OECD Economic Surveys **Euro area**



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OECD ECONOMIC SURVEYS 2002-2003

Euro area



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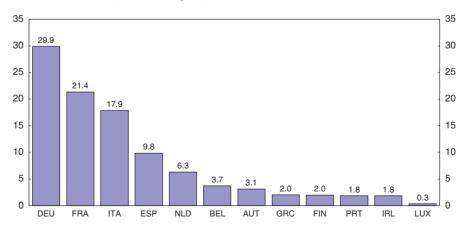
BASIC STATISTICS (2002)

LAND AND PEOPLE	Euro area	United States	Japan
Area (thousand km²)	2 456	9 167	395
Population (million, in 2001)	303.7	285.0	127.2
Number of inhabitants per km ²	124	31	322
Population growth (1993-2001, annual average % rate)	0.3	1.3	0.2
Labour force (million)	141.5	144.9	66.9
Unemployment (%)	8.2	5.8	5.4
ACTIVITY			
GDP (billion USD, current prices and exchange rates)	6 623.4	10 365.8	3 944.5
Per capita GDP (USD, current prices and PPPs, in 2000)	24 320	35 619	25 968
In per cent of GDP:			
Gross fixed capital formation	20.2	18.6	24.2
Exports of goods and services (in 2001)	19.8	9.9	10.7
Imports of goods and services (in 2001)	18.7	13.5	10.1
PUBLIC FINANCES (per cent of GDP)			
General government: Revenue	45.6	31.9	30.8
Expenditure	48.4	35.6	38.6
Balance	-2.3	-3.4	-7.1
Gross public debt (end-year)	75.0	61.0	140.5
EXCHANGE RATE (national currency per euro)			
Year average		0.94	118.1
Start of year		0.90	119.5
End of year		1.05	124.4

EURO AREA – EXTERNAL TRADE IN GOODS (main partners, % of total flows, in 2001)

	Exports	Imports
Non-euro area European Union countries	24.1	19.3
European Union accession countries	9.9	8.6
Other Europe	14.7	14.7
OECD America	19.0	16.0
OECD Asia/Pacific	5.6	8.8
Dynamic Asian Economies and China	7.2	11.6

SHARE IN EURO AREA GDP (current market prices)



Note: An international comparison of certain basic statistics is given in an annex table.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of the euro area were reviewed by the Committee on 14 May 2003. The draft report was then revised in the light of the discussions and given final approval

as the agreed report of the whole Committee on 29 July 2003.

The Secretariat's draft report was prepared for the Committee by Paul van den Noord, Laurence Boone and Carl Gjersem under the supervision of Peter Hoeller.

The previous Survey of the euro area was issued in September 2002.

Assessment and recommendations

Key macroeconomic and structural policy challenges

Entering its fifth year of existence, the European Economic and Monetary Union (EMU) has met major headwinds. At the advent of the single currency the euro area experienced solid economic growth, with unemployment falling and public finances rapidly improving. However, a number of structural problems were exposed with the cyclical downturn since 2001, from which the area is recovering only hesitantly. The challenges facing policy makers at present are both of a short-run and medium-run nature. Policy makers are currently grappling with sluggish demand. Responding to this challenge, monetary policy has been eased and fiscal policy reacted through the automatic stabilisers. However, the room for manoeuvre was reduced by lingering inflationary pressures and earlier insufficient fiscal adjustment in several member states. Meanwhile the euro exchange rate has appreciated significantly. Over the medium term, the Community has set ambitious targets and a vast programme for enhancing the performance of labour, product and financial markets. This programme needs to be pursued with vigour, thereby raising the odds of large gains in trend growth and jobs while making it easier to achieve sound fiscal positions.

The downturn proved longer than initially expected

Growth fell from a 3½ per cent peak in 2000 to 1 per cent in 2002. The bursting of the global stock market bubble, the unsettling of corporate balance sheets and uncertainty about the timing and strength of the recovery inhibited a swift recovery of business investment, while bleaker job prospects and geopolitical uncertainties affected consumer confidence and spending. Macroeconomic policies have provided some offset, as interest rates have been cut in several steps since 2001, with the cuts contingent on falling inflation concerns, while the fiscal stance has been mildly

expansionary since 2000. The latter reflected fiscal action by some countries that had achieved sufficient room for manoeuvre, but also by countries that had not yet done so and found themselves in breach of the commitments stemming from the Stability and Growth Pact and the Treaty. While the shocks have been largely global, the euro area has shown less resilience to these shocks than many other parts of the OECD area. This may reflect structural and institutional rigidities, which have inhibited a brisk rebound in domestic demand. While net external trade picked up some of the slack, this favourable influence is now vanishing as the exchange rate has recovered its earlier losses.

Unemployment has risen little so far, while inflation pressure is waning

Despite sub-par growth, the unemployment rate has picked up little to date. Since bottoming in 2001, it has risen by ¾ of a percentage point to 8¾ per cent. This could indicate a better labour market performance, but could also mask significant labour hoarding. At the same time real product wages decelerated only little during the downturn, which suggests that wage resistance against adverse price shocks remains an important feature of wage formation systems in the euro area. However, with slack in product markets growing, profit margins falling and the currency appreciating, inflation has come down to 1.9 per cent in May, after hovering in the 2 to 3 per cent range since mid-2000.

The recovery is set to be muted

The recovery is likely to face headwinds for some time. The Gulf conflict weighed heavily on consumer and business sentiment and oil prices have been high and volatile. The euro has appreciated by more than 20 per cent in effective terms from its low in late-2000, and this has eased inflationary pressure. Hence, with the exchange rate assumed to remain strong the OECD assumes the European Central Bank (ECB) to keep its policy rate on hold after the series of cuts in the spring of 2003 until mid-2004. Meanwhile, fiscal policy, which is being constrained by earlier slippage, will provide no further stimulus unless it departs further from the requirements of the Stability and Growth Pact. The OECD's assessment is that activity is likely to remain subdued in 2003, but could accelerate to potential growth of some 2 per cent in 2004. The unemployment rate would peak in 2003, and then fall only slightly to about 8½ per cent in the second half of 2004. With the negative output gap remaining large and temporary factors waning, inflation is expected to decline to 1½ per cent in 2004.

Downside risks predominate

Uncertainties around the projection are large. On the positive side, oil prices could fall by more than projected, following the end of the Gulf conflict, thus lowering inflation and boosting household incomes. Another positive factor is that there could be a quicker than projected dissipation of uncertainty, leading to a stronger recovery in confidence and a more rapid unwinding of precautionary savings, thus supporting domestic demand more than anticipated. However, there are also major downside risks, both on the internal and external side, with poor GDP growth in the first quarter of 2003 not boding well in this regard. A possible wave of company restructuring, with a labour shake-out and rising unemployment, could depress consumer confidence further. Fiscal tightening may be stronger than embedded in the OECD projections if several countries take action to respect their Stability and Growth Pact obligations. This would usually be expected to adversely affect demand in the short run. However, meeting the commitments would enhance the credibility of the Stability and Growth Pact and of fiscal policy in general. This may spur confidence among consumers and investors, with positive implications for growth over the medium term and possibly even in the short term. Moreover, fiscal consolidations appear to be more successful if they include spending reforms that sharpen incentives to work and invest. On the external side, the upswing in the US economy may stall. If, moreover, financial markets consider the widening US current account deficit unsustainable in the medium run, a further appreciation of the euro exchange rate vis-à-vis the dollar could occur. The euro area economy could perhaps weather one or another of these downside risks, given the scope for monetary policy to respond. However, coping with a combination of several adverse shocks would be very challenging for policy makers.

Temptations to ease fiscal policy in the upswing should have been resisted The Stability Programmes presented by the member countries on the eve of the 2001 downturn envisaged balanced budgets to be broadly achieved by 2002, but this goal has been put off by at least four years. Overruns were widespread, but they were particularly large in the three

major countries and Portugal. Portugal breached the deficit limit of 3 per cent of GDP enshrined in the Maastricht Treaty already in 2001. Germany and France followed suit in 2002, with Italy also approaching the danger zone. Slippage against the targets was largely rooted in the fiscal easing that was initiated at the peak of the cycle in 2000 with knock-on effects also in 2001 and 2002. These countries failed to comply with the commitments of the Stability and Growth Pact, which required them to move towards and then to stay close to fiscal balance over the medium term. Slippage was possible in part because of the almost exclusive focus on nominal (as opposed to cyclically-adjusted) budget balances which reinforced the asymmetric nature of the Pact, with constraints biting in downswings but not in upswings. But targets were also missed because of an overly optimistic assessment of underlying growth potential. These countries thus failed to take out insurance against a cyclical downturn. This is regrettable for at least two main reasons. First, it means that automatic stabilisers were not allowed to work fully during the upswing. Hence, fiscal policy failed to smooth the cycle. Second, a precious window of opportunity to build up a war chest against the looming ageing challenge was missed.

Corrective action is required alongside with structural reform

These difficulties prompted the Commission to propose a series of measures to strengthen the implementation of the Stability and Growth Pact. The spring 2003 European Council meeting subsequently endorsed the following principles:

- The close-to-balance or in surplus rule should apply in cyclically-adjusted terms each year, not just at a medium-term horizon.
- Countries that have yet to comply with this requirement will be committed to consolidate their fiscal position by at least ½ per cent of GDP per year in cyclically-adjusted terms.
- Pro-cyclical budgetary policies should be avoided, especially when growth conditions are favourable.
- The assessment of the conformity of the Stability and Convergence programmes with the close-to-balance or in surplus requirement should take account of the long-term sustainability of public finances, necessary

- safety margins *vis-à-vis* the 3 per cent threshold and quality of the public finances.
- The pace of decline in public debt plays an important role in the budgetary surveillance, especially in highly indebted countries. In conformity with the Treaty provisions, the excessive deficit procedure should contribute to ensuring a satisfactory pace of debt reduction.

While this refined framework appears to be sensible, it will only work if governments exercise "ownership" over this set of rules. The price of pursuing fiscal tightening before the recovery is fully underway is worth paying to rectify insufficient adjustment in the past and to enhance the credibility of the macroeconomic policy framework. Meanwhile, pursuing a structural reform agenda to boost potential growth would make it considerably easier to achieve sound fiscal positions. Indeed, the fact that most smaller euro area countries – which grew on average by 3 per cent *per annum* since the advent of the common currency as opposed to 1¾ per cent for the three major countries – easily met the close-to-balance or in surplus rule, provides evidence for this.

The OECD projections assume that interest rates will stay on hold until the recovery firms

The challenges facing monetary policy at the current juncture are complex. Policy interest rates were cut by a cumulative 225 basis points since May 2001 to 2½ per cent in March 2003. Stress in financial markets has eased somewhat recently, but the need to restructure corporate balance sheets may slow down the recovery of investment. Buoyant credit to households, associated with the property cycle and spurred by low interest rates, has so far provided some offset, but the persistent overshooting of the price stability objective of keeping inflation below 2 per cent over the medium run has limited the leeway for more aggressive monetary policy easing. However, helped by the appreciation of the euro, moderating oil prices and significant slack in economic activity, inflation pressure has been receding recently, allowing the ECB to lower interest rates by a further 50 basis points in June 2003. Against this backdrop, policydetermined interest rates are likely to remain on hold until there is firm evidence of sustained recovery. If evidence of further weakening of economic activity surfaces, moderating inflationary pressures further, the ECB should stand ready to reduce its key interest rates again. At the same time, the ECB should continue to be vigilant to upside risks.

The monetary policy framework has been clarified

Since the adoption of the euro four and a half years ago the framework and modus operandi of monetary policy have evolved markedly. The operational definition of price stability, - a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) below 2 per cent over the medium term – has in practice provided room to accommodate temporary price shocks. In the May 2003 review of its policy strategy, the ECB reiterated the definition of price stability, but clarified that in the pursuit of price stability it aims to maintain inflation rates close to 2 per cent over the medium term in line with its past conduct of policy. This clarification has been made to underline the need to provide a sufficient safety margin to guard against the risks of deflation. It also addressed the issue of a possible measurement bias in the HICP and the implications of inflation differentials within the euro area. Moreover, the review clarified the two-pillar framework, emphasising the role of monetary analysis as a means of cross-checking, from a medium to long-term perspective, the indications of risks to price stability in the short to medium-term stemming from economic and financial market developments. These clarifications are welcome because they bolster the resilience of the framework against deflation risks and further underpin market expectations of inflation rates staying close to 2 per cent.

The Lisbon targets now look difficult to achieve

Reaching the strategic goal set at the Lisbon summit in 2000 to turn the European economy into "the most competitive and dynamic knowledge-based economy in the world" by 2010 now looks very challenging, and requires that greater progress is made in implementing the structural reform agenda already laid out and attention be given to what additional efforts may be required. The 1993-2000 upswing partly reflected the absorption of the large amount of cyclical slack created in the recession of the early 1990s, while potential output growth picked up only a little, contrary to the United States. Although the implementation of the Single Market Programme had positive effects, its implementation has been painfully slow in some areas, innovative capacity improved little and labour market performance, while better in recent years, could still be enhanced considerably. The

OECD's medium-term scenario suggests that, on unchanged policies, a growth gap between the United States and the euro area will persist. Labour productivity would grow by 1½ per cent per annum over the period 2003-08, as compared with 21/4 per cent for the United States. With structural unemployment declining rather little and remaining, at 7½ per cent, 2½ percentage points above the US rate, trend GDP growth would be 134 per cent for the euro area in per capita terms, as compared with 2½ per cent for the United States. Looking further ahead, with ageing eventually leading to a decline in the working age population, growth can only be sustained by mobilising the participation of those who would otherwise not be employed, by reversing the trend decline in hours worked or by reforms that boost productivity growth. In this context, the potential gains from creating a truly integrated and competitive European market, increasing business dynamism, investing in knowledge and innovation and pushing ahead with labour market reforms could be very large.

Remaining barriers to internal trade should be removed

Ten years after it was launched, the single market has partly fulfilled its ambition of fostering European integration; this has been reflected in converging prices of traded goods, heightened competition in manufacturing and surging trade and investment flows. But this process has some way to go. Due partly to regulation and taxation factors, the service sectors are not well integrated and substantial barriers remain. These concern the lack of mutual recognition for business licenses and diplomas in many services and a range of sector specific issues, such as the current system of airport slot allocation, which still hampers entry. Liberalisation moves should be more ambitious, especially in the postal and railway sectors. Moreover, integration of financial markets, while progressing, is very uneven across market segments. Several Directives included in the Financial Services Action Plan still have to be adopted, including the long-overdue Take-over Bid Directive, while further efforts should focus on removing national obstacles that hamper cross-border trade and market entry. Finally, the regulatory framework of the Community has fallen considerably short of the OECD Council's recommendations on improving the quality of government regulation. For instance, a regulatory impact assessment was not mandatory until recently and implementation issues need to be tackled more thoroughly. Steps have been taken to improve the situation. In sum, while the single market programme is advancing, the pace is slow.

