European Integration Process in the New Regional and Global Settings

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Preface

Main challenges faced by the European Union to compete successfully in the global market refer to the progress needed in innovation and productivity. Taking into account population ageing, shrinking of European labour force, and increasing migration on the one hand, and increasing pressures for social policy reforms and stabilization of public finances on the other, the European Union needs to mobilize all resources, in particular its intellectual capital, to keep its competitiveness. The world economic and financial crisis, and in particular recent economic problems experienced by the Eurozone countries, and consequently by other EU member states, showed visibly how difficult is to continue the common policies. These difficulties were deepened by other threats experienced at national levels.

Economies of the European Union have to deal with some substantial consequences of the crisis: a growth slowdown, an unemployment on the rise, a high deficit and a high debt. There are also downside risks to the recovery. Therefore Europe must change. There is still much to do in completing the Single Market. And Europe can do more to reach out of the World. If we open up to the new markets, actively access new sources of wealth and reduce trade barriers between the EU and other dynamic markets, the prize would be huge: Europe could gain 5.2 million jobs, more than the number we have lost due to the recession. We need to make it easier for companies to start up, grow and prosper as well as to develop new technologies and build new industries to meet the challenges of the next decade. The transformation demanded will not happen with a little tinkering here or there – we must move our continent‘s economy forward. In other words, as the Europe 2020 Strategy points out clearly the EU needs to become a smart, sustainable and inclusive economy. The challenge now is to make it happen.

The economic context of the current situation calls for a renewed effort to increase the competitiveness of the EU through making the intellectual capital more effective.

The right point of departure is to challenge the conventional wisdom. We have already learned that standard recipes to overcome the crisis are not enough and could be simply inadequate.

The present time requires making a hard choice that can get the EU economy moving, get people back in work and provide a perspective for those in need of help. But the cost is huge. And therefore we all have a shared responsibility to provide the solutions. The publication on the integration process in the European Union under ongoing changes in regional and global settings goes in line with the Europe 2020 Strategy[1], which emphasizes strongly a need to reinforce the policy coordination.

The book is mainly an aftermath of the international conference 'European integration process in the new regional and global settings' which took place on the October 19–20, 2011 in Warsaw as one of the flagship conferences under the Polish Presidency in the EU.

This publication focuses on selected issues presented and debated during the conference. The conference made itself a platform, where researchers, politicians and representatives of other sectors of economy from countries across Europe shared their expertise and diverse points of view on the EU integration issues. The opinions delivered, questions and remarks were invaluable to create this considerable volume representing differentiated capacity of integration perspectives.

Nowadays, it is observed that most of the Member States are strongly absorbed by national level issues like economic slowdown, unemployment, inflation, regional divergence, increasing state budget deficits, etc. This is why this time the EU is facing additional difficulties to manage a common approach in implementing relevant policies and getting both understanding and approval for them. The Europe 2020 Strategy, adopted by the European Council in June 2010[2], makes it clear how important the European integration process is for the smart, sustainable and inclusive growth under the new global and regional settings, strongly influenced by the recent world economic and financial crisis. Intensive economic interdependencies require more complex, coordinated and coherent reactions by the Member States in order to return to the sustainable growth path.

A coherent framework for the smart, sustainable and inclusive growth is based on enhanced coordination of policies to promote employment and growth driven by knowledge and innovation and to build a cohesive society. Its focus on innovation,

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[1] Communication from the Commission: EUROPE 2020. A strategy for smart, sustainable and inclusive growth. Brussels: March 3, 2010, COM(2010) 2020.

[2] Conclusions – June 17, 2010, EUCO 13/10. Brussels: June 17, 2010.

energy and climate, education and research, new skills and jobs, poverty, inequalities and structural reforms gives an opportunity to get back from the stagnation phase to the growth path.

For successive implementation of the innovation strategy, declared in the Europe 2020 flagship initiative of Innovation Union, a demand side of innovation processes should be revalued, both at the Member States and at the EU level. This requires a smart use of the single market with its mechanisms supporting a demand side. The single market may become an important innovation asset of the EU, provided that a more balanced innovation market emerges. For the moment, the situation in this respect is very uneven. While the European Commission may still play an important role in setting a vision and facilitating its implementation, the Member States should primarily support the demand for innovation themselves. This is conditioned not only by employing more the demand-side innovation policies at the country level but also by making the national innovation systems more complex. The Member States should also give their backing to ambitious initiatives of the EU aiming at consolidating the single market through the innovation policy at the EU level. The supply-demand relationship may thus be considered a typical example of a synergy where one cannot do without the other and the both are mutually intertwined. If we want innovation to flourish, one cannot just concentrate on the technological issues and innovation developments but has to consider the market strategies within the single market too. However, this requires, among other things, smart consumers (both public and private) as well as properly functioning markets for new products and services. Until recently, the demand side of innovation processes has been largely neglected. Meanwhile, the global economic crisis has marked a new turning point in the way the innovation and the social and market policies are approached.

The main aim of the publication is the promotion of a strategic and integrated approach to innovation which optimizes synergies between and within different EU and national/regional policies and ensures greater involvement of all stakeholders in the innovation process and supports the full use of Europe's intellectual capital. This approach promotes strongly the idea of policies for innovation, which might be very helpful in the process of successful implementation of the Europe 2020 Strategy.

The publication strongly emphasizes the need to reinforce the policy coordination. It is focused on topics we consider to be essential for the single market under these new settings, defined not only by globalization and technological changes but also by other factors like demographic change, new world political and economic interrelations, environmental change, scarcity of resources, political uncertainty, etc. For enhancing the EU capabilities to follow a path of the smart, sustainable, and inclusive growth a better use of human and natural resources (resource effective economy), promotion of energy policies, diminishing social and regional disparities by combating poverty and improving regional cohesion of the EU are crucial and need to be highlighted.

Part I includes the speeches presented during the conference and aimed at ‘setting the scene’ by referring to both innovation and integration processes in striving for a smart, sustainable and inclusive growth of the EU. Professor Maciej Banach – the Undersecretary of State from the Ministry of Science and Higher Education; Michał Boni, Ph.D. – Minister; Professor Leif Edvinsson – an expert of Knowledge Economics from Lund University and the Hong Kong Polytechnic University, and Grażyna Henclewska – the Secretary of State, the Deputy Minister, Ministry of Economics point out to enhancing integration processes through taking full advantage of the EU intellectual capital as well as its main components i.e. human capital, social capital, structural capital, and relational capital relating. The intellectual capital and its role were also included in the priorities list of the Polish Presidency of the European Council of European Union. As research contributes substantially to progress in the intellectual capital the paper by Dominik Sobczak – DG Research and Innovation, about research in Social Sciences and Humanities under the 7th Framework Programme completes that part of the book.

Part II covers most important issues connected with the reforms of the financial system in the European Union to enhance integration processes in the context of the growth demanded and effects of the financial crisis. Therefore, this part is focused not only on the Eurozone perspectives but also on the financial regulatory systems and the banking systems as well as capital and services flows. Special attention is put to the public finance consolidation in the European Union, in particular in Poland. The case study of Greece is discussed as well. The above aspects are raised in the papers by: Professor Marek Belka – the President of the National Bank of Poland; Professor Laszlo Csaba – Central European University (CEU); Professor Finn Østrup – University of Copenhagen; Professor Alojzy Z. Nowak – University of Warsaw, Faculty of Management; Professor Dariusz Rosati – Institut of Foreign Trade and European Studies, Professor Ewa Latoszek – Warsaw School of Economics, and Stanisław Kluza, Ph.D. – Warsaw School of Economics; Professor Axel Gerloff – Baden-Wuerttemberg Cooperative State University, and Professor Anna Visvizi – DEREE – the American College of Greece.

The EU economic integration is at risk of running at the two speeds. Since improvement of the effectiveness and efficiency of the EU funding instruments is perceived as one of the priorities of investing in growth, contributions of structural funds to the regional development were viewed from both the cohesion and competitiveness perspectives in **Part III**. As it was pointed out in the papers included here, under the Europe 2020 Strategy with its major focus on competitiveness, identified mainly in terms of the smart and sustainable growth, new and less developed EU Member States may not be able to benefit fully from the new cohesion policy instruments. Problems covered here refer to challenges and opportunities regarding the new cohesion policy for the 2014–2020 financial perspective of EU and faced by different actors including countries, regions, small and medium enterprises. The wide variety of the cohesion policy aspects are presented by: Professor Danuta Hübner – Member of European Parliament; Professor Willem Molle – Erasmus University; Dominique Foray – Lousanne Federal Polytechnic; Professor Andrzej Stępniak – University of Gdańsk, Professor Anna Maria Nikodemska-Wołowik – University of Gdańsk, Maciej Krzemiński, Ph.D. – University of Gdańsk; Piotr Zientara, Ph.D. – University of Gdańsk, and Aleksandra Borowicz – University of Gdansk; Przemysław Dubel, Ph.D. – University of Warsaw, Anna Masłoń–Oracz – Warsaw School of Economics, Doctoral Student.

Part IV presents some issues regarding social policy reforms, imposed by the demographic change. In the approach proposed, the population ageing accompanied by the shrinking of labour force and its ageing as well as the labour market transformations are considered to be the main drivers of reforms. Since pension reforms are at the top of that policy debate two papers by Professor Marek Góra, Warsaw School of Economics, and by Professor Edward Palmer, Uppsala University, present two views on main dilemmas and prospects of pension reforms in the EU. They refer to the already implemented pension reforms in the EU countries, lessons drawn from the experience, and an interplay between pension reforms and labour market policies. Main obstacles to harmonize pension policies in the EU Member States are commented as well. One of the preconditions for a successful increase of working lifespan is to adjust work places to the growing number of older workers. Until now, that aspect of pension reforms seems to be underestimated in the general debate. Professor Robert M. Lindley, Warwick University, contributes to that debate by presenting employers' attitudes and practices towards older workers and firms' adaptation to manage older labour force. The paper by Professor Irena E. Kotowska, Warsaw School of Economics, shows how important is ongoing demographic change in Europe for pension systems reforms.

Part V includes some specific issues of European energy policy aspects. The development prospects of the EU are strongly determined by the energy security. Without relevant solutions on this security it is impossible to combat the climate change. Contributions by Professor Britta Thomsen – the Member of European Parliament; Krzysztof Maryl, Ph.D. – Ministry of Economy, and Bartłomiej Nowak, Ph.D. – Kozminski University focus mainly on contemporary European challenges and future actions to be taken in the EU energy policy.

The publication is the final result of the EUintegRATIO Project of the 7th Framework Programme of Warsaw School of Economics and the Ministry of Science and Higher Education. It was supported by the Faculty of Management, University of Warsaw, University of Gdansk and the National Contact Point for Research Programmes of the European Union. Our team has started the work on the project two years ago. The time which passed since then convinced us on the importance of the selected topics for the future prosperity of the EU.

We propose some recommendations referring to different targets formulated in the Europe 2020 Strategy and suggest research topics considered as crucial for strengthening the integration process of the EU in its multidimensional aspects. The Europe 2020 Strategy relates to the social and economic model which is emerging in the EU following the recent recession and in the context of the crisis in Eurozone. There has been a number of attempts during the recent months to strengthen macroeconomic policy coordination, including the Euro Plus Pact. And it was our intent to discuss how these efforts should reinforce each other in the interest of further convergence and enhancing competitiveness of the EU. We also hope that these topics would be included in the future research programmes carried out under the EU Framework Programme.

In addition, the publication should also create a platform for discussions between scientists and policy makers, including governments' representatives, as well as other important stakeholders: non-governmental organizations, representatives of business (employers and employers associations), local authorities, different social groups (students, pupils and teachers), etc.

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Beside our appreciation of efforts of the conference contributors who have written their articles for this book, we would like to address our words of gratitude

to the conference participants whose presentations and views shared during the panel debates enriched our discussions, also in the book: Anna Cristina D'Aggio, Ph.D. – OECD; Marion Deware – European Commission; Professor Elżbieta Kawecka--Wyrzykowska – the Deputy Rector of Warsaw School of Economics; Markku Markkula – Committee of the Regions; Xavier Prats Monne and Milosz Momot – European Union; Professor Mario Monti – the Prime Minister, Italy; Jarosław Pietras, Ph.D. – Council of the European Union; Paweł Świeboda, Ph.D. – DemosEuropa; Andrzej Siemaszko, Ph.D. – National Contact Point for Research Programmes of the EU, and Yanis Tirkides – Cyprus Centre for European and International Affairs.

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Ewa Latoszek, the EUintegRATIO coordinator, Warsaw School of Economics,
Irena E. Kotowska, the EUintegRATIO vice-coordinator, Warsaw School of Economics

Part I

TOWARDS BETTER INTEGRATION OF EUROPE – TAKING FULL POTENTIAL OF EUROPE'S INTELLECTUAL CAPITAL

Leif Edvinsson*

Universal Networking, Intellectual Capital

I would like to salute you and Poland for the pioneering work you are doing on Intellectual Capital. It's a very important part of Intellectual capital (IC) that you have quality of life and happy life. I'm very grateful and honoured to be here today. You are pioneering IC on national level in Europe. You started to work on this some

* Leif Edvinsson is a key pioneering contributor to both the theory and practice of Intellectual Capital. As the world's first director of IC in 1991 professor Edvinsson initiated the creation of the world's first public corporate Intellectual Capital Annual Report 1994, and inspired the development ever since on IC metrics. He was parallel to that prototyping the Skandia Future Center as a Lab for Organizational design, one of the very first in the World in 1996, and inspired many to be followed. During 1996 he was recognized with awards from the American Productivity and Quality Centre, USA and Business Intelligence, UK. In January 1998, Leif received the prestigious Brain Trust 'Brain of the Year' award, UK, for his pioneering work on IC. In 1999 noted as Most Admired Knowledge Award on Knowledge Leadership. He was also awarded The KEN Practitioner of the Year 2004, from Entovation International, where he also is an E 100. In 2006 also listed in a book by London Business Press, as one of The 50 Most Influential Thinkers in the World. He is listed in Who's Who in the world. Also associate member of The Club of Rome. He is also Cofounder and Chairman of The New Club of Paris, focused on the Knowledge Economy initiatives. He is the author of numerous articles on the service management and on Intellectual Capital. In March 1997, together with Michael S. Malone, he launched one of the very first books on Intellectual Capital. He is also special advisor on Societal Entrepreneurship to the Swedish Governmental Foundation for Competence Development, as well as on Service Science to the Swedish Governmental Agency for Innovation. His most recent book is National Intellectual Capital, 2010, with Professor Carol Lin.

years ago, long before the European Presidency, so congratulations also for your persistency. I have been working on it for more than twenty years now.

I would like to share with you some perspectives on IC, some ideas, as Krzysztof Gulda, the Ministry of Science and Higher Education, Poland, was saying, about the framework. This IC framework is a very much about the taxonomy and insights. Actually, we need a language to share the insights. It's not Polish, it's not English. Instead, it's the new IC language. To a large extent we are trapped within the old language. It's called economics. We need a deeper understanding for the sense making, so I will share with you some understanding that I have gained during the recent twenty years – some perspective on what I have seen, and what I see.

IC is about more than the Human Capital. Unfortunately a common misunderstanding. IC is much more holistic, with inter dependent components like Human Capital, Relational Capital, Organizational Capital, Innovation Capital, Intellectual Property. The meanings of the words IC are Derived Insights of Head Value, or Future Earnings Capabilities. An ever more simple distinction is the roots for the fruits!

IC is something that I started to work with as Director of Intellectual Capital, in an enterprise called SKANDIA. We also started SKANDIA POLAND during that period. I ended up on the front cover of Fortune. I now have my academic role as Professor of IC in, among others, Lund University in Sweden and The Hong Kong Polytechnic University. I have also received an award as Brain of the Year, from the British foundation called Brain Trust, for this pioneering work.

Today we sense the signals of frustration around us. It might be these new groups of young people demonstrating outside federal banks, and big banks. Perhaps with some similarities to 1968 and the emerging student demonstrations. Look at the image of the American President Obama, who doesn't look very happy on the photo where he is next to the President of China. And in between we have situation of Greece and the Euro crises. So who is in power?

We need to think differently. This is the starting point for intellectual capital. Think differently. It takes a lot of courage. Michał Boni was pointing towards six or ten points as questions. And these questions can be called Quizzics – The art and science of Questioning. That concept is coming from work on Societal Intelligence, by the late professor Stefan Dedijer, a former colleague of mine at Lund University Policy Research Centre. Ask more intelligent questions. Don't recycle old stuff.

Intellectual capital is a way to think differently. It is a starting point for this IC process. One recent phrase was coming up on internet the other day – on the 6th of October 2011. What was Steve Jobs essentially doing in Apple? He managed its intellectual capital. And it was about the capability to give proper direction to the knowledge assimilated. So the question for us is whether we have been assimilating some knowledge in Europe? Of course, a lot. But that knowledge is recorded as expenses and debt. The IC dimensions are investments for the future capabilities!

Whether it might be something else? And do we have a proper direction? And do we have the right speed? Then you are approaching navigation rather than management. So it's actually about navigation of these intangibles that we have and will have.

With the economic situation of Greece on your mind, it has partially its roots in the heritage from Italy. It's called bookkeeping; double bookkeeping or historical cost accounting. It was launched in 1494 in Italy and basically hasn't ever changed. So we are navigating with an old system from 1494. Nowadays we have GPS for navigation. But we don't have economic navigation system. And that's the problem. We don't have the GPS for the intellectual capital. So this might be one of the important research topics. How do we develop the platform with the GPS for the intangibles?

And that takes us to one of definitions and distinction of the intellectual capital. The intellectual capital is about the future earnings capabilities. It's not about the past expenses – it's about the future value creating! It's a 180 degrees of paradigm shift. And that's the important part of it. But remember we have to go from 1494 to something that is more than ICT based navigation tool for recording and forecasting of the intangible value investments.

Nowadays I am also Chairman for The New Club of Paris. There we work with the Knowledge Agenda setting for Nations, we work with the cultivations of some of these IC aspects mentioned, but more and more we focus on Societal Innovation. EU is an old societal innovation. So, perhaps we need a renewed one. Who will take charge of that? And how does that look like? What is the intangible value down the road for Europe?

I would like to really amplify again that what you did in Poland in 2008 on IC of Poland really was a milestone. It was a pioneering pieces of work for others to follow. But, of course, it's not the new GPS yet. It was a starting point, though and so that could be called the IC report prototype. And it was a rapid prototype. We need much more prototypes to get to the further insights and deeper understanding of wealth creating of Nations based on Intangibles. We did actually the very first prototype of IC of Sweden, roughly at 1996, with the government of Sweden.

But the essence of IC of Nations is how do we mobilise collective intelligence for sustainability and renewal? This is one of the core navigation questions. Where IC of Nations is, is it inside or outside Poland? How do we transform this collective intelligence into a digitalized chip for intelligent navigation? Here the metaphor of GPS comes back again.

Some of you have heard the story of Ragusa. Ragusa was a very sustainable continuously growing wealthy City state. It was sustainable for around 600 years up to 1806. It is very long period. Continuous growth, focused on knowledge and wealth based on societal intelligence and also Dragomans. Another more modern word for Dragoman is Knowledge Navigators. Who are the knowledge navigators for the European Commission? Where do you find them? What gender? What cultural frame of reference?

One interesting part of this short old story is that now every summer a selected group of E-Students from Zagreb meet in this city called Ragusa, now called Dubrovnik. And we are collectively with young modern eyes searching for the questions in the deep learning during these 600 years and how that could be applied to the modern society. What was the tipping point for that Knowledge Society?

Traditional economics is about input – output. IC economics is about input – impact. Then you have to understand the meaning of opportunity cost. The opportunity cost is the best indicator down the road to look for when we're working on IC economics. The critical question is then: What if not Renewing and Investing for the Future?

Europe is a small part of the world and how should it be competitive? Is it a right navigation question? Could it be another question to look for – *e.g.* the collaborative opportunity spaces of Europe? Because the brainpower is not in Europe. The major proportion of global brainpower is outside Europe. So we have to in-source that brainpower. Even if we have more immigration of people into Europe, do we need to work on the cognitive space and tools for knowledge flow based on the ICT. Look at CERN, also mentioned earlier today. CERN in Switzerland is a very much based on in-source of brainpower or around 90% of the staff.

The other critical futurising dimensions is about where the Science funding will be coming from. Look at the R&D spending in China. In 2010 it is described to be roughly US$ 45 billion, and ten years later is 3 times more, or about US$ 113 bn, or 2.5 % of China GDP. How can Europe ever be competitive on its R&D? We have to be much more productive, much smarter, with much more intelligence in the Science sector. Or in-source.

But that takes also to another dimension of the new intangible economy. The GPS of Quality of Life! The President Sarkozy appointed a special report team with Nobel Prize laureates. Now the team with Christopher Schmidt is in progress with a dashboard for monitoring economic performance related to Quality of Life and Sustainability, with elaborated statistical indicators. Very interesting.

And there are more such signals down the road. One such is from the Global Affairs magazine MONOCLE. There they are annually ranking the best place to work and live. Number one 2011 is Helsinki, in Finland, followed by Zurich, Copenhagen, Munich, and Melbourne.

The importance of IC is growing. And this is actually how to transform Human capital into sustainable revenue value. A further refined model of ICM 3.0 is emerging, on how to act with these three major components of IC; Human Capital, Organizational Capital and Relational Capital. And it's not adding up. It is multiplying. And that's what Steve Jobs did. That's why Apple could present earlier in 2011 that they have 5% of the volume but 50% of the revenues in the mobile sector. It is a totally different business value model, leveraging networks and Relational Capital.

Another critical dimension is the growth of Europe. It might actually not be the right phrasing or perspective. The right phrasing is renewal. It is based on a biological sustainable metaphor. Growth might be as cancer. Understanding the rhythm of renewal becomes essential for the IC navigation.

In May 2011 Ben Bernanke, Chairman of Federal Reserve USA, was presenting a major missing gap in the American accounting system of roughly US$ 4 thousand billion, due to the fallacy of reporting on Intangibles. Just imagine if you add that sum to balance sheet of US. What will happen to the value of US dollar as an exchange currency? Will it go down, or will it go up?

We have now started to develop a unique national intellectual capital mapping system for IC of Nations. We have the date of base on Taiwan, developed by Dr. Carol Lin, with more than 40 countries and its IC development during more than 15 years, based on initially 28 indicators, and now 48 indicators. We have research collaborations in Finland with professor Pirjo Stahle, and in France with professor Ahmed Bounfour. You can find more information on www.NIC40.org

This is a kind of IC navigation map on macro level [see map below]. What we see is that Norway is growing upward, but not moving forward. Finland is moving forward but not going up very much. Sweden is going up and somewhat forward. Germany is almost tilting backwards. And Singapore has the most straight line upwards and forward during the last 15 years, giving a national IC to its citizens.

So if you then take Poland, it shows a very interesting powerful forward IC evolution. See the map below. Something happened in 2000, but that perhaps had already started in 1995. And if you then take the situation and compare Poland with Brazil and Russia, as famous BRIC nations, you see that Brazil is not going so much forward. Poland is going forward and upwards. And Russia is having a turning point 2008 downwards. Other benchmarking with *e.g.* South Korea shows that they are ahead. Australia is also ahead of Poland.

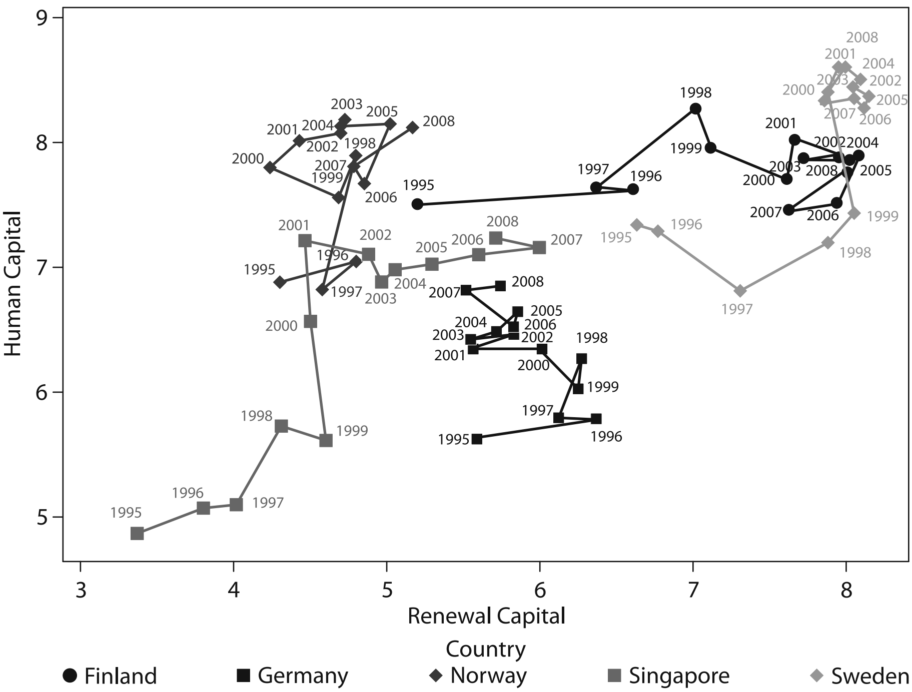

Figure 1. Scater plot Human Capital vs. Renewal Capital of Finland, Germany, Norway, Singapore and Sweden

Source: www.NIC40.org

You can also relate IC of Nations to something very interesting – GINI, which shows the income distribution. And then Poland has a very good and flat position, which means that you have probably a more sustainable outlook for the wealth creation than, for example, Brazil. And definitely than Russia.

NIC is not the total truth, but it gives you indications. NIC is a kind of starting point for Policy making of Nations. If you start you're moving into prototyping the GPS of Nations.

If you then go deeper into micro indicators for enterprises you will find Germany as the leading example for today on how to work with the intellectual capital. And you can find how they have been prototyping a process with them distributing 100 000 IC guidelines and software for support of the SME of Germany. This is a very impressive impactful IC work that started almost 10 years ago. A key player in it has been The Ministry of Economics and Technology in Germany and you can read more about it on www.akwissensbilanz.org

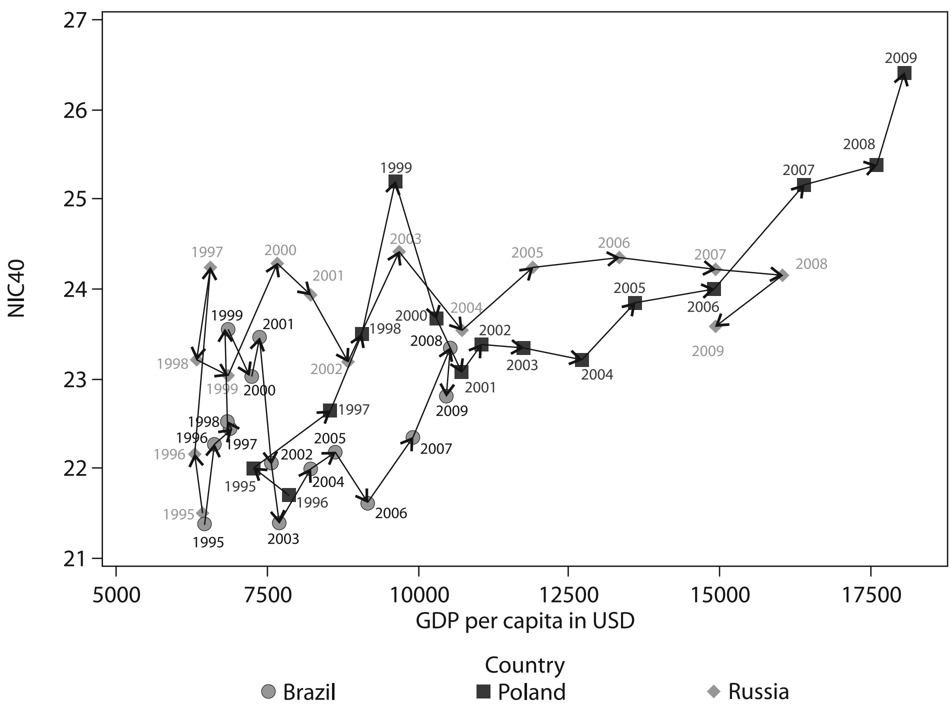

Figure 2. Scaterplott of NIC40 vs GDP *per capita* in USD for Brazil, Poland and Russia

Source: www.NIC40.org

One very important part of this is the system dynamics of IC as a holistic interdependency. It's not the adding dimension. It is the system dynamics, which has its origin at MIT in Boston and Professor Jay Forrester. This approach has also been expanded into a number of European countries under the support of the European Commission [see more on www.incas-europe.org]. This is not the historical cost accounting; it's navigation into the future and interaction of various IC components over time, as IC multipliers.

Another Nation leading since long has been Japan. They have initiated major programs for the Intellectual Assets Management and also what is called The World Intellectual Capital Initiative for accounting [see www.worldici.com]. It is now with the chairmanship from METI in Japan. Also, every year Japan arranges an IA Week – Intellectual Asset Week, together with the stock market, with the universities, and with the enterprises to share knowledge about the Intangibles. This has been going on for 7 years now in Japan, and something for Europe to pick up from?

Later on you can also move into the forecasting of IC. This is IC forecasting based on a selected list of predictive indicators with a unique Swedish IC software. You get a map like a landscape. For the qualified reader you start to see where you have the value peaks. If you are sliding down in value creation or if you are going upward and if you have the steep value in front of you? It is a trajectory dynamic fore cast for your IC navigation.

Which part of Poland is the most innovative? Why? We touched on the city areas as key aggregation spaces for the density of brainpower. You should have 2200 brains per square mile, according to some US research. And that's why we need this kind of prospective, or Cities of Opportunities [see the report of www.pwc.com/cities]. One perspective is seeing the city as a brain. And where is the Pre Frontal Cortex of the Urban Design?

We are moving from perspective of suburbia to that of sustainia. From suburbs and shopping malls to something that gives you a space as Mind Zone for societal innovation. Now we see the importance of an extended IC, as the in-sourcing of brainpower for Societal Innovation.

Finally one of the big potential IC areas of Europe is the Public Sector. And if you see that sector as % of GDP, France has 53.4%, Denmark – 53.1%, Sweden – 52.9%, Belgium – 50.8%, and Finland 50.4%. What's the efficiency of that intellectual capital? Is it hidden IC? Or idle IC in waiting? How can you work with it?

Societal Innovation and the third sector with Societal Developers 2.0 might be an option? The New Club of Paris together with Markku Markkula, Helsinki, has been pioneering something called the Aalto camp for societal innovation – ACSI [see also www.acsi.aalto.fi]. ACSI is a cross disciplinary, cross generational, cross cultural group of volunteers working on rapid prototyping on real cases during 8 days. The first one was arranged 2010, the second one 2011, and next one 2012. Furthermore, there are also now emerging initiatives in Asia as well as other places.

So to summarize into some points, mainly for action:

- Think IC, and its holistic value. Don't drown in thinking about the historical cost/expenditure accounting and debts – that's the old way of 1494 thinking.
- Arrange IC or IA weeks, like in Japan, for various stakeholders, to leverage Hidden Wealth.
- Visualize and report IC, like IC of Poland started in 2008 on hidden values, on 3 levels, the societal level, the enterprise level like in Germany and the individual level.
- Shape IC labs or Future Centre for rapid prototyping of Innovation, see www.fc-alliance.net
- Initiate new type of urban design for special parts of the city, like urban Mind zones, with the right density of brains, and with the endorphins flowing in between the brains.
- Mobilize and energize Societal and Social Entrepreneurs, like in ACSI, for societal innovation.

So, Michał Boni, what's your intellectual capital now? Is it valuable as a chip on your business card, or when will it be available on your business card as a chip? And how are you going to make more out of it?

With these different aspects of IC and some suggestions for the European IC policy I wish you Happy Future.

Michał Boni*

Levers of Poland's Development

I would like to express my deepest gratitude to Professor Leif Edvinsonn, who will speak right after me. His works were an inspiration for us when we were preparing a report on intellectual capital, published in mid-2008. The discussion initiated then concerned four dimensions of intellectual capital: a role of social capital or trust, a role of human capital (so everything what's in people's heads and their abilities), a role of structural capital (so everything what's brought to the table by the institutions) and a relational capital (so state's and economy's international relations). Intellectual capital, only if understood as a sum of these dimensions, constitutes an important development factor. For this inspiration we would like to thank You again Professor.

Today, taking the opportunity to participate in this conference, I would like to share some remarks and thoughts on the situation of Poland and to define levers of development. Personally, I emphasize ***the importance of seven levers of development***:

– a lever of integration,
– a lever of allocation,
– a lever of innovation,
– a lever of aspiration,
– a lever of digitization,

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– a lever of urbanization,
– a lever of participation.

What does the lever of integration mean? Everybody talks about a need for broader and deeper integration of the European Union. The representatives of the European Union declare that European integration process is a kind of 'unfinished business'. Obviously, this opinion is correct. Nevertheless one should remember that European Union has built a monetary union, currency union as a political project which is maybe premature in terms of individual countries' readiness for full, real economic unity (with respect for sovereignty). The crisis reveals various weaknesses of monetary union as well as of the entire European economy. In such context we should ask whether the monetary union shouldn't have been preceded by a fiscal union and a political union? When we discuss rescuing Europe, strengthening Europe's integration, shouldn't we emphasize even more than contemporary political class the need of integration understood as a full fiscal and, most of all, political union?

These questions are not easy to answer and these problems are not easy to solve, but if we refuse to confront them directly, we will continue to run in circles and in fact rescue the Eurozone at the expense of the other part of Europe by developing a EU-17 secretariat to bypass integration mechanisms functioning in EU-27 format. These are key questions for the political future of Europe. Defining the true meaning of further political European integration requires broad horizons and new political impulses.

These are the characteristics of the integration lever, which, I believe, is indispensible for the whole Europe.

The second lever of development, for the sake of narration, I call a lever of allocation. The crisis has exposed various types of imbalances, in particular between the states enjoying budgetary surplus and those experiencing budgetary deficit. The imbalances regarding public debt and public finance sector deficit require strong measures and remedial policies involving reduction of deficit and eliminating threats of rising debt. The goals concerning these issues should be achieved as soon as possible.

But let us pose a question: so ok, we achieve a better balance of public finances, we stabilize a situation in several countries as well as the situation regarding deficit, so what? Will Europe be happier because of that? Will it be more effective in competition with Brazil, Mexico, Indonesia, South-Eastern Asia? Not necessarily so…

This leads us to a question: how, while undertaking all the actions aiming to consolidate the finances, introducing security to public finances, how much allocation do we really need in the field of public spending? That's why I discuss the lever of allocation. Keeping public spending in a state like Poland, in relation to GDP, on the same level (around 42%–44%) is of key importance. Austerity is the most important instrument. But its course and scope should have an appropriate profile and a format large enough so that while saving money we should keep the level of spending, if not make it larger, in the development dimension (infrastructure, public health, education, science, culture, *etc.*).

It will not make any sense if cleaning up the European finances is to be done at the expense of Europe's abilities to develop. It makes any sense only if spending on development will rise. Introducing a sort of an iron curtain to stop the disease of public finances' imbalances is not enough without developing new competitive advantages.

This, of course, requires more radical and dramatic decisions, including dramatic austerity decisions. This requires to openly say that we cannot afford badly conducted social transfers and that we should be more interested in promoting development. In Poland it is necessary to say that by changing the model and the allocation format in the second pillar of the pension system we have managed to reduce public debt rise by almost PLN 200 bn (around 14%) in interest of both the nowadays and the future pensioners. To better balance the public security and pensions system in the future we need to rise the retirement age, so in 2027 it would be 67 years for men and women, which in turn will result in PLN 150 bn (10.5%) advantage in pensions' system in 2020–2030.

The third lever – the lever of innovation. Of course it's easiest to say that the problem will be solved by bigger spending on research and development. Surely they should be bigger, we assume so also in case of Poland (a goal till 2030 is 3% of with flexible structure, that is 2/3 of private sector shares). If we compare Europe to the USA or Japan, it hardly ranks favourably. What is the key? The key is to understand that the lever of innovation will work if we develop a complete formula of actions promoting innovation – a kind of 'innovation vehicle'.

We should begin with early kindergarten education. The school and digital education in school as well as developing competencies reflecting the changes in economic and digital background are all important. Important is the graduate who is qualified, competent and mentally matched with the requirements of the labour market. Important is the graduate who will be able to change her/his qualifications throughout the whole professional carrier. Infrastructure is very important – the 'innovation vehicle' cannot miss the contacts between cities, between cities and villages, between various territories. Philosophy of spending in the field of science, its commercialization and competitiveness are of pivotal importance – what is effectively promoted in bills recently accepted in Polish parliament. A different kind of business-science cooperation, more open, enabling the business to articulate its own needs and create pressure, to persuade what kind of researches is needed to develop market advantages in the field of merchandise and services. It's time to abandon the habit that the world of science dictates what kind of research it wants to sell to the economy.

And finally the last aspect of the lever of innovation – counteracting the weaknesses of enterprises. Very few European enterprises cooperate with enterprises from other countries (around 10–15%). The European market itself is also developing slowly. European entrepreneurs rarely cooperate with entrepreneurs from other parts of the world (less than 10%). Polish entrepreneurs are innovative to a very small extent so we should ask ourselves are we not witnessing the slowdown of Polish entrepreneurship. After a great success of Polish entrepreneurship during the transformation period – we should alter the impulses running to the business-world to promote innovations better.

The fourth lever – the lever of aspiration. Why I believe it's important? Because as the societies develop, so do their economies. Because in reality the societies build and energize the economy, not some mythological markets. The societies energize the economies by generating demand for various products and services. The societies, depending on the level of their development, have their specific and individual aspirations.

Poland is a country of great aspirations, especially its younger generations. From a certain point of view the consumerist pressure is granted for next minimum twenty few years. Why is it so important? Because this fact means an aspiration to improve the quality of life. The only really important instrument of developing the lever of aspiration is to improve the situation in the labour market, because only through work and salaries people may chase what they aspire. What does it mean 'through work'? It means a higher employment rate: more women will find jobs (if the rate employment of men and women in EU was equal, the European GNP would rise by 10 percentage points), young people will start professional carriers earlier and will achieve a stable situation on the labour market sooner. That in turn means shift in retirement age as we will work longer – the answers are obvious. One may ask how to do it but asking 'is it necessary' is out of the question – the answers are so obvious, especially from the point of view of demographic challenges. The shift in retirement age gives 300 thousand more professionally active people till 2020 and 1.2 million till 2030, what would allow to balance the effects of ageing society and lowering birthrate. At the same moment, if we want that Europe, or Poland, kept balance on the labour market in the next 10, 15 or 20 years, we should not be ashamed to talk that a higher birthrate is needed. However, if this is to happen we need to create better conditions as far as baby care is concerned, especially when one wants to combine professional carrier with family aspirations.

The fifth lever of development – the lever of digitization. As John Hagel III and John Seely Brown discuss, in their book 'The Power of Pull', how globalization and Internet influence the development of the global economy during twenty years of Internet functioning, they introduce a term 'Big Shift'. All the consequences of digital solutions functioning in various dimensions of life and different parts of economy are revealing themselves just now. We have a great chance to hasten the process of digitization, which of course involves broadband and fast Internet as well as developing digital competencies in the whole society. This makes solutions for the digital school so important. Employing lever of digitization means skilful exploitation of the speed of information management, public information and open sources (placed in repositories) easy available and free of charge. As Tapscott and Williams put it in their works concerning 'wikinomics', the contemporary world is a new great Alexandrian reality. We use a great library, like citizens of Alexandria in their times were using the splendid library, we can use Internet to democratically exploit access to knowledge and heritage. This also involves changing ways of conduct in the sphere of economics. Not long ago in Brussels, during a conference on innovation, a report concerning micro-multinational enterprises was discussed, kind of against a stereotype that only large corporations are multinational enterprises. The microenterprises, so the ones employing less than 10 people, give a great opportunity to everyone around the world to cooperate, introduce new services and products. Internet makes this process easier and faster. I see great development reserves in digitization. It involves greater openness of electronic economy and trade. Already today electronic economy in Poland generates 2.5–2.8% of the total, although only 2.5% of purchases are done on the Internet, while in EU the average is 6%. One of the goals of the Polish Presidency is to introduce the 28th regime, that is an optional choice to introduce unlimited Internet trade. If we have 27 legal regimes in different European Union countries, the 28th is to be optionally chosen – to promote electronic exchange without barriers and involving much more simple procedures. Developing 'digital impetus' in Poland will create vast reserves of productivity, increase innovativeness and state's effectiveness, introduce participation in a new type of culture – a convergent culture, based on intertwining media and transfers, create a new actor of cultural participation – 'a prosumer', a unified creator and producer as well as receiver and consumer of culture. In effect, Poles will become more creative. Over the next decade this will be the factor determining the competitive advantages.

The sixth lever of development, **the lever of metropolization**. In metropolises a new type of economy basing on new types of services is developing. More jobs are created in metropolises, or – as Florida calls them – 'mega regions'. This creates an added value, living is better – in 10 big Polish cities over 50% of is generated. The academies, the culture, they are in metropolises. One lives a different life in a metropolis. It is also worth remembering that the metropolitan culture and Power depend not only on its size and number of its citizens. There are no large cities in Scandinavian countries, nevertheless all development patterns and strengths of metropolises are functioning there.

One of the questions fundamental for economic development is – and I will state it quite clearly: what do societies do when they are not working? In the past it concerned the privacy of people, today it concerns the development of 'business leisure time'. On one hand it is complex and with promising prospects. On the other it creates framework for changing lifestyles and for satisfying the need to balance the work and private life, which is now present on a scale unimaginable in the past. Medieval cities to satisfy this need desired the Carnival. Metropolis of today is a permanent carnival.

And the last lever – the lever of participation, closely attached to new forms of democracy and state's effective and citizen-friendly functioning. In the contemporary world, in particular in developed countries, one feels a great deficit of both: of strong leadership and of citizens' participation in real democracy. Improving the situation is indispensable. However, there is a feedback between acceptance of the strong and effective leadership and opportunities for participation in decision-making processes. It's a paradox but stronger the participation means stronger leadership. Social capital is a premise of good cooperation between the Power and the society.

To improve the situation in this field it is indispensable to improve the practice of administration, to care about the client satisfaction of the citizens more, especially when they are receivers of various public services. Effective services, employing digital techniques for their greater transparency and speed, wide spectrum of consultations on-line, healthy balance between Internet freedom and protection of citizens' rights and state's security – these are the tasks to be realized by employing the lever of participation, that is developing a participant democracy.

Can Poland face the challenges listed above and employ the levers of development correctly?

And is there any other choice than to run forward and exploit the levers of development?

Maciej Banach*

The Key Role of Intellectual Capital in the Process of Modernization

Over the last few decades, the European integration has become one of the most important processes on a European and global scale. The European Union is now a symbol of integrating Europe, overcoming the barriers and finding common solutions which support the growth of well-being of all citizens.

Today the EU has reached a special moment of development, as it is changing in the scale and scope unseen for many years before. The economic crisis and global challenges the European society is facing, require finding and implementing new solutions at international scale, especially in order to strengthen the economic growth and development.

The activities aimed at strengthening economic growth in Europe have been presented in the Europe 2020 Strategy. According to this Strategy, the vision of modern European economy and society should be based on smart, sustainable and inclusive growth. The Europe 2020 Strategy also presents very ambitious goals, as

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well as activities and initiatives to enhance their implementation. Seven flagship initiatives have been proposed to achieve ambitious goals of the Europe 2020 Strategy. Implementation of these initiatives is a common priority requiring activities at all levels: the European Union, as well as national, regional and local authorities.

The activities aimed at strengthening economic growth in Europe are also one of the priorities of the Polish Presidency of the EU Council. They encompass inter alia deepening the Single Market, completing its formation and using European budget to improve European competitiveness (Multinational Financial Framework after 2013). These efforts also include the initiatives aimed at finding new sources of European growth and well-being of European society, which have been derived from its unique experiences and resources.

The key resource influencing European competitiveness is intellectual capital. The importance of the full use of intellectual capital for competitiveness of European economy was underlined by the Competitiveness Council (in October 2010) and the European Council (in February 2011). This topic was also discussed during the ministerial conference preceding informal meeting of the Competitiveness Council, which was organised in July 2011 in Sopot. During the conference, entitled 'Intellectual capital – creative impact', a very interesting and inspiring discussion was held about intellectual capital in the context of modernization of universities, cooperation of science and business and mobility of researchers. The discussion was attended by high level representatives of administration, business and academia, in particular Mrs. M. Geoghegan-Quinn, the Commissioner for Research and Innovation, Prof. L. Borysiewicz, Vice-Chancellor of Cambridge University, Mr. Ben Verwaayen, CEO of Alcatel-Lucent and Professor S. Bertolucci, Director in CERN.

The aim of the Priority 'the full use of Europe's intellectual capital' is to strengthen European integration through activities improving cohesion and synergy between policies and initiatives of the European Union, as well as to underline the role of research and innovation in building modern European society. Modern Europe requires carrying out research and introducing innovation, which address global challenges and facilitate the increase of competitiveness and innovativeness of firms in Europe. Moreover, the full use of intellectual capital includes active engagement of all European regions and countries in supporting research and innovation to decrease the disparities in the level of innovativeness between the strongest regions and the catching-up regions.

The debate on the full use of Europe's intellectual capital is now held on many forums of the European Union, in particular in the fields of the modernization of universities, partnerships in the areas of research and innovation, creative and cultural competences, mobility of researchers and youth.

It's particularly important that the debate on the full use of Europe's intellectual capital and European integration as new sources of growth is conducted on many different forums. The great example of this is the conference 'European integration process in the new global and regional settings'. Among the issues mentioned in presentations and papers presented during the conference there are many important topics related to social reforms, financial systems, energy policy and regional policy. They present how complex the process of European integration is. The presence of such eminent Authors also confirms that the debate about European integration is still important and topical.

Grażyna Henclewska*

How to Enhance Growth in the Context of the *Europe 2020* Strategy

First of all I would like to thank the organisers for inviting me here today. As we all know, Poland's first EU Council Presidency takes place in a special period for both Poland and Europe, on account of the economic and financial impacts of the ongoing crisis.

In accordance with the *Europe 2020* Strategy, we all want the EU to become a smart, sustainable and inclusive economy. But one of the conditions for achieving these objectives is the effective coordination of Member States' economic policies, as pursued in line with the so-called 'European Semester' concept.

However, it is of the utmost importance that we pursue an economic policy that will, on the one hand, ensure reductions in Member States' budget deficits, and, on the other, will seek out new sources of competitive advantage.

More than anything, the EU needs accurate identification of opportunities and threats, so that it can take appropriate preventive and pro-active measures, in order to ensure stable foundations for the growth and development aspirations of present and future generations.

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* Grażyna Henclewska is Undersecretary of State in the Ministry of Economy in the government of Donald Tusk. Before, she worked in Ministry of Economy as the director of the Department of Analysis and Forecasting.

In this context, the Presidency sees the need for serious discussion of the methods by which European economic policy is pursued, and emerging globalisation challenges responded to.

During my short speech, I would like to focus on one of the *Europe 2020* strategy's objectives, namely smart growth. The acronym SMART is often used for setting targets. It can be read as Specific, Measurable, Agreed upon, Realistic and Time-based.

Today I would like to propose to you a new approach to the understanding of the SMART acronym, which in this case is read as follows:

- **First, S is for sources of growth**

The Polish Presidency has initiated a debate on growth, and has focused EU activities on it, by publishing on 6th October its report '**Towards a European consensus on growth**'. This report suggests implementing selected initiatives in:

– Human capital,
– The Single Market,
– The SME sector,
– Infrastructure,
– European environmental policy,
– European regional policy,
and
– External sources of growth.

- **After S for sources of growth, we have M for management**

Our struggles to overcome the crisis have so far focused on reforming economic governance, and the EU now has powerful tools by which to enhance economic policy coordination, and ensure that required measures to pull Europe out of crisis are taken.

A crucial step was last month's informal meeting of the ECOFIN Council, at which the **package of six legislative proposals** on economic governance was agreed. This will provide for the higher degree of surveillance and coordination that is so much needed to ensure sustainable public finances.

- Let's now go to the next letter of the SMART concept – to **A for ambition**

Strengthening EU growth and competitiveness requires a high level of ambition, at both national and EU levels. The European economy is now competing, not only with the US, but also with the dynamic emerging economies. We all need a **political commitment and increased ownership** if the goals of the *Europe 2020* strategy are to be met. Effective measuring of progress and monitoring of achievement is needed in relation to these objectives, so country-specific recommendations for Member States made in the first European Semester should be implemented without delay.

- The next letter after A is **R as in responsibility**

Right now, when we see people on the streets that feel excluded (the so-called 'Angry Ones'), it is critical that a strong signal on the **importance of collective effort** should be given. The priorities for further EU action should therefore entail a strengthening of cooperative links so that broad support for the implementation of *Europe 2020* strategy objectives can be built. Appropriate identification of challenges, as well as the provision of a space for the exchange of knowledge and experiences between a wide range of stakeholders, will strengthen the effects of synergies between individual EU policies. It will also increase ownership for the success of the *Europe 2020* strategy.

- The element that comes last, but not least is **T for trust**

Above all, we must **rebuild confidence, credibility and trust** in the regulators and markets. There needs to be intensive work to change the culture of mutual relations between public authorities and market participants, with a view to good governance being pursued. Before our eyes, a new social and economic order is developing. The challenge is to exploit the possibilities this gives to increase transparency and trust reinforcement. In particular, it is important for us to apply appropriate risk management models, in order to understand the dynamics of markets and ensure an adequate and swift response to failures.

Now, I hope that you have found the abovementioned elements of the new SMART concept interesting. The economic crisis cannot be allowed to turn into a crisis for the EU concept, whose very essence is cooperation, solidarity and shared responsibility for Europe.

It is therefore important that we choose the right combination of measures, in order to overcome the crisis and build a strong and more diverse economy that is resilient to future shocks, and opens up new opportunities to use the potential for cooperation and creativity and create shared value.

Dominik Sobczak*[1]

European Union Framework Programmes for Research and Evolution of Funding for Social Sciences and Humanities

1. Introduction

This article aims at presenting the evolution of European level funding of research, including its magnitude, scope as well as changing approaches and priorities, both overall and in the area of social sciences and humanities in particular.

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[1] The views expressed in this article are sole responsibility of the author and do not necessarily reflect the views of the European Commission nor engage the European Commission in any way.

In the first part it discusses the policy background and major features of all hitherto framework programmes, since the first one in the 1980s to the seventh scheduled to end in 2013. At the same time it gives an outlook into the future with a short presentation of major features of the Horizon 2020, a new research programme for the next EU financial perspective. It pays particular attention to key moments in European integration as well as key political developments which shaped the EU research agenda. It discusses the underlying factors leading to substantial increase of European level funding for science over the years. It presents the evolving rationale behind the EU research funding as well as describes how new programmes were designed based on a combination of continuity and novelty.

The second part is dedicated to the evolution of funding for social sciences and humanities under the different framework programmes from the moment when the EU received a clear mandate of the Member States to take up such research. This part will also demonstrate the evolution of EU funding in this field and will characterise main priorities of each of the programmes. It is a testimony of developing research activities in SSH through the last two decades to address socio-economic challenges facing Europe and respond to deepening of European integration, globalisation and modernisation of the economy and ongoing structural changes in the society as well as evolution of international relations.

2. Evolution of research policy at the EU level

The European Union's research policy is as old as the European project itself. The initial elements appeared with the creation of the 'European Community', at the end of the 1950s. In particular, the European Coal and Steel Community and 'Euratom' treaties included provisions for research in the fields of coal and steel, and nuclear energy respectively. The third treaty, setting up the European Economic Community, did not include anything like this. However, one of its general articles allowed for the launch, during the 1960s and 1970s, of a certain number of research programmes in areas considered as priorities at the time, like for example energy, environment and biotechnology [André 2007].

The idea to create a framework programme appeared only in the beginning of the 1980s in order to address the profusion of research activities at Community level by putting them together under a single framework planned for a medium-term and therefore resulting in a budget covering several years rather than just one. In effect, the 1st Framework Programme was launched, covering the period 1984–1987 and with a budget of €3.75 bn.

Since the launch of the 1st Framework Programme (1984–1987), research funding at Community level consistently gained in importance, both in terms of increasing scope, as well as growing budget. Figure 1 presents an overview of the evolution of the Framework Programme budget over the years, both in absolute terms and annually, including the budget for the Euratom Framework Programme. It is clear that with each decade EU research funding increased very substantially from around €1 bn a year at the end of 1980s, through almost €3 bn at the end of the 1990s to close to €8 bn at the end of the first decade of the 21st Century. The current Commission budget proposal for the next Framework Programme, called Horizon 2020, continues this trend. If it is accepted, EU level research funding will reach over €11 bn per annum by 2020.

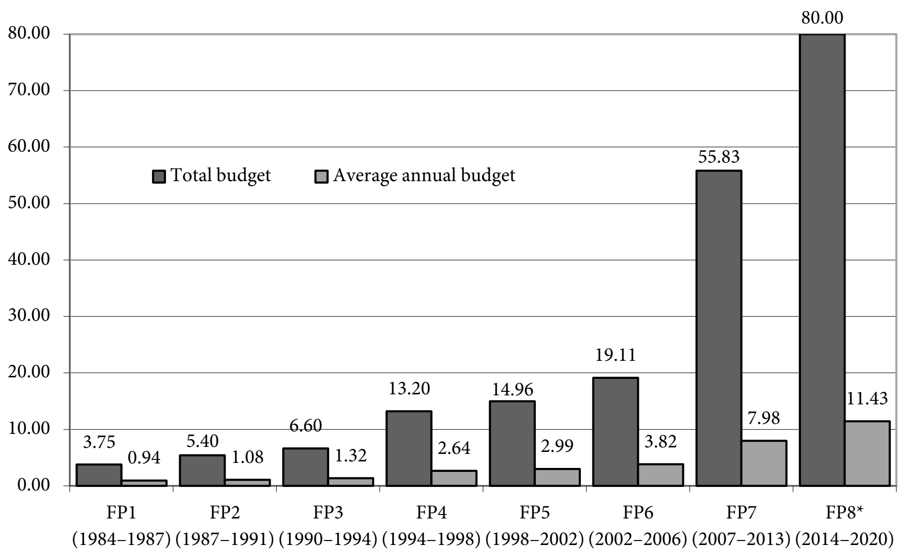

Figure 1. Evolution of the Framework Programme funding (1984–2020, in billion euro)

[a] The figure refers to the 29/06/2011 Commission proposal for a budget for HORIZON 2020, the successor to the 7th Framework Programme, within the Multiannual Financial Framework 2014–2020.

Sources: CORDIS and DG Research and Innovation, European Commission.

When the 1st Framework Programme was created, however, research policy at Community level still had no legal basis in the Treaty. Science became a Community responsibility only after the Single European Act, adopted in 1986, introduced a specific chapter on this subject which started with the following sentence: 'The Community shall have the objective of strengthening the scientific and technological bases of Community industry and encouraging it to become more competitive at international level' [Single European Act 1986: Art. 130f, Point 1]. With this provision research became part of Community initiatives aimed at optimising the potential of the internal market.

Following the Single European Act, the 2nd Framework Programme (1987–1991) was structured along three general objectives. They included strengthening the scientific and technological base of the European industry, with particular focus on SMEs and on high technology, developing its international competitiveness and reinforcing social and economic cohesion in the Community. Overall, FP2 had a pronounced industrial aim, and devoted a substantial part of its budget to enabling technologies such as telecommunications, information technologies, biotechnology, medical research and advanced materials with an objective to find rapid application in industrial production and other socio-economic activities [Communication from the Commission 1992]. The Programme received €5.4 bn of funding and adopted the approach of a five year perspective, one which was maintained until the end of the 6th Framework Programme.

The 3rd Framework Programme (1990–1994) was the first one based, from the outset, on provisions of the Single European Act, because when FP2 was being prepared the new Treaty was not adopted yet. The Programme was conceived as a result of reflection and in-depth analysis of European needs and the specifics of Community action in the research field. The programme consisted of six lines of action under three main headings: enabling technologies, management of natural resources and management of intellectual resources [European Yearbook 1992]. Figure 2 presents the breakdown of the €6.6 bn assigned to FP3 into the six lines of action.

The first heading 'Enabling technologies' consisted of two lines of action dedicated to ICT and industrial technologies and materials which received over €3.5 bn of funding representing 53.4% of the total for FP3. The second heading 'Management of natural resources' consisted of three lines of action focused on environment, life sciences and technologies as well as energy, with the total budget of €2.5 bn representing 37.7% of the Programme. The last heading 'Management of intellectual resources' consisted of one line of action on human capital and mobility with €587 million (8.9% of the total). The analysis of the different activities suggests that the whole programme was largely technology driven with three out of six lines of action having technological development as their main focus, as well as with some technology components under 'Life sciences and technologies' and 'Environment'. From the budget perspective, 76% of funding under FP3 was dedicated, in broad terms, to development of technologies [Framework Programme of Community… 1990–1994].

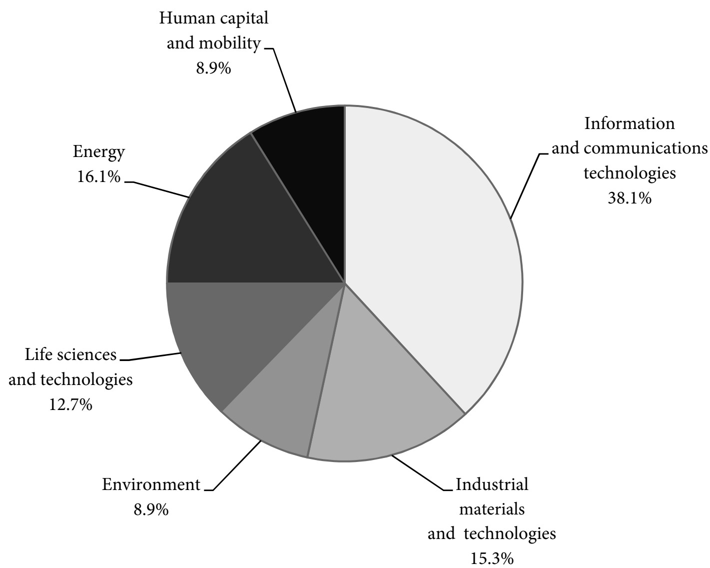

Figure 2. FP3 budget breakdown into six lines of action

Source: Own calculations based on CORDIS.

A very significant step forward in the 4th Framework Programme (1994–1998), apart from doubling of the budget to €13.2 bn for five years, was a significantly more multidisciplinary design. Even though the Programme maintained a significant focus on technology development, non-technological research gained ground. FP4 was structured differently than its predecessor. There were four activities, the first of which 'Research, technological development and demonstration programmes' comprised all research activities and took 87% of the budget. The research activities were split into as much as 15 different programmes. The other three activities were dedicated to cooperation with third countries and international organisations (4.3%), dissemination and optimisation of results (2.7%) as well as training and mobility of researchers (6%). The first two of those activities are new, while the third one is a continuation of the third heading from FP3. Figure 3 presents the budget breakdown among these research programmes.

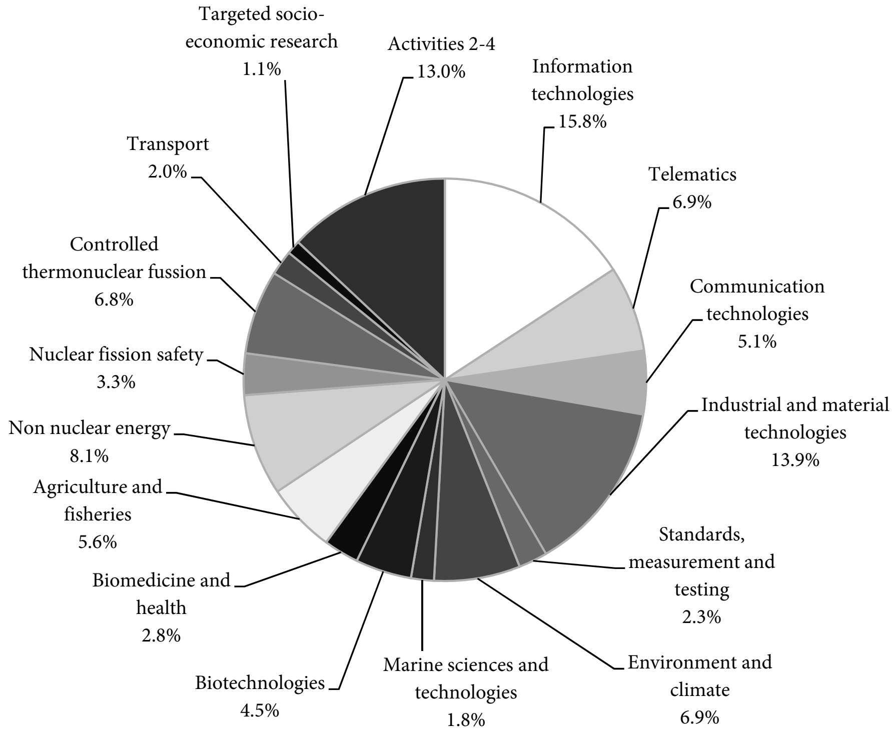

Figure 3. Budget breakdown of FP4

Source: Own calculations based on 'The Fourth Framework Programme', CORDIS.

Most of the research programmes under FP4 are a direct continuation of the five research oriented lines of action from FP3 under the first two headings. When we regroup them into these large categories we can see that only two research programmes are new – transport and targeted socio-economic research. As for the others, ICT take up 27.8% of the total budget, industrial technologies and materials 16.2%, environment 8.8%, life sciences and technologies 12.9%, and energy 18.3%. When compared to FP3, all areas maintained more or less their budget share apart from ICT which was reduced by 11 percentage points and it is predominantly at the expense of this area (the largest one in FP3 and still the largest in FP4) that new activities were funded.

The basic structure of the 5th Framework Programme (1998–2002), which enjoyed only a slight budget increase over its predecessor to €14.96 bn for five years, was a continuation of the design from FP4. Again there were four activities, the first one of which included four thematic programmes, while the remaining three contained horizontal programmes similar in scope to those from FP4. In addition to that, a specific budget was set aside for the Joint Research Centre. A major structural innovation lied in the fact that thematic programmes were no longer discipline-centric but consisted of key actions which were problem-oriented and were expected to be addressed through a combination of different disciplines and activities. Figure 4 presents the budget breakdown of FP5.

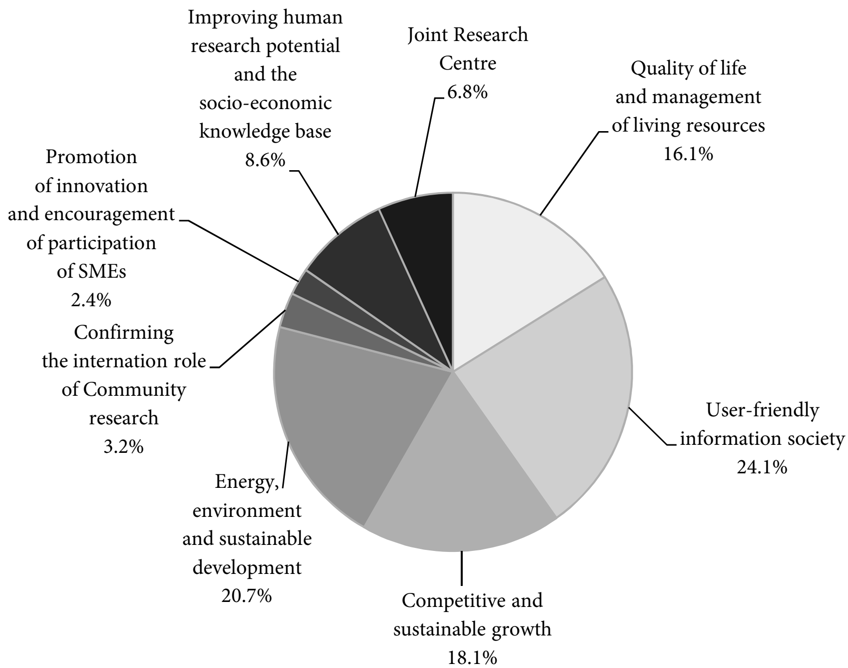

Figure 4. Budget breakdown of FP5

Source: Fifth Framework Programme, Budget distribution, CORDIS.

The problem-oriented design meant also that the whole programme was much less driven by technological development, but rather by looking for solutions to common problems and challenges. Certainly a lot of technology-oriented research was funded, but it was integrated better into a more general socio-economic context. Within the scope of the programme one can also identify two completely new elements: a budget for the Joint Research Centre entirely separated from the other activities, and a new activity focused on SMEs.

Three major political strategies developed in 2000 and 2002 led to the conception of the 6th Framework Programme (2002–2006) becoming its cornerstones and shaping its structure and objectives. In March 2000 the European Council Summit held in Lisbon set an objective to 'make the European Union the most competitive and dynamic knowledge-based economy in the world by 2010' and launched what became know as the Lisbon Strategy. This was interpreted as requiring focused community-wide investment in research, and the improvement of innovation and entrepreneurship.

At the same time, in January 2000, the Commission proposed to create the European Research Area (ERA). It was described by its main architect Philippe Busquin, the Commissioner for Research at that time, in the following words:
'The development, at European level, of an area for the coherent and co-ordinated pursuit of research activities and policies, and an area in which researchers and knowledge move freely will encourage the expression of European excellence in several ways: First, by making it possible to establish a 'critical mass' of potential excellence, by networking the capacities present in different Member States, particularly through intensive use of information and communication technologies. Second, by releasing people and teams from the protection of national barriers, thus introducing competition and increasing the general level of excellence. Third, by attracting to Europe the best researchers from the rest of the world, in the same way that American campuses are currently attracting researchers' [Source: FP6 Step by Step, CORDIS].

The third cornerstone was the so-called Barcelona Target. In March 2002 the EU Heads of State and Government, during the Summit held in Barcelona, agreed on an objective to increase expenditure on R&D and innovation in the EU to 3% of GDP by 2010 in order to close the gap in R&D and innovation performance between the EU and its major competitors.

All these three policy developments meant one thing – that there is a need to substantially strengthen and reorganise the EU Framework Programme. As a result, FP6 received some 30% more money per year than its predecessor and it was reorganised in such a way to support directly building the ERA through integrating European research (76.8% of funding), addressing its structural weaknesses (14.9% of funding) and stimulating the coherent development of research and innovation in Europe (1.8% of funding). Apart from that, nuclear research, supported through Euratom, received over 6.4% of funding.

The objective 'Focusing and integrating Community research' was divided into seven specific themes that were seen as strategically important to Europe's future. They were devised not along traditional research fields, but as strategic themes that will be achieved through combinations of different scientific disciplines. In addition to these specific themes the first objective included three horizontal activities (policy support, research involving SMEs and support of international cooperation) as well as non-nuclear activities of the Joint Research Centre.

Under the second objective 'Structuring the European Research Area' the Commission supported activities to improve Europe's innovation performance, to support development of world-class human resources in European research, to develop research infrastructures, and to enhance dialogue between science and society. The third block 'Strengthening the foundations of the European Research Area' included activities to support the coordination of research activities in Europe and encourage coherent development of research and innovation policies.

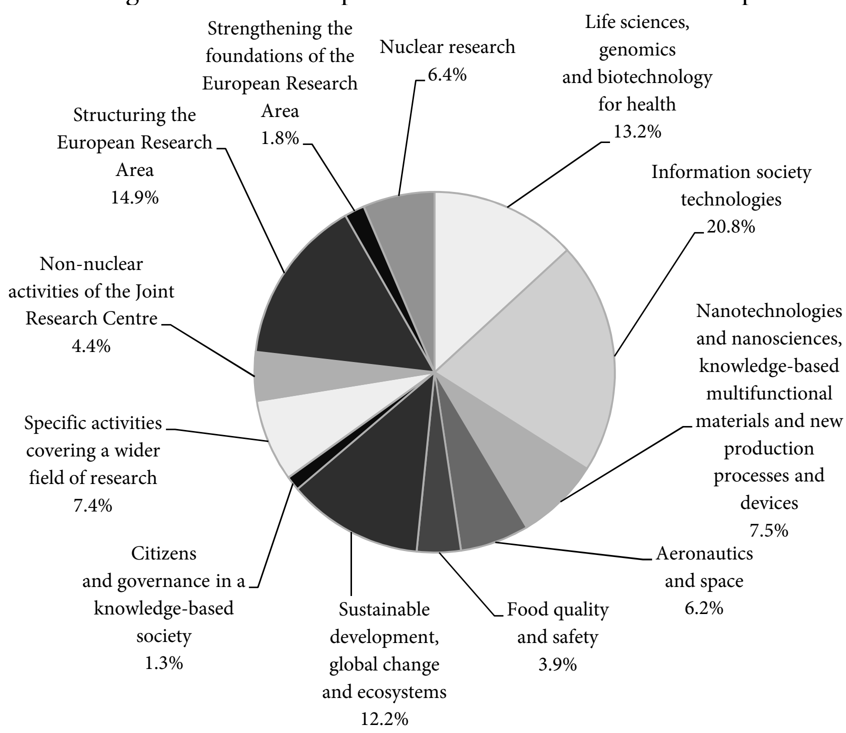

Figure 5. Budget breakdown of FP6

Source: Sixth Framework Programme, Budget distribution, CORDIS.

Figure 5 presents the overall budget breakdown of FP6. In most thematic areas there is a clear continuation of the research effort of the previous framework programmes with a new field of research on aeronautics and space and an expansion of technology driven research to include nanotechnologies and nanosciences.

The goal of creating the European Research Area was reflected in this Programme in two ways. First, two blocks of activities on structuring and strengthening the ERA were assigned 16.75% of the total funding, which is a very significant effort. Second, large scale projects were introduced with the aim to bring many partners from around Europe together and foster their durable integration through joint research activities as well as organised communication and exchange of individual work.

Following on policy goals which lay behind its predecessor, namely objectives of the Lisbon Strategy, creation of the European Research Area and the Barcelona target, the 7th Framework Programme's (2007–2013) overriding aim is 'to contribute to the Union becoming the world's leading research area' [Decision of the European Parliament… 2006: L412/1]. To achieve this it was decided to double the annual budget of the Programme in comparison to FP6 (which meant assigning over €55 bn for the seven year period) and design a comprehensive set of complementary activities that would boost European research performance. Consequently, the key objectives of the Programme are to support transnational cooperation across the EU in a number of key areas, enhance the dynamism, creativity and excellence of European research at the frontier of knowledge as well as strengthen human potential in research and technology. In addition to that strengthening research and innovation capacities in Europe received special attention. These objectives were translated into four main types of activities forming the FP7 core parts: Cooperation – where most of collaborative research is funded, Ideas – where through the European Research Council cutting edge research in a vast range of disciplines is supported, People – where mobility of researchers is funded, and Capacities – where research capacity building is supported. This is supplemented with a budget provision for the Joint Research Centre and for nuclear research under Euratom.

Table 1. Distribution of FP7 budget for 2007–2013

Programme	Budget	
	€ million	%
COOPERATION	32.413	58.05
IDEAS	7.510	13.45
PEOPLE	4.750	8.51
CAPACITIES	4.097	7.34
JRC + EURATOM*	7.062	12.65
Total	55.832	100.00

* The figure includes extension of the Euratom Framework Programme to 2012–2013.

Source: DG Research and Innovation, European Commission.

Table 1 presents the foreseen budget for each of the different programmes with 58% of it earmarked for collaborative research in thematic areas corresponding to major fields of progress of knowledge and technology with the aim to address key European social, economic, environmental, public health and industrial challenges. The distribution of funding across these areas is presented in Figure 6.

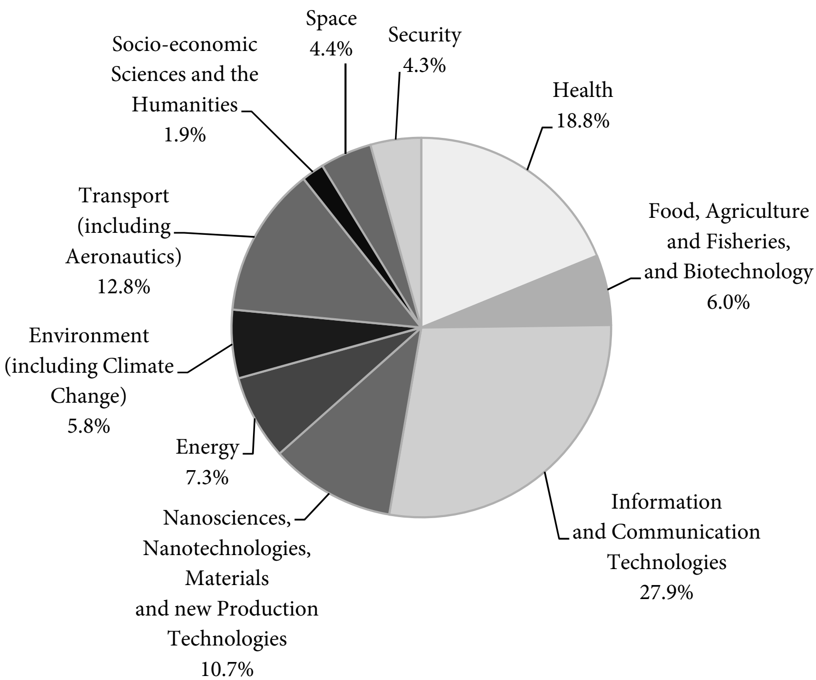

Figure 6. Distribution of funding in the FP7 Cooperation Programme
Source: European Commission.

The great novelty of FP7 is the creation of the European Research Council (ERC) whose mission is to support investigator-initiated frontier research across all fields of science with a sole focus on scientific excellence. The approach to allow researchers to identify new opportunities and directions in any field without being led by any set priorities and to direct activities towards fundamental advances at and beyond the frontier of knowledge is aimed at stimulating new and unpredictable scientific and technological discoveries. The ERC funding is divided into three broad areas: life sciences (34% of funding), physical sciences (39%) and social sciences and humanities (14%). In addition to this, a notional 13% is earmarked for interdisciplinary research.

FP7 activities not having research as main focus are concentrated in the People and Capacities Programmes and are together responsible for close to 16% of the overall budget. This is a continuation of the FP6 activities structuring and strengthening the European Research Area.

The framework programme for the seven year financial perspective 2014–2020, called Horizon 2020, according to the Commission proposal of 29 June 2011, is planned to make another leap in the EU level research funding reaching over €11 bn per year. Its main policy foundation is the Europe 2020 strategy with its flagship initiatives, in particular the creation of the Innovation Union. The main idea behind the new programme is to set up a comprehensive research framework under one roof bringing together the Framework Programme for Research, the Competitiveness and Innovation Framework Programme and the European Institute of Innovation and Technology. The ultimate aim is to maximise the contribution of EU funded research and innovation to sustainable growth and job creation and to tackling the grand challenges facing Europe such as climate change, energy and food security, health and ageing population. This will be achieved by designing a coherent set of instruments, along the whole 'innovation chain' starting from basic research, culminating in bringing innovative products and services to the market; and also to support non-technological innovation, for example in design and marketing.

The official proposal for Horizon 2020 was published on 30 November 2010 [Proposal for a Regulation... 2011] and its general outline has earlier been discussed in public on a number of occasions [Ex. Geoghegan-Quinn 2011]. It will be structured around three mutually reinforcing pillars. The first pillar 'Excellence in the science base' will strengthen EU scientific excellence through support for frontier research, future and emerging technologies, careers and mobility of researchers and key research infrastructures. The second pillar 'Creating industrial leadership and competitive framework' will support business research and innovation including investment in enabling and industrial technologies, facilitating access to finance and supporting innovation in SMEs. The third pillar 'Tackling societal challenges' will respond directly to the challenges identified in Europe 2020 Strategy through actions in six fields: health, demographic change and well-being; food security and the bio-based economy; secure, clean and efficient energy; smart, green and integrated transport; resource efficiency and climate action, including raw materials; and inclusive, innovative and secure societies.

3. The evolution of EU funding for social sciences and humanities

The door for EU level funding of social sciences and humanities was opened by the Treaty of Maastricht, which added the phrase '…while promoting all the research activities deemed necessary by virtue of other chapters of this Treaty' [The Maastricht Treaty 1992: Art. 130f, Point 1]. to the statement made in the Single European Act quoted in the previous chapter. With this addition, the EU research policy clearly contains a socio-economic dimension. As a result, a specific research programme in social sciences and humanities was launched in 1994 within the 4th Framework Programme under the name of Targeted Socio-economic Research (TSER) with a budget amounting to €147 million.

The TSER programme focused on three issues including science and technology policy, education and training as well as social integration and social exclusion. Within the first activity entitled 'Evaluation of science and technology policy options in Europe' the aim was to develop a common knowledge base for policy makers in the field of science and technology policy at regional, national and European level. Through the analysis of RTD situation in Europe in the international context, evaluation of socio-economic changes and new scientific and technological developments as well as elaboration of new methods and tools, the ultimate objective was to encourage greater consistency and closer coordination of RTD efforts and policies in Europe.

The second activity entitled 'Research on education and training' was aimed to support the efforts made by the Member States to strengthen the links between research, education and training and to improve their education and training systems by stepping up research, and disseminating the results and innovations which it produces. The final activity 'Research into social integration and social exclusion in Europe' was set out to analyse forms, processes and causes of social exclusion, with particular focus on unemployment, as well as to analyse migration patterns and evaluate the impact of social integration processes. Overall 171 research projects were funded within the TSER Programme [CORDIS].

Under the 5th Framework Programme, in the period 1998–2002, research in social sciences and humanities was funded under the Key Action 'Improving the socio-economic knowledge base'. The objectives of this programme went far beyond the three areas covered under TSER. The research agenda was considerably expanded to look in a comprehensive way into the structural changes taking place in the European society, to identify ways of managing these changes and to promote a more active involvement of European citizens in shaping their own futures. For the first time the programme also specifically aimed to provide scientific support to policies at various levels, with particular attention to EU policy fields. The programme funded altogether 185 projects for a total value of €176 million worth of EU contribution [Key Action 2003].

As can be seen in Table 2, research was funded in a number of areas crucial for European policy making. Out of twelve research themes two received particular attention: social cohesion, migration and welfare (30 projects, 15.9% of funding) and governance, democracy and citizenship (28 projects, 14% of funding). These two areas are undoubtedly of particular relevance from social and political perspective. Together with four themes with a broad focus on the economic perspective (57 projects, 27.4% of funding), these were the drivers of socio-economic research in the 5th Framework Programme. Altogether they represented 115 research projects (62.2%) amounting to €101.6 million of EU financial contribution (57.7%).

Table 2. Breakdown of Key Action 'Improving the socio-economic knowledge base' into research themes

Research theme	No. of projects	EU contribution	
		€ million	%
Societal trends and structural changes	16	14.6	8.3
Development models	9	9.3	5.3
Dynamics of knowledge, generation and use	8	6.1	3.5
Employment and changes in work	18	17.5	9.9
Social cohesion, migration and welfare	30	27.9	15.9
Quality of life of European citizens	5	6.4	3.6
Economic development and dynamics	22	15.3	8.7
Governance, democracy and citizenship	28	25.5	14.5
Education, training and new forms of learning	14	12.9	7.3
EU enlargement	13	12.8	7.3
Gender, participation and quality of life	13	12.3	7.0
Infrastructures	9	15.4	8.8
Total	185	176.0	100.0

Source: Key Action [2003] 'Improving the socio-economic knowledge base', Synopses of Key Action projects (1999–2002), Directorate-General for Research, European Commission.

Within the 6th Framework Programme the bulk of social sciences and humanities research found home under Priority 7: Citizens and governance in a knowledge-based society with the initially foreseen budget of €247 million divided among eight Research Areas. In addition to this, social sciences and humanities played an important role under Priority 8: Scientific support to policies, particularly under Research Areas 2 and 3. Tables 3 and 4 present all the relevant Research Areas as well as the final distribution of funding.

