Increasing Europe's Prosperity

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Public support for the project of European unification and the EU's influence in the world depend primarily on Europe's economic success. Europe is one of the world's richest regions and this wealth appeals above all to its poorer neighbors. At the same time, Europe is also one of the poorest performing regions in terms of growth – measured by GDP – which limits its ability both to exert influence overseas and to satisfy its citizens: unemployment and inequality in particular have grown in the course of the integration process (see Table 1). Europe's growth profile is also quite heterogeneous: individual member states are growing rapidly (above all, Ireland and some new member states) and also in terms of productivity per hour Europe appears in a better light, although it is not reinforced by long working hours, externalization of costs, and high population growth (as, for example, in the USA, China, and India). Whether such reinforcement represents a desirable increase in prosperity, however, is questionable and should be left to the free choice of the citizens.

Table 1:

The Economic Tragedy of European Integration, 1961–2005

Year	*1961–1970*	*1971–1980*	*1981–1990*	*1991–2000*	*2001–2005*
Growth	4.8	3.0	2.4	2.1	1.6
Unemployment	2.0	3.8	8.5	9.4	7.8
Wage share	72.3	73.9	72.1	69.2	68.4

Source: *European Economy* (figures relate to EU-15).

Six years after the adoption of the Lisbon strategy the German Council presidency is confronted by the challenge of boosting Europe's economic dynamism. In this connection old worries have been augmented by new ones due to changes in the world economy (the rise of China and India) and related high-energy prices. At the same time, it is necessary to manage the heterogeneity of European growth: poorer, mostly new member states need higher growth, but their integration should not take place at the expense of the prosperity of other member states and their poorest citizens. And even if these challenges must be dealt with primarily by the member states themselves the EU has a not insignificant influence through its economic policy, above all in the eurozone, as well as through common policies financed by the EU budget and the EU's coordinating role. In the following sections we address these aspects in detail.

Europe in the World – Beyond Competitiveness

The very goal of the Lisbon strategy is marked by a »dangerous obsession« with international competitiveness.[1] While this concept is of course significant for enterprises it makes much less sense when applied to national economies or the EU as a whole. It has limited significance as price competitiveness which is threatened when labor costs increase more quickly than among one's trading partners, which becomes noticeable in terms of balance of payments deficits. Ideally, competitiveness is then restored by a currency devaluation. Since this mechanism is no longer in operation in the eurozone special measures are necessary (see below). However, for Europe as a whole competitiveness represents neither a problem nor a meaningful economic-policy goal.

Europe's prosperity is not falling simply when that of other countries is increasing, not even when this increase is taking place quickly. The sole danger for Europe's prosperity resulting from foreign trade is a deterioration of the terms of trade. If Europe must export more goods and services in order to obtain the imports it demands its prosperity will decline. This happens when the prices of its export goods fall on the world market (for example, due to the size and quality of the supply from other countries) or those of its imported goods rise (for example, the price of oil due to strong demand and rising marginal production costs). However, the effect on Europe's prosperity is marginal given a share of foreign trade in GDP of around ten percent and ultimately modest price effects in rather limited segments of Europe's total foreign trade.

1. Paul Krugmann: »Competitiveness: A Dangerous Obsession,« in: *Foreign Affairs*, Vol. 73 (1994), No. 2, pp. 28–45.

Nevertheless an attempt should still be made to manage Europe's specialization in the world economy so that its exports go to markets with higher income- and lower price elasticity, that is, growth markets in which above all quality and innovation count, not low costs. Conversely Europe would do well to reduce its dependency on imports, such as oil. Such a structural transformation will partly be guided by prices and profit expectations which can be particularly effective in flexible markets with rapid reallocation of factors of production. However, since current prices do not necessarily reflect the market and scarcity situations to be expected over the long term, accompanying policy measures (for example, taxes on energy consumption, protection of endangered industries) are both useful and necessary.

The EU has tended to try to protect declining industries, which in economic circles has earned it the name »fortress Europe«. It still protects its agricultural market with a policy which consumes 40 percent of the EU budget and imposes a burden on consumers. Such a policy can only be justified if branches get into difficulty due to short-term price and exchange rate shocks; long term, however, capacities in Europe must be maintained, for example, on the grounds of security of supply. Where this is not the case specialization in accordance with comparative advantage allows gains in prosperity which, however, go hand in hand with employment reductions. A supportive and exacting social policy which both supports and requires change can accelerate desirable adjustment processes, also through the reduction of understandable fears.