Competition policy transcends national interests

Vigorous competition in goods and services markets is of particular importance for growth and consumer welfare and is the topic of the special chapter of this Survey. Competition ensures that productivity gains are passed through into lower consumer prices and input prices for producers, reduces rents accruing to dominant incumbents and raises the pressure on businesses to allocate and utilise resources in the best way. And it spurs companies to continuously invest in producing new and better products, while also improving production processes. The Community framework for competition policy aims at ensuring a level playing field for competing firms and as such is one of the pillars of the single market. It is one of the key policy areas in the remit of the Community and covers antitrust, liberalisation, state aid and merger control. Also, further trade liberalisation would enhance competition and should be pursued in the current international trade negotiations to capture the sizeable remaining gains from freeing trade. Further progress needs to be made in improving market access for agricultural commodities in developed countries, in particular for developing countries, while reducing, with a view to phasing out, all forms of export subsidies and other trade distorting subsidies in agriculture.

Keep the instruments of competition policy under review

The Community's competition rules, which apply whenever anti-competitive practices have an implication for cross-border trade, are enforced primarily by the Commission's Directorate General for Competition, and complement national competition legislation. Reforms have been adopted recently with the goal of increasing the role of national authorities in the enforcement process. The Directorate General has a wide-ranging toolkit and has reformed it recently, for instance by increasing internal scrutiny and transparency in the handling of individual cases, while strengthening the Commission's investigatory powers. In view of the recent and ongoing reforms, it is suggested to keep the following under review:

 Fines for anti-competitive behaviour are already high, but their deterrent effect should be assessed.

- The leniency programme is already very attractive, but options to make it even more attractive could be explored in the light of the experience with the programme and similar measures taken by member states.
- The effectiveness of the reforms to improve checks and balances in the merger control process should be reviewed.
- Private suits should be encouraged in a well-balanced legal framework that avoids their strategic use by competitors to hamper competition. This could free up resources in the competition authority.

Further, Community action to implement a single market in services should be strengthened and supported by competition policy, especially at the national level. Measures should be taken to facilitate a long-term focus in planning and areas where the biggest gains can be expected should receive priority. The Commission is currently studying this issue. There would also seem to be a potential for large gains from raising competition in public procurement. An important task for the Commission services is to make the broadly spread gains from competition policy more visible, to counter the often fierce opposition of entrenched interests to a greater degree of competition.

Liberalisation of network industries should be stepped up Competition policy is complemented by, and partly overlapping with, the regulation of newly liberalised network industries. Despite the EU's commendable efforts in this area, competition is still undermined by dominant incumbents in some sectors. Price declines stemming from the liberalisation of network industries have become smaller, while new entrants no longer seem to gain market share from the incumbents in some markets. Indeed, in mobile telephony dominant incumbents have been able to consolidate their position. At the same time, the dispersion in prices and the price level differences with other countries suggest that the full scope for efficiency gains has not yet been fully exploited.

Innovation should be encouraged

A raft of indicators shows that innovation activity in the euro area is lagging the most advanced OECD countries. For

instance, research and development (R&D) spending, as a share of GDP, is relatively modest and venture capital investment is only a third of the OECD average, while the export share of high-tech products is less than two-thirds of the US level. An effective EU-wide system of protecting intellectual property rights has been long overdue. The recent adoption of a "Community Patent" is a major step forward, but the estimated cost of patenting, though reduced significantly by this initiative, should still be cut by half to match costs in other major OECD economies. Raising R&D spending to the target set by the 2002 Barcelona Council of 3 per cent of GDP would imply a doubling of spending from the current level. However, it would seem to be more urgent to raise the effectiveness of R&D expenditure as opposed to its level. This requires policies that improve the framework conditions, for instance, concerning the venture capital market to encourage risk taking. Moreover, the current set-up has failed to foster research specialisation at the European level, and hence the scope for reaping scale economies remains huge.

Labour markets need to be reformed further

Labour markets are in urgent need of reform. Notwithstanding some progress made since the mid-1990s, the structural rate of unemployment was still as high as 8 per cent in 2002 on OECD estimates, leaving it several percentage points above the best performing OECD countries. Meanwhile, skill mismatches have increased and "dual" labour markets have developed, which may provide a stepping stone for certain categories of workers but also risks trapping them in poorly paid or unsteady jobs. While the Community has only limited competence on labour market policies, the 2000 Lisbon European Council and the 2001 Stockholm European Council set ambitious targets for the Union as a whole. These include targets for the overall employment rate (70 per cent in 2010 compared with 64 per cent currently) and the employment rate for older workers (50 per cent compared with 38½ per cent currently). So far, the extent of the reforms in the pursuit of these targets has varied greatly across member states and on current trends and policies the risk is high that targets will not be met. Reform - with priorities depending on specific conditions in different countries – should focus on:

- Making work pay, by reducing financial disincentives to work stemming from tax and benefit systems while reducing incentives to retire early.
- Improving the effectiveness of active labour market policies, by giving more weight to job matching by the public employment services as opposed to subsidised jobs.
- Enhancing labour mobility, to smooth the absorption of "asymmetric shocks" affecting certain regions, sectors or occupations. This requires EU-wide initiatives, concerning, for instance, the mutual recognition of skill certification or the portability of pension rights – all areas where scope for progress is large. Moreover, mobility within individual euro area countries also needs to be encouraged.
- Reforming wage setting practices, allowing local market clearing and the removal of indexation mechanisms to ease real wage resistance against adverse price shocks.
- Easing employment protection legislation, to encourage job creation and facilitate flexible adjustment to changing economic conditions, thereby also reducing labour market segmentation.

The potential gains from structural reform are large Simulations with OECD's Interlink model suggest a strong impact of product and labour market reforms on overall economic performance. A reform of product market regulation to make it as competition-friendly as in the United States could boost the level of multi-factor productivity by 2 per cent by the end of this decade. Moreover, based on conservative estimates, the combined effect of labour and product reforms could slash structural unemployment and raise labour market participation, resulting in considerably faster employment growth. Such reforms might boost potential *per capita* growth of the euro area from 1¾ to 2¼ per cent, the same as the US rate. Such a performance would imply much improved fiscal positions allowing a sizeable reduction in the tax burden. At the same time, lower inflation would allow an easier monetary stance.

Summary

To sum up, the agenda for high growth and employment adopted at the Lisbon summit in 2000 seems all the more germane now that the euro area has been faced with an unexpected protracted slowdown. While the specific targets set at this summit now look very challenging to realise, a radical shift in attitudes toward structural reform would provide the key to achieving the broader objectives set out. The near-term economic situation remains unsettled. Although the labour market has remained relatively resilient to date, this may not be sustained for long as the recovery is still meeting headwinds and downside risks are present. In the short run, there will be no relief from fiscal policy, which will need to correct earlier insufficient adjustment. However, monetary policy has been significantly eased as inflationary pressures have been receding. If evidence of further weakening of economic activity surfaces, moderating inflationary pressures further, the ECB should stand ready to reduce its key interest rates again. At the same time, the ECB should continue to be vigilant to upside risks. At this juncture it is therefore all the more crucial that the vast structural reform agenda be pursued with vigour. Remaining barriers to fully achieving the internal market should be removed – notably in the service sector - competition and innovation should be encouraged, and the flexibility of labour markets should be enhanced. The Community's regulatory framework should be improved, which would reduce red tape and lead to a better implementation of Community-wide regulations. Further liberalising trade would further enhance competition and lead to sizeable welfare gains. The potential gains from structural reform appear to be very large, and would facilitate the pursuit of a multitude of policy goals, including price stability, sustainable public finances in the face of population ageing, stronger growth and full employment.

I. Macroeconomic performance and structural reform

The euro area's economic performance since the implementation of the Single Market Programme and Maastricht Treaty in 1992 has been marked by the recovery from the deep 1992-93 recession, with structural unemployment slightly declining as well. The upswing peaked in 2000, and at present the economy is hesitantly recovering from the downturn that ensued.

Over the 1993-2000 period growth averaged 2½ per cent per annum, and accelerated to over 3½ per cent by the end of the decade. The surge in unemployment during the early-1990s recession was completely reversed by the end of the decade, and inflation halved from an initial 4 per cent to around 2 per cent per year. Interest rates across the area converged towards German levels and fiscal positions markedly improved in the run-up to the introduction of the single currency in 1999, while the common monetary policy was successfully established. Optimism about an improved medium-term performance became widespread and the belief in a "new economy" was supported by the promising developments in the United States. Yet, the upswing in the euro area largely reflected the absorption of the large amount of cyclical slack created in the early-1990s recession, while potential output growth picked up only little, contrary to the United States. Against this backdrop the Lisbon European Council in March 2000 set the strategic goal for the European economy "... to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion".

Unfortunately, growth was slashed by a series of adverse shocks, to 1½ and 1 per cent in 2001 and 2002, respectively. Confidence among consumers and producers fell sharply, partly in response to concerns over terrorism and the geopolitical situation. The labour market proved more resilient than in previous downturns, but corporate restructuring in the aftermath of the stock market crash and pressures on profitability have heightened the risks of job shedding. While the economy is not in recession in a technical sense, growth is set to remain sluggish and may accelerate to 2½ per cent, somewhat above potential growth, only by 2004, with downside risks prevailing. These developments exposed some longstanding

weaknesses of the euro area economy and cast a shadow over the ambitions of the Lisbon Council. A renewed focus on structural reform is called for.

This chapter will first briefly discuss the recent economic developments and the short-term outlook. This is followed by a review of the link between structural policies and macroeconomic performance since the advent of the single market in 1992. The remainder of the chapter will assess the effect of structural policy initiatives and the scope for further action in the pursuit of the targets set by the Lisbon Council.

Recent developments and short-term prospects

Growth in the euro area has slowed significantly in the last two years. It fell from $3\frac{1}{2}$ per cent in 2000 to $1\frac{1}{2}$ per cent in 2001 and then to only less than I per cent in 2002. Contrary to common perceptions, it was domestic demand rather than foreign trade that acted to break the growth momentum (Figure 1). Specifically:

- Stock building has contributed negatively to growth since the start of 2001 as weak sales prospects prompted companies to trim inventories.
- Business investment adjusted to bleak demand prospects and was hit in addition as companies worked off excess capital, especially in the information and communication technology (ICT) industries. The capital overhang in the euro area is considered to be smaller than in the United States, but global excess capacity and balance sheet problems also depressed investment activity in the euro area.
- Private consumption decelerated sharply as growth in real disposable income was hit by a slowdown in employment growth with employment falling since mid-2002 and sharp price increases for food (due to animal diseases and poor weather conditions) and energy. Moreover, the saving ratio soared in response to the series of adverse shocks that hit the economy since mid-2000. These included heightened fears of terrorism after the September 11 attack, a perceived hike in inflation following the introduction of the cash euro in January 2002 and the deteriorating geopolitical situation.
- There was some *policy stimulus* to counteract these tendencies (Figure 2).
 Prompted by a series of cuts in policy interest rates totalling 275 basis points since May 2001, real short-term interest rates have come down (Chapter III). Fiscal policy has been slightly expansionary since 2000 despite the commitments under the Stability and Growth Pact (Chapter II).

Interestingly, the net external trade contribution to growth remained positive all along despite a strong currency appreciation by over 20 per cent in effective

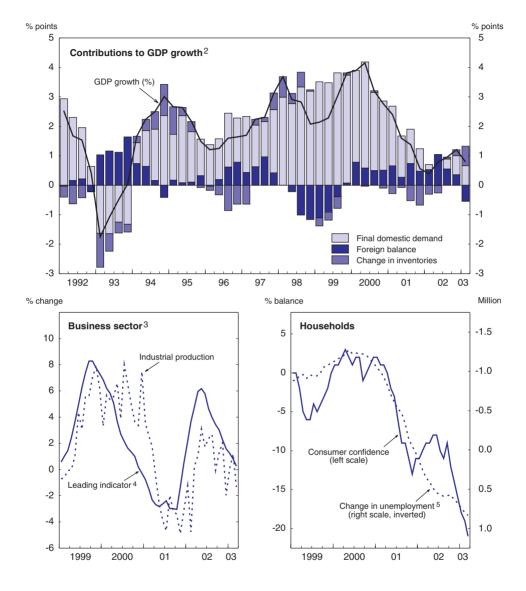


Figure 1. GDP and short-term indicators¹

- 1. Seasonally adjusted data.
- 2. GDP in constant 1995 prices, annual percentage change.
- 3. Percentage change over six months, annual rate.
- 4. OECD composite leading indicator.
- 5. Change relative to previous year.

Source: European Commission/Eurostat and OECD, Main Economic Indicators.

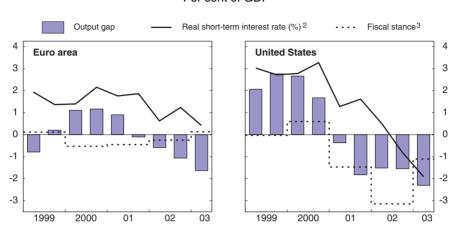


Figure 2. **The policy stance**Per cent of GDP¹

- 1. Numbers for 2003 are projections taken from the OECD Economic Outlook, No. 73.
- 2. Calculated using the consumer price index (harmonised for the euro area); annualised rate.
- 3. Change in the cyclically adjusted government primary balance in per cent of potential GDP. Source: OECD.

terms since late-2000 and prevented the economy from slipping into recession. Merchandise export volumes in the United States, having risen 11 per cent in 2000, fell by 6 per cent in 2001 and another 3½ per cent in 2002. By contrast, in the euro area merchandise export growth remained positive, albeit slowing from 13 per cent in 2000 to 5 and 2 per cent, respectively, in 2001 and 2002. While many of the adverse shocks that occurred since 2000 may be considered as "external" from the point of view of the area's economy, the globalisation of financial markets and businesses has acted to spur their transmission to domestic demand and imports. However, the growth impetus stemming from foreign trade may ease if the appreciation of the euro takes its toll or if the US recovery falters.

Short-term indicators suggest that economic growth has been losing momentum in recent quarters. GDP growth edged up from 1 per cent in the third quarter of 2002 to 1.2 per cent in the fourth quarter on a year-to-year basis. However, this stemmed largely from a positive base effect owing to negative growth in the fourth quarter of 2001; quarter-on-quarter growth actually decelerated on a seasonally-adjusted basis from 0.3 to 0.1 per cent over the same period. The slowdown continued in the first quarter of 2003, with GDP expanding by 0.8 on a year-on-year basis and flat on a quarter-on-quarter basis. Industrial production initially rebounded sharply in 2002 but has been falling since the summer. Consumer confidence is still sliding,

reflecting heightened job loss fears as unemployment is increasing. Highly exposed sectors (telecom, insurance and banking) are currently consolidating their balance sheets, with stock sold to repay debt contributing to the bear market for shares. While there is little sign of a credit crunch to date, demand for credit has moderated and financial headwinds could thus delay the recovery of investment well into the second half of 2003. It is hard to determine if poor business sentiment will be reversed once geopolitical stress eases or whether it is also driven by the ongoing profit squeeze, which is reinforced by the recent strengthening of the euro exchange rate.

