# European Union Annual Review*

## January 2005

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# European Union Annual Review

## January 2005

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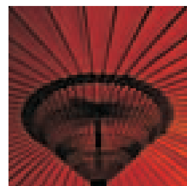

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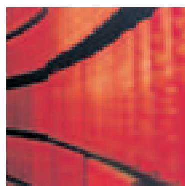

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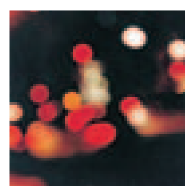

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# 1 Preface by Wolfgang Wagner

The enlargement of the European Union with ten new member states on 1 May 2004 was, despite the objections of some, a resounding success. This culmination of a project that has lasted some ten years from application to membership has turned out to be a major achievement in terms of creating and maintaining peace, democracy and sustainable economic development of the region, as well as an even larger free market for both eastern and western European companies. Last December, the European Council endorsed the opening of membership negotiations with Turkey which is a positive development enhancing and widening investment to the country, and strengthening the economic and political stability of the whole European Union.

Whereas the economies of the ten new member states are thriving with an average 4% GDP growth, the majority of the fifteen "old" member states have been lacking in meeting the priorities of the Lisbon strategy. We are now quickly approaching the mid-point of the ten-year time span which was set by EU leaders at Lisbon in March 2000 for over-taking the US as "the most dynamic and competitive knowledge-based economy in the world" by 2010. Former Dutch Prime Minister Wim Kok drew up three key messages in his report of November 2004: 'the priority now is for Europe to boost its economic growth rate and increase employment. Europe faces two enormous challenges - increasing global competition and a rapidly ageing population. In the face of these challenges, if Europe is to safeguard and strengthen its distinctive economic and social model, it must adapt. The status quo is not an option'.

Wolfgang Wagner

More in particular, the report calls for determined action to be taken urgently in the field of the internal market, completing the single market for services, especially financial services, and removing obstacles to the free movement of goods. It also says the total administrative burden should be reduced, and that an environment that is more supportive to business must be created.

As one of the leading professional services firms in Europe and the world, we would like to express our support for these objectives, in particular the objective of completing the single market for services, which I believe will be the significant engine of future European economic growth and where the development of an internal market had sadly lagged behind the market for goods.

Our annual review expands on the key themes of the Lisbon process, the new Commission and Parliament, internal market legislation (in particular the financial services action plan), and the future budget of the Union. I hope you will find our review of these and other key developments in the last year a useful summary.

Finally, I would like to thank Vice-President Margot Wallström for her interesting and thought-provoking foreword.

**Wolfgang Wagner**
Senior Partner, Continental Europe

# 2 Foreword by European Commission Vice-President Margot Wallström

## Importance of communicating EU policies to the business community as well as to the citizens of the EU

Over the last few years, the European Union has made huge strides forward, with the biggest enlargement ever, largely uniting our continent into a Europe of freedom. With the introduction of the Euro, we have seen a consolidation of a zone of financial stability.

The Constitutional Treaty has been signed, which modernises the rules of an enlarged Union resting uniquely on the dual legitimacy of its member states and citizens. We are making progress towards a common area of Justice and Security across Europe and building up the first stages of a European Defence Policy. This is a positive record, which has been however undermined by the feeling of apathy and disconnection in some parts of European public opinion.

Although the picture varies considerably between member states, feelings of indifference to the European idea are widespread. Less than one out of two citizens voted in the last European elections. There is an urgent need to demonstrate more clearly the value of what the Union brings and the legitimacy of its decisions. The European Commission is going to present in June this year its Communication Strategy which will attempt to respond to the challenge.

The cornerstones of the new Communications strategy will be that the Union advocates its policies clearly, integrates communication into its policy formulation from the very beginning and focuses strongly on adapting communication to national needs. This is a responsibility which must involve all European institutions as well as national authorities.

We need partnerships with important actors and opinion-leaders in Europe and business communities, to multiply and advocate our messages. We are also prepared to listen, as any effective communication must by a two-way process.

Margot Wallström

We want to be perceived as an ally and not as a constraint in business activities. This is where communication can be particularly useful: By saying clearly what our objectives are and how we want to reach them, we can make a real difference in the perception of the European Union's actions. Moreover, we have to tackle the common feeling of an interfering and bureaucratic Union, cut off from the realities and necessities of life.

Our key immediate task will be to communicate about the Constitutional Treaty for the EU. The Constitution allows the Union to make significant improvements.

— For the first time, the powers, competences, rights and duties of the Union are set in a single Constitution. The Constitution consolidates and simplifies half a century of Treaty changes allowing us to move from 12 basic treaty acts to a single text: it makes the Union more open and simpler to understand.

— The Constitution modernises the institutional structure, increases the powers of the European Parliament and provides for citizens to actively participate in the decision-making process by an initiative of one million signatures: we have more democracy.

— The Constitution sets out in 54 concise articles the fundamental rights we will guarantee to our citizens. The Union will also for the first time accede to the European Convention on Human Rights: more rights for our citizens.

I accept that people have fears and criticisms about this Constitution. It is not a perfect text and we should not hide from responding to these concerns. The latest EuroBarometer poll shows that 68% of our citizens support the idea of a European Constitution. Other opinion polls show us that many people feel that they are inadequately informed about the content of the Constitution. The Constitution provides a range of good reasons for the “Euro- specialists” to be voting yes. But they are not always the reasons that will persuade a single mother in Gdansk or a shipyard worker in Spain.

The ratification of the Constitution is an opportunity without precedence, to debate what kind of Europe we want.

It is of course a matter for governments and parliaments of member states how they want to conduct their national debates preceding the ratification. The Commission, while refraining from an active role in national political process, aims at facilitating an informed debate, and provide information and information tools, if requested by a given member state.

Communication is a key aspect of business activity nowadays, often a determining one for achieving success. The European Commission is only at the initial stage of integrating communication into its core activities. However, the process has started and we are determined to achieve a “culture change”. It will take years, no doubt, but it is a pre-condition for the success of the European idea in the new diverse Europe.

**Margot Wallström, Vice President of the European Commission**
Commissioner for Institutional Relations and Communications Strategy

# 3 Political Developments

## 1. European Parliament

### Introduction

To many, the European Parliament came of age in 2004. The occasion was the hearings in the autumn for the new Commissioners. Using their political muscle, rather than any Treaty-based legal powers, the MEPs succeeded in having two of the original nominees replaced and the portfolios of two others reshuffled. This represented the first time ever that the Parliament had managed to target successfully its criticism of individual Commissioners, since the EU treaties stipulate that MEPs may censure only the entire Commission team, not single members.

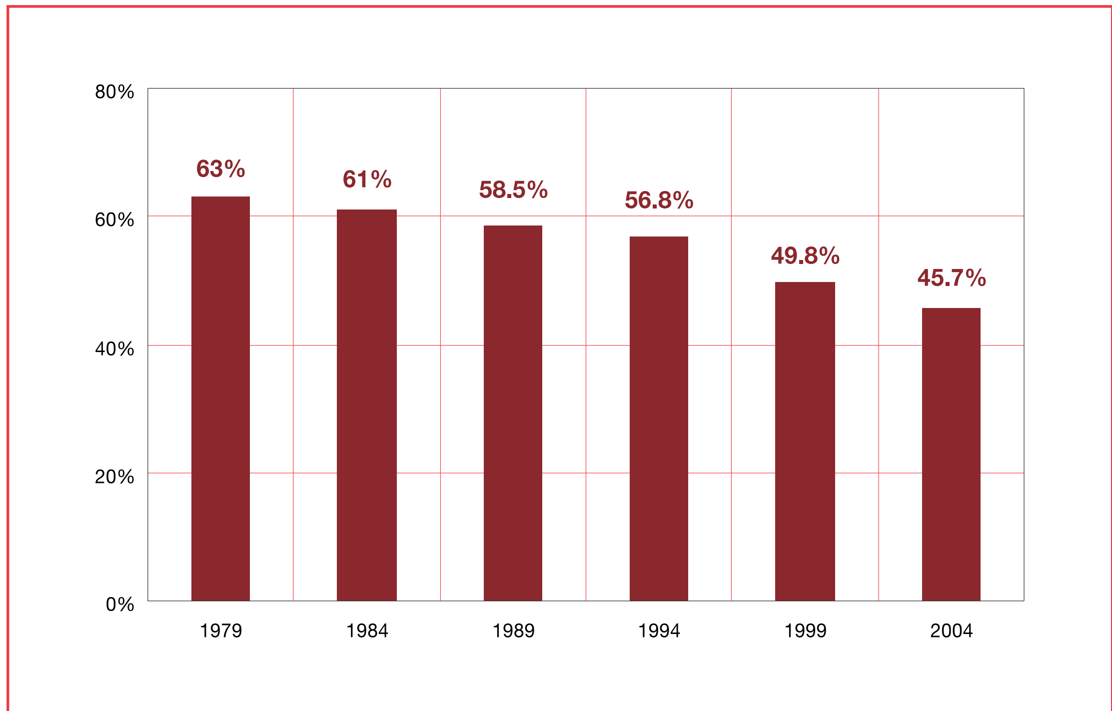
## European elections

The highlight of the parliamentary year were the elections in June. For the first time, voters in 25 countries were given an opportunity to elect members to an institution which is gaining increasing political and legislative power, although this accretion of responsibilities remains largely unknown to the public at large and to much of the media. However, the biggest democratic elections in the world outside India turned out to be something of an anti-climax.

There was no discernible pan-European campaign and issues remained national, or even local. The only clear Union-wide dimension was the call, led by Hans-Gert Pöttering, the leader of the EPP-ED Christian Democrat group in the European Parliament, that the future Commission President should come from the political family that won the elections. This was the first time such a clear stipulation had been made. It was one EU leaders heeded when they eventually selected the centre-right Portuguese Prime Minister, José Manuel Barroso.

## Figure 1

Turnout trends at European Parliament elections




*Source: European Parliament*

Overall, the turnout in the 25 countries was, at 45.7%, somewhat surprisingly the lowest since direct elections were first introduced in 1979, even below the 49.8% of five years ago. However, the EU-wide average masked contrasting trends between the fifteen “old” member states and the ten “new” ones. Voters turned out in fewer numbers than five years ago in nine of the old fifteen, but participation rates increased in the remaining six. In the UK, it rose from 24% to 39%, Ireland 50% to 60%, the Netherlands 30% to 39% and Finland 31% to 41%. The coincidence of local elections in England and Wales and a referendum in Ireland undoubtedly helped to boost participation.

