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Annette Bongardt
Francisco Torres

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Is the 'European Model' viable in a globalized world?[♣]

Annette Bongardt and Francisco Torres

Abstract

The issue of whether the 'European model' is viable in a globalized world raises the question as to what defines and conditions any European model and its competitiveness in the context of globalization and the new economy. For the sake of sustainability of its model but also to sustain support for globalization the European Union (EU) needs to take economic advantage of globalization and the knowledge-based economy. Challenges in a high-cost, high-productivity economy mean that there is a premium on dynamic efficiency gains from the liberalization and reform of markets and an economic and institutional framework that fosters innovation and flexible adjustment. The paper examines how the EU deals with governance issues and political economy factors from this perspective. The EU model, if able to legitimize itself with respect to the European integration process may as well contribute to a legitimate political governance of globalization.

JEL classification: F15, F13, F50.

Keywords: Globalization; Liberalization; European regulatory model and economic integration; Preferential trade; Global and European Governance; European Union; Single Market; Lisbon Agenda.

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1. Introduction

With globalization the viability of any 'European model' can be expected to depend on its competitiveness. What sets apart the contemporary globalized world is that governance issues have become prominent, with political economy factors making required adjustment in the international and domestic arenas much more complicated. By contrast, in an also globalized economy before the First World War, adjustment could simply be left to the market mechanism. Since wages and prices have become more rigid for both political (representative democracy) and economic (concentrated market structures, labour unions) reasons, political economy factors have to be taken into account and dealt with.[2] The difficulty to make globalization work both for given countries and in general thus might be expected to involve complex negotiations within and across countries and involves burden-sharing issues.

For the European Union (EU), globalization poses challenges that display both an internal and an external dimension, and which, one might argue, are brought together by the Lisbon Agenda.[3]

First, on the internal front, there is the need to create the conditions for the EU economy in terms of liberalization of markets and of adequate governance to perform and deliver (in particular growth and jobs) in a changed context. The need to take economic advantage of globalization led to the recognition of the necessity to undertake structural changes and a vast coordination effort which in turn has triggered an economic reform process in Europe.

Second, and with a view to the external dimension of globalization, there is a need for reform of the multilateral rules and institutions that govern the global economy. Global governance involves the kinds of issues and trade-offs that the EU is confronted with and has been addressing in its integration process. Given the EU institution-building experience, now ongoing under the heading of the Lisbon Agenda, and its economic weight, the EU could contribute to a reform agenda on global economic governance. In the international arena the EU could address a number of pressing issues such as trade, finance or the environment. With the exception of the environment, we still find a reluctant EU that is unwilling to exercise the kind of leadership that the United States (US) seems not prepared to take on at present on many issues of global governance.[4] Yet, with globalization many other countries face reform challenges akin to the EU. With regard to global governance it is relevant to consider whether we can learn any lessons from the EU in regard to institution-building and dealing with distributional issues.[5]

In this paper we consider how European economic integration conditions any European model (section 2) and contrast EU trade benefits from preferential liberalization with globalization (section 3). Section 4 addresses governance, political economy factors and trade. Section 5 examines globalization and the sustainability of

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[2] See Frieden (2006) on a comparison between the pre-First World War globalized economy and contemporary globalisation.

[3] The Lisbon Agenda is the toolbox by means of which the EU aims at transforming itself into the most competitive and dynamic knowledge-based economy by the year 2010 in the changed context of globalization and the new economy.

[4] See Ahearne et al. (2006) for a detailed discussion of the issue of a European Agenda for global governance.

[5] For a characterisation of the legitimacy-efficiency trade-off in modern societies with respect to EMU and other modes of governance in the EU see Torres (2002).

the 'EU model', namely in regard to innovation, services, and social model(s) and social risk management. Section 6 concludes.

2. European economic integration as the basis of any 'European model'

Let us first consider what may define an, if any, European model (not limited to social models, dealt with below). Any European model is conditioned by European economic integration dynamics and has come to be outlined at the European level by the Lisbon goals. Market integration is at the core of European integration. Being highly integrated not only economically but having a strong political dimension, the European Union 'club' [6] has been expanding in contrast to intergovernmental models of European economic integration such as EFTA. To make membership worthwhile the club needs to deliver benefits to its members. Those benefits are in the first place trade-related.