While corporate adjustment is likely to continue for some time and may result in job shedding, the labour market has remained surprisingly resilient so far. The unemployment rate was stable at 8 per cent in 2001 and crept up slightly in 2002 to 8½ per cent by the end of the year, despite a sharp widening of the output gap (Figure 3, top two panels). As employment growth remained positive until mid-2002, labour productivity growth, after having already slowed sharply in the second half of the 1990s, was practically nil. It is not unlikely that companies have hoarded labour as they believed that the slowdown would be short-lived, perhaps based on expectations that the euro area could easily weather a global recession as its epicentre was in the United States. This view was supported by official forecasts and initially confirmed by the (technical) rebound in early 2002. However, labour hoarding could also suggest that labour market reforms have so far failed to achieve greater flexibility in hiring and firing. As a result, excess labour resources may have been rising on companies' payrolls and may not be sustained much longer.

Notwithstanding the economic slowdown, inflation as measured by the harmonised index of consumer prices (HICP) has been above the 2 per cent mark – the rate close to but below which inflation should be in the medium run to be consistent with the ECB's price stability objective – for the last three out of four years since the launch of the single currency. This largely reflects the sequence of adverse price shocks, and has tended to prompt compensation in wage growth via de facto or de jure indexation schemes that are still in place in many euro area member countries. As a result, compensation rates have been on an upward trend from 1998 until the first quarter of 2002, suggesting that real wage resistance against adverse price shocks remains a feature of euro area economic performance (Figure 3, fourth panel). This may not be sustainable much longer without triggering some correction in the form of a cyclical boost in productivity stemming from job shedding. Since the second quarter of 2002 productivity growth has indeed picked up and, with the compensation rate also decelerating, unit labour costs declined in 2002 as a result.

Activity is likely to remain subdued in 2003, but could approach potential growth of some 2 per cent in 2004. Private capital formation and consumption are

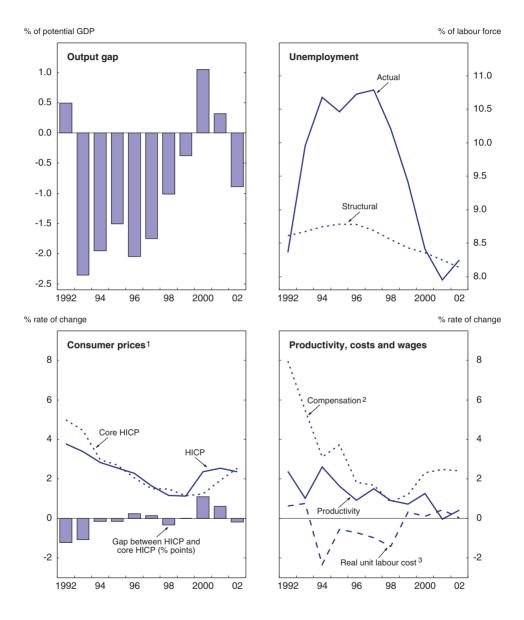


Figure 3. Economic slack and inflation pressure

- 1. HICP: harmonised index of consumer prices. Core HICP excludes energy, food, alcohol and tobacco.
- 2. Business sector, per employee.
- 3. Nominal cost deflated by the GDP price index.

Source: OECD.

expected to remain weak in 2003 before recovering somewhat in 2004. Stockbuilding should provide some positive growth impetus as inventories are replenished after the massive sell-off in the past two years. Supported by the pick-up in the exchange rate, inflation is projected to fall firmly below the 2 per cent mark in 2004, underpinning continued growth in real disposable income. Unemployment would peak in 2003 and fall to $8\frac{1}{2}$ per cent in the second half of 2004 although, as noted above, adverse risks of a sharper increase in unemployment prevail.

While the recovery is likely to be supported by the unwinding of the crisis in the Middle East, there are still risks arising from the external environment, from factors affecting domestic demand and from the future course of fiscal and monetary policy. These are illustrated by simulations with the OECD's Interlink model assuming unchanged policies and exchange rates, except where another assumption is indicated. The results, which are summarised in Table 1, suggest the following:

- A major downside risk is that the euro area's internal demand turns out lower in the short run, as consumer confidence, after having plummeted in response to the geopolitical stress, may be further negatively affected by adverse short-run labour market developments. To evaluate this risk, a simulation was run in which it is assumed that *ex ante* employment growth is ½ percentage point lower in 2003 than projected, but rebounds more quickly in 2004, implying roughly the same amount of job creation over the projection period. It is also assumed that low confidence leads to a higher saving ratio in 2003 by ½ percentage point, before falling back by ¼ percentage point in 2004. In this scenario, output would be ¾ per cent lower compared to its baseline level in the first year and return to baseline in the second year.
- Internal demand could be hit by stronger fiscal tightening than assumed in the projection, as countries that are currently subject to an "excessive deficit procedure" under the rules of the Stability and Growth Pact may implement austerity packages (Chapter II). The simulations suggest that a reduction of government consumption by I per cent of GDP in Germany and France (equivalent to a shock of ½ per cent of euro area GDP) would reduce output by ½ per cent from its baseline level in both the first and second year. However, this does not take into account a possible impact of fiscal consolidation on confidence in financial markets and among households and businesses. When this occurs, the positive effect on private spending operates to diminish or even to reverse the negative demand effects of fiscal consolidation. Such confidence effects are not incorporated in Interlink and, therefore, not reflected in the results reported in Table 1.
- While exchange rates are fixed in the OECD's projection by assumption, the current upward momentum in the euro exchange rate against the US

Table 1. Risks and uncertainties surrounding the projections
Simulation results

		Year I	Year 2
Temporary reduction in euro-area internal	GDP ¹	-0.7	-0.0
demand via a ½ per cent lower employment	Inflation ²	-0.1	-0.5
growth and a 1/2 percentage point higher saving	Current account ³	0.2	0.0
ratio in 2003.	Government lending ³	-0.4	-0.1
Tightening of government budgets via	GDP ¹	-0.6	-0.5
a ½ per cent of GDP decrease in government	Inflation ²	-0.1	-0.3
consumption.	Current account ³	0.2	0.2
	Government lending ³	0.3	0.4
10 per cent appreciation of the euro in nominal	GDP ¹	-0.8	-0.9
effective terms.	Inflation ²	-0.7	-0.7
	Current account ³	-0.3	-0.5
	Government lending ³	0.1	0.0
Weaker growth in the United States by ½ and	GDP ¹	-0.1	-0.6
1 percentage point in 2003 and 2004,	Inflation ²	-0.0	-0.1
respectively.	Current account ³	-0.1	-0.3
	Government lending ³	-0.0	-0.2
20 per cent lower oil price.	GDP ¹	0.2	0.1
	Inflation ²	-0.2	-0.1
	Current account ³	0.1	0.1
	Government lending ³	0.1	0.1
Lower interest rates (by 100 basis points)	GDP ¹	0.4	0.6
in the euro area.	Inflation ²	0.1	0.1
	Current account ³	-0.1	-0.2
	Government lending ³	0.4	0.6

^{1.} Deviation from baseline level in per cent.

Source: OECD.

dollar could continue in view of the sizeable current account deficit in the United States (Chapter III). According to the simulation a sustained 10 per cent appreciation of the euro in nominal effective terms would reduce output by almost 1 per cent and inflation by ¾ percentage point from their respective baseline levels in both the first and second year. Meanwhile, uncertainties surrounding the strength of the US recovery have heightened recently, based on evidence that industrial production and residential construction activity have been losing steam. The simulations suggest that if US growth were a ½ percentage point lower in 2003, and a full percentage point in 2004, this would have only a minor effect on the euro area's output in 2003, while GDP would fall by a ½ per cent from its baseline level in the following year.

^{2.} Deviation from baseline rate in percentage points.

^{3.} Deviation from baseline ratio to GDP in percentage points.

- Oil prices came down from around USD 35 to 25 per barrel as soon as the hostilities in Iraq started and have stayed roughly at that level since. Further declines cannot be excluded, depending on the pace of recovery of oil extraction in Iraq and the response of other oil producing countries. The simulation of a 20 per cent decline in the annual average oil price suggests that this could raise euro area GDP by about ¼ per cent from baseline in the first year, with about half that effect in the second year.
- A simulation incorporating lower interest rates suggests that a monetary easing would be fairly effective if some of the downside risks materialised. A sustained cut in interest rates by 100 basis points would raise the level of output by around ½ per cent from baseline in the first and second year, assuming a constant exchange rate.

All considered, the major risks to the projection appear to be skewed to the downside and indeed recent indicators point in that direction. While monetary policy has provided some offset to these risks, a combination of new adverse shocks could be very challenging for policy makers. However, the baseline scenario remains one of gradual recovery of the euro area economy.

Medium-term performance

The Single Market Programme (SMP) implemented in 1992 was expected to boost economic performance.\(^1\) There is some evidence that it has had positive effects, even though, as argued below, its implementation has been painfully slow in some areas, for instance in the postal and railway sectors.\(^2\) However, growth performance in the euro area did not improve appreciably as compared to the 1980s. The per capita income gap with the United States is even higher today than it was prior to the implementation of the SMP (Figure 4). This in part reflects cyclical developments, but the differential with the United States has widened in recent years also in potential terms (Table 2). Since 1998, annual potential growth per capita amounted to 1.9 per cent in the euro area as compared with 2.3 per cent in the United States. Other OECD economies also outperformed the euro area, with similar rates as in the United States recorded in Denmark, the United Kingdom and New Zealand. Even higher ones are found in Canada, Australia and Sweden – akin to developments in some of the smaller "peripheral" countries in the euro area.

Figure 5 decomposes the gap in GDP per capita *vis-à-vis* the United States into labour productivity and the quantity of labour utilised, both measured in terms of hours worked. On both counts, the euro area lags the United States, although the labour utilisation gap is twice as large as the labour productivity gap. In terms of labour utilisation the euro area scores weaker also than most other OECD economies, although it scores somewhat better on labour productivity.

While trend labour utilisation in the euro area has picked up somewhat in recent years, the United States, as well as Canada, Australia and New Zealand

100 100 95 95 90 90 Japan 85 85 80 80 Euro area 75 75 70 70 65 65 United Kingdom 1970 76 78 2000

Figure 4. **Evolution of the income gap with the United States**¹ United States = 100

1. GDP per capita in USD at constant prices and purchasing power parities. Source: OECD, National Accounts.

Table 2. Average trend growth in GDP per capita¹

	1.8		
	1992-2002	1992-95	1996-2002
Euro area ²	1.8	1.7	1.9
Denmark	1.8	1.5	2.0
Sweden	1.9	1.2	2.3
United Kingdom	2.3	2.3	2.3
European Union ²	1.9	1.7	1.9
Australia	2.1	1.6	2.4
Canada	1.9	1.0	2.3
Japan	1.3	1.7	1.0
New Zealand	1.7	1.0	2.1
United States	1.9	1.3	2.3
OECD ³	1.9	1.6	2.0

A description of the method to compute trend growth in GDP can be found in the Sources and Methods of the OECD Economic Outlook.

Source: OECD.

^{2.} Weighted average excluding Luxembourg.

Weighted average excluding Czech Republic, Hungary, Luxembourg, Poland, Slovak Republic and Turkey.

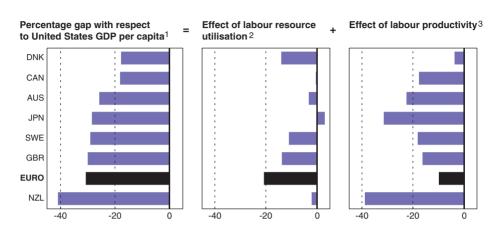


Figure 5. **Explaining the income gap** 2002

- 1. Based on purchasing power parities.
- 2. Based on the ratio of total employment to population and average hours worked.
- 3. GDP per hour worked.

Source: OECD.

outperformed the euro area in this respect (Figure 6). A further breakdown of this trend suggests that growth in the number of employees in the euro area is partly offset by the continued decline in the number of hours worked per employee. Some argue that these trends, aside from demographic factors, reflect societies' choice (Gordon, 2002). But, as discussed below, unintended spill-overs from structural policies have certainly also played a significant role. From 2010 onward ageing will lead to a further and more rapid decline in the working age population so that the use of labour resources can only be sustained by mobilising those who are currently not employed or by reversing the trend decline in hours worked, although immigration of qualified workers can also help.

The OECD's medium-term scenario presented in the OECD Economic Outlook No. 73 suggests that, on unchanged policies, a growth gap between the United States and the euro area will persist even before the impact of ageing kicks in (Table 3). Labour productivity growth averages 1½ per cent per annum in the period 2003-08 as compared to 2¼ per cent for the United States. This implies a GDP growth per capita of 2 per cent for the euro area as compared to 2½ per cent for the United States, and 1¾ and 2¼ per cent, respectively, in potential terms. Unemployment would decline only little and remain 2¾ percentage points above the US rate in 2008. This suggests that structural reform may yield a growth dividend. The sections below discuss in which areas such efforts should receive priority.

1.2 Growth in trend labour resource utilisation 1.2 Total hours worked 0.8 0.8 0.4 0.4 0.0 0.0 -0.4 -0.4 -0.8 -0.8 JPN DNK **EURO** SWE **GBR** AUS NZL USA CAN 1.2 Growth in working-age population 1.2 As a ratio of total population 0.8 8.0 0.4 0.4 0.0 0.0 -0.4 -0.4 -0.8 -0.8 JPN DNK **EURO** SWE GBR AUS NZL USA CAN 1.2 Growth in trend employment rates 1.2 As a ratio of working-age population 0.8 8.0 0.4 0.4 0.0 0.0 -0.4 -0.4 -0.8 -0.8 JPN DNK **EURO** SWE GBR AUS NZL USA CAN 1.2 Growth in trend average hours worked per employee 1.2 0.8 0.8 0.4 0.4

Figure 6. **Decomposing trend labour resource utilisation**Per cent, average 1995-2002

Source: OECD.