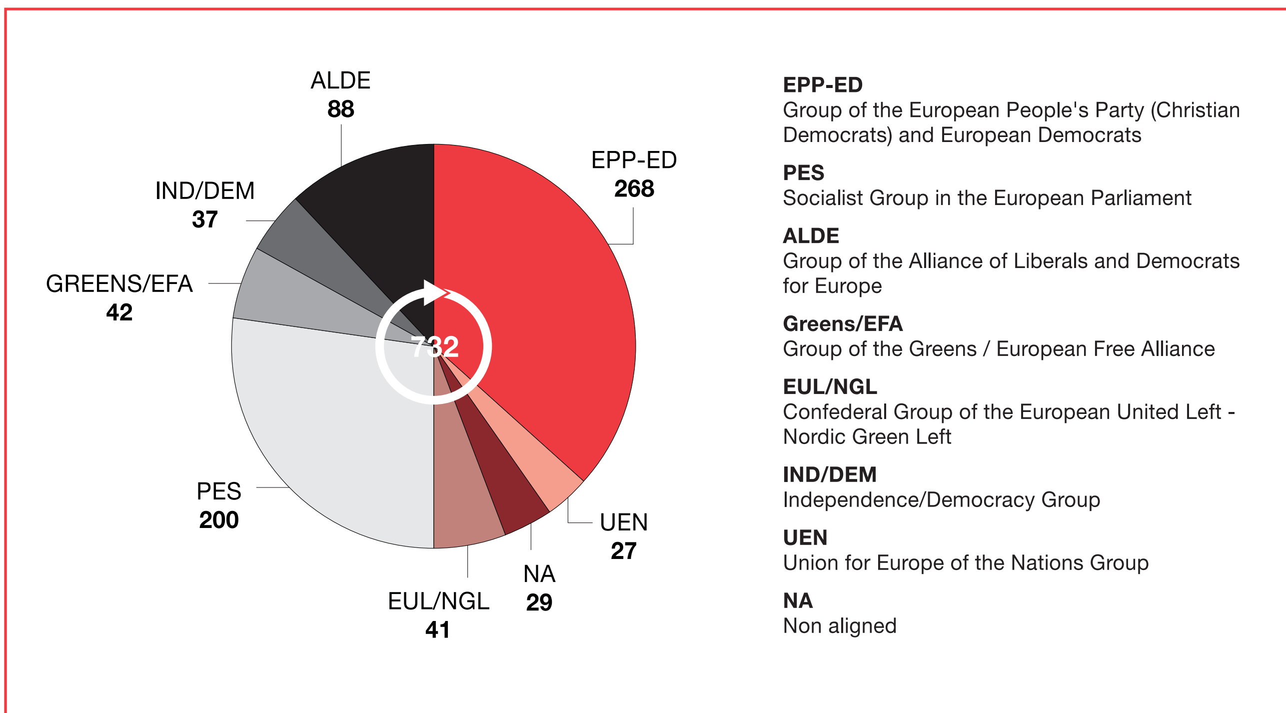
With the notable exception of Cyprus and Malta, voting in the new member states was considerably lower and was 20% in Poland and 16% in Slovakia. This may have been due to a combination of lack of familiarity with the European Parliament and to voter fatigue. Every one of the ten, except Cyprus, had put their EU membership treaties to a referendum.

While incumbent governments, with the exception of Spain, tended to be the losers, Eurosceptics were claiming victory. They are now more strongly represented than ever before in the European Parliament, largely due to the success of the UK Independence Party in winning 12 seats. They have formed the 37-strong Independence and Democracy group. Eurosceptics will make sure their voices are clearly heard in the institution, but they are unlikely to have a major impact on the legislative process.

The arrival of a strong Eurosceptic presence is being countered by a realignment in the political centre of parties with a firm commitment to the Union. Negotiations between the former Liberal group, Romano Prodi's centrist Margarita party and Francois Bayrou's Union pour la démocratie française led to the creation of the Alliance for Liberals and Democrats for Europe (ALDE) with 88 members. The group has also been boosted by the presence in the Parliament of German Liberals for the first time in ten years.

## Figure 2

Seats in the European Parliament




*Source: European Parliament*

Overall, Christian Democrats emerged as the clear winners from the elections, gaining 40% of the vote and securing 268 MEPs in the 732-member Parliament. The Socialists fared less well, but still won 200 seats. Despite their different fortunes, the two remain the dominant political forces in the institution. As a result, they negotiated a deal to support each other's candidate for the two-and-a-half year European

Parliament presidency. Under the arrangement, Spanish Socialist Josep Borrell was elected for the first term and Hans-Gert Pöttering is expected to follow him for the second.

## Hearings for new Commissioners

This was the third time such hearings had been organised as each of the 24 nominated Commissioners appeared for three hours before the parliamentary committee that most closely matches their policy portfolio. The vast majority of Commissioners passed the daunting test, many of them with flying colours. But some did not.

The Italian nominee, Rocco Buttiglione, a Minister of European Affairs who had been slotted in for the sensitive justice and interior brief, angered many MEPs with his deeply-held views on homosexuality and the role of women in society. Ingrida Udre from Latvia faced allegations on the financing of her political party. Neelie Kroes, the Dutch Commissioner who had been given the important competition policy brief, was challenged over potential conflicts of interest because of the extensive business connections she had built up after leaving government. Finally, László Kovács, the Hungarian nominee, disappointed MEPs because of his lack of knowledge of the energy portfolio he had been given, partly, it has to be said, because he had spent much of the previous 24 hours trying to sort out a domestic political crisis in his own country.

The combination of factors meant that the Parliament was in no mood to simply endorse the Barroso Commission, as required by the EU's treaties. Although Mr Barroso, supported by Mr Pöttering, as leader of the largest group, believed that approval was possible - even if by a slim margin - he had to redo his arithmetic after it emerged that all 200 members of the Socialist group would vote against him. With the Greens, Communists, many Liberals and sundry others also set to oppose his team, the Commission President took the unprecedented step, just one hour before the key vote in Strasbourg (and certain defeat), of withdrawing his request for parliamentary approval.

The climbdown may have been embarrassing. But it bought time and an opportunity to rethink. The Italian and Latvian governments were persuaded to change their nominees. Mr Barroso moved Mr Kovács to taxation and the customs union and the new Latvian appointee, Andris Piebalgs, was given the energy brief. Mr Buttiglione's successor, Franco Frattini, a former Foreign Minister, took over the justice, freedom and security portfolio. The reshaped team was endorsed without any further incident and took office on 22 November, just three weeks after its planned starting date.

## Outlook

It is early days for the Parliament. Over half its members are new and still coming to terms with their roles. Even experienced members are having to adapt to new committee structures. These were reformed and increased from 17 to 20 to ensure a better distribution of the workload. The change is particularly noticeable in the internal market and consumer protection committee. This brings into one forum the differing industry and consumer interests towards EU legislation in general and the single market in particular, which used to be handled previously in two separate committees and only emerged in debate on the floor of the full Parliament.

## 2. European Commission

### Introduction

2004 was a particularly difficult, and highly unusual, year for the European Commission. Several members left early, before the end of their mandates, to pursue high profile careers in their own countries. On 1 May, when ten new EU member states joined the Union, the number of Commissioners climbed, temporarily, from 20 to 30. EU governments squabbled over their nomination to replace Romano Prodi as Commission President. Finally, the new Commission was prevented from taking office for more than three weeks because of a dispute with the European Parliament over the credentials of some of its members.

### Outgoing Prodi Commission

The final months of any Commission mandate are difficult. Commissioners are busy preparing for new challenges and are reluctant to take initiatives that would bind their successors. An extra factor for the Prodi Commission was the early departure of some of its members. Anna Diamantopoulou started the trend when she resigned in February to participate in the Greek general election on behalf of PASOK. Two months later she was followed by Pedro Solbes after his appointment to a senior position in Spain's new Socialist government and by Michel Barnier who became French Foreign Minister. In July, Erkki Liikanen swapped Brussels for the governorship of the Bank of Finland and in September Belgium's Philippe Busquin moved to the European Parliament.

On each occasion, the governments concerned nominated successors for the outgoing Commissioners and these are now members of Mr Barroso's team. With enlargement, each of the ten new member states also sent a representative to the Commission. They were not given their own policy portfolios. Instead, they were attached to existing Commissioners, shadowing their work and generally benefiting from a running-in period during which they could become familiar with the workings of the institution.

### New Commission President

In June, EU leaders had to find a successor to Mr Prodi. It was not an easy task. Guy Verhofstadt, the Belgian Prime Minister, was keen to take on the role and won French and German backing to do so. However, just as the former British Prime Minister John Major had vetoed another Belgian Premier, Jean-Luc Dehaene, for the top Commission post ten years earlier on the grounds that he was too much of a federalist, so this time Mr Major's Labour successor, Tony Blair, opposed the nomination. Forced to find another candidate, the leaders turned to Jean-Claude Juncker, the highly experienced Luxembourg Premier. He politely declined. Finally, they agreed on the Portuguese Prime Minister, José Manuel Barroso, who was formally nominated in early July.

Mr Barroso immediately made his presence felt. Fluent in French, English and Spanish as well as his native Portuguese, he proved to be a far better communicator and public performer than his predecessor. He also won plaudits during the summer for the way he allocated portfolios among his

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team and for refusing to bow to pressure from France and Germany which had both made clear they wanted their nationals to have top economic posts. However, the honeymoon was short-lived. During the parliamentary hearings, several members of Mr Barroso's team were strongly criticised by MEPs and he was forced to change his original line-up (see chapter on the European Parliament).

Many lessons remain to be learned from the hearings episode. One is the difficult, almost impossible, position a Commission President may find himself in. He has little knowledge of the people governments present to him as Commissioners and has to take them on trust. Mr Barroso described the process as "a blind date". Secondly, Mr Barroso found himself squeezed between the European Parliament which wanted changes to the team and EU leaders who urged him to stand firm. What is clear, however, is that more care must be given to the process in five years time and the reaction of the Parliament to nominees will have to be factored in and not taken for granted.

## Picking up the tempo

The fall out from the parliamentary hearings did not get the new Commission off to the best of starts. However, one factor which should help the team to gel is the fact that they are all housed together in the Commission's Berlaymont headquarters, instead of with their separate departments, as previously. This will make for easier contact between the individuals and, more importantly, between the different cabinets which advise the Commissioners. In addition, Mr Barroso is likely to play a far stronger leadership role than his predecessor did. Mr Prodi was content to give his colleagues a generally free hand, only intervening if problems occurred. By nature, Mr Barroso appears to be far more hands-on.

## Outlook

After the Prodi Commission's main priorities of introducing the single currency and making a success of enlargement, Mr Barroso has identified competitiveness and the general objectives of boosting Europe's economic growth and creating jobs as the centrepiece of his mandate. From early on, speeches from Commissioners with very different policy briefs began reflecting these themes. This points to another feature which Mr Barroso wants to permeate his administration: cooperation, not competition, between different directorates-general. This should result in efforts to identify, and resolve, potential conflicts of interest between different policies (environmental, agricultural, industrial and competition, for instance) at a far earlier stage of the legislative process.

## 3. Constitutional Treaty

### Introduction

After missing the original December 2003 deadline for agreeing the Union's first constitutional treaty, EU leaders succeeded at their second attempt in June. The reasons for the initial failure and subsequent success are not hard to find. In December 2003, it soon became clear there was little appetite for the final crunch negotiations to thrash out the remaining sensitive issues. After that disappointment, the incoming Irish EU presidency set about reinvigorating the process. Its approach was deliberately low key, out of sight and unhurried. The European Council in March endorsed the softly-softly strategy and it came to fruition three months later. The Treaty was officially signed by EU leaders in Rome on 29 October.

### Contents of the treaty

The treaty is divided into four parts:

- Part 1 (60 articles): the values, objectives, competences and institutions of the Union.
- Part 2 (54 articles): the Charter of Fundamental Rights of the Union.
- Part 3 (322 articles): the substantive provisions on the Union's policies and institutions.
- Part 4 (12 articles): the general and final provisions.

The constitution replaces the existing Union and the European Community with a single legal entity called the European Union and it consolidates the various treaties that provide the legal base for EU activities into one text. It merges the three existing pillars (domestic policies, foreign and security policy, and justice and home affairs) and contains certain basic principles governing relations between the Union and its member states. It paves the way for greater involvement by national parliaments, enabling them to express their views on Commission proposals and on the application of subsidiarity - the principle whereby policies should be pursued at the most effective level, whether it be European, national, regional or local. It states, for the first time, that a member state may apply to leave the Union.

The constitution simplifies the range of legal instruments available to the Union by creating six categories: laws, framework laws, regulations, decisions, recommendations and opinions.

It introduces a number of institutional changes:

- European Council: this will be chaired by a single individual, chosen by EU leaders by a two-thirds majority, for two and a half years.
- European Parliament: from 2009, the number of seats may not exceed 750 with each member state having between six and 96 members.
- European Commission: from 2014, each member state will no longer be guaranteed a Commissioner. The size of the Commission will be set

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at two-thirds of the number of member states. This membership will revolve on an equitable basis.

— Minister for Foreign Affairs of the Union: the holder of the new post will conduct the Union's common foreign and security policy, chair the Foreign Affairs Council and be a Commission vice-president. The person will be able to call on the resources of the Commission, the secretariat-general of the Council and the diplomatic services of the member states.

— European Central Bank: this becomes a formal EU institution.