Independently of contextual changes like globalization and the knowledge economy, progress in the European Single market in conjunction with competition policy, Economic and Monetary Union (EMU) and the Lisbon Agenda are all potentially efficiency-enhancing and should thus be expected to contribute to the viability of any 'European model'. The Lisbon Strategy of 2000, later broadened to a European agenda, came to outline an economic and social strategy that, one might argue, goes towards defining something like a European model of society which strives to make compatible economic imperatives and social and environmental values.[7] It was motivated by international competitiveness concerns that arose against the changed background of globalization and a knowledge-based economy and aims to ensure enhanced and sustainable EU living standards. To make the single market deliver, structural problems that slow productivity and economic growth need to be solved and the conditions for the EU to successfully adapt its economy and functioning to those challenges need to be created. In European mixed and over-regulated economies liberalization faces an additional dimension to market opening. Its success ultimately hinges on whether the necessary coordination to implement policies with an EU rationale can be achieved as to realize the efficiency properties of the internal market when increased liberalization and market coordination are not sufficient to do so.

The implementation of the common Lisbon goals, i.e. of the competitiveness and economic growth objective while safeguarding the social and environmental dimensions, calls for coordination of policies at the EU and at the member state level with a view to interdependencies and policy-learning. EU market integration has triggered governance changes, such as the shift of certain matters from the intergovernmental pillars to the community pillar that facilitate the implementation of the single market (qualified majority voting instead of unanimity). Also, governance within the Lisbon Agenda is not static but has in fact moved on beyond the open method of coordination (OMC).[8]

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[6] Non-members have incentives to apply for membership when the expected benefits from so doing are larger than the associated cost. Similarly, the club may want to enlarge when a new member, at the margin, adds to its well-being. Economic analysis in terms of cost-benefit offers an important tool for application and enlargement decisions, although political reasons might be decisive in the end. Benefits may come from economies of scale and costs from increasing heterogeneity of preferences (see Alesina and Spolaore, 2003).

[7] For a discussion see also Bongardt and Torres (2005).

[8] Our thanks to Maria João Rodrigues for having called our attention to this point.

Interestingly, these internal aspects of the European model have already acquired a global dimension, to the extent that third countries believe that there are lessons to be learnt in particular with a view to horizontal coordination, institution-building and dealing with distributional issues.[9] At the same time, the role of the EU has come to be strengthened over time with a view to global economic governance. Despite not being formally a member of the World Trade Organisation (WTO) but only through its members, the EU became accepted *de facto* as an actor after the Maastricht Treaty (illustrated by the EU-US transatlantic dialogue). The Nice Treaty further strengthened the international role of the EU when extending the common commercial policy to intellectual property rights and most services. Yet, the completion of the single market and EMU brought about a different nature of conflict, arising from *behind* rather than *at* the border barriers (domestic regulation).

3. Benefits from trade: Preferential trade liberalization and globalization

Internal and external trade liberalization is central to past and future European well-being. Right from its inception the EU has professed a commitment to trade integration, with both internal and external liberalization being already enshrined in the Treaty of Rome. From the outset European economic integration is characterized both by market-orientation and ambition as far as preferential trade liberalization and the level of economic integration are concerned. The Treaty of Rome did not settle for a free trade area but aimed at higher levels of integration, that is, a common market with the free movement of goods, services and production factors plus the freedom of establishment and a customs union. For those objectives, in turn, some degree of coordination and sovereignty-sharing between member states are a prerequisite. European economic integration has since progressed to monetary union, with a much higher degree of policy coordination and political integration.

The attractiveness of Community membership owes much to its preferential trade liberalization, namely, to the advantages it confers on insiders through the large scale of its internal market and the abolition of non-tariff, frictional, barriers, and the common commercial policy. The Community preference translates into a disadvantage for outsiders. At different times in history, preferential trade integration has afforded the Community an advantage that made entry for third, in particular neighbouring, countries very attractive. In a first phase the trade-led model of integration allowed for scale economies in an enlarged (albeit incomplete) domestic market in goods protected by common external tariffs. In a second phase a regulation-based model of integration made possible the implementation of the internal market and shifted the root of advantage towards regulation-based integration. In an upcoming phase, one might argue, any advantage will be determined by dynamic efficiency, that is, how well the EU performs with respect to innovation and flexible adjustment.