JPN

DNK

EURO

SWE

GBR

AUS

NZL

USA

0.0

-0.4

-0.8

0.0

-0.4

-0.8

CAN

	EURO	DNK	SWE	GBR	AUS	CAN	JPN	USA
Gross domestic product Per capita ¹ Potential output per capita ¹	2¼	2¼	2¼	2½	3¾	3	1½	31/4
	2	2	2¼	2¼	2¾	2¼	1½	21/2
	1¾	2	2¼	2	2¾	2½	1	21/4
Employment	½	0	½	½	1¼	1¼	½	1¼
Employment rate (%) ²	65	76	73	72	71	73	75	633
Labour force Unemployment rate (% of labour force)	½ 8¼	0 4½	½ 4½	½ 5¼	1¼ 5¾	1 7	0 5	1¼ 5½
Private consumption deflator	1½	2 2	2	1½	2½	2¼	-1½	1¼
Net lending (% of GDP)	-2¼		1	-2	¼	1	-7¾	-3¼

Table 3. **Medium-term baseline scenario**Per cent growth, average 2003-08

Source: OECD and United Nations, "World Population Prospects 1950-2050 (The 2002 Revision)".

Towards better working product markets

Taking stock of market integration

The single market has partly fulfilled its ambition of fostering European integration, as reflected in the rising Internal Market Index compiled by the Commission (Figure 7). The primary aim of the single market was to raise competition, by opening up sheltered national markets. In the early stage, the Single Market Programme (SMP) focussed on eliminating non-tariff barriers to trade and investment by legislative means and mutual recognition. In the second half of the 1990s, the SMP evolved into the broad-based Internal Market Strategy, which is supported by the Cardiff process and action plans, such as the Financial Services Action Plan. The Cardiff process aims at fostering product and capital market reforms in member states, by means of peer pressure instead of Community legislation.

Deepening integration is typically reflected in price convergence, rising trade and investment flows and diminishing market shares for incumbents:

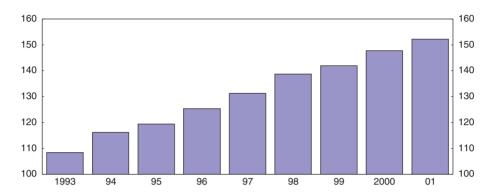
- Price convergence of traded goods has been significant but deeper integration should reduce price dispersion further (see Box 9 in Chapter IV).
 On the other hand, convergence of service prices is still clearly lacking, as highlighted by the 2002 Cardiff Report.
- On the other hand, intra-area trade has fallen relative to extra-area trade (Figure 8).³ Moreover, trade in services does not appear to have benefited from deep integration, as intra-area trade intensity is much lower for services than for goods, services accounting for just 20 per cent of trade in the Internal Market, less than a decade ago (European Commission, 2003a).⁴

^{1.} Calculated using mid-year, medium variant population projections.

^{2.} In per cent of working age population.

^{3.} Based on a wider definition of the working age population.

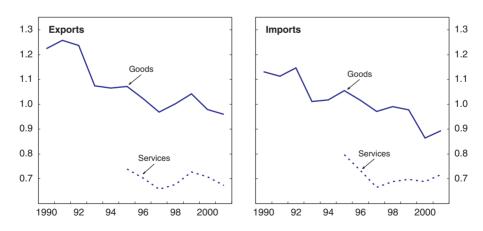
Figure 7. **Euro area internal market index** 1992 = 100



The internal market index is a weighted sum of twelve base indicators, the most important being: value of published
public procurement, sectoral and ad hoc state aid, telecommunication costs, electricity and gas prices, intra-EU
trade, intra-EU foreign direct investment and relative price level. More details can be found at http://europa.eu.int/
comm/internal_market/en/update/score/index.htm

Source: European Commission (2000a).

Figure 8. **Trade patterns in the euro area**Ratio of intra-area to extra-area trade¹



The intra-area imports do not always add up to intra-area exports due to unclassified data.
 Source: OECD, International Trade Statistics database, March 2003 and OECD, Statistics on International Trade in Services.

- Concentration in manufacturing has declined, whilst the number of large manufacturing firms with production facilities in the Union is rising. However, in sectors with a dominant leader, where concentration remains high, price/cost margins tend to be higher and the convergence of prices is slower. Large multinationals apparently have been relatively successful in pursuing price discrimination strategies (Veugelers *et al.*, 2001).
- While several measures have increased disclosure and transparency of public procurement, cross-border trade is still very low (Chapter IV).

Removing barriers to integration

Services are affected much more than goods

Whilst barriers to the integration of services are still important, barriers to trade in goods mainly concern complex products or products where risks to health are a major concern. For some of these products the Commission implements EU-wide standards, whilst for others the principle of mutual recognition (MRP) applies. The 2002 Implementation Report concerning the 2001 Broad Economic Policy Guidelines (BEPGs) points to problems in the application of the MRP and need for reforms. In response, the Commission has put forward a proposal to improve its effectiveness (Annex II).

On the other hand, recent reports by the Commission on the functioning of the Internal Market for Services point to a lack of deep integration, mainly due to regulatory and taxation factors (European Commission, 2002a). There are language and cultural barriers, too, while legal barriers cumulate at all stages of service operations:

- The establishment of a service provider abroad can be affected by quantitative restrictions, residence requirements, authorisation and registration procedures (Table 4), requirements on the legal form and internal structure of a firm and onerous conditions governing the exercise of service activities and professional qualifications.
- The use of inputs is hampered by difficulties such as restrictions on the posting of workers.⁵
- Sales promotion faces problems with respect to authorisation, registration and declaration procedures, while restrictions on commercial and non-commercial communication exist.
- The distribution of services can run into the same difficulties as the establishment of services, and in addition be hampered by nationality or establishment requirements.
- The sales of services can be constrained by rules on price setting, payments, invoicing and accounts or taxation.

	Number of procedures	Time (weeks)	Estimated costs (EUR)		
France	10	6	3 400		
Germany	6	16	1 400		
Italy	18	10	2 200		
Netherlands	2	12	1 000		
Spain	7	24	330		
Sweden	3	3	1 130		
United Kingdom	1	1	420		
Australia	1	1	340		
Japan	6	3	4 000		
United States	1	1	500		

Table 4. Formalities for establishing a business

 The after-sales aspects of services (liability, debt collection, provision of after sales services) are also often heavily regulated.

The bulk of the barriers to trade of services would be drastically reduced if national regulations were reformed, notably with the aim of reducing red tape. Moreover under mutual recognition, a service provider authorised in one country should not need to get authorisation in another EU country. As it stands now, this is not the case except in banking, and the service provider has to seek authorisation according to the rule of the member state. This means that a firm wishing to establish in another member state often has to undertake all the administrative procedures of the host country in addition to the ones it has already undertaken in its home country. Moreover, a significant amount of non-government rules apply within member states, often imposed by professional bodies.⁶

Some impediments are sector-specific. For instance, regulatory reform in some network industries is proceeding at a snail's pace (Chapter IV). Not all sectors and aspects can be covered here, but retail distribution, the airline industry and port services are discussed to highlight impediments to deep integration. For the financial sector, the lack of integration prompted the Commission to issue an action plan. The previous Survey included a special chapter on financial markets and Box I provides an update.

Retail distribution

A good example of a service sector displaying surprisingly modest effects from integration is retail distribution. European Commission (2001a)

This is the most recent comparable data available; however some member states may have taken several measures in recent years that do not appear in this table.
 Source: OECD (2000), Small and Medium Enterprise Outlook.

Box 1. Progress in financial market integration

The Financial Services Action Plan (FSAP) is the Community's central tool for attaining deeper integration in this sector (Annex III). Historically, progress in integration of financial markets in the euro area has been slow, especially in the retail markets. However, three quarters of the FSAP measures have been completed since the inception of the Plan in 1998. It is important to adhere to the timetable for implementing all the proposals in the FSAP by 2005, which were deemed necessary already in 1998. April 2004 is set as the final date for adoption by the Council of all measures – to allow 18 months for transposition in the member states. More particularly:

- Recent action to speed up the process of implementing the proposals in the FSAP, with ten measures being voted since the Barcelona Council, is a step in the right direction. Faithful national implementation becomes crucial now.
- As the FSAP measures should soon be completed, the authorities should move from an approach where isolated measures are taken to a sector wide approach. It would be important to integrate the financial sector in the regular economic surveillance programme, in light of its size and influence on other sectors.

Common financial markets in the euro area have matured in the areas where the infrastructure is simpler as in the wholesale business or where the public sector is most involved. By contrast, in areas where EU wide public infrastructure is scant, markets remain regional and transaction costs for cross border activity remain high. While the markets generate solutions around existing barriers they are often far from optimal from an economic efficiency point of view and costly. The authorities should focus on removing such barriers. Continued efforts on cross-border clearing and settlement arrangements following the Giovannini group's work (Giovannini, 2003) is an example. As underlined in the previous Survey, to deepen integration further, the following policies need to be pursued:

- Further efforts should focus on improving the financial market infrastructure, where diverging national structures are hampering cross border trade. Competition policy should focus more on cross border issues also in the financial markets, to whittle away local entry barriers.
- Access to the existing infrastructure should be open to market entrants, possibly subject to fair fees. In particular, the clearing and settlement infrastructure for securities should be made accessible to cross border trade. The authorities should let the market develop new solutions, but should take measures to stop solutions that hamper entry. A continued focus on international issues, such as the interfaces between EU and US markets and regulations, is also needed.
- National industries' interests often stand in the way of achieving a common financial market. A better balance should be struck between these interests and the common good based on the general acceptance that financial market integration cannot be achieved without free cross border ownership and trade in financial services and products. The Commission should disclose

Box 1. **Progress in financial market integration** (cont.)

trade in financial services and products. The Commission should disclose information on "national champion" policies and reinforce its policing role. Especially, a new take over bid Directive should be adopted with priority in order to clarify and establish a legal framework for cross border mergers and acquisitions.

The current structure of regulation and supervision is the result of different administrative, legal and financial approaches across countries. The focus should be on legal and regulatory reforms that protect the rights of investors and enforces contracts, and thus supports the functioning of both markets and intermediaries. Admitting the slow process of adopting legislation, the authorities have taken steps to re shape the regulatory process by separating first principles from secondary legislation. The new framework, based on the Lamfalussy proposals, has recently started working in the securities markets. The introduction of similar committee structures covering insurance and banking was a long overdue step. However, these committees, consisting of members with strong national interest, must be kept transparent and use consultation processes continuously.

reports that retail prices vary three to five times more across the Union than inside countries, mostly owing to differing national regulations, company behaviour and a lack of competition. Restrictions often concern the establishment of large outlets, zoning laws and restrictions on shop opening hours, as the sector is governed by the subsidiarity principle. Many of these are implemented at the local or regional level. An indicator of the restrictiveness of regulations suggests that the euro area's overall regime is between the United States and Japan for domestic distributors, while for foreign distributors the euro area has restrictions almost equal to Japan and is much more stringent than in the United States (Table 5).

Transport

Many aspects of air transport have been liberalised. However there remain a number of areas where further improvement would be welcome, notably regarding slot allocation, air traffic management, which is co-ordinated at the European level, and ground handling services. Regarding slot allocation, the main problem relates to the fact that slots can be kept from year to year by incumbent carriers, the so-called "grandfather rights". Similarly, under EU legislation, member states are required to ensure that the slot co-ordinator acts in an "independent" manner, but this does not prevent domestic airline companies

Table 5. Restrictiveness in distribution Total index

	Domestic	Foreign
Austria	0.05	0.19
Belgium	0.18	0.32
Finland	0.05	0.24
France	0.18	0.33
Germany	0.10	0.24
Greece	0.05	0.27
Ireland	0.05	0.19
Italy	0.14	0.29
Luxembourg	0.05	0.17
Netherlands	0.09	0.24
Portugal	0.05	0.21
Spain	0.08	0.22
Denmark	0.09	0.27
Sweden	0.07	0.21
United Kingdom	0.05	0.19
Australia	0.03	0.10
Canada	0.05	0.19
Japan	0.20	0.25
New Zealand	0.00	0.06
United States	0.00	0.16

Source: Kalirajan (2000).

from taking part in the slot allocation activities, which leads to conflicts of interests and favours incumbents even more. Additionally, according to a Commission report, insufficient planning of national airspace and air traffic control organisations results in deficiencies, leading to bottlenecks and delays (European Commission, 2000b), longer journeys and higher fuel consumption and affects safety (European Commission, 2001b). For ground handling services, EC law only requires that airports (subject to certain exceptions) have at least two ground handling services providers, at least one of which should be independent of the airport and the main air carrier at that airport, and with separate accounts. Results from a study conducted by the Association of European Airlines suggest that a lack of competition for ground handling businesses significantly increases airport charges (Association of European Airlines, 1998). But SH&E Consultants in 2002 shows that the price for ground handling services has decreased and that the quality has in many instances improved (EC, 2002b). The Commission intends to present a proposal in autumn which should lead to the further gradual liberalisation of the ground handling market.

In June 2003, a major step towards the completion of the European integration of the air transport market was realised with the Transport Council adopting a package of measures. It included three main items:

- A mandate to negotiate a transatlantic air agreement with the United States for the European Union as a whole, a mandate similar to the Commission's mandate on negotiating trade liberalisation; As well as the crucial issue of traffic rights, the negotiating mandate covers subjects including market access, ownership and control, competition rules and safety and security.
- A mandate to change the designation clause and other provisions in all other bilateral aviation agreements between Community member States and third countries:
- A general framework for co-ordination and for individual negotiations between member states and foreign states.

The first item will allow the Commission to negotiate an Open Aviation Area with the United States, negotiating the opening of the respective markets and investment rules. The current bilateral agreements with the United States will remain in place until a new EU-US agreement is reached. The second point aims to get rid of the national restrictions imposing that international routes to and from a member state can be flown only by air carriers owned and controlled by nationals of that member state, hence protecting national champions as most of these companies are national flag carriers. Finally, the third item will provide a general framework for bilateral negotiations between member states and other non-European countries, whilst preserving the freedom of each member state to negotiate its own agreement within the limits designed at the European level.

Concerning port services, liberalisation is only starting, even though some member countries have moved ahead on their own. In principle, Community rules on the freedom to provide services, the right of establishment and competition rules should also apply to ports. However, the Commission underlined that national frameworks often violate these principles. In response, the Commission issued a draft directive stating that: procedural rules should be transparent, non-discriminatory, objective and proportional; local aspects should be taken into consideration, but should not be a pretext for hampering competition; the number of port service providers could only be limited if there are space or capacity constraints, or because of maritime traffic-related safety issues; a port service provider should be in a position to employ the personnel of his own choice; self-handling should be allowed and self-handlers treated as other providers of comparable services; finally, port authorities involved in both port management and port service supply should not undercut competition. Negotiations on this Directive have been lengthy, and the current proposal

(amended by both the Council and the Parliament and still not adopted) includes many exemptions. In particular, the duration of transitional measures, whereby the number of service providers in each port may remain limited to the current authorised ones, is up to a maximum of 36 years. Moreover, under certain conditions, the existing authorisations may be extended for another 10 years. This means that competition could remain limited for another 36 or even for 46 years.

