CAN EUROPE DELIVER GROWTH?

THE SAPIR REPORT AND BEYOND *

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Abstract

In this critical appraisal of the SAPIR report of July 2003, we choose not to focus on the economic analysis provided in the Sapir Report - where we largely agree - or the analysis of governance questions and design at the EU level. Rather, we concentrate on the assignment, orientation and policy recommendations of the Report with the following question in mind: to what extent does the Report help to revitalize the growth debate in Europe? Unfortunately, the focus of the Report's recommendations is entirely on the EU level of policy and governance, whereas the motor of growth is very clearly being hindered at the Member State level. The present authors suggest that a number of coordination processes at the EU level are best regarded as 'dangerous liaisons'which are not really goal-oriented but instead ingeniously seem to serve to protect the actors' autonomously-decided positions. The Union is trapped in a low-growth equilibrium due to this deceptive construction and because in many policy areas relevant for growth, the EU cannot act without the explicit consent of the Member States, or it simply cannot act at all. Indeed, given the single market and EMU, Europe can only deliver growth at the Member States' level. We exemplify this point in a number of concrete policy areas.

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1. Introduction

The SAPIR report (Sapir et al., 2003) is important for Europe. The justification of and search for higher economic growth in the EU ought to be on the very top of the EU agenda everywhere. Offering a very rich and useful survey of many issues related to European growth, or indeed the lack of it, the report's analysis is insightful and should be compulsory reading for policy-makers and political leaders. Sapir et al.'s policy recommendations are numerous and rightly touch economic as well as institutional aspects at EU level.

Its status is therefore that of an agenda-setter. Unfortunately, this has perhaps been insufficiently appreciated. The timing of publication (17 July 2003) and the lingering fascination with the final package of the Convention (Part III and some technical revisions were handed over to the Italian presidency on the 20th of July) lowered the probability of appropriate and widespread attention. Limited as the reporting was at the outset, the media appetite for conflict has caused a one-sided emphasis on the Pavlovian reactions of (two) Commissioners objecting to a few conclusions, related to only one (i.e. the EU budget) of six sets of recommendations, solely in order to protect their turf (agriculture and cohesion). Little if any serious exposition of the analysis and strategic direction of the report has been provided in the press.

This neglect as well as the defensive reactions to just a few conclusions out of 33 recommendations are completely mistaken. Commission President Prodi was right in asking for this report from a group of well-known economists and a leading political scientist. Now that the report has finally begun to trickle down in EU policy circles, it may still accomplish what, in our view, is indispensable: to bring the growth debate back in Europe, established on a serious footing and based on solid analysis as well as policy options changing the status quo where necessary.

The following discussion will not focus on the economic analysis – where we largely agree – or the analysis of 'governance' questions and design at EU level. This is not to say that the lengthy treatment of many issues in the report could not be subjected to further scrutiny, but this should best be done on other occasions. Our appreciation of the analysis in the Sapir report is that it can serve as well as any other, if not better, as the basis for a policy debate. Therefore, it is more fruitful, for present purposes, to concentrate on the assignment, the orientation and the policy recommendations of the report in the light of a preponderant question: *How (much) does it help to revitalise Europe in securing a higher long-run growth path?*

The present Policy Briefing is therefore critical where desirable for EU growth, and supportive where growth is expected to be promoted by the Sapir recommendations.

The thrust of our critical remarks can be summarised at the outset. First, the report is largely barking up the wrong tree. This is due to the mandate and can neither be attributed to the authors nor to the principal (the Commission President). The focus of the recommendations is entirely on the EU level of policy and governance, and that is the lesser problem. The bigger problem is to be found at the member state level. Although the analysis recognises, sometimes explicitly and sometimes between the lines or by implication, the huge gap between what member states say (often, in an EU context as well) and what they do or fail to do, the policy options are almost silent about national strategies for growth. In particular, the member states' (in)capacities to reform and their lipservice rather than genuine commitment to deep and sustained investment in creating a (leading) knowledge economy are critical impediments to the Union achieving higher long-run economic growth. Second, the report deals extensively with market functioning, including labour markets, but refrains from sketching the microeconomic requirements for superior performance. One obvious reason is that, as far as labour markets are concerned, the member states and not the EU level determine whether and how (far) labour markets are to be reformed. Third, a more fundamental set of issues about market functioning in Europe remains virtually untouched in the Sapir report. They have to do with deeply engrained preferences and behavioural characteristics of Europeans today. Queries here include whether Europeans are and would like to remain risk-averters rather than risk-takers, whether Europeans are (still) entrepreneurial (compared to the past or to economic agents in other continents), whether Europeans still want higher economic growth given their current level of prosperity and realising the pains or adjustments which precede or accompany growth, and finally, whether today's inertia does not reflect an intergenerational conflict between the present and the future generations of Europeans (but with the future one not – yet in power).

Structure. The Policy Brief is structured as follows. First, we concur with the Sapir report in underlining that (sustainable) economic growth in Europe is and remains highly desirable for a series of compelling reasons. For well-off and reasonably satisfied Europeans of today, this message is critical. It must be taken seriously. Second, the manifold traps and difficulties when pursuing growth will be discussed. Warning how growth strategies can go wrong is perhaps as important as setting the growth priority in the first place. This diagnosis leads us to identify the central problem of a European growth strategy: too little at the member state level and too little acceptance of market functioning. Third, if the EU level has not delivered thus far, despite the single market and a solid EMU, it is because the Union's coordination fever has yielded little in the way of a growth dividend. Upon careful reading, the Sapir report is also critical of the coordination carousel but its language is guarded and, at times, abstract, if not (purposefully?) theoretical. The present authors suggest that a number of coordination processes at the EU level are best regarded as 'dangerous liaisons' which are not really goal-oriented – despite lip service paid – but ingeniously serve to protect the actors' autonomously-decided positions. The Union is trapped in this deceptive construction because in many policy areas relevant for growth, the EU cannot act at all or not without the explicit consent of the member states. Fourth, we will subsequently set out how Europe can grow again, the priorities being catch-up growth in Central Europe and Turkey as well as a credible strategy for the EU-15. Fifth, based on this perspective, the authors zoom in on the six sets of recommendations of the Sapir report, and discuss them critically. Sixth (and finally), we shall insist on a non-exhaustive list of operational questions that ought to be addressed if the EU is serious about a growth strategy.

2. Why growth in the EU-28 is desirable

There are four important reasons for the growth imperative. The first three are outlined and carefully argued in the Sapir report.[3] First, for the EU-15 as well as Central Europe with only a small delay, the sustainability of typically European varieties of the social model is at stake. The driving force here is ageing causing potentially difficult forms of intergenerational

[3] See Chapters 7, 8 and 4, respectively, of Sapir et al., 2003.

burden-sharing with respect to pensions and health care. It is already clear today that the present generation of adult Europeans finds it exceedingly hard to facilitate future burden-sharing. Steady and sustainable growth during the following decades will enable the European society to solve these questions without requiring excessively painful restraints on the future standard of living, and hence without the damaging political conflict to which it is bound to give rise.

Second, for the next two to three decades the new member states, including Romania, Bulgaria and Turkey, will require (sustained) catch-up growth. Although a focused cohesion policy is likely to help in the margin, and indeed also politically, the main determinants of such catch-up growth are found in the proper functioning of a deep internal market, a solid macroeconomic framework sensitive to some characteristics of these countries, especially in the first decade of their EU membership, and appropriate domestic development strategies in these 13 countries. Enlargement is about increased prosperity for acceding countries, which, in turn, is a win-win strategy for EU-28 as a whole.[4] There is no place anymore for ‘them’ and ‘us’ distinctions in national or EU politics: their growth must also be our priority.

