberalism in the EU seems largely unbroken. In the second half of 2004 a majority of the member countries of the EU had conservative governments, and in most countries with a social democratic government – particularly the UK and Germany – economic policy is not less neo-liberal. The mass media hammer the necessity of economic and social 'reforms' more aggressively than ever into the heads of the peoples of the EU. Consequently, the latter elected a clear conservative majority in the European Parliament in June 2004. A few days later the heads of member state governments adopted unanimously a Constitution that accorded the dubious theoretical basis and the harmful political practice of neo-liberalism the status of constitutional imperatives.

This situation cannot last for ever. Political strength and ideological leadership are in the long run not sustainable without economic strength and at least a minimum of social cohesion. If these cannot be ensured via economic and social policy the gap could probably for some time be closed through more manipulation of the media, repressive domestic policies and enhanced external aggressiveness. But the costs for this can also be high. However, this long-term perspective of a gradual decline of neo-liberalism is hardly

satisfactory. Therefore it is reasonable to explore the possibility of a change of the present policy course towards a sustainable European Social Model and to examine how such a change might be brought about. The question is how to get from here to there.

In the following, we briefly present three political scenarios of how such change might come about: growing realism about the threat of continuous economic and social stagnation and the EU's loss of global influence; progressive initiatives from some member states in the framework of 'enhanced cooperation'; the development of general political pressure and social movements to change the existing political climate and power relations.

25.2 Emerging realism in the face of stagnation

A first level at which moves for change could start is growing realism about the discrepancies between ambitious visions of the EU and actual developments. The standard reference in official declarations of new actions by the European authorities is to the Lisbon strategy of 2000: to transform Europe into the most competitive economic region in the world by 2010. Half of that period has now gone and the strategy has in no way generated the expected effects. This is even recognized in the interim report which was presented in November 2004 by a task force under the former Dutch prime minister Wim Kok. EU growth is still very slow, and unemployment in 2004 was higher than in 2000. The neo-liberal agenda simply does not work as its proponents promised and expected. The gap between ambition and reality is increasing. The counterproductive character of economic policy has become particularly glaring in the double failure of the Stability and Growth Pact (SGP). Not only does the policy of austerity impede economic growth and employment. The pursuit of balanced public budgets in a situation of macroeconomic weakness will even generate higher instead of lower deficits, as in Germany.

Continuing economic weakness affects the position of Europe in the world. The relative weight of the European economy is diminishing and European competitiveness – even when measured in conventional terms – has not improved. Both outcomes reduce the ability of the EU to influence international economic institutions and policies. A further consequence is that member states prefer to develop national rather than European options. There are only a few genuinely European corporate consortia working successfully in the developing world as against transnational corporations from Europe, with an exclusive national basis.

The objective of a European Union since the mid-1980s was certainly not to dilute the Community into a global market but to give members their say in the present reconstruction of more and more internationalized markets. When the EU cannot advance any meaningful programme for such reconstruction, but simply plays the game of global neo-liberal forces, then

European integration itself is jeopardized. Europe will be divided and the Union put under pressure; indeed the whole project of integration may be called into question. This is even more so with 25 EU members and when a hegemonic USA is pursuing aggressive policies on all fronts (not only on military issues but also on the environment, intellectual property rights, agriculture, cultural products, energy).

A sober view of actual developments should therefore lead to a revision of policy orientations and instruments in the EU, even among those forces that measure economic success primarily in terms of growth rates and external positions. In 2004, some moves to that effect began. The most publicized of these relate to the SGP. When the German and the French governments prevented the Council from opening an excessive deficit procedure against Germany in 2003 this was not inspired by the conviction that the SGP was counterproductive; it was mainly a power play by the two strongest nations against the priority of European rules. But when the Court of Justice rejected this policy the problem became more serious and attempts to reform the SGP have since gained momentum, even in the Commission. Some moves to reform the SGP began with the aim of making it less rigid and of giving member states more room for growth policies. Proposals were made to exempt certain categories of public investment – in the first place, research and infrastructure development – from the deficit calculation. Other proposals aim at longer time horizons for deficit reduction.

It can also be observed that the insufficiency of domestic demand has recently gained growing weight in public discussions and political declarations in such countries as Germany and France. This is a positive point, which should be reinforced and used as an argument for closer and tighter economic policy coordination and harmonization. The EU, as the largest developed region in the world, must rely on its own potential, on both the supply and the demand side. Unlike the USA, the EU cannot use currency supremacy or political and military power to compensate for severe economic imbalances.

More realism and stronger reliance on domestic demand will also lead to a more critical view of income distribution and social polarization. Growing social inequalities have in major European countries contributed economically to inadequate private consumption and to weak growth. Furthermore they destroy the social fabric on which economic development depends. Occasionally this has been recognized by officials in member countries and even in the Commission.