Improving the regulatory framework

The Commission has calculated that for the 731 Internal Market Directives that were issued between 1993 and April 2002 it took 2.28 years to adopt and transpose a Directive within the deadline for transposition. Transposition problems beyond the deadline extended the average time by 2.21 years (European Commission, 2002c). Moreover, variations across sectors are important. Implementing the financial market directives, for instance, took 7.33 years. At the same time, the number of infringements remains stubbornly high, with a wide dispersion across countries (European Commission, 2002d).

The Mandelkern Report (2001) identified some problems that may explain these long delays. These problems arise when preparing a new legislative act, during the transposition or implementation, and when ensuring compliance and enforcement. Preparation has usually been weak in terms of assessing the effects of new legislation, including the practicalities of implementation. Moreover, often the European Parliament and Council propose amendments to legal acts drafted by the Commission. Some of these amendments may significantly affect the content of the original act, and would therefore also benefit from a thorough assessment. The Mandelkern group also suggested that directives have become too technical and detailed, lack simplicity, clarity and accessibility, which create problems for transposition. Transposition problems also arise from differences in national practices and different cultures, which lead to a lack of cross-country coherence in transposing Directives, potentially distorting the internal market. Moreover, the practice of "gold plating", adding national rules on top of EU-wide rules, can lead to additional barriers to trade and the freedom to provide services.⁷

Initiatives to speed up and simplify legislation and enforcement include the SLIM (Simpler Legislation for the Internal Market), Interactive Policy Making (IPM) and SOLVIT initiatives.⁸ They have improved legislation, with a number of directives simplified or merged, while some enforcement cases have been solved. However, much remains to be done: a Commission assessment of the SLIM initiative shows that modernising existing legislation can take as much time as drafting a new one, the selection of the areas for scrutiny has been random, and most cases solved under the SOLVIT scheme have been easy ones (European Commission, 2000c and 2000d). Moreover, only about a quarter of the single market legislation (which

comprises some 20 000 pages) has been vetted so far. Recently, the Commission put forward a proposal drawing on the SLIM experience and the Mandelkern Report (European Commission, 2003b). This initiative aims at simplifying and improving the Community's law-making, using a wide range of instruments recommended by the Mandelkern Group (Box 2).

Tackling taxation issues

Consumption taxes can distort the single market, because of the procedural complications that cross-country differences in the value added tax (VAT) regime entail. Since the abolition of border controls in 1993, the destination principle - consumption is taxed in the member state where consumption takes place – still applies for commercial transactions, while the origin principle applies to individuals except for distance selling.9 For VAT purposes, the system is straightforward for businesses when dealing with other VAT-registered businesses: a vendor needs only to document a sale in another member state with the VAT registration number of the customer and evidence of the dispatch of the goods or services. However, the lack of uniformity in the implementation of Directives and procedural complications imply that the cross-country differences in the VAT regime may create distortions to trade flows. The VAT regime for cross-border trade embodies a wide variety of rules for determining the place where the transaction is taxed and, consequently, the place where the tax is deducted or refunded (Journard and Kongsrud, 2003). In addition, according to the European Commission VAT fraud amounts to EUR 8 billion annually, and is growing (European Commission, 2000e).

The Community had initially been committed to move towards the origin principle for sales to both businesses and individuals. This would have the advantage of simplicity as the VAT system would then operate within the Union as it does within a country. However, this would probably require agreement on a revenue-sharing scheme, and probably greater harmonisation of rates, both of which face significant political difficulties. Differences in VAT rates between member states remain large, especially for some sectors. For example, VAT rates in the tourism industry still range between 3 and 25 per cent. In the meantime, the Commission has launched a proposal to simplify and modernise the current regime, with a view to ensuring more uniform application of the current rules as well as ensuring closer administrative co-operation. Part of the proposal, notably on e-commerce, had been approved and led to directives or decisions. Others, such as the VAT regime for electricity and gas, is still under discussion in the Council. Overall, the changes proposed are marginal. Fundamental reforms would require the agreement of all member states under the unanimity principle that prevails for taxation matters. At present, there does not appear to be the political will to undertake a major reform.

Box 2. Proposals for improving the EU's regulatory framework

The OECD has established a checklist to ensure a better development and implementation of regulations. This list suggests that policy issues need to be precisely stated, that government action needs justification, and that regulation is not always the best form of government action. Regulation should be based on a sound legal basis and designed at the appropriate level of government. A cost benefit analysis should be undertaken systematically, and the impact of new or existing regulations assessed. Regulations must be clear and simple. All interested parties should be consulted. Compliance should be thought about in a forward looking way. Judged against these criteria, the Mandelkern Report comes to the conclusion that European legislation is of poor quality, often as a result of the multiple layers of negotiations.

Reflecting these concerns, the Lisbon European Council asked the Commission, the Council and the member states "... to set out by 2001 a strategy for further co ordinated action to simplify the regulatory environment, including the performance of public administration, at both national and Community level". The Commission responded to the Mandelkern Report with an action plan on "Simplifying and improving the regulatory environment". Most proposals were implemented in December 2002 and others will follow during 2003. Compared to existing procedures, the action plan proposes to:

- Enhance timely consultation during the preparation phase, which will be systematically accompanied by an impact assessment, the budgetary implications of the proposal, and eventually a review clause.
- Make greater use of the Commission's option to withdraw a legislative proposal should additional amendments, notably by the Parliament, blur the aims of the initial regulation, as well as providing a more systematic framework to follow up on transposition and infringements.
- Set up a network involving all Directorates General (DGs) and the Secretariat General for monitoring the legislative framework and the implementation of the Action Plan, and co ordinating relations with member states, reporting annually.
- Limit directives to the essential aspects of legislation, leaving technicalities and details to other measures.
- Simplify and reduce the volume of Community legislation, based on the lessons from the SLIM programme.
- Improve implementation by requiring member states to provide notification of transposition measures electronically in a standardised way, accompanied by a consultation and an assessment when transposition is not satisfactory.
- Create a network between the Community institutions on the one hand, and between the Commission and the member states on the other hand, monitoring the quality of legislation at Community level, and ensuring co ordination, exchange of information on transposition and application, and ongoing evaluation of how directives and regulations have been applied in practice.

Box 2. Proposals for improving the EU's regulatory framework (cont.)

- Create a network between the Community institutions on the one hand, and between the Commission and the member states on the other hand, monitoring the quality of legislation at Community level, and ensuring co ordination, exchange of information on transposition and application, and ongoing evaluation of how directives and regulations have been applied in practice.
- Expand public access to legislation through EUR Lex, extending this website as a single portal to public documents throughout the entire Community decision making process.
- Provide an annual assessment of the implementation of the Action Plan, and the subsequent regulatory measures and practices.

In addition, the European Commission has put forward further proposals in a recent communication (European Commission, 2003a), including proposals:

- to analyse by March 2004 the possibility of drawing up an "Internal Market compatibility test", which would be designed as a guidance for national legislators when transposing European law.
- to evaluate the possibility of including standard sanction clauses in Directives in case of violations of the obligations flowing from the Directives.
- to reduce the number of their infringements by at least 50 per cent.

Corporate tax differences are large in the euro area, some estimates pointing to a 30 percentage point difference in effective tax rates (European Commission, 2001c). Although tax competition can help to limit the overall tax burden and restrain public spending, the existence of 15 different tax codes makes operating across border complex, especially for smaller enterprises, thus raising compliance costs, while differences in taxation can introduce distortions (Lannoo and Levin, 2002). Against this backdrop, the Commission proposed a consolidated corporate tax base for companies having EU-wide activities. Four approaches have been identified:

- Home state taxation (*i.e.* subsidiaries are taxed according to the tax base as defined by the country where the parent company is located).
- Common consolidated base (i.e. companies have the possibility to opt for computing their consolidated tax base according to a new set of EU-wide rules).
- European Union Income Tax (*i.e.* corporate taxes would be levied at the EU level and revenues could possibly fund the EU budget).

- Harmonised single tax base (i.e. companies compute their consolidated tax base according to a new set of EU rules).

The four options would enhance transparency while leaving full scope for member states to set their own tax rates, except under the third approach. They also imply consolidation of accounts, thus eliminating problems with offsetting profits and losses across borders, and of transfer pricing within the Union. However, it may be difficult to reach a political agreement on the principle of a consolidated tax base. Whatever model is selected will involve member states ceding some control over the structure of their corporate tax systems – with a formula being applied to a standard base under most options. There are also practical problems involved in reaching agreement on a formula for apportioning profits between countries where companies are operating, for example on what factors to include, what weights to give to the different factors, whether to use different formulas for different types of industry and on the base to which the formula is to be applied. 11 For multi-national enterprises with operations outside the Union it would be necessary to divide the base into an EU consolidated base and a non-EU base using the existing international standard, the arm's length principle of Article 9 of the OECD Model Tax Convention, thereby increasing complexity and compliance costs. Finally, as formulary apportionment is different from the existing international standard, it may be necessary to renegotiate or at least re-interpret existing tax treaties thereby risking double taxation.

Enhancing innovative capacity

Following up on the Lisbon summit in 2000, a target to raise R&D spending to approach 3 per cent of EU GDP was set at the 2002 Barcelona Council, two thirds of which should be company financed. Total R&D spending – at 1.9 per cent of GDP – in the euro area has been lagging behind the United States and Japan and the gap has widened over the 1990s (Figure 9).¹² Meanwhile, private R&D still only represented 1.2 per cent of GDP in 2000 in the euro area, while it rose from 1.9 per cent in 1993 to 2 per cent in the United States. Thus, the euro area is far from the target set at the Barcelona European Council (Box 3). The Secretariat has estimated that raising R&D in the euro area to the US level could permanently increase the GDP growth rate by 0.1 percentage point (Bassanini and Scarpetta, 2001).¹³ Preferably such an increase would result from market-based incentives (as opposed to government funding) to "get more bang for the buck". Bartelsman *et al.* (2003) suggest that aligning product market regulations in the euro area on the United States could permanently enhance R&D intensity by 0.5 percentage point.

Aside from R&D, innovation indicators reveal a mixed picture regarding innovation and the diffusion of innovation in the Union compared with the United States:

- The United States Patent and Trademark Office (USPTO) has been granting a rising number of patents to EU companies, but the European Union

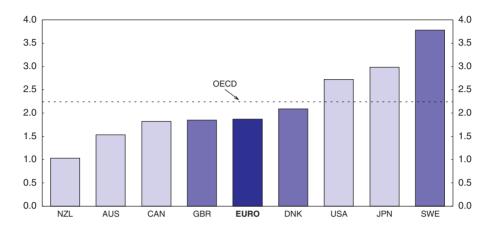


Figure 9. **R&D intensity**¹ Per cent of GDP. 2000²

- 1. Measured by gross expenditure on R&D.
- 2. 1999 for Denmark, New Zealand and Sweden.

Source: OECD (2002), Main Science and Technology Indicators, December.

continues to trail far behind the United States on grants delivered by the USPTO. At the same time, the number of US patent applications with the European Patent Office increased faster than that of the Union (Figure 10).

- Diffusion of technologies is advancing, with household internet penetration rising above 40 per cent in 2002, but still lagging behind the 50 per cent observed in the United States. E-commerce also trails in Continental Europe, as in January 2002, the United States had about 25 per cent of the total OECD population but 65 per cent of the total OECD-wide secure servers a measure of internet commerce developments. The United Kingdom had 6 per cent (and accounts for about 5 per cent of the OECD population), and the EU about 20 per cent (whilst these countries represent around 35 per cent of the OECD population) (OECD, 2002a).
- Risk capital is much less developed than in the United States (Figure 11).¹⁴
 Especially, private funding is small.
- Human capital, as measured by educational attainment, though increasing, still lags behind the United States and Japan, which comes against the background of stagnating spending on tertiary education in the euro area (Figure 12).

Box 3. Assessing the Barcelona R&D targets

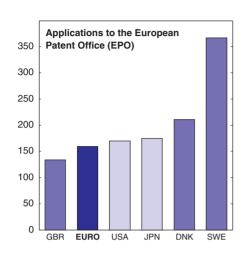
R&D targets serve a clear political purpose by providing a tangible goal for Science and Technology (S&T) policy, but they cannot be a substitute for addressing the structural problems that undermine the innovative capacity of an economy.

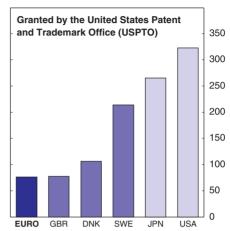
The 3 per cent target, including the aim that two-thirds should be realised by the private sector, is very ambitious, as only a few countries have achieved an R&D intensity of 3 per cent (Iceland, Sweden, Finland and Japan). Should EU wide GDP grow at an annual rate of 2 per cent, R&D spending calculated using purchasing power parities will have to rise by USD 164 billion by 2010, which would roughly double the 2000 level. Also the number of researchers would have to rise at an impressive pace. Estimates of the number of additional researchers vary and range between an increase of more than 525 000 researchers to close to 2 million (Sheehan and Wyckoff, 2003; Schibany and Streicher, 2003). This is a challenge. The largest gains in researchers registered in the past occurred between 1981 and 1991 in the United States where ranks swelled by an additional 277 000. More recently, Japan (1990-99), the European Union (1991-99) and the United States (1989-97) have increased the number of researchers by 76 000, 172 000 and 190 000, respectively (OECD, 2001a).

There are several instruments to support R&D, for instance, R&D tax credits or the granting of intellectual property rights. Moreover, governments fund private sector R&D spending. Guellec (2001) argues that government supported R&D had a considerable impact on multi factor productivity (MFP) growth over the past 20 years. In addition to R&D spending structural problems that undermine the innovative capacity of an economy need to be addressed. The business environment in the euro area countries is not as good as it should be in this regard. Moreover, public research organisations and universities do not contribute as much as their US counterparts. These are essential as they provide fundamental research, which is an important input to innovative activity. At the same time, the way in which funding is provided and the way it is used within the public research sector have a significant influence on the formation of clusters. Focused targets, close monitoring and evaluation of research funding are essential to ensure a satisfactory return on public investment. This includes greater use of contract funding, as opposed to block grants, selective increases of funding for research fields that are thought to offer greater economic and social returns, and the creation of multidisciplinary research centres to ensure diffusion. Centres of excellence based on universities will also need to re balance the focus between research and teaching and involve businesses better.

