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The economic situation and policies of the European Union were reviewed on 25 April 2007 by the Economic and Development Review Committee (EDRC) of the OECD, which is charged with examining the economic situation of member countries.

The draft report was revised in the light of the discussions at the meeting with the Survey being published under the responsibility of the Secretary-General.

The report incorporates information up to the end of May 2007.

The Secretariat's draft report was prepared by David Rae, Boris Cournède and Marte Sollie, under the supervision of Peter Hoeller. Research assistance was provided by Isabelle Duong.

This is the first review of the European Union by the EDRC. There have already been reviews of the euro area, the latest one having been published in January 2007.

This book has StatLinks

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BASIC STATISTICS OF THE EUROPEAN UNION (2005)

	EU15	EU12	EU27
LAND AND PEOPLE			
Area (thousand km^2)	3 238	1 088	4 326
Population (million)	388.4	103.5	491.9
Number of inhabitants per km^2	117.5	94.4	111.7
Population growth (1995-2005, annual average % rate)	0.4	–0.1	0.3
Labour force (million)	254.0	71.4	325.4
Unemployment rate (%)	8.2	11.9	9.0
ACTIVITY			
GDP (billion EUR, current prices)	10 292	662	10 954
Per capita GDP (current PPS)	25 400	11 919	22 500
In per cent of GDP:			
Gross fixed capital formation	19.8	21.9	19.9
Exports of goods and services	36.4	52.1	37.3
Imports of goods and services	35.5	55.0	36.7
PUBLIC FINANCE (per cent of GDP)			
General government:			
Revenue[1]	45.1	40.0	44.8
Expenditure[1]	47.4	42.9	47.1
Balance[1]	–2.2	–2.9	–2.3
Gross public debt (end-year)[2]	64.6	40.3	63.3

EXTERNAL TRADE IN GOODS
(main partners, % of total flows)

	Exports	Imports
United States	25.1	14.8
Other Europe (incl. Russia)	22.0	23.3
China	5.1	14.5
Japan	4.3	7.2
Other Asia	26.4	24.6
Other	17.1	15.6

1. Excluding Bulgaria for EU12 and EU27.
2. Excluding Romania for EU12 and EU27.

Executive summary

The EU economy is enjoying a strong cyclical rebound. Employment has risen, and the decline in the EU's sustainable growth rate seems to have halted. Reforms are paying off, especially in the countries that started early. But there is a sizeable gap in GDP per capita compared with the OECD's best performers, and the gap has widened over the past decade. Moreover, growth and employment performance differs considerably within the EU itself. Europe's laggards need to learn from its best performers. The relaunched Lisbon Strategy for Growth and Jobs provides an overarching framework that strives to keep up the pace of reforms, taking advantage of the current favourable economic circumstances and providing the conditions for stronger growth.

Europe faces challenges from technological change, globalisation and population ageing. Globalisation brings opportunities for adaptable economies but punishes rigid ones, while ageing populations will put welfare systems under pressure. There are several ways the Union can help meet these challenges.

- **Pushing ahead with the internal market.** *A vibrant internal market is central to Europe's long-term prosperity. The services directive will help achieve this, but it is only a step towards liberalisation and integration. A major effort is needed to eliminate the remaining barriers to trade. Quicker and cheaper remedies for individuals would help knock down some of the remaining obstacles. In financial services, wholesale markets are fairly well integrated, but market segmentation in retail banking and the investment fund industry needs to be reduced. The internal market needs to be supported by better regulation, strong enforcement of competition rules and less and better-targeted state aid.*
- **Opening up network industries to competition.** *Inefficient network industries raise costs for consumers and other firms. Greater competition is needed in electricity, gas, telecoms, transport, ports and postal services. In energy markets, the network needs to be effectively separated from the generation and supply activities and national markets should be linked together better to create regional or pan-European energy markets. The EU's recent Energy Policy for Europe is an important step in the right direction.*
- **Removing barriers to labour mobility.** *A mobile workforce can be an economic safety valve and can make firms more productive and innovative by bringing new skills and ideas. Mobility could be improved by making pensions more portable, improving the recognition of qualifications and removing restrictions on workers from the new member states.*
- **Making regional cohesion policy more effective.** *Regional funding has to focus on projects that can spark sustainable growth. Recent reforms go in this direction but they could be even more focussed. More of the funding should be tied to results so that resources get reallocated to projects where the payoffs are highest.*
- **Europe's global role.** *The EU is one of the key trade players. Trade barriers on manufactured goods are already relatively low, except for certain processed food products, while liberalisation of internal market in services will also provide new opportunities for service providers from outside the EU. The EU's policies will influence, together with those of the other main trade powers, whether the Doha trade round succeeds or whether world trade will splinter into regional agreements. Farm subsidies should be reduced and market access improved. Reforms to the Common Agricultural Policy (CAP) have made it less distorting but the reforms would be even more effective if all support were de-linked from production. The commitment to cut greenhouse gas emissions by 20% is welcome. This goal should be achieved through market mechanisms as far as this is feasible.*

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Assessment and recommendations

It is fifty years since the Treaty of Rome was signed. The treaty created the European Economic Community, set the goal of ever closer union among the peoples of Europe and laid down the "four freedoms" where goods, services, people and capital could move freely among the member countries. The results have been impressive. It has brought prosperity, the single market for goods among 500 million consumers works fairly well, and there has been good progress in reshaping network industries and financial markets. The union has grown from 6 to 27 countries, 13 of which now share a single currency. The European Union (EU) now has a larger GDP than the United States, it is the world's biggest exporter, and European companies are among the global leaders in most industries.

Economic reforms are paying off, especially in the countries that started early. Various member states have improved their welfare and pension policies and to a lesser extent employment policies, which has helped raise labour market participation and cut joblessness. The slide in productivity growth through much of the 1990s and early 2000s has stopped. Short-term prospects look bright as a strong cyclical rebound is underway. Output grew by just under 3% last year and prospects are for above-potential growth in 2007 and 2008 as well. So long as world economic growth remains buoyant, the short-term outlook for the EU economy looks good.

Yet, the European project has faced important challenges during the past few years. The constitutional treaty was not endorsed by some member states, the debate around the services directive was difficult and protection of domestic companies remains a problem. While some countries have learned that liberalisation works, others are lagging behind. The process of harmonising laws across member states is proving harder, partly because the low hanging fruit has gone but also because the policy agenda is colliding with differences over economic and social objectives and the best way to achieve them. At the same time, the EU is facing the challenges of technological change, globalisation, population ageing and climate change. Globalisation is a great opportunity for adaptable economies but punishes rigid ones. Ageing populations will weigh on medium-term growth prospects and put Europe's health and pension systems, some of which are financially unsustainable in the long term, under pressure.

Structural reforms would help boost growth

Further structural reforms are needed to cope with these challenges. While economic prospects are improving, there is no room for complacency. Average incomes in the EU15 are almost a third lower than in the best performing OECD countries and more than a third of the working-age population remains inactive. The employment rate has risen, but it remains below the EU's target of 70%, and nearly half of the unemployed have been out of

work for at least a year. The need for reform is also highlighted by differences within Europe itself. Some countries have performed very well, both in terms of productivity and job growth. The challenge is for Europe's laggards to learn from its best performers. The potential gains in terms of higher incomes are large, especially for the countries furthest behind the frontier. And as some European countries have shown, economic reform and stronger growth do not necessarily come at the cost of a country's social goals. With well-designed tax and benefit policies, a dynamic business environment can be combined with high levels of equity and social inclusion. In this context, the Lisbon Strategy for Growth and Jobs provides a comprehensive framework that focuses on both community and member state structural reform measures. Member states commit to and implement national reform programmes within common policy orientations agreed and monitored at the EU level, thus reinforcing policy co-ordination across the EU.

This *Survey* reviews the EU's economic performance and discusses the main challenges. It focuses on the common and shared policies of the Union. It complements the *Euro Area Survey*, which deals with monetary and fiscal policy, and the individual country *Surveys* that assess national policies. While many of the necessary policy changes are firmly under national sovereignty, the EU can play an important role by providing good framework conditions and continuing to enhance the internal market.

The single market is crucial for a dynamic Europe

The single market has delivered major benefits for EU citizens. It has given consumers access to a wider range of goods and services and has helped the business sector become more competitive. The stronger competition that it has brought about has lowered prices and lifted innovation, entrepreneurship and growth. But while the internal market process is moving forward, progress has slowed down recently. The lion's share of the improvement in trade, investment and price convergence occurred in the 1990s, with less progress since then. A fresh impetus is needed. With this in mind, the Commission will publish a wide-ranging review of the single market in the second half of 2007. A competitive and dynamic internal market is necessary to foster prosperity and help achieve the objectives of the Lisbon Strategy for Growth and Jobs. It is also important for the smooth functioning of the euro area.

The services directive will help but is only a step in the liberalisation process

The service sector is the main area that requires further progress in the internal market. Service markets are segmented, with trade among member countries amounting to less than 5% of GDP. This contributes to low productivity growth in the sector. The services directive will help by providing more legal certainty, reducing administrative barriers and boosting co-operation among member states. Certain entry barriers such as market demand tests are now outlawed (albeit with escape clauses) and the mutual screening process, where all national legislation must be vetted to see whether it meets the single market principles, should help chisel away some of the other barriers.

Many of the regulatory barriers to cross-border trade in services come from national laws such as consumer protection standards or rules about how a company must be managed

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or structured. Most of these rules are in place, at least ostensibly, for genuine policy reasons such as public safety or consumer protection. However, they can be out of all proportion to their objective and have the effect of shielding local firms from competition. The country of origin principle in the Commission's original proposal would have allowed service providers to jump over such restrictions when operating temporarily in another country. It was rejected for several reasons including concerns about possible abuses and monitoring problems. Under the directive that was finally adopted, the barriers that may remain after the screening process and the application of the freedom to provide services clause will still need to be challenged using the existing infringement procedures. Because the legal process is slow, the directive should be bolstered by quicker and cheaper remedies in order to get the greatest benefit from the reform. It will also help that the Commission is proactively making sure member states implement the directive properly and is putting a high priority on the mutual screening process. In the end, however, it is up to member states to back up their renewed commitment to the principles of the Treaty of Rome with serious efforts to eliminate unnecessary barriers. In this sense, the services directive should be seen as a step towards liberalisation, not the end of the process.

The internal market for goods works well but could be improved further

In goods markets, the mutual recognition principle has been a huge success at breaking through the vast number of product specifications that existed before the single market. But it could be applied better. The Commission has proposed a regulation that obliges member states to provide scientific and technical evidence to justify any restrictions they put on products entering their market. This should help, and it could be backed up by a fast-track mechanism. That way, the producer would have an effective way to challenge unreasonable barriers to market access and it then would be up to the member state to take an action through the full court system if it felt its restrictions were justified by the evidence.

Network industries need major reforms

Network industries are another priority. The sectors that have been liberalised the most, such as air transport and telecoms, have delivered substantial payoffs in terms of lower prices and better service for consumers and other firms alike. However, substantial barriers to competition remain in place. Further market opening is needed in electricity, gas, telecoms, transport, ports and postal services, while respecting universal services obligations. The potential welfare gains from network reform are estimated to be 1½ to 2% of GDP at least.

Pan-European markets are the best way forward for the energy sector

Energy markets need to be linked together more tightly and opened up to competition. This would lower prices for consumers and make energy supplies more secure. The gas and electricity directives adopted in 2003 contained some important measures – for example, all customers will be free to choose their supplier by July this year – but they have not been implemented well by member states. An EC competition inquiry recently found serious

malfunctions in energy markets. Vertically integrated energy giants can treat competitors unfairly and shut out potential entrants. Market concentration is high, with dominant firms often able to control wholesale prices. Competition from imports is weak because cross-border interconnections do not have enough capacity and the available links are not used efficiently or are tied up through historical contracts. Capacity is not expanding quickly enough because the financial incentives to do so are weak and the rules and responsibilities surrounding cross-border issues are unclear. Other problems include state ownership, which can distort competition, and wholesale markets that do not work well due to poor system information and a lack of transparency.

- The priority should be to create integrated EU-wide or regional markets. The Nordic market provides a good role model. Achieving this will at least require greater co-operation among system operators, and possibly moving away from national operators towards cross-border ones. The reliance on national regulators will have to change, especially on issues affecting cross-border trade as existing co-operation is insufficient. The recent agreement by the European Council on the need to establish an independent mechanism for national regulators to co-operate and take decisions on important cross-border issues is a useful first step.
- Separating the network, generation and supply activities of vertically integrated firms is needed to prevent abuse of power and create a level playing field for competition. The Commission recognised this in its *Energy Policy Review* when it proposed two options: full ownership unbundling; or independent system operators (but where the network assets may remain owned by the incumbent). While both options would go a long way towards boosting competition, OECD experience, as reviewed by the International Energy Agency and supported by the Commission's review, has shown that full ownership unbundling is more effective. The European Council recently agreed on the need for effective separation of supply and production activities from network operations (unbundling) based on independently run and adequately regulated network operation systems, but did not require ownership unbundling.

In telecoms, the regulatory framework is sound but some countries have been quicker than others at creating effective competition. Some national regulators may be too soft and competition problems are not always dealt with consistently across the Union. In 2006, the Commission made several proposals, including phasing out regulation in segments where competition was developing well, introducing a more market-based approach to spectrum management, enabling the pan-European provision of services and beefing up the regulators' enforcement powers. All these suggestions should be pursued.

The internal market can be supported by better regulation and less red tape…

The review of the single market must do more than just fill in the holes. In order to reduce the regulatory burden, red tape needs to be cut and the Commission's recent initiative supported by the European Council is welcome. New interventions need to be well chosen and effective, while having minimum cost. The Commission in conjunction with member states should push ahead with its *Better Regulation* agenda, but it could go further by insisting on impact assessments for all proposals across all EU institutions (including substantive amendments by the Council or Parliament) and ensuring that the new independent Impact

Assessment Board contributes to high-quality assessments by the Commission. According to the principle of subsidiarity, the community should intervene only where there is a clear case for action at the pan-European level. Regulation is not always the best option. When the community does regulate, it should opt for flexible rather than prescriptive rules – taking a lead from the successful Lamfalussy process in financial markets.

… and by better enforcement of existing laws

The Commission has been working hard to improve the consistency of competition policy among national agencies. It has begun to undertake sector inquiries that have helped to understand problems in certain industries. It has revised its guidelines for setting fines and has hit some cartels with heavy penalties. And it has led a forceful defence of the internal market by taking a tough line on member states that try to protect "their" companies. It is important to continue doing so. When dealing with hard-core cartels, international experience suggests that corporate fines may not be enough of a deterrent on their own. For this reason some member states use individual criminal sanctions, but others are more reluctant due to concerns that it might have adverse impacts on enforcement. To enhance deterrence, the Commission is pushing for more private enforcement. It should continue doing so, and should encourage member states to make it easier for private individuals to challenge anti-competitive behaviour through collective actions.

State aid should be reduced

State aid can distort competition in the internal market. The EU has a commendable system for state aid control that is binding, uniform and transparent. The Commission is revamping state aid policy, moving away from a rules-based approach and towards greater reliance on economic principles. As well as reining in the level of aid, the Commission wants it to be better targeted, especially towards innovation and human capital, and is streamlining administrative procedures so it can focus on the most distorting measures. This is welcome, but there is a danger that unless the new approach is administered with vigilance, it could open the door to a re-nationalisation of industrial policy. The key is to take the politics out of state aid decisions; for example, state aid policy would be more effective if member states were to make more use of independent granting agencies. When dealing with aid granted by foreign competitors, it would be better to deal with this through the World Trade Organization (WTO) rather than by getting involved in subsidy races.

There has been good progress in wholesale financial market integration, but less at the retail level

The euro and the Financial Services Action Plan have contributed to greater integration of financial markets. Indeed, Europe has overtaken the United States in some segments of global markets. Capital flows are largely unimpeded and most wholesale markets are well integrated. There has been less progress at the retail level. Retail banking – and mortgage markets especially – are mainly national. Cross-border mergers of financial institutions can be complex due to government guarantees, ownership arrangements, tax issues and resistance by supervisors, although the Commission has improved the rules in this area by

limiting supervisors' discretion. Approval for selling products across borders can be lengthy because they must be tailor-made to cater for national laws on investor and customer protection. In mortgage markets, one option would be to go for full mutual recognition (which implies that the judicial process of the lender's country would apply) since well-informed customers should be able to decide which product is best for them. However, since consumer safeguards are highly valued in some countries, another way forward may be harmonisation of the most important protections and mutual recognition for the rest. Fragmented payments infrastructure has also been holding back a pan-European banking market, and the industry will need to work quickly to ensure that the Singe Euro Payments Area (SEPA) is up and running on time in 2010. In this respect, the recent agreement by Council and the Parliament on the legal underpinnings of SEPA will help.

Stronger corporate finance markets would help European companies

Enhanced corporate finance markets would give European firms greater access to capital. By one estimate, a fully integrated financial market could lower the cost of capital by 50 basis points. The MiFID directive, which creates an EU passport for securities, should be a major step towards integrated securities markets, but member states should not unravel the benefits of harmonised rules by adding on their own provisions. The revamp of investment fund regulations that is underway should also improve corporate finance. European funds are small because it is difficult and costly to offer products and merge funds across borders. The community should opt for full mutual recognition of investment funds, with a simplification of notifications, and eliminate restrictions on the types of assets that can be included, create a framework for cross-border mergers and revise the simplified prospectus. Lastly, member states should reassess the way they have implemented the takeover directive because they have produced a more restricted market for corporate control that hampers the further integration of capital markets.

Support to agriculture has been reformed

Trade barriers on manufactured goods, except for some processed food products, are relatively low and the liberalisation of the internal market in services will also open this market further to non-EU suppliers. The European Union grants extensive preferential access to less developed and African countries, and is a lead donor of aid for trade. The Union is an active member of the WTO and its first stated priority is to maintain the strength of the multilateral system of trading rules. The EU should continue to take a leadership role in the Doha round of trade negotiations by acting together with the other main trade partners to reduce farm subsidies and open up its markets. While support to EU farmers has declined slightly over the past five years and has become less production distorting by moving away from market price support, it remains above the average for the rest of the OECD and well above the most free-trading countries. From the focus of the economic effects of agricultural policy, as is the case for many countries, further reform is desirable because of the economic benefits resulting for Europeans. However, the Common Agricultural Policy (CAP) has many objectives, including competitiveness of food production, protection of the environment, maintenance of the population in rural areas and underpinning farm incomes. But it has some negative side-effects. While imports from

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the poorest countries have been liberalised, import tariffs continue to reduce export opportunities for other countries. Consumers pay more for certain types of food, and it traps resources in a low productivity sector. There are many factors that contribute to more intensive farming, and to the extent that the CAP also encourages intensification it can cause environmental harm – although the CAP also includes policies that aim to mitigate the adverse environmental consequences.

The most significant reform has been the introduction of the single farm payment in 2003. It replaced many of the previous payments that were tied to production, herd size or planted area. Farmers can choose to produce whatever they wish (with some restrictions) or indeed to produce nothing at all so long as they keep their farmland in good agricultural condition. However, the CAP still includes elements that provide incentives to produce. Decoupling is only partial for some commodities while several countries have chosen to keep significant portions of payments tied to production. Second, support for certain products, in particular through import tariffs, still remains outside the single farm payment. Moreover, while de-linked payments are substantially less distorting than the pre-2003 system, they do not completely eliminate the incentive to produce – although the magnitude of any remaining production distortions is difficult to assess. In addition, market price support remains high for some commodities through high tariffs, especially meat, milk and sugar, and about half of estimated aid to farmers (based on the Producer Support Estimate) is still of the most market-distorting type. Export subsidies have been reduced considerably but remain extensive by international standards. The EU accounts for 90% of all WTO member states' notified export subsidies, although this measure captures only a limited portion of total export support throughout the world and EU export subsidies amount to 5% of the value of agricultural exports. However, the EU has conditionally proposed phasing out all export support, including export subsidies, in its offer to the Doha trade round.

Farm support should be reduced and made less market-distorting

The benefits of recent reforms would be significantly enhanced if all payments were decoupled from production and if the level of support were reduced further. Some non-*ad valorem* tariffs for agricultural goods applicable to processed agricultural goods incorporating several inputs, are complex and could benefit from simplification. This has been conditionally proposed by the EU in its offer to the Doha trade round. And because tariff protection on processed food is also high, reform needs to be broader than just tackling support to farmers. Lastly, because in the past richer farming regions of the EU have benefited by more than the poorer regions, and while we cannot yet assess the impact of recent reforms on cohesion, agricultural support would be more effective and efficient if it were better targeted at its objectives; for example, income support being better targeted at lower-income farm households and poorer farming regions.

Environmental goals can be met in less costly ways

The EU has been a global leader in policies to tackle climate change. Its unilateral commitment to cut its greenhouse gas emissions by at least 20% by 2020 is welcome. Market

mechanisms should be used as much as possible to make sure these goals are achieved with the lowest cost. The EU's emissions trading scheme is a good example even though it had problems during its pilot phase. These problems are being addressed, especially through tighter allocation of permits, but it would also help if allocation methodologies and cap setting were harmonised and if permits were auctioned rather than given away. Options to link with trading schemes in other countries should also be envisaged.

Regional cohesion policy can be made more effective

Cohesion policy aims to reduce regional disparities and encourage economic convergence. Its record so far has been patchy: regional disparities are not falling, or at best are declining very slowly. The budget is too small to make a real dent in income gaps, so the challenge is to get the maximum benefit from the available funds by making sure member states focus on activities that will spark sustainable growth, such as education, research and important infrastructure projects. The Commission has changed its approach for 2007-13 by focusing more on each country's broad strategy rather than vetting specific projects. The desire to decentralise is understandable as many people thought the previous system was too bureaucratic and heavy handed. At the same time, the minimum rate of national co-financing has been reduced in the new member states, so the system is now more like a block grant. Taken together, there is a risk that these changes could lead to less careful project selection and management. To maintain strong incentives to invest wisely, it would have been better to increase rather than decrease the rate of co-financing by member states. In principle, national strategic plans should allocate most money to the Lisbon goals but in practice the list of eligible activities is long and provides little focus. Moreover, it may be helpful to re-assess whether state aid and social housing schemes should be eligible. The community could achieve more with its regional budget if it were more performance-based so that money could be shifted to projects with the highest payoffs. There are several ways this could be done, including sunset clauses or a mandatory performance reserve in which a portion of funding is tied to results.

Greater labour mobility would strengthen the Union

A mobile workforce can act as a safety valve for economies that are out of sync with their neighbours – which is especially important in the euro area – and can make companies more productive and innovative by bringing fresh perspectives and new skills and ideas. But mobility in Europe is low. Only 4% of the EU workforce has ever lived and worked in another member state. The language barrier is one explanation, but it is unlikely to be the whole story.

Most of the policy obstacles have been removed. The main exceptions are the transitional restrictions on migrants from the new member states. Around half of EU15 countries now give free access to workers from the ten countries that joined in 2004, but only two of them have fully opened their doors to workers from Bulgaria and Romania. Most of the new member states have granted free access. So far, enlargement has not led to the flood of migrants that was initially feared. While the overall level of migration has been rather modest, the inflow to some countries has been higher than expected, due mostly to their

strong labour markets and the fact that they did not impose restrictions. These countries have benefited through better job matching, a reduction in structural unemployment and the easing of labour shortages. Countries that still have restrictions should reconsider their decision, but if they are retained, they should use that time to reform their employment policies as the payoff for migrants and the host country is maximised in flexible job markets. Labour mobility could also be enhanced by improving the transferability of occupational pensions. The Commission has been trying for many years to promote pension portability, and has proposed another directive on the issue. The Commission and member states should also continue to improve the recognition of qualifications, eliminate barriers in the regulated professions, reduce transaction costs on house sales and ensure that measures that provide housing for the poor are implemented in a way that does not undercut mobility.

Pushing ahead: a union for the 21st century

To sum up, the EU has achieved a great deal but there is still much to do in order to create a more dynamic and integrated European economy. The 50th anniversary of the Treaty of Rome is an opportunity to renew the commitment to the single market and back it up with action. The current favourable economic environment creates a window of opportunity to step up reforms, thereby helping to establish more sustained growth and higher living standards across Europe.

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Chapter 1

Key challenges

This chapter reviews the key challenges for the European Union. The main requirements are product and labour market reforms to boost growth and employment. Like all developed economies, Europe faces the longer term challenges of globalisation and population ageing. Europe as a whole has done well out of globalisation but some regions have struggled to adapt, and they need to boost their adjustment capacity and innovation levels. The roles of the EU include strengthening the single market, encouraging stronger competition across Europe and living up to global responsibilities such as trade reform and addressing climate change.

It is fifty years since the Treaty of Rome was signed. The treaty between the six founding members of the EU set the goal of ever closer union among the peoples of Europe. It established an economic union based on the "four freedoms" that goods, services, people and capital should be able to move freely. It set a schedule for tariff reduction and harmonisation, created the key EU institutions and laid down the division of responsibilities between member states and the community.

Initially, the Union's aims were more political than economic, but the economic gains have been large. First and foremost, integration has brought prosperity. Average incomes in Western Europe rose from about half of the US level in 1950 to around 75% today (Table 1.1). The flow of capital is mostly unimpeded and thirteen countries now share a single currency. The single market for goods among 500 million consumers works well overall, despite some technical wrinkles at the edges. The Union has expanded to include 27 countries; others, seeing the benefits, either want to join or maintain close links through the European Economic Area. The EU now has a larger GDP than the United States, it is the world's biggest exporter and European companies are among the global leaders in most industries except information technology.[1]

Table 1.1. **Income catch-up**

GDP per capita in Western Europe[1] as per cent of US level

1946	1950	1957	1960	1970	1980	1990	1995	2000	2005
46	56	67	72	78	81	78	78	76	75

1. Twelve countries: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, United Kingdom. Figures for 2000 and 2005 are based on OECD national accounts. Figures before that are based on Maddison (2003), linked so that they have the same level as the OECD source in 2000. All figures are PPP adjusted.

Source: Maddison, A. (2003), *The World Economy: Historical Statistics*, OECD, Paris.

Nonetheless, it has faced some important challenges, both from within and from outside. The past few years have been tough for the European project. The constitution was rejected by some countries, the debate around services reform has been difficult and protection of domestic companies remains a problem. There has been a public backlash, prompted by a sense that integration has gone far enough. Long-standing differences in views about the best way forward have sharpened. While some countries have learnt that liberalisation works, in others there has been a tendency to shield local companies from competition. Countries that have performed well over the past decade feel frustrated that they are being held back by the more reluctant members. At the same time, enlargement has brought both benefits and challenges. The 12 new member states that have joined since 2004 add 27% to the population but just 6% to GDP. However, they are catching up and they create opportunities for the other countries. Europe is also facing challenges from technological change, globalisation and population ageing.

Underlying all this is the fact that Europe's economic performance has been lagging behind the best performers for decades. In relative terms, the EU15 are no closer to

US income levels than they were thirty years ago. But a strong cyclical recovery is now underway and there has been a clear structural improvement in the labour market. There are signs that economic reforms are paying off. While the EU average on many indicators is often mediocre, there are member states that are among the best performers in the OECD – be it Finland for its school system, the United Kingdom and several northern European countries for their labour markets, the Eastern Europeans, Spain and Ireland for their dynamism and France and Germany for their world-beating companies. The challenge is for Europe's laggards to learn from its best performers.

The fiftieth birthday of the Union is an opportunity to reassess the policy agenda. This *Survey* reviews the EU's economic performance and discusses its main challenges (see Box 1.1 for some terminology and a quick history of the Union).[2] It is primarily a survey of the common and shared policies of the Union. However, these cannot be considered in isolation of policies that are mostly the responsibility of national governments, such as labour and product market policies (Box 1.2). It is a cousin to the *Euro Area Survey*, which focuses on macroeconomic issues for the 13 members of the euro area, and the individual

Box 1.1. **Some history and terminology**

The origin of the European Union (as it is known today) was the European Coal and Steel Community, founded in 1951 by the Federal Republic of Germany, France, Italy and the Benelux countries. These six countries formed the European Economic Community (EEC) through the Treaty of Rome, which was signed in 1957 and took effect on 1 January 1958 (it also formed the European Atomic Energy Community, Euratom). The name of the EEC was changed to the European Community (EC) under the Maastricht Treaty in 1992. Since this so-called "Treaty on the European Union", the EU consists of three pillars: the EC plus the Common Foreign and Security Policy (CFSP) pillar and the Police and Judicial Co-operation in Criminal Matters (PJCC) pillar.

There have been seven waves of enlargement since the original six created the EEC: In 1973, Denmark, Ireland and the United Kingdom; in 1981, Greece; in 1986, Portugal and Spain; in 1995, Austria, Finland and Sweden; in 2004, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia; and in 2007, Bulgaria and Romania.

In 1999, the euro became the common currency in eleven countries (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain); euro banknotes and coins were introduced in 2002. Greece joined the euro area in 2001 and Slovenia joined in 2007.

Terminology

Most of the terms in this report are used in their everyday rather than legal sense. "Europe" is used as a synonym for the European Union. Unless otherwise obvious from context, the Union refers to all member states at the relevant date. The EU15 refers to the fifteen members that had joined by 1995. The EU10 refers to the ten countries that joined on 1 May 2004; the EU12 means the EU10 plus Bulgaria and Romania. "New member states" refers to either the ten or the twelve, depending on context. The EU19 refers to the 19 member states that are also members of the OECD (the EU15 plus the Czech Republic, Hungary, Poland and the Slovak Republic). The "treaty" means the consolidated treaties. The terms "European Union" and "European Community" are used interchangeably, though strictly speaking they mean different things in European law.

Box 1.2. **The Union and its competencies: Who's who and who does what?**

The *European Council* consists of the heads of state of the member countries plus the President of the Commission. It meets on average four times a year. These "summit meetings" set high-level policy objectives.

The *Council of the European Union*, or the *Council of Ministers* as it is sometimes known, is the EU's main decision-making body. In this survey, references to "the Council" generally refer to this body. It represents the member states, and its meetings are attended by one minister from each member state. Each minister in the Council is empowered to commit his or her government. Which ministers attend depends on what subjects are on the agenda. There are nine configurations, for example "Economic and Financial Affairs", "Environment", etc, and in these guises it may be referred to as the "Environment Council", for example.

The *European Parliament* is the assembly of 785 elected representatives of the Union's citizens. The division of seats reflects each country's population. Its powers vary depending on the field. In most cases, including most areas of economic policy, both Parliament and the Council must agree on a proposal put forward by the Commission ("co-decision"). In some cases Parliament's assent is required – it can accept or reject, but not modify a proposal. In other areas it must be consulted but has no binding powers (*e.g.* agriculture and competition). It cannot initiate legislation.

The *Commission* can mean the 27 commissioners, one from each country, or more commonly the 30 000 civil servants who together with the 27 commissioners form the executive arm of the Union. It represents the interests of the Union as a whole, drafts proposals for new laws and is responsible for managing the day-to-day business of the Union: implementing its policies, running its programmes and spending its funds.

The *European Court of Justice* (ECJ) is the highest court. It adjudicates on matters of interpretation of EU law and ensures that the law is applied consistently by national courts. If the Commission believes that a member state has not implemented a directive properly it can take a case to the ECJ. Individuals cannot appeal to this Court directly; they must initially go to the *Court of First Instance*.

Community law is anchored in the treaty. The treaty specifies exclusive competence policies, while other competencies are shared between the community and the member states. There are also areas for which the Union is competent only for carrying out activities intended to support, co-ordinate or complement those by the member states, without, however, modifying their competence in these domains. The successive treaties have extended the range of competencies, which now include 21 areas. They touch on nearly all economic functions. In addition to the 21 areas, macroeconomic policy matters such as the single currency are covered in the treaty, as well as political matters, such as the right of asylum and immigration.

Source: http://europa.eu/institutions/index_en.htm.

country surveys that review national policy challenges. Chapter 1 discusses the key challenges for the EU and gives an overview of the reforms that need to be implemented by national governments and at the community level. The subsequent chapters discuss community level policies in more depth. Emphasis is given to reinvigorating the single market agenda, as it is central to Europe's long-term prosperity. The *Survey* also discusses unfinished business in competition, trade and agricultural policy, labour mobility, regional cohesion policy and the way EU laws are formulated and enforced.

The need for reform: Europe's below-par economic performance

The need for economic reform is highlighted by Europe's relatively sluggish economic performance. GDP per capita in the large European countries is well below the level of the best performers (Figure 1.1). For the new member states, average income is only about a third of the US level. For the EU as a whole, the income gap widened over the past ten years as a result of declining productivity growth and difficulties bouncing back from the recession in the early 2000s. Europe's Lisbon Strategy for Growth and Jobs aims to raise potential growth and GDP per capita through the implementation of structural reform measures.

Figure 1.1. **Differentials in GDP per capita**

Percentage point differences in PPP-based GDP per capita relative to the United States, 2005

Gap in GDP per capita | Gap in labour utilisation[1] | Gap in labour productivity[2]

1. Hours worked per capita (or employment per capita for EU12 and its members).
2. GDP per hour worked (or GDP per employed for EU12 and its members).

Source: Eurostat; OECD, *Productivity Database*, September 2006.

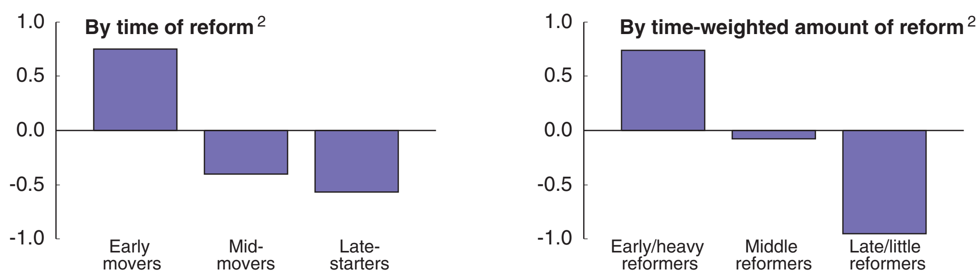
StatLink http://dx.doi.org/10.1787/082778600577

The need for reform is also highlighted by differences in performance within Europe itself. Some peripheral countries have done remarkably well. Since the year 2000, per capita incomes have grown by more than 20% in Ireland and Greece compared with just 2%

in Italy and 5% in Germany. There are many reasons for their success, including cyclical factors, but liberalisation has helped. It takes time for reforms to pay off, and countries that liberalised early and aggressively have been rewarded with higher productivity growth (Figure 1.2). They have also had stronger labour markets. About half of the cross-country variation in unemployment over the past two decades can be explained by policy settings (Bassinini and Duval, 2006). For example, reforms to product markets and tax-benefit systems have been instrumental in cutting unemployment in the United Kingdom, Denmark and the Netherlands. This also lends a note of optimism to the outlook for the EU economy. The structural reforms that have been implemented more recently in the context of the Lisbon Strategy for Growth and Jobs should, if sustained, lead to better economic performance and stronger public finances over the longer term.

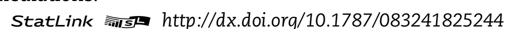
Figure 1.2. **Early reforms have paid off**

Change in labour productivity growth[1], per cent per annum relative to OECD average



1. Labour productivity growth from 2000-05 minus productivity growth in 1970-80.
2. Reform is measured by the change in the product market regulation (PMR) index between 1975 and 2003. The sample of 21 OECD countries is split into three groups based on the timing of reform efforts. In the left panel, it is based on the proportion of the change in the PMR occurring in each time period (1975-85; 1985-95; 1995-2003). In the right-hand panel, the change in the PMR is weighted so that early reforms get a higher weight (weights of 4, 2 and 1 respectively for reforms in the three periods).

Source: OECD, *Product Market Regulation Database* and OECD calculations.

StatLink  *http://dx.doi.org/10.1787/083241825244*

Of course, GDP per capita is not everything. But it is the best summary measure of living standards and is highly correlated with alternative measures of well-being (OECD, 2006a). Moreover, differences in GDP per capita partially reflect individual choices about work-leisure tradeoffs, but there is compelling evidence that a large part of cross-country differences in labour supply is explained by government policies rather than preferences or cultural differences (OECD, 2006b).

The gains from reform could be large

Estimates from a calibrated general equilibrium model suggest that if greater competition in the euro area could drive down price-cost margins to US levels, output would rise by 8.6% and hours worked by 4.5% (Bayoumi *et al.*, 2004). OECD (2005a) estimates that co-ordinated deregulation in the EU and the United States, involving product and labour market reforms plus cuts in tariffs and foreign investment restrictions, would boost EU GDP by at least 4% – and this understates the payoff as it covers only static gains and does not model truly global trade liberalisation. The Commission estimates that five key reforms associated with the Lisbon strategy could boost the euro area's growth rate by half a percentage point annually for more than a decade (Denis *et al.*, 2004). Nicoletti and Scarpetta (2005) come up with a similar estimate. The gains would be greatest for countries that are

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furthest behind the productivity frontier as there is evidence that excessive regulation reduces the speed with which economies catch-up to the leaders (Conway *et al.*, 2006).

Recent economic performance has been encouraging

The good news is that a strong recovery is underway. After a long period of sluggish growth from mid-2003 onwards, the pace of expansion picked up sharply in early 2006 (Table 1.2). Output grew by 2.9% last year and above-potential rates are likely through 2007 and 2008. Private investment rebounded strongly in 2006 as firms became more confident in the durability of the recovery. Residential investment was supported by a house price boom in some countries. Private consumption growth has picked up to some extent but has been held in check by modest growth in disposable incomes. Export volumes have benefited from buoyant world trade, but with wide variation among member states. In early 2007, business and consumer confidence were at relatively high levels, albeit slightly off their peaks of a few months earlier, suggesting the recovery is likely to continue. In particular, one of the risks that had been flagged earlier – weaker private demand in Germany due to its VAT hike – does not appear to be materialising.

Table 1.2. **Recent economic performance of the EU25**

Percentage change

	2002	2003	2004	2005	2006
Private consumption	1.5	1.6	2.1	1.6	2.0
Government consumption	2.6	2.2	1.6	1.7	2.0
Gross fixed investment	–0.6	1.0	3.2	3.1	5.6
Total domestic demand	1.0	1.8	2.4	1.9	2.8
Net exports (contribution to growth)	0.2	–0.5	–0.0	–0.1	0.1
Real gross domestic product (GDP)	**1.2**	**1.3**	**2.4**	**1.8**	**2.9**
Output gap (EU15, OECD estimate)	0.0	–1.1	–1.1	–1.6	–0.9
Inflation: harmonised CPI	2.1	1.9	2.1	2.2	2.2
Inflation: harmonised underlying	2.3	1.7	1.7	1.4	1.4
Employment	0.4	0.4	0.7	0.9	1.5
Unemployment rate (% of labour force)	8.7	9.0	9.1	8.8	7.6
Current account balance (% of GDP)	0.0	0.0	–0.0	–0.5	–0.6
Government net lending (% of GDP)	–2.3	–3.1	–2.7	–2.4	–1.7
Government debt (% of GDP)	60.4	62.1	62.5	63.3	62.2

Source: Eurostat.

The labour market has improved

The recovery and policy reforms have contributed to improving the labour market (Figure 1.3). The employment rate in the EU rose to 65% at the end of 2006, compared with 62% in 2000. The employment rate for the EU15 is at its highest level for more than twenty years. The employment gains have been largest for older workers and women (Table 1.3). Cohort effects explain some of this pattern, but pension reforms and the tightening of early retirement pathways have also contributed. Employment of younger workers on the other hand has barely changed since 2000. Comparing across countries, employment in Ireland, Spain and the Baltic countries has been especially dynamic. Comparing across industries, for the EU as a whole the service sector accounts for all of the increase in jobs since 2000. Employment in industry and agriculture has fallen.

Figure 1.3. **The labour market is improving**

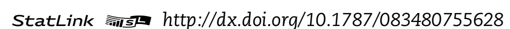
Employment rates

Employed persons aged 15-64 as a share of the total population of the same age group

Unemployment rates

Unemployed persons as a share of the total active population

Source: Eurostat; OECD, *Labour Force Statistics Database.*

StatLink  http://dx.doi.org/10.1787/083480755628

Nevertheless, the overall employment level is low by international standards and is below the Lisbon target of 70%. While the Lisbon target is for the EU as a whole, at the end of 2006 the employment rate exceeded the 70% target in seven countries while five countries fell short by more than ten percentage points, including two large countries (Italy and Poland).

Unemployment rates have fallen sharply over the past two years. By April 2007, the EU unemployment rate stood at 7.1%, down from more than 10% in the late 1990s. This improvement is partly cyclical but the estimated structural unemployment rate for the EU19 has fallen by ½ percentage point over the same period to around 7¼ per cent. The variation in unemployment rates across the EU is striking (Figure 1.4). In April 2007, seven European countries had unemployment below 5% while two countries remained above 10%. Youth unemployment remains a major problem. At 16% for the under-25s, the improvement since 2000 has been modest.

Table 1.3. **Contribution to employment creation by sex, age and type of employment**

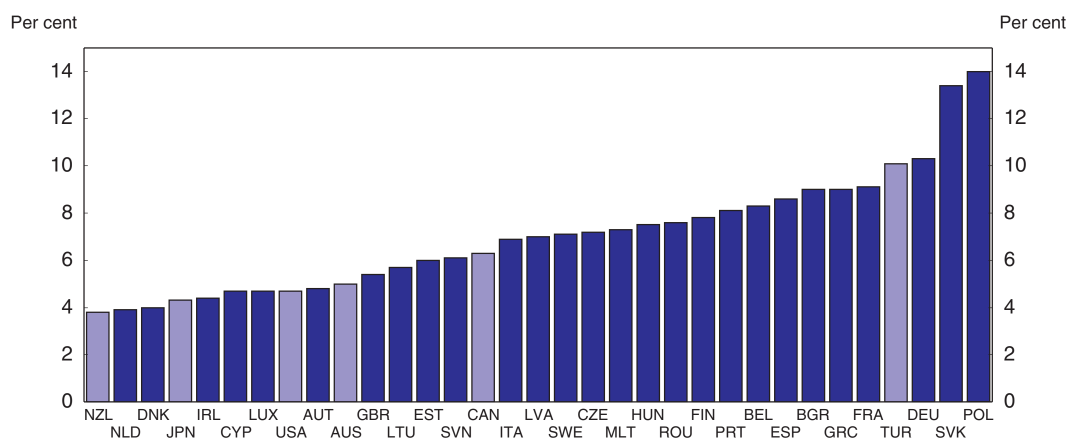
Per cent of total

	2000-06		2004-06	
	EU15	EU27	EU15	EU27
Women				
15-24	0.0	–4.0	1.0	0.3
25-54	42.6	45.3	36.5	34.6
55-64	20.1	22.9	16.3	15.7
All women 15+	64.3	62.7	55.6	51.9
Men				
15-24	0.4	–2.7	3.3	2.7
25-54	14.3	18.0	26.7	29.3
55-64	17.8	21.7	11.5	13.7
All men 15+	35.7	37.3	44.4	48.1
Type of employment				
Full-time	43.0	48.3	48.2	60.2
Part-time	57.0	51.7	51.8	39.8
Type of contract				
Permanent	76.6	53.4	59.2	60.1
Fixed-term	23.4	46.6	40.8	39.9

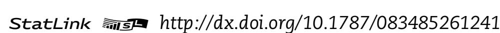
Source: Eurostat.

Figure 1.4. **Unemployment rates**

2006



Source: Eurostat and OECD, *Labour Force Statistics Database*.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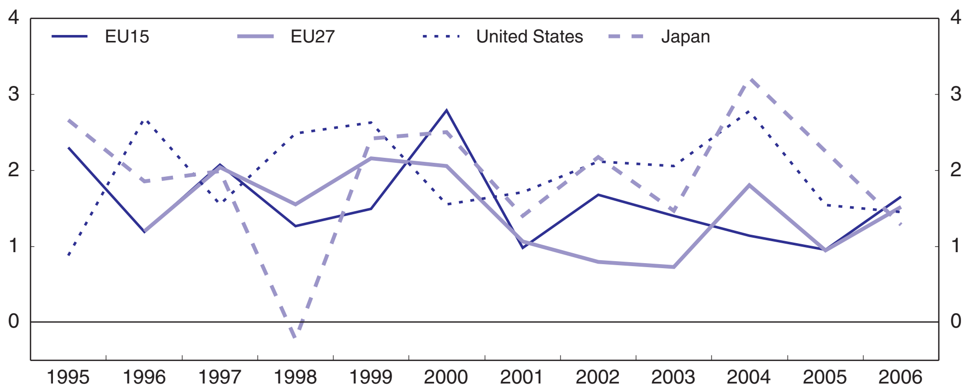
Productivity growth has recovered

Output per worker in the EU grew by 1½ per cent in 2006, which is the first time for some years that productivity growth has exceeded the US rate (Figure 1.5). Productivity growth in the EU15 picked up in the past two years but declined in many of the new member states. Most of the rebound appears to be cyclical but there are signs that the potential rate of productivity growth may have edged up slightly.

Taking a longer perspective, it has been well documented that productivity growth slowed in Europe in the second half of the 1990s while it increased in the United States and

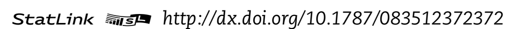
Figure 1.5. **Productivity[1] growth**

Annual percentage change



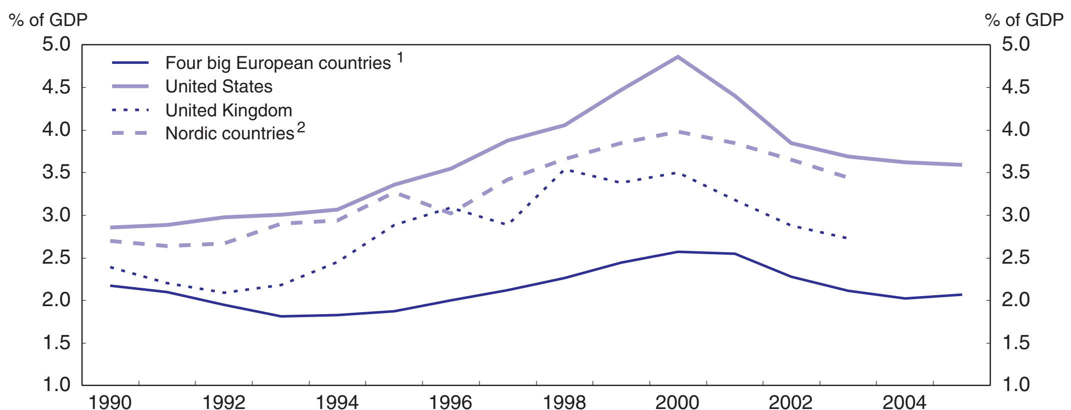
1. GDP per employee for the EU27 and GDP per hour worked for the others.

Source: Eurostat and OECD, *Economic Outlook No. 81 Database.*



several other OECD economies.[3] The productivity pick-up in the United States was concentrated in a small number of information and communication technology (ICT) producing industries and three large service sectors: wholesale, retail and financial services. On the other hand, the productivity slowdown in the EU15 was widespread: productivity growth fell in 45 out of 56 sectors over that period. The decline was greater in industries that were not heavy ICT users, but productivity picked up by a significant amount in two sectors – telecoms and finance – both of which were in the vanguard of deregulation in the 1990s. The productivity slowdown was widespread across countries but was especially large in Germany, Italy and the Netherlands. Developments in multifactor productivity (MFP) show a similar pattern. After adjusting for labour quality and capital input, MFP growth slowed in Europe in the second half of the 1990s while it picked up in the United States. Thus, the United States was not only investing more in ICT (Figure 1.6), it was catching more of the spillovers in MFP.

Figure 1.6. **The ICT investment gap has shrunk**



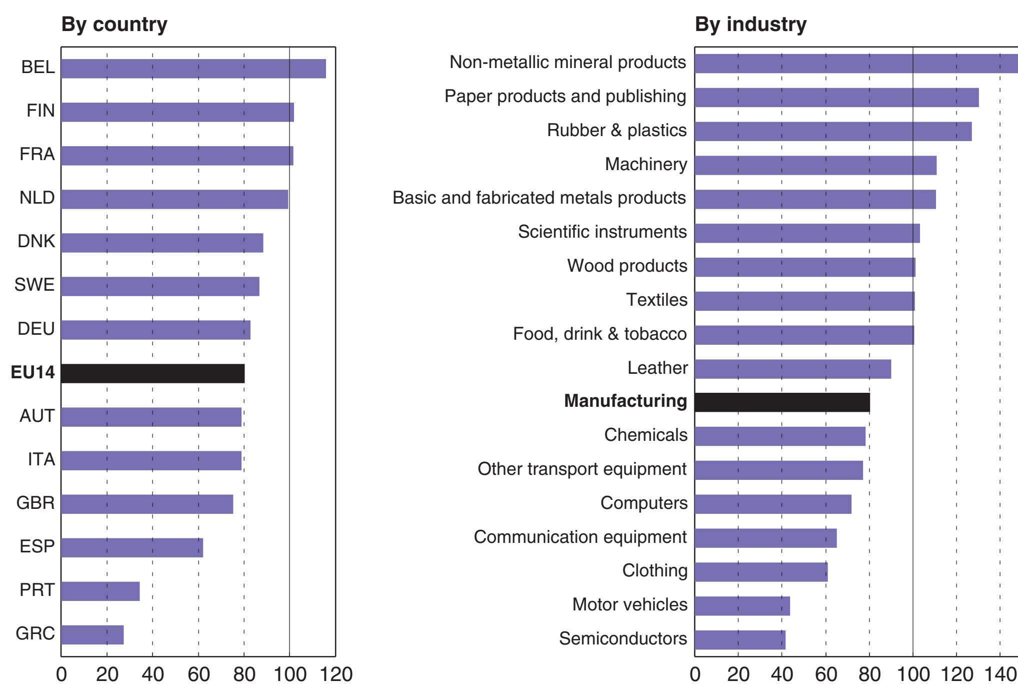
1. France, Germany, Italy and Spain.
2. Denmark, Finland and Sweden.

