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# Small can be beautiful: The EU budget - and the financial perspectives for 2007-2013

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# Small can be beautiful: The EU budget – and the financial perspectives for 2007-2013

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## I. Introduction

With the publication of the Commission's communication (Commission EC, 2004a) the debate on the EU Financial Perspectives (FP) – that is, the medium-term financial framework setting out a multiannual spending programme – for the period 2007 – 2013 has formally been kicked off. In practice, though, the first shot was taken a little earlier by the so called "gang of six" – the net contributing member states – by the writing of a letter to Commission President Romano Prodi, in which they demanded that the overall EU budget should be capped at current spending levels of 1% of GNI, despite enlargement. As a matter of fact, the size of the budget has always been defining the first battle line, pitting off net contributors against net recipients of EU spending, the second major battle line being defined by allocation of spending. Both issues are clearly associated with controversies over the role and the future of the common agricultural policy (CAP) and EU regional policy and are, also, related to controversies over correcting rebates, most notably the UK rebate. Conceivably, the accession of the ten new member states, to be shortly – within the early FP 2007 – 2013 period – followed by the accession of Bulgaria and Romania will bring new tensions to the negotiating table. And these tensions are likely to be aggravated so long as growth prospects in the EU remain feeble and national fiscal conditions are in, more or less, serious trouble.

The academic literature on the EU public finances, in general, and the EU budget, in particular, has grown considerably, especially since the late 1980s and has mostly been critical of the long-standing arrangements.[1] Mainstream economic thinking, the most recent example being the Sapir report (Sapir *et al,* 2003), has often called into question the allocation of EU spending, asking for a re-orientation of budgetary expenditure towards the promotion of growth and away from the current emphasis on regional cohesion and, especially, farm income support. Yet, several economists, policy experts and influential public figures have put forward radical proposals, ranging from a substantial increase in the size of the EU budget and a deeper restructuring of its role to an increase in its financial autonomy and its vertical integration with the national budgets (e.g. Begg, 2000; Buti and Nava, 2003; Commission EC, 2004b). Often, though, academic contributions to the debate, especially radically inclined contributions seem to simply draw normative inferences from observing the huge differences in size between the EU and the national budgets, while acknowledging that implementation of radical reforms is politically infeasible. Thus, they obviously imply that the current EU budgetary arrangements merely

* The division of our labour has, on this occasion, been defined firmly. George Andreou was, unsurprisingly for those aware of our research interests, assigned with drafting the section on redistribution.

[1] The first Financial Perspectives were agreed in 1988 and set out the Community spending programme up to 1992.

correspond to a political equilibrium, [2] albeit one that precludes the EU budget from assuming a role suitable to the EU economic needs and wider aspirations.

In this paper we argue that, contrary to these perceptions, the current EU budgetary arrangements are far from being inadequately justified and economically undesirable, so that minor changes and adjustments at the margin may, indeed, be all that is required. In the following section we sketch our broad conceptual framework, derived from the theory of fiscal federalism and recent developments in the theory of positive political economy. In the third section we follow the familiar Musgravian classification of the branches of government and discuss the role of the EU budget in regard to redistribution, cyclical stabilisation and allocation. Within the domain of allocation, then, we divert our focus towards the so called Lisbon process and argue in favour of introducing financial incentives to stimulate economic, especially labour market reform. The fourth section concludes.

## II. Is the current EU budget a mere political equilibrium? A conceptual framework

Thinking of the EU budget – and of its relation with national budgets – raises the issue of the allocation of competencies between the EU (the central government) and the member states (the local governments). The traditional theory of fiscal federalism assumes that each government seeks to maximize an ethically weighted social welfare function. For very obvious reasons social welfare functions differ among jurisdictions, so that cross-border externalities and policy conflicts inevitably arise. However, the central government can take into account the welfare of all persons irrespective of their home jurisdiction. Thus, provision of (widely perceived) public goods is more efficiently carried out at the central level. Centralization is further justified when there are economies of scale in the provision of public goods.

On the other hand, though, local governments are better informed than the central government about the preferences of their citizens. Also, the central government may inadequately differentiate its policies across jurisdictions, thus failing to respect the diversity of local preferences. Provision of public goods, then, is more efficiently carried out at the local level. It follows that the choice of the level of government at which public goods are efficiently provided depends on the existence of scale economies, the extent of cross-border externalities and the degree of heterogeneity of preferences. Obviously, centralization is desirable when cross-border externalities are widespread and strong, scale economies are important and preferences do not widely diverge across jurisdictions (for a survey of the traditional theory of fiscal federalism, Oates, 1999).