- The supply of scientists and researchers is also a widespread concern. The presence of researchers in the total EU workforce (5.4 per 1 000 labour force) is considerably lower than in Japan (9.3) and the United States (8.1), and is more heavily concentrated in the public sector. The increase in the

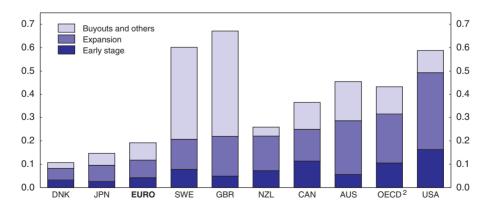
Figure 10. **Patents**Per million inhabitants, 2001





Source: European Commission/Eurostat.

Figure 11. **Venture capital investment by stages**¹
Per cent of GDP, 1998-2001



1. The definition of private equity/venture capital tends to vary by country.

Based on 23 countries. Australia, Japan, Korea and New Zealand are excluded since their data cover investment portfolio at the end of the year.

Source: OECD Venture capital database, May 2003.

10

5

USA

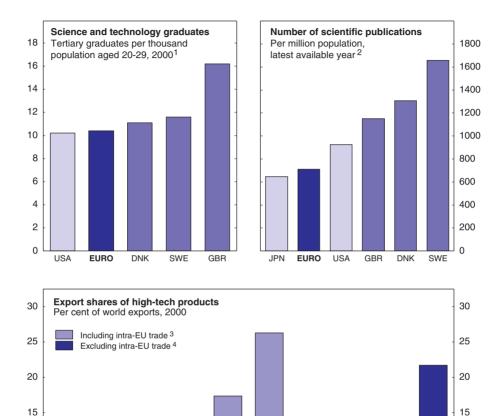


Figure 12. Science, technology and innovation benchmark indicators

1. The euro area excludes Greece.

DNK

2. 2001 for publications and 2000 for population.

SWE

GBR

JPN

All data include intra-euro area exports and the world market refers to total world high-tech exports including intraeuro area exports.

EURO

JPN

EURO

Euro area excludes intra-euro area exports and the world market refers to total world high-tech exports excluding intra-euro area exports.

Source: European Commission, Science, Technology and Innovation: Key Figures 2002; Eurostat and OECD.

USA

10

5

0

number of researchers, at 3 per cent per annum on average since 1995, is also lagging behind the United States, which registered a 6.2 per cent annual growth rate. Moreover, although the number of PhD students is relatively high in the euro area, and grows at a higher rate than in the United States, a large number of students migrate to the United States, where working conditions are better.¹⁵

Links between universities, public research organisations and businesses need to be boosted. For instance, the share of patent applications originating from universities and public research organisations in the Union is lower than in the United States (OECD, 2000a and 2003b). ¹⁶ There is an increasing focus on the potential spillovers from universities to industries. The empirical evidence concerning this link is scarce, probably because spillovers may take time to reach industry (Guellec and Pottelsberghe, 2000). In this respect, the Sixth Framework Programme focuses more on networking than previous programmes, by directing an increasing share of grants towards research institutes that co-operate across borders. The Human Resources and Mobility activity has a budget of EUR 1.5 billion representing almost 10 per cent of the overall budget. ¹⁷

Recent developments have underscored the importance of the creation of regional centres of excellence, which entail highly skilled human capital in research organisations and industries able to make a commercial use of innovations (Kuhlmann, 2001). However, the Community's role in guiding these developments is limited. It only funds research for specific projects that require large investment, both human and fixed, and could benefit the entire community, whilst more general innovation policy remained firmly in the hands of member states (Georghiou, 2001). Thus, member states still account for 95 per cent of expenditures on public civil R&D in the European Union and have encouraged the development of clusters at the national level (Bachnoff, 2002). This has resulted in a multiplicity of national laboratories and research groups, without much coherence at the European level, sometimes overlapping in their research. This is difficult to overcome as it involves distributive considerations. To address this issue the Commission has launched programmes aiming at favouring the establishment of international networks (5th and 6th Framework Programmes).

An effective system for protecting intellectual property rights (IPR) is essential and needs to strike the right balance between encouraging the diffusion of ideas and rewarding innovation. The aim of the measures provided for in the First Action Plan for Innovation in Europe (1996) was to improve the EU patenting system. Already the 1993 Green Paper on Innovation highlighted the inability of European firms to translate scientific competence into commercially successful innovation. This phenomenon persists. The Union does not score very well in terms of scientific publications or citations, it lags in the number of patents per million population and the high-tech share of extra-area exports is low (Figure 12).

In this respect, a major step was made in 2003 with the finalisation of the Community Patent, identified as one of the "targets missed" in the 2002 Review of the Internal Market Strategy. European patents are expensive by international standards (three to five times as much as in the United States), the granting process is slower and public bodies are not always fully covered as they do not always have the freedom to patent innovations. The Community Patent goes some way in simplifying the granting process, and extending its cover to university research. In March 2003, EU governments agreed on the remaining most contentious issues: the language regime, the jurisdictional arrangements (which court will deal with validity and infringement procedures), and the role of the national patent offices in the new scheme. On language, companies applying for a patent will have to translate the first three pages of the document, which define the legal scope of the patent, in all the EU languages. The rest of the patent will have to be either in English, French or German. On jurisdictional issues, ministers agreed that national courts will continue to rule on patent disputes until 2010, when an EU-wide court will be set up in Luxembourg. Notwithstanding this progress, the overall cost of an EU patent as estimated by the Commission will remain a lot higher than in the United States or Japan, but about half of what it costs currently. The first EU patents are expected to be issued in five years.¹⁸

Towards a better working labour market

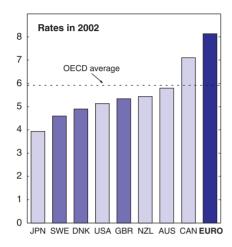
Since peaking at close to 11 per cent in the mid-1990s, the unemployment rate has come down to an average 8.2 per cent in 2002. Job creation has become much stronger, employment rising by nearly 1½ per cent per year since 1995, corresponding to more than 12 million new jobs. However, part of this improvement is cyclical, and since the early 1990s the OECD estimate of the structural unemployment rate has changed only little. At 8 per cent in 2002, it remains high and is some 3 percentage points above the best performing countries (Figure 13). Meanwhile, since the early 1990s a trend increase in vacancy rates, coupled with a trend decrease in the unemployment rate has shifted the Beveridge curve outward, suggesting that structural problems in terms of matching have increased (Figure 14).

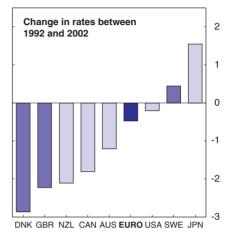
In addition, a number of problems persist for specific groups and dual labour markets have developed:

- The unemployment rate remains above average for young and older workers, and the low participation and employment rates of older workers have not evolved much. Participation of women has risen, but a gender gap remains (Figure 15).
- Disparities across regions are increasing. The lower income regions display lower employment and participation rates, higher unemployment rates (with the regional disparity increasing since the late 1980s)¹⁹ and

Figure 13. Structural rates of unemployment

Per cent





Source: OECD.

larger gender and pay gaps. They also have a higher than average proportion of low-skilled workers (European Commission, 2001d).

- More workers are on temporary contracts (Figure 16).²⁰ Temporary contracts have become an attractive option for employers as compared to permanent contracts with stringent employment protection provisions. However, the low transition out of temporary contracts into a more stable form of employment may give rise to some concern because they can trap certain categories of workers, although the alternative may be long-term unemployment in many cases (Table A1). Low-skilled and young workers are particularly prone to prolonged spells of temporary employment and unemployment (European Commission, 2001d and 2002e).
- Occupational mobility is low in the euro area compared with the United States, although it has risen since 1995 in most euro area countries. In 2001, 17.7 per cent of the workforce had been with their employer for less than one year, whilst it stood at 24 per cent in the United States (Table 6).²¹ Geographic mobility is also much lower in the euro area, although cultural and language barriers imply that the US experience may not be a good benchmark for Europe.

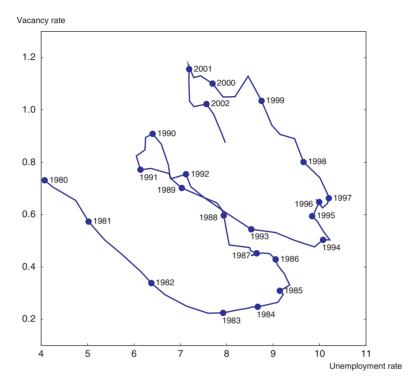


Figure 14. **Beveridge curve**¹
Per cent of labour force

 Weighted average of the following countries: Austria, Belgium, Finland, Germany, Luxembourg, Netherlands (as from 1988), Portugal and Spain. Data cover around 50 per cent of the euro area for 1980-87 and 59 per cent for 1988 onwards. The circles show the data point for the first quarter of each year.
 Source: OECD, Main Economic Indicators.

Common policies and peer pressure

Although the Community has only limited competence on labour market policies, employment was declared a matter of common concern in the Amsterdam Treaty (1997). The Luxembourg Jobs Summit (November 1997) reiterated the national competence for employment policy, but called on member states to develop a co-ordinated European Employment Strategy (EES), based on shared priorities and interests. The approach is to formulate annual guidelines endorsed by the Council and the Commission. These feed into the National Employment Plans, and are in turn assessed in the Joint Employment Report from the Council and the Commission. It is supported by quantitative targets and underpinned by

EURO JPN AUS CAN NZL GBR USA SWE DNK

Men 25-54 Women 25-54 Young 15-24 Old 55-64 90 90 **Participation rates Employment rates** 80 80 70 70 60 60 50 50 40 40 30 30 20 20 10 10

Figure 15. **Participation and employment rates**By age and gender, per cent, 2001

Source: OECD (2002), Labour Force Statistics, Part III.

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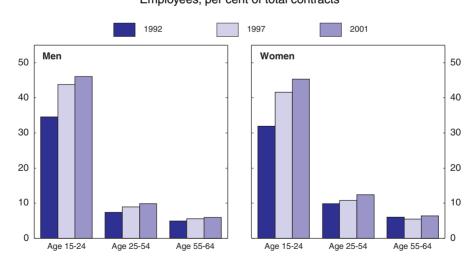


Figure 16. **Temporary contracts in the euro area**¹ Employees, per cent of total contracts

^{1. 1992} excludes Austria and Finland; 2001 is estimated. *Source:* OECD (2002b).

Duration of current employment, per cent						
		1995¹		2001		
	Less than I year	Between 1-2 years	More than 2 years	Less than I year	Between 1-2 years	More than 2 years
Euro area ²	15.5	8.2	76.3	16.8	10.3	72.9
Denmark Sweden United Kingdom	24.1 15.0 18.9	11.9 7.7 10.9	64.0 77.3 70.2	23.1 13.3 21.2	13.5 14.0 12.4	63.4 72.7 66.4
European Union ²	16.2	8.8	75.0	17.7	10.9	71.4
United States	27.8	7.9	64.3	24.5	8.4	67.1

Table 6. lob tenure of employees Duration of current employment, per cent

European Commission/Eurostat, Labour Force Survey; United States, Bureau of Labour Statistics and OECD. Source:

the development of indicators that measure progress (See, for example, European Commission, 2003c).

In 2000 the Lisbon Council underscored the importance of not only reducing unemployment, but also of raising employment, setting full employment as a medium-term goal for the Union. Ambitious targets were set for the EU employment rate (70 per cent in 2010 compared with 63.4 per cent in 2000) and for subcomponents. Subsequently, the Stockholm European Council complemented the Lisbon targets with intermediate targets to be reached by 2005. In addition a new employment target was set for older workers (Table 7).

Key EU labour market targets and indicators Table 7.

	EU benchmark	1997	2001
Targets			
Employment rate			
Total	70 (2010 – Lisbon)	60.5	63.9
Age 55-64	50 (2010 – Stockholm)	36.3	38.5
Female	60 (2010 – Lisbon)	50.6	54.9
Indicators			
Unemployment rate	0.7		
Total	2.7 (average 3 best performers)	10.1	7.4
Long-term	0.8 (average 4 best performers)	5.1	3.3
Youth	3.1 (average 3 best performers)	9.2	7.1
Female	3.0 (average 3 best performers)	11.7	8.7

^{1.} Data for the United States are for February 1998 and January 2002.

^{2.} Weighted average.

In September 2002, the Commission made proposals to integrate the Lisbon targets into the EES so that the focus will be more on the outcome of policies. Another aim was to simplify the Strategy, with a reduced number of guidelines, and a timeframe aligned with the Lisbon deadline of 2010. The Commission proposed to reorganise the reporting and guidelines. Assessment of the implementation would in the future be concentrated in January around an "Implementation Package", while the "Guideline Package" would present the Commission's strategic policy priorities for the Union at the Spring European Council.²²

Between 1997 and 2002, the EES was organised around four pillars: employability, entrepreneurship, adaptability and equal opportunity. Following the adoption of the Commission's reform proposals, the 2003 Employment Guidelines set out the overarching objectives of achieving full employment, improving quality and productivity at work and of strengthening social cohesion and inclusion. They call for reforms in the following areas: tax and benefit systems, active and preventive measures for the unemployed and inactive, entrepreneurship and job creation, adaptability in work, investment in human capital, labour supply and active ageing, gender equality, integration of the disadvantaged, undeclared work and occupational and geographic mobility. Virtually all of these include specific targets to be reached by the member countries. The new approach also provides for greater coherence between the Employment Guidelines and the Broad Economic Policy Guidelines, which provide the overarching framework for economic policy co-ordination within the EU, and makes a clear distinction between the overarching objectives, priorities for action and targets. This raises transparency and will make it easier to judge, whether policy initiatives actually contribute to raising employment. The strategy is now very broad based, even though the National Employment Plans still do not cover reforms of employment protection legislation, wage bargaining frameworks and minimum wages. There is thus less scrutiny of these important labour market aspects.

Will the targets be met?

To what extent the peer pressure via the EES has contributed so far to labour market reforms is difficult to assess. There is evidence that employment has become more responsive to business cycle fluctuations, and led to an increase in the "employment content of GDP growth" (European Commission, 2002f). However, structural unemployment has declined rather little and the extent of reforms varies a lot across member states, as does labour market performance.

Achieving the Lisbon and Stockholm targets for total and female employment rates would require annual average employment growth of $1\frac{1}{2}$ per cent up until 2010. However, this might be too optimistic when assessed against the trend performance of the euro area. The OECD's medium-term scenario for the euro area projects an employment growth rate averaging $\frac{1}{2}$ per cent (with trend growth of GDP

of about 2 per cent). In this scenario the total employment rate would be only around 65½ per cent (compared with somewhat less than 64 per cent currently), still below the 70 per cent target, while the female employment rate would only reach slightly more than 55 per cent in 2010.²³ The situation is even less favourable for older employees. Even if the performance of the second half of the 1990s is repeated, the employment rate of the older age group would not go beyond 43 per cent without policy changes (compared with 38½ per cent currently). In a more pessimistic scenario, this rate would be less than 40 per cent.