Source: OECD, *Productivity Database.*

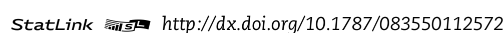
When comparing *levels* of labour productivity in manufacturing around the turn of the century, the EU15 were less competitive in the manufacture of high-tech equipment but were more competitive in some of the more traditional and scale intensive manufacturing industries (Figure 1.7). However, in these latter sectors the comparison with the United States is less relevant because the real competition comes from the developing world.

Figure 1.7. **Productivity levels in manufacturing relative to the US**

Value added per hour, 1999-2001, US = 100



Source: O'Mahony, M. and B. van Ark (2003), *EU Productivity and Competitiveness: An Industry Perspective – Can Europe Resume the Catching-up Process?*, European Commission.

StatLink  http://dx.doi.org/10.1787/083550112572

Since 2000, the pattern within Europe has changed to some extent. Productivity growth in Germany and Italy continued to decline, and they were joined by Ireland as its economic boom slowed and activity shifted towards construction. On the other hand, productivity accelerated significantly in Greece, the Netherlands and Denmark. Most new member states have continued to enjoy strong productivity growth with the notable exceptions of Poland and, very recently, Hungary. Perhaps surprisingly considering Europe's backlog of ICT investment, even after the ICT slowdown the United States still invests much more (relative to GDP) than the major European economies. Hence, there is still some way to go before Europe will be on a sustainable catching-up path.

Substantial challenges lie ahead

All in all, past reforms are paying off. But there is no room for complacency since at 1¾ per cent per annum the EU's per capita potential growth rate remains modest by international standards, especially considering how much room there is for incomes to catch up. Moreover, some significant challenges are looming. The first challenge is that Europe's welfare systems will be under considerable pressure in the coming decades. On a

no policy change basis, population ageing will reduce per capita growth in the EU15 to perhaps as low as ½ per cent per annum in coming decades (Table 1.4). At the same time it will push up public expenditure on pensions, health care and long-term care for the elderly. In addition, non-demographic factors will raise health and long-term care costs. These factors include an expansion in the types of treatments that can be offered to older patients as well as the rising relative price of health and long-term care (OECD, 2006c). These factors are projected to raise ageing-related expenditure by between 4½ and 8 percentage points of GDP (Table 1.5), depending on the underlying assumptions. But no matter whether the higher or lower figure is more realistic, the basic conclusion is the same. While public finances have improved recently, if welfare systems are to be sustainable over the long term Europe needs further fiscal consolidation, more people in work, more flexible working arrangements, later retirement and a willingness to pay more for some social services. These are essentially national responsibilities, so are left to the individual country *Surveys* for further elaboration.

The second major challenge is globalisation. This is discussed in the next section.

Table 1.4. **Long-term growth scenarios assuming no policy change**

Average annual growth rates

		2000-05	2005-10	2010-30	2030-50
Growth in GDP per capita					
EU15		1.2	1.5	0.5	0.5
EU10	Baseline scenario	3.9	3.9	3.2	1.2
	Smooth catch-up		3.0	2.9	1.6
	Slow catch-up		2.4	2.5	1.4
Labour productivity growth					
EU15		0.8	0.8	0.8	0.8
EU10	Baseline scenario	3.6	3.4	3.0	1.9
	Smooth catch-up		2.7	2.8	2.3
	Slow catch-up		2.0	2.4	2.2
Employment growth					
EU15		0.8	1.1	–0.2	–0.3
EU10		0.1	0.2	–0.1	–1.1

Note:

The rows shown above do not add up because population growth is omitted from the table. Calculations are based on EC (2006) but the assumptions are modified in several respects. The key difference is that labour productivity is assumed to be unchanged for the EU15 (the EC assumed convergence to the US TFP growth rate). Second, employment rates are assumed to increase by slightly less from 2005-10 (the increase is assumed to be 50% more than the increase from 2000 to 2010).

The scenarios for the EU10 are as follows. (1 – baseline) uses the EC's assumption. It amounts to a convergence speed of labour productivity of 3.3% per annum until 2030 and 0.75% thereafter. (2 – smooth catch-up) assumes 2% catch-up per annum for the whole period. The level of labour productivity in 2050 is almost the same under scenarios 1 and 2. (3 – slow convergence) A catch-up rate of 1% per annum is assumed. Labour productivity in 2050 ends at 72% of the EU15 level, compared with 83% under scenarios 1 and 2.

Source: OECD calculations and EC (2006), *Impact of Ageing Populations on Public Spending*, European Commission, Brussels.

Making the most of the opportunities from globalisation

The acceleration of globalisation over the past decade has not created any new issues for Europe, but it has raised the stakes on some old ones. In particular, it has put a premium on flexibility and innovation. Being open to trade and investment is one of the most important steps Europe can take to raise its living standards over the long term. By one estimate, at least a fifth of Europe's post-war income gains can be attributed to

Table 1.5. **Projected changes in public spending on health care, long-term care and pensions**

2005-50, in percentage points of GDP

	Healthcare	Long-term care	Pensions	Total
EU25	1.6	0.6	2.2	4.4
EU15	1.6-3.6	0.7-2.1	2.3	4.6-8.0
EU10	1.3	0.2	0.3	1.8
EU10 excluding Poland	1.3	0.3	4.8	6.4

Note: The projections for the EU come from EU EPC (2006). For the EU15, OECD projections for healthcare and long-term care are also shown (see OECD, 2006). These are considerably higher than the EU projections, mainly because of different assumptions for non-demographic trends such as the rising preference for health care with income and the falling share of informal long-term care which results from increases in labour force participation.

Source: OECD (2006), "Projecting OECD Health and Long-Term Care Expenditures: What Are the Main Drivers?", *OECD Economics Department Working Papers*, No. 477, Paris; EU EPC (2006), *Impact of Ageing Populations on Public Spending*, European Commission, Brussels.

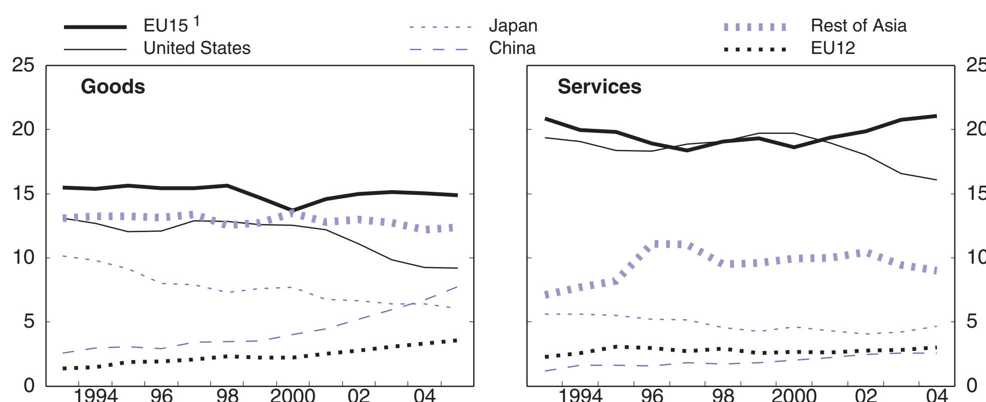
globalisation (Denis *et al.*, 2006). This has not come at the expense of high unemployment. Looking at patterns across countries, there is no link between employment rates and openness to trade (OECD, 2005b). Yet there are winners and losers within each country, and the adjustment costs cannot be ignored. Indeed, the gains from trade are being questioned in some quarters because globalisation is nowadays based more on changing patterns of specialisation associated with factor endowments rather than the intra-industry trade deepening that was characteristic of the post-war period. This type of globalisation can raise adjustment costs and focuses the pain more narrowly.

Europe has done well out of globalisation over the past decade. It has maintained its export market share for goods and services (Figure 1.8) while the United States and Japan have seen declines in theirs. It helps that the EU is a leading exporter of capital goods, so it stands to benefit more from the early stages of industrial revolutions abroad.

Nonetheless, there has been a backlash in some quarters. The dispute with China after textile quotas were removed is the most visible example. Moreover, political involvement or debate in several large mergers has led to charges that some governments are trying to protect their national champions.[4] Similarly, some politicians have complained that

Figure 1.8. **Europe has maintained its export shares**

Share of world exports, per cent



1. EU15 excludes intra-region trade.

Source: UN, *Comtrade Database* and OECD calculations.

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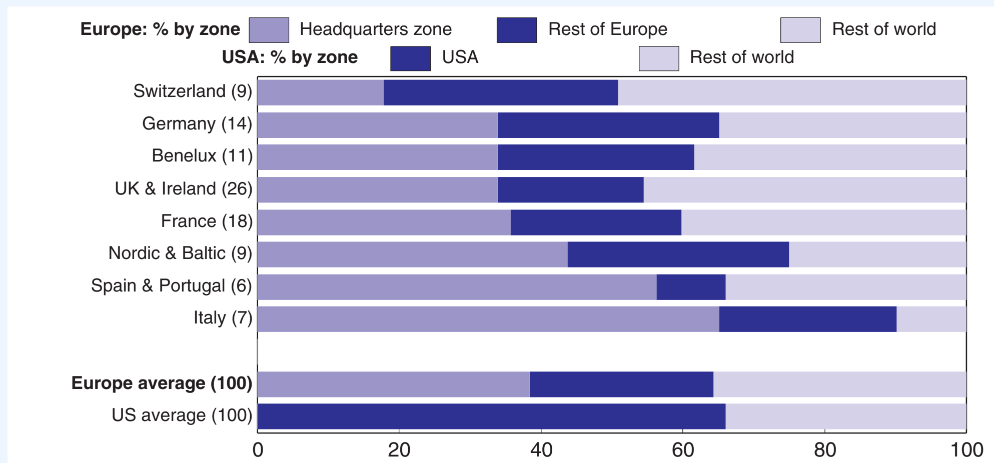
capital mobility is eroding economic sovereignty as "financial locusts" undermine national values and institutions. It is unclear whether this is marginal behaviour or whether it is a serious threat to integration, and Europe is not the only place where protectionist attitudes can be found. National champions are giving way to European champions in any case (Box 1.3). But there is a risk that protectionist attitudes could endanger market integration and potentially degenerate into tit-for-tat behaviour by member states. This would be a serious blow to living standards over the longer term.

Box 1.3. **National or European champions?**

Bruegel, a think tank based in Brussels, has looked at how globalised are the largest listed companies in Europe and the United States. They are surprisingly similar. In 2005, the top 100 European companies generated two-thirds of their revenues in Europe and one-third abroad (Figure 1.9). This is almost identical to the top 100 US firms, which also generate one-third of their revenues abroad. Among the European firms, around 37% of global revenue was generated in the home country and 28% in other EU countries. There are large differences across countries, however. German companies are among the front-runners of both europeanisation and globalisation – *i.e.* they are significant exporters to other EU countries and to the rest of the world. Italian and Spanish companies remain strongly biased towards their home markets. Comparing across sectors, the home bias is lowest for goods such as pharmaceuticals, chemicals and consumer products. The more regulated industries such as banking and telecoms remain predominantly national.

Figure 1.9. **Europe top 100: Average revenue structure by headquarters zone**



Source: Véron, N. (2006), "Farewell National Champions", *Bruegel Policy Brief*, Issue 2006/04, June, Figure 4.

The study also looked at how these patterns have changed since 1997 (for a subset of around half the companies). Interestingly, the increase in globalisation has been almost identical in Europe and the United States. The share of revenues coming from the rest of the world rose from 28 and 29% respectively in 1997 to reach 35% in both regions in 2005. For European companies, europeanisation has been stronger than globalisation. The share of sales generated at home has decreased by around 15 percentage points while the share coming from the rest of Europe has gone up by around 8 percentage points. Once again, the patterns differ across countries. The home bias has decreased in the United Kingdom, Italy, Germany and France by 25, 21, 17 and 12 percentage points respectively. French and Italian companies have tended to europeanise, with the proportion of non-European revenue remaining stable. In Germany and the United Kingdom, europeanisation and globalisation have occurred simultaneously.

The rest of this section discusses the opportunities and challenges created by globalisation. It looks at which countries are most exposed and asks why some countries have managed to cope more easily – *i.e.* why the more flexible OECD countries have thrived while others have struggled to adapt.

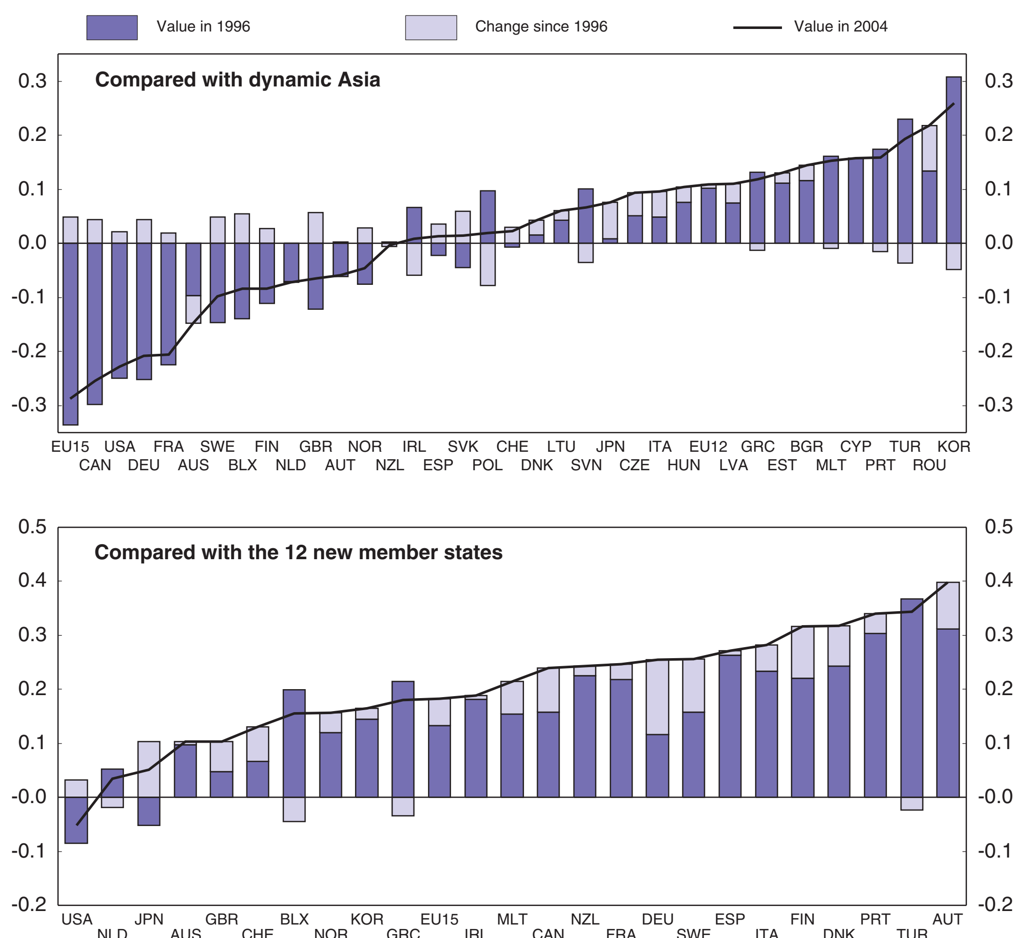
Which countries are most exposed to globalisation?

Who is competing head-to-head with China and the other emerging economies?

Figure 1.10 shows the extent to which countries are competing head-on with dynamic Asia. It is based on the "revealed comparative advantage" and in essence shows the correlation between a country's export shares and the corresponding export shares of the dynamic Asian economies, calculated at a disaggregated level.[5] For example, the EU15 is strong on engineering, pharmaceuticals and services while the new member states concentrate on medium and lower-technology manufactures and forestry related products. A positive correlation means that a country is specialising in similar industries as Asia. Most of the richer

Figure 1.10. **Trade specialisation**

Rank correlation coefficient of RCAs[1]



1. The revealed comparative advantage index is calculated across 1 043 categories of goods and services. The EU aggregates exclude intra-region trade.

Source: UN, *Comtrade Database* and OECD calculations.

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countries in the OECD, including most of the EU15, have a low or negative correlation which means that their exports compete little with those of the developing world. For them, globalisation is more of an opportunity than a threat. Most of the new member states and the poorer OECD countries export similar products as Asia, so are facing tougher competition.[6] But several of the EU15 countries, notably Italy, Greece and Portugal, are also in this category mainly due to their specialisation in traditional sectors such as textile, clothing and leather industries. Over time, they will need to shift out of these industries or become niche players in the higher value added segments, such as luxury or brand-name goods. There is some evidence of quality upgrading, for instance, in the case of Italy.

Most OECD countries have become more exposed over time as the developing world has moved up the value added chain. This is most noticeable for the mainly richer countries that were least exposed in the mid-1990s (*i.e.* the countries on the left hand side of the chart). However there are exceptions, including Australia, Ireland and Poland, which have moved away from the exports that developing countries are now specialising in.

The figure also shows correlations for the EU15 and the EU12 excluding intra-area trade, treating each region as if it were a single entity. For the EU15 as a whole, the correlation with dynamic Asia is more negative than for any of the individual member countries. This is because trade among individual EU15 countries is dominated by intermediate inputs and semi-finished products of the type that dynamic Asia produces. One implication is that it is by no means inevitable that intra-European trade will increase over time; it could go into reverse as the developing world raises its share of intermediate and semi-processed products.

EU countries are affected in a similar way by "internal globalisation", or europeanisation. Low-wage manufacturing and medium-skilled service jobs in the EU15 are facing increased competition from the new member states (Figure 1.10, panel B). The EU12's closest neighbours are most exposed. Of all OECD countries, Austria's trade mix is the most similar to the EU12, which aside from its geographical proximity may explain why it is one of the heaviest investors in Eastern Europe.

Who specialises in the fastest-growing industries?

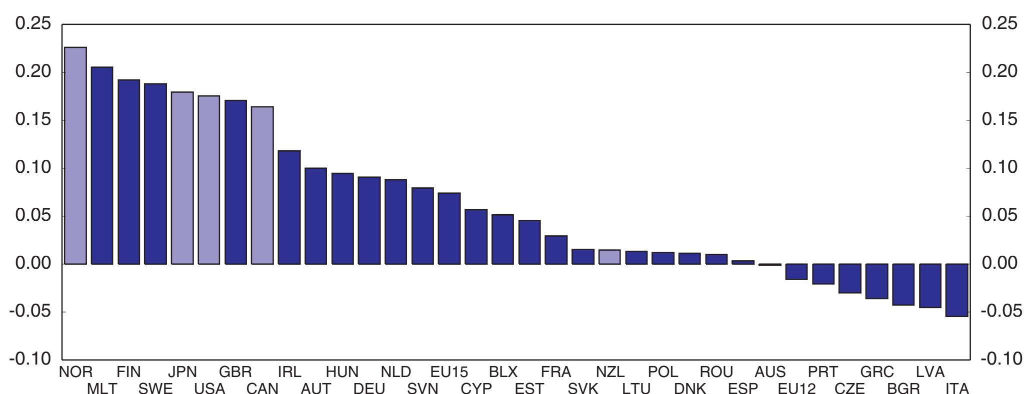
Another way to look at exposure to globalisation is to ask which countries specialise in the fastest growing sectors. Figure 1.11 shows the correlation between a country's export shares for each commodity and the growth rate of world trade in that product (weighted by world trade shares). Finland and Sweden, for example, specialise in high-growth sectors such as telecoms while at the other end Greece specialises in slow-growing textiles, agriculture and fishing. When intra-European trade is excluded, the EU as a whole specialises in products that have had relatively low export growth rates over the past decade.

Who specialises in high-tech products?

High-tech goods (especially ICT products) make up a smaller share of EU15 exports than in Japan and the United States (Table 1.6). With a couple of exceptions, the new member states and the Mediterranean countries export more low-tech products. China has shifted towards high-tech products at a very rapid pace: its share of high-tech exports doubled between 1996 and 2004. However, this may overstate the gains. While China is no longer just a low-wage country assembling cheap manufactures, in the high-tech field it specialises mainly in the labour intensive and low value added parts of the production chain (Denis *et al.*, 2006).

Figure 1.11. **Correlation of trade shares with market growth**

Rank correlation of RCA index with the growth rate of world exports,[1] 1996-2004



1. Weighted by export values, for 619 selected commodities.

Source: UN, *Comtrade Database* and OECD calculations.

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Table 1.6. **Export shares by skill intensity**

2004

	High technology	ICT (part of high-tech)	Medium-high technology	Medium-low technology	Low technology
World	**23.5**	**15.4**	**41.3**	**14.1**	**21.1**
EU15	22.8	9.8	46.9	12.7	17.6
EU12	14.1	13.9	41.3	18.5	26.1
US	32.8	17.5	43.6	9.7	13.9
Japan	23.8	18.4	59.9	12.1	4.2
China	27.7	24.9	27.7	12.8	31.8
SE Asia (excluding China)	36.9	32.5	32.4	9.3	21.4

Source: OECD calculations based on UN Comtrade.

Who has the largest pools of less-skilled labour?

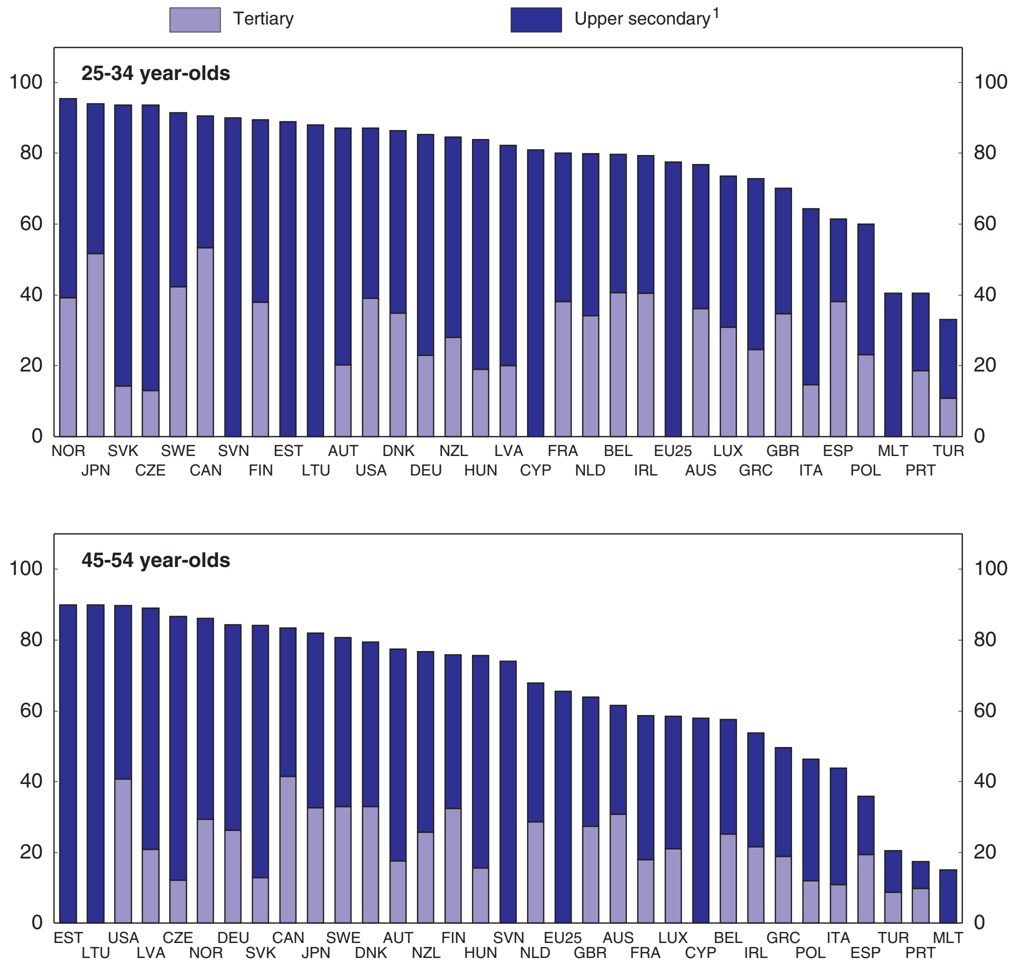
A feature of the recent globalisation trend is that it has doubled the effective global workforce. Least-skilled workers are the most affected because they face stronger competition from cheap labour abroad and are less able to move into new jobs in other industries. Education and on-the-job training are therefore becoming more important. While the average education level in the majority of EU countries is high, there is wide variation among member states (Figure 1.12). In countries such as France, Belgium, Ireland and Spain a large proportion of younger workers have tertiary qualifications while some Eastern European and Mediterranean countries face a considerable challenge, especially regarding their older workers.

Who stands to gain from outsourcing and off-shoring?

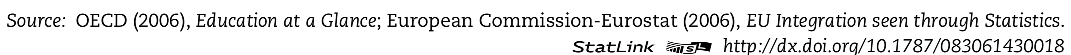
Developments in ICT and a reduction in shipping costs are leading to a fragmentation of production chains through greater international sourcing of intermediate inputs. Imports of intermediate goods and services have increased from around 8% of world GDP in 1982 to around 12% today. While such outsourcing lowers production costs, there are fears that it can lead to job losses and wage cuts for certain groups. However, the balance

Figure 1.12. **Indicators of educational attainment**

Percentage of age group having attained a certain level of education, 2004



1. The split between upper secondary and tertiary is unavailable for Cyprus, Estonia, Latvia, Lithuania, Malta, Slovenia and EU25.



Source: OECD (2006), *Education at a Glance*; European Commission-Eurostat (2006), *EU Integration seen through Statistics*.

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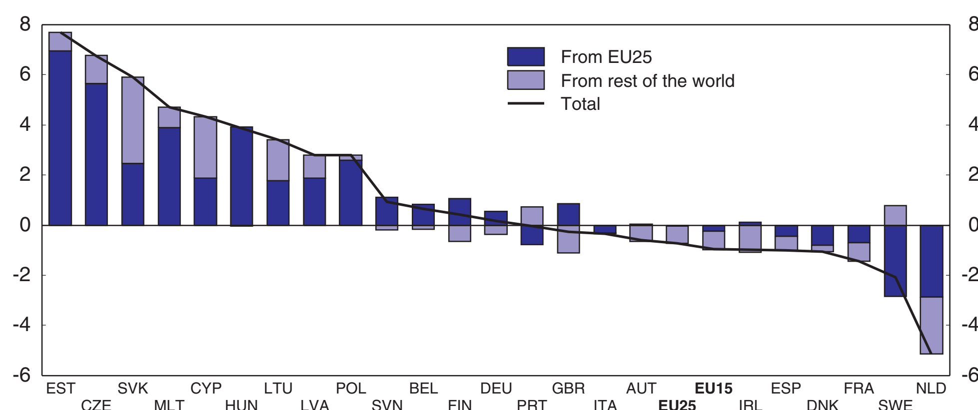
of evidence suggests that EU15 countries have been among the biggest winners from this trend (Havik and McMorrow, 2006). The EU15 has a positive trade balance of intermediate goods and services and its surplus has increased over the past decade, which suggests it is insourcing more jobs than it is outsourcing. The EU15 has about a third of the global market for trade in services (excluding tourism). Several EU countries have large trade surpluses in services[7] (including the United Kingdom, Sweden, Finland, Luxembourg and Ireland) while only one has a deficit greater than 1% of GDP (the Czech Republic). Nevertheless, some countries[8] have a low import intensity of services suggesting their companies have a lot of scope for boosting outsourcing in the future.

There are also concerns about off-shoring. The level of foreign investment is one bellwether of economic health since it is a gauge of how capital markets may be voting with their feet. The new member states have received net capital inflows over the past five years (Figure 1.13). The EU15 has seen a modest net outflow, except for Belgium, Finland

Figure 1.13. **Net FDI inflows**
In per cent of GDP, 2001-05



Source: Eurostat.

StatLink http://dx.doi.org/10.1787/083086606787

and Germany. In most cases the outflows from the EU15 are small and investment tends to go to other developed countries. For example, delocalisation to low-wage countries represents less than 3% of French investments abroad (Fontagné and Lorenzi, 2005). It can be a positive phenomenon too. Evidence from a study of Italian and French firms shows that investing in low-wage countries had a positive long-term effect on a firm's output and (in Italy) its productivity, suggesting that efficiency gains could enhance the long-term competitiveness of investing firms and therefore be a net benefit to the investing country (Navaretti *et al.*, 2006).

Which countries are best placed to cope?

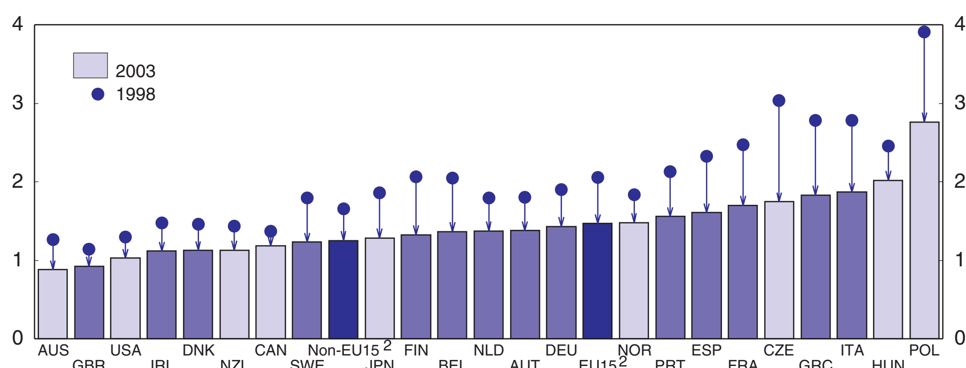
Coping with globalisation is about coping with change. Flexible product and labour markets, sound social policies, active labour market policies and well-developed capital markets are necessary to keep adjustment costs to a minimum. A regulatory environment that emphasises competition will assist the move out of struggling industries into more profitable ones. Flexible labour markets make it easier for people to move into new productive jobs and new industries while supportive welfare policies can smooth the transition from inactivity to employment.[9]

Who are the most adaptable economies?

Flexibility is reduced by anti-competitive product market regulations. Europe has made considerable progress in liberalising its product markets but it remains more heavily regulated than the average OECD economy (Figure 1.14). But this masks some important differences across countries and sectors. For example, the United Kingdom, Ireland and Denmark are among the most lightly regulated countries in the OECD but if one looks at the network industries only, Ireland's regulatory barriers are comparatively high. The way in which firms are protected differs across countries as well. At the risk of oversimplifying, countries with a Germanic legal tradition tend to have relatively complex administrative procedures; those from the Napoleonic/civil legal system have relatively high state control and barriers to business start-ups; and the new member states tend to protect their industries with sector-specific regulation and ownership barriers, including state ownership (Table 1.7).

Figure 1.14. **Product market regulation**

Index scale of 0-6 from least to most restrictive[1]



1. These indicators measure the level of anti-competitive regulation but not how strictly they are enforced.
2. Weighted average, excluding Luxembourg for the EU15.

Source: OECD, *Product Market Regulation Database*, *www.oecd.org/eco/pmr*.

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Table 1.7. **Product market regulation**

PMR index minus average for the OECD, by type of regulatory barrier

	Legal origin[1]				
	Napoleonic/civil	Germanic	British/common law	Scandinavian	New members
State control					
Scope of public ownership	0.3	–0.4	–0.9	0.0	0.8
Regulatory burden on business procedures	0.4	0.0	–0.5	–0.6	0.3
Barriers to entrepreneurship					
Administrative burdens on start-ups	0.5	0.3	–1.0	–0.8	0.9
Sector-specific administrative burden	0.3	0.3	–1.0	–0.7	0.9
Barriers to entry					
Barriers to entry in industries	0.1	0.0	–0.4	0.4	–0.4
Complexity of administrative procedures	–0.3	0.2	0.0	0.2	–0.2
FDI Barriers					
Ownership barriers	–0.2	–0.1	0.0	–0.4	0.7
Discriminatory procedures	0.2	0.0	–0.4	–0.2	0.3
Network industries	0.3	0.0	–0.2	–0.2	. .
Professional services	0.3	0.0	–0.4	–0.8	0.6

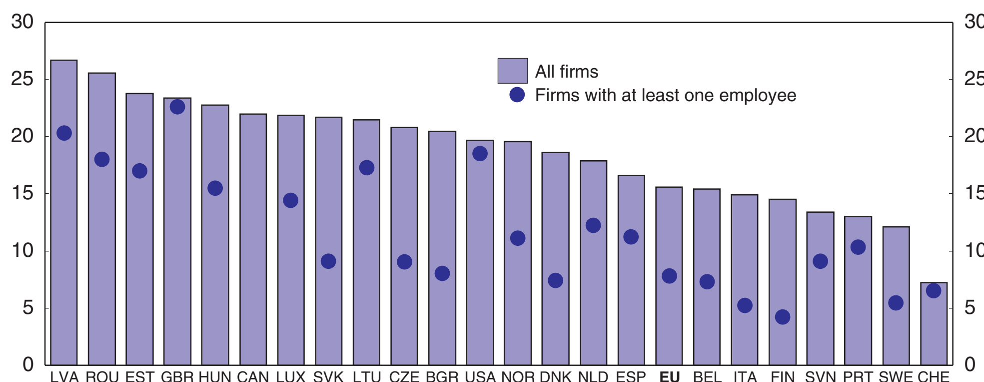
1. Countries are grouped according to the classification in La Porta *et al.* (1997), "Legal Determinants of External Finance", *Journal of Finance*, Vol. 52, No. 3. Specifically, Napoleonic/civil: Belgium, France, Greece, Italy, Mexico, Netherlands, Portugal, Spain, Luxembourg; Germanic: Austria, Germany, Japan, Korea, Switzerland; British: Australia, Canada, Ireland, New Zealand, United Kingdom, United States; Scandinavian: Denmark, Finland, Iceland, Norway, Sweden; New members: Czech Republic, Hungary, Poland, Slovakia.

Source: OECD *International Regulation Database*, *www.oecd.org/eco/pmr*.

The rate of firm creation and destruction is one gauge of flexibility. The entry of new firms in the most innovative industries makes a strong contribution to aggregate productivity growth while in mature industries productivity growth is driven more by within-firm efficiency improvements and by the exit of obsolete firms (OECD, 2001; Rincon and Vecchi, 2003). Firm turnover is higher in the English-speaking countries and some of the new member states while it is comparatively low in Switzerland, Sweden and Portugal (Figure 1.15). Once established,

Figure 1.15. **Firm turnover in industry and services**

Firm births plus deaths as per cent of number of firms, average 1997-2004[1]



1. 1996 for the United States and 1997 for Canada.

Source: Eurostat; OECD Firm-Level Data Project, *www.oecd.org/eco/firmlevel/dataproject*.

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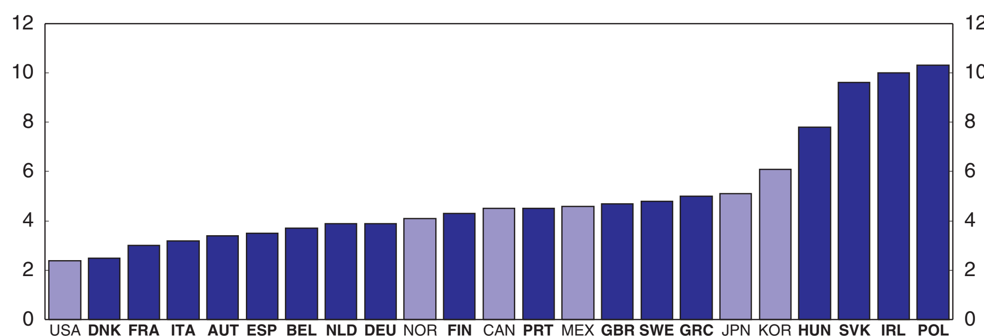
new firms grow slower in the EU than in the United States, suggesting that shifting resources towards the winners is more difficult in Europe (OECD, 2001). This could be because it is harder in Europe to find finance to grow (Aghion and Howitt, 2006).

The degree of flexibility can be gauged by the amount of structural change that has occurred, though it is not a perfect measure since it also depends on how much change was needed. For example, the industrial structures of both the United States and France have been relatively stable since the early 1990s (Figure 1.16). That may be because their economic structures were suitable to begin with or because they were slow to adapt to a changing world. But broadly speaking, there are countries such as the new member states and Ireland that have changed their industrial mix enormously while there are others

Figure 1.16. **The pace of structural change**

Index of structural change in the economy,[1] 1992-2003



1. The structural change index measures the average rate of change of the share of value added generated by each sector between 1992 and 2003 (or the closest possible years), *i.e.* if Δs_i is the change in the value added in sector *i* between 1992 and 2003, then the index is:

$$\frac{1}{44}\sum_{i=1}^{44}\left|\Delta s_i\right|/(2003-1992)\times 100$$

Data covers up to 44 sectors. It excludes the oil and mining sectors except for France and Portugal.

Source: OECD, *STAN Database*.

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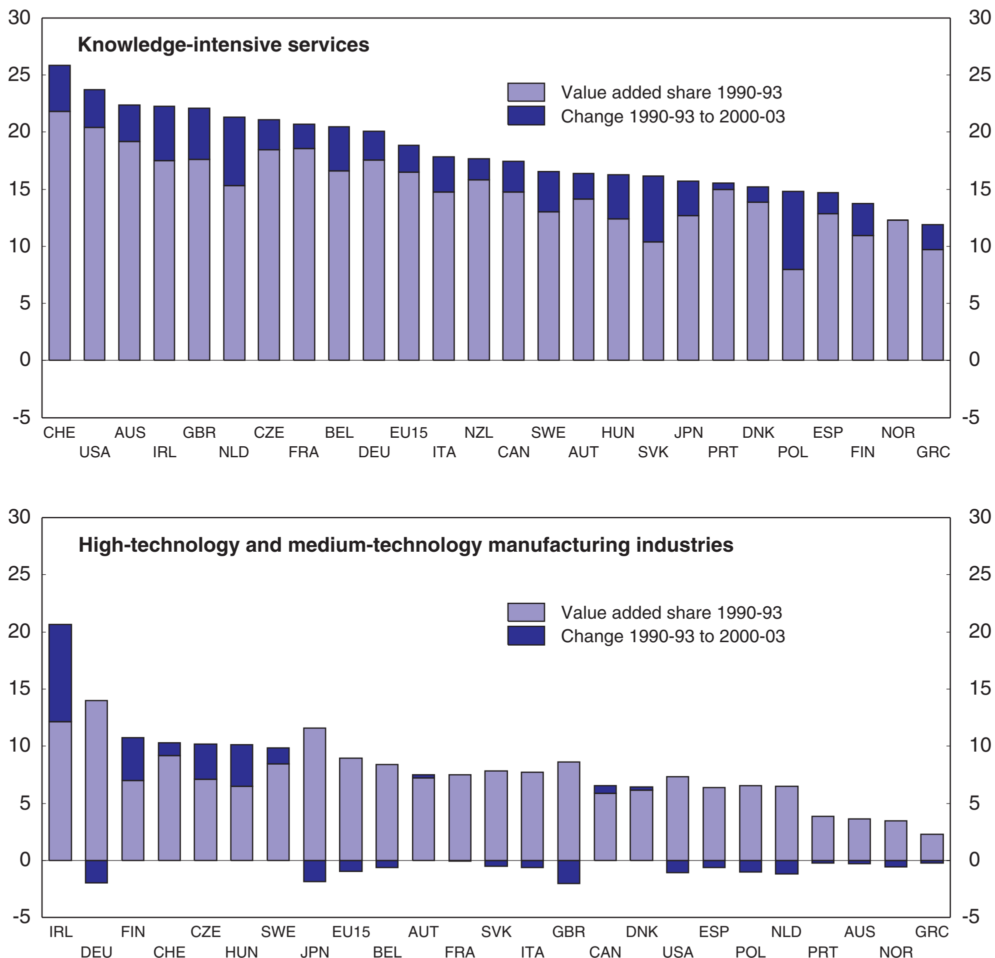
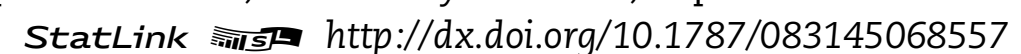
Figure 1.17. **Value added is shifting from manufacturing into services**

Value added shares by industry and change between 1990-93 and 2000-03



Source: OECD, *STAN Database*; Groningen Growth and Development Centre, 60-*Industry Database*, September 2006.

StatLink  http://dx.doi.org/10.1787/083145068557

– such as Italy and Denmark – where the pace of change has been surprisingly low. This can also be seen in Figure 1.17, which shows that some countries have been better at shifting towards knowledge-intensive services and high-tech manufacturing.

Who has the most flexible labour markets?

Strict employment protection legislation (EPL) can slow down structural change by reducing job turnover and labour mobility. Its side-effects are felt most strongly by groups on the margins of the labour market such as women, youths and older workers. Most continental European countries have relatively stringent EPL, which partly explains why trade-displaced workers in Europe are slower to find new jobs than their US counterparts (OECD, 2005b). In contrast, EPL in the new member states tends to be low.[10] Apart from Austria and Slovakia, there has been little progress in reducing EPL on permanent contracts between 1998 and 2003. EPL for temporary workers has eased in some countries, but the level of regulation in the major continental European economies remains higher than the

OECD average. Moreover, the different treatment of temporary and permanent contracts has encouraged a two-tier labour market that is undesirable from an economic and equity point of view. Some countries have managed to reduce the adverse impacts of EPL by having dynamic internal labour markets (*i.e.* job reallocation within large firms) but this strategy will be less effective when structural change affects whole industries.

Annex 1.A1 presents several indicators of labour market flexibility. Each indicator has its defects, and differences in labour mobility reflect not only an economy's ability to adjust but also whether it needs to do so. Nonetheless, the different measures are well correlated and when taken together they give a reliable assessment of differences in adjustment capacities across OECD countries:

- Low *unemployment persistence* can be a sign that a country is good at reallocating workers who have lost their jobs. The Nordics and the English-speaking countries tend to have a low incidence of long-term unemployment and significantly greater outflow rates from unemployment. The incidence of long-term unemployment is especially high in the new member states.
- *Average job tenure* is around twice as long in France and Japan as it is in Australia and Iceland. While this is a general indicator of job turnover, tenure can be high for good and bad reasons.
- In a sample of thirteen European countries there was not much difference in *job destruction rates* but some countries had considerably higher *job creation rates* than others (Gómez-Salvador *et al.*, 2004). Moreover, there was no correlation between creation rates and destruction rates across countries. This suggests that while labour market policies may not be able to do much to prevent job losses, well designed policies may improve job creation rates.
- *Regional labour mobility* can help when faced with structural change that affects regions unequally. Internal migration is high in Japan and the English-speaking countries but is very low in some European countries that have both a high incidence of long-term unemployment and large disparities in unemployment rates across regions.

Real wages will eventually adjust to structural change but faster adjustment generally implies fewer layoffs. In a meta-analysis of labour market studies, EC (2006a) finds that real wages respond more quickly in labour markets that are deregulated and where trade unions are less common.[11] The evidence from microdata goes in the same direction but is a little less clear-cut. The Brookings-led International Wage Flexibility Project (Dickens *et al.*, 2006) analysed 31 individual-level data sets in 13 countries and found that real wages are most flexible in Greece, the United States, the Netherlands and Germany while they are comparatively rigid in Sweden, France and Finland (Figure 1.A1.1, panel F).[12]

Wage rigidities at the lower end of the distribution can be exacerbated by minimum wage floors. At least one out of every eight full-time employees in Luxembourg, Latvia, France, Romania and Lithuania was earning the minimum wage in 2004 (Eurostat, 2006) although this may be less of a problem in the new member states as wage floors are rarely enforced (Boeri and Garibaldi, 2006). When faced with structural change affecting low-skilled workers, an in-work benefit may be a more effective anti-poverty measure.

Labour market flexibility is also influenced by the housing market. People will be less likely to move to another region if they face high costs in selling their house such as transaction taxes and the loss of tax privileges that are related to residence periods. Transaction costs are low in the United Kingdom (Figure 8.7), and it has a relatively high rate of regional mobility. The opposite is true for Belgium, Italy and Greece.

Who has the best innovation frameworks?

To get the most out of globalisation, countries will need to move up the value added chain. That requires innovative research-based economies. Innovation is the centrepiece of the EU's Lisbon Strategy which in 2000 set the goal to make the EU "the most competitive and dynamic knowledge-driven economy by 2010" (Box 1.4). While it is making progress in some areas, the EU is falling short of this vision, lagging behind the United States and Japan on most indicators of innovation performance (EC, 2006b). On the positive side, the ICT gap has been shrinking and the EU is a world leader in some areas such as aerospace, mobile phones and parts of the engineering industry. Some member states, including the Nordics, spend heavily on research and development (R&D), mainly because of their

Box 1.4. **The Lisbon Strategy for Growth and Jobs**

In March 2000, EU governments signed up to the goal of making Europe "the most competitive and dynamic knowledge-driven economy by 2010". There were many goals, but the main ones included: 1) boosting innovation and research and development (R&D), including setting a target for R&D expenditure of 3% of GDP; 2) faster structural reform, including completing the internal market; 3) modernising the social model (for example, through labour market reform and tackling exclusion) with a goal of an employment rate of 70% (60% for women and 50% for older workers); 4) cutting red tape; and 5) a sound macropolicy mix.

The strategy was relaunched in 2005 after a review by Wim Kok found that it was unfocussed and had delivered little progress. It is now focussed more clearly on growth and jobs. Most of the numerical targets in the first version were discarded and it now has quantitative targets for employment (70%) and R&D spending (3% GDP). At the 2006 Spring European Council member states identified four priority areas and agreed upon concrete actions to achieve progress. The four priority areas identified were: 1) investing more in knowledge and innovation; 2) unlocking business potential (*e.g.* by cutting red tape), especially for small- and medium-sized enterprises; 3) greater adaptability of labour markets; and 4) guaranteeing secure and stable energy supply.

Aside from tighter priority setting, governance of the strategy was improved through a clearer partnership and division of responsibilities at the community and national levels. Member states drafted National Reform Programmes setting out their policy intentions for 2005-08 and appointed national co-ordinators. Those reforms to be undertaken at community level were presented in the Community Lisbon Programme.

At the community level, the priorities included supporting knowledge and innovation; reforming state aid policy; cutting red tape on businesses; completing the internal market for services; finalising the Doha trade round; removing obstacles to labour and academic mobility; developing a common approach to migration policy and dealing with the social aspects of economic restructuring.

Member states have submitted reports on the implementation of their National Reform Programmes and achievements in the four priority areas. The Commission's 2007 Annual Progress Report concludes that member states are indeed making progress in structural reforms. The European Council in March 2007 has decided to address country-specific recommendations to most of its member states to keep up the pace of reforms, taking advantage of the current favourable economic conditions.

Source: http://ec.europa.eu/growthandjobs/index_en.htm.

strength in the pharmaceutical, defence and ICT industries. However, the gap in business R&D expenditure has not shrunk and there is evidence that firms in the United States get higher returns from their R&D expenditure (Rincon and Vecchi, 2003).

All countries have taken steps to improve the way they fund and steer public research and to improve the transfer of knowledge between the public and private sectors. There is a general shift towards more decentralised systems with financing from multiple sources and greater use of project-based rather than institutional funding. Some countries are trying to create critical mass by concentrating funds in a small number of research centres or clusters. There is a trend toward greater management autonomy for institutions, albeit with wide variation across member states. Many countries are reforming their intellectual property rules to encourage public research organisations to patent their inventions and to develop commercial applications. At the community level, the seventh framework programme for 2007-13 commits funding amounting to 0.06% of EU GDP per annum in ten priority areas. A European Research Council (ERC) has also been created to fund basic research and public-private partnerships in a variety of cutting-edge technology fields.

Innovation is a complex and poorly understood phenomenon, but the policy recommendations contained in *Going for Growth* (OECD, 2006a) give some guidance for other areas that member states need to focus on. First, countries with deeper financial markets tend to spend more on R&D. Venture capital can be scarce where there is excessive taxation of capital income, where portfolio restrictions limit institutional investors such as pension funds from holding non-listed or high-risk companies, where barriers to cross-border mergers make it harder to exit an unsuccessful venture and where bankruptcy procedures are long and costly. Openness to foreign investment is important because foreign-performed R&D has a significant effect on domestic multifactor productivity growth. In most cases competition boosts innovation activity, so removing barriers to competition in the sheltered sectors can be good for growth. Finally, a country's innovation performance is influenced by its ability to produce, attract and retain highly skilled people. Education is important here, but so too is immigration policy.

In general, the Nordic countries are performing well in most areas, although some of their governance frameworks could be improved to ensure they are getting maximum value for money for their high levels of public expenditure. The major continental European countries have well-trained workforces but their potential is being held back by weaknesses in tertiary education institutions. Most of southern and eastern Europe needs to improve educational outcomes and the way in which they support private-sector R&D. Some must also stimulate entrepreneurs by stripping away the barriers to firm creation.

While encouraging inventions is important, so too is protecting them. Europe's system of patent protection is cumbersome and expensive. An inventor must apply for a patent in every country where he or she wants to protect it. The cost of applying for and maintaining a patent is up to 13 times higher than in the United States or Japan, mainly because of translation costs. An attempt to create a Community Patent failed over the issue of which languages it must be filed in and disagreements over jurisdictional issues. Moreover, for "bundled" European patents, parties may be required to obtain separate rulings in different jurisdictions, which opens them to the risk of inconsistent decisions concerning the same patent. An attempt by the European Patent Organisation to break through this problem by creating a European Patent Court also failed in 2006. In order to relaunch the debate, the Commission adopted a communication in April 2007 which sets out political options for a patent strategy over the next few years.

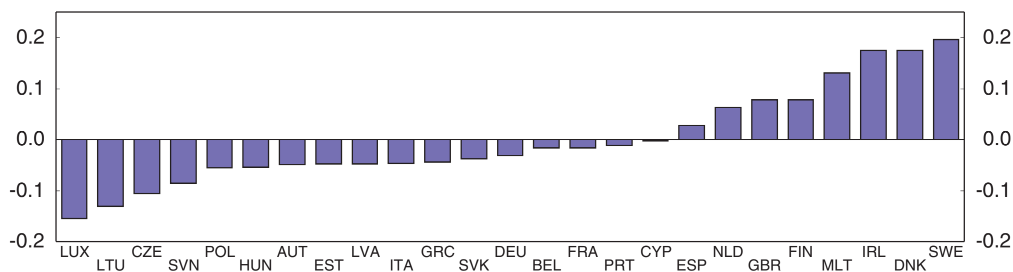
Who has the best education system?