### Qualified-majority voting

The constitution introduces significant changes to the definition and scope of qualified-majority voting (QMV). Under the new double majority, decisions would require at least 55% of the member states (this must include at least fifteen countries) accounting for at least 65% of the population. To prevent a small number of member states with the largest populations (ie Germany, the UK and France) vetoing decisions, a blocking minority will require at least four countries.

## Table 1

Distribution of voting rights in Council (as of 1 November 2004)

| | |
|---|---|
| Germany, France, Italy, United Kingdom | 29 |
| Spain, Poland | 27 |
| Netherlands | 13 |
| Belgium, Czech Republic, Greece, Hungary, Portugal | 12 |
| Austria, Sweden | 10 |
| Denmark, Ireland, Lithuania, Slovakia, Finland | 7 |
| Cyprus, Estonia, Latvia, Luxembourg, Slovenia | 4 |
| Malta | 3 |
| **Total** | **321** |

*A qualified majority is reached if a majority of Member States is in favour and if at least 232 of the 321 votes are in favour (72.3%)*

*Source: European Commission*

The constitution introduces 45 new cases of qualified majority voting, on issues such as border controls, asylum, immigration, Europol, various institutional appointments, services of general economic interest, intellectual property, space policy, energy and humanitarian aid.

Unanimous voting remains for 70 politically sensitive items, notably own resources, taxation, aspects of social policy, common security policy and defence, certain international agreements including those relating to trade, elements of criminal law and the multiannual financial framework.

## Outlook

After the lengthy negotiations on the constitutional treaty, governments now have to persuade their electorates and parliaments to accept its contents. A Eurobarometer opinion poll conducted for the European Commission in December 2004 found that throughout the EU-25, the average degree of support for a constitution was 68%. This ranged from 81% in Belgium, 80% in Slovenia and 79% in Germany to 44% in Denmark, 49% in the UK and 50% in Sweden. However, people were asked their opinion on a constitution, not the constitution agreed by EU leaders last June.

The ratification process has already started. Lithuania became the first country to approve the treaty when its parliament endorsed it by 84 votes to four with three abstentions in early November. It was followed a month later by Hungary. More significantly, the French Socialist party, which had been deeply split over the constitution, rallied round it after 59% of its members gave it their approval in an internal referendum in November. Attention will now turn to Spain, which is due to hold a referendum on 20 February.

The constitutional treaty can only take effect when all 25 (or more if the Union has subsequently expanded) EU members ratify it, according to their own domestic procedures (either by parliamentary approval, a referendum, or a combination of the two). The treaty itself sets a target date for the constitution's entry into force: 1 November 2006. However, not all its provisions will apply from that date. The change in the number of Commissioners will only be introduced in 2014, while the new qualified-majority voting rules in the Council of Ministers will not operate until 1 November 2009.

What happens if one or more member states fail to ratify the constitutional treaty is unclear, despite attempts in the earlier European Convention to devise fallback options. However, EU leaders agreed a political declaration which states that if, two years after the treaty has been signed, four-fifths of the member states have ratified it, but one or more have "encountered difficulties", the matter would be referred to the European Council. In effect, the Union - not for the first time in its history - would be facing a crisis and would have to find an imaginative solution.

## Table 2

Probable ratification procedures and potential timetable where known

| **Parliamentary ratification:** |
|---|
| Germany (possibly Spring 2005), Austria*, Cyprus*, Estonia, Finland (end 2005/early 2006), Greece*, Hungary* (approved 20 December), Italy* (possibly early 2005), Latvia, Lithuania* (approved 11 November 2004), Malta*, Poland, Slovenia, Slovakia, Sweden. |
| **Referenda (consultative or binding):** |
| Belgium (possibly May 2005), Denmark*, Spain* (20 February 2005), France* (probably first half 2005), Ireland*, Luxembourg* (10th July 2005), Netherlands* (first half 2005), Portugal* (possibly April 2005), Czech Republic (possibly June 2006), United Kingdom* (probably first half 2006). |

* The asterix in the upper box indicates where referenda have been definitively ruled out. In the lower box, it denotes a decision to hold one.

*Source: EU governments*

## 4. Enlargement

### Introduction

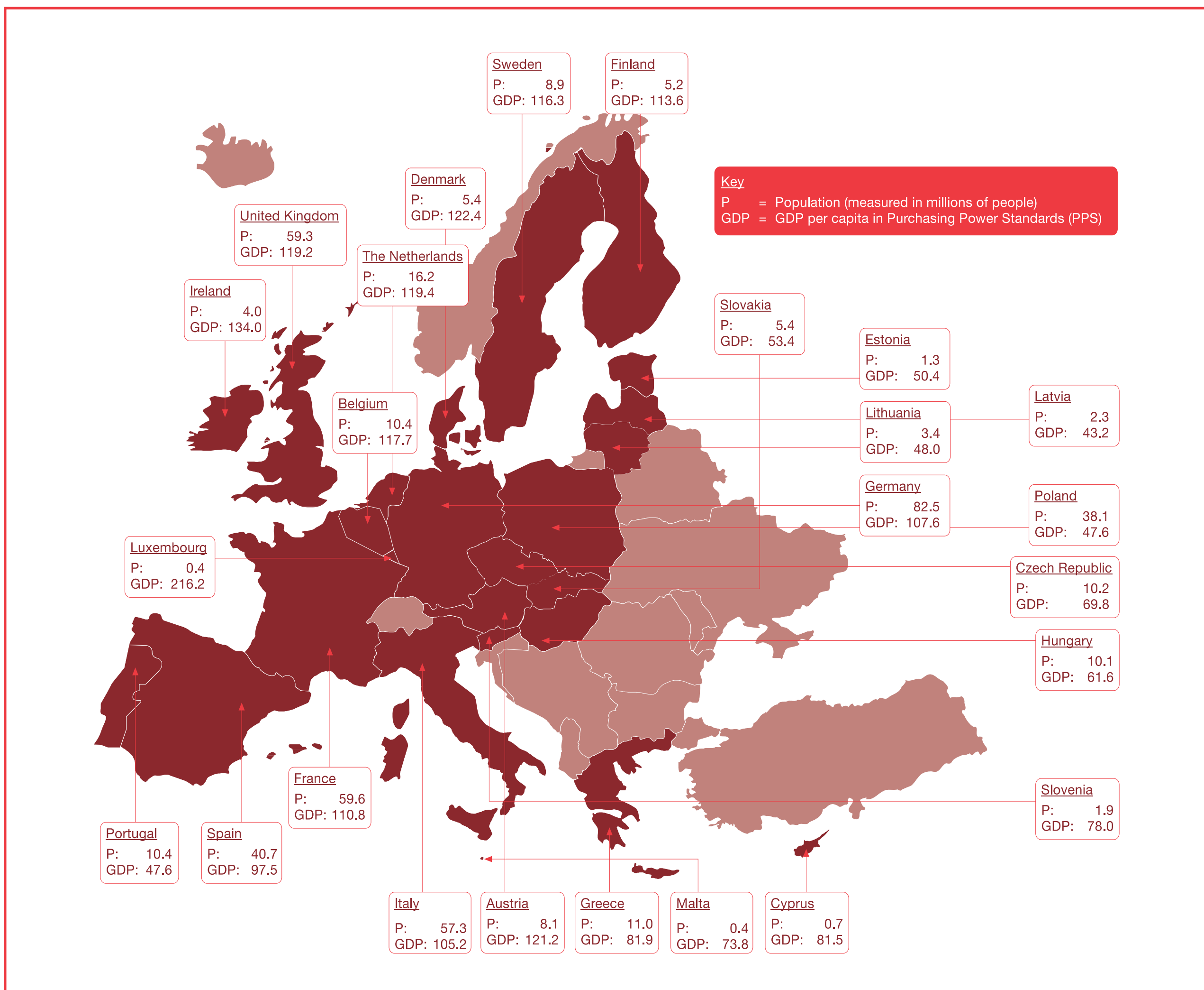
The fifth, and most ambitious, enlargement of the Union took place on 1 May when ten countries, eight of whom had been under Soviet influence just fifteen years earlier, became full members. Their arrival increased the EU's population from 380 million to 455 million, making it the third largest single market after China and India. As the year ended, EU leaders were already looking ahead to the next enlargement, with the planned entry of Romania and Bulgaria in January 2007, and the start of negotiations during 2005 with Croatia and Turkey.

### From 15 to 25

No previous enlargement had been so carefully prepared. On a policy level, the ten new members (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) had received considerable amounts of financial and practical help from the EU-15 for several years to help implement Union legislation so that this would be in place and applied from the first day of membership.

## Figure 3

Map of European Union with population and GDP of 25



In addition, efforts had begun at least a year earlier to integrate ministers, parliamentarians and senior officials into the work of the Council of Ministers and the European Parliament. In the former, ministers and ambassadors attended the regular meetings as observers, while in the latter, the ten new member states had 162 observer MEPs.

The impact of enlargement on the EU's institutional structure had been catered for by the Nice Treaty agreed by EU leaders in December 2000. This stated that every country would have only one Commissioner, ending the situation whereby France, Germany, Italy, Spain and the UK had two each. The new arrangement took effect with the arrival of Mr Barroso's team in November. The size of the European Parliament, which had briefly risen to 788 members as the 162 observers became full MEPs in May alongside the 626 from the EU-15, was also adjusted. Since the June elections, it contains 732 MEPs. This has meant fewer members for each of the EU-15 countries, except for the largest, Germany, which retains 99 and the smallest, Luxembourg, which keeps six. Representatives from the UK, France and Italy, for instance, are reduced from 87 to 72 and from Spain from 64 to 50. A new, more complex system of qualified majority voting, based on a re-weighting of votes, was also introduced for decision making in the Council of Ministers.

From an institutional point of view, the enlargement process has gone remarkably smoothly. There may be occasional linguistic problems as unexpected pressure is placed on translation and interpretation resources. Delegates may be more constrained to keep their remarks brief so all those round the table can intervene. Being aware of different national sensibilities and domestic political difficulties has also become more complex. But overall, the system has adapted efficiently to the new circumstances.

The situation is less clear on the policy front. Ensuring that EU legislation is applied correctly throughout the whole Union will be an enormous task and the dynamics of enlargement have still to make themselves fully felt in policy making. Will the low corporate tax burden, for instance, in Estonia, Lithuania and Cyprus lead to more pressure from France and Germany for EU fiscal coordination? Will the new arrivals give a boost to the Union's economic reform programme and, externally, will they be a factor for greater harmony in transatlantic relations? Answers to such questions will only begin to emerge in the months ahead. What is clear, however, is that, while the Franco-German alliance remains a powerful motor of European integration, it is no longer sufficient on its own to drive initiatives forward. Wider partnerships have to be forged to gain the necessary support and momentum in an EU of 25.

### Romania, Bulgaria and Croatia

In mid-December, the Union formally completed negotiations with Bulgaria and Romania and announced that it looked forward to welcoming both as members from January 2007 after signing the Accession Treaties in April 2005. However, it also stressed that the timetable would only be achieved if both countries continued to implement the reforms they have undertaken to put in place. In this respect, Romania is further behind than Bulgaria. Both have been told that they need to make more progress on justice and home affairs issues, while the EU has also informed Romania that greater

efforts are required for competition and environmental matters. The European Commission will continue to monitor both countries' preparations for EU membership.

After the Commission had recommended earlier in the year opening accession negotiations with Croatia, EU leaders in December set 17 March 2005 as a target date for launching the process. However, they insisted that by then, Croatia had to cooperate more fully with the International Criminal Tribunal for the Former Yugoslavia in The Hague.

## Turkey

Undoubtedly one of the most significant decisions the Union took during the year was to agree to open accession negotiations with Turkey, which had lodged its membership application back in 1987. In December, five years after the Union had agreed at its Helsinki summit that Turkey was a "candidate state destined to join the Union on the basis of the same criteria as applied to other candidate states", EU leaders deemed that Turkey met the political and economic conditions to begin the talks. The decision was far from easy. Many leading European politicians oppose the move, preferring to offer the country a privileged partnership, rather than EU membership, and there is some hostility among the general public.

