OECD Reviews of Regulatory Reform

GERMANY

CONSOLIDATING ECONOMIC AND SOCIAL RENEWAL

OECD

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Germany

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

The OECD Review of Regulatory Reform in Germany *is one of a series of country reports carried out under the OECD's Regulatory Reform Programme, in response to the 1997 mandate by OECD Ministers.*

Since then, the OECD has assessed regulatory policies in 20 member countries. The reviews aim at assisting governments to improve regulatory quality – that is, to reform regulations to foster competition, innovation, economic growth and important social objectives. It draws on two important instruments: the 1995 Recommendation of the Council of the OECD on Improving the Quality of Government Regulation *and the 1997* OECD Report on Regulatory Reform.

The country reviews follow a multi-disciplinary approach and focus on the government's capacity to manage regulatory reform, on competition policy and enforcement, on market openness, and on the regulatory framework of specific sectors against the backdrop of the medium-term macroeconomic situation.

Taken as a whole, the reviews demonstrate that a well-structured and implemented programme of regulatory reform can make a significant contribution to better economic performance and enhanced social welfare. Economic growth, job creation, innovation, investment and new industries are boosted by effective regulatory reform, which also helps to bring lower prices and more choices for consumers. Comprehensive regulatory reforms produce results more quickly than piece-meal approaches; and they help countries to adjust more quickly and easily to changing circumstances and external shocks. At the same time, a balanced reform programme must take into account the social concerns. Adjustments in some sectors have been painful, but experience shows that the costs can be reduced if reform is accompanied by support measures, including active labour market policies.

While reducing and reforming regulations are key elements of a broad programme of regulatory reform, experience also shows that in a more competitive and efficient market, new regulations and institutions may be necessary to ensure compatibility of public and private objectives, especially in the areas of health, environment and consumer protection. Sustained and consistent political leadership is another essential element of successful reform, and a transparent and informed public dialogue on the benefits and costs of reform is necessary for building and maintaining broad public support.

The policy options presented in the reviews may pose challenges for each country. However, the in-depth nature of the reviews and the efforts made to consult with a wide range of stakeholders reflect the emphasis placed by the OECD on ensuring that the policy options presented are relevant and attainable within the specific context and policy priorities of the country.

Each review consists of two parts. Part I presents an overall assessment, set within the macroeconomic context, of regulatory achievements and challenges across a broad range of policy areas: the quality of the public sector, competition policy, market openness and key sectors such as electricity, gas and pharmacies, and telecommunications. Part II summarises the detailed and comprehensive background reviews prepared for each of these policy areas, and concludes with policy options for consideration which seek to identify areas for further work and policy development in the countries under review. The background reviews for Germany have been posted on the OECD Web site: www.oecd.org/regreform/backgroundreports.

Acknowledgements. *The horizontal Programme on Regulatory Reform is headed by the Deputy Secretary-General Richard Hecklinger. The country reviews are co-ordinated by the Public Governance and Territorial Development Directorate.*

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Executive Summary

Germany's large economy, an excellent performer for many decades, faces important challenges

Germany is the world's third largest economy after the US and Japan in terms of GDP, and as one of the top exporters of merchandise products, one of the world's most important trading nations. It has a high GDP per capita of some EUR 25 900. It is also the largest economy and most populous country in the EU, with 82.3 million inhabitants. Manufacturing industries with a strong export orientation remain the backbone of a diverse economy.

The German economy enjoyed excellent growth relative to most other OECD countries in the first three decades after the war. But in the second half of the 1990s, growth slowed sharply and more markedly than in several other European countries. Productivity growth increases at a slower rate, and employment growth is weak. The fiscal deficit, which has grown steadily, is now at 3.5% of GDP. However inflation is low and export performance remains strong (the trend in Germany's market share of world exports has been upward since 2000). Exports have traditionally fuelled German GDP growth and continue to do so.

Reunification, which has been a key factor affecting performance, was completely unprecedented in OECD countries

The burden and consequences of reunification are a major, perhaps even the most important factor affecting performance. It was extremely costly and remains a heavy burden on public finances. Though many of the achievements have been impressive, the process of economic convergence between the eastern and western States stalled in the second half of the 1990s. Growth in the eastern States remains at relatively low levels, a sizeable productivity gap persists, and unemployment is twice as high as in the western States. The gap continues to impose a large burden on the economy as a whole. The annual level of west to east budget transfers is around 4-5% of west German GDP and special aid is planned to continue until 2019. Reunification proved more complicated, costly and lengthy than first anticipated.

But other factors have also affected economic performance. The external environment has been difficult, which highlights Germany's potential vulnerability as a major exporter. Though export performance has been strong, this has been necessary to compensate for a weak domestic demand. Problems such as a poorly functioning labour market and an expanding welfare state antedated reunification. These developments are not unique to Germany, but the stress of reunification brought them to the fore. And reunification absorbed the government's attention away from the need for necessary regulatory reforms, which are only now being tackled. Until recently reforms have been focused on reducing bureaucracy and improving efficiency within the administration – important but relatively narrow goals – at the expense of deeper reforms.

Weak employment generation and high public spending are major issues, and the rapid ageing of the population will add further pressure

Weak employment generation, a major factor in reduced growth, is the result of many factors, including a sharper reduction in the working age population than in most other OECD countries, decreasing employment rates and a reduction in average working hours as well as rising labour taxes. Though labour productivity growth has risen faster in recent years than in other European countries (an average of 1.9% p.a. between 1995 and 2001), this was not enough to offset the adverse effect on GDP growth of a weak labour input. The quality and quantity of investment has been an issue holding back stronger productivity growth.

Germany has one of the higher shares of public spending as a percentage of GDP among OECD countries, at 45% well above the OECD average. Social spending accounts for over half the total, reflecting in part the traditional importance attached by Germany to values of solidarity which underpin its welfare system. Today's structural fiscal deficit is largely the result of this significant public expenditure, linked to the rise in unemployment and social security dependency. Public spending imposes a heavy burden of taxation and social charges, which discourages participation in the labour market and impedes investment. The government is implementing important tax reforms which should make a substantial difference when they are completed.

A rapidly ageing population will put further pressure on public spending. Germany faces a rapid rise in the proportion of elderly in the population over the next three decades, with the old age dependency ratio set to rise to 56% in 2040, in the absence of countervailing measures Germany faces one of the sharpest increases in public pension provision among OECD countries, as well as related health spending increases.

Germany's governance system has many strengths

Germany put in place a comprehensive governance and regulatory framework after the war, known as the social market economy. Broadly this aimed to promote freedom as a political objective, prosperity as an economic objective, and solidarity and fairness as a social objective. The emphasis was on consensus-building, co-operation, and negotiation as a means of pulling together for the common purpose. Recent reforms such as Agenda 2010 seek to promote the development of a new balance between solidarity and individual responsibility.

The legal State (*Rechtsstaat*) is a central element, articulated through a comprehensive codified legal architecture rooted in the Constitution (Basic Law). The competition law has a central place in the functioning of the economy. Germany makes a clear distinction between the State and the market, generally emphasises the private ownership of assets, and promotes efficient competition. Co-operation and negotiation occupy an important place alongside market forces, and the competition law protects relationships which help to promote desirable outcomes. Co-operative federalism is another key part of the landscape. The sixteen States each have their own Constitution and Parliament, administrative agencies and courts. The two chambers of parliament (one for the federal government, one for the States) reflect the close political relationship between these two levels of government. The States have a major role in law-making.

The system was designed to be complete and carefully balanced. The disciplined and comprehensive principles of the original social market economy governance system provided an effective institutional and regulatory setting which harnessed stakeholders to the task of rebuilding and wealth creation after the war. The legal State tradition promotes reliability. By emphasising specific and comprehensive regulations and the importance of the rule of law, Germany's public administration has earned wide recognition for its reliability, legality and honesty.

Competition law and policy: a considerable and enduring asset

Competition law and policy enjoy an especially clear, coherent and comprehensive legal framework, as well as the support of a respected competition authority. The independent institutional culture of this authority, the *Bundeskartellamt*, is a considerable asset. Legal transparency and certainty are key strengths. The competition rules and their objectives are clear: notably, the rules about horizontal cartels send a clear message about the importance of competition while permitting efficient co-operation. Germany's system of competition law is particularly strong and effective compared with many other OECD countries.

Market openness: strong policies to promote this

Another traditional strength is the approach to market openness. Perhaps not surprisingly policies to promote an international trading environment are robust. Germany's policy of non-discrimination in the international context is anchored in its membership of the WTO and the EU. Important steps have been taken to streamline customs procedures, which can be a significant cost to business and attract growing attention, now that tariff barriers in OECD countries are low or non-existent. National standards are another potentially significant cost of operating in different markets, and the German standards body (DIN) is a key player in the international context. However efforts to assess the impact of regulations do not explicitly consider trade and investment issues, and because the complexity of German rules is not easy for foreigners to master, they may be unintentionally excluded from the consultation process and other regulatory mechanisms.

Some important regulatory reforms have taken place in recent years

The solid and time-proven foundations of the current regulatory framework have tended to limit the scope for, and interest in, extensive reforms, at least until recently. Importantly, there have been a number of initiatives in recent years, some more successful than others. The German government, conscious of the economic challenges, has launched a number of deeper and necessary reforms. These include labour market and pension reforms, and the launch of "*Agenda 2010*" which covers a wide range of issues from benefit and health reforms to support for new SMEs.

Tackling bureaucracy and administrative simplification: a key focus

Recent years have seen a succession of initiatives to improve administrative efficiency and reduce bureaucracy though these have overall met with only partial success. These initiatives are also part of the sustained efforts to support the *Mittelstand*, Germany's established family-owned medium-sized companies. Modernisation of the public sector was taken forward under the banner of the *New Steering Model*, which sought to introduce private sector management principles, though this initiative encountered serious difficulties. The *Lean State* programme aimed to reduce the number of tasks performed by the State and to reduce bureaucracy. The *Modern State – Modern Administration* programme aimed to promote a new conception of the State as an "enabling State", emphasising improved regulatory quality and efficiency, including across the different levels of government. The latest initiative – the *Initiative to Reduce Bureaucracy* – is a further, broad and ambitious initiative to reduce bureaucracy, help SMEs, consolidate public budgets, modernise the federal administration and support growth and employment.

Important elements of a coherent regulatory quality policy have also been developed. They have built up over time, starting with the *Joint Rules of Procedure of the Federal Ministries*, first established in 1958, which set out the steps for preparing policy proposals. Recent revisions strengthen the requirements on ministries to explain the main regulatory impacts of draft laws and regulations. Work is now being carried out to develop the Regulatory Impact Analysis (RIA) framework, but the process of turning the proposals into practical reality is taking time. Although there is no single central unit responsible for regulatory quality, there are a number of regulatory units in the federal government.

Labour market reforms: important and much-needed recent initiatives

Germany has taken a number of recent initiatives to promote employment and get the unemployed back to work. The *Job-AQTIV* Act (Activation, Qualification, Training, Investment, Placement) which came into force in 2002, promotes a range of measures to improve the efficiency of labour market policies and encourage the unemployed into activity. The government has also said that it will act on the proposals of the *Hartz* Commission. Its wide-ranging recommendations focus on the reorganisation of labour offices, putting responsibilities on the unemployed, temporary work agencies, employment of disadvantaged groups, older unemployed, self-employment, and job creation in SMEs.

Pension reform: the foundations for a multi-pillar system have been laid

After a series of partial reforms to the public pension system in the 1990s, reforms in 2001 created the foundations for a multi-pillar pension system. These foundations need to be strengthened (for example a review of the statutory retirement age) with some urgency given the time it takes to phase in new arrangements. Reforms so far include changes to the pay-as-you-go scheme and the phase-out of early retirement programmes.

Network industries: rapid liberalisation of some key sectors

Like other countries in the OECD, Germany has been pursuing policies of liberalisation. It has implemented a distinctive and radical approach in the electricity and gas sectors with a full market opening (*i.e.*, giving all consumers, not just the larger ones, the right to choose a supplier) ahead of most other OECD countries and beyond the requirements of the EU directives. The full market opening of the electricity and gas sectors has been carried out on the basis of a negotiated system of access to the grid entrusted to private associations covering these markets, under the supervision of the competition authorities. This is an unusual approach, marked by the absence of a specific regulator with *ex ante* powers.

Telecommunications liberalisation has also progressed significantly (with a more usual *ex ante* regulatory system) and the sector shows some good results. Germany has in place today a high quality, technologically advanced telecommunications infrastructure with high penetration rates for both fixed lines and wireless. Market entry is relatively easy, and local operators are providing some effective competition to the incumbent in a large number of German cities. Germany has one of the largest number of Internet users, and the Internet market is growing rapidly. However, in a sector characterised by change, rules for competition may need to be reassessed frequently.

Further reforms have a major contribution to make, improving economic prospects

Regulatory reform can make an important contribution to three issues of particular importance in achieving stronger growth. First, impediments to increased employment need to be reduced. Second, productivity needs to grow faster. Third, the fiscal deficit needs to be reduced or eliminated.

Labour markets: recent reforms are a major step forward but more is needed

Among the further measures needed (which are set out in the OECD's 2003 *Economic Survey of Germany*) are policy initiatives to support more differentiated collective bargaining outcomes. Though it has positive elements, collective wage bargaining remains a generally inflexible system which does not easily take account of productivity differences between sectors and between different parts of the country.

Product markets: exposure to greater competition should strengthen important sectors

Germany traditionally promotes rules that favour SMEs, the aims being to maintain quality for the consumer and protect the *Mittelstand* against the encroachment of larger firms. The competition law thus pays special attention to protecting smaller firms against dominance in a bargaining relationship. To this end the law controls certain types of behaviour by dominant firms, and also permits SMEs to co-operate under certain conditions. Some sectors are still heavily regulated: the retail trade, craft services and professional services and pharmacies,

though important changes are currently in progress in all these sectors. The retail trade is traditionally highly regulated relative to much of Europe, with opening hours that are still rather restricted. These rules are now being relaxed. Entry into the highly sheltered crafts sector is also difficult and costly. There are plans to limit the number of trades requiring a master's certificate. Ownership restrictions on pharmacies and a prohibition of mail order trade in pharmaceuticals are being addressed with the current health sector reforms.

Another SME support mechanism is through the public procurement rules, which seek to encourage bids from SMEs by splitting up procurement contracts to make bidding easier. But this may also reduce the scope for foreign firms to know of opportunities, as bids below a certain threshold do not have to be published at the EU level. The legal framework for procurement is also extremely complex.

To avoid the loss of competitiveness by the *Mittlestand*, there is a balance to be maintained between the traditional concern to maintain quality for the consumer and protect against the encroachment of larger firms on the one hand, and anti-protectionist measures on the other, which can foster innovation. The German government appears to recognise this through its recent initiatives.

Network industries: substantial further progress is needed for effective liberalisation

Though Germany has been well ahead of most other OECD countries in market opening of important sectors, the development of effective and sustained competition is still work-in-progress, not least because of certain weaknesses in the regulatory regimes underpinning liberalisation, and judicial appeals which slow decision-making on network access.

The use of the courts to challenge regulatory decisions in the network industries is widespread, leading to lengthy court appeals and delays in implementing regulatory decisions. This needs urgent attention. Regulatory decisions in telecommunications have been especially vulnerable, with the incumbent (DTAG) appealing against important regulatory decisions on leased lines, Internet access and line sharing. Judicial review is important, but should not become a mechanism to routinely block or delay the application of sound regulatory decisions.

A stronger policy framework for network sector regulators needs to be developed. Germany has experimented in the past few years with different paths for the oversight of these sectors: a regulator for telecommunications, none for electricity and gas. Neither approach has been wholly successful. Implementation of the 2003 EU directives on gas and electricity involve establishing a regulator. The government is currently making plans for the telecommunications regulator (RegTP) to add electricity and gas to its responsibilities from July 2004. In moving forward with an *ex post* approach Germany will doubtless want to consider lessons from experience so far, and review issues such as regulatory powers, staff competences, and independence.

The electricity and gas sectors need stronger structural reforms as well as a regulator. Market concentration in electricity has become an issue, intense merger activity since liberalisation having led to vertical as well as horizontal consolidation. There is evidence of problems with market power among the four major utilities. Electricity prices have risen (after falling sharply post-liberalisation) though this is partly due to environmental taxation. In the gas sector, *Ruhrgas* remains the dominant company, and gas prices are high

compared with other OECD countries. A basic problem is discriminatory behaviour facilitated by these industries' structure, with significant scope for cross-subsidisation of activities. Effective accounting separation is essential, at the least.

Despite important achievements in telecommunications, competition remains fragile. DTAG, which has not yet been fully privatised, is regaining lost market share and consolidating its lead in important new markets such as DSL broadband services. It has successfully challenged the regulator's authority on key issues such as pricing and leased lines provisioning. The new telecommunications law should be helpful in clarifying the regulator's powers, among other issues.

Other network industries need a stronger approach both to liberalisation and regulation, in order to secure effective competition. The postal sector is moving slowly towards competition, with the government choosing to stay with the EU's modest liberalisation schedule. Competitive neutrality between the incumbent and competitors in liberalised services is not yet assured. There has been some progress in introducing an appropriate regulatory framework in the rail sector, including the imposition by the competition authority of a non-discriminatory route pricing structure. Further developments are in prospect including separation of the track from train operation in line with EU requirements. The government should strengthen the regulatory powers of the Federal Railways Office.

Competition law and policy: a need to refocus more clearly on some of its original aims

The right balance needs to be restored between the promotion of competition and support of market relationships. The competition law's motivating ideas have become diffuse and in some respects have weakened over time through legislative fine-tuning of the rules and the special interest character of some of the changes (such as quality for the consumer). A key goal of the law is to protect market relationships and structures where these are expected to contribute to an efficient market outcome and Germany may want to consider whether this is still working effectively.

As an agent of effective change in liberalising network sectors, the competition system faces difficulties. Competition law enforcement (with the BkartA) and policy (with the ministry) are not strongly linked in practice which may affect how well they manage the development of competition in these sectors. The BKartA's enforcement tools are not well suited for applying competition law and for promoting competition in infrastructure sectors where competitive markets have not yet taken root. The normal *ex post* process for tackling misconduct is ineffective. The government now recognises this problem.

Public expenditure management: a pressing need for reforms to contain costs and improve efficiency

Fiscal consolidation is now a priority. Weak economic growth has increased the deficit, but the problem is also structural and longstanding. Spending pressures can be expected to persist with the continuing burden associated with reunification, and population ageing. The government has already taken a number of measures, including the 2002 domestic Stability Pact which should help impose stronger fiscal discipline across the different levels of government. Nevertheless, several areas need further attention.

Public expenditure needs more cost-efficient management. The same outputs can be achieved with less funding, which can reduce the government's financial needs and hence the tax burden (the high spending health sector is a potential candidate). Or the same funding can be put to more effective use, for example by improving the quality of public services (the education sector is a potential candidate). Some measures have been taken, including the introduction of modern resource accounting. The evaluation of public expenditure is another important target for reform. The federal court of auditors as well as the State courts have pointed to inadequate evaluation of the effectiveness of public sector spending. Both *ex ante* and *ex post* evaluations are needed, which can help to identify the costs and benefits of alternative projects.

Some reflection can be given to the federal-State fiscal relationship. The current arrangements work against containing costs and demand. Complex institutional arrangements are in place to promote inter-governmental co-operation and revenue-sharing, with the aim of creating broadly equivalent living conditions across the federation. These involve both vertical transfers from the federal government to the States and from the States to the communities, and horizontal transfers between the States. Co-financing is probably the most important issue. Efficiency and cost control of co-financed projects is impaired by the fact that the States and communities may opt for spending projects so long as the perceived benefits exceed their own partial budgetary costs. So an effective cost-benefit analysis cannot take place because the total costs of a project cannot be taken into account. Project control is also difficult.

Important areas of public expenditure need attention. Health expenditure reforms should be developed further to improve efficiency. Within the OECD Germany has a relatively high spending to GDP ratio, but various indicators of health outcomes are average, suggesting scope for efficiency improvements. The education system is also costly, and comprehensive reforms are needed to improve outcomes. Germany spends more than most other OECD countries on secondary education but student performance was found to be poor in the recent international PISA study.

Regulatory governance: promoting a more dynamic framework

The enduring strength and completeness of Germany's post-war governance framework has masked the need for it to adapt. It is also very difficult to make changes to a system which works on the basis of a carefully crafted, coherent and balanced set of components. Germany's regulatory functions are an integral part of a much wider governance approach which supports a set of core societal values. The challenge is to preserve what is excellent in the German regulatory system while accommodating the development of a more dynamic regulatory environment. A number of initiatives in recent years appear to have had difficulty making headway. Specific reforms to promote stronger growth will benefit from a more adaptable regulatory framework.

A more efficient process needs to be developed for regulatory decision-making. Organised interest groups take part consensus-driven decision-making. Over time this has led to a situation in which many players at different levels of the system – from organised labour to the parliamentary chamber representing the States – can block or stall progress in taking a decision. Urgent reforms are caught up in this process. Some other OECD countries with similar traditions put the development of major legislation in the hands of official government-appointed preparatory committees.

Transparency and accessibility in rule-making are an issue and outsiders are – unintentionally – disadvantaged. There are no government-wide obligations on ministers on how to conduct public consultations. One consequence is that draft regulations are not made available systematically for public consultation. The established, somewhat informal networks of stakeholders involved in consultation makes it hard for outsiders to have an influence. Some other OECD countries have adopted a "notice and comment" process to minimise the risk of such exclusion.

The evaluation of rules is weak. Costs and benefits are not systematically assessed and are often unclear. The law-driven culture means that there is only limited use of evaluation and quantitative, evidence-based assessments to help regulatory decision-making. Whole regulatory frameworks and high level regulatory decisions, not just specific rules, would benefit. Germany does in fact have an evaluation system but it has major shortcomings, including procedures which are not carried out due to lack of operational guidance and lack of expertise to guide ministries, and the absence of monitoring and sanctions for non-compliance. Closing a significant implementation gap between available tools and practice would enable regulatory policy to provide full and effective support to decision-making. The legal culture of the *Rechsstaat* tradition does not nurture an economic perspective on issues or a full appreciation of the importance of evaluation. The emphasis on administrative rather than economic reforms in the past underlines this.

The regulatory system needs streamlining. At present it is complex, likely to promote costly regulatory outcomes, and generates a growing number of federal regulations, often expressed in complex legal terms. Most federal rules are addressed to the States for implementation as they see fit. Implementation of most rules therefore varies from State to State. A tradition of steep hierarchies with narrow responsibilities in the administration promotes specialised approaches to regulation and there are signs that specific procedures are proliferating, adding to an already complex regulatory environment. The tax system is probably the most complex in Europe.

Self regulation is an important regulatory option and part of the German tradition. A checklist exists to identify opportunities for self-regulation. Caution is needed, however, in its application to important sectors. Recent research commissioned by the federal government notes the advantages of this approach when the risks for the public are low.

Last but not least, a central regulatory quality system would help to drive forward a dynamic policy for high quality regulation. Existing arrangements could be developed in this direction, including closer working arrangements to promote an organised approach and to avoid fragmentation, the development of analytical expertise, and the implementation of a broader range of regulatory quality standards. Many other OECD countries have now set up central units.

The political economy of reform: strengthening the role of marginal stakeholders

Managing the process of reform and encouraging support for it is a challenge for all countries. In Germany's case the challenge is sharpened by the fact that current stakeholders in the decision-making process are both longstanding and have interlocking interests. The involvement of new and currently marginal stakeholders would be helpful. New firms, foreigners and consumers could be involved more. A review of

current overlapping regulatory structures (notably, the mixed State-federal financing arrangements) would also help. A central regulatory unit could help mitigate overlap and encourage the adoption of general rules, reducing complexity. Reform results should be monitored and the public should be kept informed. Communicating the benefits of reform needs to address the legitimate concerns of stakeholders.

Conclusions

The governance and regulatory framework has a number of strengths and seeks to maintain a careful and necessary balance between different stakeholders and levels of government, and to promote solidarity across the federation. These goals remain important to Germany's well-being. But the system was not designed to accommodate or promote change easily. Though the commitment, attention and resources to reunification was praiseworthy, valuable time has been lost in developing new approaches to regulatory policy and to launching complementary specific economic reforms.

The German government has shown, however, through recent actions, that it is keenly aware of the need to make up for lost time. A more rounded view of the regulatory governance system itself would help ensure that these reforms are timely, efficient and effective, whether these are reforms to labour markets, network industries, or to promote SMEs. The government therefore needs to continue not just with a determined pursuit of specific reforms, but also with adjustments to regulatory governance traditions so that necessary change can take place more quickly, at least cost to the economy, and with the participation of all relevant stakeholders. Perhaps the most difficult operational challenge is to generate an engine of reform which will deliver these changes. It is too early to judge how far Agenda 2010 and the reforms of federalist structures which are currently under consideration will be able to meet the challenge. Germany also, and not least, needs to pay careful attention to the communication of the objectives and benefits of reform – and of the risks and costs of doing nothing – so that momentum and public support can be sustained.

PART I

Regulatory Reform in Germany

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Consolidating Economic and Social Renewal

PART I

Chapter 1

Performance and Appraisal

Introduction

Germany is the world's third largest economy after the US and Japan in terms of GDP, and as one of the top exporters of merchandise products, one of the world's most important trading nations. It has a high GDP per capita income of some EUR 25 900 and enjoys high standards of social welfare. It is also the largest economy and most populous country in the EU, with 82.3 million inhabitants. Re-unification has boosted Germany's strategically central location in Europe, which promotes especially strong east-west ties with other European countries. Manufacturing industries with a strong export orientation (including automobiles, chemicals, machinery, shipbuilding, electrical engineering, and household equipment) remain the backbone of a diverse economy. The services sector has overtaken manufacturing, but is still mainly focused on domestic markets. A distinctive feature of Germany's industrial structure is the important place taken by established family-owned medium-sized companies, the *Mittelstand*.

As with other OECD countries, Germany can lay claim to its own distinctive approach to governance. This has grown out of the concept known as the social market economy, which was developed after the war to rebuild society as well as the economy, though some of its roots go back much further in German economic and political thought (Box 1.1).

Box 1.1. **Germany: key features of the governance and regulatory framework**

Historical background

After the Second World War, Germany put in place a comprehensive governance framework for managing the country's social, political and economic development, known as the social market economy. The country wanted to avoid the mistakes of the pre-war period. Very broadly it aimed to promote freedom as a political objective, prosperity as an economic objective, and solidarity and fairness as a social objective. These objectives and the means of attaining them were seen as organically linked. In pursuit of them, careful balances need to be struck: between co-operation and competition, between fairness and efficiency, and between the role of the State and the role of the market. All elements of the economy, politics and society (especially employers, employees, and the government at all its levels) were called on to be stakeholders in the process and to share responsibility for achieving the objectives. This led to an emphasis on consensus-building, co-operation, and negotiation as a practical means of pulling together for the common purpose.

The legal State

The "legal State" (*Rechtsstaat*) is a central element of the framework, articulated through a comprehensive codified legal architecture rooted in the Basic Law (the Constitution). The importance of the system of law is revealed by the culture of policy making and policy implementation, in which lawyers play an unusually prominent role both in the government and in the private sector.

Box 1.1. **Germany: key features of the governance and regulatory framework** *(cont.)*

The competition law and policy

A core element of the legal architecture is the competition law, which has a central place in the functioning of the economy. Some OECD countries have historically given the State an important role in the ownership and management of economic assets, and may question the extent of the role which competition should play in ordering economic behaviour. By contrast, Germany historically makes a clear distinction between the State and the market, generally emphasises the private ownership of economic assets, and promotes efficient competition (that is, market conditions under which no firm has the power to coerce others) between private companies as the key to a well-functioning economy. Companies should be held to social as well as economic account: they are responsible to stakeholders in the community, and private economic power must function fairly.

Reflecting and underpinning these relationships, competition law sets the legal framework within which entreprises must operate. In doing so it defines the important place occupied by co-operation and negotiation as an adjunct to market forces (the feature that is less prominent in the political economy of countries which rely primarily on market forces for the allocation of resources). The competition law protects relationships which help to promote desirable outcomes, and rules to promote competition are moderated by rules to accommodate efficient co-operation.

The external dimension of competition

Competition has an external as well as an internal dimension: strengthening the German economy so that it can be competitive in international trade, and promoting open international markets in which competition can take place. An important part of the post-war vision has been to sustain and develop Germany as a major trading nation.

Co-operative federalism

Germany has been a federal State from the start. Co-operative federalism is a key part of the governance system embedded in the Basic Law. Its objectives are to support a well-functioning democracy, to ensure a harmonious political balance, and to promote broadly equivalent living standards across the federation. Powers and tasks are carefully allocated between the federal (*Bund*), State (*Land*) and community (*Gemeinde*) levels of government.

The sixteen *Länder* each have their own Constitution and Parliament, administrative agencies and courts. The Basic Law assigns the federal government responsibility for matters considered to be relevant to the country as a whole, and the *Länder* are responsible for all other issues, where they are not explicitly assigned to the federal government. In particular, they are responsible for education and health. They also have significant administrative responsibilities, notably income tax collection. However in practice responsibilities are not always clear, and overlap: for example all three layers of government are involved in health care.

The two chambers of parliament reflect the close political relationship between the federal government and the *Länder*. The first chamber (*Bundestag*) represents the federal level, and the second chamber (*Bundesrat*) represents the *Länder*. The *Länder* have a major role in law-making at the federal level. The *Bundesrat* has the right to reject draft *Bundestag* legislation, or propose amendments to it, including the annual federal budget. About three-quarters of all federal statutes are addressed directly to the *Länder* and local governments. This drives a highly consensus-driven federal policy-making process, in

Box 1.1. **Germany: key features of the governance and regulatory framework** *(cont.)*

which the *Länder* seek to influence draft legislation rather than have to reject it formally at a later stage in the *Bundesrat*. The *Länder* are responsible for implementing the legislation addressed to them directly as they see fit (federal supervision is restricted to verifying the legality of the enforcement). This independence promotes strong diversity in regulatory management and practices between the *Länder*.

The communities also play an important role in promoting a democratic balance, and are heavily involved in their local economy. The Basic Law guarantees the communities the right to regulate on their own responsibility all local community affairs, within the limits set by the law. The communities can justify a wide range of activities as a consequence of this. They have a traditionally high level of involvement in multifunction public utilities. Over 800 local utilities cover activities such as electricity, gas and water services, many of which are partly or wholly owned by the communities.

The governance and regulatory framework today

There has been an evolution over time from the original framework. Economic conditions have changed. For example the original concept assumed there would be full employment, and environmental concerns have risen up the agenda. However its main principles have so far survived. The solidarity principle continues to underpin key policies and governance structures. Examples include the State-federal fiscal relationship to promote parity of living conditions, and a generous health care system. The basis on which re-unification was carried out also reflects this principle. The west German social welfare system was extended to the east. Massive aid was, and still is, given aimed at bringing the economy and infrastructure of the east up to the standards of the west. Decision-making is still based on seeking and achieving consensus. The State-federal relationships, the political partners in government, and the social partners play a critical role in this. Consensus-seeking remains a necessary component of decision-making in a federal State where the centre is not as strong as in some other countries, and where coalition governments are the norm. The basic structure of the competition law, comprehensive from the outset, has not fundamentally changed.

All that said, recent reform policies such as Agenda 2010 aspire to promoting the development of a new balance between solidarity and individual responsibility.

The German economy was a strong performer in the first three decades or so after the war – very competitive and with excellent growth relative to most other OECD economies. This highly successful period was underpinned by the massive rebuilding of the economy which installed modern capital stock and the latest technologies. Combined with a well-educated and productive labour force, and a creative will to succeed, it yielded impressive results. The disciplined and comprehensive principles of the original social market economy governance system provided an effective institutional and regulatory setting which harnessed stakeholders to the task of rebuilding and wealth creation.

Today, however, the economy faces important difficulties. Growth slowed sharply and more markedly than in several other European countries in the second part of the 1990s, following a steep acceleration immediately after re-unification as incomes rose in the newly liberated eastern *Länder*. Productivity growth has also slowed, and employment growth is weak. The fiscal deficit has grown steadily. The burden and consequences of re-unification are a major, even perhaps the most important, factor in these developments (Box 1.2).

However re-unification has not been the only factor affecting Germany's performance. At least three other factors can be identified. First, there has been a long term slowdown in growth, predating re-unification in 1990. Productivity growth has slowed too over time. In the second half of the 1980s real GDP growth was below that of the EU average. There was also a pronounced long term increase in unemployment, starting in the early 1970s, with a trend loss in manufacturing employment, but without a fully countervailing trend growth in services employment (as happened in the US). This suggests that, leaving aside re-unification which was undoubtedly a shock to the economy and difficult to absorb, some negative economic developments were already at work, reflecting deep-seated problems such as a poorly functioning labour market and an expanding welfare State. Many of these trends and problems were not unique to Germany, but re-unification brought the issues into sharper relief than elsewhere.

Second, the external environment has been difficult: the world economy has worsened significantly since 2000, which has highlighted Germany's potential vulnerability as a major exporter. Though export performance has been strong, this has been necessary to compensate for a weak domestic demand which has helped to slow growth and reduces

Box 1.2. **Re-unification: the impact on the German economy**

Re-unification with eastern Germany in 1990 was extremely costly, and remains a heavy burden on public finances. Growth in the eastern *Länder* has stagnated at relatively low levels, a sizeable productivity gap with the western *Länder* persists, and unemployment in the eastern *Länder* is twice as high as in the west. It is inevitable that overall German performance suffers.

Re-unification, whichever way it might have been carried out, would likely have made a significant dent in overall German performance and continued to exert a drag on the economy for some time afterwards. It was a unique, unprecedented event for an OECD country. There was no blueprint to guide policy makers at the time, but a strong political imperative to act quickly and forcefully, as well as a need to act in accordance with deep-seated values that had moulded west German economy and society after the war, not least of which was the principle of solidarity. This made some key initial choices very expensive, and has also delayed the economic adaptation of the eastern *Länder*. Massive budgetary transfers were made to the east, necessary to pay for the application of west Germany's generous social security system and for aid to eastern firms hit hard by exposure to the highly competitive west German business environment. Transfers on this scale had no precedent in OECD countries.

Many of the achievements which followed have been impressive, including a radical privatisation programme that established viable new market structures and the development of new firms in sectors previously dominated by State-run enterprises, new infrastructure established on a large scale, and a huge environmental clean-up. But the economic convergence process stalled in the second half of the 1990s. Some post re-unification decisions have been relatively unhelpful to the adaptation process, for example the amount of subsidies to promote capital intensive investment and investment in construction and the length of time these subsidies were granted. This distorted eastern manufacturing production structures, and diverted investment away from higher productivity growth areas, though other factors also played a role in the difficulties of adaptation, such as the loss of traditional markets.

Germany's resilience to external shocks such as exchange rate movements. Also, while the convergence of real interest rates to lower German levels in the run-up to the European Monetary Union implied some investment stimulus for several European countries, such as Italy and France, Germany did not benefit from this convergence effect.

Third, re-unification absorbed the government's attention away from the need for important and necessary governance and regulatory reforms (which started to be carried out in many other OECD countries). Some important specific reforms were carried out, notably the complete market opening of the electricity and gas sectors. But at the same time Germany chose not to make any fundamental changes to its regulatory governance: indeed this was transplanted to the east. The regulatory governance reforms that have been made in recent years have tended to be somewhat narrowly focused on reducing bureaucracy and improving efficiency within the public administration, rather than looking out to identify broader regulatory quality reforms. Other fundamental reforms – particularly reforms that might have helped to strengthen the economy, such as labour market reforms – were also neglected or crowded out.

A further factor may now be added which can be expected to have a major and negative impact on Germany's future economic prospects if it is not effectively handled: a rapidly ageing population.

The German government is well aware of these challenges and has now implemented, or is launching, a number of necessary reforms. These include labour market and pension reforms, and the recent launch of "Agenda 2010" (which covers a wide range of issues from benefit and health reforms to support for new SMEs). It is now accepted that wide-ranging reforms are needed. Yet questions remain about the capacity of the regulatory governance system to provide effective support for these. Could it be impeding flexibility and new ideas? Is there adequate scope for new players to come into the market? How far can all relevant stakeholders make their voices heard? Is innovation encouraged? Has the system deteriorated toward less competition and more protection? Is the internally-driven, relatively slow and incremental approach to reform losing valuable time for achieving important results?

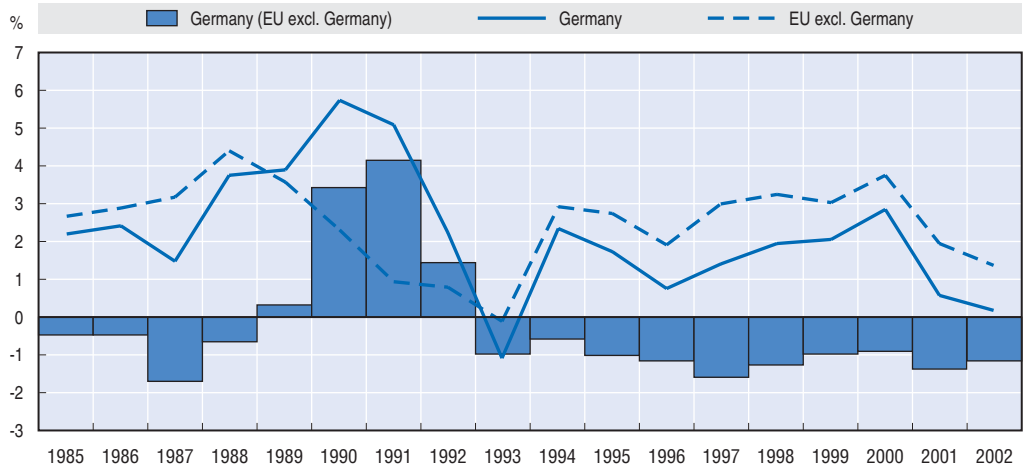
This part of the report is structured as follows. It starts by considering the key issues that are shaping the overall development and performance of the German economy and the particular characteristics of the economy that have a strong link with regulatory reform. It then considers the contribution which regulatory reform has already made to performance, before addressing the question of where further regulatory reform might continue to boost performance and the achievement of policy goals. It ends with the important conclusions that can be drawn from this analysis. This second part provides a more detailed analysis of regulatory quality, competition policy, market openness, and reforms in the electricity, gas, pharmacy and telecommunications sectors. The second part of the report does not analyse all the important issues and reforms that are mentioned in the first part. However the OECD's recent Economic Surveys of Germany provide much of this additional analysis.

Setting the scene: the macroeconomic context

Germany's average growth performance has deteriorated over the last decade relative to some other EU and OECD countries

Figure 1.1 shows the evolution of German real GDP growth compared with the EU. Over the last fifteen years and with the exception of 1990 and 1991 (when growth accelerated steeply reflecting the buoyant demand associated with re-unification) growth in Germany has slowed relative to some other European and OECD countries. Independently of comparison with others, Germany's per capita growth slowed from 2.2% in the 1970s to 2% in the 1980s and to 1.1% between 1991 and 2002.

Figure 1.1. **Real GDP growth in Germany and the EU 1985-2001**[1]



1. Growth rates for western Germany for 1984/85 to 1990/91 and for Germany from 1991/92 onwards.

Source: OECD Analytical Database.

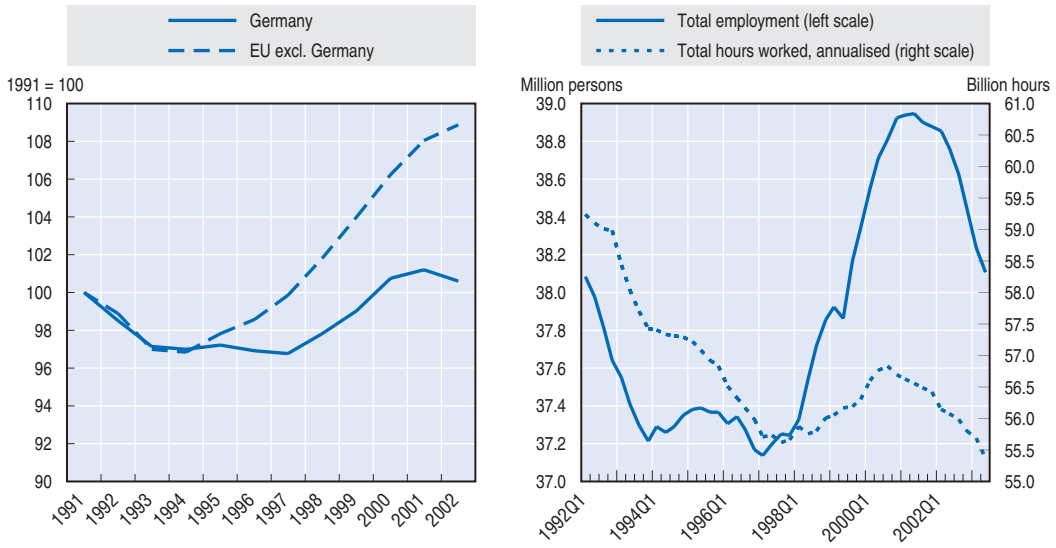
This underperformance has persisted into the new century. The economy stagnated in 2001 and 2002, and this has continued into 2003. The persistence of this relatively low growth performance points to underlying structural challenges that need to be tackled. Not only is growth weak, but unemployment is high, there is a large structural fiscal deficit, and demand is weak. However inflation is low, and export performance remains strong.

Weak employment generation is a major factor in reduced growth

A decomposition of real per capita growth into the growth contributions of labour – in terms of total hours worked per inhabitant – and labour productivity – in terms of real GDP per hours worked – indicates that weak employment performance is a key factor in the weaker growth. There are several reasons for the weak labour input. A sharper reduction in the working age population than in most other OECD countries is one factor. But decreasing employment rates and a reduction in average working hours as well as rising labour taxes are the most important factors. Figure 1.2 shows the employment trend compared with the EU. The growth rate of employment declined during the 1990s. It also shows the trend in hours worked, which has also declined.

The negative interaction of low employment generation and rising taxation of labour has reduced disposable incomes and braked private consumption. Domestic demand remains very weak.

Figure 1.2. **Total employment and hours worked in Germany and the EU 1990-2002**



Source: OECD Analytical Database and *Quarterly National Accounts*, domestic concept.

Labour productivity growth has been good, but not enough to reverse the weak GDP growth trend and investment is an issue

Labour productivity has risen faster in recent years than in other European countries. It grew by an average of 1.9% p.a. between 1995 and 2001, faster than France, Italy and Spain (1%), and nearly as much as the US (2%). But this was not enough to offset the adverse effect on GDP growth of a weak labour input. The quality and quantity of investment has been an issue holding back stronger productivity growth.

As regards quality, one key issue is that investment to rebuild the new States has not always been well-directed in support of productivity growth. Subsidies in favour of capital intensive production distorted the new States' manufacturing production structure, and construction investment in the early 1990s diverted investment away from areas associated with higher productivity growth.

As regards quantity, investment has also been an issue. Equipment investment boomed at the beginning of the 1990s, but a wide negative growth differential then opened up relative to other EU countries. The OECD's 2003 *Economic Survey of Germany* suggests that subdued investment in machinery and equipment since the mid 1990s accounts for roughly one quarter of the GDP growth differential between Germany and the EU.

Re-unification has imposed a heavy burden on the economy

Re-unification has also been a major factor contributing to the weak growth trend. The heroic aim in 1990 was to achieve rapid economic and social convergence of the east with the west. Re-unification was carried out on the principle of extending the complete west German legal, economic and social system to the new *Länder*, immediately and without any transition or adaptation. Exposure to, and integration with, the highly productive and competition-based environment of the west German economy was a harsh experience for the enterprises and workforce of the east. Mitigating the immediate pain of such exposure, the solidarity and fairness principles embedded in the political economy of west Germany

were diligently applied. In particular, the generous west German social security system was fully extended to the east. Massive budgetary transfers to the east were needed to pay for this, and for financial aid to help the eastern firms cope with their competitive disadvantages. But social spending inevitably accelerated. The budget transfers to the east and active labour market measures reduced the pressure to adapt wages to reflect the lower productivity levels of the east. Subsidies to promote investment, which were intended to help firms compete, did not always support productivity growth. And, more directly, the cost to the German budget of welfare and other support to the east was huge. Re-unification proved more complicated, costly and lengthy than first anticipated.

Though achievements are impressive, the east is not yet on a self-sustained growth path

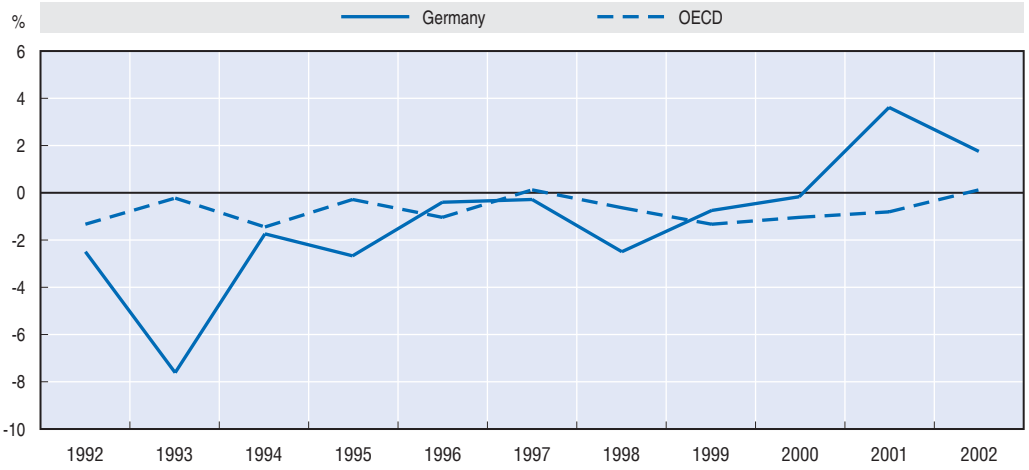
Despite a good start in the early 1990s and considerable progress, the process of economic convergence slowed down in the middle of the 1990s and is still some way from being complete. Growth in the east persists at low levels, a substantial productivity gap remains, and unemployment levels are much higher than in the western *Länder*. Though the capital stock of the new States has reached the level of the old States, capital intensity is uneven: high in some areas but inadequate in others. Self-sustaining growth in the east has not yet been achieved. The gap between east and west continues to impose a large burden on the economy as a whole, and the annual level of west to east budget transfers is around 4-5% of west German GDP. Special aid is planned to continue until 2019.

Export performance is important, remains strong, and needs to be sustained

A positive contribution from exports is, self-evidently, a key contributor to growth for a major exporter. Export-oriented economic policies have been an important feature of Germany's development, and German GDP growth has traditionally been fuelled by its export performance. This has, overall, been well sustained in recent years. Germany's market share of world exports fell in the early 1990s and the merchandise trade balance dropped sharply (as goods destined for the export market were diverted to the reconstruction of the eastern States). But it has since recovered, and the trend in Germany's market share of world exports has been upward since 2000. Competitiveness deteriorated in the early 1990s but improved in the second half of the 1990s, helped by lower costs from more moderate wage settlements and pricing by firms closely to the market. For several years now German GDP growth has been accounted for largely by net exports, as exports have been maintained while imports have weakened substantially, reflecting the weakness of the country's domestic demand (Figure 1.3).

The world economy has worsened significantly since 2000. For growth to be sustained against the vagaries of the external environment, Germany needs not only a strong and dynamic export sector, but also strong domestic demand. The weak growth trend has been partly due to weak domestic demand. This has reduced Germany's resilience to external shocks such as exchange rate movements and oil price rises (especially as Germany has to import all its oil as well as most of its gas, the price of which is indexed to the price of oil). Germany needs to consider how it can reduce its exposure to the world business cycle and improve the resilience of its export sector. The overall trade balance suffers from an important structural deficit in services trade (outgoing tourism, business services and to a lesser extent, transportation).

Figure 1.3. **Export performance for total goods**[1]



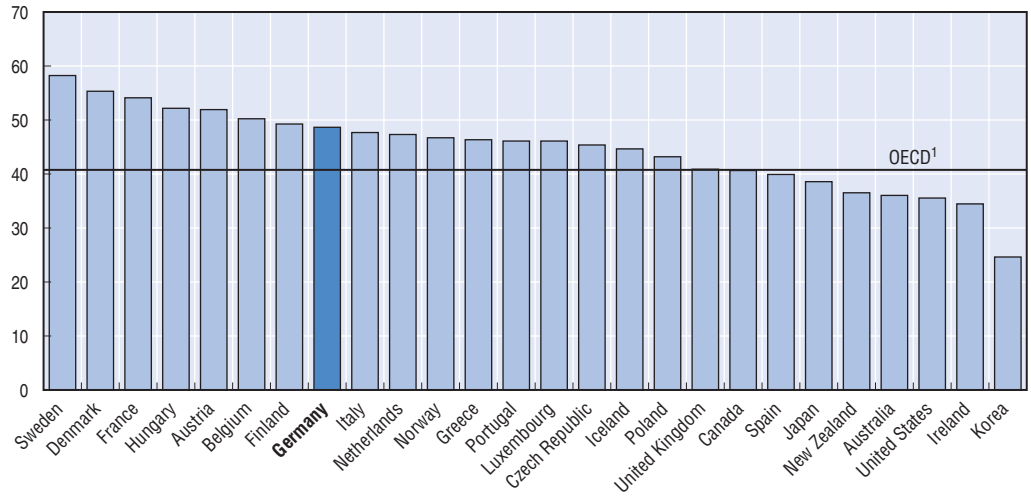
1. Export performance of country X is export volumes of X divided by potential export volumes of X, *i.e.*, divided by a weighted sum of imports of the countries to whom X exports. Estimate for Germany in 2002 and for OECD in 2000 to 2002.

Source: OECD Economic Outlook Database and Sources and Methods.

Public, and especially social, spending is high

Germany has one of the higher shares of public spending as a percentage of GDP among OECD countries, at 45% well above the OECD average (Figure 1.4).

Figure 1.4. **Public spending in 2002 as a percentage of GDP**

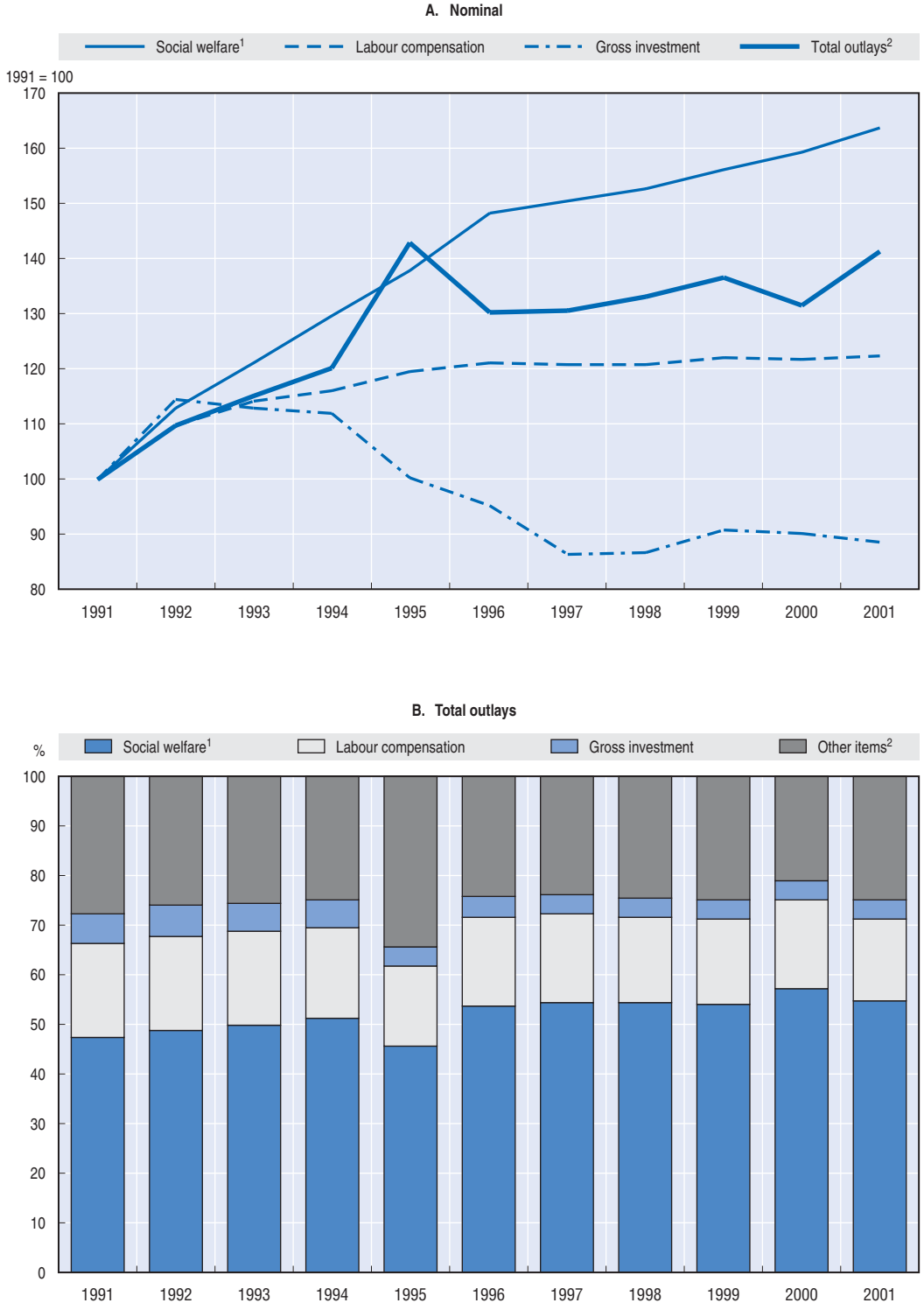


1. Weighted average.

Source: OECD, *OECD Economic Outlook*, No. 71, June 2002.