Maintaining a competitive edge requires a skilled workforce. While some of Europe's education systems are among the world's best, others have some catching up to do. According to the OECD's PISA study, Finland tops the league tables that measure the performance of secondary school students. It has succeeded mainly because it has moved away from a command and control system towards a focus on outcomes, has embraced diversity and individualised learning and has emphasised high standards of teaching. While it is difficult to assess the overall quality of education systems, at the tertiary level few of Europe's universities are regarded as world class (Schleicher, 2006).[13] Institutions in many countries are held back because governments are neither funding them properly nor allowing them to charge tuition fees. The EU spends less per student than Japan and the United States at all levels of education, and the gap is widest at the tertiary level. Some institutions are hamstrung by a lack of flexibility and dynamism that stems from overly bureaucratic control and because professors maintain what amounts to a closed shop.

Patterns of student mobility give some indication of how they view different education systems, although there are more factors at play than just quality (*e.g.* cost and language). The United States receives more than 40% of the students from OECD countries who study abroad, while Europe gets a quarter.[14] The United States also receives two-thirds of the world's internationally mobile R&D spending and a sizeable share of mobile PhD students (Denis *et al.*, 2006). Within Europe, students tend to move to where universities are better funded, such as Scandinavia, or to where they are more flexible and innovative (Figure 1.18).

Figure 1.18. **Students voting with their feet**

Net inflow of ERASMUS students, per cent of population aged 15-29, 2003/04



Source: Eurostat, *Eurostat Yearbook 2005*.

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Some education systems are not delivering on their social objectives either. A student's socioeconomic background plays a larger role in determining performance in Germany, France and Italy than it does in the United States (Schleicher, 2006; Jacobs and van de Ploeg, 2006). This class bias is exacerbated by regressive funding systems in many countries because subsidised tertiary study primarily benefits young people who come from wealthier backgrounds.

Lifelong learning is more prevalent in some countries than in others. Around 40% of the labour force in Denmark, Finland, Sweden, Switzerland and the United States are involved in job-related education and training each year. By contrast, fewer than 10% of employees in southern Europe and some of the new member states receive such training each year (OECD, 2006d).

The community and member states have taken steps to upgrade the quality of their education systems. In particular, there has been good progress since the decision was made in Bologna in June 1999 to create a European Higher Education Area by 2010. Europe has no shortage of talented teachers and researchers but their creativity needs to be unleashed with institutional reforms that boost flexibility, diversity and quality. By doing so, the European equivalent of the MIT will emerge. But creating one from scratch, as the EU has proposed,[15] does not tackle the fundamental institutional problems. It would also be difficult – it should be remembered that MIT struggled to survive for the first 40 years of its existence and was almost taken over by Harvard in the late 1800s. Any overlap between a proposed European Institute of Technology and other bodies such as the ERC also needs to be minimised.

Who has the best support for helping those hurt by globalisation?

People are likely to find new jobs more quickly in countries where income support is more active than passive, where the duration of the highest level of income support payments is limited and where tax and benefit systems do not penalise those who return to work. Expenditure on active labour market policies varies widely across OECD countries, but perhaps more important than the overall level are the types of interventions used. For trade-displaced workers, job search assistance and individual counselling are most useful while retraining programmes need to be well targeted to avoid waste. Labour market programmes and income support need to be backed up with stronger job search requirements as part of a mutual obligations approach. The European countries in which unemployment fell most sharply in the 1990s, such as the Scandinavian countries, are the ones that tightened eligibility criteria and their implementation (Grubb, 2000). While most European countries are moving towards more targeted active interventions and tougher job search requirements, there is wide variation in how strictly these are implemented.

The EU has promoted a community approach to managing structural change through its *Communication on Restructuring and Employment* and by creating a European Globalisation Adjustment Fund to assist workers in cases of large scale redundancies caused by globalisation. It has a maximum annual budget of € 500 million and took effect from 2007. Funds can be made available for job search assistance, retraining, promoting entrepreneurship, assisting self-employment and some types of in-work wage supplements. Member states must show that job losses stem from "major structural changes in world trade patterns." The Globalisation Adjustment Fund complements – and overlaps to some extent with – national labour market programmes, funding is time-limited and co-financing by member states is required. The only comparable programme in the OECD is the US's Trade Adjustment Assistance Programme (TAA), which has been in place for more than 40 years. The TAA does not appear to have added much value in the sense that it has duplicated the same types of job search assistance, retraining and relocation services routinely offered to participants in standard labour market programmes (OECD, 2005b).

An agenda for progress

Clearly, countries have different strengths and weaknesses so a one-size-fits-all policy prescription is inappropriate. But the more reform-minded OECD and EU members have shown that it is possible to boost economic performance and rise to the challenge of globalisation. Many of the required policy changes are mostly the responsibility of national governments rather than European authorities, especially labour market reform and

policies to boost innovation. These are discussed in detail in the individual country *Surveys*. However, the EU shares responsibility in some areas and can encourage domestic reform by providing good framework conditions through benchmarking, persuasion and the sharing of best practices. The rest of this *Survey* concentrates on the role that community policies can play. The priorities include enhancing the single market, removing barriers to labour mobility, enhancing regional cohesion policy, promoting free trade and competition and tackling climate change. The main issues highlighted here are consistent with the recommendations in the OECD's *Going for Growth* study (OECD, 2007a).

Implementing the single market

The internal market has delivered major benefits to EU citizens. By removing barriers to trade, it has boosted living standards and given consumers access to a wider range of goods and services. It has lowered costs for businesses and by raising competition has led to lower prices and higher quality, innovation and growth. Even so, it is not yet the "great market without frontiers," as Jacques Delors described the goal when the Single European Act was signed in 1987. Significant barriers to cross-border trade remain in place. For example, while the mutual recognition principle for goods is crucial for the smooth functioning of the single market, barriers to trade are still holding back internal trade to some extent. This is even more true in the service sector.

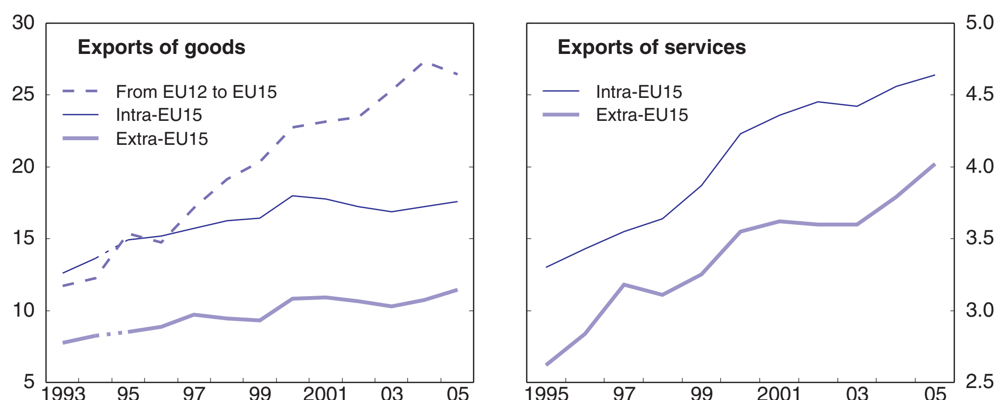
While EU economies are becoming more integrated, progress seems to have slowed down (Chapter 2). The lion's share of the improvement in trade, investment and price convergence occurred in the 1990s. The single market agenda needs some fresh impetus. A competitive and dynamic internal market will underpin long-term living standards, help achieve the objectives of the Lisbon Strategy and put European companies in a stronger position to compete on world markets. A strong internal market is also necessary to make the euro area run more smoothly (OECD, 2007b). With this in mind, the Commission is undertaking a major review and will present its final report in the second half of the year.

Services is the main area of unfinished business

While the service sector provides over two-thirds of jobs and value added, internal trade in services amounts to less than 5% of GDP (Figure 1.19). One reason is that regulatory barriers make it hard to provide services across borders. Some national laws amount to non-tariff barriers to trade, while *differences* in regulations across member states make it more difficult to sell services to all European citizens. The impact of barriers to trade in services has been recognised at least since a 1959 French report, the *Rappport Rueff-Armand*. Some national regulations are clearly discriminatory, such as nationality requirements in regulated professions, though these are becoming rare and tend to be struck down by the courts. Most restrictions are simple barriers to entry that apply to local and foreign firms alike. They can be explicit, such as national monopolies or a rule that there can be only one driving school per 15 000 people, or more subtle such as a market demand test to open a new store. Different consumer protection standards, such as advertising restrictions or early repayment rules for mortgages, can be a major barrier to firms that want to offer services in multiple markets. These barriers are more of a hurdle for foreign firms even if they are non-discriminatory on paper.

Figure 1.19. **Exports of goods and services**

As a percentage of GDP



Source: Eurostat; UN, *Comtrade Database* and OECD calculations.

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Europe is losing a great deal by having fragmented service markets. It has contributed to low productivity growth and the slow take-up of new technologies. At the time that the original services directive was being debated, conservative estimates were that full liberalisation of the services market could boost GDP by 0.7%.[16] It could also boost employment. For example, despite fears to the contrary the Italian regions that liberalised their retail sectors ended up with more employment in big stores and small shops alike (Viviano, 2006).

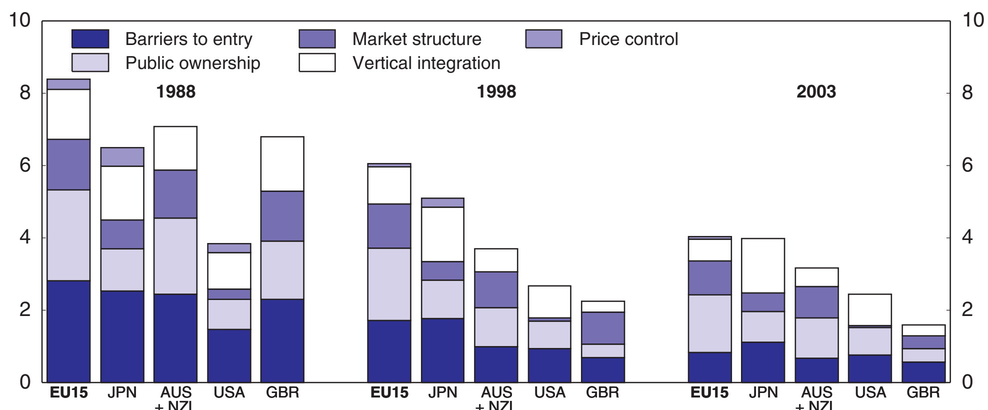
Regulatory barriers in the service sector are so hard to eliminate because often they are in place, at least ostensibly, for genuine policy reasons such as public safety or consumer protection. However, they can be out of all proportion to their objectives and have the effect of shielding existing service providers from competition. The Commission tried to break through these national regulations by proposing a country of origin principle in its draft services directive. The idea was that service providers operating temporarily in another country could jump over local restrictions by following the laws of their own country. It was rejected by the Parliament due to concerns about monitoring and abuse of the rules, and was replaced with a freedom to provide services clause modelled on what is already in the treaty (see Chapter 2 for details). The directive that was finally adopted narrows down the reasons that member states can call on to justify restrictions on service provision. Moreover, it obliges member states to screen all legislation (at all levels: central, regional and local) with a view to removing any obstacles to service providers that are inconsistent with the directive. A notification procedure has also been introduced that covers any new measures that fall within the bounds of the services directive. While in this sense the services directive is a clear step forward, it does not tackle all the problems head-on. It does not cover some parts of the service sector and there are exceptions to the "freedom to provide services" clause. In these cases, national regulations will still have to be challenged country by country, rule by rule. Considering how costly and slow the legal process can be, it will seldom be worthwhile for service providers to do this. Therefore, the need for quicker and cheaper remedies should be considered. In sum, the problems in the service sector are not all solved.

Network industries are another priority

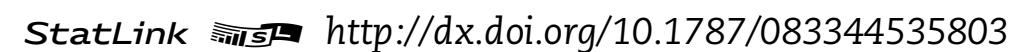
Inefficient network industries raise costs for households and other firms. While there has been good progress recently (Figure 1.20), the pace of liberalisation has varied across industries and countries. In sectors such as air transport and telecommunications, there has been a clear payoff in the form of lower prices and better service. According to one study, network liberalisation has already generated welfare gains of 1.9% of GDP since 1990 (Copenhagen Economics, 2006). Nonetheless, barriers to competition remain high. Stronger competition is needed in electricity, gas, road, rail and air transport, post and telecoms. The same study estimated that the welfare gains could be nearly doubled by fully opening markets across all network industries.

Figure 1.20. **Reform of network industries**

Indicator scale 0-10, from least to most restrictive



Source: OECD, *Product Market Regulation Database.*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While regulation of some network segments is necessary to prevent monopoly abuse, competition should be feasible in the segments that are not natural monopolies. Non-discriminatory third-party access to the network is necessary if competition is to develop. This can be hard to achieve when firms are vertically integrated or publicly owned. The market structure must also provide the right incentives to invest in new capacity, but in some cases this is not in the interest of the network owner. Insufficient co-ordination among national regulators can make it difficult to deal with capacity bottlenecks at the border. State-owned firms and private competitors do not operate on a level playing field in some countries because of implicit guarantees and favourable tax treatment of public companies. Conflicts of interest can also arise when the government is both an owner and regulator. These issues are discussed in Chapter 2.

A single market for financial services is developing, but there is work to do

The euro and the Financial Services Action Plan have contributed to greater integration of financial markets. In some areas, Europe has overtaken the United States in global markets. Capital flows are largely unimpeded and Europe is close to achieving a single market for financial services at the wholesale level. There has been much less progress in retail financial services. Cross-border banking remains limited, mainly because differences in national laws on investor and customer protection mean that products must be tailor-made for each market.

The mortgage market in particular is almost entirely national. Banks remain the first port of call for European businesses that need capital to expand, partly because securities markets are not sufficiently well integrated. This is discussed in more depth in Chapter 3.

Public procurement – bringing governments into the single market

Substantial cost savings could be achieved by further opening up the market for public procurement. About a quarter of public procurement contracts is published in the EU Official Journal. While this is a substantial improvement on the situation in the early 1990s, direct cross-border procurement is rare although procurement through foreign subsidiaries accounts for an estimated 30% of the total number of bids (Ilzkovitz *et al.*, 2007).

Internal market reform must do more than just fill in the holes

The strategy for the single market should focus on stronger enforcement of the principles of the internal market as well as a reduction in the regulatory burden. Enforcement can be hampered by the cost and time involved in the legal process. Individuals may need quicker and cheaper pathways if they are to play a greater role in challenging barriers to trade. At the same time, the Commission is trying to reduce compliance costs through its Better Regulation programme (Chapter 4). But the way that directives are written into national law is an ongoing problem as the good work of harmonisation can be undone through gold-plating (countries adding on extra provisions when writing directives into national law) – for example, there are fears this is happening now to a major initiative in financial markets (the MiFID).[17] When the Commission is considering new initiatives, an economic rather than legal approach would help it focus on the areas with the largest economic payoff. Choosing the right type of intervention is becoming more difficult because enlargement has led to greater diversity within the Union and also because the agenda is more often dealing with *indirect* trade barriers (*i.e.* rules aimed at a particular purpose but which have the side-effect of hampering the single market). The right type of intervention can sometimes be no intervention because the process of negotiation and compromise among member states can result in rules that are messy, overly costly and not flexible enough to adapt to changing circumstances.

Competition policy can underpin progress made elsewhere

Improvements in competition policy have strengthened the single market. In recent years, the framework has shifted towards a more economics-centred approach to mergers and antitrust cases. The EC's competition directorate has been working hard to ensure consistent application of competition policy among the national agencies and court systems and has started looking at whole sectors, such as energy and retail banking.

Good progress has been made dealing with some of the weak spots in the competition framework. Member states have opted for soft harmonisation of the leniency programmes to make sure the multiple programmes do not discourage whistleblowers. Some member states have been making more use of individual and criminal sanctions in competition cases. This is important for dealing with hard-core cartels. The Commission has also been trying to encourage more private enforcement in antitrust cases. Private actions are rare, mainly because of the costs involved and the difficulties in accessing evidence. Finally, the Commission now has a stronger capacity for economic analysis and has revamped internal procedures, for example with an internal panel that provides "a fresh pair of eyes" in large merger cases.

State aid policy is being revamped, moving away from a rules based approach and towards greater reliance on economic principles. As well as reining in the level of aid, the Commission wants it to be better targeted, especially towards innovation and human capital, and is trying to streamline the paperwork so it can focus on the most distorting measures. This is fine in principle, but there is a danger that unless it is administered with vigilance the new approach could open the door to a re-nationalisation of industrial policy, with all the anti-competitive consequences and inefficient subsidy races that this implies.

Taxation issues are becoming increasingly important

Taxation issues are increasingly cited as barriers to cross-border trade and investment. For example, while the VAT base is largely harmonised, there are 120 country-specific exceptions. VAT charges linked to restructuring have been cited as barriers to financial integration. According to an EC survey, half of large companies have not bothered to request VAT refunds at some point because the process is too complex and time-consuming. Such tax issues are too complex and specific to be dealt with in this report, but the Commission needs to continue working on them.

How to make progress in the single market

The debate over the services directive showed that a country of origin principle is a politically unacceptable way to deepen economic integration. There is not enough trust in the regulatory regimes of other member states, and full mutual recognition is seen by some as a race to the bottom in regulatory standards. Thus, in some sectors there is little alternative but the hard slog of harmonisation, sector by sector, rule by rule. The EU's experience, and Canada's history negotiating the Agreement on Internal Trade, shows how difficult this can be. It has become more difficult still as the Union has expanded and where, from a policy perspective, most of the low hanging fruit has gone. On the other hand, negotiations around mutual recognition of non-harmonised goods are promising.

Since 1997, the treaty has permitted "enhanced co-operation". However, it has never been used except as a threat to break a deadlock in negotiations (the *Schengen* agreement on passport-free travel is the best example of this type of integration, but it was originally done outside the EU institutional framework).[18] It can help break policy gridlock, reducing the frustration among the countries that want to move forward but without the more cautious member states feeling pressured into or vetoing reforms they are uncomfortable with. It can also have a demonstration effect, showing the benefits of deeper integration and encouraging the more reluctant members to join later on. There is nothing to stop countries co-operating or even agreeing to apply the country of origin principle outside the treaty framework so long as it does not conflict with the treaty – Nord Pool, a single market in electricity, is one example. But flexible integration arrangements can bring risks as well as opportunities. From an economic point of view, the issue is analogous to free trade agreements in the international trade arena: the outcome depends to a large extent whether the gains from trade creation among the members who have signed up outweigh any costs due to trade diversion away from the members that opted out. And clearly there is a political dimension as well.

Removing barriers to labour mobility

The second item on the reform agenda should be removing barriers to labour mobility. Labour mobility can act as a safety valve for economies that are out of sync with their

neighbours while foreign workers make companies more productive and innovative by bringing fresh perspectives and new skills and ideas. Despite this, and despite signs of increasing mobility among European workers, a third of citizens in the old member states think that labour mobility is bad for the economy.

Mobility between member states is low. Only 4% of the EU workforce has ever lived in another member state (Karppinen *et al.*, 2006), and only 0.1 to 0.3% of the working-age population moves within Europe in an average year. Clearly language and cultural differences make it harder to move, but they are unlikely to fully explain the low mobility rate. Weak labour markets in many member states are likely to have been a contributing factor.

Most of the policy barriers that keep people at home have been removed. The right of EU citizens and their families to live and work in other member states is guaranteed by the treaty. Europeans have access to health care in any member state. Social welfare benefits are portable across borders, though in the case of unemployment benefits this is true more in theory than in practice. And there are various schemes to make it easier to study abroad. Perhaps the most important barriers that remain are the explicit transitional barriers on migrants from the new member states (Chapter 8). Following the lead of the United Kingdom, Ireland and Sweden, around half of the EU15 member states have removed the restrictions that they placed on the countries that joined the Union in 2004. However, among EU15 countries only Sweden and Finland have given free access to migrants from Bulgaria and Romania (although some others have given partial access in certain sectors), while almost all of the EU10 have opened their doors. So far, enlargement has not led to the flood of migrants that was initially feared. While the overall level of migration has been rather modest, some countries such as Ireland and the United Kingdom have had very high inflows of workers from the new member states, mostly due to their strong labour markets and the fact that they did not impose restrictions. In these countries, the inflows contributed to reducing labour shortages and the risk of overheating. Evidence suggests that the employment rate of migrants from the new member countries depends on the overall economic situation as well as on the flexibility of the labour market they have moved to: they tend to have high employment rates in Ireland and the United Kingdom, for example, but they have not done well in Germany and Finland. Looking to the future, the old member states may not have a great deal to fear from immigration. A Eurobarometer survey found that only around 5-6% of people in the EU10 responded that they are likely to move to another member state in the next five years. This amounts to at most 1% of the EU15 population. A greater concern might be a brain drain from the new member states, especially for the Baltic countries and Poland where emigration rates are highest. However, most of the EU10 migrants are medium skilled rather than high skilled, though they are working in predominantly low-skilled jobs. They also tend to be young, single and childless. It is an open question as to how many will return home when the time comes to start a family.

While restrictions on the new member states are the main barrier, there are other areas to look at such as improving the portability of occupational pensions, continuing to improve the mutual recognition of qualifications, reducing transaction costs on house sales and providing social housing to the poor in a way that does not undercut mobility.

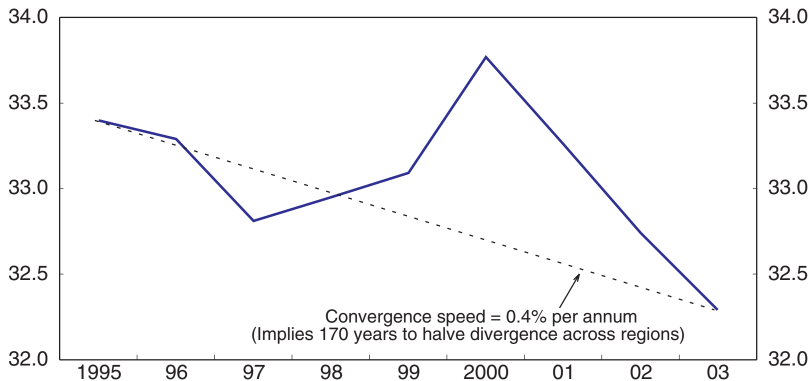
More effective regional cohesion policy

Fostering convergence in living standards across the regions has been a key objective of the European Union since its inception 50 years ago. Funding for regional or cohesion policy[19] increased substantially with the accession of the new member states. It now

absorbs around a third of the EU budget. While it is impossible to know what would have happened if regional funds had not been available in the past, cohesion programmes have had a mixed record so far. Regional disparities are not falling, or at best are declining very slowly (Figure 1.21). Some countries have been better than others at spending EU funds wisely, for example by focusing on education and critical infrastructure projects.

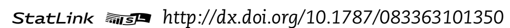
Figure 1.21. **Regions are barely converging**

Coefficient of variation of GDP per capita relative to EU23[1]



1. At NUTS-2 level (*i.e.* 228 regions). Excludes Malta and Poland.

Source: Eurostat.


StatLink http://dx.doi.org/10.1787/083363101350

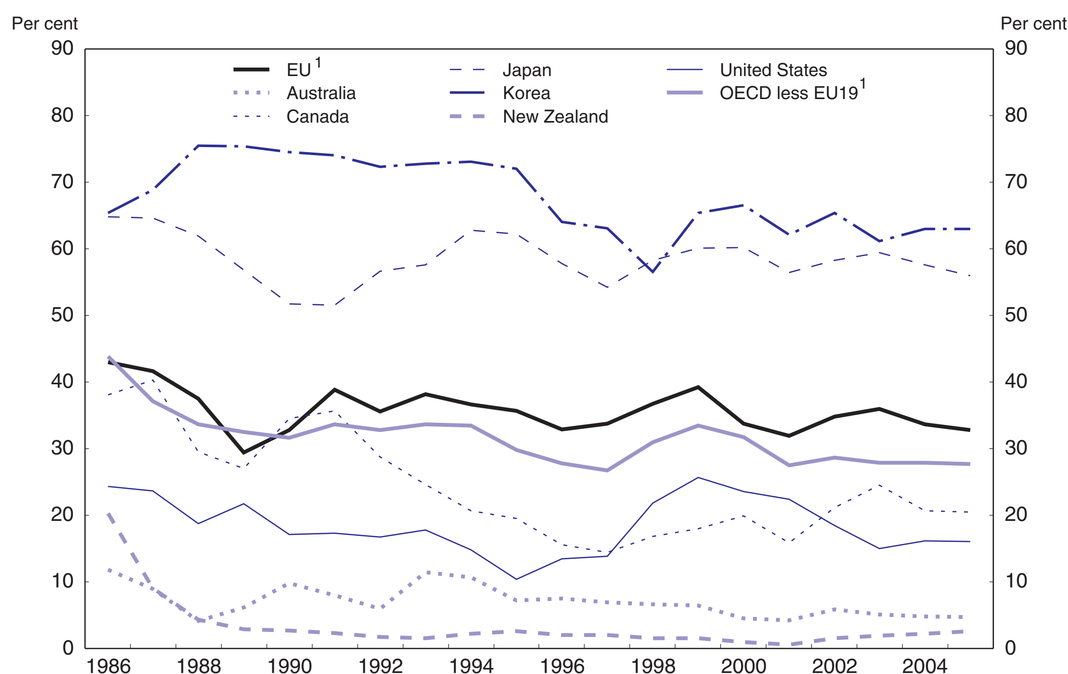
The regional budget is too small to (and is not meant to) act as an equalisation scheme: as a share of GDP, it is about half the size of Canada's inter-provincial equalisation scheme even though Europe's regional disparities are much greater. Thus it has to focus on programmes that can help kick-start self-sustaining growth. This is recognised in the funding programme for 2007-13 where the approach to cohesion policy has changed substantially. The Commission is moving away from a detailed discussion of specific groups of projects and instead will focus on each country's broad strategy and priorities. At the same time, national co-financing requirements have been relaxed for the new member states. The system has therefore moved closer to a block grant. The challenge for the Commission is to make sure member states focus on human resources, research and innovation and infrastructure programmes with a European interest. In addition, ways need to be found to reallocate funds to the projects with the highest payoff. In other words, regional policy would be more effective if it were more performance-based.

Europe's global responsibilities

Reducing farm subsidies…

Total support to agriculture amounts to more than 1% of GDP. Support has declined slightly over the past five years but remains higher than the average for the rest of the OECD (Figure 1.22). While the Common Agricultural Policy (CAP) has succeeded in underpinning farm incomes, and despite substantial reforms in the way that support is delivered, it can still have some negative side-effects. Because farm subsidies are accompanied by trade barriers (in the form of tariffs), they reduce imports from some developing countries (although access to the EU market for the poorest countries has been

Figure 1.22. **Producer support in agriculture**



1. Consists of the members of the EU at each date, so the number of countries changes over time. The EU19 consists of the EU members who are also members of the OECD.

Source: OECD, *PSE/CSE Database.*

StatLink http://dx.doi.org/10.1787/083413478481

liberalised). The CAP tends to benefit larger farms, it may trap resources in a low productivity sector and consumers pay more for certain types of food. Whereas it could work against cohesion policy since, in the past, the richer farming regions benefited by more, the impact of the significant 2000 and 2003 reforms is still not yet known. Lastly, while there are many factors that contribute to more intensive farming, to the extent that the CAP also encourages intensification, it can cause environmental harm – although the CAP also includes policies that aim to mitigate the adverse environmental consequences.

Reforms to the CAP, especially replacing commodity-specific payments with the single farm payment, are a clear improvement and have reduced some of the side-effects discussed above. Less than 1% of aid is now tied to production in Germany, Greece, Ireland, Italy, Luxembourg and the United Kingdom although more than 20% remains coupled in France, the Netherlands, Portugal and Spain. But more in the same vein could be done since the CAP still includes elements that provide incentives to produce. Even after the reforms, significant levels of market price support remain, especially tariffs for meat, milk and sugar. Export subsidies have been reduced substantially but remain extensive by international standards, amounting to 5% of the value of agricultural exports. However, the European Union has conditionally proposed phasing out all export support, including export subsidies, in its offer to the Doha trade round. Despite a sharp decline in terms of budgetary transfers, about half of aid (estimated by the Producer Support Estimate) is still of the most market-distorting type (market price support, output and input payments). And while the single payment is a definite improvement, even fully decoupled payments do not entirely eliminate the incentive to produce.

… and tackling climate change

The EU deserves praise for its proactive steps to deal with climate change, and especially for its carbon emissions trading scheme. A market-based approach to reducing greenhouse gas emissions is likely to be more efficient and effective and lead to more innovative approaches than the command and control systems used in some OECD countries. Having said that, it is clear that while the trading scheme is a good idea, it has had some teething troubles in its trial phase because there was an oversupply of permits and it suffers from some market structure problems (Box 1.5). But these deficiencies are being addressed. Once they are fixed, the EU trading scheme could be a model for similar markets worldwide.

Box 1.5. **Tackling climate change: the EU's emission trading scheme**

The EU's CO_2 emission trading scheme (ETS) began trading on 1 January 2005. It is a cap and trade system, and is one of the tools that the EU uses to meet its Kyoto commitment to reduce greenhouse gas emissions by 8% relative to their 1990 level in the period 2008-12.[1] It involves more than 10 000 combustion and energy-intensive plants covering more than 40% of the EU's CO_2 emissions. Each member state submits a National Allocation Plan that defines an emission cap for each plant (these Plans must be approved by the Commission). Companies that exceed their quota must buy additional allowances from those who manage to cut their emissions (or to a limited extent can offset them through project-based mechanism credits).

The EU is to be applauded for setting up a market-based scheme to tackle greenhouse gas emissions. In principle, letting the market set a carbon price is a more efficient way of reducing emissions than the command and control systems used in many other OECD countries. Unfortunately, it is a good idea that has had some teething troubles. But to be fair, the pilot period (2005-07) was one of learning by doing and it is the largest carbon market to date. The main problem is that countries have given away too many permits: in 2005, for example, companies were granted on average 4% more allowances than they needed. When the "overallocation" was revealed to the market, the spot price of carbon halved in the space of a few days and has since fallen to just € 1 per tonne, having been as high as € 30 per tonne.[2] The problem arose partly because there was no information on verified historical emission levels by each installation, making it harder to have effective oversight of the plans. Only three countries allocated fewer allowances than their actual emissions. A system in which member states have considerable discretion to allocate permits can lead to a prisoner's dilemma: no matter what other countries do, a country will always be better off by going easy on its own firms. When that happens, countries that make stronger efforts to reduce emissions end up transferring cash to those who do not.

It is likely that the trading scheme combined with high energy prices has encouraged some abatement of emissions, but it is difficult to estimate the relative contribution since the counter-factual for emissions is unknown.[3] In any case, no matter whether the overallocation reflects an attempt by national governments to give their firms an easy ride or an underestimate of how much abatement the trading scheme would encourage, the conclusion is that the cap for the second period (2008-12) should be considerably tighter.

Box 1.5. **Tackling climate change: the EU's emission trading scheme** *(cont.)*

National Allocation Plans for the second phase that were submitted in late 2006 also showed overly generous allocations. The Commission has accepted 18 of them so far, but only after requiring significant cuts of up to 50% relative to the caps proposed by the member states in question. It is right to take a tough line.[4] The scheme will continue to be ineffective unless the emission cap is low enough to bite. In the longer term, however, this gaming between member states and the Commission is probably unsustainable. Harmonised allocation methodologies and independent allocation decisions may be needed. Such approaches are being considered for the second phase.

Some other issues need to be addressed as well: 1) Competition is distorted because allocation rules for new entrants differ across countries. For example, a new natural gas combined cycle electricity plant in Germany would receive (for free) an estimated 105% of its required allowances; in Denmark it would receive 82% and in Sweden nothing at all (Egenhofer *et al.*, 2006). 2) Plants usually get their allowances for free, which could reduce the incentive for new entrants to invest in less-polluting technologies (countries are permitted to auction no more than 10% of their allowances in the 2008-12 trading phase, up from 5% in the pilot phase). 3) A plant that shuts down tends to lose its allocations rather than being able to transfer them to a new plant. This creates an incentive to keep polluting plants running. 4) There is uncertainty about how the ETS will operate after 2012 so a company considering a long-term investment does not know what carbon-reduction incentives it will face. However, in early 2007, the Council agreed to reduce greenhouse gas emissions by 20% relative to their 1990 level by 2020, and by 30% if an agreement among major emitters is reached (this compares with the 8% reduction for 2008-12 agreed to under the Kyoto Protocol). It has not yet been agreed how to share the burden across EU member states or whether the target should be binding. 5) Several sectors are not included in the ETS, notably transport, although the Commission intends to include aviation from 2011. 6) The pilot phase covers only carbon dioxide emissions, not the other greenhouse gases such as nitrous oxide and methane, although some countries plan to include these in the second phase. A "6-gas" strategy could significantly decrease the marginal cost of abating emissions compared with a carbon-only strategy; some of the benefits of multi-gas emission reduction can be reaped through better linkages between the ETS and project-based mechanism crediting which cover non-CO_2 mitigation projects (although there are some practical impediments to doing so, such as large uncertainty bounds in monitoring emissions of some of the other greenhouse gases). 7) Market information and transparency should be improved – emission figures are published only annually and some countries are not yet connected to the electronic registry. 8) The plant size threshold is probably too low – for example, in the United Kingdom the smallest 80% of sites contribute just 6% of emissions (Buchner *et al.*, 2006). For these plants, the regulatory compliance costs probably exceed the benefits of including them in the scheme.

These issues are being considered by a stakeholder working group, as part of the ETS review, which will report by the middle of 2007. The Commission will issue proposals for legislation by the end of 2007 regarding the third trading period starting 2013. If these problems can be solved, especially by reducing allocations and auctioning rather than giving away allowances, then the EU trading scheme would be a model for similar schemes worldwide.

1. The latest projections of the European Environment Agency are that, with existing policies and measures, emissions in 2010 will be around 2% below the 1990 level. With additional measures, they could be 6% below the 1990 level (however, these figures do not take into account the caps set in the National Allocation Plans for the 2nd trading period).
2. The price for emissions in 2008 remains around € 16 per tonne implying that markets expect the cap to be more binding in the second trading period (2008-12).
3. See Ellerman and Buchner (2006) for one attempt. They estimate that the trading scheme may have reduced emissions by 50-200 million tonnes, compared with an overallocation of 80 million tonnes in 2005.
4. For countries whose National Allocation Plans have been approved, the average cap is lower than 2005 emissions even though there are more installations in the second phase.

Market-based solutions could be used more often in other areas. There is a risk that while regulatory approaches may be effective at reducing emissions, they could do so at excessive cost. In principle, the economically most efficient way to reduce emissions is to ensure that marginal abatement costs across all approaches are equalised. Reducing car emissions, for example, has been estimated to be many times more costly than alternatives such as cleaner industrial production (OECD, 2004), although energy security issues may also be a factor to be taken into account. Other options are available, such as basing vehicle taxes on emission levels and bringing oil traders into the carbon permit scheme (although excise taxes on fuel already perform a similar function). Some ill-directed transport incentives, such as lower taxation of diesel or underpricing of road use by trucks, could also be eliminated as they work directly against the objective of reducing emissions. It would also be helpful if the EU's commitment to reduce greenhouse gas emissions by at least 20% by 2020 were implemented through market mechanisms as far as possible. In the road transport sector, they should be complemented by policy packages including, for instance, an adequate supply of public transport and better urban planning.

"Liberal Europe" versus *"social Europe" – an imaginary trade-off?*

Resistance to reform can come from a belief that labour and product market protection is the price that must be paid for Europe's social model. There is a sense that "Europe's jobless figures would be unacceptable in America; America's inequality figures would be politically intolerable in much of Europe" (Patten, 2005). But if there is such a trade-off, it is far from simple. In the first place, there is no single European social model. Sapir (2005) for example distinguishes between the Nordic, Continental, Anglo-Saxon and Mediterranean models. To oversimplify a little, the Nordics have managed to combine high income equality with low unemployment while Mediterranean countries have done less well on both counts. That is one reason why the Nordic approach to "flexicurity" has recently been given such prominence by the Union, including in the revamped Lisbon Strategy for Growth and Jobs. Moreover, there is no evidence that regulation buys security. In fact, the opposite may be true – workers in countries with strict EPL tend to feel they have *less* job security than those in more flexible labour markets (Figure 1.23). Danes for example have little protection from being fired but are confident that they will have *a* job, even if they are not sure *what* job (and they feel protected in the interim by generous income support, backed by strong mutual obligations on jobseekers). Anti-competitive regulation does not deliver greater income equality or lower poverty either.[20] The main lesson here is that liberalisation and reform – by which is meant not deregulating everything but simply removing unnecessary anti-competitive restrictions – does not have to jeopardise Europe's social goals. There are more effective ways to achieve those objectives. For example, well-designed tax and benefit policies are a prerequisite for getting the best of both worlds. Education policies are also key for dealing with social disadvantage (Machin, 2006). Such policies can ensure that pro-growth reforms enhance welfare for all, including the disadvantaged.

Figure 1.23. **Regulation is not necessarily delivering on social objectives**

1. Job security is a combined index of survey responses to questions about perceived job security (from Eurobarometer and ISSP).

Source: Eurobarometer and ISSP; Förster, M. and M. Mira d'Ercole (2005), "Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s", *OECD Social, Employment and Migration Working Papers*, No. 22; OECD calculations.

StatLink http://dx.doi.org/10.1787/083428788480

Notes

1. Europe has 29% of the world's biggest 2 000 companies, roughly in line with its share of world GDP. It punches its weight in most global industries except IT, where the United States has a big lead (McKinsey, 2007, quoted in the Economist newspaper, 8 February 2007).
2. Because this report discusses the EU as a group, differences across countries will often be swept under the carpet and some statements may smack of sweeping generalisations. In return for not bogging down the text with modifiers such as "many countries" or "some member states", the reader is asked to bear in mind that there will be individual exceptions to most statements made in the report. Such issues are picked up in the national *Surveys*.
3. For overviews, see O'Mahony and van Ark (2003) and the January 2007 issue of the National Institute Economic Review. As both sources demonstrate, differences in statistical methods such as the use of hedonic deflators do not explain all the difference in performance between the EU and the United States.

4. See CESifo (2007) for a discussion and examples.
5. The Revealed Comparative Advantages (RCA) are as defined by Balassa (1965). The RCA essentially measures a country's export share for a particular commodity and compares it with the world export share of that same commodity. The RCAs are scaled to lie between –1 and +1. A value of +1 means that country is the world's only exporter of that commodity. An RCA of –1 means that the country does not export that commodity. An RCA of zero means that the country's export share of that commodity is the same as the world export share. They are calculated at a highly disaggregated level, consisting of 1 033 goods plus 11 service categories using trade data for 2004. All correlations are Spearman rank correlations. See Rae and Sollie (2007) for further details about the method and for a greater range of results.
6. Similar calculations were done for other country groups, such as the BRIC countries (Brazil, Russia, India and China) and for India and China separately. The broad conclusions are the same although the country rankings are sometimes altered. For example, Korea and Japan are much more exposed to the dynamic South-East Asian economies than they are to China and India. The EU12 as a group is more exposed to the BRICs than it is to dynamic Asia. Calculations have also been done at a more aggregate level, consisting of 33 categories of goods plus 11 service sectors. Again the results are broadly similar, although relative positions can shift quite substantially for countries whose exports are highly specialised in a small number of commodities, such as Ireland, Iceland and Norway. For these countries, the results based on more disaggregated data are probably the most reliable.
7. Excluding royalties and the finance sector, which are typically not thought of as part of the outsourcing process. In terms of the change in the net balance on business services in recent years, the United States, the United Kingdom, China and India have increased the balance, but it has decreased in Germany and France (Amiti and Wei, 2005).
8. Greece, Spain, France, Italy, Lithuania, Poland, Portugal, Romania and the United Kingdom all have a level of "other services" imports excluding royalties and financial services of less than 2.5% of GDP. The EU median is 3.3% of GDP.
9. This section is a very brief summary of a vast empirical literature. References to more comprehensive reviews can be found in the text.
10. The EPL index is available for the four new members which are also OECD members. For these countries, EPL is low and comparable with Ireland and the United Kingdom. Anecdotal evidence for the other new member states suggests they too have lenient regulatory environments (Boeri and Garibaldi, 2006).
11. More specifically, they find that less centralised bargaining systems, lower union density and greater use of active labour market policies tend to make real wages more responsive to unemployment. Following a productivity shock, wages respond quicker where benefit replacement rates are low, where there is less employment protection for temporary contracts and where enterprise level bargaining is more common.
12. The wage flexibility project developed two indicators of real wage flexibility: a raw index, and one that adjusts the data for measurement error. The results between the two sets are broadly consistent, although for France the raw data shows considerably more wage flexibility than does the cleaned data. The data used in this report are the adjusted indices, which are the measures preferred by the authors of the report.
13. In the widely used but not uncontroversial rankings from Shanghai Jiao Tong University, 2 UK universities but no other European universities make it into the top 20. The highest ranking continental European university is in 41st place. In the Times Higher Education ranking, 42 of the top 50 universities are from countries with an Anglo-Saxon system of education. Continental Europe has only 4 in the top 50 (2 each in France and Switzerland). It should be noted that these rankings tend to emphasise research over teaching.
14. The figures for Europe refer to the EU19 and net out intra-EU flows in order to assess the situation for Europe when it is regarded as a single entity. When students from non-OECD countries are included Europe's share of foreign students rises to 32%, but the statistics are based on citizenship rather than whether a student is "away from home", and they appear to include large numbers of students that may come from families that have lived in European countries for many years but where the student has not gained citizenship (for example, the large number of North Africans studying in France). Thus, these statistics should be interpreted carefully.
15. The proposed European Institute of Technology (EIT) would be a "virtual university" without a campus, consisting of a network of joint ventures among universities, research organisations and public and private firms. A governing board would select eligible partnerships, each of which

would be established for between seven and fifteen years. EIT degrees would be awarded at the post graduate and PhD levels based on the rules of the relevant member state. Funding would come mainly from the EU with modest co-financing from industry.

16. See the studies at *http://ec.europa.eu/internal_market/services/services-dir/studies_en.htm*.

17. MiFID refers to the market in financial instruments directive. See McCreevy (2007) for the concerns about the way it is being implemented in member states.

18. The principles of enhanced co-operation were created by the Treaty of Amsterdam (1997) and revised by the Treaty of Nice (2000). It requires a minimum of eight countries, must remain open to any country that wishes to participate, must not create discrimination between the "ins" and the "outs" and can be used only as a last resort. It must aim to further the treaty objectives and must be approved by the Council (under qualified majority voting). The draft European Constitution contained measures to make it easier to use the enhanced co-operation mechanism.

19. Regional and cohesion policy are used as synonyms in this report even though in Brussels terminology regional policy is a subset of cohesion policy.

20. More rigorous econometric methods either confirm the simple correlations described in the text or they find no link between EPL and product market regulation (PMR) on the one hand and job security and income inequality on the other (Nicoletti *et al.*, 2001; Clark and Postel-Vinay, 2005). An obvious counter-argument is that causality runs in both directions so countries where workers feel insecure are more likely to put employment protection legislation in place. But EPL has been strict for many years, sometimes decades, and it has failed to cure the problem of perceived job insecurity.

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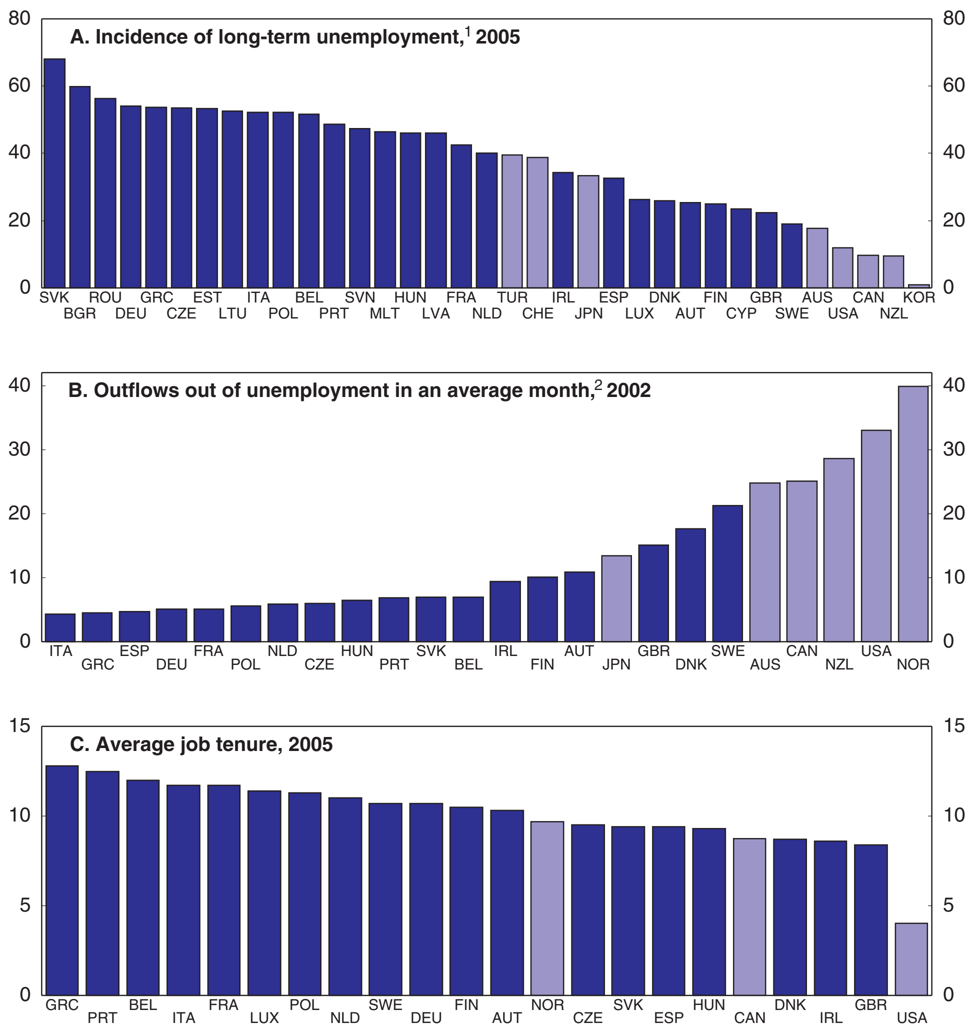
ANNEX 1.A1

Indicators of labour market flexibility

Figure 1.A1.1 shows a variety of indicators of labour market flexibility that are referred to in the chapter.

Figure 1.A1.1. **Indicators of labour mobility**



1. Defined as those unemployed continuously for 12 months or more as a percentage of total unemployment.
2. In per cent of total unemployment.

Source: OECD, *Labour Force Statistics Database*; OECD (2004, 2006), *Employment Outlook*; Eurostat; US Bureau of Labor Statistics; Statistics Canada.

StatLink http://dx.doi.org/10.1787/083603437451

Figure 1.A1.1. **Indicators of labour mobility** *(cont.)*

D. Internal migration (ratio of gross flows to population), 2003

E. Regional unemployment dispersion (standard deviation), 2003

F. Real wage rigidity[1]

1. The measures range from 0 (where no one is subject to the rigidity) to 1 (where all workers are potentially affected).

Source: OECD (2006), *Employment Outlook*; Eurostat; Dickens *et al.* (2006), "The Interaction of Labor Markets and Inflation: Micro Evidence from the International Wage Flexibility Project".

StatLink *http://dx.doi.org/10.1787/083623886327*

To combine them into a composite indicator of flexibility, a principal component analysis was performed on these six indicators plus two others:

- The level of the NAIRU in 2005, as an indicator of the structural rate of unemployment;
- The employment rate of unskilled workers as a proportion of the employment rate of skilled workers, which is intended to be a measure of the ability of the labour market to employ people at the margins of the workforce.

Missing data were replaced with the cross-country average so that the principal components are unaffected. The results of the analysis are shown in Table 1.A1.1. Only the first four principal components are shown as collectively they explain 85% of the variation in the data and the remaining four components are likely to be random noise. In the first component, all variables except wage rigidity have the expected sign in the sense that a

Table 1.A1.1. **Principal components of labour market flexibility indicators**

	Component[1]			
	1	2	3	4
Eigenvalue	3.74	1.39	0.90	0.80
Proportion of variance explained	0.47	0.17	0.11	0.10
Cumulative proportion of variance	0.47	0.64	0.75	0.85
Eigenvectors:				
Incidence of long-term unemployment	–0.45	0.07	0.31	0.27
Outflows from unemployment	0.44	0.14	–0.26	–0.20
Job tenure	–0.29	–0.56	0.30	0.05
Internal migration	0.40	–0.03	0.16	0.01
Regional unemployment dispersion	–0.41	0.20	–0.16	–0.28
Real wage rigidity	–0.00	–0.58	–0.66	0.37
NAIRU in 2005	–0.33	–0.12	–0.33	–0.68
Employment rate of unskilled relative to skilled	0.27	–0.51	0.39	–0.44

1. Only the first four components are shown.

higher value implies greater labour market flexibility. The weight on wage rigidity is essentially zero. Thus, the first principal component can be interpreted as a composite index of flexibility.

The second component puts a high weight on job tenure, real wage rigidity and the unskilled employment rate, with the other variables having low weight. An economic interpretation of this principal component could be that it is measuring insider power in the labour market. When insiders have considerable power relative to outsiders, the symptoms will be a greater ability to protect real wages, less tendency to be laid off or to quit (hence the greater job tenure) and more difficulty for the unskilled to get a foot in the door. The remaining principal components (3-8) are difficult to interpret from an economic point of view.

The two composite indicators are shown in Figure 1.A1.2 and broadly speaking correspond to priors about which labour markets are the most flexible and which have stronger insider power.