The negotiations will open under the UK presidency of the Union on 3 October, provided Turkey has signed, as it has promised to, the protocol adapting the Ankara Agreement. This takes account of the accession of ten new member states to the Union in May and is seen as providing Turkish de facto recognition of Cyprus. The negotiations will run for at least ten, and possibly fifteen, years. Nor is the outcome certain.

As with previous enlargements, the EU will closely monitor the implementation of the political and economic reforms made by the Turkish government. The actual negotiations will follow a standard format. They will take place in an Intergovernmental Conference containing Turkey and all EU member states. There will be some 30 different policy areas, each of which must be agreed unanimously.

However, other elements are also coming into play. The Union has made clear that long transition periods, derogations, specific arrangements or permanent safeguard clauses may be applied, as appropriate, in areas such as freedom of movement of persons, structural policies or agriculture. In addition, both France and Austria have announced that they will hold referenda on Turkey's membership.

## Outlook

While Croatia and Turkey begin their accession negotiations this year, the Commission will be closely watching Romania and Bulgaria to ensure there is no backsliding after the formal completion of the talks. In the longer run, other potential candidates are undoubtedly in the wings: Bosnia-Herzegovina, Serbia and Montenegro, Albania, and possibly even Ukraine. Macedonia applied for membership in February 2004. The various requests could fuel the fundamental debate of where the Union's frontiers should be drawn. It will also focus closer attention on the type of relationship the EU should develop with its closest neighbours which have no intention of trying to become members.

# 4 Competitiveness

## 1. Lisbon objectives

### Introduction

If there is one single priority for the Barroso Commission it is to place economic reform back at the top of the political agenda so that the Union can demonstrate it is able to deliver economic growth and create new jobs. In Brussels shorthand, this is termed the Lisbon strategy, a package of ambitious measures EU leaders agreed in the Portuguese capital five years ago to make the Union the world's most competitive, knowledge-based economy by 2010.

Now, half way along that timetable, the Union is preparing to take stock of the progress made. By general agreement, this has been patchy and a range of initiatives is underway to breathe new life into the process. One of the key questions to be resolved will be the extent to which the relationship between the three original pillars of the strategy - economic, environmental and social - which currently have equal ranking should be rethought so that priority is given to economic considerations. Unless the Union can boost growth and employment, it will find it hard to deliver on the other two objectives, say supporters of change. The debate is far from settled, but there are clear signs that thinking within the Commission is going in this direction.

## Fresh start

One of President Barroso's first commitments on taking up office was to make Lisbon his administration's central priority for the next five years. Within weeks, the terms "Lisbon strategy" and "competitiveness" were themes being articulated in speeches by Commissioners with a wide range of policy portfolios.

This new political drive has led to early changes within the Commission itself. At the most senior level, President Barroso has created two internal groups of Commissioners to push forward the policy priority he has so clearly identified. He chairs the first, the Lisbon group, which is open to any of the 25 Commissioners to attend. Early indications are that 18-20 are likely to be regular participants as they consider the wider economic, social and environmental agenda.

However, of potentially more significance is the second, smaller group focusing exclusively on competitiveness. Chaired by Günter Verheugen, the Industry and Enterprise Commissioner, it is a much smaller unit of six members. All have key economic portfolios: Peter Mandelson (British, Trade), Neelie Kroes (Dutch, Competition), Charlie McCreevy (Irish, Internal Market and Services), Janez Potocnik (Slovenian, Science and Research) and Markos Kyprianou (Cypriot, Health and Consumer Protection).

The group has already met on at least two occasions, preparing its input into the Lisbon strategy. Its influence will reach beyond the Lisbon mid-term review. It also meets some six weeks before each Competitiveness Council to coordinate the Commission's input into a ministerial gathering which will be the major forum in the coming years for developing policies to promote economic growth and employment.

Mr Verheugen's own department has been renamed the Enterprise and Industry Directorate-General and been restructured to reflect the wide-ranging role he now enjoys. Specific units have been created to manage the competitiveness coordinating functions it now has within the Commission and to develop close relations with other institutions, notably the Council of Ministers and European Parliament. The changes reflect a determination to make the DG more proactive and its work more visible.

The DG's policy remit has also been expanded. All aspects of the internal market as they affect goods (services remain with the Internal Market Directorate-General) now come within its ambit. This should provide a more coherent approach towards the day-to-day issues of the free movement of goods as they affect industry. It is also responsible for

research in the space and security technology sectors, emphasising the close link the Commission wishes to make between R&D in these areas and industrial policy.

## Scale of challenge

Two reports released during 2004 - one by the Commission in January and the other by the former Dutch Prime Minister Wim Kok in November - reveal the scale of the challenge. In its assessment, the Commission noted: “After four years of implementation of the Lisbon strategy, the Union’s progress is still insufficient to achieve the objectives it has set itself”. Mr Kok was more direct. “Halfway to 2010 the overall picture is very mixed and much needs to be done in order to prevent Lisbon from becoming a synonym for missed objectives and failed promises,” he concluded.

The Commission noted that there had been progress. Since 1999, the Union had created six million jobs. Significant improvements could be seen in long-term unemployment and the rate of female employment. Several strategic network markets - telecommunications, energy and rail freight - had been opened up. Internet take-up in schools, businesses, public administrations and households was on the increase.

However, it warned that despite progress in some areas of the labour market, most of the Lisbon employment targets were in danger of being missed if no further reforms were undertaken. It also pointed to the declining trend in labour productivity growth as the gap with the US continued to widen and now accounts for 40% of the difference in GDP per capita between the transatlantic partners.

Mr Kok and his high level group, who had been asked by EU leaders at their March 2004 summit to carry out their independent review, attributed the failure to meet objectives to many factors: a lack of determined political action, an overloaded agenda, poor coordination and conflicting priorities. In addition to calling for stronger political leadership, both nationally and at European level, it advised that, while recognising the continued validity of Lisbon’s economic, social and environmental objectives, priority should be given to boosting economic growth and increasing employment.

It also argued for greater effort in explaining the fundamental relevance of the strategy to Europe’s citizens and for closer involvement by national authorities. This, it suggested, could be achieved through the introduction of national action programmes which would engage governments, parliaments and social partners in the process. In addition, the Kok report contained a series of key practical recommendations with clear timetables for their completion.

## Better regulation

A central plank in the campaign to improve Europe’s competitiveness is a renewed emphasis on better regulation. It is a priority which both the Commission and EU governments share. Mr Verheugen has already indicated that he and his colleagues will constantly bear in mind the consequences of new legislation for European business. He intends to make greater use of competitive testing of legislative proposals to ensure they reach their objectives in the most efficient way possible without creating unnecessary red tape.

In the Council of Ministers, six member states - Ireland, the Netherlands, Luxembourg, the UK, Austria and Finland - which hold the rotating EU presidency between the start of 2004 and the end of 2006 issued a joint statement, Advancing Regulatory Reform in Europe, in December. This called for the presentation in early 2005 of common European methodology for measuring administrative burdens and, before the end of the year, the introduction of such assessments for all new legislation. The statement also supported an annual review of the way in which the administrative burden of EU regulation had changed.

This administrative analysis should be integrated into the impact assessments which the Commission has been carrying out on all major items of legislation since 2003. During that period, some 50 assessments have been conducted across a range of issues examining the policy options available, the trade-offs and synergies and the economic, environmental and social consequences. The process involves considerable consultation with the different interests involved.

As well as assessing the cost of legislative proposals, EU governments are also identifying where existing legislation can be simplified. During its presidency, the Dutch government drew up a list of 17 from the 350 suggestions which had been submitted by member states for treatment. The directives selected cover areas ranging from company law and annual accounts to the environment, food labelling and health and safety at work.

### Outlook

The Commission is due to finalise its contribution on breathing new life into the Lisbon strategy in early February. This will provide the centre piece for the discussions on the mid-term review of the process at the European Summit in Brussels on 22 and 23 March. It is likely that the exercise will give the Lisbon strategy a sharper economic focus and emphasise that economic reform is an ongoing process which will continue after the 2010 target date. However, as now, the degree of success which the refined strategy achieves will depend overwhelmingly on the political will which national governments invest in it, rather than on a series of new EU legislative initiatives.

## 2. Overview of main EU economies (by John Hawksworth)

### Highlights

— Euroland growth is expected to remain at around 1.75% in 2005, similar to 2004, before picking up slightly to around 2% in 2006.

— The German economy remains fragile, so PricewaterhouseCoopers' main scenario envisages only 1.5% growth in 2005 and 1.75% in 2006. French and Italian growth is expected to be only slightly stronger at around 1.75% in 2005 and around 2% in 2006, but Spanish growth should remain more robust at around 2.5-2.75% on average in 2005-6.

— Risks to Euroland growth are weighted to the downside at present, both because of fragile domestic demand and of the risk of a faster than expected deceleration in global economic growth and a further

rise in the euro over the next year. But growth could also be more rapid than projected if oil prices fall significantly and the global economy regains momentum.

— Underlying Euroland inflation is expected to remain below 2% over the next year, excluding oil price effects, allowing the European Central Bank (ECB) to keep interest rates on hold for the remainder of 2005. Rates may need to start rising gradually in 2006 if the economy recovers as anticipated in PricewaterhouseCoopers' main scenario, but any sign of a relapse could lead to an interest rate cut later this year.

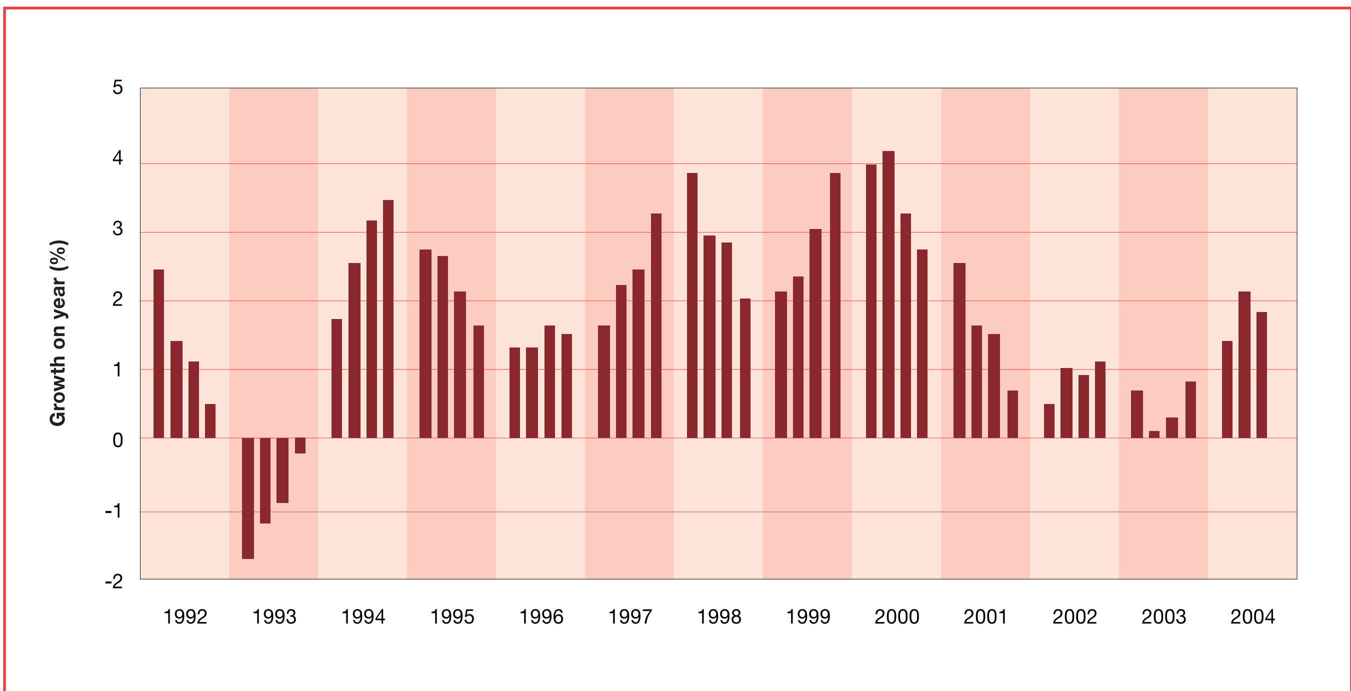
— The three largest new EU member states (Poland, Czech Republic and Hungary) are all expected to sustain relatively strong growth rates in 2005 and 2006.