The globalization fund for employees to reduce obstacles to structural transformation called for by the Commission and France and agreed under the British presidency in 2005 is relevant here. The Fund will become active in 2007 as part of the financial package for the period 2007–2013. It would be more important, however, to orientate such funds and state aid in general towards future-oriented policies (education, research) instead of maintaining the status quo. On these grounds the resources earmarked for the Common Agricultural Policy should be reallocated to the promotion of research and technology, as well as the education and training of the unemployed (active labor market policy).

The German presidency should therefore support the implementation of appropriate Commission programs (Single Market strategy, industrial policy, European Institute of Technology) cautiously in the sense of a prospective structural policy and against a pure cost reduction strategy. But structural transformation is also to be macroeconomically safeguarded through the necessary expansion of demand so that productivity increases due to specialization take the form of higher output and not higher unemployment.

Europe's adjustment to global supply structures, however, is not to be achieved only through its own structural policy. The dramatic changes which have taken place in the wake of the modernization of China and India require wise management of the global economy in order to realize the possible gains in prosperity and to encourage their fair distribution. The development of structures of global economic governance lags far behind real market integration.

Apart from that, the EU must take an interest in the social taming of globalization. This includes international labor and environmental standards, as well as a shaping of international finance and currency policy which prevents crises and makes constant growth easier. As a global actor the EU has enough weight to have an effect in this direction. A concentration of its votes in the relevant institutions (WTO, IMF, ILO, and so on) would support this aim.

A Prescient Energy Policy beyond the Market

Energy price shocks, on the one hand, characteristically strengthen the zero-sum aspects of the world economy, and on the other, tend to disappear after a few years. As a result, good intentions tend to be forgotten, thereby priming the next shock. In both respects the EU should try to pursue a policy of sustained calm in order to avoid unnecessary tensions and to ensure a long-term basis for European prosperity.

In the face of high and, in the medium-term, increasing energy prices the view has become dominant of a relatively raw-material-poor Europe competing with other energy importing regions for the markets of energy exporting countries. Although this picture is not entirely false it shifts the perspective somewhat dangerously. The value of net global oil exports, at almost USD 800 billion, according to the IMF, accounted for less than two percent of global GDP even in 2005 and for less than ten percent of world exports. There is therefore ample room to achieve export revenues without concentrating one-sidedly on the markets of energy suppliers. The EU therefore has an interest above all in seeing that supply and demand in these markets is matched by the price mechanism rather than power-political allocations.

Of course, there is little possibility of regulation in the global energy market. Markets always operate in an environment formed by extra-market influences. In the global energy market that includes, among other things, the given net of pipelines, as well as the availability and cost of other forms of transport. Here Europe should try to reduce one-sided dependencies and to make alternative sources of supply available.

In order to decrease Europe's dependency on energy imports priority must be given to developing alternative energy sources and to energy saving at home. The EU has already launched a wealth of initiatives (action plan on energy efficiency, plans for the proportion of renewable energy in electricity generation, proportion of bio-fuels, and so on) which must be determinedly pursued. They should be supplemented with further plans which, for example, reduce the oil consumption of motor vehicles or in the metal and synthetic materials industries. Early development of alternative forms of power and substitute materials for plastic and aluminum (for example, in packaging) would open up new export possibilities for Europe in the long term. Germany's motor vehicle and chemical industries, as well as its research capacities in mechanical engineering and materials research are particularly in demand in these areas and merit support – in suitable Europe-wide cooperation programs – through the 7th European Research Framework Programme.

The best incentive, of course, is high prices for energy imports which can also be ensured through customs duties. If current market prices do not reflect long-term conditions of scarcity it would be prescient to maintain them at a predictable and appropriately high level in order to give an incentive and calculatory certainty to investors in alternative supplies or saving, for example, building renovation. This must be taken into account in any European energy policy action plan.

