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## ECONOMIC POLICIES AND GOVERNANCE IN THE EU

(INTERVIEWED BY DELFIN PLLANA)

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### **Q.1 Where does the EU stand today, from a macroeconomic viewpoint? How did the May 2004 enlargement affect the macroeconomic outlook of the EU? And finally, does the Lisbon Agenda enter into this picture, and how?**

The EU now embraces 25 countries and about 450 million people. It is a union of countries, each of them committed to democracy. These countries have built common institutions, and delegated to them some of the powers which normally sovereign states tend to guard rather jealously – like the power to print money or that of controlling the borders.

But let me note one thing to begin with. We can talk about the EU-25 as one economic unit essentially because a common market has been established between those 25 countries (and in fact it has been also adopted by three other non-EU countries, like Iceland, Norway and Liechtenstein), and in this area the “four freedoms” - i.e. freedom of movement of goods (excluding agriculture and fisheries), persons, services and capital - are to a large extent granted.

Now, referring to the EU-25, we may note that its Gross Domestic Product is just slightly larger than that of the USA – about € 11000 billions. However, on a per capita basis, and adjusting for differences in the price level, this is still less than 2/3 relative to the US. We may think that this is rather good, if we observe that the US is the richest large country (that is, leaving aside Luxembourg) in the world. However, it does not appear quite so good, as soon as we realize that 10 or 20 or 30 years ago the gap in income per capita was more or less the same. In fact, the yearly growth rate of GDP in the US has been about 1% higher than in the EU (2.5 versus 1.5% per year) between 1996 and 2005. So the big question here is, why isn't the EU-15 able to grow faster, and bridge the remaining gap? Why is it instead losing ground?

Sometimes people tend to think that economists overstate the importance of this question. And I might agree with this objection, if our current level of wealth were distributed evenly throughout the Union. But it is not. It is not so in the “old” Member countries, where the GDP per inhabitant of Portugal is (on a Purchasing Power Standard) lower than 70% of the EU-25, and that of the South of Spain, or of the South of Italy, is also lower than 75% of the EU-25. And it is even less so in the New Member States (the 10 countries that entered the EU in May 2004, most of them former socialist countries). Among these countries, in 2006 GDP per inhabitant relative to the EU ranges from 75% for the Czech Republic, to 50% for Latvia and Poland. And it would be even lower if we considered the candidate countries: Bulgaria, Romania and Turkey have about 1/3 of the GDP per inhabitant relative to the EU-25.

And when we think of these inequalities, there is really only one way to get out of them: to grow faster.

This brings about the last part of your question, the Lisbon Agenda. This Agenda was motivated precisely by this problem: how can we grow faster? And the tentative answer was: by becoming a more competitive and a more innovation-based economy. But this is not so easy! We do not have simple, direct policy tools that can be manipulated to obtain this objective. Growth strategies are

complex and elusive. But the good thing is that most of the New Member States have been able to enter into the fast-growing track. All of them are growing faster than the old EU-15 countries. So some of those GDP inequalities I was referring to earlier on are going to be eased away by faster growth in the poorest but also more dynamic Members of the Union. But I think that we owe this result to the fact that these countries have become part of the Single Market, they have mobilized local resources, opened up their economies to foreign trade and have attracted a lot of foreign investment. The Lisbon Agenda, I am afraid, so far has not had much to do with this.

**Q.2 When we discuss the attribution of policy competences between the level of the EU and that of the Member States, do you think that the supranational level does in effect have more competences than it should really need? And which would be the most crucial areas where a dispute about the attribution of competences does arise?**

The one area where I see perhaps too much involvement is in the field of agricultural policy. This is reflected in the fact that, currently, expenditures for agriculture absorb almost 43% of all the EU resources. Now I can understand – and I think we all know - how this has come about historically, but frankly this is an absurdly high proportion, especially if we think that the contribution of agriculture to the EU GDP is about 2%. But on the positive side, budgetary resources committed to agriculture are going to decrease to 32% by 2013, so this is a small but relevant improvement.

If you ask about areas where I would like to see more involvement (and limiting myself to those aspects that are more directly relevant to the EU economy), I do not think that there is one area where drastic changes are really necessary. But I would like to suggest three areas of improvement.

First, I would like to see a more widespread adoption of the euro. The euro should really become soon, in the matter of a few years, a currency adopted by all the EU-25 Members. Not by imposing adoption of the euro, but simply because everybody should recognize their mutual convenience to do so.

Second, I would like to see every EU country to be also part of the Schengen agreement (only 13 Members so far have subscribed to its provisions for the free movement of persons across the internal borders). And at the same time I would like that the idea of a European Border Police Force could become true in practice.

Third, I think that there are a lot of differences between the EU member countries and that these are a part of our identities and should not be forced to disappear. But on the other hand, they should not become an alibi to prevent the development and the integration of the EU internal market, in all fields of economic activity. In this market, like in any market, there are those who gain and those who stand to lose something. But on balance, gains are much larger and widespread! Really, we must realize that growth opportunities are going to stay rather dismal if we do not complete, and further integrate the single EU market. In practice this means that the powers of Member States to prevent such developments must be kept in check. Currently there are many administrative obstacles and costs that deter companies, and particularly small and medium-sized enterprises in the service sector, from operating in another Member State. On these issues, I do not think that one should really advocate the allocation of new “strong” powers in favour of the EU institutions. More simply, I believe that the fundamental principle of mutual recognition should become better enforceable in practice.