Social spending accounts for over half of the total. It accelerated as the west German social security system was extended to the east. In terms of GDP German spending currently ranks second in the OECD behind Sweden (Figure 1.5). This reflects in part the traditional importance attached by Germany to values of solidarity which underpin its

Figure 1.5. **German trends in general government spending**



1. Both benefits and benefits in kind.
2. In 1995, debt relating to re-unification was taken over by the federal government. This was recorded as a flow in the national accounts, boosting temporarily general government spending.

Source: Federal Statistical Office, OECD.

welfare system. Although social security spending declined in the 1980s, it did not revert to the lower levels of the early 1970s. Social security contribution rates were 26.5% of the wage base in 1970, rising to 35.8% in 1990, and with a further, marked increase thereafter.

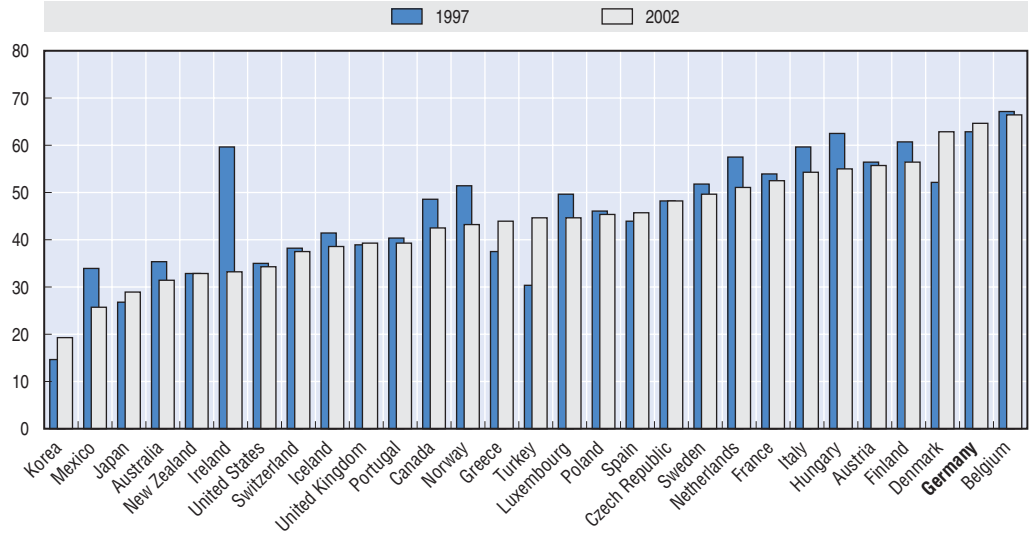
Figure 1.5 also shows that other categories of public spending (notably investment) are much smaller. Streamlining social spending is unavoidable if fiscal consolidation is to be successful.

Today's structural fiscal deficit is largely the result of this significant public expenditure, linked to the rise in unemployment and an increase in the number of people dependent on social assistance. The deficit has grown steadily, and is now at 3.5% of GDP. This breaches the EU Maastricht ceiling as well as the government's own target.

Public spending imposes a heavy burden of taxation and social charges, which discourages participation in the labour market and impedes investment

A recent OECD study on tax policies ranked Germany's tax wedge on labour (the difference between what an employer pays and what an employee receives) second among OECD countries in 2002 (Figure 1.6). This is largely due to high social charges. The government aims to reduce social charges, and new legislation on health care reform goes in this direction. Meanwhile the current tax levels give a strong incentive for firms to save on their use of labour. Germany also still ranks relatively unfavourably as regards business taxation, which discourages investment. Despite significant reforms, there remains considerable scope to improve business taxation. The tax system is also extremely complex. The tax reform measures implemented since 1999 do mark progress in several respects. Tax rates have been lowered and, at the final stage of the reform (the government brought the reform forward in 2004) the burden of personal and corporate income taxes will have been reduced substantially.

Figure 1.6. **Marginal tax rates on labour**[1]



1. Tax wedges – between labour costs to the employer and the corresponding net take-home pay of the employee – are calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll tax, minus benefits as a percentage of labour costs. To determine total labour costs, employer social security contributions and – in some countries – payroll taxes must be added to gross wage earnings of employees.

Source: OECD, *Taxing Wages*.

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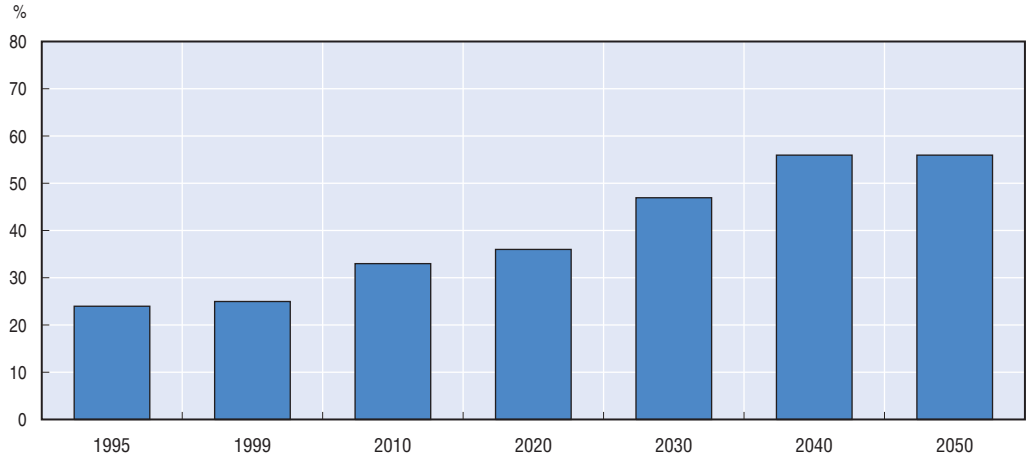
A rapidly ageing population will put further pressure on public spending

Germany faces a rapid rise in the proportion of elderly in the population over the next three decades. According to Germany's own recent population projections the old age dependency ratio (over 65s as a percentage of the working age population) will rise from 25% in 1999 to 56% in 2040 (Figure 1.7). This is more severe than in the US and in many other European countries. It has a number of important consequences. Germany faces one of the sharpest increases in public pension provision among OECD countries, and the health needs of an ageing population put an upward pressure on social spending. A budget surplus may be needed to cope with this in the future. The implications for labour inputs to the economy, already weak, are also severe.

Figure 1.7. **Projected evolution of the old age dependency ratio**[1]



1. Number of persons aged 65 and over as a percentage of number of persons aged between 20 and 65 years. The projections assume a net immigration into Germany of 100 000 persons annually.

Source: Federal Statistical Office.

The problems are acknowledged: the government is promoting a wide range of important reforms

The government is committed to addressing economic weaknesses. It has a fiscal consolidation programme and all levels of government have agreed to establish a domestic stability pact. The objective is to balance the budget in the medium term. The government has also adopted the findings of a labour market reform commission (the *Hartz* Commission). Pension and health reforms have been made. The Agenda 2010 reform platform (Box 1.3) seeks further important changes and the Master Plan is a new attempt to reduce bureaucracy. Specific problems in the network industries have been acknowledged and a regulator for the gas and electricity sectors is planned. The momentum must be sustained, however, and many areas need further stronger action.

Regulatory Reform: its contribution so far

Regulatory reform (Box 1.4) is an important part of governments' toolkit for improving economic performance and meeting public policy goals.

Germany started out with a governance and regulatory system which was considered at the time to be complete and carefully balanced, and which served the country extremely well in the post-war reconstruction period. The legal State tradition promotes reliability. By

Box 1.3. **Agenda 2010: the main proposals**

Agenda 2010 was launched in spring 2003. This is a wide-ranging reform programme which covers employment, pensions, health, education and local finances as well as public administration reforms. The main elements are:

Labour markets

- **Reform of the unfair dismissal law.** Including: more flexibility in use of the threshold level for unfair dismissal for small businesses; introduction of greater legal security for social selection for dismissals caused by factors relating to the company; supplementing unfair dismissal protection by adding the settlement option and greater flexibility for starters of business in concluding employment contracts.
- **Cutting the unemployment benefit entitlement period.** Including: the duration of entitlement will be limited to twelve months; employees above 55 can claim unemployment benefit for a period of 18 months.
- **Combined services for unemployment and social welfare.** Including: introduction of a new benefit to be paid as a fixed sum for basic needs, such as maintenance, statutory health insurance, social nursing care insurance and retirement pension insurance; rejection of reasonable job offers reduces the benefit; relief of burden of costs for federation, States and municipalities; introduction of a special scheme for young recipients of social welfare.
- **A new employment office.** Including single source service to unemployed and recipients of social welfare; active role for job centres in finding work; performance-based judgements of job centres. Creation of new job centres for all types of support services.
- **Publicly subsidised jobs in east Germany.** Including introduction of a special scheme for a total of 100 000 young recipients of social welfare benefits or unemployment benefits aged between 15-25 who are unemployed in the long run, especially in weak regions.
- **Wage setting.** Fostering plant level agreements on wages and working conditions.

Pensions

- **Adjustment of the retirement pension insurance.** Including future pensions being based on the portion of income giving rise to the insurance obligation; raise of age limit; introduction of a permanence factor; broad discussion with participants on the basis of the Rürup Commission.

Health

- **Health reform.** Including: maintenance of the solidarity principle; opportunity for sickness funds to conclude individual contracts with doctors in some sections of medical care (*e.g.,* integrated care); improved opportunities for the merging of sickness funds; expansion of quality assurance; review of list of benefits provided by GKV; taking out of sickness allowance from parity financing of the GKV; introduction of principle of resident doctors; selective introduction of individual charges for medicines and doctor's consultation; permission to use mail order pharmacies; loosening ownership restrictions on pharmacies and price restrictions on non-prescription drugs.
- **Prevention law.** Including: prevention is to be considered the fourth pillar of the health service; illness to be actively averted; more health promotion.

Box 1.3. **Agenda 2010: the main proposals** *(cont.)*

SMEs

- **New law for craft trades.** Including limitation of master's certificate to 62 craft trades in sectors where risk is involved; abolition of owner's principle.
- **New support for SMEs.** Including: support for founders of new business (small business act); a special bank for financing SMEs; introduction of so-called micro-loans; introduction of "Capital for Work" scheme; introduction of an Initiative to Reduce Bureaucracy; introduction of subordinated loans; strengthening of equity capital provision.

Infrastructure

- **Loans for housing modernisation and improvement of communal infrastructure.**

Local government

- **Reform of local authority finances.**

Training and schools

- **Training offensive.**
- **Reform of the school system.** Including; introduction of national education standards; improvement in training and development for teachers; early years support; more care for small children.

Tax reform

- The government intends to bring forward the third stage of tax reform.

emphasising specific and comprehensive regulations and the importance of the rule of law, Germany's public administration has earned wide recognition for its reliability, legality and honesty. Competition law and policy is a considerable and enduring strength.

These firm and tested foundations have tended to limit the scope for, and interest in, extensive reforms, at least until very recently. A well-tried and coherent existing regulatory governance system was already in place (which was not the case in many other OECD countries). Re-unification has also been a highly distracting burden. The big changes that have taken place in recent years have often emerged from outside Germany: through the EU legislative process (for example, network industry liberalisation, public procurement rules), or through globalisation and technological change (for example, the market and regulatory evolution of the financial sector).

Germany's own reform initiatives have tended to focus on the public administration (how to reduce bureaucracy and improve efficiency), though there has been a growing focus too on the importance of quality regulation and the related need to improve regulatory systems such as Regulatory Impact Analysis (RIA). Most recently, in response to the increasingly pressing needs of the economy, deeper economic reforms have been launched (covering among other issues the labour market, pensions, health, and SMEs).

Competition law and policy: a particularly clear, coherent and comprehensive legal framework, and a respected competition authority

Perhaps the best example of an enduringly well-conceived part of the original framework is competition law and policy. These occupy a central place in Germany's economic and political framework. Chapter 3 gives more detail. The law was enacted to be a

foundation of the post-war political economy. Though it only took effect in 1958, it can take at least some of the credit for sustaining the economic success that had taken root after the war. The independent institutional culture of the main competition law enforcement body, the BKartA, is also a considerable asset. Legal transparency and certainty are key strengths. The competition rules and their objectives are clear: notably, the rules about horizontal cartels send a clear message about the importance of competition while permitting efficient co-operation. Instruments for deterring anti-competitive behaviour are well-developed (for example significant fines can be imposed against anti-competitive cartels). The recently introduced leniency programme to encourage firms to reveal the existence of cartels looks promising. All-in-all, Germany's competition law and institutional framework are particularly strong and effective compared with many other OECD countries.

As discussed later, competition policy needs to refocus more clearly on some of its original aims, and develop further its capacity to deal with new challenges, such as the liberalising network sectors. The supporting legal and institutional structure for it to do this may need a few adjustments but it remains broadly sound.

Box 1.4. **What is regulation and regulatory reform?**

There is no generally accepted definition of regulation applicable to the very different regulatory systems in OECD countries. In the OECD work, regulation refers to the diverse set of instruments by which governments set requirements on enterprises and citizens. Regulations include laws, formal and informal orders and subordinate rules issued by all levels of government, and rules issued by non-governmental or self-regulatory bodies to whom governments have delegated regulatory powers. Regulations fall into three categories:

- Economic regulations intervene directly in market decisions such as pricing, competition, market entry, or exit. Reform aims to increase economic efficiency by reducing barriers to competition and innovation, often through deregulation and use of efficiency-promoting regulation, and by improving regulatory frameworks for market functioning and prudential oversight.
- Social regulations protect public interests such as health, safety, the environment, and social cohesion. The economic effects of social regulations may be secondary concerns or even unexpected, but can be substantial. Reform aims to verify that regulation is needed, and to design regulatory and other instruments, such as market incentives and goal-based approaches, that are more flexible, simpler, and more effective at lower cost.
- Administrative regulations are paperwork and administrative formalities – so-called "red tape" – through which governments collect information and intervene in individual economic decisions. They can have substantial impacts on private sector performance. Reform aims at eliminating those no longer needed, streamlining and simplifying those that are needed, and improving the transparency of application.

Regulatory reform is used in the OECD work to refer to changes that improve regulatory quality, that is, enhance the performance, cost-effectiveness, or legal quality of regulations and related government formalities. Reform can mean revision of a single regulation, the scrapping and rebuilding of an entire regulatory regime and its institutions, or improvement of processes for making regulations and managing reform. Deregulation is a subset of regulatory reform and refers to complete or partial elimination of regulation in a sector to improve economic performance.

Source: OECD (1997), *OECD Report on Regulatory Reform*, Paris.

Market openness: policies to promote an open international trading environment are strong

As a major exporting country, Germany has long attached importance to the promotion of an open trading environment. Chapter 4 reviews this in more detail. Germany's policy of non-discrimination in the international context is anchored in its membership of the WTO and the EU. It therefore has obligations to ensure compliance of its domestic regulations with the Most Favoured Nation (MFN) and National Treatment (NT) principles. But it is also proud to have started this process from the beginning of the last century. Important steps have been taken to streamline customs procedures, which can be a significant cost to business and attract growing attention, now that tariff barriers in OECD countries are low or non-existent. These include the consolidation of a currently fragmented set of different IT systems with the ultimate aim of eliminating paper-based procedures. German customs authorities regularly meet business associations to promote dialogue. National standards are another very significant potential cost of operating in different markets, and Germany works in close co-operation with the international and EU standardisation bodies. The German standards body (DIN) is a key player in this context. Conflicting national standards are systematically replaced by international standards where these exist.

Some issues could be better handled. Efforts to assess the impact of regulations do not explicitly consider trade and investment issues (the impact of domestic regulations on trade, as well as the impact of trade regulations on trade). As will be seen later, the complexity of German rules and the consensus-based approach to rule-making involving established stakeholders do not promote an easy environment for foreigners, who may be unintentionally excluded from the consultation process and other regulatory mechanisms.

Reform of the administration: a succession of initiatives to improve efficiency and reduce bureaucracy

A succession of reforms of the administration have been initiated since the 1990s to improve efficiency and reduce bureaucracy. These are considered below.

The New Steering Model

German variants of New Public Management have been taken forward to promote the modernisation of the public sector, under the banner of the "*New Steering Model*". Private sector management principles were introduced in the 1990s to promote a clear division of responsibilities between politicians and the administration, and to set up contract-based management, integrated departmental structures and output control. The evidence, however, suggests that implementation of the New Steering Model has encountered serious difficulties, and that the early reform enthusiasm is over.

The Lean State programme

The *Lean State* programme, started in 1995 and completed in 1998, aimed to reduce the number of tasks performed by the State and to reduce bureaucracy. An independent advisory council appointed by the government, made up of political and academic experts, trade unions, and State and local government representatives, tabled proposals in 1997. Key elements were public sector modernisation, debureaucratisation and deregulation. A steering committee was established to promote the recommended measures. This resulted in new government requirements obliging regulators to work with quality checklists in the review of draft laws, and the adoption of a law to expedite planning and approval procedures. Other recommendations, however, have not been followed through.

The Modern State – Modern Administration Programme

The *Modern State – Modern Administration* programme launched in 1999 and completed in January 2002, aimed to promote a new conception of the State as the "enabling State" (Box 1.5). It emphasised improved regulatory quality and efficiency. It had four main aims: the enhanced effectiveness and acceptance of legislation; improved co-operation between the different levels of government and with the private sector; a competitive, cost-efficient and transparent administrative system; and highly motivated employees.

Box 1.5. **The "Modern State – Modern Administration" programme**

The 1999 federal government reform programme *Modern State – Modern Administration* has the overall objective of introducing and promoting a new conception of the State as "the enabling State". At the core of this concept is the ambition of a more restricted role for the State and the encouragement of self-regulation and private initiative. At the same time the State would continue "to have the duty to protect the freedom and security of its citizens as its core task for which it remains solely responsible…".

The programme sets out four principles and four reform areas, to be carried forward by a number of specific projects:

- *A new distribution of responsibility,* promoting the devolution of social responsibility and strengthening society's potential for self-regulation.
- *Responsive public services,* stressing values such as participation, transparency of government activities, accessibility, communication .
- *Diversity of public bodies,* encouraging better co-operation between the different tiers of administration, diversity within the federation and more weight to the principle of subsidiarity.
- *Efficient administration,* calling for efficiency and effectiveness in the public sector, use of competition, benchmarking and performance-based remuneration, and reduction of administrative burdens.

The programme identifies four key areas of reform:

- Enhanced effectiveness and acceptance of legislation.
- Improved co-operation between the different levels of government and with the private sector.
- A competitive, cost-efficient and transparent administrative system.
- Highly motivated employees.

Key projects supporting regulatory quality management include:

- Preparation of RIA manuals (finalised in 2001, however new guidelines are being considered).
- Review of the Administrative Procedure Act providing the legal basis for online access to government services using qualified electronic signatures.
- Publication of a report of 80 suggestions from business to reduce administrative burdens and how to implement these suggestions.
- Preparation of a Freedom of Information Act (not yet proposed to Parliament).

The latest initiative – the Initiative to Reduce Bureaucracy – is a further effort to reduce bureaucracy and help SMEs

The 2003 *Initiative to Reduce Bureaucracy (Initiative)* has further broad and ambitious goals to reduce bureaucracy (Box 1.6). It aims to strengthen civil society, reduce burdens on SMEs, support growth and employment, consolidate public budgets, and modernise the federal administration. The operational focus is on administrative burdens, particularly on SMEs. The details of the Initiative were outlined in a Cabinet decision of July 2003.

These initiatives show that important efforts have been made over time to reduce bureaucracy and administrative burdens imposed on businesses, especially smaller ones, partly reflecting successive governments' support of the *Mittelstand*. However the impact of the earlier initiatives several years on is not always clear. The goals of the Initiative to Reduce Bureaucracy are commendable but previous reforms also sought to tackle similar issues. Following through on recent reform initiatives will be important as this appears to have been a weakness with past initiatives.

Box 1.6. **Federal government initiative to reduce bureaucracy**

The Federal government initiative to reduce bureaucracy – the Initiative to Reduce Bureaucracy – Promoting Small Business, Creating Employment, Strengthening Civil Society was launched by the government in February 2003.

The operational focus is on administrative burdens, particularly for SMEs and for citizens. The objective is to reduce burdens, and improve public sector efficiency. In this respect, it appears to the OECD Secretariat that the Initiative differs little from preceding policies and policy Statements in this area. However it is clearly premature to assess results at this stage.

The Initiative is an umbrella project into which new bureaucracy-reducing projects are continuously integrated. Immediate activities of the Plan – mostly consisting of projects already initiated by individual ministries or as part of previous programmes – include, among others:

- a review of selected federal legislation;
- simplification of official statistics and statistical reporting requirements for SMEs;
- the e-government initiative BundOnline 2005; and
- special assistance for SMEs and start-ups; *e.g.*, streamlining regulations for public procurement.

The Initiative also envisages an overall strategy for reducing bureaucracy. Based on inputs from ministries – each must identify projects where the plan's objectives can be implemented – the strategy was presented to the Cabinet, in July 2003, containing 54 projects, and adopted by it. The Initiative emphasises, that "specific bureaucracy reduction goals" are to be set for each individual measure. However the Initiative in its current version does not include such targets or measures, nor how to develop methodologies that would enable quantitative measurement of, for example, administrative burdens imposed on businesses. The Minister of Economics and Labour has commissioned work on methodologies to improve the assessment of regulatory impacts.

A Steering Committee of State Secretaries from the ministries of the Interior (chair), Finance, Justice, Economic and Labour as well as the Chancellery chief-of-staff is charged with implementing the Initiative. The Committee does not report to the Committee of Permanent Secretaries responsible for directing and implementing the Modern State – Modern Administration programme.

Regulatory policy: important elements of this have already been developed

Regulatory policy – that is, an explicit policy that aims to improve the quality of the regulatory environment on a continuous and dynamic basis – is a key part of good governance in a modern society and economy. Elements of a potentially effective regulatory policy already exist in Germany, building up over time. The "Joint Rules of Procedure of the Federal Ministries" were first established in 1958. These set out in detail the steps for preparing and presenting policy proposals for the cabinet, as well as principles for the organisation of federal ministries, the co-ordination between them and with other official bodies. Recent revisions strengthen the requirement on ministries to explain the main regulatory impacts of draft laws and regulations. The "Blue Test" questions to promote regulatory quality (precursors to a more fully-fledged Regulatory Impact Analysis system) were issued in 1984. A 1996 amendment to the Joint Procedures made it mandatory for regulators to assess all draft laws on the basis of a checklist. Most recently, work has been carried out to develop the RIA framework to suit the German context. A handbook of RIA methodologies and concepts, and guidelines to exemplify these, have been developed and tested. But this work is not yet linked to real world procedures and institutions. The Ministry of the Interior is preparing an operational RIA guide and there is an urgent need to close the gap between proposals and their application in practice.

Though there is no single central unit responsible for promoting regulatory quality across ministries, a number of central regulatory co-ordination and management units have been established by the federal government, supported by ministries with horizontal responsibilities. As discussed later, these disparate elements need to be brought together and strengthened.

Labour market reforms: important and much-needed recent initiatives

Germany's recent initiatives to promote employment and get the unemployed back to work are summarised in Box 1.7. The *Job-AQTIV* Act promotes a range of measures to improve the efficiency of labour market policies and encourage the unemployed into activity. The government has also said that it will act on the proposals of the *Hartz* Commission.

Network industries: rapid liberalisation of some key sectors

The network industries play a key role in the costs and efficiency of other sectors, as well as making a major direct contribution in their own right to GDP. Efficient, good quality telecommunications, energy and other services are important for the competitiveness and economic performance of other sectors, and consumers gain from the significant price reductions that generally accompany liberalisation. Like other countries in the OECD, Germany has been pursuing policies of liberalisation. It has implemented a distinctive and radical approach in the electricity and gas sectors with a full market-opening (*i.e.*, giving all consumers, not just the larger ones, the right to choose a supplier) ahead of most other OECD countries and beyond the requirements of the EU directives. However as discussed later, achieving sustained competition in these sectors also requires re-regulation to ensure network access and to create a level playing field for market participants.

Box 1.7. **Labour market reforms**

A. The *Job-AQTIV* Act

The *Job-AQTIV* Act (Activation, Qualification, Training, Investment, Placement) came into force in 2002. Its measures are:

- *Profiling of job seekers:* the newly-unemployed and applicants for vocational training are profiled with respect to their professional strength and potential. An "agreement of integration" may then be made, which specifies the rights and duties of the job seeker and the support they will get.
- *Job-rotation:* companies filling certain temporary vacancies receive a government grant.
- *Temporary work agencies:* conditions for temporary work through sub-contracting have been revised to make this easier.
- *Employment-promotion measures in infrastructure:* regional and local investment in infrastructure is subsidised on condition that firms give work to the unemployed.
- *Promotion of a low-wage sector*: the social security contributions of employees in low-income jobs are subsidised.
- *Modification of unemployment benefits:* sanctions on the unemployed if they refuse an employment offer or fail to co-operate in other ways have been sharpened.

B. The "*Hartz-Kommission*" proposals

The federal government set up this commission, made up of 15 representatives of the social partners and the government, following the discovery of irregularities in the operation of the Federal Employment Office. The commission was asked to make proposals for a comprehensive reform of the Federal Labour Office. It was also asked to assess and make proposals on labour market policies and placement strategies. Its report was released in August 2002. Major recommendations are:

- *Reorganisation of labour offices:* local labour and social welfare offices should be merged into "Job Centres" and provide "one-stop-services" for all unemployed. The budget responsibility and flexibility of these Job Centres should be widened, and a performance-orientated bonus system for placement officers introduced, as well as electronic tracking of key information. Placement of the unemployed should be out-sourced to newly-created autonomous "Personal Service Agencies (PSA)", commissioned by the Job Centres. Financial sanctions should be applied if a job-seeker refuses a placement.
- *Responsibilities of the unemployed:* employees who have been given a redundancy notice should immediately register at the labour office to start placement activities, or face a cut in benefits. Other measures to put greater responsibility on the unemployed are also proposed, including wider sanctions for non-co-operation (such as temporary suspension of benefit payment) and acceptance of a wider potential range of jobs.
- *Temporary work agencies (TWA):* legal restraints on TWAs should be further reduced, and the relationship between TWA contracts and placement contracts improved.
- *Employment of disadvantaged groups:* young job seekers should be made an "activating offer" such as a traineeship. Measures to encourage the creation of new apprenticeship places should be taken and personal vocational training shall be guaranteed.

Box 1.7. **Labour market reforms** *(cont.)*

- *Older unemployed:* those aged 55 years or more who have been made redundant and take up a job that is paid less than their last one should receive the difference out of social security benefits. Employers' social security contributions should be temporarily subsidised and the age limit for temporary employment lowered. But a "bridge system" should also be set up to provide older unemployed willing to leave the labour market with benefits until they retire at 60 on a "cost neutral" basis.
- *Self-employment and small jobs in the low wage sector:* to reduce illegal work, measures should be put in place to enable the unemployed to earn more with reduced taxes and social security contributions. Other measures to promote small jobs and home services jobs should also be taken.
- *Job creation in SMEs:* SMEs creating new permanent jobs should obtain equity and loan capital subsidies up to EUR 100 000 for each newly employed (a proposal aimed especially at companies with low equity capital resources in east Germany).

The electricity sector: full market opening

In line with the German tradition, the key task of working out the details of network access by third parties has been entrusted to the private associations covering the electricity and gas markets, under the public oversight of the competition authorities. In the OECD context, it is a very distinctive approach marked by the striking absence of a specific regulator with *ex ante* powers.

The telecommunications sector: a good start to liberalisation and some very good results

The telecommunications sector is a major contributor to innovation across the whole economy (Box 1.8).

Germany made a good start with liberalisation. Today it has in place a high quality, technologically advanced telecommunications infrastructure with high penetration rates for both fixed lines and wireless. Broadband access is widely available via DSL lines. Market entry is relatively easy, and local operators are providing effective competition to the incumbent in a large number of German cities. Prices for households as well as businesses

Box 1.8. **The contribution of open telecommunications markets to growth and innovation**

The OECD growth study underlines that the diffusion of ICT does not just depend on the cost of the hardware, but also on the associated costs of communication and use, once the hardware is linked to a network. Increased competition in the telecommunications industry is particularly important in driving down costs, as it leads to more entrants, greater technology diffusion, improved quality and a higher rate of innovation. Countries that moved early to liberalise their telecommunications industry now have much lower communication costs, and hence a wider usage and diffusion of ICT technologies, than those who followed later.

Source: OECD (2001b), *The OECD Growth Project: the New Economy Beyond the Hype*, Paris.

have come down substantially. Germany has one of the largest number of Internet users, and the Internet market is growing rapidly.

Pension reform: the foundations for a multi-pillar system have been laid

After a series of partial reforms to the public pension system in the 1990s, reforms in 2001 created the foundations for a multi-pillar pension system (Box 1.9). These foundations need to be strengthened, with some urgency given the time it takes to phase in new arrangements.

Box 1.9. **Pension reform**

The reform targeted a reduction in the public pension replacement rate and a cap on the contribution rate, revised the indexation of the pay-as-you-go (PAYG) pension, the phase-out of early retirement programmes and the creation of incentives for individuals to opt for compensating occupational and individual pensions.

These measures should maintain the relatively high overall pension incomes over the next decade. However, as demographic pressures mount, there is considerable uncertainty as to whether the targeted reduction in replacement rates will ensure financial balance of the public pension system up to 2020 without additional measures. The uncertainty as to whether the system is sustainable in the later decades under the current framework is even higher. Given the long time needed to phase in pension reforms, these issues need to be addressed urgently.

The government should review the statutory retirement age in the light of life expectancy increases, and ensure that the phasing out of early retirement programmes does indeed raise the effective age of retirement. Public opinion might also be influenced by considerably lengthening the time horizon of official projections, in order to better highlight the risk of falling replacement rates in the PAYG system unless further action is taken.

Regulatory reform: the challenges

Overall prospects for the German economy remain uncertain. There is still no self-sustained growth in the new States, and the gap with the west remains large. The population is ageing rapidly. A more rapidly growing economy would compensate for these structural weaknesses. Three issues are of particular importance in achieving stronger growth. First, impediments to increased employment need to be reduced. Second, productivity needs to grow faster. Third, the fiscal deficit needs to be eliminated.

Where can regulatory reform help?

Regulatory reform is never the whole answer to tackling economic and other issues. But it can provide essential support to other policies and help remove important blockages. Product and labour market reforms, for example, can provide valuable help in boosting employment and productivity growth. Recent OECD studies show that imperfections in labour and product markets reinforce each other. So the removal of barriers to trade and competition in potentially competitive product markets can complement labour market reforms aimed at increasing long-run employment levels. And product market innovation can be stimulated by a more flexible labour market. The interaction with financial markets is also important (Box 1.10).

In Germany's case, regulatory reform can make an important contribution to the three targets for achieving stronger economic growth: removing impediments to increased employment, increasing productivity growth, and reducing the fiscal deficit.

The following sections review the need for further reforms which would support stronger economic growth. They cover labour and product market reforms (including the network industries), competition policy, public expenditure management and regulatory governance, before concluding with a section on the political economy of reform.

Labour markets: recent reforms are a major step forward but more is needed

The OECD Surveys explore the reasons for Germany's weak labour inputs in more detail, as well as proposing areas for further or stronger reforms.

One important factor will be highlighted here: collective wage bargaining, which is an enduring feature of Germany's governance framework. Collective wage bargaining has positive elements, including low transaction costs, and when it works well, the promotion of modest wage settlements that help to sustain a low inflation rate and maintain international competitiveness. In the past few years, the scope for more flexible wage determination at the company level has been widened by incorporating "opening clauses" into collective wage agreements. The 2002 wage round saw an important agreement of this type in the chemical sector (it allows part of workers' remuneration to be based on the level of a company's profits). But collective wage bargaining remains a generally inflexible system which does not easily take account of productivity differences between sectors and between different parts of the country. Policy initiatives to support more differentiated collective bargaining outcomes are lacking. Consideration should be given to widening the scope for wage determination at the company level so as to better align collective wage contracts with labour market conditions.

Box 1.10. **The cross over effects of regulation in product, labour and financial markets**

Product, labour and financial markets interact with each other in a number of ways. Regulation in one of these markets may stimulate or restrict performance in the other markets. A number of studies have been carried out on these cross-over effects. For example, imperfectly functioning financial markets that restrict the availability of venture capital may limit innovation, which adversely affects competitiveness and slows job creation. Product market regulations affect wages, employment and employment security (for example wage premiums are found to be weaker in more competitive industries, so employment growth is stronger). OECD analysis using product market regulation data suggests strongly that employment rates are increased by product market regulatory reform aimed at increasing competition. It may explain just over 1% of the difference in employment rates between countries (in some cases much more). Conversely labour market regulation affects product markets. A regulatory environment that promotes competition positively affects productivity, and innovation/R&D are stronger in more open markets. There is some evidence that labour market reforms may enhance innovative activity and hence output growth.

Source: OECD (2001), "The cross-market effects of product and labour market policy", *OECD Economic Outlook*, Paris.

Product markets: exposure to greater competition would strengthen important sectors

The Mittelstand should should remain competitive

Rules favouring SMEs are rooted in two traditional concerns: maintaining quality for the consumer, and protecting the *Mittelstand* against the encroachment of larger firms. The competition law thus pays special attention to protecting smaller firms against dominance in a bargaining relationship. The law controls discrimination and "unfair hindrance" by dominant firms, associations and cartels. It also permits SMEs to combine and co-operate, under certain conditions (for example SME purchasing co-operatives may be exempted from the cartel prohibition). SMEs are, in short, a favoured class for protective treatment under the competition law.

The issue, already debated in Germany for some time, is whether the advantages of these arrangements outweigh the competition effects and impair performance in terms of productivity, costs and prices. For the *Mittelstand* to remain competitive, it should not be over sheltered.

Some sectors are still heavily regulated: a concern to promote quality may be impeding competition and innovation

An important set of heavily regulated *Mittelstand* sectors are the retail trade, craft services and professional services, and pharmacies. The question is whether the right balance has been struck between necessary regulation to protect and promote important goals and values, and market freedom. The government is aware of this issue, and has recently made some important changes.

The retail trade in Germany is traditionally highly regulated compared with many other European countries. For example, opening hours are still more restricted than in many other European countries, and there are restrictions on discounts outside the sales seasons as well as prohibition of below cost pricing (an important case concerning the latter has recently been upheld by the courts). However opening hours rules are now being relaxed. It is also noteworthy that productivity in German retailing is above the European average.

The crafts sector is also highly sheltered and entry is difficult and costly. For 94 crafts and services, a master's certificate is required in order to operate independently and to own a company in the field (a system that can be directly traced back to the medieval guilds). Professional services have been regulated to prevent competition: rules of the professional associations that limit the competitive freedom of their members, for example on fees, are exempted from the competition law. The Agenda 2010 programme, together with the Initiative to Reduce Bureaucracy, suppressed the master's certificate requirement for 53 out of 94 trades. Nevertheless, a master's certificate may still be obtained in these trades.

Business structure restrictions on pharmacies – pharmacies must be owned by pharmacists, and pharmacists may own one pharmacy at most – do not appear to promote consumer interests, as economies of scale cannot be exploited. Mail order trade in pharmaceuticals is also currently restricted. The experience of other OECD countries suggests that with adequate protection in place, this market can be safely opened up. Current health sector reforms address some of these issues: for example mail order retailing will be allowed and pharmacists will be able to own up to four pharmacies (regionally restricted).

Public procurement rules do not encourage adequate competition

Public procurement rules raise a number of issues. Calls for public procurement published at the EU level are the lowest in the EU, accounting for slightly less than 1% of GDP, compared with an estimated total contract value of just over 17% of GDP. The aim is not to evade the EU threshold rules (which are the same for Germany as for other EU countries and which Germany observes) but rather to encourage bids from SMEs. A large number of procurement contracts acts are therefore deliberately split up to make bidding by SMEs easier. The fact that such contracts are then not required to be published at the EU level because of their small size (they are published domestically) makes it harder for foreigners to learn of opportunities.

The German public procurement legal framework is also extremely complex. As in most other EU countries, EU directives are implemented in such a way that EU and national law coexist: above a certain contract value EU law applies, and below it national law applies, which can vary between the sixteen *Länder*. The level of the EU threshold varies by type of procurement. Also, EU legislation has been integrated into a web of different German laws and rules – the competition law, the ordinance on public procurement, and the procurement codes. Legal protection for bidders varies according to the value of the contract. Above the EU threshold every domestic or foreign bidder can appeal to the public procurement tribunals. Legal protection below this threshold is inadequate. The manner in which EU law has been integrated into German law results in a lack of transparency.

Finally, public procurement committees (made up of federal and *Länder* representatives and business associations representing important domestic clients) create the procurement codes. This is likely to reinforce the closed nature of the process.

Network industries: substantial further progress is needed for effective liberalisation

Court appeals on regulatory decisions in the network sectors are widespread but the process is slow: this needs urgent attention

The use of the courts to challenge regulatory decisions in the network industries is widespread. Delays in the courts hamper enforcement against denial of network access. If an *ex post* approach is to work, speed is vital so that market participants are not discouraged. Even with *ex ante* regulation (as in telecommunications) challenges are numerous (Box 1.11). Although judicial review is important and a right that must be protected, it should not be allowed to become a mechanism to routinely block or delay the application of sound regulatory decisions. Regulators need adequate and clear statutory authority to implement and enforce their decisions. The new Telecommunications Act helpfully proposes a two-stage rather than a three-stage appeals process.

A stronger policy framework for network sector regulators needs to be developed

Germany has experimented in the last few years with different paths for the oversight of liberalised network sectors: a regulator for telecommunications, none for electricity and gas. Neither approach has been wholly successful. Though it is now acknowledged that *ex post* competition law oversight is not enough for network sectors, the regulatory story in telecommunications has been controversial. What is the solution? It is not to go backwards and rely mainly on *ex post* surveillance, but rather to go forwards with a regulatory approach as an essential adjunct to the competition law that seeks to draw lessons from regulatory experience so far. Such analysis is beyond the scope of this project, but several

Box 1.11. **Problems with the enforcement of regulatory decisions in telecommunications**

Regulatory decisions in telecommunications often take a long time to be implemented. Even though the law says that RegTP decisions stand pending appeal, the telecommunications incumbent (DTAG) can and has successfully used the courts to suspend the obligation to comply, and in practice RegTP refrains from implementing decisions pending a decision by the courts. Many rulings have been contested over months or even years. About 210 court cases are pending today. Germany's confidentiality rules add to the delays. Key data cannot always be submitted by RegTP to the courts to justify its decisions. Examples of problems which have arisen:

1. *Leased lines*. DTAG's prices are relatively low but delivery times had been among the longest in Europe until 2002. RegTP imposed a number of requirements on DTAG in response to complaints. But DTAG appealed and the court's decision suspended the obligation to implement RegTP's decision, on the grounds that DTAG is obliged to offer competitors only those conditions which it offers itself internally, and that RegTP had the burden of proof for showing this.
2. *Internet access*. This is now one of the major generators of traffic over the telephone networks. RegTP has been blocked in its efforts to require DTAG to offer an appropriate wholesale interconnection product to Internet access providers. DTAG has successfully appealed to the courts (the case is ongoing). The courts have defined non-discrimination as follows: DTAG can only be obliged to offer products to competitors that it uses itself. This is a severe and arguably inappropriate test, because an incumbent running the network may not always need the same product as competitors seeking connection to the network. Competitors fear it could mean that every regulatory decision to oblige DTAG to provide an interconnection product could be denied because DTAG does not use it internally.
3. *Line sharing*. The enforcement of a requirement on DTAG for line-sharing took over two years to be resolved.

important issues need careful review. These include the issue of regulators' powers (are they strong enough and appropriate for the task? Are they quite clear?); staff competences (a careful mix is needed that will enable regulators to deal effectively with the regulated entities for which they are responsible); and independence (ensuring that the State's roles relating to ownership, policy making and regulation are carefully separated, and that regulators have the operational independence they need for their job).

Some concerns, for example, have been expressed in the telecommunications context over the independence of the ministry and RegTP *vis-à-vis* DTAG, in which the government still has a 42.3% share. Is there a conflict between the government's interests as a shareholder and regulator? DTAG's current debt problems and falling share price may be increasing pressure for a tolerant regulatory attitude toward the anticompetitive conduct of what the government may also consider to be a national champion.

The electricity and gas sectors: stronger structural reforms and a regulator are needed

Though the *electricity sector* was fully opened to competition in 1998, the approach of negotiated access has not yet succeeded in securing effective and sustainable competition. There have been no new competitive domestic entrants into generation so far (though this

has to be appreciated against the background of overcapacity in generation at the start of liberalisation, and the addition of considerable new capacity from renewables enjoying a guaranteed price regime). Market concentration has become an issue. Intense merger activity since liberalisation has resulted in vertical as well as horizontal consolidation. The four major utilities are responsible for transmission and system operation and there is evidence of problems with market power. Distribution and supply remain tied up with traditional regional and local companies, and vertical integration dampens competitive procurement. Electricity prices have risen (after falling considerably following market opening) not least because of the imposition of environmental taxes. Compared with other OECD countries, industrial prices are now around average but small consumer prices are high. The renewed rise in electricity prices is mainly due to government-imposed burdens such as the eco-tax. Private consumer switching of suppliers is low as in most other countries where private households are free to choose their supplier.

The *gas sector* was also opened to full competition in 1998 but *Ruhrgas* remains the dominant company. It imports 60% of gas consumption, and controls a large part of the high pressure pipelines within the country and about half the storage facilities. Gas prices are high compared with other OECD countries.

There is a need to tackle structural issues more forcefully. The basic problem is discriminatory behaviour which is facilitated by the industry's structure. Vertical as well as horizontal integration opens the door to cross-subsidisation of activities. An effective separation of activities, and especially the network from other activities, is needed. If ownership separation of activities is not feasible, effective accounting separation, which does not exist today, is essential. Key issues in the Associations Agreements are the proposed pricing principles and rates of return for network access (and a linked issue of regulatory accounting), which may be encouraging companies to set higher access fees than necessary.

Just as important, there is a need to rethink the regulatory framework, which after five years, and despite valiant efforts by the BKartA, has not yet delivered effective and sustained competition. Providing effective network access is perhaps the most decisive factor in stimulating competition, and here the competition law needs the assistance of pro-active *ex ante* regulation by an independent regulator. The new EU internal market directives require the nomination of a regulatory authority. The Ministry of Economics and Labour proposes giving this task to RegTP as from July 2004.

The original telecommunications incumbent is regaining lost ground and needs to be controlled more effectively

Despite important achievements, competition in telecommunications remains fragile. DTAG, which has not yet been fully privatised, is regaining lost market share and consolidating its lead in important new markets such as DSL broadband services. It has, in effect, slowed the roll-out of cable broadband services, and has successfully challenged the regulator's authority on key issues such as pricing and leased line provisioning (Box 1.11 above).

A difficult and puzzling issue is the controversial stance taken by RegTP on some important regulatory issues which contradicts the position taken by many other regulators in OECD countries (Box 1.12). Also, regulation of DTAG, which is still partly government-owned is shared between the regulator, the competition authority and the ministry. The approach sometimes appears lenient. This may reflect an over-strong political interest in the sector's regulation, which should be managed independently of short-term political considerations.

The new telecommunications law should be very helpful in clarifying the regulator's powers, among other issues.

Other network industries need a stronger approach both to liberalisation and regulation, in order to secure effective competition

The *postal sector* is moving towards competition, but slowly. The development of a more competitive postal market has been delayed by the government's decision in 2001 to prolong the monopoly of *Deutsche Post AG* (DP) on domestic letter delivery below certain weight thresholds (recently reduced) to the end of 2007. The government has instead decided to follow the EU liberalisation schedule. Where competition has been introduced the playing field is far from level. DP is for example exempt from sales tax, including on revenues generated in competitive markets (to compensate, somewhat arbitrarily, for its universal service obligation). The experience of postal market liberalisation combined with an effective regulatory framework in some other OECD countries has been very positive.

There has been some progress in introducing an appropriate regulatory framework in the *rail sector*. From mid 2002 the Federal Railways Office (which had been mainly concerned with technical and safety issues) was granted greater powers in relation to third party access, though not the power to regulate route charges. The dominant incumbent, *Deutsche Bahn*, has been forced by the BKartA to introduce a non-discriminatory route pricing structure. The Acts on railway reform and revision of the General Railway Act in 2002 have been helpful. The government expects further improvements to flow from

Box 1.12. **RegTP's controversial decisions**

1. DSL broadband services. Following complaints, RegTP investigated DTAG's pricing, and found some elements below cost, but did not take action because a predatory effect had not been proven. Complaints continued and DTAG eventually raised its prices. The sequence of events suggests that DTAG engaged in a predatory strategy to secure the long term broadband services market for itself (with initial price cuts to deter competitors, and once this had worked, price increases to recoup the initial losses). RegTP explains that it sought a balance between roll-out and competition: encouraging broadband roll-out by allowing DTAG to charge low prices, but also placing obligations on DTAG to allow equal access to its lines by competitors. The outcome suggests this was a flawed strategy, as DTAG has now asserted its dominance in this market. DTAG has been accused of "price dumping" in other markets too.
2. Fixed to mobile termination charges. RegTP's stance – they are not regulated – contradicts the view of the EU Commission and of a growing number of regulators that fixed to mobile termination charges are excessive.
3. Local loop unbundling. Local loop unbundling (LLU) is an important method of providing high speed broadband services (such as high speed Internet access and video on demand). Though Germany was the first European country to require a form of LLU it lost its lead. In fact the EU has taken action against Germany for failing to implement the EU regulation on LLU, noting the lack of any published reference offer for LLU. A key issue is pricing by DTAG. Competitors have argued that they were being squeezed by DTAG's prices for access to unbundled local loops, which was more than what they could charge their own customers. The price squeeze problem has now been addressed by RegTP (among other measures it has reduced the access price payable to DTAG).

implementation of the "Future of the Railway" Task Force recommendations, and of the EU infrastructure package. The intention in this context is to introduce rules ensuring non-discriminatory access to the rail network and to separate, in line with EU requirements, the network from train operation. However the government still considers that regulation of prices for third party network use is unnecessary given the likely pressures of competition on the track operator.

It is not yet clear whether all the changes, when they have been made, will be enough to ensure effective and sustained competition. This will need effective separation of the track from train operation. Also, the Federal Railways Office should have the power to regulate route charges, and ownership separation of the network from potentially competitive activities should be considered in the context of privatising *Deutsche Bahn*.

The *water sector* has a good performance in term of public access to water supplies and sewage treatment facilities, but efficiency is an issue. German drinking water charges are among the highest in the EU. Though the introduction of competition in the provision of water services is more difficult than in other network industries, there is scope for improving efficiency through the greater use of benchmarking, expanding the geographical coverage of individual water works, and the use of competitive tendering for water contracts.

Competition law and policy: a need to refocus more clearly on some of its original aims

The right balance needs to be restored between the promotion of competition and support of market relationships

The competition law's motivating ideas have become diffuse and in some respects have weakened over time, through legislative fine-tuning of the rules, and the special-interest character of some of the changes (quality for the consumer, protection of the *Mittelstand*). A key goal of the law is to protect market relationships and structures where these are expected to contribute to an efficient market outcome. Germany may want to consider whether this is still working effectively. Could the pursuit of this goal be encouraging (however unintentionally) the status quo, and making new entry and innovation difficult?

To redress the balance between competition and co-operation and to give more weight to the former, controls over means of doing business and in some cases over terms of entry into professions, services and crafts need review. The current system raises costs and limits entry unnecessarily. For example constraints on discounts and pricing – some of them in the competition law itself – probably tend to keep price levels too high and prevent marketing innovations. However changes are underway in the law on discounts.

The competition law alone is not enough for the network sectors: a difficulty which is now being addressed

As an agent of effective change in liberalising network sectors, the competition system faces difficulties. At a very general level, competition law enforcement (the responsibility of the BKartA) and policy (the responsibility of the ministry) are not strongly linked in practice (although the BKartA ultimately reports to the ministry). This can weaken the link that needs to exist between them in managing the development of competition as well as its counterpart, re-regulation, in these sectors.

The BKartA's enforcement tools are not well suited for applying competition law and for promoting competition in infrastructure sectors where competitive markets have not yet taken root, and which have a network monopoly core. Enforcement of the competition law in these sectors has proved difficult. The normal *ex post* process for tackling misconduct is ineffective. The usual methods of analysis and proof are hard to apply: notably, there are no comparable markets with which to compare prices. Court delays are also a major issue (see above). Germany is in a state of transition as regards the use of regulators to meet needs in these sectors which cannot reasonably be addressed by the BKartA alone. As already discussed, a regulator was established for telecommunications when the sector was liberalised, but not for electricity and gas.

The government now recognises the problems raised when the competition law is not supported by regulation. Its original "hands off" approach to regulation of the electricity and gas sectors stood out in marked contrast to nearly all other OECD countries. The experiment of self-directed industry regulation supported by competition oversight of these sectors is now giving way to a solution in which the competition law will have the necessary support of *ex ante* regulation.

Public expenditure management: a pressing need for reforms to contain costs and improve efficiency

Fiscal consolidation is now a priority. Recent developments reinforce this. Consecutive tax reductions over the last couple of years were not reflected in proportionate cuts to government spending. Against this background weak economic growth has increased the deficit. But the issue is also structural and longstanding. Social assistance and unemployment-related benefits contain considerable scope for reform to reduce disincentives for improving labour supply and encouraging job searching. Increasing social assistance, disability, sickness and unemployment benefits reduce incentives to be part of the labour force, and contribute to a disfunction of labour markets. Financing the expenditure necessitates an increase in public contributions which increases taxation and non-wage labour costs, with adverse implications for labour supply and demand. And the costly active labour market measures are often ineffective in improving the chances of re-employment, as well as discouraging wage adjustment in the new States. Instead of remaining in the labour force on terms that better reflected realities (such as productivity levels), those who have lost jobs have often instead been absorbed into social welfare.

Spending pressures are likely to persist, due to the continuing fiscal burden associated with re-unification and the substantial deterioration of the old age dependency ratio. A number of measures have already been taken. Not least, the domestic Stability Pact agreed in 2002 is an important step toward securing a higher degree of fiscal discipline across the different levels of government.

Public expenditure needs more cost-efficient management

Efforts are needed for the more cost-efficient management of public funds. The same outputs can be achieved with less funding, which can reduce the government's financial needs and hence the tax burden (the high-spending health sector is a potential candidate). Or the same funding can be put to more effective use, for example by improving the quality of public services (the education sector is a potential candidate). The goal of greater efficiency can therefore be made to work hand-in-hand with Germany's longstanding and legitimate concerns about solidarity through social welfare.

The government has already taken some measures in this direction. Steps have been taken toward the introduction of modern resource accounting for public expenditure at both federal and *Länder* level: ensuring that all costs are taken into account (the costs of administrative services used not to be included), relating expenditure to outcomes, and including assets and liabilities. This does not yet go as far as some other OECD countries (Box 1.13) and needs to be reinforced.

Box 1.13. **Linking expenditure to outcomes: the UK approach**

The UK introduced a new fiscal framework in 1997. The core is that ministries (departments) now operate under three-year plans for discretionary expenditure, subject to Departmental Expenditure Limits (DELs). The finance ministry is committed to this funding and in exchange, departments are held accountable for achieving policy targets specified in Public Service Agreements (PSAs). A department's DEL is dependent on having agreed PSAs in place to determine performance against allocated resources. The relevant minister is responsible for meeting PSAs, and progress is monitored by the finance ministry. PSAs start with an overarching departmental aim, followed by objectives and then quantitative targets against which performance can actually be measured. They also include "value for money" targets that allow inputs to be related to outcomes. PSAs are cascaded from departments to agencies, local authorities and other non-departmental public bodies.

The quality of targets is work-in-progress, as departments seek to move away from input and process targets, to output and outcome targets.

Resource accounting has also been introduced.

The evaluation of public expenditure is another important target for reform

The federal court of auditors as well as the *Länder* courts in their annual reports have stated repeatedly that there is not enough evaluation of the effectiveness of public sector spending. Is the money well spent? Does it deliver acceptable outcomes? Both *ex ante* and *ex post* evaluations are needed. Though key infrastructure bottlenecks have been removed in the new *Länder*, others remain, especially some decayed regional transport networks whose renewal would help to foster growth. Such areas need early attention to avoid further decay and preempt a future need for even higher funding. Money has instead tended to go on less growth enhancing areas such as the central administration. Evaluation can help to identify the costs and benefits of alternative projects.

The federal-State fiscal relationship, especially co-financing, also needs reform: it works against containing costs and demand

Complex institutional arrangements are in place to promote inter-governmental co-operation and revenue-sharing, with the aim of creating broadly equivalent living conditions across the federation, and accommodating the regional governments' financial needs. However optimal efficiency in resource allocation is not achieved, for a number of reasons. The relationships are complex, in terms of responsibilities as well as funding (Box 1.14).

Box 1.14. **Co-operation and revenue sharing between the different levels of German government**

The power to raise taxes rests mainly with the federal government. Revenues, however, are predominantly shared between the different layers of government. Superimposed on this primary system of tax-sharing is a secondary redistribution system aimed at meeting the constitutional objective of broadly equivalent living conditions. This involves both vertical transfers from the federal government to the *Länder* and horizontal transfers between the *Länder*, aimed at accommodating the regional governments' financial needs. Similar arrangements exist between the *Länder* and the communities. Special vertical transfers go from the federal government to the new *Länder* to promote the catching-up process (the "Solidarity Pact"). Also, certain spending projects are co-funded between the federal government and the *Länder*, and the *Länder* and the communities.