Third, the EU-28 can only grow secularly if it exploits well, and adjusts flexibly to, globalisation. The Sapir report shows convincingly that even the big EU-25 or EU-28 will need a permanent capacity to change in a globalising world economy, in which trade in goods and services will further intensify and foreign direct investment, human resources, information and knowledge, new ideas and finance will tend to respond even more actively to opportunities and incentives. A refusal to accept or spearhead change will not only throttle the long-run growth rate – as such growth is the result of structural change – but, sooner or later, it risks being amplified by the relative unattractiveness to invest in Europe, do R&D in Europe, keep the brightest people here, produce competitive offerings for markets worldwide or exploit in a timely fashion our comparative advantages while shifting out of comparative-disadvantage sectors or segments of them.

A fourth reason, perhaps implicit in Sapir et al., is the zero-growth menace itself. Whereas politicians and opinion leaders all recognise that growth facilitates adjustment and lubricates redistributive politics, the obverse is too little discussed. The social and political costs of zero growth are likely to be very high indeed, and cumulative circular causation mechanisms might well render it extremely hard to escape from stagnation. Under zero growth the political capacity to deliver reforms is likely to shrink, which, in turn, will ossify structures and induce conduct that is precisely adverse to growth. This is true for individuals in an economic climate without prospects but no less for enterprises having to assume risks or seeking a competitive return on investment. Even minor redistributive claims may then become politically sensitive, let alone the resolution of the intergenerational conflict when a roughly constant labour force will have to support a steadily increasing group of old-timers. Even the relatively mild Japanese experience with 13 years of stagnation, be it at a high level of prosperity, is not enticing. Repeated efforts of ad-hoc pump priming the economy, without reforming in earnest, without shrinking the oversized building industry, without tackling the bureaucratisation, has left the country saddled with a public debt ratio far higher than any EU country, a loss of confidence in business and politics, a doubling of (the statistical) unemployment – not mentioning the hidden one – and a frustrated younger generation. The intergenerational problem, caused by the high debt ratio, begins to loom large in Japan, which is quickly ageing. Add to this the risk of deflation and the loss of its locomotive function in East Asia (increasingly taken over by China), having slowed down the recovery from the

[4] See Sapir et al. (2003) and Kok (2003).

Asian financial crisis. It should be realised that the wage-setting process in Japan is flexible compared to Europe due to the bonus system, a feature that has undoubtedly helped to smooth adjustment and keep unemployment at tolerable levels. A European Union trapped into low or zero growth will tend to raise domestic and European conflict, while its capacity to deliver effective policies and a predictable economic climate is bound to suffer.

3. On bad and fake growth strategies

A credible and effective growth strategy for Europe can only be derived from a proper diagnosis. The Sapir report is certainly an authoritative analysis of a number of structural weaknesses in the EU economy that hamper growth (though by no means are structural rigidities its sole focus – indeed, the report is far richer). Reading the report makes one realise once again that there is no ‘quick fix’. More particularly, economists are more and more convinced that the generation of growth and development cannot be easily ‘designed’, let alone predicted. William Easterly’s (2001) and Irma Adelman’s (2001) hard-hitting accounts of the numerous mistakes in the World Bank’s recommended or imposed policies for developing countries and the underlying analytical complexities (whether theoretical or empirical) attest to the difficulties in translating economic theory into sustainable growth strategies. These failures have left a deep imprint worldwide. Economists know far better what does not work or would backfire than writing recipes for growth over long periods of time. Long-run growth is a highly complicated process where markets, government policies but also economic institutions interact in so many ways that many national or regional varieties may emerge. Analytical work is mainly concerned with the economic fundamentals, be it with increasing attention for institutions and incentives. Design of strategy is therefore subject to considerable limitations, and any suggestion of specific dose/response elements of a long-run strategy would seem to have a very weak analytical basis at best.

Now that European politicians finally are alarmed by the lackluster performance of the European economy, two ‘easy’ ways out have recently emerged in the policy debate: ad-hoc measures such as cross-border infrastructural investment and the Lisbon strategy. The former is not the way Europe should approach long-run growth.[5] The latter will be discussed shortly. Furthermore, great confusion is caused by a myriad of other contributions to the debate, without an attempt to take the diagnosis seriously and to come up with an overall approach.

Table 1 provides a short-hand overview of bad, flawed or fake suggestions for a European growth strategy. The present authors trust that the reader will regard the table as food-for-thought as it will not be possible in this commentary on the Sapir report to engage in an extensive dialogue on all the propositions in the right-hand column. Some of them will be dealt with because they are crucial to appreciate the pitfalls of current EU approaches.

[5] This is not to say that such cross-border investments are necessarily flawed. They may be motivated by solid rationales related to the single market (missing links) or cohesion. The point is that they are too ad-hoc, piecemeal and isolated for a secular growth strategy.

Table 1. Avoiding bad or fake growth policies

No.	Remedies	Assessment	Why
1.	Via more (public) debt	Bad	Short term; likely only to raise the income level, not the growth rate; not sustainable; tax on future generations.
2.	Stimulate growth first, and reform later, i.e. praying for growth, while rejecting that the status quo is a hindrance	Flawed	Except for a short while via remedy no. 1, growth cannot be generated without reforms; only proper and deep reforms prompt a higher growth rate.
3.	*Luxembourg-minus* i.e. active labour policies (ALP) on the supply side, keeping rigid labour markets on the demand side (benefiting 'insiders' only), status quo in social protection, e.g. stringent employment protection measures discouraging flexibility, sticking to short working lives (early retirement) and high pensions	Flawed	Flawed if ALP not coupled with sufficient reforms on demand side. The four mentioned elements of the status quo (see left) can be bad for the proper functioning of labour and product markets, can harden the division between insiders and outsiders in labour markets, and can have adverse intergenerational effects on redistribution; the impediments on a structurally higher growth rate can be severe
4.	Via a 'magic' eEurope	Fake	The eEurope programme is welcome but, in and by itself, can at best improve ICT usage only very marginally; ICT usage tends to raise growth (as if it is a better 'production function') but it is largely driven by market incentives.
5.	Via 'swift' cross-border infrastructural investments	Fake	Short-term expenditure policy raises level barely or not the growth rate; implementation delays are considerable; social return on infrastructure controversial.
6.	Via EU-level 'coordination'	Fake	Not as it is today (see further).
7.	By emulating the US socio-economic model	No (socially undesirable)	Neither necessary nor desirable; however, selective lessons may be learned.
8.	By 'greening' GDP	Flawed (necessary, yet insufficient)	Internalising externalities and pursuing sustainability is key, but, in and by itself, does not address the European growth issue.

It is therefore crucial that the central problem of European growth is properly diagnosed so that both the broader framework of incentives and corrections as well as targeted policies can be effective in the longer run.

Searching for *major* policy or framework improvements at the *European* level, as constructed nowadays, is likely to be in vain. For present purposes, a stylised view of the EU economic system comprises four elements: two frameworks and two policies with particular relevance. For the EU-15 the framework of EMU consists of a deep and credible internal market (except for labour) and the world's toughest monetary constitution ensuring price stability. For Central Europe accession implies a vast and credible acquis, forming the basis for the internal market surrounded by low protection (except agriculture). Temporary derogations apart, this is an almost ideal ‘lock-in’ into well-tested European regulation and supervision about undistorted competition which should, and is widely expected to, deliver catch-up growth unless a country is manifestly trying to make a mockery of implementation. The CAP will initially be a (modest) drag on growth in Central Europe (keeping too many unproductive, marginal farmers too long on the land) but in the EU-15 it has become less of a problem due to lower distortions and to the minor contribution of subsidised agriculture to European GNP. Finally, EU cohesion policies via the EU budget might induce a tiny addition to growth in cohesion countries (although this is controversial among empirical economists, see e.g. Boldrin & Canova, 2003; Ederveen et al., 2002).