Table 3. Research Areas under Priority 7: Citizens and governance in a knowledge-based society

Research theme	No. of projects	EU contribution	
		€ million	%
Improving the generation, distribution and use of knowledge and its impact on economic and social development	19	39.3	16.1
Options and choices for the development of a knowledge-based society	29	52.1	21.3
The variety of paths towards a knowledge society	11	22.2	9.1
The implications of European integration and enlargement for governance and the citizen	14	25.4	10.4
Articulation of areas of responsibility and new forms of governance	14	25.3	10.3
Issues connected with the resolution of conflicts and restoration of peace and justice	12	18.5	7.6
New forms of citizenship and cultural identities	22	45.4	18.6
Actions to promote the ERA in SSH	24	16.3	6.7
Total	145	244.5	100.0

Source: Own calculations based on Social Sciences and Humanities in FP6 [2007], Projects' Synopses 2002–2006, Directorate-General for Research, European Commission.

Among the eight Research Areas one can identify two broad clusters. First one, including the first three Areas, revolves around research on knowledge and knowledge based society. Within this first cluster 59 projects were funded (40.1%) for the total EU financial contribution of €113.6 million which made up 46.5% of the funding for the programme. The second broad cluster including Areas 4–6 addresses the issue of governance, from different angles and perspectives. Within this second cluster 40 projects were funded (27.6%) for a total EU financial contribution of €69.2 million which constituted 28.3% of the total funding. In addition to these two clusters, Area 7 on citizenship and cultural identities was the main source of funding for humanities research, while Area 8 focused on specific actions to support creation of the European Research Area in SSH.

Table 4. Research Areas relevant for social sciences and humanities under Priority 8: Scientific support to policies

Research area	No. of projects	EU contribution	
		€ million	%
Providing health, security and opportunity to the people of Europe	15	10.7	49.5
Underpinning the economic potential and cohesion of a larger and more integrated European Union	9	10.9	50.5
Total	24	21.6	100.0

Source: Own calculations based on Social Sciences and Humanities in FP6 [2007], Projects' Synopses 2002–2006, Directorate-General for Research, European Commission.

Under Priority 8: Scientific support to policies, social sciences and humanities contributed to two out of three Research Areas concentrating on such policy fields as migration, crime, European integration, competitiveness and trade. In addition, work was carried out on indicators and improvement of European statistics. The total value of funding reached €21.6 million.

Within the 7th Framework Programme, Socio-economic Sciences and Humanities (SSH), with the budget of €623 million, found home in the Cooperation Programme among ten different Themes. As Figure 6 demonstrates, this is by far the smallest of all thematic programmes representing only 1.9% of Cooperation funding. The SSH Programme is structured along eight activities, including five thematic ones, two horizontal and one supporting activity. The five thematic activities are consolidating social sciences and humanities to address major challenges facing the EU and the world including economic development in the knowledge society, sustainable development and social cohesion, anticipating and adapting to major trends in society, managing global interactions and interdependences as well as strengthening democracy and governance in the EU. The two horizontal activities, relevant for all themes, include development and use of indicators as well as foresight. The supporting activity complements the other ones boosting dissemination of SSH research, supporting networking and cooperation across countries as well as other strategic activities.

There was no a priori distribution of budget among the eight Activities. Topics, their number and size of funding are decided on annual basis. However, based on projects funded under the Work Programmes 2007–2011 and expectations for the final two years 2012–2013 it is possible to estimate the final distribution of funding over the entire lifespan of the programme. Figure 7 presents such estimation.

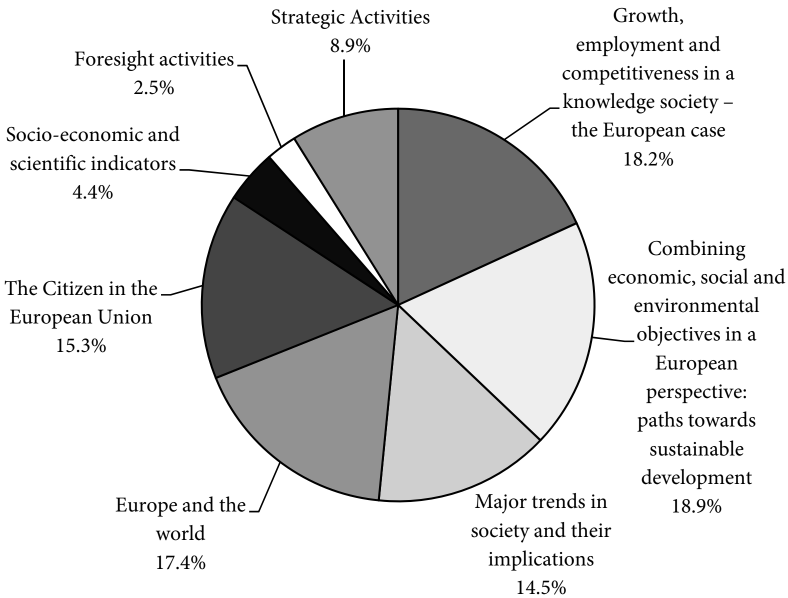

Figure 7. Estimated distribution of budget per Activity in the SSH Programme 2007–2013

Source: Own calculations based on project selection decisions 2007–2011 and estimations of project funding per Activity in 2012–2013.

Figure 7 shows that each thematic activity is expected to receive a relatively equal share of funding under the SSH Programme. Horizontal activities will receive significantly less (6,9% in total), while strategic activities will account for almost 9%, which is mostly due to support for ERA-NETs and ERA-NETs Plus[2]. Within SSH

[2] ERA-NETs are projects aimed at stepping up cooperation and coordination of research activities at national or regional level through networking of research and the mutual opening of national and regional research programmes. ERA-NETs Plus are projects that provide additional EU financial support to participants, mostly national or regional research funding agencies, who create a common fund for the purpose of joint calls for proposals among national and regional programmes.

research funding for 2007–2011 over 170 projects received support[3]. When taking into account the estimated number of projects that will be selected for funding in the last two years, the overall number of supported projects over the 2007–2013 period is expected to reach around 240.

The SSH programme is however not the only source of funding for research in social sciences and humanities in the 7th Framework Programme. The European Research Council (ERC), implementing the IDEAS programme worth €7.51 bn, has earmarked around 14% of their funding for social sciences and humanities which constitutes over €1 bn creating a major opportunity for researchers in this field in Europe. The ERC operates primarily through starting grants for more junior researchers and advanced grants for well established scientists. There are six so called 'panels' dividing social sciences and humanities into broad thematic areas. They include:

SH1 – Individuals, institutions and markets: economics, finance and management

SH2 – Institutions, values, beliefs and behaviour: sociology, social anthropology, political science, law, communication, social studies of science and technology

SH3 – Environment, space and population: environmental studies, demography, social geography, urban and regional studies

SH4 – The human mind and its complexity: cognition, psychology, linguistics, philosophy and education

SH5 – Cultures and cultural production: literature, visual and performing arts, music, cultural and comparative studies

SH6 – The study of the human past: archaeology, history and memory

In the period 2007–2011 in these six SSH panels, the European Research Council awarded 279 starting grants and 145 advanced grants for a total amount of over €580 million[4]. Researchers in social sciences and humanities can also benefit from funding under the People programme as regards job mobility, as well as under the Capacities programme for example in developing research infrastructures.

Since specific research activities in social sciences and humanities were introduced in the 4th Framework Programme, this field of research was gradually gaining importance. Figure 8 illustrates the evolution of funding since FP4, both overall and the annual average. In FP4 it started with 1.11% of the overall budget which increased only slightly in FP5 to 1.18% and somewhat more in FP6 to 1.39%.

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3 Figure based on EC selection decisions for 2007–2011.

4 Based on data from DG Research and Innovation data warehouse CORDA.

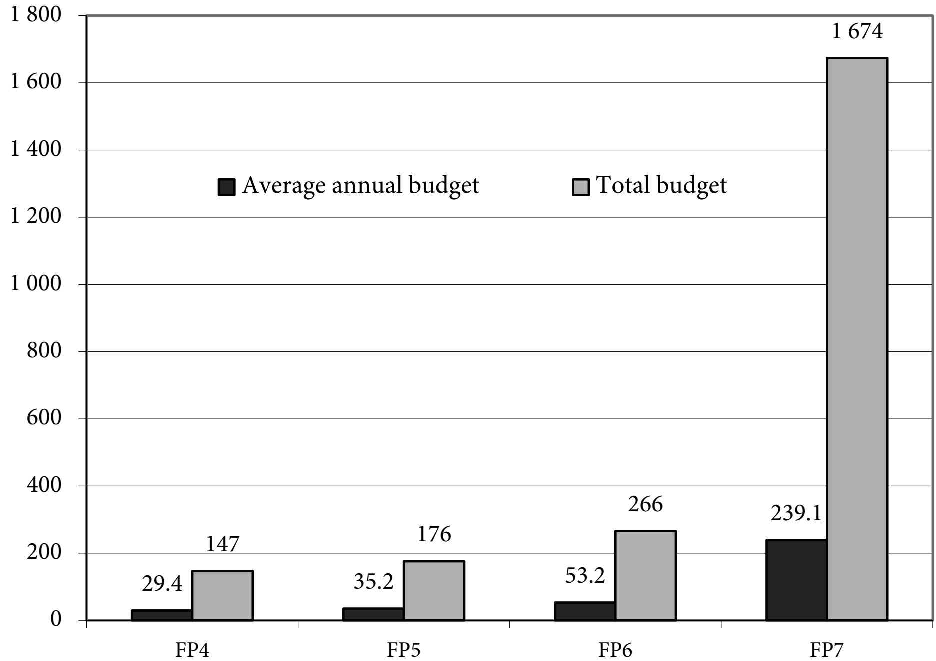

Figure 8. Evolution of funding for social sciences and humanities since FP4 (in milion Euro)

Source: Own calculations based CORDIS and data from DG Research and Innovation, European Commission. For FP7 the overall figure reflects initially foreseen budget, while for FP4, FP5 and FP6 it reflects the actual funding.

In FP7 social sciences and humanities received a considerable boost of funding, which reached 3% of the value of the entire FP7. Most of this increase was due to the creation of the European Research Council which set aside 14% of its funding for these disciplines, while in collaborative research under the Cooperation programme only 1.9% of resources go to the dedicated Socio-economic Sciences and Humanities Programme. Despite that, the EU's collaborative research programme in SSH is the world's largest in this field.

With the 3% share in FP7 budget, EU funding for social sciences and humanities has finally reached figures comparable with funding at national level, which is close to 3%. For example, the share of SSH in Gross Domestic Expenditure on Research and Development is 3.82% in the United Kingdom, 3.73% in the Netherlands, 3.05% in Poland, 2.84% in Germany and 2.83% in France[5].

The future EU Framework Programme for research, Horizon 2020, will continue to provide major opportunities for social sciences and humanities. This field of research will be embedded throughout the three pillars of Horizon 2020 to help understand how new technologies and innovation arise and how they are used in the economy and in the wider society. At a general level, social sciences and humanities will play an important part in addressing all of the societal challenges to be targetedby the new programme. In particular, one of the challenges 'Inclusive, innovative and secure societies' will be firmly aimed at boosting our knowledge of the factors that foster an inclusive Europe, help overcome the current economic crisis and the very real concerns that people have, that identify the links between the European and global context, and that encourage social innovation. In addressing these issues the leading role will be played by social sciences and humanities research. This challenge is also planned to bring security and socio-economic research together with the aim of understanding the many forms of 'insecurity' – whether crime, violence, terrorism, cyber attacks, privacy abuses, or other forms of social and economic insecurity – that increasingly affect people in Europe. The budget for those activities is not yet known and will be the subject of discussions in 2012 alongside with the entire debate on the EU financial perspective 2014–2020.

4. Conclusions

European Framework Programmes for research and technological development have already a history of close to 30 years. Since the launch of the first programme in 1984, research funding at EU level has undergone a very substantial evolution. It started with resources of less than €1 bn a year to reach €8 bn at the end of FP7. The scope has also been very considerably expanded from a limited number of research fields to a very comprehensive programme covering many different themes

[5] Source: OECD NABS_2007_10 and NABS_2007_11; OECD (2010), 'Government budget appropriations or outlays for RD', *OECD Science, Technology and R&D Statistics* (database). doi: 10.1787/data-00194-en, after D. Besnainou, 'FP7-SSH', presentation to the SSH Programme Committee, 17.10.2011.

and oriented on challenges facing Europe and the world. It became a programme not only funding science, but also supporting research careers and building research capacities so that Europe could become a world class centre of scientific excellence.

Since the Treaty of Maastricht gave in 1992 the European Union a mandate to develop a policy driven programme funding research in social sciences and humanities, this field entered the landscape of framework programmes for good. As the challenges Europe faces are fundamentally social and human in nature, the EU has recognised that social sciences and humanities research must play a central role in understanding and tackling the problems. Due to this they became an important part of the research landscape providing the evidence and analysis needed to put European policymaking on a sound footing because evidence-based policy-making is indispensable in finding sustainable solutions to pressing societal challenges. EU policies require comparative knowledge on the dynamics of our society, on the people and institutions involved in these dynamics, and on the global contexts that influence developments in Europe.

Particularly in the current context of the deep economic crisis and of constant transformation in European economy and society, social sciences and humanities help to address the most fundamental economic, social, political and cultural issues. This approach is corroborated by the planned research agenda for the next financial perspective 2014–2020 under Horizon 2020, where social sciences and humanities will play an important role in addressing the identified challenges around which research is centred and will lead work on developing inclusive, innovative and secure societies.

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Part II

STABILITY PROBLEM OF THE FINANCIAL SYSTEM AFTER THE GLOBAL FINANCIAL CRISIS

Marek Belka*

The Eurozone Perspectives. The Prospects for Poland to Join the EMU

1. The Eurozone Perspectives

The common currency – euro has been successful in becoming the second most important currency in the international monetary system. However, the current crisis, mainly in the European Union's periphery countries has shown the weakness of the euro in the following aspects:

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1. The dilemma of one size fits all has always been relevant in case of countries belonging to the Eurozone – countries having different economic structures, at various stages of development, facing problems with sustainable fulfilment of convergence criteria, but subject to the ECB common monetary policy. This policy turned out more adequate for slower growing core Europe than for catching-up South, which has finally led to an important divergence of real interest rates. The feedback loop between inflationary pressures (resulting from the booms) and the fall in real interest rates in periphery economies has resulted in their shrinking competitiveness. As underlined by Olivier Blanchard in 2006, the fact that Eurozone is composed of countries at different phases of business cycle will inevitably cause boom and bust cycles until the full convergence is attained.
2. The problem of interest free ride appeared as a result of lack of fiscal discipline in weaker countries that were taking advantage of good reputation of stronger economies within the Eurozone. This was possible in the environment of low fiscal discipline and toothless SGP (Stability and Growth Pact) as well as lulled vigilance of global financial markets where spreads between good and bad performers were unnaturally low.
3. The most frequently underlined institutional weakness of the euro area was its inability to pursue coordinated fiscal policy, which seemed to be highly desirable at the time of conducting a unified monetary policy. Lack of proper regulatory and supervisory architecture in the euro area enabled the crisis to happen. Lack of federal budget for the EU and no-bailout clause (art. 125 of the Treaty on the Functioning of the European Union) retarded first bailout decisions in the case of Greece, aggravating Greek and other periphery countries lending abilities through growing interest rates on their bonds.

The origins of sovereign crisis in Europe are not the same for all the countries in trouble. In case of Greece and Portugal, excessive public debt is the result of irresponsible fiscal policy before the crisis. On the other hand, Ireland suffered from real estate asset bubble and banking crisis. Greece and Portugal were highly indebted in the first place, at the beginning of the recession, which only aggravated their problems. Meanwhile, countries such as Ireland and Spain were complying with the fiscal deficit criteria and managed to lower their general government to GDP ratios between 2001 and 2007. However, their governments decided to bail out the banks, which in consequence led to strong indebtedness and weak economic performance. The sovereign crisis in Europe has shown that prudent fiscal policy is not enough to avoid recession in tough times, although having fiscal space helps ease the crisis hit. Therefore, some steps are already being taken in order to enhance budgetary discipline at the national level and strengthen SGP on the European level. When the Greek crisis began the European Union had no fund to support the country under pressure. Currently, permanent ESM (European Stability Mechanism) will be active from the mid-2012, helping to finance borrowing needs of member states.

In terms of European economic governance the following actions aiming at reducing the risk of sovereign debt crisis have already been agreed at the European level:

1. Fiscal discipline will be strengthened by putting more emphasis on the preventive arm of the SGP (Stability and Growth Pact). A new rule does not allow annual growth rate of budget expenditure to exceed the mid-term potential GDP growth rate. It should help member states to reach their Medium Term Objectives (MTO). Moreover, rules for the coordination of national economic policies under the European Semester have been introduced. The SGP has also been strengthened through financial sanctions for countries that disobeyed the rules.
2. Wider economic supervision should be assured through Excessive Imbalances Procedure (EIP). This procedure aims at monitoring macro imbalances on the basis of indicators chosen by the European Commission, European Parliament and EU Council jointly. Among the indicators proposed one can find current account balance, unit labour costs, real effective exchange rate, international investment position, etc. Opening the procedure may result in financial sanctions for the country involved.
3. Introduction of the comply-or-explain-principle, obliging the countries to explain any country's actions which are inconsistent with the EC recommendations or the EU Council decisions, should enhance countries' discipline.
4. Introduction of the European Macroeconomic Dialogue should help coordinate economic policies within the European Union.

Implementation of the above measures is believed to solve the euro area's problems, however it is uncertain to which extent.

The European Union has already joined the global trend of strengthening financial markets supervision through enhanced cross-border regulation and supervision through European Supervisory Authorities on the micro level and the European Systemic Risk Board on the macro level.

There are also other proposals to control the threat of deploying another sovereign crisis in Europe through enabling issuance of eurobonds. This idea, however, is very controversial for better performing euro area countries, as it may encourage repetition of interest free ride phenomenon. Nonetheless, the European Commission presented a report on the eurobonds in the end of 2011.

Still, despite the measures proposed and already implemented, financial markets seem quite far from stable. Downgrades of Italy's, Slovenia's government bonds and putting Belgium on the list for possible downgrade by Moody's as well as Italy's downgrade by Fitch and Spain's downgrades by Fitch and S&P show that the uncertainty about successful resolution of European sovereign crisis is strongly questioned by the markets. European leaders at the EU Summits in October and December 2011 agreed on economic and institutional measures that comply to the IMF's Managing Director Christine Lagarde's statement from the Jackson Hole meeting at the end of August 2011, that Europe needs to undertake three major steps: firstly, attain sustainability of sovereign finances; secondly, urgently recapitalize its banks so they can withstand times of high sovereign risk and weak economic growth; thirdly, present common vision of the Eurozone's future.

2. The prospects for Poland to join the EMU

The crisis exposed a number of vulnerabilities of Central and Eastern European economies. A combination of a banking sector dominated by foreigners and lending boom in foreign currencies (financed by short term wholesale funding) occurred to be a recipe for disaster. The turmoil led to either sharp GDP contraction, or significant currency depreciation. In some cases both effects occurred at the same time. However, it has to be emphasized that in most cases the response given by authorities proved correct. Social acceptance to inflict painful reforms was essential.

Poland was the only EU country to avoid recession. Unlike other NMS, Poland managed to record 1.6% GDP growth in 2009, followed by even more solid growth in 2010. However, a good performance of Polish economy did not make a prospect of joining the euro area any closer. On the contrary; it is extremely difficult now to foresee Poland's integration with the Eurozone. Healthy growth did not allow to avoid problems related to a sustainable fulfilment of the Maastricht criteria, which is illustrated by the following detailed review of Poland's compliance to the nominal criteria. Although the financial crisis was less perceptible in Poland than in other EU-countries, it has a significant impact on the ability of Polish economy to fulfil the Maastricht criteria. The HICP inflation rate grew above the reference value at first in July 2008. Before this date, it was constantly lower than the reference value for the Maastricht price stability criterion. Similar situation is being observed in other New Member States. The latest data (for November 2011) show that among

NMS only Slovenia, Malta and the Czech Republic met the price stability criterion. Perspectives for the future fulfilment of that criterion are not very optimistic, either. Although, according to Eurostat, the rate of HICP inflation in Poland is forecasted to moderate to 2.7% in 2012, it would still remain above the forecasted reference value[1]. The global financial crisis also caused a rise in long-term interest rates, not only in Poland but in other European countries, too. However, Poland was still able to meet this convergence criterion in the years 2006–2011. The general government deficit amounted to 1.9% of GDP in 2007. This allowed the EC to resign from an excessive deficit procedure towards Poland. However, as a result of the financial crisis in 2008, the ratio exceeded the reference value of 3%, thus forcing the EC to introduce the excessive deficit procedure towards Poland again in July 2009. According to the Eurostat, in 2010 Poland still did not meet the criterion of general government budget balance (with a deficit of 7.9%). According to the forecast (prepared by Ministry of Finance) for 2011 the deficit should be about 5.6%, which is still above the reference value. The headline deficit in 2012 is projected however to decrease to 2.9% of GDP. The ratio of government debt to GDP in Poland does not exceed the reference value. The pace of general government debt increase is projected to slow down considerably. After an increase starting from 2008, the debt ratio (MF forecast, April 2011) is projected to be at 54.9% in 2011 and to 54.1% in 2012.

But this is not only about the ability of Poland to meet the Maastricht criteria. This is all about preserving positive tendencies, which will foster both real and nominal convergence of Polish economy. However, one cannot forget in this context about the processes taking place in the Eurozone. A number of studies point out that instead of convergence, dangerous tendencies towards divergence have been observed within the Eurozone. Therefore, far-reaching reforms are needed to stop this unwelcome process. These changes are happening right now. The Eurozone is undergoing important reforms. That is why there are reasons to believe that the Eurozone – a group Poland will join some day – will be different than it used to be prior to the crisis. As the effect of Eurozone reforms is not completely certain, the best recipe for Poland as an accessing country is to make every possible effort on enhancing our ability to meet entrance criteria in a sustainable way and to observe processes taking place in the Eurozone.

[1] European Economic Forecast, Autumn 2011.

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László Csaba*

Perspectives for the Eurozone: Consolidation, Collapse or Muddling Through?

1. Introduction

The monetary model of European integration has always been subject to debate in theoretical literature. From the very outset, many economists – especially in the United States – tended to believe that single currency is a mistake, if for no other reason, because of the lack of political union, and the ensuing lack of fiscal union[1]. The thrust of the argument goes as follows: voluntary co-ordination of policies, as stipulated by the basically intergovernmentalist arrangements of the

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[1] Jonung, Drea [2009] provide a meta-analysis of over five dozens of criticisms why the single currency should have collapsed from the very outset.

EU in its post-Lisbon architecture, is insufficient to offset the imbalances resulting from a unified monetary policy in the absence of coordinated fiscal policies. More specifically, lacking the transfer mechanisms that exist inside national states to offset regional imbalances and also divergent responses to external shocks, the whole concept was bound to lead to trouble.

It is hard to deny that there is a modicum of truth in this argument, even though it is fairly textbookish economics and overlooks the difference between nation state and a community of states (in German: *Bundesstaat* – federal state – and *Staatenbund* – a commonwealth of nations). If we follow this logic, it is hard to escape the conclusion, recently proposed by Scharpf [2011], that any attempt to rescue the construct, as experienced in the 2008–2011 period, is bound to exacerbate the situation in both economic and political terms. It is because – so the argument goes – the current crisis only uncovers a number of democratic deficits and professional inefficiencies, lack of accountability and of enforcement mechanisms, deeply rooted in the political compromises having moulded the EU policies and institutions over the past decade or so. The contrarian argument, put forth by a number of analysts is that the EU is, by the crisis, triggered into the jump it has long and rightly feared, namely to move seriously towards political union, where burden sharing is although important, but not the only issue at stake. And indeed, a mere survey of major measures to fight the crisis [Benczes 2011] allows us to see attempts to coordinate and control fiscal spending, both in its size and patterns, to degrees and forms unseen ever before. The jump would imply complementing monetary union with a degree of open fiscal federalism, subordinating national fiscal policies to some of the common procedures, goals and measures.

2. History and logic of the EMU

While libraries have been produced to explain the emergence and functioning of the European Monetary Union, at times of crisis it is perhaps inevitable that fundamentals are being raised again and again. In the first part of this section we ask who benefits from the single currency, and in the second part we offer a brief survey of how we, as the Community, have got where we are now.

If one asks about benefits of the euro, rather straightforward answers can be given, both at the macro and micro levels. A single currency saves considerably on transaction costs, especially in a continent known for high banking fees and margins. Furthermore, comparability of national prices allows for evolution of what is known in economics as the 'law of one price', *i.e* a tendency to equalize charges for the same output or service performed. In short, if the flow of commodities and services is free, competition and arbitrage creates a situation where prices no longer show the traditional wide spreads across the EU countries and regions. The process is well demonstrable through observation of wholesale and retail prices, basically across the board, including non-tradables. This has much to do with the opening up of markets along the Single European Act to global competition, but also to direct comparability of prices charged by individual suppliers, from airfares to foodstuffs.

Third, stiffening competition itself is a source of consumer benefit. Fourth, by creating a zone of stability, the currency zone is institutionalizing the gains of the period of 'Great Moderation' in terms of price stability and – ideally – also financial policies, both in the fiscal and monetary legs[2]. Finally, by creating a largely closed economy, comparable with that of the Unites States, the currency zone shelters its members from external shocks – so the conventional wisdom goes. This applies *a fortiori* for small open economies, where the efficiency of monetary and fiscal policies has long been undermined by processes of globalization and capital market liberalization.

How far have those theories stemmed from the facts? Historically speaking, the rather complex arrangements of the EMU [de Haan, Osterloo, Schoenmaker 2010] have never followed from pure theoretical considerations, that were grounded either in economics or in political science, let alone integration theory. In reality, the EMU – conceived several times and by several 'founding fathers' – has been by and large the outcome of decades of learning by doing. This took place in countries with very different histories, and especially following the oil shocks of 1973 and 1979, when the efficiency of conventional Keynesian demand management has been subjected to serious doubt.

All through the 1980s a steady and gradual conversion of one economy after the other to what many term as 'monetary orthodoxy' took place. One by one, countries adopted unilateral exchange rate pegs, turned away from fiscal profligacy and a *de facto* D-Mark union has been in the making. As shown in the insightful analysis of Issing *et al.* [2004], this was more of a series of trials and errors than adoption

[2] This is clearly a normative statement, and the question if arrangements of the Stability and Growth Pact suffice for this to be delivered, has been a subject of debate from the very outset.

of any clear theoretical stance. And while insights from monetarism were playing a role, insights from other schools were at least as important. For instance, fixing the exchange rate has always been an anathema to any serious monetarist, ever since the publication of the fundamental article by Milton Friedman [1953].

Let us emphasise it: the practice of European monetary integration has therefore been by and large the opposite to what would have followed from monetarist teaching. Here the red thread has been the gradual conversion to exchange rate stability, later price stability and the discontinuation of the practice of fiscal profligacy. This long story [*cf* also Dyson and Featherstone 1999] has been, to a large degree, one of trials and errors all across the 1970s and 1980s. By the time the Maastricht Treaty was adopted in 1992, all political parties with a chance to get close to government, and any academic economist with an influence on policy-makers, either on left or the right, have been convinced of the virtues of price and exchange rate stability. By that time a *de facto* D-Mark zone emerged, with first small open economies like Austria and Finland, later large economies like France and Spain and finally Italy pegging their respective currencies unilaterally to the German mark, thereby importing stability.

Let us observe that this 'conversion to orthodoxy' was an outcome of *societal learning, not of academic consensus.* In the academic circles voices hostile to the European monetary project have always been strongly represented, not least because of the vocal opposition of the Anglo-American guild, providing the mainstream for economic thinking. However, experiences with competitive and occasional devaluations, with instability and volatility of exchange rate arrangements across the 1970s and 1980s have lent support to those practitioners who advocated the artificial creation of the zone of stability, *i.e* the currency union. Alas, this latter outcome is already in line with the then emerging wisdom of financial economics, the 'bipolar view' in which only irrevocably fixed or freely floating exchange rates are sustainable in the long run. The latter calls for small open economies, like those constituting the EU, to join into a currency bloc.

Therefore, joining the currency union has required no extra sacrifices in terms of 'giving up the exchange rate instrument', since such an instrument is out of the question among the countries forming an economic union. Furthermore, as literature has shown (Horvath, 2006 for summary), the criteria of optimal currency area to be largely endogenous, thus being self-fulfilling. Indeed, on the ground business cycles tended to be synchronized and intra-EU trade increased. Asymmetric shocks, an issue widely discussed in the literature, have not proven to be policy relevant, given the quite similar economic structures of the member-states, with intra-industry and intra-firm exchanges dominating over the traditional inter-industry or even inter-sectoral trade as postulated in the classic theorem of comparative advantage at Ricardo.

Measured against the background of truly severe external shocks having characterized the entire 1992–2012 period, it seems that the considerations and institutional arrangements of the EMU elaborated in a series of compromises and documented in the summary volumes cited above have proven viable and resistant to crisis. Neither inflation nor deflation emerged, and not only because the ECB adopted a more rigorous – and thus longer lasting – concept of recession than is customary in the United States. The harmonized index of consumer prices, *i.e* the indicator elaborated and regularly controlled by the joint statistical agency Eurostat, has never been below 0.6 per cent per annum and never exceeded 3.3 per cent – in the troublesome year of 2008. As a rule it fluctuated between 2.1 and 2.6 [Source, unless otherwise indicated: ECB 2011] per cent per annum, *i.e.* slightly above the numerical target of the ECB[3], but *ensuring price stability for any practical purpose.* The single currency has remained strong, especially during times of the financial crisis of 2008–2009, against all competing currencies except the Swiss franc. The EU has never experienced any major current account deficits or surpluses. Current and capital account taken together fluctuated between a mere +0.2% and –1.4% per cent of joint GDP, even during the crisis period of 2007–2011. Thus the level of the cross exchange rate must be considered to be an equilibrium level, despite regular complaints by some politicians and industrial interests.

If we disregard those criticisms in literature as well as in the public discourse, which demand attaining objectives which are explicitly not assigned to the ECB, we get a clear picture. If we accept that any joint agency must follow its mandate, set by its statutes, the EMU actually has delivered what it promised: price stability for a long period, *i.e* over 13 years. *Criticisms blaming the single currency for what it is not constructed for*, or which is not to be influenced by monetary policy, are therefore *misdirected*. These criticisms are rarely born out by statistics, including the euro's alleged contractionary effects, unfavourable labour market impacts and the like. In the first run, thus, we have to consider the Eurozone as a major success. This stands out especially as we compare this venture to other major policies of the

[3] Given that the ECB has never adopted a strategy of inflation targeting, much in fashion over the past decade in the academic literature, but not necessarily among major central banks, like the Swiss, Japanese or even the FED, the mere fact of numerical missing is irrelevant, as long as it is not sizable. Experience has led to the convention seeing privce stability somewhere between 2 and 3 per inflation cent per annum in order to remain on the safe side and avoid dflationary threats. More on that in Issing *et al.* 2004.

EU, such as the Lisbon Agenda, enlargement, reforming common agricultural policy or improving the efficiency of cohesion funds, let alone the Doha Round of global trade talks. Against the limited, if any, success of those areas, the single currency is one of the *unqualified success stories of European integration as a whole.* While the jury is still out if, and to which degree, this outcome is attributable to the monetary and especially the fiscal framework safeguarding the common currency, the fact of the matter is that on the Community level it seems to have worked.

We must add the proviso that the European Union has remained intergovernmentalist in its basic features. Therefore, it neither does nor it should have a body with supranational competences, able to enforce, in the worst case by military or other disciplinary measures, decisions taken at the Community level. Thereby we are at the popular theme of sanctions, widely discussed in literature. As long as fiscal policy, unlike monetary policy, is not vested in a single supranational centre, because it would contradict to democratic legitimacy, *fiscal cooperation, truly needed for successful monetary union, can only be based on voluntary compliance.* And this is the crux of the matter.

The European Union, ever since its inception, has been a club of gentlemen. In other words, cooperation was based on commonality of values, objectives and revealed preferences of the participants to do things together, attributing a value on its own to the factor of doing things together. This idea of the 'ever closer union' has been formative all across the history of the EU, acting as the driving force for various projects of deepening. In this context, sanctioning, let alone excluding any of the participants, would run against the spirit of the entire enterprise. Therefore – as external observers have never been slow to pinpoint – rather weak, if any, sanctions on trespassers, be that basically in any areas of common policies. While in exceptional cases the European Court of Justice may superimpose Community legislation over national decisions, however *this is exceptional, rather than recurring, let alone regular.* The attempts in the 1997–2009 to politicize and federalize Europe have foundered, therefore this state of affairs must be taken as a given [more on that in Csaba 2009, chapters 6 and 7].

3. Mafiosi in the club

Let us recall: all European policies and institutions are based upon voluntary compliance and goodwill, thus in each and every of the policy areas the spirit of co-operation is being pre-supposed. For instance, it is not obligatory for any member-state to join the single currency[4]. It is possible to join the European Security and Defence Policy or not. The model of flying geese [de Andrade 2005] is an apt analogy to the already evolving multi-speed model of integration, where members involved in more or less intense cooperation work together in the long run. A recent example is the Competitiveness Pact, signed in June 2011, when four very different members – Britain, Sweden, Hungary and the Czech Republic – decided to abstain, obviously each on entirely different grounds.

This 'soft law' nature of European arrangements also implies that identification with the Community ownership – much the same as IMF parlance would call 'domestic ownership of reforms' – is even more important than otherwise. Law abiding behaviour in general pre-supposes the agents' internal identification with values and objectives, formalized – always imperfectly – by the legislators. In case of conflict, the spirit of the law, the intention of the legislator is a matter for concern, up to the point of being decisive in settling court cases.

From this angle it should have been disturbing to see an ever growing number of states openly dodging the commonly elaborated arrangements. Beetsma *et al.* [2009] elaborate in great length that the stiffening of controls at times when players do not identify with the logic/value judgements behind the formal rules, has actually induced *regular and large scale cheating across the board.* This was the case with fiscal policies, an issue we shall address in some detail.

It is certainly difficult to provide a lump sum assessment of complex developments of an entire decade, that between 1999–2009. However, two or three general remarks may suffice for our purpose. *First,* as we have seen above, in the first decade – and actually until the eruption of the Greek crisis – the arrangements, however half-hearted, seem to have sufficed for sustaining price stability, and the exchange rate against the dollar even appreciated. *Second,* even if in a very incremental manner, debt/GDP ratios in most Eurozone countries tended to decline, approaching the Maastricht limit by 66.3% in 2007, before exploding, as a sign of Keynesian crisis management, to 85.3% by the end of 2010 [ECB: 46]. *Third,* in the years of the Great Moderation of the 1992–2008 period, there was a general tendency, both in much of the academe and the policy-making influenced by them, for believing that crises

[4] Technically speaking, new members, including Sweeden and the East, are compelled by the accession agreements to join. However, Sweeden has deliberately abstained, not least because of the referendum held in September, 2003, and most Eastern members simply do not seem to qualify in the current decade.

will never come back. What is seen from today's perspective as complacency was fairly widespread, both in the academic literature and in policy-making. Thus, acting on the fiscal front, calling for more stringency, or merely complaining about the lackluster efforts at structural items of fiscal consolidation sounded overzelous and pedantic textbook economics, especially to practitioners on the market and in the state administration alike.

It should be observed that a number of countries were performing well, or even extremely well, such as Ireland until 2008, Estonia, Luxembourg, Finland, Spain, Slovenia and Slovakia, but the performance of the Netherlands, Austria and Cyprus seemed acceptable, as well. Some countries outside the Eurozone, such as Bulgaria, Latvia, Denmark, Lithuania, the Czech Republic, Romania, Sweden and even Poland were, even in 2010, well within the Maastricht set limits of debt ratios. In other words, *we do not see any evidence,* theoretical or empirical, that would warrant the usual litany of some economists *about the irrationality, unfeasibility, non-practicality of meeting the Maastricht criteria at a generalized level.* Moreover, if we note that the extensive Scandinavian welfare states all fared very well under this criterion too, the doubt seems more than justified.

Under this angle we may propose the hypothesis that countries which were severely derailed in the 2008–2011 period, were the ones where some fundamental features of economic policies went wrong, and that for a longer period of time. For if public debt explodes without any preliminaries, it must be a reflection of some previously covert structural imbalances in the given economy. And it is hard not to observe that the asset bubble in both Ireland and Spain, the mismanagement of banks in Greece and Ireland, the dodging of structural reforms in Portugal, and not least Italy[5], all count among the platitudes of the literature by now. The hopeless state of Italian public finances is not to be observed with surprise since it counts among the evergreens of the public finance literature over the past few decades. One may indeed wonder, especially against the background of the wide acceptance of the theorem of efficient markets in the pre-crisis decade, how the allegedly super-rational, fully informed and ruthless capital markets allowed Italy to get away with its lousy and non-improving public finances, chronic deficits and 100 per cent plus debt rates, without even attempting to deliver the punishment, which according to finance textbooks, should have been 'instantaneous' and devastating.

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[5] The long overdue and still somewhat unexpectedly timed demise of Silvio Berlusconi, in November, 2011 following the G20 summit of Cannes, was just the latest and most conspicuous casuality in the saga.

In short, it seems rather straightforward that problems that emerged by the countries listed above are *peculiar to the individual economy on the one hand, and have fairly little, if anything to do with the common framework* of fiscal coordination, let alone with the joint policies spending a mere one per cent of the joint GNI of the EU members. By contrast, the trespassing, with or without EMU, has been flagrant and extreme, recurring and structural in nature, indeed, in each and every of the cases.

By the same token, it is important to underline: the nature of each of the respective crises has been different, not least because these were not attributable primarily to EMU and SGP arrangements. True, EMU, by allowing for cheap financing for heavily indebted countries, irrespective of their debt burden, and also ECB practices of accepting debt obligations of heavily indebted countries without a discount, in the name of mutuality, solidarity and single currency zone without differentiation, all *contributed to the ills.* But it would be hard to ascribe the ills *in toto* or even in their bulk to an arrangement which has by no means caused similar outcomes in countries with different policy options. The number of the latter, as listed above, is considerable.

Let us merely note how different the respective crises by the country has been! In the case of Ireland, the overheating of the economy, an asset bubble and lack of regulation, as well as lasting inaction by the governmental agencies at times when the crises was already open, taken together, created the trouble [Honohan 2010]. In short, this was a trouble with overheating, with non-interventionism and an overdose of *laissez-faire*, which created parallel bubbles in the construction sector as well as in banking financing those. By contrast, Portugal, according to all accounts, has been a country with miniscule if any productivity growth, with little if any economic dynamism, minimalist policies across the board and the ensuing lag in terms of competitiveness, indicated emphatically already years ago, *inter alia* by Blanchard [2006]. Finally, Greece is an entirely separate case, where analysts highlight the *de facto* failure of the Greek state [Featherstone 2011] as well as the political instrumentalization of various adjustment packages for domestic policy ends, irrespective of longer term ramifications [Visvizi 2011]. This experience, elaborated in detail in the paper cited above, is by and large a reflection of a popular attitude just opposite to what proponent of fiscal federalism [Hallerberg 2011] consider as necessary pre-condition for their suggestion to work on the ground. Namely: a popular opinion holding policy-makers responsible for fiscal irresponsibility and non-remedying structural reasons in which the dismal outcomes are rooted in each of the troubled countries.

What we find in common in the three open crisis cases is the fundamental incongruence of domestic policies and institutions with the underlying logic of the monetary model of European integration, and even with the basic logic of political integration, understood as a deepening project. Once a member no longer identifies itself – at the level of decision-makers and elites – with the original project of the political union, or *finalité politique,* the specific arrangements that emerge as an outcome of intergovernmental bargains may look absurd, irrational and of limited use (to attain the pedestrian, immediate targets of the policy-makers). Once this assessment prevails, *a minimalist approach replaces the traditional commitment to European goals.* While the latter has long helped overcome the crises, which is rightly seen as the *modus operandi* of European integration in most of its fifty plus years of existence, the lack of commitment, foot dragging over macroeconomically insignificant issues and financial flows, and generally, playing a theatre scene for domestic audiences instead of focusing on the solution of the Community goals, both in the technical and political planes, translates into inaction and drifting. The defining feature of the 2008–2011 period has been the collapse of the Great Moderation and the peaceful waters that used to characterize that period. By contrast, ever since the eruption of the financial crisis and the domino effect on a number of EU countries[6], fire fighting has replaced strategic thinking. Managing the task of the day clearly prevails over any broader consideration, including the strategy of the EU, the Europe 2020 project[7].

4. How to solve the insolvable equation?

Crisis management in the EU has, by the time of writing, reached a new dimension. First and foremost, the global economy has not returned to the normalcy of the pre-2008 period, not least because of the *crisis of confidence* which rules on financial markets. Most players remain unconvinced both about the ability and willingness

[6] These included, besides the three chronic cases, also Latvia, Hungary, Romania, Spain and Italy, the first three having to resort to IMF standby packages, a measure that used to be axiomatically excluded from the policy options of any EU member in the pre-2008 period.

[7] For a thorough and controversial assessment of the strategy, immediately upon its promulgation, cf the Forum discussion in: *Intereconomics* 2010, 45(3) .

of major governments to manage their public debt, which is only exacerbated by these governments – implicitly and explicitly – assuming responsibility for a large part of private debts in their countries[8]. Indeed, for market players the insight, highlighted perhaps most by Reinhart and Rogoff [2009], that there is no Chinese wall between public and private debts accumulated in the same country, implies a Copernican turn in the way market participants evaluate macroeconomic indicators. It is not least because of *the additive nature of the two debt mountains* that undermined the faith of markets in governmental policy, which in 2009–2011 showed little if any commitment to revert the tendency, which is obviously a warning sign, according to the historic evidence marshalled by the book cited above. By the same token, combined fiscal and monetary easing, as practised in the USA, can do precious little for alleviating the problem, which is not rooted in effective demand, but in actors' anticipating further worsening, quite in line with the traditional Lucas critique (1976) of the inefficiency of such policies.

The period 2009–2011 has seen an unprecedented degree of attempts to create new mechanisms for fire-fighting, crisis management and also to bring about a sustainable and lasting, permanent mechanism of pre-emption and cure, the European Stability Mechanism, effective from 2013. Without attempting to provide a detailed summary of this issue, which is extremely complex both in terms of management techniques and in terms of institutional arrangements [cf the broad-brush summary by Benczes 2011] let us make just a few general remarks at the level of systemic discussion, in line with the genre of the current paper.

First and foremost, the three open crises, exacerbated by the eruption of previously covert, but lasting instability in Italy[9], and to a lesser extent in Spain, have made the underlying contradiction between sustaining intergovernmentalism in decision-making and supranationalism in terms of substance. The latter is particularly clear when national debts are 'mutualized', to use the euphemism by former Commission president Jacques Delors, when the idea of issuing common European debt obligations

[8] Iceland is perhaps an extreme case where the government guaranteed the repayment of all deposits, way above the €20 thousand limit stipulated by EU banking regulations. But bailing out big firms, like GM and Chysler, or big banks, like Fortys or Hypo Vereinsbank, implied by and large the same for the fiscal position of the respective countries.

[9] According to the *Wall Street Journal,* September 10, 2011, over 70% of the bond purchases by the ECB, reaching close to €80 bn, was directed to the troubled southern members, leading to the ECB owing the larger part of external government debt of these nations, which is bizarre, given the statutory prohibition protecting the ECB from financing any government debt.

has been gaining acceptance, and when the 'de facto co-funding of individually made debts, explicitly forbidden by the Stability and Growth Pact is becoming an ongoing practice'.

It is perhaps unsurprising to see the former socialist leaders, themselves largely responsible for the explosion of debt, calling for more solidarity and in fact community level decisions on fiscal policy[10]. But it is perhaps equally unsurprising to see the conspicuous resignation of German guardians of price stability from ECB positions. The resignation of former Bundesbank President Axel Weber in April, 2011, who used to be widely and safely tipped to be the successor to ECB President Jean-Claude Trichet, was later followed by the vocal and emotionally argued resignation of chief economist Jürgen Stark [2011]. Though just tips of the iceberg, these events still reflect the deep and unbridged division over the fundamentals.

Second, we may formulate the strain as follows: if the SGP contains an explicit no-bailout clause, the idea of political community and European solidarity also contains *an implicit no bankruptcy clause.* As we have argued above, for a decade the two contradictory considerations seem to have been co-existing pretty well. But once the fundamental assumptions over gentlemanly behaviour are violated, when the Irish, Greek and the former socialist Portuguese governments run openly counter to their own obligations to revert the financial catastrophe, a system based on understandings and the spirit of co-operation was clearly and openly challenged. This is why many observers by now talk about the crisis of the periphery being gradually but irrevocably transformed into the crisis of the eurosystem. For if it is a recurring practice of non-abiding with the rules followed by non-sanctions, it is clearly a sign of erosion of the arrangement as a whole.

Third, it is hard to overlook that policy improvisation without a map – or what Germans would call *Ordnungsdenken* – inevitably leads to a dead alley. For even if we were sympathetic to the policy-makers acting under informational constraints and bounded rationality, that would not help us over the unresolved fundamentals, which are like a devil coming back through the window once thrown out of the door.

To cut a long story short, the 12 years leading up to the adoption of the Lisbon Treaty was an attempt to politicize and deepen the European Union. Whatever the reasons – and those range from the reign of popular media to the decreasing

[10] Cf *Handelsblatt* [2011], September 10.

democratic legitimacy of top EU rulers bargaining behind closed doors[11] – the outcome has clearly been an outright rejection of anything, even symbolically, supranational and avowedly federalist. Reh [2009] rightly talks about the de-constituting of the Union in and by the Lisbon Treaty, implying the watering down of the top-down, federalist and structurally binding components of previous drafts.

By the same token it is ironic to see propositions, such as that coming from the Dutch Prime Minister and the Minister of Finance where fiscal trespassing by an other member state could be actually punished, to the point of ejecting the sinner from the euro-club. Let us recall: it is not about the compelling nature or the economic rationality of their argument, which is also questionable, since the need to overcome the obvious moral hazard implicit in the ways the 2009–2011 crises were managed are clear. It is just that the constitutional, legal, political and thus technical pre-conditions have not been created, and even consciously weakened.

The long lasting row between the European Parliament, employing its enhanced powers of co-decision, anchored in the Lisbon Treaty on the one hand, and the traditionally all-powerful and single-handedly acting Council over the quasi-automatic nature of sanctions to be hanged over trespassers is just a formal sign of a deeper problem. For issuing eurobonds, or accepting government bonds of highly indebted countries as a collateral, without a discount, equals to re-tailoring the burden of debt at the Community level, *without, however, enjoying the legitimacy of the citizens,* who will, at the end of the day, have to foot the bill, now or in later generations. While technically speaking it could help alleviate the problem of heavily indebted countries, in political and legal terms it remains a non-starter. The less transparency and accountability, required in usual banking and business practices, the more so, since it remains entirely opaque who will foot which part of the bill and in what timeline.

And here we have come to a true borderline. European financial solidarity without political foundations, *without checks and balances, without remedying mechanism* and enforcing accountability of those responsible for the dismal outcomes, *comparable to those existing in the corporate world*[12], or even in the much sheltered

[11] This is the core of the lack of legitimacy argument advanced in detailed by Scharpf [2011], rightly reminding of the lack of transparency and direct accountability of Ecofin and Council decisions.

[12] Leaders responsible for the Enron scandal were sent to jail, and practices of Goldman Sachs during its 2008–2009 crisis operations are being subject to political and criminal investigation even at the time of writing. Nothing comparable looks conceivable for those who falsified statistics or were creating the balooning public debt.

medical profession, is a *contradiction in terms* anyway. Therefore far reaching suggestions to strengthen actual fiscal federalism along the lines of the Brazilian example [Hallerberg 2011] are missing the point. At the end of the day, Brazil has been a federal state, with centralized conduct of fiscal policy, which the European Union has never been. Moreover the formative features of the most recent editions of the Treaty on the European Union, though accommodate measures already taken in setting up the European Financial Stabilization Facility and the European Stability Mechanism, still clearly fall short of delegating, even in part, responsibility for the conduct of fiscal policy to anybody 'in Brussels'.

5. Options for the future

It goes without saying that any forecast is a speculative exercise here. The experience of the 2007–2011 period in the EU has casted doubt over the majority approach in the literature which took for granted continuation of muddling through as the baseline scenario for any policy-relevant analysis. With the time passing, day by day new options become politically feasible, even ones that used to belong to the realm of fantasy only a few months before.

The *first option,* which is being pushed by the creditor countries, mainly Finland, the Netherlands and Slovakia, would openly move toward *a degree of formal fiscal federalism.* This has long been a proposal in the EU literature, if constantly rejected on political grounds. One would need to see how fiscal rationality would be able to dominate the underlying political, legal, historic and emotional considerations. Asking for collateral *per se* is anything but appalling. However, when the Finnish Minister of Finance suggested something similar, it triggered Greek outrage, understandably so. But in the Community, where the Competitiveness Pact with its much softer arrangements was adopted by less than unanimity, generalizing stricter solutions does not seem to be trivial.

The *second option* is return to the old ways, including reliance on understandings and compliance basically through *voluntary action, gradual adjustment and coordinated external finance.* This would pre-suppose a co-operative and even ambitious approach from the debtor side, a case which one can observe in the case of Portugal and Spain, however not in that of Greece or Ireland, the major culprits.

Finally, *a third possibility is one of disintegration,* where some member states either leave the Eurozone or are expelled by the others. This option, long forecast by American and academic critics of the EMU, would solve one problem by creating two new ones. First, the exiting country, adopting its old currency, is likely to fall even deeper in inflation and recession, owing to the foreseeable devaluation of the national currency. Second, this would be a heavy blow to the entire European project, whose significance is perhaps beyond our ability to understand. The old continent without over-arching political and institutional cohesion has, indeed, been a dangerous place, primarily for its inhabitants in the entire three centuries following 1648.

Irrespective of which of the options will materialize, it seems that current magnitudes of external debts, such as of Ireland and of Greece, having reached 96.8% and 142.8% respectively as of the end of 2010[13], which continued to grow ever since, are unlikely to be managed in any organized way, short of an open default and debt restructuring. This option materialized in part in November 2011, however it left the larger part of the outstanding, owned by the public authorities, unresolved. If a country is contracting by 7.5% and external debt service is over 8%, as in the case of Greece in 2011, the situation is unsustainable. The solution might lie in the resort to Brady bonds, which allow for avoiding open rescheduling, while allowing for swapping the official debts at a 50% discount to market agents. This option, practised in managing the Latin American debts of the 1980s, allowed the heavily indebted countries to restructure their economies and grow out of debt in a sustainable manner[14].

Likewise, the tripling of Irish debt in 2007–2010, as well as the initial unwillingness of the new government to follow the logic of IMF-EU rescue package, created a situation where return to the pre-crisis normalcy is likely to be slow and incremental, despite the considerable progress made by the workout process in 2011. While the situation of the two nations is dissimilar, and so is Portugal and Spain compared to the others, arithmetic remains arithmetic, and sustainability conditions are yet to be worked out by those involved.

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[13] These are the last numbers officially certified by Eurostat and ECB in: ECB [2011: 46], any more recent data are sheer estimates.

[14] Here the major problem may lie in the fact, that neither ECB nor IMF, currently holding governing bonds of the problem nations, is allowed by its statutes to sell those claims at a discount and cover the loss from their reserves, as private banks or indeed fiscal authorities may do.

The ensuing downgrading of some major French and Swiss banks is a smaller evil. General, open and organized debt restructuring, including public debt, is perhaps the only way to return to civilized exchanges, growth and solid policies for the decades to come. While the fact, that discourse using previously forbidden words, such as restructuring, reorganization, rescheduling and reorganization is welcome, formative details are less than trivial at the time of writing.

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Finn Østrup*

The Future of EU Policy Coordination: Dealing with the Financial Crisis

The European Union has been engulfed in the financial crisis since 2007. At first, the institutions of the European Union played little or no role at all in dealing with the crisis. The immediate response to the crisis took place at the national level, with national governments coming to the support of failed financial institutions and trying to counter an economic downturn through expansive fiscal policies. Since 2010, however, the European Union has played an important, and increasing, role in handling the crisis. At the macroeconomic level, the goal has been fiscal coordination, with pressures on member states to reduce budgetary deficits. Fiscal discipline has been tightened especially for the Eurozone countries. It has, at the same time, become the policy of the euro countries to support other euro countries in financial difficulties. The mutual support within this group of countries represents a new policy development that is likely to bring important changes to future European cooperation.

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The article discusses the response of the European Union to the financial crisis. Special emphasis is placed on the decision to provide financial support to member states of the Eurozone that experience payment difficulties. The article first considers the role played by the European Union in the run-up to the crisis. Second, the role played by the European Union is discussed, in the immediate policy response to the crisis, involving government support of financial institutions and expansive fiscal policies. Finally, the article addresses the most recent development which involves financial support for Eurozone governments that experience difficulties in meeting their payment obligations.

1. The run-up to the financial crisis

Prior to the financial crisis, the economic situation in several European countries was characterised by a rapid build-up of debt. Easy access to finance led to speculation in fixed property, making it possible to finance more expensive purchases of residential property. Higher house prices raised building activity. Moreover, saving rates were reduced by the rise in household wealth that followed the house price increases, causing a rise in private consumption that further strengthened domestic demand. The demand pressures in those EU countries that had experienced a build-up of debt, led to wage and price increases that, in turn, caused deterioration of competitiveness.

As these developments have taken place in only some of the EU countries, the outcome has been a rise in differences between European countries in terms of competitiveness, with many countries experiencing spoilt competitiveness while others seeing reduction in wage costs relative to other countries.

The development of debt prior to the financial crisis in European countries is shown in Table 1. It follows that the development has been very uneven among individual countries. From 2000 to 2007, most countries experienced a large increase in the debt of households. There were, however, notable exceptions to this trend, namely Germany, Austria, Belgium, Switzerland, and – among the Eastern European countries – Czech Republic. The rise in household debt was especially large in Ireland with household debt rising from 51.5 percent of GDP to 105.1 percent of GDP but large increases also took place in Denmark (a rise by 36.7 percentage points), Spain (a rise by 33.5 percentage points), Britain (rise by 33.2 percentage points), and Greece (a rise by 32.9 percentage points). These countries also experienced large increases in the debt levels of non-financial corporations, with a particularly strong increase in Spain (a rise by 67.0 percentage points).

Table 2 illustrates development in house prices adjusted for the growth in consumer prices. Again, this table shows how very different these developments were from one country to another. At the one extreme we have Spain with a rise in real house prices amounting to 91.9 percent between 2000 and 2007. Other countries with big increases included France (a rise by 83.3 percent), Great Britain (a rise by 74.0 percent), Sweden (a rise by 64.0 percent), Denmark (a rise by 62.6 percent), Belgium (a rise by 56.6 percent), and Greece (a rise by 50.9 percent). At the other end of the extreme ranks Germany with a fall in real house prices of 15.4 percent between 2000 and 2007.

Table 3 shows the development in competitiveness prior to the financial crisis. A number of countries – especially the Czech Republic, Italy, and Spain – have experienced a substantial deterioration of competitiveness while other countries – in particular Poland, Sweden, Finland, and Germany – have improved their competitiveness.

Neither the European Central Bank nor the European Commission predicted the financial crisis. Neither were there initiatives from European institutions to prevent the crisis. On the contrary, statements from European institutions burst over with exuberance regarding the performance of the euro and the strong performance of the European economies. The lack of foresight may come as a surprise. After all, in the past, many financial crises have taken place as a result of speculation in assets that have been financed through debt finance. On numerous occasions prior to 2007, the Bank for International Settlements (BIS) issued warnings against speculative bubbles in housing. In analyses of house markets, the OECD (Organisation for Economic Co-operation and Development) described how house prices had risen above equilibrium levels in several industrial countries, including Ireland and Spain [See *e.g.* Girouard, Kennedy, André 2007; Girouard, Kennedy, van den Noord, André 2007].

Membership in the European Union or in the Eurozone should not be seen as reasons why financial institutions decided to finance projects that on a large scale subsequently occurred unprofitable. It follows from Table 1 that the increase of debt took place both in Eurozone countries and in such countries as Great Britain and Hungary, which remain outside the Eurozone. It is, however, possible that membership in the EU may have played, albeit indirectly, a role in evolution of the financial crisis in the European countries. First, investors may have extended finance to EU member states in the belief that they would be bailed out. Thus, up to 2008, the low spreads between EU government bonds are remarkable. Second, the expansion of EU financial institutions into the markets of other EU countries worked to increase competition in the financial markets. As an increase in lending is easy, it is likely that competition has made itself felt notably in the area of lending. The expansion of EU financial institutions into other European markets was facilitated by the work to establish a common EU financial area and by the removal of exchange rate risk

Table 1. The development in debt levels prior to the financial crisis[a]

	Non-financial corporations		Households		General government[b]	
	2000	2007	2000	2007	2000	2007
Austria	82.3	113.7	47.1	54.6	71.1	63.1
Belgium	134.2	162.1	42.9	47.8	113.7	88.1
Finland	120.9	125.5	34.6	57.4	52.5	41.4
France	111.9	147.5	42.9	66.1	52.5	72.3
Germany	91.2	95.8	73.4	63.6	60.4	65.3
Greece	51.5	65.5	20.0	52.9	115.3	112.9
Ireland	130.7[c]	167.0	51.6	105.1	39.4	28.8
Italy	98.0	122.6	33.4	50.6	121.6	112.8
Netherlands	139.8	121.2	87.0	119.0	63.9	51.5
Portugal	181.8	194.7	75.0	100.4	60.2	75.4
Spain	132.6	199.6	54.2	87.7	66.5	42.1
Czech Republic	109.7	106.0	19.9	27.1	32.8[d]	33.7
Denmark	86.0	110.5	103.4	140.1	60.4	34.7
Hungary	104.8	140.8	9.2	33.5	59.1[c]	71.8
Norway	142.6	141.2	63.6	87.2	32.7	57.4
Poland	85.9	74.2	8.3	23.7	45.4	51.7
Sweden	191.4	173.0	51.0	75.0	64.3	49.3
Switzerland	76.6	78.7	113.9	118.4	52.4	46.8
United Kingdom	93.2	120.0	75.2	108.4	45.1	47.2
Average Eurozone[e]	115.9	137.5	51.1	73.2	74.3	68.5
Average non-euro countries[f]	111.3	118.1	55.6	76.7	49.0	49.1

[a] The table shows debt levels relative to gross domestic product for the European countries shown. Members of the Eurozone are shown at the top while those of other European countries – including Norway and Switzerland – are shown at the bottom. Debt levels are shown as percentages of gross domestic product for three sectors: (i) non-financial corporations, (ii) households, and (iii) general government.

[b] Gross financial liabilities relative to gross domestic product.

[c] 2001.

[d] 2002.

[e] Simple average of Eurozone countries shown (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, and Spain).

[f] Simple average of non-euro countries shown (Czech Republic, Denmark, Hungary, Norway, Poland, Sweden, Switzerland, and United Kingdom).

Source of data: OECD National Accounts.

among the euro countries. In the Eastern European countries, the expectation of a future membership of the euro may have had the effect of boosting cross-border lending.

Table 2. The development in real house prices prior to the financial crisis[a]

	Percentage change 2000–2007		Percentage change 2000–2007
Austria	0.2	Czech Republic	–
Belgium	56.6	Denmark	62.6
Finland	33.7	Hungary	–
France	83.3	Norway	55.8
Germany	–15.4	Poland	–
Greece	50.9	Sweden	64.0
Ireland	47.8	Switzerland	12.0
Italy	44.8	United Kingdom	74.0
Netherlands	22.4		
Portugal	–7.9		
Spain	91.9		

[a] The table shows the change in real house prices in the period 2000–2007. Real house prices are measured by nominal indices deflated by the consumer price index.

Source of data: OECD, ECB.

Table 3. The development in competitiveness prior to the financial crisis[a]

	Rise in relative unit labour costs 2000–2007 (percentage)		Rise in relative unit labour costs 2000–2007 (percentage)
Austria	2.0	Czech Republic	35.9
Belgium	15.3	Denmark	23.4
Finland	–13.4	Hungary	20.5
France	8.9	Norway	30.2
Germany	–4.2	Poland	–21.5
Greece[b]	16.5	Sweden	–15.9
Ireland	9.5	Switzerland	13.7
Italy	31.4	United Kingdom	6.4
Netherlands	11.2		
Portugal	7.6		
Spain	26.6		

[a] The table shows the percentage change in relative unit labour costs in manufacturing (for Greece relative consumer prices) from 2000 to 2007.

[b] Relative consumer prices.

Source of data: OECD.

2. The immediate policy response to the financial crisis

The financial crisis began in August 2007. After many years of increase, U.S. house prices reached a high-point in mid-2006 and started an abrupt fall from the beginning of 2007. The risk of losses caused a large fall in the value of U.S. mortgage bonds that brought problems to banks and other financial institutions with investments in these bonds. Uncertainty regarding the exposure to U.S. real estate caused problems on the inter-bank markets as banks became reluctant to lend to each other. The outcome was a big rise in inter-bank lending rates from August 2007. Banks also experienced difficulties in raising finance through the wholesale markets for short-term finance.

The crisis hit the European banking sector especially hard because European banks had large placements in securities based on U.S. mortgage. As early as August 2007, due to losses on U.S. mortgages, two German banks (IKB and Landesbank Sachsen) collapsed. In September 2007, British mortgage bank Northern Rock followed the path after a bank run and was subsequently taken over by the government.

General economic situation in European countries was, however, marked by continued growth until the summer of 2008. The main policy problem was the rise in raw material prices that fed into inflation. The European Central Bank raised its policy rate in July 2008. It was only with the bankruptcy in the American investment bank Lehman Brothers on September 15, 2008 that the crisis hit the European countries with full force.

In the period following the collapse of Lehman Brothers, the EU member states responded unilaterally with a range of policy measures that were in clear breach with treaty provisions and with the principles at the foundation of European cooperation. The economic cooperation in the EU seemed on the verge of collapse.

After the collapse of Lehman Brothers, the majority of EU countries unilaterally implemented schemes in support of their national financial institutions. These national schemes were adopted without prior consultation and without being coordinated with the other EU countries. In several cases, the adoption of national measures met with sharp reactions from other EU countries. Thus, when the Irish government as the first EU government issued a general guarantee for debt obligations in the six largest Irish banks on September 30, 2008, this met with a sharp reaction from the British government that feared a distortion of competition in the Irish market, doing harm to the activities of the British banks that operated in the Irish Republic. The Irish Finance Minister Brian Lenihan openly acknowledged that the Irish government had to put its own interests first, stating: 'I accept it is a tendency towards economic nationalism but we're on our own here in Ireland and the government had to act in the best interests of the Irish people' [*Financial Times* 2008].

After the Irish guarantee scheme, European governments started a veritable race to introduce guarantee schemes for obligations in their national bank sectors. It seemed as if all considerations for EU partners had been thrown overboard, marking a return to economic nationalism. Only two days after the Irish guarantee scheme – on October 2, 2008 – the Greek government followed with a government guarantee for deposits in Greek banks while the governments in France and Italy declared that deposits in their national banks were safe. On October 5, 2008, the German government unilaterally announced a rescue plan, declaring its willingness to guarantee deposits on personal savings accounts. At a meeting between EU finance ministers on October 7, 2008, criticism was raised of countries that had introduced guarantee schemes for bank deposits. Several EU countries denounced the measures as showing a lack of solidarity, causing a distortion of competition and giving bank customers an incentive to transfer funds to countries with the best guarantees. The Swedish Finance Minister Anders Borg declared: 'If all countries solve their problems unilaterally, the solution for one country will become the problem of another country'. The national guarantee schemes were adopted without regard for the EU rules regarding state aid.

The unilateral safeguarding of national interests also showed up in connection with the government injection of capital in banks that were threatened by collapse. Thus, after the Dutch, Belgian, and Luxembourg governments had injected new capital into the crisis-ridden financial institution Fortis Group in a joint action on September 29, 2008, the Dutch government chose unilaterally, on October 3, 2008, to nationalise the Dutch parts of Fortis. The Dutch decision was made without prior consultation with the two other governments. In several cases, national governments made it a condition for the injection of capital that banks must maintain lending to national corporations and households. For example, the British government required that banks with a government ownership should maintain lending at the 2007 level. Writing in Financial Times on November 26, 2008, Ukrainian Prime Minister Yulia Tymoshenko warned that the conditions posed by governments in the advanced industrial countries of national funds being used only for the benefit of domestic customers raised the risk of international banks cutting back on lending in other countries, especially the Eastern European countries. At the meeting of the World Economic Forum in Davos in February 2009, British Prime Minister Gordon Brown raised the risk of 'financial mercantilism'.

After September 2008, with the aim to boost the economy, national governments embarked on expansionary fiscal policies. The outcome was a sharp increase in budgetary deficits which, for all EU countries with the exceptions of Finland, Luxembourg and Sweden, rose above the threshold of 3 percent laid down in the Stability and Growth Pact. National governments also embarked on policies of support for key industrial sectors, most importantly the automobile industry. In many cases, the industrial support was granted on the condition that work-places were maintained in the home country.

It can also be seen as a failure for European cooperation that it was at the initiative of the U.S. administration that countries started to tighten regulation for financial institutions and markets. Thus, immediately after the collapse of Lehman Brothers, the U.S. administration convened a meeting between G20 leaders in November 2008. At this meeting, the need for stronger financial regulation was recognised. As a result, at the next G20 meeting in London in April 2009, agreement was reached of a comprehensive package of regulatory measures, most importantly tighter capital requirements. These measures have successively been adopted, or are in the process of being adopted, as parts of EU financial regulation.

After the Lehman collapse, the European Commission and other EU institutions chose to follow a policy of accommodation. Thus, the national schemes in support of financial institutions were approved with only minor modifications. The conclusions from the meeting in the European Council in October 2008 called for EU rules on state aid to be implemented, promptly and in a flexible way[1]. At the meeting in the European Council on December 11 and 12, 2008, the national schemes in support of financial institutions were presented as parts of a wider EU strategy to combat the effects of the financial crisis[2]. In regard to fiscal policy, it was emphasised

[1] It is noted in the Presidency conclusions from the European Council meeting on October 15 and 16, 2008: 'In the current exceptional circumstances, European rules must continue to be implemented in a way that meets the need for speedy and flexible action. The European Council supports the Commission's implementation, in this spirit, of the rules on competition policy, particularly State aids, while continuing to apply the principles of the single market and the system of State aids'.

[2] It is stated in the conclusions from the meeting between Economics and Finance Ministers on December 2, 2008: 'As regards responses to the financial crisis, the Council specifically emphasised the need to establish national schemes to support the banking sector, in respect of guarantees, but also and especially in recapitalisation plans'. The Presidency conclusions from the meeting in the European Council on December 11 and 12, 2008 note: 'The EU has determined, in a coordinated manner, the emergency measures required to restore the smooth operation of the financial system and confidence among market players'.

that the Stability and Growth Pact should be implemented flexibly. The national measures to boost economic activity were presented as part of a European Recovery Plan that would add a fiscal stimulus totalling 1.5 percent of GDP[3].

3. The decision to support Eurozone countries in financial difficulties

From mid-2009 and throughout 2010, the economic situation in the EU countries again seemed to brighten. As a result, the attention again turned to the consolidation of EU public finances. Meeting in October 2009, the EU Economics and Finance Ministers agreed on the necessity to start the consolidation of public finances at the latest from 2011. The need to keep the provisions of the Stability and Growth Pact was emphasised once again. The excessive deficit procedure of the Pact was opened against almost all EU countries, and, starting in 2011, EU member states were required to bring their excessive deficits to an end. At its meeting in March 2010, the European Council turned its attention to the long-term structural problems facing the European economies and, in June 2011, the 2020 strategy was adopted.

From the end of 2009, the interest rate differential between Greek government bonds and other EU government bonds started to widen. The focus became increasingly directed towards the ability of Greece to honour its debt commitments. In May 2010, the Eurozone countries decided – together with the IMF – to grant financial support to Greece in the form of loans totalling €110 bn. In May 2010, the European Central Bank started to purchase government bonds issued by Eurozone governments. A special scheme – the European Financial Stability Facility (EFSF) – was established by the euro countries in June 2010 to provide support for other euro countries, while the European Financial Stabilization Mechanism (EFSM) was also set up to support euro countries through the EU budget. As a consequence of these new schemes, financial support was granted to Ireland in December 2010 and to Portugal in May 2011. At its meetings in July 2011 and October 2011, the European Council decided to grant additional financial support for Greece.

[3] Reference to the adoption of a European Recovery Plan was first made at the meeting in the European Council on December 11 and 12, 2008.

As a result of the financial difficulties experienced by the euro countries, they decided to establish a permanent European Stability Mechanism (ESM) based on a separate treaty that shall enter into operation from June 2013, replacing the EFSF. The purpose of the ESM is to mobilise funding and grant financial assistance to euro countries 'which are experiencing or are threatened by severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole'[4].

In the course of 2011, interest rate differentials also began to widen for other euro countries, especially for Italian government bonds. In July 2011, the tasks of the EFSF were extended so that the EFSF can purchase government bonds in order to safeguard financial stability. In August 2011, the European Central Bank extended its purchases of government bonds to include Italian and Spanish government bonds, as well.

In combination with the financial support, initiatives have been taken to tighten fiscal discipline and to strengthen economic policy coordination in the Eurozone. The Euro Plus Pact was adopted in March 2011 and, in October 2011, an agreement was reached on a package of six directives and regulations. At the Euro Summit Meeting in October 2011, it was decided to extend economic policy cooperation to new areas.

The decision among euro governments to bring support to Greece and subsequently to other euro countries is remarkable because it is in contradiction with at least the purpose behind the Treaty on the Functioning of the European Union. Following the publication of the Delors Report in April 1989, a comprehensive discussion took place among policymakers regarding the procedure to be followed if EU countries that shared a common currency, were to experience financial difficulties. This was also the subject extensively addressed in academic literature [see *e.g.* Lamfalussy 1989; de Grauwe 1990; Buiter, Kletzer 1990; see also the Delors Report (Committee for the Study of Economic and Monetary Union 1989)]. As the outcome of this discussion, it was decided that members of a European monetary union should be banned from supporting each other. Thus, if euro countries were to experience difficulties in regard to finance, the government in question would have to find a solution with its creditors, possibly seeking a debt restructuring. It was widely believed that the tightest fiscal discipline would result if euro countries were unilaterally to confront the financial markets. If governments pursued an imprudent fiscal policy, they would be punished by the markets through higher financing costs.

As the outcome of the discussion in 1989–1992, a special provision was inserted in the Maastricht Treaty that explicitly banned support among euro member states. In the current Treaty on the Functioning of the European Union, this is expressed

[4] Article 3 in the Treaty Establishing the European Stability Mechanism (ESM).

by Article 125(1) that prohibits a member state from assuming the commitments of another member state. Similarly, Article 123(1) prohibits the European Central Bank from buying debt instruments issued by euro member states.

The current financial support of other euro countries has been justified on the ground of Article 122 that opens the possibility of financial assistance in the case where a member state 'is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control'. It is, however, difficult to see the economic difficulties experienced by *e.g.* Greece as being caused by exceptional occurrences beyond the control of the Greek government. The Greek government would never have experienced difficulties if it had not incurred a large debt by running budgetary deficits for many years. This can hardly be seen as being beyond the control of the Greek government.

It has never been clearly stated why Eurozone countries have come to the rescue of other Eurozone countries. On some occasions, the need to avoid a collapse of international financial markets has been stressed. Policymakers have recalled the consequences that followed the collapse of Lehman Brothers. On other occasions, policymakers have emphasised a moral obligation of solidarity between EU countries and, in particular, among the members of the Eurozone. French President Nicolas Sarkozy has, for example, emphasised mutual euro support as a moral obligation. It has further been asserted that the euro would collapse unless support was granted to economies in financial difficulties. In official statements and texts, the purpose of the support has been stated as being to 'safeguard the financial stability of the Eurozone'[5]. In newspapers and other media, commentators have pointed to a French and German political interest in a bail-out of indebted euro countries so as to avoid losses for their own banks. The alternative would be to support French and

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[5] The Statement by the Heads of State or Government of the European Union of February 11, 2010 declares that 'Euro area Member states will take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole'. The Statement by the Heads of State and Government of the Euro Area meeting in Brussels on March 25, 2010 says: 'Euro area member states reaffirm their willingness to take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole, as decided the 11th of February'. In the Statement of the Heads of State or Government of the Euro Area from May 7, 2010 it is noted: 'we reaffirm our commitment to ensure the stability, unity and integrity of the euro area. All the institutions of the euro area (Council, Commission, ECB) as well as all euro area Member States agree to use the full range of means available to ensure the stability of the euro area'. It is further emphasised that the 'decisions we are taking reflect the principles of responsibility and solidarity, enshrined in the Lisbon treaty, which are at the core of the monetary union'.

German banks through national measures. Such national support would, however, be unpopular.

It may be questioned to what extent these explanations hold in reality. It is, for example, difficult to see why the euro would collapse if the government of one or several member countries fails on its debt obligations. Thus, in existing nation-states, large enterprises or local governments are allowed to fail on debt obligations without consequences for the national currency. Moreover, a withdrawal from the euro would require a deliberate political decision to introduce a new currency. It is difficult to see why a failure to meet debt obligations should strengthen policymakers' incentives to make such a decision. Recent data published by the Swiss bank UBS suggest that the exposures of European banks to Greece are manageable, with few exceptions being below 10 percent of a bank's equity. As discussed below, it is also questionable whether Greek failure to honour debt obligations would give rise to reactions similar to those experienced after the collapse of Lehman Brothers.

Possibly the best explanation is that a new sense of solidarity has emerged, at least among the political elites in the euro countries. For reasons of solidarity, problems in other euro countries can no longer be accepted. It is also possible that, by their actions, European political leaders want to demonstrate leadership in order to gain political advantages. This may have been the case especially for French President Nicolas Sarkozy who early advocated the need to support Greece. Another question is that this strategy seems largely to have backfired, *cf.* below.

4. The support for Eurozone countries: Was it the right policy?

It may be asked whether the policy of support in regard to euro countries with financial problems has been the right one.

At the outbreak of the crisis, the EU and euro countries had a choice between two strategies where a member state or an important financial institution experienced difficulties in meeting debt obligations: (1) to allow a write-down of debt, possibly in accordance with commonly agreed guidelines, and (2) to ensure that debt obligations were honoured. For national governments in financial difficulties, strategy (2) involves increases in taxes and/or savings on the government budget. This can be accompanied by support from the ECB or from other euro governments, allowing for a longer period over which adjustments can take place in the country that experiences difficulties. Such support also reduces the temptation to resort to strategy (1).

Since the outbreak of the crisis, the EU has opted for strategy (2), implying government support for financial institutions in difficulties and support from other member states to countries in trouble. Important debtors have not been allowed to fail. This strategy has also received backing of shifting US administrations.

It may be questioned whether the EU and the Eurozone did in fact choose the right strategy when they opted for strategy (2), *i.e.* to seek debt commitments honoured. We may suggest a number of reasons why the EU and the Eurozone made a mistake by choosing strategy (2) instead of strategy (1), *i.e.* to allow for the write-down of debt.

A first reason is that, seen from the perspective of minimising economic costs, it may be best to choose strategy (2). Thus, the experience from a large number of previous financial crises shows that, prior to crises, there are periods with excessive speculation. This is financed through a build-up of debt. After the bursting of the bubble comes a period during which debt is reduced relative to GDP. This reduction of debt can be achieved either through the write-down of debt or through a prolonged period during which debtors hold back on expenditure to finance the re-payment of debt, in the shorter term possibly supported by additional loans to avoid drastic cuts in living standards. Given the scale of the debt increase prior to 2007, by choosing strategy (2), the euro countries may be confronted with a long period during which a gradual reduction in debt levels has to take place. As it may be difficult to substitute the resultant lower demand from debtors with demand from other sources, the outcome could be a prolonged period with high unemployment.

A further drawback in relation to strategy (2) is that economic activity may for a long time be hampered by uncertainty. Creditors will be uncertain whether the strategy will be successful, worrying about whether they will eventually see their loans repaid. The likely result is frequent episodes with financial turmoil.

There would probably be lower costs in terms of unemployment and lost production if, alternatively, there was a quick debt reduction in debt levels, accomplished by the write-down of debt incurred by governments and by financial institutions. This may, over a short time horizon, cause confusion and, possibly, panic but once losses have been placed, economic activity can start again. After an initial period with confusion, countries, corporations, and/or households would no longer be restrained by high debt levels.

A further problem related to strategy (2) – *i.e.* the strategy involving debt repayment – is whether it is politically feasible. In strong economies, dissatisfaction is likely to evolve as tax payers have to support other countries. While political elites may show a sense of solidarity, it is uncertain to what extent such a sentiment is shared by the broader electorates. The strong reactions in Germany, Finland, and in other euro countries to the bail-out of Greece suggest that this may not be the case. As evidenced by the reactions in Greece to the bail-out, it is also uncertain to what extent there is understanding in debtor countries that restraint has to be shown.

In contrast to the conventional view, it is also uncertain whether the failure of a country, or of a large financial institution, to honour debt commitments will cause panic in financial markets, creating a situation similar to that which prevailed after the bankruptcy of Lehman Brothers in September 2008. Thus, in several cases, failures of countries or of financial corporations did not give rise to adverse consequences in financial markets. For example, neither the Russian default in August 1998 nor the Argentinean default in January 2002 was followed by general increases in interest rates. It must, however, at the same time be recognised that Lehman Brothers does not represent the only example of a financial failure that has caused abrupt rises in short-term rates. A similar freezing of money markets occurred when the German bank Bankhaus Herstatt collapsed in June 1974 and, in September 1990, when there was a collapse of Swedish financial corporations. Thus, it is uncertain to what extent financial markets will react with panic after a debt write-down.

Since the first Greek support package in May 2010, European leaders have backed down from the full-scale use of strategy (2), possibly in recognition of negative effects that follow it. In November 2010, it was agreed that private sector creditors from 2013 on will be required to incur losses when they lend to euro countries with financial problems. In July 2011, in regard to Greece, a debt reduction of *c.* 20 percent was required by private sector creditors and, in October 2011, this was raised to *c* 50 percent. In conclusions from the October 2011 meeting in the European Council, it was, however, at the same time reiterated that '[a]ll other euro area Member States solemnly reaffirm their inflexible determination to honour fully their own individual sovereign signature'.

5. Consequences for European cooperation

What does the financial crisis show about European economic cooperation? And what are the lessons that can be drawn for the future development of the cooperation?

The first lesson is that the crisis has shown the resilience of European co-operation. The crisis has, above all, demonstrated that European co-operation is able to withstand a major economic shock. As described above, in spite of EU member states first falling back on national intervention, member states next opted for European solutions. In several areas, European economic co-operation has even been strengthened by the crisis. This has been the case, for example, in the area of financial regulation in which a system of European supervisory authorities with independent decision-making competence has been set up. In the eurozone, a development has also been set in train that could involve a stronger future coordination of economic policies.

At the same time, however, the crisis has shown limitations related to the working of the European Union. Namely, the European Union was not able to respond quickly to the crisis. When the crisis broke out, national governments had to fall back on national solutions both in the financial area and in regard to fiscal policy. Nor was the European Union capable of showing international leadership. In the immediate period after the demise of Lehman Brothers, it was the U.S. administration that took the initiative to call meetings among G20 leaders. The stronger regulation of financial institutions that has been implemented in the wake of the financial crisis has also resulted from U.S. initiatives.

The reaction of the European Union to the financial crisis marks a further development towards the EU being dominated by national governments and, especially, by the two largest powers, Germany and France. EU initiatives have resulted from joint meetings between French and German leaders. It is noteworthy that the European leaders, instead of using the existing institutional framework, chose a special organisational set-up when they established the European Financial Stability Facility (EFSF). This is also the case for the European Stability Mechanism (ESM) that has been classified as an 'international financial institution' in Article 1 in the Treaty establishing the European Stability Mechanism. A highlight of French and German influence was the press conference held by French President Nicolas

Sarkozy and German Chancellor Angela Merkel on November 2, 2011 in Cannes where the two leaders – without legal foundation – threatened Greece with expulsion from the Eurozone if Greece did not accept the package agreed at the European Council meeting in October.