Successful regulation-based integration is important given that as efficiency-enhancing external liberalization proceeds – through the World Trade Organisation (WTO) or preferential trade agreements – any discriminatory advantage due to tariff protection that EU members possess vis-à-vis outsiders is reduced. However, a well-functioning internal market can again translate into a cost advantage for member states,

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[9] The global dimension of the Lisbon Strategy has attracted increasing interest from other continents. The conference 'The Lisbon Strategy in a Knowledge Society without Borders', held in Lisbon on 1-2 March 2007, departed from that point.

based on efficiency gains associated with the abolition of frictional, invisible barriers to trade and the full liberalization not only of goods but also of services and production factors, and the creation of a dynamic advantage through capital accumulation and innovation.[10]

EU preferential market liberalization and globalization mutually reinforce cost pressures and the need for efficiency. The new economy is characterized by the importance attributed to knowledge as a production factor and to information and communications technologies (ICT). ICTs have the potential to raise the productivity of third sectors. Successful implantation of the knowledge economy also allows for weathering cost pressures through innovation. Reaping those benefits from a knowledge-based economy requires changes at the level of firms but also depends on whether the EU and its member states have been able to create an environment that is beneficial for the enhancement of a knowledge-based economy and for economic growth.

Therefore, for the realization of the expected benefits from the single market letting the market work is a necessary condition, as in so doing it facilitates a more efficient resource allocation and deployment. Yet, it is not sufficient by itself as it needs to be complemented by an economic and institutional framework that enables static and dynamic efficiency. This framework involves notably promoting adequate incentives, competition and the functioning of the market, encouraging innovation and facilitating restructuring, and improving the general capacity of adaptation and adjustment (for example through the mobility of production factors, labour qualifications and functioning capital markets).

Despite progress in the single market its potential efficiency properties are not fully exploited[11] and governance issues and political economy factors are important for explaining implementation difficulties (see Bongardt and Torres, 2007). While there has been significant progress in internal market liberalization, chiefly in product markets but also for instance with regard to the market-opening of some sectors prone to increase tradability and reduce trade costs (banking, telecommunications, transport and energy sectors), progress has been slower in some, important areas (services, financial markets, labour markets).

This asymmetry is reflected in the persistence of member state biases in regard to domestic consumption baskets of goods and services, domestic investment portfolios and low cross-border worker mobility. As a result intra-EU trade integration of member state economies is lower than what would be expected in an integrated economic area, notwithstanding the large importance of intra-EU trade in total EU trade (see Delgado, 2006, for an analysis). Externally, the EU is more open to international trade than, for example, the US. After declining between the mid-1990s and 2000, product market bias was found not to decrease any longer when the slow liberalization of services started to

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[10] If functioning badly it could however also lead to higher heterogeneity costs.

[11] Consider for instance the service sector which is still rather closed and segmented along national lines. This sector is characterized by national regulations despite its large importance for EU gross domestic product (GDP) and has not yet been liberalized substantially since the services directive shied away from dealing with the problem of national regulatory systems that limit competition. Another example is financial market integration; for instance, the take-over directive features clauses that do not implement an EU-wide market for corporate control with the same conditions in all member states. A final example of incomplete functioning of the single market is labour markets – most of labour market regulation, and thus reform, remains in hands of member states, even though some aspects of social policy (through the open method of coordination, in particular through 'benchmarking') has had some harmonizing effect on national labour market regulation.

over compensate trade in goods with the shift to a more service-based economy. The equity market displayed dynamics towards a substantial decrease of the home bias in the recent past (although those dynamics might reflect more the exchanges, which are becoming much more international, and national market home bias is still higher than what might be explained by information asymmetries), while labour markets integration is still in its infancy. What is more, the potentially efficiency-enhancing properties of the new economy should have, but did not increase, intra-EU trade by enabling a higher tradability of goods and services and the internationalization of production chains. The state and evolution of the home bias in product markets, financial markets and labour markets shed doubt on the realization of complementarities between reforms in those markets. Disequilibria in terms of market liberalization can be expected to negatively affect single market performance when there are synergies.