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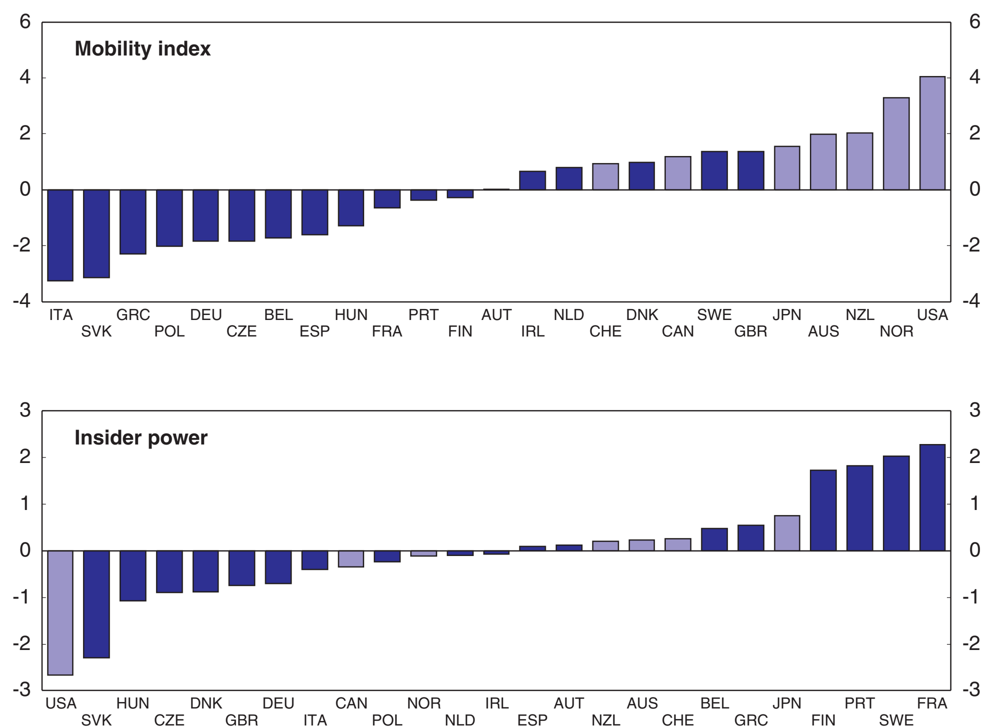
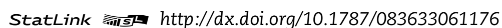
Figure 1.A1.2. **Principal components**



StatLink  http://dx.doi.org/10.1787/083633061176

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Chapter 2

Ever closer union?
Moving forward in the single market

This chapter reviews the internal market. It puts particular emphasis on the services sector, which is the main area where further progress is necessary, and discusses the potential impact that the services directive might have. It also reviews network industries, including energy, telecommunications and ports. Electricity and gas liberalisation is needed to create stronger competition and more integrated markets.

The single market has delivered major benefits for EU citizens. By removing barriers to trade, it has given consumers access to a better range of goods and services, often at lower prices and higher quality. For businesses, it has created a larger pool of suppliers, helping them to be more competitive on world markets. It has helped strengthen competition, contributing to higher levels of innovation, entrepreneurship and growth. The harmonisation of technical standards and the principle of mutual recognition for goods mean that most of the time businesses now have to comply with only one set of rules. New regulations on public procurement have opened up markets for companies in other member states as well as making it cheaper for governments to provide public services. The single market process also created a "bow wave" effect, carrying along other reforms such as the liberalisation of some important industries, a reduction in state ownership and a variety of other structural reforms. It has also been a necessary counterpart to the creation of the euro. The common currency simply could not work without a high level of economic and financial integration (OECD, 2007).

It is difficult to quantify the gains with any precision mainly because the biggest benefit – greater competition and the ongoing economic growth that this delivers – is so hard to measure. Nevertheless, the Commission has estimated that the single market programme has raised European incomes by more than 2%, though this probably understates the gains. Other studies have shown that it has contributed to a quadrupling of foreign direct investment within Europe, an increase in foreign direct investment into Europe as foreign companies try to take advantage of the internal market, higher productivity in various sectors of the economy and a reduction in price-cost margins.[1]

While the process of economic integration is continuing, there are signs that it has slowed down (Figure 2.1). For example, trade in goods among EU15 countries increased as a share of GDP through much of the 1990s but it appears to have plateaued since then. Some of this is due to cyclical factors, and the economic recovery now underway may again intensify trade growth between member states. Exports from the EU12 to the EU15 have more than doubled as a share of EU12 GDP since 1993 but here again the gains have been less in the 2000s. Similarly, the home bias – the tendency of EU consumers to buy goods produced in their own country – decreased between the mid-1990s and 2000 but has levelled off since then (Bruegel, 2006). Trade in services between EU members is growing but its level remains low (Figure 2.1, Panel B).

Comparing across countries, internal trade in manufactures is higher in Europe that it is among the Canadian provinces, though it is considerably lower than trade among US states (Figure 2.1, Panel C). Trade integration can also be gauged by the size of the border effect, which measures the degree to which geographic borders reduce trade after taking account of other factors such as the distance between markets. By this measure, internal trade among the seven largest members of the EU is relatively well integrated compared with other customs unions such as NAFTA (Figure 2.1, Panel D). Nevertheless, the border effect remains substantial, reflecting policy and institutional barriers as well as intrinsic language and

Figure 2.1. **Single market integration is slowing down**

A. Exports of goods (% of GDP): From EU12 to EU15; Intra-EU15; Extra-EU15

B. Exports of services (% of GDP): Intra-EU15; Extra-EU15

C. Internal trade in manufactures, 2002 (% of GDP): CAN; EU; USA

D. Border effect on trade[1]: EU7; ASEAN; NAFTA; MERCOSUR

E. Price convergence[2] (Per cent): EU15; EU25

F. FDI inward stocks (% of GDP): EU15; EU10

1. Shows the multiple by which trade is reduced by national borders, *e.g.* if trade were based solely on income and distance between markets so that national borders, linguistic barriers, etc., had no effect, then trade in 1999 between EU7 members (Germany, France, Italy, United Kingdom and the Benelux countries) "should" have been 2.8 times greater than what actually took place.
2. Coefficient of variation of comparative price level index for final household consumption.

Source: Eurostat; UN, *Comtrade database* and OECD calculations; Mayer, T. and S. Zignago (2005), "Market Access in Global and Regional Trade", *CEPII Working Paper 2005-02*.

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cultural barriers. Trade among the EU7 for example is a third what it could be if relative income and distance from market were the only determinants of trade.

Price levels are converging, but here again the pace of convergence appears to have slowed (Figure 2.1, Panel E). On average, prices in the new member states are catching up to the European average but there are some countries, such as Ireland and Italy, where prices have overshot. The dispersion of tradables prices across Europe appears to be greater than the dispersion across US cities (Rogers, 2002).[2] While there are many factors at play, such as different income levels, price dispersion can be a sign of insufficient competition and market integration in sectors such as services and various network industries.

Foreign investment flows tell a similar story. The stock of cross-border direct investments between EU15 countries has risen from less than 10% of GDP when the single market came into force to approximately 50% of GDP today (Figure 2.1, Panel F). Most of the expansion occurred in the 1990s during the global merger and acquisition (M&A) boom but activity has levelled off since then. In network industries, where M&As are especially important because it is often uneconomic to build a new network from scratch, the share of M&As that take place across borders has increased only modestly since the early 1990s (Ilzkovitz *et al.*, 2007).

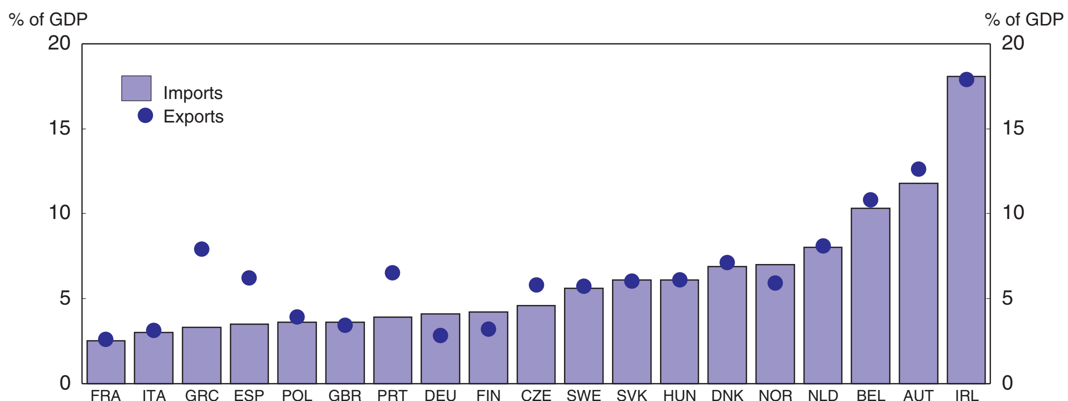
Against this background, the challenge for the Union is to give the single market fresh impetus. With this in mind, the Commission is undertaking a major review of the internal market. An interim report has been published (EC, 2007a) and the final report is due in autumn 2007. This chapter reviews the main areas of unfinished business, focussing on services and some key network industries. The following chapter looks at financial markets.

The single market for services

A decade after the planned completion of the internal market, the EU remains a long way from having a single market for services. While the service sector provides a little over two-thirds of jobs and value added, internal trade in services amounts to less than 5% of GDP (Figure 2.1, Panel B) – and more than half of this is tourism and transport. The extent of trade in services varies widely across member states (Figure 2.2). The low level of trade in services can be explained to some extent by their specific nature as many services require the physical presence of the service provider, so it helps to be local – especially when language is important. However, the development of the Internet and cheaper communication and travel means this is less important than it once was. Another explanation is that regulatory barriers make it hard to provide services across borders. Many national laws amount to non-tariff barriers to trade, while *differences* in regulations across member states make it more difficult to sell services to all European citizens.

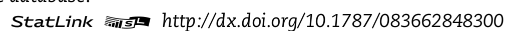
Figure 2.2. **Internal trade in services varies widely**

Exports and imports of services to/from another EU25 country, 2004[1]



1. Luxembourg: exports = 74% of GDP, imports = 47% of GDP.

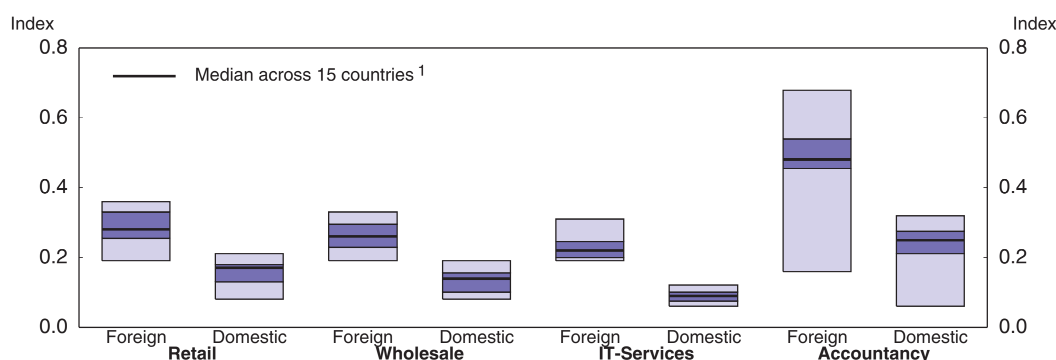
Source: OECD, *Statistics on International Trade in Services – online database.*



Insufficient competition contributes to lower productivity growth. Labour productivity growth in the service sector fell in the 1990s and is slower than in the countries that have been more aggressive liberalisers (Table 2.1).[3] EU countries have relatively strict product market regulations, although there is a wide variation across the Union (Figure 1.14) – the United Kingdom, Ireland and Denmark for example have relatively light-handed regulatory regimes. In most service sectors, local companies face lower barriers to doing business than do firms from another member state (Figure 2.3).[4] However, there are some bright spots in Europe's productivity performance. Productivity in the transport and communications industries has grown faster than in the United States since 1995, possibly because of the considerable liberalisation of telecommunications and air and road transport in Europe.

Figure 2.3. **Internal market restrictiveness in services in EU15**

A higher index indicates stricter regulation



1. The dark shading shows the two middle quartiles (*i.e.* the 25th to 75th percentiles) and the light shading shows the top and the bottom quartiles.

Source: Copenhagen Economics (2005), "Economic Assessment of the Barriers to the Internal Market for Services", study commissioned by the European Commission, Brussels.

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The distribution sector provides a good case study of the impact of anti-competitive regulation. Wholesale and retail trade has been a major driver of productivity growth in the United States and some Scandinavian countries, but the rest of the EU has lagged behind (Figure 2.4). Restrictions on shop opening hours and new stores have contributed to a slower take-up of new technologies and inventory management systems while restrictions on store sizes have made it harder to reap economies of scale. By some estimates, productivity in the euro area's distribution sector is around 30% lower than in the United States.[5] Less competition also contributes to price stickiness, with retail prices in Europe changing less often than in the United States. Dhyne *et al.* (2005) attribute this to less use of ICT and fewer superstores than in the United States. Ironically, over-regulation may also be holding back employment even though many countries cite the protection of jobs as one of the main objectives of their regulatory barriers. Some interesting evidence comes from a partial reform of Italian retailing in 1998 (the Bersani law). By comparing neighbouring districts, one which made it easier for large stores to open and one which retained strong restrictions, Viviano (2006) found that retail employment rose significantly in the district that liberalised. Employment in small shops also increased, probably because large supermarkets act as magnets for small stores.

In 2002, the Commission produced a long catalogue of barriers to cross-border trade in services (EC, 2002). Some examples are shown in Table 2.2. Several of these restrictions

Table 2.1. **Labour productivity growth in services**

Output per employee, average annual percentage changes, 1995-2003[1]

Sectors	EU14[2]	United States	Australia	Canada	Korea	New Zealand	Norway	Denmark	Sweden	United Kingdom
Wholesale and retail trade	1.0	4.4	3.0	2.7	3.7	1.3	5.3	1.8	2.7	2.6
Restaurants and hotels	–1.2	0.8	1.1	0.2	1.6	–1.4	0.9	–2.5	1.9	0.2
Transport, storage and communication	4.2	3.0	4.1	2.7	6.8	4.3	4.4	5.1	3.4	4.0
Finance and insurance	2.2	4.5	3.2	1.9	5.3	5.8	3.5	2.8	2.0	2.6
Real estate and business services	–1.5	0.7	0.4	–0.8	–4.0	–3.7	–1.8	–1.4	–1.9	1.0
Total business services	**0.9**	**2.5**	**2.6**	**1.6**	**2.9**	**0.5**	**2.7**	**1.3**	**1.2**	**2.2**
Electricity, gas and water supply	4.3	3.7	5.4	0.8	8.0	9.1	4.8	1.5	1.0	6.5
Community, social and personal services	0.3	–0.4	0.4	0.3	–1.8	0.6	0.4	0.2	0.5	0.8
Total economy	**1.1**	**1.9**	**2.0**	**1.4**	**3.6**	**0.8**	**1.6**	**1.4**	**2.1**	**1.8**

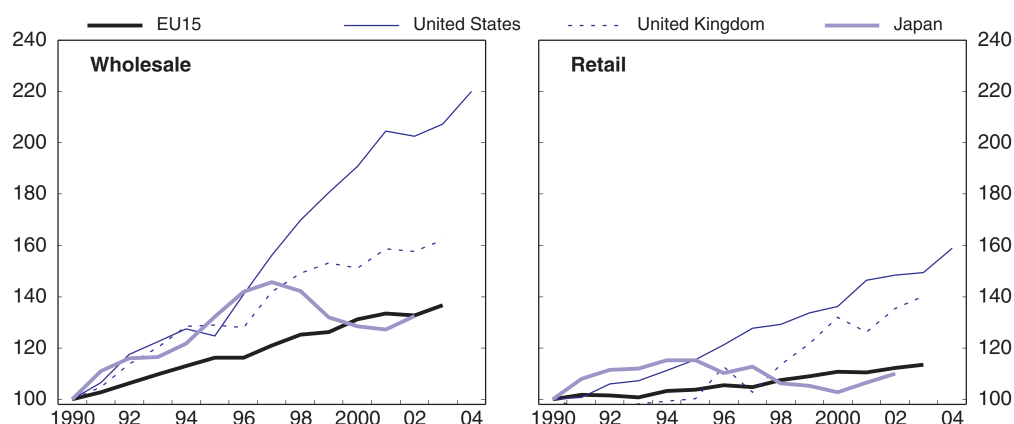
	Austria	Belgium	Finland	France	Germany	Greece	Italy	Luxembourg	Netherlands	Portugal	Spain
Wholesale and retail trade	2.4	1.2	2.3	0.3	0.8	3.3	0.8	2.7	1.7	0.9	0.1
Restaurants and hotels	0.7	–0.5	0.6	–0.7	–6.3	2.6	–1.5	–1.1	–1.4	–1.8	–1.4
Transport, storage and communication	1.3	1.4	4.0	3.0	6.9	8.4	2.5	5.2	3.5	3.9	2.0
Finance and insurance	0.0	0.2	7.6	–1.2	3.5	4.7	0.9	–0.5	1.5	13.0	1.9
Real estate and business services	–2.6	–0.4	–1.9	–1.4	–1.8	–2.5	–2.6	–5.1	–0.8	–0.8	–2.7
Total business services	**0.6**	**1.0**	**1.7**	**0.0**	**1.4**	**2.6**	**0.0**	**0.0**	**1.0**	**2.1**	**–0.1**
Electricity, gas and water supply	6.0	4.5	5.8	3.4	4.3	4.3	5.8	4.5	3.2	4.6	5.4
Community, social and personal services	–0.7	–0.3	–0.2	0.6	0.0	1.4	0.1	–0.7	–0.4	0.0	0.6
Total economy	**1.5**	**1.1**	**1.9**	**0.9**	**1.4**	**3.0**	**0.6**	**0.7**	**0.6**	**1.7**	**0.5**

1. Or nearest available year.
2. EU15 excluding Ireland.

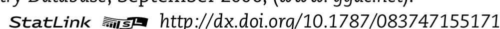
Source: OECD, *STAN Database*.

Figure 2.4. **Productivity in the distribution sector**

Index 1990 = 100



Source: Groningen Growth and Development Centre, *60-Industry Database*, September 2006, (*www. ggdc.net*).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were discriminatory as they applied to foreign nationals only. For example, a few countries imposed nationality requirements on shareholders, management and staff in some regulated professions, such as chartered surveyors. Residency requirements were also imposed, such as a rule that half of the management board must be resident in the host country. However, overtly discriminatory rules are becoming less common and tend to be struck down by the courts. Most other restrictions are simple barriers to entry that apply to local and foreign firms alike. They can be explicit, such as national monopolies or a rule that there can be only one optician per 10 000 inhabitants, or more subtle, such as a market demand test to open a new supermarket. There is also a formidable array of anti-competitive product market rules ranging from red tape (such as licences) to differences in technical standards (on laboratory equipment or tourist coaches, for example) to restrictions on legal form (professions such as lawyers having to take different legal structures in different countries). Local governments are responsible for a fair share of the burden. In addition, the Commission has issued two comprehensive reports on restrictions in the liberal professions (see EC 2004 and 2005a, and Chapter 8). The estimated tariff equivalents of such barriers to trade are large (Table 2.3).

Many regulations are in place for reasons of public safety or to protect consumers, but they can be disproportionate to their objective and have the effect, deliberately or not, of protecting the existing service providers from competition. The problem for the internal market is that the regulatory barriers tend to be more of a problem for foreign firms even if they are non-discriminatory on paper, and they compound problems caused by language, culture and the legal environment. Indigenous firms may also have a competitive advantage when it comes to receiving public procurement contracts, especially when granted at the local government level.

Individuals have the right to challenge discriminatory measures, but what is less well-known is that they can challenge non-discriminatory measures as well. EU jurisprudence has established that non-discriminatory measures which are liable to prohibit competition or otherwise render cross-border activities less advantageous can also be struck down. Proportionality can also be questioned. Even where a measure is motivated by an "overriding objective of general interest", it must not duplicate requirements already

Table 2.2. **Examples of barriers to cross-border service trade**

Barrier to entry	Some national examples
National monopolies and other quantity restrictions	Postal services, alcohol retailing; one optician per 10 000 inhabitants; one driving school per 15 000 people.
Residency or nationality requirements on management and staff	Nationality requirements for notaries, surveyors, engineers; residency requirements on management boards.
Service providers must be established in the host country	Temporary work agencies, wine transport and storage, patent agents, clinical analysis laboratories.
Single-establishment requirements	An owner of a medical laboratory cannot own another one in a different member state.
Unbundling or restrictions on multiple activities	Common in professions and financial services; real estate agencies cannot be involved in property management.
Licences and prior authorisation rules	Financial services, various professions, private security services, bakeries, trade fair organisers.
Territorial limits to a licence	Debt collection, transport, private security services.
Market demand or economic needs tests	A shop cannot be opened if it would impact on existing town-centre shops.
Enterprise must take a certain structure, including minimum number of employees	Lawyers or auditors must be limited liability companies.
Recognition of qualifications	Despite EC directives, problems still exist for professionals in many industries.
Professional qualifications in regulated professions that may not be regulated elsewhere	Vocational title for drafting legal documents that does not exist in any other member state.
Restrictions on use of temporary workers	Applies to all sectors in some member states.
Different technical standards	Weight and size limits on transport vehicles; security vans; tourist coaches; construction-site equipment; laboratory equipment.
Ownership of transport vehicles	Cannot use a hired heavy goods vehicle registered in another member state.
Advertising and promotion	Advertising for certain professional services is banned; content and timing restrictions for ads.
Unfavourable tax treatment	Costs of professional training are tax deductible only if courses take place in that country.
VAT reimbursements	Various exceptions to the rule that VAT is due in the country of establishment (*e.g.* furniture removers); VAT declarations generally must be on paper.
Must have a local bank account	Involves making a declaration of residence, which gives rise to tax declarations and other administrative costs.

Source: European Commission (2002), *The State of the Internal Market for Services*, Brussels.

fulfilled in the country of establishment and must not go beyond what is strictly required to achieve that objective. Currently, individuals can lodge a complaint with national authorities or the Commission under the infringements procedure,[6] but the EC acknowledges this can be a slow, heavy handed mechanism (EC, 2002). Experience shows that member states which are compelled to change their law following an infringement procedure sometimes just replace existing barriers with new ones, and the cycle of legal challenges starts again. In many countries, actions cannot be brought by a group of litigants such as a trade federation and decisions by the Court of Justice affect only individual infringements of the treaty and one country at a time. A case-by-case approach is ineffective in knocking down internal barriers to trade.

The main losers from trade barriers are consumers and small and medium-sized firms. Large firms can afford the transaction costs and will have the in-house knowledge of different legal systems. For small firms, including sole traders, it will seldom be worthwhile

Table 2.3. **Tariff equivalents of barriers to trade in services in the EU15**

Estimates based on gravity model of trade (including extra-EU trade), in per cent

All services	Construction	Trade	Transport	Communication	Financial	Business	Others
24	40	26	14	17	24	31	15

Source: Park, Soon-Chan (2004), "Measuring Tariff Equivalents in Cross-Border Trade in Services", *Working Paper 02-15*, Korea Institute for International Economic Policy.

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to launch a legal challenge against regulatory barriers and it will often not be worthwhile going through the administrative barriers for an occasional job in another country. Medium-sized firms also suffer as they typically market into another country then send in some temporary workers, both of which can be difficult in the current environment.

The services directive

The remaining regulatory barriers to cross-border trade are so hard to remove because often they are there for explicit policy reasons such as public health and safety. Nor does it help that powerful vested interests would lose out if the market were opened to competition. There are three broad strategies for opening up the internal market (Messerlin, 2005). The first is full harmonisation of domestic regulations. Negotiating and adopting a harmonised regulation that differs from all existing national ones is difficult at the best of times and can occur only when national objectives are closely aligned. It must take place on a service-by-service basis, can burn a great deal of political capital and can quickly erode through the law of increasing regulatory entropy as member states add additional provisions. The second way to free up trade is through a mixture of harmonisation and mutual recognition: the key provisions would be harmonised, with the mutual recognition principle covering the rest (mutual recognition of professional qualifications is dealt with separately in Chapter 8). This was the approach used in the Investment Services Directive, for example. The problem here is that it is biased towards the status quo. When a majority of member states are reluctant to liberalise, the mutual recognition part of the package tends to shrink and reaching agreement on the harmonised core means that little deregulation will be delivered. The third option is to apply the mutual recognition principle across the board. This amounts to the country of origin principle under which the service provider would mainly be subject to the legal regime of its home country. This principle is used for broadcasting and e-commerce.

When it comes to services, the first two strategies have struggled to make any headway, so the Commission proposed a services directive that made heavy use of the third. The objective of its draft, tabled in 2004, was to do for services what the 1992 single market agenda did for the internal market in goods – to make the provision of services between member states as easy as within a member state. It included two principles, in the spirit of their counterparts in the treaty, concerning freedom to establish a business in another member state and free trade in services within the community. In order to facilitate cross-border establishment, the draft contained measures for administrative simplification including a single point of contact for much of the paperwork. In order to facilitate cross-border provision, it proposed the country of origin principle.

The scope of the country of origin principle was limited, but still demanding. It applied only to the temporary provision of cross-border services without taking up a permanent establishment. It covered all modes of service delivery: services provided at a distance (*e.g.* legal advice or translation sent electronically); where the service provider temporarily goes to the member state (the famous Polish plumber); and where the recipient moves to the place of establishment of the provider. The service provider would follow the laws of his or her home country. The country of origin principle did not apply to the mutual recognition of professional qualifications or to matters already covered by the posting of workers directive which states that where a worker is temporarily posted to do a one-off job in another country, her main employment conditions, including minimum wages, working time and safety standards, must be at least as good as those in the host country.

Nor did it apply to firms setting up a permanent establishment. This is covered by Article 43 of the treaty and subsequent jurisprudence which state that the service provider must satisfy the legal requirements of the host country, though these requirements cannot duplicate or discriminate against EU nationals from another member state. Moreover, many sectors were exempted.

Even so, the Commission proposal met heavy opposition. Many groups, especially the regulated professions, feared the impact of greater competition and abuses of the rules. Labour unions worried that wages and working conditions would be undermined and that the protection under the posting of workers directive would not be adequate. There were also concerns about fraud whereby genuine employees might be declared as self-employed in the host country. Some politicians feared a race to the bottom in regulatory standards, ignoring the checks and balances that public opinion would put on that process. The public mixed it up with EU enlargement, fearing an influx of workers from the new member countries even though in some cases that was covered by transitional arrangements restricting migration flows.

The European Parliament and the Council adopted a less ambitious directive in December 2006. It is to be implemented by the end of 2009. One of the most important changes compared with the original proposal was the deletion of the country of origin principle. It was replaced with a "freedom to provide services" clause based on Article 49 of the treaty which states that any restrictions on the provision of services must adhere to the general EU requirements to be non-discriminatory, necessary and proportional (*i.e.* the minimum restriction needed to obtain that objective). But it improves on the treaty in one respect by limiting to four the "overriding reasons of general interest" that can be used to justify a restriction: public policy, public security, public health and the protection of the environment. While this is still quite wide, it is an improvement on the broader definition developed in case law by the Court of Justice.[7]

While the adopted version is less ambitious than the original proposal, it is still a step forward in several respects:

- There is more legal certainty for service providers.
- It should reduce the red tape and hidden barriers in the service sector and encourage a modernisation of bureaucratic practices. Countries must create points of single contact through which service providers can obtain information and complete all required procedures. The one stop shop is responsible either for issuing the relevant documentation itself or acting as the intermediary between the service provider and the various authorities which are directly competent. Second, a "silence is consent" rule has been introduced, albeit with some escape clauses. Third, general formal requirements such as presentation of original documents or certified translations should not be imposed except where clearly necessary. Fourth, countries have to ensure that all formalities can be completed by electronic means, such as through an internet portal.
- Economic need or market demand tests, such as permission to open a shop being refused if there are similar shops nearby, are outlawed. This is an important principle because needs tests are one of the most pernicious anti-competitive barriers to entry. But it remains to be seen how effective it will be in practice. The prohibition does not cover planning requirements that do not pursue solely economic aims but serve overriding reasons relating to the public interest. In many countries, economic needs

tests are in place for environmental reasons (to limit urban sprawl, for example), and could therefore be justified under the rules.

- A mutual screening process should chisel away at the myriad of remaining barriers. All existing national legislation within the scope of the directive must be screened to check whether it meets the principles of necessity, proportionality and non-discrimination. Each report will be submitted to the Commission and all other member states for comment. Hopefully that will spark a round of liberalisation. There is also a review clause, in which the Commission will assess what impact the directive has on regulatory barriers and whether further measures will be required.
- The principle of greater market access is combined with mechanisms for stronger co-operation between member states to ensure that service providers are supervised properly and to avoid duplication of controls. Voluntary measures by stakeholders, such as codes of conduct and standards, are also being encouraged.

Nevertheless, the directive has limitations in the sense that it excludes some services. It does not cover healthcare services, including pharmacies and some social services (namely, publicly provided or mandated social housing, childcare and family services), private security, gambling and audio-visual services (including cinematographic services and radio broadcasting), temporary work agencies and services provided by notaries and bailiffs, and transport services (including urban transport, ports, taxis and ambulances). The "freedom to provide services" rules do not apply to services of general economic interest such as postal services, water distribution, waste disposal and electricity, although the freedom of establishment rules are applicable. In some of these sectors (*e.g.* postal services, electricity and gas) specific directives apply. For the same reason, the directive does not cover financial services (banking, credit, insurance and reinsurance, individual pensions, investment, payments and investment advice).

Time will tell how much the services directive will help. It should promote the modernisation and streamlining of administrative processes, and it is encouraging that governments have re-stated their commitment to the principles of the treaty and the single market in services. Nonetheless, many of the barriers to trade listed in Table 2.2 (and the many more listed in EC, 2002) could be justified under one provision or another (public policy, protection of the environment, etc.), so they would still have to be challenged on a country-by-country, case-by-case basis as being discriminatory, non-proportional or unjustified, all of which can be hard to prove. Therefore, progress depends on how seriously governments take their renewed commitment to the single market. The services directive should be seen as another step towards liberalisation, not the end of the process.

Posted workers

The employment conditions of workers posted temporarily by their employer in another country are governed by the 1996 posting of workers directive. The directive states that posted workers (but not the self-employed) should have employment conditions at least as good as those in the host country. These include minimum wages, working time, minimum paid leave, employment protection for temporary workers, health and safety standards and anti-discrimination measures. It applies regardless whether the employment conditions are derived from acts, regulations or administratively extended collective agreements. The intention and outcome of the directive is to avoid a "race to the bottom" by ensuring that local wages and working conditions are not undermined by

competition from low-wage countries or from member states that choose to have fewer social protections for workers.

The first proposal for the services directive did not modify the basic principles of the posted workers directive but tried to remove some of the administrative barriers that in practice have been hampering the posting of workers in the context of the provision of services. For example, in some cases foreign service-providers must have a representative in the host country while some countries impose excessively time-consuming and onerous prior notification requirements for posted workers.[8] The posting of third-country nationals can also be difficult. In several member states they must be pre-authorised, *e.g.* through the granting of a work permit. This can be cumbersome and costly and is in breach of European case law. The draft services directive proposed banning pre-authorisation requirements for EU citizens and third country nationals provided they were legally present and employed in the country of the service provider. This did not survive the Parliamentary redraft due to concerns about effective control mechanisms. The Commission issued a communication to clarify community law on administrative procedures and encouraged member states to implement the letter and the spirit of the various legal requirements, in particular by improving access to information, administrative co-operation and monitoring of compliance.[9]

Where to from here?

The debate surrounding the services directive has demonstrated that a country of origin principle is politically unacceptable. The alternative is sector-by-sector harmonisation. The EU's experience to date, and Canada's experience negotiating the Agreement on Internal Trade, shows how difficult and slow this can be. Ultimately, progress requires the political leadership to stop protecting vested interests and make genuine efforts to encourage the single market. But there are some practical steps that could help. First, the Commission must take a strong role in challenging national barriers to entry no matter whether they are overtly discriminatory or not. Second, it should be proactive in ensuring that the agreed services directive is transposed accurately into national law and that the legislative screening process is thorough and honest. Third, fast-track mechanisms could help reduce the costs of challenging barriers to trade. The EU has already a cheap and successful problem-solving network (the SOLVIT network – see Box 2.1) but it deals with the misapplication of law rather than trying to overturn national laws that are inconsistent with the single market. Fourth, the Commission could continue to encourage private legal challenges, including through the use of class actions (see Chapter 5).

As a last resort, the EU may need to consider more flexible models of integration where a subset of member states opts for deeper integration among themselves (Chapter 1). Enhanced co-operation is clearly a second-best option compared with full economic integration across the Union. However, with the policy agenda now butting up against some deep philosophical differences among member states and with an underlying suspicion in some countries that policy approaches in some of the more liberal member states might lead to a "race to the bottom" in regulatory standards, it will become increasingly difficult to deliver real progress within the current framework.

Box 2.1. **The SOLVIT network**

SOLVIT is an online problem-solving network that deals with misapplications of internal market law by public authorities. It usually does not try to overturn national rules that may be in breach of internal market principles, but it has had the occasional success in this area. There is a SOLVIT centre in every member state. To give an example of the type of case that it handles, a Czech citizen wanted to set up in Germany as a self-employed construction worker. The local German authorities insisted that he needed a work permit but refused to give him one. SOLVIT Germany clarified that no work permit was needed for self-employed workers and within four weeks arranged that the Czech worker obtained an establishment license. The use of the service rose rapidly after it was set up in 2002 but the number of cases has plateaued at around 450 per annum, possibly because a lack of staff in some centres is creating bottlenecks. Around three-quarters of cases are resolved satisfactorily, and mostly within a few weeks, although there is considerable variation across countries.

Source: http://ec.europa.eu/solvit/site/index_en.htm.

The single market for goods

Internal trade in goods is facilitated through harmonised product standards or mutual recognition. The so-called "new approach" to product legislation is to limit rules to essential requirements such as product safety. New approach directives do not directly contain technical details and leave it up to industry and other stakeholders to work out the best way to implement the broad safety objectives.

Mutual recognition has worked well but could be improved further

Mutual recognition applies to all goods where technical standards have not been harmonised. It means that in sectors which have not been subject to community level or voluntary harmonisation measures, all member states must accept products which are legally produced and marketed in another member state. The principle can be challenged only on grounds of public safety, health or protection of the environment, and any measures taken must be necessary and proportional. It has been profoundly important for breaking through the more than 100 000 product and testing specifications that existed in 1985. Mutual recognition applies to about a quarter of intra-EU manufacturing trade (EC, 2007b).

There are concerns that the principle is not being applied as well as it could be. According to the Commission, "there is enormous anecdotal evidence that failure to apply mutual recognition correctly is a significant barrier" to internal trade (EC, 2003). In early 2007, the Commission proposed a regulation that aims to minimise the risk that national technical rules lead to unlawful obstacles to the free movement of goods. It clarifies that according to European Court of Justice (ECJ) jurisprudence, the burden of proof lies with member states – they will have to provide suppliers with sufficient scientific or technical evidence to justify any restrictions that they have put in place and give the supplier time for a reply. In the end, however, it will still be the product supplier that would have to take a case to court to get access to a market. The regulation would also establish product contact points in each member state whose main task would be to provide information on technical rules applicable to that product.

Two other projects should help the internal market for goods. The first is a regulation to establish a European small claims procedure that will apply in civil and commercial matters where the value of the claim does not exceed € 2 000. The second is a regulation introducing a European Order for Payment procedure that will help recover uncontested claims in cross-border cases. It will apply from December 2008.

Network industries need to be opened further to competition

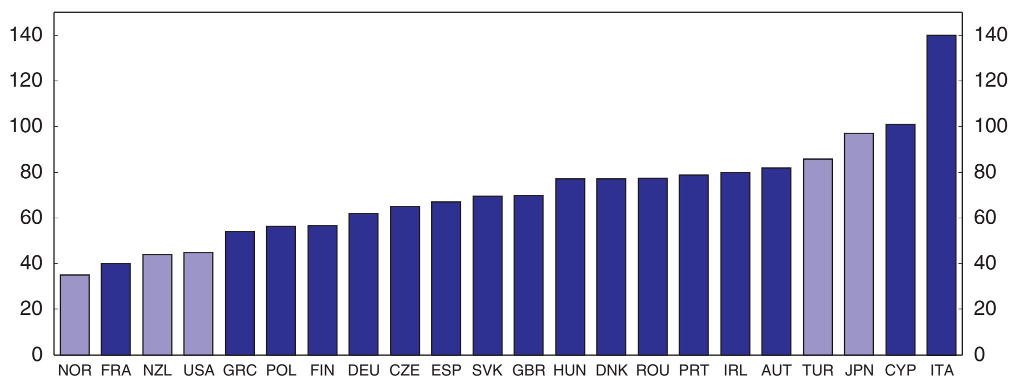
As noted in Chapter 1, there has been good progress in liberalising some network industries. However, the level of anti-competitive regulation remains high by OECD standards. Further market opening is needed in energy, telecoms, ports, road and rail transport and postal services. The following sections discuss the first three industries in this list.

Energy markets create major inefficiencies

Energy issues are at the forefront of the EU's agenda. Europe's energy markets are not well integrated and they suffer from a lack of competition. This partly explains why power prices can vary so widely across the Union (Figure 2.5). If anything, competition in the sector may be going into reverse as electricity and gas giants have been rushing to merge ahead of full market opening in the middle of 2007. The energy sector is one area where there has been a tendency to try to protect national companies, highlighting a clash in view between those who believe that national energy champions are the best way to guarantee a secure supply of energy and to retain some buying power over foreign suppliers, and those who argue that a liberalised, integrated European market is not only more efficient but is also more secure.

Figure 2.5. **Electricity prices for industry**

EUR per thousand kilowatt hours, 2005[1]



1. 2004 for Denmark and Germany.

Source: IEA, *Energy Prices and Taxes*, 4th Quarter 2006.

StatLink http://dx.doi.org/10.1787/083780331630

Following the initial liberalisation directives of the 1990s, revised gas and electricity directives were adopted in June 2003 with the aim of further opening up markets for consumers and suppliers and encouraging an integrated European market. Business customers have been able to choose their supplier since July 2004 and all European households will be able to choose by July 2007 (in some countries, they have been able to

choose since 1998). While the directives did not require full ownership unbundling of production and supply activities from the distribution and transmission sides of the industry, they did mandate legal, management and accounting separation as well as non-discriminatory access and tariffs for transmission and storage facilities and common minimum standards for public service obligations including security of supply and environmental protection. They required member states to create national regulators independent of industry, but not necessarily independent of the government. Many countries have not yet implemented the directives properly, so in 2006 the Commission launched 34 infringement proceedings against 20 countries. In many cases the breaches are more than just technicalities – they go to the heart of the single market, and include inadequate unbundling or discriminatory access.

An EC competition inquiry found "serious malfunctions" in the electricity and gas markets (EC, 2007c). The problems include:

- *Vertical foreclosure*. Vertically integrated incumbents who operate at the network, wholesale and distribution levels can shut out potential market entrants. Problems at the network level include discriminatory access tariffs, a lack of "Chinese walls", inappropriate switching procedures and pressure from the supply branch of the integrated company to delay viable investments in cross-border capacity so as to hinder the development of greater competition. The requirements for legal unbundling are not having the desired effect on the ground. Integrated companies are still able to treat competitors unfairly, posing difficulties for new entrants.[10] Vertical foreclosure can also arise from the integration of electricity generation and gas importation in the same group as the supply company, which reduces liquidity in wholesale markets and makes it difficult for new entrants to access gas and electricity. In the gas market, there is inadequate access to storage and balancing services.
- *Market concentration*. National incumbents continue to dominate, in some cases giving them effective control over wholesale prices. In nine member states, no generation company besides the incumbent has more than 5% market share; in another five countries, only a single generator other than the incumbent exceeds 5% of the market (Eurostat, 2006). The trend if anything is towards *greater* concentration, especially through mergers between gas and electricity suppliers. These mergers can have anti-competitive effects such as vertical foreclosure, foreclosure of inputs (*i.e.* gas) and elimination of potential competitors. In some cases these mergers have been brokered or at least actively encouraged by governments in order to create national champions.
- *Markets are still largely national*. Competition from imports is insufficient to erode the market power of incumbents. Incumbents rarely enter other markets as competitors unless there is free access and full and open competition while inefficient use of cross-border capacity and different market designs hamper market integration.[11] In 2004, cross-border electricity flows amounted to 10.7% of total consumption. The problems are largely caused by interconnection bottlenecks and grandfathering rights which give incumbents preferential access to the power-lines and gas pipes which can block access to transportation whether actual physical capacity is available or not. However, in 2005, the Court of Justice ruled against the legality of the preferential access given to historical long-term electricity contracts. Local planning restrictions are also a barrier to expanding interconnection capacity in some places.

- *Lack of transparency*. The level of transparency in wholesale markets varies widely across member states and is generally inadequate. The information that is released about network availability, generation, balancing, reserve power and load factors is insufficient and incomplete. This hampers the functioning of markets and gives incumbents, who have access to this information, an advantage over new entrants.[12]
- *Anti-competitive pricing*. There is some evidence that the rise in electricity and gas prices in some countries since 2003 is not fully explained by the increase in fuel costs or the introduction of the Emissions Trading Scheme. Moreover, the fact that 96% of continental European gas deliveries are tied by contract to crude oil prices means that they are isolated from demand and supply conditions and shows that there is no gas-to-gas competition in the marketplace. Regulated tariffs are also a barrier to entry in some markets.
- Other issues include insufficient competition in retail markets, balancing markets that favour incumbents, lack of clear transportation infrastructure planning criteria and difficulties in siting and building new transportation and energy infrastructure (including NIMBY problems).

Member governments, incumbent operators and national regulators have been slow to create an effective internal energy market. However, in January 2007, the Commission attempted to push ahead by tabling some significant proposals as part of its European Energy Policy (EC, 2007d). Many of the ideas were supported by the European Council when earlier this year it adopted an integrated *Energy Action Plan* covering the three goals of enhancing competition in the internal market, securing energy supply and underpinning environmental sustainability. It is necessary to boost competition within each national market but even more important is to ensure markets are better integrated across countries. This requires regional or pan-European markets, the geographic scope of which will depend on the trade-off between greater integration *versus* transmission losses. To achieve greater integration, the authorities may have to rethink their reliance on national regulators, some of which do not have sufficient powers or independence from government (HLG, 2006). Even where they have power within their domain, they have limited or unclear power at the border, which is where many of the competition problems crop up. In the past, member states have not been in favour of a single European regulator, or even a co-ordinator,[13] so national agencies are trying to improve co-ordination through the development of regional markets, each of which may have a lead regulator (for example, the Dutch regulator would oversee the north-west region). This could help deal with cross-border pricing and infrastructure issues, including the creation of regional wholesale markets and better balancing mechanisms. In its *Energy Action Plan*, the Council agreed to establish an independent mechanism for national regulators and transmission system operators (TSOs) to co-operate and take decisions on important cross-border issues. While it may be an improvement on the current system, the Commission in its *European Energy Policy* argued that stronger measures are required. At a minimum, the network of national regulators (ERGEG) should be given a formal mandate and powers to make binding decisions that are implemented by national regulators.[14] Alternatively, the EU could go one step further by creating single European regulators for gas and power.

Insufficient interconnection capacity also poses problems as foreign suppliers are not able to exert sufficient competitive pressure on local incumbents.[15] The approach of leaving it up to member states to develop joint schemes for congestion management has, with a few exceptions, not delivered sufficient progress.[16] Investment in interconnections remains

low.[17] This reflects planning and authorisation delays and insufficient use of market-based instruments for access to infrastructure. Moreover, only about a quarter of congestion revenues are used to build new interconnectors or reinforce the grid; much of the remainder is used to reduce national grid tariffs, so domestic producers have an incentive *not* to push for increased interconnection capacity as bottlenecks at the border are subsidising domestic production. As part of its energy policy, the Commission has proposed appointing four European co-ordinators to pursue what it views as the most important projects.

A third issue concerns unbundling the network and generation activities of vertically integrated energy giants in order to prevent abuse of power and create a level playing field for competition. The EC report considered two options – full ownership unbundling, and the creation of independent system operators even if transmission assets remain owned by the incumbent generators. While both options would go a long way towards boosting competition, the first option is likely to be more effective. The experience in many OECD countries has been that "functional separation and accounting separation have a limited potential to prevent discrimination because the incentive to discriminate and some of the ability to discriminate remain" (IEA, 2001). Moreover, vertically integrated firms may have less incentive to invest in new transmission capacity. The UK's experience with its gas market is a good example (helped by the fact that there were enough independent suppliers): several options were tried, but real competition emerged only after the grid was separated from upstream and downstream activities. In its *Energy Action Plan*, the European Council agreed that effective separation of supply and production activities is required but it did not go as far as requiring ownership unbundling.

The benefits for consumers of a competitive energy sector would be large. By one estimate, full market opening could boost cross-border trade in electricity by a third and reduce prices by 13% (Copenhagen Economics, 2006). When it comes to designing a regulatory framework with independent system operators and transparent real-time balancing markets, the EU already has two good examples to draw from: the Nordic and UK markets. The successes achieved there should encourage reforms in the rest of Europe.

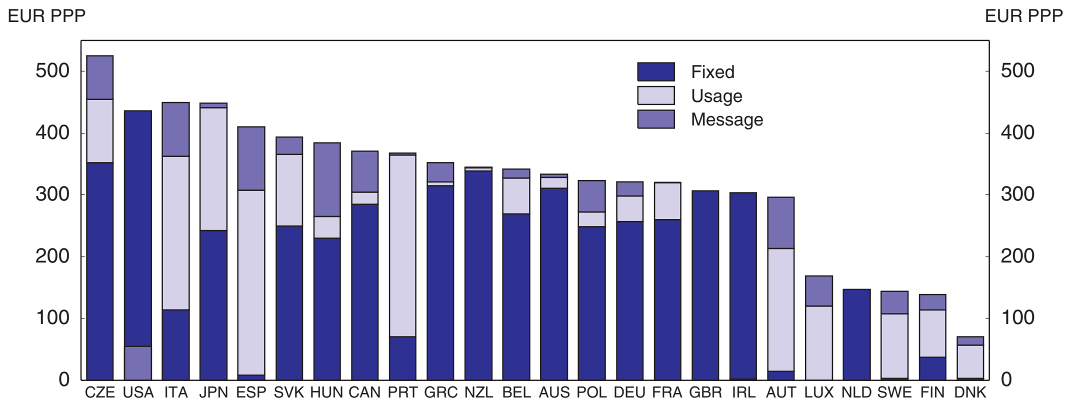
Security of supply became a more prominent issue following the power blackouts in 2003 and after Russia cut off gas supplies through the Ukraine at the start of 2006. Currently, around half of the EU's gas consumption comes from three countries (Russia, Norway and Algeria) and import dependence is expected to rise to 80% by 2025. A 2004 directive obliges member states to develop policies for supply security. It is important that security issues are not used as an excuse to segment the single market, which ultimately is the best way to ensure a diversified and secure supply for the long term. A precondition would be better interconnection between national markets. Providing incentives to link pipeline systems would not only increase security of supply but also enable greater competition.

Telecommunications

The regulatory framework for telecoms is broadly sound and competition has been increasing in most market segments. Prices for fixed and mobile calls have fallen substantially since 2000, both in Europe and worldwide (Figure 2.6). However, there is considerable diversity across member states with some having been slower to develop effective market competition. Broadband is developing well in some countries but there are lagging countries where regulators have not placed sufficient pressure on incumbents or market regulation has not yet been effective. The gains from further market integration are

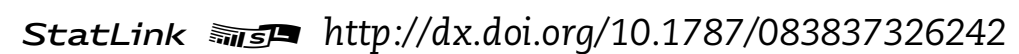
Figure 2.6. **Mobile phone prices**

Price per year, medium user basket, August 2006[1]



1. Pre-paid cards excluded, VAT included.

Source: OECD, *Telecommunications Database*.



sizeable. A recent estimate suggested that a fully open market could reduce prices by 11% across the EU15 and increase cross-border trade by 29% (Copenhagen Economics, 2006).

In 2006, the Commission released a discussion paper as part of its ongoing review of the electronic communications sector (EC, 2006b). It advocated phasing out regulation[18] in 5 of the existing 18 telecom market segments, including national and international calls, and streamlining regulation in the others. Among the more important proposals were: *i*) shifting to a more market-based approach to spectrum management, including more freedom for operators to choose which services and technology can be used in a particular spectrum band, spectrum trading and greater consistency of spectrum allocation rules across EU countries, including a default rule of general authorisations rather than licences. Currently, the regulatory framework encourages general authorisation but in practice individual rights of use tend to be required at the national level; *ii*) allowing where possible a co-ordinated deployment of services with a pan-European dimension through harmonising licensing conditions for rights of use of spectrum or numbering resources of selected services *iii*) giving greater enforcement powers to national regulators. At present, operators are given the opportunity to rectify any breaches before penalties are imposed. In practice they can delay compliance with decisions made by national regulators, including during the appeals process, then belatedly fall into line and avoid any penalties for past misconduct; and *iv*) strengthening the Commission's veto rights over decisions made by national regulators. The Commission is concerned with inconsistencies in the way that competition problems are dealt with and that remedies imposed by national regulators have sometimes been inadequate or might take too long to produce results. It has not gone as far as formally proposing a single European regulator, but the Information Society Commissioner has stated that in her view this would be "the most effective and least bureaucratic way to achieve a real level playing field for telecom operators across the EU".[19]

In a separate move, the Commission has proposed to regulate mobile roaming charges. Competition has failed to drive down prices in this highly lucrative market. The Commission considered various options including a home pricing principle in which a mobile customer travelling in another EU country would be charged the same price as at home. In the end, it opted for a cap on wholesale roaming charges and a maximum mark-

up of 30% for retail prices, although this has not yet been settled by the European Parliament and European Council.[20] New technologies and business models such as voice-over-internet and virtual operators (MVNOs) may lead to an increase in competition over time, though in some countries regulatory changes may be needed to facilitate access.[21] Ultimately, the best way to ensure adequate competition would be to have pan-European mobile services. This would require changes to the spectrum allocation system along the lines of those discussed above.