In the shorter term, it has probably aided the development of European co-operation that European institutions showed great flexibility. Legal provisions were willingly set aside when countries felt it was necessary. This neglect of legal provisions may, however, cause problems in the longer term, implying a loss of credibility. The setting-aside of legal provisions further works to strengthen the inter-governmental forces in the European Union, implying that smaller countries will find it more difficult to exercise their rights.

As discussed above, the handling of the financial crisis entered a new stage when the member states of the Eurozone decided to grant support for other euro countries. As discussed above, it may be questioned whether this was the right policy. The worst case scenario could involve a prolonged period with high unemployment. It remains to be seen whether countries will feel tempted to leave the euro if they are faced with high and prolonged unemployment. Through the re-introduction of a national currency, countries can restore national competitiveness. There is little comfort from the history of European monetary cooperation. As evidenced by the European currency crisis in the beginning of the 1980s and the European currency crisis in the beginning of the 1990s, strains in fixed exchange-rate areas have often occurred in periods with high unemployment. In 1992–1993, differences in countries' economic positions caused the *de facto* break-down of the European Exchange Rate Mechanism (ERM). The vulnerability of the euro has been greatly increased by the events that have taken place over the last two years, in particular by the open discussion about countries leaving the euro and by the threat to expulse Greece from the Eurozone.

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Alojzy Z. Nowak*

End of Eurozone?

Current fiscal problems confront the European Union with a situation that is really difficult. Questions are increasingly asked about the future of Eurozone. Now it's not just Europeans but also the key players in global economy, scholar and business circles as well as regular people that keep asking themselves a question: are politicians who make decisions about the future of European integration going to successfully cope with challenges the Eurozone – and thereby also the European Union – has faced, and if they are, then how soon. The extending financial crisis and fiscal crisis in particular coupled with economic and social crisis which also becomes more and more manifested in an increasing number of places worldwide, including some in the EU member states, makes these questions even more urgent and raises several new doubts.

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The way things happened, it was Polish presidency that experienced the period of the most serious accumulation of fiscal crisis in Eurozone. While the role Poland plays in the EU isn't the most prominent one, it should nonetheless be noticed that over the presidency period Polish government, representatives of financial institutions and Polish business circles alike truly endeavored to actively participate in preparation of proposals of how to improve the current condition of economic trends in the European Union and to suggest sound solutions to prevent similar situations from happening in the future. The task, however, is not an easy one. On the one hand, the EU itself is not uniform. Its member states feature diverse stages of economic, financial, social and political development, which is accordingly reflected in differing economic, social and political objectives they pursue. On the other hand, individual member states come up with different visions as regards the directions in which the European Union should follow in the future. Some of them emphasize the need for more independence for its individual member states, while others seem more keen on visions of the EU integrated even further.

Poland made it clear it perceives the current state of turbulence from the point of view which takes into account more than just its own particular interests. Instead, it really acknowledged the need to search and find new solutions from perspective of the entire EU. It seems that Poland's assessment of hitherto contribution of the EU's largest member states to solving the present problems is quite realistic, too. Indeed, it should be admitted with all due objectivism that the way the European Union develops has already shifted from two to at least three different speeds. Speed one is that witnessed in Eurozone. One may assume that should Poland belong there too, then it would probably also adjust its economy to speed one, thus winning better perception on the part of other countries, both EU member states and third ones, and, even more importantly, on the part of investors, both global and regional. On the other hand, however, a question arises whether it would be easier for Poland as Eurozone member to protect its economy from the financial crisis or from economic crisis. In fact, there is no agreement concerning this issue among Polish economists. On the contrary, there's much dispute over it, increasingly resulting in an opinion that while economic sovereignty is certainly costly, in this very case it really paid off to remain outside Eurozone. Notably, the country has retained the right to apply the fundamental tools and instruments of monetary policy (money supply, interest rates, cash reserve, exchange rate) it could use with relative freedom over the period of the global financial crisis. This being true, one also has to remember that membership in Eurozone increases a country's reliability mentioned above, thereby usually enhancing such country's investment grade and thus improving its opportunities for foreign capital inflow which enables real convergence to be achieved sooner. It is quite obvious, then, that it takes some very reliable and extensive economic and financial analysis to really evaluate the pros and cons of Poland's standing outside Eurozone for the time being. To be sure, no doubt whatsoever exists about the fact that Poland should become member of Eurozone, the only valid question being when. Admittedly, belonging to the group of countries which use the common and strong European currency is still the best anchor one can get for their national economies.

So far, ten out of 27 European Union Member States remain outside Eurozone. Then, among seventeen Euroland countries there are some, known as core countries, that on the one hand are mostly net payers and on the other hand are also those proposing and preparing changes in the principles regulating the way Eurozone operates – and, to a certain extent, the European Union too. It is largely them that develop and implement rescue packages for indebted countries. In this context, Germany and France are those mentioned the most as the key ones. While there are other countries included to that group as well, whether they are seen as solid members depends on the extent of seriousness and on quality of difficult problems to solve. Another group of Eurozone members are peripheral countries, sometimes referred to as 'PIGS' – an acronym for Portugal, Ireland, Greece and Spain, with Italy sometimes added as well. Their present problem is mainly that they are all very seriously in debt. Their indebtedness concerns governments as well as it does banks and private sector (households and businesses), as illustrated in Figure 1 [see page 112].

Data in Figure 1 make it very clear that the debt indeed causes a serious problem in Eurozone. Hence the question appears: where has such a vast indebtedness stem from in countries which had been obliged, on their accession to Eurozone, to satisfy the Maastricht criteria, also known as the convergence criteria. Specifically, the conditions in question included an adequate – read low – inflation rate, appropriately low interest rate, stable exchange rate and meeting a set of fiscal criteria based upon relatively low levels of budget deficit and public debt.

In fact, the above-mentioned criteria were met – if with much effort – by most countries before their accession to Eurozone. For some of them this was really some challenge, considering them being rooted within tradition where high level of inflation, high interest rates and relatively high levels of budget deficit and public debt were norm rather than anything unusual. Accordingly, it was quite a feat for such countries to manage to reduce those values to a level required by the Maastricht agreement. Moreover, according to some economists, certain balance sheet and budget-related items were 'fine-tuned' somewhat during the period of adaptation, for example by current expenditure being booked as future ones while future income, the

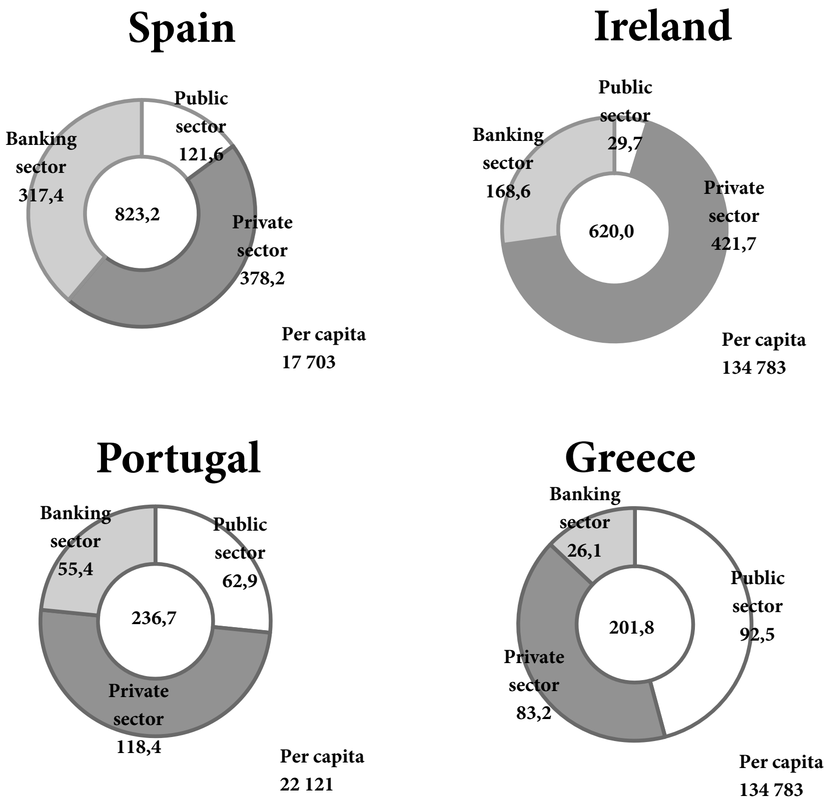

Figure 1. Indebtedness of selected Eurozone countries (in US$ bn)

Source: Krugman [2010].

other way round, were regarded as current. In result, the convergence criteria were satisfied – if in a way which is quite irritating until this day – so that everybody could make the final step and become member of Eurozone. The accession was followed by what is best described as a sort of 'euro-banquet'. Generally speaking, we witnessed an evident increase in consumption and investment. After a period of adaptation which required much sacrifice in terms of consumption and investment, countries we nowadays call peripheral believed they got the right to some relief, to indulge and to raise both consumption and investment. Indeed they enjoyed opportunities to do so, in the form of relatively low interest rates in Eurozone. Their opinion was largely shared by banks which, on the one hand, were giving credits to customers mainly from private sector and, on the other hand, were acquiring securities issued by governments of such countries as Greece, Ireland, Portugal or Spain. In both cases everybody seemed to believe they made good and sure business considering that a country having positively undergone procedures related with the accession to Eurozone earned a kind of certification of its reliability and healthy condition. That particular belief not only related to governments, but was actually extended onto such countries' public bodies and private entities. Banks themselves, as institutions the fundamental objectives of which consist in maximizing the profit and minimizing the risk (related with credits given, liquidity, interest rate and exchange rate) were also interested in giving credits and in acquiring more profitable (*i.e.* bearing higher interest) peripheral countries' government securities. This way they could increase their receipts, followed by income and eventually by the above-mentioned profits. In effect, both credit boom and investment boom could be observed for a couple of years in Eurozone and indeed in the entire European Union. Enough to say that the level of credits in PIGS countries increased, over the years 2003–2009, to between 170% in Portugal and as much as 350% in Ireland. As a direct consequence of the boom in real sphere, prompt growth of GDP followed, in some cases even exceeding the so-called potential growth resulting from the level of productive factors. This was accompanied by a growth of the inflation rate and by appreciation of the euro exchange rate. In the financial sphere an increase of prices of financial assets, prices of housing, land and so on could be seen. This resulted in the occurrence of payment gridlocks, many businesses lost their financial liquidity and problems arose related with insolvency of business entities and even of central governments.

It should be observed, however, that neither the EU member states nor even the group of peripheral countries should be blamed for all the problems they experienced thereafter. One must not forget that the financial crisis had its principal source in the United States. It stemmed from the so-called financialization of economy and creation of toxic financial assets which on the one hand lost much of their value and, on the other hand, caused a lack of trust in investing in financial markets. Many of such toxic assets were held by European commercial banks which, still trusting in American financial institutions and markets, invested in financial instruments they created.

Therefore, some problems experienced by EU countries, including difficulties with repayment of their liabilities, have been strictly related with infection brought from over the ocean. That was also where proposals of the earliest solutions came from, put forth by mainstream economy and arguing to the point that if European banks or businesses are unable to pay their debts back, then they should be let alone to fall. It should be remembered, however, that the American point of view regarding the crisis in Eurozone is very peculiar: it is biased with a well-rooted opinion that the monetary union in Europe had poor chance of successful implementation in the first place. Even as eminent and open-minded economist as Joseph Stiglitz, the Noble Prize winner in economy, observes with a great deal of sarcasm that 'it is going to be extremely difficult now to return from scrambled eggs back to intact ones'. According to him, Eurozone is never going to come back to the state of entirety it once used to be. He even asks questions about what will occur less costly – rescuing Eurozone or calling it a day.

However, it seems reasonable to maintain more reserved attitude towards potential disintegration of Eurozone than Joseph Stiglitz had. Actually, it has been more than once that the European Union managed to overcome crises and often even to come out stronger. It may well be the same way this time. Nevertheless, a number of question marks still emerge, no doubt about that. We know only too well that creditors of indebted companies and countries are mainly banks and financial institutions based in France, Germany, Netherlands and other countries (see Table 1). Considering that collapse of many entities from the group of PIGS countries would imply bankruptcy of a large number of financial institutions and, indeed, a substantial part of economy in Germany, France, Netherlands, Austria and Benelux countries. Therefore, a common interest emerges, a kind of a deal according to which it is better to come up with some rescue or emergency solutions. Put simply, some money has to be found to help bail the PIGS countries out. The task is difficult and in most core countries also controversial. Statistics suggest that such an aid-intervention should contribute the amount of at least one trillion euro. These are, quite understandably, enormous sums, extremely difficult to bear for the budget of the entire European Union. The burden of the operation has mainly been borne by France, Germany, and Benelux countries, while those standing in line to benefit from financial support also include Spain and then, more probably than not, Italy. The key doubt that arises is about where the taxpayers' tolerance in net payer countries will find its limits. It is perfectly justified, then, for Germans or the French to ask why those who don't work tenaciously, steadily and efficiently enough should enjoy better lives than they do.

Data presented in Table 1 or, more specifically, the amounts of money involved, indicate that it is appropriate for societies of countries that have to cope with bailing out the indebtedness of peripheral countries to demand the balance of that debt to be prepared together with explanation of the reasons why it emerged. While this expectation is very understandable, such complete and comprehensive explanation is also really significant as it may considerably influence the way solidarity within the EU will evolve in the future.

Table 1. Exposition of financial assets of PIGS countries in balance sheets of banks from selected countries (US$ billions)

Entities	US$ billions
German banks	512.7
French banks	410.2
Spanish banks	117.3
Italian banks	73.3
Total Eurozone	1397.6

Source: BIS [2010].

The expectations or demands in question seem the more justified that also governments of core countries are to blame, partially at least. After all, once Eurozone was established and demand for credits and for capital grew up enormously on the part of PIGS countries, the core countries failed to pay enough attention to supervision or coordination of economic policies of the PIGS countries. In fact, the former ones seemed to forget that the latter ones were countries of high economic and financial risk. Worse still, Berlin, Paris or Brussels turned a blind eye on authorities of Greece, Ireland or Portugal 'tuning up' their respective balances and official statistics, even at the stage of their accession to Eurozone, where it is in principle rather easy to get capital and to enjoy low interest rates. At the same time, one has to remind again and again that the project to set up Eurozone was mainly a political one. Otherwise, Greece, and not only Greece, would have to wait in line quite long for having the common European currency.

Today it has also become clear that Eurozone, rather than only consist of a club of gentlemen, also includes that of small- or big-time chiselers. And no wonder, after all, considering that in diversified Europe different traditions have grown. Of course, some people say: 'first we work, then we save and then we invest'. However, there are others as well, who prefer quite an opposite attitude and say as follows: 'first we consume, then we'll invest what is left, if any, and in case something still remains we'll save it'.

This way, what we have is really two different worlds existing along each other within a single common group. The financial crisis has only reminded us about that objective phenomenon.

Consequences of aggressive investments made by some investors from PIGS countries in real estate are not only experienced elsewhere; they are also felt in Poland, including Warsaw. Some of them purchased land, factories or buildings assuming that prices would grow up because Poland, along with other Central and Eastern European countries, became European Union member state. They sensed an opportunity which results from economic rights that prices for that type of assets would increase according to the principle of price equalization – perhaps they rise 10 or 15, perhaps as much as 20 per cent. The idea, then, was to take credit in Eurozone-based banks, bearing interest rate of few per cent and invest in assets whose rates of return seemed healthily above that level. In theory, the attitude was perfectly right. However, the way things went deviated from the expected course, at least partially. From the USA came the financial crisis whose effects in real estate markets also became evident in countries which became EU member states in 2004 and later. This caused prices on real estate markets to fall, thus severely limiting chances to achieve expected rates of return on investments. In consequence, a large number of businesses in PIGS countries experienced problems with their liquidity and solvency.

Which is, then, the remedy to that situation? Has Eurozone any real chances of survival and further growth? Is euro enjoying chances to play the role of an international currency any longer?

These are not questions that may be answered easily. No unanimous answer may be found to them, either among economists or politicians, or among the society. On the contrary, answers are abound, mostly divergent and sometimes even contradictory. This probably results from the fact that Eurozone was established in the first place for quite ambiguous reasons, not just due to economic or financial ones anyway. Nevertheless, in an attempt to find answers to those questions it seems worthwhile to remind here once again that Eurozone was set up not only for economic reasons; it was also due to political ones. They included, among other things, the will to deepen the processes of integration in the European Union. This was only believed possible under condition of having a single common currency. Secondly, the intent was to improve stabilization of global financial system, hitherto based upon really just one pillar *i.e.* US Dollar. The Asian crisis of late 1990s revealed a number of weaknesses of that system. Should it collapse, this would entail a great deal of serious trouble and bankruptcies around the world. In order to prevent this from happening, it seemed appropriate to propose financial system based upon at least two pillars – US Dollar along with another international currency having a similar nature and, possibly, also similar strength and importance. Finally, third reason and the one increasingly heard of these days was an attempt to weaken West German currency *i.e.* Deutsche Mark and to control the strong, united German state. Interestingly, that very reason may as well be interpreted in an opposite way. Germany favored the idea of the common currency in expectation that, in early stages at least, it would be weaker than the Deutsche Mark. That would help German economy to improve its competitiveness following the process of unification and in effect would enable the country, partially at least, to alleviate the enormous burden of that process, considering that the costs borne were aggravated by possession of strong national currency. Without involving in any profound analysis or assessment of reasons why Eurozone was established and the common currency adopted, its positive role should be emphasized in deepening the processes of integration in the European Union and in stabilizing the global financial system. For the first dozen years euro was a solid and stable currency. Prices in Eurozone were more stable than ever over the past fifty years in the Communities before euro was introduced. The average inflation in Euroland amounted, over the last 12 years, to *c.* 1.97% and the average level of inflation in Germany to *c.* 1.5%. Budgetary deficit (on the average) at the end of 2011 was at around 4.5%, while both in the USA and in Japan it exceeded 10%. Sure enough, as mentioned above, not all Eurozone countries fare just as well, but on the other hand neither it can be said that the Eurozone as the whole fares quite poorly. It may also be concluded from the data presented that Eurozone – just like the entire European Union, by the way – is not monolithic as far as its financial or fiscal condition is concerned or its principles concerning the way financial policy is run, including, in particular, fiscal policy. This diversification also gives rise to various problems regarding proposals of how to solve and find way out of the present situation and how similar troubles might potentially be prevented from happening in the future.

According to P. Krugman, there are four scenarios for overcoming the present state of affairs in Eurozone. While possible, they are also rather difficult to implement in their pure form.

Scenario one is based on the idea of applying in Eurozone a very restrictive financial policy, especially fiscal policy. In general, this would consist in strict control of budgetary expenditure and, for the time being, in particular in cuts of budgetary outlays and, where practicable, in increasing budget income.

Considering that what we are experiencing in Europe is not a currency or monetary crisis (the euro exchange rate really goes up against the US Dollar since about third quarter of 2001 and it is in euro that businesses keep more and more foreign currency reserves – at present close to 30%), but the crisis of economic policy and results of financial crisis, such ideas are hardly surprising. Budgetary restrictions or discipline in the field of public debt seem obvious remedies. However, stern fiscal policy means that something has to be taken away from somebody. From who, then, and where? Budgetary cuts would mainly regard three areas: education, health care and pension funds. In addition, it would be necessary to increase taxes and make cuts of wages in public sector. The example of Greece shows how difficult this is in practice. The riots were only little shy of letting the monuments of Athens go up in flames.

On the other hand, it should be underlined that, looking from historical perspective, positive instances of implementation of restrictive fiscal policy may be found. Among others, several years ago it was applied in Baltic countries. With considerable success. Budgetary debt was reduced as was public debt, exchange rates of local currencies were stabilized, inflation was decreased. Economies of the region were stabilized enough to enable one of Baltic countries (namely, Estonia) to meet the Maastricht criteria and access Eurozone. Restrictive fiscal policy, then, may occur successful and this means that a policy of compulsory savings need not be necessarily doomed to failure. The example of Baltic people gives reason to some optimism in this respect.

Scenario two is based on an assumption that debt may be restructured. A possibility of debt restructuring would effectively mean that the debt of all the PIGS countries and their indebted entities would be reduced. With regard to Greece we are speaking about a scenario which is already underway. With much difficulty, no doubt about that, but with also a chance for success. A limited one, realistically looking. The program of restructuring is implemented basing on an assumption that the debt, to some extent, weighs down upon both debtors and creditors, since both occurred over-optimistic, ones while borrowing money, others while giving credits. At the same time, the latter ones failed to maintain the requirement of due diligence and were too greedy in following a myth of achieving exorbitant profit. This way of perceiving the roots of present situation is certainly right to a considerable degree. Problem is, however, in that this prompts other countries and other businesses as well to demand their debts restructured. While, formally, they do not belong to Eurozone, their trade exchange with Eurozone accounts for such a significant share that in fact they might be regarded as part of it. Of course, it is next to impossible to hope that the problem might be solved by satisfying demands of all interested. One may assume, then, that also this scenario has realistically little chance of success, although, just as the previous one, it may not be ruled out altogether.

Scenario three: 'Argentinization of Europe' *i.e.* a similar thing as what happened in Argentina just over a dozen years ago. Argentinian peso was devalued with respect to US Dollar in order to improve competitiveness of Argentina's economy, thus stimulating business activity and increasing income to the state budget. Is that scenario practicable in the European Union? In my opinion it is not. It should be remembered that Eurozone was created, among other things, due to political reasons and one of the arguments used at that time was to have second financial pillar built, compatible to US Dollar and capable of contributing to stabilization of global economy, including European economy. This was to be possible thanks to possibilities of investing financial assets either in US Dollar or in euro. Therefore, devaluating euro would not only mean destabilization of Eurozone, but also destabilization of global finance and, further on, political destabilization. Also, devaluation of euro would be the more incomprehensible that – as mentioned before – in Eurozone we don't really have to deal with currency crisis. Instead, we mostly do with fiscal crisis. Additionally, some countries of Eurozone enjoy an excellent condition despite the currency being relatively strong. German economy is perhaps the best example, although even it seems not entirely secure these days. The news that Germany failed to sell its ten-years bonds out (just 40 per cent of the issue was sold) brings serious signal of warning. The economy of Germany is not totally immune to phenomena of unstable financial markets and the same holds true for economies of Benelux countries and France. Still, the risk inherent in devaluation scenario is excessive and then such a remedy seems simply ill-justified from the point of view of certain countries.

Then we have scenario four, called 'Europe's Resurrection' or 'Europe's Rebirth'. It is based upon the assumption that Europe has to come back to a community-wise manner of thinking, *i.e.* to think solidarity. It has to keep its future in mind and strive to solve its present problems in common. It must not fall to temptation of either individualist or nationalist way of thinking. Sooner or later Europe is going to face the necessity to answer some vital questions anyway and the most vital question will be how it is going to evolve: along the lines of confederation or those of federation? It has already become evident that this will take profound political changes. Adequate institutions will have to be built to take responsibility for a certain degree of supervision and coordination of economic policy of the European Union member states. What calls for such measures today is, most of all, budgets of individual states. It is quite unlikely that all countries will behave with equal decency and truly care for stabilization of the European Union through responsible economic and social policy. Therefore, perhaps it would be advisable to consider a sort of a common governance institution, such as a Ministry of Paneuropean Finance or an Agency of European Finance – it is not the very name that really matters. However, how such an agency or ministry would be meant to operate? Shall an agreement be reached between all countries interested as regards coordination of budgetary policy at a level of their national parliaments? Will such an agreement be achieved about new regulative institutions at the level of the European Union? Dilemmas that already occur today, such as an apprehension of sovereignty of individual states being restricted, are going to become commonplace. This confronts us with the pivotal problem: which Europe do we want? Do we want to have a single strong European government or rather retain national governments? The essence of the problem is in implementation of German-French concept concerning fiscal union. Such a fiscal union would effectively mean that a certain part of budgetary policy would be transferred from national onto the community level. Put another way, this would entail giving up narrowly perceived national interests. It seems worthwhile to adduce the example of America in this context. The way the United States are engineered, should Alabama, California, or Mississippi face serious hardship while Washington, New Jersey or another state fares fine, then the money go to the HQ (DC) from where they are sent to the states badly in need. From this point of view the America reveals more solidarity than most Europeans might ever think. However, in Europe there is no consensus about the need to build the Union based upon solidarity transfers. On the contrary, net payers reckon this proposal out of the question. Neither is it clear how such a hypothetical Fiscal Agency would operate. So far it is national parliaments that have been responsible for state budgets. Would such an Agency, then, be meant to approve budgets adopted by national parliaments, potentially making some corrections therein? But then again, this would largely render national parliaments redundant. Should the Fiscal Agency, on the other hand, involve in preparation of individual member states' budgets in collaboration with them in order for such drafts to be approved thereafter by their national parliaments, then what the Agency for? There are the sort of doubts and dilemmas that are going to be extremely difficult to solve unless a concept for an appropriate legal and administrative formula is adopted, concerning the existence of Eurozone and indeed the entire European Union in the future.

This leaves us with scenario five, which is perhaps even more illusory but should nonetheless be taken into account. It originates from countries which have substantial reserves in foreign currencies nowadays, that is from China and some Islamic countries. If nothing more, Chinese proposals are at least worth of mention, considering this is a very prospective country as well as one we still underestimate. Leaving aside political concepts coming therefrom and only focusing upon economic proposals, the Chinese seem to be saying quite frankly: 'No problem really, just open up your borders so we can buy out your debts and help you manage them'. Here is where a question arises whether such offers are attractive enough. Should the United States and countries associated in the European Union, that is countries having greater democratic traditions and well-proven market economy rules, take advantage of solutions proposed in the face of the crisis they face these days? Is the weakened West going to agree for a prospect of changes resulting from a new economic deal created with new roles distributed among China, India, perhaps also Brazil and South Africa? These are true challenges Europe is probably going to have to cope with in face of the crisis in the European Union.

Summing up, it seems advisable in the end to come beck to considerations relating to Eurozone only – this is, after all, the key subject we're interested in today. So, if we are to ask ourselves a question in the light of the above inquiry whether it is worthwhile to herald the sunset of euro, then the answer is it is not. First of all, because in spite of the present problems in Euroland the condition of euro is quite good. Euro is going to survive even in the case either Greece or Portugal chooses to leave Eurozone. Which, by the way, is hardly a prospect. It seems impossible, among others for a reason which, putting things simple, is that while we know how to step in, there is nobody wise enough to know how to step out. Eurozone is not a place where one might just say 'Goodbye! I quit'. Rather than that, it is more likely it will exist as long as there are core countries interested in strengthening, consolidating and developing it. The way things look now, this is what we are witnessing, for the following reasons:

- in effect of existence of Eurozone the countries involved enjoy access to large and wealthy sales markets,
- Eurozone still ensures economic, financial and political stabilization, both in Europe and worldwide,
- participation in Eurozone, all things said and done, still conveys an indisputable prestige upon members,
- quitting Eurozone, even if by just one country, would cause a great deal of economic, financial, and social turbulence both in the quitting country and in the entire Eurozone. Should that be Greece that leaves, for example, its new currency would be devaluated badly and immediately. This would, on the one hand, deteriorate living standard in Greece even further and, on the other hand, decrease import of goods and services from other Eurozone countries, thus also worsening economic condition of exporting countries. Putting things simple, one may say that no party to the game is really interested in Eurozone disintegration.

Apart from this, there are also other bodies interested in survival of Eurozone, including the European Commission and the European Parliament. Establishment and operation of Eurozone – in a similar way as enlargement of the European Union – have strengthened these institutions giving an additional legitimacy for their existence and development.

Finally, the United States are interested in maintenance of Eurozone as well. Why? Because on the one hand euro has indeed become a second pillar stabilizing the finance of contemporary world and, on the other hand, euro is precious reviewer of FED's monetary policy and of the fiscal policy of the Department of the Treasury. This role of euro can hardly be overestimated as it enables coexistence between Eurozone and US Dollar zone and also facilitates the task of stabilization of modern world opening prospects for further economic growth.

Of course, it is also here that one might be tempted to ask whether these two pillars of global economy, one basing upon US Dollar, another one on euro, shall suffice. Is a third one going to appear, Asian perhaps? This remains to be seen, probably in 10 or 15 years. Anyway, it would not be comprehensible for all Europeans if a new architecture of economic deal emerged in the history of global economy in the wake of the crisis in Eurozone, bringing an end to predominance of Western civilization for the sake of Asian civilization. And if the place Adam Smith occupies in academic textbooks as father of free market economy was deleted and replaced by some communist party secretary.

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Dariusz K. Rosati*[1]

Public Finance Consolidation for Long-term Growth in the European Union

1. Introduction

The situation in public finances of the European Union member states deteriorated significantly over last several years. Between the end of 2007 and the end of the second quarter of 2011 the gross consolidated government debt of EU27 increased from 59.0% to 80.9% of total EU GDP, and for the euro area (EA) the gross government debt increased from 66.6% to 87.4% of total EA GDP. This massive increase in public debt – by more than 20% of GDP – over such a relatively short period of less than four years has mostly been a result of large annual budget deficits during 2008–2010 and partly also a result of falling GDP levels in some countries. The deficits themselves

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[1] The views expressed in this article are sole responsibility of the author and do not necessarily reflect the views of the European Commission nor engage the European Commission in any way.

have in turn mostly been produced by a combination of cyclical factors, including falling budgetary revenues during the recession in 2008–2009, and national budgetary stimulation packages adopted in most countries, including, in particular, financial support provided to local banks by some EU governments. Fiscal deterioration of this magnitude within such a short period has been unprecedented in developed countries since the end of the World War 2.

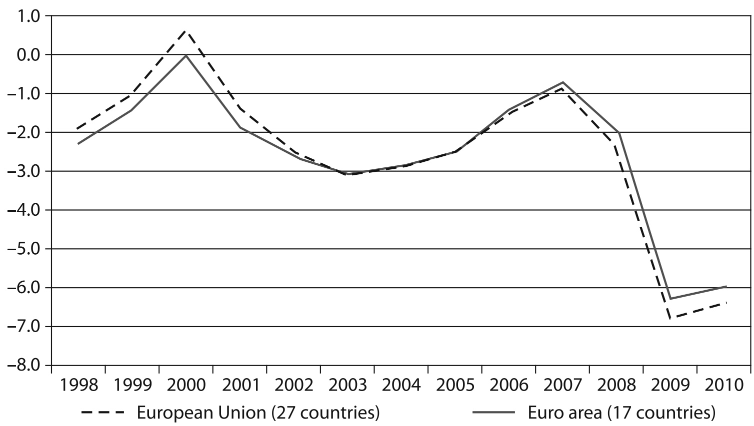
Actually, however, the fiscal position of many EU countries was already quite precarious before the crisis of 2008–2009. The debt and deficit levels were in many cases much higher than permitted under the EU system of fiscal rules as provided in the Stability and Growth Pact (SGP) and in the European Treaty (the Treaty on the Functioning of the European Union, TFEU). When the crisis hit, some countries were already overburdened with excessive debts. Further massive deterioration of fiscal balances put several most indebted EA member countries on the verge of sovereign bankruptcy – something that had not been even considered when the historical decision to establish the currency union in Europe was taken twenty years ago.

Bringing public debts under control will be difficult because growth prospects in the EU are rather grim. The European Commission's forecasts predict that output gaps for most countries, especially in the EA, will remain negative until at least 2012, which implies that debt-to-GDP ratio will still be increasing. The task of restoring public finance sustainability in a more distant future is even more challenging because of the long-term fiscal implications of ageing in Europe. Growing life expectancy combined with falling fertility rates increase the implicit fiscal liabilities which will gradually transform into explicit ones.

The purpose of this paper is to discuss the causes and consequences of the sovereign debt crisis in the EU, and in particular in the EA. We start with some statistical data on debts and deficits and then we briefly recall some theoretical explanations for the existence of excessive deficits. Next, we examine the existing system of fiscal governance in the EU and identify its major weaknesses. The following section provides an overview of the Greek debt crisis and its ramifications. It is argued that EA policy reactions to the Greek crisis have persistently followed a 'too little, too late' pattern. We then use a simple debt-dynamics framework to show how the public debt level affects the GDP growth rate and the interest rate. It is argued that high debt-to-GDP ratio levels are associated with lower growth rates and higher interest rates, and that for high debt ratio levels this relationship becomes non-linear which poses a serious challenge to policy-makers. A concept of sovereign risk channel is then introduced and its impact on the pace of economic activity is discussed. Various policy options are discussed in the context of current crisis from the point of view of their sustainability and their impact on economic growth, including possible immediate remedies to the sovereign debt crisis. A three-pillar strategy to cope with the current crisis is suggested, with ECB involvement in debt market stabilization being its crucial component. The last section concludes these consideration.

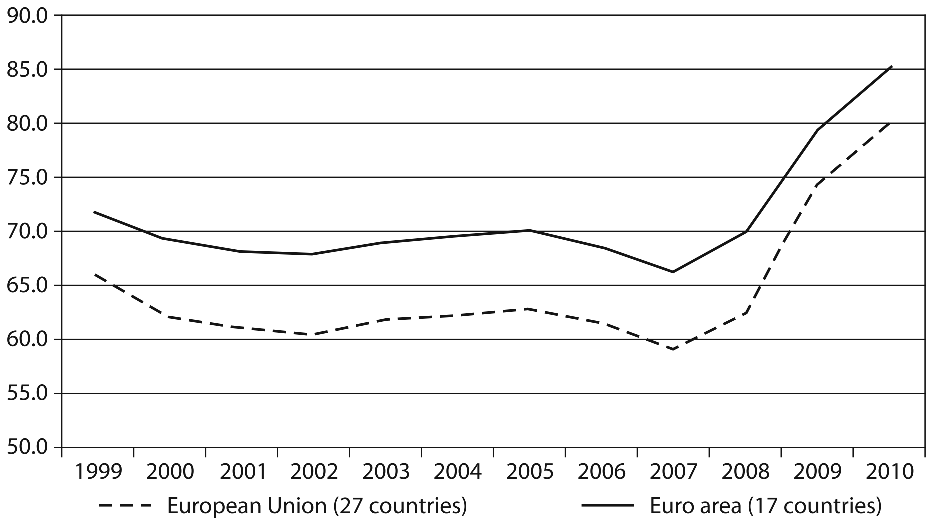
2. Facts on debts and deficits in the EU

Graphs 1 and 2 show the evolution of public deficit and debt in EU27 and EA in recent years. The sharp deterioration of public finances and rapid increase of indebtedness after 2007 is clearly evident. The graphs also show that even before the crisis in 2007 the public finances in EU27 and EA were already in deep imbalance. In particular, during 12 years period since the introduction of the common European currency in 1999 the euro area as a whole recorded budgetary deficits every year (except in 2000). This suggests that many EU27 and EA member countries must have systematically violated one of the EU fiscal rules which required member countries to maintain their budgetary position close to balance or a surplus in the medium term. In result, during the whole period 1999–2010 the debt level in EA well exceeded the maximum threshold of 60% of GDP as required by the Treaty. The situation was only slightly better for the whole EU27 where the total debt was also above the 60% reference level during the whole analyzed period (except in 2007).



Graph 1. Consolidated general government deficit in EU27 and EA, 1998–2010, % of GDP

Source: Own calculations, Eurostat data.



Graph 2. Consolidated public debt in EU27 and EA, 1999–2010, % of GDP

Source: Own calculations, Eurostat data.

When the financial crisis started in 2008, most EA countries reacted with massive fiscal stimulation, including various discretionary decisions on tax cuts and expenditure increases, as well as government support for ailing banks. Extending financial assistance to the banking sector in form of guarantees and partial nationalization, even if controversial from the political economy point of view, was deemed indispensable in order to protect banks against systemic risk of bank failures under conditions of lack of liquidity. The need to support banks became evident especially in the light of the consequences of the Lehman Brothers collapse in September 2008. In fact, it was the US government decision to let the Lehman Brothers fall which triggered the financial crisis. But it was only after the collapse when politicians realized its devastating systemic implications for the financial sector and the whole economy. This traumatic experience taught the politicians a painful lesson that no big bank should ever be allowed to go bankrupt.

The increase of indebtedness in the most recent financial crisis was similar in magnitude to the debt increases during other financial crises in the 1970s and 1980s (*e.g.* during the oil crises). The key difference, however, is that the starting level of debt this time was much higher [European Commission 2011]. These much higher initial debt levels increase debt service burdens and reduce sharply the scope for any fiscal stimulation which may be contemplated in order to prevent prolonged recession. This has made fiscal consolidation both particularly urgent and challenging.

3. Deficit bias and its consequences

While fiscal imbalances have always been facts of life, in modern democracies they are characterized by interesting asymmetry. Under democratic political system, public finances are prone to show deficits rather than surpluses. Electable politicians tend to make promises that are welcomed rather than disliked by the voters. Since voters generally prefer lower taxes and higher spending, this preference induces politicians to promise less taxes and more spending. This bias gets more intense during election campaigns. Generally, the tendency to overspend and/or undertax is not counterbalanced by a symmetric tendency to raise taxes and cut spending during periods between the campaigns. This political-electoral cycle tends to result in more deficit in public finances.

In addition, modern democracies with elected representatives are prone to the well-known common pool problem. Government spending, which is financed from general tax fund, mostly benefits specific individual social groups or regions. This is because fiscal policy is always redistributive [Eichengreen *et al*. 2011; Hallerberg and Von Hagen 1999]. This means that those who benefit from specific government programs do not bear the whole burden of paying for these programs as they are financed by the whole society. In result, these individual beneficiaries and their elected representatives always seem to demand more resources to be spent on these programs than they would if it was them who have to bear the entire cost concerned. The common pool problem reflects an important externality: social cost exceeds private cost of funding individual government programs and this creates a systematic pressure on more spending than justified by available funding. The pressure becomes stronger under deep ideological, ethnic, religious and linguistic divisions because of weaker sense of responsibility of individual groups for tax burdens falling on other groups in the society [Konotopoulos and Perotti 1999].

The electoral cycle problem and the common pool problem require efficient fiscal institutional and legal arrangements to counterbalance the resulting tendency to higher deficit and debt. Necessary arrangements may take form of fiscal rules, numerical or otherwise, which impose legal constraints on public spending, deficit or debt. They may also take form of special institutions responsible for setting up legally binding spending or deficit targets consistent with sustainable debt levels in longer run. In the absence of such institutional arrangements, the common pool problem is addressed on an *ad hoc* basis through negotiations between political groups which may result in higher deficits financed by intergenerational transfers, and higher debts.

In a currency union, the deficit bias tends to get stronger because of free riding and moral hazard problems [Stark 2001; Hagen von and Mundschenk 2002; Rosati 2010]. The free rider problem emerges when one member country increases its fiscal deficit knowing that costs of fiscal expansion will be borne by all member states. This tendency can be regarded as an international variation of the common pool problem. Moreover, a fiscally profligate country will be less induced to maintain fiscal discipline because it may assume that in case of a debt crisis it will be bailed out by other member countries. This is the moral hazard problem which appears when there is an explicit or implicit bail-out clause in a currency union agreement[2].

Both the democratic country-specific factors (the electoral cycle and the common pool problem) and the currency union-specific factors (the free rider problem and the moral hazard problem) lead to a systematic deficit bias in public finances. The deficit bias, in turn, translates into growing public debt, which may eventually end up in a debt crisis. If the debt crisis is to be avoided, special mechanisms have to be put in place to ensure fiscal discipline. Democratic countries try to reduce the scope of the deficit bias with more efficient fiscal frameworks, including rigid fiscal rules, such as 'debt brakes' or spending limits, and independent fiscal institutions. Furthermore, because the common currency is considered an important 'club' good[3] that needs to be protected in the interest of all, the EA Member States impose additional measures to maintain fiscal discipline[4].

[2] This is not the case in the EU, as there is a 'no bail-out' clause in TFEU (Art 125.1).

[3] On the general theory of 'club' goods, see Buchanan [1965].

[4] There is one more strong argument in favour of maintaining fiscal discipline in the EA. As is well known, heavily indebted governments are tempted to reduce the real burden of the debt through allowing for higher inflation. Such government would therefore likely be in favour of higher inflation which would obviously lead to a conflict with less indebted countries that have strong preference for price stability. This conflict could undermine the effectiveness of monetary policy in pursuing the price stability objective in the EA.

4. The framework for fiscal discipline in EU and EA

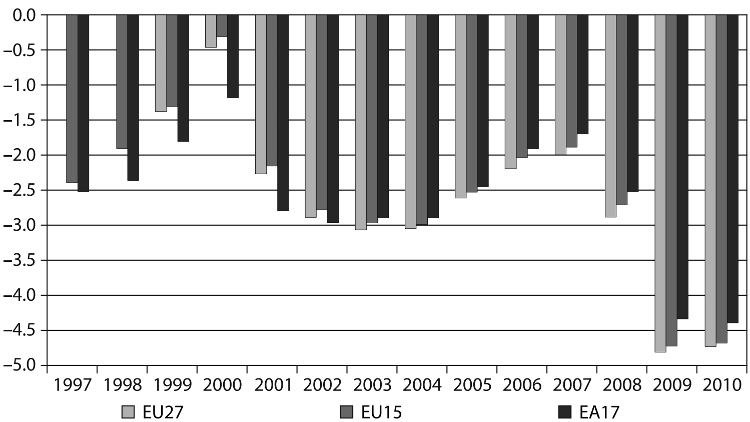
There are two principal instruments for coordination and control of fiscal policy within the EU. The first one is the Broad Economic Policy Guidelines (BEPG) which sets a mechanism for multilateral surveillance and coordination of national fiscal policies in order to avoid conflicting fiscal impulses within the EA and to ensure the implementation of necessary fiscal and structural adjustments. The BEPG mechanism is regulated by Art. 120 and 121 of TFEU which stipulate that economic policies of individual member states are subject of common interest and are coordinated within the EU. Every year, the EU Council adopts a set of guidelines which determine economic and employment priorities for the Union, and governments of member states are supposed to follow these priorities in their national policies. In case of non-compliance, the Commission and the Council may address recommendations to member states, and use peer pressure to ensure compliance. However, no formal enforcement mechanism exists under the current framework. In particular, no sanctions can be applied.

The second instrument is the Stability and Growth Pact (SGP) – a set of preventive and corrective measures specifically designed to keep budgetary deficits under control[5]. SGP provides an operational extension of Art. 126 of TFEU and of Protocol No. 12 on the Excessive Deficit Procedure (EDP). These provisions impose on Member States an obligation to avoid excessive deficit and debt, which are defined, respectively, as a deficit that exceeds the reference value of 3% of GDP and a debt that exceeds 60% of GDP. Moreover, SGP requires Member States to maintain their public finances 'in balance or in surplus over the medium term', which is referred to as the medium term objective (MTO). These three fiscal rules plus the procedures to identify, prevent and correct fiscal imbalances form the framework for maintaining and controlling fiscal discipline in the EU. By contrast to the BEPG which is a 'soft-type' framework to exchange information and use peer pressure to coordinate national policies, the SGP is a legally-binding, rule-based mechanism.

Since its adoption in 1997, SGP has been under attack from different sides. Initially, it was criticized for its arbitrariness and lack of solid theoretical foundations [Buiter, Corsetti and Roubini 1993: 57–100; Wyplosz 2002; Fatas and Mihov 2003] as

[5] SGP consists of three legal documents: the European Council Resolution of 17 June 1997 and two ECOFIN Council Regulations (1466/97 and 1467/97).

well as for its excessive rigidity [Eichengreen and Wyplosz 1998: 67–113; Melitz 2000: 3–22; DeGrauwe 2000]. When SGP was reformed in 2005 with the aim to increase its flexibility, some authors argued that the changes actually softened the rules and diluted SGP's disciplining powers [see i. Calmfors 2005]. But the ultimate proof of its inefficiency (though not necessarily of the rules themselves) is that the fiscal rules failed to be effectively enforced. Since its adoption in 1997 until 2009 the deficit rule was violated 45 times (on 154 annual reported observations) in EA12[6]. In the group of ten new Member States (EU10) there were 27 annual episodes of excessive deficit (on 66 annual observations). Broadly similar was the situation with the debt rule. In 2008, the debt level exceeded the reference value of 60% of GDP in 14 EU member states (out of 27) and in 8 EA member states (out of 15).



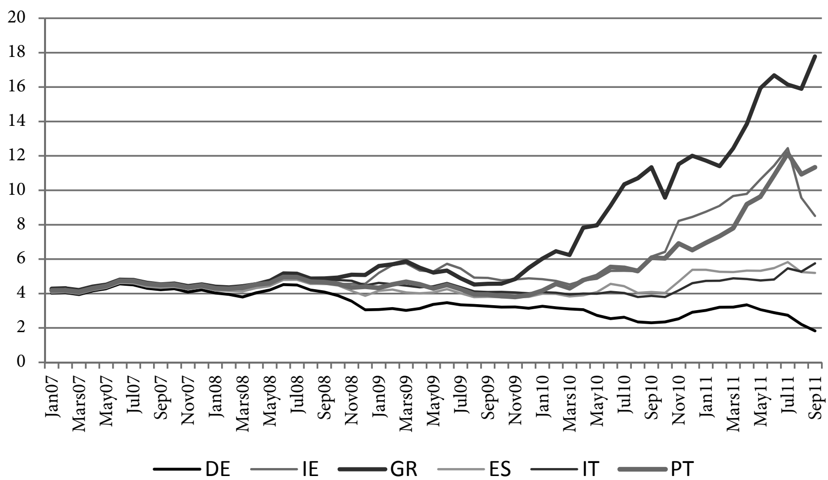
Graph 3. Cyclically-adjusted deficit in EU, 1997–2009, % of GDP

Source: AMECO database.

Also, the rule of balanced budget over the medium term was not observed. As can be seen from Graph 3, the cyclically-adjusted general government balance in EU was negative for every single year between 1997 and 2010 (the period extends over 14 years and clearly can be interpreted as covering a medium term time span). The average deficit in that period was 2.5% of GDP for EU15 and 2.6% of GDP for EA17. The average deficit for EU 27 (1999–2010) was 2.7% of GDP. Even when the crisis years 2009 and 2010 are ignored, the average deficits were still 2.2% and 2.3%, respectively. All this clearly demonstrates that required discipline was not enforced [Rosati 2010]. Simply, SGP did not work as intended.

6 Even if the crisis year 2009 is excluded from calculations, there were 36 violations on 144 observations for EA12.

The reasons for the fiscal laxity in the EU in general, and in the eurozone in particular can be found in the flawed construction and inefficient enforcement of the SGP framework [Rosati 2010]. First, incentives to avoid violations of the fiscal discipline built in the SGP have been weak: the EDP procedure has been very extended over time [up to 9 years before sanctions could have been imposed – Calmfors 2005], a temporary breach of the deficit rule had no unpleasant consequences in practice, and sanctions have actually never been imposed (not even in the case of Greece which has never had a deficit below 3% of GDP). Second, the EDP procedure has been crucially dependent on the political mechanism of decision-making in the Council (qualified majority voting was required to start the EDP and to activate its subsequent steps), which made the whole mechanism open to political pressures and behind-the-scene negotiations. Even more importantly – and in contrast to the deficit rule – no sanctions (nor any enforcement mechanism) have been foreseen in the SGP for violating the debt rule and the MTO rule. Although Article 126 of TFEU explicitly calls on the member states to respect the debt limit, the EDP procedure applies only to the deficit rule violation, so no instruments exist to enforce the debt limit. The MTO rule is even less binding because not only it lacks an enforcement mechanism, but it has a weaker legal basis as it has been introduced by Regulation 1466/97 and has



Graph 4. Ten-years government bond yields in selected EA countries, monthly averages, January 2007–September 2011 (%)

Source: Based on ECB data.

nodirect and unambiguous reference in the Treaty. Finally, the SGP framework failed to prevent some member states from underreporting or even falsifying the budgetary data submitted to the EU, as was demonstrated by the case of Greece.

An interesting and somewhat surprising (at least to some) observation was the astonishing ignorance and complacency of the financial markets (and, for that matter, also of the rating agencies) with respect to high debt levels of some EA countries. The markets clearly failed to properly differentiate country-specific sovereign risk within the Eurozone. Graph 4 shows the values of government bond yields for Germany and five other EA (most indebted) countries. It can be seen that until early 2008 the yields on government bonds within the euro area did not differ by more than 20–40 basis points which implied that markets did not attach high risk premiums to the accumulated fiscal imbalances in most indebted countries (Greece, Portugal, Italy).

The reasons for this irrational optimism could perhaps be found partly in an unjustified faith in the efficiency of the SGP framework and partly in the misplaced belief that within the Eurozone there is a *de-facto* pooling of sovereign risk through potential cross-border transfers and/or semi-automatic bail-outs [Buiter and Rahbari 2010], even though the Treaty explicitly forbids sovereign bail-out by member states and/or EU institutions (Art. 125 of TFEU). Also, it should be noted that the officially reported debt levels of most indebted countries did not change much between 2000 and 2007, so there was no *prima-facie* reason to fundamentally change the sovereign risk perception by the markets. This myopic perspective was abandoned and replaced by (probably equally unjustified) panic when it became clear that Greece cheated on its budgetary statistics and that the actual deficit and debt levels were much higher than generally believed.

5. The sovereign debt crisis in the euro area

The fiscal situation in the EA has systematically deteriorated since the first symptoms of the Greek sovereign debt crisis emerged in October 2009. The turbulences, which were initially contained to Greece, have gradually spread into other EA member countries, including their banking sectors. The negative spillovers resulted in a deep financial and sovereign debt crisis in the whole euro area, which at the time of this writing (October 2011) was still far from being solved. The lack of proper crisis management mechanisms and crisis resolution procedures at the EU level, and political controversies among and within individual EA member countries over necessary remedies, did not allow for taking swift and efficient action that would contain the impact of the Greek crisis and stabilize the situation. Instead, EA countries got stuck in protracted and sometimes heated disputes over how, and if at all, provide some form of assistance to most indebted countries.

When the decision on extending financial assistance to Greece was eventually taken on May 12, 2010, the Greek government found itself practically cut off from the access to market financing and the first sovereign bankruptcy in the EU was a matter of days, if not hours. The €110 bn financial package, put hastily together by the EU and the IMF, was an emergency attempt to help the heavily indebted country to roll over its current government obligations. It was the first multilateral rescue operation ever addressed to a Eurozone member state. The move came as no surprise to the financial markets, as it was clear that Greece's financial situation had been rapidly deteriorating already for months. Its intention was, apart from providing support to Greece, also to reduce uncertainty among investors and allay fears about stability and future prospects of the euro area.

Over and beyond providing the emergency financial support to Greece, EA member countries decided to undertake two other important initiatives. First, in order to calm down the nervous investors and restore confidence in the markets, the EA countries decided also to establish an *ad-hoc* €440 bn stability facility that would supplement €60 bn already available from EU budget. The European Financial Stability Facility (EFSF) is a collective commitment of all EA member countries to provide financing, together with the IMF and the European Commission, to most indebted EA countries when a need arises, and thus fend off any other possible sovereign debt crisis (with Portugal, Ireland, Spain and Italy being particularly vulnerable)[7]. The money coming from the three sources could be drawn upon to

[7] The European Financial Stability Facility is a special purpose vehicle agreed by the 27 member states of the European Union on 9 May 2010, aiming at preservation of financial stability in Europe by providing financial assistance to EA states in economic difficulty. The Facility, headquartered in Luxembourg City, began its activity formally on 4.08.2010. The EFSF can issue bonds or other debt instruments on the market to raise the funds needed to provide loans to EA countries in financial troubles, recapitalize banks or buy sovereign debt. Emissions of bonds would be backed by guarantees given by the euro area member states in proportion to their share in the paid-up capital of the European Central Bank (ECB), for the total of €440 bn. The Facility may be combined with loans up to €60 bn from the European Financial Stabilization Mechanism (ESFM) reliant on funds raised by the European Commission on capital markets and using the EU budget as collateral. EFSF and EFSM may be combined with loans up to €250 bn from the International Monetary Fund (IMF) to obtain a financial safety net up to €750 bn.

provide support to member countries in case of financial distress. This *ad-hoc* facility was supposed to be eventually transformed into a permanent stability mechanism, managed at the EU level and including provisions for orderly restructuring of sovereign debts. However, the actual progress was painfully slow: after 18 months since its inception the EFSF was still far from achieving its full lending capacity, with only €250 bn of committed capital (instead of €440 bn). Moreover, its competences and flexibility still remained very much limited.

The second initiative was the decision to start intensive work on comprehensive changes in the economic governance system in EMU with the aim to strengthen fiscal discipline, policy coordination and structural reforms in order to avoid similar crises in future. The European Commission was mandated to work out a blueprint for reforms [European Commission 2010]. In December 2010 the Commission prepared a package of six legislative proposals (based on the conclusions of the special task force established several months earlier and consisting of EU countries finance ministers) that aimed at strengthening the multilateral surveillance, speeding up preventive and corrective measures, making imposition of sanctions more automatic, and obliging member countries to make their national fiscal frameworks consistent with the EA fiscal rules (the 'six-pack'). However, some of the most radical provisions of the 'six-pack' met with strong political resistance in European Parliament and got stuck there for months[8].

The measures failed to reassure investors, and the crisis quickly spread to other countries. In November 2010, the Irish government, overwhelmed by enormous burden of guarantees extended to local banks to protect deposits, was forced to ask its Eurozone peers for a rescue package. Only between the end of 2007 and end-June 2011, the Irish public debt increased more than fourfold, from 24.9% to 104.6% of GDP, almost entirely because of the guarantees provided to local banks. The banks got into trouble because they invested depositors money into risky assets, including mortgage-based securities, which lost most of their value when the crisis hit in 2008. In April 2011 the debt crisis spread to Portugal where the government also found itself unable to refinance its debts on financial markets at acceptable cost. Moreover, in June 2011 it became clear that Greece was not on track with its austerity program and that a new assistance package was urgently needed to roll over the country's obligations falling due and to help avoiding immediate bankruptcy. The uncertainty

[8] A compromise agreement was eventually worked out by Polish Presidency in October 2011, paving the way for the legislative package on economic governance to enter into force in January 2012.

over possible default led to a panic on financial markets, and investors started a massive sell-off of debts of other indebted countries, especially of Italy and Spain. In July 2011 things seemed to spin out of control, the key reasons being the frustrating inability of EA countries to agree on a decisive and credible action to effectively protect other EA countries and their banking sectors from the impact of Greek crisis, and the lack of rapid progress in reforming the economic governance system in EA.

In mid-2011 the Greek public debt already exceeded 150% of GDP and the increase from 144.9% of GDP reported at the end of 2010 was the result both of the persistent budgetary deficit (the fall of budgetary revenues has been higher, and the cuts in spending smaller than planned) and of dwindling output, as the Greek economy was in recession its third year in a row. Most observers agree that this situation is plainly unsustainable[9]. Simple simulations suggest that in order to reduce the debt to 60% of GDP (the EU limit) Greece would need to post a systematic and massive primary surplus of 5.5% of GDP on average for 24 years[10]. It would be extremely difficult in a democratic country to enforce such prolonged sacrifices on the population. No developed country after World War 2 managed to sustain such a large primary surplus over such a long period (except Norway which is a special case). Also, from a political economy point of view there is a limit to economic belt-tightening determined by political constraints [Blanchard 1984].

In mid-2011 the EA member states still seemed not ready to face the reality. The official EA position was first to claim that Greek debt could be stabilized and eventually reduced to safe levels through a combination of external assistance in form of EA/IMF financial aid package and various austerity measures at home. But it soon became clear that even with international support of €110 bn Greece was unable to balance its budget and return to commercial creditors for financing any time soon. Fiscal targets were not met, the output was falling, the public debt was on the rise, and political resistance against planned austerity measures was getting stronger. Confronted with these problems – and only after long discussions – the EA member states were forced to recognize that Greek debt is unsustainable and that growing nervousness on the financial markets required bolder decisions. In July 2011 the Eurogroup adopted a new financial package for Greece amounting to €109 bn,

[9] Two leading professional newspapers (The Economist and the Financial Times) have long argued that Greece has become insolvent and that some debt restructuring is inevitable.

[10] Assuming 4% annual average GDP nominal growth rate and 5% annual average interest rate on debt, Greece would have to start with a primary surplus of 7.5% of GDP in 2012 (it had still a primary deficit of 4.9% in 2010), to be gradually reduced to 3% of GDP in 2035, and only then the debt-to-GDP ratio would fall below 60%.

softened the terms and conditions on European financial assistance and agreed on a selective and voluntary restructuring of Greek public debt held by private investors amounting to some 21% of the total nominal debt[11].

The decision to accept a partial default and admit private sector involvement (PSI) in Greek debt restructuring was both long overdue and clearly insufficient. The initial approach clearly failed to reassure investors [Darvas, Pisani-Ferry and Sapir 2011]. Uncertainty was growing over the final outcome of the Greek rescue operation and the EU was losing credibility insisting that Greece was solvent, while markets were more and more convinced that some form of default is inevitable. As a result, contagion was spreading to other indebted countries, leading to higher yields and bond sell-offs. Moreover, pouring in public money to Greece to repay current obligations was in fact equivalent to a transfer of debt from private investors to EA taxpayers, and this *de facto* 'bail-out' was raising a lot of political resistance in some countries like Germany or the Netherlands. Finally, the drastic austerity measures involving massive expenditure cuts and tax hikes, with the mountain of debt still hanging on, were certain to suffocate growth and postpone recovery.

Also, already within hours after the July decision by the EA member countries it became clear that it did not go far enough. The 21% debt reduction was not sufficient to convince the markets that Greek debt would now be sustainable. Even if debt is diminished to 130% of GDP and more favourable credit conditions are factored in, a further reduction to, for example, 60% of GDP would still require an annual primary surplus of 3–4% for the next 20 years – an extremely demanding task. Bowing to this inevitable reality, only three months later (on October 27, 2011) the EA countries decided to impose a 50% debt write-off on private investors, which implies a reduction of debt-to-GDP ratio to some 110–120%. In exchange, Greece committed itself to a new round of spending cuts and promised faster reforms [Euro Summit 2011][12]. The deal has been hailed as a 'comprehensive plan' aimed at solving the Greek crisis and restoring euro area stability[13].

[11] Statement by the Heads of State or Government of the Euro Area and EU institutions, Council of the European Union, Brussels, July 21, 2011.

[12] The view that the Greek debt is unsustainable and needs to be restructured is supported, *inter alia*, by Buiter and Rabhari [2010], Darvas, Pisani-Ferry and Sapir [2011] and Darvas [2011]. For general arguments against sovereign bankruptcy of a developed country, see Cotarelli *et al.* [2010].

[13] There are strong reasons to believe that the October EA decision on Greek debt reduction involving 50% haircut on privately held debt may still not be sufficient. It implies a reduction of the debt/GDP ratio from nearly 160% to 120%; but even at this level it will still

Unfortunately, as it turned out, the EA summit decisions were quickly dismissed by the markets as yet another half-hearted and unconvincing attempt of the ‘too little, too late’ variety. The Greek government added fuel to the fire by suddenly announcing that it wants the deal to be submitted to a national referendum. The decision, which was a shock for other EA governments and for financial markets alike, was eventually revoked few days later, but precipitated a deep government crisis which led to a resignation of Greek Prime Minister J. Papandreu. Panic returned to financial markets and contagion quickly spread out to other countries, with Italy becoming the next target on investors’ radar screens. At the beginning of November yields on Italian bonds rose to more than 7%, which was the level at which both Ireland and Portugal asked their EA peers for assistance. The market pressure forced the Prime Minister S. Berlusconi to resign amid fears that Italy’s solvency may this time be at stake. Within just two weeks there was practically nothing left from the ‘comprehensive plan’ which was adopted with such fanfare. Once again, EA reactions were overtaken by events.

6. The standard debt-dynamics framework and its extension

In order to examine the relationship between the increasing public debt levels and the risk of insolvency it is convenient to employ a standard debt-dynamics framework. Let D/Y = d be the debt-to-GDP ratio, B/Y = b is the primary budgetary deficit-to-GDP ratio, i is the interest rate, and y is the nominal GDP growth rate. The year-to-year dynamics of the debt-to-GDP ratio can be described by the following equation (where the index (–1) depicts values from the preceding period and assuming the stock-flow adjustment[14] equals zero)[15]:

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be next to impossible for Greece to stabilize and eventually reduce the debt ratio, because it would require a systematic annual primary surplus of *ca*. 5% of GDP over next twenty years.

14 The stock-flow adjustment captures the various factors that influence changes in the valuation of the stock of debt.

15 A year-to-year increase in total debt is $dD = D - D(-1) = B + i*D(-1)$. Dividing both sides by Y and denoting $Y = Y(-1)(1+y)$ yields:
$d - d(-1) = b + d(-1)*\{[(1+i)/(1+y)] - 1\}$
and after more manipulations: $d - d(-1) = b + d(-1)[(i-y)/(1+y)]$

$$d - d(-1) = b + d(-1)[(i-y)/1+y)] \quad (1)$$

So the increase in the debt-to-GDP ratio is the sum of the primary deficit-to-GDP ratio and the so-called ‘snow-ball effect’ representing the combined effect of the interest rate i and the GDP growth rate y on the debt ratio.

The stability of the debt-to-GDP ratio d implies d = d(–1), so the left hand side of (1) becomes zero. Then, the stability condition can be derived either as:

$$b = d(-1)\ [(y-i)/(1+y)] \quad (2)$$

or, in terms of absolute values, as:

$$B = D(-1)[y - i] \quad (2a)$$

Equation (2) shows that the stability condition requires the primary deficit *ratio* to be equal to the ‘snow-ball effect’, *i.e.* the debt ratio from the preceding period multiplied by the expression [(y–i)/(1+y)]. The sign of b depends on the sign of the differential (y–i). If the differential is positive, *i.e.* the growth rate is higher than the interest rate, then b is also positive, which means that a country can run a primary deficit without jeopardizing long term debt sustainability. But if the differential is negative, the country needs to post a primary surplus, and the surplus/GDP ratio is proportional to the debt/GDP ratio. In turn, equation (2a) shows the same stability condition expressed in terms of absolute values of the deficit level and the debt level.

While equations (2) and (2a) imply a theoretically linear relationship between the debt and the primary deficit, the behaviour of deficits and debts during the recent crisis suggests that the actual relationship is rather of non-linear form. This is because the parameters y and i are not anymore constant and tend to change with the level of debt. Specifically, it can be argued that for high debt levels y tends to fall and i tends to rise so that the differential (y–i) not only becomes negative, but being negative it also becomes larger in absolute terms. This requires the primary balance to be positive and growing in order to stabilize the debt-to-GDP ratio. So, the debt dynamics described by equation (2) has to be supplemented by the relationship between the debt-to-GDP ratio and the differential (y-i):

$$(y-i) = g\ [d(-1)], \qquad \text{for } d(-1) > 0, \text{ and where } g' < 0. \quad (3)$$

The relationship between the debt-to-GDP ratio d and the deficit-to-GDP ratio b are depicted on Figure 1, which shows the primary deficit-to-GDP ratio necessary to stabilize the debt ratio as a function of the debt ratio in the preceding period, for different initial values of the differential (y–i). In general, for low debt ratio values the differential (y–i) will be positive and the country can run primary deficit, as postulated by the debt dynamics equation (2). However, for higher debt ratio values the differential (y–i) becomes negative, and the country has to show primary surplus in order to stabilize the debt-to-GDP ratio. The surplus ratio will not only be higher for higher debt ratio values, but it will also be higher because the differential (y–i) is falling when the debt ratio is rising. The two lines drawn on Figure 1 illustrate the relationship between the debt ratio and the deficit ratio for hypothetical cases of two different countries, A and B, that have different paths of (y–i) changes. It can be seen that, assuming a given 'maximum politically feasible primary surplus' exists and is the same for the two countries [b(max)][16], the 'default level' of debt ratio d (A) for country A is lower than the 'default level' of debt ratio d (B) for country B, because the value of the differential (y–i) for any value of the debt ratio in country B is bigger than in country A[17].

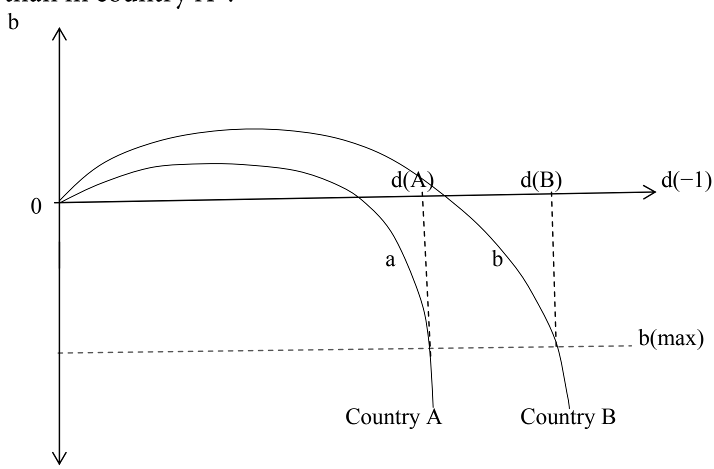


Figure 1. The primary deficit ratio as a function of the debt ratio: the non-linear case

[16] The concept of 'maximum politically feasible primary surplus', borrowed from Blanchard (1984), is explained below.

[17] The 'default value' of debt ratio is the value of the debt ratio at which the debtor country has stronger incentives to default rather that to continue to repay debts. In Figure 1, it is the point on the horizontal axis corresponding to the intersection of a given country schedule, for instance point d(A) for schedule a = d(–1) [(y–i)/(1+y)], and Blanchard's 'maximum politically feasible primary surplus' (b(max)).

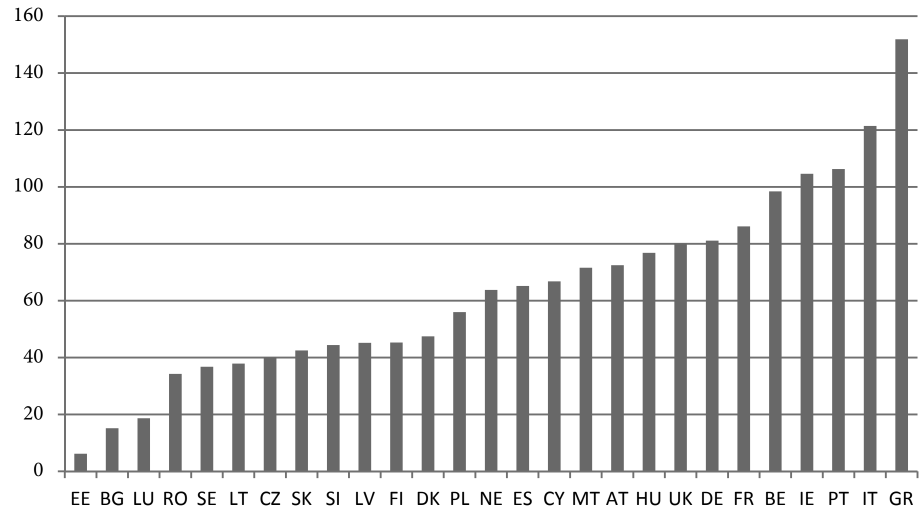
Why at high debt levels the growth rate y is falling? Because the higher the debt level, the higher the total cost of debt service in relation to GDP, which requires higher tax revenues and thus more resources diverted away from productive investment. This implies slower growth. And why at high debt levels the interest rate i is rising? For higher debt levels, yields on government bonds go up because the risk premiums in interest rates increase as the risk of sovereign default is higher, and because higher debt levels imply increased supply of bonds on the market. High debt levels are therefore associated with lower GDP growth rates and with higher interest rates.

The negative impact of high debt levels on growth has been tested empirically by several authors. Reinhardt and Rogoff [2010] estimate for a cross-section of countries that the threshold above which a high debt level significantly reduces GDP growth rate is around 90% of GDP. This is consistent with another study by Cecchetti *et al.* [2011] who find that this threshold level is between 80 and 100% of GDP. Of course, the specific threshold debt level beyond which the debt suffocates growth or becomes plainly unsustainable depends on specific circumstances of an individual country. The relevant factors that determine the individual threshold level include, *inter alia*, the share of domestically-held debt in total debt (*i.e.* the home bias among investors), the average debt maturity, demographic prospects of the country, and the value of public assets held in the hands of government. The threshold level also depends on the phase of the business cycle and on the market sentiment in general [see, *e.g.*, Irons and Bevins 2010; Eichengreen *et al.* 2011].

All these qualifications notwithstanding, the empirical results by Reinhardt and Rogoff, and Cecchetti *et al.* provide a useful 'rule of thumb' on the threshold level of public debt ratio. As can be seen from graph 5, public indebtedness in at least five EU member countries (Greece, Italy, Portugal, Ireland and Belgium) is currently close to, or well above, that level which can be expected to inhibit growth. Under these circumstances any attempt to rely on economic growth engine to 'grow out' of debt may be an increasingly challenging task.

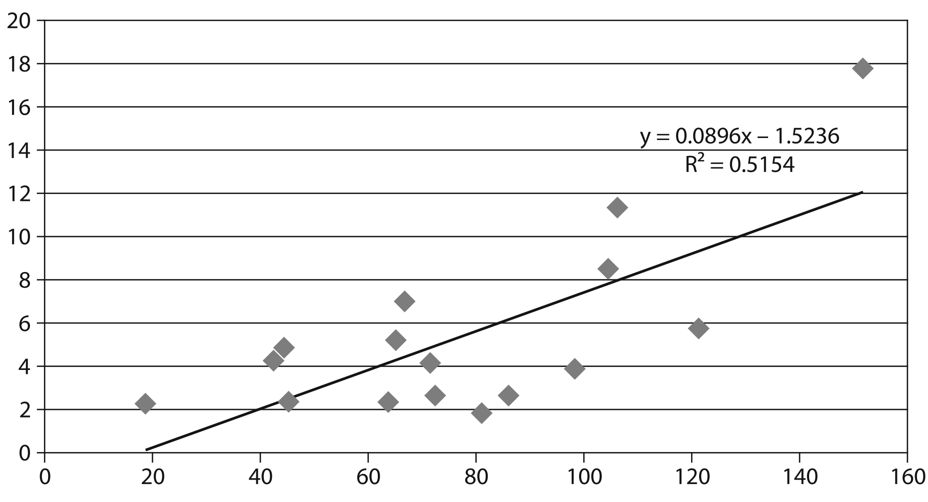
Negative impact of high debt levels on market interest rates in the EA has become apparent since the beginning of 2008 when financial investors recognized there is no pooled risk for the whole EA and started to differentiate risk premiums on sovereign debts depending on the actual debt levels in individual EA member countries. As can be seen on graph 4 (above), when the markets realized that the risk of default is much higher for high debt countries and that the assumption on the implicit guarantees among EA member countries does not hold, they immediately reacted with sharp rises in bond yields. For instance, the spreads on sovereign debt of Greece over

German bunds increased from 24–26 bps in the first quarter of 2007 to almost 1600 bps in September 2011.



Graph 5. Public debt levels in EU member countries, end-June 2011, % of GDP

Source: Eurostat.



Graph 6. Public debt levels (% of GDP) and government bond yields (%) in EA16, 2011

Note: Government bond yields are harmonized long-term interest rates for convergence assessment purposes, average values for September 2011 (percentages per annum, secondary market yields of government bonds with maturities of close to ten years)

Source: Based on Eurostat and ECB data.

The relationship between the debt levels and the interest rates is illustrated on graph 6, which plots panel data on public debt level measured in % of GDP and data on ten-years government bond yields for 16 individual EA countries[18]. The analysis is restricted to the euro area countries only to reduce the influence on bond yields of factors other than debt levels. It can be seen that there is statistically significant positive correlation between the two series which shows that an increase of debt-to-GDP ratio by one percent is associated – on average – with an increase in the yields level by nine basis points[19].

Large negative differential (y–i) in equation (2) requires the country to post large primary surplus ratio b every year in order to stabilize the debt/GDP ratio. However, above a certain threshold level the primary surplus ratio required simply becomes unsustainable and the debt/GDP ratio cannot be stabilized. While short-term fiscal adjustments involving temporary large primary surpluses are in principle possible, maintaining large surpluses in longer term is more problematic because of political constraints. At some point, when the primary budgetary surplus necessary to honour the debt obligations exceeds 'maximum politically feasible primary surplus' the debtor country has strong incentives to default rather than to continue to pay its debts [Blanchard 1984]. It can be shown that there is an upper limit to b, determined by political economy considerations. Above that limit the debtor country is likely to default (Greece may be the case in point)[20].

The non-linearity of the debt dynamics (as illustrated in Figure 1) and the correlation between the debt ratio and the value of the differential (y–i) seem to get some empirical support from EA countries data. Graph 7 shows the relationship between the value of (y–i) and the value of the debt ratio for 16 EA countries. The sample is restricted to countries sharing common currency to minimize the impact of other factors, such as different monetary policies. It can be seen that the relationship is statistically significant (R(square) = 0,53) which lends support to the hypothesis that higher debt ratio values tend to be associated with lower and negative values of (y–i). On average, the increase of debt-to-GDP ratio by 1 percent of GDP reduces the value of (y–i) differential by some 13 basis points.

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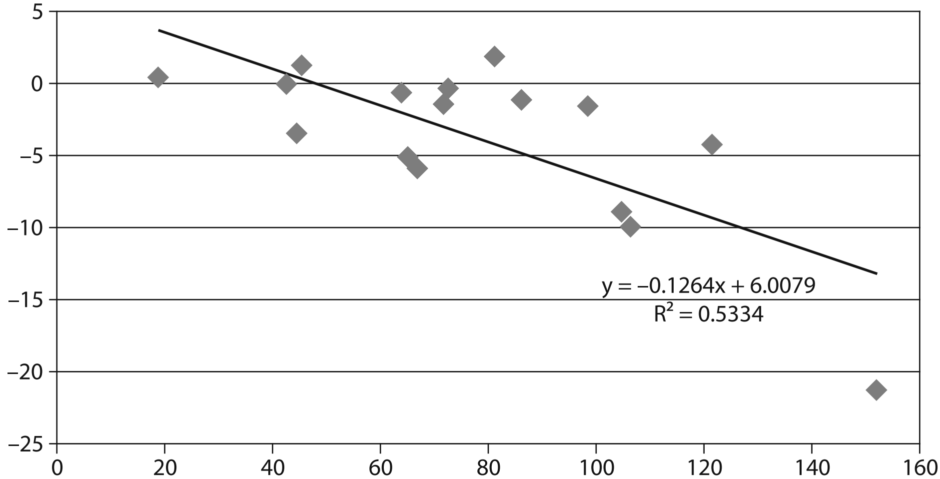
[18] Except Estonia which has very little public debt and no systematic data exist on Estonian 10Y bond yields.

[19] It should be noted that graph 6 shows the panel data, and not a time series relationship, *i.e.* it does not show the relationship between the debt level and the interest rate for an individual country over time.

[20] Then the 'can't pay' problem becomes a 'won't pay' problem.



Graph 7. Public debt ratios and (y–i) differentials for EA countries

Note: The values for (y–i) have been calculated as the difference between the percentage changes in individual countries GDP in 2010 and the ten-years government bond yields on secondary markets (averages for September 2011, ECB data). The public debt ratios for individual countries are end-June 2011 data taken from Eurostat.

Source: Own calculations, Eurostat, ECB data.

Apart from not accounting for non-linearity, the standard debt dynamics ignores two important relationships between the sovereign risk and macroeconomic instability. The first relationship is the spill-over from increased risk of sovereign default, reflected in rising bond spreads and CDSs, to the rest of the economy. The spill-over adversely affects borrowing conditions in the private sector driving up interest rates for credits, because strained public finances imply a greater threat of increased taxes in future, and higher taxes reduce the profitability of the private sector. In result, as public debt increases, investors tend to ask higher risk premiums not only on public debt, but – via the sovereign risk channel – also on private debt as well, and the resulting higher credit cost slows down economic activity. The second relationship is the spill-over into the banking sector itself. Higher public debt levels translate into lower credit and investment ratings for the indebted country. But since no financial institution can have a higher rating than its sovereign, a downgrade of a sovereign entails a downgrade of its banks, which raises the cost of capital and reduces credit emission. The resulting credit crunch will limit access to funds for the private sector. Both mechanisms working through the sovereign risk channel – higher credit costs and the credit crunch – will reduce aggregate demand and slow down economic growth.

7. Policies to achieve public finance sustainability

The sovereign debt crisis in the context of weakening economic activity and the threat of recession looming large in the euro area raise a number of questions on policies needed to regain control over public finances in individual EA member countries. These questions refer to two broad issues. The first issue is concerned with policies that aim at restoring fiscal sustainability in the medium- and long-term horizon. Some key questions are addressed below. The second issue is concerned with immediate measures that need to be taken in order to address the current crisis and to stabilize the situation on financial markets, and in particular on the European debt markets. This important issue is discussed in the next section.

When designing a correct strategy for achieving debt reduction and sustainability, one of the key decisions that must be made is whether the necessary measure should focus on cutting public spending or on increasing taxes, or both. Alesina and Perotti [1996] examine the episodes of fiscal consolidation for a cross-section of countries and conclude that spending cuts, rather than tax increases, are more likely to bring about a lasting budgetary improvement. The theoretical explanation they offer is that tax increases alleviate the budget constraint and thus allow for more spending in future when cyclical conditions become more favourable. The improvement therefore tends to be only temporary. Moreover, in countries with already high levels of taxation in place (which is exactly the case of most EU countries) further tax increases are likely to adversely affect economic growth. The hypothesis on the superiority of spending cuts over tax increases seems to be confirmed for EA countries, where lasting improvements of primary budgets have been achieved mostly *via* spending cuts, as demonstrated by data in Table 1. Also for other OECD countries improvementswere achieved mostly in countries that reduced spending, either combined with tax increases or not [Eichengreen *et al.* 2011].

Table 1. Spending cuts or tax increases? Budgetary improvements in EA and OECD countries between 1999 and 2006 (%)

Among all countries where primary budget balance improved	EA countries	OECD countries (excluding EA)
Spending cuts	67	46
Tax increases	33	31
Both	0	23

Source: Eichengreen *et al.* 2011: 59.

These observations suggest that in EA countries the strategy of public finance consolidation should be mostly based on spending cuts, not only because of the theoretical argument advanced by Alesina and Perotti, but also because taxation levels in those countries are already quite elevated. Perotti *et al.* [1998] support this conclusion with an argument based on the asymmetry between the growth of expenditures and the growth of revenues. They provide evidence that the deficit bias and the tendency for public debts to increase mostly result not from sudden falls of budgetary revenues, due to lower tax rates or shrinking tax base, but are rather produced by ever growing spending, fuelled by the common pool problem and electoral cycles. In such circumstances, finding temporary, *ad-hoc* revenues to finance additional spending is a short-term solution which does not eliminate the underlying structural problem. A preferred, first-best solution would be to reduce spending through permanent elimination of various politically motivated spending programs.

Another argument for concentrating on spending cuts rather than on tax increases for achieving successful budgetary consolidation in the European context is that the marginal social benefit of public expenditures declines with their level relative to GDP, and that at high levels of spending (in proportion to GDP) these benefits may not compensate for the efficiency losses caused by high taxation. Afonso *et al.* [2003] find strong empirical support for this argument. They suggest that the observed fall of the share of public sector in GDP in countries with largest public sectors, such as Sweden, Denmark or Belgium[21], after 1990, is precisely a result of the recognition of the fact that spending levels had grown well beyond of what is economically justified.

The second important question is how should the fiscal policy react to the current crisis in order to stop the vicious circle of falling output and growing deficits and debt, and to restore long-term sustainability of public finances. There are two alternative policy prescriptions that have been debated during the crisis. According to the first policy concept, a massive fiscal stimulus is needed to substitute for shrinking demand of the private sector. The ensuing increase of budgetary deficit is both necessary and temporary. It is necessary because it allows to avoid – or dampen – possible recession,

[21] Eichengreen *et al.* [2011] provide some interesting evidence that parallel to the declining share of public sector in GDP in countries with large public sectors there is also a tendency for countries with small public sectors to increase their shares in GDP, and that the common convergence level is about 45%. But this result can be questioned because the sample of countries consists of two distinctively different categories of countries: European countries with traditionally large state sectors and non-European OECD states with traditionally low state sectors. The convergence may rather take place in each of the two groups separately, and to two different convergence levels.

and it is temporary, because the economic recovery initiated by the stimulus will result in higher tax revenues which will quickly allow to reduce deficit and debt in future. According to the second policy concept, a consolidation of public finance is needed in order to restore confidence in the markets, and the increased confidence will induce private agents to increase their consumption. As a result, the economy will recover.