Moving from the allocation of competencies to the allocation of public spending, the traditional theory of fiscal federalism prescribes the assignment of the redistribution function and the cyclical stabilization function to the central government. The allocation function (provision of public, quasi public and merit goods) is assigned to the local governments,[3] unless cross-border externalities are pervasive, scale economies are significant and heterogeneity of preferences is limited. In the case of

[2] Adherence to the *juste retour* principle is usually thought of as testimony to the budget being a mere political equilibrium; and further inquiry is seldom envisaged (e.g. Buti and Nava, 2003).
[3] Market regulation is not mentioned here as it virtually involves no public spending.

the EU, however, the degree of market, particularly labour market integration is low – lower than in other mature federations – and, consequently, cross-border externalities are sufficiently contained, while heterogeneity of preferences – and the cost of their being neglected - outweighs the benefit arising from the exploitation of economies of scale (the prime example being the foreign and security policy). Thus, spending on the provision of public, quasi public and merit goods is – and should be – mainly footed by the national budgets. Yet, there are further arguments for decentralization of spending and they are not confined to the allocation branch of government.

The traditional theory's assumption of benevolent governments is arguably at odds with the real world of politics. Self-interested politicians tend to respond to the median voter's preferences, cause and even reinforce electoral business cycles, get caught in the demands of well organized and powerful economic interests etc. Drawing on the insights of the new theory of positive political economy, the revised theory of fiscal federalism deviates from the traditional view in that it assumes a generalized second-best environment – which is largely associated with political constraints and government failures - within which the allocation of both competencies and public spending is very likely to differ from the otherwise optimal, yet leading to increased welfare (Begg *et al*, 1993; Persson *et al*, 1996; Berglof *et al*, 2003). While the revised theory of fiscal federalism is not inherently biased against centralization (Begg *et al*, 1993; Koutsiaras, 2003), nevertheless a presumption for decentralization is readily discernible. Accountability considerations and concerns about government failures imply a predilection for local governments and, to a certain extent, reliance on competition amongst local governments in order for heavy market distortions to be removed. Arguably, symptoms of government failures have been pervasive in the EU member states – be they in terms of, say, high unemployment or fiscal profligacy. Hence, so far as the EU is concerned, the relevance of the decentralization thesis is reinforced.

Yet, the allocation of competencies and public expenditure in the EU – and, thus, the size and role of the EU budget – is not determined outside the (EU) political system, the latter being an exceptionally complex structure of institutions and policy-making rules and procedures that facilitate intergovernmental bargaining, but conspicuously lacking the ingredients of a political community (as excellently theorized and empirically supported in Moravcsik, 1998). Thus, it is conceivable that divergent national interests and policy preferences mean that competencies and public spending are only hesitantly – and when a Pareto improvement is, at least, within reach - transferred to the EU level. It is equally conceivable that, in the absence of EU-wide equity considerations, not only does redistribution remain firmly in the hands of the national political institutions, but also that member states are even more reluctant to cede authority – including spending authority - to the European institutions, the reason being that an element of redistribution is inherent in both the allocation and stabilization functions. Nevertheless, this by no means implies that the allocation of competencies and public expenditure between the Community and the member states merely corresponds to a political equilibrium. It has been argued above that a predilection for decentralization is both justifiable and desirable. EU politics simply make it also realistic and acceptable.

## III. What role for the EU budget?

### *a. Redistribution*

Redistributive considerations form an important element in explaining the relative stability of the existing federations. Indeed, equity is a key part of the federal contract, in the sense that the constituent states are willing to transfer some of their competences to the central level in exchange for redistributive mechanisms. Generally speaking, equity can be viewed in two dimensions, interpersonal and interregional. The interpersonal (or intrajurisdictional) dimension of redistribution focuses on the welfare of each separate member of a political community, and thus concerns the reduction of inequalities between individuals. The interregional (or interjurisdictional) dimension of redistribution refers to the welfare of the average citizen of each constituent state of a federation, and therefore relates to the reduction of disparities between jurisdictions (be it countries or regions).

There are different justifications for assigning interpersonal and interregional redistribution at the central level. The need for interpersonal redistribution is primarily determined by the degree of *political homogeneity* (the stronger the feeling of common citizenship, the more homogenous the preferences towards redistribution) and the mobility of tax-paying and benefit-receiving individuals (if workers are mobile and well informed, jurisdictional differences in redistributive schemes will give rise to serious externalities undermining subcentral policies) (Van Rompuy *et al*, 1991; Commission EC, 1993).

The rationale for interregional redistribution (i.e. for policies aiming at reducing spatial disparities) is founded on both political and economic grounds. First, there may be a political demand for action to reduce intercountry or interregional disparities, and the demand could be as much for the action as for the reduction (Prud'homme, 1993: 336). From an economic point of view, interregional redistribution is desirable in the face of sharp spatial differences in regional welfare that originate in structural and/or transitory factors.

The principal instruments of interpersonal redistribution in all modern states are direct taxation and the social security system. On top of that, federal states employ various systems of fiscal equalisation through the sharing out of taxing competencies among different levels of governments and the use of intergovernmental grants. These grants may serve redistributive, allocative and/or stabilisation purposes. Broadly speaking, unconditional intergovernmental grants are essentially redistributive (and can also play a stabilising role), while specific purpose grants can combine efficiency and equity purposes. In the latter case, transfers are targeted towards raising the growth potential of the recipient areas by increasing investment in infrastructure, productive capacity and/or human capital.