Ports

Progress towards competition in and between ports has proved difficult. The Commission presented a directive on market access to port services in February 2001. It aimed to eliminate monopolies on the provision of port services by requiring open and transparent bidding processes and ensuring wherever possible (*e.g.* where space constraints do not make it infeasible) that more than one service provider can operate. The proposal met with strong opposition and was rejected by the European Parliament in 2003. The Commission tried again in late 2004 but that too was rejected by the Parliament in 2006. This is unfortunate because, while some European ports are efficient and competitive, some others are well behind the productivity frontier.[22] Experience in countries such as Australia and New Zealand has shown very large productivity improvements following deregulation of the waterfront – in some cases, a doubling of productivity in the space of a few years.[23] The Commission and member states should keep trying to open up ports as part of a broader transport strategy.

Box 2.2. **Recommendations concerning the single market**

- Continue to push for greater market openness in goods and services. When implementing the services directive: *a)* ensure it is transposed effectively and efficiently; *b)* ensure the screening process leads to a significant reduction in barriers to trade; and *c)* member states should not abuse the exceptions and exclusions in the law.
- Develop quicker and cheaper remedies for individuals and enterprises, such as fast-track mechanisms, and ensure that the SOLVIT network has adequate resources.
- Facilitate cross-border business by establishing a European small claims procedure.
- Push for greater competition and further market opening in network industries, including energy, telecoms, ports, road and rail transport and postal services.
  - ❖ In energy markets, effective unbundling of networks from transmission is needed. International experience suggests that full ownership unbundling would be the most effective option. It should be backed up with effective, transparent wholesale markets and a reduction in state ownership.
  - ❖ Regulators need greater powers and clearer rules over cross-border issues. Regional system operators would be a useful first step towards establishing a pan-European market.
- In telecoms, implement proposals for phasing out regulation in competitive segments, introducing a more market-based approach to spectrum management, facilitating pan-European service provision, strengthening regulators' enforcement powers and ensuring consistency in remedies.
- Keep pushing for an EU port policy that includes greater transparency and market access.

Notes

1. See HM Treasury (2007), Notaro (2002) and Ilzkovitz *et al.* (2007).
2. The comparison is not clear cut because Europe here refers to the capital cities of the EU15 plus the relatively expensive cities of Geneva, Zurich and Oslo.
3. Statistical measurement issues such as hedonic pricing of IT equipment account for only some of the difference between the United States and Europe (see Box 1 of Vogt, 2005).
4. Restrictions faced by foreign firms include rules that are discriminatory, such as nationality requirements, as well as some rules that are non-discriminatory on paper but are likely to affect foreign firms more (such as restrictions on the use of foreign labour).
5. See Chart 12 of ECB (2006) which is based on data from OECD STAN and the Groningen Growth and Development Centre Database. For the service sector as a whole, ECB (2006) estimates the euro area labour productivity level in 2001 to be 77% of the US level.
6. After a complaint is lodged, the Commission decides whether to pursue the complaint based on its rules and priorities for opening procedures. The first step is to send a letter of formal notice requesting that an infringement be removed within a stated time limit. This is followed by an initial legal assessment (a "reasoned opinion"). If no action is taken it will be referred to the Court of Justice. If the Court rules against the country and it still does not comply, the process starts again: a letter from the Commission, a legal opinion, then back to Court. This time the Court can impose fines for non-compliance. At the end of October 2005, of the 1 096 cases where the transposition of directives had not been notified to the Commission, 615 led to letters of formal notice, 371 were followed by a "reasoned opinion", 81 were referred to the Court and 20 were undergoing the second round of infringement proceedings for failure to comply with the Court's judgements. See *http://ec.europa.eu/internal_market/infringements/index_en.htm* for details.
7. In particular, some members of the European Parliament wanted social policy and consumer protection to be included in the list of valid reasons but after negotiation and debate they were left out.
8. In some cases, formalities must be completed for each individual site. A service provider who regularly posts personnel for short periods cannot obtain authorisation that is valid, for example, for one year. EC (2006a) gives a general review of the implementation of the posting of workers directive.
9. The communication reiterates case law decisions that: 1) the service provider does not need an established representation in the host country; 2) no prior authorisation is required for posting of workers as such, but in some sectors a general authorisation to provide services may be required; 3) a declaration that posted workers will be used can be required before work starts; and 4) various documents related to *inter alia* health and safety can be required to be kept by the service provider.
10. In the electricity sector, there is full ownership unbundling of the TSO in twelve member countries (Belgium, Denmark, Finland, Italy, the Netherlands, Spain, Sweden, the United Kingdom, Lithuania, the Czech Republic, Hungary and Slovenia). No country has introduced ownership unbundling of the DSO. There is ownership unbundling of the gas network TSO in six countries (Denmark, Spain, Poland, the Netherlands, Sweden and the United Kingdom). See the statistical annex of EC (2005b) for further details of market structure in various network industries.
11. The main bottlenecks are between France, Germany and Benelux; between France and Spain; between Denmark and Germany; between Italy and all its neighbours; and between the United Kingdom and continental Europe (Coppens and Vivet, 2006).
12. Many competition authorities have the power to investigate an alleged abuse of dominance, but it can be difficult for new entrants to know that they are being discriminated against if information on flows and capacities remains hidden by the company managing the grid.
13. In 2005, EU ministers rejected a Commission proposal to appoint a co-ordinator to manage priority electricity and gas network projects. However, the option of a pan-European regulator is back on the agenda as part of the Commission's proposals in its European Energy Policy.
14. Specifically, the report argues that energy regulators need *ex ante* powers in the following areas: 1) all aspects of third party access to networks; 2) access to gas storage; 3) balancing mechanisms; 4) market surveillance; 5) compliance with functional and account unbundling for distribution system operators; 6) all cross-border issues; 7) consumer protection including any end-user price controls; 8) information gathering; and 9) sanctions for non-compliance.
15. Bottlenecks in the gas networks are most common in the western and southern EU. Electricity interconnectors are frequently congested. Some countries have a relatively high level of

interconnection capacity (20% or more of generation capacity); these include the NordPool members plus Austria, Belgium and the Netherlands. There is relatively little interconnection capacity in the United Kingdom, Spain, Ireland, Greece, Portugal and Italy (EC, 2005b).

16. See de Jong (2004) and Glanchant and Lévêque (2006). NordPool is a clear exception, although it existed well before the electricity and gas directives. Other initiatives include a co-ordinated congestion management system in the Benelux countries as well as a largely integrated market between Germany and Austria.
17. Investment on cross-border electricity connectors is running at just € 200 million per annum. From 2000 to 2003, the average annual increase in the length of 220-400 kV transmission lines was only 0.5% (see Figure 16 of IEA, 2005).
18. The EC defines the list of sectors that national regulators can regulate. National bodies can go beyond that list but they must meet relatively tough criteria to show that intervention is justified.
19. Comment from a speech on 16 November 2006 to the regulatory conference organised by the European Competitive Telecommunications Association.
20. The proposed cap on the wholesale rate for making calls is two times the EU average peak mobile termination rate for making calls within a visited country in the EU and three times the EU average peak termination rate for calling home or to a third country within the EU. For retail rates a separate cap of 130% of the EU average peak termination rate would apply.
21. Mobile virtual network operators usually do not have networks of their own but buy time and spectrum from other operators at wholesale rates and resell it to customers in the retail market. Unlike the requirement for local loop unbundling of the fixed line network, most national regulators have not made open access to mobile networks compulsory.
22. See Wang and Cullinane (2006) and Trujillo and Tovar (2007) and the literature review by González and Trujillo (2007).
23. In Australia, between 1995 and 2002, the average crane rate (number of containers unloaded per crane per hour) rose from 15 in 1995 to 27 in 2002. The average ship rate (productivity per ship while the ship is worked) doubled from 20 containers per hour to 41 (Access Economics, 2002). In New Zealand, costs per tonne at the Port of Nelson dropped by 30% in real terms between 1988 and 1995. At the Port of Auckland, the average turnaround time for a container vessel dropped from 38 hours in 1989 to 15.5 hours in 1998, despite the fact that, on average, each ship had twice as many containers as in 1989. The cost of baggage handling for luxury cruise ships at Auckland after deregulation in 1998 was a fifth of what it cost at Sydney just before Australia deregulated its ports – see Kerr (1998).

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Chapter 3

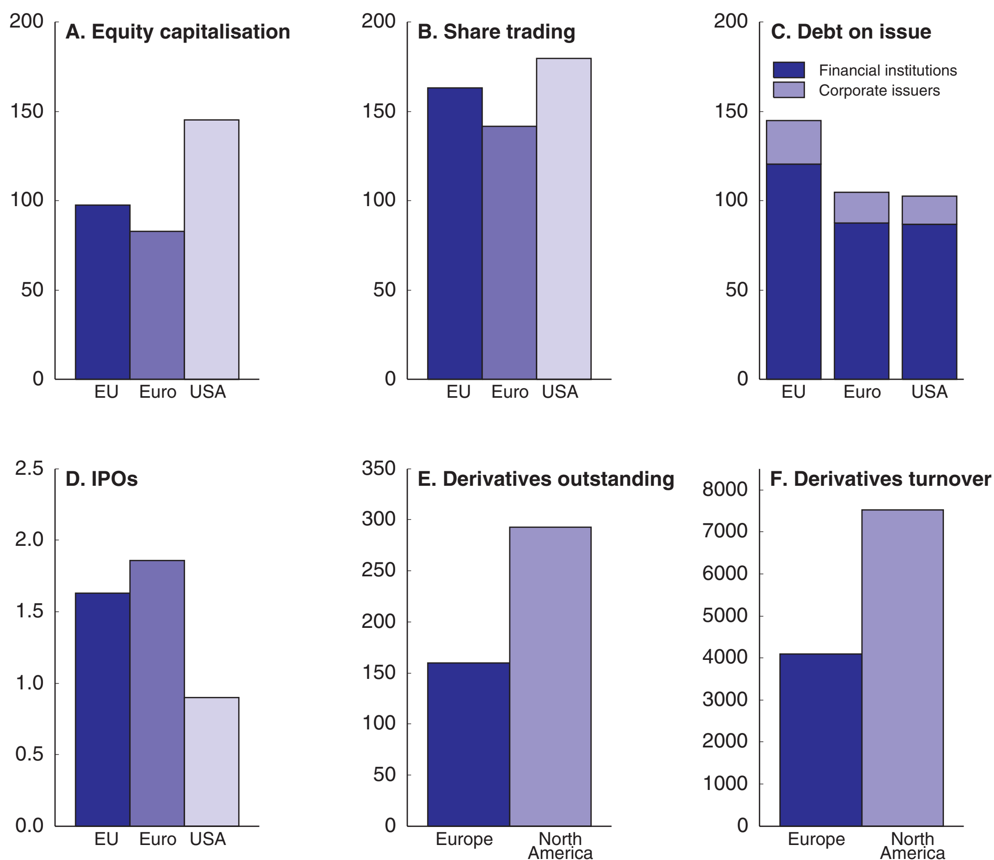
Building competitive financial markets

This chapter discusses unfinished business in financial markets. The main challenges include greater integration of retail banking, deeper corporate finance markets and stronger financial surveillance. The chapter discusses the role that can be played by the Financial Services Action Plan, mortgage market reform, the Single Euro Payments Area (SEPA), the MiFID, mutual funds and banking supervision.

Europe's financial markets are undergoing a rapid transformation. The renaissance since 1996, when the Investment Services Directive came into force, has been impressive. Bond issuance has more than doubled; equity market capitalisation has tripled; and equity turnover and the value of derivatives have increased sixfold (Casey and Lannoo, 2006). In some areas, Europe has overtaken the United States (Figure 3.1). For example, the value of initial public offerings (IPOs) exceeded the US level in 2005, the euro interest rate swap market is now the largest of its type in the world and since 2004 the euro has overtaken the US dollar as the main currency of denomination for international debt issues. The introduction of the euro has

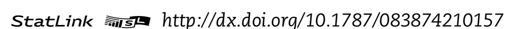
Figure 3.1. **Financial market indicators**[1]

Per cent of GDP,[2] 2006



1. EU22 (excluding the Czech Republic, Portugal and the Slovak Republic) for Panels A, B, D and EU15 for Panel C; euro area-10 (excluding Finland and Portugal) for Panels A, B, D.
2. Except for share trading which is in per cent of equity market capitalisation.

Source: World Federation of Exchanges, *Focus,* January 2007; BIS, *Quarterly Review,* December 2006; IMF, *World Economic Outlook,* September 2006.

StatLink  http://dx.doi.org/10.1787/083874210157

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clearly had a major impact but other regulatory reforms have also contributed, especially the wide-ranging Financial Services Action Plan that was launched in 1999.

Markets have not only expanded, they have become more integrated as well. However, progress varies across market segments.[1] In general, wholesale or over-the-counter markets are nearly fully integrated across the euro area and are highly integrated across the EU as a whole. Markets that serve retail customers are more fragmented, mainly because of different national approaches towards investor and consumer protection (Box 3.1).

The benefits from further financial integration would include a euro area that operates more smoothly and a financial system that is stronger and more competitive. Consumers would enjoy lower prices and EU financial institutions would be able to compete more

Box 3.1. **Integration of financial markets**

The *unsecured short-term euro money market* has been essentially a single market since the introduction of the euro. Interest-rate spreads across countries (more accurately: the standard deviation of cross-country rates) on inter-bank lending rates are currently just 1 basis point. Improvements in the payment system's infrastructure have played an important role here, especially the establishment of the real-time gross settlement system (TARGET). The overnight interest rate swap market is also perfectly integrated, facilitated by standardised product definition.

The *secured money market* also shows a relatively high degree of integration. "Spreads" on one-month and twelve-month repos (repurchase agreements) used by the European Central Bank (ECB) to conduct monetary policy are 1 to 2 basis points. However, integration of clearing and settlement infrastructures for securities is incomplete and problems remain in guaranteeing cross-border collateral.

Government bond markets are nearly as integrated as money markets. Yield differences now largely reflect credit risk rather than quantity or market microstructure issues. Bond betas, which measure the co-movement between a country's bond rate and German yields, are close to 1.0, meaning that yields move almost exactly one-for-one. Competition among issuers has led to a harmonisation of secondary market rules along with more information and greater product diversity for investors. Improved secondary market infrastructure has also helped.

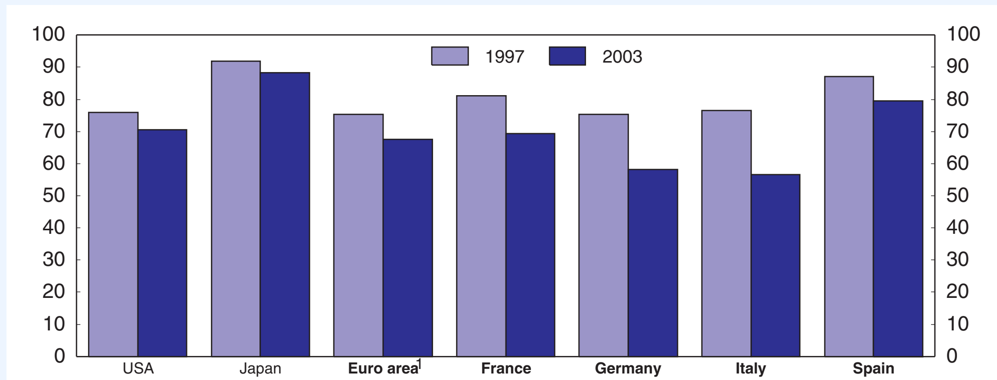
Corporate bond yields are almost entirely determined by the sector- and credit-risk characteristics of the issuer, with country factors playing a minor role (Baele *et al.*, 2004). Underwriting fees on corporate bond issues have fallen dramatically since 1999 and, at around 0.6%, are similar to levels in the United States. The euro-denominated corporate bond market has expanded significantly, but is a third the size of the US corporate bond market (measured relative to GDP). However, most companies still look to their domestic capital market as their primary source of funding.

Off-balance-sheet securitisation markets remain underdeveloped. New issues of asset backed and mortgage backed securities in the euro area in 2004 amounted to around € 240 billion, a fifth of the US market size. There is no integrated European securitisation market as each country has its own instruments. Collateralised bank bonds such as Germany's *Pfandbriefe* are more prevalent than true securitisation products (the difference being that true securitisation shifts credit and cash flow risk off the issuer's books). This pattern partly reflects history as in the past there have been tax and regulatory obstacles to genuine sale of credit risk *via* securitisation. The capital requirements directive provides further regulatory harmonisation in this area.

Box 3.1. **Integration of financial markets** *(cont.)*

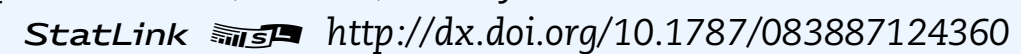
Equity markets have become more integrated, although they are still more fragmented than fixed interest markets. The degree of home-country bias has fallen but it has been replaced to a large extent by a euro-area bias (Figure 3.2 and Lane, 2005). While equity market capitalisation has increased sharply, it is still considerably lower than in the United States (Figure 3.1, Panel A). On the infrastructure side, stock exchanges are undergoing a market-driven consolidation in preparation for upcoming regulatory reforms (see below).

Figure 3.2. **Home bias in the equity market**



1. The home bias of the euro area is computed as if the euro area was a single entity.

Source: Issing, O. (2006), "Globalisation, EMU and the Euro", Speech for the 34th Economic Conference on *Globalisation: Opportunities and Challenges for the World, Europe and Austria*, Vienna, 22 May.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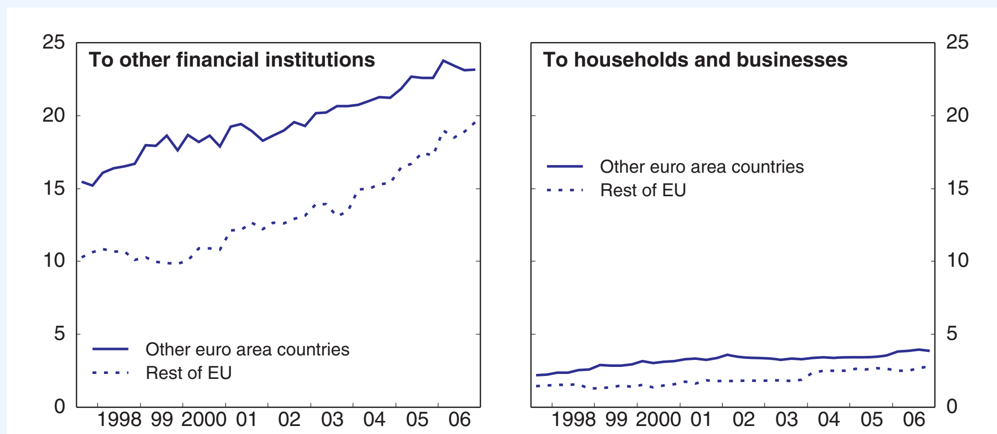
Wholesale banking and capital market related activities have become more integrated in the past few years. For example, of the loans *between* financial institutions in the euro area, 23% are across-borders, up from 15% in 1997 (Figure 3.3).

Figure 3.3. **Cross-border lending by euro area financial institutions**

In per cent of total lending



Source: ECB.

StatLink http://dx.doi.org/10.1787/084008657585

Box 3.1. **Integration of financial markets** *(cont.)*

The main weak point is *retail banking*. It is mostly segmented along national lines, especially for smaller customers. Cross-border retail bank lending is negligible (Figure 3.3). While it is difficult to compare products across countries, it seems that interest rates on similar products are far from having converged. The cross-country standard deviation of interest rates on consumer loans has been fluctuating between 80 and 100 basis points in recent years, and the corresponding figure for mortgage loans has varied between 40 and 60 basis points. Notwithstanding methodological differences, the dispersion of mortgage rates across US regions appears to be lower than between euro area countries (ECB, 2005). Most banks do not have a significant cross-border presence and there is no truly pan-European retail bank, but to be fair few US banks cover all of the United States either.[1] While the banking industry has undergone aggressive consolidation,[2] most of this reflects mergers within countries rather than across-borders. Nevertheless, signs of greater European integration are emerging. The number of cross-border financial merger and acquisitions in the EU tripled between 1999 and 2004, with banks in the new member states being a major target (EC, 2005a). Even so, cross-border deals lag behind domestic consolidation, are usually smaller and are more common in the wholesale sector. The cross-border retail banking mergers that have taken place have tended to be driven by companies looking for a second home market rather than a genuine pan-European presence.

Clearing and settlement infrastructure is segmented, with national institutions (often monopolies) unable to agree on a way forward. In 2001, an expert group appointed by the Commission identified 15 barriers to cross-border securities transactions, stemming from different market practices, technical requirements, domestic laws and procedures, including domestic tax provisions. Cross-border clearing and settlement occurs in a fragmented environment involving several intermediaries, thus raising costs and exposing participants to credit risks. Clearing and settlement costs are up to 8 times more than in the United States (EC, 2006).

1. Of the 538 US banks that had branches in more than one state in 2003, only 14 had branches in more than ten states. Around the same time, around 40 European groups were operating in five to six member countries and five groups were present in ten or more countries (IMF, 2005a).
2. Between 1997 and 2003, the number of credit institutions in the EU15 fell by 22% and the number of bank branches fell by 8%.

effectively on world markets. The gains could be large – the static gains alone may be over 1% of GDP, leading potentially to a reduction in the cost of capital by 50 basis points, while the dynamic effect on the growth rate of manufacturing could be as high as 1% per annum.[2] These gains have started to materialise as a result of greater market integration brought about in part by the Financial Services Action Plan.

The main challenges for financial market policy are threefold. The first is to boost competition in retail banking by eliminating barriers to cross-border service provision. The second is to enhance corporate finance markets, for example by developing more integrated securities markets. The longer-term challenge is to make sure that the fragmented financial supervision system will be able to deal with a cross-border financial crisis.

The Financial Services Action Plan has been a large and impressive legislative programme aimed at fostering financial market integration. It included more than 40 individual measures and resulted in 26 directives and regulations from 1999 to 2007 (see OECD, 2002 for details). Its scope is broad. For wholesale markets, there are measures aimed at making it easier to raise capital on an EU-wide basis through common rules for the

contents of prospectuses and common reporting standards for listed companies. At the retail level there have been measures related to information and marketing, an e-commerce policy, various reforms to the insurance industry and a push to create a single payment system. Other measures include harmonisation of prudential rules and supervision standards and dealing with the various tax-based barriers to cross-border saving and investment.

Most of the Plan has now been implemented, even if some of the deadlines were missed on the way. The focus is now shifting towards implementation, smoothing out the rough edges and dealing with the main items of unfinished business. Because so much was done in such a short time, some of the goals had to be lowered in order to get political agreement. Notable examples include the lack of progress on the portability of supplementary pensions, the simplified prospectus which achieved little of practical value and the takeover directive which was heavily neutered. Part of the Commission's wide-ranging agenda for financial services over the next few years, as set out in Annex 3.A1, is to make sure that national laws have delivered a coherent and consistent regulatory framework for financial markets.

Retail banking remains a largely national business

The second banking directive, which took effect in 1993, attempted to integrate the EU banking market. The key measure was a "single passport" where a bank licensed in any EU country was free to open branches in another member state. It would be regulated and supervised by its home country. In contrast, subsidiaries are subject to host country supervision in every country where they are established. More than ten years after the single passport, except in some of the new member states the level of cross-border banking is low and it tends to take place through subsidiaries rather than branches (ECB, 2006).[3] There are many barriers to cross-border banking, and the retail banking business has been the subject of an EC competition inquiry (EC, 2006), which spotted product tying and obstacles to customer mobility among other issues. Cross-border mergers of financial institutions can be difficult as some national authorities have tried to block takeovers for overtly national reasons, even if they were disguising their actions under the guise of prudential supervision[4] but the rules have recently been tightened to limit supervisors' discretion. As in other sectors, government guarantees and ownership controls, such as golden shares and foreign ownership limits,[5] are also in place in some countries, although rulings by the Court of Justice have restricted their use. Barriers are also created by the double taxation of income flows between associated companies as well as tax treatment of cross-border restructuring operations.[6] Providing financial services from abroad can also be difficult. The key problem is a lack of harmonisation of consumer protection rules – this is discussed in the next section that deals with mortgage markets. Other barriers include difficulties accessing customer credit databases, a poorly functioning cross-border payments system and the costs that customers face when switching banks.[7]

The lack of full integration in banking has several consequences. The smaller, less internationally oriented banks appear to operate under more sheltered conditions in the EU than their counterparts in the United States.[8] This may raise costs, reduce quality and stifle innovation (Figure 3.4). The studies reviewed in an unpublished OECD study (OECD, 2006) suggest that regulatory rents could add between 30 and 100 basis points to an average loan rate. It can cause differences in the way that economies respond to monetary policy, making it more difficult to manage the single currency area. It may also affect financial stability, although this is not clear-cut. There are some respectable theoretical

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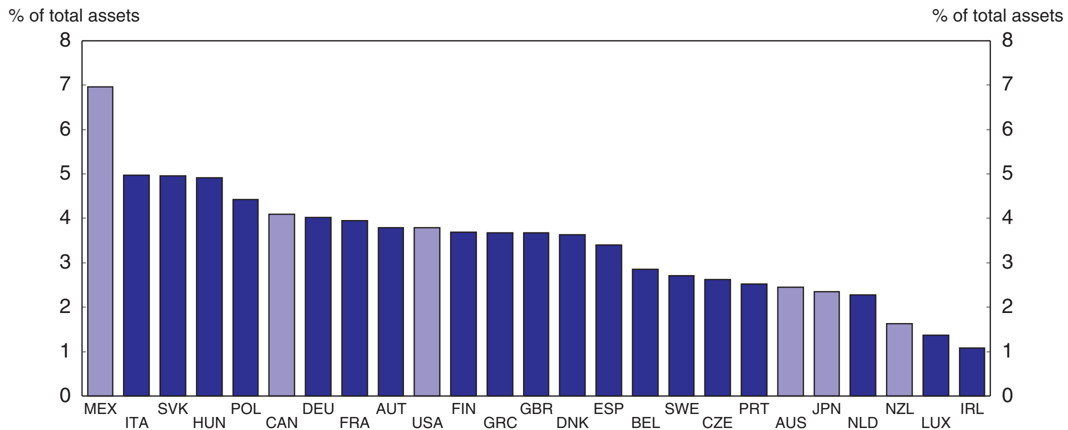
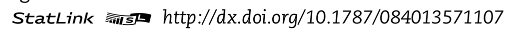
Figure 3.4. **Bank overhead costs**
Average 1996-2003



Source: OECD (2006), *Economic Policy Reforms: Going for Growth*, Figure 5.3.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reasons why increased competition may raise risk taking and reduce financial stability,[9] but de Serres *et al.* (2006) find no evidence that this has been the case in OECD countries in recent decades.

Mortgage markets are inward-looking

A consequence of the fragmentation in retail banking is that residential mortgage markets are also almost entirely national. Direct lending to consumers in other member states is less than 1% of mortgage activity, and almost all of this is related to holiday homes or properties on a border (Forum Group on Mortgage Credit, 2004). The limited amount of cross-border lending that does occur is *via* foreign banks that buy or establish a local branch network. Insufficient competition shows up in a wide dispersion of mortgage interest rates,[10] house purchase costs and slower pass-through of policy rates to mortgage interest rates (de Bondt, 2002).

On top of the general barriers to entry in retail banking highlighted above, some deeply embedded differences in regulatory regimes make it hard to offer services in other countries (EC, 2005b). Some of the main differences include:

- *Consumer protection standards*, such as a cooling off period or rules concerning pre-contractual information being regarded as a binding offer.
- *Consumer information standards*, such as the way that the annual percentage rate (APR) is calculated (the main mortgage lenders have signed up to a voluntary code of conduct to improve the consistency of consumer information, but implementation has been unsatisfactory).
- *Early repayment rules*, which in some countries are laid down in law but in others are negotiated among the parties (and some countries impose maximum fees for early repayment).
- *Differing property valuation rules*, which means that national supervisors may force compliance with two different rulebooks.
- *Rules on forced sales*, with the typical duration of a forced sale procedure varying from a few months in one country to seven years in another.

The different regimes may raise funding costs because they hinder the use of alternative funding mechanisms such as mortgage securitisation and covered bonds, especially at a pan-European level. In some cases, regulatory barriers make mortgage pooling difficult. The Commission published a discussion document on these and other issues in 2005 and will make some policy proposals by September 2007. It will look at whether intervention is necessary and if so, what mixture of harmonisation, mutual recognition and other options would be best. Since consumer safeguards are highly valued in some countries, the way forward may be harmonisation of the most important protections, and mutual recognition of the rest. A standardised, transferable Euromortgage might also help. Whatever happens, it will be important for innovation and consumer welfare that any new regulations are flexible enough to cope with change and do not reduce the variety of products that can be offered.

A single payments area is some way off

Transferring money from one country to another remains considerably more difficult than sending it within a country (although regulations now mean that charges for cross-border euro transfers within the EU are the same as for domestic transfers). Direct debits are not available at a pan-European level, cross-border credit transfers can be slow and payment systems for cards remain segmented into national and international solutions. There are two main problems: legal and infrastructural. There are conflicting national laws on issues such as licensing, liability for faulty execution of payments, revocability, refund rules and so on. To address the legal problems, in 2005, the Commission presented a draft directive on payment services. Its primary objective is to increase competition by improving market access. In some countries for example, only banks are permitted to provide payment services, effectively blocking competition and innovation from providers such as supermarkets and mobile phone operators. Its second main objective is to harmonise rules regarding maximum execution times, liability and conditions on refunding and revocability. The draft was agreed to by the Council and Parliament earlier this year, and member states must transpose it into national law by November 2009.

To tackle the infrastructure issue, the Commission and the European Central Bank (ECB) have favoured a market-led approach and left it up to the industry to find a solution. The industry is responsible for developing technical standards, rule-books and payments infrastructure for the realisation of the Single Euro Payments Area (SEPA) project. The ultimate goal of SEPA is to create a harmonised and efficient payments area without any separation between cross-border and domestic payments. Initially banks dragged their feet, with some parts of the industry arguing that the volume of pure cross-border transactions was so low that it was not worth the cost of building an automated interoperable infrastructure, but this should be taken with a grain of salt since incumbents have much to lose from competition. Moreover, while good progress has been made in some areas the industry working group still needs to push ahead over some basic issues such as implementing a common account identifier. However, the basic rule books for credit transfer and direct debits were adopted in December 2006 and progress is being achieved. For card payments a less detailed framework document was developed instead of a complete rulebook. This work is being complemented by the development of common technical standards. The SEPA project still requires vigilant monitoring if a critical mass of domestic payment instruments is to migrate to the new platform by the end of 2010. Some observers believe that further regulatory action may still be necessary – a threat that the Commission

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has periodically repeated to prod industry into action. The Commission may also want to rethink how payment cards will fit into SEPA given the concerns of some – including the ECB and the Commission – that it has the potential to raise costs for consumers.[11]

Corporate finance markets can be expanded

Europe's financial markets (or continental Europe's at least) are often described as more bank-based than market-based. This is only half of the story. In per capita terms, the United States has about the same number of bank employees and nearly twice as many banks (Table 3.1). But business strategies of banks tend to be different in the two regions (IMF, 2005a). In the United States, the more common strategy is to attempt to offload assets *via* securitisation, keeping on balance sheet only those risks for which they have a comparative advantage. Typically these are the riskier assets where specialised or on-the-ground information is needed to help overcome the problems of asymmetric information and moral hazard. However, it is not clear to what extent risk has actually been shifted off the balance sheet and regulators in many countries are concerned about a lack of information about who ultimately holds risks. In the EU, bank balance sheets are larger than their US counterparts but their assets appear to be less risky, at least to the extent that this can be measured (IMF, 2005a). A possible consequence is that, with banks probably being more conservative than financial markets, they may be more likely to channel capital to companies with which they have a long-standing relationship rather than to new, risky ventures.

Table 3.1. **Banking indicators**

Per million people, 2003

	EU15	United States
Number of banks	19	32
Number of branches	487	274
Number of employees	7 264	7 023
Banking assets (% GDP)	241	82

Source: IMF (2005), "Banks and Markets in Europe and the United States", Chapter VI of *Euro Area Article IV: Selected Issues*.

Barriers to trade across securities markets are being torn down

Trading infrastructures such as stock exchanges, clearing houses and central securities depositories are fragmented and (with some exceptions) largely national, which adds to costs and reduces competition. All this is changing, driven by market forces and by policy actions such as the Markets in Financial Instruments Directive, or MiFID, which is due to take effect in November 2007. The main provision of the MiFID is to create an EU passport so that securities firms can offer services in any country. Intermediaries such as investment firms and banks will be able to access settlement systems in other member states under non-discriminatory conditions. They can choose where to settle their transactions (but not where to clear them), so they do not need to be members of multiple systems and can therefore take full advantage of netting opportunities to lower costs. The directive will also bring a minor revolution in some of the more cosy over-the-counter markets, with new rules on transparency (*e.g.* price disclosure),[12] business practices (*e.g.* best execution of trade) and corporate governance (including dealing with conflicts of interest, but not going as far as to require Chinese walls between research and trading

activities). MiFID also creates a harmonised regime of investor protection, distinguishing between retail and wholesale customers. Thus its impact will also be felt in retail securities markets. The recent consolidation of exchanges may be a sign that markets are preparing for a post-MiFID world. Over the longer term, the directive is likely to intensify competition between trading platforms. Investment banks have already begun to compete with exchanges in data and reporting services. Regarding post-trade infrastructure, the Eurosystem is currently evaluating opportunities to provide settlement services for securities transactions in central bank money to central securities depositories, leading to the processing of both securities and cash settlements on a single platform through common procedures, the so-called TARGET2-Securities (T2S) initiative.

In 2006, the main industry players (exchanges, clearing houses and settlement systems) signed a code of conduct for clearing and settlement. It aims to improve transparency of prices and services, enhance access and interoperability and lead to the unbundling of various services. All the measures should be in place by January 2008. The Commission is encouraging the industry to apply the code of conduct to other products, starting with bonds and derivatives.

The takeover directive may have made things worse

Government involvement in several high-profile merger cases has raised concerns about attempts to protect domestic companies. As noted in Chapter 1, it is hard to know whether this is a serious threat to the integration of Europe's capital markets or whether it is just political posturing. But this political climate has contributed to the failure once again to implement a meaningful takeover code. The Commission has tried since 1989 to create a level playing field for companies in Europe with the aim of protecting minority shareholders and harmonising takeover rules. The European Parliament rejected one proposal in 2001 on the grounds that workers in companies facing a takeover bid had insufficient protection and firms would be more vulnerable to foreign takeover because they would be unable to defend themselves until authorised by their shareholders.

A hard-fought compromise was finally agreed in 2003. While it contained some minor measures to do with transparency and consultation, the Commissioner for the Internal Market lamented that the final directive was emptied of its original content.[13] In fact, it may have made things worse because of the way that two key provisions, which were made optional because governments could not reach agreement, are being implemented. The first is a neutrality rule designed to stop boards from protecting their own interests at the expense of other shareholders. Under the rule, shareholders must approve any takeover defences that the board wishes to put in place after a bid has been made, such as issuing new shares or warrants (a "poison pill"). This provision is likely to be implemented by 18 member states.[14] The second optional rule was intended to break through pre-existing defences. It creates a one share, one vote rule during takeovers by suspending defence mechanisms such as multiple voting rights, appointment rights, and restrictions on the transfer of securities. This has been soundly rejected.[15] Thus, in the Commission's view the directive may have delivered more defensive corporate behaviour, the opposite of what was intended (EC, 2007). In the end, however, there are limits to what the revised takeover law could have achieved because one of the main barriers to takeovers is Europe's concentrated ownership (Figure 3.5).[16]

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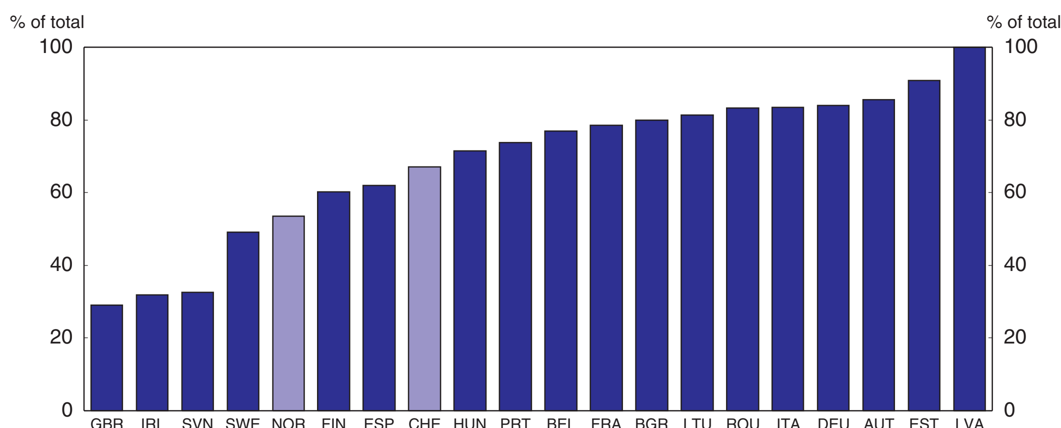
Figure 3.5. **Listed companies with a blocking minority of at least 25 per cent**



Source: Goergen, M., M. Martynova and L. Renneboog (2005), "Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe", *Oxford Review of Economic Policy*, Vol. 21, No. 2.

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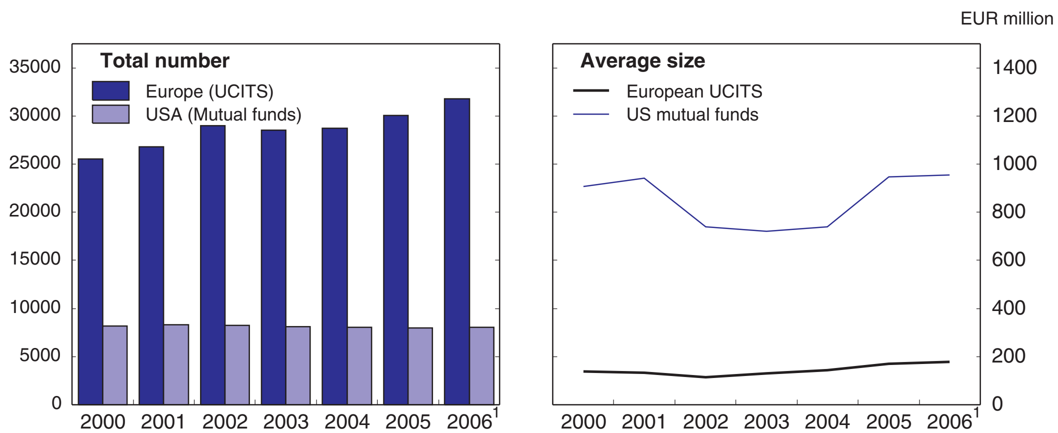
Investment fund regulation is holding back corporate finance

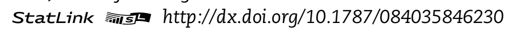
The Undertakings for Collective Investment in Transferable Securities Directive (UCITS) aimed to create a single market in investment funds subject to certain investor protections. The core of the directive is a mutual recognition principle where UCITS funds can be sold to any EU investor once they have been authorised in their state of origin (subject to notification requirements). It is not working as well as it could be: in 2003, only 16% of funds were offered on a cross-border basis (although the majority of new sales now come from cross-border funds).[17] In November 2006, a Commission policy document highlighted a number of problems with the directive, and concluded that "core elements are not functioning effectively" (although it also said that a fundamental revision was not necessary at this stage). Among the issues highlighted in the White Paper are: *First*, the procedures for cross-border marketing can be cumbersome and slow. Companies must file extensive documentation in each country where a fund is to be marketed and then wait two months for approval. In practice, notification rules are not interpreted uniformly and the two-month time limit is not always respected. It would be better to have full mutual recognition by dispensing with the current notification rules altogether as they serve little purpose. A *second* problem is that there are too many undersized funds, an issue that is exacerbated by the absence in the directive of mechanisms for amalgamating or pooling funds (Figure 3.6). Mergers of funds are difficult because of regulatory barriers between member states and because of different tax rules (a merger is treated as a taxable event in some countries but not in others). Some EU-wide ground rules appear necessary. *Third*, there is insufficient flexibility over organisational structure as the management company passport is not working effectively. *Fourth*, the directive, which dates from 1985, has not kept pace with the fund management industry. It is based on prescriptive rules, especially by listing the types of assets that UCITS funds are permitted to invest in. Real estate funds, for example, are not eligible for the UCITS passport. A principles-based system would make it easier for the regulatory environment to keep pace with financial innovation. The Commission could also consider whether to replace rules about what to invest in with a transparent system of risk scoring, giving investors both more freedom and more information concerning the management of their portfolios. *Fifth*, the simplified

Figure 3.6. **Europe's investment funds are small**



1. Q2 2006.

Source: EFAMA (2006), *Supplementary Tables for Q4 2004 and Q2 2006, www.efama.org.*



prospectus has in the words of the Commission "manifestly failed", creating "a massive paper chase of limited value to investors and a considerable overhead for the industry". The rules here need a complete overhaul.

Are financial supervision arrangements up to the task?

Questions have been raised about whether a system that has 51 separate supervisors can deal adequately with a financial crisis (IMF, 2005b). While all supervisors know their own market well, none are on top of all markets at once. The global financial system is becoming more linked, complex and opaque, so it is harder to spot emerging problems. The market is flooded with new products with no history, so it is more difficult to assess risk and to stress test institutions. While financial innovation has created a more fragmented distribution of risks, it may be difficult for supervisors to identify precisely who the final holders of risk are.

In the financial services sector, the so called Lamfalussy process provides for enhanced convergence of regulatory and supervisory practices. Within the Lamfalussy committees the national supervisors work together and facilitate the implementation of European legislation at the level of member states. Cross-border co-operation is also increasing and the committees are now trying to develop a common supervisory culture and practice while elaborating on delegation of supervisory tasks, peer reviews, mediation mechanisms and common training and secondment programmes. In addition, the Basel II rules call for increased harmonisation in this area.

In the field of crisis management, supervisors are also trying to boost co-operation through a network of bilateral and multilateral memoranda of understanding.[18] However, despite closer co-operation among national supervisors, they each have a national mandate and the risk of informal co-operation is that the national authorities concerned may take insufficient account of externalities that a failure, and the way it is resolved, may have at the European level.[19] Current arrangements for managing a cross-border crisis are under scrutiny. Decisions need to be made about whether to strengthen co-operation arrangements, create regional lead regulators and/or move towards more centralised supervision.

Box 3.2. **Recommendations concerning financial markets**

- Push ahead with the existing reform agenda but avoid over-regulation.
- Full mutual recognition or harmonisation is needed for retail banking services, especially mortgages.
- Vigilantly monitor progress in setting up the Single Euro Payments Area (SEPA). Regulatory intervention may be necessary if progress is not fast enough.
- Ensure the good functioning of the mutual recognition principle (a European passport) in the investment fund industry by reducing notification requirements to a minimum (or abolishing them altogether). Consider moving to a risk-based approach to UCITS funds by eliminating rules on the type of assets that are eligible. Create a framework to allow cross-border mergers of UCITS funds.
- Review supervisory arrangements for financial markets with a focus on clear lines of responsibility for crisis management.

Notes

1. See the 2000 *Economic Survey of the Euro Area* for a review of financial market integration at that time. Twice a year, the ECB publishes on its website various indicators of financial market integration in the euro area (see *www.ecb.int/stats/finint/html/index.en.html#info*).
2. See London Economics (2002) for the static gains (it should be noted that financial markets are already more closely integrated than at the time of that study, so some of the gains have probably already been reaped). See Giannetti *et al.* (2002) for estimates of the dynamic gains.
3. The new member states are the main exception. Governments there have typically opened up their banking systems to foreign firms as local expertise was too thin on the ground. The banking system is almost entirely foreign owned in Estonia, the Czech Republic, Slovakia and Lithuania, and mostly foreign owned in Hungary. Foreign ownership is below 50% in only three countries (Walkner and Raes, 2005).
4. One example is Portugal's attempt in 1999 to block a takeover by a Spanish bank (the deal eventually went ahead). The 2000 banking directive was designed to deal with such problems by eliminating any discriminatory treatment with regard to the establishment and provision of banking services. Questions have also been raised about an Italian case in 2005.
5. Portugal for example has imposed a 25% foreign ownership limit on already privatised companies, including several banks. The European Court of Justice ruled this illegal in 2002 but despite that the Portuguese government has not removed the restriction.
6. See section 4.2.2 of Walkner and Raes (2005) for examples of some of the legal and taxation issues.
7. Statistically speaking, when you get married you are more likely to get a divorce than to change your bank. Some countries have developed innovative solutions to problems encountered when switching banks. For example, in the Dutch *overstapservice* system, payments into the old account are automatically forwarded to the new account for 13 months after switching and the transfer of direct debits is handled automatically by banks and merchants.
8. See IMF (2005a) and the references therein.
9. For example, see Hellmann *et al.* (2000) and Keeley (1990).
10. The standard deviation of mortgage rates across euro area countries (based on harmonised interest rate data) was around 50 basis points from 2003 to 2005, and banking systems that were less competitive tended to charge higher mortgage rates (Affinito and Farabullini, 2006).
11. At present, every EU country has a national card scheme. Transactions in the card-holder's own country are usually inexpensive for both the card-holder and merchants. For transactions in other countries, they are usually co-branded with Visa or MasterCard. An interim report by the EC's Competition Directorate in 2006 raised concerns about insufficient competition associated with the Visa-MasterCard duopoly. The worry is that fees may rise if SEPA led to a shift away from national debit cards and towards a greater reliance on those two companies.

12. There are fears in some quarters that the Commission could go too far with price disclosure by reducing the incentives for price discovery and perhaps even destabilising the market by revealing trading strategies.
13. Reported on *www.euractiv.com*, 28 November 2003.
14. Eighteen member states have opted in, though in all but one case they already had such a neutrality rule in their national legislation. The countries that have opted out include some large countries (Germany and Italy) plus the Netherlands, Belgium, Denmark, Luxembourg and Poland. Seven of the countries that have opted in apply an additional "reciprocal treatment" test: the rule will apply only if the bidding company faces similar restrictions. This is to counter fears that a company could go on a buying spree throughout Europe while being shielded from hostile takeovers itself.
15. Only Estonia, Latvia and Lithuania have applied the "breakthrough" principle.
16. Bennedsen and Nielsen (2003) estimated that because of ownership structures, the originally proposed "break-through rule" in the takeover directive would make only 5% of public firms vulnerable to takeover.
17. Deutsche Bank (2006). This figure excludes "round tripping".
18. In March 2003, national central banks agreed on a non-binding memorandum of understanding to set out crisis management principles. In the IMF's assessment, it does not go much beyond information sharing, nor does it address the implications of a systemic crisis. In 2005, the relevant finance ministries, supervisors and central banks agreed on a new memorandum. Nevertheless, some responsibilities are still unclear (Decressin *et al*., 2007).
19. See Fonteyne and van der Vossen (2007).

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ANNEX 3.A1

The Commission's agenda for financial services

The Commission's work programme for financial services policy for 2005-10 includes the following measures.

Ongoing projects

- A White Paper on mortgage credit (to be released in 2007).
- A Green Paper on retail financial services (released in May 2007)
- A modified proposal for a directive on consumer credit (published 2005).
- A proposal for a payments services directive to underpin the Single Euro Payments Area (SEPA).
- The Solvency II project to overhaul regulation and supervision of the insurance industry.
- A proposed change to "qualifying shareholding" rules that can be used by national regulators to block mergers and takeovers in the financial sector (political agreement reached in March 2007).
- Investment funds: improving legislative framework and implementation of UCITS funds.

Issues being considered

- Eliminating unjustified barriers to cross-border consolidation.
- An evaluation of the e-money directive.
- Considering whether to propose legislation of insurance guarantee schemes.
- Considering whether to sign the Hague Securities Convention.

Possible future initiatives

- Bank current accounts: removing barriers to competition in this area.
- Review the regulatory framework for credit intermediaries.

Source: White Paper: Financial Services Policy 2005-10, published in 2005 by the European Commission, Brussels.

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Chapter 4

The regulatory framework at the community level

The Commission has put considerable emphasis on its Better Regulation agenda over the past few years. This chapter first provides an overview of law-making at the community level. It then reviews the Union's regulatory approach and makes some recommendations for improving the framework further.

Effective regulation can play an important role in promoting the single market. Community initiatives have been crucial in facilitating cross-border trade by smoothing out differences in regulations and standards across member states. The challenge in coming years is both to keep up the momentum for the single market and to ensure that interventions are well chosen, effective and implemented at minimum cost. This involves careful thought about whether intervention is necessary, what a measure is aiming to achieve and what the best way to achieve the objectives might be. Regulation is not always the best option. All interventions have compliance costs, and over-regulation and poorly designed laws can create more problems than they solve. Community law-making faces an additional challenge that other jurisdictions do not have, or at least not to the same extent. Because reaching political agreement can be difficult, substantive legislation often remains untouched for a long time once put in place. This places a premium on sound regulation in the first place, and especially regulation that is based on principles rather than being overly prescriptive so that it is flexible enough to apply to new and unforeseen economic and technological developments.

Law-making: how is it done?

Community policies are anchored in the treaties. Some are under the exclusive competence of the community. Others are under the shared competence of the member states and the community. Community exclusive policies include the customs union, competition policy, the commercial policy and the protection of biological sea resources in the framework of the common fisheries policies. The Union has the sole right to act in these areas. In many areas (for instance, the internal market, agriculture, fisheries, environment or transport) competencies are shared between the community and the member states. In these areas both the Union and member states can act. The member states, however, can exercise their competence only insofar as the Union has not exercised its own. Finally, there are areas for which the Union is competent only for carrying out activities intended to support, co-ordinate or complement those by the member states, without, however, modifying their competence in these domains. These include, for instance, the protection and improvement of human health or culture. No harmonisation of member states' legislation and regulation is possible in these areas. In areas which do not fall within its exclusive competence, the community takes action in accordance with the principle of subsidiarity, while the principle of proportionality applies to all community actions (Box 4.1). The successive treaties have extended the range of competencies, which now include 21 areas. They touch on nearly all economic functions, including macroeconomic issues.