**Q.3 Can we speak about fiscal federalism in the EU? And in which terms?**

The EU is a union of states, not a federal state. As a union, it is certainly very peculiar, or actually unique, because it enjoys a very large amount of powers, which have been conferred to it by the Member States, through a transfer of some of their sovereign powers. If the new Constitutional Treaty will ever be adopted, the EU will also have its own legal personality.

But among the powers conferred to the Union, those in the area of fiscal policies are quite limited – to understand this, just observe that the EU budget is 1% of the GDP of the Union, whereas in a typical Member State it would be between 40 and 50% of GDP.

Now, although this budget of the Union is very small by all standards - and I think that it should stay as such, a very small budget – some parts of it are managed according to the criteria of fiscal federalism and also of subsidiarity – that is, by allocating to the EU budget those areas of expenditure that would be dealt with inefficiently at the levels of the individual Member States. So in fact you can refer to fiscal federalism for some aspects of the EU budget, but I would not say that this characterizes the EU as a whole. For instance, each Member State decides by its own how much and how to spend on national defense, or how much redistribution should be done through the tax system.

#### **Q.4 Can we speak today of a single EU market? Is price segmentation still relevant, and to what extent?**

We certainly can and we should! But as all markets are to some extent imperfect, so is this one, and we must want, or vote, to improve it.

In this respect, you are right to ask about price segmentation, because it is precisely price differences in different parts of one market that make us realize how well, or how badly that market is working. In practice, what should we expect to see? I would say three things: first, that prices of widely traded consumer goods (like the ones commonly found in any supermarket in any European country) would converge more rapidly and more completely; second, that the adoption of the euro would contribute positively to speed up this convergence; third, that more slowly this process of convergence should gradually extend to the prices of *less* traded goods or services, and ultimately also to the prices of non-traded goods (like a residential apartment in a large city). In practice, these comparisons are difficult because most prices exhibit some dispersion also within each country and often also within each city. So to get reliable measures here it is really difficult, and also there has not been enough research of a systematic nature.

However, the data which we have show that there is considerable more price dispersion between the EU-15 countries than, for the same goods, between 12 US regions. And the introduction of the euro does not seem to have had much effect so far. There is another way to look at the same thing. This is to observe that there are some countries within the EU-15 where some prices are systematically lower relative to the others. For instance (and perhaps partly surprising) Germany and Spain tend to be rather “cheap” countries for supermarket goods. But if we include the 10 New Member States, prices here tend to be relatively less dispersed, and on average lower than in the old members.

Of course we would like to understand what keeps these prices different. There are several factors that explain this. Some price dispersion may still be attributed to different rules across countries, some to the different degree of domestic competition in each country, some to the costs of transport, and some also to the different preferences and habits of consumers. So I believe that we shall never see price dispersion disappear wholly, but we should still make considerable improvements in reducing it across the EU.

But let me conclude with one last observation on this point. In general, if price convergence is brought about by increased competition, then we should expect prices to converge towards the *lowest* initial price. But in some cases (and especially for non-traded goods and services) prices will instead converge to a higher average level, that is to the level previously prevailing in the richer countries. This might be unpleasant, but it is an inevitable part of the process of growth!

**Q.5 In which areas of economic activity has the EU been lacking, in comparison to the USA? And how, and through which policies, should the EU try to improve its performance in these areas?**

If you do not mind, I will answer this question in the relation to the EU as a whole, rather than in relation only to the policies adopted by the EU institutions. And again limiting myself to economic issues, I would like to mention two areas.

First, we are not good enough in the field of innovation, especially where new, high technologies are involved. One reason is that we do not spend enough, and especially that the private sector does not invest enough in this area: R&D expenditure in the EU-25 is 1.9% of GDP, whereas it is 2.6% in the USA (but also, it is above 3.5% in Finland and Sweden!), and the part contributed by industry is 1% of GDP in the EU-25, 1.6% in the USA, and also 2.5% in Finland and 2.4% in Sweden. So this means that in many of the EU countries, even among the rich ones (with the exceptions of Finland and Sweden, and to a lower extent of Denmark and Germany), financing of R&D by industry are totally insufficient. Another reason is that the two cultures – that of the research community and that of the shareholders and entrepreneurs – often find it hard to talk constructively to each other. And a third reason is that to make sure that these two cultures, research and production, end up happily married to each other, we need several institutions that work in the background to make this marriage possible, and I am thinking especially of the university system and of the financial system. So these are areas where there are a lot of improvements to be activated across the EU.

Second, we see in the EU a plurality of so-called “social models”. This term sums up all the institutions and policies which exist, within each country, to deal with the social costs related to the not-so-smooth workings of the labor market (for instance, the difficulties to find a first, stable employment, or to relocate between jobs after having lost one). In many countries (for instance, we have seen this happening recently in France) people seem to think that furthering the EU integration, and especially completing the internal market, would imply abandoning all ideas of a social support or of solidarity for those who are experiencing trouble in the labor market. But this view is incorrect. The real choice is not about giving up a social model that is based on principles of solidarity. Rather, the choice is between models of solidarity that are being purely defensive of existing firms and jobs, and thus end up by “freezing” both the labor market and the incentives of firms to grow and innovate, and models of solidarity that instead are conducive to higher and less costly mobility, that give incentives to workers to move to or to get ready for better jobs and that motivate profitable firms to grow faster. And we see this model at work right now in Denmark and Finland and Sweden, so I am surely not talking about a dream land! Thank you.