The fiscal relationship between the different levels of government is complex and does not encourage cost-efficiency. This applies in particular to activities that are co-financed by the three layers of government (federal, State and community). Co-funding grants extended by the federal government to the Lander and local governments accounted for some 0.8% of GDP (EUR 17.4 billion) in 2002. The *Länder* also co-finance projects in their communities with their own resources, so the overall figure for co-financed public expenditure is even higher. Broadly, three schemes involving the federal government can be distinguished. "Joint Fiscal Tasks" are jointly decided by the federal government and all States, and cover fields such as university construction, subsidies to improve regional economic structures, and financial aid for R&D. "Investment Aid" can be granted for major investment projects by the *Länder* or communities to promote balanced economic development. And grants for the "Disbursement of Funds" support social transfers by the *Länder*.

Co-financing is perhaps the most important issue. Efficiency and cost control of co-financed projects is impaired by the fact that the *Länder* and communities are likely to opt for spending projects so long as the perceived benefits exceed their own partial budgetary costs. So an effective cost-benefit analysis of a project cannot take place, because the total costs of a project are not taken into account. The potential for a distorted view is large: the federal budget contribution is usually 50% (it can be up to 90%, but only in exceptional cases of financial assistance for significant investment by the Lander/municipalities). Split responsibilities for a project not only seriously impede effective project evaluation but also project control.

Health expenditure is high but outcomes are only average: reforms should be developed further to improve efficiency

Health expenditure relative to GDP increased in the 1970s, was roughly constant in the 1980s and rose again in the 1990s (partly as a consequence of re-unification). Within the OECD, Germany has a relatively high spending-to-GDP ratio. Access to health services is excellent, but various indicators of health outcomes are close to the OECD average, suggesting scope for efficiency improvements. A number of steps have already been taken (Box 1.15). Reforms to improve efficiency and reduce costs are important, against the background of an ageing population which is making increasing demands on the health system, and continuous improvements to medical technology which are also stimulating a growth in demand.

Box 1.15. **Health sector reforms**

Recent steps to improve incentives in the health care system include the introduction of a diagnosis-related payment system (DRG) for hospital care, currently in preparation. This could be a significant source of savings by cutting the average length of hospitalisation, provided that efficient systems of cost information and for monitoring the quality of services are also put in place. The freedom for health funds to contract selectively with health care providers has been widened and more freedom given to consumers in choosing their insurer. Recent reforms introduced financial incentives to implement disease management programmes for selected chronic conditions. This is a positive step, but further reform should encourage the health funds to develop into active purchasers of health services on behalf of their patients, and to offer differentiated products. To this end the current arrangements which favour collective bargaining between the funds and health provider organisations should be re-examined. A more comprehensive risk equalisation system would mitigate the risk of cream skimming.

The education system is also costly: comprehensive reforms are needed to improve outcomes

Germany spends more than most other OECD countries on secondary education. But student performance was found to be poor in the recent international PISA study. The study also suggests that successful education systems are those that combine standardised targets for educational outcomes with decentralised flexibility and responsibility on how to achieve them. The German school system tends in the opposite direction. It is characterised by tight regulation on schools (for example no freedom to select teachers) and the absence of nationwide uniform educational standards. This points to the need for a comprehensive change in the regulatory framework. Nationwide standards, combined with regular evaluation, should be introduced. At the same time schools should be left more freedom to determine suitable ways of reaching their targets.

Tertiary education is also costly for public budgets, and suffers from long study duration and high dropout rates. Recent initiatives to shorten tertiary education and improve incentives for university teachers to deliver high quality teaching need to be widened. Tertiary studies with a shorter duration should be introduced on a broader scale. Consideration should also be given to allowing universities the right to levy tuition fees. Distributional aspects could be addressed by adjusting student support schemes. Reform should also promote greater competition between universities and public funding of universities should be linked to performance.

Regulatory governance: a number of important issues need attention to promote a more dynamic framework

Regulatory governance also needs to be strengthened and developed, in order to provide effective support for more specific reforms. The enduring strength and completeness of Germany's post-war governance framework, as well as the distraction of re-unification, has masked the need for it to adapt. It is also very difficult to make changes to a system which works on the basis of a carefully crafted, coherent and balanced set of components. Germany's regulatory functions are an integral part of a much wider governance approach which supports a set of core societal values: the importance of the rule of law, the need to balance co-operation alongside competition, co-operative federalism, and the search for

consensus in decision-making. Important changes, poorly handled, might risk destabilising the whole structure. The challenge is nevertheless to move forward and accommodate the development of a more dynamic regulatory governance system: one that makes the search for regulatory quality a permanent and continuous feature of the system. The traditional German system is more static than dynamic, and tends to adapt relatively slowly to new circumstances. The OECD Secretariat considers that reform initiatives launched over the course of the last few years appear to have difficulty making effective headway over time, and engendering any deep changes to the existing system seems difficult. But if the more specific reforms needed to promote faster growth are to succeed, they need the support of a more dynamic and adaptable regulatory policy environment, in which questions are constantly asked about the appropriateness of regulations for their purpose, costs and benefits, as well as outcomes, and which can help to speed up decision-making without losing important stakeholders along the way.

The following sections identify specific areas of the current system that raise concerns and need change.

Organised interests slow up the decision-making process: a more efficient process needs to be developed

Organised interest groups take part in the long-standing traditions and practices of elaborate, consensus-driven decision-making. Over time, this has led to an increasing interlinkage between the players taking part, who should ideally be independent of each other. Many players at different levels of the system and with different degrees of legitimacy – organised labour, organisations representing industry or the *Mittelstand*, a *Bundesrat* dominated by parties in opposition to the government – are increasingly capable of blocking or stalling the political decision-making process. The consequence is that urgent reforms, to which everyone agrees in principle, must go through a lengthy process and may also end up as the lowest common denominator that can be shared by all (Box 1.16).

A more efficient rule-making process is needed. This issue has been the subject of much debate in Germany, with no conclusive results, partly because the changes needed to make a real difference could go too deep (even, possibly, constitutional change). An independent committee set up by the government in 1994 issued proposals, but these were never followed through – perhaps because they became caught up in the very processes they were intended to reform.

Some other OECD countries have a similar strong tradition of consensus-driven decision-making, but back this up by putting the development of major legislation in the hands of official government-appointed preparatory committees. Though this is not a German tradition, recent years have seen the development of government-appointed preparatory committees, including the *Hartz* Commission for the labour market, and the *Rürup* Commission for the health sector and pensions. This is a positive development if it can be accommodated without undermining the consensus-building process which is a major pillar of Germany's governance system.

Transparency and accessibility in rule-making are an issue and outsiders are disadvantaged

Transparency is one of the central pillars of effective regulation – that is, regulation that will be suited to its purpose. It is a challenging task and involves a wide range of practices, including standardised processes for making and changing regulations,

consultations with interested parties, effective communication of the law and plain language drafting, publication and codification to make the law accessible, controls on administrative discretion, and effective implementation and appeals processes.

As matters currently stand, there are no government-wide obligations on ministers on how to conduct public consultations. German consultation procedures are generally governed by traditions internal to individual ministries. A consequence of this discretion is that draft regulations are not made systematically available for public consultation. For example there is no single Web-based public access point for draft regulations, as in many other OECD countries. Laws must be published when they are agreed and before they enter into force, but not drafts.

The consensus-building process is driven by established, somewhat informal networks of stakeholders. The early start to informal consultation and the sustained participation and involvement of these stakeholders means that the latter have a major influence on the final legislation. Conversely, it excludes any influence by others, raising important accessibility and cost issues for outsiders, for example parties which do not belong to the organised bodies such as the Federal Association of German Industry (BDI). Those who are not selected as consultation partners or who are not familiar with the workings of the regulatory process risk being systematically, albeit unintentionally, disadvantaged.

Box 1.16. **Is the German governance system slow in promoting change?**

A number of reform examples suggest that the German governance system may be slow in promoting necessary changes. Changes are eventually made, but valuable time may be lost, with costly consequences for the economy. Reforms to the regulatory governance system itself appear to be victims of this problem:

1. *Regulatory governance reforms.* The Lean State programme was initiated in 1995. It took two years for a committee to be set up to promote the implementation of recommended measures. Many measures have not yet been implemented. The process of developing the RIA framework has been slow too. An RIA handbook and guidelines were commissioned in 1998, and the practical implementation of the new system is still "work in progress". A substantial revision of the guidelines is being prepared for 2006, including a report on methodologies due in 2004.
2. *Freedom of Information Act.* Launched as part of the *Modern State – Modern Administration* programme in 1999, and originally scheduled for finalisation in 2001, this is still subject to internal government discussions.
3. *Telecommunications reforms.* The failure to formulate and implement effective rules for competition promptly and effectively is the most serious weakness of the current telecommunications regime. The implementation of EU law has often been slow and reluctant.
4. *Electricity and gas reforms.* These sectors were liberalised five years ago under a regulatory regime which was somewhat unusual in the OECD, and which has not been able to deliver effective and sustained competition. The need for change – which is now being implemented – might have been foreseen sooner.
5. *Pension and labour market reforms.* A strong case can be made that action might have started much sooner. Though pension reform is proving slow to engage in many other European countries so Germany is not alone on this issue, labour market reforms have already been engaged for some years elsewhere (for example in the UK).

The evaluation of rules is weak: costs and benefits are not systematically assessed and are often unclear

German principles for good regulation promote a high legal quality. But the law-driven culture also means that there is only limited use of evaluation and quantitative, evidence-based assessments to help regulatory decision-making. The traditional focus on administrative burdens and the many projects over time to reduce the number of rules is laudable. But a more systematic and quantitative evaluation of rules and their costs and benefits might have sidestepped some of this effort by avoiding the adoption of burdensome rules in the first place. This point applies well beyond simpler administrative burdens, to whole regulatory frameworks and high-level decisions. For example in telecommunications, the government's aim to minimise regulation should be carefully tested in relation to the current state of competition and the effectiveness of today's *ex ante* regulatory regime. This requires improved information, regular market monitoring, and the development by RegTP of performance indicators. Another example is the electricity and gas sectors where evaluation of policies could have been (and still could be) helpful.

This is not to say that Germany lacks any evaluation system: it was among the first OECD countries to start down the RIA path. RIA is perhaps the most important regulatory tool available to governments, as its aim is to ensure that the most efficient and effective regulatory options are systematically chosen. It is, however a challenging process which needs to be built up over time. It combines good habits of consultation with a rigorous review of the impact of prospective rules through a clear and balanced assessment of costs and benefits.

Cumulative initiatives starting with the 1984 *Blue Test* questions underline a significant effort to help regulators prepare effective RIAs. But the equally longstanding problem is that procedures are not sufficiently carried out, due to lack of operational guidance, lack of expertise at the centre of government to guide ministries, a reluctance among regulators to use RIAs, and the absence of monitoring and sanctions for non-compliance. In short, a culture that puts a priority on the deployment of RIAs at the outset of the rule-making process does not yet exist.

The legal culture of the administration does not support the promotion of regulatory quality: this needs to be encouraged

The pre-eminence of lawyers in the administration goes back to ensuring fairness, balance and a firescreen against capture by special interests. These are important goals. The *Rechtsstaat* tradition promotes law-trained civil servants, even for posts with a high economic content. But at the same time it discourages an economic perspective on issues and a full appreciation of the importance of evaluation which includes quantitative cost-benefit analysis, key components for ensuring regulatory quality. A number of economic research institutes offer policy advice to the government. But this advice may not always be well-digested by civil servants who lack themselves an economic training and outlook. Nor does it encourage the development of economic and other missing competencies within the administration itself. There is an application gap between the ideas and tools developed by academics and the practical rules and guidelines needed to make the ideas and tools operational.

Reflecting the general strength of the legal tradition, most business and consumer representatives also have a legal background.

Successive reform initiatives aimed at improving the efficiency of the administration underline these weaknesses. The reforms have tended to look inwards, and have overlooked the need for reforms aimed more directly at improving prospects for the economy, at least until recently. There appears to be no assessment of the impact of reforms either.

The regulatory system is complex and likely to promote costly regulatory outcomes: it needs streamlining

The regulatory system is complex, characterised by an increasing number of federal regulations, often expressed in complex legal terms. As noted, most federal rules are addressed to the *Länder* for implementation as they see fit. The way that regulations are implemented across Germany therefore varies from State to State.

Germany's public administration has a tradition of steep hierarchies covering narrowly defined administrative responsibilities. This has fostered specialised administrative competencies, but it also feeds specialised, sectorally-based approaches to regulation. Framework procedures are often overruled by specific procedures for particular policy areas, for example planning, and establishing a business. There are signs that specific procedures are proliferating.

The combination of a law-driven administration, in which cost-benefit analysis has difficulty making headway, and the complexity of the regulatory governance system may be driving unnecessarily costly regulatory outcomes. An example is the tax system, which is probably the most complex in the Europe.

Self regulation needs careful evaluation to ensure that it is the most appropriate approach

The *Modern State – Modern Administration* programme emphasised the need to strengthen society's potential for self-regulation. There are already clear formal obligations on regulators to consider alternatives to regulation, such as self-regulation, including a checklist in the federal government's Joint Rules of Procedure to identify opportunities for self-regulation. The federal government has also recently commissioned some research which proposes guidelines for "regulated self-regulation", that is, what to consider when establishing regulatory regimes based on self-regulation. The current checklist already includes a number of pertinent questions to shed light on whether self-regulation would be the right approach, the necessary framework role of the State, and how the State might need to remain involved. One important conclusion of the research is that the advantages of this approach are high when the defined policy objectives are *not* considered to be fundamental to the public (which therefore implies that the reverse also holds true). Caution is therefore needed in applying self-regulation to important sectors.

Self-regulation is part of the German tradition. Many activities are already subject to regulatory frameworks which have been developed and are managed by representatives of the sector, albeit under the umbrella of a comprehensive and efficient competition law and authority. These include professional services, the electricity and gas sectors, and public procurement.

This raises an issue: there are problems with these areas which a rigorous application of the current procedures (if not the more recent proposed guidelines) might have helped to identify. For example, the holders of the masters' certificates which are required for entry into many services and crafts are active in setting the rules and standards for their trade, and new entry is difficult. A similar problem exists in the electricity and gas sectors

where market entry is difficult. Existing systems of self-regulation as well as proposed new ones should be subject to the same analysis.

A central regulatory quality system needs to be developed: this would help to drive forward a dynamic regulatory policy

As noted, elements of a potentially effective regulatory policy already exist. But there is no single central unit responsible for promoting regulatory reform across ministries. Existing arrangements could be developed in this direction, including closer working arrangements to promote an organised approach and avoid fragmentation, the development of analytical expertise, and the implementation of a broader range of regulatory quality standards. Many other OECD countries have now set up central units (Box 1.17).

Box 1.17. **Central regulatory quality units: OECD experiences**

Experience across the OECD suggests that central oversight units are most effective if they are:

- independent from regulators (*i.e.,* they are not closely tied to specific regulatory missions);
- operate in accordance with a clear regulatory policy, endorsed at the political level;
- operate horizontally (*i.e.,* they cut across government);
- staffed by experts (*i.e.,* they have the information and capacity to exercise independent judgement); and
- linked to existing centres of administrative and budgetary authority (centres of government, finance ministries).

Central oversight units can carry out three different roles. Firstly, bodies may be *advisory*, *i.e.,* increasing regulatory capacities by publicising and disseminating guidance and by providing support to regulators. The second role, *advocacy,* refers to the promotion of long-term regulatory policy considerations, including policy change, development of new and improved tools and institutional change. Thirdly, bodies promoting regulatory quality may have a *challenge* function *vis-à-vis* new regulatory proposals. Such challenge may be in the form of an assessment putting pressure on the proponent regulatory body to improve performance in accordance with a set of given criteria. Or it may in the form of a "veto", where the reviewing body acts as a gate-keeper in the regulatory process.

Experience suggests that most regulatory policies have relied primarily on advocacy and advice. Advisory and advocacy functions are helpful preconditions for creating a fruitful and non-confrontational environment for regulatory quality. However leadership in the form of regulatory oversight bodies challenging as well as setting and enforcing targets for regulatory quality may be needed to go beyond the limits of reforms that are primarily driven by self-assessment.

The political economy of reform: strengthening the role of marginal stakeholders

The political economy of reform – how to manage the process of reform and encourage support for it – is a challenge for all countries. In Germany's case the challenge is sharpened by the fact that current stakeholders in the decision-making process are both longstanding and have interlocking interests. One answer is to seek ways of involving new or currently marginal stakeholders. Three important categories of stakeholders may not be

Box 1.18. **Strengthening the role of marginal stakeholders in the reform process**

Consumers face a paradox. They are protected – maintaining quality for the consumer is the driver of considerable regulation. But at the same time they appear to have relatively little influence in the rule-making process. There is no strong national consumer protection authority. Competition policy recognises how consumers benefit from it, but consumer policy is not closely linked. In the context of the EU Green Paper on consumer protection, Germany has argued against new and stronger consumer protection structures. Germany also does not support mutual recognition of consumer rules in the EU because it would threaten what it believes to be its higher-level protections. Consumers have particular problems making their voices heard in the network industries. For example the interests of residential and small business consumers of telecommunications services appear to be weakly represented. Consumer organisations may need more government support and even funding to help them participate effectively in the rule-making process.

In principle foreigners face the same issues and potential difficulties as domestic firms in dealing with the German administration. In practice they may find it harder, confronted with the precision of the German approach, the extent of regulations, and the complex federal-*Länder* architecture and division of responsibilities.

New and small firms are also likely to find it difficult to afford the time and money necessary to participate in the rule-making process.

playing a strong enough role in the current system and could lend new perspectives and perhaps valuable support to new initiatives – new firms, foreigners and consumers. A rebalancing of existing stakeholder interests would also be helpful, for example in the wage bargaining context, and in the federal-State relationships.

A second part of the answer is to consider how governance structures and policy areas might be rearranged so as to be less overlapping and intertwined. This would include reform of the mixed State-federal financing. Competition and benchmarking between the *Länder* could also be encouraged. A central regulatory unit to help mitigate overlap and encourage the adoption of general rules, for example on RIA and consultation, would be valuable.

Third, it is important to sustain the momentum of reform. Some past reform initiatives seem to have petered out. Reform results should be monitored and the public should be kept informed, to maintain broad support.

Last but not least, communicating the benefits of reform needs to address the legitimate concerns of stakeholders who fear they will lose out. Successful reform in the long run requires a broad constituency and effective co-ordination. This is likely to be especially true in Germany's consensus-driven society.

Conclusion

Germany faces the need for important structural adjustments to its economy. It must find a path to stronger growth which will enable it to manage the problem of a rapidly ageing population and help close the gap in performance between its eastern and western States. Though re-unification has imposed a heavy burden, more than was expected initially, it is not the only factor behind the slow growth. Deep-seated governance and structural issues have come to prominence with the pressures of re-unification.

The governance and regulatory framework which has evolved from the original social market economy blueprint after the war has a number of strengths, including a very reliable administrative culture based on the careful application of the rule of law, and a strong and comprehensive competition law and policy. Trade policy and regulation is also generally strong, and helps to sustain Germany's good export performance. Governance and regulatory structures seek to maintain a careful and necessary balance between different stakeholders and levels of government, and to promote solidarity across the federation. These goals remain important to Germany's overall wellbeing. But the system is static, predicated from the start on the idea that an effective balance has been achieved. It is not a system that accommodates or promotes change very easily. With re-unification the understandable instinct was to stay with it. Re-unification distracted from reflection on the possible need for reform in the context of wider changes in a global economy, and of certain underlying weaknesses in Germany's own economic development over time. It was a massive task in its own right and absorbed attention and energy. But while Germany was engaged in this heroic venture, unique in the OECD, many other OECD countries, including many large as well as small European neighbours, were actively updating their regulatory governance systems, as well as developing specific reforms in important areas such as labour markets and public expenditure management. Valuable time has been lost.

The German government has, in the last year or so, shown that it is keenly aware of the need for important specific reforms. There is perhaps less awareness of the need to take a more rounded view of the regulatory governance system itself, which is a necessary motor for ensuring that these reforms are timely, efficient and effective, whether they are reforms to labour markets, network industries, or to promote SMEs. This report therefore argues not just for the determined pursuit of specific reforms, but also for important adjustments to regulatory governance traditions so as to ensure that necessary change can take place more quickly, at least cost to the economy, and with the participation of all relevant stakeholders. As matters stand, the regulatory framework can be slow to adapt to change and can impose unnecessary costs. It can also, unintentionally, exclude stakeholders who may help to bring new ideas to the debate and support change.

Germany's first economics minister anticipated some of today's problems. He defined the social market economy as a framework which fosters the development of all agents' productivity. But he also warned of the risk that degeneration might take place towards a system in which the vested interests of various groups would undermine the capacity of the economy to generate wealth. A regulatory governance renewal is needed which puts the system back on the original track of harnessing all stakeholders to the common purpose of generating wealth, and at the same time encourages a more dynamic reform process.

Perhaps the most difficult operational challenge is to generate an engine of reform which will deliver the changes needed to regulatory governance. The federal, State and local levels of government provide a multitude of platforms for independent reform initiatives and ideas, but these are only brought together by the slow consensus-seeking decision process. It is too early to judge whether Agenda 2010 and the reforms of federalist structures which are currently under consideration will improve Germany's capacity to undertake and implement reforms more rapidly. Last but not least, and as in many other OECD countries, more attention also needs to be paid to the political economy of reform so that momentum and public support can be sustained.

PART II*

Regulatory Policies and Outcomes

* The background material used to prepare this report is available on the Web site: *www.oecd.org/regreform/backgroundreports*.

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Consolidating Economic and Social Renewal

PART II

Chapter 2

Regulatory Governance*

* For more information see: Background Report on "Government Capacity to Assure High Quality Regulation" available on the Web site: *www.oecd.org/regreform/backgroundreports*.

Context and history

Co-operative federalism and the comprehensive rule of law are the defining characteristics of Germany's governance

Germany is the world's third largest economy after the US and Japan, following re-unification with the east in 1990. Its governance framework, which was developed in the post-war years to support a massive rebuilding of the economy and society, is marked by several strong and distinctive features. The first is co-operative federalism, under which the States (*Länder*) have significant regulatory powers and responsibility for implementing most federal legislation. The *Länder* governments are represented by the *Bundesrat* in the German parliament and have the right to veto much of the legislation of the *Bundestag* (the federal chamber). This system promotes diversity in *Land* regulation, as well as a highly consensus-driven federal policy process. The second is the "legal State" (*Rechtstaat*) tradition, which emphasises the rule of law, comprehensive regulation, and a *Weberian* model of bureaucracy based on narrowly defined responsibilities.

There have, as yet, been no significant changes to this system

The system does not encourage fundamental change: other issues aside, there is no single central actor powerful enough to push it. Until re-unification, Germany did not face any serious crisis that might have triggered such change, though disturbing long term trends such as unemployment had already emerged. Re-unification, a unique event in OECD history, took up immense political as well as economic resources: rather than change its regulatory governance in the face of this distracting challenge, Germany extended the system to the new eastern States. Regulatory reform has therefore so far been marked by disjointed incrementalism, building on what is already there. Traditionally, efforts have focused on improving the efficiency of the public administration and reducing administrative burdens for SMEs, and have often been promoted by the *Länder*.

Two public sector reform programmes launched in the 1990s – the *Lean State* programme, and the *Modern State – Modern Administration* programme – are noteworthy for their efforts to improve capacities for developing high quality regulation, and indicate an emerging shift in the State's role, from direct provider to facilitator (the "enabling State"). The latest and much more wide-ranging government reform programme – *Agenda 2010* – also underlines this process of adaptation. This echoes the evolution in other OECD countries away from a narrow concept of regulatory reform as deregulation moves towards more dynamic regulatory management which looks at quality as well as quantity. These initiatives also highlight the fact that the government is seeking ways of responding effectively to the pressures on the economy. A consistent and cumulative process is at work with the focus on public sector capacities.

Regulatory policy

Elements of a regulatory policy are in place but there are important gaps

Regulatory policy means an explicit policy that aims to improve the quality of the regulatory environment on a continuous and dynamic basis. Experience in OECD countries suggests that an effective regulatory policy has three basic components which are mutually reinforcing: it should be adopted at the highest political levels; contain explicit and measurable regulatory quality standards; and incorporate a regulatory management system that will track and promote regulatory quality.

Some elements of a regulatory policy have built up over time in Germany. The 1984 "Blue Checklist" introduced a broad set of issues for consideration when legislation is prepared, similar to the OECD's own Checklist for Regulatory Quality (Box 2.1). The "Joint Rules of Procedure for Federal Ministries", dating back to 1958, advises on the preparation of policy proposals, and has specific requirements for the whole regulatory process including consultation and justification Statements. The 1991 "Manual on Legal Drafting", revised in 1999, provides legal drafting guidance. More recently a non-mandatory guidance note for Regulatory Impact Analysis (RIA) has been prepared.

Box 2.1. **Germany's Blue Checklist**

The checklist was made available to government officials as a guideline. As was the case for most early checklists of this kind in OECD countries, compliance with the guidelines was not monitored or sanctioned. The checklist included the following questions:

1. Is action at all necessary?
2. What are the alternatives?
3. Is action required at federal level?
4. Is a new law needed?
5. Is immediate action required?
6. Does the scope of the provision need to be as wide as intended?
7. Can the length of the period for which it is to remain enforced to be limited?
8. Is the provision unbureaucratic and understandable?
9. Is the provision practicable?
10. Is there an acceptable cost-benefit relationship?

Taken together however, these procedures do not cover certain key issues. The RIA guidance is not prescriptive, contains no clear criteria, and does not advise on how to assess regulatory impacts or quantify administrative burdens. Further, more specific guidance is in preparation but not expected to be available for at least a year or more. Legal quality is still the main preoccupation.

Regulatory institutions

Regulatory co-ordination units exist but are dispersed across government

One of the key components of an effective regulatory policy is a regulatory management system to track and promote regulatory quality principles across government.

As elsewhere in the OECD, each ministry is responsible for developing its own regulatory proposals. Each one is also responsible for consultation and regulatory quality control, within the guiding framework of the Joint Rules of Procedure. Specific ministries play a stronger general role. The *Ministry of the Interior* must be consulted on the preparation of all laws and subordinate regulations, and the mandatory aspects of RIA (it is also the lead ministry for the *Modern State – Modern Administration* programme). The *Ministry of Economics and Labour* must be consulted on the effect on business, especially small and medium sized businesses. The *Ministry of Justice* must see all draft legislation: it is responsible for ensuring technical quality as well as conformity with the Constitution. The *Chancellery* is less prominent on a day-to-day basis but shadows individual ministries to help resolve differences and promote overall policy coherence. The *Ministry of Finance* assesses the effect of proposed laws on public expenditure and revenues. The reforms to improve public sector efficiency and reduce administrative burdens are overseen by *ad hoc* committees of permanent secretaries.

Germany has established several central regulatory co-ordination units in horizontal ministries. These could form the core of a potentially effective system, but they would need development, including a closer working relationship and stronger analytical expertise. Many OECD countries have opted for a single centralised regulatory quality unit.

The local government and EU dimensions

Local government: a need to strengthen regulatory quality mechanisms

Regulatory quality is important at all levels of government: failure to carry out effective regulation at one level can undermine efforts elsewhere. Germany's federal structure is one in which the different levels – federal, State (*Land*) and local – have very close relationships. Its federalism gives Germany an advantage that some other OECD countries have to work for: a close and responsive relationship with citizens. But the independence of local and *Land* levels is also a challenge for the promotion of consistent regulatory policies across the whole government.

The municipalities are constituent parts of the *Länder*, which set parameters for their operation, and are responsible for a wide range of local service delivery. They enjoy an historic right to decide all matters relating to the local community on their own responsibility within the framework of existing law. Local governments implement more than 75% of federal and State legislation, and handle two thirds of public capital expenditure.

The *Länder* have considerable independence and regulatory powers, as well as a strong relationship with the federal level. They are responsible for implementing most federal legislation as matters of their own concern under their own responsibility (there is generally no federal representation at *Land* level). A key part of the re-unification process with the east was the rebuilding of eastern *Länder,* in line with the general policy of extending the existing west German governance and regulatory framework rather than changing it. A number of mechanisms exist to promote *Land*-federal co-operation. These include an obligation, under the Joint Rules of Procedure, for ministries to involve *Länder* representatives in the regulatory process, councils and committees to co-ordinate activities and policies (including the Financial Planning Council for budget matters), and a Constitutional requirement that every bill passed by the *Bundestag* must be submitted to the *Bundesrat*. Nearly half the laws passed by the *Bundestag* require the consent of the *Bundesrat*.

There is scope to improve the *Land*-federal relationship and thus make government decisions and spending more efficient and effective. Current fiscal arrangements provide an incentive for inefficient *Land* spending in some areas, because the *Länder* only carry a share of the total costs for activities that are co-financed with the federal government. Such activities could be reduced. Tax and spending competencies could also be better aligned. Improving the incentives for cost control would encourage the use of cost-benefit analysis. There is also a need to help parliament make decisions on a more informed basis. Quality regulatory impact assessment of draft laws is lacking, and parliament itself is concerned about this. As in some other OECD countries, regulatory quality assurance mechanisms are much less readily available to the legislature than to the executive. Measures are under discussion to remedy this weakness. The *Länder* parliaments are ahead of the main parliament in this respect.

The EU: regulatory processes are quite well handled

The EU is hugely important for regulatory reform in EU member States: much new regulation comes from Brussels. EU legislation accounts for over half all new regulation in Germany in terms of economically relevant law. Handling this is relatively well done. The Joint Rules of Procedure are applied to EU as well as domestic legislation, which means that a broadly similar process of consultation and impact assessment is in place. Systematic efforts are made to influence the EU decision-making process, with some success. Germany's deficit for implementing EU law is about the EU average, at around 3% (though the EU target is 1.5%).

Regulatory transparency

An informal and unsystematic approach serves organised interest groups well, but risks excluding others

Transparency is one of the central pillars of effective regulation – that is, regulation that will be suited to its purpose. It is a challenging task and involves a wide range of practices, including standardised processes for making and changing regulations, consultations with interested parties, effective communication of the law and plain language drafting, publication and codification to make it accessible, controls on administrative discretion, and effective implementation and appeals processes.

Transparency of rule-making processes is based on the Constitution and the *Administrative Procedures Act* as well as the Joint Rules of Procedure. These cover a general obligation to consult and inform, and the Joint Rules set out more elaborate arrangements for new regulations. The provisions are complemented by specific and varying administrative procedures for particular policy areas. Such procedures appear to be proliferating, which may reduce overall transparency even if the quality of individual rules is improved. A Freedom of Information Act is under discussion.

Transparency in terms of public consultation gives stakeholders the opportunity to help shape regulation, gives regulators valuable feedback on potential costs as well as benefits and the prospects for successful compliance and enforcement, and provides a safety net against capture by particular interest groups. Not least, it helps to legitimise government action by involving interested parties. Consultation needs to be fully embedded in the regulatory process.

In Germany, formal rules are set out in the Joint Rules of Procedure, which prescribe in some detail procedures for consultation within government, but are much more general and discretionary as regards public consultation (for example, consultation of experts and umbrella associations should be "as early as possible"). This discretion means that consultation approaches across government are based on individual ministries' traditions. But though this gives rise to a largely informal system, consultation is usually intensive from an early stage, seeking to achieve consensus among organised interests.

The process usually takes time. The use of special and expert commissions (for example the *Hartz* Commission for labour market reforms) may help to move matters forward. The process is also not systematic (who is invited, by what means, what proposals and documents are the subject of consultation, varies between ministries). Comments are not made publicly available, and there is no single consultation contact point on the federal Web portal. Forward planning – the publication of plans for future regulation – is covered in a very general way via the federal Chancellor's public presentation of government policy. But this is not backed up by a more systematic communication to the general public of future regulations.

Overall, the system gives organised interests who are invited to participate a major influence, but may easily *de facto* exclude everyone else. Finding out about what is going on is burdensome for outsiders. It is in marked contrast with the more systematic and open "notice and comment" process adopted in many other OECD countries (Box 2.2).

Transparency of communication is another pillar of effective regulatory practice. The existence and content of laws need to be known, and citizens provided with information to help them comply with, and make use of, the law. As in most other OECD countries, all new federal legislation must be published in an official gazette (accessible on the Internet since 1998). The Ministry of Justice posts important legislation on its Web site. Varied, usually somewhat basic, arrangements are made by other ministries for their legislation. The Joint Rules encourage the use of correct and understandable language. However the legal background of most government officials (as well as business and consumer association representatives) familiar with legal precision may weaken the priority attached to plain language. There is scope for improvement.

Adoption and communication of a law sets the framework for achieving a policy objective. But *effective implementation, compliance and enforcement* are essential for actually meeting the objective. A mechanism to redress regulatory abuse should also be in place, both as a democratic safeguard and as feedback to improve regulations. The rule-making process in Germany includes little prior assessment of legislative proposals' enforceability. Mechanisms for compliance and enforcement are marked by the division of powers between the federal government and the *Länder,* enforcement usually being the responsibility of the latter. Federal supervision is usually restricted to checking the legality of the enforcement. There is no systematic monitoring of compliance and enforcement practices, and mechanisms for the enforcement of federal legislation vary across the *Länder,* partly dependent on the resources allocated to them. Some efforts are being made to promote cross-*Länder* harmonisation of practices. A strongly embedded respect for the rule of law may ensure high compliance rates.

The principle of judicial review is a very strong feature of Germany's administrative and legal tradition. The Constitution provides all citizens with the right to appeal all administrative decisions and actions to the courts. A multi-stage process can be activated, and the courts generally examine both the legality and the substance of cases. Conditions are applied for

Box 2.2. **Promoting a more open rule making process: "Notice and comment" in the US**

The 1946 Administrative Procedure Act (APA) established a legal right for citizens to participate in rulemaking activities of the federal government on the principle of open access to all. It sets out the basic rulemaking process to be followed by all agencies of the US Government. The path from proposed to final rule affords many opportunities for participation by affected parties. At a minimum, the APA requires that in issuing a substantive rule (as distinguished from a procedural rule or Statement of policy), an agency must:

i) Publish a notice of proposed rulemaking in the Federal Register. This notice must set forth the text or the substance of the proposed rule, the legal authority for the rulemaking proceeding, and applicable times and places for public participation. Published proposals also routinely include information on appropriate contacts within regulatory agencies.

ii) Provide all interested persons – nationals and non-nationals alike – an opportunity to participate in rulemaking by providing written data, views, or arguments on a proposed rule. This public comment process serves a number of purposes, including giving interested persons an opportunity to provide the agency with information that will enhance the agency's knowledge of the subject matter of the rulemaking. The public comment process also provides interested persons with the opportunity to challenge the factual assumptions on which the agency is proceeding, and to show in what respect such assumptions may be in error.

iii) Publish a notice of final rulemaking at least thirty days before the effective date of the rule. This notice must include a Statement of the basis and purpose of the rule and respond to all substantive comments received. Exceptions to the thirty-day rule are provided for in the APA if the rule makes an exemption or relieves a restriction, or if the agency concerned makes and publishes a finding that an earlier effective date is required "for good cause". In general, however, exceptions to the APA are limited and must be justified.

The US system of notice and comment has resulted in an extremely open and accessible regulatory process at the federal level that is consistent with international good practices for transparency. The theory of this process is that it is open to all citizens, rather than being based on representative groups. This distinguishes the method from more corporatist models of consultation, and also from informal methods that leave regulators considerable discretion on who to consult. Its effect is to increase the quality and legitimacy of policy by ensuring that special interests do not have undue influence.

judicial review to be triggered: an applicant must file a claim that his or her own rights have been violated.

Alternatives to regulation

The approach needs development: alternatives are not yet systematically considered according to regulatory quality principles

The use of a wide range of mechanisms, not just traditional regulatory controls, for meeting policy goals helps to ensure that the most efficient and effective approaches are used. Governments must lead strongly on this to overcome inbuilt inertia and risk-aversion.

At the same time, care needs to be taken when deciding to use "soft" approaches such as self-regulation to ensure that regulatory quality is maintained.

Germany puts clear formal obligations on regulators to consider alternatives and to justify when they opt for "traditional" regulatory solutions instead of self-regulation (Box 2.3). These are part of the Joint Rules of Procedure. The recent emphasis on developing an "enabling State" lends political support to these efforts. However in practice, little is done to give effect to the instructions. Ministries for example nearly always simply summarise their consideration of the options to a traditional approach as "no alternatives", which cuts short any possible further debate.

As elsewhere in the OECD, Germany's use of alternatives is most developed in the environmental field. Here voluntary agreements are widely used (for example to phase out environmentally harmful products). More than 100 voluntary agreements are currently in effect. Germany also has one of the highest rates of participation in the EU's Eco-Management and Auditing Scheme (EMAS). Most voluntary agreements have been effective in reaching their targets, but their status is not well defined, targets may not be ambitious enough, and their efficiency may be a problem.

Box 2.3. **The German Checklist for identifying opportunities for regulatory alternatives**

The *Joint Rules of Procedure of the Federal Ministries* stipulates that draft regulations must be accompanied by an explanatory memorandum, which among others must explain:

- whether there are other possible solutions to regulation;
- whether the identified policy objective can be performed by private parties; and
- the considerations that led to the rejection of non-regulatory options.

An annex to the *Joint Rules* provides a checklist for identifying opportunities for self-regulation:

- What kind of regulatory arrangement is appropriate to address the problem? Is self-regulation sufficient? What structures or procedures should the State provide to enable self-regulation? Would it be possible for the State to make self-regulation mandatory?
- Provided the task can be carried out by non-governmental or private bodies: how is it ensured that the non-governmental service providers will provide their services for the common good (nation-wide coverage, etc.)? What regulatory measures and bodies does this require? How is reassignment of tasks to governmental institutions ensured in the case of bad performance?
- Can the problem be solved in co-operation with private bodies? What requirements for the legal design of such co-operative relationships should be imposed? What practical design is suitable and necessary to enable or support such co-operative relationships in organisational terms?
- If it seems that the problem can only be solved adequately on the basis of a programme or other target-oriented basis: what minimum content of regulation is required by the rule of law (*e.g.*, stipulations on competence, aims, procedures, etc.)?

Source: Government of Germany (2000).

Table 2.1. **Examples of self-regulation in Germany**

Sector/economic activities	Players and regulatory powers
Craftsmen	Chambers of Handicraft and Guilds: • issue ordinances for examinations to become a journeyman; prepare and execute the exams (prerequisite to exercise the trade); • issue ordinances for examinations for master certificates; • oversight of apprenticeships; • specification and oversight of vocational training; • co-administration of vocational schools.
Lawyers	Chambers of Lawyers (federal and for individual court districts): • issue licences to become a specialist lawyer; • revocation of authorisations; • specification and supervision of professional duties.
Chartered accountants	Chamber of Chartered Accountants: • issue licenses to become a chartered accountant; • provide binding opinions to the authorities on the authorisation of new accountants; • provide opinions on the revocation of authorisations; • specification and supervision of professional duties.
Doctors	*Länder* Chambers of Doctors:[1] • organisation of emergency services and further education; • specification and supervision of professional duties of doctors; • specification of vocational training of receptionists; • setting up of bodies for examining wrongful care.
Pharmacists	*Länder* Chambers of Pharmacists: • organisation of emergency services; • specification and supervision of professional duties; • specification of supplementary training.

1. According to Heilberufegesetz Nordrhein-Westfalen (Act on Medical Professions of Northrhine-Westfalia).

Source: OECD.

Germany has delegated regulatory powers to a number of self-regulatory bodies, within a broad policy framework laid down in a parent law (Table 2.1). The effectiveness of this type of regulation is not always clear, and can engender restraints on competition (for example the arrangements for the professions raise issues). Recent useful research provides suggestions for when self-regulation should be preferred to other tools, and the issues that should be examined when making a choice.

Regulatory Impact Analysis

RIA is long established but undermined by a number of important weaknesses

RIA is perhaps the most important regulatory tool available to governments, as its aim is to ensure that the most efficient and effective regulatory options are systematically chosen. It is, however, a challenging process which needs to be built up over time. It combines good habits of consultation with a rigorous review of the impact of prospective rules through a clear and balanced assessment of costs and benefits.

Germany's 1984 Blue Checklist was one of the first efforts in the OECD to get regulators to consider a range of issues in the development of rules. The last twenty years have seen a cumulative reinforcement of this approach. Current RIA policy is based on the 2000 revision of the Joint Rules. RIAs must be prepared for all draft regulations (primary and secondary) and must follow some requirements and procedures, including financial impact assessments for government budgets as well as for business and consumers. But the approach remains, overall, weak. There are no formal sanctions for non-compliance.

Resources available to the Ministry of the Interior to secure compliance with the Joint Rules are tiny. Central resources to promote RIA are insufficient. The guidance and training available to regulators is not enough and recent promising conceptual work to develop RIA has not yet been translated into practical measures for application in day-to-day ministry business. Quantitative evaluations remain especially weak. The federal and *Länder* parliaments show a growing interest in ensuring a more effective system to support their rule-making. Meanwhile some skepticism and reluctance remains among regulators, as well as a lack of awareness of what RIA can do and the guidance available.

The following list, based on best practices identified by the OECD, sets out the most important areas for government attention in the development of RIAs:

- *Maximise political commitment to RIA*. Use of RIA should be endorsed at the highest political level. Political commitment is currently inadequate, and too general to make a sustained and continuous impact on ministries.
- *Allocate responsibilities for RIA carefully*. Ownership by regulators needs to be carefully balanced with quality control and consistency: responsibility for RIA should be shared between ministries and a central quality control unit. As in nearly all OECD countries, Germany puts the main responsibility on ministries. The role of the ministries with horizontal responsibilities for regulatory quality (see Institutions above) is not clearly organised. Overall responsibility for promoting RIA and regulatory quality has not been defined or allocated.
- *Train the regulators*. Regulators need the skills to carry out high quality RIAs. Current arrangements – two to three hours as part of voluntary training in law-making – are not enough. The Ministry of the Interior is working with the Federal Academy of Public Administration to develop new training methods.
- *Use a consistent but flexible analytical method*. An effective RIA needs a soundly based cost-benefit analysis which includes quantification. Guidelines exist, but are not applied.
- *Target RIA efforts*. RIA resources should be targeted at regulations with the largest potential impacts, and with the best prospects for changing outcomes. Current guidelines offer no advice on this.
- *Develop and implement data collection strategies*. RIA quantitative evaluations are only as good as the data which support them, and lack of information is known to raise problems. Here again, guidance for ministries is essential.
- *Integrate RIA with the policy-making process*. RIA can only be effectively managed if it is integrated, as early as possible, with policy-making and is not just an "add-on" after policy decisions have been made. Stronger incentives – and a stronger cultural conviction of RIA's value – are needed for ministries to integrate RIA at an early stage, and possibly also sanctions for non-compliance.
- *Communicate the results and involve the public*. Consultation provides essential quality control, by providing feedback on a draft regulation's feasibility and likely future impact. To the extent that ministries carry out public consultations, RIAs are rarely included, and introductory summaries to proposed rules only mention briefly the likely costs for business and citizens.

Building regulatory agencies

Germany's regulatory agencies are generally well-conceived but transparency needs to be improved

Most OECD countries have established independent regulators as part of their structural reforms to promote competition in markets. These are now an important part of effective regulatory management. Setting them up to be fully effective, however, presents a significant challenge. They should be competent, accountable and independent; at arms' length from short-term political interference; capable of resisting capture by interest groups yet responsive to general political priorities; and have decision-making procedures that take into account the special features of the regulated sector, but are also transparent and accessible. The scope of the functions and powers devolved to a regulator is the major factor in identifying the best design for it, which also depends on the institutional context.

There is no general policy to guide the establishment of regulatory agencies in Germany but they do share some important features. They are mostly established by law as Higher Federal Authorities responsible to the relevant policy ministry. Overall they enjoy a high degree of autonomy, whilst remaining politically close to their ministry. Their professional integrity and expertise is generally well-regarded. The wide discretion which they enjoy in consulting on, and communicating, regulations makes for a variety of practices. Transparency could be improved with the application of a more systematic framework covering issues such as communication of decisions and the relationship with parliament.

An overview of Germany's regulatory agencies for rail, financial and postal services, telecommunications, pharmaceuticals, food safety, and social insurance as well as for general competition policy is given below. A regulator for electricity and gas is to be set up. A careful and systematic review of a wide range of design issues, using the experience of other OECD countries as well Germany's own experience (not least with the telecommunications regulator, RegTP) should be carried out in setting up this new regulator.

- *Powers*. They concentrate on the application of regulations and their enforcement, policy remaining with the ministry.
- *Independence*. They generally enjoy a high degree of independence, partly embedded in statutory guarantees, partly through the ministry's political choice.
- *Accountability*. They are legally accountable to their ministry, though they may take final decisions in individual cases and their decisions can be challenged in court. Political accountability is through annual and bi-annual activity reports.
- *Communication*. Transparency is very variable and there are no general rules or guidelines. Several regulators publish their decisions on the Web. BKartA, BAFin and RegTP must publish in the Official Gazette.
- *Management and appointments*. They are headed by a president and vice-president appointed through a political process. Advisory councils are mandatory for BAFin and RegTP, to advise and monitor the regulators' activity.
- *Resources/funding*. Most of the funding is via the federal budget and integrated in the relevant ministry's budget. Funding by fees and charges varies from 2.92% (BVA – the social insurance regulator) to 100% (BAFin).

- *Consultation and decision-making procedures.* The Act on Administrative Procedures provides a general framework. The Joint Rules of Procedure do not apply to regulatory agencies, which have set up their own and different decision-making mechanisms. These are not monitored or evaluated by the government.
- *Administrative appeals and public redress.* The first instance appeal is usually the regulator (though it is the court for RegTP). Complaints normally delay the implementation of the regulator's decision.
- *Co-ordination.* There are virtually no requirements and no framework. Ministries decide *ad hoc* whether to invite regulatory agencies in a consultation. Only RegTP among the sectoral regulators is required to consult the BKartA on competition issues. Concurrent powers with the BKartA, and supporting mechanisms, cover the relationship between regulators and the competition law. Significant horizontal co-ordination takes place between the regulators.

Keeping regulations up to date

A more systematic approach would be very helpful

Since the mid-1980s Germany's regulatory quality agenda has focused largely on the reduction of administrative burdens, led by the Ministry of the Interior. Special attention is paid to SMEs, for which there is a dedicated unit in the Ministry of Economics and Labour. The 2003 Initiative to Reduce Bureaucracy (see Part I) brings together a number of initiatives. It is an ambitious platform but it is not yet quite clear how the goals will be achieved. Recent federal initiatives to reduce administrative burdens are listed in Box 2.4. Measures are mainly applied *ad hoc* and *ex post*, and there are no specific targets. Inadequate federal authority to promote policies in areas where administrative burdens are especially high is an issue. This could be helped by increased co-operation between the federal and State governments as well as incentives for the States to support strategies aimed at reducing burdens.

Many OECD countries, including Germany, face the challenge of identifying and measuring administrative burdens imposed by new or existing legislation. This is often not clear, so that governments do not know the burdens on their businesses and cannot therefore make informed policy choices to improve matters. Some countries have put innovative practices in place to address this (Box 2.5).

As in most other OECD countries Germany has accumulated a large stock of regulations and administrative formalities. It has made substantial efforts to review this legislation, and repealed a great number of primary and secondary laws (Table 2.2). New regulations often include repeals of the regulations they replace. Some useful provisions exist. The Joint Rules of Procedure offer guidance on review (for example explanatory memoranda must explain whether a time limit can be applied to the law). However, the actual use of "sunsetting" is very limited and *ex ante* tests for review are not usually established. Mandatory reporting obligations may require and/or allow regulators to highlight desirable revisions to the law in the light of their experience. Independent committees have also commonly been used to review and simplify existing regulations, and to review government administration and procedures.

However, there is no systematic policy for review, and the guidance which is already in the Joint Rules of Procedure is not strongly embedded with regulators. It also needs more political support.

Box 2.4. **Recent federal initiatives to reduce administrative burdens**

Recent federal initiatives to reduce administrative burdens:

Mail box suggestions. In 2001 the Ministry of Economics and Labour published a report with 80 measures to reduce administrative burdens. The measures were based on an invitation in 1999 to business organisations and business to provide concrete suggestions to burdens for business.[1] The measures – some of which are still in the process of being implemented – primarily consist of marginal and practical adjustments of existing administrative procedures. No assessments have been made of cost-savings or other gains of the project.

The Digital Townhall. A pilot project, Media@Komm, launched in 2000 in three municipalities makes a large number of local government services available on-line. The objective is to simplify and accelerate citizen-local government transactions as well as to improve internal administrative processes. Services available on-line include building applications, public tendering, business promotion schemes as well various reporting obligations.

Standard nationwide business number. A pilot project launched in Bavaria in 2002 introduces the use of standard nationwide business numbers. Nationwide introduction is scheduled for 1 January 2005.

Health insurance: simplification of communication and standards. In 2000, the statutory health insurance funds standardised their benefit forms. A system developed by the Ministry of Economics and Labour has enabled electronic and simplified communication procedures between employers and insurance funds. Information about cost-savings and other effects is not available.

Reporting on line. Since 2000, German companies can use the Internet to provide obligatory information to the Federal Statistical Office for some statistical surveys. Information required by other authorities is reported through other channels, some of which are electronic.

"***JobCard*".** A pilot project launched in 2002 introduced a JobCard for employees. The card and its supporting software systems will allow the publicly run employment services to electronically access information about unemployed seeking work, employment periods, pay level information, etc. The project is intended to accelerate and facilitate the approval of employment benefit claims. No information is available on the expected or realised savings and other results of this project.

Laws and regulations on line. By mid 2003, the Ministry of Economics and Labour expects to make information about the legal framework and procedural requirements for start-ups available on the Internet.

BundOnline 2005. Launched in 2000, the German Government's e-Government plan BundOnline 2005 has as its main objective to provide online those of its nearly 400 services that can be placed on the Internet, by 2005. The project is also expected to drive comprehensive administrative reforms by enabling significant simplifications of government structures and internal procedures. Headed by the Ministry of the Interior, the project has a total budget of EUR 1.43 billion to be spent primarily on the specialist application in departments and on reorganisation projects.[2] When fully implemented, the government expects BundOnline 2005 to provide annual savings of EUR 400 millions. As of July 2003 a total of 200 federal administrative procedures and services were available from federal portal *www.bund.de*.

1. However 71% of the responses either did not address particular regulations or they were not able to point to concrete burden or barrier problems stemming from an identified regulation (Ministry of Economics and Labour (2001), 5-6). These could also be seen as a reflection of the problems which large, consensus-driven German organisations face in providing specific suggestions to reduce administrative burdens. With most administrative regulations providing some kind of benefits to specific, veto-equipped members of large business organisations, it has sometimes been necessary for business organisations to resort to very general recommendations to the government on how to reduce administrative burdens.
2. Ministry of the Interior, 2003.

Box 2.5. **Monitoring and measuring administrative burdens**

The **United States** operates a highly developed, comprehensive and centrally enforced programme for analysing and clearing individual government information collection requirements. The Paper Work Reduction Act (PRA) is intended to minimise the amount of paperwork the public is required to complete for federal agencies. The Act requires federal agencies to request approval from the Office of Management and Budget (OMB) before collecting information from the public. The OMB has the responsibility to evaluate the agency's information collection request by weighing the practical utility of the information to the agency against the burden it imposes on the public. Agencies must publish their proposed information collection request in the Federal Register for a 60-day public comment period, and then submit the request to OMB for review. In seeking OMB's approval, the agency needs to demonstrate that the collection of information is the most efficient way of obtaining information necessary for the proper performance of the agency's functions, that the collection is not duplicative of others the agency already maintains, and that the agency will make practical use of the information collected. The agency must also certify that the proposed information collection "reduces to the extent practicable and appropriate the burden" on respondents, including, for example, small business, local government, and other small entities. Since 1980 the OMB has set varying quantitative targets for the reduction of information collection burdens.

Another example of an advanced system for measuring administrative burdens is the MISTRAL methodology developed and employed in **the Netherlands**. MISTRAL works in three stages: first, all "data transfers" between a business and the authority are clearly identified (*e.g.*, a document, a telephone call, an inspection, etc.); second, the time involved in each "data transfer" and the level of expertise of the person performing the task are determined; third the data are computed to produce estimates for the administrative burdens incurred by the information requirement under review. Burdens are quantified in time as well as in monetary terms. MISTRAL has been used to quantify administrative compliance costs of very different laws and regulations, including legislation concerning working conditions, the environment, annual accounts, corporation tax, and social premiums. The Dutch government has set up successive policy goals for the reduction of these administrative burdens: minus 10% by 1998, and minus 25% by 2003, compared to the 1994 baseline.

Norway also has a sophisticated regime for measuring and monitoring administrative burdens on enterprises. The Register of Reporting Obligations for Enterprises maintains a constantly updated overview of businesses' reporting obligations to central government. Law obliges public authorities to co-ordinate their reporting requests to business. The register also maintains an overview of permits required to operate within various business and industries, and provides information on how to obtain such permits. On a yearly basis, the register publishes estimates for the total reporting obligations imposed on business by central government. The Register is responsible for the methodology and for collecting burden estimates, whereas individual ministries and agencies are primarily responsible for measuring the actual burden of a reporting obligation. Burdens are measured in time spent on filling forms and preparatory work for the reporting obligation. Norway does not have a quantitative, government-wide target for the reduction of administrative burdens.