Refocusing the Lisbon Strategy[2]

In 2000 the EU adopted its Lisbon strategy with the goal of making the Union »the most competitive and dynamic knowledge-based economy

2. See also the contribution to this volume by Udo Bullmann and Jan Kunz, »Europe must set the course,« as well as the paper by the Working Group on European Integration (Arbeitsgruppe Europäische Integration), Die EU braucht eine neue

in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.«[3] A number of subordinate aims were established to this end, such as raising the employment level, higher expenditure on education and research, and so on. At the latest by the mid-term review of 2005 it had become clear that the EU was still far from achieving these goals. The spring summit of 2005 was dedicated to the Lisbon strategy and confirmed its main points, though with stronger emphasis on the social dimension, which resulted in the new Social Agenda 2005 – 2010. In June 2005 the Council approved the »integrated guidelines for growth and employment (2005–2008).« The year 2007 has been declared European Year of Equal Opportunities. In parallel with this, processes are continuing in accordance with the open method of coordination in different areas (employment, social protection, pension schemes, education).

The EU – particularly in the Kok Report of 2004 – has taken a critical look at its own achievements (or the lack of them).[4] Nevertheless most of the Strategy's priorities remain unchanged. At its core is a market-liberal strategy grounded on the hope that the completion of European Single Market integration will automatically engender impulses for growth and employment, all embedded in the rhetoric of competitiveness. In fact, the last three decades of liberalization have been accompanied by falling growth rates and rising unemployment (see also Table 1 above). Productivity gains linked to competitiveness have too often been converted into employment decreases. In short, the market-oriented integration of the EU has contributed too little to employment, but something to unemployment. The EU's desperate fixation with competitiveness has contributed to an overdramatization of Europe's global economic situation with corresponding wrong policy recommendations: Europe needs neither lower wages nor less consumption and should strive for neither long-term trade balance surpluses nor real devaluation. All in all, economic failures have helped to reduce the public's approval of the European project.

Wirtschaftspolitik! Auftakt zur Debatte [The EU needs a new economic policy. Prelude to a debate], Bonn: FES (2006).

3. Presidency Conclusions, European Council (Lisbon), 23 and 24 March 2000: http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/00100-r1.en0.htm.
4. Cf. »Facing the Challenge. The Lisbon Strategy for Growth and Employment,« Report from the High Level Group Chaired by Wim Kok, Brussels, 3 November 2004; André Sapir (2004), *An Agenda for a Growing Europe – The Sapir Report,* Oxford.

The one-sided priority of increasing labor supply (through targets for the employment rates of women and older workers) should give way to a balanced strategy which at the same time takes care that the corresponding jobs are created. A minimum income should be guaranteed for old age, unemployment and poverty in proportion to member states' economic performance. Welcome catching up processes in terms of the GDP of poorer member states should lead to a corresponding increase of income replacement benefits for those lacking market income, for which purpose corridors should be established.

As regards the difficulties facing a reorientation of European economic and social policy in the teeth of strong opposing interests during Germany's short presidency it can only be a case of improving the conditions for a different policy. Intensive dialogue is needed for this to change the current dominant perception of the situation in public opinion and among the decision-making elites. The following core elements should form the basis of initiatives to improve understanding:

- *Competitiveness* is a problem for the EU as a whole only if there is a long-term balance of payments deficit; within the EU it is a problem for individual member states when inflation is higher than the EU average *and* balance of payments deficits occur over several years.
- *National debt* is a problem for the EU as a whole only when households and enterprises save less than they invest and the economy reaches the limits of its capacity.
- *Wage increases* which over the long term remain below productivity increases are a problem for all EU states as well as for the EU as an economic and socio-political community.
- *Taxes* are a form of payment for public goods and services in which enterprises which utilize this public provision must participate proportionately.
- *Productivity increases* are the real source of wealth. However, they only increase prosperity when they produce real contributions to national economic productivity and are not merely the nominal result of shifting costs onto other actors (for example, employees by reducing wages, the state through tax reductions, suppliers through a price squeeze, and so on).
- *Work and leisure time* are values that must be weighed against one another. Leisure time is one way of using productivity increases. The ever longer and more extensive employment of citizens is therefore not a self-evident aim.

As far as possible and *appropriate to fulfill the agenda outlined above* steps should be taken towards the general goal of reform, for example:

- Elimination of competitiveness rhetoric from EU documents and the winding up or allotment of new tasks for the bodies (discussion groups, and so on) which serve this purpose.
- Better indicators for the open method of coordination which consider prosperity in all its complexity and don't rely solely on higher labor inputs.
- Making the relative (in relation to GDP per capita) level of income replacement benefits the object of peer review in the open method of coordination.