The European growth problem is therefore hardly due to the EU level of rules and policies, even though further improvements are certainly welcome. The central problem of Europe’s lackluster economic performance is to be found elsewhere: the level of government is the *member states*, alone or as a group, and the core issue is *better market functioning.* The Sapir report deals with some aspects of this central problem without always squarely addressing the delivery failures of a number of member states. It pays more attention to the deficiencies of ‘coordination’ where the member states act as a group, in particular the ‘open method of coordination’ in national employment policies, structural reforms, pensions and other domains. However, it carefully avoids specifying the delivery failures and their costs, couching the analysis in academic concepts. Having regard to the mandate of the High Level Study Group, this cannot be surprising. The mandate refers only to the EU level of policy making (‘the entire system of EU economic policies’). For a proper understanding of Europe’s growth deficit, it follows that the Sapir report should be discussed against the backdrop of what member states do and fail to do, first and foremost where they act together in the agreed European interest: economic coordination.

4. Dangerous liaisons: The European coordination carousel

Today’s EU economic coordination fever has yielded seven coordination processes,[6] not a single one of which existed before the Maastricht Treaty and four of which are new since Amsterdam (1997). As long as the accomplished macroeconomic stabilisation will be maintained, long-run growth is about microeconomic processes, hence Cardiff, Luxembourg, Lisbon and their reflection in the BEPGs. Although early in 2003 the multitude of (partly overlapping and time-consuming) coordination processes has been streamlined, all seven processes still exist. No serious questions were raised by the Commission about the nature, remit, participation or consequences of the implementation reports of any of these processes. Cardiff, Luxembourg and Lisbon are meant to be relevant for secular economic growth. The former two are based on the ‘open method of coordination’. The reasons for this soft but ingenious approach include that the subject matter typically falls under the competences of the member states (although positive effects are expected from working together) and that far-reaching diversity as well as legitimacy militate against a more centralising role of the EU level of government.

At first sight, Cardiff and Luxembourg, and indeed some other building blocks of the Lisbon process, look like an OECD-European style. The OECD has conducted detailed, authoritative comparisons of its members for as long as four decades. It also habitually engages in ‘bilateral

[6] Namely, the Stability and Growth Pact, the Eurogroup, the Cologne process, Cardiff, Luxembourg, Lisbon and the BEPGs (Basic Economic Policy Guidelines).

examination' exercises about the regular country reports. The OECD of course has (virtually) no independent powers and solely relies on solid analysis as well as intense exchange and mutual learning. After Maastricht and Amsterdam the idea of 'open coordination' was to upgrade and slightly 'harden' these experiences into a kind of OECD-plus, without giving up the autonomy of national economic policy-making in these areas. The most prominent difference with the OECD consists in the setting of *common goals* among EU member states so as to improve the functioning of its 'economic union'. Clearly, common goals are taboo in the OECD processes; indeed, it is neither necessary nor desirable for this organisation to fulfil its role to the satisfaction of its members. The credibility of the EU common goals was enhanced by the development of 'indicators' operationalising the goals for a certain time period. Measuring progress with properly chosen indicators should raise the effectiveness of the process by allowing feedbacks and corrections, while creating transparency for the public. Furthermore, the EU strongly emphasised benchmarking on the basis of 'best practices' (something the OECD may or may not do, depending on sensitivities), thereby hoping to uplift the quality of all national economic policies. Peer review goes beyond mere bilateral 'exams' since a failure to approach the goals (e.g. the indicators) or otherwise implement sloppily or not at all is allowed to lead to 'naming & shaming', banking on domestic politics and debate to prompt the right policy reversals.

Without denying that policy learning does take place and that member states are less unwilling to experiment with approaches that, in other member states, have proven effective, it is becoming more and more evident that 'open coordination' is not a panacea for badly needed policy reform, let alone for raising the long-term growth rate in the EU.

Upon close reading of the Sapir report this conclusion is supported. Among the many reasons why such coordination hardly works – or perhaps is not allowed to deliver – one should mention the almost total disinterest for Cardiff or Luxembourg in domestic politics of the member states, the unclear function of the implementation reports, the relatively uncontroversial nature of the relevant sections of the BEPGs (which implies that the long-standing OECD practice of 'negotiating' critical remarks on a country has crept into EU coordination as well) and the lack of 'hard' powers anywhere in the process. As to the latter, it is characteristic that the Lisbon process has thus far worked better for those elements that are part of (or closely linked to) the internal market, where powers are strong and have a bite. For the pure instances of 'open coordination' the experience to date has been disappointing. Yet, it is the proper functioning of the multi-tier economic union that will have to facilitate a higher economic growth path for the Union. At the national tier, a good mix of economic coordination and policy competition (within the regulatory boundaries of the internal market) is essential for achieving this. With 'open coordination' failing, the EU seems caught between *too little* centralisation and the costly and unattractive alternative of *too much* centralisation, with its problems of legitimacy and the challenge of responding to local diversity and consensual problem-solving. The Sapir report analogue of this inference is their view that the Union might be forced into what they call "corner solutions" which would imply a drastic change in the political landscape of the Union.

Let us elaborate the discussion on coordination with a view of raising economic growth by going into a little detail for two aspects: first, an illustrative list of what the EU level cannot or not sufficiently do; second, providing a few critical remarks on the pitfalls of today's coordination carousel.

As to the first point, the reader should consider that the EU level cannot:

- alter national EPL (employment protection legislation) or early retirement,
- liberalise (seriously) cross-border labour mobility,
- go for minimum standards in higher education,
- coordinate (fragmented and often protected/duplicative) national R&D,
- improve incentives for risk-taking,
- take fiscal measures for growth (revenue-based),[7]
- reform domestic markets (if not part of the internal market acquis) or
- use a central budget for well-justified growth enhancing expenditures.

We do not want to be misunderstood. The list is not a plea to centralize such competences or even some of them. The point is that member states cannot have it both ways: a 'njet' to any form of centralisation, yet at the same time hardly getting beyond the OECD in terms of results, through coordination, behind the smokescreen of a permanent carousel of meetings and ever more elaborate BEPGs.

As to the second point, we provide a selection of criticisms that are not, or only after a painstaking exegesis of a conceptual analysis,[8] to be found in the Sapir report. The sources for this selection consist of a mixture of the emerging literature[9] and our subjective views distilled from conferences on 'EU economic governance'. Our list of criticisms is reproduced in Table 2.

Table 2. Dangerous liaisons: the pitfalls of EU economic coordination

Luxembourg process
- Not really an employment strategy
- Controlled, if not throttled, by vested interests (tripartite)
- Hence, several paralysing taboos (e.g. labour market flexibility)
- Hardly any domestic political resonance
- No sanctions of whatever kind

Cardiff process
- Fragile basis (no legal basis, no implementation reports)
- Few if any process incentives for domestic (structural) reforms
- Little transparency
- No domestic political resonance at all

Lisbon process
- Goal too nebulous and too distant, without a clear, focused programme
- Credibility has fallen to a dangerously low level
- Overload of objectives, domains, indicators, without 'ownership'
- Some domestic resonance in cases of extreme performance failure

BEPGs
- Political leaders set BEPGs, without 'ownership' or changing priorities
- Few if any domestic (e.g. parliamentary) debates on BEPGs
- Language of BEPGs often lacks verifiability (non-actionable)
- Implementation reports attract little attention for microeconomic issues

[7] The EU cannot levy taxes, and hence cannot take fiscal measures; the EU level has no say on the structure of national taxes.