The stimulus-versus-consolidation controversy is deeply rooted in the eighty years-old debate between Keynesian and neoclassical economists on whether and to what extent the stabilization policy works. The debate has not been solved once and for all, and in different periods one or the other side seemed to prevail. The debate has been revived again in the context of the current crisis, when arguments in favour of fiscal stimulation have clashed with arguments in favour of 'expansionary fiscal contraction'.

The theory of fiscal stimulation derives from the concept of Keynesian multiplier. Assuming there is a negative output gap and looking first at real flows, the fiscal stimulus financed by deficit may be spent on productive investment or on consumption (including non-productive investment). The total increase of output will be equal to the initial stimulus times the multiplier, where the multiplier is typically represented as the inverse of the sum of three elements: propensity to save, propensity to import and marginal tax rate, which determine the magnitude of the 'leakages' on savings, on imports and on taxes. In this set-up, financial flows are neutral from the point of view of the impact on real activity, because the debt liabilities acquired by the government in financing the deficit are exactly equal to the new assets (bonds) acquired by private sector lenders [Corden 2009].

The standard neoclassical arguments against this scenario which are often raised in the context of a crisis are: (a) the propensity to save may be close to one because of uncertainty, and thus the total output effect will only be slightly higher or equal to the initial stimulus, (b) public investment tends to crowd out private investment so that the net demand effect is negligible or even negative, and (c) higher deficit and higher debt translate into higher interest rates and expectations of future tax increases. As to the first argument, even if the propensity to save may be high in crisis times, it is seldom close to one, so there is always a positive multiplier effect, although its magnitude may differ. As to the second argument, the crowding-out depends on the stance of monetary policy – under monetary accommodation there will be no crowding-out, and during deep crises the monetary policy tends to be accommodative, rather than neutral or restrictive.

The third argument carries more weight. Traditionally, it has been developed along the lines of the familiar non-Keynesian effects of deficit spending, including the concept of 'expansionary fiscal contraction'. Higher deficits translate into higher debts, and higher debt levels raise the expectations of possible tax increases in future when debts will have to be repaid[22]. A credible, permanent program of government spending or tax reductions will therefore stimulate a large increase in private demand, working through the expectations of permanently lower tax liabilities. Private spending may increase sufficiently to offset the direct effects of the fiscal contraction, so that in fact, the net effect of deficit reduction can be positive rather than negative[23].

In its essence, this view represents a variety of the famous Ricardian equivalence (RE) which postulates that deficit financing *via* more debt is equivalent to higher taxes in future, so any fiscal stimulus undertaken now will not induce more spending by the private sector, because extra incomes will be saved to accumulate money for paying future tax liabilities. The fundamental problem with the Ricardian equivalence is that despite its elegant intellectual appeal it is generally not supported by empirical observations. The key reason for this result is that its underlying assumptions do not hold: market participants are not perfectly rational, there is no perfect information on the implications of the current debt, and people are in practice more short-sighted than the theory assumes.

But the argument on the impact of higher debt on interest rates gets recently more support. Recent experience of EA countries show how markets' concerns about government solvency can quickly translate into higher borrowing costs for both the public and the private sector which in turn may lead to a full scale fiscal and economic crisis [Corsetti and Mueller 2011]. The channel through which the risk of sovereign default spreads into the private sector is the sovereign risk channel which has been discussed earlier.

On balance, it is difficult to establish a universal rule. On the one hand, the recent developments in some EA countries suggest that strict austerity measures have indeed strong contractionary effects, as demonstrated by the experience of Greece

[22] This mechanism is sometimes called the 'German' view of the impact of fiscal spending reductions, as it was originally propounded by the German treasury in the early 1980s [*e.g.* Fels and Froehlich 1986; Barry and Devereux 2003].

[23] In an empirical study, Giavazzi and Pagano [1990] find that in two cases the fiscal contractions (Denmark and Ireland) led to a strong positive reaction of aggregate consumption and thus was indeed expansionary. For a dissenting view in the context of current crisis, see Parentau [2011].

and Portugal, where GDP levels are expected to shrink in 2011 by 5.5% and 1.9%, respectively, and the output falls are clearly linked to budgetary cuts undertaken within stabilization programs under EA-IMF auspices. On the other hand, achieving fiscal sustainability is probably impossible without austerity measures. A possible solution of this dilemma would be to combine external assistance with moderate cuts concentrated in current spending (excluding investment, education and other pro-growth expenditures) and front-loaded structural reforms that would send a clear signal that the fundamental causes of fiscal imbalances are permanently eliminated.

8. How to address the Greek crisis?

A credible and effective solution of the Greek crisis would require a more radical and more comprehensive approach. Financial markets are typically characterized by the existence of multiple equilibria. A sudden loss of market confidence moves the demand curve downwards to a new point of equilibrium, with lower prices and higher bond yields. This is exactly what happened in the euro area in June and July 2011, when Italian and Spanish bond prices collapsed, even though there was no any deterioration in the fundamentals of the two economies[24]. Under such conditions, the key issue is to restore confidence in the markets. The necessary action should consist of three main components.

First, a clear line needs to be drawn to separate the solvent EA member countries from the insolvent ones. With Greece clearly on the insolvent side (and Portugal still being a border-line case) and assuming all the remaining countries fundamentally solvent, a debt restructuring agreement for Greece should be quickly reached that would reduce total private sector debt by at least 50%. This could be done through a voluntary bond exchange with a nominal discount of 50% on notional Greek debt held by private investors (as the 27 October Euro Summit decision predicts). Second, financial support should immediately be provided to Greek banks (and other EA banks with large Greek bonds exposures that may not be able to absorb losses with their own capital), to avoid a possible collapse of the Greek banking system after the debt restructuring is announced [Darvas 2011]. And third, a strong and

[24] Just the opposite: both countries were already in the process of undertaking important structural reforms (especially Spain).

credible commitment by the EU to provide sufficient financial assistance to other high risk countries such as Portugal, Ireland, Italy and Spain, in order to ring-fence those countries and to protect them against Greek contagion. This can be done either through involving EFSF funds, or through involving ECB. The first option would require EFSF to have sufficient funds at its disposal to credibly commit itself to supporting debts of the remaining countries. That would, in turn, require the EFSF to be massively recapitalized – probably up to at least €1.0–1.5 trillion [Buiter and Rabhari 2010] – with funds coming from EA member countries and/or from other potential creditors (China, Japan, oil-exporting countries). This option may be difficult given the precarious state of public finances in most EA countries and taking into account strong political reluctance of many countries to commit more national taxpayers money for bailing out profligate governments. Also the early signals from other potential – non-European – creditors suggest that there is so far little interest in investing in EFSF. Moreover, EFSF is basically a political mechanism that requires consensus-based decision making, which makes it prone to lengthy and cumbersome procedures[25]. Clearly, this is not an efficient instrument to fend off crises.

The alternative option is through ECB involvement. The ECB is the only institution in the world that can commit itself in a fully credible way to buy unlimited amounts of debt of any EA member country. The credibility of such commitment comes from the fact that only ECB can provide unlimited amounts of euro. If the ECB declared publicly that it would be ready and willing to buy unlimited amounts of debt of all solvent EA countries – of course except of Greece – it would immediately reduce uncertainty and restore confidence in the markets. As a result, private investors would stop selling off Italian, Spanish or Portuguese bonds at discount prices, and that would bring down yields on those bonds and help moving markets back to the previous equilibrium.

The ECB can be involved in stabilizing the markets in several different ways, of which two may be of special interest. Under one scheme, the ECB directly purchases bonds at the secondary market. The other scheme uses the EFSF which gets a banking license and acts as a quasi-bank having access to ECB refinancing and buying bonds on the secondary market. Of course, ECB commitment should be based on strict conditionality. EA countries would only be covered by ECB guarantees it they were fundamentally solvent and if they credibly committed themselves to implement necessary reforms according to a strict and predetermined timetable. The IMF could

[25] Especially when the decision of the German Constitutional Court that defines a much enhanced role of German Bundestag in the decision process is taken into account.

serve as an executive agency for the ECB to monitor and assess the implementation of these programs. The ECB support would thus allow the solvent but temporarily illiquid countries to restore market credibility through structural reforms.

The idea of having the ECB to purchase government bonds of indebted countries raises two major concerns – first, that it would effectively amount to monetization of debt and thus it would sharply increase the danger of inflation, and second, that this would lead the ECB to overstepping its mandate, which obliges it to pursue the goal of price stability in the EA. With respect to inflationary impact of debt purchases it should be noted that these purchases would likely to be limited precisely because when a credible commitment is made by the ECB, investors would not be willing to sell off bonds with generally high coupons. More importantly, to the extent that bond purchases by the ECB would lead to an increase in monetary base, they would not translate into an increase in total money supply under current conditions of credit-crunch. With respect to the objection concerning the ECB mandate, it can be argued that bond purchases on the secondary markets are not inconsistent with the goal of price stability, because under conditions of a generalized credit-crunch there is real risk of deflation rather than inflation that needs to be addressed by monetary policy ease. To the extent the ECB action prevents deflation, it thereby contributes to price stability.

More generally, if strengthening financial stability in the euro area is seen as a way to avoid a major financial crisis, bond purchases by the ECB can be justified. It can also be argued that a central bank mandate that is restricted to a price stability only may be too narrowly defined for a central bank in a currency union. Specifically, the function of the lender of last resort for governments – which is a standard responsibility of central banks in most countries – is not within the current mandate under the Treaty. This appears to be a major shortcoming of the current set-up, because this is precisely the function of the lender of last resort which underpins the ability of the central bank to stabilize the financial system of a country in times of financial crises and bank runs.

9. Conclusion

The paper examines the evolution of public debts and deficits in EU member countries and suggests necessary policy solutions. It is shown that many EU countries followed expansionary fiscal policies for too long, building up unsustainable levels of public debt which eventually put some of them on the verge of sovereign bankruptcy. The reasons for this systematic and clearly irresponsible fiscal profligacy include the failure of the EU system of economic governance to ensure necessary fiscal discipline under conditions of strong systemic deficit bias, caused by the common pool problem and electoral cycles. The crisis of 2008–2009 contributed to further deterioration of public finances. In result, the public debt levels in EA countries have increased substantially and are now in most cases close to, or above, the 'threshold' level, with strong negative impact on growth *via* higher taxes, spending cuts, rising interest rates and credit crunch.

A simple debt-dynamics framework is used to explain the relationship between the public debt ratio levels on the one hand, and GDP growth rates and interest rates on the other hand. It is argued that the relationship is non-linear because higher debt ratios cause economic growth rates to fall and government bond yields to rise. This mechanism makes the debt stabilization task very demanding. Stabilization of high debt ratio levels requires large primary surpluses over long periods of time, which may be politically unfeasible. In addition, the growing risk of sovereign default affects negatively the borrowing conditions of the private sector *via* the sovereign risk channel, which is likely to further slowdown economic activity, making the task of debt stabilization even more difficult.

Policies to achieve public finance stability in EA member countries need to focus on spending cuts rather than on tax increases, because such spending-based stabilization generally has more lasting effects and is more growth-friendly. An important policy dilemma refers to the choice between fiscal stimulation under conditions of high debt levels and 'expansionary fiscal contraction'. One possible solution of this dilemma would be to combine necessary external assistance with moderate cuts concentrated in current spending (possibly excluding investment, education and other pro-growth expenditures) and front-loaded structural reforms that would send a clear signal to financial markets that the fundamental causes of fiscal imbalances are permanently eliminated.

Finally, it is argued that the inability of EA member countries to cope effectively with the Greek crisis reflects important flaws in the system of economic governance and decision-making in the EU. A three pillar strategy to address the crisis is proposed, with conditional ECB involvement in public debt market stabilization – based on the necessary extension of its mandate to include the function of the 'lender of last resort' – being of crucial importance.

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Ewa Latoszek*

Trajectories of Consolidation of Public Finances in Poland during the Crisis

1. The need for changes in Polish public finances sector on the road to Eurozone

Poland, as a European Union Member State, participates in the third stage of the Economic and Monetary Union, although it enjoys a temporal derogation. Such a status means that Poland should pursue the criteria of convergence, which will allow it to join the Eurozone. These encompass fiscal criteria *i.e.* the deficit and public debt

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criteria. According to the Treaty, a state introducing the common European currency may not exercise the excessive deficit procedure[1]. Poland introduced the excessive deficit procedure again on July 7, 2009, what means that until 2013 it has to restrict an excessive deficit.

Public sector deficit is not at all an extraordinary phenomenon. Nevertheless, fiscal situation in Poland requires bold actions aiming to limit the deficit and to reduce the amount of debt. In most cases, the budget development procedure first involves defining the spending and then the income available to fund the former. Usually, the government income is insufficient. The emerging gap between public spending and public income requires additional sources of income to cover it. These include as follows:

- Increase of income tax – involves defining new tax sources, extending the taxation base or increasing the nominal rate of taxation.
- Incomes from privatization.
- Profits (mint rent) and incomes (credits and loans) of the Central Bank[2] – in practice financing of the government by the Central Bank means exchanging the mint rent for fiscal rent.
- Loans and credits on the financial market.

As far as financing the loan demand of the public sector is concerned, we may define two general approaches:

1. Discretional approach – employed very often, its goal is to achieve the level of deficit and public debt which it is possible to finance on the financial markets at a price acceptable by the government. Such an arbitral approach usually makes the liabilities' level and the budgetary balance volatile.
2. Approach based on fiscal rules – the fiscal policy is run according to fiscal rules concerning the level of public deficit and public debt. Excessive deficit procedure or Polish public debt limit are examples of this approach. According to Polish Constitution, Article 216(5), 'It shall be neither permissible to contract loans nor provide guarantees and financial sureties which would engender a national public debt exceeding three-fifths of the value of the annual gross domestic product'.

The need to control and to limit the state's ability to satisfy its loan demand on the financial market is based on the following grounds:

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[1] However, the EDP cancellation decision can be made by ECOFIN Council together with the derogation cancellation decision.

[2] Subject to the Polish law, financing the public sector by National Bank of Poland is forbidden.

- The external sources of deficit financing are easier to acquire and more appealing than increasing the incomes of reducing the state's loan demand. Thus they can lead to unreasonable fiscal policy.
- The increase of the debt increases its costs and creates a threat of debt spiral.
- Raising demand for loan of the general government sector positively influences the interest rates, what in turn negatively influences the situation of borrowers.
- Excessive level of debt may cause problems in case of financing an extraordinary demand for increase of public spending (like natural disasters or long-lasting recession) and hampers desirable changes in the structure of public spending [see Marczakowska-Proczka 2006: 54].

It's worth noting that unreasonable fiscal policy leading to sovereign debt crisis may cause a financial crisis – by negatively influencing the macro-economic stability. In Brazil or Russia a currency crisis was initiated by fears of investors regarding possible monetarization of public debt, which would cause a dramatic increase of inflation [Marczakowska-Proczka 2006: 33].

In Poland the necessity of sustained limitation of budgetary deficit and public debt was never negated. Even more, to meet the basic goals of the Lisbon strategy, the Ministry of Economy and Labour, in National Reform Program 2005–2008, assumed to conclude several reforms reducing general government's spending and increasing its effectiveness. However, the actions presented in the document were not concluded in a systemic manner. The risk of partial reform involves regulating a certain dimension of the state's activity in a dysfunctional way. That's why it is so important to correlate all elements of the solutions introduced. It's hard to escape an impression that in case of general government sector consolidation all Polish governments lack determination to go on with crucial changes which could have a positive long-term influence upon the state's loan demand reduction [Alińska, Pietrzak (eds.) 2011: 87–93]. Poland did not use the incentive to reform its public finances – the economic crisis – to its advantage. The state trusted its picture as a 'green island' on the map of Europe. *Ad hoc* actions, like obliging resorts' chiefs to generate 10% savings in 2009 or temporary rise of VAT in January 2011[3], were only aimed at postponing the crossing of the second safety 55% GNP threshold. They did not aim to solve the real problems of public finances. In the meantime the Ministry of Finance heralds balancing the budget as soon as by 2015 [see Fandrejewska 2011]. However, before this timeline, Poland has to close the excessive deficit procedure.

[3] New tax rates, that is 23%, 8% and 5% are to be in force until December 31, 2013.

Driving the deficit under 3% GNP already in 2012 and closing the excessive deficit procedure in Poland the next year is by all means an ambitious, but not a realistic assumption. Although the Ministry of Finance sends reassuring signals, few experts share its optimism as regards the next year's budget. This concerns in particular the economic growth in 2012, assumed at around 4%. According to July projection of inflation prepared by the Economic Institute of NBP (National Bank of Poland) the GNP will drop down to 3.2% [see Sławiński 2011].

German data are not optimistic, either. In the second quarter of 2011 German economy's GNP increased by just 0.1% compared to the first quarter of the same year. In France in the second quarter of 2011 there was no growth at all. Such disappointing results recorded by the biggest economies of the Eurozone are reflected in a slowdown of the whole European currency area[4]. The European Central Bank during its last session lowered the economic growth prognosis to 1.6% in 2011 and to 1.3% in 2012[5]. Anyway, Minister Michał Boni sees no need to revise the assumption data concerning next year budget [see Boni 2011].

2. Novelization of Public Finances Law

As far as long-term recovery of general government sector finances is concerned, the novelization of public finances statute, in December 2011, is the most important instrument [DzU 2010]. According to the Ministry of Finance's estimations, the solutions that will be introduced from January 2012 will generate around PLN 19 bn of savings. The most important changes introduced in the December novelization regard the following issues:

– **Limiting the debt burden of local government institutions**

Public finance statute, August 27, 2009, imposed a 60% limitation of the debt burden on the local government bodies and obliged them to limit their budget deficit. According to the Article 242 of the statute, 'at the end of the budgetary year the current spending may not exceed the current incomes combined with the previous

4 Economic growth in the Eurozone in the second quarter reached only 0.2% [see Chądzyński 2011a].

5 The June prognosis assumed the GNP increase of 1.7 and 1.9% in 2011 and 2012, respectively [see Prusek 2011].

years' budgetary surplus'. From 2014, the Article 243 of the statute introduces an index based on operational surplus generated by local government, encompassing previous three years (that is 2012, 2013 and 2014). The limit imposed on local government sector reflects the dynamics of its indebtedness.

The budgetary balance of local government bodies deteriorated during the last three years because of two major reasons. The major source of financing of local government is the income tax. The introduction of family tax allowances caused its decrease of around PLN 10 bn per year. This was coupled with negative consequences of the financial crisis[6]. The local government bodies did not find enough savings on the side of their spending. Moreover, the opportunity to exploit the EU funding is limited by the requirement of co-financing from own sources. Thus the situation of the local governments was deteriorating as they were increasingly using the EU funding [see Bień 2011].

Apart from instruments imposing higher discipline on local government bodies, to drive the public finances' deficit below 3% GNP the Ministry of Finance plans to generate additional savings, around PLN 6 bn (0.4% GNP). Representatives of local governments formed the following proposals:

- Constant monitoring of long-term financial prognoses;
- Developing a mechanism for deficit control already during the budgetary year;
- Introducing commissary management in local government bodies generating excessive deficit [see Bień 2011].

It's worth observing that apart from the new disciplinary measures, on December 23, 2010, the Ministry of Finance introduced a regulation concerning a detailed classification of public debt components. It encompasses liabilities from all kinds of contracts involving over one year delay of payment, thus also factoring and forfeiting contracts which were often used by local governments as an alternative form of investment financing. The local governments used them especially because the so called long term commercial credit was not taken into account in 60% debt limit [see Chądzyński 2011].

– The Disciplinary Spending Rule

According to the public finance statute, novelized in December 2010, an increase in flexible spending and new fixed (legally determined) spending in real terms cannot be higher than one percentage point compared to the previous year. The

6 High percentage of PIT and CIT taxes in local government incomes implies a high sensitivity to economic cycles [see Bartman 2011].

goal of this procedure is to limit the excessive growth of the state's budget at times of positive economic cycle so that it becomes possible to use the economic growth to reduce the deficit. It should be noticed that this solution refers to only around 26% of public sector spending. The rule will not be in force in case of martial state, state of emergency or natural disaster influencing the whole territory of Poland. Estimated savings in 2011 will amount to PLN 2.8 bn and in 2012 to PLN 8.5 bn [*Reguła*... 2011].

The disciplinary spending rule is to be in force in Poland under excessive deficit procedure. After concluding the excessive deficit procedure it will be replaced with a stabilizing spending procedure. According to a justification of public finances novelization bill, September 12, 2010, it should be anti-cyclic in nature. In real terms it will be based on economic growth, in nominal terms on the inflation goal or on the inflation prognosis [Alińska, Pietrzak (eds.) 2011: 110].

– System of Liquidity Management

To limit the annual net loan demand, the Ministry of Finance used a solution well known in other Member States of the European Union, namely the system of public sector liquidity management[7]. The December novelization obliges to pass the unused economic means, under management of the Ministry of Finance, to the state fixed funds (excluding ZUS and KRUS), executive agencies, NFZ and other organizational institutions created under separate statutes. Local government bodies, public academies, ZUS, KRUS and Independent Public Health Institutions may voluntarily place unused economic means under the Ministry of Finance's management, as a forward deposit. Responsibility for optimization of financial circulation in general government sector was passed upon the Bank Gospodarstwa Krajowego. As the regulations under discussion refer only to a part of public finances' sector institutions, large part of financial means' circulation is still dispersed, what makes their precise management a difficult task. More comprehensive exploitation of the potential of this solution would allow to reduce the transactional costs of bank handling and to limit the need for current liquidity [Alińska, Pietrzak (eds.) 2011: 55–58].

[7] For example, similar systems operate in Finland, France, Ireland and Great Britain.

3. Changes in the Pension Scheme

Other actions undertaken to heal public finances in Poland concern changes in the pension scheme.

The pension scheme reform was introduced on January 1, 1999. It involved:

1. Organization and Functioning of Pension Funds Statute, August 28, 1997 [DzU 1997].
2. Social Insurance System Statute, October 13, 1998 [DzU 1998a].
3. Social Insurance Fund Pensions and Benefits Statute, December 17, 1998 [DzU 1998b].

The essence of the 1999 reform was to move from a repartition system with defined benefit to a capital system based on the rule of equivalency [see Szumlicz (ed.) 2010: 185–208].

On April 7, 2011 the President signed a statute introducing changes in the pension scheme. Since May, same year, the Open Pension Funds are supplied with only 2.3% of our wages, instead of 7.3%, as previously. 5% is recorded on a special ZUS subaccount and together with hitherto benefits of 12.2% dedicated to pensions paid currently. The means stored on the subaccount in ZUS will be inherited in analogous way to the ones in OFE. They will be revaluated depending on the economic growth rate and the inflation rate over previous five years. According to the Ministry of Finance estimates, the introduced changes will help to limit state's loan demand by around PLN 190 bn before 2020 [see *Prezydent*... 2011]. Furthermore, the statute forbids canvassing in favour of OFE[8] and introduces a higher limit of stocks allowance in the portfolio – rising it from 40 to 62%, with 90% as a future threshold. The government also plans to introduce a 4 percentage tax relief for persons allocating savings on the so called individual pension provision accounts (IKZE).

The principal goal of the changes introduced is to limit the dynamics of public debt which dangerously approaches the 55% GNP safety threshold. The capital part of pensions' scheme generates a so called systemic deficit. According to assumptions of creators of the 1999 pension scheme reform, an introduction of a new system was to be financed by incomes from selling the public assets [see Góra 2011]. Over 11 years the refund of OFE subscriptions generated PLN 155.8 bn of deficit, while privatization

[8] Polish Labour Union 'Contact' questioned the validity of the prohibition of canvassing in the Constitutional Tribunal on July 4, 2011.

in the same period generated PLN 101.9 bn. This means that one third of the systemic deficit (equalling to PLN 53.9 bn) was not covered by the state's budget incomes, thus enlarging the state's deficit [Alińska, Pietrzak (eds.) 2011: 159].

The proposed changes in the pension scheme started a public debate on a scale unseen ever before. This fact bears witness of popular care about both: the situation of public finances and the situation of the future pensioners. Some voices in the debate represented the interest of the institutions most involved in the changes, that is OFE and other actors of the financial market on which OFE were the largest institutional investors [see Bojanowski 2011]. Regardless of the arguments used by supporters of the changes and their antagonists, it's worth to remind the statement of Professor Marek Belka, the President of the National Bank of Poland: 'Writing about good and bad sides of the pension scheme reform is interesting only from the perspective of constructive actions which need to be taken, values which we intend to protect and goals which we want to achieve' [see Belka 2011].

* * *

New solutions, like the disciplinary spending rule, refer only to cases of discretional spending and new legally fixed spending. The high percentage of fixed spending remains the main problem of the Poland's public sector.

Analysis of potential risks, like weakening of Polish Zloty in context of World Economy changes indicates that – while taking into account the rising percentage of foreign debt in the public debt structure – there is a threat of crossing of the 55% GNP safety threshold already in 2012. In light of recent prognoses, economic growth in coming years may be lower than assumed in the Program of Debt Convergence and Management Strategy, 2011–2014. In case of economic slowdown because of the negative production gap, the reduction of budget deficit below 3% of GNP may turn out unrealistic. Consequently, the conditions of concluding the excessive deficit procedure and of cancelling the derogation will not be fulfilled by Poland.

Polish excessive deficit and rising level of indebtedness influence the ability to meet the other criteria of convergence. High level of debt means relatively high costs of its financing. In case of threat of debt spiral meeting the inflation and interest rates criteria may occur very difficult. Worsening fiscal situation may lead to higher volatility of currency exchange, what certainly will postpone introducing Polish Zloty to ERMII mechanism.

It's impossible not to refer to the situation in the Eurozone. The debt crisis and its consequences show systemic flaws of the Economic and Monetary Union. On the EU level for few months actions are taken to strengthen the coordination mechanisms of economic policies of EU countries, including fostering the Stability and Growth Pact, in both preventive and reconstructive dimensions. One of the proposals involves strengthening the sanctions against members of the Eurozone. That's why it is so important to achieve long-term recovery of Polish public finances, instead of just closing the excessive deficit procedure to cancel the derogation.

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Fiscal Stability in the Eurozone

1. Introduction

After the break-out of the financial crisis fiscal deficits widened and public debt ratios worsened around the world as a consequence of both lower collection of state revenues and higher expenses through fiscal stimulus packages. The trend towards higher debt ratios in Europe and elsewhere [Gerloff 2011: 28–30] has shifted the focus from avoiding excessive public deficits to achieving sustainable public debt levels, albeit the former strongly influences the latter. Since 2010, some Euro area countries, namely Greece, Ireland, and Portugal, have been facing problems servicing their debts. As the Euro area members are closely interrelated economically

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and financially, the European leaders put together support programmes to provide financial aid to these members.

Greece was the first country to receive funds in spring 2010. However, although the financial rescue package was already increased from €45 bn to €110 bn one month after the initial commitment [Wissenschaftlicher Beirat 2010: 4], Greece needed additional support in summer 2011. The European Council decided at the end of July 2011 to extend the maturity of the loans and to ramp up the financial support by an additional €109 bn to fully cover Greece's financing gap [Council of the European Union 2011: 2]. In the meantime, Ireland (in November 2010) and Portugal (in May 2011) had taken recourse to the EU's financial safety net. In August 2011, Italy and Spain faced increased pressures to finance their debt.

Despite the relatively large volumes of financial support, politicians and international investors remain nervous. Discussions about default and contagion never seem to subside. This paper analyzes the European fiscal policy framework. Using a simple political economy approach, it attempts to explain the continuing uncertainty and evaluates different policy proposals.

The paper is structured as follows: Section 2 looks at the design of the Euro area and the crisis management of the Euro area leaders. It addresses the problem of harmonized European monetary policy being combined with unsustainable national fiscal policies of some Euro area members. Referring to the three cases of Greece, Ireland, and Portugal, the emergency policy response of the EU is analyzed. Subsequently, the current proposals for permanent crisis resolution are discussed. Section 3 highlights the limits of financial aid to debtor countries. In the recipient country, the policy-makers' willingness to adhere to a strict conditionality will depend on their objective function. However, the creditor country's willingness to provide financial assistance will equally be bound by the parameters of its policy objective function. Under the current European policy approach, the costs in both governments' loss functions increase. Therefore, it can be argued that the success of the rescue packages will depend on which group of countries reaches its threshold for a policy change first. The last section summarizes the main findings and offers some ideas for future research.

2. Evolution of the debt crisis and EU policy response

2.1. Single monetary policy and different national fiscal policies

The purpose of this section is to look at the institutional setup of the Euro area and how the economic policy mix is designed within it. The use of a single currency is an important stage in the European integration. Politically, this integration process has unquestionably led to a peaceful period in Europe for more than five decades. From economic perspective, theoretical and empirical studies have also demonstrated the benefits of the common currency. For example, the Euro significantly promotes intra-Eurozone trade and has a positive effect on trade with countries outside the EMU. Moreover, advantageous impact of Euro area membership on foreign direct investment has been proven [Baldwin, DiNino, Fontagné, De Santis, Taglioni 2008: 5–6].

While monetary and exchange rate policies are harmonized within the European Monetary Union, national governments continue to assume responsibility for each country's fiscal policy. Since the introduction of the Euro, the European Central Bank has successfully controlled the single monetary policy for the Euro area. By definition, exchange rate policy was eliminated within the Euro area. Therefore, nominal exchange rate adjustment is a policy instrument not available to Euro area governments. While monetary and exchange rate policy are elevated to harmonized European level, fiscal and structural policies are still managed by the member states' governments. National policy-makers have to focus on price and wage flexibility, *i.e.* structural policy and fiscal policy to achieve necessary adjustments in their respective countries.

Initially, the Stability and Growth Pact (SGP) was approved in 1997 to avoid excessive public deficits and to ensure sustainable fiscal policies among Euro area countries. Sound public finances were viewed as an important requirement for the Euro area to function properly. While the institutional design of the Euro area harmonizes monetary and exchange rate policy, the SGP's intent is to coordinate fiscal policies among EMU member states and safeguard sound public finances at national levels. The rationale of the SGP is supported by a recent study of Reinhart and Rogoff [Reinhart, Rogoff 2010: 573]. They find positive correlation between high debt ratios and low growth rates for the developed and developing economies. For advanced economies, countries exceeding the threshold of 90% of gross government debt as per cent of GDP, experience growth rates that are several per cent lower than their peer group.

However, in March 2005, a reform of the SGP entered into force that changed and softened some of the SGP's regulations. The following year government budget balances showed improvement, but was not primarily an effect of fiscal consolidation. Rather than that, it was caused by more favorable economic conditions that led to higher tax revenues. The Member States concerned did not follow the provisions of the SGP which stipulated that the countries did more in economically 'good times' [Gerloff 2011: 27]. The consequences of insufficient budgetary discipline during better times became apparent when the Euro area was struck by the global economic crisis in 2008.

2.2. The emergency rescue measures of the European Union

In late 2009, after general elections in Greece and the formation of a new government, the new administration announced that the fiscal deficit was 12.7%, rather than the previously reported 6% and the 3.7% promised at the beginning of the year by the previous government [Wissenschaftlicher Beirat 2010: 4]. In February 2010, the European Council prompted Greece to implement immediate and drastic measures to correct the excessive deficit. Among others, this included a cut in public payroll, reduction of the number of public employees, an increase of the value added tax rate and a reform of the public pension system. As the Greek government announced drastic budget measures, the European Council agreed on €30 bn financial support that would be disbursed over the next three years and supplemented by IMF funds of €15 bn. However, the country's 2009 budget data turned out to be worse than expected and the Greek economy slowed down more than in original forecasts. In mid-April, the 3-year financial aid package was increased to €80 bn from EU sources and €30 bn from the IMF. Moreover, the ambitious budget targets were eased and the objective to reach the 3% deficit target was postponed until 2014.

In May 2010, against the backdrop of the developments in Greece, the authorities had to respond immediately. The European Union, in cooperation with the European Central Bank and the International Monetary Fund, established short-term emergency measures to provide further financial support to other Euro area members, in case they might run into financial difficulties. The emergency policy rests on four pillars: the European Financial Stabilization Mechanism, a temporary European Financial Stabilization Facility (EFSF), financial support from the International Monetary Fund, and the ECB's Securities Market Programme. The maximum amount of the initial rescue package was €750 bn. Access to these funds is limited to Euro area countries and subject to a strict conditionality.

At the end of November 2010, as the first country, Ireland officially applied for funds provided by the newly established EU financial safety net. The Irish fiscal burden, reflected by the deficit of more than 30% of GDP in 2010, was mainly due to financial sector bail-out. Bank recapitalization was estimated to account for approximately 20% of GDP. The government's support of the banking sector pushed sovereign spreads to historic highs and significantly hampered bond market access for the Irish government [International Monetary Fund 2010: 4]. The total amount of the rescue package comprises €85 bn, of which €45 bn are provided by the European safety net.

In May 2011, after Portugal had experienced increased difficulties in tapping the international bond market, a financial support package of €78 bn was agreed on [European Financial Stability Facility 2011: 2]. Portugal's program is financed by the IMF, the EU and the European Financial Stability Facility (one third each).

However, not only did the number of countries which needed the shelter of the European safety net increase. It also became obvious, in summer 2011, that the Greek economic growth was lower than forecast and that it took the government longer to implement the necessary reforms. This led to additional financing needs of the Greek government. On their summit at the end of July 2011, the Euro area leaders decided to increase the financial support by an additional €109 bn to fully cover Greece's financing gap [Council of the European Union 2011: 2]. Moreover, with mounting pressures on Spain and Italy at the beginning of August 2011, the European Central Bank stepped up its Securities Market Programme [European Central Bank 2011: 1] and purchased larger volumes of sovereign bonds to stabilize securities markets. While more and more countries took recourse to the European safety net, the emergency measures themselves remained temporary. The instruments will expire in June 2013 so the European leaders have to find a long-term solution to stabilize the Euro area.

2.3. The search for sustainable long-term crisis prevention

The envisioned structure of a permanent crisis prevention mechanism consists of different components. The Stability and Growth Pact (SGP) will be reformed and amended in two aspects. The aim is to make the SGP more rules-based. First, the fiscal field is supposed to be strengthened and more emphasis will shift upon monitoring debt developments. The second reform aspect of the SGP is related to structural imbalances. This adds a new element to the SGP that has so far been focused on the fiscal area. In addition to the new regulations to be incorporated into a reformed SGP, intensified fiscal policy coordination and surveillance of possible economic imbalances is to be reached through a so-called 'European Semester'. According to the decisions of the Brussels summit in December 2010, a European Stability Mechanism (ESM) will be established that provides financial assistance to Euro area countries under strict conditionality [European Council 2010: 8]. The ESM will replace the current instruments that expire in 2013. The financial assistance is expected to complement the new framework of reinforced economic governance. The focus is on prevention, in order to reduce the threat of a future crisis. In addition, private sector involvement is another aspect of the long-term instruments.

However, before the agreed-upon measures were ratified by the member states, a need became evident once again to increase the level financial aid. On their summit at the end of March 2011, the Euro area leaders decided to increase the European Financial Stability Facility's effective lending capacity to €440 bn. Therefore, critics question whether the proposed European Stability Mechanism will be equipped with sufficient funds. More fundamental opponents argue that the entire approach aims at camouflaging a birth defect of the Euro area: The European Monetary Union lacks a single fiscal policy, and the countries in financial difficulty do not have an incentive to implement necessary reforms.

If this holds true the consequences are twofold. On the one hand side, the recipient countries only receive financial assistance if they fulfill the conditionality of the support programs. If the required measures face strong opposition from certain domestic interest groups – as can generally be expected and as already becomes evident in the case of Greece – the government will have to weigh the benefits of staying in the Euro area versus the costs of increasing domestic opposition. On the other hand, the creditor countries will have to balance the benefits from a functioning currency union versus the costs of providing financial aid to poorer members of the Euro area.

3. The limits of financial assistance within the Eurozone

3.1. The debtor country's policy objective function

Assume that the policy-makers of the debtor country make their decision based on a policy target function familiar from the rules rather than discretion debate [Kydland, Prescott 1977: 473, and Blackburn, Christensen 1989: 1]. While the maintenance of the single currency can be viewed as a rules-based policy, a withdrawal from the Euro area or the default of the member country is interpreted as the discretionary policy approach. The policy-makers minimize the loss function L_{DC} which is given as

$$L_{DC} = L_{DC}^{MP}(\pi, \varepsilon) + w \cdot L_{DC}^{FP}(\beta, \sigma) \qquad w > 0$$

The total value of the debtor country's loss function L_{DC} consists of the loss from monetary policy L_{DC}^{MP} and of the loss from fiscal and structural policy L_{DC}^{FP}.

The first component of the total loss is determined by price changes π and by exchange rate fluctuations ε. The second term of the debtor country's loss function varies with changes of the state's budget balance β and a structural change component σ. While the latter captures changes in structural policy like labor market reform and deregulation, public finances (β) move with tax revenue and government expenditure. The extreme cases of sovereign default or exit from the Euro area can also be reflected by σ –changes. The factor w represents the weight of the fiscal component as opposed to the monetary component in the authorities' loss function.

As long as the debtor country remains solvent and stays in the Euro area, the loss from monetary policy is unchanged. This component is strongly influenced by the ECB's monetary policy – which determines medium-term price movements in the Euro area – and by the exchange rate of the Euro on international financial markets. Looking at the second component of the loss function, recourse to a rescue package tends to improve the budgetary situation. Funds provided by the European Union in conjunction with the IMF should alleviate some of the fiscal pressure through the

'β -channel'. At the same time, however, the conditionality of the financial support requires substantial expenditure cuts and tax increases. Together with structural policy changes (through σ), they drive up the fiscal loss portion L_{DC}^{FP} during the early stages of the adjustment process when the government has to implement these unpopular measures. If growth does not pick up quickly public support for the reform program may fade. The increasing cost of the fiscal and structural adjustment process could lead to the rule-based policy becoming suboptimal. The government might render their currency union commitment obsolete by either leaving the Euro area or defaulting on its debt.

The Lisbon version of the EU Treaty does explicitly contain the provision for voluntary withdrawal. Article 50 of the Treaty stipulates that a country can leave the EU – but not EMU alone [Athanassiou 2009: 23]. What would be the benefits of the country leaving the Euro area? The European Union's objectives of political integration and harmonization would experience a massive setback. For decades, the European integration process has been the cornerstone of peaceful co-habitation and political cooperation within Europe. The political barriers to exit are accompanied by economic obstacles. It is questionable whether a re-nationalized monetary policy would be more credible. If, however, it is intended to be used for increasing the inflation tax, the costs L_{DC}^{MP} might be high. Moreover, persistently high inflation expectations would complicate the monetary policy stance. With regard to exchange rate policy, a new national currency would have to be re-introduced at high one-time costs. The expected devaluation would lead to a significant increase of debt servicing costs on Euro denominated debt. While the economic obstacles are already significant, actually the greatest barrier is probably political in nature as 'that the high value that member states attach to the larger European project would prevent them from exiting from the monetary union' [Eichengreen 2010: 47].

While withdrawal from the EMU is politically infeasible, some economists argue that Greece would be better off defaulting on its debt obligations which would allow it to restructure its debt albeit others argue that sovereign defaults of advanced economies are undesirable and unnecessary [Cottarelli, Forni, Gottschalk, Mauro 2010: 4]. Unquestionably, a sovereign default comes at high cost. The government will be excluded from the international, and possibly also the domestic, capital markets for an indeterminate period of time. The default can lead to a bank-run and will not only harm domestic creditors but also private investment. A severe economic recession is likely to occur. However, based on historical observations, sovereign defaults are usually partial rather than complete and governments are often able to borrow again shortly after the default [Grossman, Van Huyck 1988: 1088]. Within the Euro area, the default of a sovereign will have wider repercussions also adversely affecting other EU member states. However, the latter is not reflected in the debtor country's loss function and, therefore, does not increase the L_{DC}^{FP} – component further.

In conclusion, a voluntary default of the debtor country could emerge as the optimal debtor country's policy strategy if the value of L_{DC}^{FP} under default is lower than the L_{DC}^{FP} – cost of the prolonged reform process under an adjustment program. A voluntary withdrawal from the European Union (as a legal prerequisite for leaving the Euro area) would only be rational if the resulting increase in the loss component L_{DC}^{MP} were expected to be lower than the cost differential between the L_{DC}^{FP} inside and outside of the currency union.

3.2. The creditor country's policy objective function

If politicians shun real reforms and the proposed institutional changes lead to a Euro area in which financially sound countries have to support members with lax fiscal discipline, the path towards a transfer union will be paved. This means that poorer countries receive financial transfers from the richer EU members. Eventually, this might lead to fading support for the Euro area in the latter countries, especially when an increasing number of member states take recourse to a safety net that has to be funded by few financially strong countries.

Surveys indicate an increasing unease with the European leaders' approach to solving the debt crisis in member states that guarantee the financial support. Finland's authorities announced that they were only willing to provide additional support when the Greek government offered some type of collateral for the financial exposure. Another proposal asked the recipient state to back the financial support by parts of its foreign exchange reserves. Those demands are a clear indication of increasing dissatisfaction with the current policy stance.

In early September 2011, a survey of the Forschungsgruppe Wahlen found that a majority of Germans opposed the planned extension of the rescue funds provided through the EFSF [Forschungsgruppe Wahlen 2011: 1]. 76 per cent of Germans would vote against an increase of the EFSF's lending capacity and an expansion of the German share to more than €211 bn. The rejection was in unison among supporters of all main German parties. Despite this poll the German parliament voted in favor of the enlarged financial aid at the end of September. The ruling coalition was able to secure enough votes among its own members of Parliament. How long will governments be willing to conduct a policy that is not backed by the majority of the electorate?

In analogy to the debtor country, a policy loss function can be formulated for the creditor country:

$$L_{CC} = L_{CC}^{MP}(\pi, \varepsilon) + \omega \cdot L_{CC}^{FP}(\beta, \sigma) \qquad \omega > 0\,.$$

The variables have the identical meaning as in the previous section with the index *CC* indicating the creditor country's variables. Again, the factor ω represents the weight of the fiscal component as opposed to the monetary component. For an optimal policy, the authorities attempt to minimize the loss function.

As a member of the Euro area the country benefits from low inflation rates, the single European currency and its positive trade effects. These factors keep L_{CC}^{MP} low. To reap the benefits of the large European Monetary Union, the creditor state contributes to a rescue package for ailing member states to avoid their sovereign default or the need of financial aid to its own domestic banking sector. The latter will inevitably be required if a Euro area country is not able to service its debt. However, this policy stance increases the fiscal cost component L_{CC}^{FP} of the policy objective function. When the country merely guarantees funds it only potentially increases government spending. Once funds are being transferred, government expenditure rises. In minimising the loss function, the politicians will have to weigh the favorable effects of the Euro area membership against an increasing fiscal burden. As long as only a relatively small country faces problems servicing its debt, the benefits of maintaining a large, functioning currency union may outweigh the cost resulting from the national contribution to a financial support package. Potentially high costs of having to save the domestic banking sector can be avoided, not to mention the political costs of a debtor country's default or withdrawal from the Euro area. This can explain why the European leaders' immediate policy response to the Greek debt servicing problems in 2010 was a financial rescue package despite the provision of a 'no bail-out' clause in the Treaty. However, the more Euro area member states have to be supported, the more likely it becomes that the fiscal burden of contributions to the Euro area safety package exceeds the political costs and the costs of supporting the domestic financial sector.

4. Conclusion and Outlook

So far, with defaults and bail-outs both being costly alternatives, the European governments opted for bail-outs to avoid the adverse consequences of a member state's sovereign default. To avoid future debt crises, or at least to reduce the probability of their recurrence, rules have to be established that create adequate incentives to conduct national fiscal and structural policies which are sustainable and compatible with a single European monetary policy. If a member state has access to financial aid as demonstrated by the precedent-setting cases of Greece, Ireland, and Portugal, and as envisioned by the establishment of a permanent crisis mechanism, it can be expected to opt for foreign assistance. Although the financial support is subject to strict conditionality a debtor country will prefer to use the European Union's 'lending of last resort' funds. Substantial economic reforms are a prerequisite for a successful adjustment program. An implementation without the use of international financial support would lead to a stronger increase in the L_{DC}^{FP} – cost component of the debtor country. The structural adjustment (reflected by σ -changes) would not be cushioned by international financial assistance (represented by a positive β -influence on the value of the loss function). Therefore, the provision of financial rescue packages has a built-in incentive mechanism to make use of the funds. Moreover, it can also be advantageous to blame a foreign institution for the implementation of unpopular rigorous reforms.

It is important to look at the creditor countries, too. The weight of the positive effects of a large Euro area in the policy-makers loss function will determine how long they are willing to fund an ever increasing European Stabilization Mechanism. The more generously the financial safety net is endowed, the more member states will use these funds. However, at the same time, the probability increases that a creditor country refuses to contribute to the rescue package. It is important to note the mounting uncertainty. When a large member state takes recourse to the safety net it does not only represent a new recipient country. Moreover, a net contributor to the rescue package vanishes which puts a larger burden on the remaining financiers. Obviously, the L_{CC}^{FP} – cost component would increase dramatically for the remaining creditor countries if a large member state like Italy or Spain were seeking financial support from the European Financial Stability Facility. It can be argued that the benefits from the currency union are especially high for a member state when other large countries use the single currency, too. Therefore, the monetary policy component (L_{CC}^{MP}) of a creditor's country would drastically increase if a large Euro area member defaulted. However, it cannot be ruled out that the fiscal cost component rises more strongly than the monetary cost component which could lead to a suspension of payments to the EFSF by a creditor country. A crucial aspect will be the distribution of costs over a longer period of time and the discount factor used to calculate future costs.

For a more substantiated analysis, the extension to a multiple-period model would also allow for the incorporation of contagion effects and repeated game aspects. Moreover, the loss functions would need to be specified. In addition, the weights of monetary versus fiscal and structural targets would have to be identified. This would provide an opportunity to determine which group of countries (debtors or creditors) can be expected first to depart from the current policy consensus of avoiding sovereign default of Euro area members through financial bail-outs.

However, even when based on simple political economy considerations, it is shown that the EU's current policy approach for the emergency rescue measures as well as for the long-term crisis prevention creates an incentive for countries to use the emergency facilities while the contributors' willingness to pay is likely to be reduced with each additional member taking recourse to the rescue package. Therefore, the policy stance does not seem to be able to solve the debt crisis and, inevitably, will have to be changed to create a more sustainable incentive mechanism.

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The Crisis in Greece & the EU Economic Governance: Lessons & Observations

1. Introduction

The compromise reached during the Euro Summit Meeting on October 26, 2011 concerning 50% voluntary bond exchange programme aimed at reduction of the Greek debt/GDP ratio to 120% by the year 2020 closes a chapter in the time-line of the sovereign debt crisis in Greece. Simultaneously, it confirms that the €110 bn rescue programme for Greece devised by the European Union (EU) and the International Monetary Fund (IMF) in May 2010 failed. Given the fact that the sovereign debt crisis in Greece served as catalyst in reinvigorating the debate on strengthening EU economic governance, it is timely to reflect on lessons that could

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be drawn from the crisis in Greece in view of enriching this debate and potentially of improving the emerging EU economic governance framework. The crucial argument put forth in this paper is that several misconceptions regarding the true nature of the crisis in Greece guide the popular understanding of the situation in this country and to a large extent affect the quality of decisions made at the EU-level concerning Greece and the financial assistance it receives. These misconceptions influenced the way of handling the sovereign debt crisis in Greece by the EU-level actors, eventually contributing to the failure of the EU/IMF rescue programme of May 2010. The objective of this paper is to clarify some of the mistaken beliefs about the crisis in Greece, and to spell out the major concerns prompted by the so far fruitless measures devised at the Greek domestic level as well as at the EU-level to address the crisis in Greece .

The discussion is structured as follows. In the first part, the major misconceptions concerning the causes of the crisis in Greece are dealt with and the key reasons behind the escalation of the crisis are identified. A short section on the major assistance programmes devised at international level to address the sovereign debt crisis in Greece follows. In the next step, the appropriateness of these measures is discussed. In the concluding part lessons and observations prompted by the crisis in Greece are projected on the question of EU economic governance and its efficiency.

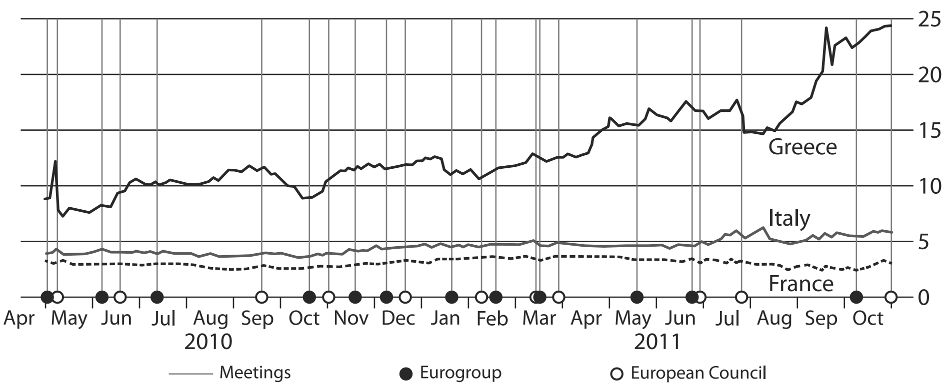
2. The crisis in Greece in context

The sovereign debt crisis in Greece triggered a heated debate on its reasons as well as on relevance of the €110 bn EU/IMF assistance programme extended to this country in May 2010. As a variety of misconceptions shaped the mainstream debate on the crisis in Greece and on measures employed to address it, the following paragraphs dwell on some of these misconceptions.

2.1. On the causes of the crisis

In the discussion about the roots of the sovereign debt crisis in Greece, the global financial crisis and the speculative pressures of the capital markets have occupied a prominent position. In this view, fiscal imbalances in the Greek economy have been ascribed secondary role, with Greece being presented as a victim of the global financial markets. A corollary of this take on the crisis in Greece was a discussion, on the one hand, of the need to strengthen global regulation of financial markets and, on the other hand, of the need to work out a common European solution to potential future speculative attacks targeting the euro. An undercurrent of this debate focused specifically on rating agencies with the argument being that the rating agencies are responsible for generating biased and false images of certain economies of the Eurozone, and that in turn these images trigger some market players' propensity to engage in speculation. Given the fact that since the start of this debate in Autumn 2009 the price of Greek bonds has been on a constant rise (see also Graph 1), with the 10-year yield reaching 25% in mid-September 2011 [Moses 2011], clearly oblivious of the EU-level attempts at taming the financial markets, the accurateness of the 'speculative pressures' argument has to be put in question.

In order to identify the roots and the nature of Greece's insolvency problem it is necessary to distinguish between three interrelated and overlapping crises that Greece experienced over the recent period, *i.e.* the demand crisis and the liquidity crunch (2008–2009) caused by the global financial crisis, the sovereign debt crisis (2010-up to now) related to specific course of action undertaken by the Greek government in Autumn 2009, and deep economic recession (2011–?) being the result of inadequate policy-mix implemented by the socialist government starting in 2010.



Graph 1. Ten-year government bond yields, %, and meetings of the European Council and Eurogroup

Source: The Economist [2011]: The Euro Deal, 'Comment', October 29.

As it has been argued elsewhere [Visvizi 2012], Greece was not affected by the immediate consequences of the global financial crisis. Greek banks tend to pursue rather conservative investment strategies and for this reason their exposure to toxic assets was marginal when the global financial crisis peaked. In 2008, after the collapse of Lehman Brothers, Greek economy would still experience modest but positive growth rate, while the banking sector remained intact. As the secondary consequences of the global financial crisis started to unfold internationally in the form of liquidity crunch and demand crisis, Greece endured their implications both domestically as well as through its international exposure. Internationally, demand for Greek services (mainly shipping and tourism) declined; simultaneously, domestic consumption and investment levels fell and the ratio of non-performing loans increased significantly.

Essentially, the secondary consequences of the global financial crisis revealed structural weaknesses inherent in the Greek economy, such as: the public sector which is overgrown, inefficient and generating deficits, including numerous deficit-bearing and subsidised state-owned enterprises (SOEs); overspending leading to continuous deficits and accumulation of public debt; overregulated economy; unfavourable structure of the economy (declining industrial production, and overdependence on revenue from services, shipping and to a lesser extent tourism); inflexible labour market; and the resulting low competitiveness. Importantly, these weaknesses alone did not lead to the sovereign debt crisis that peaked in May 2010. Instead, the crisis should be associated solely with specific actions, and their unintended consequences, by the socialist government throughout 2009 and 2010.

Shortly after victorious parliamentary elections of October 2009, the newly formed government of PASOK started questioning the validity and accuracy of macroeconomic estimates for 2009 as presented by the previous establishment. The new government declared that public deficit was significantly higher than announced earlier that year and that it would reach about 11–12% of GDP by the end of 2009; an announcement contested by many at that time. While this sudden and unexpected declaration by the Greek government confused the EU-level actors, it caused havoc among disoriented market players. Rather than addressing the situation immediately by suggesting a viable reform programme for the economy, in a series of state-level visits the Greek Prime Minister argued that Greece had fallen prey to massive speculative attacks, and thus that global financial regulation should be strengthened to prevent market manipulation [Visvizi 2012]. The already shattered credibility of the Greek state suffered further damages through blunt statements of the Prime Minister that Greece's 'basic problem [was] systemic corruption' [Barber, Hope 2009].

Over a short period of time, spreads for Greek bonds rose sharply, making it eventually impossible for Greece to draw new credit lines to cover its financing needs. It was not until January 2010 however that a reform programme was announced; too late to convince the markets. As a result, Greece found itself detached from them. Faced with insolvency, in April 2010 Greek authorities sought financial assistance. Accordingly, in May 2010 an unprecedented financial assistance package of €110 bn was granted to Greece by the Eurozone member-states and the IMF as a means of assisting Greece in addressing both the insolvency problem as well as its roots.

2.2. On reasons behind the programme's failure

One of the misconceptions about the crisis in Greece is consistent with some commentators missing the connection between the programme's failure and the government's underperformance. To clarify this issue it should be noted that the sovereign debt crisis (as explained in the previous section), the current economic recession in Greece, and missing the target values agreed with Troika, *i.e.* representatives of the European Commission, European Central Bank (ECB) and the IMF, are directly and explicitly related to specific economic policy choices made by the Greek government. In principle, the economic reform programme approved by Troika in May 2010 relied on fiscal consolidation and fiscal discipline that coupled with structural reforms were expected to yield positive outcomes in the form of growth and increased revenue. The structural reform measures listed in the programme included public administration reform, labour market and wage-negotiation system reform, pension system reform, healthcare system reform, business environment reform, reforms aimed at promoting foreign direct investment and exports, as well as reforms increasing the levels of absorption of structural and cohesion funds [EC 2010b].

The key problem related to the programme, and the major reason behind its failure, is that the government chose to embark on a front-loaded fiscal adjustment strategy entailing solely the introduction of several and multiple increases in taxation. The tax measures included: several and multiple increases in VAT rates; sequential increases in excise tax on fuel, cigarettes and alcohol; introduction of luxury goods tax (cars, yachts, pools), followed by several 'one-off' emergency payments; multiple special levies on profitable firms; new tax measures on distributed and retained revenue; presumptive taxation; and finally steep increases in tax rates on real estate accompanied by emergency payments, presumptive taxation, and increase in objective (*i.e.* administratively set) value of real estate in certain districts of Athens. Admittedly, the imposition of harsh tax measures was not accompanied either by reduction in public expenditure (in fact, public expenditure increased by 8% over 2010–2011) or by necessary structural reforms, such as privatization and downsizing of the public sector.

As regards privatization, it should be stressed that over the period between May 2010 and late October 2011 no progress has been achieved in this area. Regardless of 'the strong commitments by Greece to …, fully and speedily complete the €50 bn privatization (programme' [European Council 2011a], that were welcomed, as it seems now, over-enthusiastically by the European Council in March 2011, the privatization-drive in Greece has never actually begun. As the EU-level actors intensified their pressures for the Greek government to proceed with the privatization process, around June 2011 the argument was raised that since the value of shares of SOEs listed on the stock-exchange fell, privatization should be postponed as it would not bear any significant revenue to the budget.

The point is that privatization in Greece, a topic consumed by a number of misconceptions, both domestically and abroad, should be understood neither as fire-selling of state-owned assets (incl. real estate and shares in enterprises), nor as a one-shot revenue generator. Rather, privatization in Greece should be understood as 'a fundamental element of structural reforms that in a path-dependent manner would pave the way to the restoration of the Greek economic system' [Visvizi 2012] and of its competitiveness.

In other words, privatization in Greece and the reform of the legal/regulatory frameworks that privatization will require will result in structural changes in the Greek economy conducive to improving its competitiveness and growth. For instance, as a result of privatization of deficit-generating SOEs that receive state subsidies until today, fair competition will be re-established in Greece and several entry barriers to specific niches of business activity will be dismantled. A consequential element of the legal changes enforced by privatization would consist of de-unionization and of limiting the abusive influence of trade unions on the management of specific SOEs as well as on the entire economy. However, as privatization remains a highly sensitive and politically costly issue for the government in power, it remains to be seen how declarations and announcements on privatization will translate into practice.

As a result of the government's overemphasis on taxation, economic activity in Greece declined and the economy entered deep recession in 2011, leading to further losses in revenue and increased expenditure, *e.g.* on account of unemployment. Particularly important in this context is taxation imposed on real estate and corporate taxation, as both sets of measures squashed business activity in Greece and led to exponential growth in unemployment. Due to several and multiple increases in taxation on real estate (currently about forty different tax measures apply for real estate), the construction sector (traditionally the growth engine of the Greek economy) collapsed leading to decline in related industries (*ca*. 130) and causing additional strain on the labour market.

As for corporate taxation, measures implemented by the government over the last couple of years have raised the level of corporate taxation to about 50%, as compared to about 10% in neighbouring countries, creating disincentives for investing in Greece. Given the fact that since late 2009 the Greek economy has been operating under constant pressure of limited access to liquidity reflecting falling creditworthiness of the Greek state, a phenomenon referred to in literature as 'sovereign risk channel' [Corsetti *et al.* 2011], the tax burden proved incommensurate with businesses' ability to deliver. Not surprisingly, budget revenue on account of tax collection decreased significantly in 2010 and 2011, reflecting economic downturn and later recession, rather than tax evasion as the government repeatedly claimed.

In other words, contrary to what many commentators may have said about the reasons behind the non-fulfilment of quantitative criteria attached to the EU/IMF rescue programme for Greece, its failure is directly related to an inadequate policy-mix implemented by the Greek government. Essentially, the Greek government chose to focus on a strategy of limitless broadening and deepening of the tax base. Several reforms that were needed, such as liberalization of the services market, due to weaknesses characterizing relevant regulatory frameworks proposed by the government, failed to be implemented, *e.g.* liberalization of the taxi profession. More importantly, other reforms, such as privatization and restructuring of the public sector, although fundamental to the programme's success, as politically costly, have been neglected altogether.

3. The assistance programmes for Greece in perspective

Over the last two years three assistance programmes for Greece were agreed upon, though not implemented, and the Greek sovereign debt crisis remained the top item on the EU's agenda. As a result of the apparent impossibility to address the Greek crisis efficiently, the stability of the entire Eurozone was challenged. Although the compromise about the 50% reduction of Greek liabilities toward private creditors was received by the markets with relief, it is still too early today to be enthusiastic about the implications of the generous deal for the Greek economy. To put it differently, as misconceptions about the nature of the crisis in Greece rendered the efforts at rescuing it futile, the compromise with private creditors will serve its purpose only if current misconceptions about the roots of the crisis and about the role of the current government in its escalation are replaced by political and economic pragmatism. In the following paragraphs the basic features of these three assistance schemes are highlighted and general observations are made.

3.1. The May 2010 financial assistance programme for Greece

In view of its imminent insolvency risk, the financial assistance programme for Greece was approved by Eurogroup and the IMF Board in May 2010. This unprecedented loan of the total value of €110 bn was to be disbursed in twelve tranches over the period 2010–2013. The financial assistance package consisted of €30 bn Stand-by Agreement (SBA) approved by the IMF, and a €80 bn worth bilateral loans granted to Greece by the Eurozone member-states, centrally pooled and managed by the European Commission. The terms and conditions of the loan were specified in three agreements (memoranda) dealing respectively with quantitative and qualitative policy conditionality attached to the programme as well as with technical methods necessary for assessment of the programme's implementation. The price for the IMF part of the loan was set at 3.3%. Following the European Council's meeting of March 11, 2011, the initial interest rates for the EU part of the loan were adjusted from 5.2% down to 4.2% and their maturity was extended from 3 years to 7.5 years. In this way, the maturity of the EU and the IMF loans were brought in line, and the difference in interest rates was diminished [European Council 2011b: 4].
In May 2011, one year after the start of the rescue programme for Greece, serious discrepancies between the target values set in May 2010 and the actual values/estimates as revealed in the Commission's Spring Forecast 2011 were recorded [Visvizi 2012]. Although, clinging to a rather wrongly defined interest of the Eurozone, the 5th tranche of the loan was eventually disbursed in early July 2011, it became apparent that a debt rollover, debt 'hair cut', or controlled/selective default was necessary in order to address Greek insolvency and deal with its consequences for the rest of the euro area. On July 21, 2011, the agreement on basic principles of a second rescue package for Greece of a total value of €159 bn was reached.

3.2. The July 2011 financial assistance programme for Greece

The basis of the July 21, 2011 assistance programme for Greece was the so-called Medium-Term Fiscal Strategy 2012–2015 (MTFS) of June 2011. In the MTFS, the Greek government committed itself to additional fiscal consolidation measures of the value of *ca*. €28 bn, *i.e.* through expenditure reduction by €14.8 bn (6.3% of GDP) and increase of public revenue by €13.4 billion (5.7% of GDP). As the initial quantitative targets set in May 2010 were beyond the scope of the possible, in the MTFS these targets were 'softened'. In this sense, the MTFS *de facto* constituted revision of the May 2010 conditionality attached to the EU/IMF loan.

The July 21 agreement, facilitated by the Institute of International Finance (IIF), was designed to supplement the programme from May 2010. This new assistance scheme envisaged significant private sector participation (PSI), *i.e.* members of the IIF and other major financial institutions agreed on a 'voluntary programme of debt exchange and a buyback plan' worth €50 bn aimed at a 21% reduction of the Greek public debt [IIF 2011]. In line with the draft programme, the rest of funding of the total value of €109 bn, necessary to cover Greece's financing needs up to 2020, would come from the European Financial Stability Facility (EFSF) and the IMF. In addition, the programme sought to improve the maturity profile of Greece's debt by increasing the maturity from an average of 6 years to 11 years [IIF 2011].

As the desired PSI level was calculated at 90% and in September 2011 it had reached only about 70–75% [Alloway 2011] questions about the programme's viability arose. These were reinforced by a discussion provoked by the Finnish government's request for Greece to provide collaterals for the Finnish part of the loan [Rettman 2011].

3.3. Toward a third assistance package for Greece

The 5th review mission accomplished by Troika at the beginning of September 2011 revealed (although no official review mission report was published until the end of October) that, once again, the Greek government failed to meet the fiscal consolidation and reform targets as renegotiated in June the same year. Accordingly, the decision about the disbursement of the 6th tranche of the EU/IMF loan had been postponed to October 2011. Simultaneously, a firm message was sent to Athens to take extraordinary measures to stand up to its June commitments. The Greek government's imminent response was consistent with the imposition of another tax on real estate, effective immediately. Subsequently, under pressure of the EU-level actors, the government revealed some details concerning possible reduction of employment in the public sector. Further cuts in pensions had been scheduled, and some reductions in remuneration in the public sector were announced. Introduction of a uniform remuneration scheme in the public sector followed. At the time of writing, the effectiveness of these measures remains an open question.

For example, during preparation of the budget for 2012, in early October 2011, a reduction of 30,000 jobs in the public sector was announced: a figure that corresponds to the number of people employed in the public sector over the last couple of years. Similarly, under explicit pressures by Troika, a uniform remuneration scheme for public sector employees was announced (to be introduced as of November 1, 2011) aimed at harmonization of wages and their overall reduction. However, employees of Greek SOEs listed on the stock-exchange have been exempted from this scheme, while only marginal reductions in basic salaries and benefits have been planned. It should be noted that the average annual basic salary level in diverse deficit bearing SOEs, representing bastions of unionism, varies between roughly €29.000 through €59.000 [EC 2010a: 53]. Importantly, individual monthly revenue is complemented by a variety of benefits that exceed the value of the basic salaries in SOEs.

Amidst uncertainty about the scope and efficiency of the reform measures announced by the Greek government in early October 2011, and in context of discussions on the approval of the disbursement of the 6th tranche of loan, on October 21, 2011 Troika released confidential report depicting that Greek public debt was unsustainable.

3.4. The October 2011 'voluntary bond exchange programme'

On October 26, 2011, during an extraordinary Euro Summit, under a very clear leadership of German Chancellor Angela Merkel and French President Nicolas Sarkozy, a compromise concerning the Greek debt problem and the stability of the Eurozone was reached. In line with the compromise, a 'voluntary bond exchange with a nominal discount of 50% on notional Greek debt held by private investors' was scheduled. The so-defined PSI 'should secure the decline of the Greek debt to GDP ratio with an objective of reaching 120% by 2020' [European Council 2011a: 4].

The EU and the Eurozone member-states will contribute €30 bn to the PSI. Furthermore, in line with the Euro Summit Statement, additional programme financing of up to €100 bn until 2014 will be provided by the official sector, *i.e.* the EU/EFSF and the IMF. Details of this new multiannual programme are to be agreed upon by the end of 2011.

Although the compromise implies significant reduction of the Greek debt and consequently results in substantial decrease in the debt service burden for Greece, in itself the compromise with private creditors does not constitute a sound solution to the crisis in Greece. This voluntary bond exchange programme will be meaningful only if it is accompanied by a set of reforms aiming at restructuring of the Greek economy, at its liberalization, and at full privatization. What seems encouraging in this context is a provision included in the Statement issued after the Summit, in which the establishment of 'a monitoring capacity on the ground' is envisioned for the duration of the implementation of the new assistance scheme. This 'monitoring capacity', as noted in the Statement, would work closely and 'in continuous cooperation with the Greek government and the Troika', and will 'advise and offer assistance in order to ensure the timely and full implementation of the reforms … within the commitments of the programme' [European Council 2011a: 4].

Recent developments suggest that a consensus has emerged in the EU over the need to devise a mechanism that will ensure Greece's compliance with its commitments. The role of the 'monitoring capacity on the ground' is thus to improve the overall efficiency of the measures formulated at the EU-level to address the crisis in Greece in view of restoring growth of its economy and of improving its competitiveness. It is too early to draw any conclusions from the developments discussed above. At the time of writing, the Greek government's suggestion to submit the question of whether Greece should stay in the Eurozone or not to a nation-wide referendum is deeply disturbing. Reactions of the markets and of the private creditors that consented to the compromise reached on October 26 are unknown. It remains to be seen how the developments on the Greek political scene and at the EU-level arena regarding the debt-reduction issue and the new reform/assistance programme will converge.

4. The appropriateness of measures devised for Greece

When evaluating the appropriateness of assistance measures devised for Greece at the EU-level it is necessary to focus on benefits of international assistance in general and on the broader logic underpinning it. It is equally important to look into some very specific questions concerning efficiency and relevance of the assistance programmes. The following paragraphs address these issues.

4.1. International assistance and its benefits

Although the crisis in Greece is home-made, it would be myopic to believe that domestic solutions alone would allow for comprehensive and efficient treatment of the situation in Greece. International institutions, and in this particular case the European Commission, the ECB and the IMF, constitute an indispensable anchor for a country undergoing process of fiscal consolidation and structural reforms. The benefits of institutionalization and of the resulting international assistance are evidenced by the example of successful transition and transformation of the Polish economy in 1990s. In this case, institutionalization of external (economic) relations was consequential for the process of consolidating the frame and direction of the reform process that the democratic government in Poland had just began. Moreover, it made the liberal and open-market economic model that Poland embarked on largely immune to influences of domestic party politics and electoral cycle [Visvizi 2010a]. Undeniably, apart from the political commitment of the Polish authorities to pursue the reform path, conditionality attached to the assistance programmes served as an equally important success-factor in the process of transition.

Clearly, the prospect of the IMF's involvement in the €110 bn rescue package for Greece raised hopes that conditionality attached to this assistance scheme would allow detaching the reform process from domestic politicking. This would happen either by imposition (via the threat of non-disbursement of consecutive loan tranches) or by adding legitimacy and improving efficiency of the implementation process (through discursive interventions of the government in which the IMF would be cast as the authority that the government has to follow).

Four sets of solutions targeting specifically Greece were generated at international level as a means of addressing the imminent implications of the sovereign debt crisis in Greece. That is, firstly, in May 2010 the ECB Governing Council approved the so-called Securities Markets Programme that allowed the ECB to purchase Greek treasury bills on secondary markets; a move considered controversial by many [Blackstone 2011]. Secondly, in May 2010 the euro area member states, in a gesture of solidarity, consented to bilateral loans to Greece centrally pooled and administered by the European Commission. The IMF joined this conditional assistance scheme.

Thirdly, in July 2011 second rescue programme for Greece was accepted. Finally, as discussed in the previous section, on October 26, 2011 a compromise concerning a 50% voluntary bond exchange programme aimed at reduction of the debt/GDP ratio to 120% by 2020 was reached. By negotiating the debt-reduction deal, the EU-level actors acknowledged that the measures devised earlier to address the crisis in Greece have been fruitless. This suggests that the opportunity in the form of providing external anchor for the reform process that international assistance offers, in the case of Greece was wasted. It is timely to reflect on the question 'why'.

4.2. On (in)efficiency of the EU/IMF assistance programme

In the literature investigating the efficiency of the IMF intervention programmes worldwide, the impact of domestic factors on a given programme's success is emphasized [Woods 2006]. In particular, several authors point to the role of ownership of the reform programme and the resulting political commitment with regard to its implementation [Balcerowicz 2011; Drazen 2002; Visvizi 2010a]. Equally important is the notion of professionalism of those responsible for putting the programme into practice. Finally, the sensitive issue of surveillance is pointed to [Visvizi 2012].

In the case of Greece, each of the four factors identified above, *i.e.* ownership, political commitment, professionalism, and surveillance has had, to a varying degree, a role to play in the processes of addressing the sovereign debt crisis. For instance, it would be possible to evidence shortcomings in the programme's implementation stemming from either ailing professionalism or lack of deliberation, or both, *e.g.* liberalization of the services market. On the other hand, the case of privatization and restructuring of the public sector, where no progress was observed until October 2011, substantiate the claim of lacking political commitment to pursue these reforms. A very specific relationship between the government and Troika has emerged since the beginning of the programme's implementation, well-captured by terms such as misleading and entrapment [Visvizi 2012], leading to a number of (largely open) questions about the oversight mechanisms attached to the assistance scheme, about compliance, and about the role of conditionality attached to the programme. In this regard it seems relevant to highlight the following issue.

Many observers watching the consecutive stages of the crisis in Greece will certainly recall the argument reverberating in mass-media worldwide according to which tax evasion was the main reason behind the collapse of public finance in

Greece. The point is that in early 2010 the Greek government launched a purposeful strategy aimed at avoiding politically costly privatization and cutbacks in the huge public sector, while at the same time manipulating public opinion (at home and abroad) into believing that tax evasion was the culprit of Greece's downturn. This argument was skilfully framed by the notion of 'swimming pools'. Having acquired a symbol status, at the domestic level the swimming pool argument allowed the government to present itself as a 'just' government allocating the burden of fiscal adjustment evenly across the society, *i.e.* including also so the perceived 'rich' [Visvizi 2012].

In the government's relations with Troika, the same argument proved consequential in redirecting the EU/IMF officials' attention away from structural reforms to the largely constructed issue of tax evasion. That this strategy was successful is proven by the fact that, irrespective of lacking progress regarding privatization and downsizing of the public sector, disbursement of the 2^{nd}, 3^{rd}, 4^{th} and 5^{th} tranche of the loan was approved by Troika. In a similar manner, disregarding signals from the real economy, Troika approved further increases in taxation provided for in the MTFS of June 2011.

4.3. The inefficiency issue revisited: the instrumentalization trap

A frequently upheld argument on reasons behind the failure of the EU/IMF assistance programme to Greece is that the programme's objectives were too ambitious and thus unrealistic. As it may be the case, it is important to dwell on the logic that led to the specific fiscal policy targets and other conditionality components included in the agreement between the Greek government and Troika of May 2010. This agreement was based nearly mot-à-mot on the Greek government reform programme of January 2010. Simultaneously, measures targeting increase in tax revenue, the so-called Additional Fiscal Measures, were based largely on provisions of Tax law adopted on April 23, 2010. Clearly, if the programme's objectives were too ambitious and unrealistic, the responsibility for it rested predominantly with the Greek government, the author of the reform programme forming the thrust of the May 2010 agreement with Troika. The question is why would the government seek to embark on such an unrealistic programme?

It could be argued that at the end of 2009 when the reform programme was drafted to be presented to Ecofin in February 2010, the Greek government wanted to overwhelm the EU-level actors and, by distancing itself from the previous establishment, to gain credibility. More importantly, starting right after the elections in October 2009, the government sought to discredit the previous government in order to consolidate its electoral success domestically. The size of the budget deficit for 2009 was employed instrumentally here.

By way of explanation it should be noted that in September 2011, a new set of information revealed amidst the government's controversial decision to dismiss the board of the Hellenic Statistical Office (ELSTAT) revived the question of the value of the budget deficit of 2009 (see Table 1 for details). In Autumn 2009, estimates of the size of the deficit/GDP ratio, revised upward, triggered the complex chain of events that eventually lead to the sovereign debt crisis in May 2010.

Table 1. Greece: public debt, deficit, and growth 2000–2012

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Deficit	3.7	4.5	4.8	5.6	7.5	5.2	5.7	6.4	9.8	15.4	10.6	7.6*	6.5*
Public Debt	103.4	103.7	101.7	97.4	98.6	100	106.1	105.4	110.7	127.1	142.8	156.6*	161.3*
GDP growth	4.5	4.2	3.4	5.9	4.4	2.3	5.2	4.3	1	-2	-4.5	-5.5	-2.9

Source: If not otherwise indicated: Eurostat, arranged by the author; Estimates for 2011–2012 indicated by * from: European Commission [2011],The Economic Adjustment Programme for Greece', European Economy Occasional Papers 82, July; Directorate-General for Economic and Financial Affairs, Brussels.

Recent developments suggest that the initial estimates of a budget deficit for 2009 reaching *ca.* 9% of GDP, as announced around June 2009, were accurate. However, they had been affected by two issues. First, due to prolonged political stalemate on the Greek political scene leading to enforced parliamentary elections in October 2009, accompanied by a climate of uncertainty in the Greek economy prior to the elections and further affected by developments right after the elections, public revenue declined substantially in the 3rd and the 4th quarter of 2009, thus affecting estimates from June. Second, the size of the budget deficit for 2009 was revised twice, *i.e.* first in April 2010 to the value of 13.6% GDP and then in November 2010 to the value of 15.4% GDP. This was achieved by including in relevant calculations debts and deficits of the major deficit-generating SOEs as well as negative values of currency swap transactions that the government was engaged with in 2001, on the eve of the adoption of the euro. These 'creative recalculations' were objected by the ELSTAT Board as contradicting the standard methodology employed by other EU member-states.

While independent investigation will be launched to provide insight into the above arguments, the point is that the deficit issue played a role in the government's communication strategy employed for domestic and international purposes. Importantly, it was employed instrumentally in the fiscal consolidation and reform programme presented to Ecofin in February 2010 and then to Troika in April the same year. This explanation complies, in any case, with the government's rhetoric of success emphasizing unprecedented (5 percentage points) reduction in the deficit/GDP ratio over 2009–2010, *i.e.* from 15.4% to 10.6% [ELSTAT 2011]. It also reiterates the government's responsibility for setting overly ambitious goals.

To conclude, the deficit issue acquires a new twist if the deficit/GDP ratio is adjusted by including in it public sector liabilities toward the private sector creditors. Accordingly, the best-case scenarios for 2011 see the size of the deficit at the level of ca. 8.6% of GDP. At the same time, in August 2011 the value of the public sector liabilities toward the private sector creditors reached €6.5 bn, which equals to 3% of Greece's GDP [Κακούρης 2011]. Had these liabilities been paid, the value of state expenditure would increase automatically, with corresponding effects on the deficit/GDP ratio.

4.4. On relevance of the measures employed

The crisis in Greece and the way it is dealt with has recently been discussed in the context of Europe's banking system and its fragility. Véron [2011: 2] argues that 'had western Europe's banks been in a better shape a year and a half ago, the policy approach to the Greek debt crisis would have been entirely different, possibly allowing for a much earlier sovereign debt restructuring'. The author goes on to depict that currently we are dealing with a twin sovereign and banking crises that 'mutually feed each other'. This approach to the question of relevance of measures employed to handle the crisis in Greece adds to the argument proposed here that the crisis in Greece was treated by the EU-level actors as if it was a crisis of the euro, whereby in fact it was a traditional domestic fiscal imbalances problem.

As a result of wrong treatment, possibly due to fragility of the banking system, this inherently domestic issue escalated and eventually generated real threat to the stability of the Eurozone. In other words, measures devised to help Greece in fact missed the roots of the problem. As such, they could not be effective. Moreover, by extending the specific assistance measures to the Greek government, unintentionally the EU-level actors might have actually sent a message to the market players that the euro was in trouble. In this sense, the EU-level actors have constructed the crisis in the Eurozone, i.e. by generating an unprecedented rescue package, and by casting shadow on independence of the ECB [Schubert 2011], the EU-level actors created very specific expectations concerning the follow-up of developments in the Euro area.

That the ensuing speculative attacks were directed at the remaining countries of the European 'South' is not surprising, considering that stereotypically (and wrongly) these countries together with their economies are treated as a homogenous group. (This stereotype was fuelled by discussion on the consequences of the global financial crisis.) The point is that irrespective of limited applicability of the European 'South'-stereotype, it fit in the broader logic attached to the assistance programme for Greece. As a result, a new wave of (negative) expectations concerning stability in the Eurozone and a possible default of one or more of its members was ignited.

Discussing the benefits of an early default over bailout that Greece received in May 2010 will not change the course of events. Nevertheless, as 'crises have always the benefit of shaking overconfident assumptions' [Csaba 2009: 468], it is imperative to reflect on lessons that the crisis in Greece offers. In specific, we should ponder on how the crisis in Greece may enrich the debate on EU economic governance in view of rendering this macroeconomic coordination framework more efficient in the future. It is also useful to reflect on how the crisis in Greece and the ways of dealing with it have impacted the European integration process in general. The following section deals with these broad issues.

5. The crisis in Greece: lessons and observations

The sovereign debt crisis in Greece created a momentum to reinforce the debate on strengthening EU economic governance. Weaknesses inherent in the Stability and Growth Pact (SGP) have long been identified, yet it was the crisis situation in the Eurozone that allowed a consensus to emerge about the relevance and specific measures of economic governance. Given the unprecedented mode and value of rescue measures initiated at the EU-level explicitly for Greece, it could be argued that Greece has received all the assistance that the EU could afford in 2010. However, recognizing the temporary nature of these measures, in September 2010 the Commission came forward with a set of proposals on strengthening EU economic governance [EC 2010c]. In parallel, far reaching institutional changes in the EU architecture have been set on track.

