ISSN : 1287-4558

Analyses Économiques vol. III-07 (Nov. 2004)

The Newsletter of the French Council of Economic Analysis

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Structural Reforms and Coordination in Europe

Report by Guido Tabellini and Charles Wyplosz

Because of the current distribution of tasks within the European Union, individual Member States are responsible for a large proportion of supply policies. Is this a suitable set-up given that the Union needs to revitalise its economy through structural reform? Guido Tabellini and Charles Wyplosz examine this question in their report. The response is clear: in terms of economic efficiency, the current distribution of tasks should be broadly left as it is. Nonetheless, Europe does has a part to play, and the authors make a number of suggestions concerning the operation of the single market, R&D funding and the Lisbon process.

The report was presented to the Prime Minister at the plenary session held on 27th May 2004. This letter, published under the direction of the permanent unit of the CAE, summarises the authors' main conclusions.

By giving up their monetary sovereignty and adopting the Growth and Stability Pact, the Member States of the European Union reduced their capacity to implement independent demand-side policies. However, supply-side policies, except those involving the single market, remain for the most part under the responsibility of the individual States, particularly for issues relating to the labour market, health, pensions, R&D, education and taxation. Is this distribution of tasks appropriate, or should it be reconsidered? The economic literature, based on criteria of economic efficiency, sets out a number of guiding principles which lead the authors to conclude that, on the whole, the current distribution of powers does not need to be revised.

Europe's macroeconomic performance remains well below that of the United States: a significantly lower employment rate, sluggish productivity growth, mainly due to the slower spread of new information technologies, lower and less productive R&D spending, etc. Reforms are clearly needed. The Lisbon strategy, which aims to make Europe "the world's most dynamic and competitive economy", reflects European decision-makers' concern for change, but this strategy has failed.

The solutions needed to boost the European economy are well-known. However, reforms are difficult to implement due to political reluctance to challenge existing social balances. This report looks at ways of making the reform process more effective. Centralisation is not the answer, but this does not mean that Europe does not have a role to play. The existing systems can be improved, and we put forward three proposals in the spirit of the Lisbon strategy: extend the centralisation of the single market, improve the application of the open method of coordination (OMC) which sets common targets and compares national policies, by using it as a means for public opinion to put pressure on governments, and use European Union funding to create university and research centres of excellence.

There is no overall justification for the coordination of reforms

Where there are externalities (actions taken by countries have repercussions, either positive or negative, on other countries) or

EDITORIAL

What should be centralised and what should be decentralised? Just as the answers are clear in the case of monetary policy and becoming more settled in the case of fiscal policy, so they remain much more uncertain in terms of structural policy.

The Lisbon agenda is relevant here. Even though Lisbon now provokes feelings of frustration, the main issues of the era are as topical as ever.

This report shows that the optimal point between centralisation and subsidiarity depends on the area we are dealing with. In some cases the open co-ordination method, which reconciles the authority of national policies with the need for flexible co-ordination, is the best option. However, we should not shrink away from regulation and European regulators in other cases.

The report also focuses on the urgency of a genuinely single market and the need to obtain the institutional means to achieve this. It also comments on the need to create European centres of excellence in higher education and research. In fact, more than the relevant means, Europe is singularly lacking in ambition and perseverance in its efforts towards structural reform.

Christian de Boissieu
Executive Chairman of the CAE

increasing returns (some activities cost less on a scale outside the national economic area), some policies are more effective at a level of government that is higher than the national government. Coordination, or even centralisation, is then justified.

This does not generally involve supply-side policy. Effective supply-side policies, i.e. those which result in a lasting rise in employment and productivity, can create externalities, but these externalities are pecuniary, which means that, through market mechanisms, they create the right incentives for each government. Those which implement good policies see their economy grow. Those which do not suffer from an economic downturn.

This reasoning is based on the assumption that governments try to maximize their national welfare. However, this assumption may be questioned. We must face the fact that governments often react to electoral interests or are influenced by organized groups who seek rents for themselves. The impact of coordination on the incentives it creates must also be taken into account. Centralisation can be dangerous where governments agree to implement ineffective policies. Tax competition is a good example of governments not acting in the best interests of the nation. It can be harmful when this competition involves taxation of the most mobile tax bases, but can also play a useful role when governments tend to overspend and overtax. Similarly, if national and foreign lobbies have common interests, centralised decision-making can strengthen their influence. However, if their interests are opposite, their influence is neutralised and existing distortions reduced. Even in this case, centralisation can only be a second best optimum, as the first best solution require internal institutional reform in each country.