The major decision-making bodies are the European Parliament, the Council of the European Union and the European Commission. Their respective roles are discussed in Box 1.1. There are three legislative procedures: co-decision, assent and the consultation procedure. The treaty determines which one must be followed. The co-decision procedure is now used for most EU law-making and provides for a complex interplay between the

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Box 4.1. **The subsidiarity and proportionality principles**

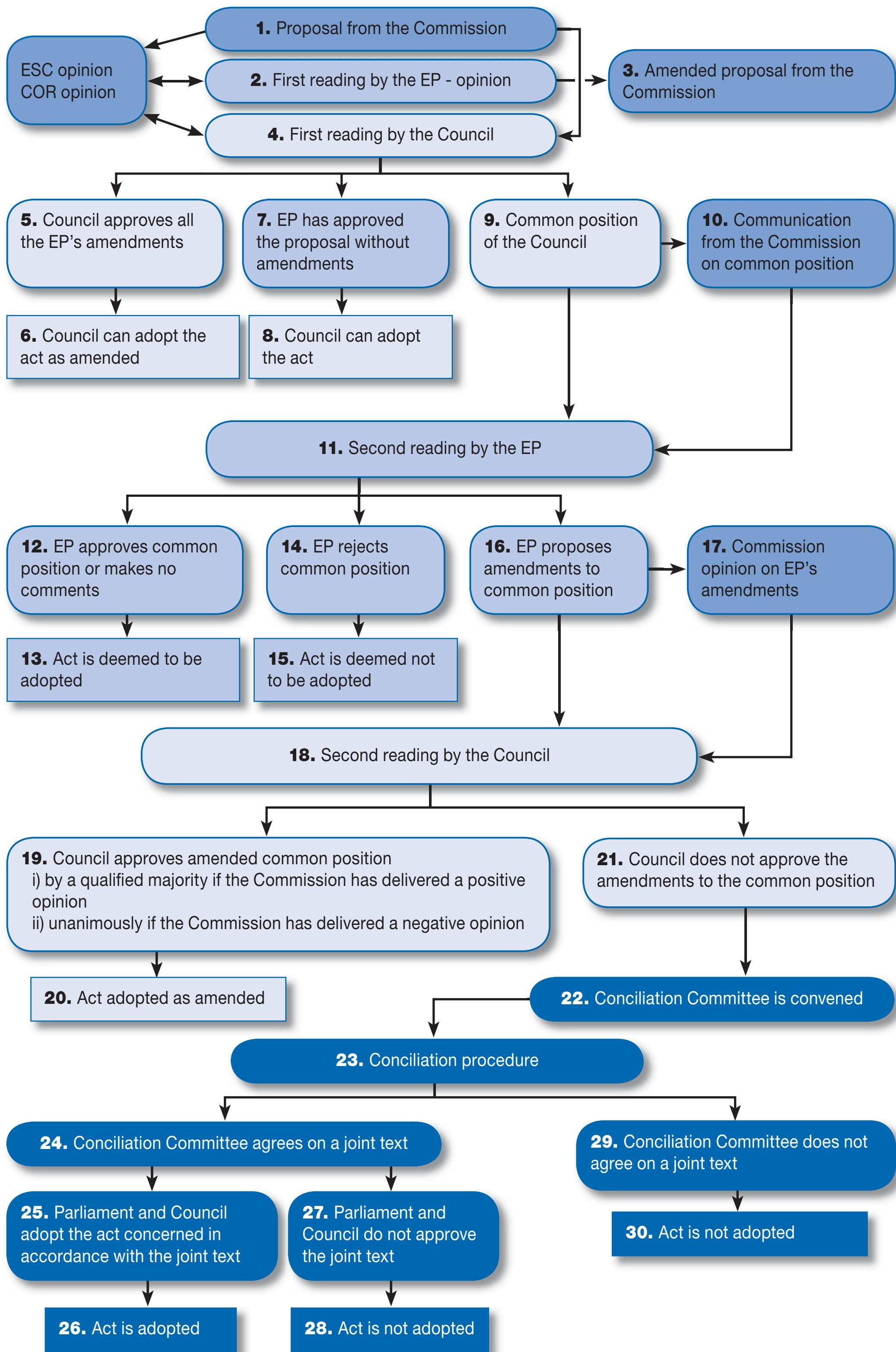
The subsidiarity principle is enshrined in Article 5 of the treaty establishing the European Community, while Protocol 30 annexed to this treaty elaborates on its application. The principle provides a guide as to how the non-exclusive competencies should be exercised at the community level. It states that in these areas, the community should only take action "if and in so far as the objectives of the proposed actions cannot be sufficiently achieved by the member states and can therefore, by reason of the scale or the effects of the proposed action, be better achieved by the community" (Article 5 of the treaty). Subsidiarity is a dynamic concept: community action can be expanded within the limits of the treaty, and conversely, can be scaled back or discontinued. The proportionality principle states that any action by the community should not go beyond what is necessary to achieve the objectives of the treaty. Proposed community legislation has to justify its compliance with these principles. The reasons for community, rather than member state action must be substantiated by qualitative or, wherever possible, quantitative indicators. The Protocol also provides that each institution shall ensure that the principle of subsidiarity is complied with. The Parliament and the Council have to verify that their amendments to Commission proposals satisfy the conditions set by Article 5 of the treaty. Various mechanisms of political and judicial control are in place (European Economic and Social Committee, Committee of the Regions or the European Court of Justice).

It is difficult to establish on how closely these principles are respected. The community, for instance, has issued directives on environmental issues with mostly local ramifications. And the Commission's impact assessments of proposed legislation, which are discussed below, scrutinised compatibility with the subsidiarity principle in less than 50% of the legislative proposals since 2005, which is fewer than in 2003 and 2004. None of them has yet used a quantitative indicator in this respect. Also proportionality was assessed in less than 50% of the legislative proposals, but this is probably mitigated by the fact that close to 90% discuss other policy options in the assessments. There is also the question on whether it should be the Commission, the member countries or a combination of both that ensures that these principles are adhered to. The recently established group of high-level national regulatory experts, for instance, could provide an input in this respect.

Council, Parliament and the Commission. The Commission has a significant agenda-setting capacity and is the crucial actor in the initial phase of law-making as it is the Commission that puts forward proposals for new legislation, though the Parliament and the Council may request the Commission to submit a proposal. The Council and the Parliament then have to arrive at a text that is acceptable to the two institutions. In the event of disagreement, a conciliation committee made up of representatives of the Council and of the Parliament will attempt to hammer out a compromise. If no agreement is reached, the legislative process is liable to be broken off. Figure 4.1 shows the various stages of the co-decision procedure.

Apart from primary legislation (the treaties, protocols, etc.) and international agreements, secondary legislation is the major source of community law. It comprises binding legal instruments (directives, regulations and decisions) and non-binding instruments (recommendations and opinions). A directive is adopted by the Council, in most cases in conjunction with the European Parliament, and is addressed to the member states. Its main purpose is to align national legislation. It is binding on the member states as to the result to be achieved but leaves national parliaments the choice of the form and

Figure 4.1. **The co-decision procedure**



EP = European Parliament; COR = Committee of the Regions; ESC = Economic and Social Committee.

Source: http://ec.europa.eu/codecision/stepbystep/diagram_en.htm.

method to realise the community objectives. A regulation is a general measure binding in all its parts, addressed to everyone and directly applicable (*i.e.* it does not have to be transposed into national law), while a decision is an individual measure addressing particular matters, such as rights and obligations of individuals and firms. There is also an increasing body of case law that can be addressed to member states, for instance, in the case of infringements or addressed to community institutions if they fail to act, which can spur community initiatives.

The policy process is complex, though it is not that different from policy processes in OECD member countries, especially federations, where several layers of government often have to hammer out compromises if their competencies overlap. Concerning the Commission's work, disagreements may appear at different stages of the decision-making process: witness, for instance, the recent public spat about the stringency of car emission standards between different parts of the Commission. Another layer of complexity is due to the need to reach an agreement among 27 member states. Their bargaining behaviour is dictated by several factors including domestic preferences that can diverge considerably, differences in weighing trade-offs, and the perceived impact of legislative proposals on their own country. Compromises that are eventually reached may bear little resemblance to the initial Commission proposal, as was the case with the services and takeover directives, or it can take decades to reach agreement, as was the case with the savings directive and the eternal battle to promote port reform. Negotiation outcomes are often shaped through "side payments" (compensation to a bargaining party that loses from a particular collective policy measure); "log rolling" (vote-trading by which one actor votes for an issue that does not serve its interest in exchange for a positive vote on another issue); and "package deals" (decisions are taken over different issues simultaneously to achieve support by all actors involved). Negotiations and compromises are part and parcel of policy making everywhere and are not unique to the community. But it puts the onus on bringing all the available information and evidence into the decision-making process so that the various stakeholders have a clear understanding of the problems and solutions, including the costs and benefits involved. Comprehensive and transparent explanation is an essential element of successful reforms (OECD, 2007).

The better regulation agenda: can it become even better?

It is estimated that around half of national legislation is nowadays directly or indirectly shaped by community-decisions. EUR-Lex, the community's online legal database contains more than 300 000 documents, though this also includes preparatory acts, case-law and parliamentary questions. Legislative acts and executive measures run to some 80 000 pages, with close to 30 000 pages on the single market, though these numbers include original acts and their successive modifications for acts that have not been codified. Given the pervasiveness of Union-wide legislation, there is clearly a need to have a well-performing regulatory framework in place at the community level.

The Commission adopted a method for assessing the impact of its regulations first in 1986, with the Business Impact Assessment. It focused on the impact of regulations on enterprises and was criticised for its low quality and narrow focus on compliance costs (EC, 2002). During the 1990s, new tools were added, such as the SLIM project (Simplification of the Legislation on the Internal Market), which aimed at strengthening the *ex post* assessment of the quality of regulation, and the Business Environment Simplification Task Force (BEST) was created.

As the system did not perform well and was fragmented, the European Council requested the Commission, the Council and the member states in early 2001 to define a strategy to simplify the regulatory environment through co-ordinated action. In response, the Commission issued a White Paper on European Governance and an action plan for simplifying and improving the regulatory environment. The member states established an intergovernmental high-level consultative group (the "Mandelkern Group") to which the Commission was invited. The Mandelkern Report (Mandelkern Group, 2002) outlined features of a prospective new impact assessment model; recommended that the Council and Parliament should not consider proposals that had not been subject to an impact assessment; highlighted the need for increased participation by member states at an early stage in the preparation of proposals and the need for each member state to adopt its own impact assessment system.

The Commission introduced an integrated impact assessment model in 2003. It takes into account the economic, social and environmental impact of Commission proposals, thus focusing on both the community's competitiveness and sustainable development goals. All Commission initiatives that require some regulatory measure undergo a preliminary impact assessment and legislative proposals with a large expected impact are subject to an in-depth assessment. The extended impact assessments should provide estimates of policy effects in qualitative, quantitative and possibly monetary terms, specify alternative policy options and the interaction with existing and planned community policies, and assess the cost of resources required and the user-friendliness of the regulatory options. Given the comprehensiveness of the approach, the new procedure was phased in and was fully in place in 2004.

In reviewing the early achievements of the impact assessments, in March 2005 the Commission said that they were "first steps in what must be a permanent effort". Teething problems were revealed by several studies (Renda, 2006, Lussis, 2004 and Vibert, 2004). They pointed out that: there was a lack of identifying overall and business compliance costs; specific benefits and policy options are seldom assessed; the methodology guidelines are not always adhered to; subsidiarity and proportionality are often not taken into account; environmental and social impacts are not always assessed; an assessment of competitiveness effects is rare; and there is quite some difference in the quality of impact assessments across the directorates-general. But there were also positive assessments, highlighting the progress in moving the impact assessments closer to international best practice, the comprehensiveness of the approach and that the policy consequences of legal initiatives are assessed, rather than just whether, as in the United States, the laws are being implemented well (Wiener, 2006; Jacobs, 2006; and Economic Policy Forum, 2006).

At the same time, the Council and Parliament had argued for a greater involvement and specifically advocated impact assessments of major amendments to legislation underway, while goals to streamline the *acquis*, spelled out by the previous Commission, had not been achieved. The Commission issued a Communication on Better Regulation for Growth and Jobs in March 2005 which, among others, launched a three-year action plan for simplifying regulations in heavily-regulated industries and which argued that the assessment of economic impacts needs to be strengthened in view of the re-launch of the Lisbon Strategy; the measurement of administrative costs needs to improve; and the Parliament and the Council need to carry out impact assessments of all their major amendments to Commission proposals, an option foreseen in the 2003 Inter-Institutional Agreement on Better Law-making. As a result the impact assessment guidelines were revised in June 2005, which

devote considerable attention to the assessment of regulations on growth, competitiveness and employment as well as the assessment of administrative costs. In 2006, the Commission withdrew 68 legislative proposals (out of 183 pending at the Parliament and Council) and another 10 in 2007, because they were seen as inconsistent with the Lisbon Strategy, did not meet Better Regulation standards or did not advance in the legislative process. Finally, the Commission established an independent Impact Assessment Board in late 2006 to reinforce quality support and control of the impact assessments prepared by the Commission departments. This is a welcome move. International experience suggests that such a change can make a big difference: for example, after Korea transferred the responsibility for reviewing preliminary studies from line ministries to an independent unit in 1999, the unit rejected 78 of the 153 projects that had been pre-approved by the line ministries (OECD, 2004). Other important actions include an external evaluation of the Commission's impact assessment system and the adoption of the action plan to improve the use of *ex post* evaluation in the policy development process.

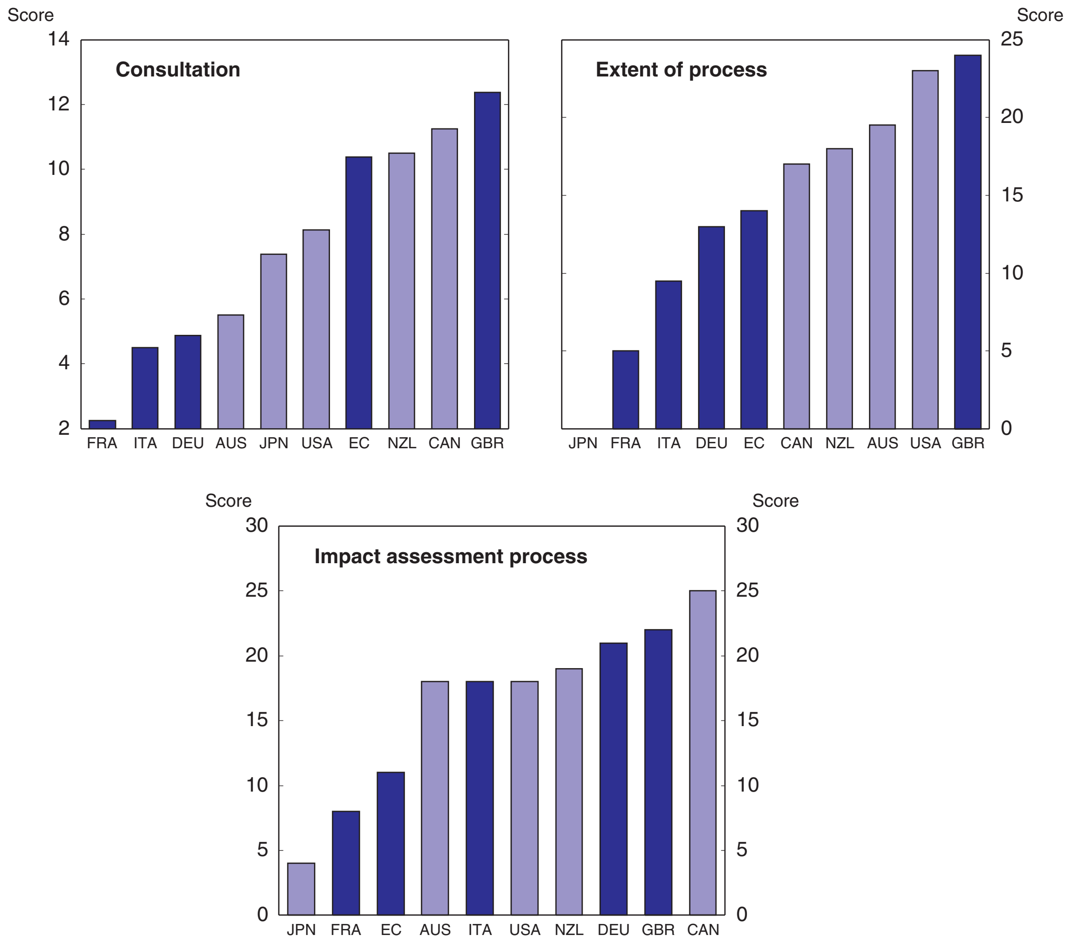
In January 2007, the Commission launched an action programme to reduce red tape on businesses by a quarter by 2012 to be achieved jointly by the union and the member states and to reduce the volume of EU legislation through codification. Most EU member states already have programmes in place to cut red tape (OECD, 2003). Kox (2005) estimated that administrative costs amounted to between 1.5% of GDP in the United Kingdom and 6.8% of GDP in Greece, with an EU average of 3.5% of GDP. Based on these estimates, the Commission (EC, 2006) estimated that reducing red tape by 25% would raise GDP by 1.3%. Efforts to cut red tape are currently hampered by the fact that if administrative obligations are enshrined in EU law, their reduction will have to go through the full legislative process, which is lengthy and complex. Consideration should be given to provide mechanisms that would speed up simplification without re-opening fundamental political arguments, which could be done by an Inter-Institutional Agreement. Legislation could also build in scope for amendments or sunset clauses (OECD, 2006).

Summing up

While starting with establishing a comprehensive impact assessment system in earnest much later than the United States or the United Kingdom, progress has been rapid. The EU's framework is generally in line with the OECD guiding principles for regulatory quality and performance (OECD, 2005). The OECD has constructed aggregated indicators of regulatory reform frameworks, which are based on an extensive questionnaire (Jacobzone *et al.*, 2007). The indicators reflect impact assessment guidelines and not how well they are respected in practice, so that they need to be interpreted with caution. By international standards, the community framework performs well when it comes to the quality of the consultation processes[1] (Figure 4.2). It performs less well on an indicator that assesses the extent of impact assessment processes,[2] while the score is relatively low when the quality of the impact assessment process[3] itself is assessed. Concerning the latter, lacunae identified include: there is no specific threshold for applying an impact assessment; that the quantification of costs and benefits is not binding; that benefits of new regulations need not exceed costs; that impact assessment documents do not undergo a public consultation; and that there are no *ex post* comparisons of actual and predicted impacts.[4] Not included in the questionnaire, but important, the assessment of amendments of legislation by the Council or Parliament has still not fully taken off yet.[5] There is thus still considerable room for further improvement.

Figure 4.2. **Indicators of the regulatory framework**[1]

A higher score means a better framework, 2005



1. For more details on these indicators, see footnotes 1 to 3 and source.

Source: Jacobzone, S. *et al.* (2007), "Regulatory Management Systems across OECD Countries: Indicators of Recent Achievements and Challenges", *OECD Public Governance Working Paper*, forthcoming.

StatLink *http://dx.doi.org/10.1787/084057066835*

Box 4.2. **Recommendations for improving the regulatory framework**

- Use impact assessments for all proposals across all EU institutions. Substantive amendments by Council or Parliament should also be assessed.
- The Commission's independent Impact Assessment Board should control the quality and consistency of the impact assessments and aim at improving the framework and methods underlying the impact assessments. Use outside expertise and scientific peer reviews of impact assessments regularly.
- In the impact assessments, assess the subsidiarity and proportionality principles systematically.
- Step up *ex post* monitoring and evaluation of impact assessments.
- Streamline existing legislation. Specifically, allow simplification to be done quickly without re-opening fundamental political arguments (*e.g.* through Lamfalussy-style regulatory frameworks).

Notes

1. Based on the answers to the following questions: Is public consultation a routine part of developing draft primary laws? Is it a routine part of developing draft subordinate regulations? What forms of public consultation are routinely used? Can any member of the public choose to participate in the consultation? What is the minimum period for allowing consultation comments inside government? What is the minimum period for allowing consultation comments by the public? Are the views of participants in the consultation process made public? Are regulators required to respond in writing to the authors of consultation comments? Are the views expressed in the consultation process included in the regulatory impact analysis (RIA)? Is there a process to monitor the quality of the consultation process?
2. Based on the answers to the following questions: Is the RIA required to include assessments of impacts on the budget, competition, market openness, small businesses, regional areas, specific social groups and impact on the public sector? Is risk assessment required when preparing a RIA? Are RIAs required to explicitly consider compliance and enforcement issues? Are reports on the level of compliance with the above RIA requirements prepared? Are these reports published?
3. Based on the answers to the following questions: Is RIA carried out before new regulation is adopted? Is a government body outside the ministry sponsoring the regulation responsible for reviewing the quality of the RIA? Is there a clear "threshold" for applying RIA to new regulatory proposals? Is RIA required by law or by another binding legal instrument? Is RIA required for draft primary laws? Is it required for draft subordinate regulations? Are regulators required to identify the costs of new regulation? Are regulators required to identify the benefits of new regulation? Does the RIA require regulators to demonstrate that the benefits of new regulation justify the costs? Are RIA documents required to be publicly released for consultation? Are *ex post* comparisons of the actual *versus* predicted impacts of regulations made? Is there an assessment of the effectiveness of RIA in leading to modifications of initial regulatory proposals undertaken?
4. This is partly because amendments by the Parliament and the Council to the Commission's original proposal make such a comparison difficult. However, an elaborate system of *ex post* evaluation of interventions and activities is in place. See: *http://ec.europa.eu/budget/evaluation/Key_documents/evalguide_study_en.htm*.
5. The Parliament has started an impact assessment training programme, has secured funding for impact assessments and has launched several reports dealing with impact assessment issues.

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Chapter 5

Strengthening competition policy

This chapter discusses competition policy reform. It reviews leniency programmes, individual and criminal sanctions, abuse of dominance and state aid reform.

Competition policy has a key role in underpinning the internal market. The EU competition framework has been shifting towards a more economics-centred effects-based system in the areas of antitrust, mergers and state aid. The Commission has been working to encourage greater consistency in the way competition law and policy are applied by the national competition agencies and court systems. The increased emphasis on economic analysis has led to a modernised set of guiding principles, and has encouraged national authorities to apply broadly consistent substantive rules. The Commission has also started looking at whole sectors, such as energy or retail banking. This is a welcome development.

Progress on past recommendations

In 2005, the OECD Competition Committee came down with a broadly favourable review of the EC's competition framework.[1] The report put forward four policy options for consideration. Progress on implementing these recommendations is discussed in the following sections. The final section discusses the revamp of state aid rules.

Clarify the relationship between the leniency programmes of the community and the national enforcement agencies

The community's leniency programme was set up in 1996, and revised in 2002 and 2006. Most member states have established national leniency programmes. With this system of parallel competencies and multiple programmes, to be fully protected cartelists that operate across borders would need to apply for leniency with all authorities that could pursue a case against them. This, combined with the fact that the details of the programmes differ in some respects, creates a paperwork burden that may discourage applications. While the number of leniency programmes has increased sharply in recent years, four member states do not have one, so companies might be exposed there despite receiving leniency elsewhere.

Various reform options have been considered to ensure that multiple programmes do not discourage applications. These include mutual recognition of leniency decisions and partial centralisation (the Commission would take the lead if the effects of the cartel covered more than three member states). In the end, the authorities opted in 2006 for soft harmonisation. The European Competition Network has developed a Model Leniency Programme that spells out the type of information an applicant should provide in order to get immunity, along with a coherent set of co-operation duties required of the applicant. All competition authorities in the EU have pledged to align their leniency programmes towards this model. In the past, uncertainty about what type of information and evidence would be required may have discouraged applicants and slowed down the process. Under the new programme, the applicant can rely on a certain minimum protection level granted by all agencies. The application process should also be quicker since the applicant can make a full declaration to the Commission with a summary or short-form declaration to the relevant

national competition authorities for cases where it is likely that the Commission will deal with them (namely, where there are effects in more than three member states).

In the past, one inconsistency between the various programmes has concerned the rules about whether a whistleblower must leave the cartel immediately. Some agencies allow them to stay if abandoning the cartel would tip off the others. The Commission tended to frown on this, but the new approach gives national authorities some flexibility to decide what is best in the circumstances. This approach has also been implemented in the Commission's revised leniency programme.

Consider means for extending sanctions to individuals as well as firms

In 2006, the Commission revised its guidelines for setting fines in antitrust cases in order to raise deterrence and improve consistency across countries and across cases. The maximum fine remains 10% of total turnover, but actual fines will now depend on the duration of the infringement (with a minimum fine for merely being involved, even if for a short time) and repeat offenders will be hit harder. The Commission will use these guidelines itself, but they are not legally binding on national competition authorities. Under the new guidelines, some recent fines have been heavy – for example, the almost € 1 billion fine given to an elevator cartel earlier this year.

In its review of policies towards hardcore cartels, OECD (2005b) argued there was a strong case for sanctions against individuals. The consensus among OECD competition experts was that corporate fines have not been high enough to be an optimal deterrent, and that the threat of individual sanctions can be an important complement to financial sanctions of enterprises. So long as they are appropriately designed, they can also increase the effectiveness of leniency programmes. The Commission does not have the power to impose fines or imprisonment on individuals, and only a few member states have penalties on individuals for competition abuses. Some member states use individual criminal sanctions[2] but others are more reluctant due to concerns that it might have adverse impacts on enforcement.

The Commission continues to encourage greater private enforcement in antitrust cases. Community law gives individuals the right to claim compensation if they have suffered a loss even if national legislation does not. But private antitrust damages actions are rare. The main barriers appear to be the costs involved and the difficulties in accessing evidence. Several options were canvassed in a Commission discussion paper published in 2005, such as permitting consumer associations to take representative actions on behalf of consumers. It was wary of US-style class actions covering consumer interests, although there are important differences in the United States and European legal frameworks that would help insulate Europe from the worst excesses of the American system.[3] It looked more favourably on opt-in collective actions by other groups such as retailers who may be large enough and fewer in number to have better control over the process. A White Paper on these issues will be published in late 2007 or early 2008. The basic goal of encouraging private actions is to be welcomed in principle, but the devil is in the details. Very difficult issues remain to be resolved, including the burden and standard of proof, whether harm must be proven, which defences may be valid, whether private claimants can access evidence held by competition authorities, how to resolve conflicts with criminal proceedings or leniency programmes and how damages should be distributed.

Increase further DG Competition's capacity for economic analysis

After being criticised by the Court of First Instance in 2002 for its insufficient economic analysis in three large merger cases, the EC's competition directorate substantially increased its pool of economists, appointed a Chief Competition Economist in 2003 with a staff of ten other economists, and created an internal panel to provide a "fresh pair of eyes" or to play devil's advocate in major cases. These were important changes, but the *OECD Competition Policy Review* and others (*e.g.* Neven, 2006) still felt that economic resources were being stretched thin. Indeed, things are still not going entirely smoothly. In 2006, the Court of First Instance overturned the Commission's approval of a merger between two large music companies (to create Sony BMG), criticising the Commission for "a manifest error of assessment". In response, the Commission may reorganise its internal procedures so that the internal panel can have its say earlier. In 2007, the Chief Economist's staff was doubled to twenty.

In adopting an economic approach to dominance, make liability depend on effects that harm competition

In 2005, the Commission issued a discussion paper regarding the abuse of a dominant position. The treaty (Article 82) lists a variety of acts that can be regarded as abuse, including imposing unfair purchase or selling prices, limiting production or markets in ways that harm consumers, discrimination, etc. The discussion paper considers moving to an approach based on economic effects rather than on the form of a specific conduct and discusses some general economic principles for establishing whether a firm is engaging in exclusionary conduct. Some concrete proposals will be released for public consultation in the second half of 2007.

State aid policy is being revamped

In the same spirit as the other changes to the competition policy framework, state aid policy is moving away from a *per se* rules-based approach and towards greater reliance on economic principles (Box 5.1). The aims include: a reduction in the level of aid, which in recent years has been stuck around 0.6% of GDP in the EU15 (Table 5.1 and Box 5.2);[4] helping member states to target aid better, especially towards innovation and human

Table 5.1. **State aid**

In the EU15, per cent of GDP

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total less railways	0.98	0.94	1.13	0.73	0.61	0.62	0.63	0.68	0.57	0.58	0.57
Total less agriculture, fisheries and transport	0.72	0.70	0.90	0.56	0.43	0.45	0.46	0.51	0.41	0.42	0.41

By country in 2005, total less railways

Austria	0.56	Greece	0.20	Poland	0.82
Belgium	0.40	Hungary	1.83	Portugal	0.67
Czech Republic	0.54	Ireland	0.63	Slovakia	0.66
Cyprus	1.43	Italy	0.45	Slovenia	0.64
Denmark	0.64	Latvia	0.84	Spain	0.41
Estonia	0.46	Lithuania	0.58	Sweden	1.08
France	0.56	Luxembourg	0.15	United Kingdom	0.26
Finland	1.75	Malta	3.16	**EU15**	**0.57**
Germany	0.90	Netherlands	0.40	**EU10**	**0.93**

Source: EC (2006), *State Aid Scoreboard*, autumn 2006 update.

Box 5.1. **The state aid action plan**

In 2005, the Commission published its State Aid Action Plan outlining the principles for a reform of state aid rules and procedures over the next five years. The aims are:

- Less and better-targeted aid, focused on improving economic efficiency, generating more growth and sustainable jobs, social and regional cohesion, improving social services, sustainable development and cultural diversity.
- A more economics-based approach so that the Commission can focus on cases that are most likely to distort competition and trade.
- Streamlined procedures with better enforcement and transparency.

The plan is to move away from the current rules-based approach towards an effects-based approach. In deciding whether state aid is warranted (and consistent with the treaty), the basic principles are:

- There must be a well-defined objective of common (European) interest. This could be aimed at addressing a market failure (*i.e.* efficiency) or adjusting market outcomes (equity).
- The aid instrument has to target the identified objective, which means that: 1) state aid is an appropriate instrument; 2) the aid measure has an incentive effect (*i.e.* it must change the behaviour of the recipient firm); and 3) it is proportional to the problem tackled (*i.e.* does not go beyond what is required to meet the objective).
- The benefits (to the common interest) should exceed the costs (distortions to competition and trade).

The framework for state aid for research, development and innovation published in 2006 fleshes out these criteria to some extent. For example, when considering whether aid is necessary, the Commission will consider the nature of the project, the counterfactual, whether the project is likely to be profitable in risk-adjusted terms, and the time path of cash flows. When analyzing whether a measure may be distorting or crowd out innovation elsewhere, it will look more favourably on a measure where the aid has been minimised as far as possible and granted in an open selection process, where the product is far from the market, where exit costs mean competitors are unlikely to abandon their own research, where the market is competitive and where product innovation is aimed more at developing differentiated rather than genuinely new products.

The Commission also plans to simplify, consolidate and extend as much as possible the use of block exemptions. Currently, there are block exemptions for support to SMEs (including R&D aid), environment, employment, training and regional development. When certain conditions are met, aid in these areas for projects of a size below specific thresholds does not need to be notified to the Commission. These thresholds vary depending on the circumstances and the type of project, but are around € 50m for a regional aid project, € 25m for R&D and € 1m for training.*

* These figures refer to the size of the project, not to the amount of aid granted (which usually are well below 100% of project costs). There is also a *de minimus* rule that any aid under € 200 000 granted to an individual enterprise over a three-year period does not need to be notified (the Commission has recently raised this from € 100 000). For the exact thresholds and more precise definitions, see *http://ec.europa.eu/comm/competition/state_aid/legislation/block.html.*

capital; and streamlining the paperwork so that the Commission can focus on the most distorting types of aid.

The basic state aid principles are laid down in the treaty. The treaty prohibits any form of state aid that distorts competition by favouring certain firms or the production of certain

Box 5.2. **State aid in the old and new member states**

The level and type of state aid differs substantially in the new EU members compared with the EU15 (Table 5.1), in large part due to the transitional or restructuring measures including aid to specific industries such as steel and coal. However, some of them still have a legacy of fiscal incentives such as tax holidays that aim to attract inward investment. Some of the key differences with the old member states include:

- Aid levels are substantially higher in the EU10:[1] 0.9% in 2005, compared with 0.6% in the EU15. This partly reflects pre-accession measures which are being phased out, so the difference between the two groups may fall over time.
- Overall, the new members give a greater share of support to agriculture and less to manufacturing although there is considerable variation even within the EU12. Support for the coal industry is high in Poland while support for the steel industry is high in Slovakia. Latvia gives a comparatively high share to the service sector. Aid to the steel industry is now very low in the EU15 but has been comparatively high in the Czech Republic, Slovakia and Poland (at least in 2003).
- More aid is sector specific rather than aimed at horizontal objectives (in the EU12, one-quarter of aid goes to horizontal objectives compared with two-thirds in the EU15).
- Concerning the horizontal objectives, most funds go to regional and employment projects in the new member states, whereas more funding goes to the environment and SMEs in the EU15. The share devoted to environmental and energy saving projects is very low in the new member states. They also allocate relatively little to R&D.
- Direct grants are used less in the EU12 (18% of aid, *versus* 50% in the EU15) but loan guarantees are much more common (36% *versus* 7%). For example, in the Czech Republic loan guarantees to the banking sector represented 80% of total aid. The share delivered through tax exemptions is similar in each region.
- As a share of GDP, the new members before accession spent ten times as much on rescue and restructuring aid to failing companies (0.3% of GDP per annum from 2000-05, compared with 0.03% in the EU15[2]).

1. The figures here cover aid as defined under Article 87(1) of the EC Treaty; that is, they include only those measures that have an effect on internal trade or threaten to distort competition. Non-distorting aid measures such as a general tax break for R&D are not included.
2. The figure for the EU15 is an underestimate because it excludes some significant aid measures that are impossible to quantify.

Source: European Commission, *State Aid Scoreboard,* Spring and Autumn 2006 updates.

goods in so far as it affects trade between member states.[5] These principles have been put in place to avoid subsidy races and to ensure a level playing field in the single market. They have the same objective as the subsidy provisions of the World Trade Organization. In both cases, there is a presumption that financial support granted by governments may distort trade. The EU is one of the few jurisdictions with such a system of state aid controls. Any measure that amounts to state aid must be notified and approved by the Commission in advance. The Council has enabled the Commission to adopt block exemptions for certain purposes, such as aid for small- and medium-sized enterprises (SMEs), training and employment, and can set specific rules for individual sectors including transport, coal, fisheries and agriculture. Aid below a certain threshold does not have to be notified.

At the heart of the state aid reforms is the "balancing test": member states must identify a market failure, show that state aid will have the desired effect and that its

benefits outweigh any costs in terms of distortions to competition or trade. Member states still need prior approval for aid measures, but responsibility for assessing compliance with the treaty may be shared with member states in the sense that the Commission can check compliance *ex post*. In line with the Lisbon Strategy, the reform has made it easier to give aid for research and development (R&D) in the sense that it has been widened to include new measures on aid for innovation and notification rules have been eased.[6]

The shift to a more economics-centred approach is sensible, but carries risks. In particular, it may make it more difficult for the Commission to rebut member states' justifications for state aid. To simplify a little, a member state must point to a market failure and show that state aid is an appropriate measure for dealing with it. But it does not have to show that state aid is the *best* solution, only that it is *a* solution (although this is not new: it was also the case under the previous approach to state aid). It should not be difficult to assemble a fairly compelling case in support of a state aid proposal, especially in areas like innovation and R&D where the spillovers and dynamic gains are almost impossible to quantify. In such cases it will be hard for the Commission to argue against a proposal because it will come down to different judgements over the key assumptions where empirical evidence may be thin and inconclusive. On the other hand, a potential advantage of the new approach (including the expansion of block exemptions) is that it frees up resources to concentrate on the more important cases. This may lessen the chances of member states bending the rules to their own advantage.

To be sure, it is impossible to design a perfect set of rules or institutions to ensure that the common interest prevails over national concerns. In practice, probably the most important step is to try to take politics out of state aid decisions. This is even more important now that there is an increased emphasis on support for R&D, since it is not uncommon for blatant support of national champions to be disguised as aid for research and innovation. The use of independent or arms-length granting agencies by member states would go a long way towards improving the system. The Commission is nudging in this direction as it will look more favourably on proposals that have been subject to an open selection procedure. The EU could also rethink the "matching clause" which stipulates that aid can be granted at higher intensities than otherwise permissible under the framework if competitors outside the EU receive similar support (and provided all other conditions are met). It would be better to deal with anti-competitive government support under the rules of the World Trade Organization rather than getting involved in tit-for-tat subsidy races.

Box 5.3. **Recommendations concerning competition policy**

The main recommendations are to defend internal market rules and to continue modernising competition law and policy. Other recommendations, many of which the Commission is already actively working on, are listed below:

- Ensure that national and EC leniency programmes are clear, simple and consistent with each other.
- Push for more private enforcement in antitrust cases.
- Encourage member states to reduce the amount and improve targeting of state aid. Ensure that additional flexibility of state aid rules does not lead to a re-nationalisation of industrial policy. Encourage member states to use independent granting agencies. Reconsider the "matching clause".

Notes

1. See OECD (2005a). Suurnäkki (2006) provides a succinct summary of the report and the response of the Directorate-General for Competition. The 2003 *Economic Survey of the Euro Area* also reviewed competition policy.
2. Substantial fines can be imposed on individuals in nine countries (Denmark, Germany, Ireland, Netherlands, Poland, Portugal, Slovakia, Sweden and the United Kingdom). Small fines (under € 100 000) can be imposed in France, Greece and Spain. Offenders can receive jail terms in seven countries (Bulgaria, Estonia, France, Germany, Ireland, Slovakia and the United Kingdom), although this has only been done once (in Ireland in 2006).
3. In particular, juries are not involved in awarding large punitive damages, “no win, no fee” contingency fees are rare and costs are usually awarded against the losing side.
4. According to national accounts definitions, which are broader than the ones used here, subsidies amounted to 1.1% of GDP in the EU19 in 2005, which is nearly twice as high as the average for the non-EU OECD.
5. Aid is permitted for addressing underdevelopment and unemployment and for dealing with serious economic disturbances and important projects of common European interest.
6. This covers aid for R&D projects, feasibility studies, costs of patenting, innovation in services, secondments of scientific personnel, innovation clusters, advisory services and young innovative enterprises.

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Chapter 6

Reforming agricultural and trade support

EU policies will have a decisive influence on developments in world trade. The EU is the world's leading exporter and second-leading importer of goods, and the biggest trader of commercial services. Along with the other major trading blocs, decisions by the EU will have a major influence on whether the multilateral approach to world trade will continue to dominate or whether trade arrangements splinter into regional and bilateral agreements. Agricultural policies in particular will influence whether the Doha round can be concluded successfully, where success is measured by major cuts in trade-distorting domestic subsidies, the elimination of all forms of export subsidies and better market access worldwide. Concerning other trade issues, EU tariffs on manufactured products are relatively low except for certain processed food products, but its complex web of preferential trade deals makes access more difficult for those left out. In services, there is little discrimination against foreigners – except in the professions – but anything that undercuts the internal market for services also hampers provision from outside the EU.

The Common Agricultural Policy

The EU is the world's third biggest exporter of agricultural products.[1] Its exports account for around a third of the world total in cheese, milk powder, pig meat and wine and around a fifth of world trade in butter. Agriculture accounts for 2% of GDP in the EU15 and around 4% in the new member states. The importance of agriculture varies significantly across the Union, employing around 1% of the workforce in Belgium and the United Kingdom but more than 15% in Greece, Poland, Lithuania, Romania and Bulgaria. Farms are small by international standards,[2] and in some of the new member states they are mostly tiny subsistence farms: in Poland and Romania for example, around half of farms are smaller than 1 hectare.

In 2005, total support to agriculture is estimated to have been € 108 billion, or 1% of GDP. Support to producers has declined slightly over the past five years but remains above the average in the rest of the OECD (Figure 1.22). In 2007, agricultural funding in the EU budget amounted to € 54 billion. While the EU has been moving away from the most distorting types of support (market price support, output and input payments), in 2005 such support still accounted for approximately half of the total. However, it should decline further over the next few years as the 2003 Common Agricultural Policy (CAP) reforms are phased in (see below). In terms of budgetary transfers, approximately 10% of payments are for market support, down from 90% in 1993. Support includes 91 tariff rate quotas (TRQs) on agricultural products, up from 89 in 2003.[3]

Agricultural subsidies are combined with tariff protection and export subsidies.[4] The system of agricultural supports has several objectives, including boosting competitiveness, underpinning farm incomes, keeping farmers on the land, protecting the environment and keeping agricultural land in good condition. However, it can also have a number of adverse consequences:

- Consumers pay more for some food products than they otherwise would and, because poorer households spend more of their income on food, the impact is regressive. The CAP is estimated to raise farm-gate food prices by 21% in 2006 (OECD, 2007), although the impact on final consumer prices will be less as agricultural prices constitute only a small share of overall food prices.
- Because subsidies are accompanied by trade barriers (import tariffs), and despite some offsetting policies, they reduce imports from certain developing countries (some of which have competitive agricultural sectors). As imports from a large number of the poorest countries have been liberalised, the impacts vary greatly across different countries depending on whether they have preferential access to the European market and whether they are potential exporters of products that face trade barriers or depressed world prices. Tariff protection in particular is uneven. Developing countries that benefit only from the generalised system of preferences obtain very limited access to the EU market in sectors such as beef, dairy and sugar (Bureau and Matthews, 2005).

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In general, Latin America and East Asian exporters face greater restrictions while the poorest countries enjoy zero tariffs under the *Everything but Arms* initiative.[5]

- A sizeable share of subsidies benefits larger farms (OECD, 2003). In 2005, the top 6% of EU farms received more than half of all direct payments while the bottom 63% received less than € 1 250 each, amounting to 4.9% of total payments.[6] This implies that further economy wide savings would come from targeting payments to lower income farm households on a similar basis to social policies (OECD, 2002).
- Market price support can undermine regional cohesion policy because richer farming regions of the EU benefit by more than the poorer regions in southern and eastern Europe (Shucksmith *et al.*, 2005). In the most comprehensive study to date of the territorial impact of the CAP, Arkleton Institute (2004) concluded, based on an analysis of impacts at the NUTS-3 level, that in aggregate the CAP has worked against the objective of balanced territorial development in the EU15 and has not supported the objectives of economic and social cohesion. It found that "Pillar 1" support favoured the core European regions relative to the periphery, although the rural development programmes (Pillar 2) have been more neutral. It found that Pillar 1 support per hectare goes unambiguously to richer regions, although support per worker is distributed more ambiguously.[7] However, this study is based on EU15 data for 1999, and pre-dates both the Agenda 2000 and the 2003 reforms. The territorial impact of these significant reforms is not yet known.
- CAP support may trap resources in a low-productivity sector, an issue that is especially important for the new member states. Phasing in support over ten years for the new member states should help reduce this risk.
- Intensive agriculture can lead to more intensive use of inputs, the expansion of farming to marginal land and overuse of irrigation water. The environmental consequences can include over-extraction of water from aquifers, a rising salt table, alteration of natural habitats and irrigation-driven soil erosion (OECD, 2006b). The problem is acute in the Mediterranean regions, which are facing more frequent and intense droughts, but where two-thirds of water is used by agriculture. To the extent that the CAP contributes to more intensive agriculture, it will also have these adverse environmental consequences. However, the EU has introduced measures to reduce these risks, including agri-environmental support, limitation of livestock density and the introduction of "cross compliance" that ties the receipt of subsidies to "good farming practices", which includes taking steps to mitigate pollution. Its water framework directive also lays out water pricing policies, to be implemented by 2010.

Agricultural policies have become less distorting

Recent reforms have made the EU's agricultural policies less distorting and should help ameliorate some of the problems identified above (Box 6.1). The Agenda 2000 reforms were primarily designed to prepare for EU enlargement and involved cuts in guaranteed prices, partly compensated by direct payments to farmers. This approach was taken further in the 2003 reforms which saw the introduction of the Single Payment Scheme (SPS). Many of the previous payments that were tied to production, area planted or herd size have been replaced by the single payment. In 2004, it was agreed to include Mediterranean crops (cotton, hops, olive oil and tobacco) and in 2006 sugar was included. Under the SPS, farmers

Box 6.1. **Recent reforms to the CAP**

The 2003 reforms

In June 2003 EU farm ministers adopted some important reforms to the Common Agricultural Policy (CAP). The key changes include:[1]

- *A single farm payment*, independent of production ("decoupling"), replaces many of the previous payments. Farmers will receive payments based on their entitlements in 2000-02. They do not need to continue producing to receive the payment. Farmers receiving the single payment will be able to produce any commodity on their land except fruit and vegetables. Some payments must remain fully commodity-specific (protein crops,[2] nuts, energy crops)[3] while in others a certain level of coupling is retained (42% for rice and 60% for starch potatoes). Nine of the EU15 implemented the single payment in 2005 with the other six following in 2006 (the new members are discussed below).
- *A choice of a farm-level or regional model*. The single payment can be calculated at the farm level (a per hectare amount based on what each farm received in 2000-02) or at the regional level. Under the regional option, farmers receive a uniform payment entitlement per hectare within a region (although countries can choose from several options including making a distinction between arable land and grassland and having different sectors contributing to differing degrees to the redistributed amounts). Funds can be redistributed between regions under certain conditions.
- *A partial opt-out*. Countries can choose to keep some payments linked to production if they want to avoid abandonment of production (including all of the slaughter premium for calves and the suckler cow premium, which can remain linked to herd numbers; and 40% and 25% of durum wheat and cereals and oilseeds respectively can remain coupled). Per hectare payments remain in place to encourage production of energy crops (*e.g.* for biofuels).
- *Maintaining the farmland ("cross compliance")*. To receive direct payments, farmers must keep all farmland in good agricultural and environmental condition. Pasture land may not be converted to arable crops and may not be diverted to non-agricultural uses such as forestry. Farmers must also respect various environmental, food safety and animal welfare standards.
- *More money for the rural development programme (RDP)*. From 2007, 5% of direct payments per farm will be redistributed to the RDP (the first € 5 000 per farm is exempt). It will result in an additional € 1.2 billion per year for these programmes. Funds can be used for quality improvement programmes, support to help farmers meet food safety and animal welfare standards, investment support for young farmers, etc. These measures are approximately fifty-fifty co-financed with member states.
- *A budget ceiling*. In 2002, the Council agreed that direct support to farmers will rise by no more than 1% per year until 2013. If spending is forecast to come within EUR 300 million of the ceiling in the following year , payment rates will be cut to remain within the limit. All the burden of the cuts will fall on the EU15 until the new member states' regimes are fully phased in.
- *Additional cuts in guaranteed prices*. Intervention prices for butter, skimmed mild powder and rice are reduced by 25%, 15% and 50% respectively. The guaranteed price for rye was eliminated and storage subsidies to grain farmers were halved.

From 2004 (2007 for Bulgaria and Romania), the new member states except Malta and Slovenia have implemented a transitional system with all farmers in a country receiving the same payment per hectare. Malta and Slovenia are applying the regional model of the single farm payment. The full payment rate is phased in over time: in 2007, they receive

Box 6.1. **Recent reforms to the CAP** *(cont.)*

40% of the full EU15 payment rate, rising to 100% by 2013. They can top it up from their own funds by a maximum of 30 percentage points so long as they do not exceed 100% of the EU15 rate (in practice, this means they could reach the full EU15 rate by 2010 if they are willing to pay for it themselves). There are country specific add-ons that were negotiated for certain products. In the end, however, payment rates will be substantially lower in the new member states because they are based on a 1995-99 reference period when agricultural yields were low.

Intervention prices and production quotas remain in place for milk, in conjunction with import protection and export subsidies. The beef market is supported by a safety net system (with low guaranteed prices), tariffs, tariff rate quotas (TRQs) and export subsidies. Support for pig meat is mainly provided by tariffs and export subsidies. For sheep meat, the market support regime comprises tariffs and TRQs, with most country specific TRQs subject to a zero customs duty. For poultry and eggs, there are no intervention prices, although there are TRQs and export subsidies. There are no intervention prices for oilseeds and protein crops. The market support regime for cereals and sugar comprises trade protection through tariffs, TRQs and export subsidies.

In a separate reform, it was agreed that the end beneficiaries of all EU spending will be published from 2009. Thus, the public will know who receives what under the CAP (some countries publish this information already).

Mediterranean crops (cotton, hops, olive oil and tobacco)

In 2004, it was agreed to include part or all of the direct payments related to these crops in the single payment scheme from 2006. At least 75% of the payments to hop production and 60% of the olive oil payment are now part of the single payment. Member states have the option to keep the remaining percentage crop-specific but have made limited use of this possibility. For tobacco, half of the production payment will be included (at any time between 2006 and 2010) with the other half being used for restructuring programmes. For cotton, a maximum 65% will become part of the single payment with the rest being paid on a per hectare basis.

The sugar reforms

In 2005, agreement was reached on the first major overhaul of the sugar regime since its inception in 1968. It took effect in July 2006. The guaranteed price for white sugar will be cut by 36% over the period 2006-09; a little under two-thirds of the price reduction will be compensated by payments as part of the SPS; countries that give up more than half their quota can receive a bonus 30% income compensation for five years; restructuring incentives will be offered for four years to encourage companies to leave the sector; the two quota streams have been merged into a single quota that will remain in place until 2014-15; quotas are now transferable between member states; and the intervention buying of surplus production is being phased out, to be replaced by a private storage regime in which growers and processors jointly pay to dispose of excess production. There will be no compulsory quota reductions in the first four years, but if voluntary restructuring is insufficient to balance the market by 2010 then across-the-board cuts will be necessary. The preferential import system, which favours sugar imports from certain countries, will continue but at the lower intervention price. A total of € 1.2 billion has been set aside to assist the African, Caribbean and Pacific countries adversely affected by the reduction in their export prices.

Box 6.1. **Recent reforms to the CAP** *(cont.)*

Bananas

A new banana regime took effect in January 2007. The current aid scheme, which compensates producers for drops in prices, is abolished. In the main banana-growing countries (France, Greece, Portugal and Spain) it is replaced with a budget transfer or can be included in the single payment scheme.

A proposal for fresh fruit and vegetables

In early 2007, the Commission proposed bringing fresh fruit and vegetables within the single payment scheme. The SPS ceiling will be expanded by around € 800 million but this is expected to be financed by the abolition of export subsidies and aid to processing. It is proposed that various environmental and crisis management measures will be put in place along with measures to simplify and encourage restructuring among the more than 1 500 producer organisations.