## Recent developments

The Euroland economy saw a slowdown in growth to only 0.3% in the third quarter of 2004, with the year-on-year growth rate easing to 1.8% as a result (see Figure 4). This reflected particular weakness in Germany and France in the third quarter, although growth held up better in Spain and Italy during that period. Domestic consumer spending and investment growth remain relatively subdued in Euroland, and export growth has slowed in the face of an appreciating euro and somewhat weaker growth in the world economy since mid-2004.

## Figure 4

Euroland GDP growth




*Source: Eurostat*

Recent business surveys suggest that growth remained modest in the fourth quarter, with exporters being hit by a further rise in the euro. Business confidence levels have also tended to remain relatively weak. Consumer confidence levels in the euro area have flattened off at levels that are low by historic standards.

Earlier oil price rises mean that headline Euroland inflation remains above 2%, but underlying core inflation is still consistent with the ECB's revised target of keeping inflation "below but close to 2%" over the medium term. The ECB therefore left official interest rates unchanged at 2% throughout 2004 and there is no indication that an early change in rates is planned.

The UK economy grew strongly during the first half of 2004, but also suffered a deceleration in growth in the third quarter, with manufacturing output falling and consumer spending growth moderating in the face of a cooling housing market and earlier interest rate rises. Growth has been supported by significant increases in public spending, although this has led to some concerns that tax rises will be needed in the medium term in order to reduce the budget deficit from its current level of around 3% of GDP. For the moment, inflation remains well below target, despite the effect of oil price rises, and interest rates have been left on hold since August.

Elsewhere in Europe, growth recovered strongly in Sweden in 2004 and more gradually in Switzerland. The Polish, Czech and Hungarian economies all continue to record growth well above the EU average.

### Future prospects

PricewaterhouseCoopers' main scenario for Euroland (see Table 3 for details) is similar to the consensus view, with growth averaging around 1.75% in 2005, similar to 2004, and then returning to trend at around 2% on average in 2006. This scenario assumes that oil prices moderate over the next year, helping to mitigate the extent of any slowdown in the global economy, while the euro stabilises against the dollar.

## Table 3

Outlook for European GDP growth (%)

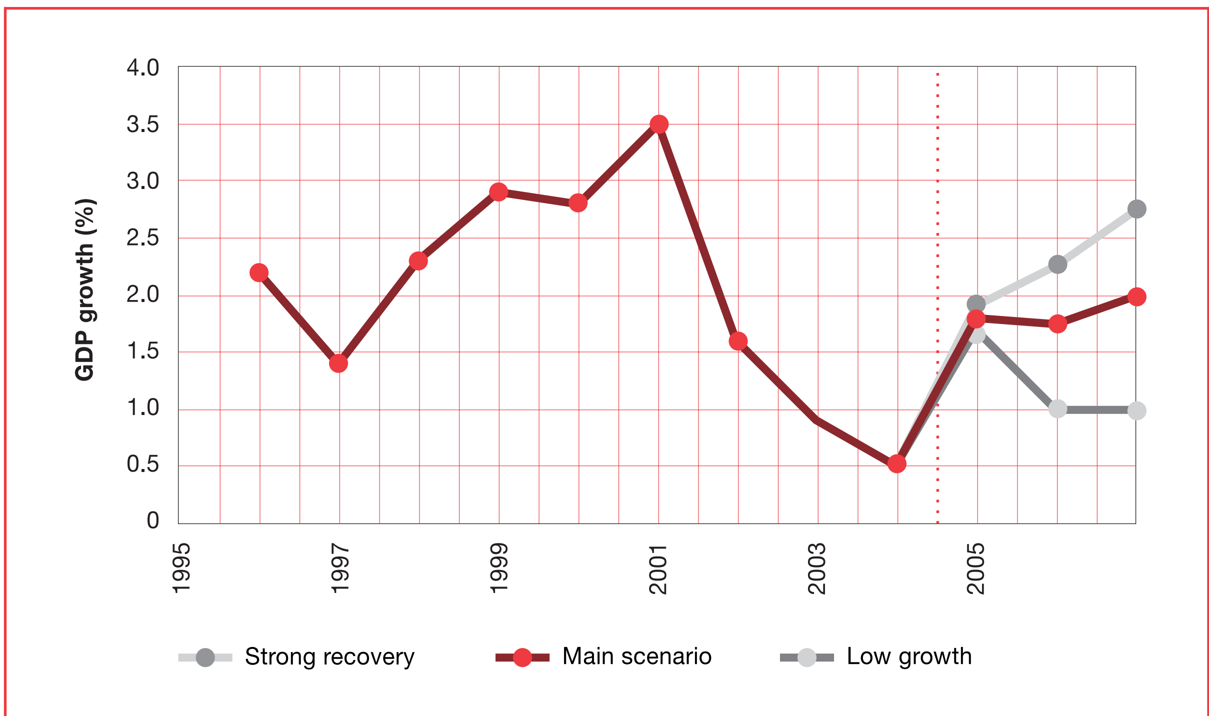
| Country/region | 2004 estimate | Main scenario | |
|---|---|---|---|
| | | 2005 | 2006 |
| Germany | 1.7 | 1.5 | 1.75 |
| France | 2.1 | 1.75 | 2 |
| Italy | 1.2 | 1.75 | 2 |
| Spain | 2.6 | 2.5 | 2.75 |
| Netherlands | 1.2 | 1.5 | 2.25 |
| Other Euroland | 2.25 | 2.25 | 2.5 |
| **Euroland** | **1.8** | **1.75** | **2** |
| *Plausible range for Euroland* | - | *1 - 2.25* | *1 - 2.75* |
| UK | 3.2 | 2.5 | 2.5 |
| Sweden | 3.4 | 3 | 2.75 |
| Switzerland | 1.8 | 1.75 | 1.75 |
| Other Western Europe | 2.8 | 2.75 | 2.5 |
| **Western Europe** | **2.1** | **2** | **2.25** |
| Poland | 5.7 | 5 | 4.5 |
| Czech Republic | 3.8 | 4 | 4 |
| Hungary | 3.8 | 3.75 | 3.75 |

*Source: PwC estimates for 2004 based on Eurostat data; PwC growth scenarios for 2005-6 are rounded to the nearest quarter of one percent*

There are considerable uncertainties around this main scenario, however, as illustrated by the alternative scenarios shown in Figure 5. The risks to growth still appear to be weighted to the downside at present given that the Euroland economic recovery remains relatively fragile and that there are significant risks around the sustainability of US growth, due to its large budget and trade deficits. These deficits also create the risk of a further significant decline in the dollar, with adverse consequences for Euroland exporters, particularly if China and other Asian currencies continue to follow the dollar down.

## Figure 5

Euroland GDP growth scenarios




*Source: PwC estimates based on Eurostat data*

On the other hand, it is also possible that the Euroland economy could pick up steam faster than anticipated over the next year, boosted by near zero real interest rates in the euro area. But this depends on the global recovery being maintained and confidence levels picking up in Euroland.

In the main scenario, German growth is projected to remain modest at around 1.5% in 2005, with only slightly faster growth in France and Italy this year. Spain is expected to grow faster at around 2.5%. Projections for 2006 should only be taken as broad indications at this stage, but the assumption is that Euroland growth returns to a near-trend growth rate of around 2% next year.

In this scenario, PricewaterhouseCoopers assumes that the ECB keeps interest rates on hold for the rest of 2005, but that these then rise gradually

during 2006 as the economy begins to recover. If the pessimistic scenario begins to emerge, however, then the ECB will need to cut rates again at some point.

The UK economy is expected to slow to a near-trend rate of around 2.5% in 2005-6 as a downturn in the housing market constrains consumer spending growth. This should, however, be offset by continued relatively rapid public spending growth and reasonably strong business investment and export growth. Inflation is expected to remain under control in this scenario, with interest rates at or close to their peak. But if growth is faster than expected, then some further rise in UK rates cannot be ruled out.

Growth is expected to continue to be relatively robust in Sweden, averaging around 2.75-3% in 2005-6. Growth in Switzerland is expected to be more moderate at around 1.75%. Growth is expected to remain relatively strong at around 5% on average in 2005 in Poland and around 3.75-4% in the Czech Republic and Hungary.

## 3. New EU competition policy

### Introduction

2004 saw the first major reforms in 40 years to the Union's competition policy. The modernisation package came into force on 1 May, after five years of preparation, ushering in new rules and procedures for clamping down on cartels and abuses of dominant positions. Its arrival coincided with the introduction of a major overhaul of the EU's practices for processing mergers.

Later in the year, Mario Monti, who had run competition policy since 1999, stood down and was replaced by Neelie Kroes, a former Dutch government minister who, after leaving office, had had a prominent business career for a decade. To many, her appointment brought to the Commission a welcome dose of business acumen and understanding of the impact of political and administrative decisions on the corporate world.

### Modernisation package

The new antitrust regulation (Regulation 1/2003) updates implementation of the EU's main treaty competition provisions: Article 81, which bans agreements and concerted behaviour that distort competition within the single market, and Article 82, which prohibits abuses of dominant positions. It replaces enforcement rules which had been adopted as far back as 1962. The new merger regulation (Regulation 139/2004) supersedes legislation that had operated since 1990.

Mr Monti described the changes as "a revolution" in the way EU competition rules are enforced. He predicted they would "usher in a mature system in which law-abiding companies that do business in Europe will be freed from decades-old legal straightjackets and will benefit from less bureaucracy and a more level playing field in the European single market".

The new antitrust measures abolish the need for companies to routinely notify the Commission of business agreements and practices. The system had become unnecessarily bureaucratic; businesses now operating in Europe are generally familiar with the competition rules they must apply; and most of the notifications, such as joint research and production agreements, traditionally posed few specific problems. Now that it no longer has to process these, the Commission will be able to focus its resources on central problems, such as hard core cartels and major abuses of dominant positions.

One of the central elements of the package is the European Competition Network which had been launched a year earlier and links the Commission and national competition authorities with each other. In parallel with the entry into force of the new antitrust measures, the Commission published detailed guidelines on how this cooperation would operate. These covered work-sharing between public enforcers, mutual information about pending cases at different stages of the procedure, the exchange of information for use in evidence, and the issue of leniency applications in cartel investigations. The Commission also issued guidelines on other aspects of antitrust enforcement in order to provide advice for businesses and national authorities and to ensure that the EU rules are applied coherently and uniformly.

The new regulatory framework and the decentralised enforcement of anti trust rules will make it easier for individuals and businesses to raise possible grievances. Under the new system, they can bring antitrust actions directly in their national courts. The Commission believes that this possibility of private actions will be a powerful added incentive for companies to comply with EU competition rules.

## Table 4

Anti-trust fines in 2004

| | |
|---|---|
| € €497.2 million | Microsoft |
| € €222.3 million | Copper plumbing tubes cartel (Sweden's Boliden group, Halcor S.A. of Greece, HME Nederland BV, the IMI group (UK), the KME group (Germany, Italy and France), Mueller Industries, Inc. (USA, UK and France), Finland's Outokumpu and Wieland Werke AG of Germany. |
| €66.34 million | Choline Chloride cartel (Akzo Nobel, BASF and UCB) |
| €20 million | Spanish raw tobacco cartel (Compañia Española de Tabaco en Rama (Cetarsa), Agroexpansión, World Wide Tobacco España (WWTE), Tabacos Españoles (Taes) and Deltafina |
| €2.5 million | French beer cartel (Groupe Danone/Brasseries Kronenbourg S.A., and Heineken N.V./Heineken France S.A.) |
| €1.56 million | Topps |

*Source: European Commission*

The wide-ranging merger review package, which was approved by EU governments in January 2004 and came into force on 1 May, contains four main elements. At its core is a revised merger regulation and guidelines, to provide advice to the business and legal communities, on appraising

mergers between competing firms - so-called horizontal mergers. In addition, there is a set of best practice guidelines for merger investigations, and internal reforms have been made within the Competition Directorate-General itself to ensure all decisions are objectively and soundly based.