The powers of the Commission must be extended to complete the single market

Commercial laws, public procurement, competition policies, etc. must be extensively harmonised for the single market to work. Most of this harmonisation has been accomplished. However, progress must be made in terms of the free provision of services and regulation of public services and energy, as the opening of national markets is limited by regulations and state aids. In order to complete the single market, the Commission must have more power in these different areas.

For instance, the Commission's power over industrial policy is negative as it can essentially only limit or prohibit state aids. This control is justified where governments tend to help their enterprises at the expense of their foreign competitors. However, experience shows that the Commission rarely vetoes state aids, which could indicate that it lacks adequate power to enforce the law, particularly in politically sensitive cases of company bailouts. This power should be reinforced and exemptions reduced. The likely assumption whereby national industrial policies are implemented to defend private interests argues in favour of a European industrial policy. The Commission should therefore be granted positive power and be able to intervene where the market fails.

Competitive capacity is closely linked to the functioning of financial markets. In the European Union, businesses are generally financed by bank loans. However, financing by anonymous markets, since it encourages risk-taking, better stands to harness new opportunities arising in periods of rapid innovation. Moreover, in continental Europe, the control of businesses is characterised by national minority shareholders and the development of cross-ownership, often to the detriment of smaller shareholders: control and ownership are separate. Consequently, it is difficult for agents, particularly foreign agents, to challenge the dominant shareholders. This in turn reduces the pressure for effective management or the adoption of new business practices when new opportunities arise.

Europe must catch up to the United States by improving the supervision and regulation infrastructure within each Member State, notably by better protecting investors and minority shareholders. A country that cannot implement adequate institutions primarily penalises national borrowers, in such a way that decentralisation reinforces the incentives for reform. However, the Union can play a role, by adopting standards which challenge businesses beyond national borders: set out common standards for the publication of information, define a common framework for mergers and acquisitions, facilitate shareholder voting, discourage complex control structures.

Member States must reform their labour market

The failures of European economies are mainly due to the poor functioning of their labour markets. European Union countries present a wide variety of situations, with the three large countries among some of the worst-positioned. Research conducted in the past two decades has identified solutions which have proved effective when implemented. Labour markets must be more responsive to change: adjust job protection to attract businesses and employees to high value-added activities, reintegrate unskilled workers into the labour market through reinsertion programmes and productivity-based wages and make work more attractive primarily by adjusting unemployment benefits.

These points are no longer questioned, but governments struggle when it comes to implementing these kinds of measures. Obviously, any reform in the labour market which is in the nation's best interests also involves a redistribution of powers. Only national governments understand the social balances and have the political legitimacy required to find politically acceptable solutions. The European level of government can nevertheless help overcome the obstacles of reform. The authors identify three ways:

- extend the single market, by strengthening market competition. This leads to a reduction of existing rents that foster resistance to change;
- identify employment as a Union-wide goal. Governments could therefore be encouraged to act, as it would cost them politically to remain idle;
- the success of the countries which have reformed their labour markets should be emphasised vis à vis the public opinion in order to allay the perception of the short-term costs of reform and doubts as to its long-term benefits.

The last two points very clearly involve the open method of coordination (OMC), which is currently not always applied effectively. This issue is dealt with below in the section on the Lisbon process.

Tax policy coordination only seems justified for the taxation of financial capital

Tax competition on financial capital can prove harmful as it is mobile and sensitive to taxation levels. Each Member State is currently required to provide information on assets held by residents of other Member States in order to effectively comply with the principle of taxation based on the country of residence. Progress in this area within the European Union is blocked by Switzerland, which refuses to apply this practice.

The need for Coordination in terms of the taxation of physical capital is less obvious, partly because it is less mobile, and partly because taxation is only one of many criteria in choosing a business location. The corporate tax base should nevertheless be standardised to allow for greater clarity and to provide insight into how businesses "optimise" taxes.

In general, excluding the taxation of financial capital, it is difficult to choose between the advantages and disadvantages of tax competition. Tax competition can lead to the concentration of taxes on labour, which is the least mobile factor, but it positively affects governments which tend to overspend due to pressure from numerous influential individual interests. There are too many contradictory factors to determine whether the coordination of taxation is needed, particularly since Member Countries disagree as to the desired balance between the different forms of taxation. Therefore, the principle of subsidiarity must be applied.