1. This description concentrates on the main features of the reform. For more of the details, see OECD (2004).
2. Peas, beans and sweet lupins.
3. This is true only of the farm-based option (see the next bullet point) and in any case the fruit and vegetable reforms propose removing this restriction.

can choose to produce whatever they wish (with some restrictions) or indeed to produce nothing at all, so long as they keep their farmland in good agricultural condition.

A budget ceiling on market support measures and direct support to farmers (so-called Pillar 1 spending) has been imposed out to 2013. Despite a substantial increase in the number of farmers due to enlargement of the Union, spending can increase by no more than 1% per annum. If spending is expected to exceed the ceiling, payment rates will be cut across the board. Any expansion of the single payment to cover more crops must be absorbed within the overall expenditure cap.

Reforms to the sugar sector are a clear improvement

A major reform to the sugar regime in the spirit of the 2003 CAP reforms was agreed in 2005 (Box 6.1). The EU is the second biggest sugar exporter in the world, mainly because producers receive very high guaranteed prices, although it is likely to slip down the rankings in response to the reforms. Germany, France and Poland account for around half of EU sugar production. Reform was unavoidable after the EU lost a key case at a WTO panel and because the Least Developed Countries would soon get free access to the EU sugar market as part of the *Everything but Arms* agreement. The guaranteed price will be cut significantly between 2006 and 2009, although in the end it will still be about twice the world market price. Around two-thirds of farmers' income losses will be compensated through the Single Payment Scheme. The Commission has estimated that EU production will fall by around 30% through voluntary exit from the industry. That reduction is expected to lead to an end to EU sugar exports and a near-doubling of imports. However, progress implementing the reform does not look good so far. The reduction in quotas to date is well below the targeted level. If voluntary restructuring is insufficient to balance the market by 2010, across-the-board quota cuts will be required.

Assessment and next steps

By loosening the link between income support and production, the incentive to produce is reduced substantially. In this respect the reform is a major improvement. However, the incentive to produce will not be entirely eliminated. In the first place, the "decoupling" is not applied to all types of support. Some countries were concerned about land management and wanted to make sure farms were not abandoned, so some payments remain commodity-specific. For some other payments, countries have the choice of keeping a portion of the payment linked to production. Less than 1% of aid (measured by budgetary transfers) is now commodity-specific in Germany, Greece, Ireland, Italy, Luxembourg and the United Kingdom. More than 20% remains so in France, Spain, the Netherlands and Portugal. The Commission has estimated that by 2013, approximately 91% of budgetary transfers in the form of direct payments (including national envelopes and top-ups) for the arable crops, milk, beef and sheep sectors will be decoupled (EC, 2007). OECD producer support estimates, which give a broader measure of support than just direct budgetary transfers, show that in 2006 approximately 28% of producer support can be thought of as "decoupled" in the sense that it does not require any production. This proportion will increase as other policy reforms, such as in the sugar and banana sectors, become fully phased in.

The implementation of the single payment scheme, requiring the retention of land in the agricultural sector but giving farmers wide flexibility in the choice of what, if anything, to produce, constitutes a major improvement in terms of the degree of decoupling. OECD research has shown that such measures have much smaller potential production impacts than the price support measures or area payments they are replacing (OECD, 2006c). Nevertheless, there are a number of channels through which production distortions may persist. All agriculture-specific measures will have some production impact. Eligibility conditions (maintenance requirements or any other condition such as excluding the right to produce certain products) will influence the farmer's production decisions. Risk mitigation is also an important channel through which production effects may persist. Moreover, even payments that are highly decoupled at the margin could have significant production effects when the level of support is high or when the relationship between support and production is not linear. The magnitude of such effects is unknown and remains to be established empirically through careful *ex post* analysis. The risk of production effects could be reduced by the removal of the remaining restrictions and conditions and by paying close attention to the level of support. More careful targeting of payments, through specific actions tailored to achieve specific results in terms of, for example, income support or environmental performance, would ensure an even greater degree of decoupling.

Overall, while the reforms have not eliminated all the distortions, they clearly are a step in the right direction. In general, the reforms go in the direction desired by ministers as expressed in OECD reform principles (OECD, 1998). On their own they should lead to a shift from crop land to pasture land, less intensive land use and small increases in world prices for most crops. According to OECD model analysis, the impact of the reform on dairy markets is expected to be limited because production quotas remain binding (OECD, 2004). The Single Payment Scheme should allow market forces to play a greater role in allocating resources among commodities, and distortions to international trade should be reduced. Having said that, the benefits of the reform would be even greater if countries were to replace all commodity-specific payments with the Single Payment Scheme.

The positive effects of the reform could be reinforced by a reduction in the overall level of support and by improvements in market access. The 2003 reform was deliberately designed to alter the composition of support without substantially reducing its level and, as noted above, the level of support to agriculture remains high in absolute terms and compared with most other OECD countries.[8] Even after the reform, significant levels of market price support remain in place, mainly by means of border protection, and especially for meat, milk and sugar. Export subsidies have been reduced substantially in recent years but are still maintained for certain products. The EU accounts for 90% of all WTO member states' notified export subsidies (WTO, 2007), although this measure captures only a limited portion of total export support throughout the world (it excludes the subsidy elements of food aid, state aid, export credits among other factors). These subsidies amount to around 5% of the value of agricultural exports. Subsidies are likely to fall further as guaranteed prices move closer to world market prices and the EU has conditionally proposed phasing out all export support, including export subsidies, in its offer to the Doha trade round.

Some non-*ad valorem* tariffs for agricultural goods applicable to processed agricultural goods incorporating several inputs are complex and could benefit from simplification. Non-*ad valorem* tariffs apply to nearly half of agricultural product lines, compared with 0.5% of non-agricultural tariff lines. The EU has conditionally proposed simplifying them in its offer to the Doha trade round.

Under the Single Payment Scheme, countries can choose to base payments on what each individual farm received in the period 2000-02 or to calculate it at a regional level, with the same payment per hectare given to all farmers in the region. The majority of EU15 countries chose the farm-based option.

As part of the reform, resources are being shifted towards rural development programmes (RDPs, the "second pillar" of the CAP). Some additional funding will come from what amounts to a tax on direct payments to larger farms. In 2006, funding for the RDP amounted to around 10% of CAP spending but by 2013 it will be approximately a fifth of the total. A proposal that member countries could voluntarily choose to shift additional funds from the first to the second pillar was essentially rejected by the European Parliament in 2007 (only Portugal and the United Kingdom will be permitted to do so). To ensure that they do not become a subsidy programme in disguise, it is important that these programmes target well defined policy goals, that the level of support is proportional to the problem being addressed and that the delivery of funding adheres to best practice guidelines regarding public expenditure – including mandatory cost-benefit analysis, *ex post* assessments, transparency and accountability. The useful steps in this direction that the EU has taken recently could be reinforced. Some of the subprogrammes may still be tied, such as investment subsidies and area payments to less favoured regions, which partially undermines the decoupling in the first pillar. More of the measures for the provision of public goods and rural development should be available to farmers and non farmers alike (as regional programmes are).

Lastly, tariff protection for processed food products can be even greater than for farm-gate products. The average applied tariff rate on agriculture is 11%, but ranges as high as 167%. For processed food products, the average is 20% and ranges up to 428% (Table 6.1). Thus, agricultural trade reform needs to be broader than just tackling support to farmers.

Table 6.1. **Applied MFN tariffs for selected commodities in 2006**

Item	Number of tariff lines	Simple average tariff rate (per cent)	Range (per cent)	Standard deviation
Agriculture, hunting, forestry and fishing	598	10.9	0-167	20.4
Total manufacturing	9 113	6.8	0-428	13.5
of which:				
Food processing	1 754	20.1	0-428	26.6
of which:				
Processed food products	1 419	22.1	0-428	27.7
Other food products, animal feeds	145	14.0	0-164	21.1
Beverages	181	7.0	0-106	14.2
Tobacco manufacturing	9	41.8	10-75	25.5
Manufacturing excl. food processing	7 359	3.8	0-51	3.8
of which:				
Textiles and clothing	1 399	7.6	0-17	3.5
Wood and wood products	187	2.5	0-10	2.7
Paper, printing, publishing	227	0.5	0-7	1.8
Chemicals	1 770	4.3	0-51	3.7
Non-metallic mineral products	275	3.9	0-14	3.0
Basic metals	663	1.2	0-10	2.3
Fabricated metals, mach. and equipment	2 547	2.5	0-22	2.8
Other manufacturing	291	2.6	0-17	2.3
Total	**9 843**	**6.9**	**0-428**	**14.0**

Source: World Trade Organization.

Selected trade policy issues

The EC trade policy strategy

The EU is the world's leading exporter and second-leading importer of goods, and is the biggest exporter and importer of commercial services. It is an active member of the World Trade Organization and its first stated priority for world trade is to maintain the strength of the multilateral system of trading rules. It has been a key player in the Doha round of trade negotiations, where it is seeking 1) improvements in market access for non-agricultural products on the basis of a non-linear formula that will cut the highest tariffs most and offer flexibility for developing countries; 2) liberalisation of agriculture according to the July 2004 Framework Agreement; 3) further liberalisation of the services sector; and 4) incorporation of development priorities (WTO, 2007). Tariffs on manufactured products are relatively low except for certain processed food products. The EU is modernising its customs procedures, while services reform (Chapter 2) and the revamp of state aid policy (Chapter 5) both have the potential to reduce trade distortions at the same time as boosting the competitiveness of the domestic economy. The EU is also a lead donor of aid for trade, providing over half of the global total of aid for trade policy and trade development. This is important to ensure that developing countries take advantage of market access opportunities.

In 2006, the Commission published a strategic paper on trade policy. While enhancing the multilateral trading system is its first priority, it will work towards striking further bilateral free trade agreements, especially with dynamic markets such as in emerging Asia. Beyond tariff reductions, the paper highlighted deficiencies in intellectual property right protection, market access and public procurement markets in other countries as major issues. Anti-dumping and other trade defence mechanisms will be reviewed to make sure the application of these

measures serves European interests under new conditions of globalisation where EU companies have global supply chains and considerable foreign investments.

Preferential trade relationships

The EU has the most extensive web of preferential arrangements of any WTO member. As a result, only nine WTO member countries are covered by the most-favoured nation (MFN) tariff (although they account for 30% of merchandise imports). The stated EU aim is to use regional agreements as a stepping stone to full integration of partner countries into the multilateral trading system. From 2009, duty-free and quota-free market access will be provided for all products from less developed countries, and only a limited number of products from Africa, Caribbean and Pacific (ACP) countries continue to face tariff duties. In the past five years the EC has signed one new agreement (with Chile) and free trade agreements with most Mediterranean countries have entered into force. It recently announced revised criteria for considering new free trade agreements. Its main criteria will be market potential and the existing level of barriers against EU exporters. As well as the usual provisions on tariffs and non-tariff barriers, the Commission wants new agreements to have provisions addressing services and investment, safeguarding intellectual property rights, opening up public procurement and promoting a convergence of competition laws and enforcement. They will also cover environmental and social issues, including the promotion of "decent work for all". In doing so, it is using trade policy to achieve non-trade objectives and is trying to reintroduce measures that were dropped from WTO negotiations. Other WTO members did not agree to the EC's proposal to include labour standards in the Doha round, and after Cancún it was agreed to drop competition policy, investment and government procurement from the negotiating agenda.

The transatlantic trade relationship

The EU and the United States are each other's main trading partners and together account for about two-fifths of world trade. In 2005, the stock of two-way investment was over € 1.6 trillion, composed of € 856 billion of EU foreign direct investment (FDI) in the United States and around € 770 billion of US FDI in Europe. Close to a quarter of all EU-US trade consists of transactions within firms based on their investments on either side of the Atlantic.

Co-operation takes place in a variety of settings, such as the New Transatlantic Agenda. In 2005, a new EU-US Economic Integration and Growth Initiative was launched to tackle remaining barriers in investment, public procurement, and services. In the same year, the EU and the United States agreed on a strategy for enforcing intellectual property rights in third countries.

The potential gains from deeper transatlantic integration are large (OECD, 2005). However, a transatlantic free trade area may not be the best option to deepen trade when a multilateral approach can be used instead. A multilateral approach would lead to a greater trade boost worldwide and would minimise the risks of trade diversion. The proliferation of regional and bilateral agreements worldwide is proving an increasingly serious barrier to firms with global supply chains. But there is always scope to boost trade by aligning product standards and broadening mutual recognition, which is where the main focus of EU-US policy lies.

Contingency remedies

In December 2006, the Commission launched a public stakeholder consultation on its trade defence instruments by releasing a Green Paper. The EU uses contingency remedies more often than most countries. As at 30 September 2006, 135 definitive anti-dumping measures were in place, of which 39 were on imports from China, 10 from Russia, and 9 each from India and Thailand. Between January 2004 and September 2006, it initiated two countervailing investigations. During the same period three safeguard investigations were initiated. Two resulted in the imposition of measures and one was terminated when the product concerned became subject to anti-dumping measures.

The EU does not apply quotas on imports of textiles and clothing except for ten product lines made in China. Those ten products were subject to the greatest surge in imports after the WTO agreement on textiles and clothing expired at the end of 2004. In response, China agreed to export limits consistent with the WTO's safeguard clauses. These restrictions are due to expire at the end of 2007.

Technical trade barriers

Technical barriers, such as hygiene requirements and regulations on packaging, labelling and testing, can be a major issue but by their nature it is difficult to assess objectively whether such barriers are more burdensome in one region than another. Nonetheless, according to World Bank estimates, EU regulations are stricter than those of the United States (Kee *et al.*, 2006). The EU has not signed any new mutual recognition agreements (MRAs) over the past three years but amendments are being introduced to some existing MRAs. One issue that has raised concerns is the EU's new chemical safety law (REACH) under which toxicological information for all chemical substances (above 1 tonne per year per manufacturer or importer) must be registered over an 11-year period. Central to the system is a reversal of the burden of proof: producers and importers of chemicals must prove that their substances can be used safely before they can be placed on the market. Under the previous system, it was up to the authorities to prove that a substance posed a threat before it could be withdrawn. The authorisation requirement applies to substances of very high concern on their own and to substances in preparations or articles (for example, a chemical that may form part of a consumer durable). While the regulatory compliance burden for importers was substantially reduced between the initial Commission proposal and the adopted legislation, it remains unclear to what extent it may affect market access. On the other hand, third countries may benefit from the safety information that will be published on the internet, and smaller companies will benefit from a fee reduction.

Genetically modified organisms

In 2006, a WTO panel found that the community had acted in violation of its WTO obligation to complete its GMO approval procedures without undue delay. It also concluded that safeguard measures in nine member states that banned the sale and use of some genetically modified products were not consistent with WTO rules as they were not based on a proper scientific risk assessment. The Commission has said that it will comply with the panel's ruling but needs a reasonable period of time to do so. In 2004, it introduced new labelling and traceability rules for products containing genetically modified organisms.

Box 6.2. Recommendations concerning agriculture and trade

- In the context of the Doha trade round, reduce the level of support to agriculture.
- Fully decouple all sectors and improve market access.
- Cut tariffs on processed food products.
- Work towards a successful multilateral trade agreement.

Notes

1. Excludes intra-EU trade. The EU is third behind the United States and Brazil. When processed food, alcohol and tobacco are included, the EU is the world's largest exporter of agriculture and related food products.
2. In 2004, the average farm size was about 20 ha in the EU15 and 9 ha in the EU10. This compares with 3 800 ha in Australia, 224 ha in New Zealand and 194 ha in the United States (in the early 1990s).
3. A TRQ is a combination of an import tariff and an import quota in which imports below a specified quantity enter at a low (or zero) tariff and imports above that quantity enter at a higher tariff.
4. In 2006, export subsidies notified to the WTO amounted to € 2.97 billion, or 6% of total guaranteed expenditure for agricultural support (see Table IV.5 of WTO, 2007).
5. See OECD (2006a) for a discussion of the impact of trade reform on different regions.
6. See *http://ec.europa.eu/agriculture/fin/directaid/2005/annex1_en.pdf*.
7. Labour Asociados (2003) reached a different conclusion but the analysis in that report was based on a rather simple regression analysis of data at the NUTS-2 level and in this sense was less comprehensive and reliable than other studies. In particular, they looked at the distribution of support across Mediterranean regions, and not across the whole EU. They did find a positive correlation between GDP per capita and CAP support but dismissed the result as being not statistically significant, reflecting in part the small number of observations. They also compared the distribution of support across regions with individual countries, but not across all regions of the EU.
8. Nevertheless, there are countries that have higher support rates as measured by the PSE. These include Iceland, Norway, Switzerland, Japan and Korea.

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Chapter 7

Making the most of regional cohesion policy

Successive rounds of enlargement have given an increasingly important role to the Union's regional cohesion policy and its ambitious aim of reducing regional income disparities. This chapter offers policy options to raise the impact of cohesion policy.

Fostering convergence in living standards across the regions of Europe is a key objective of the European Union. The signatories of the treaty establishing the European Community declared in its preamble that they were "anxious to strengthen the unity of their economies and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favoured regions." A full title of the consolidated treaty is devoted to economic and social cohesion, with Article 158 affirming: "in order to promote its overall harmonious development, the community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions or islands, including rural areas." The draft constitution went one step further by raising "territorial cohesion" and "solidarity among member states" to among the main objectives of the Union.

As these lines from the treaty demonstrate, cohesion policy has both equity and growth objectives. Actual policy reflects a tension between the two. For example, a policy focussed solely on economic growth may lead to a hollowing out of some regions through agglomeration effects. Policy also reflects a tension between the same objectives over different time horizons. Reducing income inequality at a point in time can be achieved through income redistribution, but that could slow down the catch-up process, which is the most sustainable way to reduce regional disparities. In any case, the regional budget is not large enough to finance wide-scale income redistribution, and hence this chapter emphasises the efficiency and growth aspects of cohesion policy.

Cross-regional disparities remain large

Large disparities in economic activity separate the regions. In 2004, GDP per capita ranged from € 5 500 in Severozapaden (Bulgaria) to € 65 000 in Inner London. When the EU is divided into 254 regions, the average income in 2003 of € 21 700 is surrounded by a standard deviation of € 7 700 (35%). This is somewhat below the regional dispersion in the NAFTA (comprising the regions of Canada, the United States and Mexico), but if the comparison is restricted to the more developed economies, dispersion within the EU15 is considerably higher than across US states (Figure 7.1). Comparing disposable income per capita, rather than output per capita, reduces the regional dispersion to some extent, but not by much.

Cross-regional economic disparities have barely declined, or at best have fallen at an extremely slow pace since the mid-1990s (Chapter 1). The large number of econometric studies generally find weak or non-existent evidence of convergence across regions.[1] The persistence of regional divergences reflects to quite some extent member country policies: there is a North-South divide in the skills and technology diffusion, labour market rigidities can trap labour in lagging regions and the segmentation of markets has undercut gains from agglomeration. The EU's regional policies, which are limited in scope, have to be judged against this background.

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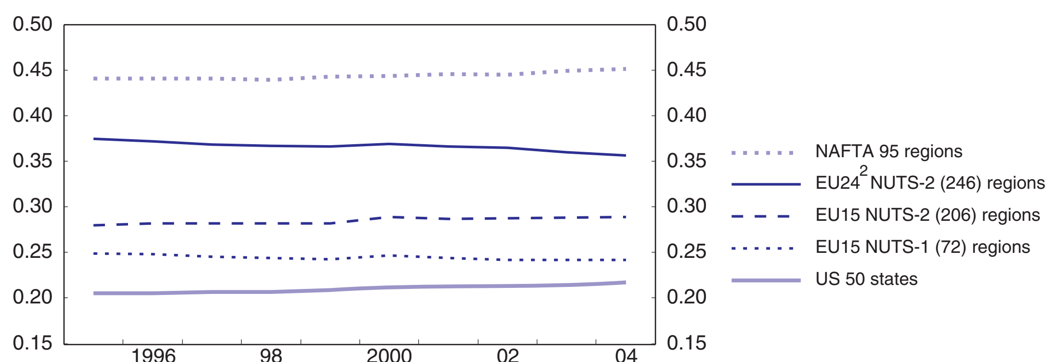
Figure 7.1. **Large economic disparities separate the regions**

GDP per capita dispersion[1]



1. Ratio of the population-weighted standard deviation to the average.
2. EU25 excluding Malta.

Source: Eurostat, US Bureau of Economic Analysis and OECD, *Regional Database*.

StatLink http://dx.doi.org/10.1787/084104626276

Policies

The budget

The importance of cohesion policy to the European Union is illustrated by its share of the EU budget. With an appropriation of EUR 308 billion (2004 prices) for the period 2007-13, regional policy[2] absorbs more than a third of the EU budget (Table 7.1). This allocation represents an 18% increase in real terms over the budget for the previous seven-year programming period. At 0.37% of gross EU income, however, transfers under EU regional policy are much smaller than equalisation transfers made by individual member states and considerably lower than equalisation schemes in other countries (Table 7.2). However, they can amount to a significant portion of GDP for some of the poorer recipient member states.

Table 7.1. **Main items in the EU 2007-13 budget**

	Amount in 2004 prices (EUR billion)	Share in EU GNI (%)
Common agricultural policy	371.2	0.45
Cohesion policy	307.6	0.37
Industrial and social policy	72.1	0.09
Administrative costs	50.3	0.06
International development assistance	50.0	0.06
Police and justice	10.3	0.01
Other	0.8	0.00
Total	**864.3**	**1.05**

Source: http://ec.europa.eu/regional_policy/sources/slides/2007/cohesion_policy2007_en.ppt.

The objectives

In the pursuit of its mandate of promoting economic, social and territorial cohesion, the cohesion policy of the EU is structured around three broad objectives for the period 2007-13:

- The *Convergence Objective* is the main pillar of regional policy. It channels 81.5% of the EU budget for regional policy to Europe's less-developed regions. Funds under the

Table 7.2. **Fiscal equalisation schemes**

2005

	As a per cent of GDP	EUR per capita (PPP-adjusted)
Austria	3.8	1 054
Denmark	2.8	779
Finland	3.8	970
Germany	2.0	489
Greece	1.2	221
Italy	3.0	729
Norway	0.5	189
Portugal	1.9	295
Spain	3.0	660
Sweden	2.6	698
United Kingdom	1.7	455
Australia	0.5	95
Canada	1.0	280
Mexico	3.8	330
Switzerland	3.0	889

convergence objective are intended to finance investment in physical and human capital, the development of environmental infrastructure, actions to encourage adaptability to economic and social change and efforts to improve the functioning of public administrations.

- The *Regional Competitiveness and Employment Objective* finances a broad range of actions aimed at strengthening regional competitiveness and social inclusion across the Union. It amounts to 16% of the regional policy budget. All regions not included under the convergence objective are eligible. It is the responsibility of member states to define which regions in their country can apply for EU funding under this objective.
- The *European Territorial Co-operation Objective* aims at fostering co-operation, especially across national borders. With 2.5% of total regional funds, actions under this objective are of moderate scale compared with the others.

The framework

While the objectives of cohesion policy are updated with each new financing period, the financial instruments to fund these objectives are enshrined in the treaty. There are three funds:

- The *European Regional Development Fund* (ERDF) finances investment in infrastructure, physical capital, local development projects and grants to small- and medium-sized businesses.
- The *European Social Fund* (ESF) finances active labour market policies, especially the retraining of workers in declining industries, lifelong learning and actions to promote social inclusion and women's participation.
- The *Cohesion Fund* finances investment in transport networks and environmental infrastructure in less-developed member countries.

Moreover, developing less-favoured regions is also one of the three main objectives assigned to the European Investment Bank.[3] In 2005, the European Investment Bank provided EUR 47.4 billion of loans for capital investment, an amount similar to cohesion policy support. Of this total, the EIB granted EUR 34 billion for projects in regions lagging behind in their economic development or grappling with structural difficulties (corresponding to objectives 1 and 2 in the classification laid out in Box 7.1).

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Box 7.1. **The growing importance of regional cohesion policy**

From its inception in 1957, the treaty set the objective of reducing regional disparities. Two financial instruments created the following year were intended to contribute towards this objective: the *European Social Fund* (ESF) and the guidance arm of the *European Agricultural Guidance and Guarantee Fund* (EAGGF). In the discussions prior to their joining what then was the European Economic Community in 1973, Ireland and the United Kingdom negotiated the establishment of a *European Regional Development Fund* (ERDF). The ERDF was set up in 1975. The ESF, the guidance arm of the EAGGF and the ERDF are together known as "structural funds".

Cohesion policy really took off after the accession of Portugal and Spain in 1986. The decision was then made to increase funding for cohesion policy and to adopt multi-annual programming, starting with the "Delors I" package for 1989-93. The share of regional policy in the EU budget rose to 31% in 1993 against only 12% ten years earlier. A "Delors II" package followed for the period 1994-99, structured along the same objectives as its predecessor:

- *Objective 1*: promoting the economic development of lagging regions, defined as those where GDP per capita was below three quarters of the EU average. Two-thirds of EU structural funds were allocated to this objective.
- *Objective 2:* facilitating the adaptation of regions affected by industrial decline. This objective received 11% of EU structural funds.
- *Objective 3:* tackling long-term unemployment. The allocation for this objective was nearly a tenth of EU structural funds.
- *Objective 4*: helping workers to adapt to structural change.
- *Objective 5:* fostering the modernisation of the farm sector.
- *Objective 6:* supporting the economic development of low population density regions.

Recognising the complexity and fragmented nature of this array of objectives, the European authorities simplified the framework for delivering cohesion policy when setting up the multi-annual programme for 2000-06, known as "Agenda 2000". Three objectives subsumed and redefined their six predecessors:

- *Objective 1:* promoting the economic development and structural adjustment of lagging regions.
- *Objective 2*: facilitating the adaptation of regions affected by industrial decline, rising unemployment and declining employment.
- *Objective 3:* fostering the development of human resources, including in regions not covered by other objectives.

Besides the structural funds, negotiations towards the Maastricht Treaty led to the creation of the Cohesion Fund in 1994 to finance investment in poorer countries. The rationale for the Cohesion Fund was to avoid a situation where the fiscal discipline required by EMU could imply insufficient investment in public capital in less developed EU countries. The current multi-annual plan, "Cohesion Policy 2007-13", brings together structural and cohesion funds in an integrated framework aimed at achieving the three objectives listed in Table 7.3.

Source: European Commission, Dall'Erba (2003) and OECD (2004).

The imperfect mapping between objectives and instruments (Table 7.3) reflects to a large extent that regional policy as it exists today has not been built from scratch but has evolved from the previous programmes (Box 7.1).

Table 7.3. **The objectives of EU cohesion policy and their funding for 2007-13**

Objective	Instrument	Eligibility	Appropriation		Priorities
			Amount (billion EUR)	Share (%)	
Convergence	ERDF and ESF	Regions with GDP per capita below 75% of the EU25 average	177	58	Innovation R&D Entrepreneurship Information society Local development initiatives
		Regions with GDP per capita below 75% of the EU15 average and above 75% of the EU25	13	4	Environment Risk prevention Tourism Culture Transport Energy Education Health investment Human capital Administrative capacity
	Cohesion Fund	EU countries with GNI per capita below 90% of the EU25 average	61	20	Transport networks Environment including renewable energy
Regional competitiveness and employment	ERDF and ESF	All regions not eligible for convergence funds	49	16	Innovation Knowledge economy Environment Risk prevention Accessibility Human capital
European territorial co-operation	ERDF	Border regions and other regions involved in transnational co-operation	8	2	Innovation Environment Accessibility

Source: European Commission.

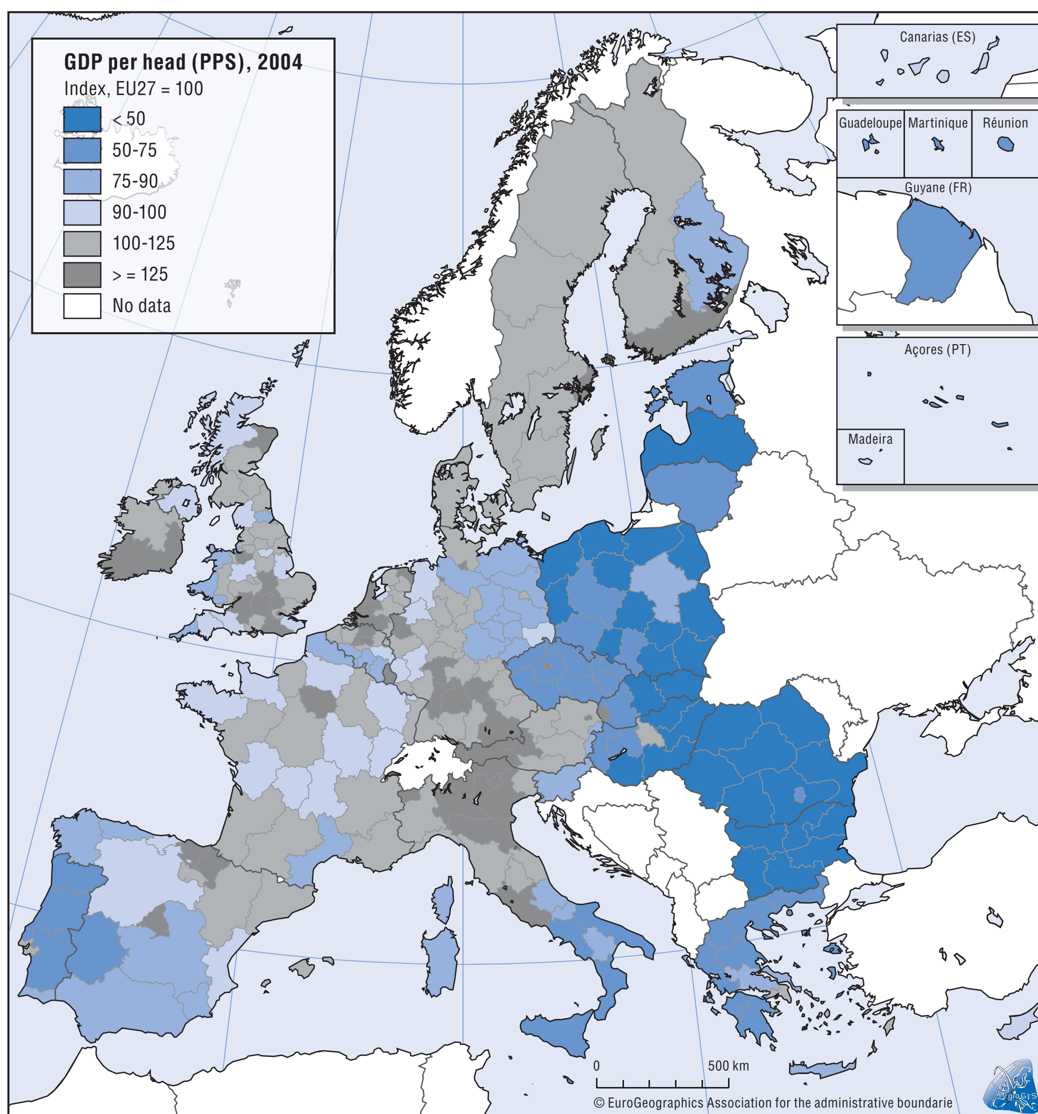
The geographic distribution of the budget

The 2007-13 framework for cohesion policy has been designed with the aim of channelling most of the funds to the poorest regions. The convergence objective was allocated 82% of the EU regional budget (the dark blue areas in Figure 7.2). In the negotiations, the stronger focus on lagging regions and countries was a counterpart of the 8% reduction in the budget compared with the initial Commission proposal.

The focus on the poorest regions does not imply, however, that they are the only recipients of cohesion policy funds (Table 7.4). A 40% share of the EU cohesion policy budget goes to member states with above-median income. In the breakdown of the regional policy budget by country, the second and third largest recipients are Spain and Italy while Germany comes fifth. Spain, Italy and Germany together receive a quarter of the total budget even though their GDP per capita is above the EU average. This situation is both a consequence of the large regional disparities within these three countries and of the size of the population concerned (Figure 7.2). In addition, transfers under EU cohesion policy are capped at a level below 3.8% of the GDP[4] of a recipient country on a yearly basis. This provision, motivated by the considerations about absorption capacity, has the effect of adjusting downward the overall allocation for the poorest and comparatively slow-growing economies.

On a per capita basis, the relationship between cohesion funding envelopes and income is uneven (Figure 7.3). For comparatively rich countries (defined as those with a GDP per capita above the EU25 median), there is a very strong correlation between higher incomes

Figure 7.2. **Rich and poor regions**



Source: European Commission, Directorate General for Regional Policy.

and lower funding under EU regional policy.[5] However, this relationship is less strong for poorer countries (see Figure 7.3) due to the cap on transfers. For instance, with a comparable level of GDP per capita, Estonia is set to receive nearly one and half times as much regional funding per head as Poland and significantly more than its Baltic neighbours.

There may be a risk that EU funding to poor regions within rich countries may (at least partly) substitute for, rather than add to, national regional policy measures which rich countries can afford and would otherwise finance on their own. If it occurred, such "crowding-out" would be a source of considerable deadweight cost (van Roozendaal, 2006). The EU framework for regional policy attempts to reduce this risk through so-called "additionality" requirements. Member states have agreed to adhere to the principle that EU regional funding should not displace their own national measures. To assess compliance with this requirement, the European authorities check that annual national expenditure on items also subsidised by EU regional cohesion funds does not decline in

Table 7.4. **EU regional funds appropriations for 2007-13 by recipient country**

	Amount at 2004 prices						Memorandum item (2004 GDP per person[1])
	Convergence objective		Total EU regional funds				
	Billion EUR	EUR per person in recipient region	Billion EUR	EUR per person in recipient country	Share of GDP (Per cent)	Share of total (Per cent)	
Austria	0.2	159	1.3	161	0.07	0.4	27 600
Belgium	0.6	452	2.0	195	0.09	0.7	26 800
Bulgaria	5.9	753	6.1	768	3.15	2.0	7 100
Cyprus	0.2	265	0.6	812	0.56	0.2	18 800
Czech Republic	23.0	2 252	23.7	2 323	3.25	7.7	15 900
Denmark	0.0	0	0.5	101	0.04	0.2	27 600
Estonia	3.0	2 221	3.1	2 247	3.31	1.0	11 600
Finland	0.0	0	1.5	295	0.13	0.5	25 800
France	2.8	1 623	12.7	208	0.10	4.1	24 900
Germany	14.3	933	23.5	284	0.14	7.6	24 600
Greece	17.4	1 585	18.2	1 658	1.34	5.9	18 600
Hungary	20.2	1 998	22.5	2 210	3.22	7.3	13 600
Ireland	0.0	0	0.8	207	0.06	0.3	31 000
Italy	19.3	1 112	25.6	449	0.25	8.3	24 000
Latvia	4.0	1 725	4.1	1 749	3.52	1.3	9 700
Lithuania	6.0	1 737	6.1	1 757	3.42	2.0	10 800
Luxembourg	0.0	0	0.1	130	0.02	0.0	54 000
Malta	0.7	1 878	0.8	1 922	2.35	0.2	15 800
Netherlands	0.0	0	1.7	105	0.05	0.6	28 200
Poland	59.0	1 546	59.7	1 562	3.43	19.4	11 100
Portugal	18.3	1 750	19.1	1 847	1.82	6.2	16 400
Romania	16.9	778	17.3	795	3.00	5.6	7 300
Slovakia	9.7	1 796	10.3	1 904	3.30	3.3	12 000
Slovenia	3.6	1 827	3.7	1 874	1.70	1.2	17 900
Spain	23.8	1 566	31.5	778	0.49	10.2	22 100
Sweden	0.0	0	1.7	188	0.08	0.5	26 600
United Kingdom	2.6	949	9.5	160	0.07	3.1	26 600

1. In euros at 2004 purchasing power parities.
Source: EU Commission.

real terms from its level in the previous programming period. One potential limitation of this approach is the possibility of reclassifying public expenditure items to ensure apparent compliance while redeploying spending to other areas, while “no decrease in real terms” will seldom bite in most of the fast-growing EU12 countries.

It is debatable whether in the future relatively poor regions within rich member states could remain eligible under the convergence objective, with a view to focusing resources on the poorest ones. The 75% threshold, which has not been modified since the beginning of cohesion policy, happens to be less than 5 percentage points above the GDP levels of 18 EU regions listed on Figure 7.4, 11 of which are located in countries where GDP per head is higher than the EU25 average. However, the financial support from the EU budget to the poorest countries is already considerable as a ratio to their GDPs. Further increasing funding to these countries in the future should be considered against assessing their absorption capacity with particular attention to the potential impact on macroeconomic stability.

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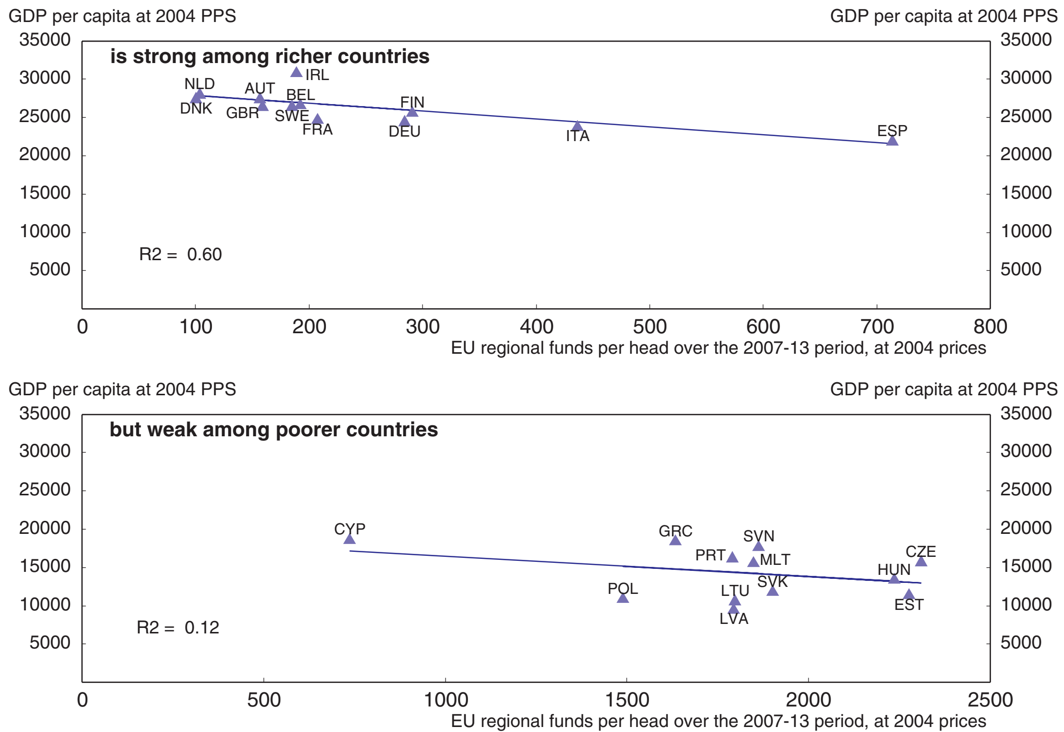
Figure 7.3. **The link between income levels and regional funding envelopes**



Source: Eurostat.

StatLink *http://dx.doi.org/10.1787/084121484126*

The allocation of funds to particular activities

The aims of addressing both EU objectives and local needs

The institutional setup for the allocation of funds aims at ensuring that activities financed under EU cohesion policy are guided by EU objectives as well as by local needs. This aim is reflected in a cascading process that translates the broad objectives enshrined in the treaty into increasingly specific priorities in EU Council regulations, community guidelines, National Strategic Reference Frameworks and Operational Programmes (Box 7.2).

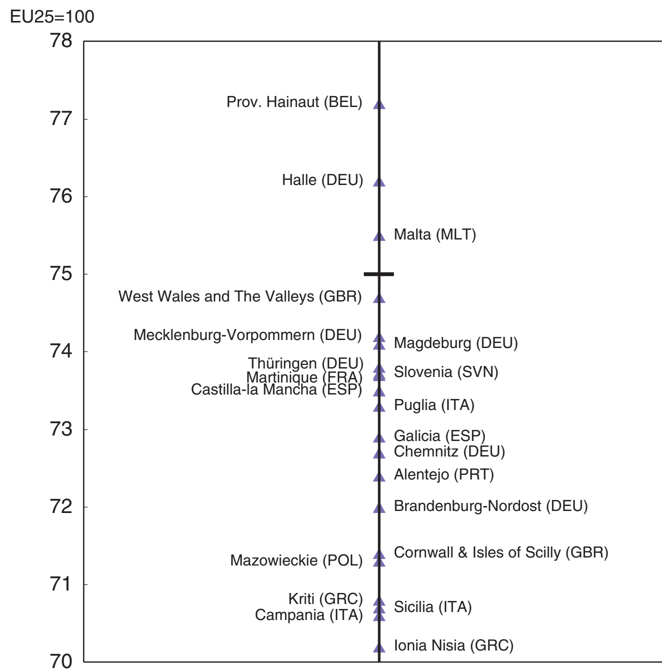
Cohesion Policy 2007-13 aims at reducing regional disparities as enshrined in Article 158 of the treaty. In doing so, it supports the EU's overarching Growth and Jobs (or Lisbon) Strategy (Chapter 1). The tool designed to achieve this goal is the "Lisbon earmarking" requirement. Minimum shares of 60% of expenditure under the convergence objective and 75% of expenditure under the competitiveness objective must go to items the EU authorities have identified as contributing to the objectives of the Lisbon Strategy.

A high degree of delegation to local authorities

A key guiding principle for the implementation of Cohesion Policy 2007-13 is to delegate most of the management of funds to national and regional authorities. To be sure, the process governing the allocation of funds gives a strong role to the Commission in its earlier stages (Box 7.2). However, once National Strategic Reference Frameworks and Operational Programmes are agreed, national and regional authorities are entrusted with identifying and funding individual projects and actions. Member states have to comply

Figure 7.4. **Regions close to the 75% eligibility threshold**

Average 2000-02 GDP per capita, relative to EU25



Source: Eurostat.

StatLink http://dx.doi.org/10.1787/084177648805

with a number of monitoring and auditing requirements, including regular reporting and evaluation, separation of responsibilities between managing, certifying and auditing authorities, and the member state's auditing system must also be certified.

Cohesion policy further encourages recipients to bear responsibility for individual projects and actions ("local ownership") by contributing to their financing from their own resources. Minimum co-financing requirements vary by objective and fund:

- 15% for the Cohesion Fund,
- 25% for the ERDF and ESF under the convergence and co-operation objectives,[6] and
- 50% for the ERDF and ESF under the competitiveness objective.

The Commission retains part of the responsibility for individual projects that exceed pre-defined cost thresholds in the areas of environment and transport. The thresholds are € 50 million in the transport sector and € 25 million for environmental infrastructure. Projects whose costs exceed these thresholds are subject to full cost-benefit analysis and Commission approval.

Rising to the challenge of an ambitious objective

More than just income transfers – supporting endogenous growth

Cohesion policy has been assigned an ambitious objective with limited means. Reducing regional disparities with a budget amounting to less than half a per cent of EU output is a tall order. If regional funding disbursements were to be pure income

Box 7.2. The allocation of EU funds under Cohesion Policy 2007-13: a cascading process

Four EU Council Regulations provide the legislative framework governing cohesion policy: a general regulation laying down the general provisions governing all funds and one specific regulation for each fund (ERDF, ESF and Cohesion Fund). The European Parliament approved the four draft regulations on 4 July 2006 and they entered into force on 1 August 2006. The legal processes through which the regulations are adopted require a high degree of consensus.

The Community Strategic Guidelines on Cohesion define broad orientations governing the use of EU cohesion funds. The Community Strategic Guidelines take the legal form of a Council decision. After a year of consultations on the basis of a communication released in July 2005, the Commission tabled a proposal that was adopted by Council in October 2006.

Consistent with the orientations defined in the Community Strategic Guidelines, EU countries propose National Strategic Reference Frameworks which describe how each country intends to implement the EU priorities for regional policy across its territory. National Strategic Reference Frameworks are negotiated with and ultimately adopted by the Commission. National Strategic Reference Frameworks are due for adoption before the end of 2007.

For each fund, Operational Programmes then spell out the priorities and management methods governing the use of the corresponding funds. National or regional authorities propose draft Operational Programmes for approval by the Commission. Operational Programmes are due for adoption before end 2007.

Once these steps have been completed and the corresponding documents have been endorsed by the Commission, the national and regional authorities are responsible for the management of the programmes.

Each year, prior to the Spring European Council, member countries and the Commission issue progress reports on the implementation of the cohesion policy.

transfers, they could do little to close income gaps. In the six countries where regional fund payments are poised to amount to more than 3% of GDP each year, GDP per capita is below half the EU average. The implication is that on its own the sole mechanical impact of transfers under Cohesion Policy 2007-13 will cut less than a tenth off the distance that separates these countries from the average.

If it is to meet its aims of reducing regional disparities, regional policy has to do more than transfer resources: it must focus on spending items which can help kick off endogenous growth. With the "Lisbon earmarking" requirement, Cohesion Policy 2007-13 focuses on growth-oriented activities by directing resources in accordance with the guidelines identified in the EU's Growth and Jobs Strategy. The introduction of this link between cohesion policy and the broader economic objectives of the Union is in line with a recommendation made in the *2004 Economic Survey of the Euro Area*.

A limitation of the "Lisbon earmarking" requirement is that it does not apply in the twelve countries that joined the European Union after 2004 even though they together receive more than half of all EU regional funds. However, in their national action plans they have all voluntarily adhered to the earmarking. This is encouraging as the new member countries are the ones most in need of rapid catch-up, so focussing on growth-boosting items is especially important there to help them integrate fully with the rest of the Union.

Second, in the fifteen countries where the requirement applies, the wide scope of eligible activities implies that in practice the "Lisbon earmarking" requirement is likely to have only a limited effect on allocation decisions (Box 7.3). Polverari *et al.* (2006) highlight the concern that "the breadth of the definition of 'Lisbon' would effectively rule very little out for the purposes of earmarking". The experience with previous rounds of cohesion policy is that investment in human and physical capital is more effective than items such as subsidies to existing activities which the Community Strategic Guidelines under discussion consider a priority for rural areas. There is widespread agreement in recent studies that regional policy should give a high degree of priority to investment in human capital and physical infrastructures and avoid any form of wage subsidy (Badinger and Tondl, 2005; Eckey and Türk, 2006; Fenge and Meier, 2006; Fitz Gerald, 2004).

Box 7.3. **Activities eligible under the "*Lisbon earmarking*" requirement**

Cohesion Policy 2007-13 regards the activities in the following spending items as eligible for meeting the "Lisbon earmarking" requirement because they have been identified as contributing to one of the 24 priorities of the Lisbon strategy:*

- Research and technological development (R&D), innovation and entrepreneurship: R&D activities in research centres, R&D infrastructure, technology transfer between small- and medium-sized enterprises (SMEs), assistance to R&D in SMEs, advanced support services for firms, assistance to SMEs for environmentally friendly products and production processes, investment in R&D-related equipment, other investment in firms, other measures to stimulate R&D or entrepreneurship in SMEs.
- Information society: telecommunications infrastructure, information and communication technology (ICT) equipment, services and applications for the citizen and SMEs, other measures for the use of ICT by SMEs.
- Transport: railways, motorways, multimodal transport, intelligent transport systems, airports, ports, inland waterways.
- Energy: trans-European networks for electricity, natural gas and oil; renewable energy; energy efficiency.
- Environmental protection: promotion of clean urban transport.
- Adaptability of workers and firms: development of life-long learning systems and strategies, design and dissemination of productivity-enhancing organisational practices.
- Improving access to employment and sustainability: modernisation and strengthening of labour market institutions, implementing active and preventive measures on the labour market, measures encouraging longer working lives, support for self-employment, measures to reduce sex-based discrimination in the labour market and to reconcile work and private life.
- Improving the social inclusion of less-favoured persons: pathways to re-entry into employment for disadvantaged people, promoting diversity in the workplace.
- Improving human capital: reforms in education and training systems to develop employability, measures to increase participation in lifelong learning, and develop post-graduate studies and networking activities between universities, research centres and businesses.

* See EC (2005) for the list of and more details on the 24 priorities.

Source: Council Regulation 1083/2006, Annex IV.

Supporting economic integration and catch-up mechanisms

Even with substantial rates of return, regional policy funds can only account for a small part of the expected convergence in lagging regions to the EU average. Analysing the experience of Ireland, Portugal and Spain over the 1990s, Fitz Gerald (2004) concludes that, while EU regional funds have helped, freer trade and economic integration with the rest of the European Union have been the main drivers of the convergence of these countries.

While they involve limited amounts, provisions related to social housing in the 2007-13 regional cohesion framework could in certain situations work in the direction of hampering mobility. On the other hand, providing social housing in growth areas where deficits in the supply of low cost housing slows growth may in some cases support mobility. In previous rounds of cohesion policy, the possibilities to use EU regional funds to build social housing projects were very limited. As a result of the negotiations on the 2007-13 package, social housing is now eligible for EU funding in new member states under specific conditions and with a capping on the total amount (maximum 3% of total regional fund budget of the member state). This responds to social policy objectives, but one difficulty could be that entitlement to a social housing flat often comes only after a long queuing process and is not portable geographically, with the implication that beneficiaries will be more reluctant to move closer to better job opportunities than they otherwise would have been.

One condition for cohesion policy to be effective in reducing disparities is to take into account the need that wages evolve in line with productivity. If, in combination with local and national policies, the disbursement of regional policy funds contributes to pushing up wage inflation in recipient regions over what productivity gains warrant, the process of catch-up can slow down or stop.[7] In this regard, when implementing the priority assigned by the Community Strategic Guidelines to subsidising the provision of public services in rural areas, the wages paid in the subsidised services should reflect local productivity conditions.

Ensuring efficient delivery

Meeting ambitious goals on a tight budget requires creating strong incentives for recipients to maximise returns on the allocated funds. There is a trade-off between the benefits of detailed reporting to the providers of the funds (the Commission in this case) on the value delivered by individual activities and the benefits of more managerial autonomy and less red tape. It is generally agreed that a high co-financing rate reduces this trade-off: if local decision makers are committing local resources alongside EU funds on a given activity, they will have to show value for money to their local constituencies, which reduces the need for central oversight. In its current setup, Cohesion Policy 2007-13 combines low co-financing requirements (15% for the Cohesion Fund) with a high degree of local autonomy in the use of EU funds. An implication is that the current framework may offer room to improve the trade-off between the benefits of central oversight and local autonomy in encouraging efficiency.