Over the last two decades the neo-liberal strategy has had every chance to demonstrate its theoretical and practical validity. With regard to the promises of more employment and general welfare it has failed in every respect, although for the upper classes and major economic corporations it has paid out very well. It has been clearly demonstrated that taking low inflation and balanced budgets as the main, if not the only, control variables

for economic policy has made it impossible to achieve prosperity with full employment and welfare for all in the EU. Where stronger economic growth was attained it was linked to increasingly precarious work and welfare conditions and brought benefits mostly to the richer social groups. Growth is not an end in itself but is only beneficial as an instrument for more and better employment opportunities and more and safer welfare for all people in a society. The conservative answer to these empirical policy outcomes is to assert that the improvement of supply-side conditions has not yet gone far enough and that 'modernization' towards more flexibility and competition must be continued and reinforced. However, doubts about this strategy and calls for the stimulation of domestic demand are gaining weight in public discussion.

Pragmatic criticism of neo-liberal policies and the call for correction will of course be met by strong reactions to defend neo-liberalism. In this debate differences and contradictions will become clearer: between economic sectors which are working primarily for the domestic market on the one hand and transnational corporations and global financial market actors on the other. While the first group will certainly welcome social cuts and wage reductions it is at the same time affected by the ensuing fall in domestic demand. This makes its interests partly diverge from those of the second group, which can compensate for the loss of domestic sales by more intense international expansion. Growing realism should therefore lead the sober and Europe-oriented fractions of capital to welcome a policy shift towards a more expansionary macroeconomic orientation and the stimulation of domestic demand – while at the same time fighting against increases of wages and taxes. In the debate about economic policy which such open differences of interest provoke, the strong imbalance in favour of neo-liberalism in the Constitution could be emphasized and proposals for its correction could be made so as to leave much more room for flexible policy decisions.

25.3 Multi-speed initiatives

The second source of change could be initiatives of a limited number of governments to adopt a more appropriate policy in the macroeconomic, social or structural/regional areas. Already in the 'old' EU-15 it was often enormously difficult and sometimes impossible to formulate a common opinion on issues like the EU budget, fiscal policies or consumer protection. The recent enlargement will probably aggravate these difficulties, and the accession of Bulgaria, Romania and then Turkey will add to problems to developing a coherent policy for the establishment of a European Social Model as a distinct alternative to the American model of society. Therefore the question arises of whether it would be useful if only some members of the EU undertook an initiative for specific policy measures, while others – temporarily or

permanently – did not participate. The most prominent example of this kind has been European Monetary Union (EMU) in which initially a majority but, after enlargement, now only a minority of 12 EU members participates. The scope for such 'enhanced cooperation' or multi-speed integration has been expanded by the Constitution. Are there realistic perspectives for the promotion of a European Social Model through a multi-speed strategy? The limits and caveats are clear: enhanced cooperation must not lead to new or reinforced hierarchies in the EU; they must avoid deepening divisions between countries and they should not increase complexities in the EU.

Taking these limits into account, one can conceive of several issues where advances could be made through enhanced cooperation: joint research or infrastructure programmes, adjustments to tax systems to avoid harmful tax competition and dumping among member states; the setting of minimum standards in social welfare systems to reduce disparities; harmonization of trade rules for product markets to preserve the environment and to protect health; common measures to promote the development of national and regional cultures; joint employment initiatives by subsets of countries are also conceivable.

Two further conditions appear necessary: firstly, participation in an enhanced cooperation project by a limited number of countries should not be decided in a top-down way by governments but should be based on a broad social consensus. This presupposes a social debate among various social groups and actors. Such debates make the points at issue clearer for a wider public and thus make it possible to extend enhanced cooperation to additional partners. Secondly, enhanced cooperation projects should only be launched if a minimum number of participants is reached. Such coalitions or 'pioneer groups' should be led by countries with a long experience and strong attachment – for instance to some types of social protection (policies against child or old age poverty) or on environmental issues. The diversity of Europe could be put to work in that respect. The Scandinavian countries offer a good anchor for such a move. Even countries that rely more than others on market-based modes of regulation could contribute. Their experience regarding prudential regulations, ethical norms and the fight against fraud and corruption can be used to develop European codes of conduct on a wide range of issues from foreign investment to the control of political representatives.

Such initiatives from groups of member states may well be challenged and attacked by non-participating countries or by the Commission as distortions of competition. Such objections, however, may give a welcome opportunity for a European debate about the relative weight of competition rules as against social, employment and environmental considerations.

Initiatives from a limited number of countries for progressive projects towards the establishment of the European Social Model could be challenged because they conflict with primary legislation of the EU. Although the Treaty

of Nice, and to an even greater extent the Constitution, have broadened the possibilities for enhanced cooperation, the competition rules could be invoked against multi-speed projects which for instance aim at improvement of regional employment opportunities through state subsidies or common rules for environmental protection which contain restrictions on suppliers. Solutions for such conflicts are by no means obvious and predetermined. In the past particular provisions in countries to protect the environment have been successfully defended before the European Court of Justice against the priority of competition rules. This should also be possible for common projects of enhanced cooperation. In any case controversies over such initiatives can contribute to the clarification and public discussion of the issues at stake and perhaps even open the way for legislative improvements.