The changes are designed to enhance the transparency and efficiency of the Commission's merger control system and policy, and to guarantee the system's effectiveness in tackling anti-competitive mergers. Like the antitrust innovations, the new rules encourage participation by national competition authorities.

The legal test for assessing a merger has been clarified so as to cover various harmful scenarios, whether they be dominance by a single firm or by an oligopoly, or through coordination or unilateral effects. The wording of the new test focuses more directly on the effects on competition from a concentration than the old "dominance tests" did. While aiming to protect consumers against all forms of anti-competitive mergers, the Commission now also takes into account efficiencies which may result from a merger, provided some of these are passed on to the consumer in the form of cheaper prices or new products.

The new regulation introduces some flexibility into the timetables for investigations and simplifies the notification and investigation procedures. It also retains the "one-stop shop" concept whereby companies may approach just one authority for approval if they have to notify in three or more member states. Certain reforms, such as the appointment of a chief competition economist and the creation of a panel to scrutinise the investigating team's conclusions had already been introduced before 1 May.

## Microsoft

*After a five-year investigation, the Commission concluded in March that Microsoft Corporation had broken EU competition rules by abusing its dominant position. It fined the US software company 497.2 million euro and proposed a series of remedies to restore fair competition to the market. In early June, the company lodged an appeal against the Commission decision before the EU's Court of First Instance (CFI) and, a few weeks later, applied for the remedies demanded by the Commission to be suspended pending the outcome of its appeal. On 22 December the CFI dismissed the application for the interim measures, explaining that the evidence supplied by the company was not sufficient to demonstrate that implementing the remedies stipulated by the Commission would cause Microsoft serious and irreparable damage.*

*The major trial of strength between the Commission and one of the world's most successful companies began in 1998. Sun Microsystems, another American firm, complained to the Commission that Microsoft had refused to provide information to enable it to develop products that could "talk" with Windows PCs. It maintained this prevented it from competing on an equal footing in the market for work group server operating systems.*

*After learning that other companies had experienced similar problems, the Commission decided that the non-disclosure was part of a broader strategy to keep competitors out of the market. In its decision, it concluded that Microsoft had abused its market power by deliberately restricting interoperability between Windows PCs and non-Microsoft work group servers, and by tying its Windows Media Player (WMP), a product where it faced competition, with its ubiquitous Windows operating system.*

*Under the remedies, Microsoft had to disclose complete and accurate documentation which would enable interoperability to take place and to offer manufacturers a version of its Windows client PC operating system without WMP. The Court of First Instance is expected to deliver its judgement on the substance of the case later this year.*

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## Mrs Kroes's impartiality

To demonstrate her impartiality and integrity, Mrs Kroes has taken unprecedented measures to sever all links with her business past - measures which no Commissioner has ever taken before. She has resigned from the dozen or so supervisory boards of which she was a member, sold all her shares and pledged not to carry out any business activity once her Commission mandate ends in 2009.

Moreover, she has given a firm commitment not to take part in any case involving a company with which she was previously associated. When such occasions could arise, the Competition Policy Director-General will inform Mr Barroso who will then designate someone else to be in charge of the case. The commitment is not entirely without precedent. Karel van Miert, a former Belgian Competition Commissioner once stood aside during an investigation into Sabena because a family member worked for the now defunct Belgian airline.

Mrs Kroes has already demonstrated her independence and ability to take tough decisions, and, in her terms, not be a "pussycat" when confronted with business interests. In early December, she convinced her colleagues to issue the Commission's first merger veto for three years on the grounds it would create a quasi-monopoly. At the same meeting, she fined three chemical companies a total of 66 million euro for operating an animal feed vitamin cartel. The merger case was particularly sensitive since it concerned  a planned takeover of state-owned Gas de Portugal by Energias de Portugal and Eni, the Italian energy company. The proposed deal was intended to form part of the energy restructuring plan devised by Mr Barroso when he was Portuguese Prime Minister. The Commission President did not intervene at any time in the final decision.

## Outlook

In policy terms, most attention is likely to focus on the way the reformed antitrust and merger systems work in practice and on the current review of the application of competition rules to maritime transport. Mrs Kroes has also made it clear she believes in a proactive competition policy, based on the communication the Commission tabled in April 2004. This makes a close link between the policy and measures to promote Europe's industrial and entrepreneurial base and competitiveness. In partnership with the European Competition Network, this will involve closer monitoring of markets to identify practices which could harm consumer interests or wider competitiveness goals.

While being tough on unfair state aid practices, Mrs Kroes will also argue that competition rules must be more responsive to specific market failures which harm the European Union's general cohesion. "Imaginative solutions here could help deliver the results we all want to see in terms of innovation, balanced regional development and more research," she explains.

## 4. Stability Pact

### Introduction

The Stability and Growth Pact (SGP) came under particularly close scrutiny and strain during 2004. The legal battle between the Commission and the Council of Ministers over their respective roles in applying the Pact came to an end with a European Court of Justice ruling in July. But a month earlier, EU leaders had asked the Commission to come forward with ideas for strengthening and clarifying the implementation of the Pact. This the Commission did in September. Then, in December, a Commission investigation concluded that, because of incorrect statistical data, the Greek government's deficit between 1997 and 2003 had to be revised upwards by 2.1% of GDP on average. This meant that the country had consistently exceeded the 3% of GDP ceiling set out in the Pact.

### Clarifying the Pact

At their June summit, EU leaders stressed that raising growth potential and securing sound budgetary positions were the two pillars of the Union's economic and fiscal policy. What contribution, they asked the Commission, could the Pact make towards these twin aims. To some, this heralded a significant reform of the SGP. Others were more cautious. But, as President Prodi pointed out in September 2004, the Union's economic agenda had moved on since the creation of the euro. Now, it was the priority of raising the EU's growth potential that was at the centre of economic policy considerations. He pointed out that there had to be more coherence and coordination between the objectives set for the Lisbon strategy and for stability.

The Commission believes its September proposals achieve a balance between economic soundness and political realism and between sustainable growth and sustainable public finances. It has done so by introducing greater flexibility, without damaging the credibility of the Pact by fundamentally rewriting its rules.

The proposals seek to introduce more economic rationale into implementation of the SGP, while strengthening surveillance and enforcement. They place more focus on debt sustainability when examining budgetary positions. They take greater account of country-specific circumstances when defining the medium-term objectives of "close to balance or in surplus". They consider economic circumstances and developments when implementing the excessive deficit procedure. This suggests that the budgetary impact of periods of exceptionally weak growth will be taken into account when deciding recommendations and deadlines under the excessive deficit procedure. Emphasis is also placed on the need to act earlier to correct inadequate budgetary developments. In addition to these refinements, the Commission proposed closer coordination between the Broad Economic Policy Guidelines, the Pact and national budgetary processes.

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## Greek figures

In Spring 2004, the new Conservative Greek government decided to launch a thorough fiscal audit. This, in cooperation with Eurostat, the Union's Statistical Office, led, in September, to a large revision of Greece's budgetary statistics. The government deficit for 2003, which was initially reported at 1.7% of GDP was raised to 4.6%. The deficits notified to the Commission in 2000, 2001 and 2002 were also revised upwards by more than two percentage points. A subsequent analysis by the Commission concluded that the government deficit ratio had consistently exceeded 3% of GDP since 1997.

The anomalies in the accounts were due to a range of factors: under-recording of military expenditure, over-estimation of the surplus of social security funds, downward revision of tax revenue estimates, and the treatment of capital injections and EU grants. The Commission placed responsibility for the failings, in the first instance, on the Greek authorities for not providing data according to established European systems and procedures.

However, in December, EU Finance Ministers acknowledged that the blame should be more widely attributed. Eurostat, the Commission, the European Central Bank and EU governments themselves should all have paid greater attention to the quality of data being supplied. The Commission has started infringement proceedings against Greece for failing to present the necessary data and is also examining ways of guaranteeing that, in future, all governments supply the highest standard of statistical information.

## Outlook

The Luxembourg Presidency is aiming to secure an agreement on a remodelled Pact around March. There is no doubt that the 3% deficit ceiling will remain. What is unclear is the degree of flexibility that will be introduced. Countries pressing for military spending or R&D funding to be discounted are likely to be disappointed. However, countries investing in structural or pension reform, or with low public debt, might be given a longer period during which to eliminate any excessive deficit. Attention will also focus on the measures required to ensure the accuracy of the statistical data national authorities transmit to the Commission. Some may try to use the debate to acquire more supervisory powers for Eurostat, but this will be resisted by most member states, particularly the large ones.

# 5 Internal Market

## Introduction

The internal market is one of the foundations of the Union's success and relevance to ordinary citizens. As such, it is a key ingredient in the new political impetus which the Barroso Commission is bringing to economic reform and the push for greater competitiveness. Much progress has been made, but, as the annual Scoreboard demonstrates, more is still required. After the heavy legislative agenda of the past few years, emphasis now will be on proper implementation.

## Internal Market Strategy and Scoreboard

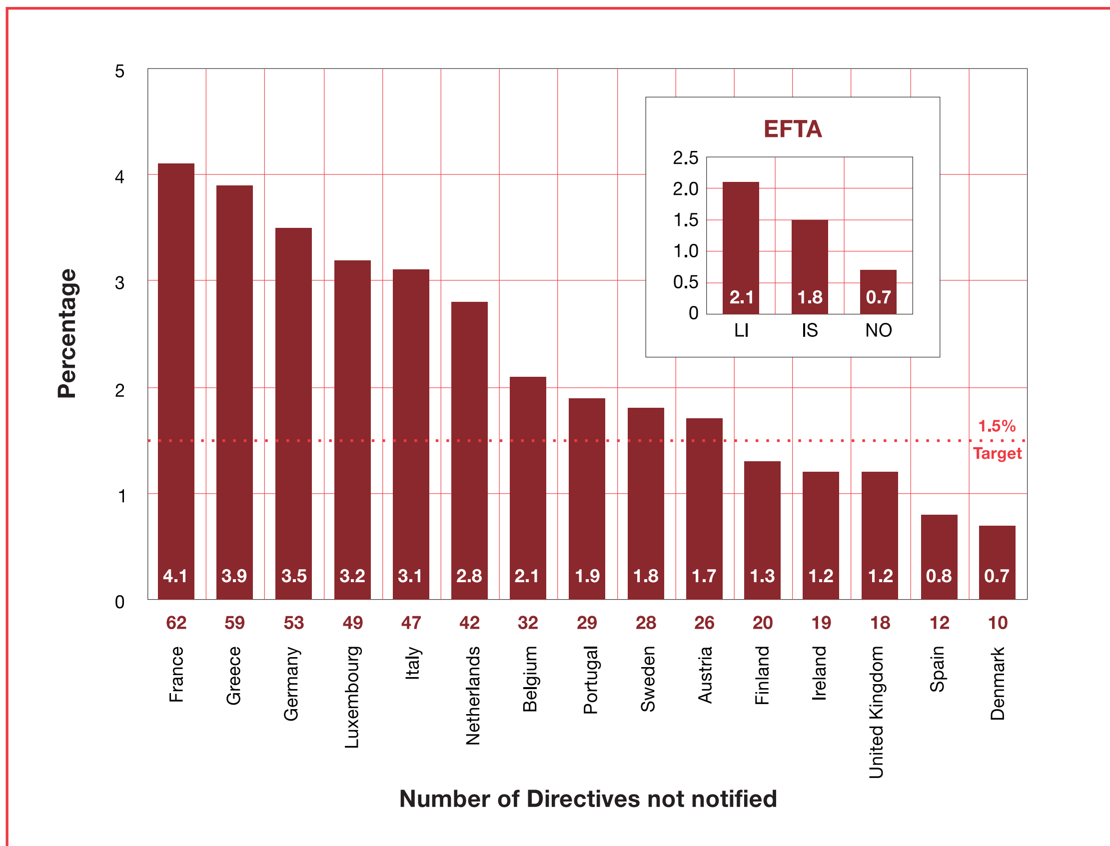
At the beginning of 2004, the Commission produced a report on the implementation of the three-year Internal Market Strategy agreed 12 months earlier. This annual exercise now forms part of the wider package of economic assessments the Commission makes alongside the Broad Economic Policy Guidelines and the Employment Guidelines.