As a matter of fact, redistribution in the EU exhibits a high degree of diversity, with social expenditure remaining highly heterogeneous across groups of countries. Besides, the very allegiance of European peoples to national democratic institutions is closely linked to the development of different national welfare states in the post-war period. In this context, member states continue to protect their dominance in the areas of social and fiscal policy and to oppose to any significant transfer of fiscal capacity to the Union. Moreover, mobility in Europe is low not only in comparison to the USA, but also by historical standards (Puga, 2002). One may, therefore, conclude that there is neither demand nor need for interpersonal redistribution at the EU level, at least in the medium term.

On the other hand, since 1987, the EU has undertaken explicit assignments in the name of "economic and social cohesion". As defined in the Treaty, cohesion is an imprecise and nebulous concept that is open to multiple interpretations. Emphasis is placed on the economic dimension of the term, the reduction of levels of development between regions (and, since 1993, countries), whereas no definition of social cohesion is provided. It can be argued that the goal of cohesion is only marginally linked to the traditional notion of economic solidarity. Indeed, cohesion is distinct from the broader concept of equity, which relates to the narrowing of the primary income gap between individuals through taxes and transfers (Commission EC, 1993: 48). Instead, the emphasis is placed on improving economic efficiency by using a variety of fiscal and non-fiscal instruments. Thus, the Community and member states intend to improve the allocation of resources across the territory of the European Union, and in the long run, to ensure equal opportunities for the various economic actors.

Following the inclusion of the principle of cohesion in the Treaty, the EU undertook to coordinate and develop a complex set of policy instruments labelled "structural policy" or "cohesion policy". Since 1989, most of these instruments operate within a multi-annual programming framework according to a set of common principles: concentration, partnership, programming and additionality. The primary aim of this policy is to induce a "catching up" process for the EU regions with a GDP per head inferior to 75% of the EU average (the so-called "Objective 1"). According to the terminology of fiscal federalism, EU structural transfers are "specific purpose close-ended grants"; this implies that, despite its far from negligible redistributive impact (Mairate and Hall, 2001), structural policy is not primarily concerned with equity, but with efficiency. This assertion is justified by the conditional character of EU transfers -the equity motive is hoped to be temporary, since "successful" regions or countries lose their eligibility for EU aid- and by the existence of the programming and additionality principles –hence, recipients cannot spend EU subsidies as they wish, nor can they use them as a substitute for own spending (Pelkmans, 1997: 260).

How successful is EU structural policy? From a political viewpoint, structural policy can be regarded as a side payment in favour of countries with a high "nuisance potential" (Moravcsik, 1993); in this line of argument, the presence of structural policy has been instrumental for both the deepening and the widening of European integration. On the other hand, even a cursory introduction to the politics of the EU budget is sufficient to reveal that the allocation of EU funds is hostage to widespread log-rolling, a practice that undermines the principle of concentration and dilutes the redistributive impact of structural policy. On top of that, available evidence suggests that, despite the existence of a relatively strict regulatory framework and the close involvement of the Commission, national governments still enjoy significant leeway in terms of both programming and implementation, and this has often led to inappropriate programming, inadequate absorption rates and ineffective implementation.

Assessing the economic performance of EU structural policy is an extremely complicated issue. To begin with, the question of cohesion is closely linked to the impact of economic integration on spatial development. The relevant theoretical literature was traditionally grouped into two rival groups of thought: the "convergence school" (building on classical and neo-classical analysis) and the "divergence school" (based on "cumulative causation" processes) (Commission EC, 1990). More recent studies, inspired by the approaches of "new economic geography" and endogenous growth, reach more ambiguous conclusions (Krugman and Venables, 1990; Puga, 2002). At any rate, the main message of the new theories is that, in the absence of policy intervention, regional integration, by reducing transaction costs, may lead to self-sustaining inequality (Martin, 1999).

Given the above, one has to examine whether EU structural expenditure has led to the narrowing of interregional and inter-country disparities within the EU. The available empirical data on economic convergence in the EU give a very different picture depending on whether one looks at the 15 member states or at the 211 administrative regions of the EU. Income differences between states have fallen; on the other hand, regional inequalities in Europe have not narrowed substantially and, in addition, inequalities between regions within each state have risen (Puga, 2002). If one looks at the six macro-regions receiving the bulk of the EU funds (Greece, Spain, Ireland, Portugal, the new German Laender and the Italian Mezzogiorno), one finds that their average GDP did converge. Nevertheless, there are wide differences between these areas, with Ireland and Mezzogiorno occupying the upper and lower extreme respectively. Besides, due to the scarcity of sufficient regional data, it is not possible to ascertain convincingly what the relative performances of EU regions would have been in the absence of EU structural policy (Sapir *et al*, 2003: 59-60). Finally, one should bear in mind that the absolute and relative performance of regions and countries also depends on a host of local and national variables, such as macroeconomic and fiscal performance, the quality of local administration and, perhaps most importantly, the degree of flexibility of markets, and labour market in particular (Pelkmans, 1997: 262).

The advent of enlargement poses an additional challenge to EU structural policy. Nearly all new entrants are going to acquire Objective 1 status, while most of the regions formerly eligible for Objective 1 will be lifted above the 75% threshold because of the so-called "statistical effect". Given the modest increases in cohesion spending advocated by the recent Commission budgetary proposals (Commission EC, 2004a), this development does refuel the debate on the rationale, the scope and the methods of delivery of structural policy.