Well-functioning local government institutions are key to maximising the benefits of regional policy. In previous rounds of cohesion policy, the high degree of Commission involvement in the management of the programmes proved a powerful incentive to improve local governance, even if it was perceived by some as sometimes intrusive (Fitz Gerald, 2004). The situation is now different because under the 2007-13 cohesion policy framework the management of programmes is delegated to national, regional and local authorities. The Community Strategic Guidelines for 2007-13 recognise the need for sound local governance and include a recommendation that some regional funds be used to

finance activities that improve administrative capacity. Empirical evidence suggests that implementing this recommendation is particularly important: while the debate on the overall effectiveness of EU regional policy is still largely inconclusive (see OECD, 2004 for a survey), there are clear indications that EU regional funds have delivered measurable results in areas with sound governance (Ederveen *et al.*, 2006). In this context a positive development is the inclusion, under the 2007-13 cohesion policy framework, of a specific institutional capacity development priority targeted at the convergence regions.

Another way of encouraging efficiency in the local management of regional funds is to have them expire after a certain time. By definition time limits avoid protracted delays and can therefore encourage recipients to speed up procedures and adopt more efficient processes. The EU authorities have confirmed the "use it or lose it" rule in which unused funds expire after two years.

Funding should be conditional on results

Some regions have been absorbing high levels of regional funding for many years, with little evident payoff. This reflects a combination of the projects selected and the fact that in some areas development is being held back not by a lack of cash but by regional and national policies, including labour market, welfare and regulatory policies (OECD, 2004). Funds are scarce, and the demands on them have risen with the accession of 12 relatively poor countries to the Union. The effectiveness of regional policy could be enhanced if more of the funding was made conditional on results so that resources get pulled out of regions where they are not achieving a great deal and towards the regions where the returns are highest. There are several options for achieving this:

- *Automatic sunset clauses*. Programmes should be time-limited and should be carefully evaluated against objective criteria, preferably by an independent agency. Programmes that do not meet pre-set objectives should be halted. In the 2000-06 period, EU-funded regional development programmes were subject to an *ex ante* evaluation, a mid-term review and an *ex post* evaluation. The available evidence suggests that this process has contributed to improving governance at the local and regional levels (OECD, 2006). Tying this process to sunset clauses would be helpful.
- *An EU-wide performance reserve*. Funds could be set aside so that regions that do not achieve measurable performance criteria (such as a certain increase in per capita GDP or the employment rate) lose some of their funding, with the resources going back into an EU-wide pool for reallocation to regions that do meet the criteria. In the current funding period a national performance reserve exists, but it is not quite the same thing. It sets aside 3% of resources allocated under the convergence and regional competitiveness objectives, with the funds being released in 2011 if a country meets certain criteria. That is, the last 3% for each country is held back. But at 3%, the size of the reserve is too small to make a real difference; it is optional; and it is national, so funds do not get redistributed to other countries. Moreover, it is a step backwards compared with the performance reserve in the 2000-06 funding period because the previous system was larger (4% of funding) and compulsory.
- *Rewarding success*. Within each funding period, funding could grow in line with per capita GDP rather than being allocated in fixed amounts. That way, a region that grows faster would see its funding expand automatically. However, between funding periods the current arrangements would need to apply to ensure that regions that grow out of poverty eventually lose their cohesion funding.

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Conclusions

Reducing regional disparities with funds amounting to less than half a per cent of output is a tall order. With the reforms that have accompanied the preparation of the 2007-13 round of regional policy, substantial progress has been made towards implementing changes aimed at improving the efficiency of regional policy in line with the recommendations in the *2004 Economic Survey of the Euro Area* (Table 7.5). Making further headway requires concentrating the limited resources on the areas that most need them, focussing spending on items that generate the highest returns and ensuring maximum efficiency. Box 7.4 summarises recommendations to these ends.

Table 7.5. **Progress in implementing recommendations in the 2004 *Survey***

Recommendation	Action taken
Allocate regional funds to those countries and regions that most need them	Some movement has been made towards greater focus on poorer areas.
Bring regional development programmes in line with the EU economic policy framework	In the EU15 countries, minimum shares of EU-funded regional policy expenditure must go to areas identified in the EU Growth and Jobs ("Lisbon") Strategy.
EU spending on regional development should be conditional on the capacity of the region to properly channel or absorb the funds	An incentive scheme has been introduced, but only on a voluntary basis. Institutional development is one of the priorities of the framework for cohesion policy in 2007-13.
Limit the availability of funds in time	The "use it or lose it" clause introduced in 2000 has been confirmed for the new programming period 2007-13.
Further expose agriculture to foreign competition	See Chapter 6.

Box 7.4. **Recommendations concerning regional cohesion policy**

Bearing in mind that the framework for cohesion policy for 2007-13 has been adopted and is being implemented, the following recommendations could be considered for the future.

- Ensure that funds are allocated in the most effective way. This could involve:
  - Introducing sunset clauses and independent project assessments so that programmes that are not performing get shut down.
  - Introducing an EU-wide performance reserve for reallocating funds to the projects where the payoffs are highest.
  - The "Lisbon earmarking" requirement should cover all EU countries and the list of eligible activities should be narrowed down, putting more emphasis on investment in human capital and critical infrastructure projects. State aid for large industries should not be eligible.
- Regional policy should boost employment opportunities in each region, without creating obstacles to labour mobility. EU regional funding for social housing projects should be limited and conditional on recipient countries ensuring geographic mobility of beneficiaries (when a new job is the reason for the move).
- In countries eligible for the Cohesion Fund, a higher minimum co-financing rate than the current 15% or alternatively a closer involvement of the Commission in the management of programmes would strengthen the incentive to pursue maximum value for money. The EU authorities should:
  - Ensure that activities to improve administrative capacity receive a high degree of priority in the allocation of funds. And
  - Closely monitor the selection and implementation of projects to ensure that recipients are maximising value for money.

Notes

1. See for instance the literature review in the 2004 *OECD Economic Survey of the Euro Area*, plus Eckey *et al.* (2006) and de Siano *et al.* (2006).
2. In this chapter, the term regional policy is used as a synonym for cohesion policies (in Brussels terminology, regional policy is a subset of cohesion policy).
3. Article 267 of the treaty establishing the European Community.
4. The cap depends on the income level of the country and is on a sliding scale that varies between 3.7893% for countries whose GNI per capita is under 40% of the EU25 average, to 3.2398% for those in the 70-75% range.
5. Using the data in these graphs, a regression with the logarithm of per capita regional funding as the dependent variable and the logarithm of GDP per capita as the independent variable gives a slope coefficient of –5.1 for rich countries and a statistically insignificant –0.4 for poorer countries. The R-squared statistics are 0.60 and 0.12 respectively.
6. This co-financing requirement is loosened to 20% for EDRF and ESF funding under the convergence objective in countries that are eligible for the Cohesion Fund.
7. Ireland in the 1980s is an example (Fitz Gerald, 2004).

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Chapter 8

Removing obstacles to geographic labour mobility

The free movement of persons is a key objective of the European Union as it can foster the sense of European citizenship and enhance the working of the EU economy. This chapter reviews recent trends in labour mobility in the Union with a special focus on migration from the new member states. It then discusses how policy reforms can help to lower barriers to labour mobility between EU countries.

The Treaty of Rome enshrined the free movement of persons as one of the "four freedoms" guaranteed in the single market. The main reason was political as mobility is seen as a powerful way of fostering the development of a European identity. The European Union particularly focuses on the cross-border mobility of workers, a subject to which the treaty devotes a full chapter. The importance of this goal was recently illustrated by the decision to make 2006 the European Year of Workers' Mobility.

In addition to its political motivation, labour mobility can bring large benefits for the economy, and for these reasons, geographic labour mobility is also an important goal of the Lisbon Strategy:

- First, it can lead to a more efficient labour market with a better job matching across the Union.
- Second, it provides a useful adjustment channel in the face of asymmetric shocks for members of the monetary union.
- Third, in countries where they do not face obstacles to their employment, immigrants can lower structural unemployment by lowering the reservation wage of local workers. Immigrants may also target regions and sectors where labour demand is strong, thereby reducing labour market pressures. These two effects "grease the wheels of the labour market" and lower the structural rate of unemployment (Borjas, 2001; Saleheen and Shadforth, 2006; Blanchflower *et al.*, 2007). However, the opposite can happen where high minimum labour costs combined with high social transfers generate unemployment traps.
- Fourth, emigration countries can benefit from labour mobility. Movers who return after acquiring human capital in more advanced countries can boost productivity (Heinz and Ward-Warmedinger, 2006). Remittances from emigrants can also be a sizeable source of income for their family members in emigration countries. In addition, emigration can serve as an adjustment channel in the wake of unfavourable asymmetric shocks.

Patterns of labour mobility in Europe[1]

General trends

Most working-age immigrants living in EU countries come from outside the Union rather than from another EU member state (Table 8.1). Belgium, Ireland and Luxembourg are the only EU countries where citizens from other EU countries are more numerous than third country nationals. Overall, non-EU immigrants make up 3.4% of the EU25 working-age population.

According to labour force statistics (LFS) (which are subject to considerable uncertainty),[2] mobility *within* the EU is much lower, as only 1½ per cent of working-age EU citizens live in another EU country (Table 8.1). On average between 2000 and 2005, the internal borders of the EU were crossed by only 0.1 to 0.3% of the working-age population each year, although geographic mobility within the EU member states is on average higher at about 1%, similar to the rate across Canadian provinces (Figure 8.1).[3] Anecdotal and

Table 8.1. **Share of working-age foreigners in EU countries**[1]

Per cent of working-age population, 2005

Country of residence	Citizenship			Country of residence	Citizenship		
	EU15	EU10	Non-EU25		EU15	EU10	Non-EU25
EU10	**0.1**	**0.1**	**0.5**	Ireland	2.7	1.9	2.7
EU15	**1.5**	**0.3**	**4.0**	Italy	. ..	. ..	. ..
EU25	**1.2**	**0.3**	**3.4**	Latvia	. ..	. ..	(0.4)
Austria	1.7	1.4	7.1	Lithuania	. ..	. ..	(0.4)
Belgium	4.4	0.3	2.8	Luxembourg	32.9	(0.2)	3.2
Cyprus	5.5	(0.3)	7.4	Malta	1.1	. ..	1.7
Czech Rep.	(0.0)	0.3	0.4	Netherlands	1.3	0.1	2.6
Denmark	0.9	(0.2)	2.5	Poland	. .	. ..	0.1
Estonia	. ..	. ..	8.4	Portugal	0.4	. ..	2.6
Finland	0.3	0.3	3.1	Slovak Rep.	. ..	(0.1)	(0.1)
France	1.8	0.1	3.6	Slovenia	. ..	. ..	(0.4)
Germany	1.9	0.6	5.4	Spain	1.2	0.2	8.4
Greece	0.2	0.4	5.3	Sweden	2.0	0.3	3.1
Hungary	(0.1)	. ..	0.5	United Kingdom	1.7	0.4	4.0

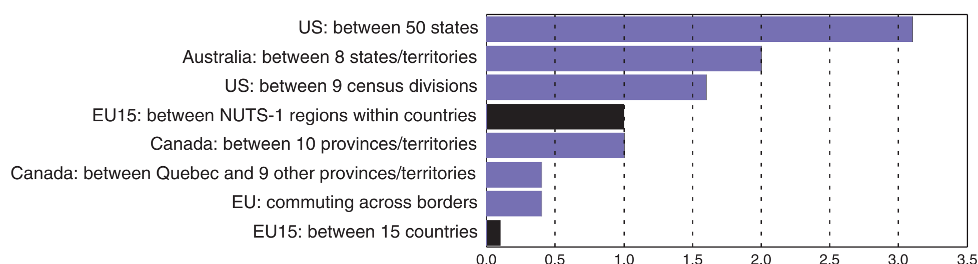
Note: Figures in brackets are subject to large uncertainty due to a small sample size.

1. Following Bulgaria and Romania's accession to the EU, in the case of Spain and Italy the percentages of community and non-community foreigners will be altered substantially.

Source: Eurostat, LFS, spring data.

Figure 8.1. **Annual cross-border labour mobility**

Per cent of the working-age population, 2000-05



Source: US Census Bureau, *Current Population Survey*; Eurostat, *Labour Force Statistics*; Statistics Canada; OECD (2005), *Employment Outlook*, Chapter 2, Paris.

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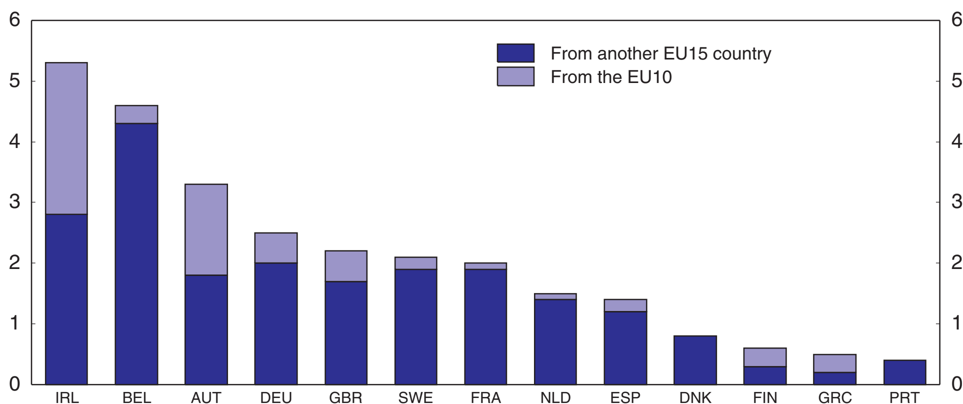
other evidence suggests that for some countries migration rates in Table 8.1 may be under-reported and that migration may have increased since 2005 into countries that have been growing rapidly such as the United Kingdom, Spain and Ireland. In the United Kingdom, for instance, data from the worker registration scheme suggest that half a million migrants from new member states (1.2% of the UK working-age population) entered the country between May 2004 and late 2006 (Blanchflower *et al.*, 2007).[4] In Spain, statistics issued recently by the Economic Bureau of the President (2006) suggest that immigrants from other EU member states made up 1.8% of the working-age population in 2006 (against 1.4% according to LFS for 2005 as shown in Table 8.1). In Ireland, the share of immigrants from new member states in the working-age population was up to 2.8% in the second quarter of 2006 (Irish Central Bank, 2007).

Limited migration from the new member states

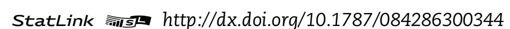
Despite widespread concern about social dumping and large inflows from new member states following the recent waves of enlargement (Sinn and Ochel, 2003), the share of workers from the EU10 countries was still very modest in most EU15 countries in 2005 (Figure 8.2). Even though inflows of EU10 workers may have been large in some countries in 2006 (see above), they are unlikely to be large enough to alter the observation that the stock of EU10 workers is low in most EU15 countries. Ireland and Austria are two exceptions, reflecting special factors. Combined with a policy of openness to EU10 workers (see below), the Irish economic boom has attracted large numbers of immigrants from new member states – but the strong Irish economy has also been a magnet for many mobile workers coming from the EU15 (Figure 8.2). In Austria, long-standing historical links with new member states and shared borders with four of them largely explain why EU10 immigrants make up an important share of the population, despite the restrictions it imposed. The case of Sweden has largely belied fears of social dumping: even though the country opened its borders and its generous welfare system to EU10 workers, their share in the working-age population has remained extremely small. EU15 immigrants still outnumber EU10 immigrants in all EU15 countries according to LFS statistics for 2005, except in Greece.

Figure 8.2. **The stock of mobile workers in EU15 countries**

Per cent of destination country working-age population, 2005



Source: Eurostat and OECD calculations.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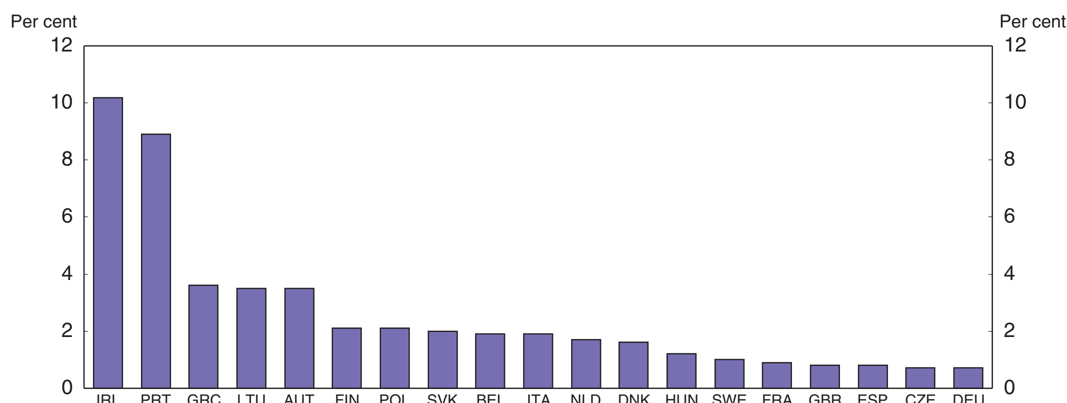
While migration from the new member states has not flooded "old Europe", it has not hollowed out "new Europe" either. As of 2005, emigrants to EU15 countries made up only a low share of the home working-age population in all EU10 countries except Lithuania (Figure 8.3). Migration out of EU10 countries has not so far reached the levels observed in Ireland or Portugal (Figure 8.3). Moreover, as anticipated in OECD (2001), most EU10 countries have attracted significant numbers of migrants from their eastern neighbours. Apart from Lithuania where net emigration was strong, EU10 countries have consequently recorded either very small net outflows (Estonia, Latvia, Poland) or even net inflows.[5]

Figure 8.3. **Workers living elsewhere**

EU citizens who are active in a foreign EU15 country, 2005[1]



1. Per cent of home country working-age population.

Source: Eurostat and OECD calculations.

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Commuting is another form of mobility

Commuting to work is an alternative to making a permanent move to a different country. It enables employers to tap into the labour supply beyond their local labour markets. In 2005, 0.4% of the EU working-age population commuted between member states. Slovakia has by far the highest rate of commuting (from a source country perspective): more than 5% of the working-age population commutes to work mainly in the neighbouring Czech Republic and Austria. The highest rate in the EU15 is for Belgium (2.5%) among source countries. Among destination countries, Luxembourg by far has the highest share of cross-border commuters in its workforce (35% in 2005).[6]

Characteristics of mobile workers

Recently mobile workers (defined as active working-age foreigners who have been living in their current country of residence for less than five years) are on average younger than the rest of the working-age population (Table 8.2). The trend is particularly pronounced among EU10 movers as nearly four in five of them are less than 35 years old. Another characteristic of recently mobile workers is that they are more likely to be unmarried and have fewer children than the general working-age population. These features are unsurprising as moving across borders is easier for young people without family ties. Women make up about half of the migrants from the new member states and 43% of EU15 mobile workers (a proportion very close to the share of women in the EU15 workforce).

Partly owing to their youth, mobile workers have higher average educational attainment levels than the workforce they are joining. Higher education graduates make up a much larger share of EU15 movers than in the entire EU15 employed population (Table 8.2). The same is not true of EU10 movers, who are slightly less likely than EU15 workers to have received higher education. EU10 migrants tend to have intermediate skills. EU10 workers are nonetheless more likely than local workers to be engaged in elementary occupations.

The occupational distribution of mobile workers is different from that of the local workforce. Mobile workers from both old and new member states are comparatively numerous in the hotel and restaurant sector (Figure 8.4). Some sectors exhibit differences

Table 8.2. **Employment of recently mobile workers by age, education and occupation**

Per cent of total, 2005

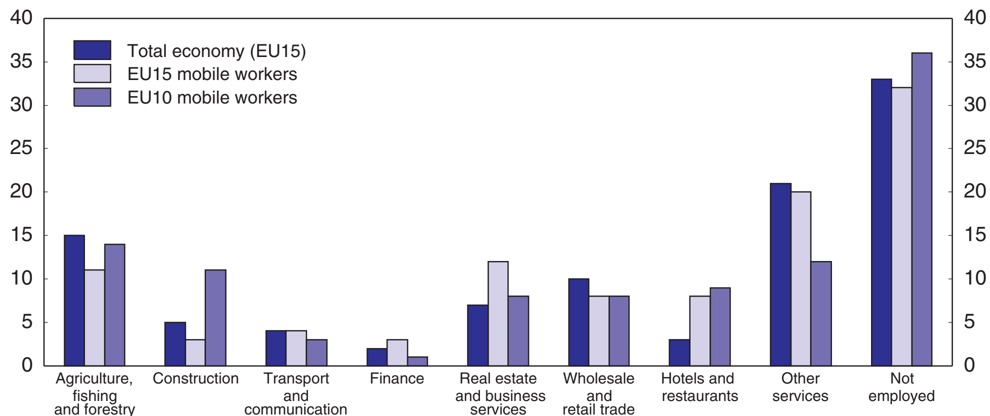
	Mobile workers from EU15	Mobile workers from EU10	Mobile workers from outside EU	Overall employment in EU15
Age Group				
15-24	12	27	19	12
25-34	48	51	46	24
35-64	40	22	35	64
Education				
Low	15	15	36	27
Medium	41	63	40	47
High	44	22	24	26
Occupational level				
High-skilled white collar	55	16	20	40
Low-skilled white collar	24	28	25	26
Skilled manual	12	27	21	25
Elementary tasks	9	30	35	10

1. Recently mobile workers are defined as active working-age foreigners who have been living in their current country of residence for less than five years.

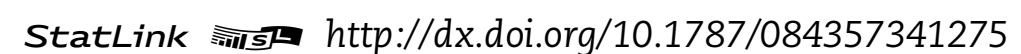
Source: Eurostat, LFS, Spring results.

Figure 8.4. **Occupation of recent movers to the EU15**

Per cent of EU15 working-age population, 2005



Source: Eurostat and OECD calculations.


StatLink http://dx.doi.org/10.1787/084357341275

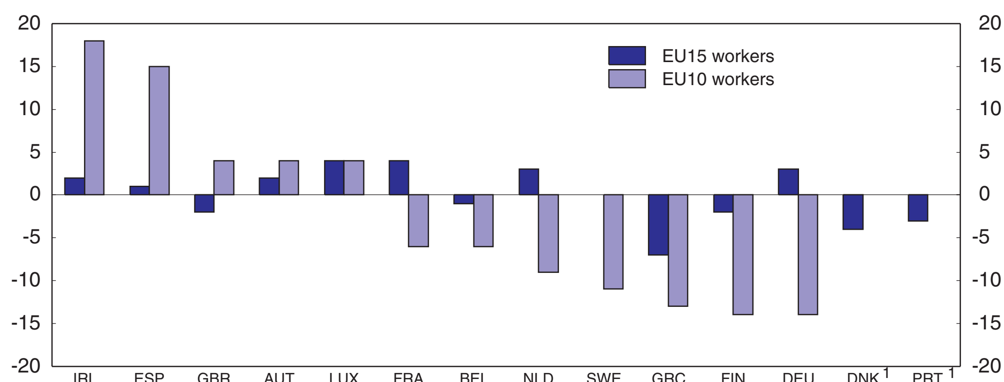
between EU15 and EU10 movers: mobile workers from EU15 countries are more likely than the local population to work in business services and real estate activities, while EU10 immigrants are overrepresented in construction. A related, important difference is that a majority of EU15 mobile workers are engaged in high-skilled occupations while a majority of EU10 mobile workers accomplish manual or elementary tasks. Thus, they are more likely to be overqualified for the jobs they do.

Labour market outcomes of mobile EU workers

The labour market performance of mobile EU15 workers, measured by the employment rate, compares well with that of the overall working-age population. The difference between the two employment rates is less than 5 percentage points in all EU15 countries except Greece (Figure 8.5). The situation is much more contrasted for workers from new member states. In Ireland and Spain, EU10 workers have a considerably higher employment rate than the overall working-age population. In Germany, Finland, Greece and Sweden, workers from the new member states have a significantly lower employment rate than the overall working-age population.

Figure 8.5. **Employment rates of mobile workers**

Difference relative to national employment rate in the destination country, 2005



1. No data for EU10 workers in Denmark and Portugal.

Source: Eurostat and OECD calculations.

StatLink http://dx.doi.org/10.1787/084424552612

Policies

Truly free movement of labour within the Union requires more than just the fundamental freedom enshrined in the treaty. First, language and cultural barriers obviously play a role. Second, workers from new member states still face explicit barriers to their mobility within the Union. Third, even with a right to work in every member state, EU citizens face obstacles such as differences in rules governing social security coverage, the accrual of occupational pension rights, the recognition of their professional qualifications and entitlement to social housing. Fourth, domestic policy settings, especially in the housing market, can also hamper cross-border labour mobility within the EU. Among these barriers, the rest of the chapter looks at the most important policy obstacles.

Explicit restrictions on workers from new member states

Enlargement treaties allow member states to restrict inflows of workers from new member states. Restrictions can be imposed on workers from the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia and Slovakia (a group thereafter referred to as EU8 countries) as well as on those from Bulgaria and Romania.[7] The restrictive measures can be maintained for up to seven years after the entry of new member states into the EU, that is to say until May 2011 for EU8 countries and December 2013 for Bulgaria and Romania. In most countries that apply them, the restrictions imply that national authorities will allow

migrants from new member states to work only if they pass "labour market tests" typically aimed at ensuring that they will not displace local employment. While initially a large majority of old member states initially chose to impose restrictive measures (except Ireland, Sweden and the United Kingdom), a number of countries relaxed them in the second phase that started in May 2006 (Table 8.3). While new member states have the possibility to put reciprocal barriers in place, only Hungary was doing so as of March 2007.[8]

Table 8.3. **A number of EU15 countries still impose restrictions on workers from new member states**

	Entry of EU8 workers		Entry of workers from Bulgaria and Romania[1]
	May 2004 to April 2006	May 2006 to April 2009	2007-08
Austria	Restricted	Restricted	Restricted
Belgium	Restricted	Restricted	Restricted
Denmark	Restricted	Restricted	Restricted
Finland	Restricted	Open	Open
France	Restricted	Restricted[2]	Restricted[2]
Germany	Restricted	Restricted	Restricted
Greece	Restricted	Open	Restricted
Ireland	Open	Open	Restricted
Italy	Restricted	Open[3]	Restricted[4]
Luxembourg	Restricted	Restricted	Restricted
Netherlands	Restricted	Open[5]	Restricted
Portugal	Restricted	Open	Restricted
Spain	Restricted	Open	Restricted
Sweden	Open	Open	Open
United Kingdom	Open	Open	Restricted

1. Bulgarian and Romanian workers also face restrictions in Hungary and Malta.
2. Except for health care, transport, construction, hotels and catering.
3. Since July 2006.
4. Procedures for obtaining work permits are simplified in certain sectors.
5. Since May 2007. Between May 2006 and April 2007, the Dutch labour market was open to EU8 workers in a large number of sectors.

Source: European Commission and *www.euractiv.com*.

Portability of social security entitlement

Legislation was introduced as early as 1958 to ensure, *inter alia*, the portability of social security rights across the EU. The relevant regulations were updated regularly, last in 2004 to extend its scope and clarify implementation rules. The legislation is simple in spirit: mobile workers and their families benefit from social security coverage and must pay corresponding contributions in the host country.[9] In the absence of harmonised national schemes, EU law on social security aims at ensuring that workers take their accrued rights with them when they cross national borders. In practice, this arrangement requires good co-operation and co-ordination among member states.

The general principle (with some exceptions) is that workers enter the host country's social security system. The regulation on the co-ordination of social security schemes is very broad in scope. It covers sickness benefits, parenthood and family benefits, invalidity benefits, statutory old-age pensions, death grants, survivors' benefits, benefits related to accident at work and occupational diseases, and unemployment benefits.

The portability of *health insurance* has by and large been a success. The right is in principle straightforward to implement: mobile workers receive the same health-care rights as nationals. Implementation challenges arose, though, concerning the reimbursement of cash advances made in the host country to the mobile patient (Jorens and Hajdú, 2005 and 2006). The launch as of June 2004 of the European Health Card has considerably simplified practical procedures and in particular speeded up reimbursement.[10]

Similarly, *statutory contributory pension rights* are largely portable across countries. The principle guiding the implementation of the 1971 regulation is fairly simple: retired workers draw pensions from the social security schemes to which they have contributed in accordance with the rules of the different systems. Compliance with the vesting period in each member state is assessed against the workers' full employment history in all EU member states.

The large variation in statutory retirement ages across the EU, coupled with features of employment protection legislation (EPL), creates an obstacle to mobility. Elderly workers considering a move from a country where the retirement age is high to one where it is low are faced with the risk of incurring a period with little replacement income. Take the example of a 50-year-old Dutch worker who thinks of moving to work in France where he is offered an indefinite duration contract. French data on layoffs by age suggest that he incurs a very high risk of being made redundant when he reaches the local statutory retirement age of 60.[11] That the probability of layoff spikes at age 60 probably owes much to EPL, which is very strong before 60 and greatly reduced afterwards. If the risk materialises, the worker will receive a very small French pension and no Dutch pension from the time of the layoff until the age 65 because the retirement age is 65 in the Netherlands. The consideration of this risk is bound to impact on the mobility decision. Recent and ongoing reforms in many member countries, which tend to lower the importance of minimum pension ages and to base replacement rates more on actuarial rules, go in the direction of lowering this barrier to mobility.[12]

There is both an upside and a downside to the portability of *unemployment benefits*:

- On the one hand, the movement of unemployed workers to areas offering better employment opportunities can be an effective way of absorbing asymmetric labour demand shocks. While very powerful in the United States (Bayoumi and Prasad, 1997; Davis *et al.*, 1997), this channel has consistently been found to be much weaker in the EU (Blanchard and Katz, 1992; Décressin and Fatás, 1995; Kézdi, 2002). Of particular concern is that adjustment through migration in response to labour demand shocks is also very weak in the euro area (L'Angevin, 2007), where it is more acutely needed in the absence of the nominal exchange rate channel (Cadiou *et al.*, 1999; Heinz and Ward-Warmedinger, 2006).
- On the other hand, unfettered portability entails a risk that recipients of high and long-lasting replacement incomes may move to countries with low price levels (and possibly also attractive climates). Replacement incomes tailored for high-price countries can be close to or even exceed wages for the same skills in low-price countries, thereby creating little incentive to take up a job.

The establishment of portability rights for unemployment benefits therefore requires careful design to promote adjustment through migration while avoiding rent-seeking behaviour. The EU framework for social security co-ordination aims at achieving this balance by guaranteeing the cross-border portability of unemployment insurance benefits but limiting it to three months.[13] After that, they may be entitled to nothing. A

three-month limit is clearly tight enough to prevent abuse. However, it is a very short time to find a new job in a foreign country, on an EU labour market where unemployment lasts 16 months on average.[14]

An option to encourage greater mobility of the unemployed would be to loosen the time limit while at the same time enforcing job-search and availability-to-work requirements with the same stringency as in the home country. However, given that each national employment service can hardly be expected to stand ready to implement the rules of 26 other countries, implementing such a scheme would first require setting minimum job-search and availability-to-work requirements across the Union. A practical way of progressing towards this end would be to reach bilateral portability agreements between countries which enforce similar unemployment insurance conditions. Nordic countries offer a concrete example: unemployed persons returning to a Nordic country where they previously acquired unemployment insurance rights can claim unemployment benefits there and are subject to local job-search and availability-to-work requirements.[15]

A practical way of facilitating the mobility of the unemployed is to ensure easy access to job vacancies across the EU. An important step has been made in this direction with the Commission's launch of the EURES internet portal for job offers in 2006. The EURES portal regroups all job vacancies collected by the employment services of all EU member states. An encouraging sign of an emerging EU job market is that, besides (and in some cases before) EURES, a number of commercial operators are providing EU-wide job match services. Efforts should be strengthened to create synergies between the publicly funded EURES and market-based services.

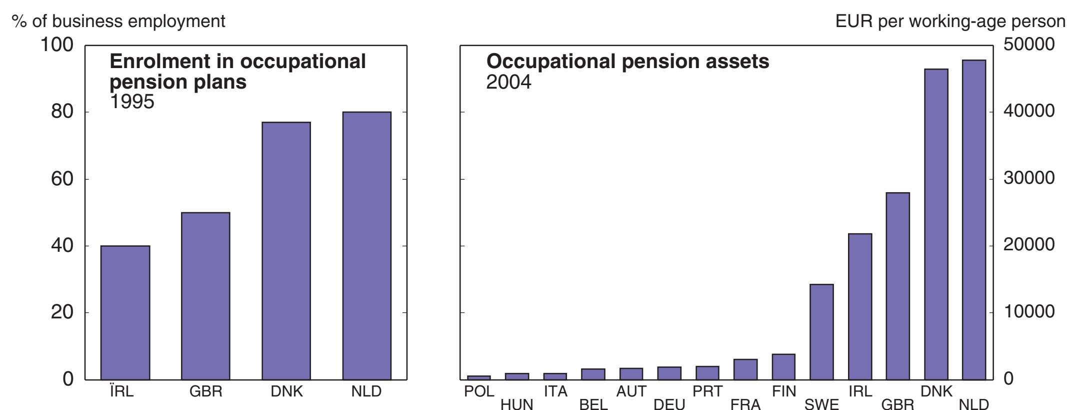
Invalidity benefits can also create disincentives to move. A worker moving from a country where people becoming disabled can claim an invalidity pension irrespective of their contribution history (say Belgium) to another member state with a similar system will receive benefits determined by the rules of the country in which the accident or invalidity occurs (Reyes, 2004). If invalidity benefits offer lower replacement rates in the host country (say Spain compared with Belgium), this can work in the direction of discouraging mobility (from Belgium to Spain keeping the same example). One way of avoiding this effect would be to align the invalidity regime with that applying to social assistance and welfare old-age pensions – in other words, the "home country pays" for the first twelve months, "host country pays" thereafter. With the same example as before, the disincentive to moving from Belgium to Spain induced by invalidity benefit schemes would be eliminated by the possibility of coming back to Belgium and claiming benefits there.

It should be noted that the disincentive related to invalidity benefits is not universal because contribution-based disability insurance rights (such as acquired in France and Germany) are paid by every country where the worker contributed based on contribution histories. A practical difficulty is that invalid workers eligible to contributory disability insurance must lodge their claims in every member state from which they are to receive invalidity benefits. However, removing this practical obstacle appears to be very difficult because it would require harmonising invalidity insurance schemes, which would imply a strong departure from the principles currently underpinning the co-ordination of social security schemes in the Union.

Portability of occupational pensions

Despite sustained efforts, a missing element in the EU framework for the portability of accrued rights concerns occupational pensions. The lack of transferability of these rights creates a serious obstacle to labour mobility as occupational pension schemes cover a large share of the workforce in several countries and can be very large (Figure 8.6). There is some empirical evidence that non-transferable occupational pension rights are associated with lower mobility (Belot and Ederveen, 2006).

Figure 8.6. **The role of occupational pensions**



Source: Andrietti, V. (2003), "Occupational Pensions and Job Mobility in the European Union", in Castellino, O. and E. Fornero, *Pension Policy in an Integrating Europe*, Edward Elgar, Cheltenham; European Federation for Retirement Provision (2005), *Annual Report*, and OECD, *Economic Outlook No. 80 Database*.

StatLink http://dx.doi.org/10.1787/084441542607

A first step towards more portability was made in 1998 with the adoption of legislation ensuring that workers taking up a new job in a different EU country retain the same occupational pension rights with their former employer as if they had changed firms within the same country. Further progress was made with a 2003 directive enabling occupational pension providers to operate across the EU. While the 2003 directive primarily aims at improving competition and efficiency on the side of providers, it should also – albeit to a limited extent – facilitate geographic mobility by allowing pan-European firms to set up pan-European pension plans for their employees.

A legislative proposal currently under discussion could greatly improve occupational pension portability. The main features of the proposal, which to a large extent reflects OECD recommendations on core principles of occupational pension regulation (OECD, 2004), aim at guaranteeing that:

- The period before which employees have to wait before they can join their employer's occupational pension scheme cannot exceed one year.
- The minimum membership period before which rights are vested cannot exceed two years.
- As a general rule, workers changing jobs can choose between transferring their accrued rights or maintaining them with their former employer.
- Occupational pension schemes must treat the rights of previous and active members equally.
- Employers must inform outgoing workers about their rights.

The proposal, however, foresees two important derogations. First, member states can authorise occupational pension schemes to provide outgoing workers with a transfer or lump-sum payment equal to the actuarial value of their accrued rights in lieu of the preservation of their rights within the scheme in case these rights do not exceed a certain threshold. Second, member states can exempt unfunded occupational pension schemes from the obligation to accept the transfer of previously acquired rights. The first derogation should not materially alter the benefits of the proposed directive. Its aim is to avoid excessive administrative costs stemming from the management of a high number of low-value dormant rights. However, the second one implies that mobile workers can continue to be severely penalised relative to their "static" colleagues because unfunded occupational pension schemes often put a high premium on long membership records.

Notwithstanding the derogations, the directive could go a long way towards reducing what remains one of the most important institutional obstacles to labour mobility within the Union. Some have objected that the directive may reduce the incentive for firms to provide occupational pensions because of the costs it creates for employers.[16] Besides, workers themselves have good reasons to demand occupational pension coverage as part of their compensation package (McCarthy, 2006). One is the favourable tax treatment that many countries give to occupational pension contributions.[17] Another important reason is that employers are, or are perceived as being, better placed than workers to provide or purchase coverage against longevity risk. Moreover, with occupational pension plans, workers can benefit from the lower transaction costs as the employer pools together a large amount of savings. The upshot is that the directive will leave many factors motivating the provision of occupational pension plans unchanged, belying the perception that it could lead to a collapse of this form of retirement saving. The priority now should be to adopt the proposed directive while preserving the incentive for firms to provide occupational pensions.

The recognition of professional qualifications

A key factor for the mobility of skilled workers is that professional qualifications acquired in one country are recognised across the Union. Mutual recognition is a requirement for mobile workers in regulated professions (see below). But it is also important for other mobile skilled workers to get their diplomas obtained in one EU member state recognised in others. Great strides have been made in this direction since the decision was made in Bologna in June 1999 to undertake reforms with the aim of achieving a European Higher Education Area by 2010. One particular goal with potentially high benefits in terms of skilled labour mobility is to establish a common EU-wide scale for university degrees (bachelor, masters, doctorate) backed by a co-ordinated system of quality assurance. By 2005, half of undergraduate and masters' students in most EU countries were enrolled in the common degree system.[18]

In principle, EU law guarantees that professional qualifications acquired in one country are valid to practise a regulated profession in another EU country. Despite the EU legislative framework, however, hurdles remain for mobile professionals. They must obtain recognition from the host country, which can involve administrative difficulties. More importantly, they can be asked by the host country authorities to take an aptitude test or to exercise their profession under the supervision of a locally qualified professional for a period of up to three years. A specific provision is aimed at avoiding excessive recourse to the requirement of an aptitude test or an "adaptation period". Member states can require an aptitude test or an "adaptation period" only when the host country requires

more training than the home country for the profession under consideration and if there are substantial differences between those trainings. However, while limiting the possibilities for market segmentation, this clause does nothing to ensure that the requirement for lengthy training in the host country was commensurate in the first place with what is needed to protect the public.

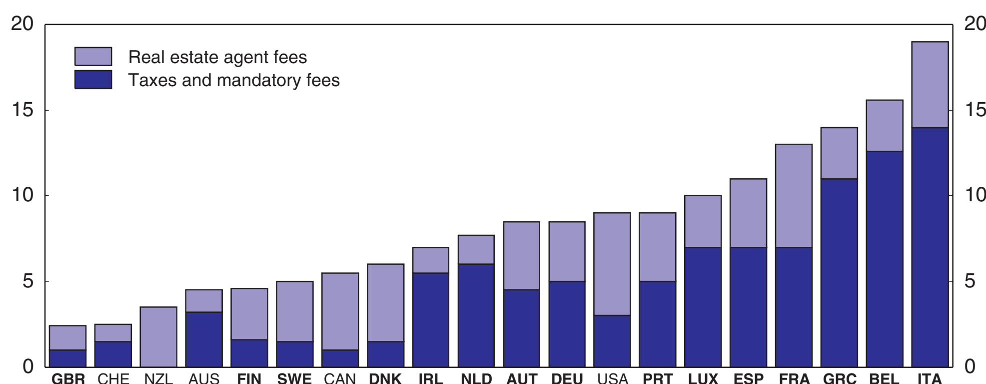
A powerful way of facilitating the mobility of professionals would be to extend the regime of immediate mutual recognition that currently applies in a number of professions. Architects, doctors, dentists, nurses, midwives, pharmacists and veterinaries have their diplomas recognised across the European Union without any test or probationary period. Similarly, lawyers are entitled to provide services and establish in any EU country under their home professional title. However, extending these regimes through the adoption of a directive would require unanimity among the 27 EU member states on agreed minimum training conditions per profession, which appears to be unlikely for any of the regulated professions. More "automaticity" could be introduced for professions subject to a common platform of training as foreseen in the 2005 directive on the recognition of qualifications which will enter into force in October 2007.

Housing

The lack of affordable housing is a cause of much duress and an obstacle to the mobility of labour in some member states. But when not well-designed, housing policies themselves can create obstacles to geographic mobility. Heavy taxes on property transactions and anti-competitive policy settings resulting in high real estate agent fees can imply large costs for home owners wishing to move (Figure 8.7). Empirical evidence confirms that high housing transactions costs reduce mobility (Belot and Ederveen, 2006). Policies can remove this obstacle by shifting the tax base to less distorting sources of revenue (such as replacing stamp duty with property tax) and by removing anti-competitive regulations in the real estate brokerage sector.

Figure 8.7. **Housing transaction costs**

Per cent of house prices, 2004



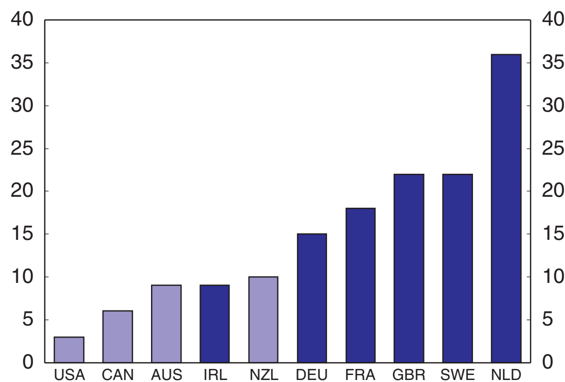
Source: ERA Immobilier (2005), *Le marché européen de la transaction immobilière*; Belot, M. and S. Ederveen (2006), "Cultural and Institutional Barriers to Migration between OECD Countries", mimeo.

StatLink http://dx.doi.org/10.1787/084448338225

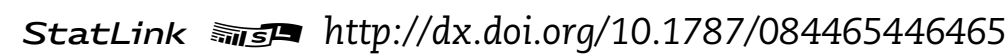
Social housing policies can also reduce geographic labour mobility. Where social housing assistance relies on the provision of shelter and involves long waiting lists, beneficiaries face a strong disincentive to move to take up a job elsewhere if they have to queue again in their new place of residence. Given the sheer size of social housing as a share of all dwellings in several EU countries (Figure 8.8), this can create a significant barrier to mobility. One way to lower this barrier is to provide housing-related social assistance without tying it to a particular location, for instance by issuing vouchers or introducing allowances.

Figure 8.8. **The share of social dwellings in the housing stock**

End 1990s, per cent



Source: Ditch, J., *et al.* (2001), "Social Housing, Tenure and Housing Allowance: an International Review", UK Department of Work and Pensions.


StatLink http://dx.doi.org/10.1787/084465446465

Other policies at the national level

Besides housing, other purely domestic policy settings can also have an effect on labour mobility. Restrictive EPL, such as prevails in many EU countries, creates a powerful disincentive for workers to change jobs and therefore reduces overall job mobility, including across borders.[19] The capacity of education systems to equip pupils with foreign language skills will also have an impact on their ability to move across borders in their working life.

Conclusions

Labour mobility within the Union is low, partly reflecting policy factors. Even though considerable progress has been achieved, a number of policy-related obstacles are still getting in the way of would-be mobile workers. Implementing the recommendations summarised in Box 8.1 would help lower these barriers. The need for further progress on the policy front is all the more important given that significant non-policy factors create obstacles to mobility.

Box 8.1. **Recommendations to remove obstacles to labour mobility**

Community and national policies can contribute to removing obstacles to labour mobility:

- Remove restrictions on workers from new member states.
- Improve the portability of supplementary pensions.
- Make EU citizens eligible to non-contributory invalidity benefits in the host country irrespective of where the claimant was living when the risk materialised. Loosen the time limit for the portability of unemployment benefits while enforcing stringent job-search and availability-to-work requirements. As a first step, encourage bilateral agreements that increase the time limit between countries that enforce similarly stringent requirements.
- Achieve the European Higher Education Area by 2010 as planned.
- Extend the immediate mutual recognition regime currently in place for certain professions to other activities.
- At the member state level, it would be desirable to shift the tax burden away from taxes such as stamp duty that result in high transaction costs, to remove anti-competitive regulations in the real estate brokerage sector and to provide social housing assistance in ways that do not undercut mobility.

Notes

1. This section draws heavily on the analysis in EC (2006).
2. Caution is needed regarding the information that the LFS provide about recent labour flows. The LFS migration data refer to 2005, the latest year for which internationally comparable data was available, but especially regarding the new member states the situation may have changed substantially since then. Furthermore, certain characteristics of the labour force survey are likely to imply some downward bias in the estimation of immigrant numbers (Martí and Ródenas, 2007; OECD, 2006). First, in many countries, LFS samples do not include collective dwellings such as hostels and reception centres for immigrants. Second, LFS samples assume that the geographic repartition of the population is unchanged since the previous census and thus underweigh areas where immigration has recently generated high demographic growth. Third, except in four countries, LFS statistics are not corrected for the fact that immigrants may have a lower probability of responding to the questionnaire, especially when they are recent or short-term arrivals.
3. Labour force statistics put the annual mobility rate of the working-age population at 0.1%. This figure is subject to a downward bias among other reasons because the sampling method of the labour force survey cannot pick up all short-term movers. However, even after correcting for this bias, the annual migration rate is most unlikely to be above 0.3% (EC, 2006).
4. One limitation of this estimate is that it counts all EU8 workers who moved to the United Kingdom at some point in time, including those who left the country afterwards.
5. The statement refers to 2005 statistics as reported by Heinz and Ward-Warmedinger (2006) and Muenz (2006) and refers to net migration rates (immigration minus emigration). Gross emigration out of Poland has amounted to 0.7% of the working-age population per year since accession (Polish Ministry of the Economy, 2007).
6. The ranking of EU15 countries is taken from Hitzelsberger *et al.* (2001) and the 2005 statistic for Luxembourg from EC (2007).
7. EU15 member states can invoke a safeguard clause to restrict the entry of workers from Malta, but they have not used this provision so far.
8. Information on Bulgaria and Romania could not be obtained.
9. For the purpose of this report, “host country” means the country of employment. “Home country” means the country of origin.

10. Sizeable implementation difficulties have emerged and an abundant case law has developed concerning the extent to which people moving to a different EU country to receive treatment there can benefit from the provisions of the EU regime on social security co-ordination. This issue, however, has little impact on the mobility of workers.
11. See INSEE (2005) for data on layoffs by age in France.
12. See Queisser and Whitehouse (2006) for an in-depth discussion of actuarial neutrality.
13. Employment services in the home country are free to extend the period to six months.
14. This statistic relates to EU19 countries and is taken from Turmann (2006).
15. A further limitation is that the claimant's stay abroad must not have exceeded five years. See Finnish Federation of Unemployment Insurance Funds (2005) for more details.
16. See for instance the very critical position paper issued by the European Federation of Employers (UNICE, 2006).
17. See Yoo and de Serres (2004) for a detailed description of the tax treatment of private pension contributions, including occupational pension schemes, in OECD countries.
18. See Communiqué of the European Ministers Responsible for Higher Education, Bergen, 19-20 May 2005.
19. See OECD (2007) and Chapter 1 for indicators of the stringency of EPL.

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Glossary

ACP	Africa, Caribbean and Pacific
BRIC	Brazil, Russia, India and China
CAP	Common Agricultural Policy
CFSP	Common Foreign and Security Policy
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Commission
ECB	European Central Bank
ECJ	European Court of Justice
EEC	European Economic Community
EIT	European Institute of Technology
ERC	European Research Council
EPL	Employment protection legislation
ERDF	European Regional Development Fund
ESF	European Social Fund
ETS	CO_2 Emission Trading Scheme
EU	European Union
EU10	Ten countries that joined the EU on 1 May 2004
EU12	EU10 plus Bulgaria and Romania
EU15	The fifteen members that had joined by 1995
EU19	EU15 plus the Czech Republic, Hungary, Poland and the Slovak Republic (*i.e.*, the EU members that are also OECD members)
EU27	All EU countries (EU15 plus EU12)
FDI	Foreign direct investment
HICP	Harmonised index of consumer prices
ICT	Information and communication technology
IPO	Initial public offering
LFS	Labour force survey
M&A	Merger and acquisition
MiFID	Markets in Financial Instruments Directive
MFP	Multifactor productivity
MRA	Mutual recognition agreements
PJCC	Police and Judicial Co-operation in Criminal Matters
PISA	OECD Programme for International Student Assessment
PMR	Product market regulation
PPP	Purchasing power parity
PPS	Purchasing power standard
RCA	Revealed comparative advantage

REACH	Registration, Evaluation and Authorisation of Chemicals (EU's chemical safety law)
R&D	Research and development
RDP	Rural development programme
RIA	Regulatory impact assessment
SEPA	Singe Euro Payments Area
SME	Small- and medium-sized enterprise
SPS	Single Payment Scheme
TRQ	Tariff rate quota
TSO	Transmission system operator
UCITS	Undertakings for Collective Investment in Transferable Securities
VAT	Value added tax
WTO	World Trade Organization

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