Table 2.2. **Repealed federal laws and subordinate regulations in Germany**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002[1]
Primary legislation	29	15	48	15	12	21	34	14	12	40	20
Secondary legislation	114	127	170	79	89	157	172	89	74	125	122
Total	**143**	**142**	**218**	**94**	**101**	**178**	**206**	**103**	**86**	**165**	**142**

1. As of 7 November 2002.

Source: The Government of Germany.

Conclusion

Germany's current regulatory policy is based on some very sound fundamentals: a coherent rule-based framework which is highly respected, a search for consensus in rule-making, and a public administration recognised for its reliability and integrity. These strengths, however, need to be balanced and supported by other features which are currently absent, so that regulatory policy can provide full and effective support to sound decision-making. Until recently, the main focus of regulatory policy was the important but somewhat narrow issue of reducing administrative burdens, especially for SMEs. Ensuring regulatory quality involves more than this. Recent efforts to develop RIA, which was implanted quite early, show a growing appreciation by the government of the need to go further. But RIA has not yet blossomed into an instrument capable of supporting a broad and effective evaluation of rules. Germany's regulatory system as it stands is complex, there is a significant implementation gap between available tools and practice, the administrative culture is legalistic which means a lack of quantitative, evidence-based evaluation of rules, and there are issues of transparency and accessibility for stakeholders.

Regulatory governance in Germany can be strengthened by working on three mutually supportive issues. The first is to promote a more systematic and coherent approach to consultation and communication of regulations, including the rapid finalisation of planned measures to strengthen RIA. The second is to improve the institutional and procedural framework. Many other OECD countries have found that a successful regulatory policy is best supported by an explicit definition of that policy, developed and monitored by a permanent committee of high level officials and/or stakeholders, and supported by a central government unit with the capacity and competence to guide, monitor and possibly exercise some control over the regulatory process. Improving the framework also means paying more attention to the transparency of regulatory agencies, and reviewing the current structure of inter-governmental funding to improve economic incentives for better cost control, not least via stronger cost-benefit analysis. The third issue is to promote an administrative culture which is supportive of regulatory quality management, complementing current legal perspectives with economic ones aimed at improving efficiency in rule-making. With progress on these three issues, Germany would be on the right path to a highly effective and comprehensive regulatory policy.

Policy options for consideration

1. Close the implementation gap between regulatory policies and practices.

The immediate challenge for regulatory governance in Germany is to close the implementation gap between existing regulatory policies and practices by enhancing and improving the political, institutional and practical support for high quality regulation. This can be done by expanding, converting and making operational existing tools and concepts

into coherent and consistently applied regulatory practices. Meeting this challenge would include improving and enhancing the current support for these policies – political, institutional as well as practical support – as set out in the recommendations below.

2. Strengthen regulatory policies by setting out a single government-wide regulatory policy.

Germany should strengthen regulatory policies as a permanent, high priority for the government, with an integrated approach to the use of regulatory tools, procedures and institutions. Several programmes and policy commitments address different aspects of a regulatory policy in Germany, but with a notable emphasis on *ad hoc* projects focussing on *ex post* reviews and the reduction of administrative burdens. Germany does not have a single explicit or published policy promoting a government-wide regulatory policy. Many regulatory policy elements are applied *ad hoc*, depending on the political strength of individual ministers, without a permanent, government-wide and institutionalised management structure to support them. Policy-makers and civil servants have no strong incentives to pursue a consistent and coherent application of the regulatory policy guidelines already in place. An explicit government-wide policy on the quality of regulation, with the institutions and legal support to carry it out, would boost the benefits of reform for Germany. It is equally important that the policy endorses the systematic use of evaluations and quantitative, evidence-based assessments as the basis for regulatory decision-making and for the review and revisions of existing regulation.

3. Select a permanent ministerial committee responsible for promoting regulatory policy.

Once adopted at the highest political level, a permanent ministerial committee should be established or adapted to support Germany's regulatory policy. The committee should increase accountability for regulatory reform results within the ministries by establishing a systematic process of oversight, against which ministries will be held accountable. Such a committee could be particularly valuable in the context of adopting and reviewing a regulatory policy, and it would provide the necessary "championship" to drive forward the effective implementation of a regulatory policy. Past experience shows that *ad hoc* committees of civil servants implementing selected regulatory policy issues have not been sufficient to change the political agenda towards comprehensive and consistently applied regulatory policies. Similar arrangements to ensure high-level political attention and accountability to regulatory reform have been successfully adapted in the Netherlands and South Korea.

4. Equip a technical unit in the centre of government with capacities to support regulatory quality.

The German government should equip a unit located in the centre of government with the mandate and resources needed – in particular economic expert capacities – to promote, advice, support and evaluate a government-wide and comprehensive regulatory policy. The current criteria, sanctions and staff resources available to enforce RIA obligations are insufficient. A centre-of-government unit with stronger and more credible capacities would oversee the RIA system and provide technical opinions on the *substantive* – not just technical – quality of proposed measures. The unit could also offer training and provide advice on regulatory instruments. As part of this, evaluations of applied regulatory tools and procedures would constitute an important feedback loop to on-going improvements

and revisions of the regulatory policy. Another option could be to equip the unit with a formal challenge function *vis-à-vis* ministries' regulatory proposals.

5. Establish standards for consultation procedures and improve accessibility to existing regulations.

There is scope for improving current consultation and communication mechanisms. Germany should improve regulatory transparency by establishing formally defined standards for consultation procedures and by improving accessibility to existing regulations. The discretion left to ministries and the lack of minimum standards for the timing, content, process and scope of consultation procedures raises concern about the costs, transparency and accessibility of the process for stakeholders not familiar with or not frequently operating in this framework. The German government should: establish uniform and clear obligations for consultation procedures for all regulation on the federal level, *i.e.*, a notice and comment procedure with minimum standards for the timing, content, process and scope of consultation processes; establish a single, easy searchable, free of charge, consolidated, Internet based database for all federal laws and regulations; establish a notice-and-comment procedure to replace or supplement the current practice of consulting with selected parties; consider making responses to consultation papers publicly available; improve and expand information available to the public about future planned legislation, for example by drawing more on information already available in internal government planning systems; reduce the proliferation of sector-specific administrative procedures; and work towards reduction of current exceptions.

6. Ensure that promotion of self-regulation and alternatives is supported by thorough analysis.

Germany should further promote and support systematic consideration of self-regulation and regulatory alternatives for new regulatory proposals. Considerations about the use of self-regulation and soft-law alternatives should be matched with the same scrutiny, transparency and accessibility that apply for traditional regulation. It should also develop practice-orientated guidelines including examples and criteria for the use of regulatory alternatives. Improving and encouraging a more widespread use of alternatives is contingent on an increased awareness among regulators about the potential benefits of non-regulatory alternatives, and on improving the monitoring of regulators' obligation to consider alternatives.

7. Address identified shortcomings in the RIA process.

The current RIA requirements and guidelines provide an important basis for a continued and needed improvement of RIA practices. As a first step, the German government should establish safeguards to ensure a consistent and coherent application of these requirements by ensuring that resources and expertise are available for a centre-of-government unit charged with monitoring, guiding and possibly sanctioning compliance with these standards (see above). In particular, it should be mandatory that draft regulations sent to public consultation are always accompanied by RIAs. Based on the existing RIA concept, the German government should consider sequencing the RIA process into a two or three step model, allowing for early, informed and flexible responses to draft regulations. This would help target the efforts and resources on the impact of major regulations only. RIA guidelines should also be reviewed and consolidated with a view to making the guidelines more operational and aligned to the actual

regulatory process, and, preferably, coupled with a clarification of ministries' obligations during a sequenced RIA procedure. Furthermore, the German government should consider enhancing accountability for RIAs by having responsible ministers "sign off" and guarantee the quality of impact assessments presented to Cabinet and Parliament.

8. Consider a general regulatory governance framework for independent regulatory authorities.

Germany should consider establishing a general framework for the accountability and quality assurance mechanisms applied by independent regulatory authorities. The German system of regulators has been developed *ad hoc* and explicitly for the sectors and the market characteristics in which they operate. This approach has many advantages which should not be lost. However Germany should consider developing a general framework for the use of RIA, communication, consultation and other quality assurance measures applied by the independent regulators. Such frameworks may provide benefits in terms of improved transparency and accountability. Furthermore, in its ongoing consideration of the design of a new independent regulator for gas and electricity, Germany should benefit from the experience in many OECD countries.

9. Develop a strategy and methodology to estimate and monitor administrative compliance costs.

Germany should continue efforts recently initiated under the "Initiative to Reduce Bureaucracy" to establish targets for burden reduction projects. To match the significant political focus on reducing administrative burdens, mechanisms and procedures should be established to quantify administrative burdens and to systematically integrate these assessments in the RIA process. The measurement of the size of existing burdens can be an important information-based approach to developing a policy on burden reduction and the basis for the evaluation of policy initiatives taken. Where possible the German government should attach specific, quantitative targets to new and existing administrative simplification initiatives. The German government should continue to pursue efforts for a nation-wide strategy to reduce administrative burdens – credibly committing the federation as well as the *Länder*.

10. Encourage – especially by training – the continued development of an administrative culture supporting regulatory quality management.

A continued effort is needed to embed good regulatory practices not only in procedural guidelines but also into the culture of the public administration. Government actions rely on an excessively legalistic approach as the standard for quality. The appreciation on the part of some officials of the benefits associated with early integration of regulatory impact analysis in the policy-making process needs to be extended to other departments and regulatory authorities in order to support a broad and continuous development of high quality regulation. The development of such a culture could be encouraged by making regulatory quality management an integral part of the training not only of junior civil servants engaged in the regulatory process, but, as importantly, also of senior civil servants.

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PART II

Chapter 3

Competition Policy*

* For more information see: Background Report on "The Role of Competition Policy in Regulatory Reform" available on the Web site: *www.oecd.org/regreform/backgroundreports*.

Context and history

The roots of Germany's competition policy lie in its highly cartelised industrial past

Competition law and policy occupy a central position in Germany's economic and political framework, and have deep roots in the country's history. Vigorous economic growth accompanied industrialisation and re-unification in the second part of the 19th century, underpinned by a strong belief in the merits of the free market. As the economy started to experience the "boom and bust" of industrial cycles, the perception of competition changed. It needed to be controlled, and in response to crisis, firms started to co-operate by entering agreements on production and capacity. By 1900 there were 400 established cartels, an apparently permanent feature of the economy: larger, more numerous and more durable than elsewhere in the industrialised world. The political leadership did not fundamentally object (cartels helped to bind the newly integrated German State together), and economic thinkers tended to support the cartel movement, stressing the importance of institutions in managing industrialisation so as to mitigate the damaging effects of market processes on producers. A landmark legal case in 1897 (the *Saxon Wood Pulp* decision) found that cartels were generally beneficial, by preserving firms from ruin and maintaining adequate prices. The basic legal rule was established that cartel agreements were valid and enforceable, although a cartel to establish an actual monopoly or exploit consumers might be struck down.

There was, however, increasing concern about the harmful effects of cartels, not least on consumers and SMEs. After the First World War, the government enacted Europe's first general laws and institutions aimed specifically at protecting competition and controlling abuse. The 1923 Regulation against Abuse of Economic Power Positions was part of a set of emergency measures to control inflation by promoting market freedom, and was also aimed at promoting firms' social responsibility. An administrative body (the Cartel "Court") was created to decide cases. Though these developments were controversial, they upheld for the first time the need to protect competition in the interests of consumers, and became the model for competition policy across Europe.

The post-war social market economy made competition policy a cornerstone of the new order

A new system was designed to meet Germany' s special needs in the wake of the second world war, though it drew inspiration from the practical experiences and political thinking of the past (Box 3.1). Competition law and policy were made a centrepiece of the new "social market" political economy which aimed, successfully, to establish a coherent and comprehensive framework for management of the economy, politics and society.

The legal basis for the new system was the *Act against Restraints on Competition* (ARC), which took effect in 1958, following ten years of contentious debate which eventually softened the purist ordo-liberal position, which favoured a law that would clearly prohibit cartels.

Box 3.1. **Competition policy as the economic Constitution: the ordo-liberal foundation of the social market economy**

Germany's post-war conception of the "social market" political economy is a distinctive, comprehensive approach to corporate management, industrial relations, social welfare, and government policies, including notably competition policy. Companies are held to social as well as economic account, being responsible to stakeholders in the community as well as to shareholders, employees, customers, and suppliers.

The intellectual energy for this system and for post-war German competition law came from Freiburg, where a group of professors of economics and law rebuilt liberalism during the inter-war period in a way that bridged public and private responsibilities. One of these professors was a veteran of the Ministry of Economy cartel office and thus brought a particularly relevant experience to the project. They held that a competitive economic system was necessary for prosperity and freedom, but that achieving these results required setting the market in a constitutional framework.

The Freiburg liberals believed that the Weimar republic had collapsed because its legal system could not constrain private economic power from undermining political and social institutions.* They faulted both classical economic theories and traditional legal positivism for excessive attention to matters of form. Economic formalism was oblivious to social impacts, while legal formalism had become a willing tool of entrenched interests. But they acknowledged that the "historical" approach to economics needed theory in order to be useful.

The "ordo-liberal" viewpoint accepted tenets of classical economic theory and some traditional liberal principles, notably the importance of competition to economic success and the link between economic freedom and political freedom. Seeing how private economic power had subverted government, the Freiburg school called for breaking up monopolies. They argued that the economy could integrate society on democratic principles, but only if it functioned fairly to provide equal opportunities for participation.

Their conception was "constitutional", in that it set out legal principles that would constrain the government. This economic Constitution would be constructed through legal and political decisions. Indeed, ordo-liberalism reversed the presumption of conventional liberalism: rather than divorce the economy from law and politics, it supposed that the economy's success depends on its organic relationship with law and politics.

Economics would set out the conditions for "complete" competition, in which no firm has the power to coerce others in the market. Those conditions would then become the standards for legal decisions. Officials could intervene only on those terms, and in doing so they could not exercise discretion. Administrative control was rejected, because it could be captured by the interests being regulated. Yet legislation about detail was disfavoured too, because the constitutional principle and general competition rules would provide a sufficient framework.

Enforcement would be entrusted to a strongly independent and autonomous body, outside and above politics just like a court. Like a court, it was imagined as applying objective law-based standards, without discretion to favour parties or outcomes. It should eliminate monopolies where possible and force firms to act as though they faced effective competition. Firms would be encouraged to compete in performance, but not in measures to hinder their rivals.

Box 3.1. **Competition policy as the economic Constitution: the ordo-liberal foundation of the social market economy** *(cont.)*

The ordo-liberal viewpoint became the basis for Germany's post-war economic reconstruction, in which some of its proponents played key roles. A professor associated with the Freiburg school's ideas, Ludwig Erhard, headed the self-government (under occupation) that eliminated rationing and price controls in 1948, then served as minister of economy until 1963 and as chancellor until 1966. The social market economy, built on ordo-liberal principles, was part of his party's platform from 1949. In that conception, competition policy assumed a leading, constitutional status and role, promoting basic values, protecting fundamental rights, and operating on juridical principles.

* Their early criticism of corporatist arrangements under the Weimar Constitution, and advocacy of a strong State that would be independent of economic interest groups, may also have prepared the ground for the authoritarian alternative that appeared after 1933.

Source: Gerber, 1998.

The 1958 competition law has shown enduring strength and adaptability so far: its distinctive features pose a growing challenge in relation to EU developments

The long gestation of the law, combined with its deep roots in Germany's political experience and academic tradition, produced a system that has shown enduring strength. The law set out specific rules to address the competitive effects of market actions. At least as important, it set up the *Bundeskartellamt* (BKartA), as a strongly independent, court-like expert body for enforcement. The political and economic climate of the 1960s reemphasised the importance of competition policy for economic success on the one hand, and for consumer and worker protection on the other. The ARC was amended in 1973 to add merger control, sharpen the provisions for controlling abuse, prohibit resale price maintenance, and permit more co-operation among smaller firms. Merger control soon became the BKartA's most important function. A new institution, the *Monopoly Commission*, was introduced to report on competitive conditions (and on the clearance decisions of the BKartA, which were not published at that time).

The most recent amendments to the ARC in 1999 bring the law more in line with EU competition law. They incorporate principles about restrictive agreements and dominance, a revision of the merger review process, and new responsibilities for the BKartA over competitive tendering in public procurement. Importantly for regulatory reform, changes were made that will allow the ARC to be more easily applied to infrastructure monopolies. Further amendments are underway, reflecting the growing importance of the EU dimension. Germany faces important challenges in adjusting to EU competition principles and to the EU reforms which are underway. Several features of its law make it distinctive and some of these run counter to the EU way (Box 3.2 gives an overview of the EU law). These include an approach to horizontal agreements which provides for classes of agreements that are subject to less stringent rules in the primary legislation (so as to reduce administrative discretion), and the use of specific rules to manage conduct by dominant firms in addition to a general prohibition against abuse. Reforms in EU competition law enforcement which will shift responsibilities to member States challenge Germany's institutions. Germany has been concerned that reducing the role of notification and clearance will reduce the legal certainty and transparency which it considers to be one of its strengths.

Box 3.2. **The EU competition law toolkit**

The law of Germany retains many distinctive features, but it also now includes some of the elements of competition law that have developed under the Treaty of Rome (now the Treaty of Amsterdam):

- **Agreements:** Article 81 (formerly Article 85) prohibits agreements that have the effect or intent of preventing, restricting, or distorting competition. The term "agreement" is understood broadly, so that the prohibition extends to concerted actions and other arrangements that fall short of formal contracts enforceable at civil law. Some prohibited agreements are identified explicitly: direct or indirect fixing of prices or trading conditions, limitation or control of production, markets, investment, or technical development; sharing of markets or suppliers, discrimination that places trading parties at a competitive disadvantage, and tying or imposing non-germane conditions under contracts. And decisions have further clarified the scope of Article 81's coverage. Joint purchasing has been permitted (in some market conditions) because of resulting efficiencies, but joint selling usually has been forbidden. All forms of agreements to divide markets and control prices, including profit pooling and mark-up agreements and private "fair trade practice" rules, are rejected. Exchange of price information is permitted only after time has passed, and only if the exchange does not permit identification of particular enterprises. Exclusionary devices like aggregate rebate cartels are disallowed, even if they make some allowance for dealings with third parties.
- **Exemptions:** An agreement that would otherwise be prohibited may nonetheless be permitted, if it improves production or distribution or promotes technical or economic progress and allows consumers a fair share of the benefit, imposes only such restrictions as are indispensable to attaining the beneficial objectives, and does not permit the elimination of competition for a substantial part of the products in question. Exemptions may be granted in response to particular case-by-case applications. In addition, there are generally applicable "block" exemption regulations, which specify conditions or criteria for permitted agreements, including clauses that either may or may not appear in agreements (the "white lists" and "black lists"). Any agreement that meets those conditions is exempt, without need for particular application.
- **Abuse of dominance:** Article 82 (formerly Article 86) prohibits the abuse of a dominant position, and lists some acts that would be considered abuse of dominance: imposing unfair purchase or selling prices or trading conditions (either directly or indirectly), limiting production, markets, or technological development in ways that harm consumers, discrimination that places trading parties at a competitive disadvantage, and imposing non-germane contract conditions. In the presence of dominance, many types of conduct that disadvantage other parties in the market might be considered abuse. Dominance is often presumed at market shares over 50%, and may be found at lower levels depending on other factors. The prohibition can extend to abuse by several firms acting together, even if no single firm had such a high market share itself.
- **Reforms in administration:** Recent reforms of EU competition policy reduce the scope of the prohibition against vertical agreements and will eliminate the process of applying for exemptions for particular agreements. Instead, exemption criteria will apply directly in decisions applying the law, and these decisions will increasingly become the responsibility of national competition authorities.

Competition law aims to promote effective competition and the market structures which help this: the network industries raise new issues

Germany's competition system relies on the analysis and application of rules rather than an appeal to expressions of legislative purpose which would need interpretation and reduce legal transparency. The ARC does not therefore contain a formal Statement of purpose. However the policy motivation of the law is clear. The ARC was in the first place intended to guarantee freedom of competition, and to prevent the emergence of economic power where it might impair the effectiveness of competition. Effective competition was expected to increase economic efficiency, via the classic virtues of competitive markets in allocating resources, responding to consumer demand, promoting productive efficiency and disciplining management. But effective competition was also considered important for sustaining a large number of competitors, so as to prevent companies from becoming too influential in society and politics. The law is therefore an instrument for political as well as economic ends.

The focus is on protecting the structures within which firms compete, rather than assessing the economic effect of particular conduct. The law thus aims to protect relationships which may be expected to yield desirable economic outcomes. One clear example is the use of the law to protect SMEs against the aggressive conduct of larger firms (amendments to the law since 1973 underline this). Retail regulations and the master-crafts qualification system are also consistent with this approach. The liberalised infrastructure industries pose a new type of structural challenge. Their network monopoly core means that competitive structures are hard to develop and to maintain. The deep-rooted faith in competition law led Germany to rely on it initially for promoting effective competition in these sectors, but this approach is now being adapted with the creation of regulators working hand-in-hand with the BKartA.

Competition policy is institutionally separated from the enforcement of competition law, which has implications for effective regulatory reform

There is a separation between the enforcement of competition law – the job of the BKartA – and competition policy, for which the responsibility is primarily with the Ministry of Economics and Labour. This can weaken the link between competition law and competition policy in regulatory reform. The relative weight of competition policy as a principle in regulated industries may be questioned in the light of a recent ministry decision to override the BKartA and allow a major gas-electricity merger.

The substance of the competition law

Cartels are handled according to sound assumptions about likely effects, and the system of sanctions works well

The first and most fundamental provision of the ARC prohibits horizontal agreements in general terms. There are two classes of exceptions: the "unopposed" cartels and the "authorised" cartels. Both classes must be notified to the BKartA. The former are permitted unless the BKartA objects, and the latter require prior BKartA approval. Unopposed cartels are categorised into three types: agreements about terms of business, specialisation cartels (so long as they do not lead to a dominant position), and agreements among SMEs. Likely efficiencies are presumed in these cases, for example that standard terms can facilitate transactions. About half of the 300 currently effective cartels are "unopposed" cartels involving SMEs.

Prior BKartA autorisation is required for rationalisation cartels and structural crisis cartels, and the law sets out the criteria for qualification. The benefits of rationalisation cartels must be significant: they must not create or strengthen a dominant position, and there must be no other means of achieving the rationalisation if price, purchasing or selling agreements are involved. Structural crisis cartel requirements are less stringent. The 1999 amendments to the ARC also provide for the authorisation of agreements that meet criteria for exemption similar to those of EU competition law: however, the ARC sets tighter competition-related criteria than EU law.

A cartel may be authorised – by the minister not the BKartA – for policy reasons that do not appear in the ARC criteria for exception. The minister may not reject the BKartA's decision under the ARC, but may exempt a cartel that fails to meet any of the criteria for exemption if the restraint is "necessary for prevailing reasons concerning the economy as a whole and the public interest". Ministerial authorisation is also possible in "especially serious individual cases" where there is an "immediate danger to the existence" of most of the firms in a sector, and other measures cannot be taken in time. The power to intervene has rarely been used.

Self-regulation by professional and trade associations is subject to special oversight, where it is not exempted from the ARC entirely.

Though the cartel rules have been mainly applied via the notification process, enforcement against unauthorised cartels has stepped up. The highest fines ever, 660 m euros, were imposed in early 2003 against a cement cartel, following an earlier set of cases. A criminal law against bid-rigging now backs up the ARC, resulting in a number of cases and some jail sentences. This should improve the effectiveness of the BKartA's well-conceived leniency programme which offers participants a strong incentive to provide evidence, and may well discourage the formation of prohibited cartels in the first place.

Vertical agreements are, with one major exception, allowed unless they substantially impair competition

With one exception vertical agreements are not prohibited, unless they involve a dominant firm and are thus covered by the ARC's prohibition against abuse of dominance. Instead they are subject to *ex post* control for abuse. A "competitive effects" test is applied: agreements may be prohibited only if they substantially impair competition. This sounds tolerant but may be demanding, as the test does not depend on market power or market share. The one prohibition is resale price maintenance. This is subject to a major exemption for newspapers, magazines, books, sheet music, and maps.

Abuse of dominance is subject to strong rules, with special regard for SMEs, though the enforcement record is mixed

German law traditionally controlled single-firm misconduct through specific rules. A general prohibition is also now in place to reflect EU law. This can be applied to practices that are not clearly covered by the specific rules. The specific rules apply to firms with a dominant or paramount position, and cover the following misconduct: impairing the ability of others to compete without objective justification (through predatory pricing for example), exploitation aimed at consumers (prices may be compared with those in a comparable competitive market, which can be difficult), discrimination that harms customers, and (a recent addition) denying access to a network or infrastructure facility. Some other conduct (such as boycotts) is also prohibited by the ARC, even in the absence of dominance. There is no provision for ministerial intervention.

Dominance is defined in several ways. A firm that has no competitors or that is not exposed to substantial competition is considered dominant. A firm that faces some competition would nonetheless be treated as dominant if it has a "paramount market position", which is assessed on a wide range of factors (market share, financial power, access to suppliers and markets and others). Several firms together could be considered dominant to the extent there is no substantial competition between them. Market share thresholds for presuming dominance are low, though this test is not conclusive.

Special attention is paid to protecting smaller firms against dominance in a bargaining relationship. Economic dependence issues are specifically covered by the ARC, which controls discrimination and "unfair hindrance" by dominant firms, associations and cartels. A recent addition defines sales below the seller's cost price as an abuse of market power relative to SMEs. As in other countries, the food retailing sector, and its use of "loss leaders", is a main target. The BKartA's first enforcement action was against three supermarket groups, and was largely upheld on appeal.

However the enforcement record against abuse of dominance has been limited and mixed so far. Most of the BKartA's formal challenges in the 1990s were rejected by the courts or overruled by the legislature, though some recent actions have been more successful.

The ARC's abuse of dominance provisions are increasingly being applied to the network industries, albeit with considerable difficulty (Box 3.3).

Box 3.3. **ARC abuse of dominance provisions and the network industries**

The ARC is increasingly involved in cases arising in the network industries. This was facilitated with the elimination of exemptions for most of these industries, and the new misconduct rule on denial of access to essential network facilities. Numerous cases have arisen both in telecommunications, and in the power sector concerning network access terms and charges. But enforcement has proved difficult. The normal *ex post* process for tackling misconduct is not adapted to sectors where the primary requirement is to encourage the emergence of competition across a whole industry where none existed before. The usual methods for analysis and proof are hard to apply in this context: notably, there are no comparable markets with which to compare prices. The substitute is detailed cost analysis, and a 2002 court decision supported this alternative, but determining the relevant costs to establish the existence of abusive pricing is also difficult. Also, delays in the courts hamper enforcement against denial of network access. An *ex post* approach could work, but speed is vital in these cases, and the process of investigation and proof takes time. Even after a decision is reached, the usual practice has been to suspend the decision pending appeal, though access orders for the energy sector may now remain in place pending appeal.

Merger control also has a strong legal framework but ministerial intervention is possible

For many years Germany had the most active programme of merger control in Europe. The standard is whether the transaction is expected to create or strengthen a dominant position (using the ARC definition that is also applied to abuse of dominance). The concept

that is most often relevant in merger cases is "paramount position". The BKartA will be concerned if an already paramount position is likely to become stronger. Assessment focuses on the position of the parties and market structure, and on the development of competition in the future. Economic analysis is used for market definition and identifying market-dominant positions. Defined markets reportedly tend to be narrow, making it more likely that the BKartA will find dominant positions. Issues of market structure and legal analysis appear to dominate the review process. The BKartA is dubious about efficiency as a defence, as consumers may be expected to suffer from the lack of discipline on the conduct of a dominant firm.

Whether a merger is subject to control is determined mainly by the size of the parties. A merger must be notified and approved if the parties' aggregate annual worldwide turnover exceeds 500 m euros and the domestic turnover of at least one party exceeds 25 m euros. Special rules for calculating turnover have the effect of contracting or expanding coverage in particular sectors. The legal characterisation of a concentration that is subject to merger control is such as to ensure broad coverage. Covered mergers must be notified and approved in advance. The examination period is four months (if the BKartA has taken no action the merger is cleared after this time). The BKartA must inform the companies within a month if it has initiated a "main examination", which happens for 10% of cases. Otherwise it issues an informal notice of clearance. For main examinations the BKartA publishes a formal decision with its reasoning, and the decision may impose conditions on clearance. Mergers implemented without authorisation are legally void, and those that are implemented despite the BKartA's prohibition may be dissolved, and penalties (fines) could be imposed.

The Minister of Economy and Labour may authorise a concentration that the BKartA has rejected, if the restraint on competition is outweighed by advantages to the economy as a whole or if the concentration is "justified by an overriding public interest". International competitiveness of the parties may be taken into account. Such interventions are infrequent, but important. The minister must first obtain a report from the Monopoly Commission and solicit comments from the *Länder* governments where the firms are registered, and must act with some speed and transparency. The Monopoly Commission assesses the non-competition policy interests against the BKartA's findings. The minister had not disagreed with it since 1989, until the *Ruhrgas* case in 2002.

The BKartA has tried to use merger control to support the development of competition in the network industries. For example in gas, it has examined a combination of neighbouring regional companies. However the *Ruhrgas* case may have set a political limit to this approach. The BKartA rejected the combination of the largest pipeline operator (Ruhrgas) and a combined gas-electric firm (E.ON). But it was approved by the ministry, which concluded that creating a national champion could improve supply security, a conclusion that undercuts the logic of restructuring to promote competition, even if the security argument is a strong one. As many other OECD countries have also found, competition and security of supply may raise difficult trade-offs.

The approach to related issues – procurement, State aid, unfair competition and consumer protection – is uneven

Oversight of competition in *public procurement* was added to the ARC in the 1999 amendments. The principles and jurisdictional thresholds are based on EU procurement rules. This addition is consistent with the conception of the BKartA as a law enforcer and

of the goal of the ARC to preserve competitive structures and relationships. In contrast, *State aids and subsidies* are not covered by the ARC (though they come under EU competition law), because these are considered to be policy matters for the ministry, despite the potential distortions to competition.

Germany's laws about *unfair competition* have probably tended to impair competition more than they have promoted it. Some protectionist rules (for example on discounting) are now being eliminated or corrected, encouraged by EU legislation. Two laws that made rebates more difficult were repealed in 2001. Some important protectionist legislation remains, not least the Unfair Competition Act (UCA) which can be used to prevent price competition, and which is still applied in ways that underestimate the extent to which consumers may be able to look out for themselves. A revision of the UCA is underway to reflect EU developments, and to give more weight to the interests of consumers, though Germany is seeking to preserve the rule against sales below cost.

Competition policy recognises how consumers benefit from it, but *consumer policy* is not closely linked and there is no strong national consumer protection authority. Enforcement of the rules on unfair practices or misleading advertising is left to private litigation by competitors or consumers. In the context of the EU Green Paper on consumer protection, Germany has argued against new and stronger consumer protection structures, a position that implies faith in the power of the informed consumer and the competitive market. Germany also does not support mutual recognition of rules in the EU because it would threaten what it believes to be its higher-level protections.

Competition policy institutions and enforcement

Germany's strongly independent institutional culture for competition issues is embodied in the BKartA

Germany's federal structure and separation of roles produce a complex set of institutions. Perhaps the most defining feature of German competition policy is the independent institutional culture of the BKartA, which is the main enforcement body. It is a federal agency, responsible to the Federal Ministry of Economics and Labour, but based in Bonn and hence geographically separate from it. Its independence results from political choice and support, not statutory guarantees. The BKartA president does not serve a fixed term, but it is politically inconceivable that he would be removed over a difference in policy. The enforcement staff are divided into 11 sections each covering particular sectors. There are also two divisions acting as procurement tribunals and a special unit for combating cartels. BKartA independence is embodied in its decision-making structure, under which actions in cases are determined by panels of staff (all career civil servants with lifetime tenure) organised like a court of law. There is no appeal to the BKartA president, only to the courts (unless the parties go the Minister on other policy grounds).

This all makes for a stable and efficient system. The BKartA is also reasonably transparent: the ARC requires public notice for many actions, and decisions are published in the Federal Gazette (albeit often in condensed form). Other information such as applications for recognition of associations' competition rules must be published. The main decisions and notices are posted on the BKartA's Web site and the BKartA must publish a formal report every two years.

The BKartA makes efficient use of its relatively modest resources for a large country and in a context of increased responsibilities

The BKartA's resources have been stable or even declining, against a backdrop of increased responsibilities (for procurement and utility industry problems) and a wider jurisdictional reach following re-unification. Total person-years were 267 in 2002, 300 with the addition of the *Länder* enforcement resources. The BKartA seems surprisingly small for such a large economy, but its distinctive and highly professional institutional culture may make it unusually efficient. Staff stability has been stirred up by the move from Berlin to Bonn, with shifts from the ministry to the BKartA and *vice versa*. This is healthy but the learning process could stretch resources in the short run. Budget support appears stable and adequate.

Until recently the BKartA concentrated almost completely on horizontal agreements and mergers. Activity increased across the board in 1999 with the new responsibilities, and there is increased attention to vertical agreements and abuse of dominance (Table 3.1).

Table 3.1. **Trends in competition policy actions**

	Horizontal agreements	Vertical agreements	Abuse of dominance	Mergers	Unfair competition[1]
2000: matters opened	55	18	79	1 735[2]	n.a.
Sanctions or orders sought	n.a.[7]	n.a.[7]	n.a.[7]	n.a.[7]	n.a.
Orders or sanctions actually imposed	3	–	5	6[3]	n.a.
Total sanctions imposed	DM 40 539 340	–	–	n.a.	n.a.
1999: matters opened	67	18	101	1 687	n.a.
Sanctions or orders sought	n.a.[7]	n.a.[7]	n.a.[7]	n.a.[7]	n.a.
Orders or sanctions actually imposed	4	1	–	7[4]	n.a.
Total sanctions imposed	DM 287 325 100	–	–	n.a.	n.a.
1998: matters opened	36	4	49	2 024[5]	n.a.
Sanctions or orders sought	n.a.[7]	n.a.[7]	n.a.[7]	n.a.[7]	n.a.
Orders or sanctions actually imposed	3	–	–	4[6]	n.a.
Total sanctions imposed	DM 21 741 350	–	–	n.a.	n.a.
1997: matters opened	26	3	19	1 736[4]	n.a.
Sanctions or orders sought	n.a.[7]	n.a.[7]	n.a.[7]	n.a.[7]	n.a.
Orders or sanctions actually imposed	2	–	1	6[5]	n.a.
Total sanctions imposed	DM 281 817 600	–	–	n.a.	n.a.
1996: matters opened	23	2	22	1 516[4]	n.a.
Sanctions or orders sought	n.a.[7]	n.a.[7]	n.a.[7]	n.a.[7]	n.a.
Orders or sanctions actually imposed	4	–	1	3[5]	n.a.
Total sanctions imposed	DM 19 394 950	–	–	n.a.	n.a.

1. In Germany, "unfair competition" falls under the Act against Unfair Competition. The *Bundeskartellamt* is not responsible for applying this Act.
2. Merger notifications per year.
3. 2 prohibitions, 4 clearances subject to conditions obligations.
4. 2 prohibitions, 5 clearances subject to obligations.
5. Merger control proceedings under the previous law which are subject to preventive and subsequent control (the most recent amendment of the ARC came into force in 1999).
6. Only prohibitions; the previous law did not provide for clearances subject to obligations.
7. In Germany, the competition authorities are the competent administrative authorities to issue orders and determine administrative fines. Therefore, sanctions or orders do not require to be requested.

Source: BKartA 2002, item 17.

The Länder have an important enforcement role too

Germany being a federal State, another set of enforcement bodies exist at the *regional level* (Box 3.4).

Box 3.4. **Federal structure and competition enforcement**

Because Germany is a federal State, there is another set of enforcement bodies at the regional level. For conduct (other than mergers) whose effect is limited to a single *Land*, the competent enforcement body is not the BKartA, but the authority designated by the local law. (Sec. 48) Each of the *Länder* has a competition office. All of these offices together comprise about 80 staff, of which about 30-35 are lawyers. The competition office in Bavaria is the largest, with a total staff of about 10, about half of whom are lawyers. The head of that office is a graduate in economics and law, and the office works with experts, including economists, from the Bavarian Ministry for Economic Affairs. Some of the offices also do procurement matters, as the BKartA does. Only the BKartA decides about mergers, but the governments of the *Länder* must be consulted in a merger matter, if the FCO proposes to prohibit it or if the parties apply for intervention by the Minister.

The BKartA and the offices in the *Länder* all apply the same federal law, because there are no *Land*-level competition statutes. But the *Länder* offices are not responsible to the BKartA. Their decisions applying the ARC are independent and final. They often work together with the BKartA, and by law the BKartA is always a party to their enforcement matters. But they may respond to local policy priorities. Bavaria, for example, has traditionally supported small business. Bavaria has issued its own guidelines about ARC compliance for small businesses, and some features of the ARC that protect small business interests represent Bavarian initiatives.

Typical objects of local responsibility are retail trade, construction and construction materials, and services. In the last few years, several have concentrated on the electric power sector. In Bavaria alone, there are 270 grid operators, and the Bavarian competition office has already handled about 25 cases about the cost of access to distribution. Taxicab service is another common source of problems, ranging from boycotts of taxi stands and dispatch services to claims of exclusion and evasion of local price regulation.

The Ministry looks after competition policy

The *Ministry of Economics and Labour* is responsible for competition policy. The BKartA does not have a regular, formal role in the policy process, though it is consulted about legislation that would directly affect the ARC. The ministry's responsibility includes monitoring the competitive effects of other regulations and legislative proposals, and responsibility for the EU dimension. But it also has a role affecting enforcement through its power (see merger section above) to authorise a cartel or merger for reasons other than competition policy. Typical justifications for going to the Minister are industry rationalisation, job preservation, or supply security.

The *Monopoly Commission* is the other independent federal body, set up in 1973 to be a politically neutral source of analysis and guidance. Its five members are appointed by the Federal President and may not be government officials or connected to industry or labour organisations. It chooses its own chairman. Its biennial report, which is presented by the

Federal government to parliament, assesses conditions and likely trends in industry concentration, appraises the application of merger control, and offers analysis on other economic issues. It can also issue special reports.

Enforcement rules and processes are well designed, and include an effective sanctions regime

The BKartA and the Land competition offices apply the ARC both through administrative work (such as reviewing notifications) and investigation and enforcement against conduct that violates the prohibitions. Proceedings can be initiated *ex officio*. A complaint is not necessary. Information is usually obtained through informal requests, backed up by formal authority that is subject to stringent due process protections. In practice, a formal request for information requires a concrete initial suspicion of a violation. Enforcing compliance with investigative requests can require going to court. A court order is needed for a search.

Enforcement action can lead to orders and substantial financial sanctions. Orders are typically prohibitory, to prevent repetition of the violation in future. Structural relief such as divestiture is not allowed, except in merger cases. Administrative fines are generally up to three times the additional proceeds obtained as a result of the violation or EUR 500 000. The fixed sum is not a minimum or mandatory fine, but it is intended to ensure that a significant fine could be imposed even if the gain from the violation is not great. This approach is consistent with economic theories of deterrence. Fines can be levied against natural persons as well as legal persons and associations. The BKartA's discretion in setting fines is broad enough to support a leniency programme, to encourage members of a cartel to come forward with evidence.

Appeals from BKartA decisions may be taken to the Court of Appeal at Dusseldorf (a new location with the BKartA's move to Bonn, so this court must now develop expertise in competition matters). Appeals from decisions of the Minister also go to the Dusseldorf court. Appeals from *Land*-level decisions go to the local Court of Appeal. A further appeal on points of law is possible to the Federal Supreme Court. Special chambers in these courts enable competition cases to be handled by a small group of judges who develop expertise in the subject. Appeals normally suspend the order being appealed. This makes it difficult to use competition law effectively where the problem is access or refusal to deal. The upcoming energy law reform would make network access orders effective immediately (though this will need to be put to practical test).

Private law suits are a significant, but difficult, enforcement alternative

The main alternative to public enforcement is private law suits. These are significant, although there are obstacles to success. Most of the Supreme Court's rulings about the ARC have been in civil law suits. Claims for private relief are based on violations of "protective" provisions of the ARC (prohibitions against horizontal cartels and abusive practices). The protected parties are typically competitors who are excluded from the market (consumer complaints about horizontal cartels have not been welcomed by the courts). It has been generally difficult to claim damages from a horizontal cartel because of the German civil code's historically stringent requirements to prove causation and the amount of damage, though the approach seems to be opening up. Civil actions for injunctions are also unattractive: the usual rule is that costs (including legal costs) are paid by the losers (the BKartA is not excluded from this).

The option of challenging BKartA inaction is circumscribed, and so far the courts have denied that parties have any right to compel the BKartA to exercise its powers to control abuse or challenge a merger.

Competition policy in the EU and international context

Changes in EU competition law raise important challenges for the German approach to competition policy

The upcoming modernisation of EU competition law procedures will increase the responsibilities of member State authorities for applying the competition provisions of the EU treaty, so this part of the BKartA's activity is likely to become more important. The changes present a particular challenge, because the German conception of competition law and its approach to enforcement differ from the new EU model (Box 3.5). A complicating

Box 3.5. **The challenges of EU competition law for the German approach**

The Monopoly Commission heavily criticised the draft proposed regulation that led to Reg. 2003/1. A fundamental complaint was that asserting the primacy of EU rules would disable national agencies from resisting the politicisation of EU competition policy and would undermine the clear separation of roles between the BKartA and the Minister in the German system. Its concerns illuminate the distinctive aspects of German competition law and tradition.

The Monopoly Commission called attention to variations in substantive law and to the tools in German law that are absent from EU law. For example:

- The classification of cartels is more systematic in German law than in Article 81, leaving little room for enforcement discretion.
- Abuse control is more clearly differentiated in the ARC's Secs. 19(2) and (3) than in Article 82.
- Relative market power, an important issue in German law, is absent from Article 82.
- A dominant firm has a greater obligation to provide access to its essential facility under German law, because it has the burden of showing that access is impracticable [Sec. 19(4)].

Even where texts appear similar, variations in doctrine matter. For example, the Monopoly Commission pointed out that the EU treats price recommendations as a species of agreement, considering the 2 parties as equivalent. By contrast, Germany regards these recommendations as one-sided, to be supervised as a species of abuse. The Monopoly Commission feared that the EC's proposed assertion of jurisdiction, which would not depend on an international competitive effect, might promote the tendency of EU law to deny the anticompetitive significance of most vertical restraints, a result that the Monopoly Commission did not support. The German approach based on control of abuse, though seemingly more lenient that the EU approach based on prohibition, might actually produce stricter control of vertical agreements, depending on how it is applied and on the breadth of the exemption from the EU prohibition.

Pointing to decisions under German law that could not have been reached under EU law, the Monopoly Commission claimed that the new regulation would be "moving away from well-proven national law and so tolerating a reduction in the protection of competition".

Source: Monopoly Commission, 2001.

factor is that the BKartA can apply both German law and EU law, but the *Länder* offices can only apply the ARC.

Co-ordination with other enforcement bodies is extensive and mostly informal

The ARC contains a broad "effects" test, and thus it applies to conduct anywhere that affects competition in Germany. But the converse is not true (for example export cartels are not covered if their only effect is outside Germany). Co-ordination with other enforcement bodies is extensive and mostly informal. It includes a couple of bilateral treaties on judicial assistance (one is currently under negotiation with the US). The mutual, shared, interests of national competition enforcers are increasingly recognised. The BKartA has worked informally with most competition authorities on merger cases. In a cartel investigation that also involved the US, the BKartA co-ordinated its own search action to coincide with the US action.

The limits of competition policy: exemptions and special regulation

SMEs are a favoured class for protective treatment

The quasi-constitutional heritage of the ARC might imply an unusually broad application of competition principles. But the scope and nature of exceptions are similar to those in most other OECD countries. A few are evidence that enforcement has been serious, as the prospect of BKartA action led the legislature to enact protection against it. Competition law defers to the demands of other laws in the event they conflict (as may happen, for example, with the health and social welfare system, and professional services). Publicly-owned enterprises must comply with the ARC with a few exceptions. Many, notably the postal services and municipal utilities, have been targets. SMEs are not technically exempted, but are a favoured class. The ARC gives SMEs tools to shield themselves against aggressive competition and hard bargaining from larger firms, and permits them to combine and co-operate, under certain conditions. For example SME purchasing co-operatives may be exempted from the cartel prohibition. The ARC's solicitude for SMEs is consistent with other policies to support the *Mittelstand* (Box 3.6), reflecting its importance and influence in Germany.

The network industries raise challenges for effective use of the ARC

The broad conception of the ARC and BKartA emphasises the unity of competition policy, and this disfavours special rules and regulators for competition in individual sectors. Also, there is a preference for local authority and private initiative. So Germany has traditionally favoured self-regulation subject to oversight by the competition enforcement bodies. The sectoral exclusions from the competition law that do exist are often aimed at avoiding the application of ARC prohibitions to conduct that is probably not anti-competitive. However the attitude to sectoral arrangements is changing, partly encouraged by EU legislation. Notably, Germany now has a regulator for telecommunications and postal services, and a decision has been announced to establish a regulatory authority to oversee the energy networks. The Monopoly Commission, for one, has come round to the view that natural monopolies need to be controlled through a regulatory process.

Arrangements for the *energy sector* (Chapter 5 gives more detail) are in a state of flux with this announcement. With liberalisation, exemptions from ARC prohibitions were repealed. The main basis for the control of market power is the ARC, via the BKartA and the *Länder* competition offices. The BKartA set up a separate unit in summer 2001 to deal with

Box 3.6. **Crafts and professions**

The ARC's solicitude for small and medium sized enterprises is consistent with other policies to support and protect the *Mittelstand*. Some systems of regulation that shelter smaller scale operations have been criticised for raising the costs of entry, preventing efficient business structures, and limiting consumer choices.

Master-crafts qualifications: For 94 defined services and crafts, a master's certificate is required in order to operate independently and own a company in the field. The system is the linear descendant of the medieval guilds. It has survived several rounds of efforts at reform since the beginning of the industrial era. Like the old guilds, the chambers of these crafts and services have some self-regulatory powers. The holders of the master's certificates are active on the boards that set the rules and standards for their trade. Obtaining a master's certificate requires 1 000-1 600 hours of formal training, in both technical subjects and business administration. Fees for training may range from EUR 3 000 to EUR 7 500 depending on the trade. Preparation for the master's certificate examination takes about a year if pursued full-time; in this case candidates must forgo a year's income in addition to bearing the expense of training fees. Candidates preparing for the master's certificate examination part-time usually do so in addition to their regular occupation. Depending on the trade, such preparation may take between two and two and a half years until the master's certificate examination. The costs imposed by this system discourage entry. Certification of high qualifications may provide customers with useful information and assurances, at least in some of the service areas. For many, though, restricting entry only to the most highly qualified probably leads to "gold-plating" and inhibits provision of acceptable, lower-quality, lower-priced services. The apprenticeships associated with the system are credited by some with performing a vital role in training workers for industry as well as for the crafts trades themselves. Apprentices who do not pursue the master's qualification, perhaps because they cannot afford it, often go to work in the same trade in industry. The training aspects of the system were recognised as a "best practice" in a 1998 EU study.

The master-craftsman system of training, certification, and entry control has come in for criticism. The Deregulation Commission report in 1991 explored the anomalies and recommended reforms, principally to open up new opportunities for providers who are technically capable but who cannot afford the time or expense of obtaining master's certification. The Deregulation Commission suggested this could be done by focusing on the apprenticeship system. Holders of master's certificates would continue to be the only ones who could take on and train apprentices. Removing the master-crafts qualification for doing the work would permit more providers to go into business for themselves, improve management opportunities, and increase competition.

Since then, the Monopoly Commission has repeatedly called for reform, in its regular report for 1996-97 and in a May 2001 special report. The latest report noted a decision by the European Court of Justice which in effect magnified the discrimination between master-craftsmen in Germany and competitors from other EU member States. The EU Commission argued that this awkward result should support a long-overdue thorough reform in Germany. Otherwise German firms would lose business to other providers, at least for one-time, unusual, or near-the-border work. Meanwhile qualified providers in Germany, frustrated at their inability to establish a German company because they lack the master's certificate, are setting up companies in other EU member States for that purpose, even to provide services in Germany in some cases.

Box 3.6. **Crafts and professions** *(cont.)*

Germany's Constitutional Court has ruled that preventing anyone without a master's certificate from establishing a company restrains a constitutional freedom, the right to enter a business. That ruling still left it up to Parliament to regulate access, though.

Professional services have also been regulated to prevent competition and preserve small-scale, local operations. Rules of professional associations that limit the competitive freedom of their members are exempted from the ARC because they are authorised by other federal laws. Examples include schedules of maximum and minimum fees for lawyers, architects, engineers, and doctors. These rules may be contained in bylaws pursuant to legislative authority. Even if they are exempt from the ARC, the rules may not be entirely beyond the reach of competition policy, because they might still be subject to European cartel law if they affect trade between EU member States. Restrictive rules may also be subject to constitutional scrutiny. Germany's courts have relied on the guarantee of the free choice of profession, in Article 12 of Germany's Basic Law, to limit constraints on providing professional services. Legislation that prevented truthful, informative advertising is being relaxed in some areas, such as accounting, engineering, and architecture, although not for doctors. Since 1994, a form of professional incorporation has enabled inter-professional co-operation that previously had been prevented, and lawyers gained the right to form limited liability companies in 1998.

electricity network problems, and numerous cases have been taken forward, mainly over excessive fees for network access. The terms for network access have been set by industry negotiation (the "Associations Agreements") rather than regulation (negotiated access rather than regulated access). The BKartA has expressed concern that these Agreements could facilitate agreement on prices. The industry was tasked with developing a better set of Agreements by the end of 2003, and the ministry reported on the performance of the negotiated access system in September 2003.

Using the ARC to promote competition in network industries is, in short, proving difficult. None of the ARC's actions has yet reached a final decision. The Monopoly Commission concludes that the negotiated access system is not leading to much interconnection. Market structure is part of the problem. A series of mergers in the last few years (nearly all approved by the BKartA) has reduced the number of independent power producers and extended vertical integration. Competition in the gas sector – which is also subject to negotiated access – is developing even more slowly.

Arrangements for the *telecommunications sector* (Chapter 6 gives more detail) have been handled differently. A regulator (the Regulatory Authority for Telecommunications and Post – RegTP) was set up by the Telecommunications Act (TKG) of 1996. Its main task is to regulate *Deutsche Telekom* AG (DTAG), the successor to the State-run monopoly, where it is dominant. To some extent the TKG displaces the ARC. The BKartA has merger control authority, although RegTP also has powers that affect mergers. There are both substantive and procedural links between the sectoral regulation and the ARC. For example, the TKG's requirements for financial transparency, rate approval, interconnection control and access depend on a finding of dominance through the ARC. The Monopoly Commission must make a status report on developments in both the telecommunications and postal sectors every two years.

Despite the specific arrangements for regulated access (intended to be expeditious), there are problems. Delays have arisen from numerous challenges to RegTP decisions, despite "fast track" procedures and a principle that RegTP decisions are to be immediately effective. DTAG has gone to court to resist RegTP's oversight efforts with some success, and has resisted disclosing its costs.

Postal services are subject to a monopoly authorised by the Postal Act which leaves little room for application of the ARC. The exclusive right of Deutsche Post AG (DP) was recently extended to 2007, though its scope is shrinking. The Postal Act regulation – which includes licensing and price control – has an important effect on competitive conditions. DP has certain financial advantages over competitors, and the EU Commission has found fault with the use of federal transfers to support DP's activities in competitive markets.

Competition law has some limits in *passenger transport*. The sectoral legislation exempts agreements among associations of regional and local passenger service (bus and train) providers (to allow connecting services and combined tickets). Mainly, competition is constrained by public sector regulation of rates and conditions of service, which take precedence over the ARC, and by slow and cautious restructuring. Deutsche Bahn AG (DB) has been restructured to separate the track from train services but accounting separation is as yet incomplete and DB remains sole owner, which undermines the effort to determine appropriate terms for track access. The Federal Railways Authority oversees access and timetables to prevent discrimination, and the BKartA also has the power to deal with abuse. Other providers now account for just 7% of passenger service, mostly at local level, though this is expected to increase. Non-DB providers are a more significant factor for freight service, though track access is a problem. The BKartA has found that DB's pricing system was discriminatory and non-transparent, and DB has made changes, but access issues in particular remain.

Access issues need to be tackled through strict managerial and accounting separation at the minimum. However the German Act on Corporations renders strict managerial separation impossible as managers of subsidiary companies have to act in the interest of the whole concern. Ownership separation may therefore be the only legally sound way of solving this problem. The Monopoly Commission has recommended stronger measures than exist today.

Public supply of *water,* which is mainly provided by municipally-owned utilities, remains exempt from the ARC, for reasons of public health and pollution control. Rates are high compared with others in the EU though quality is high too. Improvements could be promoted through greater use of benchmarking, expanding the geographical coverage of individual waterworks, and competitive tendering of water contracts.

Other sectors benefit from exemptions and special treatment, which is not always fully justified

A number of other sectors come under special arrangements and exemptions. Agreements involving the *agricultural sector* are excluded from the ARC prohibitions, as long as they do not fix prices or exclude competition. This is to allow for special conditions that limit market responsiveness, such as the weather. One exemption remains for agreements among *credit and insurance firms* concerning risk and loan syndication. *Statutory health insurance funds* are now in effect exempted from the ARC, because they are not considered undertakings (which would be subject to the ARC). Aspects of EU law may still apply.