In view of the political and economic questions that have formerly been outlined, it is worth making a few modest policy suggestions, most of which have already been put forward by the Commission (2004a). First, taking into account the increased demand for structural policy by the new entrants and also the value of the said policy as a "nuisance deterrent", it must be concluded that political imperatives favour the continuation of Objective 1, with some generous transitional support for the victims of the "statistical effect". In addition, the possibility of placing greater emphasis on a national approach to structural funding is worth considering, given the complexity and the significant coordination costs of the current system, the magnitude of the management demands posed by structural programming, the administrative shortcomings of the new member states and the experience of the former "cohesion countries". For the same reasons, it would be desirable to promote the simplification of managing procedures and to enhance accountability and evaluation. On the other hand, faced with serious shortage of resources, the EU should seriously examine the option of limiting (or even abolishing) its contribution to the remaining Objectives; such a solution is undoubtedly equitable, because the richer member states (that receive the lion's share of these Objectives) do have the fiscal capacity to bear the financial burden of the relevant programs (Begg, 2003: 177). Last but not least, the Commission suggestion to place structural policy within the EMU-related policy coordination framework should be examined in greater detail.

*b. Stabilization*

The establishment of EMU has inevitably raised concerns about macroeconomic stabilization in the event of symmetric and, especially, asymmetric economic disturbances. Obviously, in the case of symmetric disturbances, concerns are mostly related to the ability of a single monetary policy to provide for EMU-wide stabilization given, inter alia, that mechanisms transmitting the effects of monetary policy on output and employment differ in speed and effectiveness among the eurozone member states.[4] However, so far as asymmetric disturbances are concerned, concerns and anxieties are associated with a wide range of economic and political factors.[5]

The fundamental question is what level of government, EU or national governments should be responsible for fiscal stabilization against asymmetric economic shocks.[6] In spite of its being a seemingly natural option (given heterogeneous conditions and preferences), national fiscal autonomy is rendered unattainable once cross-border externalities are taken into account. While positive externalities, in the form of additional demand stimulus in the trading partners of a country undertaking fiscal expansion in times of recession, have so far been thought of as relatively unimportant (Oudiz and Sachs, 1985),[7] thus necessitating no more than soft – open - coordination of fiscal policies, negative externalities have received thorough attention by both economists and European policy makers. Negative cross-border externalities occur when lack of fiscal discipline in one EMU member state imposes costs on the others, as the ECB may feel compelled to intervene (e.g. by keeping interest rates inappropriately low in order for the real value of the profligate state's debt to be eroded), with inflationary consequences for the eurozone as a whole. As a corollary, a tendency for fiscal profligacy (in the form of excessive fiscal deficits) may further be reinforced, even causing an inherent bias toward excessive deficits and unsustainable debt levels. Such negative externalities have, obviously, provided the rationale for the

[4] This may be thought of as the weak version of the "one-size-doesn't-fit-all" argument. Nonetheless, even this weak version may lend support to proposals urging the adoption of a symmetric inflation target by the ECB.

[5] Yet, endogenous optimum currency areas (OCA) theory has forcefully maintained, inter alia, that with the progress of integration economic shocks will be growing more similar across regions (the seminal contribution is Frankel and Rose, 1997). Admittedly, neither time nor empirical methodology have allowed for accumulating conclusive evidence.

[6] A further distinction is made between supply and demand shocks, a distinction which also bears mainly upon monetary policy.

[7] Yet, positive externalities may be increasing with rising trade interdependence.

establishment of strictly enforced fiscal policy rules, albeit in the form of numerical ceilings, within the context of the Stability and Growth Pact (SGP).

This is not the place to review the voluminous literature that has hitherto been accumulated and addresses issues ranging from the extent of negative cross-border externalities and the response and anti-inflationary credibility of the ECB to the relevance – the merits and demerits – of the SGP (for a review, Brunila *et al,* 2001; for a thorough, yet critical assessment, Fatas *et al,* 2003). Nevertheless, a few arguments pertaining to the issues in hand may be raised. Firstly, irrespective of the precise extent of negative cross-border externalities, the need for a rule-based fiscal framework for EMU has anything but been made redundant. As a matter of fact, since 1999 there has been a weakening of fiscal discipline especially in the larger EMU member states, which may partly be attributed to electoral pressures (Hallet *et al,* 2004). Yet, a fiscal or sustainability crisis in one of the larger EMU member states could threaten stability in the eurozone as whole, thus making the ECB more sensitive to fiscal developments in larger member states and, consequently, resulting in monetary policy being more contractionary than it would otherwise be and, also, in a less than optimal macroeconomic policy mix for the eurozone as whole. Therefore, the observed reluctance of the ECB to contemplate early and adequate in their magnitude changes in its interest rate, in the face of changing economic circumstances (e.g. Begg *et al,* 2002),[8] may cause little surprise.