In an optimistic scenario, which extrapolates the growth rates observed over the past five years the euro area unemployment rate would diminish to about 6½ per cent by 2010. The OECD's medium-term scenario suggests that it may only decline to somewhat above 7 per cent.²⁴ Projections for youth would be in line with the evolution of aggregate unemployment, but female unemployment would remain higher than average unemployment, and long-term unemployment would not drop below 3 per cent.

Priority areas for reform

Making work pay

Tax and benefit systems are in need of reform to enhance job search intensity, incentives to invest in human capital and the matching process. Moreover, disability and early retirement schemes need to be changed so as to encourage labour market participation. The scope for reform is large in view of the limited progress in a number of countries. Unemployment benefits have been reduced somewhat and eligibility criteria for several groups of unemployed or disabled workers have been tightened, but rather little (Figure 17 and Table A2). Efforts aimed at reducing incentives to retire early, whether into early retirement or disability schemes have been extremely modest, apart from a few countries. The number of disability benefit recipients has continued to rise, albeit at a slower pace. Reforms affecting benefit access have led to a stabilisation or decline in benefit inflow rates in most countries, but outflows have remained very low in virtually all countries.

The tax burden on labour has remained significantly higher than in the United States and Japan (Figure 18, upper panels). To lower the cost of low-paid jobs and stimulate demand, several countries have reduced the wedge between the wage paid by the employer and the take-home pay of employees by cutting labour taxes. After rising steadily between the mid-1970s and the mid-1990s, tax wedges on labour have slightly declined according to various measures (OECD, 2002c). Reductions were larger for the low paid over the same period and achieved mainly through reduced social security contributions (Figure 18, lower panels). This may be one key factor behind the relatively strong job creation in

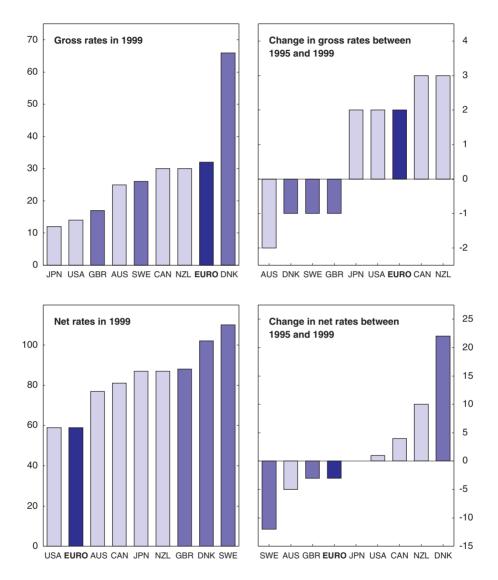


Figure 17. Estimates of gross and net replacement rates¹

Gross rates are an overall average of rates for different family situations, earning levels and duration of unemployment. Net rates are after tax and including family and housing benefits for long-term benefit recipients; situation corresponding to a couple with two children and a single earner paid 67 per cent of the average production worker's salary. The euro area is a weighted average excluding Luxembourg.

Source: OECD (2002), Benefits and Wages.

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-3

GBR EURO SWE USA CAN NZL DNK AUS JPN

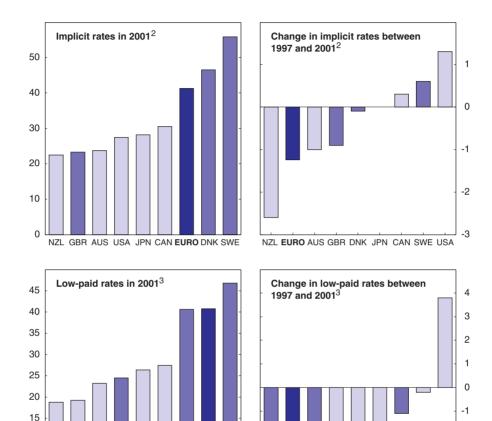


Figure 18. **Tax rates on labour**Per cent¹

1. The euro area is a weighted average.

NZL AUS JPN GBR CAN USA DNK EURO SWE

- Measured as the difference between the total labour compensation paid by the employer relative to the production price and the net take-home pay of employees relative to the consumption price, as a ratio of total labour compensation. The calculation is based on National Accounts data and includes the effect of indirect taxes and of the terms-of-trade.
- Income tax plus employee and employer contributions less cash benefits, for a single person with no children, earning 67 per cent of the earnings of an average production worker, in per cent of labour costs.
 Source: OECD (2002c).

10

5

some euro area countries. Nevertheless, there is obvious scope for further progress, although further tax reductions are currently hampered by the dire fiscal situation in some countries.

Closing the gender gap

Measures directed at raising the participation rate of women are also part of the EES. The development of part-time work is one element, as it provides an effective tool for reconciling work and family life. In addition, ensuring adequate training and the availability of childcare are key policy objectives (OECD, 2001b), while maternity leave, though of course important, should not be too long to ensure women are not excluded from the labour market (OECD, 2003a). Indeed, there is evidence that the impact of parenthood on women's employment is negative, whilst it is positive for men.²⁵ Thus, the trend increase in the availability of childcare should be sustained. European Commission (2002g) underscores that only few countries provide training for women returning to the labour market or have taken measures to improve care services for children. Overall, female participation in the euro area has progressed somewhat, with a number of countries remaining far below the Barcelona target, whilst others are already above the target (Table A3).²⁶

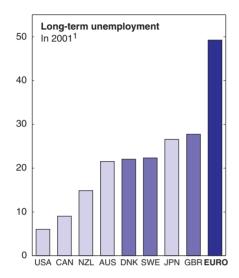
Improving active labour market policies

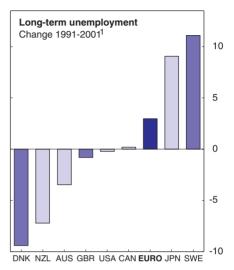
The incidence of long-term unemployment in the euro area is considerably higher than in the best performing OECD countries (Figure 19). Active Labour Market Policies (ALMPs) aim to reduce or prevent long-term unemployment and between 1998 and 2002, the Employment Guidelines have emphasised their usefulness in this regard. Over the 1990s, there was a considerable switch from passive to active labour market policies, with some countries prioritising particular groups such as young people. By 2001, all European countries had achieved the 20 per cent target share of active policies among labour policies set by the Commission and the number of ALMP participants has been rising fast.

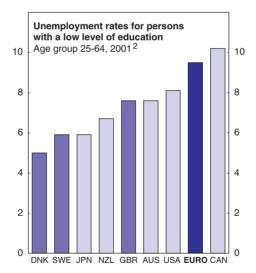
Traditionally, there has been little evaluation of the effectiveness of ALMPs. However, European Commission (2002h) underlined some directions for improvement. In particular, measures that put people back into sustained employment should have priority. In this respect, the EES evaluation acknowledges that the focus on quantitative targets may have unwittingly contributed to a relative neglect of the effectiveness of the measures, whilst a successful ALMP requires making "the right offer at the right time to the right person". Against this background, member states now tend to give a higher weight to training measures (nearly half of the active measures) and to an individualised approach, especially for long-term unemployed. Overall, the empirical evidence usually

Figure 19. Incidence of long-term unemployment

Per cent







Long-term unemployment defined as one year or more in per cent of total unemployment. The euro area excludes Austria, Ireland and Netherlands and shows data for 2000 instead of 2001.

Source: OECD, Education database, March 2002 and OECD (2002b).

^{2.} Less than upper secondary education.

finds a high dead-weight cost of ALMPs, but provided they are well-targeted and accompanied by support from Public Employment Services (PES), they can be more effective.²⁷

Several member states have reformed their Public Employment Services (European Commission, 2002g). A trend has emerged towards a mixed market of public and private employment services, although there is scope in some countries to expand further their complementarity. In addition, there should be more emphasis on the obligation of beneficiaries. Benefits, PES support services and training should be provided to beneficiaries on condition that they effectively look for a job, otherwise risking a sanction.²⁸ On the other hand, almost all member states are now using information and communication technologies to significantly expand electronic self-service facilities. At the same time, the Commission has developed an electronic PES, the European Employment Services (EURES, launched in 1993), which gives access to national PES web sites, and provides a database for employers and employees on vacancies in Europe, as well as an assistant system for information on mobility (http://europa.eu.int/eures/index.jsp).

Enhancing labour mobility

In the absence of exchange rate and interest rate adjustments in the area and with the scope for fiscal stabilisation policy constrained (Chapter II and III), flexible labour markets are essential to absorb asymmetric shocks in monetary union. Flexibility can take the form of real wage flexibility or of labour mobility, both geographic and occupational. While occupational mobility is needed for the adaptation of the labour force to changes in the industrial structure and new skill requirements, geographic mobility within and across countries is essential to ensure that labour supply and demand match. Also immigration could help in this respect (Box 4).

Within national borders, a low degree of mobility is often related to housing policy and the rigid setting of wages. Across borders, the issues are wider and a recent survey suggests that many barriers to geographic mobility are also policy related. Employers point to the lack of European-wide employment legislation, the non-portability of pension schemes, and differences in taxation and to a lesser extent benefit systems. ²⁹ Employees rather see a lack of employment opportunities for partners and lack of language skills as the most important barriers. Most of these issues are addressed in Commission's Action Plan on Skills and Mobility (European Commission, 2002i), together with the recognition of qualifications and movement of non-EU citizens (Table A4).

Concerning a single market for occupational pension funds, work is on-going to eliminate tax-obstacles to the cross-border provision of occupational pensions, ³⁰ while discussions are underway to replace and simplify the current Regulation

Box 4. Can immigration help?

Immigration may help to cope with short term labour shortages, but also with the prospective decline in the working age population due to ageing. While research has shown that migration alone can not alleviate the impact of ageing on the financial viability of pension schemes, the question is not so clear cut as to whether selective labour recruitment policies can help resolve current and future imbalances in European labour markets.

Some euro area countries have already targeted immigrants with special skills to cope with bottlenecks, while in a number of countries immigration has been the main source of employment growth over the last years.* Articles 61 63 in the Amsterdam Treaty established Community competence for policies concerning immigration and asylum. A number of joint actions have been agreed regarding asylum seekers and illegal immigration, aiming at the harmonisation of practices, but little concrete action has yet been taken. Regarding conditions of residence and employment, the initiatives have failed to achieve any harmonisation of national practices. The rules on family reunification are very flexible, for example, allowing for substantial national differences. Directives to regulate immigration had been proposed by the Commission but were not adopted. Therefore, the policy setting for deciding on the number of immigrants to admit and for their selection, as well as integration policy, remain the competence of member states.

Recent work by the Secretariat highlights some important issues. First, it provides evidence that immigration can only play a limited role in alleviating bottlenecks, even when migration policy targets certain skills, because of the difficulties related to effective targeting. Issues such as family reunion and internal mobility will prevent a focused selection. In this respect, the division of competence between member states in charge of selection and the EU in charge of mobility and family reunion issues needs careful co ordination. Second, social aspects should not be neglected, as these will entail costs notably regarding integration. Overall, migration can be of help but is not a panacea to offset the negative consequences of a badly functioning labour market, nor can it solve the fiscal implications of ageing (OECD, 2002d).

on the co-ordination of social security systems. An EU-wide health card will be introduced, aiming at transforming the relevant European paper forms into an electronic card. The objective is for card-holders to be able to claim access to health care in another member state. As noted above, an important impediment to mobility is due to problems with the recognition of qualifications for the regulated professions. For most regulated professions, a worker from another member state often

^{*} Immigration from third countries was the largest source of population change between 1995 and 2000 (European Commission, 2002i).

has to undergo some training or to take an aptitude test when study length and content "is substantially different in the host member State" (European Commission, 2002j). Against this background, the Commission is updating a Directive on the recognition of professional qualifications. Moreover, several processes exist to promote recognition of diplomas: the "Bologna" process for university degrees and the "Bruges" process for vocational training. The Union has also agreed on minimum standards in education and training for ICT-related professions.

It is widely acknowledged that due to cultural differences and the many languages, the degree of geographic mobility is unlikely to converge towards that of the United States. However, occupational mobility can be enhanced and this should help reduce bottlenecks and ensure the availability of skills in view of the changing industrial structure. Occupational mobility is influenced by education and training systems. Although most member states have laid the groundwork for comprehensive strategies covering the whole spectrum of learning, from compulsory education to workplace training, life long learning strategies are not well developed yet (Table A5). Public outlays on education and training have generally risen, but countries remain reluctant to specify targets in this regard. In addition, the links between the education and training systems and the labour market is seldom addressed in a comprehensive manner, and their evaluation is scarce. Furthermore, there is little focus on enhancing training and skills of certain groups. For example, while there is a consensus that providing greater opportunities for older people is an important issue, there are only a few initiatives that specifically target them (OECD, 2002e). Overall, the participation rate of older workers in training programmes only increased from 1.2 per cent in 1997 to 3 per cent in 2001, which is only a third of the participation rate for the adult working age population (European Commission, 2002g). Moreover, policies have not been very effective at enhancing the training opportunities of the low skilled, who have much less training opportunities than the highly educated.

Reforming wage setting

Reforms of wage bargaining frameworks to raise wage flexibility should be stepped up. Wage setting systems that prevent wages from reflecting differences in qualifications or in labour market conditions across occupations, regions or sectors hinder the market-clearing role of wages and contributes to labour market mismatches. The concentration of problems in certain regions and for some groups of workers suggests that such adverse mechanisms are at work. In this respect, more possibilities for opting out of collective agreements, especially for small firms, are needed. Also wage minima create problems. Eight euro area countries have a legal minimum wage with a wide variation in level as a per cent of the median wage across countries (Figure 20). Minimum wages have significantly increased over the last decade in real terms although relative to the median wage it has declined in most small euro area countries, while rising in one big one.

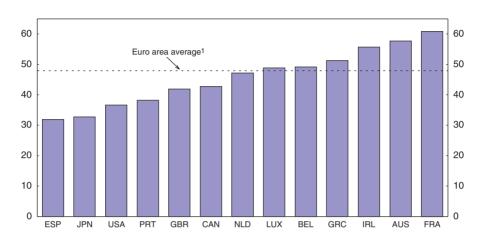


Figure 20. Ratio of minimum wage to full-time median earnings

Per cent. 2000

 Unweighted average of countries shown. Source: OECD.

While in Greece the minimum wage is set by binding national-level collective agreements, in the other countries (Belgium, France, Ireland, Luxembourg, the Netherlands, Portugal and Spain) the minimum wage is set by law. Few countries have a differentiation for younger workers and some have implemented targeted measures to reduce labour cost for those earning the minimum wage. Countries with no legal minimum wage tend to have bargaining systems that put a wage floor for less productive workers. Moreover, implicit mechanisms of wage indexation are still important in the euro area and a significant proportion of total employees is covered by backward indexing to national inflation (Table A6). This leads to wage cost inertia and is one of the reasons, why inflation has remained stubbornly above the ECB's 2 per cent upper limit for so long.