Copyright societies are exempt from the basic prohibitions against horizontal and vertical agreements (though they would be subject to control for abuse) to help ensure the effectiveness of individual rights. *Sports broadcasting* is subject to certain exemptions, to help ensure that non-competition objectives such as youth training and sports can be promoted. Another media-related exemption applies to areas regulated by treaties, including the "treaties" among the *Länder* about the scope of *commercial television* and the distribution of fees among TV stations.

As regards the *media* the Lander are generally responsible for licensing private radio and TV operators and assigning broadcast frequencies, a role that is explained by their legislative competence concerning cultural matters. Media concentration and viewpoint diversity in national private broadcasting are overseen by the Commission for Investigating Concentration in the Media Sector (KEK).

An important sector with special treatment, which predates the competition law, is *publications*. The ARC continues to reflect this with an exemption for the imposition of resale prices by publishers, though it appears to authorise "rule of reason" treatment (the practice may be voided under certain conditions). The BKartA examined the market effects of the exemption in the 1970s when it found that prices in Germany were 2 to 3 times higher than in France for a category that was subject to different treatment in the two countries. The arguments advanced for resale price maintenance include promotion of cultural values, cross-subsidisation of low-demand products to encourage innovation and viewpoint diversity, and preserving an industry structure of SMEs throughout the country. A new law in 2002 – to counter an EU finding that the provision violates EU law – makes the protection even stronger, by requiring resale price maintenance for books, sheet music and maps.

Competition advocacy for reform

The BKartA has a limited policy and advocacy role: could it do more?

The Monopoly Commission has become the main source of analysis and advocacy about regulation and competition, through its biennial reports which examine topical issues as well as business concentration and merger control. It also now reports regularly on the state of competition in telecommunications and postal services. It also produces occasional special opinions, at its own initiative or at the request of the Federal government. Its work has, notably, drawn attention to problems with the master-crafts system and with network access.

The BKartA's role in policy and advocacy is limited. In the past, its policy comments ranged more widely. In the early 1990s (in the context of legislative proposals) it commented on a range of important issues such as the media laws, telecommunications policy and private competition with public service providers. Today it concentrates on infrastructure issues and its enforcement role. The BKartA's isolation from general debate about competition policy at first appears surprising, given the traditionally paramount importance attached to the competitive process in the social market economy. But the same tradition also emphasises independence in the application of the competition law. A strong ethos of impartiality can give the comments of an independent body considerable weight and authority. But that capital is a valuable resource, and there may be a concern that spending it too freely in contentious policy debates could undermine enforcement credibility.

Conclusion

Germany's competition law is an important heritage. The ARC was enacted to be a foundation of the post-war political economy, and must therefore take at least some of the credit for the success that followed. The institutional structure has been notably successful, within the law's defined sphere. The BKartA is widely respected and from the beginning has had a strong sense of mission, motivated by belief that the law it applies is "synonymous with the very principle of Germany's economic order". The institutional disruption attending the recent move to Bonn may challenge its confidence and capacities: its future efficiency depends on maintaining the traditional *esprit*. Methods tend toward legal formalism (as might be expected in the German context) but the implied presumptions behind the rules promote efficiency and are consistent with economic policy goals. The core of the law is well-balanced, and can now draw on nearly 50 years of precedent and experience. The rules about horizontal cartels send a clear message about the importance of competition while permitting efficient co-operation.

The law's motivating ideas have, however, become diffuse and in some respects have weakened over time through legislative fine-tuning of the rules and the special-interest character of some of these changes. Another issue concerns the key goal of the law to protect market relationships and structures. This needs to be tested against economic standards of market performance and encouragement of innovation, to be sure that the pursuit of this goal is not promoting the status quo and actually preventing competition. The risk is clearly present: for example (and notwithstanding the repeal of laws which made discounts difficult) the unfair competition rules which discourage discounts and give consumers too little credit for being able to look out for themselves.

The link between the law and competition policy is limited, because the law is institutionally separated. There are good reasons for this: it insulates the BKartA from political pressure and promotes its independence, which is a great asset. As the BKartA confines itself to applying the law, competition policy is with the Ministry. The reports of the Monopoly Commission inform policy debate too. But the latter cannot speak with the same authority as the BKartA, and the Ministry's capacity to advocate effective competition-based reform can be compromised by its role in promoting other policies, as shown in the recent action in the gas-electricity merger. Recourse to the minister has been rare, but two major mergers have been taken there within the past year. This process was not intended to be routine. If disappointed parties resort to it too often, it may be necessary to devise more stringent standards to discourage what may appear to be an effort to second-guess the BKartA's judgment.

The challenge of dealing with the changes in EU competition law and enforcement is a large one, and perhaps the most important issue facing Germany's competition law today. The BKartA rests on a distinctive system which could become an anomaly in Europe. An extended process of experiment and co-evolution is likely. Despite moves toward EU practices key underlying approaches remain fundamentally at odds, such as the EU system's reliance on administrative discretion and general criteria for exemption, rather than Germany's more systematic notification and clearance based on clear rules.

Regulatory reform has difficulty finding a place in the German system of competition law and policy. As an agent of effective change in liberalising sectors, the system falls short. Reform is not well served by the disconnection between competition law enforcement and policy. And the ARC is not well suited for implementing competition

policy principles in infrastructure sectors where competitive structures have not yet taken root. The usual methods of analysis and proof are hard to apply. The experiment of self-directed industry co-ordination subject only to antitrust oversight is now giving way to a regulatory solution. This incremental approach to reform does have the merit of clearing the way for other measures, where an experiment founders.

Policy options for consideration

1. Empower consumers by encouraging entry and competition in craft services and professions.

The high costs of qualification and the limitations on offering services increase the cost of entry and inhibit innovation. Moreover, they undermine the process goals of German competition policy, by reducing opportunities for producers and denying consumers the choice of different combinations of price and product quality. To be sure, in some of these fields – but not all of them by any means – there are information asymmetries that support maintaining standards, especially to protect uninformed or vulnerable consumers. But experience in other countries shows that less intrusive regulation can maintain sufficient protection while improving market outcomes. The pending ministry draft of a new Act Regulating the Craft Sector would respond to some of the criticisms of the current system, by limiting the master-craft qualification requirement to services that could endanger health and life, and by permitting others with sufficient experience to offer services in the field.

2. Reform protectionist marketing rules for the modern economy of informed consumers.

Regulations have protected incumbent producers and retailers against marketing innovations, while giving consumers too little credit for being able to protect themselves. Some of these constraints are already changing: the Discounts Act, which dated from 1933, and the Gifts Ordinance of 1932, were abolished in 2001. The trend is thus in the right direction, but the pace of change is slow. Changing shop hours did not revolutionise the schedule of daily family life; people continue to shop mostly during the times that they have been used to. Thus fears that change would rip apart the fabric of society were unfounded. A similar muted response is likely to follow relaxing the constraints on discounts and sales, which is promised in the upcoming reform of the unfair competition law. That reform should go further, and eliminate the formalistic prohibition of sales below "cost price" in the absence of any risk of predation or monopoly. That prohibition, which probably tends to sustain higher price levels along the distribution chain, ignores the reality of modern merchandising by requiring that market offerings be decomposed into individual "things." Consumers who respond to discount offerings and patronise mass merchandisers may find they prefer the corner store. Or they may not – and if they do not, it is because they have concluded that the alternative makes them better off.

3. End the anomalous special treatment for the publishing industry.

Mandating conduct that would be prohibited per se in every other sector of the economy is difficult to justify. To be sure, the sector has unusual characteristics, including very low marginal costs and highly variable prospects for success. Most items are losers, a few are big winners, and it is hard to tell in advance which will be which. Some means of spreading risk and sharing the windfall is inevitable. But doing so through an explicit

exemption undermines the consistency of competition law. More importantly, the goals, including supporting experimentation and viewpoint diversity, can be achieved by less disruptive means. In older distribution systems, these might take the form of sales through consignment or generous return policies, putting the risk on the publisher. In modern distribution environments, they might be sophisticated inventory control, overnight delivery, and distributed, just-in-time manufacturing of slower-selling items. In each setting, a recommended retail price, which could be permitted under the ARC, probably would achieve all of the legitimate purposes of the complete exemption. Even in small language markets, such as Sweden, experience has shown that allowing competition about retail prices need not reduce consumer choices, although it could lead to different systems of distribution.

4. Reassign disputes over the terms of network industry access to a single regulator.

Recognising the difficulties that have already been experienced in trying to promote reform through antitrust enforcement, the government has announced its intention to shift this function to a regulator in 2004. Details remain to be worked out. One important one is the institutional form and location, whether it will be connected to the BKartA or built on the existing network regulator for telecoms.

5. Raise the profile of competition advocacy and policy analysis.

This function has been left to the Monopoly Commission, except for matters that directly concern competition law enforcement. That body has the necessary technical expertise, professional stature, and political independence. But it does not have many resources. It is wasting some of the resources it has in obeying the statutory command to generate meaningless reports about industry concentration. The results are not useful for enforcement and not relevant to policy. The function is a relic of the political temper of the era when merger control was added to the law in order to challenge monopoly capital. Eliminating this reporting obligation would make time and resources available to deal with modern problems. In addition, the BKartA should reconsider its currently limited level of engagement in policy analysis and advocacy, other than concerning the content and application of the ARC itself. Although the Monopoly Commission is now a well-established institution, its purely advisory role might make its advice easier to ignore. To be sure, involvement in policy controversies can use up political capital and expose the enforcement body to some risks. Those potential costs counsel a judicious choice of opportunities for BKartA advocacy, perhaps concentrating on matters that implicate conduct which, but for the regulatory scheme or proposal at issue, would be covered by the ARC. Clearer formal authorisation should be considered, if that would facilitate the BKartA's performance of a wider advocacy role.

6. Consider enlarging the BKartA's staff resources.

The staff of the BKartA is about the same size it was a decade ago, with recent additions attributable only to its new responsibilities for procurement disputes. Differences in jurisdiction, powers, and processes make exact comparisons with other competition agencies imperfect. Even so, the BKartA looks surprisingly small compared to the agencies in many other countries – no larger than the competition policy staff of the UK's OFT, and well below France, Canada, and the Netherlands – and the addition of the *Länder* offices would not make up all of the difference. Professionalism and experience may

mean BKartA can do more with less. Some pressure will be relieved when electric power matters are transferred to a network regulator. But the likely increase in activity as EU modernisation is implemented will likely demand a larger staff.

7. Improve tools for dealing with network industry relationships and decisions.

Efforts to apply the ARC to network industry access situations have exposed some potential problems, in information gathering methods and in rules for addressing vertical relationships. The urgency of resolving these problems depends upon how quickly these cases are transferred to a network regulator. Pending that transfer, they may require some attention. Problems of getting information stemmed principally from controversies about what kind of information would be relevant. Now that the Court of Appeal has decided that enforcement of the ARC can be based upon costs as well as comparative prices, the purported irrelevance of cost information is not likely to be raised again as grounds for resistance to requests for that information, at least not so broadly. Controversies about details will probably recur. Increasing the sanctions for non-compliance with information requests or changing the procedure for obtaining information are not likely to be either necessary or feasible. The level of sanction is not relevant, because the courts do not in fact impose it. A process that exposes a party to sanctions without a hearing in court would not be acceptable. Obtaining information appears to be an increasing problem for German agencies. RegTP has had difficulty getting basic cost data from DT. The BKartA has not complained that its investigative tools are inadequate, As its practice extends to more foreign firms that do not have a history of co-operation with the BKartA, it may find more coercive methods to be necessary, though.

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PART II

Chapter 4

Market Openness*

* For more information see: Background Report on "Enhancing Market Openness through Regulatory Reform" available on the Web site: *www.oecd.org/regreform/backgroundreports*.

Context and history

Germany's large economy is strongly export-oriented and its trade policies promote market openness

In the European context, Germany's striking feature is its size. It is the world's third largest economy after the US and Japan, the world's second largest exporter of merchandise products, and the largest market in the EU, with a population of 82.3 million and a GDP of EUR 2 269.2 billion in 2001.

It also faces the continuing challenge of adjusting its economy to re-unification. The integration of the new *Länder* has been pursued with the aim of equalising living standards across the country, and this has proved costly. Budgetary transfers to the new *Länder* remain a major burden on public finances and contributed to a government deficit of euros 25.7 billion in 2001. The cost has also been reflected in the evolution of the trade balance. The merchandise trade balance dropped sharply after re-unification, as goods were diverted to the east for reconstruction, and has only recently recovered to pre-unification levels. In 2001, the merchandise trade surplus was about euros 87 billion (roughly 4.5% of GDP). Merchandise trade is largely concentrated on chemicals, manufactured goods, and machinery and transport equipment. These accounted in 2001 for nearly 80% of merchandise exports and were responsible for its surplus in the trade balance (Table 4.1). There is a longstanding deficit in services trade. The main services importing sectors in 2001 were travel, business services and transportation (Table 4.2).

Table 4.1. **Sectoral structure of merchandise trade, 2001**

	Imports		Exports		Balance
	(Million EUR)	%	(Million EUR)	%	(Million EUR)
Food and live animals	29 916	5.4	21 313	3.3	–8 603
Beverages and tobacco	4 976	0.9	4 133	0.6	–843
Crude materials, inedible, except fuels	16 968	3.1	8 939	1.4	–8 029
Mineral fuels, lubricants and related materials	46 869	8.5	8 896	1.4	–37 973
Animal and vegetable oils, fats and waxes	1 139	0.2	1 241	0.2	102
Chemicals and related products, n.e.s.	54 963	10.0	80 815	12.7	25 852
Manufactured goods classified chiefly by material	69 064	12.6	86 077	13.5	17 013
Machinery and transport equipment	206 202	37.5	331 166	52.0	124 964
Miscellaneous manufactured articles	66 884	12.2	59 482	9.3	–7 402
Other commodities and transactions	53 293	9.7	35 269	5.5	–18 024
Total	**550 273**	**100.0**	**637 333**	**100.0**	**87 060**

Source: Statistisches Bundesamt, 2002.

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Table 4.2. **Sectoral structure of services trade, 2001**

	Debits		Credits		Balance
	(Million EUR)	%	(Million EUR)	%	(Million EUR)
Transportation	28 126	18.2	22 952	23.5	–5 174
Travel	51 607	33.4	19 232	19.7	–32 375
Communications services	3 494	2.3	1 804	1.8	–1 691
Construction services	5 273	3.4	3 981	4.1	–1 293
Insurance services	1 257	0.8	1 779	1.8	522
Financial services	4 127	2.7	4 566	4.7	439
Computer and information services	7 124	4.6	5 199	5.3	–1 925
Royalties and licence fees	5 850	3.8	3 515	3.6	–2 336
Other business services	42 689	27.6	29 626	30.3	–13 062
Personal, cultural and recreational services	3 718	2.4	374	0.4	–3 344
Government services	1 476	1.0	4 777	4.9	3 301
Total	**154 742**	**100.0**	**97 804**	**100.0**	**–56 939**

Source: OECD, 2003b.

Export-oriented economic policies have been an important feature of the social market economy which was developed after the Second World War to put Germany back on its feet. Competition – abroad as well as within Germany – was strongly encouraged. Germany has also worked to promote market integration both within Europe and internationally. Trade policy is closely tied to the EU. Within the EU Germany has promoted an open common external trade policy, whilst the development of the EU single market has led to a reduction in regulatory barriers to trade between EU countries. Trade relationships are strongly anchored within the EU (Table 4.3). Half of all trade is conducted with other EU members.

Table 4.3. **Geographical structure of merchandise trade, 2001**

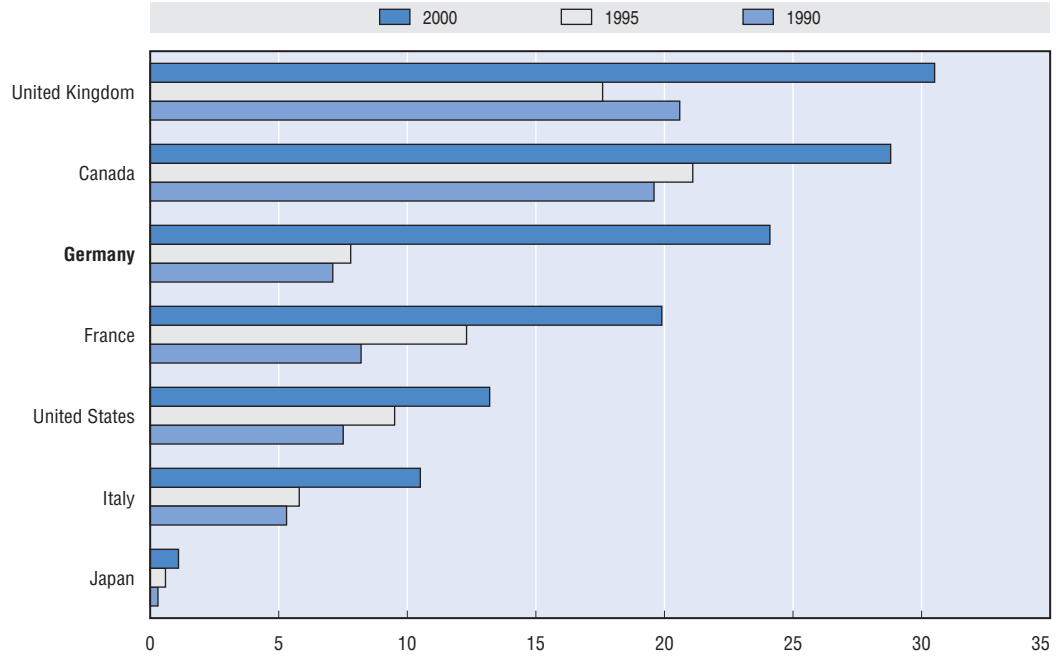
	Imports		Exports		Balance
	(Million EUR)	%	(Million EUR)	%	(Million EUR)
OECD	**432 381**	**78.6**	**522 020**	**81.9**	**89 639**
EU-15	274 374	49.9	342 720	53.8	68 346
Non-EU Europe	78 339	14.2	81 100	12.7	2 761
NAFTA	49 946	9.1	76 895	12.1	26 949
Asia and Pacific	29 721	5.4	21 304	3.3	–8 417
Non-OECD	**96 959**	**17.6**	**99 044**	**15.5**	**2 085**
Europe	19 378	4.0	26 880	4.2	4 745
Africa	11 192	2.0	11 812	1.9	620
America	8 689	1.6	11 144	1.7	2 456
Near and Middle East	5 081	0.9	13 646	2.1	8 565
Asia and Pacific	50 069	9.1	35 561	5.6	–14 508
Unspecified	**20 934**	**3.8**	**16 269**	**2.6**	**–4 664**
World	**550 273**	**100.0**	**637 333**	**100.0**	**87 060**

Source: OECD, 2003a.

Investment flows are also EU-dominated. Half of all German investment abroad is in the EU, and over 60% of foreign investment in Germany is from other EU countries. Foreign direct investment (FDI) inflows to Germany were relatively low until the mid-1990s, but

have been growing. The ratio of inward FDI to GDP remains lower than for the UK and Canada, but higher than for other large OECD countries (Figure 4.1). The scale of recent FDI has been boosted by some large transactions (including the Mannesman takeover by Vodafone Airtouch). The three core manufacturing sectors of chemicals, manufactured goods and machinery and transport equipment also account for about two-thirds of the inward and outward FDI stocks in the manufacturing sector. However most FDI (over 80% inward and over 70% outward in 1999) is undertaken in the services sector. Outward FDI stocks exceed inward FDI stocks by nearly 40%.

Figure 4.1. **Inward stocks of FDI as a share of GDP in selected OECD countries**



Source: OECD.

The consensus-based approach to decision-making and extensive regulation make a challenging environment for outsiders

The governance system is also characterised by a constant search for consensus in decision-making, and especially, intensive consultation with unions and business associations. This, together with the extent of regulation, can be a demanding environment for foreigners in their efforts to understand the German framework. Time and resources may be needed to come to grips with it. An initiative to promote greater efficiency in governance – "*Modern State – Modern Administration*" – was launched in 1999. The "Agenda 2010" reform programme is a more ambitious and comprehensive initiative to promote structural and regulatory reforms, which has considerable potential for fostering market openness.

The policy framework for market openness: the six efficient regulation principles

As tariff barriers to trade have fallen, the impact of domestic regulation on international trade and investment has become more important. In a global economy,

regulations need to be market-oriented and friendly toward trade and investment. The *1997 OECD report on regulatory reform* identified six "efficient regulation principles" for building these market openness qualities into regulations. These are reviewed below.

1. Transparency: the nature of Germany's governance system generates some difficulties, especially with public procurement.

Market openness requires that all market participants be fully aware of regulatory requirements so that they can base their decisions to invest, produce and trade on an accurate assessment of likely costs, risks, and benefits. This is especially important for foreign firms, which have to cope with differences in the business environment, such as language and business practices. Transparency requires access to information on regulations and openness of the rule-making process through public consultation. The handling of public procurement is an important aspect of transparency.

Despite big efforts to promote transparency, the amount and complexity of Germany's regulations, its federal structure, and its consensus-driven approach to rule-making constitute a challenge for foreigners. For example, consensus-seeking drives a large number of consultation mechanisms, and the tax law is very complex.

Access to information. The context is important here. Most government officials and business and consumer representatives have a legal background, and extensive regulation is an integral part of Germany's approach to governance. At the same time, there is a solid framework for making rules available to all. Any legally binding text must be published in the Federal Law Gazette, which can also be accessed via the Internet. Laws must be published before they enter into force, but not drafts. Thus, information on legal texts only becomes available after the committee involved has come to a consensus or reached a decision by a vote. This inevitably puts outsiders to the consultation mechanisms at a disadvantage. The Agenda 2010 programme and the Master Plan promise to tackle the amount of regulation, explicitly promoting the abolition of unnecessary rules and the use of alternatives to regulation.

Consultation mechanisms. Rule-making is characterised by intensive co-ordination and consensus-building, generally involving established groups such as trade unions, business associations, NGOs and consumer groups. A consensus with a majority of the *Länder* is necessary if their interests are affected. The responsible ministry decides who to consult and approaches vary. This contrasts with the open "notice-and-comment" practice of most OECD countries. A federal manual on legal drafting and assessment of regulatory impacts sets out the procedures. The interests of foreign stakeholders are generally expressed through professional associations, such as the Federal Association of German Industry (BDI). In principle therefore, foreigners have the same opportunities for comment as others, and there are no special arrangements for them. But the need to belong to these associations may *de facto* exclude foreign interests from the consultation process.

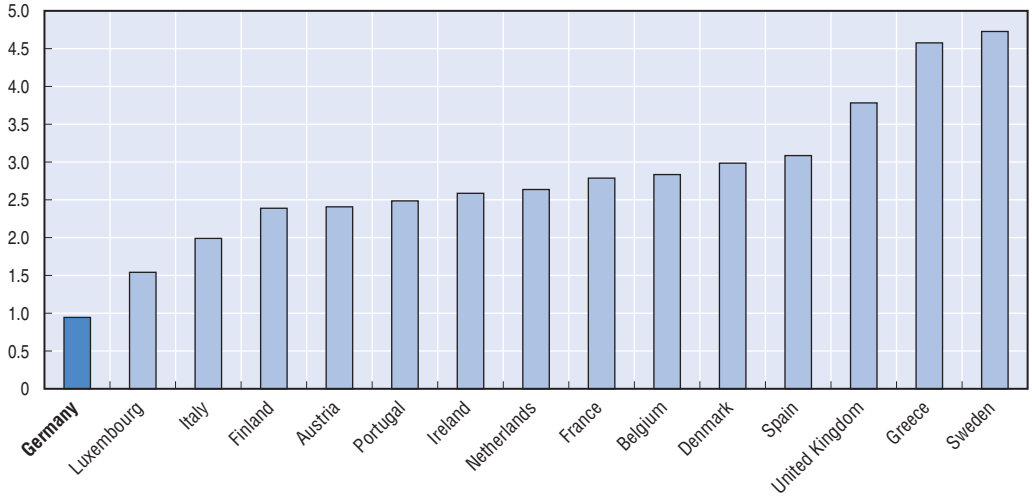
Openness of appeal procedures. No distinction is made between foreign and domestic interests. The rules provide for complete legal redress against acts of the State (part of the Basic Law).

Transparency of technical regulations and standards. The German Institute for Standardisation (DIN), a non-governmental technical association, is responsible for voluntary technical standards. There are a huge number of standards and committees (some 83 committees and 4 100 working parties in 2002). DIN follows standards-making

guidelines which require consensus-based decision-making, and is responsible for identifying relevant stakeholders. Decisions are made public once a consensus has been reached, which can take several years. This is done through DIN's Web site among other means. The scale and length of the standards-making process can be daunting for SMEs. DIN also maintains the German Information Centre for technical rules (DIETR), and publicly accessible standards collections in wall major German cities. To help foreigners it makes an effort to publish in other languages.

Public procurement. Calls for public procurement published at the EU level are the lowest in the EU, accounting for slightly less than 1% of GDP, compared with an estimated total contract value of just over 17% of GDP (Figure 4.2).

Figure 4.2. **Openly advertised public procurement as advertised in the *Official Journal of the European Union*, 2001**



Source: OECD.

Part of the reason is that a large number of procurement contracts fall below the EU threshold for publication: contracts are deliberately split up to make bidding by SMEs easier, but the fact that such contracts are not then published at the EU level makes it harder for foreigners to learn of opportunities (the contracts are however published domestically). Foreigners face further difficulties in that the German public procurement legal framework is extremely complex. As in most other EU countries, EU directives are implemented in such a way that EU and national law coexist: above a certain contract value EU law applies, and below it national law applies, which can vary between the seventeen *Länder*. The level of the EU threshold varies by type of procurement. Also, EU legislation has been integrated into a Web of different German laws and rules – the competition law, the ordinance on public procurement, and the procurement codes. In line with EU law, a tender can be avoided if a public company can provide the good or service. This is also unhelpful for international competition. Box 4.1 sets out EU rules on procurement. Legal protections for bidders vary according to the value of the contract. Above the EU threshold every domestic or foreign bidder can appeal to the public procurement tribunals. Some EU law has been implemented by reference to existing national law. This is unique in the German legal system and has led to a lack of legal transparency.

Box 4.1. **EU rules on procurement**

Public procurement in the European Union accounted for 11% of GDP of the EU in 1996. Before common directives were passed at the European level not more than 2% of public tenders were attributed to foreign firms. Within the OECD countries it accounted for 20% of GDP in 1998 (OECD, 2001).

Because of its economic importance it has been considered as one of the cornerstones of the Single Market and led to the adoption of a series of rules aimed at promoting a climate of openness and fairness and securing enhanced competition in the area of public works, supplies and services. A special framework is applied to utilities (energy, water, telecommunications and transport). Some of the major requirements of EU rules on public procurement are the following:

- *Information:* Contracting authorities must prepare an annual indicative notice of total procurement by product area that they envisage awarding during the subsequent 12 months. The annual indicative list and any contract whose estimated value exceeds specific thresholds must be published in the Official Journal of the European Communities. Tenders must indicate which of the permitted award procedures is chosen (open, restricted or negotiated) and specify objective selection and award criteria. Contracting authorities must also make known the result of the tender procedure through a notice in the Official Journal of the European Communities. Provisions setting minimum periods for the bidding process ensure effective opportunity of interested parties to participate in the tender.
- *Remedies:* Member States must provide appropriate judicial review procedures of decisions taken by contracting authorities. In particular, they must provide for the possibility of interim measures, including the suspension of procedures for the award of public contracts, for setting aside decisions taken unlawfully and for awarding damages to parties affected by the infringement. The EU Directives require that these procedures be effectively and quickly enforced. Effectiveness and speed may however be difficult to judge in practice, given the diversity of judicial systems across EU member States.
- *Non-discrimination:* This principle, applicable among EU member States, is set by the Treaty of Rome which prohibits any discrimination or restrictions in awarding contracts on the grounds of nationality and prohibits the use of quantitative restrictions on imports or measures with equivalent effect.
- *Use of international standards:* EU rules require the use of recognised technical standards in defining specifications, with European standards taking precedence over national standards.

In May 2000 the EU Commission introduced proposals aimed at consolidating and modernising the regulatory framework on public procurement. Their main features are the consolidation of the directives on public works, supplies and services into a single text; incentives for a wider use of information technologies in public procurement; and an improved and more transparent dialogue between awarding authorities and tenderers in determining contract conditions. Initiatives have further focused on transparency, information dissemination and accessibility of appeal procedures. Public procurement tenders are published in the Official Journal, but are equally available electronically. The most prominent e-initiatives are SIMAP (*Système d'Information pour les Marchés Publics*) and TED (Tenders Electronically Daily). To foster mutual understanding the European Commission developed the Common Procurement Vocabulary (CPV) which is available in all European languages. The EU Commission also developed explanatory guides on Community law in that field. The purpose of these publications is to raise awareness among companies of the possibilities in public procurement.

Source: EU Commission.

Procedures present another challenge. Committees create the procurement codes. These, part of the self-regulation tradition and operating by consensus, are made up of federal and *Länder* representatives and business associations representing important domestic clients. So the foreign and indeed any third party perspective is lacking. Tender procedures can follow six different modes, as prescribed in the procurement codes. Apart from the public or open procedure, all the other procedures involve a restricted group of bidders chosen beforehand by competition. Box 4.2 sets out Germany's general principles for public procurement.

2. Non-discrimination: Germany has promoted this for a long time; current policy is anchored in its membership of the EU and WTO.

The application of the non-discrimination principle in regulation, through most-favoured nation treatment (MFN) under which all firms are treated the same, and national treatment (NT) under which foreign firms are treated the same as domestic firms, aims to provide equal competitive opportunities irrespective of the origin of products or services and so maximise efficient competition.

Germany's policy is anchored in its membership of the WTO and the EU. It therefore has obligations to ensure compliance of its domestic regulations with the MFN and NT principles, but is also proud to have started this process from the beginning of the last century. It has one Germany-specific exception to MFN, related to ships' personnel. It also, as an EU member, adheres to the EU-wide list of exemptions to MFN treatment in the GATS, the schedules of commitments to market access, and national treatment.

Preferential agreements give more favourable treatment to specified countries and are thus inherent departures from the MFN principle. Germany's policy is an integral part of EU policy which, notably, includes the creation of the EU's Single Market. Though the Single Market has drawn criticism from trading partners outside the EU, efforts have been made to keep the process open and to apply regional policies on an MFN basis. A number of preferential agreements have been concluded by the EU: with EFTA countries, with central and eastern European and Mediterranean countries, and also with developing countries. There are number of safeguards for third parties in this process, including a review by the EU Council of Ministers of compatibility with WTO rules, and the WTO's dispute settlement mechanism.

3. Avoiding unnecessary trade restrictiveness: awareness of this is high and significant measures are being taken.

Where possible regulators should favour measures that have the least restrictive effects on trade. For example taxes might be used instead of regulations to achieve the same policy goal. Mechanisms need to be put into place to give effect to the principle, including *ex ante* assessment of the impact of proposed regulations on trade and investment, reviewing them after a certain time, streamlining procedures, effective consultation of foreign interests, and access to a dispute settlement procedure. In short, a business-friendly environment needs to be created which extends to foreigners as well as domestic interests.

Impact of regulations on trade. Efforts to assess the impact of regulations do not explicitly consider trade and investment issues (the impact of domestic regulations on trade, and the impact of trade regulations on trade). The consensus-driven approach to rule-making has some advantages in this context, as it should help to identify a wide range of potential effects of proposed rules (though not necessarily those affecting outsiders to the process). *Ex post* evaluation of the impact of rules is equally important. Chapter 2 gives more detail on these issues.

Box 4.2. **General principles for public procurement in Germany**

Principle of private law

The State acts in its purchases like a private company and therefore takes up the legal status of a natural person in the context of public procurement.

Principle of competition and transparency

The State identifies suppliers through international competition. Services are to be assigned through a competitive process to ensure the participation of the greatest number of bidders. This has implications on the procedures of public procurement tenders. Since there are many different possibilities to conduct a procedure, a hierarchical order has been established. Preference is given to public tenders over restricted tenders which prevail over the negotiated procedure and the single tender action. Once a rule of procedure has been chosen it cannot be modified unless the tender is terminated. A call for a tender above the EU threshold needs to be published in the official Gazette of the EU before it can be published domestically. Henceforth, tenders can only be initiated through a publication in the official Gazette of the EU.

Principle of long-term economic efficiency and effectiveness

Tenders should not be decided on the basis of price only, but should offer value for money. According to EU law social and environmental aspects may be taken into account.

Principle of decentralised procurement

By avoiding centralised procurement, competition among buyers can be maintained and clientilistic structures avoided. Arbitrary discrimination against bidders is prohibited. In order to offer SMEs adequate participation in the bidding process, construction contracts and freelance services are supposed to be split up. The principle of awarding by lots only applies to VOB and VOL. To avoid unfair competition no bidder is allowed to improve his/her offer *ex post* in order to obtain a tender.

Principle of consensus

Since the 1920s the rules of public procurement have been laid down by the committees of awarding authorities and contractors. In general, decisions have to be taken by consensus. The construction sector represents an exception. Here a three/quarter majority is generally sufficient. Due to the amendment of public procurement law (VgRÄG) in 1998, tenders above the EU threshold fall outside the competence of the committee of awarding authorities and contractors, which can therefore not draft regulations in that domain.

Principle of budget law

Decisions made by consensus within the committees of awarding authorities and contractors below the EU threshold are fed into the budgetary law of the Federal Government and the *Länder*. In this way the committees of awarding authorities and contractors are bound to produce decisions that reflect the general framework of budgetary law and accountancy. The legal character of the decisions of the committee of awarding authorities and contractors is that of internal directives. Therefore bidders have neither the right nor the legal protection to demand the compliance with public procurement rules.

Source: Federal Law Gazette 1994 II, p. 1724 ff, Marx/Jasper (2001).

Administrative burdens on business. In principle foreigners face the same issues and potential difficulties as domestic firms in dealing with the German administration. In practice they may find it harder, confronted with the particular thoroughness of the German approach, the extent of regulations, and the complex federal-*länder* legal architecture and division of responsibilities. Legal predictability is, however, a strong point. The federal government recognises a general need for improvement. It has given priority to reducing the administrative burden in its "*Modern State – Modern Administration*" programme and its "Agenda 2010". This includes a new division named "controlling bureaucracy" in the Federal Ministry of Economics and Labour (BMWA), expanding the use of online procedures, and one stop shops to improve the interface between firms and local authorities. Some special support to foreign investors is also provided by FDI agencies whose objective is to encourage FDI. There is a large number of these agencies at the federal, *Länder* and local levels (about 1 000 in total), but they tend to operate largely independently, which can lead to duplication of promotional effort.

Customs procedures. Customs procedures attract growing attention, now that tariff barriers in OECD countries are low or non-existent. They can represent a significant cost to business. Steps have been taken in Germany to address this. Risk management can help to expedite trade whilst protecting a country's interests, and a centralised institution for risk analysis (ZORA) helps the customs service. Germany supports the EU Common Customs Code aimed at simplification of customs procedures, and expects to ratify (with the EU) a new simplification convention under the World Customs Organisation. An important e-customs initiative is being taken forward, the Tariff and Local Customs Procedure (ATLAS), which will replace currently isolated IT systems and whose ultimate aim is to make procedures paperless. Traders will be able to initiate customs declarations from their home base. German customs authorities also regularly meet business associations to promote dialogue, among other trade facilitation measures.

4. Use of internationally harmonised measures: Germany's strong international trade orientation includes active involvement in the international standards-making process.

Compliance with different national regulations and standards can make the cost of operating in different markets significant, even prohibitive, a major issue raised by the international business community. Internationally harmonised standards offer a solution, and their use has gained prominence with the WTO Technical Barriers to Trade (TBT) agreement. This encourages countries to base their technical requirements on international standards where these exist. The reduction of standards-related barriers to trade within the Single Market has also been a high priority, and is reflected in the "New Approach" to technical harmonisation, under which regulation is limited to defining essential requirements, not detailed technical specifications. In practice this means that the development of standards is left to European standardisation bodies, and their use is not mandatory, although they provide a presumption of conformity.

The international environment for standardisation now provides a strong guiding framework for national standards. Thus European and German national standards are increasingly transpositions of international standards produced by international standardisation organisations such as ISO, IEC, and ITU. The EU Commission mandates standardisation work within this context. Completion of the EU internal market has promoted the development of European standards under the "New Approach". Germany's

standardisation work is done in close co-operation with international and especially EU standardisation bodies, as well as with industry and consumer representatives. 75% of standards published in Germany are developed internationally, and the number of national standards has continuously decreased.

DIN is the cornerstone of the German standardisation work and a key player in Germany's policy of promoting international trade. It is a member of the International Organisation for Standardisation (ISO) and it promotes the adoption of standards harmonised at the EU and international level. As a private institution it has voluntary membership and participants usually contribute to its costs. DIN standards have to be purchased and this provides its main funding. When DIN adopts European or international standards it withdraws all conflicting national standards. It can also choose not to adopt a European standard if it sees no need for a standard in Germany. National standards cover areas where international standards are not yet available (notably, construction materials, services, special test methods for food products and special types of plugs). DIN also co-operates technically (for example through training) with developing countries, which helps these countries to improve their capacity to export to the German market.

International and DIN standards are publicly available, including electronically. Public procurement tenders are legally bound to require European standards, where these exist.

5. Recognition of the equivalence of regulatory measures adopted by foreign countries: the approach is embedded within the EU framework.

Where international standards are not available, trading partners can mutually agree to accept their standards as equivalent. The existence of differing national standards and the need to use differing national procedures for assessing conformity adds to the costs of producers wishing to sell in different markets. Mutual Recognition Agreements (MRAs), which can cover the standards themselves or the procedures used to assess conformity, can help to reduce these costs. Mutual recognition activities are often left to the private sector so as to ensure that the work is relevant to the needs of evolving markets.

Here too Germany's work is intertwined with that of the EU, in the context of developing the Single Market. As regards EU MRAs, these function well, according to the EU Commission, where products do not raise security issues (for example bicycles). But there is room for improvement for more technically complex products and those that pose a potential hazard for health or the environment. MRAs have also been promoted by the EU with those third countries that have a comparable level of technical development and comparable approaches to conformity assessment. MRAs have been concluded so far with Australia, New Zealand, Canada, Israel, Japan and the USA (Table 4.4).

A special type of MRA (PECA) has also been established by the EU for the ten countries which are expected to accede to the EU in 2004. These serve as a tool to foster the countries' integration.

Mutual recognition is critically dependent on robust and agreed methods of accreditation (the procedure by which a third party formally recognises entities for the performance of conformity assessment). Accreditation in Germany is through a group of bodies that are members of the German Council of Accreditation (DAR), a working group of the federal government, the *Länder* and the business community. DAR co-ordinates their work and represents them internationally.

Table 4.4. **MRAs concluded or under negotiation by the EU**

	Mutual Recognition Agreements							PECAs[4]								
	Australia	New Zealand	United States	Canada	Israel	Japan	Switzerland	Czech Republic	Hungary	Estonia	Latvia	Lithuania	Slovakia	Slovenia	Malta	Poland
Construction plant and equipment								N		N	✓					
Chemical GLP[1]						✓		N								
Pharmaceutical GMP[2]	✓	✓	✓	✓		✓	✓	N		N	N					
Pharmaceutical GLP[1]			N		✓		✓			N	N					
Medical devices	✓	✓	✓	✓			✓	✓	✓							
Veterinary medicinal products								N								
Low voltage electrical equipment	✓	✓					✓	N	N	✓	N					N
Electromagnetic compatibility	✓	✓	✓	✓			✓	✓	✓	N	N	✓	N	N	N	N
Telecom terminal equipment	✓	✓	✓	✓		✓	✓	✓		N					N	N
Pressure equipment	✓	✓N[3]					✓	✓	N	N	N					N
Equipment and systems used in explosive atmosphere							✓	N								
Fasteners																
Gas appliances and boilers							✓	✓	✓	N				N		N
Machinery	✓	✓					✓	✓	N	N	N	✓	N	N	N	N
Measuring instruments																
Aircraft								N								
Agricultural and forestry tractors							✓									
Motor vehicles	✓	N					✓									
Personal protective equipment							✓	✓	N	N		✓	N		N	N
Recreational craft			✓	✓												
Toys							✓		N		✓					N
Foodstuffs										N	N					

✓ Concluded.
N Under negotiation.
1. Good Laboratory Practices.
2. Good Manufacturing Practices.
3. The Agreement covers simple pressure equipment. Extension to other pressure equipment is being considered.
4. Protocols on European Conformity Assessments. Amendments to these agreements are in the pipeline as negotiations on accession advance. In 2002, Romania and Bulgaria sent a formal request to the EU Commission expressing their intention to open negotiations on PECAs.

Source: EU Commission, DG Trade.

6. Application of competition principles from an international perspective: a robust and outward-looking competition law and authority is an asset for foreigners.

The benefits of market access can be reduced if anti-competitive conduct is not addressed. From an international perspective, the important issues are commitment to competition principles in law and policy, and the existence of open and effective procedures for hearing and deciding complaints over market access.

Germany starts from a general principle embedded within the social market economy: maintaining a balance between fairness and efficiency, with a strong emphasis on competition (internal and external) as a driving force for the economy. Chapter 3 gives more details of the competition law framework. In brief, the German competition law has strong rules for dealing with anti-competitive behaviour, notably the abuse of dominance and cartels, backed up by a strong and respected competition authority (the BKartA) as well as *Länder* level authorities. Enforcement rules and appeal processes are well designed. EU competition law is also highly relevant. There is a sector regulator for posts and telecommunications, which seeks to control abusive practices by the former incumbent telecommunications and postal monopolies and to help new market entrants. The Federal Railway Office regulates the railways and a new electricity/gas regulator will be set up. The German competition law contains a broad "effects" test. If a firm operating abroad creates anti-competitive behaviour on the German market, the German competition authorities can intervene. (But if a firm operating in Germany has effects abroad it is perceived to be beyond the competence of the German authorities.)

These arrangements are helpful for international as well domestic firms. The BKartA makes special efforts to ensure that its procedures are transparent and accessible to non-German speakers. It also co-operates with other competition authorities, for example in merger cases with the relevant authorities in the UK and US). It has agreed, together with members of the European Competition Authorities (ECA) to share non-confidential information. The telecommunications and posts regulator also promotes co-operation and information-sharing. Bilateral and multilateral agreements complement the picture. The former involve Austria, Yugoslavia, Germany and France.

Market openness and regulation in selected sectors

International market openness and the six efficient regulation principles can also be assessed by looking at key domestic sectoral regulatory regimes: how well do these square up? A factor of growing importance for many sectors is the EU regulatory framework. In some cases this is now the main reference point, so regulatory quality needs to be assessed at the EU level. The rules are, however, designed through a process involving the EU member States, which are also responsible (in the case of directives) for transposing them into national law. Dissemination of information on the rules and enforcement are also the responsibility of member States. EU rules are of considerable importance in the four sectors reviewed below.

The automobile sector is becoming more open through harmonisation of regulations and the new EU-wide car market competition rules

The automobiles sector has traditionally been the source of considerable global trade tension, because of its dynamism and the interventionist policies of some governments. Automobiles remain among the most highly regulated products in the world (safety, energy conservation and protection of the environment are the main regulatory targets) with divergent national approaches to these issues.

The industry is of considerable importance in Germany, accounting for about 17% of manufacturing turnover in 2001. It is highly export-oriented, with almost 70% of production exported in 2001. The industry is also well established abroad through foreign subsidiaries, whose production reached some three quarters of domestic production in 2001. Outward FDI in this sector is about four times larger than inward FDI, though big foreign firms including Ford and General Motors maintain major production sites in Germany.

The EU regulatory framework dominates the picture. Some 165 EU directives lay down the detailed technical requirements for motor vehicles. National approval procedures for the certification of passenger cars and motorcycles were replaced in the late 1990s by a mandatory EU-wide approval system. This works through approved national test centres.

Despite this progress, the EU automobile market remains far from open. Price differentials between countries remain significant. German car producers have been fined by the EU Commission several times for pursuing discriminatory pricing policies in different national markets. In 1998 the EU Commission fined Volkswagen euros 102 million for a policy of refusing to sell cars in Italy to foreign buyers. Moreover in 2001 the EU Commission imposed a fine of nearly 72 million euros on Daimler-Chrysler for infringing the EU competition rules in the area of car distribution, as the company had impeded parallel trade in cars and limited competition in the lease and sale of motor vehicles. A new EU regulation in 2002 on vertical agreements and concerted practices in the motor vehicle sector seeks to address the problems, notably by fostering competition between dealers. In the case of concerns about anti-competitive practices both domestic and foreign companies can have recourse to the German legal system.

The UN-ECE (United Nations Economic Commission for Europe) plays a major role at the international level in the harmonisation of the regulatory framework for the automobile sector. The relevant working party has become the *de facto* global forum for the international harmonisation of technical standards for motor vehicles. Germany participates in this work through the EU.

The EU framework for telecommunications equipment liberalisation is developing well

Germany's trade in telecommunications equipment was roughly balanced in 2001,with imports and exports each amounting to about euros 21 billion. Here too regulation is largely at the EU level. The main framework currently consists of two "New Approach" directives, but is due to be replaced from July 2003 by a new, more comprehensive framework (Chapter 6 gives more details). Germany participates in the activities of the European Telecommunications Standards Institute (ETSI) and other international standardisation bodies through the German Committee for Electronical, Electronic and Information Technologies (DKE).

Telecommunications services liberalisation, where Germany has a trade deficit, is also underway

Germany is a net importer of telecommunications services, and the trade deficit has increased over time. The market was fully opened to competition in 1998 in line with EU rules, but the ex-monopoly incumbent is still strong and further work is needed to promote effective competition. Chapter 6 gives more details. There are no formal restrictions on the activities of foreign companies, who have the same recourse to the German legal system as domestic companies in case of dispute.

The current German regulation of electricity markets raises problems for foreigners as well as domestic firms

Chapter 5 gives more details on the German electricity market and current regulatory issues. Germany has completely liberalised its market and two of the four major groups in the German electricity market are controlled by foreign companies. Germany trades electricity widely with nearly all the countries on its land borders and beyond, and trade amounts to about 10% of domestic consumption. However, there have been complaints concerning the terms of access to the grid. Third parties, including foreign companies, that did not participate in the design of the industry-led Associations Agreements may be at a disadvantage. In this context, one advantage of the proposed establishment of an independent regulator will be to increase transparency and accountability and so avoid any potential discrimination between incumbents and new entrants.

Conclusion

Germany has a strong and distinctive governance framework which evolved as part of the social market economy after the war. The framework encompasses both unity and diversity through the Federal-*Länder* relationship, and co-operation as well as competition. The search for consensus through extensive consultation is a cornerstone of decision-making, and pervasive, carefully applied regulation permeates the landscape. Germany is also a major exporting country which has long attached importance to the promotion of an open trading environment.

Some of these features are very helpful for market openness; others less so. The well-designed competition law and effective competition authority help to provide a sound trading environment for foreign as well as domestic firms. The legal framework and its application are highly predictable. The principle of non-discrimination is anchored in the Constitution. Considerable efforts are made to facilitate international trade, which include the streamlining of customs procedures and the work of the standards institute (DIN) across international fora to promote international standards and other trade-facilitating measures. Internal reform measures to reduce administrative burdens, improve regulatory tools such as RIA, and better manage the Federal/*Länder* relationships, as well as the efforts to find the right regulatory framework for competition in the network industries, will also help outsiders.

There is a considerable will to promote fairness and avoid discrimination, but Germany's governance framework by its very nature can feel closed and difficult from an outsider's perspective, even if this is not deliberate. The consensus-based and often lengthy decision-making process which precedes the making of new rules usually involves established stakeholders. Public procurement is an especially closed process and the government recognises the need for improvement. The extent of regulation, the precision with which it is applied, and its complexity are other difficulties faced by outsiders. There is scope for the current reform initiatives to do a great deal of good for market openness.

Policy options for consideration

1. Actively manage current reform programmes.

The current reform programmes should focus on the implementation of key issues on the reform agenda; the momentum should be sustained; reform results should be monitored; and the public should be kept informed to maintain broad support.

2. Improve transparency of the regulatory framework.

For the international trade and investment community, transparency of rules can be difficult given the amount and complexity of legal texts. Improving transparency should focus on:

- reviewing and withdrawing legal texts that are outdated;
- simplifying legal language; and
- offering foreigners legal information and explanation of German laws and regulations, and on the distribution of different competencies of the different authorities.

3. Promote openness of decision-making.

The current practice of publishing legal texts only after they have entered into force, and leaving it to the respective authorities to invite potential stakeholders to consultations, should be reconsidered. Outsiders who are not invited under the present system have no means of making their views heard, as information on draft legal texts is not publicly available. Measures to consider are:

- publish draft regulations at an early stage to offer potential stakeholders the opportunity to gain insight into current debates, possibly by establishing an Internet platform or a chat room: these might be cheap and effective ways to improve access to information;
- allow potential stakeholders to participate in consultations on their own initiative, in addition to invitations, and provide advance notice of upcoming consultations to make this possible;
- enhance efforts to include the views of foreigners, particularly in cases that affect trade and investment.

4. Foster market openness in public procurement.

Despite the size of its economy and policies to promote an open trading environment, Germany is not at the forefront of EU work to promote greater openness in this area. In fact, it has the lowest number of public procurement tenders openly advertised at the EU level. Measures to consider, which would put Germany in the reform frontline among OECD countries, are:

- increase the percentage of openly advertised public procurement tenders at the EU level;
- clarify the regulatory framework and abolish contradictory regulations;
- simplify procedures for public procurement tenders, perhaps by reducing the current variety of procedural options;
- revise the role of committees of awarding authorities and contractors by allowing new entrants and foreigners full and direct access to these bodies, and by strengthening their monitoring by the competition authorities;
- offer adequate legal protection below the EU threshold.

5. Accelerate efforts to eliminate unnecessary burdens on business.

This is an area where reform efforts are already underway. Measures could be taken to foster co-operation between the numerous FDI agencies by identifying common areas of collaboration. A strong focus should be maintained in the pace and impact of current

reforms in this area. And the government should sustain its efforts to consult with all stakeholders to identify key areas of improvement.

6. Strengthen administrative capacity for the enforcement of reforms.

The human dimension is an essential element in the reform of public institutions for all OECD countries. The staff of public institutions need a service-oriented attitude that seeks to help the business community. Competence in foreign languages is a precious value-added from an international perspective. As well, Germany should consider attracting staff from a diverse background. Currently most staff in the administration have a legal background, which does not especially encourage economic thinking or the adoption of a market openness perspective. The following measures could be considered:

- reinforce a client-oriented culture among "front line" civil servants;
- offer training programmes to staff in communication, foreign languages, and outcome-oriented management;
- enhance performance-based evaluation;
- focus on diversity when hiring and retaining staff.

7. Introduce a coherent approach to Regulatory Impact Analysis (RIA).

An important step toward greater market openness could be taken by addressing trade and investment-related issues in Regulatory Impact Assessments. Germany should consider:

- developing a consistent practice for the assessment of trade and investment effects of proposed regulations;
- according greater importance to trade and investment experts in quality checks; and
- taking advantage of the opportunity to leapfrog through "lessons learnt" from other countries.

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PART II

Chapter 5

Regulatory and Competition Issues in Key Sectors: Electricity, Gas and Pharmacies*

* For more information see: Background Report on "Regulatory and Competition Issues in Key Sectors: Electricity, Gas and Pharmacies" available on the Web site: *www.oecd.org/regreform/backgroundreports*.

A. ELECTRICITY AND GAS

Context and history

Germany's energy policy objectives, and the history of its energy sector, provide a challenging and distinctive context for reform

Reform of Germany's electricity and gas sectors needs to be set in the context of its high-level energy policy objectives, the sectors' distinctive structural evolution, and the country's equally distinctive framework for governance developed as part of the post-war social market economy.

German energy policy promotes, with equal weight, security of supply, economic efficiency, and environmental protection. The policy mix thus includes a number of sometimes conflicting goals. A programme of rapid liberalisation, well beyond the requirements of the current EU directives aimed at creating a single internal market, has been pursued to increase efficiency. On the environmental front, Germany seeks to reduce greenhouse gas emissions, *inter alia* via strong policies to promote the growth of electricity generation from renewables. It has also put in place an ambitious programme to phase out nuclear power by 2025. Energy security concerns, in a country which has limited indigenous resources, are reflected in the subsidies to domestic coal and the maintenance of significant coal-based electricity generation, as well as the recent promotion of a national gas-electric champion when the government decided to allow the takeover of Ruhrgas by E.ON.

Though the security and environmental goals are of great importance and a complicating factor, this review focuses primarily on the issue of economic efficiency and the development of effective and sustainable competition as a means to achieve this.

Historically, the German gas and electricity sectors were highly fragmented, made up of thousands of utilities (in 1936 there were about 16 000 electricity supply companies). Most were municipal utilities serving only their local market. The first significant change for electricity was in the 1920s, prompted by technology: more efficient long distance transmission and cheaper large-scale generation. This promoted the development of regional companies, followed by the assignment of exclusive territories. The gas sector was initially based on town gas but the advent of natural gas (made possible by technology: pipelines became economic) promoted the position of Ruhrgas which became the pre eminent importer, and supplier, of Dutch gas. The sale of gas through long-term contracts, to allow sunk infrastructure and fuel conversion investments to be recouped, was also established at this time. The 1970s saw the legendary "gas-for-pipes" deal between Ruhrgas and the then Soviet Union, followed by an import deal with Norway. The pattern for today's gas imports was set.