[8] Note: in Chapter 6 of the Sapir report.

[9] See e.g. Pelkmans & de Souza (2004); Begg (2002); Wessels & Linssenmann (2002); TEPSA (2003) and WRR (2003).

Box 1. EU labour markets: Employment protection and active policies

For over two decades, rigid labour markets have been cited as one of the overarching obstacles to growth in Europe, and yet, in several large EU countries and a few smaller ones, surprisingly little has been done to improve the situation. Social measures imposed to buffer the welfare costs of the two oil shocks have often hardened with time, petrified by a policy preference for maintaining the same level of protection when confronted with worsening labour market outcomes. That member states are very reluctant to introduce flexibility into their labour markets, both unilaterally and through the open method of coordination, does not portend well either for a better functioning of the single market or for growth. With respect to the Lisbon objectives, we argue that the selection of an ambitious aim (becoming the world's most competitive economy by 2010), without measurable progress on the necessary dynamics of adjustment, is not serious.

Abundant in rhetoric that emphasises such noble goals as full employment, social cohesion, inclusion and quality of work, the Employment Guidelines (EGs) have less to offer in terms of hard proposals. Even the recommendations of the Council, when a member state is judged to be out of sync with the common objectives, are vague. In the absence of specific provisions, no pressure can be exercised to enforce change, and member states are free to continue their current policy course, perhaps with a little window-dressing. A brief glance at the latest EGs will betray the bias towards active labour policies (ALPs), thereby not granting sufficient attention to restructuring. It is important to note that we support ALPs. (Indeed, the IMF in two recent studies recognises that they may have some beneficial aspects – see Estavão, 2003 and Estavão & Nargis, 2002). We also do not want to give the impression that coordination only yields watered-down proposals. There are concrete examples to the contrary.[10] Rather, what we are suggesting is that if active labour market policies are seen as a substitute for, rather than as a complement to, necessary structural reforms, they are an ineffective way to raise employment levels. Ideally, labour market reforms on the demand- and supply-side ought to be seen as complements.

Unfortunately, there is ample evidence within the EU that points to a substitution effect between ALPs and employment protection legislation (EPL). As many governments have amplified initiatives on active policies, EPL reform stagnated. Worse yet, it has regressed in certain member states. The paradoxical result that there is a seeming improvement for EU countries in the OECD employment rankings merely reflects, according to David Young (2003), the liberalisation of temporary contracts between the late 1980s and 1990s, and not politically costly reforms to reduce the power of 'insiders'.

While we appreciate that the overall empirical record on the costs versus the benefits of employment protection legislation is mixed, we agree with Young's assessment that in the EU, the legal constraints binding employers are overbearing. Young cites good theoretical reasons to reduce excessive rigidities in hiring and firing:

- Stringent EPL is not consonant with a rapid pace of technological innovation and organisational changes, where turnover is high and restructuring frequent.
- 'Insiders' are choking the wage-bargaining process, causing bottlenecks in employment creation and a continued marginalisation of non-union workers.
- 'Liberalisation at the margin', that is, liberalisation of temporary contracts without reducing overly protective measures for the permanently employed is a tactic of escaping reform.
- Significant deadweight losses arise from excessively constraining bureaucratic procedures and legal expenses related to layoffs.

[10] One example of a concrete and reachable target is the proposal in the latest Employment Guidelines to put into place measures ensuring that by 2005, job-seekers throughout the EU will be able to consult the vacancies advertised through national employment agencies.

However, there are signs that change may be slowly occurring. Germany's Article IV consultation with the IMF went significantly better than expected, not least because the current government seems to be (finally) getting serious on reform. In a comprehensive package entitled Agenda 2010, the Schröder government has introduced wide-ranging reform proposals. These include: reforms in public sector remuneration, so that the Länder can apply differentiated pay scales for their employees and are free to negotiate significant wage cutbacks; merging unemployment assistance with social assistance, introducing greater flexibility since social assistance is less generous than unemployment assistance; limiting the duration of benefits to 12 months for all unemployed except those of age 55 and above (they get 18 months); reduction and clarification of firing criteria, lowering legal costs associated with lawsuits; and finally, continued product market liberalisation by reducing the restriction on shop-opening hours is an important complementary reform spurring greater labour market flexibility.

The resistance to reform in national industrial relations in the Union is deep. Consensual approaches do not necessarily help, not even in a country widely respected for its consensual social model. Gelauff and Pomp (2000, p. 424) found: "… that in the Netherlands reforms that weaken the position of insiders were opposed by the unions. This is confirmed in all four countries included in the comparison. This suggests that it is pointless to try to lure the social partners into cooperating in such reforms. Indeed, such attempts may be time-consuming, leading to costly delays in the reform process."

The Social Partners are unelected bodies with privileged access to the decision-making process. They claim to speak in the name of all, whereas in reality they only represent the interest of a few. It would be naïve to think that their inputs in the Luxembourg process, hence for the Employment Guidelines, are not coloured to some extent by their respective agendas. This explains why (demand side) labour market reforms are not a pillar in the Luxembourg process, although they are critical, whereas fancy work on 'entrepreneurialism' (and this in tri-partite committees, with analysts!) can constitute a pointless form of distraction. Also, the wage-setting process is hardly or not discussed in the process although there is solid empirical economic evidence that regional alignment of wages with local productivity in particular would significantly reduce unemployment precisely where it is highest. This conclusion is largely taboo as it represents a radical break with national wage-setting processes, precisely because labour unions insist on 'solidarity' or equality. National reform resistance as well as the Luxembourg process prevent a cut in unemployment, resulting from reforms such that wages could be differentiated with a view to reflect regional and sectoral productivity disparities.

To conclude, neither the Union nor a selection of member states pays sufficient attention to deep-seated structural reforms in labour markets. This is one major reason for the (deliberate) weakness of the peer review process of Article 128, EC. Our appraisal is that priority ought to be given to introducing flexibility on the demand-side for labour and the wage-setting process, reducing ALPs to the secondary role of buttressing the former.

Combining the Sapir report analysis and Table 2 makes it abundantly clear that the coordination in the economic union is poorly designed to be effective. Economic growth is not generated by talking and writing reports. Worst of all, the member states first and foremost control the process and its (non-) transparency, and subsequently ignore it almost fully at the level of domestic politics where reforms will have to be accepted and implemented. In the Luxembourg process, the situation is more worrying still. Its creation was a puzzle to many economists since employment has long been one of the objectives of the Union, and explicitly so since the Maastricht Treaty. Besides mutual learning about 'active labour policies' for the structurally unemployed and systematic attention to skill enhancement of the labour force (see Box 1), it is exceedingly hard to discover any value-added of the Luxembourg process. Indeed, one gets the strong impression of a self-interested circuit of Social Affairs ministers, labour unions, employers and social policy analysts, building consensus by excluding all the hard mechanisms and queries about the badly functioning labour markets in the EU. One should realise that national labour markets in the Union are relatively isolated (since languages and close family ties naturally reduce cross-border labour flows, and an array of restrictions, fiscal uncertainties and the EU principle of 'host country control' further limit the residual cross-border mobility to a trickle). What this means is that – unlike in goods, services and capital markets – policy competition between member states hardly works! A good labour market policy in member state A, leading to low unemployment and a relatively robust adjustment capacity, has virtually no effect on member state B, no matter how 'bad' its own policies and regulations are. Given this insulation from policy competition, the Luxembourg process can enjoy a focus on consensual issues and avoid all the conflictual ones. It can also afford to call 'entrepreneurship' (one of its four pillars) a form of employment policy (sic!). The upshot is that the examples set by a number of smaller economies in reducing their unemployment have no more effect than they would have in the OECD: reporting on better practices without any impact for the 'outsiders' in the badly functioning labour markets of the EU. The slow and excessively costly way out is for those member states, notably some of the big ones, to drift into a domestic crisis forcing electoral shifts and eventually hard-won (yet marginal) reforms.