Prudent Regulation of Markets and Enterprises in the Public Interest

The capitalist market economy is a powerful force for the creation of prosperity, and something very much to be preserved, like the goose that lays the golden eggs. It has inherent weaknesses and dangerous tendencies, however, which, without political and societal control and embedding can lead to its self-destruction. The three main blind spots are protection of the workforce, of the environment and of consumers. Through the neglect or exploitation of these three areas short-term gains in the form of higher productivity, higher growth and higher profits – that is, the competitiveness so highly prized in EU jargon – can be achieved. Environmental and labor protection burden above all enterprises by restricting their ability to pass on costs to society (externalization). They are necessary, however, because market forces alone will achieve little, since property rights are unclear (in the case of the environment) or are not exercised (above all in the case of high unemployment). In relation to consumer protection one could leave it to the consumer, but here too asymmetric information and market power interfere with the workings of competition.

Aware of these market failures the EU early regulated market competition by safeguarding labor protection (as early as the Treaty of Rome – Art. 137 EC Treaty), as well as environmental (Art. 2 and 174–6 EC Treaty) and consumer protection (Art. 3 and 153 EC Treaty) in treaties and in numerous regulations. Consumer protection in particular often served protectionist interests too (for example, the so-called *Reinheitsgebot* in relation to German beer). Especially in this field more can be achieved, above all by strengthening consumer sovereignty, including information obligations for enterprises, than through regulations, which may serve producer interests unilaterally. But various food crises and scandals (BSE, bird flu, and so on) and climate change have increased public consciousness of the necessity for regulation.

The German presidency should energetically continue existing programs in environmental and consumer protection (European Climate Change Programme, emission reductions for motor vehicles, the EU action platform »Nutrition, movement and health«, consumer policy strategy, animal protection action plan, FLEGT, and so on) and in labor protection (Community strategy on health and safety in the workplace). Intensified efforts are necessary among other things in management of the fishing industry.

Regulation is not an end in itself. For that reason steps towards the simplification of the law are fundamentally welcome. Of course the keyword »simplification« should not hide the basic conflict of interest between the short-term profit interests of enterprises and the long-term interests of society. EU documents so far have been dominated by a *rhetoric*, which – pursuant to the fixation with competitiveness criticized in detail above – above all calls for the unburdening of enterprises. To the extent that this is possible by cutting back bureaucracy it is to be welcomed. However, when it only conceals the benign neglect of enterprises shifting private costs onto society on a large scale it makes no sense.

Crisis Prevention in the Eurozone

The EU lays down basic conditions for member states' employment and growth policy by means of the European Central Bank's (ECB) monetary policy, the Maastricht deficit criteria, the regulations on the Single Market and competition, and the priority given to competitiveness within the framework of the Lisbon strategy. These basic conditions have not produced the desired results, however, but have considerably reduced the employment- and social-policy options. While some member states are coping to some extent or even well with these basic conditions, in others they have led to persistent weak growth and structural unemployment, and consequently have even aggravated existing problems. The potential of Europe's national economies is not being fully utilized.

The EU needs a coordinated economic policy in which monetary policy does not serve the sole purpose of stability, with more public investment in up-and-coming industries and a continuing expansion of consumption. In the case of Europe-wide imbalances between savings and investment, public investment should also be credit financed. In order to bring about more growth, employment, and social justice in Europe the emphasis of European economic policy should be shifted. In macroeconomic policy stability should no longer be given priority over growth and employment. The coordination of monetary, fiscal, and wage policy will be improved by, on the one hand, strengthening demand and preventing competitive disinflation, and on the other hand by putting a brake on excessive credit expansion and wage increases which can (could) only be corrected by major austerity measures and recession (for example, in Italy and Portugal).

The successes of the currency union and of the euro on the stability front and in relation to its external value (despite initial weaknesses in relation to the US-dollar) should not be obscured by the fact that in some countries worries about the consequences of euro-adoption have increased alarmingly. They reached a peak with the utterances of the former Italian social minister Roberto Maroni (Lega Nord) in June 2005 who called for a referendum on withdrawal from the euro. Italy is not the only country which has had to cope with problems arising from economic »asymmetries« and asynchronous business cycles in the eurozone. The uniform interest rate is too high for some core countries with weak growth dynamics and low inflation (for example, Germany and France), while for some periphery countries with strong growth and higher inflation (Spain and Ireland) it is too low. The restrictions on fiscal policy are too tight which tends to have a pro-cyclical effect.[5]