The regulatory environment has, until quite recently, actively discouraged competition

The regulatory environment was, until quite recently, extremely light-handed and actively discouraged competition. Until 1998 agreements in the electricity and gas sectors were exempt from the cartel prohibition of the competition law. This meant that many types of anti-competitive agreement – demarcation agreements to divide the market territorially, long-term concessions between the municipalities and utilities, resale price maintenance, and restrictive interconnection agreements – were allowed, though they were subject to abuse supervision by the competition authority. Also, the 1935 energy law aimed to prevent economic harm due to competition, and encouraged co-operation among the electric utilities. Prices to small consumers were regulated through a price cap, by the *Länder*: no other prices were regulated. The municipalities played an important role. Their control of rights-of-way gave them significant bargaining power *vis-à-vis* the electric utilities. They could choose whether to provide electricity themselves or licence a private provider with a long concession (in return, often, for substantial concession payments – which today are estimated to generate more than 3 bn euros income, and which help to pay for municipal services).

The other, and distinctive, feature of the regulatory environment has been the tradition of government-promoted private agreements among the market players to implement political objectives (under threat of legislation if this cannot be achieved). Important examples are the agreement to reduce greenhouse gases under the Kyoto Protocol, and the phasing-out of nuclear power. This remains an active political tradition which deliberately seeks to avoid the need for more formal arrangements.

The regulatory environment raised important concerns over a decade ago. The Deregulation Commission was an independent commission of experts mandated by the federal government to examine regulations of economic activities and to make recommendations for the reduction of regulations which are inimical to market forces. It reported in 1991. As well as general recommendations it made specific sectoral recommendations including for electricity reform. It noted that "achieving the objective of reliable and at the same time reasonably priced supplies of electricity better than before means first and foremost creating the conditions for competition. The need is both to abolish regulations that restrict competition – deregulation – and to change State intervention – reregulation. The latter is needed where competition alone cannot produce satisfactory market results, where supplies cannot be reliably ensured without additional measures or where the protection against abuse of market power would remain insufficient, but where a form or regulation that is in conformity with competition can be found".

EU-led liberalisation from the mid-1990s was followed by restructuring which resulted in a high degree of market concentration

The EU's electricity (1996) and gas (1998) directives established minimum standards for a competitive internal market in these sectors, and generated important changes to German law aimed at promoting competition. Among other measures, the exemption of anti-competitive agreements from the competition law was removed, as were the legal monopolies for electricity and gas supply. All consumers (not just the largest as required by the directives) were allowed to choose their supplier. The institutional context, however, stayed within the tradition. Negotiated third party access to electricity and gas networks, rather than regulated access, was implemented, with government encouragement, through

Associations Agreements between the market players. Control of this self-regulation rested with the competition authority – the *Bundeskartellamt* (BKartA) – and the abuse of dominance provisions of the competition law.

These developments set off a profound restructuring of the sector as the firms sought to adapt to the new environment and the future EU internal market by enhancing their efficiency. Part of this process involved a wave of mergers (over 400 including co-operative agreements). When the dust settled the number of vertically integrated electricity utilities was reduced to four – E.ON, RWE, a third force in the east, now owned by the Swedish Vatenfall, and Energie Baden-Wurttemberg AG (EnBW), now part-owned by EdF. The horizontal consolidation went alongside the purchase by these grid-owning utilities of stakes in the municipal utilities (*Stadtwerke*) of their traditional region. The electricity sector emerged not only highly concentrated at the production level, while the local and regional distribution companies succeeded in defending most of their former positions and generally remained the dominant supplier in their areas, especially in the household sector.

The gas sector experienced its own type of consolidation – vertical and across energies. Ruhrgas, E.ON and RWE increased substantially their holdings in regional and municipal gas companies. Upstream integration with pipeline and gas production companies (Gazprom) has also been substantial.

The most recent changes aim to promote effective competition in practice: it is realised that liberalisation alone is not enough

Experience of the first hectic years of competition, together with a further EU push for liberalisation, has led to some further changes in German law. These reflect a better understanding of the conditions needed for effective competition. Agreement has been reached on two new directives on electricity and gas (Box 5.1). These directives – which will be implemented into German law, as in other EU countries – take a much stronger line than their predecessors on important issues such as unbundling of monopoly from potentially competitive activities.

As well, German law has been adjusted and clarified in response to the competition difficulties that have emerged. The BKartA's decisions concerning energy network access (which generally used to be suspended pending appeal) are now immediately enforceable. At the same time the new Energy Industry Act provides for a "juridification" of the Agreements *i.e.*, for there to be a presumption in the law that if the Agreements were observed, good practice conditions would be considered fulfilled. The new law confirms that competition law remains fully applicable to access conditions despite this presumption, but at the same time, the Dusseldorf Court of Appeal in its latest decisions "Stadtwerke Mainz" and "HEAG" interprets the new law in a way that the "presumption of good practice" in favour of the Associations Agreements almost completely precludes the enforcement of the abuse control provisions of the competition law. In the light of this, juridification of the Agreements may be an uncertain step for competition. Further changes are underway in the light of the latest EU directives. At the end of August 2003, the Ministry of Economics and Labour sent a report to parliament where it announced the introduction of a new regulatory framework and the proposed nomination of RegTP as regulatory authority for electricity and gas by July 2004.

Box 5.1. **The new directives on electricity and gas**

The new EU directives on electricity and gas entered into force on 8 August 2003. They mark further progress toward electricity and gas market liberalisation in Europe. They include general rules regarding public service obligations, universal service, customer protection, and monitoring security of supply, and set deadlines for liberalisation of all customers (1 July 2004 for commercial customers and 1 July 2007 for household customers). Of particular interest here is the strengthening of the rules regarding unbundling, regulatory bodies, and third-party access.

The separation of system operators is reinforced and separate accounts for supply activities are now required. System operators in electricity and gas, for both transmission and distribution, must be independent in legal form, organisation, and decision-making from activities not related to transmission or distribution, respectively. (Member States may decide not to apply this to distribution systems with fewer than 100 000 customers.) This contrasts with silence on the point in the earlier gas directive, and "management independence" in the earlier electricity directive. Under the new rules, separate accounts must now be kept for supply to "eligible" (free-to-choose) customers and to ineligible customers, for electricity and gas, and for LNG (liquefied natural gas) activities. This cumulates with the earlier directives' requirements to separate accounts for generation, transmission and distribution for electricity companies, and for transmission, distribution and storage activities, for gas companies.

- The new rules require that one or more regulatory authorities, meeting certain minimum requirements, be established in each member State.
- They must be wholly independent from the interests of the electricity or gas industry, respectively.
- They must be responsible for at least ensuring non-discrimination, effective competition and the efficient functioning of the market.
- They must at least monitor: rules and allocations related to interconnections and congestion, timeliness of response to requests for network access and repair, publication of information, effectiveness of accounting separation to ensure no cross-subsidies, and access conditions to those activities they do not regulate, *e.g.*, new network connections and gas storage.
- They must have the competence to fix or approve the tariffs or, at least, the methodologies underlying the calculations of tariffs, before they enter into force, of transmission and distribution for electricity and gas, and of access to LNG facilities. (Member States may also require the regulatory authorities to submit the tariffs or methodologies for formal decision to the relevant body in the member State.)
- They must have the power to order, if necessary, companies to modify their access terms to ensure that the terms are proportionate and applied in a non-discriminatory manner.

This contrasts with the earlier directives that required the member States to create "appropriate and efficient mechanisms for regulation, control and transparency so as to avoid any abuse of a dominant position, in particular to the detriment of consumers, and any predatory behaviour". Where access was negotiated (Germany) only "an indicative range of prices for use of the transmission and distribution systems" had to be published for electricity, and the "main commercial conditions for the use of the system" had to be published for gas.

Box 5.1. **The new directives on electricity and gas** *(cont.)*

Third party access changes fundamentally under the new rules. The responsibilities of the regulatory authority (or authorities) combined with its powers over access tariffs mean that the regulatory authority cannot approve tariffs that *e.g.*, provide subsidies to incumbents or that constitute unnecessary barriers to entry, since the first would be discriminatory and the second would hinder effective competition and the efficient functioning of the market. Negotiation does not necessarily go away entirely, for two reasons. First, the inputs into the approved tariff-calculating methodologies could in principle be negotiated. Second, the approved tariff-calculating methodologies do not necessarily yield a single value.

Security of supply is a complicating factor in the liberalisation of the energy sector

Security of supply being one of Germany's high level energy policy goals, it is (as in many other countries) a complicating factor in the liberalisation of the energy and especially the gas sector (Box 5.2). The issues are beyond the scope of this review, but from the efficiency and competition perspective, current policies and actions that promote security of supply are slowing the development of competitive markets.

Box 5.2. **Security of supply: what does it mean?**

Security of supply is an objective of many countries' energy policies, but what does it mean? According to the International Energy Agency, "Security of supply refers to the likelihood that energy will be supplied without disruption. Note that economic variables such as price levels and price volatility are excluded from the definition" IEA (2002).

For electricity, security of supply depends on adequate investment to provide:

- enough generation capacity to meet demand;
- an adequate portfolio of technologies to deal with variations in the availability of input fuels;
- adequate transmission and distribution networks to transport electricity.

Energy security requires adequate and timely investment in the energy infrastructure. Electricity prices are key drivers of investment activity. A debate continues as to whether market price signals will stimulate adequate and timely investments in generation, especially of peaking capacity. (Demand side management, such as increasing the share of electricity users subject to real-time prices, can help reduce peak demand.) Energy security also requires diversified energy supply and the regulation of those parts of the infrastructure which remain monopolistic. Ensuring adequate investment in transmission is a challenge for regulators due to site and permit issues, and incumbents may have little incentive to invest, since improved transmission capacity may bring increased competition to the areas under their control. Existing interconnection capacity is insufficient in, among other regions, the EU. The development of effective electricity markets requires sustained government effort to monitor reliability, adapt policies and regulations to the needs of an open electricity market and, ultimately, ensure energy security.

Box 5.2. **Security of supply: what does it mean?** *(cont.)*

For the EU Commission, which examined energy security from the perspective of all sources of energy used in the economy, the focus is on the uninterrupted physical availability at prices that are affordable for all consumers, private and industrial. It is particularly concerned with imported energy and diversifying the sources of supply by product and geographic region. Indeed, in a paper on the subject the EU Commission identifies the main characteristics of oil, gas, and coal supply in terms of their geographical and geopolitical spread and degree of competition. Of these three products, coal is distinguished for its geographical and geopolitical spread and "absence of price tensions". Both oil and gas have greater geographic concentrations of sources, and oil is seen as being priced by a worldwide cartel while gas is priced by "regional oligopolies forming functional cartels in which prices are effectively determined by the oil market" (EU Commission, 2002).

The International Energy Agency, in its 2002 review of German energy policies, noted that "The government's policy is diversification of energy source including imports, especially gas, because excessive dependency on a single or few sources can increase price risks and [supply risks]". Later, in a discussion on coal, the IEA wrote that, "There is no compelling energy security reason for coal subsidies" to maintain domestic coal production, and instead suggested the development of diverse sources of primary energy through trade, maintaining a diverse fuel mix and actively encouraging the development of a European market in electricity and gas.

The promotion of renewable energy is also a key policy objective and another complicating factor

The energy sector has a significant effect on the environment. Reform and the introduction of competition raise both challenges and opportunities. The promotion of renewable energy is a key part of Germany's energy policy. The target of doubling renewable energy's share of overall electricity production by 2010 is ambitious. It needs, and is getting, specific government support. This includes financial support for R&D, investment incentives, and a guaranteed price for renewables-based energy supplied to the grid. The government knows that renewable energies must become competitive in time. There is, meanwhile, scope to review the most effective means by which renewables could be supported.

Description of the electricity and gas sectors

1. ELECTRICITY

Generation is concentrated, and market entry is difficult

Nuclear, lignite and hard coal dominate electricity generation. Incumbent generators are withdrawing capacity faster than they are adding to it, which can be seen in the context of a continuing reduction of overcapacity built up before liberalisation. This part of the electricity supply chain is highly concentrated. In 2002 two utilities, E.ON and RWE, produced more than 60% of total generation, and the largest four utilities produced more than 80%. The regionalisation is also marked: the utilities' distribution territories are generally distinct. However, (and this is a general observation not specific to Germany) market power in electricity markets is not just an issue of geographic concentration. The time dimension also matters because electricity cannot be easily stored and there is particular scope for the exercise of market power in peak demand periods (which occur regularly as part of the electricity demand cycle). This is when most generation is exhausted, and this can leave the

field open to a few remaining, possibly dominant, firms which set their own price. It is not clear whether this is an issue in Germany, whose four large utilities are focused on baseload generation, and which has a number of smaller utilities with peak load plants, but the situation should be kept under review (as in most other OECD countries).

Market entry, though in principle liberalised since 1998, is an issue: there have been no new entrants of significant scale to date. There are two main reasons for this. The first is that the market had significant overcapacity upon market opening, which offered little or no incentive for new market entrants to build new capacity. The second is the government's promotion of renewables capacity which has further dampened incentives to build other types of new generation. Against this background, the potential for encouraging gas-based generation might usefully be reviewed. Market entry in some other liberalised countries has often been through independent power companies building combined cycle gas turbines (CCGTs) with relatively cheap capital costs, using natural gas. Two potential new entrants to the German generation market withdrew in 2001 citing problems with gas supply contracts and high gas prices. Two other CCGT projects are still at the planning phase.

The four major utilities are responsible for transmission and system operation: there is evidence of problems with market power

The four major electric utilities own geographically distinct parts of the transmission grid, and are the transmission system operators (TSOs) for their area. The TSOs purchase services (such as balancing services) as part of their responsibility to ensure reliable supplies, and co-ordinate network expansion. Transmission is not congested within Germany even during peak periods, though there is congestion across some national borders. The lack of national congestion reflects good management (based on obligations under the law). As competition develops further, the situation may change though: in countries where competition has developed further, previously adequate transmission capacity often feels the strain.

Germany does not have a single nation-wide system operator responsible for the co-ordinated dispatch of electricity on to the grid. Instead, the large TSOs have a co-ordinating association. An important issue in liberalisation is discrimination in dispatch, which can be difficult to detect. Incentives to discriminate must be reduced: expanding TSO areas to make them larger than the transmission grid area under TSO ownership would help.

Another issue is the pricing of balancing energy – that is, the energy needed to make up the difference between planned and actual demand (because electricity cannot be easily stored, and the grid must be supplied at all times to avoid meltdown). It is estimated that within their respective balancing areas RWE and E.ON generally supply between 70% and 100% of balancing energy. The BKartA has obliged all four main utilities to introduce a tender system for the procurement of balancing energy. However the large firms are often the only bidders, and seem to forbear from bidding outside their traditional service territories. The prices for some forms of balancing energy doubled in 2002 in the RWE area. This led to a new abuse proceeding by the BKartA, which is still pending.

A nationwide power exchange has been in place since 2000: it has grown but bilateral trades continue to dominate

Germany has one power exchange with both day-ahead physical markets and futures markets, the European Energy Exchange (EEX) at Leipzig. It was founded in 2000. In 2003, about 10% of German electricity consumption was traded in the day-ahead market, seven times as much as in the futures market. The total volume of trade has increased significantly

in the last couple of years, and in 2003 accounted for some 75% of total generation (day-ahead and futures trades combined). There is no evidence of anti-competitive conduct in the exchange. As well as the trades in the exchange, there is substantial bilateral trading among the four main utilities, which dwarfs the exchange trading. In 2001 for example E.ON procured 57% of the electricity it sold.

Distribution and supply remains tied up with traditional regional and local companies; and vertical integration dampens competitive procurement

Electricity distribution and supply is in the hands of numerous regional and local utilities, which are usually the dominant supplier in their network area. There are some 840 local utilities (Stadtwerke), and some 50 regional utilities. Many are owned (partly or wholly) by the major German utilities, or by foreign utilities.

An indicator of effective liberalisation, apart from lower prices, is the extent to which consumers switch supplier. According to estimates by the industry associations 35% of industrial customers have changed supplier and the other 65% have renegotiated their contracts with their traditional suppliers. The estimate for households is that slightly more than 4% had switched by autumn 2002, and 28% had renegotiated their agreement with their existing supplier to obtain better terms. The low household switching rate could reflect high fixed costs (including the high costs of network access) so that the room for competition from alternative suppliers (on the variable costs) is small. Electricity may also be considered

Box 5.3. **Local utilities and energy procurement**

The widespread vertical integration in the electricity and gas sectors dampens competition in the transactions between the local utility and the sources of electricity or gas supply. Consumers, particularly household consumers, rarely switch away from their traditional supplier. Hence, the procurement choices made by the municipal utility largely determine which generation will supply households in the municipality's territory.

- Partial or complete ownership by an upstream firm reduces incentives to purchase from a different, competing upstream firm:
  - If the upstream firm exercises control, then it has an incentive to, as it were, "buy from itself" even if it does not make the lowest-priced offer to the local utility. It has this incentive because it will receive the rents both from the upstream and the downstream activities, whereas if the local utility bought from a different, competing upstream firm, then it would receive only the rents from the downstream activities.
  - If the upstream firm does not exercise control, the incentives remain similar. However, in this case, it must offer a price that at least meets the offer of any competitor. The upstream firm would have information advantages over its competitors, particularly if its board member(s) has information about characteristics of the local utility that influence the cost of supply, bid evaluation methodologies or competing bids.
- Partial or complete ownership by an upstream firm reduces incentives to compete to supply small and medium sized customers:
  - So long as the upstream firm exercises control of at least several local utilities, then it dampens competition with other local utilities in which it owns a stake, whether or not it exercises control. It has this incentive because less competition downstream is more profitable for the local utilities, increasing the benefits of ownership.

a "low interest" product (at least until consumers get used to the idea of competition). Actions have been taken to reduce the costs of switching for small consumers, such as suspension of the "transfer fee" for switching, and a task force at the lead ministry (now disbanded) for dispute resolution and other issues involving small consumers.

The widespread vertical integration dampens competition in the transactions between the local utility and its sources of supply (Box 5.3).

2. GAS

Germany is mainland Europe's largest consumer of gas, and highly dependent on imports

Reform of Germany's gas industry needs to be set in the context of upstream production and supply, which is concentrated and not generally handled on competitive lines. Germany is the largest consumer of gas in mainland Europe, as well as being highly dependent on imports (which account for over 80% of consumption). It is therefore the most affected by the current mainland European framework for supply, and security of supply issues loom large in the path to reform.

The main sources of supply to mainland Europe are the Netherlands and, from outside the EU, Russia, Norway and Algeria. Gas production within all these countries is highly concentrated. Suppliers use the same pricing methodology which indexes the price of gas to oil, there being no competitive gas market (yet) in mainland Europe to set the price. Liquefied natural gas (LNG), which could help open up new supply and hence competition, has not yet developed as a competitive alternative, due to the continuing relative price advantage of piped gas.

A number of hurdles stand in the way of developing gas-on-gas competition in mainland Europe, including the unattractive sunk cost of developing new gas production and transport infrastructure, low growth prospects in the German market (it is projected to grow by just 1% a year), and existing long-term supply contracts (90% of predicted European demand to 2010 is covered this way). The EU Commission has also identified a number of barriers such as contractual prohibitions on the resale of gas, on which it is taking action. There are some competitive market developments though: a gas trading hub is being established in Germany (hubs promote gas-on-gas competition and allow players to discover competitive gas prices). But its liquidity – and hence development – is impeded by the continued domination of incumbent suppliers, difficulties of access to the pipelines and storage, and the long-term contracts.

The structure of the German gas industry remains on traditional lines and little new competition has emerged yet

The structure of the German gas industry is three-tiered. The top tier consists of the six supra-regional companies that import gas, transport it over high-capacity transmission pipelines and supply the next tier. The middle tier consists of the regional gas distributors/suppliers that supply larger industrial customers as well as the third tier. This tier consists of more than 800 local and municipal gas distributors/suppliers and supply smaller industrial consumers and households. Most of these companies also provide other network or public services such as electricity generation and distribution, heat and water supply, and public transport. *De facto* geographic monopolies in the supply chain to consumers provide the conditions for high profits. The trend is vertical integration of the tiers (part of the same trend for the electricity supply chain).

The first tier is illustrated in Table 5.1.

Table 5.1. **Main gas import and transmission companies**[1]

Name	Ultimate parent	Gas supplied (bcm)	Transmission (high-pressure km)	Storage (bcm)
Ruhrgas AG	E.ON	50.6	10 750	< 5
BEB Erdgas und Erdöl[2]	Exxon Mobil (50%) Shell (50%)	16.4	3 439	> 2.7
Verbundnetz Gas AG (VNG)	EWE (47.90) BASF (through Wintershall Erdgas Beteiligungs GmbH 15.79%) Gazprom (ZGG-Zarubezhgas-Erdgashandel-Gesellschaft mbH 5.26%) Gaz de France (through EEG-Erdgas Transport GmbH (5.26%) Twelve municipalities in East Germany (25.79%)	15.8	7 300	> 2
Wingas GmbH	BASF (65%) Gazprom (35%)	11.8	1 836	4.2
Thyssengas GmbH	RWE AG (100%)	6.7	2 500	> 0.3
EWE	Administrative districts and towns in the Weser-Ems region, Administrative districts and towns in the Weser-Elbe region	4	3 870	> 1.1

1. Ownership shown as from late 2003; physical data from 2000.
2. BEB was dissolved in 2003.

Source: OECD.

The dominating company is Ruhrgas, which imports 60% of gas consumption, and controls a large part of the high-pressure transmission pipelines within Germany and about a quarter of all storage facilities. It also has significant interests downstream especially after integration with the E.ON distribution activities. Upstream it has a stake in the new trading hub, and a 6.5% interest in Gazprom. The main competitor is Wingas (a joint venture between BASF and Gazprom) which has set up a rival pipeline system in Germany and owns important storage facilities. But the competition which it can provide Ruhrgas may now have been dulled by various factors including the fact that more investment is needed to expand its capacity, and a new Ruhrgas/Gazprom contract, the terms of which substantially reduce the profitability of any expansion of Wingas for Gazprom. Competition with the other big players is also dampened by various factors such as common costs arising from the common purchase of imported gas, and arrangements that make it unprofitable to encourage consumer switching. The EU Commission considers that an oligopolistic dominant position exists between at least Ruhrgas and two other main companies (BEB and Thyssengas). The liberalisation so far has led to very limited switching, mainly by large industrial consumers, and virtually no switching by households.

Storage plays an essential role in the management of the gas supply chain, and access to storage on reasonable terms is an important part of an effective competitive framework.

Electricity and gas price performance

1. ELECTRICITY

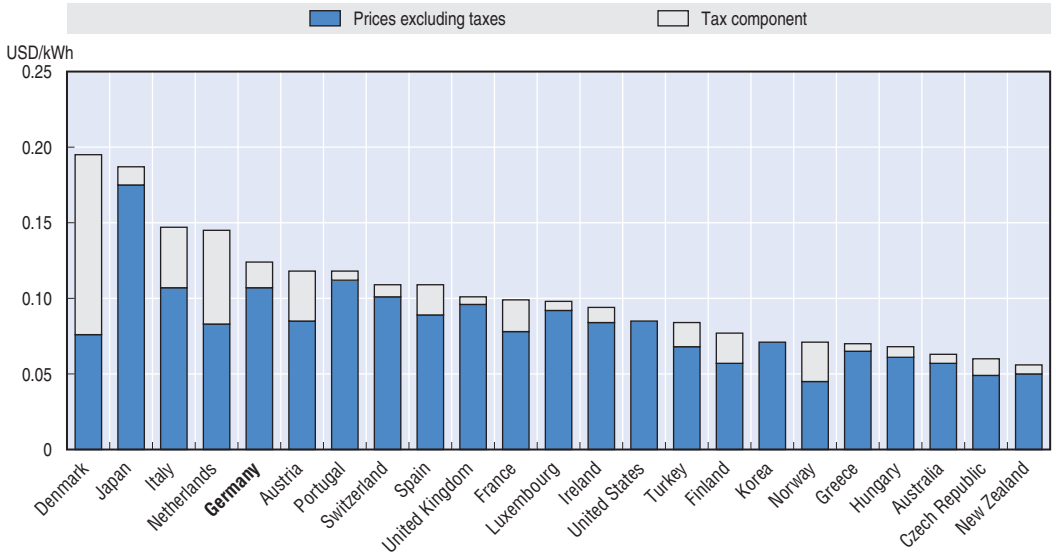
Electricity prices fell after liberalisation but have now started to rise

Electricity prices fell after liberalisation, though this was partly offset by new taxes and legislation to promote renewables. Industrial consumers were the main beneficiaries, with price reductions of up to 50%. Small consumers benefited later and to a more modest extent. Factors explaining the difference include the low amount of switching by small consumers. It has been noted that the price falls may not have been entirely due to liberalisation: power generation costs also fell. From 2000, electricity prices started to rise. The reasons for this are debated, but it is likely that tax increases and other burdens such as the promotion of renewables are largely responsible, together with falling capacity and pricing strategies by suppliers to ensure an adequate return.

Compared with other OECD countries industrial prices are around average, but small consumer prices are high (Figures 5.1 and 5.2).

Electricity (and gas) prices need careful interpretation as pricing is not simple. Electricity is sold in complex contracts that incorporate various risks including high sunk costs and low variable costs, and demand that *inter alia* depends on the weather and economic growth. Electricity can simultaneously change hands at a variety of prices. An important component is network access charges: these are unusually high in Germany relative to the EU for medium and low voltage transmission, though they vary a lot between regions.

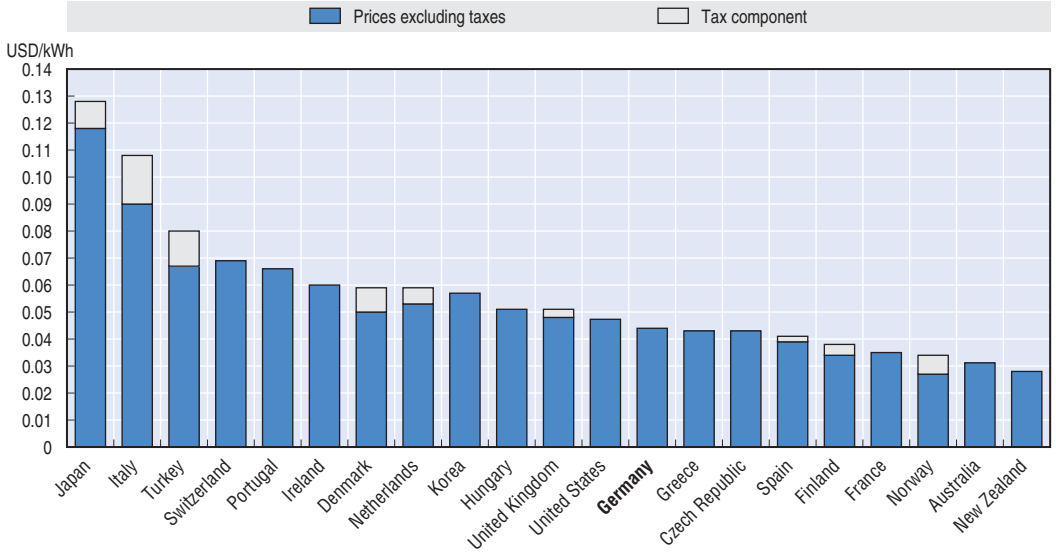
Figure 5.1. **Electricity sold to households with and without taxes**[1]



1. Data for Germany after 2001 is unavailable.

Source: IEA.

Figure 5.2. **Electricity sold to industry with and without taxes**[1]



1. Data for Germany after 2001 is unavailable.

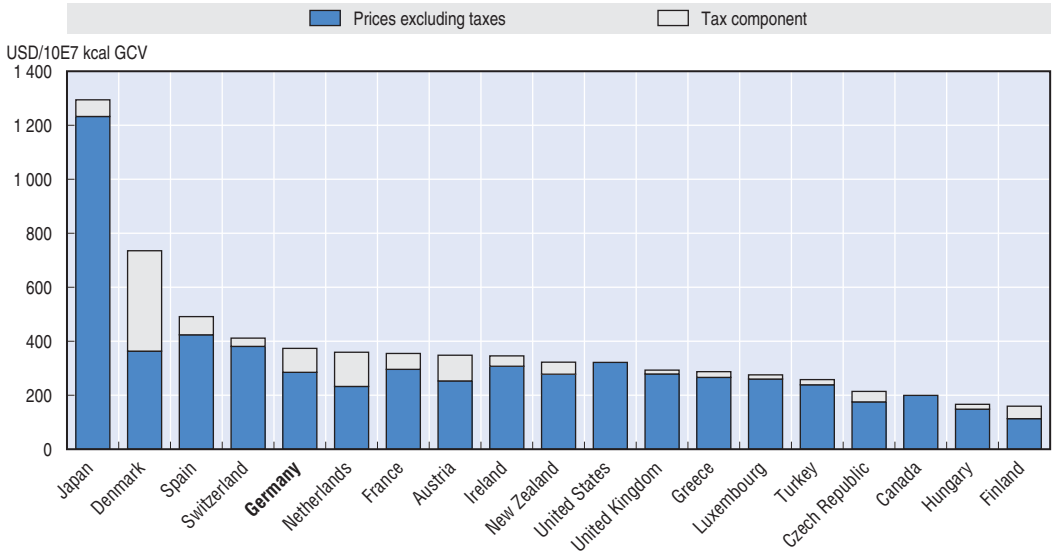
Source: IEA.

2. GAS

Gas prices have risen, in step with higher worldwide prices

Gas prices for both industry and households rose substantially in the first two years after liberalisation, in step with higher worldwide prices for gas. There is currently less leeway for price reductions in the gas sector than in the electricity sector because of import dependence, the fact that the gas market is less liquid, and the continuing close link to oil prices (more competition would address the last two issues). The price of gas is high in Germany compared with other OECD countries (Figures 5.3 and 5.4).

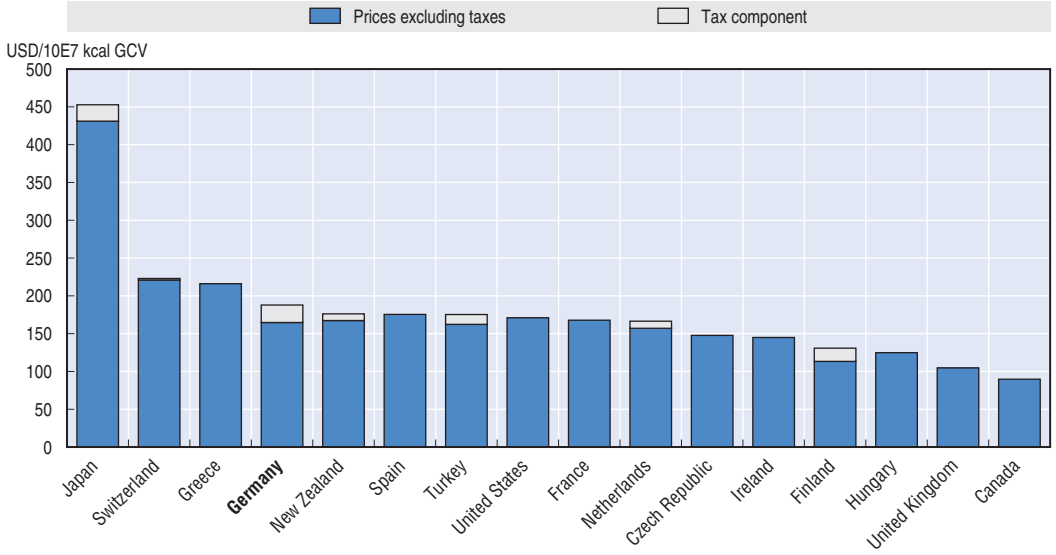
Figure 5.3. **Gas sold to households with and without taxes**[1]



1. Data for Germany after 2000 is unavailable.

Source: IEA.

Figure 5.4. **Gas sold to industry with and without taxes**[1]



1. Data for Germany after 2000 is unavailable.

Source: IEA.

The regulatory framework for electricity and gas

The current regulatory framework for the electricity and gas sectors rests on two pillars. The Energy Industry Act and the Act against Restraints of Competition (ARC) make up the first pillar. The 1998 amendments to these acts marked a fundamental change to encourage competition. The Associations Agreements for each sector make up the second pillar.

The 1998 amendments to the Energy Industry Act took some important competition-enhancing measures

The amendments to the Energy Industry Act included three measures to promote competition:

- *Reduction of entry barriers*. The legal monopolies for the supply of electricity and gas for all consumers were removed. Special licensing requirements for electricity generation (nuclear excepted) were also removed. The previously complicated approvals system, which had enabled incumbents to block new generation entry, was minimised. On the other hand reciprocity may be used: until 2006 electric utilities are entitled to refuse access for electricity to be supplied from abroad, to the extent that a similar customer located abroad could not also be supplied by a German supplier.
- *Provisions for non-discriminatory access to the electricity supply system*. These include an obligation on network operators to publish minimum technical requirements, to publish annually an indicative range of prices, to provide terms and conditions that are no less favourable than for their own company, and to manage the network system separately from their other activities.
- *Increased accounting transparency*. To help identify cross-subsidies, separation of accounts into (at least) generation, transmission, distribution and non-electric businesses is required.

The consumer protection provisions in the electricity sector were retained. "General suppliers" must continue to connect and supply consumers in low-voltage and low-pressure areas. The price cap for small electricity consumers was also retained.

The amendments also promoted renewable energy, requiring all "general supply" electric utilities to buy electricity generated from renewable energies in their supply area and to pay a specified price.

In May 2003 an amendment to the Act introduced similar access rules for the gas sector, notably third party right of access to the pipelines and storage and a requirement to separate accounts.

The amendment provided for "juridification" of the Associations Agreements which will likely make it more difficult to prove abuse of dominance, as it establishes the presumption that if the Agreements are observed, good practice conditions will be considered fulfilled. The latest decisions of the Dusseldorf Court of Appeal (see above) seem to confirm this difficulty. At the same time however, juridification sets minimum standards for network access by shifting the burden of proof to any operator that does not fulfil the conditions set out in the Agreements. Thus any network operator has to grant network access at least under the conditions specified by the Agreements. Also, the amendment stipulates that the BKartA's decisions concerning network access are immediately enforceable as a general rule.

Finally, as required by the amendment, the Ministry of Economics and Labour sent a Monitoring Report to parliament at the end of August 2003 about experience with the negotiated access system for competition. It concludes that the Associations Agreements in the electricity sector have developed a workable access system, although improvements are required. The report notes that similar progress in the gas sector has been lacking so far. The report also provides an outlook of the basic features of the future government regulation of the German electricity and gas markets.

The Act against Restraints of Competition is the main instrument for control of the electricity and gas sectors

The general provisions of this act against cartels, anti-competitive mergers, and abuse of dominance are especially important to these sectors on their path to greater competition (Chapter 3 gives more details). Enforcement of the ARC in the electricity and gas sectors has been a growing part of the BKartA's work.

The primary control over terms and conditions for network use is *ex post* supervision of abuse under antitrust law. Box 5.4 sets out the ARC's abuse of dominance provisions.

To prepare the way for competition the exemption of anti-competitive agreements in the electricity and gas sectors was removed (so that demarcation agreements and concessions became subject to competition evaluation under the ARC). A new rule has also been introduced, to require access to "essential infrastructure facilities" except where the infrastructure operator can demonstrate that such access "is impossible or cannot reasonably be expected". The aim is to control abusive denial of access, or granting access only under abusive terms and conditions, to infrastructure such as networks (grids and pipelines) and storage.

The BKartA has addressed abusive denial of access in both gas and electricity. Most abuse proceedings have centred on abusively high prices for electricity network access, balancing and other network services, and discounting and long term contracts. For example, in February 2003 the BKartA decided that the fees charged by RWE for metering

and billing services were abusively high, and RWE had to lower its charges by up to 48%. In April the BKartA prohibited Stadtwerke Mainz from demanding abusively excessive fees for network use and ordered it to reduce its current fees for network use by a total of just under 20%. And in October 2003, The BKartA prohibited the energy supplier Mainova from denying connection to its medium voltage distribution network. The *Länder* cartel offices have also investigated the electricity sector.

Enforcement practice to determine whether prices are abusively high is to compare prices with a similar market, so as to obtain a comparison with the price "which would very likely arise if effective competition existed". But as there are no electricity or gas network markets with effective competition this approach does not work in these markets. A court ruling in 2002 confirmed that the BKartA may apply cost analysis in addition to the comparable market concept. This is helpful, but determining the relevant costs is also difficult, and resource-intensive.

The other main way in which the BKartA oversees the electricity and gas sectors is merger control. The BKartA often negotiates remedies to competition problems created by mergers in these sectors. For example its position on the purchase of regional and municipal suppliers by E.ON and RWE is that these mergers are anticompetitive unless other measures are taken (such as selling off other interests in regional suppliers). However the BKartA was overridden by the ministry on an important merger which it had rejected, between E.ON and Ruhrgas (Box 5.5).

The BKartA has also reviewed the Associations Agreements. These are tolerated. The Agreements do not exempt companies from competition oversight under the ARC.

Box 5.4. **Abuse of dominance in the Act against Restraints of Competition**

Section 19 Abuse of a Dominant Position prohibits "abusive exploitation of a dominant position by one or several undertakings". After defining dominance, the law goes on to define abuse:

"(4) An abuse exists in particular if a dominant undertaking, as a supplier or purchaser of certain kinds of goods or commercial services.

"1. Impairs the ability to compete of other undertakings in a manner affecting competition in the market and without any objective justification.

"2. Demands payment or other business terms which differ from those which would very likely arise if effective competition existed; in this context, particularly the conduct of undertakings in comparable markets where effective competition prevails shall be taken into account.

"3. Demands less favourable payment or other business terms than the dominant undertaking itself demands from similar purchasers in comparable markets, unless there is an objective justification for such differentiation.

"4. Refuses to allow another undertaking access to its own networks or other infrastructure facilities, against adequate remuneration, provided that without such concurrent use the other undertaking is unable for legal or factual reasons to operate as a competitor of the dominant undertaking on the upstream or downstream market; this shall not apply if the dominant undertaking demonstrates that for operational or other reasons such concurrent use is impossible or cannot reasonably be expected."

Box 5.5. **The E.ON/Ruhrgas case**

The E.ON-Ruhrgas merger was a series of transactions by which E.ON bought out other companies' stakes in Ruhrgas.

Formally, these were two merger projects that were examined and prohibited by the **BKartA.** The first was the acquisition of a majority stake in Gelsenberg (holding 25% of Ruhrgas) from BP by E.ON, rejected on 17 January 2002, the second was the acquisition of a majority stake in Bergemann (holding 34% of Ruhrgas) by E.ON rejected on 26 February 2002. On 3 July 2002, E.ON announced its purchase of the outstanding 40% of Ruhrgas held indirectly by ExxonMobil, Shell and Preussag. The BKartA was concerned about the anti-competitive effects of the vertical integration of Ruhrgas's gas import contracts and high-pressure pipelines with E.ON's regional and municipal gas distribution and electricity generation and grid businesses.

The **German Economics Minister's override** was exercised. Controversially, the override was exercised by a secretary of State because the Minister had declared himself prejudiced because of his former employment by one of the parties. After holding hearings, the Ministry found E.ON's arguments for a "national champion" for supply security and for improving international competitiveness persuasive. Consumer interest groups were excluded, from these hearings despite applying to be heard and pointing out their estimates of a 10% gas price increase as a result of the merger, because the Ministry did not view them as sufficiently affected parties. The decision acknowledges that the negative effect on competition is immediate whereas security of supply and international competitiveness are *future* concerns that *might* arise if certain market developments occur.

Therefore, conditions were imposed to mitigate the negative effects on competition. Five major assets had to be sold: 1) E.ON and Ruhrgas' stakes (totalling 42.1%) in Verbundnetz Gas AG in eastern Germany; 2) E.ON's 27.4% stake in EWE; 3) E.ON's 80.5% stake in gas and water utility Gelsenwasser AG; 4) E.ON and Ruhrgas' stakes of 33.3% in Stadtwerke Bremen; and 5) E.ON and Ruhrgas' stakes of 44.02% in Bayerngas. Bayerngas supplies about 66% of Bavaria's gas demand (Handelsblatt, 2002). Ruhrgas also had to auction off 7.5-bil cu m/yr to competitors (about 2.6% of annual German gas sales), and allow regional distributors to reduce their purchases to 80% of their total gas requirements. Ruhrgas had to engage in some legal unbundling. Finally, the Ministry imposed the condition that E.ON must sell its stake in Ruhrgas if: 1) another company gets a majority of voting rights or capital in E.ON; and 2) there is reason to think that such a move would be "contrary to Germany's energy policies". (This poison pill will help protect against hostile takeovers.) E.ON was allowed to keep its share in Thuga and Heingas, strong retailers.

The **Düsseldorf Higher Regional Court** blocked, on 13 July 2002, E.ON's takeover of Ruhrgas, saying it had "serious doubts" as to whether the Economics Ministry's approval was legitimate because the Court had identified a couple of procedural mistakes. E.ON reached out-of-court settlements with nine complainants just before a final court ruling in February 2003.

The Associations Agreements are the second pillar of the regulatory framework: the rules for negotiated network access have been entrusted to private hands

In line with the German tradition, the key task of working out the details of network access by third parties has been entrusted not to a regulator but to the private Associations covering the electricity and gas markets, under the public oversight of the competition authorities. The legal claim to network access is enforceable with the help of the competition authorities and/or the civil courts. The Associations developed the detailed

framework of access conditions in the form of Agreements which they recommended to their members (the government threatened regulation if agreements could not be reached, and this nearly happened when negotiations on the gas agreement broke down in 2002). Box 5.6 gives an overview.

The Agreements as they currently stand raise a number of issues, despite some evolution in response to criticism. The cost-based methodologies for setting prices are covered very fully and in great detail, to the extent that the Agreements raise a question about the potential link between the pricing principles and prices. The BKartA has expressed concern that the Agreements could facilitate agreement on prices. For gas transmission, which is not based on costs, it is tempting for gas companies to influence the benchmark. The fact that the Agreements do not have a compulsory nature is unhelpful: some 80-90 electricity distribution companies have yet to publish access charges despite expiry of the deadline. And most of the associations party to the Agreements are on the supply side of the market, or represent the larger consumers. Non-industrial consumers are underrepresented. However, representatives of private consumer associations took part in negotiations on the second set of Agreements in electricity but did not sign. Table 5.2 gives more details.

Box 5.6. **Overview of the Associations Agreements**

The Agreements set out frameworks for negotiated contracts among companies on the use of electricity and gas infrastructure. As well as the negotiations among associations to set up the framework, a second negotiation takes place between the party that wishes to use the network and the network operator. The Agreements bring together the existing associations of electricity and gas industries, network users and customers. They are one means by which legal claims to third party access are implemented.

The associations party to the Agreements have set up clearing offices for dispute settlements. As of late 2002 these offices had dealt with four disputes.

A main purpose of the Agreements is to establish voluntary criteria for determining access prices. Under the ARC the Agreements cannot restrain competition and hence cannot actually set prices.

The first *electricity Agreement* was made in May 1998. It has since been updated twice. The main principles of the current agreement are that access is to be non-discriminatory and that access charges are to be cost-based and transaction-independent. Pricing is based on: 1) costs and revenues assumed for costing purposes; 2) annual financial Statements prepared according to commercial law; 3) the principle that network prices have to reflect the costs of efficient operation is to be monitored by a benchmarking procedure where transmission and distribution prices of structurally comparable system operators are compared. Thus the heterogeneity of electricity distribution is taken into account, where costs can vary significantly according to such factors as population density and the amount of underground cable. Distribution operators are grouped into categories according to these structural factors.

The first *gas Agreement* was made in July 2000, and has also been updated. The main difference with the electricity Agreement is that it does not provide for a transaction-independent access system and that transmission pricing is based on benchmarking rather than costs. Pricing is on the basis of "an international and national benchmark", and must "not exceed the reference market-based fees for the pipelines subject to pipe-to-pipe competition".

Table 5.2. **Associations in the Associations Agreements**

Associations representing		Associations Agreement Electricity II-plus		Associations Agreement Gas II	
		Suppliers	End-users/ consumers	Suppliers	End-users/ consumers
BDI	German industry	Yes	Yes	Yes	Yes
VIK	Industrial consumers and autoproducers		Yes (large only)		Yes (large only)
VDEW	Electricity industry	Yes			
VDN	Network operators (within VDEW)	Yes			
VRE	Regional energy utilities	Yes			
VKU	Municipal utilities	Yes		Yes	
BGW	Gas, water, sewerage utilities			Yes	

Source: OECD.

Other key issues in the Associations Agreements are the handling of pricing principles and rates of return for network access, which may be encouraging companies to set higher access fees than necessary. Pricing principles are based, *inter alia,* on "annual financial statements according to commercial law". The Independent Regulators Group (a group of European telecommunications regulators) notes that financial information for regulatory purposes is often very different from other financial information, and proposes guidelines for regulatory accounts (Box 5.7).

Box 5.7. **Regulatory accounting guidelines**

According to the Independent Regulators Group, a group of European telecommunications regulators, "The basis on which regulatory accounts are prepared requires special regulatory rules as well as the application of generally accepted accounting practices".

"Regulatory accounting guidelines" will normally refer to the following:

Regulatory accounting principles

These principles establish the key doctrines to be applied in the preparation of regulatory accounting information. They should include, *inter alia*, the principles of cost causality, objectivity, transparency and consistency.

Methods for attributing costs, revenues, assets and liabilities

A description of the attribution methodologies used to fully allocate revenues, costs, assets and liabilities.

Basis for transfer charging

A description of the basis used to transfer charges between disaggregated regulatory entities as required under accounting separation obligations. Typically this will prescribe methodologies for ensuring an operator charges itself on the same basis as other operators for similar services where there is a regulatory requirement to do so.

Accounting policies

These policies are those that follow the form used for the preparation of standard statutory accounts and will include, for example, details of fixed asset depreciation periods and the treatment of research and development costs. Where the regulatory accounts are prepared on a current cost basis then the basis on which assets are valued will be included as accounting policies.

Box 5.7. **Regulatory accounting guidelines** *(cont.)*

Long run incremental cost methodologies

If LRIC applies, a description of the methodologies used to prepare long run incremental cost information. This description would also include details of the identification and treatment of shared or common costs as well as combinatorial tests.

"Normally the preparer of the regulatory accounts would arrange the procurement of an independent audit opinion. The audit opinion and accompanying report have potentially high value in enhancing the quality, objectivity and credibility of the information presented. Users' confidence and understanding of the financial Statements are significantly enhanced by the presence of an independent audit."

Source: Independent Regulators Group (2002).

Institutions and regulatory approach

Institutional oversight is provided by the competition bodies and the government: there is no regulator

The *Federal Ministry of Economics and Labour* (BMWA) is the lead ministry responsible for energy policy. The *Bundeskartellamt – Federal Cartel Office* – (BKartA) has the main responsibility for enforcing the ARC (see above). The *Länder* have energy sector supervisory agencies that implement federal law, as well as cartel offices for competition cases restricted to their state. The *Monopoly Commission* advises the government on competition issues. In its 2002 report on the state of competition in Germany, it highlighted the continuing lack of competition in many sectors, and especially the network industries. It noted that providing network access is the decisive factor in creating competition in markets where monopoly conditions once prevailed.

The most striking institutional characteristic, compared with most other OECD countries, is the absence of a regulator. Private agreement among the market players via the Associations Agreements has been the preferred route, backed up by the BKartA and its enforcement of the competition law.

Should there be a regulator?

This leads on to what is perhaps the most important issue of this review. In the context of the policy objective to maximise efficiency and ensure acceptably priced electricity and gas supplies through effective competition, the question needs to be asked whether this objective is better served by the current system of negotiated access under the Associations Agreements backed up by the BKartA and competition law or by an independent regulatory agency? The evidence on which to take a view might reasonably include the price of electricity and gas, the price of network access, the number of third party access agreements reached so far, the level of entry by new competitors, and the readiness of consumers to switch supplier. The effectiveness of the regulatory approach can also be assessed in terms of the safeguards to enforce respect of the rules for liberalisation.

On some of the evidence so far, the current approach falls short. Electricity network access fees are high, at least for distribution, and have not fallen much post-liberalisation. There is no equivalent estimate for gas, but new entrants consider that access fees are still too high and only a very few third party gas access contracts have been signed. There has been no new domestic entry – beyond renewables – into electricity generation since liberalisation (imports however have added some further competition). Relatively few electricity consumers have switched supplier, and there has been virtually no switching by gas consumers. Electricity prices, which initially fell, have started to rise again. The evidence does need to be interpreted with care: the reasons for some of these trends may be complex.

Safeguards are slow and incomplete, but some improvements are in sight. It takes a long time for access fees to be reduced under the current system. An investigation was started by the BKartA into the access fees charged by 22 network companies in late September 2001. Some of the companies immediately reduced their fees, but it took until February 2003 for a formal ruling to be made on one of the remaining utilities. This is too long a wait for a supplier. A recent amendment to ARC and Energy Industry Act has made the BKartA's decisions immediately enforceable. Also, changes arising from implementation of the new EU directives may enable the use of *ex ante* regulation of methods for calculating access fees.

The experience and analysis of other OECD countries may be helpful

The analysis and experiences of other OECD countries, as well as work by the OECD secretariat, may help in assessing which way to go.

In support of the current system, many in Germany believe that its highly fragmented structure, with a large number of legally distinct network operators, makes an *ex ante* and case-oriented regulation virtually impossible organisationally. The issue of cost is important (though not the only issue). Would it be more expensive to have *ex ante* regulation? The answer may seem obvious – yes – but a fair comparison of the two approaches would need to take account of the cost to individual suppliers of negotiating access, as well as the general efficiency losses from access fees which are likely to reflect market power rather than costs.

Australia has published a checklist to help identify the cases when self regulation backed up by the competition law is appropriate (Box 5.8). Some of its points (for example the first and second bullets in Box 5.8) suggest that self regulation may not be appropriate for the German gas and electricity sectors.

Box 5.8. **Australian Commonwealth Office of Regulation Review: Regulatory Impact Statement Checklist**

Self-regulation should be considered where:

- there is no strong public interest concern, in particular, no major public health and safety concern;
- the problem is a low risk event, of low impact/significance, in other words the consequences of self-regulation failing to resolve a specific problem are small; and
- the problem can be fixed by the market itself, in other words there is an incentive for individuals and groups to develop and comply with self-regulatory arrangements (*e.g.,* for industry survival, or to gain a market advantage).

In addition, for self-regulatory industry schemes, the checklist determines success factors to include:

- presence of a viable industry association;
- adequate coverage of the industry by the industry association;
- cohesive industry with like minded/motivated participants committed to achieving the goals;
- voluntary participation – effective sanctions and incentives can be applied, with low scope for the benefits being shared with non-participants; and
- cost advantages from tailor-made solutions and less formal mechanisms such as access to quick complaints handling and redress mechanisms.

Source: Office of Regulation Review (1998), Australia.

Australia's own energy regulatory framework is an interesting approach. It is not, as sometimes cited, a self regulatory approach, as the Australian Competition and Consumer Commission (ACCC) plays a very pro-active role in overseeing the electricity and gas codes, to the extent that the regime is called "co-regulation" (Box 5.9).

The UK's economic regulators – OFTEL (telecommunications), OFGEM (gas and electricity) and OFWAT (water) – are another approach worth studying. Their duties are to promote efficiency and competition, but also to protect consumers and ensure universal supply.

Box 5.9. **Is Australia an example for Germany?**

Australia is sometimes cited as an example where there is self-regulation of the electricity and gas sectors. However, the contrasts with the German regulatory structure are greater than the similarities. In Australia, there is significant self-regulation in the electricity, gas, and telecommunications sectors. However, in contrast to the German system, the Australian Competition and Consumer Commission has an active role, sufficiently so that the regime is called "co-regulation". There is a National Electricity Code and a National Gas Code, both developed with active participation by the ACCC, consumer groups, and the industry. (Small users came in late to the negotiating process, but the ACCC approved a mechanism to fund user groups to hire consultants and therefore become informed and active participants. The funding mechanism is essentially a tax on electricity.) In electricity, the ACCC accepts the access code, which governs access, including price principles,* to transmission grids and distribution networks, under Part IIIA of the Trade Practices Act, authorises the market rules under Part VII of the Act, and regulates network pricing for the transmission businesses. In gas, the ACCC is the regulator for gas transmission pipelines in all of Australia (except one State) and for transmission and distribution pipelines in one territory. As the regulator, the ACCC *inter alia* assesses proposed pipeline access arrangements; monitors and enforces reference tariffs, ring-fencing, incentive regulation and other access arrangement provisions; and arbitrates access disputes. The ACCC also regulates both industries through the general merger, anti-competitive conduct and consumer protection provisions of the Trade Practices Act. Indeed, the ACCC has found that, while in certain circumstances, industry can be left alone to regulate behaviour, "it is important that the appropriate regulator is both seen to be and actually underwriting compliance with the codes through necessary enforcement action". Australian Competition and Consumer Commission (2000), p. 21.

The key formal arrangement for self-regulatory schemes under the Australian competition act is authorisation, but the ACCC also engages in regular review of self-regulation arrangements, has its own staff on code-related bodies, and requires regular monitoring and reporting. In addition, where there is blatant disregard or systematic breaches of the competition act, then the ACCC is willing to use its enforcement powers. *Ibid*., p. 22.

* The National Grid Code is fairly prescriptive, aiming to control not just discriminatory fees but also discriminatory conduct.

Two important structural questions arise in relation to independent regulators. Where should they be placed: as part of the competition authority or separate from it? And should they be single or multi-sector? The OECDs' work on this is summarised in Box 5.10.