In particular, following revisions of the Treaty on the Functioning of the European Union (TFEU), €60 bn EU balance of payment facility has been created, the European Financial Stability Facility (EFSF) has been established and the European Systemic Risk Board (ESRB) has been set up. Simultaneously, three supervisory authorities, European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA) have been endowed with the task to oversee banking, insurance and securities markets. Finally, a permanent liquidity facility, i.e. the European Stability Mechanism (ESM) was set to replace the EFSF in 2013 [Young 2011: 11, 14]. In the meantime, in December 2010 the possibility of extending the EFSF maximum guarantee commitments from €440 bn to €780 bn was discussed. It was approved in July 2011, following discussions on the second rescue programme for Greece [EFSF 2011]. As of October 18, following the ratification process by the parliaments of the Eurozone member-states, the effective lending capacity of EFSF is €440 bn, secured by guarantees from the Eurozone member-states of the value of €780 bn.

The EU economic governance framework, the so-called Six-pack of reforms, as revised (including considerable number of suggestions from the European Parliament) and approved in September 2011, will strengthen the SGP, and by improving surveillance and enforcement mechanisms it will establish an improved economic policy framework in the EU. In essence, via the instrument of European Semester, the newly created framework will foster coordination of economic policy priorities and of relevant fiscal measures. This could lead to greater convergence of fiscal policies of the Eurozone members. Nevertheless, the institutional changes triggered in the EU by the crisis in Greece, only to a certain extent address the problems that this crisis revealed, including 'a major deficit of executive decision-making capability in the EU and euro-area institutional framework' [Véron 2011: 2], as well as the inefficiency of the existing framework to enforce lasting compliance with the fiscal policy requirements defined in the SGP. The broader implications of the developments in Greece on the Eurozone have also exposed the fragility of the banking system [Véron 2011]. This has been confirmed by recent pleas by the IMF managing director, Christine Lagarde, to recapitalize banks in Europe [Lagarde 2011]. Undoubtedly, further decisions are needed as regards the institutional design of the EU/Eurozone; also, the emerging broader macro-prudential framework will need to be adjusted accordingly. This may come somewhat easier today than in the past for the simple reason that the 'talk of crisis' is supportive of negotiating solutions that would be impossible to be reached otherwise.

That this may be feasible is also related to the fact that current institutional developments at the EU-level, triggered by the crisis in Greece and its consequences, have created a momentum for delineating the specific economic (governance) model that the EU seeks to embark on. This certainly resonates with a similar 'moment' on the eve of Eastern enlargement of the EU when the free-market economy based on free competition principle was embraced in the Copenhagen criteria of 1993. In this sense, it could be argued that the current crisis has (once again) forced the EU-level actors to address the questions about what the EU is and what it is for [Visvizi 2010b]. Decision-making capability, increased compliance, and ever greater coordination in the fields of fiscal policy and banking system are the top items to be addressed in this context. Similarly, the role of the ECB has to be discussed seriously.

Of course, the discussion on (the limits of) solidarity accompanying the crisis in Greece indicates that reaching consensus about the economic model and the EU's role in it is by no means an easy process. On a different count, what is evident in the way the crisis in Greece has been dealt with is that increasingly countries choose to resolve their specific domestic policy priorities through EU-level debates. The way the nature of the crisis in Greece was portrayed by Greek authorities, essentially equal to shifting the blame for the crisis from domestic to EU-level, and the way it was addressed by the EU-level actors, confirms it. In a similar manner, the controversial issue of collaterals for Finland highlights that bilateral agreements disregarding the EU-level institutions and intergovernmental deliberation are no longer an option to rely on. The same case suggests as well that by default rather than by force of regulative frameworks in existence, in the field of economic policy, the EU member-states are brought to negotiate, to reach consensus and to follow. It does not mean that the space of the politically possible narrows for the EU-member states. Though, it may be indicative of a new quality of the decision-making process in the hands of national governments exercised through new EU-level forums.

In other words, the infamous case of Finnish collaterals, to use Puetter's [2011] terms, is reflective of 'deliberative intergovernmentalism'. Specific to EU economic governance, the term captures gracefully the fact that 'growing policy interdependencies motivate more co-operative intergovernmentalism that relies on deliberative processes of policy co-ordination' [Puetter 2011: 15]. Accordingly, 'deliberative intergovernmentalism' is 'about the representation of national interests as much as about the search for collective policy responses' [Puetter 2011: 15]. It seems that the emerging macro-economic governance framework, in which prudential fiscal policy, conditionality, compliance and enforcement are meant to go hand-in-hand, will add to the relevance of the above observation, while 'deliberative intergovernmentalism' will enable improving the efficiency of EU economic governance.

Certainly at this stage it is too early to evaluate the emerging economic governance framework. First assessments of the European Semester instrument (in force as of January 1, 2011) suggest that several improvements would add to its efficiency [Hallerberg *et al*. 2011: 30]. Here the need for the Member-States to adapt to and to internalize the process is evident. Furthermore, the need for greater involvement of national parliaments and of the European Parliament is emphasized in the context of boosting legitimacy of the mechanism as well as in view of national governments keeping up with their political commitments as regards fiscal policy. Undeniably, these observations fit squarely with the specific problems that, as argued earlier, lie at the heart of the crisis in Greece and that have blocked the efficiency of the EU/IMF assistance programme until now. It remains to be seen how the lessons and observations that the crisis in Greece prompts will be employed in the debate on the EU economic governance framework in the future.

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Stanisław Kluza*

New Regulatory Architecture towards Safety and Stable Growth

Role of Regulating and Monitoring the Financial System in Strengthening the Financial Stability of the EU

1. Introduction

Works on the New Regulatory Architecture in the EU, which have been going on for a few years, will create a new legal order for the financial market at least for the next ten or more years. On the one hand, financial stability is a public good and requires state's active engagement. On the other hand, when state's involvement is too big,

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it goes against the rules of free market. The optimal proportion is needed. The search for the proportion is accompanied by a dispute between home and host countries as regards the scope of powers and responsibility for supervising local markets and international financial groups. Capital and liquidity parameters, as well as risk management processes remain the most important means of achieving financial stability.

2. Financial stability as a public good

Financial stability is a public good. The impact of the last global crisis has brought financial markets into the sphere of active interests of state. Looking back, it has not always been the case [Turner 2009; Kluza 2011].

While the definition of a public good is rather broad, one should stress some of its chief characteristics: consumption of the good by some individuals does not diminish its availability to others (non-rivalry), no one can be effectively excluded from using the good (or its benefits) (non-excludability), the necessity of state intervention if any serious disturbances occur. For example, banks that act rationally and maximise their own profit will not lead to the optimum level of social welfare. Additionally, their overall condition strongly depends on exogenous effects, and such phenomenon as moral hazard occurs in their decision-making processes.

Banks also act as private entities that engage their owners' capital, yet they are entrusted by their depositors with funds of much higher value. Consequences of bad management of their clients' funds may by far exceed the value of the owners' capitals. Moreover, bankruptcy of a given bank is not always caused by bad management. This sector is very dependant on external factors. When a serious crisis occurs, state intervention is necessary. For example, because such potential situations are anticipated, deposit guarantee schemes are created in order to increase confidence in the banking system.

Financial market is not entirely a private market.

Let's discuss it on the example of a grocery shop. If it is not self-sustaining, it will go bankrupt. The capital that the owners' invested in it will be lost and competition will gladly take over the shop's customers. It is even possible that the competition, due to increased turnover, will be able to slightly reduce the margin without changing its profits.

In the case of financial sector, such disturbances lead to opposite results. A bankruptcy of a financial institution means the loss of deposits for its clients. The level of trust between other economic actors is lowered. When it comes to banks, the interbanking market shrinks and becomes more expensive. The fact that financial institutions are interconnected results in greater danger of bankruptcy for other economic actors. If disturbances are of considerable size, the stability of the whole system is endangered (PFSA, V 2010). An extremely serious macroeconomic problem of the lack of financing in economy, and subsequent far-reaching negative consequences of that for the real economy, are the fallout.

State cannot remain inactive in the face of such a situation. Various methods are used to restore the patency to the system and the state tries to use institutional means to restore public's trust in it. In extreme cases the state has to use public funds.

State aid is nothing but taxpayers' money. When the state decides to support, for example, a bank, it is de facto weighting the social and economic consequences of such an action. In the case of the 'too big to fail' dilemma, it might be more profitable to invest public funds in saving the institution than to allow it to fail.

According to the most dangerous scenario, citizens who are unable to withdraw their deposits on a mass-scale create a risk of civil tumult. The loss of deposits affects, to a large extent, individuals who at no point had influence on the security of their funds. Moreover, the responsibility for keeping those funds secure is transferred to the state. Side-effects appear: economic trends are affected negatively (economic growth, job market, *etc.*), the cost of public debt service rises.

Should the state protect itself against such a scenario? Can the state protect itself against such a scenario?

It is up to the state to decide to what extent it should get involved in shaping the environment in which financial sector operates, as it is the state that is responsible for social and economic policy. This includes the decisions about both financial institutions' obligation in the area of stable management and the financial sector's participation in paying for the consequences of its ineffectiveness.

The first of these areas is commonly known as the 'regulatory corset'. For example, capital requirements, liquidity norms and new, stricter rules of rating creditworthiness all limit banks' lending. From the perspective of banks' profitability analyses, they are considered a cost. Yet, these are also means of protection against excessive increase of risk, whose coverage by capitals is shrinking. There is also a question about the proper scope of these regulations.

Theoretically, it is possible for a country to adapt very strict prudential norms. Unfortunately, too many regulations mean an increase of costs of financial sector's functioning, which consequently increases, for instance, the costs and availability of money in economy. Its shortage cools down the economy and can lead to weakening of the market rules in access to the sources of financing.

On the other hand, lack or shortage of regulations creates a temptation to attempt to get higher and higher returns on equity, while accepting the increased level of risk. In the long run, this results in creating malpractice in the sector whose responsibility for its financing is covered to a smaller and smaller extent by its equity, and one that accepts more and more risky ventures. Such a scenario allows for generating incredibly high profits when economic situation is good. The profits are then consumed in the form of dividends, bonuses and rewards. History demonstrates that only small parts of significant surpluses are used to build equity or to put aside for the period of economic downturn. 'Privatisation of profits' takes place. When lean years come, the too-riskily-managed financial institutions record substantial losses and not always have enough money to cover them. At the same time, they become a risk for the whole economy and for the functioning of the state. 'Nationalisation of losses' takes place. For example, among the most developed G–20 countries direct state aid for financial institutions amounted to 3.7% of their GDP in 2008 during the first phase of the 2009–2009 crisis. To compare, in Poland that percentage would amount to the sum of PLN 47 bn. The events of 2010 and 2011 show that the crisis is not over yet. According to the last estimates of the European Commission, the scale of total aid for all Eurozone banks reached the value of €420 million[1]. Situation in the US is similar. American banks have already received USD 432 bn from TARP (Troubled Asset Relief Program)[2]. The largest financial institutions in the world are among the majority of entities with the most significant problems (see Table 1). Both in Europe and in the US, all these funds come from taxpayers' pockets. Fortunately, no financial institution has gone bankrupt in Poland since the beginning of the crisis and none of them had to resort to seeking state aid.

It is the economic policy of the state that defines more precisely how the issue of 'financial stability' is to be understood and what its lack and consequences thereof mean. State can take an 'active' or 'passive' approach, that is, either efficiently make firm decisions or remain merely an observer.

1 The above mentioned amount does not take into account €1.4 bn of the proposed fund that would be created in the Eurozone for the purpose of preventing mass bankruptcies of banks resulting from the controlled bankruptcy of Greece. There is also a possibility that this sum will be raised, if it proves insufficient.

2 The limit of TARP's budget was about USD 700 bn.

Table 1. The scale of sample state aid for the largest financial institution between 2008 and 2011[a]

Name of the bank	Amount	Comments
AIG	USD 182 bn	Total sum from several tranches since 2008.
Royal Bank of Scotland	GBP 45 bn	The highest amount of individual aid in the EU.
Citigroup	USD 45 bn	The above mentioned sum is merely the amount of aid from the US government. The outlays from state investment funds were not included.
Bank of America	USD 45 bn	Public funds received for the purpose of saving Merrill Lynch (taken over by the Bank of America).
Anglo Irish Bank	€30 bn	
JPMorgan Chase	USD 25 bn	
Wells Fargo	USD 25 bn	Public funds for the purpose of saving Wachovia (taken over by Wells Fargo).
ING	€10 bn	
Credit Suisse	CHF 10 bn	
Allied Irish Banks	€7 bn	BZ WBK, a subsidiary of Allied Irish Banks in Poland, was sold during restructuring of the bank.
Dexia	€6 bn	The estimate amount for 2008 only. Later Dexia was divided into French, Belgian and Luxembourgian parts. More support was given, as well as state guarantee for €90 bn.
UBS	CHF 6 bn	

[a] Despite significant scale of state aid only in very rare cases were so-called foreign assets sold as a part of the process of cleaning up the financial group.

Source: http://finanse.wp.pl/gid,13953755,galeria.html?ticaid=1db52

In the first case, financial stability is defined as a continuous state which cannot be disrupted and which can be a subject to state's regulatory intervention in any situation that might endanger it. In the second case, the state might hypothetically put itself in the shoes of an observer who is especially vulnerable to the negative effects of disturbances on the market. It should be noted that as far as financial sector is concerned, financial stability cannot be narrowly understood as a short-term state of market equilibrium, which changes dynamically from period to period, thus establishing new forms of market equilibrium again and again. In this case, the notion of market equilibrium does not necessarily have a lot to do with the stability of the financial sector.

The state can formulate the rules of this game: hard rules (statutory), as well as soft ones (in the form of recommendations). There is a possibility of transferring personal liability for the situation on the financial market to the managing board, as well as increasing the scope of capital consequences for the owners. It is also possible to collect an 'insurance premium' of sorts for the purposes of dealing with future bankruptcies in the banking sector. So-called 'banking tax' solution can be used for this purpose. It doesn't have to be a type of levy or fulfil any fiscal function. It is collected to be used in the future when bankruptcies or periods of instability occur. It is a substitute of an accident liability insurance, insuring the banking sector against accidents that occurred with no fault of the banks and were not the results of bad management. State would have the power to use the money from this fund to cover the losses and consequences brought about by banks' bankruptcies without having to use any public funds. In the case of such a solution, it is extremely important to define the right insurance premium calculation base, as it may be another factor lowering the risk level in the financial sector.

In practice, when public trust entities go bankrupt, a state that does not have such a fund still cannot avoid taking action, which undoubtedly will not be possible without engaging public funds.

When one compares historical results of the financial sector with other sectors of the economy, it can be seen that they were characterised by long periods of above-average profitability. The same was true in the case of salaries of executives of financial institutions, but to an even greater extent. The following question arises: what was so special about this sector that it was so generously rewarded for its function as an intermediary in the collection and relocation of funds? This high level of reward was not connected with adequately high added value, and no special skills or complex knowledge were necessary to conduct such activity.

There are more branches in the economy that deal with providing public goods, for example, energy, water, health services, telecommunication services, and many others. In great many cases these services are provided by private entities. State privatises them or allows for creation of companies conducting such activities assuming that the market rules will lead to a decrease in the costs of the service. It will result in a creation of a more efficient market, leading, in turn, to an increase in economic development. This is why state withdraws itself from state monopolies or significantly restricts their scope.

Financial intermediation is crucial for the functioning of the economy. Theoretically, the state could create a very limited private financial sector, wielding influence over the key players in this sector. Yet, the balance of costs and benefits is in favour of market solutions, ... as long as we do not include the costs of public support for failing financial institutions in the analysis. This applies especially to those among them that are 'too big to fail'. In their cases the cost of bankruptcy for the state would be higher than the consequences of investing public funds in the process of rescuing them.

In the search for optimal solutions, one can formulate a set of issues that need to be settled. Should state be the owner or manager of key institutions in the financial sector? Should state prevent the formation of entities that are 'too big to fail'? Shouldn't state, after offsetting the benefits of the financial sector during the boom of the later consequences of public assistance, establish key security factors and later enforce them?

Security is a cost, but it brings aggregate benefits in the long run. It means that providing banks with capital is a cost for their owners. The same can be said about the fulfilment of liquidity norms and the increased diligence in the process of checking creditworthiness (which additionally makes the process lasting longer). However, the latter factor fairly quickly brings benefits in the form of a better credit portfolio and lower overall costs.

Lack of well-organised regulatory architecture for the financial system in the EU generated an enormous capital shortfall which would have been at present necessary for covering the losses resulting from banks' bad investments and engagements. The results of stress tests and the autumn estimates of the EBA for the key European banks indicate that the shortfall is no lesser than €100 bn. Much bigger amounts appear in private sector analyses (see the chart below). Credit Suisse estimated that the capital shortfall amounts to €400 bn.

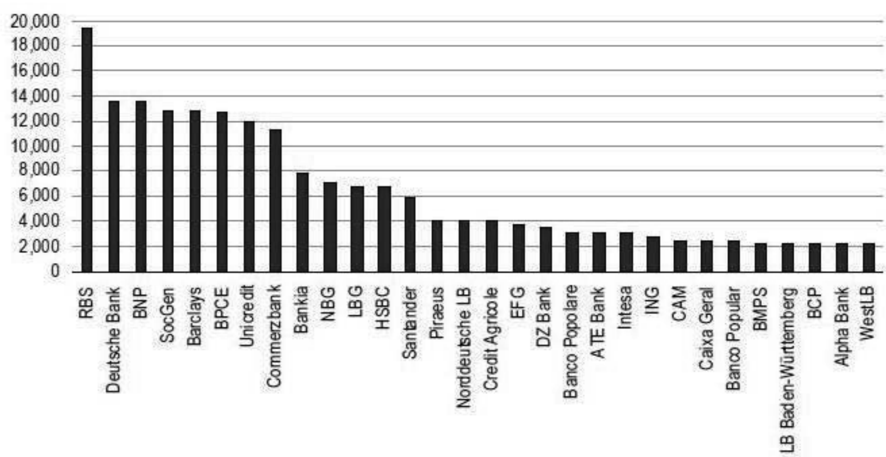

Chart 1. Estimated capital shortfall under the new EBA stress test (9% min. CET1 ratio) (in million euro)

Source: European Banks: Equity Research Report for Credit Suisse, October 13, 2011.

3. Regulatory discrepancy of interests in the EU

27 Member States of the EU can be categorized for example in terms of the recent history of their economy. Ten out them[3] represent economies which, following World War 2, for over 40 years were centrally planned. Normally, there was no financial sector present there like it was the case in other market economies. With the arrival of market reforms in 1989, it turned out that there were no banks, insurance companies or other entities in the field of financial services functioning there. Not only legal solutions and institutions were missing (which theoretically could be created overnight), but most of all there were deficiencies as far as capital, human resources and know-how were concerned. Each of these elements determined the effectiveness of system changes. This crucial development gap could be counteracted either through attempts to considerably stimulate long-term organic development or to invite foreign entities with their experience and resources which could substantially accelerate the process. The latter solution proved more appealing from the systemic perspective. Thus, in the 1990s, foreign capital entities obtained the dominant share in the financial systems of countries which were undergoing system transformation. These states were called 'the New Europe'. For example, foreign capital share in the banking sector in this region exceeded 70% [De Larosière 2009; Kluza 2012], whereas in some of the countries in question it reached up to 100%. This was the case for instance in Estonia. Growing involvement of foreign capital in the financial sector of 'the Old Union' states ensued in several ways: through participation in privatization, through acquiring private enterprises or starting green field investments.

From the economic point of view, the expansion of international financial institutions in a rapidly developing and, at the same time, economically and politically safe region was attractive. Also, shareholder mechanisms in the form of subsidiaries or branches had a sufficiently proven track record.

However, in the course of 20 years of the transformation process and then following the EU accession of, among others, the 'New Europe' states, what was observed was a polarization of EU Member States in terms of the so called supervision

[3] Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Romania, Bulgaria.

criterion. Old Europe states have become mostly the so-called 'home countries' for financial sector capitals[4]. Whereas the 'New Europe' states obtained the status of 'host countries'.

In the times of prosperity, the expectations and interests of home and host states were convergent as the former strived for the greatest expansion possible, whereas the latter did their utmost to attract foreign investors to capital-thirsty markets in the time of accelerated progress and system changes. Still, the climax of the process is over and at the same time the 'Old Union' states need to confront with the growing impact of the financial crisis whose first signs become visible in the second half of 2007.

The financial crisis did change many more rules of the game which in the previous years had not been so explicit. First of all, the first crisis symptoms to a variable extent affected those who used to actively invest on emerging markets because of the situation shift on the home market. For many companies this was the time of consideration which markets to withdraw from and where to focus on profit generation instead of further investing. Back then, supervisory bodies in home countries also realised the range of risks related to home supervision policies applied to home entities – the policies which were not always sufficiently prudential. In the face of 'profitable', but not entirely safe bank portfolios it became difficult to maintain financial safety in numerous Old Union states. The size of financial sector in the old EU against GDP sky-rocketed. However, the problem was the real value of those assets and securing their financing. But in the meantime, with the arrival of the crisis, people started to search for most beneficial ways of withdrawal from certain investments or modes to transfer risks and costs to the countries which in the earlier years had not been involved in home financial institutions.

The potential range of problems that European financial institutions were faced with required far-reaching and thorough steps to be taken across the whole EU. Therefore, European Supervisory Agencies (ESAs) were established and works started on directives to increase the security of European financial system. In the place of previously functioning third pillar committees dedicated to banking, insurance and capital markets, three European sectoral agencies were created. The establishment of ESA met with a consensus of EU Member States. However, in reality this acceptance was not full. ESA were not given clear competences and a power to act. This deficiency

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[4] There are some exceptions to the rule, for example with respect to the financial market segment: banking, insurance *etc*., or with respect to the role of a given financial market on the global financial market, for instance Great Britain and London or Luxembourg.

resulted from various outlooks on the role of ESA. Home countries believed ESA should strengthen the steps to limit host countries supervisory bodies with respect to financial groups. On the other hand, host countries insisted ESA should contribute to better information flow in complex financial groups and in the future it should most of all deal with a general European supervision of internationalized financial institutions. In practice, this would mean that the influence home countries can exert on the largest financial institutions as far as European structures are concerned, would decrease [Kluza 2010].

Moving the supervision over financial groups to the European levels can naturally evoke objections of the leading EU Member States. After all, this is against national interests of the countries which, until then, had been making use of their privileged position enabling them to influence the situation on various markets. For instance, allowing the EU banking sector to acquire the astronomical public debt resulted from the symbiosis between financial institutions and the political circles in power. As a consequence, indispensable systemic reforms were delayed in a number of EU Member States. Deficiencies and problems were only seemingly solved as the debt kept rising. It was easy to find debt buyers. At the same no attention was paid to the fact the maintenance of the high ratings for the debt.

But there were more weak points to be found in the domain of analysis, statistics or methodology. For many years, across the supervisory forums and expert debates the view had been promoted that with a more extensive range of activities and more internationalization the security of financial activity increases. To prove this point the following argument was frequently used: scale effect levels some volatilities and distortions better, whereas from the statistical point of view diversification allows for the so called negative correlations of some assets which theoretically makes them resistant to future unstable market situations. Unfortunately, this approach has many flaws. First of all, levelling the effects of random volatility is beneficial in the situation of general prosperity and provided that balance sheet components are 'fundamentally healthy'. In the case of crises or 'big subprime portfolios', especially if of global dimensions, the risk goes up both at the local as well as at the international level. Second of all, negative correlations of rates of return regarding particular assets only mirror their historic behaviour. This behaviour especially concerns long periods of stability. In the event of sudden and deep crisis-like distortions many of these correlations 'stop working'.

Simultaneously, a new type of risk emerges: the 'too big to fail' risk. It refers to institutions which are just too big to fail, as the cost of their bankruptcy would have more dire far-reaching economic consequences for particular states then the situation in which the states decide to protect them using public money. In practice, this accounts for non-market protection at the cost of the tax-payers.

When operations scale increases, also the risk structure changes. To put it simply, big players are no longer market players but they become market makers. The debates in the past had the following deficiency: no one balanced all benefits and costs. Only the benefits of scale and the effect of statistic negative risk correlations were perceived – and exaggerated. No estimation was conducted of potential impact of big international financial institutions going bankrupt. In reality, it might turn out that the benefits in terms of risk related to globalization and the associated diversification are incommensurately smaller than the risks connected with big financial corporations falling into crisis.

With respect to this issue, it is especially worth to pay attention to the EU debate on Capital Requirements Directives (CRD IV), EU mitigation framework and crises management in the banking sector, as well as on deposit guarantee schemes. The events of the last two years have demonstrated numerous deficiencies of the European regulatory and supervisory system. In the face of these dire experiences steps were taken to improve the current system, increase the stability of financial market and the security of its participants. Unfortunately, solutions suggested in various directives raise many doubts.

The solutions suggested in the Capital Requirements Directive which aim at averaging of capitals and liquidity at the group level consist in the acceptance of lower security levels. The averaging mistake has wide-reaching impact. It does not allow for earlier fishing out of weaker entities. It gives the impression that at the level of financial group everything is all right, which results in the fact that crisis situations evoked by single entities come even more surprisingly. Less transparency and a mandate to slow down the recovery of weaker entities are not conducive to good crisis management. And what can prove even more crisi-genic are the consequences of deliberate capital resources and liquidities allocation with a view to maintaining on particular markets for instance lower capitals, accepting aggressive development models (which brings considerable profits in the times of prosperity) and subsequently leaving weak and dysfunctional companies to the local tax payers. This undesirable business model could be achieved if the directive suggestions had been enforced in the field of cross border crisis management in the banking sector or in the case of defining group's interest as more important than the company's interest. These ideas are partly based on the introduction of the notion of 'group's interest' from the perspective of the home country interest. As such, it is disadvantageous for host countries. According to the new suggestion the *arm's length* principle would be abandoned and the same would apply to transactions standard. If the principle was suspended, transactions between entities which belong to the same group could prove disadvantageous for one party and so the market rules would be abandoned. Such a transaction would be justified as acting in the group's interest. The implementation of this suggestion requires the permission for free asset transfer within the group at the stage of early intervention. Such transfers shall be possible thanks to amendments of commercial companies law, law on bankruptcy, civil and banking law and accounting rules. However, national supervisory bodies would not be able to block asset transfer carried out by the entity subject to its supervision. Owing to this idea, liquidity shall be provided for particular entities in the group in terms of assets allocated in subsidiaries in other jurisdictions. Presumably, this idea could create favourable conditions for the spread of contagion effect and could move the fiscal costs of bankruptcy of a given entity to a different country.

For some time already, home countries have been trying to enforce the idea of crisis mitigation in the group by introducing the notion of lead supervision which would coordinate the supervision over entities which compose a group. Another idea would be to pass these competences to the EU level. At the stage of recovery proceedings and liquidation, the home supervision or another EU body would manage the whole bankruptcy estate of a given group. It is doubtful, however, that in this process sufficient attention would be paid to the interests of host countries or minority shareholders of respective companies which belong to the group. The European Commission's proposal does not contain any idea of the equal cost division of a banking group bankruptcy. Therefore, it seems obvious that this is a political solution that at the end it will provide liquidity to mother companies and transfer the costs of potential crisis to host countries.

In order to build new supervisory architecture it is necessary to maintain balance between the transferred competencies and the responsibilities for decisions made. Currently, in the event of a financial institution going bankrupt, financial consequences are incurred by the competent national guarantee funds which are financed by national entities or directly from the budget – if there is systemic justification for the necessity to keep an institution operating. Only later can the accounts be squared with the mother entity or the mother entity state. As long as the EU institutions do not take over the financial consequences of bankruptcies among financial groups, local supervisory bodies should have the competence first of all to set and execute capital requirements with respect to second pillar which will allow for keeping a safe level of capital in the supervised entities thus creating conducive conditions for their safe and stable development.

It is also the case that local supervisory authorities have more knowledge on specific nature of local banking sectors and entities operating in them. Passing important competencies in this field to institutions unaware of this specific character of the local market and using the same yardstick for all member states can affect the supervision quality. Moreover, asset price cycles and credit expansion processes vary across the Member States. Therefore, it is not uncommon that certain supervisory measures such as anti-cyclical measures need to be taken in host countries at different times than in home countries. This means that local supervisors can be deprived of the possibilities to take efficient steps attuned to the local market situation.

Irrespective of the scope of the consequences, the sources of crises are of local character. If at each state level the financial sector works smoothly, also at the aggregated level (European or global) no problems will be observed. From this perspective European solutions should be directed at setting clear minimum standards but excluding any potential external interference in case any country desired to impose on the financial sector more prudent parameters in a situation when this could be justifiable with respect to a given economic situation or the financial sector condition.

Another behaviour associated with groups of systemic importance is moral hazard. Systemically important financial institutions are aware that some countries are held hostage by them. In case these huge entities went bankrupt, the social and macroeconomic impact would be so vast that such countries prefer to prevent their bankruptcy even with help of tax payers' money. Unfortunately, the problem with the suggested directives is that they do not propose any solutions which would deter from establishing such huge entities. Furthermore, some solutions proposed affect competitiveness of smaller market participants.

4. Supervisory policy tools

The experiences gained during the recent financial crisis as well as other crises in the past prove that the idea of financial market self-regulation is an illusion. Financial institutions are prone to self-restraint and consideration only in short periods of the heights of crisis situations. They are to some extent hostages of their clients and of potential institutional assistance of the state. In such a situation one can observe a surge of risk aversion or even concern for each client. Most financial institutions apply more precautions than expected or recommended by the supervisory bodies. On the other hand, whenever a sign of recovery on financial markets arises, the willingness to self-regulate evaporates. Supervisory standards turn into a straightjacket which the financial sector tries to get rid of whenever possible. Then, any appeals from the supervision for self-regulating measures in the financial sector are quite futile. At the same time excessive expansion and financial products bypassing prudential recommendations of the supervisory bodies lay foundation for future imbalances and crises. Unfortunately, during prosperity periods the prevalent rule is: worse money supersedes better money. The banks which adopted more conservative approach to risk management are pushed out of the market by the more expansive ones. Frequently, they need to protect their market position by replacing some restrictive standards with more lenient ones. A good example could be growing the struggle for market share in the field of currency mortgage loans or consumer credits.

And it is the responsibility of the state, and in particular of financial market supervisory bodies, to introduce and execute principles of prudential functioning of financial market institutions. It does not mean that the supervisory authorities should not be consulted or informed of actions taken. Still, the state whose executors are supervisory bodies should act in a sovereign manner. After all, potential economic consequences of financial institutions going bankrupt will affect tax payers.

Practices worked out and consolidated by the Polish supervisory authorities in the course of the last several years can be judged as conservative. In this period there took place also the evolution from the supervision of 'compliance' type (with the regulations) to 'risk based' type of regulation (based on risk identification). In practice, compliance with regulations (following the law) is prerequisite but is not sufficient to create stability on each local financial market. Contemporary supervisory methods are more and more oriented on risk identification and mitigation. What can be observed is the growing importance of supervisory activity from the inter-sectoral perspective in the face of internationalization of markets and financial institutions as well as the development of financial holdings and cross-sectoral financial products. Also, intersectoral transmission channels of risks between market segments are becoming more and more significant [KNF V 2011]. With the identification of this factor, integration of supervisory activities in each country acquires importance. Also in Poland this was one of the arguments raised in 2006 which laid foundations for merging of supervisory bodies and creating the integrated Polish Financial Supervision Authority. The role of supervision in Poland became even more pressing with the EU accession. Back then a considerable increase of foreign currency indexed loans was observed. One may not simply ban them, as this would infringe EU free market principles. On the other hand, NBP interest rates channel is less efficient as it used to be a couple of years ago. Therefore, the scope of lending campaign and money supply to some extent grew independent of NBP policy. What is left is the prudential aspect. Only through supervisory tools can the excessive expansion of currency loans be limited. This expansion could namely threaten not only single borrowers and banks but also the stability of the whole economy.

There are numerous mechanisms of exerting influence on the financial sector through supervision. The main source of lawmaking are acts and ordinances. Nevertheless, Polish Financial Supervision Authority can adopt resolutions, recommendations or sets of best practices. Influence can be also exerted through direct supervisory recommendations or open letters. Some of them can even take the form of well-meaning hints. The effectiveness of these tools depends on the level of trust towards the supervisory bodies. And the trust depends on the transparency of the supervision and on the same rules applied by it for all market participants.

Recent history has shown that the conditions of financial sector functioning can be enhanced even during the crisis. For example, in 2009, encouraged by the office of Polish Financial Supervision Authority, banks suspended the issuance of dividend for 2008. This was not a mere psychological move. The solvency ratio in Polish banking sector was declining in the long-term and at the end of 2008 it fell below 11%. Non-issuance of dividend and supervisory activities undertaken to create a capital buffer allowed to effectively bring the process to a halt and to reverse the trend. Moreover, in the years of the crisis, they allowed for increasing the solvency ratio of the banking sector to almost 14%.

However, there were additional benefits of reaching high solvency ratio in the years of economic decline and bigger risk as the capital reserve created for example opportunities for maintenance and development of lending campaign.

Another success of the difficult year 2009 was PLN 17 bn of external funding gained by Poland. Simultaneously, the phenomenon of financing foreign mother entities by national subsidiaries was not observed.

With respect to the supervision philosophy, the liquidity standards debated currently in Basel and the EU are in many instances based on the Polish solutions. Direct requirements with respect to liquidity were introduced in Poland in 2008. Their presence made banks realise the importance of this criterion. And given the possibility of daily reporting of liquidity parameters, they had to adopt such resources management policies that in fact left the Polish banks much better prepared for the crisis than the institutions in other Member States.

For many years the policy of supervisory recommendations has proved to be an efficient form of dialogue between the supervisory bodies and the banks. They are especially significant in the field of risk management which is not thoroughly regulated and clarified in terms of acts and ordinances. Wide range of recommendations from A to T covers most areas connected with the security of banks. For instance, according to recent recommendations S and T, banks should improve the process of creditworthiness check [KNF VI 2011]. Also, quality and quantity standards for retail clients have been introduced. Their role is to protect both the banks from accumulating risky portfolios but also the clients from remortgaging. In case of the Polish market there was also the problem of seeming attractiveness of foreign currency loans which is why there was considerable expansion of this type of credit after Poland entered the EU. Consistent policy of recommendations building in the field reduced this risk.

There are many steps taken at the EU level with a view to raising security of financial sector. For example, stress-tests linking management remuneration with financial results in the long-term perspective. Yet, in practice only national implementation of best practices can bring about the expected results.

The first European stress-tests for banking sector provided evidence for its huge crisis resistance. However, as soon as a couple of months later minor problems distorted the security of certain banks. This undermined the trust to the sector and credibility of previous studies. Against this background it becomes visible how important local supervisory bodies are in order to create individual stress-tests in the financial sector (especially with respect to banking sector). The work conducted by local supervisors dispels unintelligibility resulting from for example aggregation and standardization of data among countries. Moreover, local supervisors take into account specific characters of their markets and can better define their problems. Being closer to the entities subject to supervision, they can do a better parallel use of stress-tests as a tool to raise the quality of risk management and the banking sector risk awareness. This exercise conducted in Poland in 2010 brought about measurable results in terms of risk modelling.

In 2011, criteria were adopted in Poland relating to management remuneration in the banking and investment sector in the course of implementation of acts passed previously at the EU level. Nevertheless, implementation of directives implies some leeway as to how they will be adjusted to local conditions.

In particular, it should fall within the supervisory body discretion to set all the requirements with respect to anti-cyclical activities. There are no two identical economies and so each levelling solution will be always mistaken as to its efficient implementation. Not only anti-cyclical steps are important but also other specific determinants of local financial markets. These include, for instance, adequate financial leverage, mismatch of timelines between short-term liabilities which finance long-term assets or the separation of traditional banking from investment banking. The local character issue does not apply only to the banking sector. In the field of insurance activities works are being conducted on Solvency II and the creation of optimum internal models with the consideration of operations on market in various countries. In case of Poland lower risk in the sector through the introduction of more diversification of allocation policy of liquid assets in the banking sector.

5. Conclusions

In order to maintain financial stability at regional level or at the whole global economy, it is crucial to maintain stability at the level of each country. Given the existence of vital differences among macroeconomic parameters, and in particular among the local specific characters of business cycles, only local supervisory bodies are able to make use of certain supervisory policy tools precisely and in a timely manner. What needs to be kept in mind while creating prudential standards in the financial sector at the international level is that they need to be conceived as universal minimal requirements. On the other hand, each national supervisory authority should have the competence to impose complementary capital, liquidity or risk-management requirements which are attuned to current macroeconomic situation and the state of the financial sector in a given country.

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Part III

REGIONAL DEVELOPMENT IN EUROPEAN UNION POLICY

Danuta Hübner*

Regions in the New Financial Perspective 2014–2020

We cannot discuss the role of the regions in the Multiannual Financial Framework 2014–2020 in an abstract. The European Union is undergoing one of the most severe crises in its history. As the old saying goes: 'What does not kill me, makes me stronger'. I hope this will be the case now, for the level of spending on the regional policy, as one of the largest portions of the budgetary pie, depends to a large extent on the overall health of the Union as it emerges from the crisis.

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The Union has to manage the crisis, coordinate the adjustment needed at the level of Eurozone and Member States and reform its economic governance to reduce the risk of future crises. We have not prevented the crisis from happening, so at least we have to do our job in exploring what went wrong. We discovered that the EU budgetary surveillance mechanism did not reflect the real situation, the enforcement of fiscal rules failed, non-fiscal risks were not monitored when important decisions were needed urgently, lack of clarity with regard to bailouts persisted and lack of fiscal coordination undermined market confidence. Member states did not take advantage of good times to generate sufficient fiscal space for the bad times. Fundamental reforms of the Eurozone system have become urgent as it has become clear that the problems go much deeper than sheer enforcement. But fundamental reforms are always difficult. And, as usual, when it comes to addressing fundamental questions, crisis has helped.

Despite the fact that the latest data are telling us that Europe is slowly emerging from the crisis, there are still many threats that we have to cope with today. The threat of a sovereign contagion is still looming around the corner, despite our rescue packages for Member States in need. All will be well, as long as we can contain this situation with the stability mechanism, but we should be looking towards long-term solutions that will not only solve the current problems, but also prevent future crises of this nature.

What is important here in terms of the impact on regional policy funding is that there are underlying discrepancies in terms of economic situation in the euro area. There are economies which grow dynamically and these are rather rich economies. On the other end there are mostly poor economies that are confronted with austerity packages and unsustainable debts. This makes it rather likely that the crisis will draw a new map of European economy where the gap between the rich and the poor will be widened. The truth is that not only growth rates are less favourable in case of those more strongly affected by the crisis but that they also suffer from more severe adjustment difficulties.

The challenge of a two speed Europe and a growing divergence is real. It does not come as surprise that the crisis has pushed policymakers' attention to debts, fiscal austerity and governance reforms. But sustainability of reforms and debts depends on whether Europe will be capable of restoring growth. Europe is currently faced with an evident growth deficit. As the lack of growth comes in the moment of austerity imperative, the question that we therefore have to address is how to finance the growth that Europe needs. It will not suffice to finance growth that will merely take Europe back to pre-crisis levels of GDP. Growth in Europe will have to be supply-driven, based on structural change and productivity gains and delivering a more competitive economy. The unfortunate fact is that national budgets have been cut, and they will face further cuts in the near future as a result of budget consolidation imperatives and in order to ensure the long-term sustainability of public finances that is necessary to ensure growth in the long term. It is easy to say that fiscal austerity must be implemented in such a way that it does not undermine the long-term capacity of the European economy to create growth and sustainable jobs. It is more difficult to do it. In the face of national budget cuts, there is also a serious risk that governments may first of all look to cuts on education and research budgets. Since European universities are predominantly funded through national budgets, this would severely reduce Europe's capacity for technological development and innovation and therefore its medium and long-term economic growth potential. This would for obvious reason increase the knowledge and innovation gap between Europe and the US.

In this situation an important role as a public source of funding growth will, have to be played by the European budget. The EU budget, in particular the multiannual financial framework for after 2013 will by no means, become a fund of last resort for EU investment needs, because it is too small. Practitioners also know that for any investment policy to be effective, efficient and result oriented, a critical mass of funding is essential.

Therefore, decent, adequate funding of European policies through the EU budget is a precondition for full use of their potential and achieving their full impact. Again, as in the case of national public funding, the EU budget catalytic role, its quality and its leverage function will have to be ensured. Its new role should be the one of coordinating funding available for some policy areas through different financial instruments, creating additional synergies. The challenge of careful selection of priorities for public funding through identifying market failures in the current financial context and growth priorities will have to be taken into account more than ever in making choices on growth policy.

Funding from the EU budget should therefore focus on policies that, in a measurable way, contribute to the achievement of objectives and interests of the Union, strengthen integration and cooperation in Europe, ensure the application of European law, relate to important aspects of EU citizens' lives, engage and use well the potential of civil society, strengthen European institutional capacity, improve the Union's territorial cohesion, promote mobility, promote mutual learning, prevent development disparities, and work towards economic, social and territorial cohesion.

With regard to public funding, ensuring the highest quality of spending will be instrumental, as well as using it to influence changes in investment patterns. Exploiting fully the catalytic role and the leverage function of public funding, including through public procurement and public-private partnerships will be essential. Europe is in need of large amounts of investment in transport, telecommunications and energy infrastructures.

All EU member states, not only those in the Eurozone, will require huge volumes of financing in the years to come. Governments, regions, municipalities will have to borrow large sums both to pay debts and to grow. The task is to get the confidence of markets back, to convince those who make investment decisions that they should invest in Europe. Poorer countries with adjustment problems and unsustainable debt resources needed to boost growth are in particularly difficult situation with regard to the availability of resources needed to finance growth and restructuring. It will take time till private sustainable financing will be available. Therefore, the question whether and how the growing divergence will influence European politics is legitimate.

It is in this context that the role of regional policy as a multifaceted mechanism to reduce the disparities in development is especially important.

Sometimes it is necessary to remind ourselves that regional policy is not an accidental allocation of structural funds by a sort of a chance, but a long-term, well-thought out and finely crafted European investment policy. Its unprecedented added-value is its multi-level nature which makes possible a mobilization of human, material and organizational resources on all level of participation and governance: European, national, regional and local. It also function as a bridge for clustering all types of partnerships between public institutions, government agencies, civil society, as well as business and scientific communities. This is a uniquely European formula that has assured the success of the EU and is being replicated now in other parts of the world, even China and Russia.

As I said before, Europe is in need of growth. In order to be sustained, growth must be built, first of all, on confidence in the existence of a reliable consensus concerning the need and value of the regional policy as one of the primary instruments of pro-development policies on the EU scale.

We also have to think of growth in an innovative way – as a good combination of existing and new growth factors, based on a comprehensive strategy of smart specialization as a way of mobilization of local development potential. This should reflect a sound analysis of the assets of the regions and technology foresight studies. This would, in turn, help avoid unnecessary duplication and fragmentation of EU-wide efforts.

Also, there is another potential problem looming on the horizon: if we introduce a strong thematic concentration with a limited number of priorities it might become difficult to design the right policy mix to unleash smart growth that concentrates resources on areas of comparative advantage in a given territory. Smart specialization needs to exploit regional diversity and it needs a certain room for manoeuvre. We have to be careful to do it in such a way that thematic concentration will not lead to the situation where several regions decide on the same type of specialization, as dictated by any current concept.

When it comes to MFF, the controversial issue are macroeconomic conditionalities. In my view they can become an obstacle and a source of legal turmoil, especially concerning the middle of the programming period. We touch here on the idea of Europe that we want to create in the post-crisis period: do we want it to be built on a foundation of strict punishments? It has to be said clearly that macro-sanctions are counterproductive and unfair, even more so when approached from the perspective of 'territorial dimension'. Its unintended consequence would be that although its goal would be to punish misbehavior on the national level, suspending founding will have the most direct negative impact in the regions. The most reasonable way is to directly link the conditionality measures to cohesion policy implementation. They should be determined in dialogue with member states and regions. It is a principle that is supported by a resolution of the European Parliament of July 5, 2011.

In the negotiations on the MFF , the impact assessment of regional potentialities for growth and development and the territorial aspect should be taken with an utmost seriousness. The most desirable outcome of the negotiations under way should be a reformed cohesion policy that is able to respond effectively and timely to the need to boost growth, while employing an inclusive approach for specific territorial advantages.

We have to become more and more aware of the fact that there will be no sustainable growth without investment. That brings the issue of how to fund it. At the end of the day it is the private capital that generates growth but there are moments when it is indispensible to look anew at the role of public spending, its leverage power, its catalytic role, and its confidence building function. In this context, as we live the time of national budgetary cuts, the role of the EU budget becomes pivotal.

We need the new MFF to be both the source of smart investment policy funding and a mechanism pushing European policies toward modernization and effectiveness.

We all agree that the next MFF must generate a strong European value added, financing growth-generating policies that measurably contribute to EU goals and interests, that strengthen cooperation and standards, that are concerned with fundamentals of citizens' lives, that enhance and use the potential of civil society, that improve institutional capacity, contribute to economic, social and territorial cohesion, increase mobility and are conducive to the process of learning from each other. This is exactly what European regional policy is about and cares for.

The MFF should not be a self-standing object of political bargaining in an intergovernmental context, but a basic part of an integrated approach to EU development as annunciated in the overarching goals of the Europe 2020 strategy: making smart, sustainable and inclusive growth a key to the EU's future.

The European Parliament approaches this in exactly such a way, and thus it is particularly important that it plays an increasingly important role in the decision-making process that is ahead of us and which will be decisive for the European economy's capacity to get out of the crisis strengthened and competitive in a sustainable way.

There are two strands of the decision process at the level of EU institutions.

One is the MFF, the other the regulatory framework for policies to be financed from the EU budget. These strands have a very complex relationship. You may boil it down to the empty brackets we will have in separate form waiting for the friends of presidency, the group negotiating the MFF, to give us figures.

On the MFF, let me say that there is a formal procedure as described in article 312 of the Treaty on the Functioning of the European Union. It says that the Council decides by unanimity and the European Parliament gives its consent. But the experience of the first two years of the reading of the new Treaty has clearly enhanced the political role of the European Parliament in decision making. For the MFF, a special committee was established ('SURE') which worked for a year and adopted its view on the 2014–2020 MFF ahead of the Commission proposal. It has not only expressed the view of the Parliament on the size of the budget but also on how to further modernize it from the point of view of its European value added and its effectiveness. It has offered major lines on reforms needed in the regulatory frameworks of individual policies. Negotiations of the financial framework for 2014–2020 and the regulatory framework will proceed in a parallel way. Decisions will be interdependent, most likely the slowing down factor will be the financial one. Nevertheless, the commitment of the Troika, Poland, Denmark and Cyprus, is to complete both processes by the end of 2012.

The time of the crisis is on one hand a time of severity, of limiting our expectations, but at the same time it can become a moment to seize an opportunity for mobilization and effective use of all our resources. We have to re-balance our thinking between the necessity of making the public finances healthy in EU member countries, and leveraging pro-investment and pro-development resources for growth. This is why looking at the European budget exclusively though the glasses of Finance Ministries is not the best way to progress. If we want to emerge from the crisis with a globally competitive European economy that meets the criteria of Europe 2020, we have to look beyond the simple accounting. The 'anorectic' economy is not the path that will lead us to success. The robust growth that we need fast will be mostly generated on the level of the regions. The new MFF and the new legal framework for cohesion policy should be accessories to achieving that growth, or at least should not stand in its way.

The responsibility of the European Commission and the European Parliament is to assure that in January 2014 regions can begin the realization of the new programs on a level of funding that will meet their investment benchmarks and long-term development goals.

Willem Molle*

Competitiveness, EMU and Cohesion. Conditions for an Effective post Crisis EU Policy

1. Introduction

The European Union (EU) is struck by what probably is the worst crisis in its history. The combination of a loss of competitiveness and high indebtedness of a number of the member countries of the Economic and Monetary Union (EMU) have led to unprecedented turmoil on financial markets. The resulting instability has put a great challenge to the EU institutions that leads to the rethinking of the foundations of the major policies pursued by the EU. Three such policies stand out in this respect; competitiveness, macro-monetary and cohesion.

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The objective of this paper is to step back a little bit from the present turmoil and review the rationale of these policies in order to check what is essential and what should be adapted.

The paper is *structured* as follows. In the first section we will describe the pursuit by the EU of the Competitiveness objective and its impact on cohesion. In the next section we will do the same for the EMU objective. For both subjects we will detail first the policy context, recall a certain number of theoretical considerations and finally give the results of empirical studies into the effects. The crisis has shown how dangerously inadequate this split up into separate policy pillars has been. So in the following sections we will describe some new proposals for a more integrated framework and the role of cohesion policy in this respect. We conclude with some considerations about stricter conditionality for Cohesion Policy support.

Our major recommendation is to step up considerably the EU support for the improvement of administrative capacity and to make the allocation of aid from the Structural and Cohesion Funds (SCF) aid conditional upon significant programmes for Administrative Capacity Building (ACB).

2. Competitiveness

2.1. Policy context

All along the history of the EU the drive towards improvement of its competitiveness has been a key in the policy concerns. This has been the case for the creation of the customs union in 1960s and 1970s, of the completion of the internal market in the 1980s and 1990s. It has been put on the pinnacle of the policy architecture of the EU with the adoption of the Lisbon Strategy that was pursued during the first decade of this century. It was confirmed with the Europe 2020 strategy for the second decade of this century. The key aspects of the Europe 2020 strategy are smart, sustainable and inclusive growth. Many policies of the EU had an aspect of competitiveness and their impact on cohesion has been checked, without attempting to integrate them [*e.g.* Hall *et al.* 2001].

The Lisbon strategy has not been an overwhelming success. Much of its lack of effectiveness has been attributed to inadequacy of the instruments that the EU had deployed. The lack of success of the Lisbon strategy has induced the EU to look for stronger instruments, including, in particular, financial ones. As new resources were hard to find, existing ones have been reoriented; in this way the Structural Funds have been reoriented to aspects such as innovation in order to support Lisbon. However, the policies were only partly integrated [Molle 2006, 2009, 2010, 2011a, b].

2.2. Theoretical aspects

The term competitiveness is generally understood as the capacity of countries or regions to produce goods and services that meet the test of foreign competition (reflected in a sustainable balance of payments) while simultaneously maintaining and expanding domestic real income and creating jobs. Most studies use productivity as the main indicator of competitiveness [Aiginger 1998; Camagni 2002; Kitson *et al.* 2004]. While this indicator is very practical for analytical purposes; for policy purposes it is not. The attention has therefore shifted towards the drivers of productivity[1]. These are to be found on the supply side of the economy. The major categories are: productive and firm structure, knowledge and innovation; transport and communication infrastructure, labour skills and institutions. We give in the following sections a selection of studies that are representative of the developments on each of these scores[2].

[1] This is clearly what the most well known reports on competitiveness do, both on the world (World Economic Forum), the EU (European Competitiveness Report) and the regional level (EU Regional Competitiveness Index). In this way competitiveness factors become policy oriented. The European Competitiveness Reports stay pretty close to industrial structure and innovation; mentioning other factors such a labour market and skills. At the regional level a whole series of detailed factors are addressed [e.g. EC 2010a, b, c and Molle 2007: chapter 2–5].

[2] See for the detailed data for these items e.g. EC 2010a, b, c.

2.3. Empirical studies[3]

2.3.1. Industrial structure

Many regions in the cohesion countries are specializing in labour intensive traditional sectors that are particularly exposed to global competition; this applies to traditional industrial sectors such as clothing but also to service sectors such as tourism. This specialization increases the volatility of (un)employment [Ezcurra 2011].

Restructuring their economies has not been an easy task. The regions that have performed best in the past have often moved within their sectors to more high value functions. They have made considerable investment in human capital; a prerequisite for such developments. This has been often at the expense of employment growth [Affuso *et al.* 2011]. Many other regions have failed to grasp such opportunities and are now confronted with a lack of growth potential.

2.3.2. Innovation

The distribution of innovation (potential) over the EU space is very unequal. The countries of North-Western Europe show the highest values. The East shows lowest values; immediately preceded by the South-West. There is a real problem for many of the countries of the South; their innovation potential seems now to be lower than the one of the most dynamic new member countries in the East [*e.g.* Molle 2009].

Moving to the regional level, the picture is even more accentuated. One observes the highest values of innovativeness in the capital cities of the most developed countries; and the lowest in the least developed areas in the cohesion countries. This polarized picture is in turn very dependent on a series of interrelated factors, such as the quality of the R&D institutes, innovativeness of the local firms, links between the firms, institutes and policy makers, *etc.*[4]

[3] See in this respect LSE 2011.

[4] See the 2011 special issue of Regional Studies on this subject [Vol. 45.7].

2.3.3. Infrastructure

Investment in transport and telecommunication has always been one of the favourites in regional development. A large part of the financial effort Regional and Cohesion Funds is actually channelled through this category. As a result one sees a massive increase in endowment with infrastructure in the cohesion countries and regions. This effort has significantly contributed to the convergence process at the regional level [Del Bo *et al*. 2010].

2.3.4. Labour qualifications

Labour market volatility (unemployment) is particularly high in the less developed regions of the periphery of the EU (Ezcurra 2011). So, cohesion implies an improvement of the basic factors determining productivity. An essential prerequisite for a regional economy with a sound basis of modern competitive and innovative economic activities is a highly qualified labour force. Much effort has been made to improve this aspect (via the Social Fund). However, it has not solved the problem; in many of the cohesion countries (including cohesion countries such as Portugal that are part of EMU) labour productivity and qualifications are deficient. All the same, public expenditure has in the past rather gone into hard infrastructure than in industrial renewal and labour qualification enhancement[5]. This has become a very serious problem as many of the new Member countries now actually perform better with respect to human resources and investment in equipment than some of the traditional cohesion countries in the South West of Europe.

2.3.5. Institutions

The situation in all cohesion countries of the EU as regards the quality of institutions and notably of administrative capacity is rather alarming. The data on both the national level and regional level [analysed in Molle 2010] show that there is a clear geographical split in the EU between a group of countries with high quality indices in North-Western Europe and another group with low indices consisting of countries in the South-West of the EU (in particular Italy and Greece) and the New Member

[5] Portugal, for instance, is very poor performer on this score. Notwithstanding repeated warnings on the part of the EU and the OECD, the country has not changed its priorities.

States (NMS). There is also a middle group of countries, including France, Spain and Portugal. A worrying aspect is that the data show much persistency; we cannot discern any trend towards an overall improvement of the quality of governance in the EU. On the contrary, one remarks for a few countries quite rapid decline (notably Italy and some new Member States).

The data on the regional level show little variation among the regions of one country. There is one notable exception to this rule; Italy shows a very large diversity in government quality among its regions according to a North South gradient. It means that the regions that have the lowest incomes also have the lowest institutional quality.

2.3.6. Conclusion

The drive towards better competitiveness has resulted in the catch up of Member States and regions where the potential for productivity increases was highest and where the right set of policies has been pursued. This applies to some of the traditional cohesion in countries South-Western Europe and to all New Member States. Mind that the productivity increases were often realized at the cost of increases in unemployment (*e.g.* Gardener *et al.* 2004). However; in many countries serious deficiencies in the drivers of productivity have persisted and reduced competitiveness in a fast globalizing world. Mind also that cohesion policy was found to be most effective in areas where institutional conditions were good [Ederveen *et al.* 2006].

3. EMU

3.1. Policy context

The present struggle of the EU against unforeseen effects of the economic crisis (including management of the EMU) must not make us forget that the EMU was once designed as a prevention mechanism to two other types of crises (admittedly much less severe). The first one were the excessive exchange rate and capital movements that threatened macro economic stability and thereby growth. The other one concerned the growing lack of competitiveness in a fast globalizing world. Indeed, by the end of the 1990s the EU faced slow growth, high unemployment and many problems of structural adjustment, particularly in the so called cohesion countries. It was thought that the EMU rules would create a new social-economic configuration that would compel these countries (that in the past did frequently use the devaluation instrument to regain competitiveness) to seriously address their structural and institutional problems [Salvatore 1998, Dyson 2000].

The establishment of the EMU was to be followed by an unprecedented enlargement of the EU. This did make internal competition even more severe. A special Cohesion Fund was created by the Treaty of Maastricht to help the existing cohesion countries to finance a number of investments in supply side factors and to regain competitiveness in an enlarged EU. For the rest the adapted Regional and Social Funds were supposed to be able to cope with any negative effects on cohesion that might occur [EC 2000].

As in the early years of EMU the cohesion countries of the eurozone indeed showed higher growth rates than the richer countries, the cohesion concern tended to fade away. So did the pre EMU effort for structural adaptation (due to reform fatigue). This was particularly evident for Greece [Featherstone 2003].

3.2. Theoretical aspects

The introduction of the EMU was thought to have an effect on cohesion through a number of different channels [see Molle *et al.* 1993; Martin 2001; Ardy *et al.* 2002; Begg 2003 and Rodriguez Fuentes, Dow 2003].

The first effect comes via improved *allocation*. The introduction of the euro increases confidence and decreases a large number of cost items on international transactions, which lead to substantial higher internal trade and investment[6]. EMU was found to positively influence internal Foreign Direct Investment flows [see Morsink and Molle 1991a, b; Morsink 1998 and Patroulas 2007], which is growth enhancing. The impact on economic cohesion could not be established beforehand and became a matter of quite some controversy[7].

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6 The size of this effect is a matter of controversy. See the references given in Molle 2007: 262.

7 The new economic geography school thought that the 'EMU is likely to promote a modest increase in specialization amongst EMU countries, although industry specific

The second effect of EMU is the elimination of the need for adjustment to problems coming from *external asymmetrical shocks*. Already in the run up to the EMU the EMS had reduced the likeliness of such shocks as monetary stability had increased the correlations between fluctuations in economic activity among regions in different member countries [Fatas 1997]. Under EMU, bilateral *exchange rate shocks* from partner countries are eliminated. The effects of this decrease in macro-economic vulnerability were supposed to be particularly beneficial for cohesion countries that are most exposed to this type of problems. EMU is most positive for catch up countries with a high trade openness and low inflation proneness [Sanchez 2008]. This positive effect, however, comes at a cost. The single currency eliminates the possibility to adjust via the exchange rate (in other words, to improve competitiveness by devaluation), so other mechanisms such as wage and price flexibility will have to do more of the job. Cohesion countries are not well equipped with institutions that efficiently operate these latter mechanisms.

The third effect of EMU is the *decrease in the interest rate* that follows from low inflation, elimination of exchange rate risks, higher credibility of the debtors and better capital markets efficiency. Again, this is particularly interesting for cohesion countries, traditionally confronted with high interest rates. The lowering of the cost of capital stimulates private investment and frees resources from the public budget (less debt servicing) that can be spent on programmes that improve productivity or that can alleviate the tax burden. The low inflation target (two per cent) is found to have beneficial effects upon growth [Tsonias and Chistopoulos 2003], in particular on growth in the formerly high inflation countries, many of them characterized by below-EU average income levels. So the effect on cohesion was thought to be positive.

The fourth effect is related to this, but addresses the possible inadequacy of the European Central Banks (ECB) monetary policy for individual regions. The interest rates it sets for the whole Union may not correspond to national preferences. It may set interest rates too low (creating inflation and bubbles in certain countries) or too high (freezing out cohesion countries).

The fifth effect comes from the loss of independent macro policies in combination with a drive for competitiveness and fiscal restraint. It may lead to a decrease in the capacity of governments to promote *social cohesion* and income equality

shocks are sufficiently small for this not to pose further difficulties for macro- economic management. Improvements in market access are likely to raise income levels in insiders relative to outsiders' [Midelfart *et al* 2003: 847]. This effect is due to the EMU effect on specialization and hence competitiveness. The authors foresaw some more concentration in urban areas.

by redistribution policies [Bertola 2010], although such effects do not need to become too problematic [Pappa and Vassilatos 2007].

Only very recently has a new effect been identified; it concerns the vulnerability to changes in attitudes of financial markets towards the sovereign debt of countries that have lost their competitiveness [De Grauwe 2011]. It can lead to a downward spiral leading to default.

To *conclude*, at the start of EMU the theoretical reasoning gave rise to some concern but failed to give clear indications as to the total effect of EMU on cohesion. Schematizing, one may say that there appeared two views. Some (notably the new economic geography school) believed that the total net effects would be negative due to polarization. Others (notably the neo classical school) believed that markets would be able to rebalance possible negative tendencies so that further real convergence could be expected.

Rigorous empirical work on the effects of the EMU is scarce. In the next sections we will review shortly the evidence by effect.

3.3. Empirical studies

3.3.1. Allocation

The impact of better allocation due to the EMU upon cohesion is very difficult, if not impossible, to dissociate from other effects; such as the increase in market size due to the Eastern enlargement, the increased openness that went hand in hand with further globalization, the drive for competitiveness by sectoral policies, *etc*. Even if the precise net effect of EMU is difficult to measure, there is little doubt about the positive trade creating and investment creating effects of the EMU.

3.3.2. Shocks

The *more synchronic development of the business cycle* did indeed occur [Darvas and Szapary 2008; Christodoulakis 2009]. Moreover, over time a further dampening of the cycle has occurred as well. It is however not clear to which degree this effect can be attributed to the EMU. Indeed, during the first decade of EMU a similar moderation could be observed in other (non-EMU countries).

3.3.3. Interest rates

The effect of the *decrease in interest rates* has been very pronounced. They have in first instance helped many private and public sector developments in cohesion countries to be financed. However, they have also facilitated allocation of resources to less productive uses. As such we may mention public sector consumption and redistribution, housing and real estate bubbles, leading to the accumulation of very large private and public external and internal debt.

The effects of the inadequacy of the ECB's central interest setting have been particularly important in boom countries, such as Ireland. An independent national macro policy would have stopped this boom but under the conditions of EMU such instruments were not available to the Irish government.

3.3.4. Social cohesion

On the effect on *social cohesion* only some indications are available and these are not very positive. Indeed, the putting in place of EMU has been associated with an increase in inequality in disposable income, which in turn accounted for less generous social policies [Bertola 2010].

3.3.5. Current account

A largely unforeseen effect of the EMU has been the accentuation of large current account imbalances [*e.g.* Christodoulakis 2009]. Over the past decade the northern members of EMU did produce very large surpluses while the southern ones generated huge deficits. As these surpluses and deficits among member countries of the EMU did balance out at the EU level, they did in first instance not affect the international position of the euro. As long as the capital account did compensate for this imbalance, the situation could be sustained. Actually, the low interest rates that these countries could enjoy thanks to their EMU membership did facilitate their recourse to debt financing. The crisis, however, made financial markets aware of the real risks involved, leading to a very sudden upsurge in the price they asked for further financing.

We recall that the current account was neither part of the entry criteria for EMU nor of the Stability and Growth Pact (SGP) indicators. This omission has had serious consequences and had to be repaired. So, since some years the current account has become an essential part of the surveillance mechanism of the European Commission [EC 2010a, b].

3.3.6. Conclusion

The results of the studies reviewed above are difficult to summarize in a few words. Indeed, the net effect of EMU on cohesion is still a matter of controversy. In the recent past regional divergence has occurred together with national convergence. There is some evidence that this is related to EMU. For instance, in Spain relatively large and more diversified regions were best prepared for EMU [Costa-I-Font and Tremosa-I-Bacells 2003][8]. Some claim they can identify the role of the EMU; for instance Bouvet [2010] finds that 'the adoption of the common currency has, thus far, exacerbated regional inequality in poorer countries, while it has not significantly affected regional inequality within richer countries'. Most are however much more cautious given the uncertainty about the relative importance of the causes of regional inequality developments [*e.g.* studies mentioned in Molle 2007: chapters 10 and 11].

4. The post crisis response

4.1. Lessons from past experience

During the past decade the EU has pursued in a largely independent way its competitiveness and its macro and monetary policies. For fostering the major objectives of both policies it has influenced the major determinants: e.g. innovation in the case of competitiveness policies and budget deficits in the case of macro policies. For the first it has put in place a soft version of policy coordination (the Open Method of Coordination), for the second a hard form of coordination (the SGP with sanctions). Moreover, it has attempted to make sure that these two policies would not endanger another policy objective, namely cohesion. To that end it has used a very strong policy instrument, that of financial support (through the SCF). These Funds target the determinants of regional competitiveness so they were by and large

[8] An important factor in this respect is the higher instability in the pattern of credit availability for some peripheral regions [Rodriguez-Fuentes and Dow 2003].

consistent with the Lisbon objective. The increase in competitiveness was supposed to create the conditions for macro-economic balance: it would enhance productivity and hence exports (the current account), while the European Funds would provide a relief to the government budgets.

The previous sections have made abundantly clear that this set up has not worked as planned, as far as EMU countries are concerned. This is the case for competitiveness; as in many of the cohesion countries increases in productivity have been insufficient to stay abreast of competitors. In many respects, such as industrial restructuring, innovation, quality of labour, institutions (government), the cohesion countries and regions of the EMU have lost ground. The set-up has not worked properly for macro policy, either. The low interest rates (an EMU effect) induced countries to mask their situation by extensive borrowing for insufficiently productive purposes, leading to fast deteriorating current accounts. The macro policy failed to identify the unsustainability of this situation.

The crisis has brought to light the fragility of the situation in the cohesion countries of EMU (Portugal, Spain, Italy, Greece and Ireland). It has forced these cohesion countries to reduce their debt and deficit levels by adopting severe austerity measures, reducing both the level of their GDP per head and their immediate growth potential. Moreover they have to go through a series of structural reforms that are politically very costly and only after some time likely to restore their competitiveness. In the process much of the progress previously made in terms of catching up (and hence the improvement of cohesion) has been lost.

4.2. Immediate policy response; optimizing the existing frameworks

The crisis has made the need for a more integrated policy response apparent. The immediate response of the EU has made some steps in that direction. Faced with the severe effects of the crisis on the cohesion countries the EU has attempted to mobilize any instruments possible to alleviate the problems. The first element has been to coordinate national efforts in the framework of the European Economic Recovery Plan. This concerned both fiscal aspects and policies that address structural reforms. The second element has been an adaptation of the way the EU deploys its own instruments. This involved, for instance, relaxation of state aid rules. another example was optimization of the EU financial instruments. This concerned in particular Cohesion policy, which seems well suited, for several reasons. It involves considerable sums, happens to be targeted towards the problem ridden countries, favours adaptation of the determinants for competitiveness and benefits from a long term experience on the ground. To alleviate problems of cash in member states whose public finances are squeezed, the EU has decided to bring forward a number of payments for projects. Moreover it has reduced the percentage of national co-financing of projects. In a similar way, the EC has brought forward expenditure on Trans European Networks. Finally the European Investment Bank has increased its lending [Smail 2010].

4.3. Further steps; a new more integrated policy architecture[9]

The crisis has also made the need for new frameworks and instruments evident. This is particularly the case for restoring of macro-economic and financial stability. The EU has innovated with the creation of a series of institutions and instruments, such as the European Systemic Risk Board (ESRB) and the European Stability Mechanism (ESM). They address the stability of the financial sector and the sustainability of the government debt and the balance of payments. In that sense they all are in the remit of the governance of the EMU.

The creation of more and new sectoral institutions has exacerbated the problem of lack of oversight and coordination between policy areas. So, a more integrated policy set up had to be created. It is particularly urgent to manage the close relation that exists between competitiveness and macro-economic imbalances showing up in the current account. This has resulted first in the introduction of the European Semester for coordination of all EU and national policies and next in the integrated review of three surveillance elements; fiscal policy (under the SGP), growth and jobs (under Europe 2020) and macro unbalances (under the new EIP; the Excessive Imbalances Procedure). The European Council intends to monitor closely this annual process to avoid inconsistencies and improve implementation, which they consider as essential for realizing the twin targets of fiscal consolidation and growth stimulation.

The EIP has (in a similar way as the SGP) a preventive and a corrective arm. The preventive arm consists of a surveillance mechanism that is designed to detect,

[9] Based on Buti 2011.

on the basis of an in depth expert analysis of forward looking indicators (including possible signals from the ESRB), the emergence of major imbalances. If this tends to lead to emergence of excessive imbalance, the corrective arm is activated. It consists of an action plan that the member state in question has to submit to the Commission and the Council and that should specify measures that will be taken to redress the situation. The progress will be monitored closely and if this it occurs insufficient there will be automatic financial sanctions (subject to having qualified majority in the Council).

4.4. The role of cohesion

The solutions put in place for the lack of integrated policy responses are designed to make the EU (and in particular the EMU) operate properly, even under difficult circumstances. However, they do not address the immediate situation in which many of the cohesion countries, member of EMU, have stranded due to the crisis. Their problem is to select a package of efforts under the austerity plan in combination with external support so as to come back, as soon as possible, on a sustained growth path. In how far is the EU cohesion policy available and adequate to contribute to such a package?

The first question of *availability* has given rise to much discussion. On the one hand, there have been pleas to withdraw these funds from the beneficiaries that do not meet their obligations under the EMU and in particular under the present rescue packages. The EU has not followed such a course for reasons of solidarity. On the other hand, there have been pleas to ease conditions and accelerate the disbursements of the Structural Funds to enhance the capacity of the countries to accelerate their competitiveness and growth. The EU has not followed this course either, as the management rules of the funds have been made for very good reasons and suspending them would increase the risks of misuse and fraud and endanger their effectiveness. So, the Structural and Cohesion Funds stay available for the crisis ridden cohesion countries of EMU under experimented rules.

The second question about *adequacy* calls for a critical review of the fundamentals of the policy (see Box 1). A critical assessment of the fundamentals of the convergence objective has shown that these are sound and correspond to a long term need of the EU [Molle 2007; Ecorys/CPB/Ifo 2008]. In how far the modalities of the policy have to be adapted to meet the needs under the new circumstances is a matter of much debate. The arguments in this discussion blend with those of the parallel discussions about the new long term financial framework and the periodic review of the cohesion policy. A stakeholder analysis [Ecorys 2011] showed interesting results in this respect. In terms of the competitiveness aspect respondents were generally in favour of the orientation of the projects to the EU 2020 priorities. With respect to macro aspects, they opposed the inclusion of macro conditionality into the programmes. As far as policy integration in general is concerned, they agreed to inclusion of the related aspects in the Common Strategic Frameworks. Finally, they demanded simplification of the delivery and accountability aspects.

Box 1. The basics of EU cohesion policy

In the past decades the European Cohesion policy has regularly been adapted to make it best suited to its diverse objectives and to enhance its effectiveness. The most important of those objectives is the convergence of the less well off countries and regions. The application of the principle of solidarity has resulted in the rule for allocation of resources; the worse the problems, the higher the sums of aid. The amount of support that the EU provides in this way is very substantial. For example, the EMU countries that struggle to emerge from the crisis receive an annual 1.2% of their GDP in the case of Greece and some 1.8% in that of Portugal.

However, this aid does not come for free. There are many strings attached to it in order to make sure that the aid is really used on projects that foster growth and are consistent with the objectives of the EU. That means that countries have to submit programmes and projects that are eligible according to these criteria. Moreover, in order to make sure that countries are really committed to the programmes, they have to put up a certain percentage of co-financing coming from their own budget. Finally, they have to comply with a set of administrative requirements so as to be able to show the conformity of the expenses with the plans.

The demands that the system puts on the beneficiary countries are quite heavy. They lead to two problems: first a lack of a pipeline of good projects and second a delay in the execution of projects, leading to a lack of absorption of the available funds. This is a quite general phenomenon in the EU. However for the cohesion countries this problem is exacerbated by the low quality of the institutions (poor administrative capacity) that we discussed in section 1.3.5.

5. Response to persistent challenges and conditionality

5.1. The new Commission proposals

After long and extensive debates on the future of the cohesion policy, the Commission has recently published its proposals for the policy for the 2014–2020 period [EC 2011b]. These proposals maintain the essentials of the objectives and of eligibility but bring considerable change as regards the priorities and delivery method. For our purpose the main aspects to highlight are as follows:

- Focus upon Europe 2020. Minimum allocations are fixed for specific actions to deliver the various E2020 objectives of smart, sustainable and inclusive growth.
- Better coordination of various EU actions. A Common Strategic Framework contains the EU top priorities and will apply to all funds; Member States will integrate all funding into an integrated development plan to improve impact 'on the ground'.
- Integration with requirements for a sound macro-fiscal environment. This implies a tighter link between the cohesion policy and European economic governance, such as the excessive deficit procedure, excessive imbalance procedure and the European semester for economic policy coordination.

So, the main changes are an increased focus on priorities and definition of methods to improve policy coherence at the EU level.

5.2. The aspect of conditionality[10]

An important aspect of the proposals of the Commission is the introduction of conditionality. The Commission proposes a two-pronged approach:

1. Conditions linked to the direct implementation of the policy. This would take the form of both 'ex ante' conditions that must be in place before funds are disbursed and 'ex post' conditions that make the release of additional funds dependent on

[10] This section is taken from EC 2011b.

performance. Ex ante conditions will be defined in the partnership contract at the beginning of the programming period. For example, a member state intending to use EU funds to invest in water management will be required to transpose the related EU environmental legislation in full. If these conditions are not satisfied at the start of the programming period, each member state and the Commission will agree when they should be met. If, then, the conditions are not fulfilled by the agreed date, the Commission may decide to suspend the programme payments partially or completely until necessary actions are carried out.

2. Terms linked to macro-economic conditions. The effectiveness of cohesion policy in promoting growth and jobs depends significantly on the economic environment in which it operates. Past experience suggests that the funds in some instances have not delivered the expected outcome due to unsound macro-economic framework conditions. Establishing a tighter link between cohesion policy and the European semester of economic policy coordination would, therefore, ensure better coherence between macro economic policies at the national level and investments through European programmes. Thus, the Commission is proposing that where a country faces economic difficulties, the Commission can invite the member state to revise its strategy and programmes. Only if the economic situation becomes so serious as to undermine the effectiveness of cohesion investment, continued support from the SCF will become dependent on the fulfilment of certain fiscal or economic conditions. This 'conditionality' has already existed for the Cohesion Fund, but the process of the suspension of funding will become more automatic and extended to all funds.

5.3. Towards even stricter conditionality?[11]

The question of conditionality is a very controversial one. Many authors [*e.g.* Babb and Carruthers 2008] have observed that conditionality does not bite when it is meant to. For that reason they have been pleading in favour of changes. One example is the proposal for ex post conditionality; support only being disbursed after proof is given of improvements [*e.g.* Adam *et al.* 2004].

On the EU level there are also strong reasons to doubt in the effectiveness of conditionality. The case of the accession of Greece to the EMU, the accession of some

[11] This section is taken from Molle 2010.

of the NMS to the EU (see Hughes *et al.* 2004) and the deficient functioning of the Stability and Growth Pact are just three examples. Another example that gives reason for concern is external aid [Adam *et al*. 2004].

So, there is an urgent need to check under which conditions conditionality can be effective and to see how one can apply these results to the case of cohesion policy. The proposals of the Commission need be implemented because they are necessary to increase compliance with EU priorities and to enhance policy coherence and effectiveness [see Molle 2011a].

6. Reinforced conditionality; focus on administrative capacity

6.1. Quality administration; a public good

We recommend that conditionality should be extended even to other factors; in particular to the capacity of institutions and administrations to deal effectively with the intricacies of EU policies. We are aware of the fact that this proposal runs counter to the pressures of many crisis-struck countries that ask to do away, at least temporarily, with the financial, administrative and technical conditions of the various EU policies, so as to speed up their absorption of EU funds. However, one should remember in this respect that the Commission has also proposed a very significant uniformization of the rules for the different Funds and a considerable simplification of the administrative procedures. So, under such new rules, quality standards have to be kept, which implies that conditionality with respect to the quality of the institutions needs to be enhanced.

The situation in the EU with respect to the quality of governance gives rise to serious concern. In the Annex we have described the considerable disparities that exist in the EU. We indicated there that many of the countries that qualify for cohesion policy aid under the convergence title do show considerable deficiencies in government quality. What makes things worse; these problems seem to be of a very persistent nature, actually in quite a few countries the situation rather tends to deteriorate instead of to improve. The European Commission is aware of this and has for some time given financial support to administrative capacity building

(ACB) under the European Social Fund (ESF). Unfortunately it has not targeted the countries where the problems are most acute. It depends much on the priority setting of the individual governments whether they pursue a strong action in this field or rather let it go. We consider this an inadequate situation. Firstly, because the new place based integrated approach of the cohesion policy puts very heavy demands on the institutions that have to implement it. Secondly, because high quality governance is a European public good in itself. It is a public good because both citizens and corporate actors cannot provide it themselves yet are very much dependent on it for the quality of their life and for the efficiency of doing business. It is a European public good because there are very strong externalities; the (lack of) quality government in one country has a negative effect in other countries (contamination).

6.2. EU efforts in administrative capacity building (ACB)

In order to increase the quality of delivery of public goods and increase the effectiveness and efficiency of the public sector, many countries have launched programmes of public sector reform [*e.g.* Pollitt and Bouckaert 2004]. These programmes have especially been set up in the more developed countries. In the weaker countries these ideas have had less resonance. The EU is aware of the weak administrative capacity in many of its member countries. It has become particularly sensitive to the problem with the Eastern enlargement, where the old structures remaining after the communist period had to be transformed into modern Western type administrations capable of delivering quality public goods. Under the PHARE programme the EU has provided considerable resources to assist such countries prepare for the accession. Action Plans have been developed that identified levels of administrative and judicial capacity that were required in order to qualify for membership. However, given the enormous scale of difficulties, the short time available and the lack of a strategic framework, the PHARE interventions have occurred less effective than hoped for. On the accession, PHARE was discontinued. After the accession it appeared that many of the improvements were not sustained; in many new Member States the reforms have stalled and sometimes even reversed [*e.g.* Hughes *et al.* 2004].

Efforts in ACB for convergence countries were henceforth supported by the European Social Fund (ESF). They have been placed in the framework of the Lisbon and good governance agendas of the EU; both objectives indeed requiring effective institutional and public administration capacity (EC200x). Most of the support falls under category 81 art 3.2b of reg. EC 1081/2006; it applies to governments at all levels. The programmes mainly target improved legislation, adjudication and provision of public services through training, and specific support to specialized services. Some further possibilities (mainly concerning labour market institutions) are opened by art 3.1b of the same regulation. The funds for ACB are subject to co-financing; the EU can finance up to 85% of the total cost. The total EU budget for this activity in the 2007-2013 period is about €2 billion (or some 3% of total ESF interventions). Given the large sums that represent the European Regional Development Fund and the Cohesion Fund as compared to the ESF, it should be no surprise that the total effort on ACB is less than one per cent of the total of the SCF.

The potential beneficiary countries have taken very different approaches to the ACB support. The countries where the problems are most acute have special Operational Programmes (e.g. Bulgaria, Romania); the other countries have defined ACB in the form of priority axes.

6.3. ACB efforts by government quality

In order to see just how far countries give priority to the ACB we have calculated two figures (see Table 1). First we have related the total amount of support given to ACB as a percentage of the total support to a country from the Structural Funds (columns 2, 5 and 8). Next, we have calculated the aid for ACB per head of population (columns 3, 6, 9). We have limited the analysis to the countries that perform below the EU average (categories 4–6 of the Table 1A of the Annex indicated in the second row of Table 1). In order to facilitate interpretation of the data we have ordered them from left to right (columns) and from top to bottom (rows) by decreasing government quality[12].

[12] The data given here are based on ESF http://ec.europa.eu/employment_social/esf/discover/spending_en.htm. resp. http://ec.europa.eu/employment_social/emplweb/esf_budget/. The data exclude support to partnership building and e government. Inforegio provides a different data set (EC 200y) from which we have taken the categories 'Mechanisms for improving good policy and programme design, monitoring and evaluation' (mainly corresponding to the figure on ACB) and on the other hand 'Community amount' (corresponding to our figure on SF). There are quite some differences in the figures for individual countries. However, the percentages as used in this table (ACB/SF) are very similar to the (MEC/CA) percentages for most countries. Exceptions are Italy and Bulgaria for which MEC/CA is about double the size of ACB/SF. So the general conclusions do not change by

Table 1. Efforts on ACB and Structural Funds support by government quality class ACB/SF (%) and ACB (euro per head of population)

1	2	3	4	5	6	7	8	9
Cat		**4**	**Cat**		**5**	**Cat**		**6**
	ACB/ SF(%)	**ACB (€/p)**		**ACB/ SF(%)**	**ACB (€/p)**		**ACB/ SF(%)**	**ACB (€/p)**
Cyprus	1.7	11	Hungary	0.7	15	Bulgaria	3.6	21
Estonia	0.7	15	Slovakia	0.5	8	Romania	1.4	9
Slovenia	0.5	8	Latvia	1.9	30			
Czech R.	1.7	35	Lithuania	3.0	50			
			Poland	1.0	14			
			Italy	0.6	3			
			Greece	0.4	8			
Av. Class	1.5	28	*Av. class*	0.8	10	*Av. class*	*1.9*	*12*

The share of ACB in total SF support does seem to vary somewhat as a function of the severity of the deficiencies in government quality. Indeed, one sees that some of the best performers in terms of government quality have the lowest percentages (Slovenia and Estonia). It can likewise be noticed that one of the worst performers (Bulgaria) has the highest percentage. However, for the rest there does not seem to be much of a correspondence between the two series (no systematic increase in percentages going downwards in the table).