Multi-speed initiatives – provided they meet the above conditions – should therefore be regarded as a legitimate and useful tool in the development of an alternative economic strategy for the EU. One could even argue that, with the recent increase in the number of EU members, the growing difficulties of reaching a satisfactory level of comprehensive policy coordination have started to endanger the progress of the European project. Therefore it could be reasonable to launch some initiatives with subsets of countries. The problem is not that such projects are politically unjustified or legally questionable. The real problem is rather that currently no group of governments is planning such démarches. There is little prospect of realistic and progressive enhanced cooperation. On the contrary, multi-speed initiatives could under present political circumstances tend to reinforce the neo-liberal agenda. To reverse the neo-liberal thrust and give enhanced cooperation a positive orientation require a considerable shift in power relations.

25.4 Social and political movements

The third basis of change is a stronger political opposition and stronger social movements against polarization, insecurity and the almost complete disappearance, from the perspectives of many people, of a reliable social basis upon which to build independent lives. For growing parts of society almost every aspect of material and social life is becoming insecure: jobs, homes, wages, education, health care, pensions, unemployment and even welfare benefits. This increasing insecurity is – in spite of large, persistent differences among countries – an elementary factor of convergence across the EU. Another such factor is that, in all member states, incomes and wealth are rising rapidly for a minority group – mostly managers and large financial investors. Insecurity and inequality are both the results of political decisions, not the inevitable consequences of globalization. However, criticism and opposition are also in one way or another present in all countries. The ambitions of the movements against neo-liberalism sometimes go well beyond economic and social policy. Although they have no common

organization they have a common denominator: they stand for dignity and democracy, against human devaluation and degradation for the sake of economic competitiveness and private profit.

Active opposition to neo-liberalism has emerged in many ways. It is promoted and supported by different organizations, informal groups and spontaneous movements. Immediate targets differ: corporate downsizing and dismissals, relocation of firms, closure of public kindergartens, theatres or swimming pools at the local level, privatization of pensions and other 'modernizations' of social security systems, 'reforms' of labour market legislation and tax policies on the national level, tax competition on the European level, militarization, warfare and aggressive Third World strategies in a global perspective.

In spite of differences in origin and in concrete activities, growing insight into the common features of neo-liberal attacks and how these attacks converge can contribute to mutual understanding, solidarity and alliances. In developing these insights the use of ICT is extremely helpful. Internet and e-mail have contributed much to the creation of national, continental and global networks of information, critique and mutual support for progressive groups and activities. Traditional organizations such as trade unions, anti-war movements or churches, and new formations such as Third World groups, consumer organizations, feminist associations, movements of unemployed and homeless people have started to communicate with each other and to combine against the forces which exert more and more pressure on them, in the name of modernization. This is difficult and mutual solidarity is often fragile. Traditions, theoretical and political backgrounds, ideologies and experiences differ across groups and sometimes there exist considerable mutual scepticism and mistrust. This is hard and time-consuming to overcome. Here again, multi-speed policies are ambiguous: on the one hand 'autonomous' actions or campaigns can stimulate and strengthen the common movement. But they can also alienate the 'pioneers' from actual or potential partners and weaken the thrust of the movement.

Recent years have seen the beginnings of a generalization and internationalization of social opposition against neo-liberalism as a comprehensive strategy. Such generalization began with an 'Intergalactic meeting against neo-liberalism and for humanity' convened by the Zapatista movement in Mexico in June 1996. There followed global 'social fora' in Porto Alegre and Mumbai and corresponding assemblies in Europe (Florence, Paris and London) and other continents. Protests against American war policy were organized worldwide. In Europe large demonstrations have challenged the elitist and undemocratic organization of G7 or EU summits in Prague, Genoa and Evian. Alternative conferences are organized against the annual World Economic Forum. In several EU member states demonstrations and national strikes have been called against social cuts, dismantling of work protection and privatization of social security systems. None of this has stopped the

neo-liberal thrust or the main projects in the economic and social policies of the EU. But it has raised public consciousness and concern, and thus contributed to the politicization of the overall social climate. One result of this was the recent rejection of the Treaty on a Constitution for Europe in referenda in France and the Netherlands. It opens the perspective for a much broader public debate about the way in which the people of Europe wish to live together in peace, solidarity and welfare. This debate, together with strong, democratic and persistent social movements, is the basis for a turn in economic and social policies towards the construction of a progressive European Social Model.

25.5 Conclusion

In spite of its obvious economic weaknesses and the social regression for which it is responsible, the neo-liberal orientation continues to dominate economic and social strategy in the EU. To alter this course is difficult and requires the exploration of different approaches, of which three were briefly discussed. The first is based on growing realism about policy failures among firms and political leaders, realism which could lead to political modifications and compromises. The second could consist in progressive policy initiatives by a limited number of member states in the framework of enhanced cooperation. To give these initiatives a realistic prospect of success a shift in power relations is necessary, and to promote such a shift through the critique of neo-liberalism, resistance, protest and social movements are the third approach. Experience in the last few years suggests that progressive initiatives for enhanced cooperation are still absent, while discussions about pragmatic corrections have begun and the level of public critique and social movements against the neo-liberal agenda has risen. Progress is slow but it is real and it is possible to extend it.

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