The EU is already confronted with new developments related to relocation and outsourcing that are motivated by competitive, cost pressures (Kroeger, in this volume) and which imply a further internationalization of the EU economy. The first one regards the relocation of production facilities within the internal market to new member states, to candidate countries or neighbouring countries, motivated by cost arbitrage (including primarily labour cost differentials, but also other factors such as taxation, social and environmental standards). The second one consists of the increased outsourcing of services, namely information technology (IT) related ones, to countries such as India or China in previously non-tradable sectors now opened up to global competition (and which imply competition not only at the level of low-skilled but also of high-skilled labour). At the same time an ever larger share of manufactured goods comes from developing countries such as China.

Mounting cost pressures in turn put a premium on innovation and flexible adjustment. Therefore, the sustainability and international competitiveness of the EU model ever more comes to depend on innovation and on its adjustment capacity for sustained growth. While doing away with integration asymmetries that persisted despite the single market programme and which impair tradability and aggravate trade costs is a necessary condition, it also requires fostering innovation and technological change and putting in place an adequate economic and institutional framework for innovation and growth. In other words, the sustainability of any EU model is conditioned by its adaptation and reform capacity and the Lisbon Agenda is the tool put forward by the European Union to achieve that.

4. Governance and political economy factors

For the EU, a functioning internal market holds the key to the challenges ahead (such as an ageing population, enlargements, or reforms). The failure to deliver satisfactory economic performance and/or an adequate (or perceived as such) social system within the setting of the information society and globalization imply political risks. Public opinion might turn against internal and external liberalization on the European single market and in the WTO, respectively, and resist necessary structural and institutional change or enlargement in the name of some European or national model. This lack of public support might eventually jeopardize the EU political integration project itself, as the Bolkestein services directive might have played an important role in the consideration of some of those that rejected the EU constitution in France and the Netherlands in the 2005 referendums.

Product, financial and labour market reforms are often interrelated.[12] If reform in one market exerts pressure for reforms in other markets (for instance financial integration tends to follow product market integration) this suggests that product and services market reform should continue as to trigger reforms in financial and labour markets. However, reform might also be resisted on precisely these grounds, as illustrated by the example of services liberalization that might have been seen as to imply subsequent labour market reform. Adequate coordination cannot be taken for granted.

Even though society as a whole stands to benefit from increased trade and liberalization that contribute to higher living standards, within society there are winners and losers. Whether and how those latter ones are to be compensated will not only be important for the political acceptability of reforms (issues of equity and distribution), but also raises the question of sustainability and of the efficiency (providing adequate incentives) of social systems.

Policies whose coordination is vital for the implementation of the Lisbon goals involve different governance levels (EU and member states) and coordination modes. Whereas a coordination mismatch between markets and reforms can be expected to affect performance negatively, it is a fact that the EU cannot act or that it needs the explicit consent of member states for reform in many policy areas relevant for innovation and growth. While progress in the European single market is mostly in the EU domain (although labour market reform is essentially in the national sphere), it is the necessary adaptation of national institutions and policies in particular which raise political economy issues.

According to the theory of fiscal federalism[13], policies should be centralized at the EU level when there are economies involved in pooling competences and when preferences are similar, whereas it should take place at the national (or sub-national) level when different preferences and circumstances dominate. Coordinated efforts make sense when there is interdependence between member states, such as in the case of synergies (for example spillovers in the case of research and development) or complementarities (such as in the liberalization and reform of product and labour markets), or when there is scope for policy-learning with a view to common goals (case of social systems). These criteria may justify EU involvement in the Lisbon process in many policy areas.[14] Political economy reasoning (that is, who gets what, when, why) suggests that changes at the Community level, subject to qualified majority voting, tend to go through more easily than changes at the national level, more liable to be held up and resisted by political economy forces. Resistance at the national level is aggravated by the joint impact of single market restructuring and globalization. National policy makers are more prone to give in to political economy arguments at the national level (although burden-sharing might be easier in smaller countries), while it is easier for

[12] See Blanchard and Giavazzi (2003) and Eijffinger (2007) for theoretical and empirical illustrations of a correlation between product market regulation and labour market regulation.