5. How Europe can grow again

The EU-25 or better still the EU-28 can grow again – if it wants to. In the larger Union two priorities must be set: the new member states or acceding countries have to turn into 'growth dynamos' and the EU-15 has to devise a credible growth strategy. Clearly, both priorities interact positively. The Sapir report (by mandate) focuses only on the second priority.

This is not the place to provide an analysis of the determinants of long-run catch-up growth of Central Europe and Turkey. But a few points are in order, if only because there is still a lingering ambiguity in the Union about the economic impact of enlargement[11] and a climate of uncertainty in the acceding countries about their prospects for real convergence in a real time-span. In the confusing mix of good and negative news about accession countries which is poured into the media every week, the central messages tend to get lost. For the purposes of this policy brief, there are two messages. First, Central European accession countries as well as Romania and Bulgaria are (all) consistently growing since 2000 and generally (much) faster than the EU-15. The sharp fall in the Polish real growth rate to a little over 1% in 2001 and 2002 was the exception and the country is beginning to catch up again. Despite the recession in their dominant export market, the EU-15, the Commission's spring 2003 forecasts for the acceding countries amounts to 3.1% and for Romania and Bulgaria over 4.5% for 2004, the weighted average amounts to 4% for the new member states and 5% for Romania and Bulgaria. Also Turkey improves to 4.5% in 2004. Both UNCTAD (2003) and the EBRD (2003) expect strong surges of FDI inflows now that growth in Central Europe seems to demonstrate that transition is definitely over so that EU membership can pay off, just as it did immediately after Spanish and Portuguese entrance into the Union.

Secondly, long-run catch-up growth is entirely possible for Central Europe and Turkey and there is every reason to welcome EU membership as a set of exceptionally strong incentives to further growth. This message contrasts with the ambivalence of some vested interests or the frictions about the last hurdles of transposition of the acquis or the doubts about implementation. Indeed, there is nothing wrong with a tough attitude on the acquis and on implementation, but in the final analysis these warnings are about instruments, not about goals and results. *If enlargement is about prosperity – and it is – what really matters for its*

[11] See Kok (2003).

success is to turn Central Europe into growth dynamos. Here the news is quite good and probably will get better soon. For the long-run, catch-up growth depends essentially on five factors: i) market functioning (incentives and competition) and openness; ii) initial income gap; iii) macroeconomic stability and predictability; iv) solid basic policies (e.g. education, etc.) and reliable economic institutions (for trust, risk-taking, specialisation, enforcement and e.g. FDI); and v) no 'policy reversals'. Pre-accession and EU membership should greatly help (i), (iii) and (v) and to some extent (iv). In this perspective, the tough pre-accession approach might be hegemonial but it is definitely benign and in the common interest of the two 'parties'. Looking back to previous accessions with less prosperous countries, real convergence is the factual trend of the past. However, the combination of bad domestic policies (including a systematic lack of serious implementation of the acquis) and a weak EU response to negative cross-border externalities they might cause or to outright underperformance despite coordination and agreed cohesion programmes, *can* break the trend of convergence. Today's EMU and tougher monitoring of implementation would seem to render it more unlikely that the case of Greece, underperforming formally and substantially in the 1980s and the early 1990s, would be tolerated again – and rightly so. Generating growth dynamos in Central Europe is just as much in the interest of the EU-15: there is no better cohesion policy, and the funds, even if welcome, are not central to it.

The second priority is a credible growth agenda for the EU-15. Anybody interested in European growth issues ought to study the Sapir report carefully. The present authors wish to be clear about their support of many of its recommendations. Nevertheless, our contention is that there is too little that has more than a marginal impact, it seems at times too apolitical, and – as noted – the member states escape from hearing the basic message to change their attitude radically.

Essentially, the premises of the Sapir report rest on two pillars: microeconomic reforms have overriding priority, and member states must develop a sense of 'shared ownership'. It is not so clear, however, that these premises are reflected in the six packages of recommendations of the European agenda to which we now turn. Before listing and discussing those, we note that the member states disappear from the 'agenda' because the mandate of President Prodi does not cover them. This most unfortunate limitation might be caused by the example of the Padoa-Schioppa report of 1987, which inspired the High Level Study Group: the 'systemic' economic implications of 'EC-1992' for Padoa-Schioppa et al. did not require a focus on the member states. In the economic union, however, the core problem is precisely that joint policy-making or coordination ought to be accomplished, *even though* member states are often competent in the relevant areas.

The contradiction in the report is best illustrated by the view the Sapir group develops on microeconomic mechanisms of change which find, at best, a weak echo in the recommendations. Yet, it is precisely in stronger incentives and flexible response possibilities in markets, firms and (e.g.) education that sources of growth can be found. The report identifies six essential microeconomic changes or reforms which the present authors would readily agree with. They include: 1) new organisational forms of production of goods and services; 2) less vertically integrated firms; 3) greater mobility of (human) resources within and between firms; 4) greater flexibility of labour markets; 5) greater reliance on market finance; and 6) higher investment in both R&D (corporate and public, hence, the incentives for them must be improved) and higher education. In future EU and national policy-thinking, these reflections of the Sapir report should not be missed out, even if they are hard to trace in the recommendations.

6. Discussing the Sapir recommendations

The report has six clusters of recommendations. We shall select or group the main ideas and provide brief comments or queries for each cluster.

6.1 Make the single market more dynamic

This cluster is rightly given the first priority. As Sapir et al. say (p. 127): “A dynamic single market is the keystone to Europe’s economic growth”. The problem is to get the member states to act according to this insight. However, the state of the internal market for services, subject to free movement (including mutual recognition), demonstrates the very opposite: local rules and far-reaching discretion by all kinds of authorities, if not violation of mutual recognition, throttle cross-border initiatives and competitive rivalry or dynamism. The slow liberalisation of network industries and the agonising problems of the EU patent, to mention two other examples, form a brake on potential growth; besides, compromises in these fields are unnecessarily costly due to a refusal of (enough) member states to take bolder steps for growth. Also, the Sapir group backs the Risk Capital Action plan (so do we), but the deeper issue of risk-taking in Europe ought to be addressed. How many venture capital funds in Europe dare to fund promising new technologies very early in their applied R&D phase (e.g. nano technologies; hydrogen or biotechnology) – something widespread in the US?