The total amount of *ACB support by head of population* shows a large variation by country and no clear increase of ACB efforts in function of the severity of the governance problems[13]. As far as the average for category 5 is concerned a short remark is in order. SF support to Italy is concentrated in only about half of the country. That would imply that we should double the *per capita* figure for Italy and augment the class 5 figure to some €12 per head.

using a different data set. However conclusions for individual countries do require a more detailed analysis of the composition of the basic data.

13 Mind that these figures may change also in function of the attribution of certain categories of expenditure to ACB. Reasons for such a different attribution exist in the cases of the Czech Republic (very significant decrease and Slovenia (very significant increase). For all other countries the figures would stay virtually the same [Ecorys 2010].

6.4. Evaluation

The differences that exist between individual countries in terms of their efforts on ACB certainly reflect national differences as regards priorities. However, they also reflect differences in the pressure that the Commission exerts on Member States to change their priorities and make them more consistent with EU-wide demands. We may recall here the conclusion of Hughes *et al.* [2004] that ACB conditionality has been the result of a negotiation process between the Commission and the Member States and that the outcome did depend on the institutional and political conditions of the latter.

The evaluation of the efforts in ACB is at the moment difficult to make for several reasons. Firstly, most programmes are only half way and have not yet shown the full effects. Secondly, the relation between inputs and impacts is difficult to establish. Indeed, most programmes are of a very general nature and their final effect (on competitiveness, investment, growth and employment) cannot be isolated from many other influences.

6.5 Which form for a reinforced effort on capacity building?

There is a considerable need for improvement of the quality of government and this implies the need for the stepping up of EU support for projects on *administrative capacity building* (ACB)[14]. Enhanced EU conditionality in matters of ACB should be changed on to the following dimensions:

Strictness. In first instance disbursements for the whole SCF support package should be made dependent on size, compositions and the quality of the national ACB programme. Government Quality should become one of the indicators that

14 We thereby reiterate a suggestion made at the occasion of the previous recast of the cohesion policy among others by Ederveen *et al.* [2003: 54]. They observed: 'In this respect we may learn lessons from the World Bank. They conclude on the basis of an evaluation of foreign aid programmes that the main ingredient of effective financial support is that it is used as a catalyst for change in policy and institutions. In analogy to this, effective cohesion policy may require that funds are accompanied by conditions that improve the functioning of the public sector in the countries and regions that receive funds'.

is regularly measured by independent organizations. In second instance, the continuation of SCF support should be made dependent on progress on the GQ indicator.

Structure. Total SF support is progressive; it is higher the lower the *per capita* GDP. In other words, the bigger the[15] problems, the higher the support. A similar approach should be advocated for ACB; the lower the quality of government, the higher the proportion of SF support that should be dedicated to ACB.

Level. EU support to ACB in the previous programming (up to 2006) did not seem to have led to much result; in fact, our figures rather a trend towards deterioration, instead of one towards improvement in that period (notwithstanding positive developments in specific cases)[16]. For the present period (2007–2013) no comparison is available yet on which to base an evaluation of the stepped up ACB efforts. However, given the previous results, one may doubt in their effectiveness. That would justify a considerable increase in the amounts spent on ACB. In case an average percentage of 2% of SF would be adopted (corresponding to some 20 euro per head), this would imply a doubling of the present effort[17].

A final question concerns *organizational aspects*. At the moment it is the ESF that funds ACB. This may be inconvenient in cases where important programmes are rather related to other aspects than social and employment. So, it may be advisable to involve the ERDF as well. An involvement of the Cohesion Fund seems less likely, because that fund has a simplified system that works on a national basis and makes fewer demands on quality government.

[15] Moreover we rejoin the most ambitious option from Ecorys [2010].

[16] For instance Portugal; see Country monograph annexed to Ecorys [2010].

[17] It would amount at levels presently obtaining in Bulgaria; for most countries it would still fall short of the priority given to ACB by countries such as the Czech Republic.

Annex[18]

Government quality and administrative capacity

A.1. Basis

There is much international evidence on the beneficial impact of good institutions on national growth [*e.g.* Kaufmann *et al.* 1999; Rodrik *et al.* 2004]. For the EU the relation between growth and quality of government is an under-researched area. There is some evidence that the effectiveness of the Structural Funds in matters of stimulating growth is enhanced by quality government [Ederveen *et al.* 2006]. This relation is robust even after accounting for the critique on the methodology [Bradley and Untiedt 2008]. The relation government quality /growth is in part due to the relation government quality FDI [Katsaitis and Doulos 2009].

So, it is particularly important to be sure about the capacity of the national and regional administrations to perform these tasks effectively. The EU cohesion policy regulations prescribe in much detail the institutional, governance and administrative systems of its delivery. The EU considers that over the past period (as of 2000) these systems have been put in place successfully in the new Member States and improved in the old Member States [EC 2010b: 244]. It states that these EU obligations have had a positive effect on national and regional administrative cultures by prescribing the forms in which programming, monitoring and evaluation have to be done and partnership has to be given substance. The EU recognizes that there is still considerable room for improvement, in particular in Romania and Bulgaria.

The EU is aware that the success of its major strategies (in particular Europe 2020) depends on the quality of national and local government [EC 200x]. The same holds true for the success of future changes in cohesion policy such as the integrated place based approach [EC 2010a: 20]. We may add that a high quality of governance is a European public good in itself. Many (also on the global level) observe that there is a positive relation between good governance and economic growth. Even if this

[18] This part of the paper has been presented earlier at the international conference 'What future for cohesion policy?' of the Regional Studies Association in Bled, March 2010.

relation is not very clear for the moment on the regional level in the EU, the other arguments make that good governance is rightly seen as a priority axis for EU cohesion efforts.

Unfortunately the EU has not published any data on government quality, nor has it published any comparative assessments of the (future) capacity of governments to assume the more complicated tasks that would be entailed by integrated policy making. As this is in stark contrast to the wealth of data on all sorts of regional indicators that have become available over time, one wonders what has stopped EU decision makers from establishing them. Awaiting the answer, it is useful to see whether other data are available that can shed some light on both issues.

A.2. National level

A.2.1. Categories of quality

An interesting quantitative info is available for the national level and the period 1998–2009 [Kaufmann *et al.* 2009][19]. These indicators are based on surveys among economic decision makers and in that sense may be relevant for economic development purposes. We have adapted the detailed information from this publication to construct an average index running from 0 (worst) to + 100 best)[20]. Table 1A classifies the EU Member States in six groups by decreasing order of governance quality. We have defined three groups above EU average and three below EU average[21].

19 The indicators are based on a large number of qualitative data that have been grouped in four composite indicators: government effectiveness; regulatory quality; control of corruption and rule of law.

20 The World Bank studies use an indicator that runs from –2.50 to +2.50. As this is not common we have decided to multiply all results by 40. All EU countries are in the positive range; so between zero and one hundred.

21 The delineation of the groups is done on the basis of rank orders for each indicator. It was facilitated by the similarity in the order of each of the indicators; the groups have been made where a rift occurred; irrespective of the width of the classes. In interpreting the results one should take into account that the delineation of the groups is not on all points very sharp and that differences between countries on the border lines between the groups are rather small. However, these concern mostly small countries that are not weighing heavily in the averages. On the basis of sophisticated techniques applied to the 2009 data the report UoG (2010) has made three groups of countries. It happens that each of them correspond to combinations of two groups of our table. The composition differs only in one case: the Czech

We have added a last column with the GDP/P as an indicator, as already a first glance at the results shows that there is a certain relation between the quality of government and average wealth levels[22].

Table 1A. National indices of governance quality by class

Group	Member States	GDP/P index EU 27 = 100
1	Denmark, Finland, Sweden	150
2	Austria, Germany, Ireland, Luxemburg, Netherlands, United Kingdom	130
3	France, Belgium, Malta, Portugal, Spain	110
4	Czech Republic, Cyprus, Estonia, Slovenia	60
5	Italy, Greece, Hungary, Latvia, Lithuania, Poland, Slovakia	70
6	Bulgaria, Romania	20

Source: Kaufmann, Kraay, Matruzzi 2009.

The data from Table 1A show that there is a clear split between above average and below average that runs largely along the lines of old Member States and new Member States. This can be explained by the long (albeit different) administrative traditions of the countries in the former group and the difficulties of transition of the countries in the latter group. There is one country that is a positive exception (Malta) and two that are negative exceptions (Greece and Italy).

A detailed analysis gives rise to two further comments:

- **Above average**. In the highest subgroup (1) we find the three Nordic countries (Sweden Denmark, Finland) with scores around 80. In the middle group (2) we find countries of the North West of the EU with scores around 70. The group just above the EU average (3) is mainly composed of countries in the South West of the EU.
- **Below average**. In the highest subgroup (4) we find four new Member States that have performed best in adapting their civil service to modern standards. In the

Republic that moves one class down in their analysis. We have stuck to the results of our more artisan method because the majority of the regions of the CR happen to be in group 4 (see next section). Mind that other non EU European countries tend to associate closely to one of the groups distinguished. This is the case for Norway and Switzerland that would fit perfectly in the first group and for the candidate countries Croatia and Turkey that would fit in the last group.

22 The EU uses in general GDP per head figures according to PPP; these attenuate the differences but do not change the overall picture as given in the table.

lowest one (6) we find two countries that on many other performance indicators (such as GDP/P) close the list. In the middle group (5) we find a mix of Southern and Central European countries.

A.2.2. Developments

The basic data as published by the World Bank show two main features.

- **Persistency**. Indeed, most countries stay in the same class over the whole decade. So we cannot discern any trend towards an overall improvement of the quality of governance in the EU. Neither do we see a general trend towards convergence between new and old Member States (as we see in matters of GDP/P). So, one cannot take it for granted that with increased wealth the quality of governance will increase as well.
- **Dynamism**. Some movements are positive, such as the improvement for some new Member States (notably Slovakia). Others are quite negative, such as the rapid decline in the scores of some old Member States (notably Italy) and the fall back of new Member States.

Both features give reasons for concern.

Persistency. The main reasons for concern here are the long time period needed to come to improvement on one hand and the possibility of a reverse development on the other. In this context the following citation is very relevant [Verheijen 2007: ix, x].

'The new member States have a very mixed record in the performance of their public management systems. Whereas most states were and are effective in the management of the core related issues (such as the transposition of EU legislation), their record in fiscal management, the planning and use of Structural Funds and addressing broader issues of competitiveness remains uneven'. 'While vertical management on the whole was of reasonable standard horizontal management (strategic planning and policy coordination) was very weak'. 'Throughout the region there has been a retreat from the changes made pre – accession in order to make the requirements of the acquis communautaire, especially as regards horizontal management systems'.

It indicates that the institutional systems of many of the new Member States are not capable of coping with new requirements in matters of consistent policy making.

Erosion. The main reason for concern is the downward development of many of the older EU member states. In the previous paragraph we mentioned Italy but similar tendencies occur in Member States such a Portugal and Spain that score just above average in terms of governance quality. The mechanisms that are at work here are not yet sufficiently analyzed. Yet the very fact that such developments have occurred in countries that have all benefited from considerable support of cohesion policies seems quite alarming.

A.2.3 Lessons from global developments

Many countries in the world suffer from a combination of poverty and poor governance. They are beneficiaries of considerable amounts of development aid. Unfortunately, growth has often been weak and notwithstanding decades of support the problems in matters of governance have persisted. Some blame aid for this lack of progress and speak about the 'curse of aid' *e.g.* Djankov *et al.* 2008. Others who have tried to identify the causes of this lack of effectiveness come to the following conclusion:

'Aid dependence can potentially undermine the quality of governance and public sector institutions by weakening accountability, encouraging rent-seeking and corruption, fomenting conflict over control of aid funds, siphoning off scarce talent from the bureaucracy, and alleviating pressures to reform inefficient policies and institutions. Analyses of cross-country data in this paper provide evidence that higher aid levels erode the quality of governance, as measured by indices of bureaucratic quality, corruption, and the rule of law' [Knack 2000].

On the other hand, there are also indications that conditional aid can avoid such effects. It may increase quality (decrease corruption) because it decreases the discretion of the recipients country's officials, takes away pressure by increasing salary levels of the public service, *etc.* [Taveres 2003].

The comparison of the global situation to the EU situation shows some striking similarities. Indeed, many of the present convergence countries and regions have (although to a lesser degree) two characteristics in common with developing countries; long term beneficiary of aid programmes and poor governance quality. This entails a few questions. First: will the EU system lead to the same results of persistency of poor quality government and a slow growth and hence slow convergence? And second; assuming that it is unacceptable that in ten years time a third of the EU population has still to live in countries with governments of poor quality, what should be done to improve the situation? Is stricter conditionality necessary?

These questions are highly uncomfortable. They actually seem taboo, given the absence of an open discussion on the subject. But the recent history of the financial crisis has shown that academics should not stop in the face of a political taboo, but analyse with a cold mind first the likeliness of these situations to occur and second the best ways to prevent them.

A.3. Regional level

A.3.1. Basic data

Very recently some data about the quality of government have become available on the regional level from a survey contracted by the European Commission [UoG 2010] on the quality of delivery of public services such as education, health and justice. Figures have been established for some 180 regions covering the whole of the EU27. The index runs from –2.9 (worst) to + 1.7 (best). We have grouped the regions into the same 6 classes in which the countries have been grouped (see Table 1). Table 2 shows that the three upper classes correspond to positive indices (comparable to above average in Table 1A) and the three bottom classes to negative scores (comparable to below average scores of Table 2A). The table gives the number of regions that come in each category.

Table 2A. Number of regions (EU 27 Nuts 2) by governance quality class

1 Group	2 Gov. Quality Index	3 Total	4 In same class	5 In class above	6 In class below
1	1.3/1.7	10	9	Not applicable	1
2	0.7/1.3	44	37	–	7
3	0/0.7	47	38	5	4
4	−0.6/0	25	8	9	8
5	−1.0/−0.6	30	27	2	1
6	−1.0/−2.9	25	13	12	Not applicable
Total		181	132	28	21

Source: Own elaboration of basic data from UoG 2010.

An inspection of the figures shows that the national situation determines to a large extent the classification of the regions. Most regions come in the group in which their country has been classified[23]. The regions that are differently classified mostly belong to a class just above or just below the one in which the nation was ordered (resp. columns 5 and 6).

A.3.2. Disparity patterns

The basic data from which the figures in the table are extracted give more detailed pictures. They show that one can mainly distinguish two types of countries with respect to their internal diversity:

- **Low disparity**. Let us take an example of a big country from each of the main categories. For Germany (category 2) only three of its 16 regions (mainly in East Germany) score a category lower than the country as a whole. For France (category 3) six of its 26 regions score better than average and only three score worse (overseas departments). For Poland (category 5) the disparity of the scores of its regions is low as well; of a total of 16 only two regions score marginally lower (in category 6).
- **High disparity**. The most striking case here is Italy (category 5) that shows a very large variation in the scores of its regions. On the upper side three of them (situated in Northern Italy) come in category 3. On the other side nine of them (situated in Southern Italy) come in category six; of which four regions situate themselves in the very bottom part of this category. Strong diversity also prevails in a country such as Romania (category 6) of which some regions are at the lowest (–2.9) end of the wide bracket, while others are at the highest end (–1.0).

A.3.3 Correlation with GDP/P

On the national level we have seen that there is a very high correlation between the quality of government and the GDP/P level. For our purposes the countries that score above the EU average in terms of governance quality and GDP/P are not much of a problem; indeed, we may assume that they will be able to cope with most of the requirements of the EU delivery system. However, the same is not the case for the main beneficiaries, that all show large deficiencies in government quality. So, we will further concentrate on the regions of the countries of the below average classes in Table 1 and 2.

[23] Mind that these figures are somewhat distorted as nine countries have not been divided into regions.

We have made, first of all, a direct correlation of the scores in terms of government quality with those of GDP/P. Overall, we found positive relation with a coefficient significant at the 5 per cent level but with a low R2 (.194). However, this general picture hides important contrasting details. The positive relation is based on the patterns in a small number of countries: Italy, Greece and Slovakia[24]. In other countries such as Poland no clear relation exists[25]. And in countries such as Bulgaria, Romania and Hungary the relation is even negative; the quality of governments is lowest in the capital cities that are by far most wealthy.

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24 This applies in particular to Italy where the regions are scattered over a range of governance quality and GDP/P classes. It applies also to some other countries where the richest regions are in the top of their class and the poorest in the bottom of their class.

25 The assumed relation is also far from obvious in many other countries; for instance in France, Portugal, Spain and the UK.

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Dominique Foray*

Smart Specialisation: from Academic Idea to Political Instrument, the Surprising Destiny of a Concept and the Difficulties Involved in its Implementation

1. From taboo policy to hit policy

Smart specialization is a policy concept that has enjoyed a short but very exciting life! Elaborated by a group of academic 'experts' in 2008, it very quickly made

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a significant impact on the policy audience, particularly in Europe. As a matter of fact, the concept is now a key element of the EU 2020 innovation plan [see Europe 2020… 2010] – the Commission has decided to build a platform of services (S3) to support regions in their efforts to devise and implement a smart specialisation strategy [see *Regional Policy…* 2010: 1183]; discussions are currently under way about introducing smart specialisation as a conditionality clause for structural fund attribution; and the OECD is launching an activity for measuring smart specialisation [see *Comparative advantage…* 2011].

Such a success story in such a short time naturally represents a very pleasing result for the academics at the origin of the concept. But it also suggests something that, in a sense, helps us maintain a certain degree of modesty regarding our academic contribution to policy discussion. It suggests that the idea had been in the air for some years, decades even. However, it was stifled and repressed as a result of the enormous conformity that has characterised innovation policy research and practices over the last decades in many international policy forums. The dogma stated that a good, tolerable and honourable policy aims to address market failures while not favouring any particular sector or technology based on certain 'priorities'. According to the dogma, departing from such neutrality is always dangerous since it implies guessing the future developments of markets and technologies and this opens the door to all those little monsters that economists like to eradicate: wrong choices, picking winners, market distortions. According to the dogma, it is much better to leave any issue concerning sectoral strategies, specialisation, or direction to the 'magical chaos of the blind watchmaker'. Any notion of specialisation policy was a taboo in policy discussion, particularly in the main policy institutions.

However, the last two years of crisis that have left many regions and countries with very few opportunities for economic recovery and restart and observation of the persistence of many coordination failures in systems of innovation as well as huge capacity asymmetries between regions and countries have exerted a certain amount of pressure to revise the dogma. Today we are witnessing a renaissance of 'industrial policy' (of 'a competition-friendly sectoral policy' to paraphrase P. Aghion). And so the idea of smart specialisation has suddenly become very obvious: the simple idea that (i) regions cannot do everything in science, technology and innovation and (ii) they need to promote what should make their knowledge base unique and 'superior'. The idea of smart specialisation has in fact two facets:

Firstly, it is important to focus on certain domains in order to realise the potential for scale, scope and spillovers in knowledge production and use – the main driver of productivity in the domain of R&D and other innovation-related activities.

Secondly, it is important to focus on certain domains *by* developing distinctive and original areas of specialisation for the future. Strongly mimetic regional programmes to promote export capacity expansion in certain fashionable high-tech domains or foster industrial agglomerations of high-tech firms that duplicate what's happening in neighbouring states or provinces have the effect in the EU setting (and that of other integrated regional systems) of dissipating potential gains from agglomeration economies, and vitiating efforts to create multiple lines of regional and national specialisation that were sustainably profitable[1].

This very simple idea was already in the air and perhaps all that was needed was just for a few academics to lend it some academic legitimacy, which in fact happened in 2008 [Foray, David, Hall 2009].

However, the simple idea of smart specialisation implies a very complex process in practice, and it is this complexity that academics have tried to better analyse and comprehend in order to help policy makers understand what is possible, what is feasible, what should be a useful and effective policy towards smart specialisation, what are the objectives and what are the tools.

The complexity of the process resides both in discovering the right domains of future specialisation and fixing the many coordination failures that can prevent emerging trends from becoming real and solid drivers for regional economic growth. Discovering the right domains is by no means trivial and technology foresight exercises or critical technology surveys ordered by administrations tend to produce the same ranking of priorities, without any consideration of the context and specific conditions of the 'client' for whom the exercise is carried out. Too many regions have selected the same technology mix – a little of ICTs, a little of nano and a little of bio – showing a lack of imagination, creativity or strategic vision. The discovery process is thus an issue in its own right. If accomplished properly through an entrepreneurial process of discovery (see below), it should logically identify not necessarily the hottest domains in nanoscience or biotechnology but rather the domains where new R&D and innovation projects will complement the country's other productive assets to create future domestic capability and interregional comparative advantage. To put it bluntly, a successful smart specialisation strategy is unlikely to be found by reading the tables of contents of the most recent issue of *Science* or *Nature*. If anything, it rather will by observing the structures of the economy and supporting the processes of discovery undertaken by the firms and other organisations operating in this economy.

[1] For analytical development of this argument [see David 1999].

Fixing coordination failures is another difficult policy challenge. The emergence and growth of a new activity, or the transition from an existing activity to a new one, or the extension of an existing activity through some kind of diversification, are processes that can be blocked by many types of coordination failures among economic agents (suppliers, users, specialised services, banks, basic research and training institutions, *etc*.). The sources of coordination failures are well known and have been extensively studied in the literature dedicated to development and innovation economics. But brilliant academic works regarding the identification of these sources have been more or less discarded because wrong policy lessons were drawn from them (sometimes by their authors). Any attempt to model or conceptualise coordination problems in order to design mechanisms to fix the failures necessarily involves the risk of trivialising the difficulty of such problems in practice which are in fact immense [Aghion, David, Foray 2009].

2. The economics of smart specialisation: a primer

Smart specialisation must not be associated with a strategy of the simple industrial specialisation of region X in tourism or fisheries for example. Smart specialisation is about R&D and innovation and it suggests that region X should specialise in R&D and innovation in the sector of tourism or fisheries. This means that smart specialisation is a process addressing the missing or weak correlations between R&D and innovation resources and activities on the one hand and the sectoral structure of the economy on the other.

A key point is that smart specialisation is not just for the best regions or technology leaders. On the contrary, this concept provides strategies and roles for any region. Indeed, the concept is built on the fact that there is not only one game in town in terms of R&D and innovation; *i.e.* there are many other kinds of productive and potentially beneficial activities apart from the invention of fundamental knowledge needed for the development of general purpose technologies and tools (GPTs). There are, in fact, different logics or orders of innovation [Bresnahan, Trajtenberg 1995].

Some regions can indeed specialise in the invention of the GPT while others will invest in the co-invention of applications to address particular problems of quality and productivity in one or several important sectors of their economies. Co-invention is here an important notion because it means that the very act of adopting some ICTs (or any other generic technology) to improve operational efficiency or product quality in a given sector of industry or service is by no means a simple task. ICT applications are not ready and waiting on the shelf for new users. The co-invention of applications actually involves a great deal of R&D, design and redesign, *i.e.* a collection of knowledge-driven activities. Smart specialisation therefore implies rejecting the principle of a sharp division of labour between knowledge producers and knowledge users. Any region is facing at least some challenges in terms of improving the operational efficiency and product quality of 'something' and this is a matter of R&D, capabilities, innovation, *etc*.

3. The anatomy of smart specialisation

3.1. A short (hi)story

By starting with a historical case describing a successful story of smart specialisation, we simply want to stress that the phenomenon of smart specialisation is not at all new; what is new, instead is the analytical description of the phenomenon which generates a few insights and directions concerning policy making.

In 1796, Pierre-Hyacinthe Caseaux, a producer of nails in Morez (French Jura), discovered that from the production of nails he could shift to the production of spectacles on the basis of the same techniques and capabilities. Because spectacles were by then a market with very high growth potential, many other nail producers started producing spectacles and many spectacles factories were created within the next 20 years and by the end of the 19th Century, Morez was considered one of the few world-class centres for the production of spectacles. The regional authorities helped the process by funding a technical school to train apprentices in this new specialisation. This is a nice story that includes all the ingredients of a successful smart specialisation strategy. First, this is a story of an entrepreneurial discovery of a potential specialisation and the knowledge produced by the entrepreneur does not concern a technical invention; it rather relates to the fact that a new domain of specialisation might be very beneficial for the region given the existing productive assets. Second, this is a story about imitative entry: when the initial experiment and discovery are successful and diffused, this is likely to induce other agents to shift investments away from the old domain to the new one. Third, the story concerns policy objective and practice, which is not about telling people what to do or which are the right specialisations, but accompanying emerging trends and improving coordination by providing the necessary public goods (education, training) and creating additional incentives at certain critical bottlenecks to help the new activity grow. Fourth, the outcome of the process is much more than a 'simple' technological innovation – rather than that, it is a structural evolution of the entire regional economy – in this case the transition from one old, perhaps declining activity to a new one offering superior commercial prospects.

We have made the Morez story very simple to help identify some stylised facts of smart specialisation. It is of course much more complex and the production decisions made by Caseaux were far less obvious than what we have described, making such success a low probability event and hard to predict. However, let's consider this simple narrative structure to illuminate three important ingredients of a smart specialisation process and derive from them a few policy insights.

3.2. Entrepreneurial discovery

Smart specialisation involves an entrepreneurial discovery process that reveals what a country or region does best in terms of R&D and innovation. This principle is so important that any model that did not include this provision would have an entirely different nature. It is important in order to make a clear-cut distinction between the smart specialisation approach and some older policy approaches involving centralised planning procedures as the main way to identify industrial development priorities. Although these old approaches to the problem of prioritisation and resource concentration involved formal exercises based on rationalist and robust theories (inter-sectoral matrixes, technological interdependencies and hierarchical structures, technological complexities), they were by their very nature largely technocratic. Such approaches, which claimed to be very scientific and rational in their ways of identifying priorities, targets and objectives, were actually very irrational in their quasi-ignorance of essential knowledge in this matter, which is entrepreneurial knowledge.

Entrepreneurial knowledge involves much more than knowledge about science and techniques. Instead, it combines and relates such knowledge about science, technology and engineering with knowledge of market growth potential, potential competitors as well as the whole set of inputs and services required for launching a new activity. The synthesis and integration of all this knowledge which is initially dispersed and fragmented create a vision and drive the decision 'to go'. It is this type of knowledge that needs to be activated, mobilised and supported as the main ingredient of a process of smart specialisation.

Smart specialisation is fundamentally based on a process of entrepreneurial discovery. Entrepreneurs in a broad sense (firms, higher education institutions, independent inventors and innovators) are best positioned to discover the domains of R&D and innovation in which a region is likely to excel, given its existing capabilities and productive assets[2]. And it may be that for many regions and countries the most important 'innovations' are not purely technical but in fact reside in this discovery process of what the country should do in terms of R&D and innovation [see Haussmann, Rodrik 2003]. For example, some entrepreneurs in the Finnish pulp and paper industry viewed nanotechnology as a promising source of valuable application innovations, and firms in this industry were taking steps to assess this potentiality. Some p&p companies responded to these opportunities by increasing their overall internal R&D investments, which were aimed not only at implementing available technologies but also exploring recent advances in areas of nanotechnology and biotechnology [Nikulaien 2008]. And so the process of discovery is achieved thanks to entrepreneurs who identify and reveal an original way of modernising their industrial processes.

Because of the importance of entrepreneurial experiments and discovery, there is no contradiction between a smart specialisation policy and a policy oriented towards entrepreneurship, young innovative firms and the openness of society[3]. On the contrary, these two policies are mutually reinforcing: without strong entrepreneurship, the strategy of smart specialisation will fail because of a deficit of the entrepreneurial knowledge needed to feed and nurture this strategy.

But another extremely important point is that such emphasis on entrepreneurial discovery should not result in narrowing the scope of policy intervention that is needed to address market and coordination failures which are likely to impede the transition from an initial discovery to a cluster of activities giving rise to a new domain

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[2] The first economists who highlighted the process of entrepreneurial discovery to identify potential specialisations were Haussmann and Rodrik in development economics [see Haussmann, Rodrik 2003].

[3] 'An open society is a marketplace where the rules of entry are clear and simple, and where entry into a legal business is easy or easier than entry into an illegal one' [Hall 2004].

of R&D and innovation specialisation. Emphasizing the role of entrepreneurial discovery is not, as we see it, a plea in favour of a *laissez-faire* philosophy.

3.3. Imitative entry and imperfect appropriation of the initial discovery

The discovery of Pierre-Hyacinthe Caseaux will very quickly result in a multiplication of 'entries' in the new activity. But this will raise an appropriation issue. The entrepreneur who has made the discovery will not be able (and actually should not be able) to capture a significant fraction of the social value of his initial investment. Consequently, there is a risk that not enough agents and organisations will invest in this particular type of discovery. Since imitative entry is desirable to a certain extent, the necessary correction of imperfect appropriation raises a difficult problem that we shall address below.

3.4. Structural evolution

As already underlined, the discovery that drives the process of smart specialisation is not about a simple innovation but generates knowledge about the future economic value of a possible structural change. In the Morez story the whole process gives rise to a transition from an old, declining activity to a new one. Transition is one pattern of structural changes that a smart specialisation strategy is likely to generate: it is discovered that a new domain can emerge from the existing industrial commons (the collective R&D, engineering, and manufacturing capabilities that sustain innovation).

But other patterns of structural changes are possible as the outcome of the smart specialisation process. 'Modernisation' is a familiar one: it is discovered that the development of specific applications of a general purpose technology can have a significant impact in terms of efficiency and quality in an existing (perhaps traditional) sector. The Finnish p&p industry has already been mentioned as an example. But many other cases can be quoted too, such as the development of ICT applications in the fishery industry or application of nanotechnologies within the agro-food sector. In all these cases, the intersection between the potential of a GPT application to 'modernise' and improve efficiency and quality and one important sector of the regional economy defines the feasibility space for smart specialisation strategy to be undertaken; *i.e.* where entrepreneurial experiments and discoveries are expected to produce socially useful knowledge and perhaps need to be induced, initiated and supported.

Another pattern of structural changes is about diversification. In such cases the discovery concerns potential synergies (economies of scope, spillovers) which are likely to materialise between an existing activity and a new one. Such synergies make the move towards the new activity attractive and profitable.

Another pattern is radical foundation of a new domain. The discovery here is that R&D and innovation in a certain field have the potential to make some activities progressive and attractive whereas they were not so before. Such radical foundation involves the co-emergence of an R&D/innovation activity and the related (and future) business activity. While some assets are present as well as market opportunities, a situation of no industry at all or just a very weak one makes it difficult for a knowledge-intensive activity related to these assets to emerge spontaneously. The discovery here is that research and innovation will transform an existing non-progressive service in such a way that it may become more profitable and beneficial for the regional economy. The development of IT applications for the management of knowledge about and the maintenance of archaeological and historical patrimonies is a good case in point.

4. Information and coordination failures and policy

As stressed above, the short story of Morez should not be taken as a plea in favour of a *laissez-faire* policy simply because governments cannot pick winning locales. Certainly the main issue to be addressed by policy is not 'what to do' but 'how to help agents to discover what to do and how to implement the policy according to what has been discovered'. Policy makers have to allow and help economic agents to find their own ways in a decentralised and bottom-up logic and then carefully observe what is happening. They have to aggregate the decentralised information generated by entrepreneurial experiments and discoveries, assess the outcome and help the most promising projects to grow. We have qualified the Morez story – which is about a small town becoming a world-class centre for spectacles design and manufacture – as a low probability event. This means that the main policy issue is to identify which structural conditions and policies in a specific region would increase the likelihood that there would be X>1 new industrial (and/or service) localisations appearing and surviving within the next 20 years.

4.1. Top down and bottom up: the false dichotomy

The policy process is complex: on the one hand, the principle of entrepreneurial discovery is essential, but on the other hand the constraints involved (smart specialisation should happen via an entrepreneurial discovery process) should not result in a shrinking of policy scope. Such complexity makes the standard 'top down' versus 'bottom up' dichotomy utterly useless to describe the political logic of the process. Policy aimed towards smart specialisation needs to be much more complex and sophisticated than this dichotomy would suggest. It is rather an iterative process through which policy makers (i) support (perhaps even orient towards certain directions) entrepreneurial discoveries (through some kind of incentive mechanisms); (ii) observe and assess the results of the experiments and construct and share a strategic vision according to what has been discovered and observed and, finally, (iii) help fix coordination failures so that a few discoveries are likely to become real and solid drivers for regional economic growth.

4.2. The three steps comprising the smart specialisation policy process

Above we have defined three main topics for policy as an iterative process towards smart specialisation. These three topics define three steps in the policy process, each being associated with different kinds of policy instruments.

The first step involves creating an economy that generates intensive activities comprising experiments and discoveries. Market failures restrict the process of entrepreneurial discovery due to the imperfect appropriation of the knowledge produced by these entrepreneurs. Indeed, imitative entry is a key ingredient of smart specialisation so that agglomeration externalities can be realised: the discovery of a potential domain in which a region could become a leader should very quickly result in a multiplication of 'entries' in the new activity. It is thus important to provide incentives to help the system generate more experiments and discoveries but this must be done without granting entrepreneurs a monopoly on the knowledge they produce. In fact, the ultimate objective is to diffuse the knowledge regarding the value of a new activity for future specialisation in order to generate collective emulation and imitative entry towards the new domain[4]. The policy instruments involve various types of public-private partnerships, ranging from direct public funding of entrepreneurial projects to collaborations at national laboratories between firms and government scientists as well as prizes and bonus mechanisms [Stiglitz, Wallsten 1999]. It may prove useful to draw inspiration from some historical examples where a prize was awarded to inventors, the amount of which was calculated according to the importance of the diffusion (imitative entry) of the invention [Foray, Hilaire Perez 2005].

But building such an economy of intensive activities regarding entrepreneurial experiments and discoveries requires not only addressing the imperfect appropriateness problem but also creating conditions for multiple micro-systems of experiments and discoveries to emerge. To use David and Metcalfe's argument – built at the same time and in the same context as the smart specialisation argument – the performance of entrepreneurs and firms in experimenting with and discovering potential domains for future specialisation may depend upon the way in which they build an external organisation of connections with universities, laboratories, suppliers and users. The main policy problem therefore appears to be one of helping to design such inter-organisational connections and coordination of efforts in the sphere of experimentation and discovery [David, Metcalfe].

An example of a proactive policy to boost experiments and discoveries while encouraging connections among economic agents is one using a voucher mechanism. Vouchers (credit notes) could be provided to firms to commission an R&D project from a public research institution or any specialised R&D organisation. Depending on sectoral contexts and local circumstances, voucher attribution could be conditional on projects aimed at exploring a certain possibility of structural evolutions that has been ex ante identified through some kind of foresight process involving firms, universities and policy makers (modernisation, transition, diversification, radical foundation, see above). Thanks to this incentive plus some ideas concerning the kind of structural evolution desirable, given the strengths and weaknesses of the regional system, the policy process is in a position to guide the whole smart specialisation

[4] Moreover, the discovery does not concern a technical invention but involves the identification of a domain of future specialisation. This type of discovery is normally not subject to legal protection, whatever its social return may be [Haussmann, Rodrik 2003].

strategy. However, subsequent decisions and choices (whether to help and support one particular trend as a potential domain for future specialisation) are conditioned by the quality of the entrepreneurial discoveries that will be (or not be) made. Finally, being granted a voucher for discovering a domain (not inventing a technology) implies that the company will publicly disclose the knowledge about its discovery to generate imitative entry and collective emulation towards the new domain.

The second step involves assessing the outcome so that the support of a particular line of business will neither be discontinued too early nor continued so long that subsidies are wasted on non-viable projects. Of course, *ex ante* assessment of the future value of an R&D specialisation is next-to-impossible a task. But at least simple criteria should be considered such as the potential size of the new activity (*i.e.* relative importance in the economy of the relevant sectors that will benefit from the smart specialisation strategy) and the connectedness of the new domain (it is always better to occupy the dense part of the forest, where it is easier to jump to other branches; R&D domains with high connectedness will create greater opportunities for future structural changes [Klinger, Lederman 2004]. When the assessment has been made, the role of policy is to construct and disseminate a strategic vision of where the regional economy should go according to the assessment. Such a strategic vision, which is elaborated on the basis of decentralised, market-driven experiments and discoveries and shared among all the actors in the economy, is critical to create positive expectations concerning the new activity and help fix coordination failures.

The third step involves the support and strengthening of the emerging trends so that the most promising projects can grow and become solid drivers for regional economic growth. But most projects with the potential to give rise to a new activity require simultaneous large-scale investments to be made in order to become profitable [Haussmann, Rodrik 2003]. All the necessary services and complementary activities have fixed costs and are unlikely to start unless service and other input providers have enough positive expectations regarding the future of the smart specialisation strategy. Profitable new activities can fail to develop unless upstream and downstream investments are made simultaneously. How does one help solve this problem in a 'generic' fashion that does not turn into a government subsidy for the development of a particular industry in a specific region? This is one instance of a category of difficult issues that frequently bother economists and experts from international organisations like the World Bank working in developing regions. Possibly the resolution in this case lies in the idea that there are phases in smart specialisation where temporary 'industrial policy' measures, such as infant industry policies, are warranted.

The most obvious coordinating action is to provide the specific public goods – such as education and training or basic research – whose supply is crucial to allow the new activity to grow. This implies supporting the provision of adequate supply-responses (in human capital formation and research) to the new 'knowledge needs' of traditional industries that are starting to adapt and apply the GPT by subsidising the follower region's access to problem-solving expertise from researchers in the leader region, and attending to the development of local personnel that can sustain the incremental improvement as well as the maintenance of specialised application technologies in the region.

Not all regions need to go through all the three steps. A few (leading) regions have a supercritical density of entrepreneurs and capabilities so that the discovery process is happening all the time and sufficient knowledge about the value of future activities for the region is constantly produced. Alternatively, in some regions the industry commons (the local collective capabilities and knowledge of technologies and engineering associated with existing industries or services) are very rich, generating many opportunities for transition and evolution. In such cases, the policy tasks can start right from step 2. However, the step 2 may in this case occur more difficult, since so many experiments and discoveries are happening that taking stock of them, observing and assessing the outcomes and creating a strategic vision will require strong capacities of observation, aggregation and interpretation by the policy makers. In many other cases – those of regions which are relatively poor in entrepreneurial discoveries so that the possible paths for structural changes are not discovered – the process needs to start from step 1.

5. Conclusion: 'Getting focused by developing original and unique areas of knowledge expertise'

A specialisation strategy is *smart* in two senses:

The specialisation is about knowledge resources and seeks not only the concentration of resources but also to do it in an original and rather unique area of knowledge expertise. Smart specialisation involves both a logic of concentration and a logic of particularisation of the regional knowledge assets. And the peculiar properties of GPTs, such as information technologies, make it possible for any region, including 'followers', to distinguish themselves in the knowledge economy.

The policy process follows a complex and iterative logic that cannot be described as essentially top down or essentially bottom up. This is a process in which the principle of entrepreneurial discovery plays an essential role and yet does not minimise the importance of policy intervention.

Smart specialisation is not the same thing as a *cluster policy*. Of course generating a vibrant innovative cluster is a classic outcome of a smart specialisation policy which is 'good for my region'. But smart specialisation as a policy process also exhibits 'efficiency properties' at the system level (*i.e.* for the integrated regional system as a whole such as the EU). Regional cluster policies do not fundamentally change (and are even likely to accentuate) the problem of strongly mimetic national programmes resulting in knowledge base uniformisation, wasteful duplication of R&D efforts and dissipation of the potential agglomeration economies at system level (too many too small sites competing to attract the same kind of knowledge resources). Smart specialisation, on the other hand, involves the discovery of what makes a local knowledge base original and somewhat unique. Therefore, smart specialisation generates a greater diversity of areas of knowledge expertise at system level and makes the whole system more capable of reaping the benefits of the agglomeration economies arising from the development of distinctive and original sets of capabilities in each region.

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Pomorskie Province in the New Global Settings

1. Introduction

'Region' is a term recently used in the context of the new financial perspective. All Member States are interested in the use of structural funds. In the context of the

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economic crises this issue is discussed more and more often. For the regions of the European Union, it is crucial to benefit from structural funds. It is not only the matter of the amounts of money distributed within a country, but also of the quality of the framework in which it is distributed.

The term 'region' can have different meanings. It can refer to a region within one country or to a group of countries like Baltic Sea Region. However, it is used very often to describe an individual country. The European Union decided to divide the levels of regions into groups. It created the NUTS classification. For the purpose of this article, regions are the level of NUTS2. In Poland, it is the level of province.

Regional development remains in the scope of interest of many specialists. It is a dynamic process which refers to development of specific areas in regions and brings significant changes to socio-economic conditions. It means that regions witness positive changes in terms of their economic potential, competitiveness and the quality of life of their inhabitants [Murzyn 2010].

That process can be influenced by various determinants which could be divided into 5 groups: economic, social, technical and technological, environmental, political.

Table 1. Determinants of regional development

Determinants	Internal	External
Economic	Technical, social and economic infrastructure Economic potential Income Capital and investment	Macroeconomic situation of a country External capital and investment
Social	Needs, values and ambitions of the inhabitants Level of education Level and style of living Attitude towards reforms, innovation and technical development Creativity and entrepreneurship	Culture, tradition of a wider territory
Technical and technological	Increase in the capital and the change of its structure Development of the high technology industry	External determinants of technical and technological development
Environmental	Natural resources Environmental values Progress in environment protection	External determinants of the environment
Political	Effective leadership Acceptance of the local authorities	Political system of the state Local authorities independence

Source: Murzyn 2010: 23.

Taking into consideration the economic determinants, we would like to present the Pomorskie province as a case study. The aim of the article is to present the current status of the region in Poland, and to present the initial scenarios of its development in the future. Is Pomorskie able to become a part of Europe 2020 Strategy? The Strategy, which was proposed in 2010, presents three principal directions for future development of Member States [Conference... 2011]:

1. Smart growth which is characterized by creation of real knowledge-and-innovation based economy through the increase in R&D expenditures, better education, training, lifelong learning, and the development of the digital society.
2. Sustainable growth which means more environment-friendly society and economy by effective use of natural resources, and through the EU being the environment preservation leader, combating climate change, and increasing the renewable energy share.
3. Inclusive growth which results in making the most of the labour potential through the increase in the employment rate, improving skills, participation in lifelong learning, and fighting poverty.

2. Pomorskie province – current situation

Pomorskie province covers the area of 18 310 km^2 [Central Statistical Office 2011]. The region is situated in the centre of the Baltic coast, and is one of the 3 Polish provinces with the access to the Baltic sea. What are the main characteristics of the Pomorskie province?

2.1. Population

The population of Pomorskie was 2.2 million in 2009, accounting for 5.7% of Poland's total population. In 2009, the region had the highest birth rate of 3.5 (per 1000 people). In 2009, the total fertility rate reached the highest level of 1548 among Polish provinces [Central Statistical Office 2011: 36–39].

Since 2005, the Pomerania region has witnessed positive changes in the internal and international migration for permanent residence. Since 2000, the region has seen the inflow of inhabitants. However, this is mainly true for the sub-region of Gdańsk, whereas other sub-regions witness their outflow. The outflow abroad is higher than the inflow from abroad. The Main Statistical Office in Gdańsk predicts that by 2035 the population of the region will stay at the same level, but there will be the observable decrease in birth rate to –3.1 per 1000 people [Umiński 2010].

Between 2000 and 2009, the decrease in the number of people below 25 was observed, from 37.4% to 31.1% (% of the total population). At the same time, the share of people over 65 increased from 10.8% to 12.3% [Central Statistical Office 2011: 40–41]. That is a global trend observed in most countries. The demographic change is considered to be one of the crucial challenges for the future of the world.

In order to briefly present the quality of life, we need to present the level of unemployment and the average monthly wages in the region. In 2009, Pomorskie province recorded 11.9% unemployment, which was higher than the average for Poland by 1.2%. However, it was greatly diversified across the sub-region, ranging from over 18% on its periphery to just 4% in Gdańsk, Gdynia and Sopot (Tri-City sub-region). In Gdańsk, Sopot and Gdynia, business life is concentrated and new jobs are created [Statistical Office in Gdańsk 2010b].

Since 2000, the rise in monthly salaries has been observed. The average monthly gross wages and salaries rose from PLN 1938.07 (2000) to PLN 3383.58 (2010).

Pomorskie province has always been considered an attractive place for living. The reputation is not only a result of its economic potential, but also its tradition, culture and diversification. Specific determinants make the region interesting for young people, *e.g.* the combination of conservative lifestyle and innovative way of thinking.

2.2. Economy

The province is economically diversified. The region contributes 5.5% of the national GDP (2008) [Central Statistical Office 2010b: 86]. If GDP *per capita* is considered, the Pomerania region is ranked even higher. It holds 5th position behind Mazowieckie, Dolnośląskie (Lower Silesia), Śląskie (Silesia) and Wielkopolskie province. In addition, *per capita* GDP of Pomorskie province rose by 4.9% in the years 2007–2008 [Statistical Office in Gdańsk 2010b].

The regional economy is greatly diversified with regard to its various branches.

In 2009, in Pomorskie province there were 1118 (per 10,000) national business entities registered in REGON. It gives the region 3rd place among Polish regions (behind Mazowieckie and Zachodnio-Pomorskie provinces) [Statistical Office in Gdańsk 2011]. In 2000, the indicator for Pomerania region was 920.

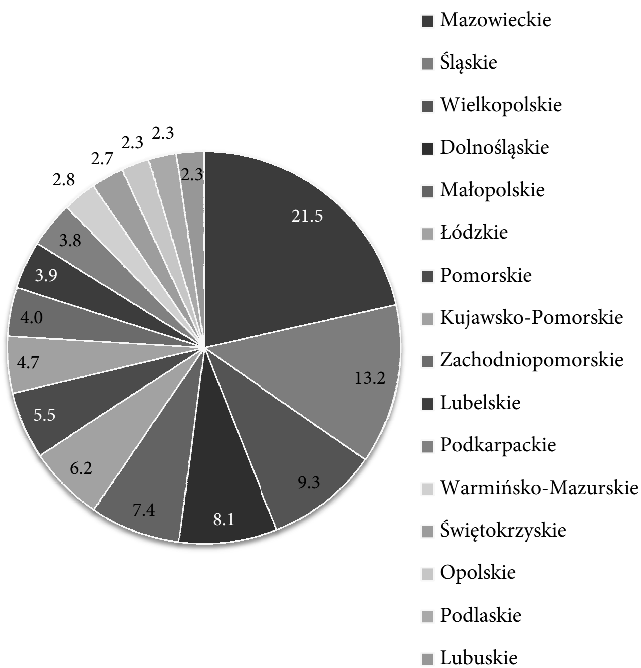

Figure 1. Share of regional GDP in Poland's GDP in 2008 (current prices)

Source: Statistical Office in Gdańsk [2011].

In 2009, the investment outlays reached the level of PLN 17 583.7 million. The rising trend can be seen in the recent years. In the case of Pomorskie province, the industry and construction sector (38.7%) are responsible for the highest share of the investment outlays [Statistical Office in Gdańsk 2011].

In Pomorskie province, a constant increase in innovation expenditure is observed in industry. In 2008, it reached the level of PLN 2.182 million, whereas in 2000, it amounted to PLN 742 million. However, at the same time, there is a decrease in enterprises making expenditures. The number of companies investing in innovation shrank from 40.4% in 2005 to 26% in 2008 [Statistical Office in Gdańsk 2010b].

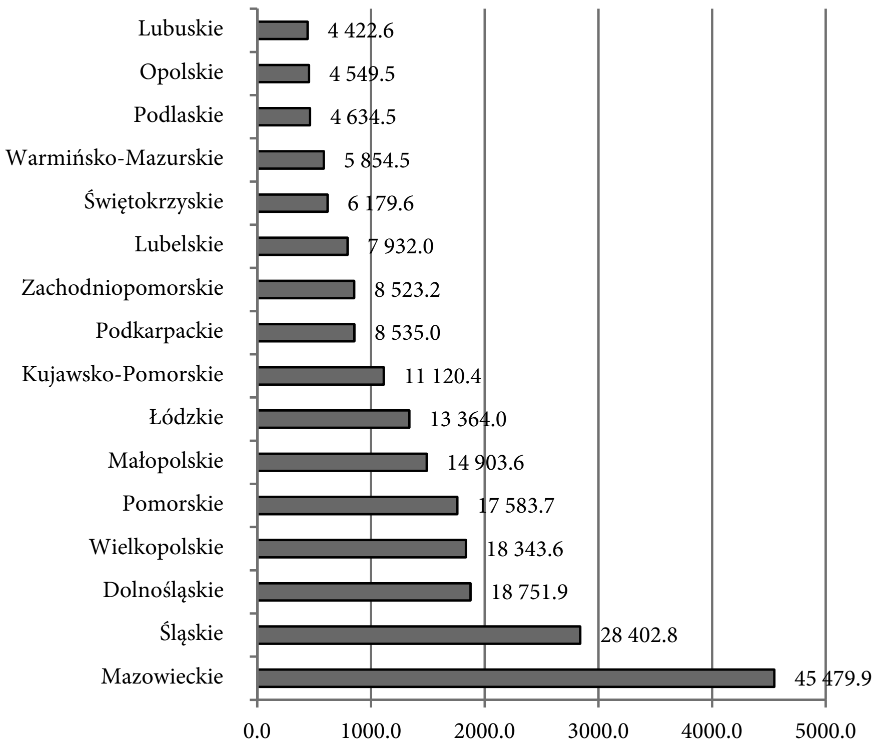

Figure 2. The investment outlays in provinces in 2009 in PLN millions (current prices)

Source: Central Statistical Office 2011.

According to the report by Gdańsk Institute for Market Economic, in Pomorskie province there are branches crucial for socio-economic development, which are naturally concentrated in this region. The analysis took into consideration the number of employed people (at least 10,000), the share of production sold and location indicator (higher than 0.85). Construction sector, agriculture and food industry (fishery), maritime (incl. shipyards) industry, ICT, LTD, chemical, woodwork and furniture businesses, tourism, hardware, machine-tool and jewellery are the branches that can be pointed out as the key ones for the economic development here [Instytut Badań nad Gospodarką Rynkową 2008].

2.3. Global setting

Since 2002, the share of the Pomorskie province export in Poland's export has decreased. In 2002, it reached 11.4% and in 2009 fell to the level of 6.7%. However, in terms of the volume of trade, no reduction has been observed. It may be a result of the dynamic development of total export in Poland. Other regions, however, managed to increase their trade volume. In 2009, there was a decrease in the volume of export (from €10 000 million to €7 000 million). In this case, it is a result of the crisis [Umiński 2010].

In 2009, the share of export in the income from total sales in the service sector in Pomorskie was higher than in the rest of Poland. In agriculture and industry, however, it was lower. By comparison, in 2008 and 2009, Poland witnessed an increase in the share of export in the income from the total sales in agriculture (from 4.8% to 6.8%) and industry (from 34.3% to 35.7%). In the service sector, a slight decrease was observed (from 5.4% in 2008 to 5.3% in 2009). In Pomorskie province a drop was observed in all sectors [Umiński 2010].

Research shows that the most important areas of export are: machinery and consumer electronics production; production of transport equipment, motor vehicles, trailers and semitrailers; office equipment and computers production; textiles. In these areas, the share of export in the income from the total sales exceeds 70% [Umiński 2010].

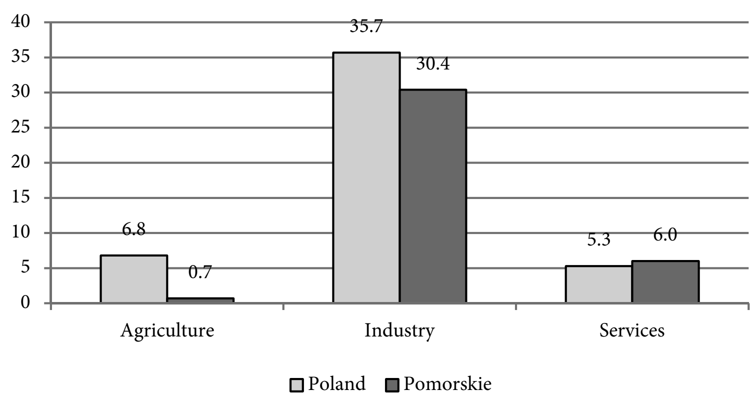

Figure 3. Share of export in the income from the total sales (%)

Source: Umiński 2010.

Pomorskie province is one of the leading exporting regions in Poland. When we compare the share of the region in Poland's export and its share in Poland's GDP, it is obvious that the region's contribution to Polish export is higher. The region is more concentrated on foreign markets than the domestic one.

In the region, there were 1270 entities with foreign capital, which accounted for PLN 13 028.5 millions' worth of export in 2009, and PLN 11 030.2 million. About 42% of the companies both export and import. However, for a few years now, as revealed by the statistics, the foreign capital has mainly been directed to Mazowieckie, Dolnośląskie, Śląskie and Wielkopolskie provinces [Central Statistical Office 2010a].

Another important determinant for the region is the role the European Union plays. If we look at various economic indicators, *i.e.* export, inflow of foreign capital, *etc.*, it becomes obvious that the highest dynamics was observed between 2000 and 2007. However, it was not only Pomerania that lost its dynamics; other regions in Europe did as well, which was a result of the economic crisis.

The European Union plays an important role in the future of Pomorskie province. Starting from 2007 and by 2013, numerous construction investment projects will have been realized. Companies have the possibility of development thanks to structural funds.

3. Summary – development scenarios

Considering the effects of globalization and the role of the European Union, a project by Gdańsk Institute for Market Economics proposed a few scenarios for Pomorskie province. The main determinant influencing Pomorskie province development strategy in the future is the European Union.

The EU may be considered both a chance and a threat. Currently, it is difficult to predict the future status of the EU. The economic crisis shed a new light on politicians on the European level who seem unable to take responsibility for the difficult situation in countries like Greece, Italy or Spain.

If the crisis keeps expanding, probably, the next financial perspective for the years of 2014–2020 will be very difficult to agree on through consensus. Whatever the new financial perspective looks like, however, there is a chance to use it wisely and effectively in Pomorskie province. The discussion on the cohesion policy continues and the phenomenon is difficult to evaluate. On the other hand, if the priorities are competitiveness and innovation, the potential of the companies based in Pomorskie province may be put to use. The focus on the entrepreneurship may lead to further dynamic growth.

If the EU funds support the idea of cohesion and the basic infrastructure in Pomorskie province, it will be possible to build a unified region offering all its inhabitants equal standard of living.

On the other hand, the role of the economic centre may be pointed out. The economic crisis has shown that the Western countries are not able to help each other during less favourable periods. The European Union is looking for financing from China. In that scenario, in which Asia becomes the new centre of economic life, the region's strategy must be revised.

A brief description of the possible scenarios for Pomorskie province is presented below [Instytut Badań nad Gospodarką Rynkową 2010].

Table 2. The future scenarios for Pomorskie province development

Scenario	Short description
Asian air carrier	In next few years, Asia becomes the most dynamic region of the world. Representatives from these countries look for partners in the West. The strategy for Pomerania region shall be based on transport and communication, providing the inflow of foreign capital into the region, cooperation with Asian administration, as well as cultural and language education concerning Asia.
Service centre	Because of the economic crisis the world is becoming more and more unstable. Pomorskie province's strategy pays a lot of attention to university education, and, thanks to the structural funds, provides highly-qualified employees for foreign companies. The region attracts various investment projects which focus on services (off-shore), mainly in the Tri-city agglomeration.
Baltic Lake	The strategy of the region concentrates on the Baltic Sea Region. Through the development of transport and communication, it leads to a decrease in costs. The companies from the region cooperate closely with innovative Swedish and Finnish companies with Pomerania companies playing their role in the production chain. Later, the companies in Pomorskie province will acquire the know-how from the Scandinavian companies. The growing branches are ICT, biotechnology and environmental technologies.
Technological niche	Pomorskie province focuses on specialization. Because of its economic structure, strengths and close proximity to Denmark, Sweden and Finland, the region specializes in ICT, IT, biotechnology and renewable energy technologies. That makes the province attractive, and many foreign investors are interested in doing business in the region. It is supported by educational institutions which provide highly-qualified employees.

Scenario	Short description
Pomorskie Residence	The world crisis is drawing to the end. The developed countries are slowly starting to grow, whereas the BRIC countries and the developing countries are on the right track to do so. Poland records high growth and the welfare of the nation is increasing. Poland attracts new investors thanks to its infrastructure and professional specialists (education), which focus on the central and southern Poland. Therefore, Pomorskie province becomes a good place to live. The development strategy focuses on medical services, tourism and sports. Numerous investments create an attractive place to spend free time and live there. The region develops more steadily.
Indigenous entrepreneurship	The strategy is based on local entrepreneurship. Because of the crisis many investors withdraw their capital from the region. The foreign markets are not stable, and it is difficult to run an international business. However, Pomorskie province has always had a very high level of entrepreneurship. The companies that survived the crisis were operating with the use of loans and their own resources accumulated in the past. Investments in education and innovative infrastructure resulted in establishing science and business centres, where new technologies are elaborated. New young scientists set up companies based of their research. The region is growing slowly.
Forgotten periphery	The economic crisis did not enable the countries to come back on their track to growth. Investors moved away from the developing markets to their domestic ones. As the EU is in stagnation, the structural funds also decreased. There is no financing for innovations. Young and ambitious people leave for different regions. Because of the slowdown and high level of unemployment, the local authorities agreed to have 'dirty' investments in the region to create new jobs. It leads to future pollution, people becoming ill and other external costs. As a result, Pomorskie province loses its reputation for high standard of living.

Source: Instytut Badań nad Gospodarką Rynkową 2010.

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Przemysław Dubel

Regional Policy in Reducing Regional Disparities

1. Introduction

The creation of a common policy covering the principal areas of economic life on a supranational arena is a major characteristic feature of the European Community. However, a gapping difference is seen in the lack of internal balance, leading to disparity in the social and economical development in these regions. The most evident disparity is in the excessive concentration of various marketing processes in operation in these regions resulting in reduction of regional diversification [Ciepielewska 2001: 383].

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One of the mechanisms effective in decreasing inequalities within regional development is the presence of a Regional Policy. The legal fundaments of this policy were first written in 1957 in Rome in the preamble tract to the EEC[1] and then again in 1960 in the ECSC[2] Treaty. This entailed details on how to go about financing new activities in regions which were in dire need of industry development.

One of the main purposes of the EU regional policy is to reduce disparities in economic, social and territorial development through redistribution of the budget. In this area EU regional policy is very often identified with the Cohesion Policy, because its purpose is to reduce disparities in the economic development between regions using the Structural Funds which are addressed to the poorest member states[3].

The Regional Policy is also identified with the Structural Policy[4]. This policy is applied in the regions with decadent branches or sectors of economies, such as heavy industry or textile industry [Nowak, Milczarek 2006: 287].

As regards the Regional Policy, two distinct options are available: the first is levelling, while the second is polarization [Bachtler *et al.* 1996]. The followers of the levelling variant opt for the State's intervention in developing its regions so that poorer regions are supported by the State. The aim of this type of intervention is to restructure the economy which in turn dynamically boosts the increment and starts the process of 'catching up' the rich regions.

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[1] European Economic Community – EEC – this international organization emerged as a result of an integration process started just after World War 2 by European democratic States in the area of market economy. Their activities began on 1 January 1958, on the basis of the Treaty of Rome of 25 March 1957. The main aim of this community is to develop the economy of member states, guarantee economic liquid flow, raise the living standards and intensify international relations among member states.

[2] European Coal and Steel Community (French De Communauté Européenne du Charbon et l'Acier – CECA) is a European organization having a legal entity with its headquarters in Luxembourg, having a lifecycle of 50 years, has a strong international structure as signed in the Treaty of Paris by representatives of six European States (Belgium, France, Holland, Luxembourg, West Germany and Italy) on April 18th, 1951. The ECSC was established in order to create a common carbon market between France and West Germany.

[3] This purpose is in line with that of the cohesion policy, which is to support different activities resulting in equalization of economical and social conditions in all the regions within the European Union.

[4] Some authors alternatively use the names: regional policy and structural policy, where over 90% of the funds are allocated by the European Union for the structural policy in proportion to regional needs [see *e.g.* Szlachta 2000: 27; Duczkowska-Małysz 2000: 71].

Those advocating the polarization variant believe that any interference by the State breaks the market mechanism which is most effective for them; they prefer that the State refrain from interfering in the processes of regional development.

2. Regional intervention

The above-mentioned variants are both used to achieve the main objective of aligning the social and economic development of regions, especially after the enlargement of the European Union on 1st of May 2004 where poorest countries with their underdeveloped regions were given membership of the already existing EU-15. It challenged the policy of regional development in two dimensions: firstly, it led to the doubling of population in regions where their *per capita* GDP was below 75% – which, by the way, is the present average GDP in the EU; secondly – it increased the scale of existing disparities even more.

Basing on the *Third Report on EU Social and Economic Cohesion*, the acceptance of the ten new countries into the Community gave a statistic effect of decreasing the average *per capita* GDP by about 12.5% and, as a result, a relative corrugation of 'old' Union regions was formed.

Based on the Eurostat data from 2010, the richest countries (Luxembourg, Norway, and Sweden) account for about 10% of the Union population after the enlargement to EU-27. They are characterised by an average *per capita* GDP reaching up to 200% compared to EU-27=100. Yet poorer regions, like Bulgaria, Latvia and Romania have a meagre *per capita* GDP which does not surpass 47%.

In effect of such a disparity, all the countries that became the EU member states on the 1 May 2004 chose to opt for the 1st Objective of the Regional Development Policy which is Convergence. This means the development by cohesion of the poorer member states and regions, through corrugating conditions for economic growth and escalation of employment within them.

The implementation of the European Regional Development Policy (within the first period of programming 2004–2006) meant the opportunity to use around €18 bn within that period. The total sum available in the Community funds is around €13 bn, within the confines of seven operative programmes, two Community Initiatives (INTERREG and EQUAL) and the Cohesion Fund [see Narodowy Plan Rozwoju 2003].

Polish Regions taking the lead with respect to agreements signed and therefore partly financed by the EU are: Mazovia Region, Silesia Region, Great Poland Region, Lower-Silesia Region, thus having the highest *per capita* GDP. However, Lower-Silesian and West Pomeranian regions are characterized by being able to give its inhabitants more financial support.

The financial support in the current period of programming of Structural Funds in the European Union amounts to about €60 bn, which places Poland in the leading position in the EU-27 (see Figure 1).

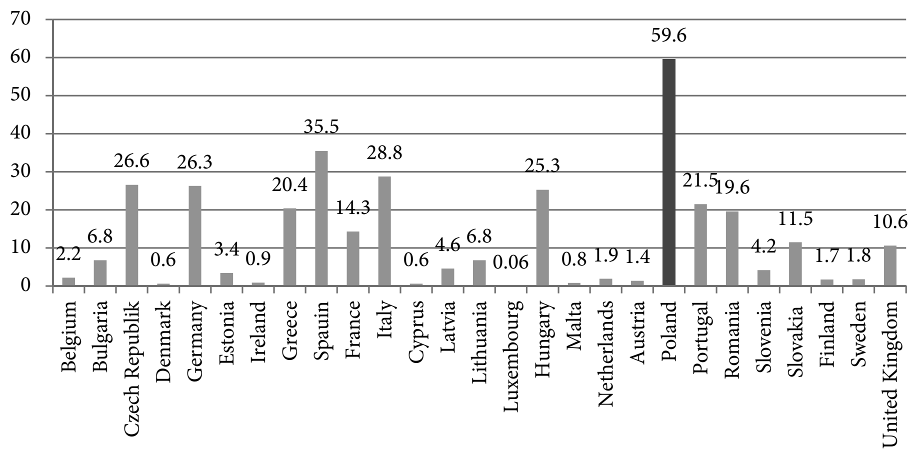

Figure 1. Allocation levels in the new period of programming (2007–2013) in billions of euro

Source: Personal elaboration based on EUROSTAT, 2007.

The main areas of intervention which received support (Figure 2) are operations within the confines of development of infrastructure and environment, regional operative programmes, human capital and innovative economy (42%, 25%, 15%, 13% of allocation, respectively) [National Strategic 2007].

Levels of absorption achieved from 2004 onward made it possible to evaluate, using HERMIN macro-economic model[5], the scale of influence of investments co-financed by European Union upon the principal macro-economic categories, such as

[5] HERMIN Model is an econometric model which serves for forecasting activity of macro-economic influence of implementation of structural investment on national or regional economies. This model is applicable by many EU member states as well as by the European Commission. More information about HERMIN model is available on the websites: www.funduszestrukturalne.gov.pl, bookmark /ewaluacja/ and also www.warr.pl

the growth of national economy and change of situation on the labour market. Data used for calculations were those concerning the total value of all expenses incurred by beneficiaries on implementation of projects eligible for refund under the operative programs, Community initiatives and the Cohesion Fund for the years 2004–2005.

A forecasted influence of implementation of involvements co-financed by the EU upon the level of *per capita* GDP is presented in Figure 2.

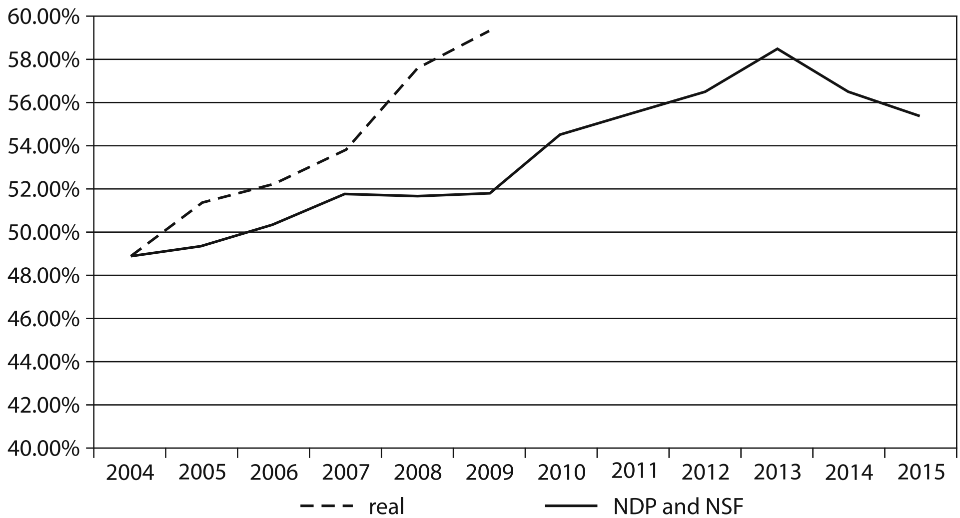

Figure 2. The influence of the Structural Funds under the National Development Plan (NDP) and National Strategic Framework (NSF) upon *per capita* GDP (average for EU-27 = 100)

Source: www.ec.europa.eu/eurostat from November 26, 2009. BDR, Central Statistical Office 2010 and Zaleski, J., Tomaszewski, P., Zembaty, M., *Ocena makroekonomicznego wpływu realizacji NPR..., op.cit.*

As seen in Figure 2, at the beginning of the period of foreseen transfers from the EU Structural Fund the influence of implementation as regards the NDP and NSF upon *per capita* GDP was small, but then it gradually increased to achieve its peak level of 59.3% in 2009 (blue line). According to the HERMIN model (red line), the maximum level will be achieved in 2013 (However, a lower level was achieved in 2009), and then begins to decline to 2.5% till 2015. This situation *i.e.* real *per capita* GDP growth larger than foreseen, mainly results from a high level of absorption of the Structural Funds, which in 2009 surpassed 100% of allocation[6].

[6] At the moment of closure of the first period of programming *i.e.* at the end of year 2009, percentage of utilisation of the structural funds within all the operative programs under implementation amounted to 107.3% of the entire allocation.

3. Summary

The analysis of the Community expenditure carried out by the Author of this article, shows that the influence of the Structural Funds is especially significant as regards a boost of production capacity of production factors (both through increased levels of labour force skills and better access to technical and transport infrastructure). An increase of production capacity of global economy results in smaller demand for labour force (at constant production volume). However, in the long run it improves international competitiveness of economy, attracts foreign capital, stimulates production and, in effect, positively influences the employment.

Structural intervention which took place during both the first and the second period of programming resulted in economic growth, both thanks to increased demand and to consolidation on the supply side (due to improved condition of infrastructure and of human capital), which has influence upon the growth of cohesion processes. Regions covered with the activities of 1st Objective (the entire Poland) managed to partially decrease the gaps between them thanks to deployment of innovations, improvement of environmental conditions as well as escalation of institutional production capacity.

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Anna Masłoń-Oracz*

EU 2020 from the Small and Medium Enterprises' Perspective

The EU trade contributes to developing and maintaining working places in the long term perspective. Trade influences life of every EU citizen, businessman, family. While taking this into consideration and the fact that 'EU is struck by what probably is the worst crisis in its history'[1] changes in EU trade policy play an important role in both sustaining and improving Europe's position on the international arena.

Potentially, the EU 2020 policy objectives of achieving smart, sustainable and inclusive growth and of creation of working places could be reached by deepening EU trade policy [SEC 2010]. But this will not happen if the established rules of running business across the EU won't be accessible to all, simple and efficient.

Attempting to answer how small and medium enterprises may benefit from EU 2020 regulation is not the objective of this paper. Nor does this paper measure all the aspects of entrepreneurship influencing competitiveness or economy.

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[1] W. Molle's speech during the EUIntegRatio conference, October 19–20, 2011.

The aim is simply to answer how the changes may affect the enterprises? As the deep and efficient single market is the key factor determining the EU's overall macroeconomic performance, which regulations constitute constraints and which package of regulatory reforms may prove to be the most effective in developing a competitive economy?

The upcoming 20th anniversary of the 1992 Single Market Program is the opportunity for Europe to make substantial progress within the market integration. As Jose Manuel Barroso said, the Commission would aim to 'regain momentum in the internal market by bringing forward a major package for tomorrow's Single Market'[Barroso 2009]. The single market today is less popular than ever, while Europe needs it more than ever [*A New Strategy...* 2010] because deeper understanding of the connections between business regulation reforms means broader economic outcomes. Changes in the trade policy seem to increase the predictability of the economic interactions worldwide.

On November 9, 2010, European Commission has published a communiqué on new approach to EU International Trade Policy 'Trade, Growth and World Affairs – Trade Policy as a Core Component of EU's 2020 Strategy' [*Trade, Growth…* 2010]. Although the communiqué is the key element of foreign dimension of 'Europe 2020' strategy, which goal is the intelligent, sustainable and socially inclusive development, what is important from the perspective of development of entrepreneurship, the document outlines how politics will contribute to trade and investment development. The communiqué is linked to the following documents: Trade as a driver of prosperity [European Commission 2010a] and Report on progress achieved on the Global Europe strategy [European Commission 2010b]. Developing competitive economy based on knowledge and innovation may to bring Europe back to its lost position in World's affairs [see Bochnik 2006]. This process in particular should involve more support for small and medium enterprises sector. United States experiences show that small enterprises, while themselves not prone to changes in economic cycle, may often influence it positively [Wardęga, Kucharski 1999]. Economic boom in the Seventies and Eighties in US was mostly based on intensive development of small and medium enterprises [Surdej 2000: 8; Piasecki 1998: 110]. Small enterprises are perceived as the most 'mobile' sector of the economy. That means that they are able to respond in the most rapid way to changes in the environment and to the needs of potential clients [Skowronek-Mielczarek 2002: 37]. If EU enterprises' cooperation is to be continued on such a poor level, not even the best strategy will give Europe a competitive edge on the global stage[2].

The ability of an enterprise to develop innovative solutions in production, processing, marketing or management dimension[3] is the core of its competitive advantage, protects it from losing its position on the market and guarantees a market success [Matejuk 2005: 14]. It is also reflected in EU GNP. As developing innovations requires many years of costly researches, enterprises exploit external innovations [Rigby, Zook 2000: 80–89]. This is the goal of technological parks which create opportunities to access the sophisticated knowledge and abilities impossible to attain with limited financial means of actors active in small and medium enterprises sector. The Eighties and Nineties in OECD countries was the time of popularization of the idea of technological parks and the dynamic development of clusters. Concentration of specialized enterprises led to a higher productivity, what is closely linked to comparative advantage theory and influencing the potential competition to cooperate in a given sector. Because of their specifics the parks play an incubating and cluster-promoting role. In the growth stage the incubating function gives enterprises an access to infrastructure, which is often expensive, and to management support. As far as the cluster-promoting function is concerned, the effect of spatial concentration is definitely an advantage. Assembling enterprises and research institutions at a close distance may lead to a larger number of more rapidly implemented innovations. This in turn generates externalities and leads to production growth of enterprises of the cluster. The common features of every park are: transfer and commercialization of technologies, creating advantageous conditions for developing innovations in enterprises, creating new working places, developing and introducing new products to the market, developing clusters. The development of entrepreneurship and the increase of innovativeness, achieved through strengthening the environment supplying services for enterprises, could bring Europe back on the economic growth track. Preparing modern infrastructure for economic activity, including stimulation of entrepreneurship and innovative activity by fostering business – research links, improving innovations' introduction and commercialization (and technology transfer) – this is the synergy effect which is possible to achieve.

Turning Europe into an important player is the goal of the Europe 2020 Strategy. It encompasses few leading initiatives, like: Union of Innovations – exploiting research

[2] However, lack of cooperation between enterprises in Europe (around 10–15%) is evident. In Europe's foreign dimension this falls even further to 10%.

[3] Four OECD categories of innovations.

activity and innovations to solve our most grievous problems and eliminating the gap between the world of science and the market, so the inventions turn into products. The technological parks may make this happen.

'After a great success of Polish entrepreneurship during the transformation period – we should alter the impulses running to the business-world to promote innovations better' [Boni 2011]. In my opinion only investing in human capital [*Innovation*... 2007] which is prepared for the transfer of knowledge and innovations, the enterprises may be able to compete on the dynamically developing market, regardless EU or other. This is reflected in P.F. Drucker idea, that innovation should be conceived together with individual's role in production and management processes [see Drucker 2002]. In process of achieving the leader status, the knowledge and science, which are responsible for technological and organizational progress [Berliński 2003: 56], influence the market success of an enterprise, which constantly diversifies the sources of assets and opportunities concerning their exploitation in production and consumption.

From the perspective of Polish enterprises this is far less promising because domestic entrepreneurs will not take advantage of benefits brought by knowledge and innovation. The knowledge is an under-exploited asset in Polish enterprises [see Brdulak 2005]. On European scale innovativeness of Polish economy is very low[4]. In the long run, only 'innovation coercion', through systemic elimination of civilization and development differences may positively influence competitiveness of Polish enterprises [Szymański 2005: 7–8]. Despite actions like those introduced in 'Directions of Developing Economy Innovativeness, 2007–2013'[5], the Polish situation did not improve. The document encompasses recommendations regarding the directions of action which would enable developing economy based on knowledge in Poland. This would mean that its strength and competitive edge would be a high level of innovations in Polish enterprises.

So does it mean that position of Polish small and medium enterprises sector, in context of planned changes aiming to give EU competitive advantage may improve? Certainly yes, if Polish small and medium enterprises exploit the opportunity created by further liberalization of the market. However, paraphrasing the words of Polish

4 One may reach such conclusions after the lecture of European Commission [2005], *European Innovation Scorboard*, Brussels. This places Poland at the end of the list.

5 Government document accepted on September 4, 2006. The document is a continuation of the government program 'Improving Innovativeness of Polish Economy before 2006', accepted on July 11, 2000.

minister Michał Boni referring to the regress of Polish entrepreneurship, because of limited innovativeness it might be hard to achieve. Nevertheless, Polish entrepreneurs representing the sector perceive their situation positively. Despite barriers, like: complicated procedures (35%), unclear law (33%) and dysfunctional tax system (29%) they efficiently develop their business. Only 18% perceived their situation as bad while 42% as good or very good [*MŚP…* 2011].

In the Central Statistical Office's report 'Economic Trends in Industry, Construction, Trade and Service in November 2011' far less optimism is seen. In all enterprises researched the economic climate is perceived negatively and all sectors signal problems regarding current financial obligations. Enterprises more and more often overuse trade credit, what in many cases determines the situation of Polish small and medium enterprises sector. In perspective of last six years the situation in that respect has deteriorated, as shown on the diagram below.

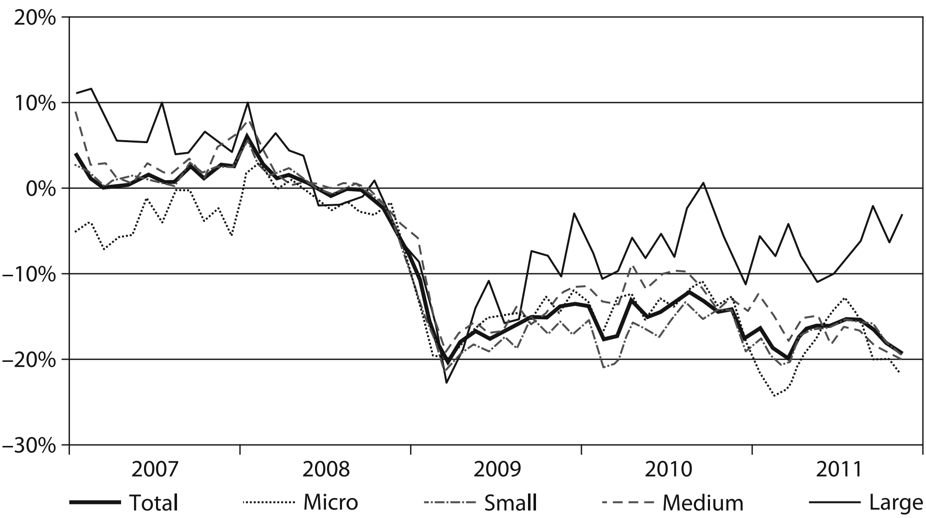

Figure 1. Delay/Payments – Diagnosis

Source: Economic development in construction, trade and service sec tors, November 2011

The structure of enterprises in Poland is quite similar to the whole European Union, where small and middle enterprises sector makes up 99% of it. The only factor distinguishing Poland is higher than European average (91.8%) share of micro-enterprises (95.9%). The gap is filled mostly with small enterprises employing 10 to 49 employees. According to the Ministry of Economy the share of the smallest enterprises is much higher in Poland than in European Union. This may mean that because of many barriers constraining 'Polish micro-enterprises, they evolve into the higher stage of development, that is small enterprises, less often than in the rest of EU'. Polish small and medium enterprises are definitely weaker in terms of technology, capital and cadres, than the members of the old Union. That's the main reason why it is more difficult for them to compete on the single market as well as on global markets. These basic indicators characterizing Polish Small and Medium Enterprises sector, while emphasizing the particularly low level of innovativeness, weaken their competitive position and ability to develop sustainable competitive edge. However, the small and medium enterprises consist the greatest strength of Polish economy, what is shown for example in GUS data referring to the level of employment. 52% of employed work in small enterprises, 40% of which in micro-enterprises. Medium enterprises give work to around 19% of employees. Large enterprises employ 29% of employees.

The role of small and medium enterprises sector is generally perceived as a key to limiting the development differences between Poland and old Union countries. Their activity should be more vigorously supported by the institutions forming their business surroundings. Such a cooperation gives an opportunity to limit or even eliminate all the constraints arising in course of running an enterprise. Additionally, it makes external funding more easily accessible, what definitely intensifies the investments aiming to introduce new technological solutions [*Szczegółowy*... 2008: 62]. Lack of financial means is a considerable barrier in transferring new technologies to the sector, and is a significant constraint of their development, sometimes even decisive for their survival on the market. High credit costs, limited usage of public funds, lack of venture capital, high costs of B+R [*Kierunki*... 2006: 50], create a situation in which most of the enterprises still compete on the basis of prices, while new technologies are a competitive edge in only 5% of the researched cases [Pyciński, Żołnierski 2007: 238].