As welcome as the growth at the EU periphery is, the sustained price and cost increases there are dangerous, above all when Germany, the most important core economy, is continually reducing unit wage costs. Since the correction of these faults in the eurozone (for example, 40 percent between Germany and Italy since 1998) is no longer possible by means of revaluations or devaluations painful adjustments of nominal income are almost unavoidable, which could lead to serious political cri-

5. Cf. Peter Bofinger (2003) »The Stability and Growth Pact neglects the policy mix between fiscal and monetary policy,« in: *Intereconomics,* Review of European Economic Policy, 1, pp. 4–7.

ses. On the other hand, a real estate boom which is not sustainable over the long term, as in Spain and Ireland, and which has driven consumption and employment to new heights, requires careful monitoring.

The Maastricht criteria on national debt discipline national budgets but they are biased in a twofold sense: (i) they ignore private household and enterprise debt, although excessive private sector debt threatens stability, just as that of the state does; and (ii) they have no influence on the public rate of saving, if it does not lead to deficits which exceed the three percent limit. An appropriate European economic policy must take all of these states of affairs into account and take corresponding measures or demand that member states do so. The central shortcoming of the eurozone – for example, in comparison with the USA – is the lack of automatic stabilizers[6] which make possible a balance between states with different economic situations.

Two stabilizers could balance the effects of regional business cycles:

1. *A eurozone-wide unemployment insurance:* contributions to which would go up pro-cyclically on a regional basis as employment increases, while in recessions payments would be made counter-cyclically and demand in crisis regions would increase.
2. *A eurozone-wide corporate taxation*, which could also co-finance unemployment insurance, would have higher revenue during economic boom periods thanks to the better profit situation, while during recessions the relevant regions would be less burdened.

For that purpose the German presidency should improve the Eurogroup's capacity to act. The making permanent of the chairmanship is a step in the right direction. The group needs a better infrastructure, however. As regards content it should, among other things, attend to the question of strengthening the automatic stabilizers and international financial policy (risk of dollar weakness). It should also take up the application of the Stability Pact again in order to correct the one-sided fixation on national debt.

6. That is, the components of public expenditure which grow and shrink counter-cyclically, for example, expenditure on the unemployed.

Preparation for a Fundamental Revision of the EU Budget

Both the reform considerations with regard to the Lisbon strategy, which are congruent with a meaningful interpretation of competitiveness (that is, high productivity growth through modernization), and better management of different regional economic cycles and levels of development strongly suggest revision of the EU budget. The Lisbon strategy calls for more expenditure on research, education, and active labor market policies, while the Common Agricultural Policy, which makes up the lion's share of the EU budget, is counter-productive. The second big budget item, EU regional and structural policy, while incorporating a number of desirable measures, has little effect on reducing income disparities. Significant inter-regional income transfers, as required by a meaningful regionalized economic policy, have so far not taken place.

Regarding this need for fundamental revision the German presidency finds itself in an ambivalent position. The budgetary framework 2007–2013 has just been passed after long wrangling. New budget negotiations are therefore on the agenda only for 2011. Although the European Council has been calling for reforms since December 2005 and has requested proposals from the Commission it has set a deadline for that purpose of 2008, by which time a White Book should be ready. Consequently, while on the one hand there is no pressure for action, on the other hand there is an opportunity to explore open and unbiased options without national distributional interests imposing themselves.

A debate under the German presidency could attempt to lend some clarity to the following fundamental principles of a new budget policy:

- an end to »juste retour«;
- establishment of priorities for expenditure (future orientation, European added value);
- reform of the two major policies (agricultural policy, structural and regional policy);
- own resources for the EU (automatic inter-regional stabilizers, corporate taxation).

In agricultural policy retrenchment is to be recommended on a number of grounds, particularly on account of the foreign trade complications (Doha round) and the unequal distribution of payments (large sums to large landowners who are already wealthy). Making known the identity of the recipients throughout Europe would probably be enough to increase political support for reform. Although large landowners in Germany are also beneficiaries of the Common Agricultural Policy this should not be made the basis of a future-oriented shaping of the EU budget. Those who on good grounds would like to help former agricultural cooperatives in Eastern Germany (LPG) should try to convince German tax payers of that and to carry it out from national resources. To the extent that agricultural policy operates as a kind of hidden social policy it should be organized nationally. The EU could coordinate the level of such payments of income replacement benefits. Agricultural policy could in that way become a laboratory for a new European incomes policy to which it has already made innovative contributions with a long-term Europe-wide uniform level for direct payments (despite high income and cost of living differences in the EU).