A few specific comments are in order:

i. The impact assessment on new EU regulation should incorporate, according to Sapir, a test on the effects on ‘entry’, with a view to innovation and the pro-competitive effects of actual entry. Indeed, there is a risk that the strong emphasis on ‘consultation’ in the 'Brussels circuit leads to ‘capture’ of regulators by what is euphemistically called ‘stakeholders’. Such a test could be a sensible check against a hidden or de facto increase of the barriers-to-entry. Although the report (p. 130) does not explicitly mention this, what is referred to is a subtle instance of raising such barriers, namely, via ‘raising rivals’ costs’.[12] Incumbents might agree to greater intensity of (EU) regulation because not only would it raise their costs but also those of potential entrants, and, in the margin, render it more difficult to recuperate the sunk costs of entry increased by higher standards, or in other ways; it might imply as well that the cost differential with the entrants becomes *relatively* small which tends to reduce the competitive effect of entry. The report does not discuss the very recent experiments of the Commission with regulatory impact assessment (RIA) and hence does not give any clue how to incorporate such an ‘entry test’ into RIAs.

ii. The emphasis on innovation and entry is carried over to competition policy: “Thus, when defining markets and assessing dominance, market dynamics and potential competition, in particular the potential for competition from the newly-innovating needs to be taken into account”(p. 130). However, it is entirely possible to agree with this remark and, yet, being sceptical about the actual implementation, be it for reasons of legal certainty (the ECJ is very critical when it comes to assertions about future conduct) or sufficient knowledge of the Commission (when experts will typically be divided into opposing camps in such cases).

iii. The recommendation on “major infrastructure for connecting up the broader European economy…” (p. 132) is neither based on analysis nor is it elaborated upon in the slightest way. The core problem here is the violation of the principle of subsidiarity. Subsidiarity is

[12] See Salop & Scheffman (1983 and 1987)

a functional assignment principle. Public functions (in this case a power to deal with cross-border infrastructure) can be assigned to the national or the EU level or both. The treaty's subsidiarity protocol is clear on the premise that the starting point is to keep powers at the national level unless the EU can do better due to scale and/or 'effects' (cross-border spill-overs). Thus, subsidiarity is a *two-way* principle: too much (unjustified) centralisation is suboptimal but so is the unjustified attachment to a national competence that is ineffective in reaching a commonly agreed goal or that is excessively slow and costly compared to an EU competence. The test in the protocol is specifically meant to apply to 'shared powers', both EU and national. Infrastructure (in the form of TENs, the trans-European networks) is formally a shared power but the EU power in the treaty is slight and merely 'facilitating' in a soft way. The central point we make is that the division of powers on cross-border infrastructure is wrong in the EU. The costs of a lopsided assignment almost entirely to member states – and a total taboo at EU level before Maastricht – have been and still are very high, be it for the patchwork of 'national' railways, the great inhibitions of member states to invest in true transit systems of motorways with a European network in mind, the cross-border interconnectors in electricity or air traffic control networks. Let us briefly set out the reasoning that a functional application of subsidiarity requires, hence, showing by implication why the principle of subsidiarity is violated. The 'need to act in common' is very strong for cross-border infrastructure (since cross-border externalities are, by definition, a bilateral but often a European network issue) and bilateral cooperation is necessarily inappropriate in those cases where 'missing links' ought to be identified in a *European* (transit and network) perspective. Therefore, a subsidiarity test would conclude that cross-border infrastructure ought to be an EU competence, with safeguards for environmental and local interests, and allowing bilateral solutions where relevant. However, after 45 years of European economic integration this is still not the case and the draft constitution only implies weak progress in this respect. Given the network effects a substantial EU budgetary contribution would be justified as SAPIR at al. note as well. The national sensitivities have thus far had a paralysing impact: design and finance of TENs are too decentralised and suboptimal due to heavy and narrow-minded politicisation. The Commission's new 'European initiative for growth'[13] should, in our view, be assessed from this angle. This means that it is not so much a 'growth initiative' – at best, perhaps for the short run, which is not the issue except for electoral politics. Common infrastructure belongs to the framework of the internal market just as much as rules and liberalisation do, with one difference: the better infrastructure is and the higher its quality (e.g. seamless interconnection), the higher the level of prosperity that can be generated in the single market for the same set of rules (and other things kept equal). Thus, it is a prerequisite for growth, and today's suboptimal approach (with frustrating congestion which rapidly increases, with missing links and with sometimes unacceptable external costs) will soon begin to throttle EU growth. With long lead times and no willingness to accept a functional solution to subsidiarity (that is, more centralisation), what we witness is a refusal to facilitate long-run growth in the Union.

iv. The recommendations on cross-border labour mobility are very welcome. For decades member states and the Commission have looked the other way when the so-called free movement of workers was actively and passively frustrated, and the few daring workers who did migrate usually paid unforeseen and disproportional costs. Only 33 years after the

[13] See European Commission (2003).

free movement of workers was formally achieved,[14] a first, shy attempt to overcome or remove barriers was initiated. The Veil report (1997) on frontier workers, far too little protected by EU laws, forms another demonstration of the 'fortress' character of national labour markets and welfare states. The Sapir report wants "non-transferability or non-compatibility of acquired rights in terms of basic provisions for health, pensions and unemployment … to be removed" (p. 131). It strongly favours a liberal attitude of active (and of course free) migration between the new member states and the EU-15. We concur, in that this will generate considerable economic benefits and strengthen cohesion as well.

6.2 Boosting investment in knowledge

Europe invests too little and inefficiently in higher education and research. Part of the problem is with the private sector and this ought to be emphasised. The Sapir report (rightly) takes a harsh view of European practices in many specialisations and universities. We agree that reform of European education has to be profound and that mobility as well as competition in research must become well-accepted principles. This should be combined with a series of quality guarantees and openness (often lacking in university education, where some quite hidden 'protection' has lingered).

Two specific comments:

i. The report advocates the creation of an independent European Agency for Science and Research (EASR) so as to stimulate rigour and independence in appraisals. This proposal is interesting because it avoids the *juste retour* curse of European R&D funding and, because it is based on a 'bottom-up' philosophy, gets around a drawback of centralisation. The focus on EU-level research causes the Sapir group to ignore a bigger problem, however, namely, the (duplicative) waste and (often) avoidance of excellence in national R&D. The Commission only funds some 5%-6% of all European public R&D outlays, and there is no coordination of national efforts. Some duplication may be beneficial in terms of competition, but the strong impression (for many years) is that a proper combination of coordination and competition would yield much higher quality due to specialisation and a push for excellence. The EASR proposal is silent on this. National R&D is sacrosanct and taboo at EU level, yet, at the same time everybody nowadays laments that 'European' R&D is far too low and too ineffective. Well, the overwhelming share of this total originates in the member states and acceptance of the taboo will mean a ban on greater effectiveness. Perhaps the EASR could be given a role here for, say, 50% of the outlays, beginning on a voluntary basis, hopefully acquiring rapid recognition on the basis of quality criteria.

ii. The report advocates tax credits to encourage private research investments, especially for start-ups. Unfortunately, this suggestion does not result from its analysis nor is it elaborated in any way. In future work it is critical to obtain a clear and authoritative view of why it is that European business spends so little on R&D, compared to the US or Japan. This isolated suggestion on tax credits might then deserve a place in a wider approach.

6.3 Improving EMU's macroeconomic policy framework

This section of the recommendations, and the underlying analysis in Chapter 4, is worth reading. Two points must be stressed. First, the proper macroeconomic framework for the

[14] See European Commission (2001).

Union does not represent a true growth policy, although the lack of it can hamper growth significantly. Second, the Sapir group firmly rejects the assertion that the Stability and Growth Pact somehow would be an anti-growth package. We have little to add. Their six suggestions on the Pact go further than the Convention has dared to do. A seemingly minor point is to be highlighted. In order to enhance 'ownership' by the member states, the report advocates a European and a national semester in national budgetary processes (p. 145). This would lead to explicit domestic political agreement on European guidelines and constraints, on the basis of which the domestic elaboration of national budgets can be started.