However, secondly, the SGP has proved to be counterintuitive, counterproductive and incredible. As a matter of fact, there is enough evidence to suggest that the SGP is more effective in smaller member states and provides for weak incentives for fiscal consolidation at the top of the economic cycle, while also taking insufficient account of the quality of fiscal consolidation, thus placing little emphasis on the long-term sustainability of public finances and the improvement of the trend growth of GDP (Fatas *et al,* 2003; Hallet *et al,* 2004). Yet, failure to discipline the larger member states, which may have felt that their sheer size makes them impervious to the risk of default and allows them to evade the rules, not only does it seem to refute early predictions about the distribution of the risk of fiscal profligacy across the eurozone, but also increases the threat to stability in the eurozone as a whole. Furthermore, given that strong growth is evidently a necessary condition for bringing about a lasting reduction of deficit and debt ratios, it would appear that the SGP in its current form addresses neither growth nor stability and thus – perhaps quite ironically – even fails to live up to its own title. No wonder, then, that the credibility of the SGP would have, sooner rather than later, been seriously damaged.

Hence, it is conceivable that the EMU fiscal framework is in need of reform. Economists and policy makers have put forward several proposals, including a better interpretation of the SG pact in order for the effects of the economic cycle to be sufficiently taken into account,[9] an increase in the Commission's powers and discretion in interpreting and implementing the pact, a shift of focus toward the debt ceiling and away from the deficit ceiling and adoption of the so called "golden rule" (for a proposal along the "golden rule" lines, Padoan and Rodrigues, 2004). A group

[8] Yet, the sign of monetary policy has been found to be right.

[9] As a matter of fact, the European Commission has already changed its approach when assessing compliance with the medium-tem objective of budget balance, by explicitly quoting the cyclically adjusted budget.

of CEPR economists have recently called for the replacement of the rigid SGP rules with a judgemental approach, implementation of which should have to be entrusted to an independent authority. In their view, informed and credible judgement rather than adherence to numerical rules allows for a sufficient link to be made between the short-run fiscal behaviour of governments with the long-run sustainability of public finances, while making possible sufficient attention being paid to the quality of fiscal policy and its impact on the short-term macroeconomic performance and the long-term growth prospects (Fatas *et al,* 2003). However, in spite of its obvious advantages in terms of flexibility, a fiscal framework that is utterly unbounded by numerical rules may fail to deliver on its promises. It is doubtful whether simplicity and transparency, which are closely associated with rigid rules and numerical ceilings, might equally be secured within the context of a judgemental approach. Consequently, it is also questionable whether pronouncements on the stance of fiscal policies and the sustainability of public finances would be conveyed to the public opinion and the financial markets reliably and unequivocally and, thus, it is uncertain whether fiscal discipline would effectively be enforced.

Thus, a reformed SGP, paying sufficient attention to the issues of long-term fiscal sustainability and economic growth and allowing for its flexible implementation and credible enforcement, seems to be the only feasible option for an EMU fiscal framework. Yet, adherence to rules and numerical ceilings admittedly constrains the room for fiscal policy manoeuvre and probably holds national governments back from pursuing painful structural reforms. This might be the cost to be paid in order for fiscal discipline and stability to be safeguarded. The relevant question then is whether and how this cost might be recouped – and whether and how the EU budget might accordingly help; we shall come to that later.

On the other hand, it is often suggested that, in the event of asymmetric economic shocks, stabilization via the national budgets should have to be complemented by EU level action.[10] This is usually justified, albeit indirectly, by reference to the experience of mature political federations which normally have a large central budget and stabilizers providing for an automatic response to various idiosyncratic shocks. However, empirical research on the actual contribution of automatic fiscal transfers to smoothing idiosyncratic shocks has been rather inconclusive (e.g. Sala-i-Martin and Sachs, 1992; but Fatas, 1998). Moreover, some writers have argued that geographical labour mobility, in conjunction with wage flexibility, has largely been allowing for smooth (market) adjustment to idiosyncratic shocks in the US economy (Blanchard and Katz, 1992). Within the EU context, early day proposals for the establishment of automatic stabilizers at the central level (Commission EC, 1975) have lately been replaced with calls for setting up an insurance fund activated by idiosyncratic shocks (Italianer and Vanheukelen, 1993). Nevertheless, the inherent risk of moral hazard strongly challenges the desirability of an insurance instrument. National governments, which retain control of economic policy, may be following, say, over-generous income policies, anticipating the inflow of transfers in order for the recessionary effects of their policies to be offset. To put it another way, in the presence of an insurance fund, there is a risk of idiosyncratic shocks being policy- induced. On the other hand, anticipation of transfers may, also, make governments postpone, if not

[10] In effect EU level action would compensate for restricting national fiscal autonomy.

abandon institutional reforms that would have provided for a better (market) adjustment to economic disturbances.

*c. Allocation*

The allocation branch of government defines a wide spectrum of public sector activity which, in effect, encompasses interventions in the markets for goods and services and, even, extends to the realm of social relations and political affairs. It also includes a wide scale of instruments, ranging from regulation and price subsidization to direct provision of public and merit goods.