Box 5.10. **Where should an independent regulator be placed? Should it be single or multi-sector?**

The choice about whether access regulation is better performed by a competition agency or by a sector regulator is not clear. The answer depends on a complex mix of comparative advantage and synergy issues. It is also heavily influenced by a country's general legal framework and regulatory history. Hence the "optimal" solution could certainly vary from country to country and even across industries within the same country.

The objective of access regulation is to promote as well as protect competition in certain situations where access to a portion of a vertically integrated incumbent firm's assets is vital to the development of a satisfactory level of competition. On the one hand, because of experience with abuse of dominance cases, competition agencies are more suited to performing this task than are sector regulators. On the other hand, ensuring a level playing field requires processing a large volume of cost data in order to set access terms, and then following up with continuous monitoring to ensure compliance with those terms. These are functions that seem more in tune with what sector regulators normally do.

Although both sector-specific regulators and competition agencies should presumably be able to hire appropriate expertise, the experience and institutional cultural differences between them are not so quickly and easily eradicated. Moreover there is a significant risk that trying to change or mix institutional cultures could compromise abilities to perform core functions. Five aspects of experience and institutional culture seem particularly important. First, sector regulators are often charged with attenuating the effects of market power, whereas competition agencies basically focus on reducing such power. This tends to produce quite different views on the extent to which market power can be managed for the public good. Second, sector regulators typically impose and monitor various behavioural conditions whereas competition agencies are more likely to opt for structural remedies. Third, sector regulators generally apply an *ex ante* prescriptive approach while competition offices, except in merger review, apply an *ex post* enforcement approach. Fourth, sector regulators typically intervene more frequently and require a continual flow of information from regulated entities, while competition offices rely more on complaints and gather information only when necessary in connection with possible enforcement action. Finally, sector regulators are typically assigned a considerably broader range of goals than competition agencies are asked to pursue, so they may become more adept at trading off conflicting goals.

Assigning competition protection to competition agencies and economic regulation to sector regulators, as static comparative advantage considerations might suggest, means that important synergies might be lost. Synergies exist between competition protection and economic regulation and also between both of those functions and access regulation. They arise largely because the same staff expertise can be applied to a number of related problems, and because combining several policy instruments in the same agency increases the chances that they will always be used in tandem rather than sometimes at cross purposes.

General, economy-wide agencies are more immune to regulatory capture than sector-specific regulators. The desire to avoid distorting competition through subjecting competitors to very different regulatory regimes also works in favour of general as opposed to sector-specific agencies, as does a closely related legal certainty argument. Wherever there is sector-specific regulation there will be a need to define jurisdictional boundaries among regulators and this will create legal expenses, delay and uncertainty. None of these problems arise where regulation is carried out either by a general competition agency or a multi-sector regulator. It can be noted in this context that the Monopolkommission has endorsed a multi-sector regulatory authority.

Source: Adapted from OECD, 1999.

Conclusion

As in most other OECD countries, Germany pursues a complex mix of energy policy goals – notably economic efficiency, environmental protection and security of supply – which sometimes conflict. The focus here is on economic efficiency and the development of effective competition to deliver this. The rest is beyond the scope of this report save for two important points. First, there is a need for full awareness of how the other policy goals may be affecting the economic efficiency goal (for example higher electricity prices from renewables support). Second, there is the related need to identify means by which these other goals can be pursued at minimum economic cost (for example, cost-benefit analysis to determine the best policy instruments for supporting security goals).

As regards economic efficiency, the German experience raises two main issues which interact: the structure and special characteristics of the electricity and gas sectors, and the current regulatory framework for promoting market liberalisation and effective competition.

Germany has taken a number of important steps to promote competition, not least full market opening of the gas and electricity sectors ahead of most other OECD countries, and more recently adjustments to the legal framework in response to the difficulties encountered in the early years. The competition law is an important asset which addresses fundamentals such as non-discriminatory access to the networks.

However the current regulatory system rests on a presumption that a combination of the competition law and private agreements between the market players to regulate network access is enough. This approach is fully within the German tradition, which promotes self-regulation under the umbrella of a comprehensive competition law enforced by an efficient and respected competition authority. But a system implicitly designed for markets where competition is already established is now battling with different circumstances. The electricity and gas sectors are markets in which competition has to be developed from a low or even non-existent base, and which also have a monopoly network core. The structural evolution of the two sectors in recent years has further complicated the picture, with vertical and horizontal consolidation through intense merger activity since market opening. The industry structure today approaches that of *de facto* regional monopolies which mirror historical demarcations of territory. Market entry is clearly difficult in practice. Notably, there have been no new entrants into electricity generation that could affect competition. Electricity prices have risen (after falling initially). Consumer switching is low.

There is a need to tackle the structural issues more forcefully, and to rethink the regulatory framework. After five years, and despite valiant efforts by the BKartA, it has not yet delivered effective and sustained competition. An opportunity is provided by the phase-out of nuclear power to promote new market entry in generation and this should be seized. Providing effective network access is perhaps the most decisive factor in stimulating competition. Here the competition law needs the assistance of pro-active economic regulation by an independent regulator.

Policy options for consideration

The reader should note that the options below were formulated before adoption of the most recent EU directives and related changes to German law. For example Germany has now confirmed that there will be a regulator (RegTP) for the electricity and gas sectors.

1. STRUCTURE AND RELATED ISSUES

1. Reinforce the legal prohibition of cross-subsidy between network and non-network activities through separation of generation, transmission, distribution and supply for electricity and transmission, distribution, storage and supply for gas, into separate companies with separate management, as well as active oversight by supervisory authorities with no ownership interests. Introduce regulatory accounting within a reasonable time period.

Much of the difficulty of promoting competition in the electricity and gas sectors stems from its structure. The recent consolidation of the industry has not been helpful. The market is not just highly concentrated but entry is also difficult. Generation entry is hampered by the likely need to purchase gas from an integrated competitor. High network access charges are a key issue. The President of the BKartA said in August 2002 that "fees for network use… currently constitute the main obstacle to effective competition in the electricity markets". Competition is impeded in two ways. Access fees and taxes form the main part of an electricity bill in Germany, so the scope for competition on the rest of the bill is limited. And high access fees discourage market entry by rival energy suppliers.

The basic problem is discriminatory behaviour which is facilitated by the industry's structure. Access fees that exceed costs enable a vertically integrated utility to cross-subsidise its energy sales and charge energy prices that are lower than their costs. But even if access fees are cost-based, the utility can still favour itself by attributing common costs to the network. A rival generator's potential cost advantage in generation may be wiped out by the higher cost of network access. Discriminatory conduct is another problem. This can be subtle, involving issues of information and timing. Preferential access can be as damaging as high access fees. Despite the Associations Agreements rules, such conduct is reported to persist.

The basic need is to promote an effective separation of activities, and especially the network from other activities. Given that ownership separation is unrealistic, it is unlikely that the *incentive* to discriminate can be reduced. However there is further scope to reduce the *ability* to discriminate. This can be done through better accounting information (on the lines of the Independent Regulators Group definition) to identify cross-subsidies, together with adequate supervisory capacity, and not least, stronger separation of the network from other activities.

2. Continue to keep under review the lower limit on "decisive control" in the light of the strong incentives of a vertically integrated utility to influence a partly-owned municipal utility to procure power or gas from its partial parent.

3. If it is found that vertical integration is impeding the development of competitive markets, take steps to bring about the ownership separation of potentially competitive activities from natural monopoly activities.

Some observers, not least the BKartA, have already noted a negative effect on competition from the widespread partial integration of local utilities with upstream utilities. The BKartA has now changed its policy with respect to decisive control. It formerly took 20% as the level below which a decisive influence is not exercisable, but it will now look at transactions below that threshold if one undertaking exercises (directly or indirectly) a competitively significant influence on the other undertaking. This is welcome in the electricity and gas context, as there are reasons to expect that incentives for anti-competitive procurement conduct, even at low levels of ownership, are strong. The absence of competition in distribution means that any

excess cost can be passed on to consumers. There are also cost incentives for the local utility to buy from its parent. Widely practiced, this reduces incentives to enter generation and supply in the electricity market, and supply in the gas market, which is negative not just in the short term but also for long term competition.

4. Ensure that the prices of ancillary services reflect only the cost of efficient provision.

As well as network access, there are a number of other natural monopolies in the electricity sector related to system operation. The Associations Agreement specifies that payments for certain ancillary services – services that are necessary to support the transmission of high-quality power from seller to purchaser such as voltage control – as well as transmission losses are to be covered by the general access fees. This may avoid complexity, but results in a certain loss of transparency. Requiring competitive tenders for balancing energy is helpful, but these must be truly competitive, with a number of participants.

2. REGULATORY APPROACH

Two sets of recommendations are proposed below. The first addresses improvements to the Associations Agreements as well as changes to improve regulatory effectiveness whether or not the current regulatory approach is maintained. The Agreements contain a number of provisions that dampen competition. The second set of recommendations proposes a new regulatory approach with the establishment of an independent regulator. The German system has now been in place since 1998. Ideally it needs a more fundamental adaptation – which goes beyond changes to the Associations Agreements – so as to create an environment where competition will more readily develop. It seems that this is now being taken forward with the recent announcement that a "regulatory authority" will be established to oversee the energy sector.

a) Current system

5. Modify the objective of avoiding new transmission lines in the electricity Associations Agreement to limit it to instances of inefficient by-pass.

Transmission capacity is key for competition among generators. The Agreement has an objective to avoid the construction of new transmission lines, wherever possible. This will impede competition in the long run, as competitive markets require more transmission capacity because they use the grid in a new pattern. Even an unloaded transmission line can affect competition by making the threat of competition credible. At present, supply from abroad is unlikely due to the congestion on international transmission connections. If the objective is to eliminate inefficient bypass (for example to prevent a large user from building a direct line to the higher voltage network so as to avoid paying access charges for a lower voltage network) the provision as drafted is too broad for this specific objective.

The approval process may need to be facilitated, especially as regards international connections, while protecting sensitive environmental areas.

6. Ensure that flexible contracts for gas supply are feasible under the gas Associations Agreement.

In gas, competition is impeded by the very rules of the Agreement. Potential new entrants are obliged to purchase transport in a contract for a fixed flat volume over the

year. But the difference between peak demand and the actual use is often considerable, so new entrants need access to storage or other flexibility instruments to handle this. Also, the TSOs' policy on balancing the network over shorter periods is an important part of the conditions for network access. The gas regulators' Madrid Forum guidelines for good practice require TSOs to offer "short-term on-demand" services. They also promote entry-exit rather than point-to-point tarification so as to reduce the transactions costs of gas trading and therefore not impede gas on gas competition.

7. Ensure that the rates of return on equity reflect the rates obtainable in financial markets, adjusted for the risk of the network business.

The annexes to the Agreements appear to allow the co-ordination of pricing and hence high access fees. They specify pricing principles and rates of return (6.5% and 7.8% respectively). The agreed rates of return do not seem to have been justified *ex ante* by any study of the rate of return on equity in German investments, nor any study of the riskiness of the electricity and gas transmission and distribution businesses. The rates are high compared with long term returns on equity during the relevant period. They are even higher on a risk-adjusted basis, if the risk characteristics of network businesses are taken into account. Whether or not the Agreements continue, this needs review.

8. Ensure that the consumers' organisations can participate strongly in regulatory decision-making, while safeguarding their rights to sue under the competition law.

Facing monopolists, consumers do not have a strong bargaining position. Information, including access to independent expert advice and studies of German and foreign electricity and gas sectors, is crucial. It can provide consumers with arguments to promote more competitive and consumer friendly German markets. Consumer organisations should have the funding they need to participate in regulatory decision-making in a well-informed, timely manner. This may require a fee, acting as a tax, on small electricity and gas consumers.

9. Ensure that the authorities responsible for the electricity and gas sectors have sufficient resources to fund empirical studies of these sectors.

The BKartA has been commendably open minded about learning from experience. Notably it has modified its doctrines in the light of observations of how the German electricity and gas markets work in practice. It has, for example, updated its views on the competitive role of a third vertically integrated utility. From assuming that the creation of a "third force" (now Vattenfall Europe) could apply competitive pressure on RWE and E.ON, it now concludes that the latter two companies occupy a joint dominant position in the German electricity markets, because observation shows the relevant markets to be regional rather than national. So far, the BKartA has depended on the ministry for funding studies: this could reduce its independence.

10. Increase the resources devoted to the regulation and oversight of the electricity and gas sectors.

Though resources devoted to competition oversight and enforcement in the electricity and gas sectors have increased over recent years, they remain limited. Current resources consist of the BKartA electricity decision unit's ten staff, and the staff of the *Länder* energy supervisory authorities and competition enforcement agencies.

11. Within the constraints of the German legal system, increase the information and the powers to gather information available to the authorities responsible for the electricity and gas sectors.

A significant limit to the effectiveness of the BKartA in eliminating abusive pricing in network access is access to information. The BKartA may demand information by means of a formal request, but the procedure is heavy. It must have a concrete suspicion of a violation of the competition law, and provide a Statement of reasons together with advice as to the available legal remedies. In contrast, a regulatory authority may demand access to a company's regulatory accounts.

b) New system

12. Establish an independent regulatory authority, at least for electricity and gas. It should reflect the good practices that have been established among regulatory authorities, including independence, adequate resources, adequate powers, clear objectives, and accountability to the legislature.

A number of voices in Germany have called for the establishment of an independent regulatory authority for electricity and gas. The Monopoly Commission now takes the view that a multi-sector *ex ante* regulator is needed for the network based industries. It notes that providing network access is the decisive factor in creating competition in markets where monopoly conditions once prevailed, and that guaranteed network access is of little use if the prices are fixed by the network incumbents.

The BKartA has already taken on some of the characteristics of an independent regulatory authority, but with insufficient powers to fulfil that role. For example it cannot demand information other than within the course of an investigation, which means that cost information is very incomplete.

The regulator should have the power to inspect regulatory accounts upon request, not only in the context of a specific case. Given the incentives of regulated firms to exaggerate costs, and the independent regulator's incentive to operate with professionalism and political neutrality, the burden of proof on cost calculations should be reversed. The regulator should be sufficiently well-resourced to ensure adherence to the law. The regulator should be funded directly from the federal budget so as to ensure that there are no conflicts of interest between ownership and regulation.

The introduction of an independent regulator would still allow substantial input and even negotiation by the energy industry. Network regulatory agencies in other countries typically work on the basis of collecting information from interested parties before making their decisions about how regulation should be applied, for example the level of the price cap. In this context, the regulator's independence and resources are very important.

13. Make access to the electricity and gas infrastructure, and prices of related monopolies, subject to cost-based price cap regulation by an independent regulatory authority.

In many countries, where a monopoly is expected to persist, economic regulation is imposed to reduce prices below the monopoly level. A price cap approach to network access fees should be implemented in Germany.

3. OTHER ENERGY POLICY GOALS

14. Review whether alternative arrangements would achieve greater use of renewables generation at lower cost.

As matters stand in Germany, any general electricity supply company must purchase renewables-generated power at specified prices. This provides an incentive for each firm to minimise its costs in supplying renewables power. But an even greater incentive to general efficiency could be achieved through the use of auctions or a market in "green" energy. Such a market would work on the basis that a specified quantity of "green" electricity is generated and consumed, and the tradable feature means that the most efficient "green" generation is used. Further, some consumers may be willing to pay extra in order to increase the quantity of "green" electricity generated: they too (not just the supply companies) could be purchasers of green certificates. Several other European countries have implemented green certificates trading, and could be a source of information about how to reduce the cost of green generation.

15. Apply Regulatory Impact Analysis, or other structured benefit-cost analysis, to programmes aimed at meeting other energy policy goals. Aim through this to identify less costly means of achieving these goals.

Regulatory Impact Analysis (RIA) is a structured means of evaluating the economic impact of policy decisions (Chapter 2 gives more details). It can help identify the most cost-effective means of achieving policy goals. It could usefully be applied to three specific energy policies. The first is the subsidisation of domestic hard coal. Subsidies are applied to further energy security as well as social, regional and employment objectives. The energy security argument deserves review, given that cheaper coal can be obtained from an international market that is well established, reliable and geographically diverse. The second is the special provision for lignite mining to ensure demand for lignite in electricity generation (in 2001 the Swedish power company Vattenfall agreed with the Federal government to generate 50TWh/year from lignite until 2011). The third is phase-out of nuclear generation. This was the outcome of a consensus between the government and the nuclear utilities. To the extent that the phase-out causes nuclear plants to be retired before the end of their economic life, there is a cost of premature retirement.

B. PHARMACIES

Background and context

Community pharmacies are an integral part of the German health care system; they are also businesses

This chapter reviews community pharmacies in Germany. These pharmacies provide a wide variety of services as an integral part of the German health care system (Box 5.11). They support the government's health objectives which include ensuring the orderly supply of medicines to the whole population (supply at any time, at all places, with all necessary medicines); ensuring drug safety and information to the patient; and reducing health care costs.

Important reforms have recently been made to the German pharmacy sector

The Act on the Modernisation of the Statutory Health Insurance, which is part of agenda 2010, came into force on 1 January 2004 and addresses several issues raised in this report (see Box 5.12).

Box 5.11. **The health system, community pharmacies, and the pharmaceutical market in Germany**

Among OECD countries, Germany has relatively high health spending. About 90% of the population are members of one of the statutory health insurance schemes (SHIs). The other 10% are covered by private health insurance. The SHIs compete for customers on the basis of contribution rates (not coverage). Contributions are paid by the insured, their employers and for the unemployed, by the State. An equalisation system transfers funds between SHIs. SHIs pay pharmacies for prescribed pharmaceuticals. SHIs do not operate as undertakings within the meaning of private law, so competition law does not apply to them.

Community pharmacies provide a wide range of professional services in the context of the German health care system. Community pharmacists typically have more frequent contact with patients than doctors, so can assist in determining medication effectiveness, patient tolerance to medications, and other related factors that can affect the success of a patient treatment programme. The pharmacist performs an important safety check: for each prescription, he/she must check to see that the information provided by the prescriber is complete, that the medication will not interact with other medications, that the medication and dosage are appropriate for the patient's health condition, and that the patient has information about the medication (including possible side-effects, what food, drink or activities to avoid, storage, and dosage).

A community pharmacy sells three types of medicine: prescription-only; pharmacy-only; and free trade over the counter (which may be sold by certain other retailers). Prices of the first two are heavily regulated. Prices are low compared with other European countries. The price received by drug manufacturers is on average 55% of the retail price (lower than the UK and France, which are the highest in Europe). The German distribution margin is quite high by European standards.

In 2001, there were 21 569 community pharmacies each serving, on average, 3 810 people. There were 45 869 pharmacists in these pharmacies.

A pharmacy is also a commercial business. Pharmacies have a wide range of turnover. About 5% of those in west Germany have an annual turnover under EUR 250 000 (excluding VAT), and some 2% have turnovers between EUR 2 million and EUR 2.25 million. Turnover is nearly all drugs (93.5%) and especially prescription-only drugs (69.5%). In 2000, about 40% of community pharmacies in west Germany reported operating losses (part of the reason for this high figure may be new entry). Generic pharmaceuticals (those that are not longer protected by patents) made up 21% of pharmaceutical sales in 1999 (the highest share in Europe).

Over half the expenditure on drugs is for pensioners. Demand for pharmaceuticals and the number of prescriptions continues to grow.

As in other OECD countries, the sector is heavily regulated, but market entry is reasonably open

As in other OECD countries, pharmacies are heavily regulated (regulation goes back 750 years in Germany). Regulation covers a wide range of issues including those set out on Box 5.13.

However market entry is relatively unrestricted compared with many other OECD countries. New pharmacies may locate anywhere including near incumbents. Incumbents cannot prevent market entry, and there is no constraint on the number of new pharmacists. Table 5.3 contrasts regulation in Germany with some other OECD countries.

The following sections review the main elements of regulation.

Table 5.3. **Regulation of pharmacies in selected countries**

	United Kingdom	France	Germany	Netherlands	Norway	United States	Canada
Licence or contract required?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Location of new pharmacies restricted?	Yes	Yes	No	No	Yes	No	No
Ownership structure restricted?	No	Yes	Yes	No	No	No	No
Number of stores per owner restricted?	No	Yes	Yes	No	Yes	No	No
Freedom to reduce prescribed drug prices?	No	Yes	No	Yes	Yes	No	Yes

Source: Reproduced from Table 3.1, in Office of Fair Trading (United Kingdom) (2003), "The Control of Entry Regulations and Retail Pharmacy Services in the UK", January, citing Mossialos and Mrazek (Annexe C), Mossialos, E. and M. Mrazek, 2002. "Entrepreneurial Behavior in Pharmaceutical Markets and the Effects of Regulation". In R.B. Saltman, R. Busse, and E. Mossialos, *Regulating Entrepreneurial Behavior in European Health Care Systems*, Open University Pres, Buckingham, UK and Philadelphia, pp. 146-162.

Box 5.12. **Germany: The 2003 health reform**

- Mail order trade of pharmacy-only drugs in Germany and with the EEA is allowed for registered pharmacies. Pharmacies have to comply with all standards of traditional pharmacies and several additional quality and safety standards (advertising, Web site layout, technical equipment, dispatch matters, delivery, patient information and consultation) to be accredited. The objective was to offer a safe and reliable opportunity to patients who would like to use mail order of medicines.
- Ownership restrictions for pharmacies have been loosened. Pharmacists may now own up to four pharmacies, which have to be located in the same or neighbouring district, though. This is regarded as a first step towards a more liberal system. The ban on multiple ownership has not been lifted completely in order to gain experiences with new basic conditions that will not influence consumer protection or drug safety (which were given top priority) in a negative way.
- Restrictions on products that may be carried in pharmacies have been loosened. Pharmacies may now offer medical devices and products that generally support health care.
- Pricing requirements for non-prescription medicines have generally been removed and thus price competition between pharmacies has been initiated. The SHI's will now only reimburse for non-prescription medicines when taken as a medication for special severe illnesses; in this case, medicines are still subjected to state-controlled retail margins.
- Retail margins have been abolished for prescription-only drugs. SHI's will reimburse pharmacists with a fixed consultation fee of EUR 8.10 and an additional 3% on the wholesale price (per package) to cover interest; pharmacists have to return a rebate of EUR 2 per package to the SHI's.
- Reference prices will be applied to drugs still under patent as well.
- Co-Payments on drugs reimbursed by the SHIs will be raised from EUR 4-5 (depending on the size of the package) to 10% per package (depending on the price of the drug), with a minimum of EUR 5 and a maximum of EUR 10.

Box 5.13. **Regulation of German pharmacies**

- Professional training requirements.
- Restriction of authorisation to be a pharmacist to EU citizens or Stateless foreigners.
- Premises and opening hour requirements.
- Restriction of the form of the business to a sole proprietorship or partnership or an open commercial company, where all owners or partners are authorised pharmacists.
- Restriction that each pharmacist may own at most one pharmacy in Germany.
- Restrictions on which products must be carried and which products must not be carried.
- Pricing requirements.
- Requirements that at least a certain fraction of prescriptions be filled by parallel imports.
- Restriction of prescription drugs import to authorised persons and prohibition of mail-order prescription drugs.
- Requirements to substitute low-priced drugs having the same active ingredients, effectiveness and pack size, and a comparable form, if the prescriber has not actively ruled out such substitution.
- Prohibition of consumer advertising of prescription drugs and of comparative advertising.

Pharmacists' training and certification: some restrictions on foreigners

A Qualification Code for Pharmacists regulates training. Training lasts five years. Pharmacists must have certification in order to practice. This is granted if training has been successfully completed (in line with German and EU law – the EU has mutual recognition of diplomas); and if the applicant is German or an EEA citizen (the EEA covers the EU plus Norway, Iceland and Liechstentein) or a Stateless foreigner under German law. Other foreigners cannot practice, and those that can may only run a pharmacy that has been established for at least three years.

Entry of new pharmacies: relatively open

A pharmacy requires authorisation from the *Land* where it will operate. This depends on the person's qualifications, the existence of premises and their conformity with the Pharmacies Operations Regulations. No geographical or numerical restrictions exist.

Advertising: strictly regulated

This is strictly regulated, and much of it is prohibited. Professional law prohibits excessive or misleading promotion. Prescription drugs cannot be advertised outside the pharmaceutical circuit.

Restrictions concerning the business structure

The "Law on Pharmacies" is based on the idea of the self-employed pharmacist running a single pharmacy. The aim is to uphold professional standards in the provision of pharmacy services; enhance capacity to enforce professional standards; and promote universal access to pharmacy services. The ban on multiple ownership was modified in 1994

to accommodate EU law: pharmacists who can practice under German law may run more than one pharmacy elsewhere in the EEA (but pharmacists running several pharmacies elsewhere in the EU can still only run one pharmacy in Germany).

These provisions may significantly and unnecessarily restrict the development of more efficient structures for the delivery of pharmacy services. Economies of scale cannot be exploited. Also, the asymmetric treatment of non-German pharmacies seems difficult to justify. The question is whether the cost of the restrictions is proportionate to the additional benefits which may accrue to the consumer. There are good arguments for questioning whether professional behaviour of pharmacists needs the support of the restrictions, which are based on a dubious distinction between owners and non-owners. First, success for a pharmacy depends on providing a quality as well as a cost-effective service, and the former depends on the professional skills of the pharmacist regardless of whether he/she is a salaried employee or the owner. Second, it is unclear that commercial pressures on the behaviour of owner-pharmacists would be larger than those on employee-pharmacists. Third, it is in the interests neither of owners or non-owners to expose themselves to the risks of loss of income or even litigation if the pharmacy is unsafe. Fourth, as regards the possibility of serious harm to consumers from professional misconduct, the deterrent of professional discipline or litigation would seem equally valid for both types of pharmacist. Fifth, good pharmacists are not necessarily good at business or management, and the sector may need the input of such people to improve innovation, efficiency, etc.

One valid concern is the possibility that drug wholesalers might enter the market and form an oligopoly. This could be countered by maximising the scope for competition wherever possible in the supply chain (for example by ensuring market transparency and low switching costs for buyers). The range of potential suppliers could also be expanded by broadening the freedom to sell at least some drugs (as some other OECD countries have done). Consumer education would have to be enhanced if this were done. More generally, current controls over pricing, opening hours etc. would have to be relaxed for consumers to benefit fully from a development towards large chains. In short, changes affecting business structure would need to carried out as part of a broader reform.

Cross border/mail order trade: the current ban is, helpfully, to be lifted

Currently mail order trade (including e-commerce) in medicines is prohibited in Germany for pharmacy-only medicines. However, the ban is circumvented by health insurers and consumers. The EU's European Court of Justice is about to rule on whether the ban is compatible with the free circulation of goods in the EU. The preliminary view is that less severe measures could be used to meet health and safety objectives. The government is, however, planning to permit regulated and monitored mail-order trade in Germany and with the EEA. Regulation will cover pharmacy premises, Web site layout, dispatch matters, delivery, patient information and consultation. Some other OECD countries (such as the Netherlands and US) already permit regulated mail-order trade (Box 5.14). Debate and review in Germany has been prompted by the activities of a Netherlands-based mail order pharmacy, DocMorris.

German opinion is divided. Health insurers, politicians, consumers' organisations and a small number of pharmacists are in favour of mail order. The pro-pharmacists have developed a security standard with *Deutsche Post,* would offer counselling via a call centre, and patients' historical medical records would be maintained. But most pharmacists are against change, arguing that it could risk patients' health (because of counterfeit drugs and inadequate consumer counselling) and threaten the livelihoods of bricks and mortar pharmacies. A study

by the Bavarian government shows that a 5% market share gain by mail order pharmacies would result in the closure due to loss of sales of 20-30% of traditional pharmacies. The main German pharmacists' association has tried to block mail order development.

Consumers, however, are likely to benefit from mail order pharmacies in a number of ways. Access to drugs is facilitated for working people and the homebound. Mail order offers privacy for those who wish it. Internet search programmes offer access to a wide range of information, more easily than in the traditional store. Computer technology to transmit prescriptions from doctors to pharmacies is likely to reduce prescription errors. That said, traditional pharmacies offer benefits and services such as immediate access to prescription drugs. Where mail order has been permitted in the OECD, careful regulation is in place. In New Zealand for example, Internet pharmacies must be accredited. They must comply with all the standards of a traditional pharmacy, and meet other requirements related to patient consultation, privacy and advertising.

Box 5.14. **Netherlands pharmacy mail order/Internet developments**

The particular Internet/mail-order pharmacy that has shaken up German pharmacists is 0800 DocMorris. DocMorris is located just over the border in the Netherlands, within reach of German courier services who can pick up parcels and deliver them cheaply in Germany. Opened in June 2000, in 2001 DocMorris had a turnover of EUR 5 million and in 2002 a turnover of EUR 25 million. Three-quarters of the company's customers are from Germany. DocMorris is attractive to German consumers and health insurance funds because prices are considerably lower than those charged by German pharmacists and DocMorris is not limited by opening hours, medicines are delivered to the patient's door, and there is no risk of meeting the neighbours in the pharmacy. The success of DocMorris has encouraged imitation: a second Dutch mail-order/Internet pharmacy is getting started and the German Association of Pharmacists has launched its own Web site, aponet.de, which allows customers to pre-order a prescription, but not to have it filled and mailed.

DocMorris, as a pharmacy operating in the Netherlands, is subject to Dutch law and regulation of pharmacies. The Dutch Ministry of Health has a specialised section to oversee pharmacies using mail-order. In addition, DocMorris received an ISO certification after a check of its internal processes. DocMorris has controls to address safety concerns. DocMorris requires an original prescription for medications requiring a prescription, and accepts an order only after the prescription is verified. Narcotics cannot be ordered. DocMorris will directly bill statutory health insurance schemes,* if a panel doctor's prescription is presented, and does not require any co-payment from the patient although a co-payment for members of the German statutory health insurance is provided by the social code book 5. The medicines are delivered by a delivery service and acknowledged by signature, and normally only within the European Union. DocMorris screens medicines to identify whether a patient should not take the medicine in a second prescription together with that in a previously filled prescription.

* In the EU, about 65% of the pharmaceutical market (by value) is accounted for by products that are reimbursed. Thus, the ability of patients to be reimbursed if they buy from an Internet pharmacy is important to its gaining scale. However, two decisions in the European Court of Justice (Nicolas Decker v. Caisse de Maladie des Employés Privés (28 April 1998, Case C-120/95) and Raymond Kohll v. Union des Caisses de Maladie (28 April 1998, Case C-158/96)) upheld the right of every citizen to obtain goods and services related to medical care and treatment from whichever member State they chose. Ashurst *et al.*, pp. 36, 37.

Source: http://0800docmorris.com.

One issue of concern is a patient's medication record, given that the latter are encouraged to use the same pharmacy and may end up using several if mail order became available. Advances in computer technology mean however, that patient records could be securely accessed from a number of pharmacies.

Pharmaceutical pricing: this needs reform in the context of wider health care reforms

The pricing of drugs is complex, for a number of reasons reflecting difficult social, political and economic trade-offs which are not distinctive to Germany (Box 5.15).

Box 5.15. **The general factors affecting the price of pharmaceuticals**

1. *Payers and beneficiaries.* The revenues to pay for medecines come from insurance funds (paid by employers and employees) or from the State (taxpayers). This raises the problem of "moral hazard" which affects insurance markets. Consumers use more drugs than is economically efficient because they do not have to pay the cost directly. The typical government response is to set up policies aimed at restricting the quantity and quality of medicine consumption. These include "formularies" (lists of reimbursable drugs); reimbursement policies (*e.g.*, the extent of reimbursement); controls on prescribing doctors and pharmacists; controls on pharmacists' margins; and controls on drug prices.
2. *Free movement of medicines.* Drugs are both compact and valuable, thus very tradable. At the same time countries apply different pricing policies (for example different levels of reimbursement) and related regulation, though the EU is seeking to reduce the differences. So prices differ widely across countries. This has given rise to a substantial and growing parallel trade of drugs in the EU (which transfers profits from the manufacturers to the traders).
3. *R&D.* Pharmaceutical R&D is costly and time-consuming, typically taking more than a decade. This R&D must be compensated.

Pharmaceutical pricing in Germany is covered by a wide range of restrictions aimed at curbing overall spending (Box 5.16 and Figure 5.5). Broadly, the components of a retail pharmacy price are: manufacturer 55%, pharmacies 27%, VAT 14%, wholesalers 4%.

Pricing reform will necessarily need to be part of a more comprehensive health sector reform, and has an important contribution to make to a more efficient health sector. Reform needs to give consumers incentives to choose cheaper options, so as to encourage more efficient pharmacies and manufacturers. Reform of the fixed margin system is supported by the SHIs, in order to reduce costs, but the pharmacies' and wholesalers' associations reject this, fearing an increase in drug consumption and supply difficulties. A 2002 round table on the health system suggested that price competition should be initiated where possible. The next few paragraphs review the scope for reform of specific aspects of current pricing regulation.

Uniform retail prices. These are one reason why there is no competition among pharmacies. The justification for uniform retail prices is to ensure that the safety of medicines is not endangered by price competition, that patients do not have to compare prices, and that medicines should be available promptly throughout the country. A council of experts called for lifting the restrictions in 1995, at least for non-prescription medicines.

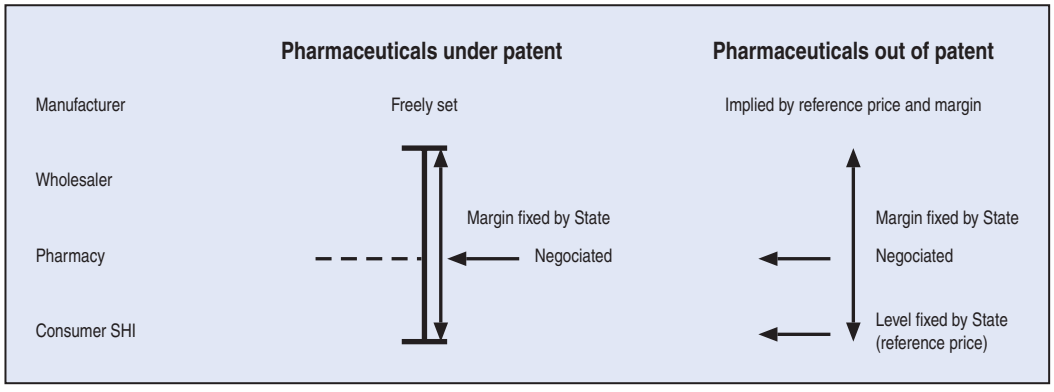
A 15% fall in prices might be expected, helpful both to the insurance companies and to consumers. The council also suggested a possible broadening the list of non-prescription drugs, given that consumers were increasingly well informed. These are good arguments. There is an argument, too, for reviewing the case for uniform pricing of prescription drugs for the chronically ill, who are buying drugs regularly and have an opportunity to shop around (or can get a family member to do so). If pharmacies can start to differentiate their pricing, this may help higher profits (*e.g.,* for infrequently demanded products) as well as a better deal for consumers (*e.g.,* advantageous pricing of babycare products in areas with many families).

Reference prices. They cover around two-thirds of prescribed pharmaceuticals, but only one third of SHI drug expenditure. If the retail price is above the reference price, the patient must pay the difference, and as consumer resistance to this is high, the manufacturer usually adjust prices to equal the reference price. The system may maintain higher prices than would be the outcome of free price competition.

Box 5.16. **Pharmaceuticals regulation of pricing in Germany**

Prices for prescription-only or pharmacy-only pharmaceuticals are heavily regulated. The retail price for prescription drugs must be uniform throughout Germany. Retail margins are fixed by the State. For patented drugs the retail price is determined by the manufacturer. For drugs no longer under patent, the State fixes a reference price. Pharmacies pay drug wholesalers, which is concentrated in Germany with the five main wholesalers accounting for some 90% of the market. The maximum margin for wholesalers is fixed by the State. The system leaves a small margin of negotiation on the wholesale price, which only affects the distribution of rents in the supply chain between the final consumer and the manufacturer, as it cannot change the (fixed) retail price and reimbursement rate, or the manufacturer's price. An important complication is that the SHIs receive a rebate of 6% of the retail price for drugs not covered by the reference price. Finally, pharmacists must sell cheaper imported medicines under an import quota (7% of turnover), and must substitute cheaper but similar drugs to those prescribed unless this is ruled out by the prescriber.

Figure 5.5. **Pharmaceuticals under patent**



Source: OECD.

Distribution margins. These may also have negative effects. Given that the cost of efficiently providing pharmacy services varies from location to location, a fixed nationwide margin means that low cost pharmacies receive high profits at the expense of SHI contributors, and attract entry which could be excessive.

The effect of the *import quota* is to transfer some profits to authorised parallel importers from drug manufacturers and wholesalers. There is no incentive for the pharmacist to choose the most cost-saving substitutes so the rule only has a marginal effect on manufacturers' prices.

The requirement for *generic substitution* has not had such a large effect on prices as had been expected, because generics had already largely displaced branded drugs where they could.

Conclusion

There is scope in Germany to improve the efficiency of community pharmacies without damaging consumer health and safety. The sector has several positive features already – relatively open entry, and relatively low prices – but further improvements are possible. Business structure restrictions could be loosened, enabling economies of scale to be exploited for the benefit of consumers. Professionalism has not suffered in those countries where non-pharmacists may own pharmacies. Mail order trade may also be safely opened up provided necessary regulation is in place. Other countries have adapted their regulatory systems to maintain safe delivery of medicines by this route. Further reforms to pricing seems to be called for, but must be integrated into a more comprehensive reform of the health sector.

Policy options for consideration

The reader should know that many issues have now been addressed by Germany in recent legislation. For example ownership restrictions have been partially lifted (pharmacists will be able to own up to 4 pharmacies, on a regionally restricted basis) and mail order and Internet pharmacies are permitted under certain conditions.

1. Eliminate the citizenship requirement for certification to practice pharmacy.

There does not seem to be any justification to exclude automatically from the practice of pharmacy all persons who are trained and certified as pharmacists, perhaps even in a German university and pharmacy, but who are not EEA citizens. Any exclusion should be confined to persons trained in a third country where the quality of the training cannot be checked either by Germany or the EU, and where exclusion may be justified for health and safety reasons.

2. Remove pharmacy ownership restrictions and at the same time, prohibit inappropriate or improper interference with a pharmacist's professional conduct.

The ban on multiple ownership of pharmacies should be lifted, and non-pharmacists should be allowed to own a pharmacy. The arguments for maintaining current restrictions seem weak. Owner and non-owner pharmacists are likely to behave according to the same professional standards, and the entry of non-pharmacists into the sector would inject fresh business ideas. A prohibition aimed at reinforcing professional behaviour would provide reassurance on the maintenance of professional standards.

3. Remove the prohibition on advertising pharmacy-only medicines by pharmacies, while ensuring that the advertising remains accurate, is not misleading, and does not tend to bring the profession into disrepute.

Accurate advertising of pharmacies which does not diminish the professional standing of pharmacists, and targets those areas where pharmacies have commercial freedom, would enable pharmacies to attract customers and better satisfy their needs. For example being able to advertise lower prices would help pharmacies to offer these prices in the first place. The advent of mail order/Internet pharmacies which can advertise on the Internet also means the need to establish a level playing field for competition between virtual and traditional pharmacies.

4. Bring authorised EEA mail order/Internet pharmacies into the German pharmacy regulatory framework. Ensure appropriate regulation, oversight and education.

Germany should go ahead with its plans to permit mail order/Internet pharmacies, but at the same time it should ensure that effective and comprehensive regulation is in place to protect the health and safety of consumers. This should include:

- A certification and control process to ensure that standards of pharmacy professional services are maintained, especially as regards authentication of prescriptions and consultation with patients; that delivery is safe and reliable, consumer privacy is protected; and that consumers can identify "safe" pharmacies.
- Specifying the requirements of electronic trading and mail order, and the corresponding quality assurance systems in drugs, pharmacy and advertising legislation, and ensuring appropriate monitoring at national and European level.
- Consumer education to recognise a certified mail order/Internet pharmacy and to understand the safety benefits of choosing to buy only from certified pharmacies, whether traditional or Internet.
- Sharing information and co-operative enforcement of laws and regulations with corresponding regulators in other EEA States and with third countries.

Germany should go ahead with its plans to permit mail order/Internet pharmacies, but at the same time it should ensure that effective and comprehensive regulation is in place to protect the health and safety of consumers. This should include:

5. Eliminate State control of non-prescription medicine prices and permit comparative advertising of non-prescription medicines.

Price competition should trigger price reductions which would benefit both health insurance funds and consumers. Companies that offer lower prices will expand sales at the expense of others, encouraging firms upstream in the supply chain to compete and become more efficient.

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PART II

Chapter 6

Regulatory and Competition Issues in Key Sectors: Telecommunications*

* For more information see: Background Report on "Regulatory Reform in the Telecommunications Industry" available on the Web site: *www.oecd.org/regreform/backgroundreports*.

Context and history

The liberalisation of Germany's telecommunications sector started some time ago

The telecommunications industry is a key part of the German economy and critical to its competitiveness. The government recognises its role in economic development and the fact that a competitive environment is the best way to stimulate private investment, as well as bringing consumer benefits.

Liberalisation started in 1989 when Deutsche Bundespost was split into three, and regulation was separated from operations. The telecommunications arm was partly privatised in 1995, becoming *Deutsche Telekom* (DTAG). Though full privatisation is the long term aim, the State retains a 42.3% holding. Competition in mobile communications began in 1990 with the licensing of a second provider to compete with DTAG. EU legislation aimed at developing a single market in telecommunications promoted further liberalisation in 1998, which abolished DTAG's monopoly on voice telephony, and established the Regulatory Authority for Communications and Posts (RegTP).

Though there are many market players, the ex-monopoly incumbent remains by far the largest company

There are now a large number of operators. Competition to DTAG grew, especially in the early years after 1998, when new operators offered highly competitive tariffs. The number of telephone line providers in competition with DTAG grew from 21 in 1998 to 64 in 2002, mainly in ISDN. The share of new entrants in the national long distance market has increased steadily to 40% (only surpassed by three other OECD countries). However, DTAG remains the largest company (not only in Germany but also in Europe). DTAG has regained market share in international long distance markets as prices have declined and margins for competitors have decreased. DTAG continues to be the main provider of both analogue and ISDN lines, and remains dominant in the local service area with over 95% of the market (though much higher market shares have been achieved by competitors in some urban areas).

In the mobile telephony market DTAG's mobile subsidiary T-Mobile, and Vodafone are the two largest operators with a market share of 41% and 38% respectively in June 2003. The two other providers were E-Plus Mobilfunk and O2 Germany. The mobile market has taken off dramatically since the mid 1990s, with 7.1 subscribers per 100 inhabitants in 1992 rising to 71.7 in 2002 (more than the US and Japan but slightly below the west European average). Third generation mobile has also developed, with six successful bidders for a Universal Mobile Telecommunication System (UMTS) licence in 2000. Their licences require that at least 25% of the population be covered by the end of 2003 (50% by the end of 2005). Germany has been an early mover in awarding Wireless Local Area Network (WLAN) frequencies.

EU law is driving further pro-competitive developments but a rapid move away from ex ante *regulation should be avoided*

EU policies remain a driving force for pro-competitive change. The 1996 German telecommunications law is currently under revision to meet the requirements of the most recent EU directives, which should have been done by July 2003. The government has engaged in wide consultation of industry and interested parties. It has affirmed that it wants to continue to promote pro-competitive policies, staying broadly within the existing framework. It wants to improve the framework and to avoid extending regulation to currently unregulated market segments. Indeed the ministry has said publicly that it wants to move from *ex ante* to *ex post* regulation and towards the application of standard competition principles. This is in line with the new EU framework for communications. However, a rapid move away from *ex ante* regulation seems premature given the continued dominance of the incumbent. Application of the EU's Relevant Markets Recommendation (see below) should help to identify the markets where *ex ante* regulation needs to continue.

Regulatory institutions

The Federal Ministry of Economics and Labour (BMWA) is the policy-maker. The main regulatory institutions are the Regulatory Authority for Telecommunications and Posts (RegTP), and the Federal Cartel Office (BKartA), together with the Monopoly Commission which plays an advisory role.

A regulatory authority has been set up separate from the ministry, but there are concerns over the extent of its independence from political pressures

The BMWA has policy responsibility for the telecommunications sector, which includes drafting and updating the guiding policy principles and regulatory framework for the sector, EU legislation and other international tasks including standardisation issues, spectrum planning (which it shares with RegTP), and the supervision of RegTP. It is responsible for drafting the new Telecommunications Act. RegTP (Box 6.1) is the sector specific telecommunications regulator subordinate to the ministry.

Some concerns have been expressed over the independence of the ministry and RegTP *vis-à-vis* DTAG, in which the government still has a 42.3% share. This gives rise to concerns of possible conflict between the government's interests as shareholder and its role in policy and regulation. DTAG's current debt problems and falling share price may be increasing pressure for a tolerant regulatory attitude toward the anti-competitive conduct of what the government may also consider to be a "national champion". Such concerns can lead to investor uncertainty which only full privatisation can resolve. Questions of RegTP's independence have also arisen especially *vis-à-vis* the ministry. Sceptics can point to RegTP's continued support for the ministry's position on fixed-to-mobile termination charges (see below) which flies in the face of international regulatory opinion on the issue. On the other hand it took a strong stand for competition with the imposition of penalties on DTAG for delays in the delivery of leased lines. A related issue is the Beirat: it is not evident that this advisory body (consisting of representatives from the German Parliament) is necessary to an independent regulator, and it could undermine the perception of RegTP being independent from political influence.

Some other issues arise in relation to RegTP. The competences of its staff may need some adjustment to ensure that it can cope effectively with the demands of growing competition. More transparency and information on its regulatory decisions would be

helpful: for example decisions should be published on its Web site (the rulings issued by Ruling Chambers can be obtained from the office of the Ruling chambers), and the reasons for decisions explained.

The competition authority plays an important role, in close co-operation with the regulator

The competition institutions (see Chapter 3 for more details) complete the picture. The BKartA is the federal competition authority responsible for enforcing the competition law, and focuses on merger control, cartel prohibition and abuse of dominance. For telecommunications, abuse of dominance issues are primarily handled by RegTP under the Telecommunications Act. The Monopoly Commission is an independent "think-tank" which provides the federal government with advice on competition policy. The BKartA is efficient and widely respected, but faces considerable and growing challenges in overseeing the development of competition in industries characterised by monopolistic network cores and powerful traditional incumbents.

In merger cases and cases of legalising horizontal agreements the minister can, under certain circumstances related to wider policy interests, overrule BKartA decisions. This happened recently when the minister overruled the BKartA and allowed an important electric-gas merger (Ruhrgas-E.ON). This decision generates uncertainty about the government's competition stance. Also, the grounds for the decision – to promote a national champion for supply security reasons – raise the question of whether the government's tolerant stance toward DTAG stems from a wish to promote DTAG as a national champion for telecommunications.

The competition and telecommunications laws interact closely, and RegTP and the BKartA co-operate to ensure that a uniform approach is applied, notably as regards findings of market dominance. The telecommunications law provisions on key issues such

Box 6.1. **The Regulatory Authority for Telecommunications and Posts (RegTP)**

RegTP was set up in 1998 (as required by EU legislation) as a structurally separate and independent regulatory authority, "within the scope of business of the BMWA". It is based in Bonn. Its determinations cannot be overruled by the ministry or the minister. However, actions against its determinations may be brought directly before the administrative courts. Its regulatory decisions are published in the Official Gazette.

An advisory council, the Beirat, made up of representatives of both houses of parliament, must be consulted by RegTP on a limited number of issues (not tariffs), and kept informed of RegTP's activities. RegTP's president is nominated by the federal government upon the proposal of the Beirat. RegTP must report to parliament (via the ministry) every two years on the extent to which its regulatory activities have resulted in increased competition.

RegTP's income is determined in the federal government's budget.

RegTP has four main responsibilities in the fields of licensing and frequency regulation; universal service; price regulation; and network access and interconnection. It must promote competition, control anti-competitive practices, and monitor the market.

Its enforcement powers include information and investigative rights as well as sanctions. It can inspect and audit the business records of telecommunications companies.

Some 200 to 220 staff deal with telecommunications regulation.

as interconnection charges and access depend on a finding of dominance flowing from the competition law, which must be agreed with the BKartA. The two organisations' joint assessment of the markets in which dominance has been established is published annually. Also, the BKartA must have the opportunity to comment on RegTP's determinations before they are made. DTAG is considered to be dominant in the market for fixed network voice telephony.

Box 6.2. **Some examples of Germany's reluctance in implementing EU directives**

In April and in July 1999, the EU Commission alleged in an official notice (which represents a first step toward an official infringement proceeding) that Germany had not sufficiently implemented the interconnection directive and the voice telephony directive. With respect to the interconnection directive, the official infringement proceeding was then initiated in November 1999. With respect to the voice telephony directive, no official infringement proceeding was commenced. In both cases, the EU Commission alleged in particular that Germany had not sufficiently ensured the use of appropriate cost calculation systems by dominant providers. In response, RegTP has published guidelines relating to appropriate cost calculation systems.

The EU Commission alleged that Germany had not fully implemented a Commission directive requiring that any telecommunications company with a market share of over 25% be considered as having SMP. Germany's SMP is defined as one-third of market share, but RegTP has announced that, contrary to Germany's general competition law, it will investigate SMP at 25% market share.* The *Bundeskartellamt* was brought into this procedure for drawing up and approving the administrative rule.

In April 2000, the EU Commission alleged in an official notice that Germany had not fully implemented the EU's full competition-directive and the ONP voice telephony directive. Tariff approval procedures did not sufficiently ensure cost-oriented tariffs and there had been inadequate implementation of price re-balancing provisions.

On 30 October 2000, the EU Commission commenced an infringement proceeding alleging that Germany had failed to fully implement the EU interconnection directive with regard to local carrier selection, and on 12 November 2002, the EU Commission brought an action against Germany before the European Court of Justice. The EU Commission alleged that, although the deadline for doing so had expired on 1 January 2000, no carrier pre-selection for local calls was being offered by DTAG. The EU Commission considers that the grounds given by Germany in justification of this are invalid. Call-by-call selection was finally implemented in April 2003 and local call pre-selection in July 2003.

An EU regulation on unbundled access to the local loop entered into force in January 2001. In December 2001, the EU Commission opened an infringement proceeding against Germany (among other member States) for alleged failure to implement in national law EU regulations on unbundling of the local loop. (In view of the approval of a relevant fee for line sharing by RegTP on 15 March 2002, the EU Commission has since closed the proceeding.) In March 2002, the EU Commission announced the commencement of an infringement proceeding against Germany for alleged failure to implement the EU regulation on sub-loop unbundling. Since then DTAG has published an offer for access to the sub-loop that has been approved by RegTP.

* RegTP Official Journal Notice 574/2001.

The EU Commission is an important force shaping the regulatory environment: Germany is often reluctant to follow

Last but not least, EU legislation flowing from the EU Commission is a major force shaping the telecommunications environment, in Germany as in other EU countries. Two major legislative initiatives have been taken recently. The first is a directive that promotes a common regulatory framework for electronic communications networks and services, to address convergence in communications. This must be implemented by EU member States by July 2003. To promote even-handed regulatory treatment the directive requires that markets be defined in accordance with the principles of competition law and aims to reduce *ex ante* sector specific regulation as competition develops. The related "Relevant Markets" recommendation of February 2003 identifies the product and service markets in which *ex ante* regulation may (still) be warranted.

Convergence raises the issue of whether there should be a single regulator (as exists in some other OECD countries such as the UK). The Monopoly Commission has raised this. However, Germany's political structure and constitution would make it difficult to achieve. For example broadcasting content is the responsibility of each of the *Länder*. Effective co-operation is crucial under these conditions, not least to ensure that new services generated by convergence are not suffocated by over-regulation.

Germany shows some reluctance in implementing EU law (Box 6.2).

Regulation

The dominant provider and operators with significant market power are subject to special rules

As the (only) dominant provider of telecommunications services in Germany DTAG is subject to special rules and obligations, including:

- *ex ante* or *ex post* review of tariffs and related business terms and conditions by RegTP;
- the obligation to offer competitors unbundled special network access as well as access to essential services and facilities on a non-discriminatory basis;
- potentially, the obligation to provide universal services in a market;
- the possible inclusion of restrictive conditions in licences.

Operators with significant market power (SMP) are also subject to special rules.

Market entry and licensing: concerns have been expressed over the failure to prevent anti-competitive practices by DTAG

Licensing procedures will be streamlined with the implementation of the new EU legislation. High licence fees (for example euros 1.52 million for a national voice telephony licence) have been a contentious issue, and a new regulation is being prepared following pressure to change from the EU.

There are no foreign ownership restrictions on market participation. However, some new entrants have alleged that Germany is in violation of the 1997 WTO agreement on basic telecommunications which promotes principles for open markets, by failing to prevent DTAG from engaging in anticompetitive practices in a range of areas including pricing and leased line provisioning (see below).

Pricing: DTAG's pricing causes problems for competitors and the regulatory response is controversial

Under the current telecommunications law, end user tariffs of dominant providers are subject to *ex ante* regulation. Price cap regulation is used for standard tariffs. The regulation of optional tariffs takes place through an actual price approval processes. As well, tariffs for universal services must be set at an "affordable price". Other tariffs are not regulated *ex ante*, but the tariffs of dominant providers may be reviewed *ex post*. The law provides for two approaches: a price cap, and individual approvals based on costs. Wholesale access prices are based on the latter, retail prices on the former (using four different "baskets", for example local calls).

The EU Commission has found that Germany's price cap regulation is not sufficiently cost-based, as required under EU law. Price caps are restricting the scope for price rebalancing to reflect costs, which is important for ensuring effective long-term competition, especially in the local market. RegTP agrees that tariffs have not yet been fully rebalanced. A full review of current price cap regulation seems warranted.