The report noted that since the abolition of internal frontiers a decade ago, the Internal Market had boosted economic growth by at least 1.8%, adding nearly 900 billion euro to collective prosperity and helping to create 2.5 million extra jobs. It found that eight months after the Internal Market Strategy had been adopted over half of the measures due by the end of 2003 had been delivered on time. However, it stressed that greater attention had to be made to key legislative files such as the recognition of professional qualifications and noted that in many areas, notably services, the strategy had made hardly any impact at all.

In July, the Commission presented its annual Internal Market Scoreboard. This revealed a transposition deficit of 2.2%, meaning that as many as 134 Internal Market directives had not been turned into national law in all the Member States, although the deadline for doing so had passed.

## Figure 6

The founding members of the European Community, and Greece, are bottom of the league

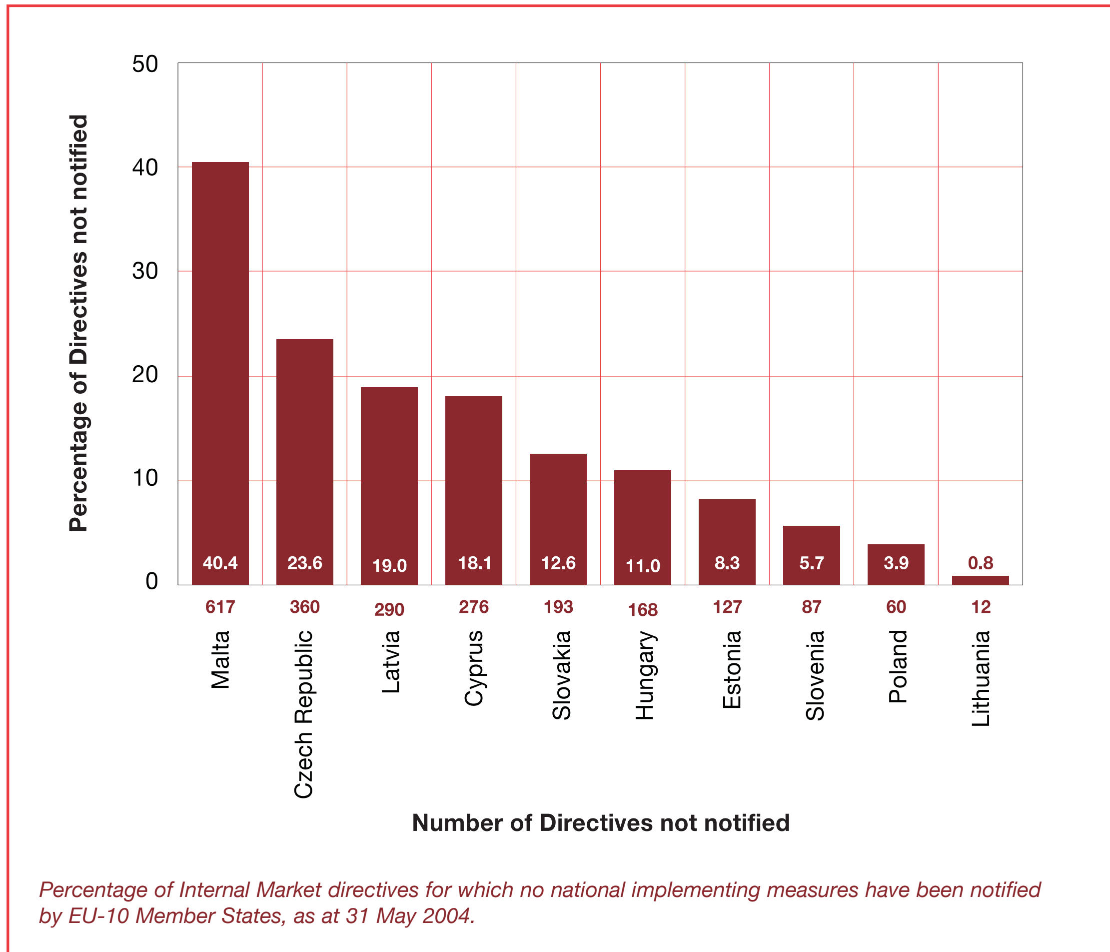



*Source: European Commission*

France has the worst record of the EU-15, followed by Greece, Germany, Italy and the three Benelux countries. In an early assessment of the state of play in the EU-10, the scoreboard, while emphasising that the figures were preliminary, noted that Lithuania and Slovenia had already notified national implementation laws for the vast majority of Internal Market directives. However, Malta, Slovakia and the Czech Republic still had much to do.

## Figure 7

Commission statistics show big disparities among EU-10 Member States in notifying national implementing laws



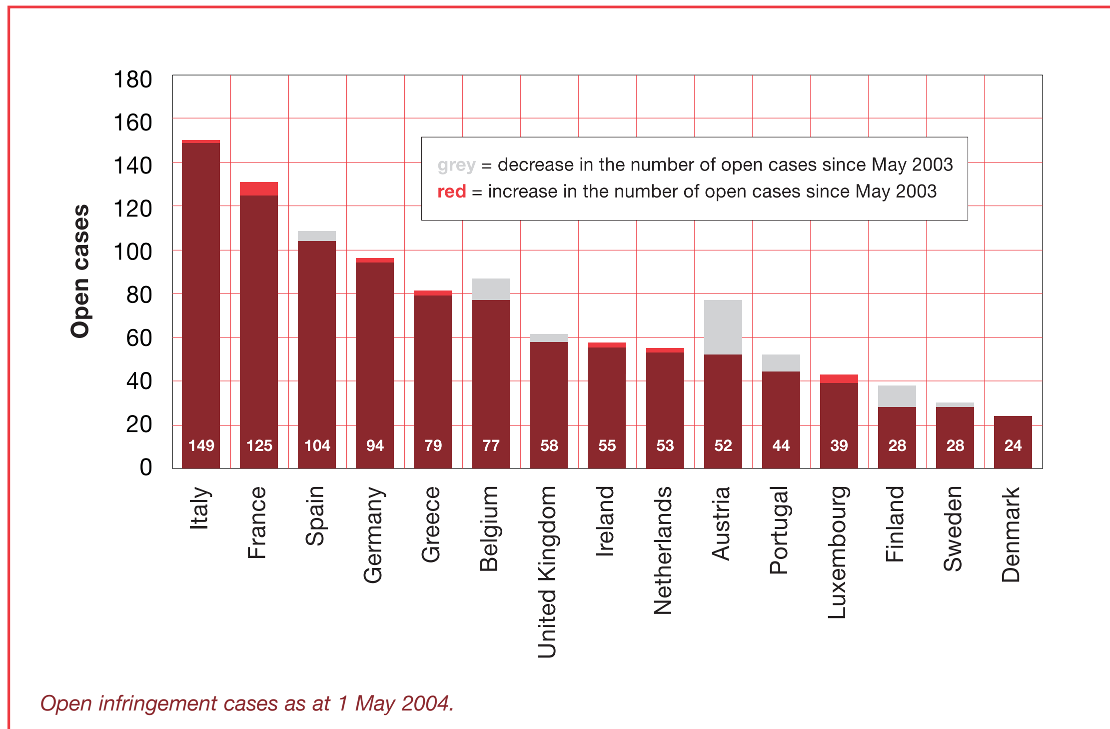

*Percentage of Internal Market directives for which no national implementing measures have been notified by EU-10 Member States, as at 31 May 2004.*

*Source: European Commission*

There are still as many infringement cases against Member States as a year ago, even though the Internal Market Strategy had called for a 50% reduction by 2006. The most are against Italy, with France in second place (see Figure 8). However, alternative ways of solving problems are having some success. Almost half of the infringements discussed in “package” meetings between the Commission and Member States were resolved. In addition, the SOLVIT network that helps businesses and citizens reached satisfactory conclusions within ten weeks in 75% of the cases it handled.

## Figure 8

Italy and France are by far the worst EU law-breakers




*Open infringement cases as at 1 May 2004.*

*Source: European Commission*

### Services Directive

One of the major items of single market legislation expected to be processed this year is the services directive. This aims to completely remove red tape and restrictions by 2010 for companies in the service sector looking to operate in another member state. The businesses covered by the proposal account for at least 50% of all economic activity in the EU and, once fully implemented, the Commission believes it will bring the biggest boost to the single market for over a decade.

The proposal not only aims to make it easier for businesses based in one member state to establish themselves in another, it is also intended to help service providers who wish to offer their expertise beyond national borders from their existing base. This second objective would be achieved by the country of origin principle whereby any provider operating legally in one EU country may market services in another without having to comply with further “host” state rules.

The scope of the legislation is unusually wide. It covers a host of professions: retailing, employment agencies, certification, laboratories, construction and architectural services, estate agencies, craft industries, travel agencies, tour operators, hotels, restaurants, entertainment, regulated professions, information technology-related services, advertising, car rental, security services, audiovisual and health care.

Because of the many diverse interests involved, negotiations in the Council of Ministers and the European Parliament are expected to be long and protracted. Already, there are strong moves from a number of member states, for instance, to exempt all health care activities from the directive.

## Financial Services Action Plan

In June, the Commission presented its latest progress report on the implementation of the Financial Services Action Plan (FSAP). This confirmed that 93% of the legislative measures it contained had been completed on schedule by the mid-2004 deadline. However, it stressed that it was too early to assess its impact since many of these had only just entered into force and others still needed to be written into national legislation.

Although the Commission is still conducting an extensive consultation exercise to determine what the next stage of the action plan should be, it is clear that this will involve considerably fewer new regulatory initiatives. Charlie McCreevy, the new Internal Market Commissioner, has announced he will not table a second FSAP and has highlighted three main challenges.

The first will be to ensure proper implementation and enforcement of existing legislation through close cooperation between Commission and national authorities to ensure EU law is correctly interpreted and applied.

Secondly, the Commission is looking to consolidate the internal market for financial services. This will involve initiatives on cross-border clearing and settlement and the establishment of an up-to-date prudential framework for European companies in the insurance sector. Attention is also being given to reform of the current single market framework for investment funds to increase its ability to provide more innovative, better tailored and lower cost products. Overall, greater focus than in the past will be given to the retail sector and to the development of an integrated EU retail banking market where customers can actively shop across borders for financial services.

The third challenge involves global cooperation between legislators and supervisors. This is already leading to a closer financial services regulatory dialogue between the EU and the US and the Commission is developing similar contacts with Japan, China and India.

## Corporate governance action plan

In October, the first ever high level corporate governance conference organised by an EU presidency took place in The Hague, just as the Commission was tabling measures under the action plan it had adopted a year earlier. Frits Bolkestein, the outgoing European Commissioner in charge of the internal market, taxation and customs, used the occasion to explain the Union’s involvement in this area. He stressed that it was not simply a response to high profile scandals. “It is due first and foremost to the fact that businesses which have sound corporate governance practices perform better and are valued more highly,” he said. He insisted that good corporate governance was “not an optional bolt-on”, but part of modern economics and business practice.

As part of this process, the Commission has set up a European Corporate Governance Forum. Its remit is not to work towards the drafting of an EU-wide code, but to examine the different national initiatives now taking place, determine where scope for convergence exists, help to raise overall standards and to provide advice to the Commission. It consists of 15 senior experts from various professional backgrounds (issuers, investors, academics, regulators and auditors). Appointed for three years, they will meet two to three times a year under the Commission’s chairmanship and produce an annual report.

Earlier, in September, the Commission launched a broad strategy based on a holistic approach covering financial services, justice and home affairs and tax policy to tackle financial and corporate malpractice. Key elements of the strategy are: enhanced transparency, improved traceability and better coordinated enforcement. It defines four lines of defence against corporate malpractice: internal control in the company (mainly through board members); independent auditors; supervision and oversight; and law enforcement.