European regional policy has so far contributed little to income convergence within the EU. Despite considerable expenditure regional differences have remained high across Europe. In pursuit of the Lisbon goals it is also questionable whether support for weaker regions contributes less to European growth overall than more determined support for promising and worthwhile poles of growth. Numerous studies are available which cast a critical light on this state of affairs.[7] Reform in favor of future-oriented policies is overdue.

Revision of the EU budget should deal with both the revenue and the expenditure sides at the same time. UK Prime Minister Tony Blair has signaled a willingness to enter into discussions about the British rebate in the context of agricultural reform. With that further possibilities open up. Packages of measures which combine political reforms with revision of the EU's revenue basis, although more difficult and complex, make possible – as is familiar from many European decisions – compromises and progress which do not appear possible in the case of an unbalanced fixation on one side.

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7. Cf. EU Commission (2001), *Unity, solidarity, diversity for Europe, its people and its territory. Second report on economic and social cohesion,* Brussels; EU Commission (2004), *A new partnership for cohesion. Convergence, competitiveness, cooperation.* Third report economic and social cohesion, Brussels; Michael Dauderstädt and Lothar Witte (2001), Cohesive growth in the enlarging Euroland, Bonn (FES); Daniel Tarschys (2003), *Reinventing cohesion. The future of European structural policy,* Stockholm (SIEPS).

Cohesion within the EU

Precisely because of the relative ineffectiveness of cohesion policy so far the reduction of prosperity differentials between member states or regions remains of great significance in the enlarged and further enlarging Union. Per capita incomes vary greatly within the EU. If one takes the EU-15 average to be 100, the richest country, Luxembourg, stands at 227, and the poorest in the eurozone, Portugal, at 50. Among the new member states the successful euro candidate Slovenia does better, with 54, while the Baltic countries, Poland, and Slovakia lag behind, at below 30. In terms of purchasing power parity the values are higher since the same amount in euros in poor countries can purchase more goods and services than in the richer member states. On that basis Slovenia reaches 74 percent and even the poorer post-communist countries almost 50 percent of the EU-15 average.[8]

The EU has set itself the goal of promoting »economic, social and territorial cohesion and solidarity between member states« (Art. 1–3.3 Constitutional Treaty, currently Art. 2 and 16 EC Treaty), and »reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions« (Art. III-220 Constitutional Treaty, currently Art. 158 EC Treaty). With the accession of eight poor post-communist countries on May 1, 2004 and plans for future enlargement to bring in predominantly very poor countries (Romania, Bulgaria, Turkey) the Constitutional Treaty gains considerably in importance.

The successes of cohesion policy so far are ambiguous.[9] Entry to the EU (or earlier to the European Commission) has seldom led immediately to higher economic growth. On the contrary, significant catch-up processes (Greece, Portugal, Spain) took place in Europe before 1970; the spectacular rise of Ireland began 20 years after its EU accession; and the second catch-up process of the »poor« member states of the South after 1990 only took place long after their accession (which in the case of Greece heralded relative decline) in the wake of currency union. Signifi-

8. All figures from *European Economy* 6/2004.
9. Cf. EU Commission (2001), *Unity, solidarity, diversity for Europe, its people and its territory. Second report on economic and social cohesion,* Brussels; EU Commission (2004), *A new partnership for cohesion. Convergence, competitiveness, cooperation. Third report economic and social cohesion,* Brussels; Michael Dauderstädt and Lothar Witte (2001), Cohesive growth in the enlarging Euroland, Bonn (FES); Daniel Tarschys (2003), *Reinventing cohesion. the future of European structural policy,* Stockholm (SIEPS).

cant interest rate falls (above all lower real interest rates due to the still higher inflation at the periphery) triggered a consumer and investment boom which ultimately raised growth rates well over those of the EU core countries and, sometimes dramatically, reduced unemployment (for example, in Spain).