DTAG's pricing of its services suggests – not surprisingly – a strong will on the part of the ex-monopoly incumbent to remain the dominant player. The more controversial question concerns the attitude of the regulator to this. Court rulings have added to the climate of uncertainty for competitors to DTAG.

DTAG's pricing of DSL broadband services has been controversial, linked to its dominance in this market (see Box 6.3). Others have found it hard to compete. RegTP investigated DTAG's pricing, and found some elements below cost, but did not take action

Box 6.3. **Local loop unbundling: the DTAG price squeeze**

Competitors have argued that they were being squeezed by DTAG's prices for access to unbundled local loops. DTAG charged new entrants an access price of 12.48 euros; at the same time customers were charged a subscriber line rental of 11.82 euros. This meant that new entrants could not make any money in this market, as the access price they pay is more than they can charge their customers (which must be less than DTAG's charge to customers). RegTP explained that new entrants could upgrade the line so as to offer ISDN lines and charge more. The access price payable to DTAG was reduced to EUR 11.80 on 1 May 2003 as a result of a RegTP decision of 29 April 2003, and the subscriber line rental DTAG charges customers was EUR 13.50 effective September 2003. This addressed the price squeeze problem. In addition, in its ruling of 28 July 2003 RegTP approved Deutsche Telekom AG's increase in the monthly rental for an analogue line to EUR 0.50 (net). This fully eliminated the access deficit RegTP had previously identified.

This issue revealed some weaknesses in the t regulatory framework. The telecommunications law requires cost-oriented pricing for unbundled local loops. But as the dominant incumbent, and given the weak regulatory accounting rules, DTAG has both the incentive and the ability to influence cost calculations in its favour. Also the price cap regime may have been actively preventing DTAG from rebalancing its prices to reflect real costs. DTAG's actual prices compared with other EU countries are reasonable: the monthly rental is about the EU average, and the connection fee is much lower than the EU average. However prices could probably be even lower, given the flaws in the current situation (the difficulty of rebalancing prices to reflect costs).

because a predatory effect had not been proven. Complaints continued and DTAG eventually raised its prices. The sequence of events suggests that DTAG engaged in a predatory strategy to secure the long term market for itself (with initial price cuts to deter competitors, and once this had worked, price increases to recoup the initial losses). RegTP explains that it sought a balance between roll-out and competition: encouraging broadband roll-out by allowing DTAG to charge low prices, but also placing obligations on DTAG to allow equal access to its lines by competitors. The outcome suggests that this was a flawed strategy, as DTAG has now asserted its dominance in this market. DTAG has been accused of "price dumping" in other markets too.

RegTP has also authorised DTAG's bundling of tariffs (AktivPlus) which includes reductions on local calls, national calls and fixed to mobile calls, though competitors say this presents a prohibitive barrier to market entry for long distance network operators. New entrants also face difficulties in the business market where DTAG offers business users large rebates under its tariff schemes. In this case RegTP sought changes from DTAG but the obligation to implement the decision has been suspended by the courts.

A different kind of problem has emerged with DTAG's leased lines. Prices are relatively low, but delivery times had been among the longest in Europe until 2002. For example the delivery for 64 Kbit/s lines has been 90 days, compared with 21 days in France. RegTP has decided to impose a number of requirements on DTAG in response to complaints (including binding delivery times and penalties). But DTAG appealed and the court's decision suspended the obligation to implement RegTP's decision, on the grounds that DTAG is obliged to offer competitors only those conditions which it offers itself internally and that RegTP had the burden of proof for showing this. RegTP's appeal to a higher court was turned down. It should, however, persevere on this issue by requiring DTAG to provide a reference agreement to competitors, and to enhance transparency by publicly reporting data on prices and performance.

Accounting separation: DTAG's cost accounting system needs reform to discourage price discrimination

An underlying problem is DTAG's cost accounting system, which needs reform to discourage price discrimination and cross-subsidisation. Under the current law, DTAG (as dominant operator) must have accounting separation, but only according to the standard accounting rules. The new law should help, as RegTP will be able to oblige DTAG to make its cost accounting methodology (including cost categories) public, and will also be empowered to verify the accounting method. The approach of some other OECD countries (notably the UK and Australia) may be instructive. However Germany's strict corporate laws in relation to disclosure of confidential information are an issue.

In the circumstances it seems very doubtful that Germany should move quickly from *ex ante* to *ex post* regulation. DTAG's pricing strategy shows that it is very difficult to "recall" a dumping price once it is in the market.

Interconnection: fixed to mobile termination charges need to be regulated

SMP operators must publish a Reference Interconnection Offer (RIO), which includes a detailed description of their interconnection offering. They must charge cost-oriented tariffs for interconnection and access, supported by transparent cost-accounting systems, and must comply with the principles of transparency and non-discrimination. An RIO now exists, after considerable delay. Also, element-based interconnection charges have

replaced the old distance-based tariff structure, with the result that DTAG has had to lower its interconnection rates by some 14%. RegTP's interconnection pricing system follows a two -step approach which causes delay. The technical conditions are set in the first step, and tariffs are set in the light of this. A single step procedure would help new entrants by streamlining the process.

Fixed to mobile termination charges may also be regulated, if a mobile network operator is determined to have SMP or if termination to the mobile network has been ordered in an interconnection decision. This has not happened so far. RegTP considers that there is no single operator with SMP and no joint dominance, despite the fact that the two largest mobile providers have a combined market share of about 80%. It also considers that end users encourage competition between the operators, and notes that termination charges are among the lowest in Europe.

This is another controversial stance by the German regulator which contradicts the view of the EU Commission and of a growing number of regulators (including those in the UK, France and Italy) that fixed to mobile termination charges are excessive. Germany (with Denmark and Finland) are the only EU countries that do not regulate fixed-to-mobile termination rates. Recent data indicate that Germany is in sixth position among the EU countries with regard to the level of mobile termination rates. Also, customer-driven competition in this market, according to studies by the UK regulator, appears to be insignificant: most customers do not pay much attention to termination charges. Indeed the UK has concluded that each mobile network operator has a monopoly of call termination on its own network, for technological reasons, and that price cap control of charges is the only likely effective remedy.

RegTP's reasons for not regulating the mobile market are debatable. Some have suggested that its present reluctance to take action stems from existing political concern that a reduction in charges will damage the profitability of the mobile operators (hard hit by the high prices they paid for 3G licences). RegTP considers that competition in the end customer market is a countervailing influence on prices. End-users would react to price increases by shortening their call duration and, in addition, take account of the prices from fixed-to-mobile networks when considering a possible subscription to a mobile operator. However, no evidence has been forward to show that end users are sensitive to the pricing of mobile termination and can influence prices.

Mobile to fixed termination charges also warrant review because of large price differentials that are unlikely to reflect costs.

Interconnection: DTAG is resisting the regulator on provision of wholesale Internet access products

Internet access is now one of the major generators of traffic carried over telephone networks. EU law requires that SMP operators who offer unmetered (flat rate) retail Internet access should offer flat rate wholesale Internet interconnection to new entrants on a non-discriminatory basis. This allows them to compete on fair terms with SMP operators in the retail Internet market. So far, however, RegTP has been blocked in its efforts to require DTAG to offer an appropriate interconnection of this type. DTAG has so far successfully appealed to the courts (the process is not yet completed). The latter have defined non-discrimination as follows: DTAG can only be obliged to offer products to competitors that it uses itself. This is a severe and arguably inappropriate test because an

incumbent running the network may not always need the same product as competitors seeking connection to the network. Competitors fear it could mean that every regulatory decision to oblige DTAG to provide an interconnection product could be denied because DTAG does not use it internally.

Local loop unbundling: an early start has been spoilt by DTAG resistance and an often weak regulatory response

Local loop unbundling is an important method of providing high speed broadband services (such as high speed Internet access and video-on-demand). Though Germany was the first European country to require a form of local loop unbundling (LLU), in 1998, it has lost its lead in particular as regards access by ISPs to the different forms of unbundling, although from the EU perspective Germany still has the largest number of unbundled network access links as measured in absolute terms. For example, most unbundled loops are used to provide voice services, and very few for DSL services. In fact the EU has taken action against Germany for failing to implement the EU regulation on LLU, noting the absence of any published reference offer for access to unbundled local loops. A reference offer for access to the unbundled local loop and shared lines was published by Deutsche Telekom in February 2002 and the proceeding by the European Commission was closed during 2002. A key issue is pricing by DTAG (Box 6.3). Here again the regulator's response raises some questions.

The regulator has stood up more successfully to DTAG (with the help of the courts) on the related issue of line sharing, an EU requirement. RegTP fixed the conditions for line sharing by DTAG in 2001. DTAG challenged RegTP's decision in court, and was twice unsuccessful. The charges finally fixed by RegTP were much lower than DTAG's original proposals: for example a connection charge of 74.91 euros compared with DTAG's proposed 117.73 euros. However take-up of line sharing is so far disappointingly low, against a background of allegations that DTAG is using delaying tactics and not complying with its obligations.

The picture is mixed as regards other related DTAG offerings. Access at the Main Distribution Frame (MDF) level is important to new entrants in order to allow them to make full use of their own network, and to control the technical characteristics of the connection to the end user. Here Germany compares well with some other EU countries. It does less well with sub-loop unbundling, where the EU Commission has started proceedings against Germany's alleged failure to implement the relevant EU Regulation. RegTP has not yet mandated DSL bitstream access (which enables a new entrant to provide unique features to its customers, control quality of service and hence differentiate its services from those of the incumbent) despite DTAG's dominance of the DSL market. The reason is that RegTP can only issue an order for a bitstream product if required to take action by a new entrant requesting access. To date this has not happened.

Collocation has started to happen (at about 33% of DTAG's 8 000 sites). But new entrants still experience problems. DTAG recently obtained a court injunction to stop the implementation of a RegTP decision setting time limits for the delivery of unbundled local loops and collocation.

Wireless services: some regulatory progress is being made in support of more competition

Several competition-enhancing regulatory issues should be noted in connection with the wireless sector.

The current policy for spectrum is to "use it or lose it". A licence can be revoked if it is not being used after a year. RegTP has also made clear that existing mobile operators will not be allowed to merge or trade frequencies. So merging UMTS operators will only be able to keep one of their licences. However the new telecommunications law will allow spectrum trading *i.e.,* the freedom for operators to resell portions of spectrum to other companies, under certain conditions.

The cost of deploying UMTS infrastructure is a growing issue, with the current unhelpful investment climate. Infrastructure sharing is one solution. RegTP has ruled that infrastructure sharing of wireless sites and masts etc., is permissible, and this should help the further roll-out of UMTS networks by new entrants. Several mobile operators have already announced infrastructure sharing agreements.

Mobile Virtual Network Operators (MVNOs) are another way of injecting competition into the mobile sector, which suffers from scarce frequency resources. MVNOs use other operators' frequencies without owning or operating these. For this they need access, but under the current law access can only be mandated for operators which have been determined to have SMP, and RegTP has not done this. However, in Germany 10 service providers with no networks of their own (with a market share of 27% at the retail level) compete with network operators at the retail level.

Numbering and number portability: roaming raises concerns which need to be addressed

RegTP is responsible for numbering functions. Fixed number portability was introduced in January 1998. It is currently free of charge to the customer (*ex ante* regulated cost-based charges may be introduced). Mobile number portability was introduced in November 2002 (current rules do not mandate portability between second and third generation networks – GSM and UMTS).

Roaming has been the subject of investigations by the BKartA and the EU Commission. The BKartA was concerned about the competition effects of an agreement between two of the mobile operators but has allowed it to continue until the end of 2003 because of concern that without the agreement, one of the operators would have to leave the market (which is already very concentrated with just four operators). The EU Commission has found serious competition concerns regarding pricing practices, notably in the UK and Germany, which may result in significant fines. For example German operators may have illegally fixed the wholesale prices they charge other operators.

EU legislation requires national authorities to assess whether wholesale roaming markets are competitive and if not, introduce regulation. RegTP is starting its assessment later than many other EU countries, which yet again suggests a reluctant rather than enthusiastic compliance with EU law, and an equivocal attitude toward encouraging greater mobile competition.

Carrier selection and pre-selection: Germany lags the rest of the EU for the local market

Carrier selection (call by call) and carrier pre-selection are available in the fixed network for long distance calls, international calls and calls to mobile networks, but were not implemented to meet the deadline of January 2000 for local calls. According to the EU, Germany is the only country that had not yet done this by the beginning of 2003. Legislation to introduce it has been adopted by parliament, but RegTP has deferred its

introduction, accepting DTAG's argument that there are technical barriers to rapid introduction. Carrier selection and carrier preselection in the local call market were finally introduced on 25 April 2003 (call by call) and preselection on 9 July 2003. Delays initially built up after 9 July 2003 as a result of the large number of applications. The backlog has now been cleared, however, as DTAG, also at RegTP's behest, deployed staff from its special service agencies between 9 July 2003 and 31 August 2003 to switch over some 1 million lines. RegTP now has no more complaints to hand from the competitors.

Although to date RegTP has not received any formal complaints on win-back, strong "win-back" campaigns from incumbents have been a problem in some member States and an important *ex ante* measure would be to impose a priori requirements on DTAG to prevent it from doing this.

Rights of way: legislation is in place to help new entrants

The telecommunications law sets out principles for facility-sharing and access to private land. If new operators seeking to set up a new line face insuperable difficulties or unacceptable costs, the operator of an existing line using public rights of way may be required to allow the new operator joint use of its installations, under certain conditions.

Universal service: Germany relies on the market, and DTAG is the de facto provider

The Constitution requires the federal government to ensure that there is sufficient and appropriate nation-wide provision of telecommunications services. The current telecommunications law defines universal services as "a minimum set of affordable telecommunications services for the public in respect of which quality levels have been defined and to which every user must have access, irrespective of his place of residence or work". More details are set out in an ordinance. If the universal service can only be provided at a loss, RegTP can invite tenders for its provision, the cost of which must be compensated by all operators with a market share of at least 4% of the relevant market. If nobody volunteers, RegTP can require the regionally dominant licence holder to provide the service (this has not happened yet). DTAG is the *de facto* universal service provider. The government expects that the market will continue to be able to provide adequate universal services.

EU legislation requires examination of the extent to which universal service objectives have been achieved and will be achieved in future. This has not been done in Germany. With the introduction of the new EU regulatory framework (of which universal service is one of four major strands), it is particularly timely for RegTP to review and report on universal service targets and achievements in Germany.

The delivery of broadband services to less favoured regions is an issue (not just in Germany), as it may not be economically viable to roll these out in areas that are, for example, sparsely populated. But in contrast to a growing number of OECD countries, no systematic evaluation of this issue has taken place.

Quality of service: there is not enough pressure on market players, and not enough information to consumers

Two ordinances set out the quality of service activities to be undertaken by RegTP. However it is not an "active" system: reliance is placed on the market, and there are no specified targets, and hence no sanctions. This contrasts with some other OECD countries (*e.g.,* Australia, UK, US) where targets are set. Service providers and operators must provide

information to RegTP and this is published in RegTP's Official Gazette. These arrangements are not enough to ensure an effective flow of information to consumers.

Consumer issues: a more pro-active approach to consumer interests should be implemented

An ordinance covers the rights and obligations between telecommunications providers and their customers. RegTP provides a conciliation service but does not take decisions. The government's view is that conflicts (whether by industry or consumers, no distinction is made) should be resolved bilaterally between the parties, with the courts as a last resort. The main complaints to RegTP in 2002 were (in order of importance) unsolicited direct marketing, bills, numbering and charges. There are rules to ensure clear billing (for example the charges of other providers must be listed separately) though further improvements could be made. Consumer provisions overall are, however, relatively weak compared with best practice elsewhere and should be strengthened. An industry code of conduct could cover issues such as financial compensation and time limits for dealing with complaints. RegTP could also encourage the development of user groups to represent small consumers, again following the example of other OECD countries. Also, RegTP does not publish as much market information as some other OECD regulators and should define performance targets (see above) so that consumers can make comparisons.

Broadband and cable development: this raises some concerns

Broadband is recognised to have a particularly important place in communications development. This is an issue of some concern as regards Germany (Box 6.4). The take-up of broadband services is relatively disappointing. It is mainly via DTAG's DSL lines and DTAG dominates Internet service provision. Alternative cable broadband services play a relatively minor role so far.

Regulation and the courts: delays and blockages of regulatory decisions are a serious problem

A key problem in the German regulatory environment is the time it takes to implement regulatory decisions. Though the law says that RegTP decisions stand pending appeal, DTAG can and has successfully used the courts to suspend the obligation to comply, and in practice RegTP refrains from implementing decisions pending a decision by the courts. Many rulings have been contested over months or even years, as they work their way from a lower court to a higher one (there are three potential stages). An example is line-sharing which took over two years to resolve (Box 6.5). About 210 court cases are pending today. Germany's confidentiality rules add to the delays: key data cannot always be submitted by RegTP to the courts to justify its decisions. An attempt has been made to address this problem but does not appear sufficient.

Though RegTP has been successful in many cases, it has lost cases on important issues (Table 6.1).

RegTP can also be slow to act, leaving issues to be fought out between DTAG and competitors through the courts. This happened with resale of DTAG's network subscriber services to other operators (Box 6.6).

Box 6.4. **Broadband and cable: their importance and development in the OECD and Germany**

Governments worldwide recognise that wide availability and take-up of broadband (high bandwidth communication services including high speed Internet access) play a key role in economic growth. A number of technological platforms can provide broadband services. These include:

- digital subscriber lines using existing copper wires (DSL);
- co-axial cables of television distribution networks (cable);
- broadband satellite access;
- broadband fixed wireless access (FWA) or wireless local loop (WLL);
- mobile higher bandwidth access (3G/UMTS);
- fibre optic networks to the home (FTTH);
- powerline (using the electricity grids).

DSL is currently the most important broadband platform: the government has encouraged the take-up of this particular technology. DTAG is by far the biggest provider of broadband DSL services, with 3.7 million lines installed as of mid-2003, compared with 250 000 by new entrants. Over 90% of access lines had been upgraded with DSL capability by the end of June 2002. But only 10% of households had subscribed by the end of 2001 (though this is expected to rise).

Relative to some other OECD countries, other broadband technologies do not play a significant role. Of considerable concern is the insignificant role played by cable. Cable passes 68% of households. But as of mid 2002 cable broadband services were available to only about 0.4% of households. Cable networks are a prominent feature of broadband access in the US and some European countries such as the UK and the Netherlands.

Germany's performance on broadband services compared to other OECD countries is relatively poor, especially given its size. It ranks 14th in terms of subscribers per 100 inhabitants, a little ahead of France and the UK, but behind Korea and Canada (the top two), the US and Japan as well as a large number of smaller European countries. DTAG has around 92% of the whole broadband access market (though competitors' market penetration is higher in some areas).

A disappointing cable performance is part of the problem and there are several reasons for this. Uniquely, Germany separates licensing and ownership between so-called Level 3 (cable distribution network up to the connection point) and Level 4 (domestic distribution network), which has inhibited investment and development in cable. Also DTAG, which until recently owned most of the cable networks, may have had little incentive to develop cable, as this would undercut revenue from its fixed line telecommunications service. More generally the unhelpful investment climate for technology may have aggravated the slowdown of investment in German cable.

EU legislation requires the structural separation of the telecommunications and broadband cable activities of dominant operators. After considerable delay, DTAG has now sold all its cable networks. This has removed an important barrier to the upgrading of the network. The government has said that it wants to establish cable as an alternative telecommunications infrastructure, including for high speed Internet access. It has commissioned a review on the barriers to cable development.

Box 6.5. **Enforcing the line sharing decision**

October 2000: Application of QS Communications to RegTP.

January 2001: EU obligation that line-sharing be offered in Germany.

March 2001: RegTP instructs DTAG to offer line-sharing within 2 months. DTAG challenged the decision in the Courts but was rejected twice (by the Cologne Court in 22 June 2001; by the Munster Court on 23 August 2001).

May 2001: RegTP obliges DTAG to offer line-sharing, refusal of DTAG.

July 2001: Summary proceeding at regional administrative court in Cologne; court obliges DTAG to offer line-sharing, appeal by DTAG.

August 2001: The higher administrative court in Munster obliges DTAG to offer line sharing.

March 2002: RegTP approves the line-sharing prices.

Table 6.1. **Some important decisions made by RegTP that have not been implemented because of DTAG's court appeals**

RegTP decision	Date of RegTP decision	DTAG action and result	Implemented?
DTAG obliged to provide wholesale flat rate Internet access (FRIACO)	11 June 2002	DTAG successfully appealed decision to Cologne Court resulting in injunction against obligation to provide FRIACO. Decision confirmed in February 2003 by Higher Administrative Court in Munster.	No (as of 22 April 2003)
Mandatory provisioning times for leased lines and automatic penalties for late delivery of local loops	March and May 2002	DTAG appealed to Cologne Administrative court which suspended the RegTp decision on 12 November 2002.	No (as of 22 April 2003)
RegTP ruled that DTAG's TDN or T-VPN tariffs for business users be replaced by authorised tariffs	15 October 2001	On 13 December 2001, the Cologne Administrative Court suspended implementation of the decision; this ruling endorsed by the Munster Higher Administrative Court on 13 March 2002 leaving business users with legal uncertainty about their contract terms.	No (as of 22 April 2003)
Ex post review of DTAG's prices for "closed user groups" voice communication services (as TDN or T-VPN)	9/10 December 2002	On 13 December 2001, Cologne Administrative Court suspended implementation of these decisions; the ruling has been confirmed in September 2003 by Münster Higher Administrative Court.	
On 17 April 2002 – in response to the EU Numbering Directive requiring pre-selection by January 2000 – the German Federal Parliament passed legislation to introduce carrier pre-selection and "call-by-call" in local networks starting 1 December 2002.	Legislation passed in April 2002	DTAG appealed. On 24 February 2003, RegTP announced that "for technical reasons" call by call in the local network would not be obligated until 25 April 2003, and 9 July 2003 for carrier pre-selection.	Yes, since 25.04.03/09.07.03.

Source: OECD.

Box 6.6. **Resale: the DTAG and Debitel case**

Resale. In March 2001, RegTP issued an order requiring DTAG to present an operator, Debitel, with an offer for resale of DTAG's subscriber network services (*i.e.*, subscriber lines, local calls and city calls). DTAG challenged the order before the Cologne Administrative Court and sought a preliminary injunction against the implementation of this order. The Court denied the request for a preliminary injunction and in October 2001 the Munster Higher Administrative Court upheld this decision. In February 2002, the Appellate Administrative Court in Munster rejected an appeal by DTAG obligating the company to make a resale offer to two companies, riodata and Tele2, and other companies upon request. However, in November 2002, Debitel announced it had decided to abandon the negotiations with DTAG saying that the companies' positions were too far apart. RegTP discloses that it had left it to Debitel and DTAG to "reach agreement themselves as far as possible, and had eschewed setting any pricing or other targets in order to give the parties maximum scope".*

* "Clear direction for the telecoms market", RegTP Press Release, Bonn, 30 March 2001.

Performance

Performance varies from reasonable to good

Regulatory reform is expected to yield positive benefits. For telecommunications the benefits can be assessed in terms of a number of factors: network development, competition, prices, revenue growth, quality of service, productivity, benefits to the community and economy, and Internet development. These are reviewed below.

Network growth and modernisation. The figures are impressive. DTAG has made substantial investments in its telecommunications networks since 1990, including a new network in eastern Germany after re-unification (Box 6.7).

Box 6.7. **Modernising the telecommunications infrastructure in eastern Germany**

DTAG devoted considerable effort to expanding and modernising telecommunications infrastructure in the former East Germany where telecommunication facilities were obsolete. In 1989, one year before re-unification, there were only some 100 lines for east to west traffic, but by the end of 1991, there were more than 30 000 lines. Between 1990 and 1997, DTAG implemented its so-called "Telekom 2000" development programme to provide a phased build-out and complete digitisation of east Germany's supply network, complete local network upgrade, introduction of mobile services and broadcasting coverage parity for the eastern German States. During this time, DTAG invested EUR 25.5 billion and installed 120 000 km of optical fibre as well as 276 000 km of copper cable. Digitisation and the use of optical fibre have given east Germany one of the most modern telecommunications networks in the world. In the first three years of its "Telekom 2000" development programme, DTAG alone accounted for around 10% of total economic investment in east Germany.

By 1994, mobile rollout (C and D1 networks) was practically complete. A wide range of mobile and data services was available across the country and a further 4.6 million households were connected to modern cable television networks.

DTAG's fixed line network incorporates the latest technology, and some 90% of lines have been upgraded with DSL capability. Its capital expenditure grew sharply at the end of the 1990s but has since fallen. A small but growing share of investment is by competitors. Overall, it is estimated that over 20 billion euros has been invested since liberalisation.

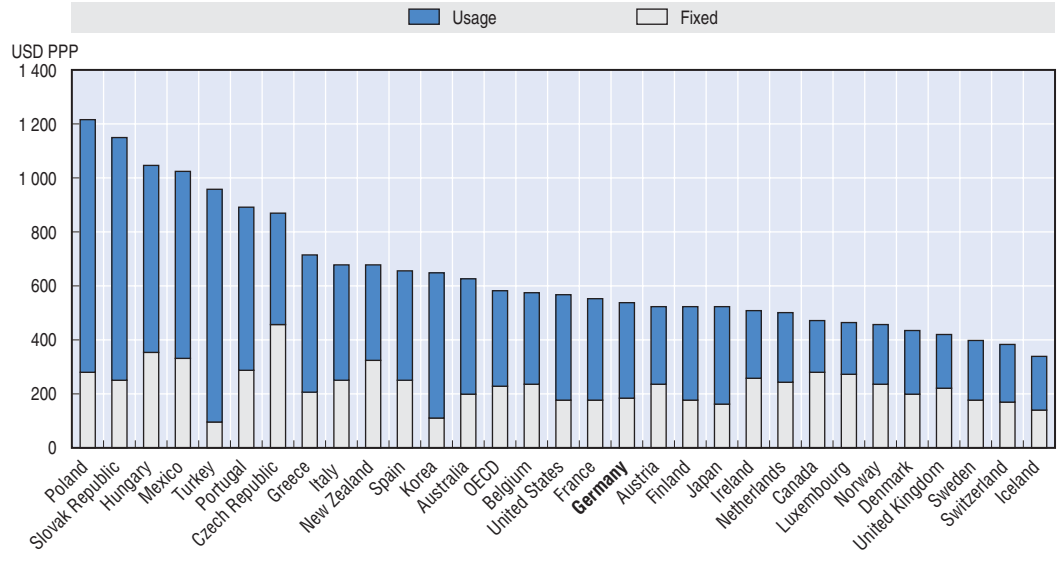
It has been estimated that investment in building out the UMTS infrastructure could amount to some 20-30 billion euros, but prospects for this investment are now uncertain.

Competition. Competition has grown strongly in the provision of long distance and international services. As of 2001, DTAG's share of the national long distance market had fallen to 60%. But competitors only had 4.4% of lines in 2002 (with DTAG providing some 96.6% of DSL lines). That said, competition has emerged much more strongly in some local networks. RegTP estimates that some 47% of the 188 German cities with over 50 000 inhabitants are able to switch from DTAG to some 64 "city carriers" (local utilities, banks etc., that were already active in their area). These carriers offer a wide range of services from public voice telephony to Internet access, with some offering "carrier's carrier" services such as dark fibre.

Prices. Prices for international long distance calls have fallen sharply since liberalisation, by as much as 95%. National long distance calls are also much cheaper: some weekday calls are only about 7% of what they used to be. Prices for a basket of household telecommunications services are similar to the OECD average (Figure 6.1). The same is true of business services (Figure 6.2).

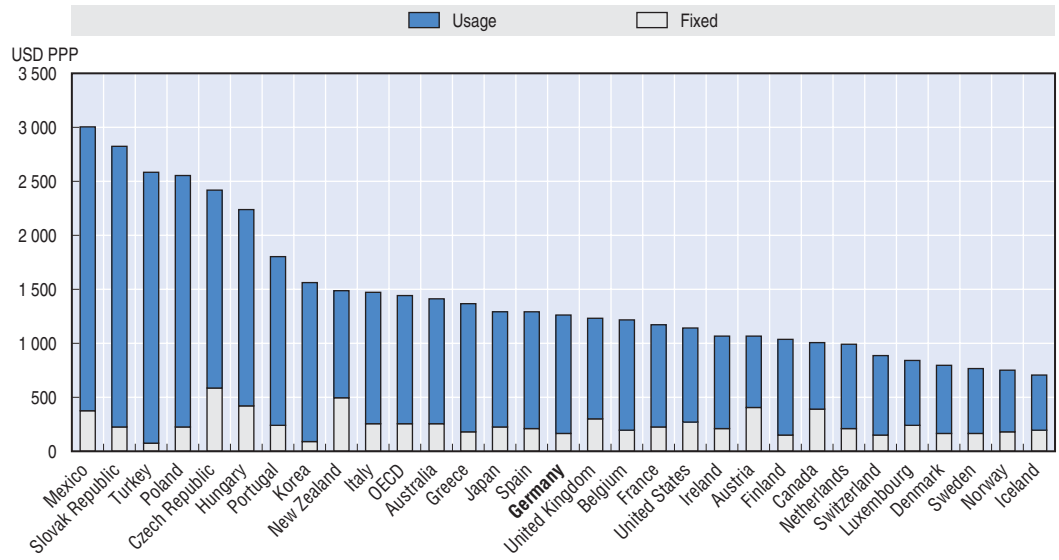
Mobile prices are also middle of the OECD range. However prices for low users are relatively high. Prices for mobile services have fallen by almost 60% since 1995, which has both resulted from and contributed to increased demand in this sector. Increasingly, mobile phones are competing with DTAG's traditional fixed line voice telephony services, especially local calls.

Figure 6.1. **OECD composite basket of residential telephone charges (including VAT), August 2002**



Source: OECD.

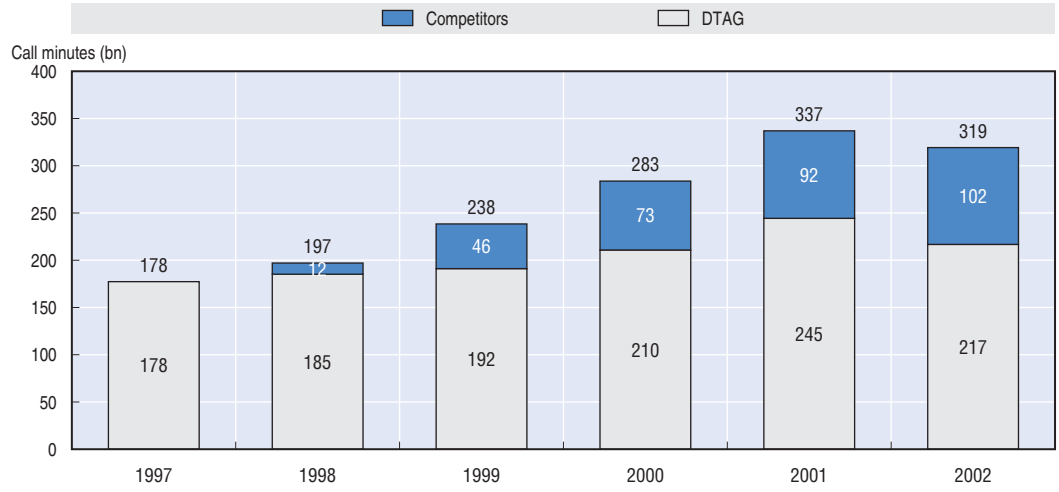
Figure 6.2. **OECD composite basket of business telephone charges (excluding VAT), August 2002**



Source: OECD.

Revenue. Total revenue has grown strongly between 1998 and 2002, but with significant variations between categories. Revenue from access provision and calls has been declining, whilst revenue from interconnection charges and mobile telephony has been growing strongly. DTAG's international net revenue increased significantly after liberalisation, but its net income has fallen substantially (including a massive net loss in 2002). Its revenue from the traditional fixed network voice telephony business has declined since market opening, partly because of competition in the long distance voice telephony business, but also due to the increase in mobile telephones. The market share of new entrants in the fixed network continues to grow, though DTAG still retains over half of it (Figure 6.3).

Figure 6.3. **Call minutes in the fixed network, 1997-2002**



Note: Figure for 2002 is provisional.

Source: RegTP *Annual Report 2002*, available at *www.regtp.de*.

InternetCompetition (see above) has led to sharply declining tariffs. The revenue from mobile companies has been growing, as they roll out new services.

DTAG has a substantial debt problem (Table 6.2). A declining trend was reversed in 1999, in large part due to the purchase of UMTS licences but also due to acquisitions. DTAG has since been making strenuous, and quite successful, efforts to reduce debt through asset sales and cost savings. It should be underlined that the debt problem is due to DTAG's investments rather than liberalisation, as net revenue increased sharply following liberalisation.

Table 6.2. **Trend in DTAG's Debt**

Billion EUR

1996	1997	1998	1999	2000	2001	2002
51.1	44.9	39.9	42.3	60.4	67.0	63.0

Source: Deutsche Telekom, *Annual Report 2002*.

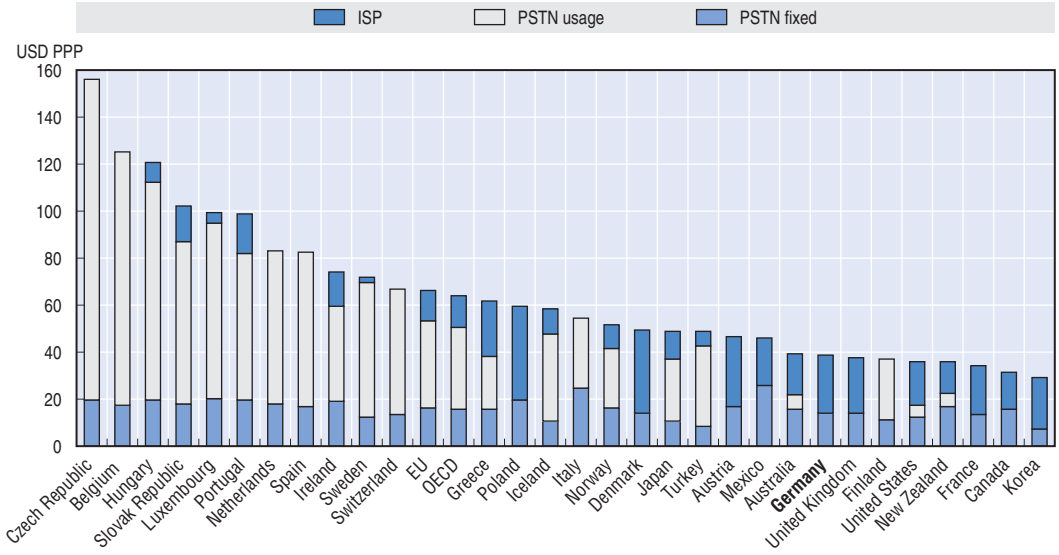
Quality of service. This has improved significantly. Technological developments play a large part in this, but also competitive pressures. As noted, information to consumers could be improved.

Productivity. As elsewhere, labour productivity has grown: a combination of rapid network growth and a slower growth in the workforce. The number of access lines per employee increased more or less steadily from 1992 onwards. Revenue per employee in the sector also grew overall from the early 1990s. RegTP should require DTAG to publish productivity estimates to help in setting the price cap, and should develop its own work on productivity.

Benefits to the economy and community.Germany is broadly similar to other countries. The telecommunications and postal services sectors are economically important. They account for 1.9% of the gross production value, and 2.4% of the gross value added of the economy, telecommunications accounting for much of this. As well, there are knock-on effects for competitiveness and economic performance arising from an efficient, good quality telecommunications sector. Consumers gain from this, and not least from the big fall in prices for long distance and international services. Accelerated network development has created employment, with multiplier effects in other industries. Overall employment (DTAG and competitors) was a little higher in 2002 than in 1998, though considerable downsizing by operators is now taking place.

Internet developments. Germany has one of the largest number of Internet users, and there is rapid growth. Consumers have a good choice of tariffs and access packages. Residential consumers have relatively low access prices. The price of a basket for 40 hours of day time Internet access was eighth lowest in the OECD in 2002 (Figure 6.4). Broadband services (see Box 6.7 above) are mainly via DSL lines. About 10% of households have subscribed to broadband so far.

Figure 6.4. **OECD basket for 40 hours of Internet day-time use**



Source: OECD.

Conclusion

Effective pro-competitive regulatory reform of the telecommunications sector has been successfully tested across many OECD countries: it can make a major contribution to growth and innovation across the whole economy. Germany has made a good start, emphasising the importance of developing competition. Today it has in place a high quality, technologically advanced telecommunications infrastructure with high penetration rates for both fixed lines and wireless. Broadband access is widely available via DSL lines. Market entry is relatively easy, and local operators are providing effective competition to the incumbent in a large number of German cities. Adequate resources have been made available for regulation, and the competition authority works closely with the regulator in overseeing the market.

But five years on from full liberalisation in 1998, the regulatory framework needs careful review. Is it really capable of delivering sustained competition? The incumbent, DTAG, is regaining lost market share in some market segments such as international long distance, consolidating its lead in important new markets such as DSL broadband services, has in effect slowed the roll-out of cable broadband services, and has successfully challenged the regulator's authority on key issues such as pricing and leased line provisioning. Allegations of DTAG's anti-competitive practices are rife. The current review of the telecommunications law is timely. However Germany should strengthen the existing *ex ante* regulation in many areas so that it can deal effectively with the competition weaknesses that have emerged in recent years.

The failure to formulate and implement effective rules for competition promptly and effectively is the most serious weakness of the current regime. The regulator has sometimes been reluctant to act: fixed-to-mobile termination charges, and DTAG's pricing of DSL broadband services are cases where RegTP's arguments for not intervening are difficult to support. The implementation of EU law has also often been slow and reluctant. These cases raise concerns over the regulator's independence from government pressure,

which could be addressed by a full privatisation of DTAG. But more often the problem is delays generated by the courts as DTAG systematically challenges the regulator's decisions. Nearly all major decisions have become bogged down in lengthy court appeal processes. Lack of clarity over the regulator's powers in the current telecommunications law does not help. This problem needs urgent attention.

Policy options for consideration

1. Specify clearly in the new telecommunications act the regulatory powers conferred on RegTP and remove ambiguities in the law.

The revised law must articulate clearly the powers conferred on the regulator, and remove ambiguities in the law. This should include powers to apply sufficiently severe penalties when DTAG abuses its dominant position. The law should also be clear that, as well as discriminatory conduct, *hindering* new entrants should be curtailed/prohibited. (This provision is, helpfully, in the new draft law and should be retained). Where RegTP has the right to intervene, the courts should not have to overrule its decisions because of ambiguities in the law.

2. Streamline and shorten the lengthy court appeals process.

In a fast moving communications market it is important that disputes and the uncertainties they create are resolved rapidly. The regulatory regime must include disincentives against the use of excessive delaying measures by DTAG through the legal appeals process and other tactics. The opportunity for judicial review of decisions by a regulator is important. But judicial review should not be allowed to become a mechanism to routinely block or delay the application of sound regulatory decisions. Appeals have resulted in a current backlog of hundreds of lawsuits challenging RegTP rulings. It is essential that RegTP is granted adequate statutory authority to implement and enforce its decisions, and that the courts have the statutory authority to hear appeals in a timely manner.

A number of options could be considered by Germany. Increasing court staff would allow appeals to be heard more quickly. Changes to the system could be considered. For example the system could be changed so that telecommunications cases are heard in the civil courts, which cover competition authority cases, rather than the administrative courts. The number of appeal courts could be reduced.

Measures to shorten and streamline the court appeals process are suggested in the new telecommunications act.

3. Proceed with the full privatisation of DTAG as soon as possible under transparent and non-discriminatory conditions (or at least announce a firm schedule for full privatisation).

Questions raised about the independence of the regulator can lead to investor uncertainty that will only be definitively dispelled if the regulator's decisions are truly independent of the government and the Ministry of Economics and Labour. The full privatisation of DTAG would help in dispelling some of this uncertainty.

4. Review the role of the Beirat with a view to its removal.

The existence of the Beirat – consisting solely of politicians – within the formal institutional structure of RegTP, can sharpen concerns about RegTP's independence from political influence, despite protestations to the contrary. It is not evident that such an

advisory body, comprised of politicians, is necessary to an independent regulator. If an advisory body were considered necessary, it should have a broader and more representative base, especially of consumer interests.

5. Ensure timely provision of leased circuits at cost-oriented wholesale prices, including an obligation on DTAG to commit to a reference agreement for competitors.

New entrants should be able to obtain timely access to leased circuits at wholesale cost-oriented prices. This would help ensure effective access to local markets and facilitate the development of local competition. RegTP should persevere with its efforts to effect the inclusion of deterrent contractual penalties to reduce delays in the contracts for the provision of leased lines and local loop unbundling. The new telecommunications act should include a provision for RegTP to levy fines on operators of a size that acts as an effective deterrent. At the least RegTP should require DTAG to publicly report data on leased line prices and performance, including data that indicates performance differences between the delivery of services to DTAG's own retail operations and to competitors. In this context RegTP should be provided with the legal authority to obtain and publish data which in its view is in the public interest and would help improve competitive conditions.

6. Ensure that prices are rebalanced as rapidly as possible with a specified and transparent schedule for achieving this goal.

The development of competition and local loop unbundling requires that prices are rebalanced. RegTP and DTAG need to agree on a target date to achieve rapid rebalancing.

7. Streamline and simplify the price cap system.

The price cap system on end user prices is too complicated and has inhibited price rebalancing. It should be abandoned or at least simplified by abandoning the four sub-cap baskets in favour of a single basket that would allow rebalancing to occur more quickly, while reducing the overall average level of prices for consumers. Price caps on services in the competitive national long distance and international call markets should be removed.

8. Strictly enforce regulatory provisions concerning accounting separation.

Accounting separation is an important regulatory instrument. Under the provisions of the Telecommunications Act, DTAG (as the dominant operator) is required to practice accounting separation. But this requirement is not being adequately enforced, and DTAG is required only to apply Germany's standard accounting rules.

9. Carry out an independent review of mobile termination charges as soon as possible.

RegTP has concluded that the German mobile market is competitive and that fixed-to-mobile termination charges do not need to be regulated. This position is in sharp contrast to that of a growing number of regulators who consider that these charges have been excessive in their countries. An independent review of the mobile market should be conducted as soon as possible. Regulatory controls should be applied immediately to mobile operators that are found to be dominant or jointly dominant in termination markets.

10. Allow spectrum trading, subject to appropriate conditions.

Spectrum is of increasing importance. The government should promote efficient spectrum management and the availability of spectrum for innovative solutions. It should commission an independent review to advise on spectrum management, including further action to ensure that all users, including non-commercial users, use spectrum in the most efficient way. It is important to implement the provisions foreseen in the draft Telecommunications Act allowing for spectrum trading should be permitted, subject to appropriate conditions.

11. Establish a regular review mechanism for telecommunications regulations, to ensure that they are achieving their intended purpose and that they can be, if necessary, streamlined.

The government's resolve to minimise regulation and to move as quickly as possible from *ex ante* to *ex post* regulation is commendable in the right circumstances. Decisions in this direction will need to rest on improved information and regular market monitoring to judge regulatory effectiveness. RegTP should define performance indicators for evaluating the development of effective competition, and obtain and publish data on these indicators on a regular basis. It should also report on the time taken to handle a complaint.

12. Identify and publish information, including quality of service targets, that will help consumers to make informed choices.

Competition provides consumers with a choice of service providers, but in order to exercise this choice effectively they need information from a reliable source that enables them to compare prices, quality of service etc. This is already done in several OECD countries via quality of service targets. Such targets also expose service providers to "benchmark" competition: a company will be under pressure to demonstrate the superiority of its services. Timely and up-to-date information is also important: publication of information should be prompt.

13. Initiate a review to identify ways of addressing barriers to the development of cable as an alternative source of telecommunications services, including high speed Internet access.

Infrastructure competition is critically important. With the sale of DTAG's cable interests, a major barrier to the development of a competitor (or competitors) using alternative technology to copper wires no longer exists. The government should follow-up on its report of May 2003 addressing the development of cable networks to ensure these networks' development as a source of telephony and broadband high speed Internet access, and the policy options for addressing these barriers.

14. Constrain DTAG from engaging in win-back campaigns to recover a customer for a period of four months.

There must be effective implementation of carrier selection and pre-selection in the local market. In this context, a problem in some OECD countries has been strong win-back campaigns from incumbents. Germany should take pre-emptive measures against this.

15. Initiate a study to identify barriers to broadband deployment and take-up, especially in less favoured areas, and the policy options for addressing these barriers.

A related issue (to universal service) is the delivery of broadband services to regional, remote and rural areas. Features such as a low population and revenue base are a big disadvantage for an industry based on economies of scale. But again, Germany does not appear to have carried a systematic evaluation of the "broadband digital divide". The main reliance is, sensibly, on market forces. But market deficiencies may exist and need to be addressed by the government.

16. Assist the development of a consumer voice and consider the introduction of a formal industry code of conduct to promote consumer interests.

The interests of residential and small business consumers appear to be weakly represented. RegTP has a mandate to safeguard the interests of consumers. It should encourage, even assist, the development of more effective consumer representation. This could, as in a number of OECD countries including the UK and Australia, include financial support. Consideration could also be given to fostering the use of an industry code of conduct, provided that the regulator is vigilant in ensuring that DTAG complies.

17. Reprofile RegTP to boost its skills in monitoring and addressing anti-competitive conduct.

Developments over the last few years underline the fact that DTAG is bent on finding ways of maintaining its market dominance, and has been able to get away with various forms of anti-competitive conduct. The regulatory staff must be equipped to deal with this effectively. The competition authority also plays an important role, not least through the abuse of dominance provisions of the competition law. It too must ensure that it has adequate staff and skills to address issues related to the development of competition in the challenging circumstances of the network industries.

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APPENDIX

Appendix Tables

Table A.1. **Sectoral regulatory reform in Germany**

Industry	Key legislation/regulatory framework	Regulation on prices	Regulation of entry and exit	Other regulations	Remaining regulations on prices, entry, exit	Other remaining regulations
Telecommunications	Fully open to competition since 1.1.1998. Competition-oriented regulation in principle covers all telecommunications markets.	Sector regulator (RegTP) controls the market on *ex ante* and *ex post* basis.	Free entry and exit. (Proof of reliability and professional qualification); access regulation (interconnection, essential services).	Carrier-selection and pre-selection for local calls introduced by law since 1.12.2002, implementation of CbC 1.5.2003, pre-selection in summer.		Universal service obligation exists but without practical impact.
Electric power	Market liberalised in 1998. All customers free to choose supplier. Conditions for network access determined by Associations Agreements. *Ex post* control through BKartA/courts. Introduction of regulatory authority planned.	No *ex ante* regulation. Abuse control by BKartA/courts on the basis of competition law and/or the Act Against Unfair Competition. Tariff approval (small consumers via low voltage electricity networks) by State agencies (relevant for retailers, who are also entitled to special contracts).	Supply of electricity does require specific approval (however, specific activities are not included); reasons for non-approval are legally fixed. No specific regulations for exit.	Minimum quotas for "green" electricity purchased at regulated prices, compensated by fee on some consumers.		Universal service obligation exists but without practical impact.
Natural gas	Market liberalised in 1998. All customers free to choose supplier. Conditions for network access determined by Associations Agreements with quasi legal status. *Ex post* control through BKartA/courts. Introduction of regulatory authority planned.	No *ex ante* regulation. Abuse control by BKartA/courts on the basis of competition law and/or of the Act Against Unfair Competition.	Supply of natural gas does require particular approval (however, specific activities are not included); causes of decline for approval are legally fixed. No specific regulations for exit.	Notification of long-term natural gas supply contracts (longer than 2 years).		Universal service obligation exists but without practical impact.
Insurance and banking	Liberalisation of insurance market in 1994. Abolishment of insurance monopolies and *ex ante* control of insurance products. Phasing out of State guarantees for State-owned banks by 2005.	None.	Comprehensive licensing requirements and on-going financial supervision in compliance with globally accepted core principles including minimum capital requirements and professional qualifications. Supervisory powers include withdraw of licence.	On-going financial supervision in compliance with globally accepted core principles. New Federal Financial Supervisory Authority effective 1 May 2002 for banking, insurance, securities/asset management supervision with involvement of the Central Bank in the on-going supervision of banks.		Some agreements among health insurance funds are not covered by the competition law.

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Table A.1. **Sectoral regulatory reform in Germany** *(cont.)*

Industry	Key legislation/regulatory framework	Regulation on prices	Regulation of entry and exit	Other regulations	Remaining regulations on prices, entry, exit	Other remaining regulations
Railways	State monopoly transformed into joint stock company in 1994. Partial unbundling of infrastructure and train services in 1999. Currently guidelines of EU (first railway package) and results of task force of government "Future of railways" are put into practice.	Supervision by Federal Railway Office (mainly technical issues and track access and abuse control by BKartA *ex post i.e.*, prices for track access).	Proof of professional qualification. Free entry and exit.			
Air transport	National carrier privatised in 1997.	Unregulated pricing subject to abuse control by BKartA *ex post*.	Free entry and exit within EU.	Bilateral treaties on air traffic.		
Road transport	Partly liberalised market for occasional bus services; abolition of contingents for freight transport in 1998.	Prices fixed by the operator of regular bus services (approved by competent authority) and occasional bus services; prices for taxi services fixed by competent local authority. Liberalisation of freight rates in 1994 for road haulage.	Proof of professional qualification, financial and personal liability for carriage of passengers and road haulage. Restricted entry for taxi services.			
Postal services	In 1989 the integrated post and telecom operator was transformed into three enterprises (telecom, post, and bank); transformation into joint stock companies in 1995 with partial privatisation afterwards. Partial monopoly rights (to date for letters up to 100 g) were granted in return for universal service obligations; market opening for letter above 100 g and outgoing letters to foreign destinations.	RegTP is regulator and supervises price setting of dominant carrier(s) (letters *ex ante* regulation; other postal services *ex post* regulation).	Entry for the delivery of letter post items up to 1 kg is subject to a licence (licences are not restricted, except for the exclusive right area, now set at below 100 g). Some competition for Deutsche Post AG for letter services with added value. Free entry and exit for parcel and courier services where many companies entered the market long ago.			

Table A.1. **Sectoral regulatory reform in Germany** *(cont.)*

Industry	Key legislation/regulatory framework	Regulation on prices	Regulation of entry and exit	Other regulations	Remaining regulations on prices, entry, exit	Other remaining regulations
Pharmacy	Regulated sector.	Uniform prices for drugs that may only be sold by pharmacies (including prescription-only drugs).	Proof of professional qualification and citizen of a European Union State. Free exit and limited entry as neither pharmacy chains nor non-pharmacist owners are permitted.	Pharmacies restricted in products that may be carried; some restrictions on advertising. Subject to retail restrictions on opening hours, with modifications.		
Retail sector	The Gifts Ordinance and the Discounts Act were lifted on 31 July 2001. Opening hours recently further liberalised (takes effect from 1 June 2003). Act against Unfair Competition to be revised: regulation of special sales to be abolished.	Ordinance on proper price quotation. Act against Restraints on Competition forbids sales below purchase costs.	Free entry and exit; notification in register of companies and register of commerce. Construction license demanded outside town centers, even if change of use of an existing building for retail is intended.	Some locations are exempted from opening hours limit (gas station, railway stations). Ordinance on Packaging requires outlets to charge deposit for certain types of packaging and to recollect used packaging.		

Source: OECD.

Table A.2. **Potential impacts of regulatory reform in Germany**

Industry	Industry structure and competition	Impact on output, price, and relative prices	Impact on service quality, reliability and universal service	Impact on sectoral wages and employment	Efficiency: productivity and costs
Telecommunications	State monopoly in long distance and international services replaced by competition, mostly local monopolies in local connections, but some competition is developing.	Significant decline of prices for long distance and international calls, some decline for local calls.	More freedom of choice for customer.	Positive employment effects (since 1998).	Acceleration of productivity and declining unit costs.
Electric power	Regional legal monopolies replaced by oligopoly. Entry mostly on retail level and for renewables.	Prices have decreased, in particular for industrial customers.	More freedom of choice for customers, but relatively low rate of switching in reality. However, many customers have renegotiated prices.		Higher level of productivity.
Natural gas	Regional legal monopolies replaced by oligopoly at retail level, duopoly remains at import level and generally monopoly in transport.	Prices have developed in line with prices in other European countries. No relative decline.	More freedom of choice for customer; customers have renegotiated prices. However very low rate of switching in reality.	Wages still above average; employment decreased.	Increase in productivity.
Insurance and banking	Competitive market, with trend towards consolidation and mergers.		Improvement of service level due to ICT applications.	Negative employment effects.	Increase in productivity.
Railways	Increasing intramodal competition in the freight market; increasing competition for the provision of (subsidised) local passenger services; beginning intramodal competition for long distance passenger services.	Output by and large constant in the freight market with probably declining prices and declining market share of rail transport; output increase for local services even prior to public tenders, with partially shrinking subsidies per train kilometre; output by and large constant in the market for long distance passenger services. Successful entry of one competitor.	Improvement of service level due to ICT applications. Service level is generally good, so is reliability. Significant improvements of service level for local services.	Negative employment effects.	Increase of productivity.
Air transport	Competitive market.	Decreasing prices and new entry of several carriers.	Service level is good, as well as reliability.		
Road transport	Many small suppliers. Competitive market for road haulage.	Decreasing prices.			
Postal services	Partial monopoly.	Prices slightly falling in real terms.	Limited choice for customer, apart from courier services.	Decreasing employment.	Productivity increase.
Pharmacy	Potentially competitive.				
Retail sector	Competitive market.		Increased service level due to liberalised opening hours.		

Source: OECD.

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