Within the EU context the division of responsibilities between the Community and the member states has not been straightforward, while policy instruments have not been employed in an equal manner at the Community and the national level. Heterogeneity of preferences and contained cross-border externalities, with scale economies apparently being considered as a second-order criterion, have precluded full transfer of authority to the EU, except in a few policy areas (e.g. monetary policy, commercial policy, competition policy). Exclusive EU competence in these areas is primarily associated with regulation. On the other hand, shared competence, that is, shared legislative power in areas such as the internal market, certain aspects of social policy, consumer protection etc., is also mostly related to regulation, while EU spending merely complements national spending in a few areas only (principally in research and development, but also in external relations, home affairs etc.), though assuming far greater proportions in the case of the agricultural sector and the CAP. [11] Last, but probably not least, following recent developments, including Treaty revisions, soft coordination of economic and employment policy provides for the assignment of a special competence to EU, while supporting EU competencies, defined as competencies to carry out actions to coordinate, support and supplement the actions of member states, to which the competence does belong, are enshrined in areas such as health, education, social exclusion, culture etc.

It is beyond the intentions of this paper to thoroughly examine whether the division of policy responsibilities, in general, and public spending, in particular, within the context of the allocation function is adequately justified and relevant to the EU economic needs and political aspirations – the latter being lately associated with the so-called new policy areas (on this, Begg *et al,* 1993; Sapir *et al,* 2003). Yet, in regard to certain policy areas that have stirred up controversies and political disputes, say taxation and social policy, the existing division of power is both justifiable and desirable. For example, widespread allegations for distorted arrangements leading to outcomes which are economically inefficient and morally unacceptable – the social dumping and the-race-to-the-bottom theses – have received support from neither economic theory nor empirical analysis (e.g. Koutsiaras, 2001). On the other hand, though, it is very likely that restoration of national autonomy in certain areas (e.g. industrial democracy and labour law),[12] along with an increase in EU competence in

[11] Of course, there is the question whether the CAP mainly serves allocation or redistribution. Recent reforms have, inter alia, shifted the focus away form allocation toward redistribution and, consequently, have renewed calls for a partial re-nationalization of agricultural policy.

[12] In areas where Community action has barely had an added value, besides that of projecting a human face, or, if we believe in cynical views, besides that of defending the Commission's own institutional interest.

other areas (e.g. migration, regulation and supervision of financial markets) would be welfare enhancing. Also, it is equally likely that, changes in economic governance structures, that is, the combination of policy responsibilities, rules, procedures, instruments and methods, would make them simpler and improve their consistency, coherence and effectiveness in delivering the goals. It is the latter issue we wish to shift our focus on, in particular on the so-called Lisbon strategy.

- Economic growth, employment and the Lisbon process

During the second half of the 1990s, EU made a decisive step forward and embraced some broader ambitions and, also, increased its potential role and responsibilities. At the Lisbon European Council of March 2000, the Heads of State and Government of EU member states agreed on an integrated strategy of economic and social reform, with the intention of transforming Europe, by 2010, into the most competitive and dynamic knowledge-based economy in the world, with more and better jobs and increased social cohesion, by promoting mutually reinforcing policies to address the needs of competitiveness, employment, social protection and care for the environment. Given that EU competencies were, quite justifiably, curtailed in most of the relevant policy areas and EU policy instruments were in short supply, emphasis was placed on the soft coordination of national policies and, correspondingly, on the implementation of the Luxembourg, Cardiff and Cologne processes, dealing respectively with employment and labour markets, product markets and the micro-macro policy nexus – the latter also featuring involvement of the social partners. The Lisbon strategy has, therefore, been an attempt to integrate and give impetus to separate processes and, for this purpose, a new instrument, the open method of coordination has been introduced.

The open method of coordination (OMC) consists of four key elements: a. setting out common guideline for national policies and, in certain areas, fixing EU-wide quantitative targets; b. comparing national performance with best practice on the basis of detailed indicators; c. asking member states to submit national action plans to implement the guidelines and, in certain areas, to fix national quantitative targets; d. joint monitoring of national policy and, in certain cases, addressing recommendations to member states.

Nevertheless, in most of the policy areas covered by OMC national competences are fully respected and implementation of OMC is, also, in full compliance with the principle of subsidiarity.[13] Following the Lisbon European Council, spring sessions of the European Council have set themselves the twin task of monitoring progress and taking the Lisbon strategy forward, which has so far resulted in adding new processes …and establishing high level task forces (with Wim Kok being their habitual chairman).