What's interesting, in the last 2011 edition of the report 'Doing business' prepared by the World Bank the opportunity to acquire external financing was given the highest category. Poland was ranked on 15th place in the World. The World Bank highly emphasized clarity of Polish law regarding enterprises' obligations and access to information concerning financing. This reflects the fact that for most people participating in the research access to external financing does not pose a problem. The majority (71%) of respondents emphasized that information acquired from financial institutions proved valuable in planning and realization of enterprise's investments [*MŚP*... 2011].

Although small and medium enterprises improve their financial results and manage to amass some savings[6], they are cautious in terms of new investments. One of the reasons of limiting investment decisions may be a fear of another economic slowdown in Eurozone, which may negatively influence Polish economy. As the research *MŚP pod lupą* shows, if nowadays small and medium enterprises decide to invest, they mostly finance their decision from their own sources. The fact is uninfluenced by relative liberalization of financial institutions policy regarding financing enterprises.

Despite the fact above, Poland, in terms of general conditions of enterprises' activity, was ranked the 70th among 183 states under research, close to Bielarus (68th), Namibia (69th), Tonga (71st), and Panama (72nd) [Doing business 2011]. Compared to the earlier edition of the report, Poland advanced 3 positions. However this is still not optimistic. To put the results in a perspective: Great Britain was ranked 4th, Germany 22nd and France 26th. Other countries of Central and Eastern Europe were also ranked higher: Lithuania 23rd, Latvia 24th, Slovakia 41st, Slovenia 42nd, Czech Republic 63rd. Despite dissatisfying ranking in the report, Polish small and medium enterprises dealt very well with Eurozone turbulences. It turns out that enterprises successfully dealt with economic slowdown[7], which decreased the dynamics of Polish GNP in 2009 to 1.8% from over 6% in 2007 and 2008[8]. One should remember that the result turned out to be the best in Europe. Other countries were experiencing recession. Current dynamics of GNP is as high as it was then and it will reach about 4% [*PKB*... 2011].

To conclude, during the global crisis small and medium enterprises are important for the economy, because:

– they soften the radical changes of the economic cycles,
– make the allocation of assets more rational,

6 According to National Bank of Poland data, AT the end of May 2011 enterprises amassed deposits of PLN 177.1 bn. This means 20% increase compared to the beginning of 2009.

7 According to Central Statistical Office's *Działalność przedsiębiorstw niefinansowych w 2009 roku*, particularly small enterprises often decided to change the profile of activity to sustain or improve the position on the market. The data does not encompass entities, in PKD classification, to sections: A (agriculture, forestry, hunting and fishery), K (financial or insurance activity), O (public administration and national security, obligatory social security).

8 Działalność przedsiębiorstw niefinansowych w 2009 roku [2011] (Activity of non-financial enterprises in 2009). Warszawa: Główny Urząd Statystyczny.

– support changes in the economy,
– create majority of the new working places,
– play an important role in developing and introducing innovations [Kudla, Banasik 2000].

However, the small and medium enterprises sector after losing 3.25 million of working places, because of the economic crisis, needs a special attention to overcome its consequences.

What may strengthen the position of small and medium enterprises sector in Europe?

The recently conducted review of EU policies showed advantages of the Small Business Act, which it brought to the European enterprises, after being accepted in 2008: it decreased the costs of starting business in EU and substantially simplified the relevant administrative procedures. Additionally the system of support of European norms is beneficial because it positively influences the trade, limits the costs and information disproportions between the supply and demand, especially in case of transnational transactions. A clear correlation on macroeconomic level between normalization of the economy and increase of the output, trade and general economic growth is visible in many econometric researches [*Strategiczna*... 2011]. EU should further exploit the Small Business Act to achieve even more, as far as developing friendly environment for promoting entrepreneurship and supporting small and medium enterprises are concerned.

Intensification of actions of the EU member states in regards of budget consolidation, sustaining means serving stimulation of the economic growth (in such areas like research and innovation, business environment, competition in service sector) may counteract the second wave of the crisis, fear of which impedes the development and investment decisions of entrepreneurs. Further actions on the labor market aiming to improve the indicators of professional activity, countering systemic unemployment, fighting unemployment of young people and limiting premature decisions of finishing education as well as correlating the wages with work efficiency [MEMO... 2011].

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Family Enterprises in the European Union. A Case for Regional Support

1. Introduction

The last few decades saw a surge of interest in the nitty-gritty of the family business [see, *inter alia*, Chua *et al*. 1999; Poutziouris *et al*. 2006; Westhead, Howorth 2006; Mandl 2008; Bailly *et al.* 2008; Uhlaner 2008; Berent *et al.*, 2009].

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Of late, with the rise of China and India becoming a reality, this form of corporate structure has been extensively studied in the context of emerging economies [*Economist* 2011]. Paradoxically, there is no generally accepted definition of the family business due to certain conceptual ambiguity. Hence scholars have not only attempted to define this complex phenomenon, but also to determine basic strengths and weaknesses of family-owned enterprises. There has also been debate on whether – and if so – how to support them, in particular in times of crisis [European Commission 2009; *Economist* 2011]. In a bid to answer these queries, researchers have set out to explore, among other things, the inner workings of such companies. Specifically, the focus has been on governance, strategic thinking and managerial practices typical of family-owned enterprises [Birdthistle 2003; Uhlaner 2006; Westhead, Howorth 2006; Bailly *et al.* 2008; Berent *et al.* 2009].

The conceptualisations and findings from these studies were frequently juxtaposed with the results of similar research undertaken into the functioning of listed corporations (with multiple, and often institutional, owners). The idea was to find out – and highlight – the advantages of family ownership, especially in view of the failings and imperfections that came to be associated with quoted companies as numerous big-business abuses and unethical practices came to light. The unscrupulousness and immortality of senior management at Enron, Tyco and WorldCom or, more recently, Lehman Brothers not only sallied the reputation of Wall Street (and emphasised the need to 're-regulate' financial markets), but also threw into sharp focus the significance of such 'old-fashioned' notions as ethics and values. By the same token, private equity companies and hedge funds (alongside assorted 'speculators') came in for a lot of criticism, too (although whether this was well-substantiated is a matter of heated dispute). From this perspective, the collapse of Lehman Brothers, which *de facto* triggered the 2008–2010 recession, is symptomatic. There needs to be a recognition that this investment bank was founded by a family of German emigrants and survived the Great Depression. Yet the demise of Robert Lehman in 1969 (and the lack of an obvious successor from within the Lehman family) and the subsequent expansion (necessarily accompanied by changes in the ownership structure) led to the loss of its family-business-like attributes – a factor that is seen by some analysts to have played a part in its bankruptcy in September 2008.

Thus more and more researchers, following this line of argument, claim that family-owned enterprises – unlike many large corporations – behave ethically (and generally in line with the ideals of corporate social responsibility). Apart from this aspect, there are other reasons why a family firm has drawn so much interest.

For one thing, family enterprises are seen to offer stable employment, to pursue a long-term vision of development (rather than being driven by short-term gains) and to cultivate regional and national traditions. It is also argued that they stand out among other companies for their (more relaxed) workplace atmosphere and, in general, less formalised and more supportive organisational culture. For another, family enterprises have proved recession-resilient, weathering the recent storm relatively well, at least in Germany, the Netherlands, northern Italy and Scandinavia [see also Berent *et al.* 2009].

Nonetheless, they are not devoid of certain weaknesses. Arguably, the risk of family feud is their most serious flaw. The bitter dispute between the Ambani brothers and the subsequent split of Reliance Industries, founded by Dhirubhai Ambani in 1958, is a case in point [*Economist* 2011]. Examples of similar family quarrels, *toutes proportions gardées*, are plentiful. Another problem is the difficulty family firms often have with raising funds and financing their activity (especially in the area of R&D). Notwithstanding these weaknesses, however, it is fair to say that the family enterprise is indeed endowed with valuable characteristics and thus merits special attention from researchers and policy-makers alike.

The aim of this paper, which is theoretical in character, is to explore issues related to the functioning of family enterprises in Europe. In doing so, the study, drawing on the findings from two relevant reports, conceptualises this type of business entity and, essentially, makes a case for EU support. The structure of the paper is as follows. The next section offers a conceptual framework, attempting to explore the nature of difficulties with defining (and ascribing identity to) the notion of the family enterprise. Subsequently, we present EU policy on family business, discuss potential forms of support and examine implications for Poland. Finally, we summarise the argument, highlight the paper's limitations and suggest further research directions. It is believed that the study will deepen our knowledge of the issues at hand and encourage academics to do more research into the area of family business.

2. Conceptualisations of the family enterprise

As mentioned in the introduction, there has been much debate on the identity and, by extension, the definition of the family business. Symptomatically, it transpires from two seminal reports entitled 'Overview of Family Business Relevant Issues'

[Mandl 2008] and 'Making a Difference: The PricewaterhouseCoopers Family Business Survey 2007/09' [Bailly *et al.* 2008] that it is very hard to agree on an unambiguous definition of the family enterprise. This holds true both at the level of individual Member States and at the level of the entire Community. Within the EU, only in Spain and Finland there have been attempts to define the family enterprise and to distinguish it from other companies at the ministerial level. In the event, the Spanish Ministry of Finance and Economy and the Finnish Ministry of Employment and Economy, respectively, came up with a consistent definition (elsewhere in the world, Japan did so, too).

The ambiguity surrounding this particular business structure also stems from the fact that it would be hard to offer a generally accepted definition of (the notion of) the family [Westhead, Howorth 2006]. This is because perceptions of what really constitutes the family vary across Europe (and indeed the whole world). In other words, at issue are cultural-cum-sociological differences (of national or regional character) that weigh on the business environment in general and the approach to individual entrepreneurship in particular [European Commission 2009]. It seems reasonable, therefore, to opt for – on each occasion – a definition that accentuates those aspects that are central to a given study's purpose and scope.

That said, there is broad consensus on three main criteria characterising the family enterprise:

1) family ownership,
2) management by a family member,
3) involvement of family members in the day-to-day running of a company.

Besides, there is little controversy over other common characteristics. These include:

a) self-demarcation – understood as family identity (in particular, in the UK, Belgium, Finland, Greece, Ireland, Portugal and Slovenia),
b) chief source of finance for maintaining family (in particular, in Austria, Lithuania, Poland, Turkey, the Czech Republic and Slovenia),
c) family succession (it is worth noting that in Europe 48% of family entrepreneurs intend to hand over the company to their descendants, while in the USA – 84%),
d) being part of the SME sector (in particular, in Luxemburg, Norway and Sweden).

In a similar vein, the ELISA model has come to be seen as helpful in capturing the quintessence of the identity of the family business. While describing one dimension (characteristic) of the identity business, the letters of the acronym stand for:

a) E – excellence (quality dimension),
b) L – labour ethics (ethical dimension),

c) I – initiative for innovation (strategic dimension),
d) S – simplicity of lifestyle (value-related dimension),
e) A – austerity (tactical dimension).

Hence, in the light of the above statements, it is legitimate to claim – with all reservations in mind – that the family firm is an entity that is controlled by at least two family members who exert formal influence over its management and strategy. In line with this definition, one should also count as the family company such large corporations as Wal-Mart (controlled by the Waltons), Ford (the Fords), Samsung (the Lees) and PSA Peugeot Citroën (the Peugeots). Even though there exist substantial differences in terms of size, range and operation between these multinationals and typical family business (often belonging to the SME sector), it would be problematic – if downright unjustified – to exclude them from that category. This only bears out both the ambiguous nature of the family firm and the scale of the difficulty with defining it.

3. EU policy on the family business

The family firm is one of the most common forms of business structure in the world. In fact, family-owned enterprises employ millions of people and generate a considerable part of the global wealth [Bailly *et al.* 2008].

Europe is, of course, no exception in this respect. It is estimated, for instance, that in Ireland family business constitutes 90% of the indigenous business sector and provides approximately 50% of employment [Birdthistle 2006]. Northern Italy is renowned for its clusters of family-controlled companies that excel in the production of, among other things, fashionable high-quality garment and shoes. The vast majority of Germany's *Mittelstand* are family-owned, too. In Spain, one can hold up Torres, which specialises in wine and brandy production, as a model of family business. It is worth mentioning in this context that the label on every bottle of Torres wine contains the following items: (a) the family brand (*Familia Torres desde 1870*); (b) a copy of the owner's signature (*Miguel A. Torres*); (c) a symbol certifying that Torres is a *Member of Leading Wine Families*; (d) the family coat of arms (heraldic sign); (e) information about its involvement in the conservation of nearby forests and the Catalan eagle. All this, to refer back to the line of argument made in the previous section, expresses and, at the same time, reinforces the firm's identity.

The growing realisation of the importance of family firms for the European economy has found its reflection in official thinking. Tellingly, José Manuel Durão Barroso, the president of the European Commission, declared – at the conference of European Group of Owner Managed and Family Enterprises held in 2007 – that 'family firms have been the invisible giants of the European economy for far too long. And yet, rooted as they are in Europe's landscape, they are our natural partners in building an open, innovative economy for the 21st Century … It is time for family firms to stand up and fulfil their true potential in Europe!' [Barroso 2007]. Crucially, it was at that meeting when for the first time European officials declared support for development of family business in the EU. Besides, in the same year Expert Group on Family Business was set up with a view to co-ordinating the assistance [European Commission 2009]. In 2008 the European Commission's document entitled 'Think Small First. A Small Business Act for Europe', while distinguishing the family enterprise from other types of business structure, laid out key areas of its activity (such as succession or women status) that call for institutional support.

It is worth mentioning that necessity of institutional engagement in family firms support was underlined by Jorge Bastino, policy officer in the Directorate General for Enterprise and Industry of the European Commission. It was demonstrated clearly during his presentation at the prestigious Annual *International Family Enterprise Research Academy* Conference, held in Limassol, Cyprus in 2009. The summit belongs to the most important discussions on family owned business and is traditionally organized in European academic institutions. That time Bastino declared his active participation in promotion of family firms and their competitiveness improvement.

It follows that the issue of the family firm is now high on the EU agenda. Table 1 summarises European Commission initiatives aimed at helping European family business.

Table 1. European Commission initiatives aimed at helping family business

Initiatives already implemented	Planned initiatives/initiatives due to be implemented
Establishment in 2007 of Expert Group on Family Business under the auspices of the European Commission (Directorate General Enterprise and Industry)	Strengthening of the position of Expert Group on Family Business
Carrying-out of a pan-European study on family business in 2008	Deepening and expanding of the previous research
Distinguishing the family enterprise from other business structure in the document entitled 'A Small Business Act for Europe' in 2008	Preparation of a document devoted uniquely to family business and laying out priorities and objectives

Source: Authors' compilation.

It is important to realise at this juncture that European entrepreneurs themselves also contribute to buttressing and shaping the common identity of the family firm. They are increasingly aware of the benefits that result from the consolidation of their milieu. In fact, only recently have organisations that draw together family business started to be set up (with the notable exception of Germany, where Berlin-based Die Familienunternehmer – ASU e.V. has been functioning for 60 years). From the European Commission perspective, the most important one is the European Group of Owner Managed and Family Enterprises.

Also worth mentioning is an international organisation called Les Henokiens (founded in 1981) that brings together the oldest family enterprises (that is, those that have been operating for the last 200 years and have been controlled by the same family). Amongst their members, European family firms are the most numerous (one from Belgium, 11 from France, two from the Netherlands, 14 from Italy, one from Northern Ireland and two from Germany).

4. Discussion and implications for Poland

In this context, the fundamental question arises of what (else) might be done to help family business. Arguably, the issue of institutional (state) assistance to any entity functioning in the free-market economy – be it an industry, a specific company or a group of firms – is highly contentious [see also Zientara 2007].

This is because, to follow the strictly laissez-faire line of argument, such support can be seen as distorting competition and, at the same time, as flying in the face of the basic principle of democracy, namely, equality before the law. In other words, opponents of interventionism are likely to question the rationale of provision of special support for family business. Many may ask why not help – rather than only family enterprises – all SMEs. After all, most family business belong to this sector, but not all SMEs are family-owned (which implies that all small companies, regardless of their ownership structure, are equally vulnerable to the vicissitudes of the globalised markets and the hostility of national business environments). It is true that in the era of state-led (and blatant) assistance for banks and car companies such a dilemma could be easily dismissed as irrelevant, but the fact remains that, in principle, this argument holds water.

Nonetheless, on the same grounds one could theoretically call into question the *raison d'être* of the EU's Common Agriculture Policy or its direct support for such industries as shipbuilding. Thus, while bearing all these reservations in mind, it is fair to argue that, given the importance if family business for the European economy, some steps might be taken to help them. Above all, considering that in most EU Member States there are business unfriendly environments [World Bank 2012], the European Commission should insist that national governments cut red tape and make labour markets more flexible (which, not at all coincidentally, is in keeping with the structural reform recommendations issued by the IMF and the World Bank). This would undoubtedly help *all* business; yet – given that it is usually smaller entities that have considerable difficulty coping with stifling bureaucracy – family enterprises would be particularly well-placed to benefit from such measures. Likewise, European banks, many of which in recent months were given direct government backing or implicit guarantees, should be urged to step up lending, thereby providing much-needed funds to SMEs, with family business to the fore (as is well known, lack of access to funds might thwart their development due to the inability to implement capital-intensive projects).

On the other hand, prospective European Commission initiatives aimed specifically at family business should not be conceived as one-off and/or stand-alone projects. Rather, they should be integrated into comprehensive programmes that deal with the problems that afflict particularly family business. These include, among much else, the need to ensure that employees of family companies are able to reconcile their professional activity with private lives (in line with the spirit of work-life balance). Last but not least, given that (small) family business are seen to lag behind other entities in terms of R&D investment, some kind of assistance – possibly in the form of tax deductions – might come in handy (by the way, less red tape and a less heavy tax burden could also free resources for R&D activity).

Even though family entrepreneurship has a long tradition in Poland, the country – unlike Italy or Germany – is not renowned for its family business. Under communism, the authorities, in a bid to stifle private entrepreneurship, directed their attack at family enterprises (and privately-owned farms) [Zientara 2009].

During the communist era Polish private property was reduced to minimum so the fact of having an own firm was a natural aspiration. In state-owned companies the sentence: 'It belongs to the state, that means to nobody' caused stiffening negative attitudes such as widespread ignorance, slap-dash work, lack of responsibility, 'real landlord's' absence and in the effect – often waste. Consequently, all those circumstances led to killing an entrepreneurial spirit. However, there were some exceptions to the rule: small companies and manufactures owned by Polish families tended towards tradition and their roots. It should be stressed here that, contrary to some communist countries, in Poland private companies could function in a limited scope. This country was not totally closed as concerns economic, tourist and cultural contacts with the West [Nikodemska-Wolowik 2005].

It was only in 1989 when, with the collapse of the old regime, the outburst of entrepreneurialism resulted in the creation of numerous family business, which *de facto* became the backbone of a nascent free-market economy. Many of them – faced with the red tape and heavy taxation typical of Poland's hostile business environment [see also World Bank 2012] – did not survive. Yet many others managed to grow, generating much-needed jobs and wealth. All this has prompted a growing realisation of the benefits of family ownership. Hence – like in the West – stability, predictability and (positively understood) conservatism have come to be associated with the family firm.

Consequently, over the last decade, the family enterprise has drawn a great deal of interest from academics, practitioners and policy-makers. And it is Polish Agency for Enterprise Development that has made support for family business one of its top priorities. Since autumn 2008, PARP, a governmental body, has been engaged in an unprecedented project entirely concentrated on family enterprises *per se*. The aforementioned project is an exploratory one because the significance of family firms in the Polish economy, as well as the role of training and consulting tools designed for them, had not been studied in Poland before. The project is implemented by the PARP Team for Human Resources Development within the Operational Programme *Human Capital* (Activity no. 2.1.3) of the European Social Fund.

In doing so, it carried out a number of initiatives with a view to exploring the nitty-gritty of the family enterprise as well as accessing its significance for the Polish economy. This does matter since, as mentioned above, Poland fares badly in the rankings of competitiveness and ease-of-doing-business [World Bank 2012]. The same goes for creativity and innovativeness: the Polish economy in general and its business in particular are not regarded as particularly innovative [Zientara 2009; PRO INNO Europe 2011].

However, the new conditions and regional settings seem to become more favourable for creativeness and innovativeness. Due to the revised goals included in the Lisbon Strategy, striving for innovativeness improvement has a tremendous impact on European economies. Therefore, different possibilities of financing such undertakings owing to the EU funds have appeared since 2000. Although according to some research findings many family firms are identified with lower dynamism of innovation in comparison with non family owned firms [Chaberski 2009], a gradual progress can be perceived in their attitudes toward innovations.

In this sense, Polish family enterprises seem well-positioned to benefit from putative EU support, as suggested in the previous section. Of course, improving Poland's business environment would be on balance beneficial to the entire economy. It is particularly important in the context of an envisaged slowdown in the near future.

5. Conclusions

Throughout this paper we have attempted to show that the family firm, while playing a vital part in the functioning of today's economic systems, deserves special attention and well-thought-out support.

Compared with other business structures, it has undeniable strengths (though it is not devoid of certain weaknesses). Hence we have made a case for EU-level assistance that would take various forms. The major limitation of the present paper is its strictly theoretical character. It is believed, however, will prompt researchers to take up the subject of the family enterprise. Accordingly, prospective scholars might carry out qualitative and quantitative research, for instance, into the family enterprise's governance and succession problems, strategic decision-making processes or human resource management issues. This will deepen our understanding of the issues at hand and, at the same time, help policy-makers devise (and implement) adequate action plans.

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Maciej Krzemiński

EU Structural Policy for 2014–2020. Opportunities and Challenges

The ongoing debate on the future EU structural policy was formally launched by the European Commission in September 2007, during the Fourth Cohesion Forum. This informal phase of public consultations ended on 9 November 2010, during the Fifth Cohesion Forum in Brussels (when the Fifth Cohesion Report was published). On 29th of June 2011, the European Commission published proposals of the Multiannual Financial Framework 2014–2020 [Budget for Europe 2020, 2011a, b] and then on 6th of October 2011 it presented a legislative package for cohesion policy 2014–2020, consisting of six draft regulations concerning the functioning of EU funds [Proposal for a... 2011a–e]. Now, then, all the legislative projects essential to start working on national legislation are already known.

The official documents published and the statements given by politicians and the EU officials indicate that the most likely (though the situation is still dynamic) it will be possible to maintain the budget for cohesion policy at the current size, although the implemented activities will be oriented differently. These discussions will probably be completed in 2013.

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It is in Poland's interest to maintain the structural policy in its current form. Now, when the budget for 2007–2013 is €925 bn, Poland is the biggest beneficiary of structural policy as it receives 19.3% of cohesion policy (€67 bn). This is 1.7% of Poland's GDP which results directly from implementation of projects made under this policy. This money is essential for reducing disparities in social and economic development in regions. Theoretically, in the Commission's new budget proposal, Poland could receive up to €80 bn (from €376 bn on cohesion policy). On the other hand, reduction of the maximum level of support (so called capping) from the current 4% to 2.5 of GNI is expected, but due to the growth of Poland's GNI in recent years, such a change is not a serious threat to the resources available for our country [*Fifth report...* 2010] (although in the Baltic Countries the situation is worse in this respect).

Saving packages, necessary to fight the crisis, should not affect the structural policy. The European Union funds are instruments that can help member states to mitigate the effects of the crisis. In this aspect, European funds can be observed in two ways. First, all the money from the European funds result in an increase of investments (public and private) that stimulate the economy by increasing domestic demand. In addition, one of the most important effects of the crisis is a reduction of availability of capital. Banks restrict lending, declining tax revenues, increasing pressure on the spending side of the budget so that financial capacity of enterprises is significantly reduced. The EU structural funds can significantly increase access of the private and public sector to the capital during the crisis [Stępniak, Krzemiński 2009: 7]. Secondly, the operational programs for the years 2014–2020 should include actions for reducing of social effects of the crisis. These programs are to be created soon, and it is important to remember about crisis emergency.

The crisis and the related serious trouble of some EU countries will have great importance for the future structural policy negotiations. Net contributor countries would like to reduce their expenses and use saved capital for internal anti-crisis actions. One have to remember that these are the same countries that incur costs of the euro area saving plans. Their financial involvement in activities independent of the structural policy will certainly have an impact on their negotiating positions on the 2014–2020 budget.

If net payer countries fail to reduce the budget for cohesion policy they will at least seek to make such a change in financed activities as to be able to benefit themselves from this type of aid. It is most likely for two main types of arguments to be put forth: low efficiency of existing activities undertaken within the cohesion policy and the need to improve the international competitiveness of the European Union as a whole, not only the poorest regions.

Discussion on the first argument will certainly be accompanied by another one about measures of regional policy effectiveness. In its ‘Cohesion Reports’ the European Commission has presented data showing that regional *per capita* GDP in the poorest regions is growing, that unemployment is decreasing, the level of education is increasing, *etc*., all due to the cohesion policy. This was to convince of the rightness of the actions and spending undertaken. Most likely, other arguments will be presented in the present discussion, such as that the number of regions with *per capita* GDP of less than 75% of the EU average *per capita* GDP is decreasing very slowly. Countries of the ‘old EU’ will also argue that even a very strong infrastructure development does not necessarily translates into economic success of a region, with Eastern federal states of Germany being apt examples. Most of the territory of the former GDR are the regions with *per capita* GDP below 75% of the EU average. Theoretically, they enjoy several factors that should work in favour of their vigorous development. They are part of the country where the lack of capital is not a problem and at the same time, by its own characteristics, ex-GDR regions can benefit from the support of the EU funds. Thus, they have access to external sources of financing for infrastructure investments, while ensuring financing of their own contribution. In recent years in these regions the problem of lack of infrastructure has been overcome. Still, these regions are not experiencing an increased economic development. This may be an argument for reduction of such investment. However, one should also remember their another particularity, namely that most of their vibrant, educated, enterprising human capital has left those regions right after the unification, and it is this, rather than a lack of infrastructure, that remains the factor that strongly inhibits development of these areas. Therefore, specificity of German Eastern states should not be an argument for reduction of infrastructure investments as ones that fail to directly translate into development of regions.

Second group of arguments for changing the structural policy will concern improvement of competitiveness of the European Union by increased spending on innovation. In today’s globalised world price competition becomes less and less possible in Europe. Quality remains the only valid competition factor and now it often means just offering innovation. Promoting innovation generally seems the correct way. What is worrying is that financing of pro-innovative resources will take the capital previously available for infrastructure. One of the tasks for our country in the forthcoming meetings will be to demonstrate that the EU structural policy can not be converted to innovation-oriented policies only. Of course, elements of innovation and innovation should be included therein, but they must not replace the existing shape of the policy.

Most likely in the new budgetary perspective the priority will be given to promote development of innovative projects. The EC also proposes to increase, by 46 per cent, funds for research and innovation (€80 bn). The question is whether such a shift of priorities is beneficial for our country. Even if the current budget for cohesion policy, intended for our country, will remain at a level similar to that from the years 2007–2013, will our ability to absorb these funds after the change of priorities stay unchanged? Certainly, in Poland we have many areas that are still in dire need of basic infrastructure. It is appropriate to question and debate over whether European funds will continue to finance this type of investments and what will be the scale of this type of intervention. Available financing will probably not be reduced, but emphasis on implementation of innovative projects will be increased. Their implementation only at enterprise level will not be possible; cooperation with research and scientific institutions will be necessary. To facilitate this cooperation, Public-Private-Partnership formula would be useful as one which allows projects to involve different actors [Krzemiński 2006: 99]. This formula can bring even greater results by combining European, public and private resources in projects.

Which arguments should we use during negotiations? In the discussion on the future structural policy we should take into account the most important strategic document in the European Union – the 'Strategy Europe 2020' [Communication... 2010]. The European Union has included five objectives in it:

- Increase in employment (75% of those aged 20–64 should have employment);
- The fight against climate change (the so-called achievements of assumptions. 20–20–20 package, namely reducing CO_2 emissions by 20% compared to 1990, growth in energy consumption from renewable sources by 20%, increase energy efficiency by 20%);
- Education (limiting the number of early school leavers to 10% while increasing to 40% the percentage of people aged 30–34 who possess a university degree or equivalent);
- The fight against poverty (at least 20 million people should be protected from poverty and exclusion);
- Promotion of innovation (3% of the EU GDP should be invested in research and development.

By adopting this document as a basis for negotiations on the future of cohesion policy, the arguments for complete reorientation of priorities into innovation activities seem to have no chance. Just one of the five objectives of the strategic document Europe 2020 is about innovation. However, one can also recourse to the objectives which directly mention the need to build basic infrastructure. To fight climate change, to create alternative energy sources, to increase energy efficiency – it all needs this type of investment. The combined targets for combating poverty, promoting employment and education also are compatible with existing ‘soft’ elements of structural policy. All these activities may be in line with the priorities of innovation (*e.g.* promotion and improvement of the quality of education in selected fields). At the moment structural policies are aimed, *inter alia*, at research and development, improving access to broadband Internet, intelligent transport and energy infrastructure, energy efficiency and renewable energy, development of entrepreneurship and skills development through training and improvement of the quality of education. Such activities should still be developed. The argument for maintaining and even increasing the spending in these fields in the next programming period may be mentioned, by the example of the former GDR, where the primary weakness is that regarding human capital.

Conclusions of the recent ‘cohesion report’ [*Fifth report...* 2010], published in 2010, also include demands arising from the need to achieve the objectives of the document ‘Europe 2020’. One of the principal postulates is to increase concentration of resources. Countries and regions will have to implement a few key priorities for their development. The more money the region will receive, the greater the number of priorities is possible to achieve, but in the case of regions where the funding will be smaller, one will need to identify key priorities and focus only on them. Some of the priorities will be mandatory, while others will operate on an ‘à la carte’ principle.

The draft budget for the years 2014–2020 proposes creation of energy, transport and telecommunications infrastructure fund – known as Connecting Europe Facility (CEF) [Budget for Europe 2020, 2011a]. The creation of the instrument responsible for the infrastructure is in line with our expectations, but the method of implementation of this instrument raises some concerns. The fund, totalling €50 bn (€40 bn plus €10 bn from the Cohesion) is going to replace the current €8 bn earmarked for the development of Trans-European Transport Networks. The transportation account for the new instrument is €31.7 bn, but the rules of its operation are not clear yet. What is already known is that Poland took advantage of €5 bn from the total amount of €10 bn from the cohesion. Now, new facility will be managed from Brussels, and there is no guarantee that these measures will reach a similar scale as before for our country.

Another reason for anxiety may be found in introduction of a system of conditions and incentives, in particular conditioning of regional aid upon compliance to the rules of the Stability and Growth Pact. Even though the need to sanction non-compliance is not in doubt, especially in the perspective of occurrences in the ‘PIIGS’ countries. Very questionable, instead, is that the response would be to punish the poorest regions with suspension of development assistance. It is hard to imagine how the rule that: 'cancellation of the current or future payments from the EU budget should not impact the end beneficiaries of EU funds' will work in practice. The philosophy behind this solution is in sharp contrast with the gigantic support that European countries are providing to Greece – the country that broke the discipline of public finances. On the one hand, net contributor countries granted enormous support and commit funds for aid to that country, while on the other hand in the structural policies it is planned to connect the assistance to budgetary discipline. The solution mainly penalizes regions and businesses *i.e.* actors that do not have direct impact on decisions of the central authorities in charge of the situation of public finances.

While the punishment is questionable, the proposed introduction of a system of positive incentives seems reasonable. Regions which, through the mid-term evaluation, would have shown the highest progress in the implementation of the Europe 2020, could expect to increase the allocation for them for a further period (not at the expense of other regions, but through special provisions).

The future decentralization and increased flexibility seem positive. According to our experiences with ZPORR in 2004–2006 and RPO in 2007–2013, postulates in the conclusions of the Cohesion Report go in that direction. Most probably, regions will be allowed to create operational programs not only at national or regional level, but also at the level of groups of cities or river and sea basins, which sounds very reasonable, especially in coastal regions. On this basis, Western Polish provinces has already begun work on establishing a large Polish Western operational program.

Polish Government's opinion on the future of Cohesion Policy after 2013 rightly emphasizes a fact that results from the Europe 2020 document. Decisions about the allocation levels for individual funds and thematic areas should be undertaken with different start points of particular regions taken into account and through negotiations between the Commission and member states and regions, and not by way of their top-down imposition. What is positive for Poland is that *per capita* GDP will be the principal criterion for allocation of funds. This means that 15 Polish regions, except for Mazovia, will still qualify for the so-called Objective 1 Convergence for regions with a GDP of less than 75 percent of the EU average. For those regions the proposed budget provides €162.6 bn.

According to the data in the Cohesion Report [*Fifth report*... 2010], after 2013 *per capita* GDP in the Mazovia will exceed 75% of the EU average (it is estimated that it will reach 86 per cent of EU average) so the region will lose the right to use funds from the so-called Objective 1 – Convergence. After 2013, 51 regions in the EU will have *per capita* GDP between 75 and 90 per cent of the EU average. To enable them to continue using structural assistance, it is proposed to create a new category of ‘intermediate regions’. The proposed budget provides for them €38.9 bn. Poland, with Mazovia in mind, is going to support these changes. For the richest regions with an average above 90 per cent, the European Commission proposes €53 bn. Currently, there are two categories – below and above 75% of EU average. Poorer regions receive about €190 per person while the richer ones receive about €23 per head. In addition, €68.7 bn will be earmarked for the Cohesion Fund for large investments in countries with a GDP below 90 per cent of the EU average. Also here Poland qualifies for support.

The EC has proposed obliging member states to dedicate at least 5 per cent of the allocation of European Regional Development Fund from the national to urban development [Proposal for a... 2011d]. Promotion of urban development would also be implemented using integrated investment projects, which can be financed by both the ERDF and ESF. The Commission proposal also included introduction of a cooperation platform for European cities, the so-called urban development platforms. In the new budget the amount of €400 million will be allocated for creation of a platform where 300 European cities will belong. From this pool an exchange of ideas and projects that apply to urban areas will be funded.

Poland identifies weaknesses in the system of implementation of the EU policies that have been particularly revealed by the crisis. Accordingly, Poland calls for creating no new sectoral instruments, but instead to improve efficiency and operation of the existing policies. Poland prefers the previous structure to be continued; Polish government only welcomes changes in assessment and evaluation, in order to ‘reward the focus on results, and only secondarily a procedural compliance and the rate of absorption’.

Another action proposed which aims to increase participation of countries – net beneficiaries of structural funds is that to substantially increase the level of funds allocated to projects jointly implemented by several regions (in the current programming period, these activities are called European Territorial Cooperation). This change may also occur beneficial for some Polish regions – certainly by increasing the number of projects within the framework of cooperation in the Baltic Sea Region. It can contribute to regional development through technology transfer, *e.g.* from Scandinavia. According to the project, funds for this purpose will be substantially increased compared with the current programming period, but still this instrument will only constitute a small part of the whole structural policy.

Summing up, Poland and its representatives face hundreds of hours of negotiations, discussions and fight for arguments. It should be remembered that they will not be alone in this struggle: we can count on support of other countries

– beneficiaries of the existing structural policies. In my opinion, if they manage to maintain the current level of transfers, it will be a great success, especially in the face of the crisis, and possible changes in the rules for allocating (more pro-innovative actions) may be beneficial for our economy, which has significant potential also in this field.

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Part IV

SOCIAL REFORMS FOR THE SUSTAINABLE AND INCLUSIVE GROWTH

Irena E. Kotowska*

Population Change as a Main Driver of Pension Reforms in the EU

1. Introduction

Comprehensive demographic change in Europe, taken place in the second half of the 20th Century, was generated by a continuously declining mortality combined with a deep fertility drop to levels far below replacement, remarkable changes of families and social networks, and migration on the rise. These developments labelled as a new demographics of Europe [Kaa van de 2004] resulted in considerable shifts in the population age structures. Besides the population ageing, the global process related

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to the long-term evolution in population reproduction, however mostly advanced in Europe, the distinctive feature of future changes in the age composition of the European population is shrinking of the working-age population. These changes in age structures are to be intensified in the coming decades.

Common demographic trends are, however, diversified across the EU countries in terms of their onset and intensity, especially between the EU-15 and the EU-12 as well as between the Northern and Western Europe versus the Southern and Central Europe. Altogether with differences in economic performance, the labour market structures and human capital on one hand, and institutional settings and culture on the other hand, they define country-specific and regional contexts of progressing with the integration processes in the EU. However, societal challenges to be faced are common: how to adapt economy and social institutions to population change, especially to population ageing accompanied by labour force shrinking. There are increasingly referred to in debates of the European Union growth potentials and situated at the top agenda when debating about the future growth of the UE. The EU policy paper [EC 2006] identified five key policy responses to manage demographic change:

- supporting demographic renewal through better conditions for families and improved reconciliation of working and family life;
- boosting employment – more jobs and longer working lives of better quality;
- raising productivity and economic performance through investing in education and research;
- receiving and integrating migrants into Europe;
- ensuring sustainable public finance to guarantee adequate pensions, health care and long-term care.

Two of them are directly aimed to influence demographic behaviour *i.e.* to increase fertility through supporting people in combining their family life and paid work and to promote human mobility through open and inclusive attitudes and practices towards immigrants. The other are directed to better economic performance, more efficient use of labour force as well as stable and sustainable public finance. The proposed response to demographic challenge refers to main economic and social domains of contemporary economies and shows that in order to adjust the economy and the society to the new demography of Europe only comprehensive policy reforms are to be considered.

Especially, the social security system needs to be reformed but other domains of the social policy demand reforms as well. And moreover, these reforms seem to be even more challenging when taking into account that they should be supportive for economic and social progress of the EU, defined in the Europe 2020 Strategy in terms of the smart, sustainable and inclusive growth. Especially, sustainability and inclusion seem to be extremely ambitious goals, taking into account recent developments. For instance, increasing human mobility, which stimulates the economic growth, makes European societies more diverse and stratified. Similarly, growing inflows from non-EU countries contribute to more diversity. Despite strong efforts to combat inequalities, poverty and social exclusion, reflected in the EU social and economic policies, socio-economic inequalities have increased and are higher today than in the 1980s [*e.g.* OECD 2008; Perrons & Płomien 2010; Förster & d'Ercole 2009; Ward *et al.* 2009]. Except for the CEE countries which experienced a deep economic recession in the 1990s, this increase has happened during a period of economic growth and gradual improvements in employment. Moreover, in contrast to declining differences in major components of socio-economic inequalities between the EU-15 and the CEE countries the within-countries disparities are on rise, having a strong regional dimension [*e.g.* EC 2010; Eurostat 2010; UNDP 2010]. In addition, the growing share of older people along with declining family and kinship networks, a main source of support and care, challenges the social inclusion of all of these people. And finally, impacts of economic and financial crisis on national state budgets make these undertakings even more difficult to be implemented.

At the top of debates on policy reforms is the pension system. The reports of the Working Group on Ageing Population and Sustainability of the Economic Policy Committee show visibly effects of demographic and labour market changes on public expenditures on old-age pensions, health and other social spending [e.g. The 2009 Ageing Report, 2009; The 2012 Ageing Report, forthcoming]. They consistently demonstrate how strong are effects of population change. The assumed increase in the labour force participation rates, driven mostly by better use of women's labour force and older workers potentials, will mitigate impacts of both labour force shrinking and its ageing till 2020 – labour supply is expected to rise by 1.4% [The 2012 Ageing Report, 2011]. Next, labour supply will be contracted by nearly 12%. Similarly, the assumed productivity improvements can only partially offset slowing down of growth rates due to lower labour supply.

On one hand, these findings provide arguments for further measures facilitating a better use of available human resources, especially those aimed at attracting more people in employment and prolonging working life *i.e.* for labour market and pension system reforms. On other hand, they highlight how important is to counteract these deep demographic change by striving for demographic renewal which will bring results after 2040.

In addition, the remarkable number of the EU Member States experiences much stronger effects of demographic change than described for the EU. That defines much stronger demand for relevant reforms in terms of measures proposed and their timing. Therefore, the first section of this chapter shows both common trends and diversity of demographic pressure across countries, while in the next section some remarks on pension systems reforms are presented.

2. Population and age structure changes in the European Union, 2010–2060

The subsequent population projections prepared by the Eurostat [EUROPOP2004, EUROPOP2008, EUROPOP2010] under slightly different assumptions about fertility, mortality and migrations, the main components of population dynamics show small differences in foreseen changes of the population size while future shifts in the age composition consistently point to advanced population and labour force ageing and shrinking of the working-age population [Gaag van der & Erf van der 2008; The 2012 Ageing Report, 2011][1]. Contrary to the 2004 results, predictions of 2008 and 2010 show the EU27 population on rise by nearly 5% until 2050 and 2040 respectively, and its decline thereafter. That difference is due to slight increases in fertility and further improvements in mortality as compared to the levels assumed under EUROPOP2004 projections. In 2060, the EU population will be at 517 millions *i.e.* by 16 million more than in 2010. However, for about half of the EU countries a population decline is projected (the EU 10 without Slovenia, the Southern European countries except Italy and Cyprus, and Germany) while the other Member States will experience a population growth.

The common advancement in population and labour force ageing accompanied by the labour force decline are consistently shown by subsequent projections. The age pyramid moves gradually towards the regressive one with more persons aged 65 and more than aged 0–14 years (Figure 1). The share of young people is expected to decrease

[1] The comments refer to projection results of the convergence scenario, which assumes gradually diminishing differences across countries in fertility and mortality. However, the theoretical common levels are not reached within the time horizon of the projections, *i.e.* until 2060.

only slightly (from 15.6 per cent in 2010 to 14.2 per cent in 2060) while the most pronounced changes refer to the old age people and the working-age group (Figure 2).

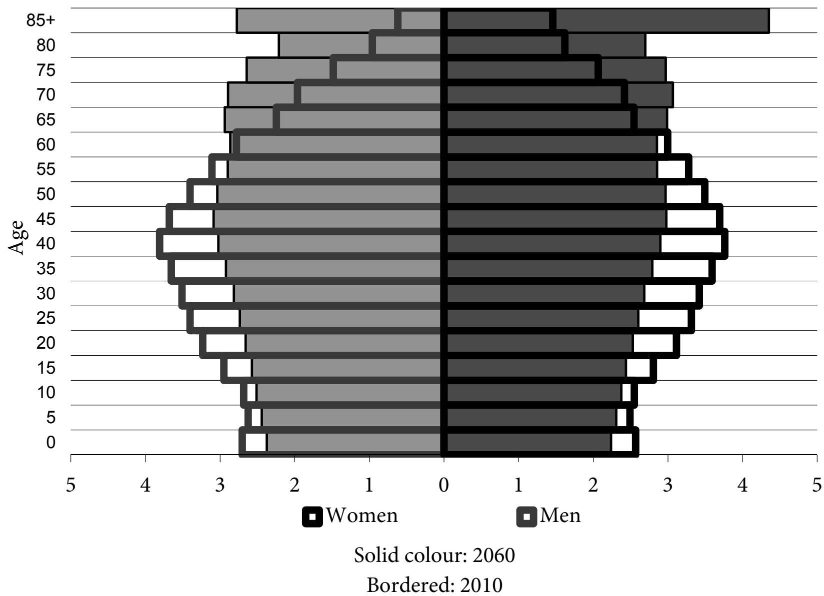

Figure 1. The age composition of the EU population by major age groups, 2010 vs. 2060 (as per cent of the total population)

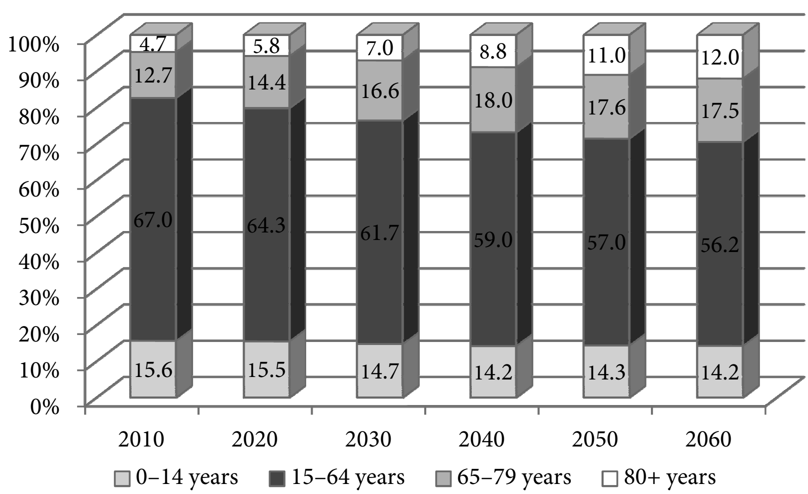

Figure 2. Changes in the age composition of the EU population, 2010–2060 (as per cent of the total population)

Source: EUROPOP2010, convergence scenario, Eurostat.

is predicted during the whole prediction period from 67 per cent in 2010 to 56.2 per cent in 2060. Over the next 50 years the working-age population is foreseen

The remarkable decline in the share of people between 15 and 64 to decline by nearly 42 million. Until 2030 that change will go together with the intensive population ageing which makes the share of persons aged 65 and more increasing from 17.4 to 25.6 per cent. Next, the population ageing will continue with a lower intensity – in 2060 the elderly are expected to count for 29.5 per cent of the EU population. Altogether, the number of the old-aged people will rise from 87.5 million in 2010 to 152.6 million in 2060. In addition, the share of those aged 80 and more will rise from 5 to 12 per cent approaching almost the proportion of the young people.

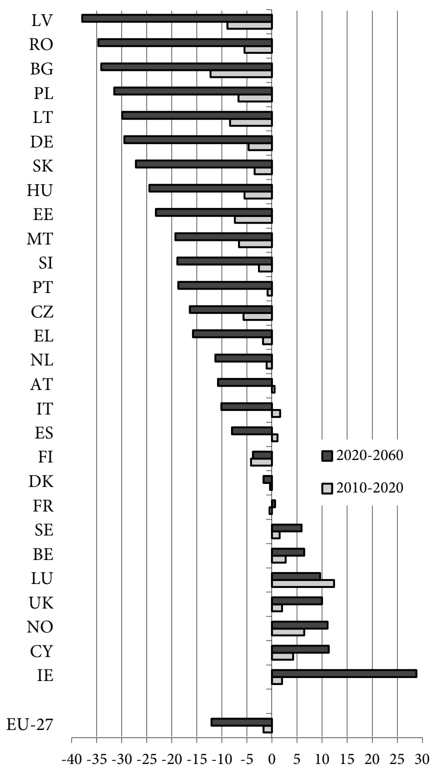

Figure 3. Changes in the working-age population, 2010–2020–2060 (as per cent)

Source: EUROPOP2010, convergence scenario, Eurostat

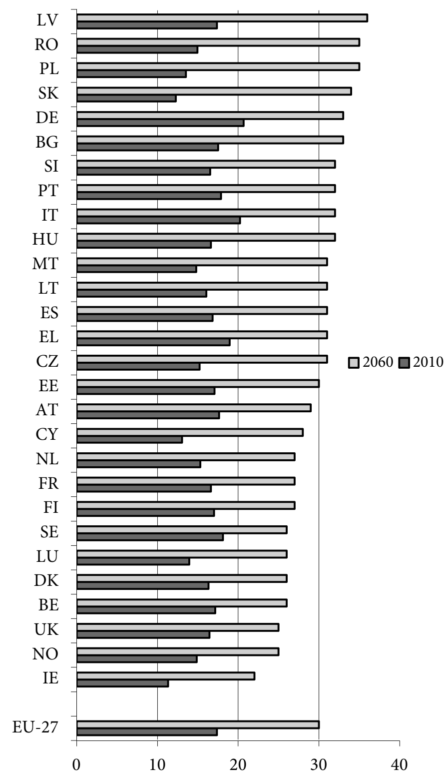

Figure 4. The share of persons aged 65 and more, 2010 vs. 2060 (as per cent of the total population)

Source: EUROPOP2010, convergence scenario, Eurostat.

In the remarkable number of the EU countries shrinking of the labour force starts between 2010 and 2020 already (Figure 3). That downward trend will continue over the subsequent decades. Only few Member States will not share these developments (France, Sweden, Belgium, Luxemburg, United Kingdom, Cyprus and Ireland). The highest drop *i.e.* by more than 30 per cent over the 50 years is predicted in the majority of the Central and Eastern European countries (Estonia, Hungary, Slovakia, Latvia, Lithuania, Poland, Bulgaria, Romania), and in Germany.

In parallel, the ageing will progress at a different intensity as well. Countries considered as relatively less advanced in ageing in 2010 like the Central and Eastern European ones are expected to be more advanced in ageing in 2060 along with countries of the Southern Europe and Germany. They show at least 30 per cent of persons aged 65 and more (Figure 4) while in the remaining countries that proportion is between 22 and 29 per cent.

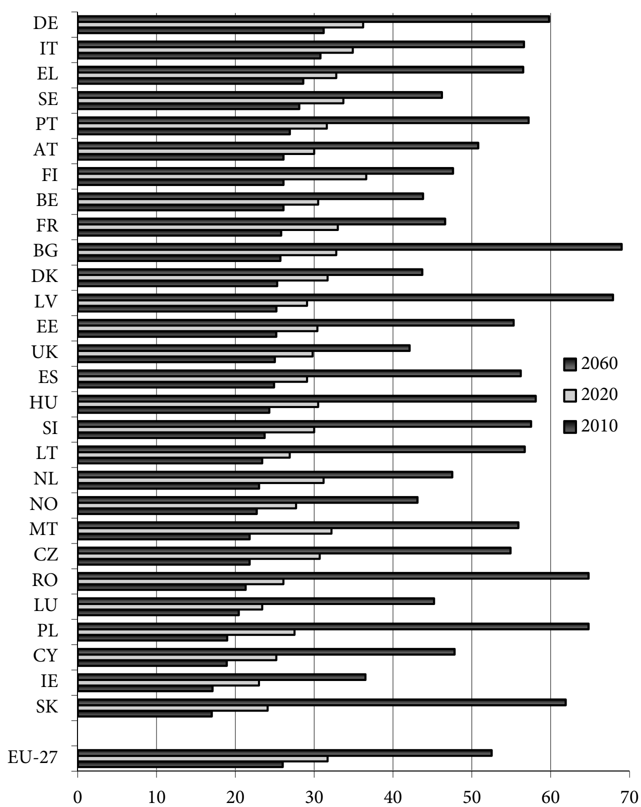

Figure 5. Old-age dependency ratio, 2010–2020–2060 (persons aged 65 and more per 100 of persons aged 15–64)

Source: EUROPOP2010, convergence scenario, Eurostat.

By combining these predictions one can easily demonstrate that the most unfavourable shifts in the age composition are projected for countries of the Central and Eastern as well as the Southern Europe and Germany (Figure 5). The EU demographic old-age dependency ratio, defined by the number of persons aged 65 and more to those aged 15–64, will increase from 26 to nearly 53 old persons per 100 persons at the working-age in 2060 *i.e.* from four working-age persons per one person aged 65 and more to only two working-age people per one pension-aged person. In that group of countries the dependency ratio ranges between 55 (Czech Republic) and 69 persons (Bulgaria) in 2060.

In addition, when taking into account age- and country-specific employment levels, needed to estimate the effective economic old-age dependency ratio , demands for policy reforms aimed at improving the relationship between contributors to pension funds and pension receivers are more strongly justified, especially in above mentioned countries affected more by age structure shifts. In general, the overall employment rates are lower in these countries, women's involvement in the labour market is also below the EU average and in some countries the employment rates of older workers remain at low levels [EC 2010b].

3. Pension reforms in the EU

The rising awareness about new demographics of Europe and consequently about the deep shifts in the age structures influenced reforms in the labour market and pension systems. The Lisbon Strategy of 2000 set directly employment targets – to reach 70 per cent by the overall employment rate, at least 60 per cent by women's employment rate and 50 per cent by older workers in 2010. Despite the fact that these targets were not reached by relatively numerous Member States the gap between current employment rates and the Lisbon targets diminished due to both better labour market performance of older workers (that trend is clearly pronounced in the EU 15) and women's labour force participation on rise. These improvements in the labour market were affected also by measures implemented to strengthen links between work records and retirement entitlements and income. Unfortunately, the financial crisis halted these trends [EC 2010b; EC 2011].

Several pension reforms have been undertaken in the Member States since the 1990s, especially since the second half of the decade. They aimed at consolidation of funding arrangements for pension systems by establishing a closer link between contributions and benefits, reducing pension generosity, removing financial incentives to early retirement, increasing the adequacy of pension benefit levels, increasing the share of the population covered by pension arrangements, promoting private pension schemes, and getting greater coherence between existing public and private pension schemes [*e.g.* Casey *et al.,* 2003; Holzman *et al.,* 2003; Chłoń-Domińczak, 2004; Holzmann & Hinz, 2005; Whitehouse, 2007; EC 2010c].

The EU 15 countries implemented predominantly parametric reforms which refer to changes in some parameters of existing national pension schemes of the defined benefit (DB) type[2]. They concern, for instance, increases in the standard age of retirement (like in Denmark, Germany, Austria, Ireland, Greece, Netherlands, United Kingdom, Malta), raising the contribution period (like in Belgium, Greece, Portugal, and France), increasing the minimum age (like in Finland and Germany), reduction in the access to early retirement schemes (like in Austria, Finland, Germany, Netherlands) and improvements of the actuarial fairness of the system (Austria, Finland, France, Germany, Portugal, United Kingdom, Netherlands).

Another approach to reform of pension systems is labelled as the paradigmatic (systemic) reform and means a radical and complete transformation of the pension system (entitlements, financial organization, provision of benefits, administration, *etc.*). Paradigmatic pension reforms have been implemented in a number of countries in the Central and Eastern Europe (Latvia, Estonia Lithuania, Hungary, Poland, Bulgaria, Romania, and Lithuania) as well as in Italy and Sweden. However, only Poland, Latvia, Italy and Sweden replaced the 'pay as you go' (PAYG) schemes by the notional defined contribution (NDC) schemes[3]. Others implemented multi-pillar systems with the public mandatory pillar based on significantly modified PAYG schemes. These modifications concern: increases in the standard age of retirement (Czech Republic, Estonia, Lithuania, Hungary, Romania, Slovenia, Slovakia), reduced accrual rates (Bulgaria, Hungary, Estonia), adjustments to individual contribution

[2] Under the public defined-benefit pension systems two types of pension schemes can exist: the flat-rate basic pension scheme and the earnings-related pension scheme. The former aims to guarantee the minimum income for the elderly while the latter scheme provides the income to retired persons. The public defined-benefit systems are predominantly based on contributions and tax revenues from the current working population ('pay as you go' basis).

[3] The notional defined contribution pension scheme is based on individual accounts of workers. Accumulated contributions are credited with a special rate related to growth in the aggregate wage. Individual old-age pensions depend on the amount accumulated and the average life expectancy at the age of retirement.

(Poland, Latvia) and lower indexation of pension benefits in all countries, which kept their increases below a rise in wages [Chłoń-Domińczak 2004]. The indexation of pension was defined that way to control their increase: pensions increased less than wages.

Both a decade of reforms that have altered pension systems in most Member States and changes in the age composition of the EU populations, to be deeper than expected, as well as the recent financial and economic crisis impose a need to formulate harmonized policies at the EU level to deliver sustainable and adequate pensions. Despite remarkable progress in adjusting pension policies to demographic and economic challenges still additional reforms need to be discussed commonly and coordinated with efforts to enhance the integration processes within the EU (*e.g.* the Single Market Act and the Stability and Growth Pact). Moreover, that new 'wave' of pension reforms should be consistent with the Europe 2020 strategy. To highlight these demands and launch a debate at the European level the Green Paper 'Towards adequate, sustainable and safe European pension systems' has been published in July 2010 [EC 2010a].

4. Concluding remarks

In the recent years debates on reforms of pension systems to deliver adequate and sustainable pensions have been reinforced. Research on the topic, carried out systematically by individual scholars and institutionalized teams of the World Bank, OECD, and the Economic Commission provided valuable contributions. The EC documents like the Green Paper on pensions, reports of the Economic Policy Committee and the Social Protection Committee show that agreed approach at the EU level is needed to harmonize pension reforms. Undoubtedly, without such attempts human mobility will meet severe barriers as it is currently while diverse demographic pressures in the Member States make labour migration a key measure to overcome labour market shortages.

Sustainability and adequacy of retirement income are referred as principal goals of pension reforms. Highlighting adequacy of contributions as one of the reforms goals shows direct links between pension reforms and labour market measures stimulating labour supply. Hence, any instruments aimed at better usage of shrinking labour force can be considered also in the context of old-age pensions sustainability.

Pension reforms, implemented already in many countries, show a variety of measures used to make the system more robust to demographic and economic risks. The parametric reforms i.e. those referring to modifications of the DB-type systems prevail while the NDC systems have been introduced in a relatively few countries only. However, both recent economic developments and demographic prospects seem to bring new insights into managing of the NDC systems with the economic and demographic risks.

Another important issue to be focused in pension reforms is a stronger labour market integration of older workers. However, one of the preconditions for a successful use of full potential of older workers is referred to adjustments of work environment to the growing number of older workers. Until now, that aspect of pension reforms seems to be underestimated in the general debate. The recent OECD report 'Pensions at Glance 2011 [OECD 2011] refers directly to employers' attitudes and practices towards older workers and makes firms' adaptation to manage older labour force a coherent component of the effective pension reforms along with policies aimed at combating age barriers in the labour market and extending working life.

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Marek Góra*

Pension Reforms in the EU – Main Dilemmas and Prospects

1. Introduction – demographic dividend financing the welfare state

The problem of ageing and its consequences for developed countries is widely discussed in economic literature and considered in general public debate[1]. However, the discussion is usually narrowed down to fiscal problems. Other issues such as: labour market consequences of ageing, likely reduction in overall level of welfare in the entire population, or obstacles to further necessary steps of the European integration are much less present in the discussion.

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[1] The literature on ageing is really broad, so I do not quote its particular pieces here.

Population developments as seen through demographic projections clearly show that a fiscal gap generated by changing proportions of the number of retirees to the number of workers will increase substantially in the decades to come. Both the public and politicians are aware just of the existence of the problem. That is already a great achievement – say the first step of internalisation of consequences of ageing. However, the real scale of the problem can be internalised only by experts who are able to read appropriate studies. Consequently, the essence of the problem is not a part of public debate yet. We all seat on a bubble that has been created not only in financial markets but also in public finance, which means the level of welfare available for current and future generation of Europeans is smaller than we tend to expect. Our expectations being based on previous demographic situation are highly inflated nowadays. Understanding that will be the second – much more painful – step of the problem internalisation. We should also be prepared to understand and implement conclusions stemming from the bad news.

The change of population structure by age is fundamental for the future of Europe[2]. An increasing share of GDP is spent on pensions and – consequently – thus it decreases the part left for remuneration of production factors. That undermines long-term growth potential of European economies [for broader analysis see Góra 2003]. In principle, the trend is irreversible since even the most successful cases of increased fertility (France, Sweden) achieve no more than generation replacement[3]. Demographic pyramid used for running financial pyramid of pension systems and public finance in general existed when the rates were much higher. Mere replacement – an extremely ambitious goal for most European countries in itself – means no pyramid.

For a very long period public finance has been fuelled by a demographic dividend. Among others the European Social Model we are so proud of was also established thanks to that dividend. A kind of demographic Santa Claus kindly financed inflated pensions and many other elements of our welfare. Unfortunately, we have definitely lost the demographic dividend. 'Santa Claus passed away' a couple of decades ago. Politicians have been pretending they are still his 'dealers' able to maintain inflated promises. That has led to the current situation in which we have not only lost the

[2] I narrow the scope of the paper to the European Union. Other OECD countries are in a similar situation. Situation in countries outside the OECD area is diversified and I do not take them into account in this analysis.

[3] Fertility rate sufficient for generation replacement is 2.09; EU-27 average is 1.5 (2008).

dividend but we start owing huge debts caused by distributing promises with no financing to back them.

The focus of public debate in Europe is on direct and indirect effects of the recent financial and economic crisis. That is natural since we tend to assume a firm long-term upward trend behind all economic and social phenomena. So the challenge we perceive is to cope with the crisis. After it is over we expect a recovery. The nature of the recent crisis is unusual. It is the first one where we know that long-term effects affect not only distant future but our current life as well. However, it would still sound strange if I say: the current crisis is peanuts in comparison to the already accumulated and projected effects of ageing. For analysis of economic and fiscal effects of ageing see ECFIN (2009).

2. What can we do after the demographic dividend is gone?

Before the demographic dividend disappeared we had established a set of important goals. They were affordable. Throughout decades European societies have deeply internalised them. Institutional framework was established on that background. Now, when the dividend is definitely gone we have the huge problem. It is really hard to realize that 'Santa Claus has passed away' thus leaving us on our own.

Perception is the crucial element of the pension (public finance) problem. Setting goals in this area – namely, sustainability and adequacy of benefits – gives a kind of apt illustration of confusion in our thinking on pensions. The problem is that the goals come from different conceptual frameworks which makes contradiction of the two goals less visible.

Changing perception of the situation is much more difficult than just to develop good methods of coping with the problem. An average citizen cannot take out from various systems constituting public finance more than he/she paid in. In the past a 'bonus' was financed out of the demographic dividend.

3. Work generates welfare

Sustainability and adequacy – these are the key goals often quoted. However, adequacy is commonly narrowed to benefits, while adequacy of contributions is usually neglected. Pension expenditure increases in terms of GDP, which means shrinking net remuneration of the production factors. This in turn means that interest of the working generation is undervalued. The nature of the problem is that remuneration of the current and next working generations cannot be reduced any further (we may think of higher taxation on some bankers but that would be far from sufficient). The problem of expected falling replacement rates (*ex ante* announced or left for future *ex post* decisions) is unsolvable unless we work more. In terms of the pension system that mostly means much longer working careers (later retirement).

Actually, the initial idea of the pension system was to support very old workers[4]. In terms of today's demography this corresponds to people in their nineties. I do not recommend to increase the retirement age so drastically. However, increasing it by one or two years – which seems a huge challenge – is blatantly insufficient. No matter what politicians say today, the current generation of thirty years old workers will probably work until say 75. The idea to introduce a stable proportion of time in retirement to the span of working career is fine but any reasonable proportion is difficult to introduce.

In the meantime, before we the Europeans work substantially longer, a number of problems need to be solved. Some of them are not clearly defined, which makes them even more difficult to solve. I address selected conceptual problems without going into technical details.

4. Accounting problem

It is quite a long time since demographic Santa Clause left us. Since then public finance has absorbed additional debt (not to be financed out of demographic rent

[4] Late 19th Century, when first universal coverage pension system was established in Germany retirement age was set at 70, while life expectancy at birth was below 50.

anymore). That debt has not been earnestly accounted – partially because that would be conceptually difficult, partially because it seemed politically safer not to. However, the pension debt exists irrespective of whether it is accounted or not. The difference between accounting debt and keeping it hidden is in the way it is serviced. Despite that difference, still €1 to be paid in one or two decades will have to be financed. Of course, unless pensions are cut down. Economists and policy makers tend to roll over the problem of inflated pension expectations since they assume somebody else will 'do the job' in the future. The crucial question here is: maybe saying the truth (pensions will drop in the future) *ex ante* is better than cutting pensions down *ex post*? I mean better for the people, not for today's politicians who will have to deliver that unpleasant message instead of leaving it to the ones who will come next.

Transparency does matter, so the answer to that question seems clear. However, to implement the transparency we need to develop accounting standards in order to reflect both parts of public debt, namely the regular one and the pension debt. The latter used to be serviced automatically thanks to the demographic growth. Now this is no longer the case, so its proper accounting is needed. I mean accounting, not just estimating. The two parts of debt are not identical since the former is exposed to financial markets, while the latter is serviced within public finance without that exposure. That may mean the pension debt is safer. However, changing proportions between both parts of debt does not mean any reduction thereof. If politicians claim they reduced debts by just hiding them this is no more than an accounting gimmick.

Economists have not solved the accounting problem yet. In-depth discussion of that problem goes beyond the scope of this chapter. I just suggest that eventually we shall have to account the entire debt. A GDP-indexed bonds corresponding to pension debts could be a tool to do that in a non-revolutionary way[5].

Actually, in the long run the key difference between PAYG and funding narrows down to whether liabilities created within the pension system are openly accounted (funded schemes) or not (PAYG). In the European Union it is very popular to sweep pension liabilities under a carpet. The scale of that practice is really huge [see for instance Roseveare *et al.* 2001 or Dang *et al.* 2001]. Presenting pension liabilities irrespective of whether they are openly accounted or hidden is not very common. However, that situation is changing. Coefficients S1 and S2 estimated and published by the European Commission make a step towards more transparent public finance

[5] For more discussion of the GDP-indexed bonds as well as longevity bonds as instruments dedicated to the pension system see Blake *et al.* 2006.

[for definitions and estimations of S1 and S2 see ECFIN 2009]. The coefficients, while being very informative, are not attached to any binding institutional arrangement.

5. Pension benefits

Transparency is needed in public finance. It is also needed in the way pension promises are expressed. Pension levels as measured by the replacement rate will go down. It is an inevitable result of falling proportion of those who pay (active generation) to those who receive (retirees). Defined benefit pension schemes allow for hiding that unpleasant message, while defined contribution systems provide the message *ex ante*. The latter ones are much more transparent, which is their value. That should not be confused with issues related to financial markets and so on.

The best way to understand the issue is to look at pension systems called Non-financial Defined Contribution (NDC). In these systems defined contribution regime is combined with non-financial way of generating rate of return, which is just GDP growth or a factor converging to that. A transparent system can be established without exposure to financial markets – something many people are afraid of nowadays[6].

Defined contribution systems are based on individual accounts that are well known to the people. Using the accounts helps to understand that the system cannot pay out more than it collects from workers. The individual accounts are applied at the micro level which is more intuitive to the people than macro approach usually applied when pension issues are discussed.

Individual accounts are often blamed for low expected pensions. That is misunderstanding. Pension systems just distribute what they collect from active workers. It is demography that can be blamed for the reduction of future pensions as measured by the so-called replacement rate[7].

The replacement rate (z) is given by the following simple equation:

$$z = c\,\frac{1}{d}$$

[6] Notional Defined Contribution system is also called Non-financial Defined Contribution system [for more on NDC see Góra, Palmer 2004 and Holzmann, Palmer 2005].

[7] Pensions in absolute terms (in euro for instance) can (and most likely will) increase, even if the replacement rate (expressed as percentage) decreases. In public debates the two approaches, namely the absolute one and the relative one, are often confused.

Where: (c) is the contribution rate (including possible subsidies financed out of general revenues); (d) is dependency ratio (the number of retirees per worker).

There are two way of delivering the bitter news to the workers. The first one, typical in traditional pension systems, is doing that *ex-post*, when it becomes impossible to finance inflated pensions. The second one is to do that *ex-ante*, contributing to reduction of pension expectations. The latter should not be confused with cutting pensions down. The pensions will be all the same determined by demography[8].

6. Labour mobility

Labour mobility within the EU is reduced due to lack of integration of pension systems. Their harmonisation (*ex post*) does not solve the problem that requires *ex ante* mobility decisions. Workers cannot predict long term effects of their mobility decisions. Systems in the EU countries are different and they are hardly 'translatable' between countries. Moreover, future inevitable pension reforms are unpredictable both in source countries and in receiving countries. Portability of pensions being pushed forward in the EU concerns only additional pensions, not the public ones, while it is the latter that makes stronger obstacle for mobility than the former. However, public pension systems' integration would mean going ahead with fiscal integration which is not very popular yet.

Fiscal integration is a kind of a natural step in the project in progress called the European Union. The question is not whether to go ahead but how to organise that. Decisions contributing to more labour mobility depend on integration of social systems – pension systems in the first order – but at the same time labour mobility pushes for more fiscal integration in Europe.

[8] Increasing the contribution rate is another option. However, it has already been used to the extent that it hardly allows for any further increases.

7. Public-private partnership in the area of pensions

No institutions are perfect – either private or public. Market as well as government failures are well known. Traditionally, public pensions have been delivered by public institutions. However, the ownership nature of institutions delivering pensions does not require to determine the nature of systems themselves. Is contracting out, running a public pension system, to the private sector equivalent to its privatisation? Not necessarily. The notion of 'private pensions' can be misleading. Public pensions mean arrangements covering the entire population. There is little left for individual decisions. Options are standardised. The risk, however, is spread over the entire population. Private pensions are based on individual decisions and individual responsibility. Risk is more concentrated.

Public pensions can be run by public as well as private institutions/firms. The public institution cannot be replaced by a private one only if the system runs structural (actuarial) deficit that needs to be hidden. Under current accounting regulations governments being in charge of public institutions can do that (implicit debt that do not need to be presented in official statistics) while private firms can not.

Public-private partnership (private firms running the public system) in the area of pensions can contribute to more transparency at the macro level.

8. Social redistribution

Traditionally, old-age pensions are additionally used as redistribution channels while their own goal is income allocation. That mixture of goals has become really inefficient since the time the demographic rent is lost. Moreover, redistribution embedded in pension systems has led to perverse effects, such as poverty risk being in some countries larger for prime age workers than for pensioners. Workers' interest *vis* à *vis* the interest of the inactive has been automatically neglected since the demographic rent was lost.

Separation of methods aiming at the two goals, namely social redistribution and income allocation, can increase the efficiency of each. Redistribution base in the case of the pension system is only the labour share, contributions are linear (not progressive). Redistribution via general revenues is distortive anyway, while income allocation is not – or if it partially is, then only to a much lesser extent. So, channelling redistribution via general revenues does not change much, while channelling it via the pension system causes income allocation becoming distortive.

9. Concluding remarks

The loss of the demographic dividend is not perceived by the public yet. Other way round, people expect to enjoy the level of welfare they are used to. If not now – since we have the crisis now – then after it is finished. So the public debate focuses on the crisis and its current consequences rather than on the long-term gloomy perspectives. That is psychologically natural. However, this does not help in facing the real challenge.

The common perception of the public is well illustrated by the so-called occupy movement. The 'occupy people' protest against the current situation characterised, among others, by lack of good opportunities for young generation, unable to enjoy the same or similar level of welfare the previous generations did. The young enter the labour market and if they can find a job it is a low paid temporary one as opposed to still pretty well paid stable jobs of those who entered decades ago. Moreover, it becomes clear that there is no perspective for any substantial improvement of the situation over the years to come. The 'occupy people' blame financial markets, bankers in particular and also politicians for the situation.

There is a lot of right in widespread criticism of financial markets and governments. The institutions in developed countries urgently need reforms or even exchange for new ones. They should follow social and economic developments while they have not adjusted and consequently they more or less fit the reality two or three decades ago. Confronted with our times they fail.

However, the bankers and politicians did not 'kill' Santa Claus. They can be rightly blamed for shortening a 'carnival of illusions' after the death of Santa, but it is his death that is the real reason for poor prospects of the young generation. After the loss of demographic dividend there is little left for them. The generations who entered the labour market earlier and those already retired have much stronger position indeed. It is very difficult to reduce their welfare. It is much easier to reduce that of the young entering their adult life. This is why they are in such a difficult position.

The challenge we face after losing the demographic dividend requires rethinking of the very background of institutions organising social and economic life of societies. If we had done that and if we had implemented conclusions some 20–30 years ago then evolutionary adjustment would have probably been sufficient for coping with the problem. Having neglected that in the past, however, we are facing two problems now. The first is about finding new ways of financing the old goals after the traditional way is not available any more. The second one is what to do with the already acquired debts that cannot be paid back without significant harm for the current working generation. There is no simple solution.

Solving problems related to pension systems requires putting the issues belonging to macroeconomics, demography, labour economics and public finance together. What is optimistic is that such pieces of the puzzle are more and more often discussed together.

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Edward Palmer*

Pensions in an Ageing Society. Time for NDC?

1. Introduction

The importance of solvent pension systems to the overall financial situation of countries has been highlighted by the ongoing EU financial crisis. The lesson of the crisis is that national pay-as-you-go pension systems can have indirect as well as direct effects on the general economy. Economists have long been concerned about the effect of pension design on individuals' supply of labour and national saving. What we are now experiencing on an unprecedented scale is the financial market judging the creditworthiness of sovereign states, where, justifiably, concern is focused on the future pension liabilities of national pension systems.

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One of the properties of financial defined contribution (FDC) and properly designed non-financial (notional) defined (NDC) pension schemes is that they bring long-term financial stability to national pension systems. Even prior to the recent period of crisis the trend in reform of national pension schemes since the mid-1990s has been in the direction of DC. Whereas financial DC individual account schemes are generally well-known, NDC schemes are not, since the first NDC schemes were introduced only as recently as the mid-1990s. This paper discusses what NDC is and why countries are reforming national schemes in the direction of NDC.

2. Pensions and Public Finances

The fundamental problem of standard defined benefit schemes is that they do not react to changes in the economic and demographic environment. The direct effect of the typical defined benefit (DB) pay-as-you-go pension system on the general finances of government is that when a country moves into recession and contributions fall, commitments nevertheless remain the same. This means that a larger percentage of any unit of tax money must be paid to pensions, with less remaining for other purposes. In other words, relatively, consumption is transferred from the working-age population to pensioners. Since increasing the tax rate in recession runs counter to the fiscal goal of increasing domestic demand to fuel growth and employment, the state will be inclined to borrow money to meet expenditure commitments. And, pensions are a major, if not the major expenditure commitment of national states.

A strategy of borrowing during recession to support household expenditures and bolster the economy would be a fruitful strategy if the government used the budget as a national reserve fund. The government would then set off reserves (retire debt) in good times to create room to borrow to finance commitments in bad times. This simple funding rule would then be used to keep a desirable long-run debt-to-GDP ratio.

To varying degrees, the plight of many countries in the EU and elsewhere is that debt has been allowed to grow faster than GDP and that countries have not embraced the idea of saving in good times to finance commitments in bad times. Put another way, the national product of countries has not been sufficient to support the spending of governments. Therein lies the financial dilemma now haunting many of the developed economies of Europe. Repeated periods of crisis in the past decade have been met with increased debt without sufficient saving – debt reduction – in better times. The problem is not just 'cyclical', however, and the fact that countries have not been capable of employing a large percentage of job seekers should also focus attention on structural problems affecting the labour market, countries' relative labour costs, *etc.* – that is the fundamentals of macro economics.

Cyclical fluctuation is per se no reason to revalue the risk of soverign debt, however, at least not if countries follow the simple idea of using the government budget as the country's reserve fund. The problem is that the underlying long-term causes of upward pressure on government expenditures are also structural, one being the pressure of demography – the ageing society – on pension systems. Because national pay-as-you-go pension commitments constitute a large share of any country's public expenditures, the connection between the rules of the pension system and the issue of long-term solvency of sovereign states is not surprising. What we are now seeing is the market evaluating risk on sovereign borrowing in terms of whether countries can be expected to maintain long-term financial solvency in the face of the coming demographic challenge. Reduction of soverign risk will depend on the structural properties of national pension systems.

Low birth rates in most EU countries since early 1990s have decreased the size of the labour force at a time when post-war baby-boomers are moving into retirement. This may be a partial blessing in the coming years if it leads to increased employment opportunities for younger cohorts, but at the same time a decline in the number of persons in the labour force will create a long-term structural drag on economic growth. What the long-term picture now looks like is that a decreasing labour force will be forced to finance the pensions of an increasing number of pensioners. We have seen the threat 'on paper' for at least a couple of decades. Now, we are experiencing the consequences of not adapting our policy resolutely to these changing circumstances.

Let's take a brief look at the coming demographics and the possible consequences for Europe's pay-as-you-go pension systems. What is important for pay-as-you-go pension finances is the ratio of pensioners to workers, *i.e.* the dependency ratio. The mathematics behind it are simple. Pay-as-you-go systems per capita cost less the more workers there are per pensioner. The present dependency ratio in the EU, expressed as the number of persons 65+ divided the number of persons 15–64, is presently close to four working age persons (15–64) to one pension-aged person (Table 1). It is projected to fall successively to under 2 by 2050. This will put tremendous pressure on the public finances of all EU countries, with the force of this demographic change being greater the more extensive the pay-as-you-go commitments are. The truth is that in many countries consolidation of implicit future debt is unlikely to succeed without extensive pension reform. This in turn will shift the focus in pension scheme design to affordability and financial sustainability.

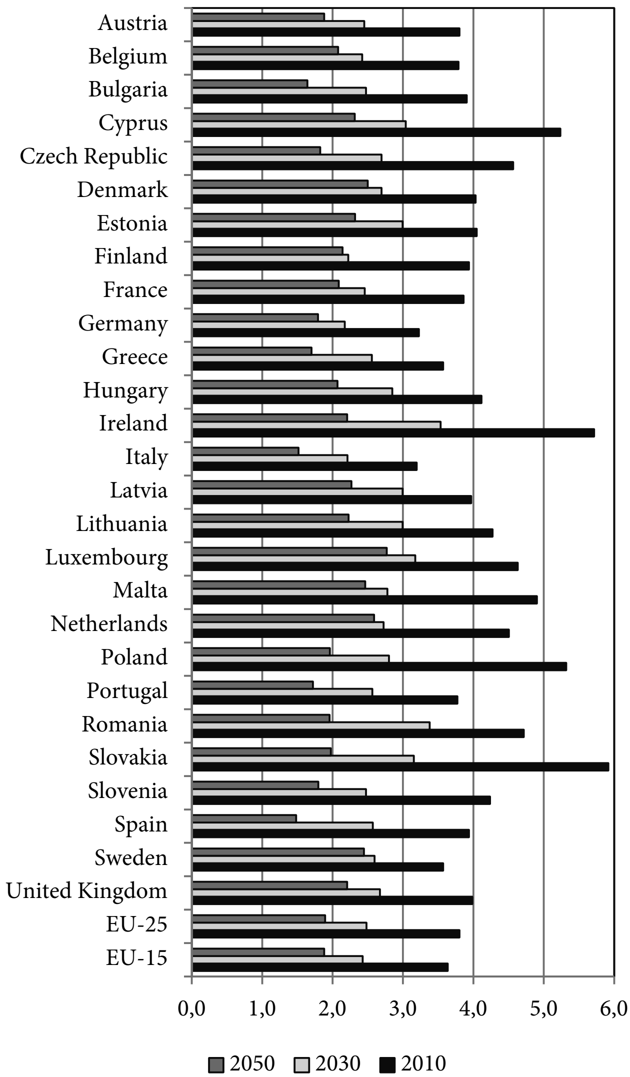

Figure 1. Demographic Dependency Ratios for EU Countries. Population 65+/Population 15–64

Source: Eurostat, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsdde511&plugin=1

It is against this background that defined contribution reforms in general and NDC in particular have become attractive, even in low and middle-income countries. NDC brings to the table a pension scheme with fully transparent liabilities and when properly designed a built-in approach to ensure solvency and financial sustainability. NDC is neutral vis-à-vis individual labour supply decisions and has exactly the same potential to promote labour-force formality as financial (or pre-funded) defined contribution (FDC) individual account schemes, as opposed to typical DB pay-as-you-go schemes. In addition, the design of NDC opens the door to integration or at least harmonization of parallel FDC schemes and facilitates the portability of benefits – between occupations, branches and geographic regions, including countries. The latter is especially interesting in the context of the EU. NDCs can also become the building block to design alternative arrangements to expand pension rights, for example, rights granted in conjunction with child birth, care of young children, care of handicapped children, *etc.* – financed through general revenues.

Countries are taking an even closer look at NDC for yet another reason, as recently argued in Holzmann and Palmer (2012). Confidence in what many economists considered to be the preferred alternative for a national pension scheme, financial defined contribution individual account schemes (FDC), has been shaken by the repeated and severe financial crises of the 2000s. With over a decade of financial crises, marked by low returns and extreme volatility in the equity market and on top of this the loss of the government asset as the safe haven, FDC schemes are now less attractive for policy makers. On top of this, quite a few experts now expect the financial market to deliver lower rates of return in the future as populations in most regions of the world age and move into the dissaving stage of their life cycles.