The other poor member states should also be allowed this »miracle.« The stability gains of adopting the euro and the reduction of external economic risks such as revaluations and devaluations inappropriate for the real economy caused by speculative capital flows would benefit their economic development. The EU can cope with that perfectly well, especially in the case of small countries, which is what most postcommunist countries are (with the possible exception of Poland whose national income, however, is still only about the same as that of Hesse in Germany). Montenegro long ago, with the tacit connivance of the EU and without its economic-policy guardianship, adopted the euro, without problematic effects being observed.[10]

In fact, the post-communist countries were able to reduce the income gap with the EU-15 in the 15 years before entry. At the beginning of the 1990s the Baltic states stood at two percent and even the »richer« Slovenia at only 30 percent, while in 2004 they had already reached over 20 percent and over 50 percent respectively. How did this come about? Some currencies (especially in the Baltic states) were revalued. More important, however, was the higher inflation in local currency which was not compensated by corresponding devaluations. Real adjustments were clearly weaker.

These two phenomena rule out adoption of the euro, however. A poor country must remain outside in order to allow these processes free reign. Only when it is so close to the level of the richer countries of the eurozone that the catch-up process is slowed down is entry permitted. Unfortunately this optimistic interpretation is only partly valid. As most countries would like to join the euro, they find themselves obliged to stop exactly those processes (inflation, revaluation with regard to the euro) which in fact – in salutary amounts not harmful to competitiveness – are

10. This passage relies on Michael Dauderstädt, Euroland: Zutritt für Arme verboten? [Euroland: entry forbidden to the poor?], Bonn: FES, 2006; cf. also Béla Galgóczi and Gintare Kemekliene, *»Eurozone: a club of rich countries with slow growth – dynamic poor countries, please keep out?«* European Economic and Employment Policy Brief No. 3, Brussels: ETUI-REHS, 2006.

indispensable to catching up. In that way the waiting room for the eurozone could potentially become a poverty trap.

The economic-policy management of the euro-area should orient itself in such a way that the different countries organize their wage and price trends so as to maintain their competitiveness. Portugal and Italy have transgressed in this respect in the past. Portugal paid for it with a severe recession. However, some countries have sinned in the other direction, such as Germany, which has mercilessly cut back wages and demand in its home market and flooded its partners in the eurozone with its cheap exports. Germany's export surplus within the EU is about 120 billion euros.[11] A European economic policy should intervene in good time against both.

However, it would be wrong to want to prevent possible nominal catch-up processes in the form of higher inflation in all circumstances. Higher incomes are linked to higher prices in service economies. As long as productivity increases sufficiently in the branches of the economy which produce tradable goods this inflation is a healthy adjustment. It also ensures sufficient demand within the euro-area. Only if the purchasing power of the poor increases can higher employment be attained. Locking in income differentials is a recipe for poverty and unemployment.

For more rapid income convergence the policy of eurozone admission should be revised. Higher inflation and the revaluation of national currencies in relation to the euro should as such (that is, without additional problems, such as high balance of payments deficits) not be a hindrance to adoption of the common currency. Poor members of the eurozone should be able to have higher inflation rates than the eurozone average without being reprimanded by the EU.

An Enlarged Competition Policy

The increased heterogeneity of the enlarged EU opens up opportunities not only for specialization and modernization processes which increase

11. These figures rely on Michael Heine and Hansjörg Herr, »Die Europäische Währungsunion im Treibsand. Fehlende Lohnkoordination und fiskalische Schwächen gefährden das europäische Projekt« [European currency union in quicksand. Lack of wage coordination and fiscal weaknesses jeopardise the European project], in: *PROKLA,* Zeitschrift für kritische Sozialwissenschaft, 144 (36) (2006): 370.

prosperity but unfortunately also for Europe-wide »races to the bottom,« especially regarding wages and taxes. With the dismantling of most competition-distorting barriers (duties, quotas, trade barriers, subsidies, exchange rates, and so on) the prices of most tradable inputs of enterprises are converging and so too are their cost structures. European minimum standards as regards labor and environmental protection also narrow the ability of enterprises to obtain a competitive advantage by externalizing social costs. As a result, enterprises concentrate their efforts on the large remaining costs, such as wages, taxes, and non-tradable local inputs (land, real estate). This strategy is worthwhile for small member states in particular since any losses in tax revenues and demand incurred due to tax-rate or wage reductions can be more than compensated by attracting relocated enterprises which pay taxes and offer jobs.[12]

True prosperity of national economies or even of the European economy as a whole derives not from shifting costs between enterprises, households, and states, but rather from greater and more productive use of labor and capital. Competition policy should therefore create incentives for enterprises to optimize their operations and increase the quality of their products instead of attempting to compensate for failures in that respect by tax avoidance and downward pressure on wages.