[13] See Baldwin and Wyplosz (2006: chap. 3).

[14] One should note that national distortions cannot always be taken for heterogeneous national preferences but may also reflect the difficulties of national governments to cope with and implement the common agreed goal of the single market for which preferences have already converged. For a discussion of these issues and of the notion of systems competition (which might imply a misleading notion of subsidiarity) versus single market implementation with EU involvement in many policy areas, see Bongardt and Torres (2007).

governments to circumvent special interest groups when there is qualified majority voting.

However, the competitiveness rationale has gained ground and EU market integration has already set in motion governance levels and modes.[15] Increasing market integration is having an impact on governance, leading to new coordination needs, making coordination requirements and mismatches more visible and their resolution more pressing in the light of competitiveness considerations.[16] The very discussions prompted by and facilitated within the context of the Lisbon Agenda have meant that, in practice, governance has moved on beyond the OMC and makes use of a range of instruments. Horizontal coordination in the Lisbon process has already led to more similar preferences and possibly circumstances. At the same time the process has led to issues being pulled to the European level and to the creation of institutions, it has resulted in the application of the normal legislative process, namely EU directives (leaving some room for manoeuvre at the national level) that are the result of discussions within the Lisbon process, or EU regulations (which are directly applicable to member states and do not have to be transposed into national law). The emerging consensus and move to flexicurity and the creation of the Globalization Adjustment Fund bear witness to the importance of dealing with political economy factors with a view to economic efficiency and for making globalization work for the EU.

Also note that global governance in the present setting involves the kinds of issues and trade-offs that the EU has been confronted with and has been addressing throughout decades of European integration: a diversity of preferences despite increased interdependence, an international distributional dimension and domestic political economy divides (Ahearne et al., 2006). Still, a successful possible role for the EU in the reform of global economic governance appears to hinge on prior successful internal governance reform.

5. Globalization and the sustainability of the 'EU model'

5.1 Innovation

It is the slowdown in European productivity growth from the mid-1990s onwards (in contrast to that of the US) and the link between productivity and growth that have given rise to the discussion of whether current productivity levels and living standards are sustainable in the medium term and which ultimately motivated the Lisbon Strategy in 2000.

The existing GDP per capita gap between the EU and the US might be ascribed to different preferences or to institutional failure. As stressed by Blanchard (2004), figures might give a distorted picture when used as the sole benchmark of well-being to the extent that lower GDP per capita in the EU also reflects different European societal preferences for more leisure (shorter working days, longer holidays). Moreover, it is a specific sector - retail - that importantly accounts for the productivity differential

[15] For instance, in the case of competition policy, industrial restructuring has led to more delegation to the EU level (merger regulation) but also the decentralised, parallel application by national competition authorities of EU competition law (see Bongardt, 2005).

[16] For a more detailed discussion on the issue of delivery of the Lisbon Strategy see Bongardt and Torres (2006).

between the US and Europe, also attributable to preferences of society for more urban, smaller-scale units of distribution rather than for large, out-of-town supermarkets. However, rather than a matter of preference it might reflect institutional failure, namely a lower employment rate due to a disincentive to work in the face of high tax rates. Yet, then the question arises whether resulting lower incomes would not also provide an incentive to work more (so that substitution and income effects might cancel out).

Various reasons have been put forward to justify the importance for the EU to grow faster –such as the sustainability of European varieties of the social model in the face of unfavourable demographics, the need to facilitate catching-up of the new and of future members, the fact that low growth makes the political task of reform more difficult, or indeed the EU's political influence negligible (Alesina and Giavazzi, 2006). The EU's capacity to grow hinges on its ability to innovate and adjust flexibly in order to take advantage of globalization.