In addition to this, the fiscal capacity and willingness to pay for the transition costs to pre-funded FDC schemes can be expected to be low in view of the currently high explicit public debt in many countries. Finally, there is an additional word of caution. Countries introducing FDC schemes have downplayed transition costs and have not stabilized non-pension fiscal expenditures in conjunction with the introduction of national mandatory FDC schemes. As a result, a combination of underestimated transition costs and overall poor fiscal management has proven deadly for newly introduced FDC schemes in a number of countries in Latin America, Central and Eastern Europe. Seen in this perspective, NDC reform offers an attractive DC alternative to FDC.

3. Pension Economics in Brief

The contribution rate needed to finance pensions is determined by the ratio of pension expenditures to the contribution base. Pension expenditures can be expressed as the average pension (P) times the number of persons receiving a pension, *i.e.* retirees (R), receiving a benefit and the contribution base as the average wage (w) times the number of workers (L) paying contributions:

$$C = \frac{\bar{P} \ x \ R}{\bar{w} \, x \, L}$$

So the change in the contribution rate (C) over time is determined by the change in these four components.

Assume the goal of policy is to maintain a given macro replacement rate, *i.e.* ratio of an average pension of a current pensioner to the average wage of all current workers. The rate of growth of the average wage is exogenous – that is, it is beyond the control of the policy maker. In the defined benefit context, *i.e.* most EU national pension schemes, P is not a policy parameter. For given values of P and w, *i.e.* ratio of the average pension to an average wage, if the dependency ratio is increasing, as we have just seen it is in the countries of the EU, then the contribution rate will have to increase to maintain a given desired outcome for the benefit level.

The figures in Table 1 tell a sobering story. If the goal of policy is to maintain a specific macro replacement rate, simple mathematics says that if this goal is set at 50% (60%, 70%), with a dependency ratio of two workers to one pensioner and an assumed pension age of 65 through 2050, the contribution rate would have to be 25% (30%, 35%). If the wage sum is about two thirds of GDP, then this means pension expenditures are 16.75 (20.1, 23.5) percent of GDP.

The expenditure financing equation above also tells us something about the dynamics of pension financing. We interpret the average pension as the average nominal pension and the average wage as the average nominal wage. If the contribution rate is to remain constant, *i.e.* if pension expenditures are to maintain a constant share of GDP over time (given a constant share of wages in GDP), then, technically, pension expenditures should grow at the same rate as the contribution wage base, wL. If real benefits are indexed to the consumer price index and if this is the index used to compute the per capita real wage, then the equation is inflation neutral. What determines the long-term capacity of a country to pay pensions is the growth of productivity, which determines the room for real wage growth, and the growth of the labour force. Combined, these two growth rates constitute the internal rate of return in an NDC scheme. The basic design of NDC follows this rule and in doing so creates long-term solvency. This is, then, the feature of NDC that makes it worth considering in establishing a solvent pay-as-you-go contribution-based pension scheme.

Several observations are in order in discussing pension reform. First, the policy maker must determine the extent of the state commitment that is desirable, given the interests of both present and coming generations. One can argue that the obligation of the state is to provide at least a minimum benefit that keeps all elderly people above a poverty line. The government's pension mandate is a paternalistic measure to protect people from their own myopic tendencies. Most of the countries of Europe have the more ambitious goal of providing an adequate living standard in old age. It is easily arguable, however, that the state should not attempt to cover all pension needs, since what is adequate depends on varied individual situations.

Second, considering continuous improvements in the drivers of healthy longevity – life style factors, health care technology, workplace safety, *etc.*, it is not reasonable to design pension schemes that enable/encourage people to exit the labour force at an age that generates such a large number of benefit recipients that the resultant benefit expenditures are unaffordable for the working generation. Life expectancy in high income and some middle income countries with high economic growth is around one additional year for every 10 calender years. This suggests a normal pension age for publicly provided pensions in the EU around year 2050 of 67–71 years for persons entering the labour force around 2010, depending on the country's present age-related mortality rates. It also suggests that the parameters of pension systems should be designed to achieve this goal and that politicians need to be truthful and communicate the logic behind this simple message to their voters.

Much of the recent political turmoil around increasing the pension age in Europe may in fact be a hangover from an 'over-sell' of the life course model in the 1950s and 1960s when politicians in many countries saw the political opportunity to support unions in their demands for a low pension age – an argument based on a world where older workers in the 1950s–1960s may have entered the labour force as middle-aged teenagers and at a time when work environments were much less friendly than they would be fifty years later. At this time many had the vision of age 55–60 as the normal pension today, *i.e.* age. We have to remember too that pension cohorts were small several decades after the war. In fact, dependency ratios were around eight workers per pensioner. In addition, life expectancy at age 60 (65) in 1960 was on average five years less than in 2010 and may easily be ten years less than in the year 2050. So, with this in mind, who's really willing to argue for a fixed defined-benefit pension age? On top of this, younger persons now entering the labour force are middle-aged twenty year olds with a much longer period in education; they are much healthier and much less likely to work in dangerous working environments compared with earlier generations.

Third, systems should be designed so as to create the freedom to retire after a specified minimum age, with actuarial adjustments of benefits, that is, working longer gives a higher yearly annual benefit based on the development of longevity. The minimum age to claim a public pension must be set high enough so as not to allow people to claim a benefit that will put them into poverty and this age should also follow the development of life expectancy. Disability pensions are important, since not everyone is capable of working to age 65–70, but the gatekeeping function of disability must be strict. The eye of the needle for moving from long-term sickness to disability should be narrow, making uptake of pensions that are not strictly health-related a strictly private affair. In occupations where full-time employment is not normally possible at the general pension age targeted by the policy maker, there should be privately financed occupational pensions to fill the gap.

Fourth, there is a clear trade-off between policy designed to support and promote child birth and the cost to workers of pensions. With high fertility rates – *i.e.* around two children per woman – it becomes financially easier to support increasing longevity, by cushioning or avoiding labour force decline. Combined with the ambition of achieving gender equality in labour force participation, this suggests introducing tax-financed pre-school child-care facilities and family benefits that enable parents to spend considerable time during their children's early years at home and, when necessary, away from work for care of older sick children, handicapped children and even seriously ill parents.

Fifth, labour force productivity is dependent on education. So, the better educated the labour force is, the greater is the country's potential economic growth. Expenditure on education is important and it is not in anyone's interast that it is cromwed out by a misguided ambition to provide pensions at too yong an age. Sixth, labour force mobility – where people are not locked into jobs due to their pension scheme (for example as a result of vesting rules) – together with lifelong learning, promotes economic growth. Well-designed national unemployment benefit systems should be seen as a support vehicle for desirable labour mobility.

Good policy for an ageing society, where expenditures on health care technology are a driver of good health, is to design pension systems so as to facilitate and encourage upward drift in the normal age at which people exit the labour force. This includes making it easy to combine some portion of work with some portion of a pension, *i.e.* pension system design should facilitate gradual exit from the labour force towards the end of the working career.

A conclusion of this discussion is that a public commitment for provision of income security in old age is needed, although the extent of the public commitment should be carefully weighed against other uses of public resources, and, it should be added, the trade-off between consumption when young and consumption when old. Another conclusion is that, to be sustainable, pension schemes must be designed to cope with the pressures of low fertility and increasing longevity. The track-record of DB schemes is not good in this respect. So, let us turn now to the alternative, DC pension schemes, with a focus on NDC.

4. Towards Defined Contribution Pay-as-you-go – or NDC

Prior to 1994, when the first non-financial (notional) defined contribution (NDC) pension system was legislated in Sweden [*e.g.* Palmer 2000; Palmer 2002; Könberg *et al.* 2006], it was generally thought that a sustainable defined contribution pay-as-you-go pension scheme was an impossible construction. Now NDC has been introduced in a number of countries: Latvia [Fox & Palmer 1999; Vanovska 2004; Palmer *et al.* 2006; Vanovska 2006], Italy, for new entrants [*e.g.* Franco 2002; Franco & Sartor 2006; Gronchi & Nistico 2006], the Kyrgyz Republic, for new entrants [*e.g.*, Palmer 2006a; Palmer 2007], Poland [Chłoń, Góra & Rutkowski 1999; Góra 2001; Chłoń-Domińczak 2002; Chłoń-Domińczak & Góra 2006] and Norway [Christenssen 2012]. Elements of NDC can also be found in other more recently reformed pension systems, for example the Russian pension system introduced in 2002 [Hauner 2008]. Chłoń-Domińczak, Franco & Palmer [2012] evaluate the performance of NDC schemes in the original NDC countries (Latvia, Italy, Poland and Sweden) and the anthologies by Holzmann & Palmer [2006] and Holzmann, Palmer and Robalino [2012a and 2012b] provide extensive discussions of numerous issues involved in the choice and implementation of NDC schemes. In separate contexts Palmer [2002, 2005] and Holzmann [2006] have pesented the case for NDC in Europe.

So, what is NDC?[1] NDC combines pay-as-you-go financing with an individual lifetime account structure, where the accounts of individuals have a one-to-one correspondence to contributions paid by them or by their employer on their behalf, and throughout their entire working career. The government sets a contribution rate that is exactly the same for all generations. Pensions are granted as life annuities, based on the individual's account balance and his or her birth cohort's life expectancy at retirement. Accounts of workers and pensions are indexed with the internal rate of return, already discussed above. There is no 'the' retirement age. Instead, there is a minimum age and thereafter individuals are at liberty to choose partial or full benefits at any time. People can choose to continue to work while receiving a partial or full pension benefit. In this case they pay additional contributions on all additional earned income. Their pensions are then recalculated at a later time to take the additional payments into consideration.

What distinguishes NDC from all other pay-as-you-go schemes is a fixed contribution rate. NDC also shares several other features with FDC individual account schemes. These are: individual lifetime accounts; benefits computed as life annuities based on the individual's own account value and life expectancy of the retiring individual's birth cohort; and indexation of accounts with the internal rate of return. This given, there are also two significant differences. First, as long as the rate of return on financial assets is expected to surpass the rate of growth of the economy (or more specifically the wage sum giving rise to contributions), any pay-as-you-go scheme, including NDC, will be second best to a fully pre-funded scheme [*e.g.*, Lindbeck and Persson 2003]. Second, FDC individual account schemes are also based on full pre-funding, whereas the funding for NDC schemes is the flow of future contributions. NDC schemes may, however, have reserve or buffer funds that cushion cyclical or demographically induced volatility [see Holzmann *et al.* 2012].

The direct link between contributions and benefits in NDC means individuals are rewarded with a higher pension for every extra monetary unit of contributions paid. NDC has no direct distributional aspirations, but the NDC individual account scheme opens the way for entering transparent distributional policy into the pension scheme. This is because the government can create non-contributory rights, *i.e.*, rights not based on the individual's earnings, that can augment individual account

[1] Palmer 2006 and 2012 are detailed exposés.

values for socially desirable activities, already mentioned above. What is important is that these rights be accompanied by a source of finance external to the otherwise financially self-contained NDC scheme. This is because the fundamental logic of NDC is that every monetary unit of a liability has to have a financial counterpart (contributions on earnings, contributions from the government for special rights, *etc.*). This is a principle that when fulfilled, *ceteris paribus*, is key for long-term financial balance. If this principle is broken then financial balance is jeopardized.

NDC should also be supplemented with a minimum income (pension) guarantee. The guarantee can be formulated either as a universal flat-rate pension which constitutes the basic pension for everyone; or as a top-up means-tested only vis á vis the NDC and other public pension benefits; or against all income and wealth.

Given the actuarial link between benefits and contributions in NDC there is no need to set either a 'vesting' period for eligibility or a fixed 'final' retirement age, a feature typical of pay-as-you-go DB schemes. Neither is there a 'full-benefit' or 'the' pension age in NDC. NDC gives individuals the freedom to choose to retire at any age – after reaching the statutory minimum pension age. The minimum age is necessary, however, to protect people from myopic decisions to leave the labour force at too early an age, which can lead to a low lifetime pension and a higher risk of poverty in old age as a single survivor. After all, the raison d'être of the public engagement in pensions is to prevent individual myopic behaviour leading to poverty in old age.

We also note that, at a time when experts [*e.g.* World Bank 1994, Disney 1996, 1999] were beginning to stress the need to reform pension systems, the emergence of NDC provided a structural reform alternative to the piecemeal reforms undertaken by countries attempting to come to grips with unfair distributional rules and unaffordable schemes that pushed off increasing costs onto future generations. In contrast, NDC provides a model for intergenerational fairness. All generations pay a fixed percent of earnings on NDC pensions. This result can be obtained, however, only if the scheme is well designed and correctly implemented. This is discussed with reference to present NDC countries in and analysed with the examples of Sweden, with a balancing mechanism that maintains financial stability, and Italy, with an internal rate of return that does not necessarily deliver financial balance Chłoń-Domińczak *et al.* [2012]. In addition, in Italy, a slow rate of transition from the old DB to the new NDC scheme has detracted from the message of NDC that benefits are contribution based – *i.e.* you get what you pay for in NDC. This message has also a corollary: retiring at an older age gives a higher benefit per year of retirement due to the actuarial adjustment, but also to additional contributions and indexation ofacounts.

5. Final Remarks

Summing up, NDC combines desirable individual economic incentives, flexibility in retirement decisions, transparency in redistribution and a framework for ensuring financial equilibrium. If designed properly it deals completely with the economic and demographic risks of pension systems. It distributes the necessary adjustments implicit in the projected development of dependency ratios in Table 1 proportionately to accounts (future pensions) of workers and pensioners. Indexation deals with the risk of a declining labour force in cyclical recessions and/or due to chronic decline due to fertility rates falling below 2.1 children per woman. The pension benefit takes the form of a life annuity based on life expectancy at retirement. A further safeguard can be introduced in the form of a solvency ratio, as in Sweden, which also allows countries to index, for example, solely with the wage rate, covering the risk of a declining labour force within the framework of the solvency ratio and the indexation form resulting from this. As a result of these design features, the contribution of the national pension debt to the soverign risk is under financial control in NDC.

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Robert M. Lindley*

Extending Working Life: Employer Behaviour and Social Policy

1. Introduction

Population ageing has different implications for different actors. Policy stances at both national and European levels make assumptions about their behavior and seek commitments from them. The aim of extending working life has been actively embraced by most European governments. But the imperatives they face and their approaches to diagnosis and prescription differ, especially regarding the extent to which the 'economic' and the 'social' dimensions are seen as clearly distinguishable and are kept apart. This is no more apparent than in the way they deal with the roles of employers.

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To some degree, population ageing presents new ground on which to reignite the long-standing debate about where the dividing lines are or should be placed between what might be seen as the responsibilities of employers and what might fall to the individual/family or the state? However, there also seem to be relatively new combinations of pressures within the socio-economies of Europe affecting but as yet unresolved among the different actors. These pressures come from three directions: labour supply constraints on economic growth, pension-fund sustainability, and individual rights to 'active ageing' [European Commission 2012; Kotowska 2012; Walker 2009].

Although the 'labour supply – pensions – active ageing' issues have been recognised as presenting medium-to-long-term dilemmas, the first two have acquired additional force following the near-collapse of parts of the western financial system in 2008. Concern over skilled labour supply has arisen, in spite of the youth unemployment situation, given the critical importance of avoiding any impediments to economic recovery such is its fragility. Similarly, cyclical sensitivity demands evidence of concerted plans to tackle the rising public and private pension system deficits as an important element in attempts to boost financial market confidence. This leaves the third issue, active ageing, which has been emerging in the form of increasingly coherent advocacy at European and some national levels since the mid-2000s but struggling to make headway in the choppy waters of the aftermath of the financial crisis. It remains to be seen

Given the scale of the latter, it is easy to become pre-occupied with surviving the recession; this may even go as far as attaching to each of the three issues an unduly cyclical frame of reference. One is also naturally drawn to examine the recessionary experience for evidence of longer-term significance. Previous periods of high unemployment were accompanied, for example, by falling labour force participation rates amongst older people and disproportionate rises in older worker unemployment. Increases in early retirement, long-term illness and disability rates were major features alongside the difficulties facing young entrants to the labour force.

The latest *Ageing Report*, produced on behalf of the Economic Policy Committee and European Commission (2011*)* provides an extensive analysis of the financial and economic consequences of population ageing among Member States. However, whilst macro-levels dominate EU and national levels of public policy debates, the primary space in which 'labour supply – pensions – active ageing' pressures come together is at the level of the employing organization. Here, the trade-offs between different ways of seeking to reconcile business and personal objectives are at their sharpest and employers are being drawn further along what, arguably, might be deemed the 'social dimension'.

Section 2 of this paper briefly examines notions of social policy that circulate in EU debates and links them to employer behavior. Section 3 turns to evidence on employer behaviour in relation to social policy and 'age management' where the focus is on organizations that are actively engaged with one or other dimension of human resource practice in the field. This area of employment relations raises issues concerning the scope of employer behavior in relation to social policy and the interpretation of evidence on age management practice. Section 4 provides some concluding reflections.

2. EU notions of social policy and employer behaviour

In terms of European political economy, the Single Market initiative brought matters to a head over the status of the 'social dimension' [Lindley 1997]. This basically concerned various areas of both fiscal and regulatory social policy designed to establish a 'level playing field' within Europe without undermining its competitiveness relative to third countries. The process culminated in the Treaty of Maastricht (with the UK opt–out for the Social Chapter). Some regulations, however, arguably went beyond this and imposed obligations on employers in the interest of strengthening social partnership and improving, broadly-speaking, the quality and security of jobs, especially for 'vulnerable groups'.

The style of policy discourse changed markedly under the Open Method of Co-ordination launched under the Lisbon Treaty, moving away from extensive negotiation of legal instruments to peer group assessment and sharing of experience. The social programmes influenced by this approach, culminating in the *Lisbon Strategy* 2005–2010, have now been replaced by the *Europe 2020 Strategy.*

In this context, 'social policy' may be seen to focuses on three areas: *social protection and social inclusion*; *social services of general interest* and *fostering social partnership.* The first of these deals with social inclusion (equality and diversity); social protection, security and poverty; and healthcare and long-term social care.

Social services of general interest comprise social security, employment and training services, social housing, child care, long-term care, social assistance services.

They contribute to the well-being of the individual, family and community overall and constitute a basis for supporting them

The third component of social policy covers the process of social partnership. This involves reinforcing collaboration between employers and trade unions through regulation, fiscal measures and the promotion of joint deliberation [ETUI 2011].

Essentially, social policy in the above senses is concerned with gains to efficiency, equity and community. Some objectives can be seen as ends in themselves, too important for them to be matters of calculation as to how far, if at all, to support them. Some may be supported on the grounds of creating public goods. Others seek to accelerate the adoption by certain actors of practices that are seen actually to be in their own *individual interests*, in spite of resistance on their part to recognize this.

The position of older people is thus addressed from the point of view of the disproportionate incidence of social exclusion and poverty among them in many countries, from the perspective of their roles in the economy and civil society, and (to a degree only) the extent to which their interests are adequately represented by exisiting actors and institutions in the EU.

Of course, employers have long-since acted across the economic-social boundary both as 'funding recipients', on the one hand, and 'societal resource providers', on the other hand. In the former category, for example, companies receive substantial public subsidies to promote their investments in R&D and human capital, and to locate new investments in particular areas. They benefit from reduced legal liabilities through company law, from the public services that, arguably, form vital parts of their supply chains (for example, certain education, training and infrastructure programmes) and from citizens, as their employees, who work beyond the terms and conditions of their contracts of employment.

Set against these 'corporate welfare payments', however, are the roles played by employers when they *collect taxes and social security contributions* on behalf of the state, act as *education and training providers/funders*, administer *pension schemes*, help employees with *health and social care* matters (and, less common now, *housing*), and provide *buffers against unemployment*. These roles draw on the economic *and* social capital of the employer. The extent of these roles varies across sectors, forms of organization, social welfare systems, etc. They are also subject to considerable change over time. In the last decade or so this applies especially to thoseorganizations in transition economies which emerged from their close relations with the state and the complex of functions they performed (notably, dealing with unemployment and social support within 'the factory gate') and which eventually became members of the European Union.

3. Social policy and 'age management'

3.1. The intersection between employer behaviour and social policy

The impacts of population ageing on the age structures of the population, labour supply and workforces at organisational level are hugely variable across the EU. Even recognizing the spatial (e.g. regional), sectoral, and occupational differences in the incidence of ageing leaves great heterogeneity among organisational and individual circumstances and the responses to them. The notion of 'age management' has emerged which recognizes the importance of an organization taking into account the demographic structure of its workforce in order to capitalize on the potential of its members, strengthen their capabilities, and address their needs for development, flexibility and security. The focus has been particularly upon older people for whom the gaps between potential and opportunity have been of special concern in an era when they were expected to represent a higher proportion of the workforce and there were pressures upon them to stay in employment longer.

The wide variety of activities captured among the key dimensions of HR practice or 'employment relations' includes the following:

- awareness raising, changing attitudes and promoting diversity
- flexible working
- entering, leaving and retiring
- organizational design
- job rotation and re-deployment (internal mobility)
- training and professional development (working and learning)
- health and safety at work, workplace design and accessibility
- personal counselling
- health promotion, health insurance
- information, advice and guidance (careers, re-deployment/training)
- general well-being, preparation for retirement
- additional age/service-related holiday entitlement
- remuneration and pension arrangements
- maintenance of social partnership.

Most large and many medium-sized employers will cover these functions. Some clearly belong to the core of HR practice in support of central corporate objectives. Others bring with them, to different degrees, broader considerations. The dimensions of practice within the organization that most intersect with social policy *service provision* tend to be those indicated below:

- awareness raising, changing attitudes and promoting diversity
- flexible working
- training and professional development (working and learning)
- health promotion, health insurance
- information, advice and guidance (careers, re-deployment/training)
- personal counselling, general well-being, preparation for retirement
- pension arrangements.

3.2. Research on 'good practice'

As with other longer-standing perspectives on HR policy with strong relationships with social policy objectives, namely, gender, race, and disability, promotion of 'age management' has been accompanied by ideas about what constitutes 'best' or 'good' practice. This refers to practice that is carried out effectively and sustainably, essentially creating high quality employment, consistent with the interests of employers and workers.

There have been a number of comparative studies at the European level during the last decade or so which have generated insights into what might constitute good practice age management [Walker and Taylor 1998; Lindley and Duell 2006; Naegele and Walker 2006; Taylor 2006;]. Most recently, as part of the ASPA project, Frerich *et al.* [2011] have extended the available evidence by exploring the state of age management practice among European organizations that have been relatively active in the field and point to the following findings of their study.

- There is growing evidence of good practice but it is still quite limited.
- There is little indication of a general increase in comprehensive or extensive age management practice integrated across several HR dimensions.
- Good practice cases are still more identifiable among large private companies and less so among SMEs and the public sector.
- There is a significant tendency to replace age-specific measures with ones which see the working-life cycle more as a whole.

- There are complex responses to the combination of underlying workforce ageing and cyclical changes (usually from labour shortage to surplus), including the present crisis.
- Pension reform and the issue of working-age health are generating stronger pressures on age management agendas.

Good practices in age management can be found particularly in the area of 'training, lifelong learning and knowledge transfer'. Other areas include 'flexible working practices', 'health promotion', 'career development and mobility management', and 'transition to retirement'. However, it is also apparent that some organisations may be active in promoting the retention of older workers whilst discriminating against them when in recruitment mode.

In examining the practices of organisations in the age management field, it becomes clear that focusing on destinations of good practice ignores the potential insight obtainable from looking at the pathways travelled by organisations as they seek to respond to business conditions, the situations of their employees and societal pressures. Research indicates that certain generic pathways can be identified and these offer more insight for both the practitioner and policy communities than do periodic enquiries about 'good practice destinations', which have been reached at the time of enquiry but may or may not be sustainable. This particularly applies as the number of good practice cases multiplies across the EU and leads to a somewhat daunting task for those wanting to learn from the experience of others either at institutional or organizational levels.

Without going into the methodology behind the pathways of practice approach [Lindley, forthcoming] or specific cases [Frerich *et al.* 2011] four general conclusions can be drawn.

- Significant extensions to working life need employers as key 'social policy actors' and 'delivery agents'.
- Employers with small internal labour markets need support to 'widen them', given their lack of economies of scale in providing services.
- The imperative is to keep employees 'attached' to the employer for as long as possible so as to access the organisation's 'economic and social capital'.
- Age management case studies show how this can happen but the cost-benefit calculus is not always clearly in favour.

As regards the last point, the experience of age management initiatives may be related to the evidence of what features are associated with high organisational performance [Lindley 2002]. Overall these seem to be a combination of the following:

- more co-operative relationships with customers and suppliers

- participative management with horizontal co-operation
- quick adjustment to changing technology and markets
- stability sought through quality, productivity and flexibility
- constant improvements on the job
- great attention to education and training
- need for higher order generic skills.

The question is, does good practice age management foster high performance or does high performance create the financial headroom in which companies can afford to engage in the practice?

In deriving as much benefit for both the organization and the individual, the evidence points to the critical importance of the potential capacity of the enterprise to provide for internal mobility, training and development, and working-age health-related support. To a considerable degree, such potential capacity depends partly on the size of the enterprise. Member states vary greatly in this respect. Large companies (250 or more employees) in the so-called 'non-financial business economy' in the five largest economies account for about 40 per cent or more of that sector's employment in France, Germany and the UK, but only about 20 per cent in the case of Italy and Spain. Very roughly halfway between these two groups, we find the Czech Republic, Poland, Romania and Sweden.

Micro-enterprises (fewer than 10 people employed) account for over 45 per cent of those employed in the non-financial business economy in Italy, almost 40 per cent in Poland and Spain, and 20–25 per cent in the Czech Republic, France, Germany, Sweden and the UK.

Large scale, however, may not provide for as much scope for redeployment as might be expected. Companies with strongly distributed operations in terms of financial independence, functional specialization and spatial location may neutralize their potential advantages from both 'demand' and 'supply' sides. From the point of view of making a wider range of jobs available to employees seeking other work, management barriers may need to be surmounted, including those relating to the HR function that is required to operate such schemes. Employees may, themselves, be reluctant to embark on transfers to unknown work groups or locations. On the other hand, there are examples of companies using their supply chains as extensions of their internal labour markets for the purpose of redeploying experienced employees.

Organisations with effective approaches to training and development that exploit the substantial economies of scale attached to these activities will offer more promising scope for designing provision that suits older employees, though their willingness to do so cannot be taken for granted.

Turning to small and medium-sized enterprises, there is the question of whether or not there are ways of compensating for the limiting effects of low scale on the potential for harnessing 'internally-organised' mobility, with or without additional training, in prolonging working life. This arises when the employment relationship is not severed suddenly but, through shared facilities and/or training courses, the employee is able to move on to another role in the company or leave in a manner that increases the chances of finding other work promptly.

Sectoral and/or locally-based initiatives, organized through groups of employers or through local public agencies (or a combination of both) can act so as to extend the size of the training market available to employers sufficiently to make redeployment feasible even in small enterprises. The capacity of the employer to provide 'age management' can then be expanded through collective or public action to provide certain services directly or by public agency commissioning in such a way as to create markets in which intermediaries tender to provide services to such employers.

Of course, similar initiatives can also be designed which reverse the direction from which the stimulus to action comes as regards the roles of employers and training providers; thus, the latter are then seeking to organize on-the-job training and/or work experience for those who are in training but without employment.

4. Concluding reflections

Extending working life as a matter of state policy initiative is critically different from responding to an underlying evolution of individual preferences – which might be heading in that direction anyway – by seeking to remove barriers to continuing in employment for those wanting to do so. Behind such an evolution, we might point to a number of factors but, notably, longer healthy-life-expectancy and the desire among an increasingly educated and skilled labour force to continue working later in some capacity; it is also fuelled by a concern to buttress income prior to full retirement. But there are many who do not share these preferences; their health, well-being and access to congenial work do not add up to a strong case for prolonging working life.

So a benign situation in which the shifting preferences among some older employees for more opportunities for work may be harnessed in the interests of the economy and wider society cannot be taken for granted. This makes it all the more important to find some common ground between different actors in positive organizational contexts in which potentially conflicting objectives can be reconciled:

those of employers and employees, skilled and less skilled workers, young and old, women and men – overlaid with varying health conditions and caring responsibilities. Such challenges have led to a search for ‘good age-management practices’ in Europe and beyond. They have also led to the designation of 2012 as the European Year of Active Ageing and Solidarity between Generations [European Commission 2012].

The emerging age-management agenda brings to a head the long-standing European debate about the boundary between the ‘economic’ and the ‘social’, between ‘efficiency’ and ‘equity’. This applies throughout the working-life cycle but is acutely the case for older people where gender and disability interact with age in generating a diversity of conditions facing employers and employees.

The notion of *working-age well-being* has, for some time, been a subject of concern at national and European levels. It sits alongside social inclusion objectives and acts as a warning that achieving the latter should not simply be through increasing the volume of work to marginalized groups but rather should also aim for equality of access to good quality jobs. However, it also figures in studies of what factors appear to contribute to the achievement of high performance among organisations. More generally, the arguments that social policies (or, at least, some of them) should be seen as ‘factors of production’ that may generate their own returns rather than having to be paid for by the ‘economically-productive’ parts of society then apply not only at the societal level but also at the organizational level.

Paying attention to working-age well-being becomes even more of an imperative when the notion of ‘working age’ is itself being examined with a view to extending it. Strategies may start with concrete steps to end age discrimination and increase opportunities for work and learning throughout working life. They may continue by modifying pension schemes so as to introduce greater flexibility, compatible with partial employment/retirement solutions that retain skills in organizations and compensate individuals adequately for postponing their retirement. In passing, we may also recognize that continuing longer in employment can itself have a positive effect on the well-being of many older people.

But there is a major factor that is hardly conducive to persuading the citizen to take the potential benefits of these government initiatives and employer responses at face value. This factor is more fundamental pension reform, seeking to delay the age at which pensions are paid whilst reducing their probable benefits and shifting more of the costs and risks to the individual.

Tackling the challenge of an ageing population at societal level lies first in recognizing that the most effective ways of promoting the extension of working life at the same time as promoting well-being is to draw on the resources and expertise embodied in employing organizations – essentially, their *economic and social capital*. This means keeping the employee attached to the employer and avoiding as far as possible transitions that involved the external labour market. National actors with neo-liberal inclinations may resist the notion of social partnership but already employers are, in fact, acting as social actors whether or not they place much value on collaborating with trade unions or other employee representatives. What *seems* to be happening is that pathways to 'good practice' are leading increasingly into deeper and more diverse social territory than hitherto.

Without wishing to overstate the last point, some discussion about the most effective sites for 'social policy delivery' is then warranted. For a start, if working lives throw up more challenges and potentially more choices for individuals at later stages, a particularly important issue is the availability of information, advice and guidance. This applies especially to employees in enterprises that lack the resources and expertise to engage in these kinds of discussions with their employees. Moreover, it is reinforced if the age-management agenda is, indeed, broadening to encompass issues of health in working age, care responsibilities of employees, and flexible retirement options. When the notion of retirement age ceases to have legal force in the EU as an automatic justification for ending an employment contract, this changes the terms of the employment relationship. It also extends its scope.

Keeping the active ageing scenario away from the shadows cast by pension reform initiatives can only be achieved through action at the organizational level. Moreover, well-judged age-management initiatives accompanied by commitments to effective employee consultation should have positive effects on helping to reconcile conflicts over pensions. Seeing pension sustainability simply as a financial problem requiring more collective realism and a return to good housekeeping would be a mistake. The success of the reforms depends on raising productivity over the extended lifecycles of employees and attending to working-age well-being, not just among older workers, and not merely by getting them to work longer for less.

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Part V

THE EUROPEAN SECURITY, ENERGY POLICY ASPECTS

Britta Thomsen*

Renewable Energy and the Energy Efficiency Directive

Take a walk down imaginary lane with me

Imagine that we are at tonight's reception. The music is playing. People are laughing. And we are all networking our merry way around the room. Our deliberations have led us to new insights on the challenges of European energy policy. The food is delicious and the band is delightful. All in all. We are having a good time.

Then: disaster strikes! Someone has noticed that we are running out of wine! What do we do? The wine is really quite good, and it would be a shame to continue without it. We send someone to pick up a few extra bottles of wine in the storage

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room, of course. Imagine then, that our emissary returns with dreadful news: no more wine is to be found anywhere in the storage room. What then?!

Well. We drink champagne! Our world is hosting an energy party. And it is about to run out of wine. I am here to tell you how energy efficiency and renewable energy can be the champagne that makes the party last. European energy policy is faced with three challenges.

Challenge number 1. We are running out of energy.

The British Petroleum 2011 Statistical Review of World Energy estimates that proven oil reserves will last us another 46 years at current production levels. 46 years. This is an industry estimate. The average lifetime of a coal power plant is 40 years by comparison.

Challenge number 2. We depend on energy imports.

As of 2007 more than 50% of European fuel consumption was based on imported fuels. This number is expected to increase in the future. Depending on imports of energy means two things. It means we are vulnerable to supply cuts – for whatever reason. And it means that resources spent on energy does not contribute to domestic growth. The security of our energy supply is based on fuel sources that are expected to run out; and it is based on the political stability of unstable regimes.

This brings us to challenge number 3. Energy prices are rising.

Take those two factors together and add that population is growing. The UN expects 10 billion people to be on the planet by 2100. Add also that we can probably expect most of those people to want an increased standard of living.

The result is an ever increasing demand for energy despite a decreasing supply of current energy sources. This can only mean one thing for prices. They are going up. Indeed we are already witnessing that tendency. Despite our current economic woes, real oil prices today are on par with those we endured in the 1970s.

These are the challenges we face in defining Europe's energy future.

We stand at a cross-road. As I said: our energy party is running out of wine and it is time to find the champagne. I would like to propose, that Negawatts and renewable energy will be the champagne to keep our party going.

In 1989, Amory Lovins coined the concept of Negawatts. A theoretical unit of power used to measure energy saved in watts. Dr. Lovins' ambition was to equate electricity capacity built with electricity capacity saved. A watt saved is a watt earned. The point is that Negawatts – energy efficiency measures that is – and renewable energy are two types of champagne to keep the party going. And we are going to need both. And we are going to need them now.

We are in the midst of the worst economic crisis since the great depression. Our economies are under pressure. Young Europeans are finding it ever harder to enter the work force. And most of the EU is still struggling with little to no expansion of their economies. Some question the wisdom of transforming the energy sector in the midst of a crisis. I question the wisdom of postponing the problem. Energy efficiency and renewable energy both provide a ticket out of the crisis.

The argument for investing in renewable energy is straightforward. Bloomberg New Energy Finance estimates that global annual investment in clean energy will be more than 500 Billon dollars by 2030. Enormous markets are emerging in the field of clean energy, and Europe already has a strong position to build on. The argument for investing in Negawatts is a little more elaborate:

In a world where energy prices are ever increasing it will become a larger and larger portion of the cost profiles of companies. This implies that energy efficient companies will have an increasingly large advantage over their competitors. Energy efficiency measures provide an opportunity to position our industry in future global competition. It is cost-effective in the sense that it is the cheapest option for diversifying our energy supply.

American studies have shown that the per-kilo watt hour price of energy efficiency is much lower than that of alternative generating technologies. Obviously energy efficiency won't solve all of our problems. We can only make energy use so efficient. It is clear, however, that energy efficiency is part of the solution – and that it is the low hanging fruit. It is also cost-effective in the sense that the gains from energy efficiency outweigh the costs. Installing insulation in your house lowers the cost on the heating bill enough to justify the initial investment. Pay-back rates however, usually aren't fast enough to completely unlock the inherent potential in the market.

As many of you are likely aware, **the Commission has proposed a directive to achieve the target of 20% energy efficiency by 2020**. I speak to you today primarily in my capacity as shadow rapporteur for the S&D group on this directive.

The Commission has chosen to propose a set of binding measures rather than binding targets. I support binding measures as a compliment to binding targets. I hope, support and still believe in mandatory targets – and I am willing to fight for them in the parliament. Just like we have a binding target for renewable energy, we need a binding target for energy efficiency.

That being said, I also support binding measures, but preferably as an addition to targets – as oppose to an alternative. And I do appreciate the need for binding measures.

In the eighties I was an interpreter for a Portuguese delegation on a study trip in Denmark. On a visit to a district heating plant, I wanted to explain how it works. But there was not a Portuguese word for district heating. They are still trying to figure out what to call it. While the rest of us are busy exploiting the benefits of cogeneration and district heating. My point is – it makes sense to agree on measures – as long as it is both energy efficient and cost efficient. It is beyond dispute, however that we need to hit the 20% target. That has already been agreed to by all the EU institutions time and again.

I would like to highlight some of the most important of these in the current Commission's proposal. The Commission proposes to force energy retailers in member states to achieve energy savings in end-use of energy. The energy efficiency obligation schemes already adopted by EU countries, Poland included. And so far, they have been a tremendous success.

Despite variation across the composition of schemes, the common denominator of programmes across Europe has been successful achievement of targets. **Energy efficiency schemes work** and we must focus our efforts in strengthening the ambition of the energy efficiency directive.

We must also recognize that **our energy policy is a matter of equity**. Far too many people in Europe spend too high a share of their incomes on energy. Energy poverty is an issue we must include in our work to strengthen the energy efficiency directive. Articles 6 and 12 both state that social aims may be a part of national energy efficiency schemes. In my opinion we need to look at ways to strengthen these formulations.

I would like to recognize **the importance of the Commission's focus on split incentives**. The potential of energy efficiency gains to be had by dealing with this issue is huge. For those who are not familiar with the challenge of split incentives, the classic example is the landlord-tenant issue.

The tenant of an apartment pays the heat and electricity bill but does not own the apartment. Imagine that he or she is considering investing in insulation of the apartment. The benefit of insulation in monetary terms is two-fold. It will reduce the heating bill and it will increase the value of the apartment. The reduction of the heating bill will benefit the tenant but the increase of the value will benefit the landlord. In other words, neither is able to appropriate the full value of the investment. Taking steps to deal with this issue is hugely important. And I believe that perhaps even more can be done to establish guidelines for member states in terms of bridging split incentives.

At this point, **I would like to speak briefly about climate change**.

Some may have noticed that I have omitted the issue until now in my remarks. I believe that climate change is a crucial issue for us as a global community. I also believe that the **EU in particular should assume leadership in mitigating climate change**. However, I want to emphasize that a strong and persuasive case can be made for investing in energy efficiency and renewable energy. Whether or not we link the issue to climate change. I would hate to witness a fruitful discussion about the preparation of EU for long-term sustainable growth deafened by debates over the veracity of climate science. Energy efficiency and renewable energy are the bottles of champagne to keep the party going. But despite the metaphor – it is no laughing matter. It is not a matter of convenience; it is a matter of bare necessity. **If we do not act now – European energy security will remain in the hands of unstable political leaders and regimes**.

Therefore: It is not a question whether we can afford it. **The question is: Can we afford not to? Energy efficiency and renewable energy are crucial parts of future European energy security, growth and sustainability**.

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Krzysztof Maryl*

Political Coordination in Constructing the EU Internal Energy Market

Energy utilized for supplying machines and industry was a part of human life since its very beginning. The ability to accumulate and make use of energy resources was one of primary activities of the mankind. Regarding its important role in the history, energy became an object of multidisciplinary activity of many scientific disciplines. Achievements in this field consolidated a starting point for respective politological reflection. Energy makes part of the domain of political science. As energy-implied problems (of economic, strategic or social nature) become political, that is when they become an object of interest as well as a subject of conscious and intentional activity of public authorities or other political actors.

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In particular, energy is an object of exploration for such subdisciplines of political science as political systems, international relations or European integration studies. Political systems studies describe legal and institutional framework of the energy sector. On the other hand, international studies perceive energy as an important factor of inter-state relations (and a matter of activity of some specialized international organizations). European studies are exploring energy-related issues as a part of the process of European integration.

Why the interest for energy matters is so obvious for politological subdisciplines? ‘Let us take the example of energy, not just as one among many branches of industry, but the one being a condition for functioning of all other branches, with no exception’. These words of Aleksander Bocheński, eminent historian and publicist are emphasizing prerequisite role of energy in analyzing economic potential of state, its prospects for development and consequently in assessing its general political power. Needless to remind that the category of state in political science is one of the most important points of reference.

Contemporary state and public authorities on supranational and international level are making energy part of their different policies – in particular of the external policy, economic policy or development policy. External policy encloses activities focused on assuring energy security as well as multilateral cooperation within international organizations specialized in the domain of energy. Economic policy defines rules of functioning of particular markets, also for the energy market. Development policy facilitates R&D activities and implementation of new technologies in the energy sector.

An in-depth analysis of the above-mentioned policies proves a variety of topics and domains for exploration. It also allows to define a specificity of energy from the politological perspective. This specific approach can be determined as:

- correlation with many areas of public authorities’ activity,
- mutual interaction and interdependence of different aspects (political, social, economic and technical),
- variety and diversity of political actors involved, a wide range of stakeholders,
- specific character of political coordination among those actors.

The potential of politological reflection on energy seems to be underestimated and not only by representatives of political science as a whole, but also by specialists in European studies in particular.

Still, energy – given its eminent political role – has always been an important factor in European integration process following the World War 2. The European Coal and Steel Community, established in 1951 constituted coal (the most important energetic resource at that time) a core domain of its activity. No doubt that after this 'heroic period' the role of energy lost some of its importance, but after the Single European Act in 1987, along with the idea of completion of the Internal Market, the initiative was launched to restore the role of energy as one of the important fields of integration [*Completing the Internal Market 1985*]. That is why steps towards the creation of the Internal Energy Market were taken.

The starting point for politological reflection concerning the role of energy in the process of European integration is to clarify its specificity and political nature as well as its role at the national and European level. Relevance of energy led the EC to create special energy-related sectoral policy. Once established, European energy policy provoked a problem of coordination (allowing the achievement of policy's goals by assuring cooperation and synchronizing activities of its actors from national and community level at all stages of the policy process) [Further on coordination: Jupille 2004].

Therefore, focus on EU energy policy implies seeking for key domain of politological research. This key domain seems to be an issue of construction of the Internal Energy Market (the IEM construction) defined as a specific political project. In the scope of this domain the crucial problem is the issue of political coordination in the framework of a given project (divided in three stages: defining strategy, decision-making and implementation), with a specificity of the project and premises of concentration of the EU energy policy around the IEM also taken into account.

In the light of the above the following hypothesis can be put forth: the political role of energy, given its important socio-economic relevance, is increasing and that is why the issue of energy was raised also within the political system of the EU. Coordination of the EU energy-related activities (multilateral clarification of positions among the committed actors) is conducted in a specific way (typical for that system), enclosing three stages: strategy formulation, decision making and implementation. Regarding the specificity of the energy sector and its structure, and given a limited legal basis in the Treaties, that coordination is focused around the project of the IEM construction.

Coordination shall be understood as a formula of clarifying positions among stakeholders of the particular process. Political coordination is an element of policy process at every stage and is a common phenomenon in social and political relations. Its specificity can be defined in the European integration process, where one can distinguish the following types of political coordination: coordination of European policy of particular member states (coordination in narrow meaning) and coordination between European and national level (coordination in broad meaning).

Energy is strongly influenced by the politics and this influence results from various economic, social and environmental premises. Increasing political role of energy results from such aspects as growing awareness of its strategic impact on social and economic growth and making energy a subject of public debate. That is why a special sectoral policy was created, conducted by public authorities.

The role of energy caused it to become a subject of specific sectoral policy – energy policy, implemented on three levels – international, national and regional. Energy policy is a particular domain of activity of public authority, enclosing a set of procedures allowing achievement of political goals.

Making energy a subject of political activity at the European level was a result of the following premises: evolution of relevance of energy for the EU, evolution of the political system of the EU and evolution of the political coordination among the EU [Andersen, Eliassen 2001]. Goals and values of the EU energy policy are connected with key aspects of functioning of the energy sector (economic, strategic, environmental) and are defined on the basis of documents of legal or official nature[1].

Once energy achieved status allowing it to be coordinated at the European level, it implied necessity of setting policy guidelines related to the energy sector and – first and foremost – defining methods of coordination of that policy.

As far as the EU energy policy is concerned, given its specificity, three methods of coordination were possible to adopt: the external cooperation method (externalization of the energy policy), the multilateral cooperation method (internationalization of the energy policy) and the community method (communitisation of the energy policy).

Not surprisingly, the community method was chosen as an essential formula of coordination for the purpose of the energy policy of the EU. This approach was implied by the shortage of the legal basis for such a policy, provided by the Treaty. That is why, regarding limited capacity of the Treaty provisions referring directly to the energy, a foundation of the EU energy policy were provisions relative to the Internal Market and the project of the Internal Energy Market became the core of the whole EU energy policy.

After this brief description of the origins and conditions of the IEM construction project, let us present its consequent stages. The initial part of this political project is the stage of strategy formulation. Strategy formulation can be understood as

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[1] http://europa.eu/legislation_summaries/energy/internal_energy_market/index_en.htm.

defining formal shape and content of documents enclosing the official plan of action of particular political actor. A project of Internal Energy Market also requires strategy formulation. Strategy of the IEM construction is defined at three levels: supersystemic, systemic and subsystemic together with many different conditions (economic, social, environmental) [Peterson, Bomberg 1999: 4–30]. The supersystemic level encloses activities of strategic character, accomplished by the European Council. Systemic level is one where activities of the EU Council take place, whereas the subsystemic level is the arena of actions relatives to elaboration and public consultation of the project of the strategy.

Actors of the strategy formulation at the supersystemic level are the member states and a collective body reflecting their political will – the European Council. Also some European institutions (the Commission, the EU Council) play an accessory role at this stage. Therefore, at the systemic level the principal actors are as follows: the Commission, the EU Council, member states, with the latter ones playing the crucial role, coordinating their positions in the framework of the Council. As for the subsystemic level, the most important political actor is the European Commission [Edwards, Spence 1997: 125–154].

In the process of the strategy formulation at the supersystemic level political coordination includes activities undertaken by representatives of the member states within the framework of the Council. The mechanism of the strategy formulation at the systemic level is similar to the one applied for the decision-making process. Consequently, a great deal of coordination activities applied at the stage of strategy formulation is not of a political character, but much more of technical, procedural or even scientific kind.

Products of the strategy formulation process are the European Council conclusions and its result is an agreement reached about general framework of the strategy. At the systemic level the principal strategic products are resolutions of the EU Council, whereas at the subsystemic level documents of the Commission may be considered products (Communications, Green Papers [Dero-Bugny 2005: 95], White Papers).

Once the strategy is defined, the next stage is that of decision-making. Three different kinds of decision-making processes can be distinguished within the political system of the EU. Legislative process means taking political decisions concerning creation of the secondary community law. A specific equivalent of that process at the national level is the administrative process, enclosing activities undertaken by the member state in order to assure appropriate progress of the legislative process at the European level. Consequently, the judicial process is the one assuring taking political decisions in a form of judicial decisions of the European courts [Bomberg, Stubb (eds.) 2003: 111–176].

Among the most important features of the EU decision-making processes one can count their supranational character, co-participation of member states and European institutions, separation of interests of different stakeholders (national and European interest), clarification of procedures and competences of particular actors on the basis of the EU law as well as separation of the decision-making process from the stage of implementation.

Among the aftermaths of the legislative process one can distinguish modifications of the European law and in consequence – of socio-political reality resulting from particular decisions concerning acts of the community law. Also products of the judicial process play important role in defining the shape of the IEM.

Implementation is the last but not least stage of the project. It is a political process, the core of which is a planned and intentional restructuring of socio-political reality for the purpose of implementing political decisions. In constructing the EU Internal Energy Market, implementation can be applied in two ways: as a set of activities performed by the administration of one member state [Bomberg, Stubb (eds.) 2003: 82–83] in order to make the IEM happen or as a formula of restructuring of the energy sector at the national level compatible with the project's assumptions. With respect to political decisions concerning the IEM project, made at the community level, three procedures of implementation can be applied: initial implementation, fundamental implementation and complementary implementation.

Actors of initial implementation are authorities of the acceding country and the European institutions committed to at the procedures of preparation and conduct of negotiations. Premises for actor's participation at the initial implementation are their appropriate competences in the law-making process (or in the process of integration of the EU law to the national legal system) and their appurtenance to the energy sector being subject of implemented regulation. In particular one can distinguish legislative, programming and restructuring actors. In the context of the IEM construction project, two categories of actors can be pointed out: actors with general competences and those specialized in the energy-related issues.

Coordination of initial implementation follows in parallel at the national and European level. As coordination of fundamental implementation can be described a set of activities and procedures facilitating clarification of legislative, program and restructuring activities, conducted in parallel, whereas coordination of complementary implementation requires management of preparatory, regulatory and evaluative activities.

Products of initial implementation are in particular screening lists of legal acts, official governmental positions for the purpose of negotiations as well as the Accession Treaty and related documents. Result of initial implementation is widening of territorial scope of the IEM construction project by adhering new member states with their energy sectors. Pursuing fundamental implementation results in restructuring of law, what implies modification of the structure of the energy sector. Nonetheless, a result of complementary implementation is ensuring application of the implemented EU law in its wide context of preparatory activities, day-to-day application and control.

Initial implementation is conducted in the way of the adhesion process and involves acceptance of the EU primary and – to some extent, as agreed during negotiations – secondary law by the candidate country. On the other hand, the complementary implementation is an aggregate activities of preparatory, evaluative and accessory character, conducted at the national level with respect to the processes of initial and fundamental implementation.

To sum up and evaluate the IEM project results, the SWOT approach can be applied, naming its achievements, weaknesses, chances and challenges. Among achievements of political coordination at the European level one can mention in particular establishing institutional framework for European policy concerning Internal Energy Market within the EU political system. At the national level creation and development of national system of coordination for European policy (enclosing also Internal Energy Market- related issues) is worth emphasizing.

As far as the successes of political coordination at the European level are concerned, one can name creation of the system of coordination of European policy concerning the IEM construction within the political system of the EU. A success at the national level is that a national system of coordination of the European policy has been established, including the IEM construction-related issues.

While analysing weaknesses of political coordination, at the European level one can mention a lack of real functioning of the IEM, being the principal goal of the whole project. At the national level such a weakness is a disparity between guidelines of the IEM construction project and provisions of the national energy policy.

By chances for development of political coordination in the process of construction of the Internal Energy Market can be envisaged such modifications of structures, procedures and products of coordination that may lead to faster and more efficient accomplishment of the project's goals. Possible development of political coordination can be achieved in its procedural aspects and in those relative to the content, both at the European and national level.

Challenges for the political coordination are changes of respective procedures, modifications made in the range of the project, transformation of project's environment or its actors that may affect efficiency and effectiveness of political coordination in the framework of a given project [Egenhofer, Gialoglou 2004].

After this brief overview, some conclusions can be made. Firstly, political coordination of the IEM project seems not to differ much from the one in other projects pursued within the EU political system. Secondly, the IEM construction project can be questioned as a main political project in the scope of the EU energy policy, crucial for the political coordination of this policy. That criticism can be raised from the perspective of current, not satisfying progress of the IEM project, as well as given the new challenges for the EU energy policy, arising from energy and climate issues.

Moreover, the energy market can be also questioned as a formula of economic coordination of functioning of the energy sector. Scepticism about this concept can be connected with the relative weakening of the neo-liberal theories during recent world financial crisis.

On the other hand, political coordination as a mean of clarifying positions among the participants of the particular process is a frequent factor in socio-economic reality. It has some specific role within the European integration process. Energy has a lot of political importance and because of that was made an object of particular EU policy, reaching defined goals and political values [Matlary 1997: VII–IX]. Political coordination of activities raised in the framework of that policy was assured by applying the community method. Guidelines and actions of the EU energy policy were concentrated around the core project – the one of construction of the Internal Energy Market.

That is why further research on political coordination and on the Internal Energy Market should and shall follow, in particular in the scope of the European studies.

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Bartłomiej Nowak*

Towards Energy Solidarity in the Treaty of Lisbon

1. General remarks – towards common energy policy at the EU level

The need to establish common energy policy – one that would highlight energy solidarity among Member States (MS) and foster integrated energy market – can clearly be derived from the Treaties. However, political will to translate this idea into practice at the Community level has been rather slow to emerge. Over previous decades up to mid 1980s the energy sector was under serious domination of public monopolies, heavily dependent on national government command and control and thus very resistant to change. It should be no surprise to learn that the steps the European Commission had taken to foster development of the common energy policy strategy prior to mid 1980s brought little progress [Roggenkamp, Boisseleau 2005: 3–6]. The position of monopolies was too strong to overcome, especially since the

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Commission had weak institutional measures and procedures at hand and since the Member States evinced no real interest. It is no exaggeration to say that for several years the EC Treaty provisions concerning the network-bound energy industry were ignored. For that reason national legislation took precedence over the Community legislation in the energy sector. Of course, the Commission took some steps to deal with the common energy policy shortcomings at that time, but the impact these steps had upon the industry was insignificant, either.

Some scholars [see Swann 1988] believe that the lack of a special chapter on energy in the EC Treaty (although there were proposals for including energy policy in the Single European Act or in the Treaty on European Union – Maastricht Treaty) hindered creation of the solid energy policy. The introduction of a new energy chapter has had very little support among Member States, a fact that underlines their strong desire to maintain control over energy, with energy solidarity among MS being brought to the minimum. However, it is was also within the Commission itself that there have been different opinions concerning the need for a special chapter on energy in the Treaty. Advocates of the energy chapter have argued it would give additional powers to the Community to enact measures required within the internal energy market or common energy policy in general. At the same time, competition law experts have argued that the basic principles of the Treaty are clear enough and no special energy chapter is needed [See, for instance, Ehlermann 1994: 342, 346–347 ('it is… totally wrong to justify the status quo by the lack of a special chapter on energy in the EC Treaty. Such chapter is neither necessary nor, in my view, desirable')]. Interestingly, the European Parliament was a strong supporter and enthusiast of the energy chapter. In its various resolutions[1] the EP insisted on the integration of the ECSC (European Coal and Steel Community) and all other relevant competencies of the EC Treaty into a single energy chapter called 'Environment and Security of Supply'.

Subsequent to the Treaty on European Union – Maastricht Treaty, the Commission produced a proposal for the energy chapter, which would either consolidate the energy provisions of the three Treaties or would introduce a new chapter following the completion of the common energy market, the putting into place of environmental protections, and the securing of supply [see Report from the Commission to the Council 1996] all per newly established Article 3t of the Maastricht Treaty. However, no action was actually undertaken in this respect. Instead, the Commission adopted an approach based on greater coordination of the existing EU competencies

1 Resolution of May 17, 1995; December 14, 1995; March 13, 1996; and June 19, 1996.

[COM(95)]. Only recently, with the advent of the Constitutional Treaty[2], and the Treaty of Lisbon (Reform Treaty), has the idea of single chapter on energy as part of the fundamental Treaty regained attention and consideration. According to Hancher, however, the inclusion of a separate energy chapter in the Treaty of Lisbon will not resolve all the legal problems surrounding the Commission's competence to deal with national energy matters [Hancher 2005: 3]; it would, however, certainly strengthen the Commission's role as initiator of changes in the national energy markets and would serve as a base for the common EU energy policy.

2. Energy solidarity in the Lisbon Treaty – from the New Member perspective

In this regard the relevant energy chapter in the Treaty of Lisbon (Treaty on Functioning of the European Union – TFEU) requires explanation. Energy, one of the shared competencies is discussed in Article 194 TFEU. The inclusion of energy in the Treaty of Lisbon as an area of shared competencies should be perceived as an attempt to establish a 'special cooperation modus operandi' between the EU and national governments in the interest of greater transparency with respect to the energy markets. Transferring some of the energy competencies from national governments control to the EU level shall serve as a step forward in further creating common energy policy. In fact, the amended Treaty will provide a direct legal basis for the EU's competences in the field of energy, especially since the European Parliament and the Council are empowered to establish measures necessary to achieve the objectives of EU energy policy. Of course, it does not mean that Member States would be deprived of any control over energy resources or supply policies. On the contrary, it would be together with taxation domain of the Member States, where unanimity is required. Article 194(2) provides:

'… measures shall not affect a Member State's right to determine the conditions for exploiting its energy resources, its choice between different energy sources and the general structure of its energy supply…'.

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2 For the Constitutional Treaty see www.euabc.com or http://en.euabc.com/upload/rfConstitution_en.pdf For more on the European Constitution, its legal basis, process of creating, *etc*. see Ziller 2006.

A separate chapter on energy included in the Reform Treaty has been regarded by Polish authorities with suspicion. Poland's Eurosceptic government at that time claimed that it would accept new articles on climate change and energy as long as doing so did not entail more powers to the EU. Ironically, at the very same time Poland was the most enthusiastic supporter of inserting into the Treaty an energy solidarity clause in the case of serious supply problems, thus undermining its own policy on the energy Article.

Article 194(1) states as follows:

'In the context of the establishment and functioning of the internal market and with regard for the need to preserve and improve the environment, Union policy on energy shall aim, in a spirit of solidarity between Member States to…

(b) ensure security of energy supply in the Union'.

The security of energy supplies has became a major popular geopolitical theme aggravated by the fragile situation in which the new Member States of the EU find themselves, since they were and still are concerned about pressure from Russia over its former areas of influence. The apprehension of supply cuts weighs heavily on a number of Central and Eastern European leaders. Therefore, the energy solidarity clause in the case of serious supply problems envisioned by Poland was a concern of importer (consumer) of energy products such as gas and oil. Insisting on the energy solidarity clause, Poland wanted to alleviate its concerns over its tense relations with Russia, especially since it remains heavily dependent on Russia for approximately 70% of its gas and 90% of its oil consumption.

In fact the solidarity clause proposed by Poland is not a novel issue. In early 2006, Poland proposed a plan to all NATO and EU countries with support of the USA: creation of a European Energy Security Treaty [for more on this see Nowak 2010: 54–55]. Such energy security pact would provide mutual support to members in the event of any energy crisis. It would require creation of a political system applying the rule of solidarity, the rule of mutual aid when the energy security of one country within the Treaty was threatened. This Treaty would also require construction of joint energy storage, joint gas and oil pipelines, electricity networks as well as mutual reaction in case of emergency situation [for more on this see Geden, Marcelis, Maurer 2006]. However, the energy solidarity pact proposed by Poland – most probably due to its complexity (suspension of domestic control over too many crucial issues for the national governments) – occurred unacceptable to many Member States, including the biggest ones, such as Germany and France.

3. EU energy solidarity – third country aspects

The issue of solidarity in energy supplies became clearer in the European debate after German decision to privilege Russian relations by developing a gas pipeline project (Nord Stream) under the Baltic Sea. This project was considered all but an affront by the Central and Eastern European countries and a selfish response to a problem that involves all Member States. Poland which is bypassed by the new pipeline sees a threat to its energy security in this project. Some experts argue [Wyciszkiewicz 2007] that construction of the Nord Stream may undermine the idea of energy solidarity, and also may become an obstacle to creating a common external energy policy on the EU level. However, this option seems fairly possible, especially since the Nord Stream project is perceived by the European Commission as a strategic investment for the European energy (gas) security. From Poland's point of view, the most negative element of the pipeline construction is the fact that Poland will considerably lose, as a transit country, the status which has been essential for negotiations' policy towards the Russian partner. Additionally, recent conclusion of the Polish–Russian negotiations regarding the Jamal gas contract might also, paradoxically, provide some complications for Polish energy policy. Namely, Gazprom which is Russian national champion, in due course of negotiations gave up its moderate control over gas transit on Polish territory to Germany (Gazprom is using around 80% of the Jamal pipeline capacity by sending yearly 34 billions cubic meters to Germany and around 9.5 billions cubic meters to PGNiG SA). EuRoPol Gaz[3] which has been so far system operator for the Jamal pipeline was replaced by the Gaz-System (Polish state owned transmission system operator). One may consider this as a very sophisticated move – where Gazprom, by giving up the control over transit, seeks to relocate in the future its gas delivery to Germany to a newly constructed pipeline Nord Stream, slowly lapsing the transit over Jamal. This of course would further significantly diminish the role of Poland as a transit country [For more see Nowak, Grzejszczak 2011]. Naturally,

[3] EuRoPol Gaz Transit Pipeline System was incorporated as a joint stock company on September 23, 1993. The company consisted of three shareholders: PGNiG SA (48% of shares), Gazprom (48% of shares) and Gas-Trading (4% of shares). Gas-Trading conducts business in the field of investment, manufacturing, trade and services as well as foreign trade. EuRoPol Gaz was mainly responsible for the operation and maintenance of the Jamal gas pipeline.

from Russian perspective omitting transit countries, thus no transit fees payable, shall be considered an important factor behind the decision to construct the Nord Stream, though not the only one. It seems that Poland currently has nothing to do but to join the started investment of the Nord Stream and quickly finish construction of its LNG terminal, which will partially diversify sources of gas supply. Germany might be a very good example here. It acquires gas from four sources: (i) its own, (ii) from the North Sea, (iii) from Russia and (iv) from the import of the liquefied gas (LNG) from the Arab countries. Such a diversification, 20–30% per each direction, makes Germany independent of various political and economic turbulences and what is more important – it enables running flexible and economically rational gas policy, were solidarity among MS is pushed to a second plan.

The Belarusian and Ukrainian crisis of 2006 and 2009 and several delivery incidents have increased the feeling of urgency about a common policy at the EU level. However, even though it is clear that there is a need for a cohesive, EU-wide energy policy to ensure security of supply and reduce demand, hereby reducing the dependence of Europe on foreign energy supply, actual creation of such a policy presents a difficult task. Forces at play, such as Member States sovereignty, protectionism of national industries and different approach to Russia among Member States (just to mention a few), all pose obstacles to establishing an effective European energy policy. Moreover the EU does not speak with one voice, especially with regard to gas supplies, mainly because there are still 27 different energy mixes and import dependency structures. As a result, EU energy security policy largely relies on intergovernmental co-operation, in which each Member State may exercise veto power [See for more Egenhofer 2002].

The problem with a joint energy policy, one that takes into account European dependence on gas imports, and especially dependence on Russia, also rests on a disparity in perceptions toward Russia between new Member States and the old Member States. Poland, supported by the Baltic States, envisaged the European Union as a place where the new Member States would move quickly to reduce their energy dependence on Russia and the EU itself would adopt a much tougher and collective position in relations with Russia. But the big EU states, such as Germany, Italy or France, did not seem to realize the legacies of difficult relations with the former Soviet Union for the CEE countries, thus claimed they were unwilling to isolate present Russia, preferring instead to engage in a long energy relationship beneficial to both sides. For France and Germany, where imports of gas from Russia constitute around 35% of all the gas they import [*Bundesministerium für Wirtschaft und Technologie…* 2006], cooperation with Russia is not perceived as deeply threatening to domestic security of supply. For the CEE countries on the other hand, where dependence on Russian gas oscillates between 60% and 100%, close cooperation with the former regional hegemony is hard to accept politically. Moreover, the fact that especially Germany has staked on strengthening relations with Russia, allows to speak about special or strategic relations between Russia and Germany [for more on this, see Rahr 2007; see also Gusev 2008: 68–74]. Such special relations with regard to energy sources, in particular among those two countries, is difficult to accept by the new Member States and especially by the Baltic countries.

Finally, it is true that Europe is dependent on gas from Russia, but conversely, the EU is also the largest client of Russia. If Russia loses credibility as a reliable supplier of gas, it stands to lose revenues in the future. However, there are two principal issues that seem to hamper a healthy relationship between the EU as such and Russia when it comes to supplies of energy: European Energy Charter which Russia refuses to ratify and liberalizing energy networks within Russia with access granted to the EU.

4. Conclusions

The need for a common EU energy policy on security of supply with solidarity among MS is more evident now than ever before. Shortages of energy supplies carry implications not only for domestic producers and consumers, but also for external security of the whole EU. In fact, energy becomes a strong bargaining chip and a political toll for Russia who can easily exert pressure on the EU members – especially those which possess no supplies of their own and whose energy sources are not diversified. However, the problem of dependence on foreign gas is, in fact, common to all European countries, albeit to a different extent. Because of this shared requisition, the EU demands a more cohesive common policy. This might not necessarily prove to be a common one at the beginning, but one that at least shows solidarity, on the part of the European Union in terms of energy supply. In fact as a solid block, the EU possesses an enormous buying power that comes from being one of the world's largest energy consumer.

However, Europe's approach to energy in the past has been *disjointed, failing to connect different policies and different countries* ['Europe's Energy Challenge' 2006]. Member States different levels of dependency on energy sources, protectionist policies of governments and disparity in perceptions toward Russia between CEE states and Western Europe, just to name a few issues, are responsible for lack of common policy in the sphere of energy. The present practice of individual Member States taking important energy related decisions without consulting or assessing their impact on other Member States hampers the coordination of the energy policy and setting common objectives for the EU as a whole [for more on this, see Nowak 2010b]. Another important issue is the endowment of Member States with natural resources. Some of the countries are producers, such as the UK and the Netherlands, while the majority of them are energy importing countries. As a result, there is a great variation in the level of import dependence among EU countries. This, apart from disparity in relations with Russia among Member States, creates rather difficult obstacle to energy market integration and energy solidarity. Other significant reasons impeding the common approach to solidarity in energy matters are differences in the energy mixes of the Member States and different structure of national energy sectors. This predetermines different national energy priorities and sets the pattern for respective energy policies such as protectionism. Among big EU states the protectionist trends are the most visible in France and Poland. The first fears that in an open market it could lose its national champions, and the second that its energy sector will end up under Russian control, giving rise to its energy security.

The Treaty of Lisbon, among other things, should bring provisions and direct legal basis for secondary law which refers to the principle of energy solidarity anticipated by Poland as well as other new Member States. However, only legislation without political action is unlikely to result in much progress being made. In order to enable energy solidarity, the EU will not only have to develop rules for strategic stocks and crisis management mechanisms for fossil fuels, but it also has to support the construction of storage and network infrastructure. Perhaps in combination with a real internal energy market, such developments will enable Member States to have comparable energy mixes and import dependencies and therefore similar interests in the field of external energy policy.

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Summary

Nowadays, more than ever, the EU Member States are asked to show mutual trust in their relationships within the European Union. However, at this moment they do not have a clear unified vision of the European Union. This fact can seriously weaken their willingness to undertake a joint responsibility for the EU future development. The financial and economic crisis influences the Member States differently – some countries have suffered badly from its impacts while in other countries these effects were less painful. Reforms undertaken by national governments respond to situations specific from one country to another, but still they need to be situated in the framework of agreed policies. A strict cooperation between the national and the EU institutions is indispensable. This is the only right way to overcome the consequences of the crisis. The EU leaders set up recently several projects aimed at strengthening the EU economy like the Europe 2020 Strategy, the Single Market Act, and the Stability and Growth Pact.

The EUintegRATIO project was aimed to show a new perspective on the integration process in the new economic and social contexts in Europe. The principal aim of the project team was to indicate that Member States should not forget about solidarity being the fundamental rule in the European integration process. This rule should be reflected in debates on topics related to appropriate economic policy under new challenges, including incentives to start new industries and fostering innovation processes, to strengthen research and development, and to strive for progress in social cohesion under trends towards more stratified and diverse societies. Despite the effects of the crisis, these policies determine a new phase of the EU growth to elevate the EU position on the global scene. For enhancing the EU capabilities to follow a path of the smart, sustainable, and inclusive growth, better use of human and natural resources (resource effective economy), promotion of energy policies, and diminishing social and regional disparities by combating poverty and improving regional cohesion

of the EU are crucial and need to be highlighted. The EUintegRATIO project offered a platform for relevant debates during the Polish Presidency in the EU – the conference 'European integration process in the new regional and global settings', held on the October 19–20, 2011 in Warsaw, as well as this publication document our efforts to integrate a wide range of representatives of different institutions and societal groups in sharing their views and concerns on the integration related issues.

The Eurozone shows symptoms of fiscal crisis. Fortunately, the currency crisis is still absent. The last changes of USD-Euro exchange rates may undermine opinions on the stability of the latter. This fact, however, does not negatively affect the reserves kept in Euro. The real problem of the Eurozone is the debt of PIGS states (Portugal, Italy, Greece and Spain). Some reasons of the debt are common for all those countries, others are country-specific. One could elicit inadequate fiscal policy, relatively low labour efficiency, low competitiveness of the PIGS countries as well as political issues which enabled them to access to the Eurozone without having met the requested conditions (Greece). In order to maintain the financial stability at the regional level or at the whole global economy, it is crucial to maintain stability at the level of each country. Local supervisory bodies are able to control efficiently local/regional performance following prudential standards in the financial sector formulated at the international level which need to be conceived as universal minimal requirements. At the same moment, the Eurozone is not really in danger of collapse, nor shall any country decide to leave it, regardless whether it is being theoretically possible. There are two reasons for that view. Firstly, political and economic costs of such a decision would be too high. Secondly, as long as the key countries (France and Germany) are directly interested in the Eurozone survival, it is not under threat of collapse. Nevertheless, reforms both in the Eurozone and in the EU are urgently needed, both for the sake of its economic effectiveness and for its better functioning. There are some suggestions that the EU should follow the path of Federation or a Confederation. Meeting the Maastricht criteria seems just not enough for future effectiveness of the Euro and of the European Union as the whole.

Another important area, intended as leading development and investment policy for closing the Member States' competitiveness gap, is the cohesion policy for the EU and its Member States. The cohesion policy faces new challenges. The incoming financial perspective brings new settlements. The policy, aimed to reduce regional disparities, needs re-thinking. Regional policy must be in line with the Europe 2020 Strategy. The priorities of Europe 2020, *i.e.* smart, sustainable and inclusive growth, should be incorporated into the new cohesion policy.

Firstly, it is crucial to change the mindset of regional authorities: they should look for smart specialization based on real entrepreneurial potential of their regions. It is not only the IT or biotechnology that may create comparative advantage. To find the niche in a region, however, it is necessary to think about resources that lay at the heart of it. New global settings open possibilities, but there must be regional strategy that sets out the priorities.

Secondly, the new cohesion policy should create the added value. The money invested in regional policy must create the effect of snowball. To make it happen it is crucial to set the priorities in line with the Europe 2020 strategy. Deeper integration will make the efforts more cohesive. New cohesion policy must focus on: industrial restructuring, innovation, quality of labour, institutions (government).

Finally, to make the new financial perspective effective, it is needed to build the critical mass through the projects. European funding is not the only part of regional policy; national co-funding must be safeguarded, too. The new financial perspective should be focused around growth in innovative sense (smart specialization). New goals should be consistent with the Europe 2020 Strategy, because this strategy sets out long-term goals, the achievement of which will get the EU back on the path of growth.

The sustainable and inclusive growth means reconciling economic, social and environmental goals and diminishing socio-economic inequalities. In addition, these activities have to be performed smartly to increase the UE competitiveness in more complex and demanding business environment, subjected to financial economic shocks. These ambitious goals seem even more demanding when one accounts for population change in Europe. Profiting from long-term increases in life expectancy Europeans live longer and longer and more people survive until old ages. Population ageing, resulted from continuous mortality decline, is easily predicted and obvious consequence of population reproduction change generated by development processes. However, its intensity is higher than expected mostly due to fertility drop. And moreover, the low fertility levels approached by a remarkable number of Member States already in the 1990s produce declines in the working-age population to be experienced along with acceleration of ageing. These developments have far-reaching consequences for many domains of economy and society, which should be adjusted to the new demographic regime in Europe. Clearly, demographic change cannot be ignored when discussing about future growth prospects of the EU. In fact, relevant EU policy documents refer to demographic change in Europe and key policy responses which include demographic renewal, migration, better economic performance, more efficient use of labour force as well as stable and sustainable public finance. Within these policies those regarding pension systems play a crucial role.

Pension systems have been built under the completely different demographic regime, which has produce age structures with favourable proportions of the elderly and the working-age population, crucial for the relationship between retirement income contributors and receivers. That time has been gone. We cannot profit from the demographic dividend any more. Attempts to cope with threats generated by increasing numbers of pensioners which are not counterbalanced by rising numbers of contributors have been undertaken by several European countries in the two last decades. Implemented independently, they have changed pension systems in Member States. Gradually, it has being become clear that these country-specific efforts need to be coordinated at the EU level. Moreover, both population projections and impacts of the financial and economic crisis on the labour market and public finance make facilitating pension reforms and their harmonization even more urgent issue.

Main dilemmas and prospects of pension reforms in the EU cover, among others, general evaluation of already implemented pension reforms in the EU countries, lessons drawn from that experience, an interplay between pension reforms and labour market policies as well as main barriers in increasing records of working life. Sustainability and adequacy of retirement income, main goals of reforms, are not properly approached when referring to adequacy of benefits only and neglecting adequacy of contributions. It results in undervaluation of the role and interest of the working people. By including adequacy of contributions to pension reforms goals one can highlight how important is work record and longer stay in the labour market. Increasing retirement age is a widely used measure to improve contributions which however is not easily accepted by people while it is clear that further extensions are needed.

Another issue related to pension systems reforms is accountability. System liabilities should be transparent which would help to make expectations about future pension levels more realistic. Similarly, a clear distinction of income redistribution and income allocation via pension systems would contribute to better understanding of regulations of the system and a role of public and private partners in the system.

The pension reforms implemented already show a variety of measures used to make the system more robust to demographic and economic risks. Despite the fact that DB-type systems prevail and only relatively few countries introduced NDC systems both recent economic developments and demographic prospects, especially more advanced population ageing coupled with contracted labour force, seem to show them more adaptive to changes in population and economy and dealing better with the economic and demographic risks.

The road to increase the EU competitiveness should be connected with a full liberalization of the EU energy markets, which has still a long way to go. Many years after the process has been started, the energy sector in Europe is still highly concentrated, cross-border trade in energy is limited and prices differ substantially from one country to another. The EU is seeking to establish a single open market for energy, giving companies easier access to gas and electricity distribution networks in hope that increased competition will drive prices for its citizens down. But however, we still do not witness a full integration. European energy markets are poorly integrated not only because of the technical difficulties specific for energy markets but also because of the weak political support for the process of integration.

A common market means that consumers will have a legal right to purchase gas and electricity from any supplier in the EU. In order to make an internal energy market a reality, the following core areas need particular attention:

– a European grid with common rules and standards for cross-border trade;
– a priority interconnection plan to stimulate investment in infrastructure linking the various national grids, most of which are still not adequately interconnected;
– solidarity between member countries for monitoring energy demand and security of supply (500 million consumers have to talk the same voice);
– adequate energy reserves in the EU to cope with potential supply disruptions.

To achieve this, Europe should certainly invest in infrastructure, as the energy security is one of the pillars of the EU policy. But the cost is huge. Energy system infrastructure needs total investment in energy and gas sector of about €1 trillion.

The possible principles of the energy policy for Europe were elaborated a few years ago and the key proposals are still valid: cutting by at least 20 per cent of greenhouse gas emissions from all primary energy sources by 2020; striving for the minimum target of 10 per cent for the use of biofuels by 2020; improving energy relations with the EU's neighbours, including Russia (which is not so easy after the third part accession rule was introduced), progressing in the European Strategic Energy Technology Plan aimed at developing technologies regarding renewable energy, energy conservation, low-energy buildings, 4th generation nuclear power, clean coal and carbon capture; protecting vulnerable consumers having access to energy; and keeping a technological leadership of Europe (by investing around €3–8 bn per year).

The next important aspect of the future EU Energy Policy is renewable energy. The EU Renewables Directive is a unique creation which addresses two of the biggest challenges of our time – the energy security and the climate change. EU Member

States expect to reach 20 per cent of gross final renewable energy consumption by 2020. If we convince the whole world to participate in the process of reducing emissions, we could go up to 30 per cent.

The new European energy policy is one of the biggest challenges that Poland is facing: to reconcile the economic growth while caring for the environment. Polish economy was always based on coal (in 80 per cent). Emission reduction costs influence on energy and transport companies in Poland. The crucial issue is to invest in infrastructure. Poland needs 13 years to meet a fundamental energy security level. According to International Energy Agency US$ 33 trillion will be needed to be invested in energy supply infrastructure between now and 2035 in the whole world – a half of that amount in power generation and around 42 per cent in transmission and distribution of energy. Non-OECD countries account for 64 per cent of the total investment needs, with China alone representing 16 per cent of investment needed.

However, the core element of the Europe 2020 Strategy is the Innovation Europe ensuring Europe's competitiveness and growth for the coming decade. World-beating science is essential to the Innovation Europe. Productivity improvements are necessary to become more innovative and to explore our lead in high-growth markets. To make it possible that Europe remains a place where great inventions are made and find their way to the market we need to act, to act fast. Moreover, according to the latest Innovation Union score, the EU level of performance is significantly below that of the US and Japan. Despite recent efforts, there has been no major progress to reduce this gap since 1980s. Over the last fifteen years the EU share of world R&D expenditure has decreased by one fifth. This gap is widening. At the same time, emerging economies like India and China are catching up. Therefore, we have to create an environment that is more open to innovation and thus better positioned in terms of global competition to attract investors, entrepreneurs and top talents to research and innovation.

Summing up, to make the EU progressing along the Europe 2020 Strategy path we should explore and examine how the formidable arsenal of intellectual capital the EU should used within the context of growing competition, increasing economic and social inequalities along with regional disparities, demographic change, and energy and environment pressures. Contributions to this book and the conference debate show clearly that this will require, first and foremost, some fine tuning of our knowledge, as country specific conditions are becoming increasingly important when dealing with the competitiveness issues of the EU which is suffering very deeply from the financial crisis. The impact of the crisis will be experienced for many years. Today an unequal distribution of income and wealth in Europe together with ratings published by rating agencies generate large interest rate differences between indebted and 'wealthy' countries. In debtor countries the results are negative capital account balances. The compulsion to generate a current account surplus is used to justify austerity measures, *i.e.* cuts in wages and social spending. People affected by these policies do not accept such an explanation and protest loudly, with street riots. As long as the current account generates no or only small surpluses this can only be resolved through inflows of new capital. But pumping money into the economy leads nowhere. The only way out is to work out a sound recovery program which will identify country-specific conditions and its strengths, with intellectual capital properly taken into account.

Another important issue is social agenda. The most visible human cost of the crisis is high level of unemployment, particularly among the youth, as well as inequalities. Also, the issue of social reforms under demographic change should be regarded just as important.

Next, a focus should be on outcomes, not incomes. This is not only related to competitiveness but to the economic policy in general. A good example are structural funds and the EU cohesion policy. It is clear that a financial support, with a special emphasis upon the Structural Funds, is a pre-condition for growth and development. But this is not an end in itself. Results should be measured against improvements in the standard of living. In this context it is crucial to remember that a smart growth is the key to successful competition. Better addressing the priorities which will go along with the Europe 2020 Strategy will result in more effective usage of the financing.

It is also important to review growth strategies vis-à-vis their impact on the environment. Concern about environment and a growth can and indeed must go well together. There are many economic opportunities that promote green growth. We should tap into them and create a conductive policy framework that will allow for structural transformation of our economies based on the energy security policy.

Finally, we need to better define the targets we pursue. Rather than being limited just to put up growth rates, they should also include real improvements in people's lives. This is not only an ambitious goal but something truly worth to be considered while advancing competitiveness issues and proposals.

Europe is currently experiencing a number of serious problems. There are a number of grand challenges that have to be dealt with. Optimizing the intellectual capital of the EU with special attention to research and innovation are key factors to overcome the current socio-economic difficulties, to keep working places in Europe, and to address the other economic and societal challenges that are forthcoming.

The Europe 2020 Strategy, the Innovation Union, the future Common Strategic Framework for Research and Innovation, Joint Programming, an EU-wide patent, the Structural Funds, and all other policy initiatives and instruments have their own roles to play, but they should be managed in a cohesive way. The structure of the programs through concentration of the resources shall create the effect of synergy. But we have to remember that the process of building modern European economy must be based on the commitment of all Member States which could be achieved only if their current socio-economic conditions and development aspirations will be taken into account. Each Member State has specific resources and unique experiences – its own intellectual capital, which may become a source of future economic growth, well-being of the European societies and sustainable development of Europe. But taking full advantage of intellectual capital requires also an active participation of EU institutions and other players, including research communities. With their capacity for developing, adapting and transferring ideas, knowledge and technology the universities and other research and innovation players are essential for the process of shaping and strengthening the European Research Area and putting Europe back on the road to economic progress and innovation leadership.

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