Indeed, despite the thick institutional machinery – or, is it because of it? – progress toward meeting the Lisbon goals has been all but anemic and mid-way targets are unlikely to be met. Furthermore, when compared to the US, Europe is found lagging in terms of average living standards, productivity and employment, while the

[13] Nonetheless, this has not stopped institutional integration experts of the integrationist variety to think of OMC as an entrance to the Community method (for a short, yet informative account, Borras and Greve, 2004)

prospects for catching up appear to be rather weak. However, whether in terms of growth, productivity or employment, talking of one Europe hardly makes justice to reality. In fact, there is wide variation in national performance and lack of economic dynamism is largely concentrated in the largest continental economies (Sapir *et al,* 2003; de Koning *et al,* 2004). At the root of Europe's economic malaise, it is routinely argued, is the sclerotic nature of its economic and social institutions, that is, the rigidity of its complex web of formal rules and informal arrangements regulating market behaviour and correcting market outcomes. In fact, there is ample and convincing empirical evidence that stringent economic regulation, particularly product and labour market regulation has a negative macroeconomic impact (Blanchard and Wolfers, 2000; Blanchard and Giavazzi, 2001; Alesina *et al,* 2002). Yet, several economists (most notably Sapir *et al*, 2003) go on to argue that Europe, especially the largest continental economies, suffer a chronic malaise, because institutional inertia coupled with the reluctance of European governments to implement fundamental reforms render European economies unable to cope with increased international competition and adjust to the requirements of an innovation-based growth model.

Nevertheless, some authors adopt a more cautious and less pessimistic view of Europe's (past and) future. They disprove of the pessimists' economic accounting and diagnosis and, instead, argue that Europe's long-term productivity growth has been higher than the US, but it has partially been used to increase leisure rather than income, largely as a result of workers' own preferences (e.g. Blanchard, 2004).[14] Yet, the same authors acknowledge that, as a result of relatively low IT production and investment in IT capital, Europe's productivity has been growing slower than the US since the mid-1990s. Nevertheless, they also maintain that there is little room for pessimism, because European governments have embarked on a reform process which, though, is mainly focused on financial and product markets. This has not been coincidental. Financial and product market reform has largely been orchestrated, monitored and enforced by the EU, following implementation of the internal market programme and EMU. Yet, certain reforms, most notably privatizations, have only loosely been associated with EU legislation, whilst empirical evidence on their impact on productivity and employment appears to be rather inconclusive (Alesina *et al,* 2002).

No doubt, product market deregulation has so far produced mixed effects on productivity. Following Blanchard's (2004) tentative explanation, this is attributed to flawed employment policies, especially policies promoting job-rich growth, putting pressure on firms to maintain employment levels and, thus, distorting incentives to innovate and restructure. However, Blanchard also subscribes to the view that labour market reforms will eventually take place.[15] The fact is, though, that there is hardly convincing evidence that product market deregulation is a close substitute for labour market reform, in regard to both its microeconomic (labour market competition) and macroeconomic effects (productivity and employment/ unemployment) (e.g. Saint-Paul, 2004a).

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[14] However, it is debatable whether workers' preferences rather than various labour market distortions (e.g. labour taxation) have influenced the amount of hours worked (e.g. Boeri and Tabellini, 2004).

[15] One is thus reminded of the well known, yet macabre Keynes' dictum

Notwithstanding differences in opinion, though, it seems that so far as policy is concerned there are some areas where consensus is rather strong. Thus, one may hardly dispute that focus should shift on research and development to foster innovation. Therefore, the Commission's proposal, within the context of the Financial Perspectives 2007-2013, for increased EU spending on research and development to complement national public spending is both justifiable and desirable, given, of course, extensive cross-border externalities and, to a lesser degree, scale economies.[16] Yet, increased public investment in research and development is just a necessary condition. Acceleration of productivity growth depends upon innovation and restructuring at the firm level which, in turn, relies on competitive product markets and responsive labour markets.

However, evidence coming from a vast literature on the microeconomic and macroeconomic effects of European labour market regulation is sufficiently strong to suggest that stringent regulation and other long-established institutions (e.g. collective bargaining arrangements) have an overall negative impact in terms of labour market efficiency, productivity and employment (e.g. Siebert, 1997; Blanchard and Wolfers, 2000; Scarpetta *et al,* 2002; Nickell, 2003).[17] Labour market reform is, thus, desirable, although the underlying justification may differ among national economies.

Furthermore, there is no single institutional model for each and every country to follow (Freeman, 1998). As a matter of fact, there are several paths to the desired destination, the latter being no less than genuine labour market flexibility. Path dependence and institutional interactions both constrain and broaden the room for policy manoeuvre (Orszag and Snower, 1998).

Implementation of regulatory and institutional reforms in labour markets is much harder than in product and financial markets (e.g. Berthold and Fehn, 1996; Blanchard, 2004). Leaving other factors aside, what seems to be the most important obstacle to labour market reform is the distribution of gains and losses and, obviously, the way it bears on the political system. It follows that in order to withstand resistance to reform, governments should be able, inter alia, to compensate losers.

Therefore, it comes as little surprise that neither has there been a common pattern of labour market reform across the EU, nor have rigidities been removed in several member states. Notwithstanding divergent national experience, however, a few generalizations may readily be made. Thus, governments have frequently tinkered with small and politically convenient changes and have often followed contradictory policies, sometimes implementing "positive" reforms and sometimes "negative" ones (Boeri, 2000; Saint-Paul, 2004b). There has also been a marked preference for reforms at the margin, albeit leading to entrenched secondary labour markets (Saint-Paul, 2000; Bentolila and Dolado, 1994). Since around the mid-1990s a consensus about the need for labour market reform has emerged in Europe and the reform process has somehow accelerated. Nevertheless, there is enough evidence to suggest

[16] Moreover, EU spending in R&D is found to have a favourable impact on cohesion (Sharp and Pereira, 2001).
[17] This by no means refutes the efficiency properties of appropriately configured labour market institutions, nor does it subscribe to the so-called structuralist view of European unemployment that solely attributes the post-1970s rise and persistence of European unemployment to labour market rigidities.

that governments have focused their efforts on certain aspects of labour market policy (active measures, reform of nonemployment benefits, internal labour market flexibility) at the expense of other aspects (primarily employment protection legislation) (Koutsiaras, 2002). Apparently, government policies have been dictated by political expediency rather than robust economic evidence on the economic impact of labour market policies and institutions.