The discussion within the context of the Lisbon Strategy became often focused on the relevance of ICTs for the productivity slowdown, and within this context on underinvestment in ICT production or on research and development (R&D) spending targets, rather than on an inadequate business environment for innovation that would hold down total factor productivity or on output efficiency of R&D investments. Yet, in a high-cost, high productivity economy innovation needs to be a pervasive phenomenon.[17]

On the one hand, innovation-based growth requires investment in R&D, with emphasis on output efficiency rather than merely input indicators. On the other hand, an adequate business environment is required to make the knowledge economy work. Such an environment promotes fast and decentralized innovation initiatives and features institutions that facilitate the mobility of labour between unprofitable businesses and competitive areas as well as capital mobility (including well-functioning markets for corporate control). The need to innovate against the background of globalization and the knowledge economy heightens the importance of functioning markets, adequate incentives and competition – internal and external – for single market performance. Accepting that the EU is close to the technological frontier and that growth in such an economy requires different capabilities and policies than those that have worked in the past in order to produce leading-edge innovations, requires on the one hand different policies, on the other hand openness to foreign competition and strong competition enforcement (Aghion, 2006). First, higher investment in R&D and tertiary education would be needed to allow for the upgrading and adaptation of capacities that might have served during a catching up or imitation phase (technological follower) but are not sufficient once the emphasis is on originality and technological breakthroughs. In this new setting R&D intensity would increase in all industries as firms' capability to innovate conditions their survival and growth. Second, a high degree of competition and the entry of foreign firms in the market are efficiency-enhancing and promote innovation and total factor productivity growth, respectively. Aghion argues that productivity gains in new innovative firms would be particularly important for growth, and that the EU could facilitate the entry and post-entry growth of firms by keeping barriers to entry low, with functioning financial markets being more important in practice than labour market rigidities.

[17] The December 2006 EU summit under the responsibility of the Finnish presidency endorsed a shift towards a broadened concept of innovation with the recognition of the importance not only of supply side factors but also of the interaction with demand.

The outsourcing of IT-related services (for instance to China or India) and integration of value chains made possible in the information economy should not be merely seen as posing cost pressures but also as a contribution to innovation. Cost savings are the driving force of outsourcing although they happen to be a lot less pronounced once other cost factors than merely wage differentials are taken into account, such as lower productivity, different working habits, search and transaction costs related to a new entity or higher risk (Kroeger, in this volume). However, the international integration of value chains also opens up economic opportunities linked to the availability of qualified workers (for example a large pool of IT graduates that Europe does not possess), an improved innovation capacity, the exploitation of market opportunities in dynamic foreign markets or labour market flexibility that benefits the firms as a whole. The fact that outsourcing may have costs from the point of view of a part of society (the outsourcing of low productivity jobs but also increasingly of higher qualified ones, putting potential downward pressures on wages) highlights the importance of dealing with distributional issues to make globalization and the new economy work.

5.2 Services

The current difficulties with implementation of service sector liberalization are related to political economy factors. Goods trade was high on the international and European agenda in the post-war period with, one might argue, political economy factors less powerful. At the time of the internal market programme goods trade was already well established, albeit with frictional barriers to trade, while the liberalization of services and of production factors (labour and capital) was lagging. Services liberalization faced issues of public ownership (for instance in the banking and insurance sector) and network externalities (for instance in telecommunication or electricity). Network industries were only included *a posteriori* in the internal market programme. The issue of a European energy market is only now being addressed. Also, issues might become more complex when considering not only tradable services but services provided by EU citizens in other member states.

To date, increased competition from developing countries in manufactured goods might be one of the most visible signs of globalization as yet in the EU, but increased competition in the service industry is bound to become an issue soon. Lessons might be learnt from services liberalization and related resistance in the labour market in Europe that illustrated how the lobbies and distributional issues can get in the way of market liberalization. These issues are bound to acquire an external dimension as well with IT service outsourcing to, in particular, India and China. Failure to liberalize might ultimately impede the EU to gain a regulation-based advantage in services.