Location competition between member states in respect of wages and taxes leads in extreme cases to, in competition-policy terms, questionable subsidization of production and – as far as export production is concerned – dumping as enterprises are relieved of all workforce reproduction costs and the costs of utilizing public goods. Stricter control is required here which allows for minimum wages and harmonization of corporate taxes. The EU's few social-policy competences (for example, labor protection, equality, social dialog) should be developed and not, for example, subordinated further to competition under the mantra of subsidiarity by means of renationalization.

Wages should tend to increase together with productivity. The EU's Broad Economic Policy Guidelines (BEPG) should therefore adopt a more balanced approach and criticize not only excessive wage increases but also excessive wage restraint (for example, in Germany). Workers should therefore be paid in accordance with the wage level where they

12. Cf. in more detail Michael Dauderstädt, »Der erweiterte europäische Spagat: Gemeinsamer Markt und sozialer Zusammenhalt« [The extended European balancing act: common market and social cohesion], Bonn: FES (2005).

work, not that of their country of origin, in order to ensure an appropriate level of reproduction. Members of the European Parliament apply this principle to their parliamentary allowances. Adjustment to the standards of the place of work can be ensured either through state minimum wages or generally binding wage agreements.

Harmonization of corporate taxation is to be driven forward along the same lines by standardizing the basis of assessment and improving the control of transfer pricing. The regional-policy argument that lower tax rates reflect the lower quality of the location is not really sustainable. First, states can finance the services, which determine quality of location by means of other taxes. Lower taxes therefore do not necessarily reflect a narrower range of public services but only their financing from other sources, which in real terms amounts to subsidizing the enterprises which utilize these services. Second, the EU provides other instruments to compensate for disadvantages of location, namely regional policy. Double compensation cannot be justified.

The long-term aim should be an EU corporate tax whose rates could be differentiated regionally. The criteria for classifying regions should be developed between the EU and the member states in a process based on the open method of coordination. A combination of per capita income and unemployment rate would seem reasonable. On the basis of these criteria enterprises in weak locations could be given tax relief. Such far-reaching reforms are clearly not on the agenda during the German presidency. However, a debate could be launched and by means of small steps (for example, regarding basis of assessment and transfer pricing) a serious effort should be got under way.

Outlook

Europe's prosperity consists of private and public goods and services and leisure time. Markets and social and political institutions determine their supply and distribution. Unavoidable dilemmas arise in the course of this: more leisure time restricts the supply of goods and services. The provision of public goods and services requires resources which thereby elude private use. Unequal distribution restricts both supply and demand by tolerating involuntary unemployment and increasingly giving higher incomes to the more thrifty rich. Member states have deployed various solutions for these things which are now competing in an increasingly harmonized Single Market. At the same time the establishment of

Europe-wide regulations, not least thanks to the enlargement to include countries with very different systems and levels of development, will be very difficult.[13]

One-sided market integration penalizes social arrangements which favor more leisure time and public goods, and at the same time proliferates income differentials resulting in weak mass purchasing power and so *subsequent* underemployment.[14] Growth and prosperity in Europe require supply-side productivity increases which are to be expected above all from specialization in the enlarged market and public provision of education and research. On the demand side, however, productivity increases can be ensured by means of a strong wage and income development commensurate with productivity, particularly in the poorer countries, as well as redistribution in favor of low-income groups. Only if common policies distribute the benefits of integration fairly in this way will the European project be able to regain its appeal, both internally and externally.

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13. Cf. Fritz W. Scharpf (2002), »The European Social Model: Coping with the Challenges of Diversity,« MPIfG Working Paper 02/8, Cologne: Max Planck Institut für Gesellschaftsforschung; Dorothee Bohle, »Race to the Bottom? Die Dynamik der Konkurrenzbeziehungen in der erweiterten Europäischen Union« [Race to the bottom? The dynamics of competition relations in the enlarged European Union], in: *PROKLA*. Zeitschrift für kritische Sozialwissenschaft, 144 (3), (2006).
14. Cf. J. K. Galbraith, Toward Income Convergence and Full Employment in Europe, Bonn: FES (http://fesportal.fes.de/pls/portal30/docs/FOLDER/POLITIKANALYSE/PUBLIKATIONEN/JGALBRAITH.PDF).