Towards the end of the year, the Commission presented two non-binding recommendations designed to restore confidence in EU companies and financial markets. The first invites member states to adopt a series of measures on directors' remuneration. The second seeks to reinforce the presence and role of independent non-executive directors on listed companies' boards. In December, it also closed a public consultation on shareholders' rights in the general meetings of listed companies. The input this generated will help to shape the draft directive designing a framework to define intermediaries' obligations and investors' rights that it intends to table as part of the corporate governance action plan.

## Table 5

| Priorities as in the Corporate Governance Action Plan of May 2003 | Achievements during 2004 |
| --- | --- |
| Enhanced corporate governance disclosure requirements (including a possible corporate governance statement in annual reports) | Proposal adopted in October |
| Integrated legal framework to facilitate efficient shareholder communication and decision making (participation in meetings, exercise of voting rights, cross-border voting) | Proposal for directive expected end 2005 |
| Strengthening the role of independent non-executive and supervisory directive | Recommendation adopted in October |
| Fostering an appropriate disclosure regime for directors' remuneration | Recommendation adopted in October |
| Confirming at EU level the collective responsibility of board members for financial statements | Proposal for directive amending first and fourth company law directive expected in 2005 |
| Establishing a European forum to coordinate corporate governance initiatives of member states | Established in October 2004 |

*Source: Building the European Capital Market, PricewaterhouseCoopers*

### Modernising company law

Towards the end of October, the Commission, in line with the Company Law Action Plan it presented in 2003, proposed four key revisions to existing EU accounting legislation as part of moves to improve confidence in financial reporting by companies. It proposed that board members of limited companies should be collectively responsible to the company for the financial and other information they publish and that governments should apply appropriate sanctions if accounting rules are not complied with. Secondly, it would like to see the disclosure requirements which already apply to listed companies, on transactions with all related parties such as family members and company managers under International Accounting Standards, extended to unlisted companies.

The third amendment is designed to address Special Purpose Entities located offshore that are not captured in the balance sheet. The Commission is proposing that all companies should disclose all off-balance sheet arrangements, including their financial impact, in notes to the annual and consolidated accounts. Finally, it wants all listed EU companies to provide a corporate governance statement in their annual report.

### Outlook

Mr McCreevy has already given a clear indication of how he intends to approach his internal market portfolio. He has told MEPs that by the end of his five-year term, he wants to be able to say that the Commission has significantly simplified the regulatory environment for economic operators. To achieve that, he will concentrate on ensuring effective implementation of existing legislation, consulting widely before tabling legislative proposals, and ensuring these are targeted at areas where real gains may be made.

# 6 EU Budget

## Introduction

In February, the Commission presented its initial proposals for the multiannual financing of EU policies. Overall, the proposals foresee Union spending of €,025 billion for the seven-year period beginning in January 2007 when the current financial framework ends. The Commission believes the EU should concentrate its efforts on three main priorities: promoting sustainable development by completing the internal market, encouraging competitiveness and cohesion and protecting natural resources; giving meaning to the concept of European citizenship by developing the area of freedom, justice and security and ensuring basic access to public goods and services; and promoting a coherent role for Europe as a global partner.

## Greater focus

The new financial framework would reduce the number of separate policy headings in the annual EU budget from eight to five. It also aims to give the financing system more flexibility by making it easier to reallocate expenditure within, and between, different headings. The areas, with their proposed seven-year budgets, are:

| Area | Budget |
|---|---|
| Sustainable development<br>— competitiveness for growth and employment (single market, R&D, EU networks, education and training, social policy).<br>— cohesion for growth and employment (regional programmes) | € 133 billion<br><br>€ 345 billion |
| Sustainable management and protection of natural resources (agriculture, fisheries, environment) | € 417 billion |
| Citizenship, freedom, security and justice (common immigration and asylum policies, European Border Guard Corps, European Border Agency, justice cooperation, fight against crime) | € 19 billion |
| European Union as a global partner. This includes all foreign policy activities, pre-accession aid, the European Development Fund, emergency assistance, anti-poverty programmes and loan guarantees | € 96 billion |
| Administration | € 28.6 billion |

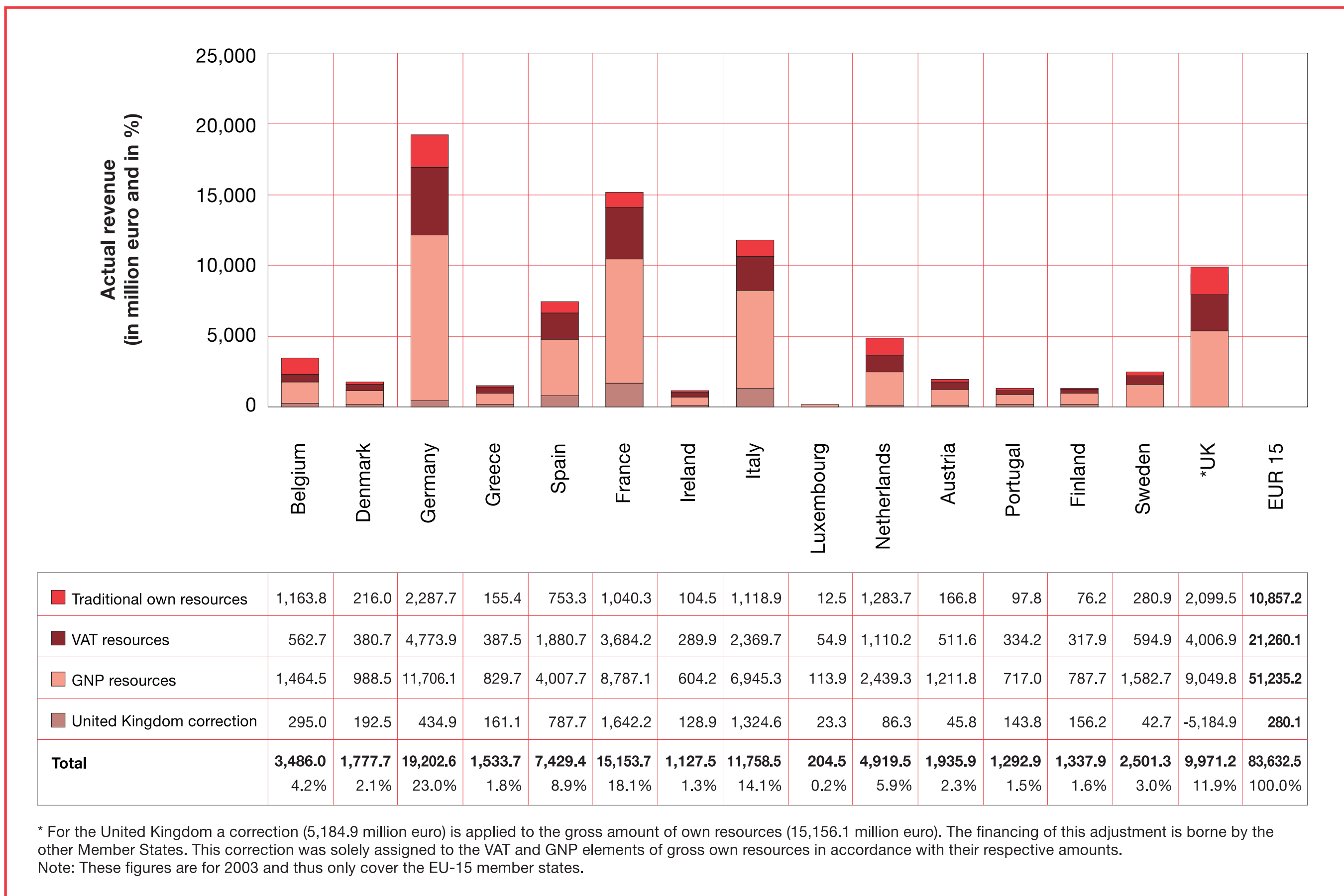
*Source: European Commission*

Member states are divided over the Commission's proposal to set an overall 1.24% of gross national income (GNI) ceiling for the budget. A hard core - the UK, Germany, France, Sweden, the Netherlands and Austria - is firmly opposed to the proposed increase. At a time of intense pressure on public funding, they want to limit EU spending to 1% of GNI. This, they say, would provide €15 billion for the EU over the seven-year period. However, their opponents, retort that 1% is a purely arbitrary spending limit which would reduce actual expenditure to €38 billion. The effect of the ceiling, they point out, would mean that spending in 2007 would be € billion lower than in the previous year. The political consequences, they add, would lead to cutbacks in several EU policies, ranging from trans-European transport networks to research.

One of the most politically sensitive issues to be addressed is the Commission's proposal to reform the budget rebate scheme agreed for the United Kingdom in 1984. In essence, it is proposing that this should be replaced by a more generalised correction mechanism whereby member states whose budgetary contributions are above an agreed threshold - determined by a percentage of gross national income - would receive a refund. The UK opposes the idea since it would mean a cut in the annual abatement of some € billion it receives annually from Brussels. In contrast, the idea appeals to net budgetary contributors such as the Netherlands, Sweden, Germany and Austria.

# Figure 9

## Own resources in 2003, by Member State




| | Belgium | Denmark | Germany | Greece | Spain | France | Ireland | Italy | Luxembourg | Netherlands | Austria | Portugal | Finland | Sweden | *UK | EUR 15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Traditional own resources | 1,163.8 | 216.0 | 2,287.7 | 155.4 | 753.3 | 1,040.3 | 104.5 | 1,118.9 | 12.5 | 1,283.7 | 166.8 | 97.8 | 76.2 | 280.9 | 2,099.5 | **10,857.2** |
| VAT resources | 562.7 | 380.7 | 4,773.9 | 387.5 | 1,880.7 | 3,684.2 | 289.9 | 2,369.7 | 54.9 | 1,110.2 | 511.6 | 334.2 | 317.9 | 594.9 | 4,006.9 | **21,260.1** |
| GNP resources | 1,464.5 | 988.5 | 11,706.1 | 829.7 | 4,007.7 | 8,787.1 | 604.2 | 6,945.3 | 113.9 | 2,439.3 | 1,211.8 | 717.0 | 787.7 | 1,582.7 | 9,049.8 | **51,235.2** |
| United Kingdom correction | 295.0 | 192.5 | 434.9 | 161.1 | 787.7 | 1,642.2 | 128.9 | 1,324.6 | 23.3 | 86.3 | 45.8 | 143.8 | 156.2 | 42.7 | -5,184.9 | **280.1** |
| **Total** | **3,486.0** 4.2% | **1,777.7** 2.1% | **19,202.6** 23.0% | **1,533.7** 1.8% | **7,429.4** 8.9% | **15,153.7** 18.1% | **1,127.5** 1.3% | **11,758.5** 14.1% | **204.5** 0.2% | **4,919.5** 5.9% | **1,935.9** 2.3% | **1,292.9** 1.5% | **1,337.9** 1.6% | **2,501.3** 3.0% | **9,971.2** 11.9% | **83,632.5** 100.0% |

* For the United Kingdom a correction (5,184.9 million euro) is applied to the gross amount of own resources (15,156.1 million euro). The financing of this adjustment is borne by the other Member States. This correction was solely assigned to the VAT and GNP elements of gross own resources in accordance with their respective amounts.
Note: These figures are for 2003 and thus only cover the EU-15 member states.

*Source: European Court of Auditors*

## Outlook

The package must be agreed by EU governments by the end of 2005, if it is to enter smoothly into force in January 2007. Given the prominent role the UK is playing in the negotiations, many participants would like the issue resolved before Britain takes over the rotating six-month EU presidency on 1 July. This places pressure for securing an agreement on Luxembourg which took over the presidency on 1 January. With the strong possibility of a British general election in the first half of the year - many are predicting a 5 May poll - that would offer a window of opportunity of just seven weeks to strike a deal.

| 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| 133,560 | 138,700 | 143,140 | 146,670 | 150,200 | 154,315 | 158,450 |

*NOTE: we have used commitment figures, rather than payments. But in the current political debate, both categories are being used.*

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