The service sector lags behind the goods sector with respect to European market integration despite its potential for employment creation. Liberalization has been slow and the services sector in the EU is still segmented along national lines by national regulations with intra-EU trade in services being low and progress largely explained by technological advance. The lack of competition is problematic in the light of unrealized efficiency gains to raise productivity and the need for the single market to deliver, in particular since the weight of the services sector in the economy is so large (more than 60 per cent of EU GDP). Still, the Bolkestein services directive of 2005 that aimed to liberalize the sector was rejected and gave way to a watered-down compromise version that does away with the home country principle of regulation and thus with competition between national regulatory systems.

Deregulation in the internal market raises the question as to the regulatory model when pure market coordination is regarded as not sufficient. There are various styles of complex, country-specific domestic regulation in EU member states and different degrees of tightness of regulation (OECD, 2005) but those different regulatory systems contribute to the segmentation of the single market. However, national regulations that constitute invisible barriers to trade are incompatible with the common market and market integration and services liberalization already enshrined in the Rome Treaty. So the question is not whether but how regulation will take place in Europe (positive or negative integration), through European regulation, harmonized essential rules in conjunction with the mutual recognition of national regulation, or mutual recognition, or by simply letting the market work. Far from constituting a mere technical deregulation exercise the liberalization of services sector and more specifically the fate of the initial version of the services directive has illustrated that the choice of the regulatory model is highly political and that perceived complementarities between markets might become an impediment to reform.

In the light of different national circumstances and/or preferences and the difficulty to have European regulation on the one hand and the need to guarantee non-discrimination on the other, the initial services directive had initially embarked on the third option, mutual recognition of home country regulation for the provision of services in the internal market. Opposition to the directive was directed importantly against the home country principle which implies competition between national regulatory systems. The resistance owed much to political economy reasons, that is to powerful vested lobbies in (often relatively small but well protected) service sectors with high barriers who stood to lose most, such as liberal professions and public sector services and who managed to mobilize public support (see Sejeroe et al., 2005). The compromise version of the directive, adopted in December 2006 (and accepted by the European Parliament in February 2007) to be implemented within three years, abandons the home country principle and thus regulatory competition: member states preserve the right to fix general obligations applicable to the service providers on their territory. Yet, and despite (or because of) the limited scope of the services directive, things are moving in the service sector. With the free movement of services enshrined in the Rome Treaty, judgements by the European Court of Justice (ECJ) push liberalization (recently in healthcare and patient mobility), and there are moves within the European Parliament who had initially excluded healthcare from the directive to re-insert it.

In the case of mutual recognition of home country regulation an economic agent's competitiveness would have to an important degree depended not on own efforts, but on the – more or less – favourable regulatory framework provided by his/her home country. Thus, this form of mutual recognition proved not to be politically acceptable in the single market, as in that case a country's regulatory system would be part of its comparative advantage (or disadvantage). It is debatable whether adopting mutual recognition of home country regulation would have led to a race to the bottom or whether countries would have tried to compete via more efficient and better quality regulatory frameworks. In the event, the public discussion became focused on the defence of social models and public sentiment turned against the EU regulatory model, which could be witnessed in scepticism in France and the Netherlands against the European Constitution. There might be a risk of the same negative public sentiment to occur with respect to globalization once internationalization of services becomes more widespread.

In the EU, wide-ranging services liberalization failed due to political economy factors and given the link with between services liberalization and pressures towards labour market liberalization. Labour law (which protects insiders and may slow down restructuring unlike social protection that can facilitate adaptation by protecting against unemployment) does not fall under the adopted services directive.

5.3. Social model(s) and social risk management

Benchmarks indicate that member states differ not only in terms of their productivity and growth performance but also in terms of reforms. Yet, the specificity and path-dependency of national situations makes anything more than the emulation of principles rather difficult and complex. Therefore, one should expect pressures for change to be exerted by national discussions, fuelled by European benchmarks, and by competition between national systems in the market.

The Lisbon Strategy entails the recognition that social policy can be efficiency-enhancing and promote structural change and adjustment. The Treaty of Rome, by contrast, which was very ambitious with respect to economic integration, did not include any wording regarding harmonization of social policies. On the one hand, there were political difficulties to social harmonization due to different national circumstances and preferences. On the other hand, the economic logic that prevailed in the Treaty of Rome suggested that there was no need for national social policy harmonization since as general policies (as opposed to sectoral policies) they would not distort competition. Given wage and/or exchange rate flexibility, different social standards would trigger wage adjustments that would offset competitiveness effects (Baldwin and Wyplosz, 2006).