The EU's research policies are ineffective and must be rethought

Europe is behind the United States in terms of research and innovation, which weighs on growth. Europe has a role to play in research as it is a major source of externalities (everyone benefits from scientific progress made elsewhere).

Among the measures taken by the European Union thus far, the adoption of common standards in terms of higher education and the development of student and researcher mobility, is undoubtedly the most promising since it helps create an integrated European education and research area. The main advantage, which should be seen in the years to come, is that it encourages competition between national education and research institutes.

The Union research budget remains inadequate in relation to its importance (1/10th of the PAC budget) and is badly spent. The Commission claims the right to choose which areas of research to be financed take priority although it has no expertise on the subject. These decisions should be made by internationally renowned scientists, following the example of the National Science Foundation (NSF). This US agency is made up of peers who set out the allocation criteria, which do not involve the areas of research but rather the quality of the proposals and researchers. The use of European research funds, which finance a wide variety of low-cost projects, resembles an ineffective sprinkler system. Europe should focus its resources to help establish centres of excellence outside of the university system, which seems difficult to reform today. The Union could then select a limited number of projects presented by the Member States by providing long-term financing to selected projects. The creation of an independent European agency, made up of professionals who are in charge of allocating funds, should avoid politically influenced decision-making.

The Lisbon strategy must be revised

The Lisbon strategy defines common economic, social and environmental targets. It is based on the OMC which aims to keep governments under pressure in order to give them incentives to implement reforms. The progress of Member States is monitored by a total of 102 indicators. This method is based on the benchmarking method applied in the private sector. The Lisbon strategy is primarily a political process that encourages governments to implement necessary but unpopular reforms. Governments maintain the control of their economic policies, leaving the current distribution of powers unchanged.

The Lisbon strategy has failed. The targets set for 2010, notably the employment and R&D targets, will not be reached. The myriad targets and indicators used in a number of areas diverge from the basic goals. The Spring session of the European Council, which examines the progress of the Lisbon strategy, is a mere formality which is not taken seriously.

The Lisbon strategy was originally a good idea, i.e. the use of benchmarking to enable each country to learn from what is done elsewhere. However, it must be revised and refocused on a few key objectives, notably in terms of employment. But a crucial point is to encourage its understanding at the national level. The OMC has been created for this purpose, but has had no impact thus far. Peer pressure has proved extremely limited if not non-existent, particularly in the large countries, which are precisely the countries struggling the most to reform their anaemic economies.

The Commission's annual reports, including its assessment of each country based on a reduced set of criteria, could be debated within each national parliament so that public opinion and its democratic representation can be properly informed and pressure governments.

Jean Pisani-Ferry argues that the report overlooks the political dimension of European construction. However, he understands the authors' reasoning: the Union's legitimacy, at least to date, has had more to do with its capacity to guarantee prosperity than its democratic nature. Clearly, the distribution of tasks needs to be judged on economic criteria based on efficiency. However, the second criterion relating to economic policy is debatable. The Union cannot back reforms solely on the basis that national governments do not have the political capacity to see them through. Jean Pisani-Ferry also argues that the authors overlook an important type of externality in that the single monetary policy cannot help to overcome the short-term problems associated with national reform. This is a good economic argument in favour of co-ordinating reform, or at least the timetable of reform. Finally, he agrees with the authors' practical conclusions. The open Coordination method has failed because it lacks a genuine means of incentive. The use of European Union funding as an incentive to promote research and university excellence – a field in which the European dimension is undeniably important – is fully justified.

Jean-Pierre Vesperini believes that the report's stance on the distribution of tasks is theoretically and empirically sound. However, he finds it unfortunate that the report focuses on supply. Europe's slow economic growth is also to a large extent the result of a deficit of demand, and Europe lacks the tools necessary for the active Coordination of national demand policies. He also disputes the authors' take on the European Commission's role in the running of the single market. He argues that centralisation is excessive and hinders Member States' supply policies, that the rules governing the control of government aid are too restrictive and based on a negative understanding of aid, that anti-trust efforts go too far and can in some cases damage European production capacity. A review of competition policy is needed to allow acts of will in the area of industrial policy. Generally speaking, the single market is no more than a framework. A genuine supply policy at the European level can only be developed by governments co-operating on major projects, e.g. aerospace. Jean-Pierre Vesperini agrees with the authors that the labour market, healthcare and pensions must remain under the control of individual governments, but that they can be subject to a flexible coordination method such as OCM.

La **documentation** Française

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Publisher: Christian de Boissieu – Editor: Hervé Bonnaz – Electronic Publishing: Christine Carl