Unlike the case of product and financial market reforms, labour market reforms are not enforced by “Brussels”, that is, EU has no legislative powers other than setting out minimum workplace standards and prohibiting discrimination in the labour market. In the area of employment and labour market policy EU plays the twin role of reform preacher and catalyst for national policy action, within the context of the Luxembourg process implementing the European Employment Strategy (EES). Arguably, the impact of EES on national policies, not to mention labour market performance, is easier to allege than to empirically confirm and the Commission’s optimistic assessment (Commission EC, 2002) has met with little support from academic research (e.g. Meyer, 2004). What is more, European labour market performance leaves little room for complacency. Persistently high rates of unemployment in the largest continental economies are testimony to institutional reforms being inadequately implemented or inappropriately targeted (e.g. de Koning *et al,* 2004). Low unemployment countries, on the other hand, have not been immune to policy and institutional failures. Skill shortages, increased inequality of earnings and, quite often, prevalence of irregular employment, all point to the need for changes in labour market institutions and practices.

Yet, almost none, including the authors of this paper, would seriously envisage an increase in Community powers in the area of employment and labour market policy. Besides, recent changes have exclusively focused on streamlining the employment policy coordination process, including its better synchronization with the economic policy coordination process, and on simplifying the EES structure and content, especially in regard to the specification of guidelines. Nevertheless, we believe that in order for the EU role as a reform catalyst to become effective there need be an innovative institutional change, yet modest as to its broader political and economic implications. Thus, instead of sanctions, which are normally embodied in conventional EU law-making processes, we favour the introduction of financial incentives. The latter should be funded by the EU budget, following a slight revision of its spending priorities/ allocation of expenditures, be solidly tied to labour market reform and performance and specified and decided upon within the context of the EU annual economic policy coordination process. Opting for financial incentives/ financial rewards, instead of sanctions, is justified when taking into consideration that the EMU fiscal framework leaves less room for national compensatory measures, than would be left in the absence of EMU, thus failing to address the need – political as well as economic - for alleviating part – in fact, a good part - of the pain associated with labour market reform. Needless to say, our suggestion has, at the time of drafting this paper, not taken the form of a concrete policy proposal; but this is currently being studied by one of your present authors and will be the subject of a new paper.

## V. Conclusions

There is a widespread view amongst academic economists and policy experts that the Community's public finances, in general, and the EU budget, in particular, are in need of fundamental reform; and there has been no lack of reform proposals. It is often argued that the size of the EU budget should increase and allocation of its expenditure should be improved. Yet, the size and allocation of EU spending are closely associated with allocation of competencies between the Community and its member states and, under the present economic and political circumstances, there seems to be little scope for major reforms.

Indeed, it is both justifiable and desirable that the EU budget plays no role insofar as cyclical stabilization is concerned. Rules-based coordination of national fiscal policies is all that is required for effective stabilization against asymmetric economic disturbances and fiscal sustainability and stability at the national and EU (EMU) level. Yet, on top of being simple and clear, fiscal rules should also be flexible enough to allow for policies and measures aiming at increasing long-term growth trends; reform of the SGP should, thus, focus on increasing its flexibility – and economic relevance.

On the other hand, EU spending on interregional redistribution is primarily politically motivated, its economic rationale being sometimes questioned. There is no robust empirical evidence as to the impact of EU regional policy on economic convergence, the latter being observed at the state level but not at the level of regions. Enlargement poses an enormous challenge to EU regional policy and the most appropriate response would be to concentrate focus and expenditure on Objective 1, while limiting EU spending on the remaining objectives.

EU spending directly associated with resource allocation is limited, as it should logically be expected. Leaving aside agriculture and the CAP, its main bulk is concentrated on research and development. The Commission's proposal on the Financial Perspectives 2007- 2013 provides for a substantial increase in EU spending on research and development to stimulate and complement national public spending; and this is much welcome. Yet, in order for the EU economy to become the most competitive knowledge-based economy in the world, increased investment in research and development is not the sole requirement. Reform of European economic and social institutions has moved to the top of the political agenda, but the record is still far from being satisfactory. Labour market reform, in particular, has progressed little, especially in the largest continental economies and EU employment policy coordination – the so-called Luxembourg process – has so far not proved much effective. Opting for pecuniary incentives, instead of sanctions, aiming at stimulating comprehensive labour market reform, rewarding successful national efforts and contributing to national compensatory policies, would likely accelerate the process of reform and, thus, increase long-term growth trends.

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