6.4 Convergence and restructuring in an enlarged EU

The Sapir report envisages an overhaul of the EU funds. It advocates a convergence fund and a restructuring fund. The convergence fund should only be allocated to (low-income) countries, not regions. The arguments for this approach are convincing: richer countries having one 'poor' region obtain transfers due to *juste retour* considerations, the effectiveness of transfers is reduced by a lack of concentration and money (from net payers) is needlessly pumped around causing a lot of cohesion bureaucracy for no good reason. In the EU-15 a focus on countries rather than regions would immediately avoid some 40% of transfers. It is not difficult to agree with the offered advice on institution-building in the new member states, the emphasis on human capital and the avoidance of 'crowding out' due to principles such as additionality, multi-annual programming and (limited) co-financing (for ownership). The virtue of the Sapir advice has to do with the fact that the advocates in the Council of Ministers of the countries-only approach are net-payers (e.g. the UK, the Netherlands, and Germany). Their credibility in advocating this reform is reduced by their political positioning obsessed by net payments, as if there is little more to EU integration. In contrast, the report provides a detached support to reform, and Commissioner Barnier – rather than being so swift in trying to crush the report politically, one day after it appeared – should take up its suggestion.

The restructuring fund would serve as a complement to national funds for e.g. displaced workers. Instruments would include retraining, help with industrial relocation or assistance when setting up a new firm. Some of this would appear to be very similar to today's Social Fund (however, we entertain great doubts whether most of the Social Fund's activities would pass a functional subsidiarity test, quite apart from effectiveness indicators). The remainder might well be problematic as there is bound to be a thin line between aid with industrial relocation and distortion of competition. Other difficulties (and adverse selection) can be suspected for assistance when setting up firms in poor regions. Where one can support this new fund is its role in the agricultural sector where the need is beyond any doubt in many cohesion countries in the EU-25, a far better suggestion than the ill-focused collection of what has come to be called 'rural policy'.

6.5 Effective EU governance

Like anybody having to address this intricate question, the Sapir group has struggled with the EU governance issue. The question is so hard because clear-cut solutions are rarely politically feasible on the sensitive interface between the EU level and that of the member states, let alone what the report calls "corner solutions". The term refers to two relatively unambiguous governance methods of the EU, namely, "delegation" by member states to the EU level (centralisation) and to its opposite, namely, "autonomy" of the member states. The two intermediate methods, analysed at length in Chapter 6 of the report, are "commitment" by the member states and "coordination". Whereas Chapter 6 carefully avoids the term "corner solution" and demonstrates (also) the great complexity of, if not confusion in, the EU economic governance system as recently developed, the summary in Chapter 1 (p. 4) sets out the fear of the Sapir group that the EU is drifting towards corner solutions that will likely increase friction and bottlenecks rather than solutions, simply because the two intermediate methods do not work or are not credible. In any event, their recommendations section on effective governance is far more clear and straightforward than the analysis in their Chapter 6. We agree with most of them.

In the final analysis, however, what matters is whether these recommendations are significant for an EU growth strategy. More precisely, how critical are *European Union* institutions for higher long-run growth in Europe? The answer is that, given the deep and wide internal market (and the economic institutions that ensure its proper functioning) and EMU (and its solid monetary set-up), the further improvements desirable at the EU level are relatively modest. In so far as the E of EMU[15] is to be given a policy meaning for growth, the focus ought to be on the member states acting jointly in 'coordination'. But Europe's long-run growth efforts will largely have to emerge at the *national* level, even if (or, precisely because) coordination works!

A second question is that of timing. The Convention would have been an ideal occasion to introduce some of the proposals of the Sapir group. The authority of and the analysis by the group might have impressed the Convention members as a non-political contribution that deserved a follow-up. This opportunity is now foregone.

Both our queries may well reduce the impact of this institutional section for any EU growth strategy. A few specific remarks:

i. The Sapir report advocates selected delegation of regulatory powers to independent agencies on the condition of precise mandates. We strongly support this idea which finds more and more backing among EU scholars. The Commission has traditionally been hiding behind the 1958 Meroni doctrine,[16] which is completely outdated given the tasks of the Union and the experiences of many countries, including federal ones. In any event, even if one were to stand by the Meroni doctrine, why was a simple legal basis (with unanimity) for independent agencies not proposed during the Convention? The details of Meroni cannot be discussed here but one illogical (and costly) consequence is, for example, that everywhere in the world, and indeed in member states of the Union, independent regulators are vested with powers to ensure sufficient competition in network markets once liberalised, and yet the even more complicated Union market for network industries – if anything, more in need of such a clear regulatory authority – has to make do with partial and complicated second-best solutions because a European regulator is *per se* out of the question! The upshot is that, despite the liberalisation, there is still no

[15] The E of EMU refers to 'economic union', often used in everyday Eurospeak but not defined in the EC Treaty. See Pelkmans (2001, pp. 351–355) for elaboration. Besides the internal market, in the widest sense, and cohesion, this includes the hard and softer economic coordination processes.

[16] The Meroni doctrine refers to a 1958 ECJ ruling. The doctrine is derived from the idea that the (Rome) treaty is and remains an international treaty. This must mean that member states delegate (some of their) powers to the EU level and that such powers are not 'vested' in the EU institutions (e.g. the Commission) themselves. If that is so, then the Commission or the EU level cannot create 'independent' regulatory agencies as it cannot (fully) delegate authority it received itself from the member states. Therefore, an independent agency at EU level must be created, every time again, by amending the treaty. Alternatively, member states could agree to include a legal basis in the treaty and act, case by case, on the basis of this clause, without the tremendous barrier of treaty revision.

functioning internal market in network industries; the liberalisation is a patchwork of national attempts, with distorted and incomplete cross-border competition.

ii. Where decentralised implementation of regulatory policies is at stake, the report argues for steered networks and partnerships of national bodies. This is the way the Union is already going. The query then is: how relevant is this for growth?

iii. The group advocates that risk assessment and risk management be combined under the same authority as is the case (now) for food and medicines. However, this seems to be the direction already taken for rail and air transport. Moreover, the query is: how key is this for growth?

iv. According to the report, the Open Method of Coordination (OMC) should only be applied in areas where there is no alternative. It remains unclear what this means: more centralisation? The recommendation speaks of "…stronger EU involvement … such as incentive-financing and Community method." (p. 161). The areas mentioned for an EU-supporting role only (p. 156) are: labour markets, taxation and welfare, education, innovation and R&D. It would be unfair to dismiss these suggestions as this is a tricky twilight zone between the two levels of government. Nevertheless, the recent experience in these six areas – partly reflected in the Lisbon agenda – is disappointing and the empirical analysis of Sapir et al. only confirms that. It seems entirely reasonable to request a firmer judgement and more effective solutions for the sake of higher EU growth than these proposals imply.

v. SAPIR et al. address the 'strategic capabilities' of the EU institutions, the Commission first of all. They argue for a growth Commissioner and a more strategic role of the Competitiveness Council, backed up by a strengthened Economic Policy Committee. In fact, they seek to give growth the same prominence as macroeconomic stability. Such ideas might work. The question is, however, whether the manifold weaknesses of the Lisbon strategy would be overcome with these suggestions. Table 3, taken from the Sapir report, juxtaposes the Lisbon and internal market strategies and the sharp contrast between the two is telling.

Table 3. A tale of two strategies: The Single Market and Lisbon compared

	Single Market	**Lisbon**
Ultimate aim	Integration and growth	Growth, social cohesion, employment
Intermediate objectives	Cuts on cost of cross-border transactions for products and services	Advances in education and innovation Increase in R&D spending Liberalisation of service industries Increase in labour force participation and employment rates Etc.
Means	Elimination of border controls Harmonisation and approximation of laws	Definition of common targets Performance reporting and benchmarking Joint monitoring
Instruments	EU directives Enforcement by case law of courts	Mostly national (spending, taxation, regulation)

Source: Sapir et al. (2003, Table 6.5, p.85).