Together with increasing political and economic integration, notably EMU, the EU has also gained policy tools for social protection in addition to existing structural and cohesion policies, such as the European Employment Strategy and policies within the context of the Lisbon process. This strengthening of social protection occurs in a changed context – notably wage rigidities and a common currency / exchange rate stability – and globalization. In this setting a social system's capacity to adapt and promote restructuring and more efficient resource deployment has become important from a competitiveness perspective and for reaping the benefits of the single market. Also, it will be measured up against how well it solves distributional issues that arise due to necessary adjustment. The phenomenon of economic changes that have a bearing on the social sphere is referred to as social risk management. In contrast to the traditional concept of social protection, it endorses the notion that social protection can be managed as a productive factor with a view to welfare gains for society (Draxler, 2006).

The evolution of European varieties of the social model towards higher efficiency is an imperative for their future sustainability. Equity is a matter of preference of society but has also an impact on its adjustment capacity. It might facilitate or smoothen it by contributing to overcome resistance from powerful groups within society, to the extent that legal protection is limited to insiders and thus may slow down restructuring while social protection covers everybody against unemployment and might hence facilitate adaptation (note that labour law and social protection serve the same aim). Therefore, there might be some convergence or a common approach to social systems as they are conditioned by the very process of European integration (EU regulation and coordination) and that there are shared values, coupling social norms with economic requirements (Hemerijk, 2005; Begg and Berghman, 2002). Flexicurity and the creation of a Globalization Adjustment Fund seem to reflect the common search for augmenting Europe's adjustment capacity in the face of market liberalization and globalization while trying to overcome resistance rooted in political economy factors.

6. Concluding remarks

With globalization the viability of any European model depends more on its competitiveness in the international arena. It is conditioned in turn by whether the EU manages to do away with persisting market and reform asymmetries in product, service (including financial) and labour markets so as to realize the full potential of the internal market and is able to create an inducive economic and institutional framework for an economy based on innovation and flexible adjustment to produce growth. This transition however raises governance and political economy issues that need to be dealt with to make globalization work for the EU.

Globalization is making itself felt in the EU, aggravating cost pressures, notably through rising imports of manufactured goods from developing countries and the outsourcing of information-technology related services. There is thus a premium on innovation and adjustment to counter cost pressures. To make use of the benefits associated with a Schumpeterian creative destruction logic in a high-cost, high productivity economy such as the EU requires a functioning internal market (in particular to facilitate financial development) but also adequate policies to make possible and incentivate innovation (higher investment in R&D and tertiary education, competition policy enforcement and openness to foreign firm entry). The international integration of value chains should also be considered to offer opportunities for innovation.

Liberalization calls for adequate governance and for addressing political economy issues. This is true at an internal level with EU market integration (as illustrated by the services directive) but might soon gain an international dimension with increasing internationalization of goods and services trade. Given rigidities (for instance of wages) European social models are evolving towards a social risk management perspective that considers social protection from a productive factor perspective (flexicurity). Also, the establishment of a Globalization Adjustment Fund is motivated by the wish to promote adjustment as to take advantage of the economic opportunities from globalization and make compatible economic needs and social values.

While the Lisbon Agenda was developed for internal sustainability reasons of the European model in a globalized, knowledge-based society, there is also an external dimension to it. It is striking a cord with many outside countries, in particular concerning aspects related to horizontal / networked governance and distributional justice. Over recent years the EU has become a more important international actor. Contemporary global economic governance faces many issues and trade-offs that the EU has been confronted with in its integration process. Its success with resolving internal governance issues will condition its possibilities to play a role in the resolution of global economic governance issues and its capacity to shape globalization in the international arena. Differentiated national responses to globalization pressures, while possible, are unlikely to achieve what the EU could possibly do as a global actor. Given its economic weight in the world and its experience in managing internally different national preferences, domestic political economy and international distributive issues, the EU is potentially able to offer a model of society in the face of globalization.

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