Strategies need more than (too) weak commitments and a more sensible internal organisation in EU institutions. Lisbon looks structurally fragile. The agenda overload (outside the Competitiveness Council, one would still need the Social and Environment Councils), the open-ended and soft nature of OMC, the lack of (political) 'ownership' of the member states would not be resolved by a better strategic capability. Furthermore, the Competitiveness Council merges very different activities and the Brussels circuit laments at length about its functioning (especially, with respect to the internal market).

6.6 Mobilising the EU budget

Among the better parts of the report are the recommendations on the EU budget. They are sufficiently radical to make a difference, they are refreshing and inspiring as well as economically sensible. Nonetheless, before discussing them one has to point to two drawbacks. First, the EU budget is tiny and can never be a major driver of EU growth. Of course, Sapir et al. realise this very well. Second, despite its small size (indeed, relatively shrinking now for some ten years) the EU budget is highly politicised, even if the multi-annual framework has greatly facilitated the operation *during* the six or seven years of a framework. Within days of the publication of the report, the Commissioners of Agriculture and of Cohesion condemned the recommendations, in particular on the budget. Clearly, their disagreement is a pure case of protection of turf and/or power, rather than the outcome of a reflection on what would be best for EU growth in the longer run. Since the Union's public interest is captured in the latter, a reform of the budget should be embraced rather than shot down, even if this requires an overhaul of today's powers or assignments. At the same time it demonstrates how hard progress will be on this dossier.

Essentially, the report proposes that (apart from foreign policy-related expenditures and administration) the EU budget would in the future consist merely of three funds: a Growth Fund, a Convergence Fund and a Restructuring Fund.

A few specific remarks are desirable:

i. The effectiveness of the Growth Fund depends critically on reforms as well as complementary spending by the member states. Indeed, EU R&D and cross-border infrastructures spending is to serve "as a catalyst" (p. 163). Therefore, the creation of such a fund is only meaningful (for growth) if a convincing framework for the EU/national interface can be set up and implemented. We have commented before that this requires reforms and a different mindset of national policy-makers. A risk is that such a fund might consist of no more than reshuffled items of what are dispersed spending lines in today's budget, certainly not what Sapir et al. have in mind.

ii. The Restructuring Fund implies "a very sizeable reduction in the amount devoted to agriculture" (p. 164). Enumerated in the report are several typical subsidiarity arguments (with which we agree) on why the redistributive function of the CAP ought to be assigned to the member state level: personal income redistribution cannot be satisfactorily carried out at EU level without causing a lot of waste and introducing distortions, which become even more problematic when done for one sector only; a single agricultural policy is not well suited to the heterogeneity of preferences across an enlarged EU; and the CAP as it stands today is clearly inconsistent with the Lisbon goals. This is even more problematic when done for one sector only, the heterogeneity of preferences and inconsistency with the Lisbon goals. The latter argument can be formulated much more forcefully for the case of Central Europe:[17] extending the CAP eastwards in more or less its present form will cause a drag on the growth rate of the new member states, hence slowing down their convergence. What might be welcome for their farmers is manifestly against the general interest of these countries as a whole. Presumably, agriculture would still retain benefits from structural grants from a restructuring fund as well as assistance in upgrading rural areas so as to improve locational advantages. All this is very sensible. Its political feasibility is unfortunately too much influenced by the same vested interests that have been holding the EU ransom for decades already.

iii. The Convergence Fund has been discussed before. Its crux is to help sustain high investment rates in cohesion countries.

iv. On EU revenues the report argues for a direct link with EU-wide tax bases (e.g. seigniorage from issuing euro bank notes or capital income taxation as a prominent example of a mobile tax basis). The idea of a light degree of progressivity in contributions, that is, rich countries paying proportionally more to the Union than relatively poor members, is ignored. In effect, this proposal is a corollary of the current move towards GNP- based contributions. After all, the latter move was agreed so as to undo the regressive effect of VAT weighing unfairly on low-income earners but of course also on low-income countries. Even the more modest proposal of the Sapir group would be extremely helpful in removing the basis for a lot of irrelevant political bickering on net payments (portrayed as losers even though the EU budget is a tiny part of overall economic integration) and net receipts, which wastes political energy better spent on making the EU grow faster.

7. Conclusions

The Sapir report is required reading for all policy-makers and opinion leaders in the Union. Its lengthy analysis is highly recommended. Many of its policy recommendations are useful, some refreshing, other ones sophisticated and worth reflecting upon. The greatest virtue is undoubtedly its convincing demonstration that a long-run growth strategy for the Union has to be thought through for the entire economic system of the EU. It also cannot come about without an overhaul of the status quo in some, perhaps painful respects.

Its mandate (focused on the EU level only) is less a problem in the analytical sections but a genuine hindrance for the policy recommendations. Thus, a careful reading of the full text preceding the recommendations supports our contention that the major culprit in the failure of European growth is to be found at the member state level. Also, its recommendations, which on the whole are sensible and deserve support, fall short of adding up to a powerful strategy. Some have not been elaborated, others are merely a weak or indirect contribution to growth and yet others are institutionally or politically very demanding indeed. The Sapir group's view on the microeconomic mechanisms in markets and enterprises are well-taken, but they do not show up in their policy conclusions. We accept that the task of the group was perhaps too ambitious to be resolved in one go, quite apart from the restrictive mandate. As noted before, economists have become cautious in claiming that authoritative 'growth strategies'

[17] See, for instance, Pelkmans & Casey (2003) and WRR (2003).

can be designed so easily.[18] Our critical review should therefore not be read as an even partial dismissal of the report. To the contrary, our extensive discussion is meant to contribute to a debate which this important report deserves and Europe badly needs.

Europe must face up to a number of hard questions which, if dismissed or played down, will neither go away nor be resolved for the compelling aim for higher secular growth in the EU.

Let us end with a short list of such queries:

- How to make the EU member states actually spend (much) more on R&D?
- How to get European business to keep R&D in Europe and spend more on it?
- How to realise genuine, deep reforms of Europe's third-level education (more competitive, better geared to the job market, more oriented to technical specialisations)?
- How to enhance risk-taking in a prosperous, often risk-averse Europe?
- How to enhance (incentives for) innovation and entrepreneurship in the EU?
- How to alter the mindset of member states with respect to the thus far minimal role of the EU level in cross-border infrastructure (notwithstanding the political agreement on the new 'growth initiative')?
- Why is labour market reform possible in small EU countries and not or only slowly in at least three big ones?
- Why is the internal market for services (potentially much bigger than industry, agriculture and fisheries together) so hard to accomplish?
- Should subsidiarity (a *functional* assignment principle, after all) not be depoliticised much more frequently, or, put differently, are the *politics* of subsidiarity bad for growth?

These queries and much of the Sapir report add up to a very considerable workload, if indeed the enlarged Union wants to reach a higher growth cruising altitude.

[18] See a recent survey by Dani Rodrik (2003, p. 29), who concludes: "… Is the reason that we all talk about growth that we understand so little about it? It is certainly the case that growth theory is now a much more powerful tool than it was before Solow put pencil to paper….Economics is full of big ideas on the importance of incentives, markets, budget constraints and property rights. It offers powerful ways of analyzing the allocative and distributional consequences of policy changes. The key is to realize that these principles do not translate directly into specific policy recommendations. That translation requires the analyst to supply many additional ingredients that are contingent on the economic and political context, and cannot be done a priori".

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