Easing employment protection legislation

Further reform of Employment protection legislation (EPL) for regular contracts is clearly needed in many euro area countries. EPL covers hiring and firing rules and conditions for using temporary, part-time or fixed-term contracts. Strict regulation raises the cost of dismissals and reduces the incidence of layoffs and hence the flow into unemployment. On the other hand, it makes firms more hesitant in hiring, making it harder for the unemployed to re-enter the labour market. As a result, it negatively affects prime-age women, young and older workers who have a high incidence of unemployment (OECD, 1999). They

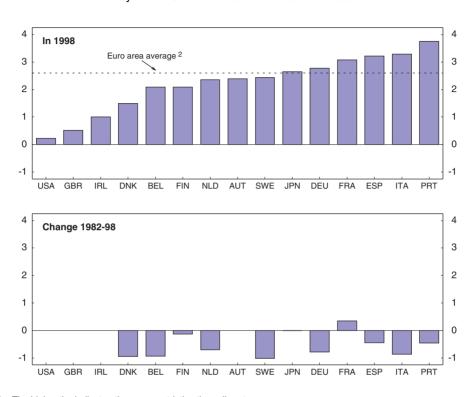


Figure 21. **Strictness of employment protection legislation**Synthetic OECD indicators of restrictiveness¹

1. The higher the indicator, the more restrictive the policy stance.

2. Unweighted average excluding Greece and Luxembourg. *Source:* Nicoletti *et al.* (2001).

may also have contributed to the increased use of temporary contracts, if firing cost are lower for such contracts, thus creating a two-tier market between insiders on a permanent contract and outsiders on temporary contracts. Employment protection legislation has changed little between 1982 and 1998 for permanent contracts (Figure 21), while reforms have focused on easing EPL on temporary contracts, thus pushing up the share of such contracts.³¹

Working condition legislation falls under the remit of the Community as regards health and safety, and such legislation can affect labour market flexibility. However, it seems that the various directives under this heading have had little impact so far on labour markets (Box 5).

Box 5. **Directives on work organisation**

The Working Time Directive (WTD, Directive 93/104/EC) was adopted in 1993. The WTD provides a set of rights:

- A maximum 48 hour week, including overtime averaged over a four month period.
- An entitlement to a rest break period after six consecutive hours' work, and eleven hours daily with a maximum fourteen day reference period.
- A right to a day off a week, or 48 hours off a fortnight.
- A minimum four weeks paid annual leave with no opting out, no carrying over or pay in lieu, except on termination of employment.
- Some provisions on night work, including a daily maximum of 8 hours of night work.

A lot of leeway in transposing the Directive was left to member states. For example, employers and employees define what constitutes working time and rest periods, while a large number of agency workers may not be affected, because employers can define a different period of time worked for agency workers (Forde, 1998). There are also many exemptions, which allow the WTD to be overturned by custom, practice or agreement. The Commission will review this Directive in 2003.

The rationale behind the Directive is not very clear. Introduced as a health and safety measure, the empirical support for this rationale is limited (Adnett and Hardy, 2000). Economic arguments would also not tend to favour it. Whilst working time has been declining, the trend in work organisation has rather moved towards annualised hours and work on call, making working time more heterogeneous and individualised. Moreover, most member states already had national working hours legislation, which was considerably more restrictive than the WTD, except in the United Kingdom (Fajertag, 1998). Finally, a regulatory impact assessment was not undertaken, but some UK studies underline that compliance costs are uneven according to the workers targeted and the affected sector. For example, the extension of the WTD to young workers would not be very costly, whilst restrictions on night work could be a lot more costly.²

These Directives require that atypical contracts provide similar rights to "comparable full time work", in the same establishment. For part time workers, the objective is to extend opportunities for moving between part time and full time work. For fixed term contracts, the aim is to prevent abuse, by requiring member states to fix, after consultations with the social partners, a maximum total duration of successive fixed term employment contracts, and the number of renewals of such contracts. Both Directives are framework Directives and require member states to legislate on these issues, but do not impose the maximum duration or other terms.

Another Directive concerning the working conditions of temporary (agency) workers is still under negotiation. It aims at the equal treatment between agency workers and comparable workers in the user enterprise, with a possible exemption

Box 5. **Directives on work organisation** (cont.)

for periods less than six weeks. It is on the length of that exemption period that the debate currently focuses. Exemption is also granted to those workers who are in fact employees of a temporary work agency – as they already benefit from the regular contract conditions derived from "regular employment". According to the assessment provided by the Commission, the impact of the proposed measure would vary across member states. Where temporary agency work is lightly regulated, labour cost would rise and agency employment decline. On the other hand, this Directive will not favour temporary work in countries where it is heavily regulated, as it only sets minimum requirements.

A Directive concerning the posting of workers (the PWD) was adopted in 1996. The objective of the PWD is to ensure a minimum set of rights for workers posted by their employer to work in another country. For example, some temporary agencies based in a member state with particularly low employer's social security contributions, could have opened a subsidiary there to hire temporary workers and send them to work in another EU member state with higher contributions. The PWD aims at preventing such behaviour through the basic principle that working conditions and pay in a member state should apply both to workers from that state and those from other EU countries posted to work there. The Directive had its strongest impact in the construction sector, by preventing the posting of "cheaper" workers across member states. However, it does not ease the posting of all temporary workers, since, for example, for temporary workers posted for more than three months most member states require them to get a residence permit; most member states also impose some administrative burden on the undertaking company.

Achieving the Lisbon targets by 2010: a reasonable goal?

As noted above, the Lisbon Council set a number of concrete performance targets. The overarching objective is to enhance the capacity of the EU economy to generate sustainable high rates of non-inflationary growth, with low unemployment

^{1.} In 2000, the European Parliament/Council conciliation committee extended the WTD to excluded sectors and activities. Some sectors were brought under the full or partial scope of the 1993 Directive, most notably workers in the transport sectors. The most controversial issue concerned the extension to doctors in training. It was finally agreed to limit the working week for doctors in training to 48 hours, albeit only after a transition period of up to 12 years. Self employed drivers also got an exemption until 2006.

^{2.} See the UK web page on The Working Time Regulations www.dti.gov.uk/er/work_time_regs/

^{3.} Council Directive 1999/70/EC and Council Directive 97/81/EC.

^{4.} Proposal for a Directive of the European Parliament and the Council on working conditions for temporary workers (European Commission, 2002k).

Table 8. Change in productivity induced by a change in product market regulation 1

By component, percentage points over a ten year period

_	Privatisation	Entry liberalisation	Industry specific barriers
Convergence to the United State Convergence to 3 best euro are	1.59	0.12	0.17
performers Estimated effects of historical	0.44	0.08	0.18
change (1982-98)	0.17	0.49	0.27

On average over 1996-2000, MFP growth was 1.3 per cent in the United States and 0.9 per cent in the European Union.
 Source: Nicoletti and Scarpetta (2003).

and sound public finances able to cope with the bleak demographic prospects. The challenge now is to implement the necessary labour, product and financial market reforms to boost employment and productivity, while raising the resilience to shocks.

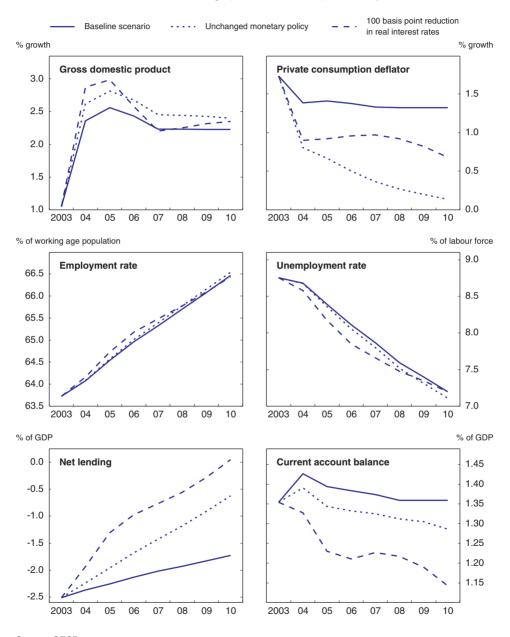
The OECD has published numerous documents presenting estimates of the impact of structural reforms on aggregate performance. In particular, recent work has highlighted how reforms affect productivity and employment. For instance, Nicoletti *et al.* (2001) show that reducing unemployment benefits or the tax wedge in the euro area to the US level would raise the euro-wide employment rate by ¾ and 1¼ percentage points respectively. Assuming that labour and product market regulations in the euro area were aligned with those in the United States, the employment rate would rise by up to 10 percentage points.³² The same work also provides quantitative evidence of the gains from aligning product market regulations to more lightly regulated countries. Table 8 below provides an example of how product market liberalisation may affect multi-factor productivity.

Simulations based on these estimates were undertaken using the Interlink model to take account of spillover effects. Two different scenarios were explored:

- The first exercise assumes that product market regulation in the euro area becomes as competition-friendly as in the United States. This implies an improvement in multifactor productivity of nearly 2 percentage points over ten years (the sum of the three columns in the first line, Table 8). In the simulation, stronger productivity growth boosts activity, whilst triggering a decline in inflation (Figure 22). This would improve the sacrifice ratio, as stronger growth would go hand in hand with lower inflation. At the same time the budget deficit would shrink, mostly on a structural basis. Lower inflation would allow monetary policy to be more supportive. Assuming that real rates decline by

Figure 22. Medium-term effects of structural reforms boosting productivity

Effect of a 2 percentage points rise in the productivity level



Source: OECD.

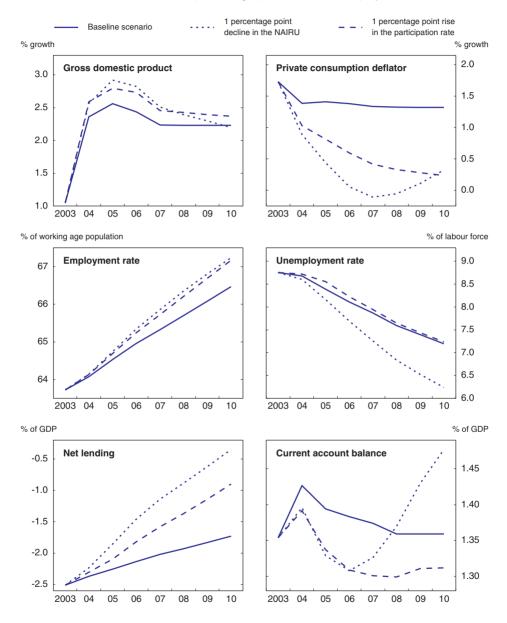
100 basis points, instead of maintaining real rates unchanged, the reduction of inflation would be less, but the euro-wide budget deficit would converge towards balance as interest payments fall, and the debt-to-GDP ratio would be down by 8 percentage points. In this scenario, there is barely any effect on employment, as growth gains come entirely from improved productivity.

- A second, separate, exercise evaluates how a better labour market performance, due to reforms in product and labour markets, affects medium-term prospects in the euro area. It is assumed that reforms are modest and result in a 1 percentage point rise in the employment rate due to a lower structural rate of unemployment and increased participation. While the decline in structural unemployment may appear modest, it is double of what has been achieved so far since the peak in the mid-1990s.³³ Two simulations were run: one where the increase in employment is entirely due to a decline in the structural unemployment rate, and a second one where the rise in employment is triggered by increased labour force participation so that unemployment declines by less. In both cases, the effect on the euro area's performance after eight years is strong (Figure 23). The level of real activity is boosted by about 1.5 per cent, whilst inflation decreases by around 1 percentage point. A reduction in euro wide public deficits occurs in both cases, although it is larger in the case where participation does not rise (as the decline in the unemployment rate is more important in this scenario).

In both exercises, most of the improvement in public finances is structural. The effects are sizeable and stronger and more rapid when monetary policy is supportive (Table 9). The area-wide budget deficit would decline by between 1 and 2 per cent of GDP, depending on the simulation and monetary policy assumption, half of the improvement appearing after about four years. Thus, this exercise suggests that should deep enough structural reforms be implemented, it would also allow fairly quickly some reduction in taxes, which would provide a further growth impetus, while the Pact would be respected.

Moreover, combining the two exercises would raise underlying eurowide growth by about ½ a percentage point. This would be close to US potential growth in per capita terms in the OECD's medium-term baseline. However, given the assumptions concerning labour market reforms, the employment rate would reach only 66.5 rather than 70 per cent in 2010. Reforms that increase the employment growth rate to 1.5 per cent per year would be needed to raise the trend employment rate by an additional 4 percentage points by 2010, which would in turn raise potential output to slightly more than $2\frac{1}{2}$ per cent per year in per capita terms.

Figure 23. **Medium-term effects of structural reforms enhancing employment**Effect of an *ex ante* 1 percentage point rise in the employment rate



Source: OECD.

, 1 0 1									
			ge points rise ctivity level	I percentage point rise in employment rate					
	Unit	Unchanged monetary policy	100 basis point reduction in real interest rates	I percentage point decline in the NAIRU	I percentage point rise in the participation rate				
Gross domestic product Private consumption	% growth	0.2	0.2	0.2	0.2				
deflator	% growth	-0.9	-0.4	-1.0	-0.7				
Unemployment rate	%	0.0	-0.1	-0.5	0.3				
Employment rate	%	0.0	0.1	0.4	0.3				
Government net lending Current account balance	% of GDP % of GDP	0.6 -0.1	1.3 -0.2	0.8 0.0	0.3 0.0				

Table 9. **Summary results of the medium term effects of structural reforms**Deviations from baseline, percentage points, average 2003-10¹

The simulations thus suggest a strong impact of product and labour market reforms on overall economic performance. The exercise shows that implementing these reforms in due time would imply an unprecedented improvement in performance. On the other hand, even partial progress would enhance employment and growth prospects significantly. Better performance would also imply that fiscal performance improves to such an extent that the tax burden could be slashed considerably, while lower inflation would allow an easier monetary stance. Summing up, pushing ahead with reforms would launch a virtuous circle where growth and employment are rising, inflation declines, and tax reductions are possible, whilst at the same time the SGP is respected.

In addition, the enlargement of the European Union provides additional growth opportunities for the euro area, the other current and the future EU-member states.³⁴ As shown in Table 10, per capita GDP in the accession countries is less than half of that of the European Union, which suggests that there is an important growth potential from which the euro area will certainly benefit. Spurred by the abolition of duties on EU-imports from accession countries in 1997 and massive foreign direct investment by EU investors in accession countries, trade with the existing EU economies already exceeds half of the accession countries' exports. The exposure to international competition and further far-reaching structural reforms to improve framework conditions, moreover, are expected to yield huge gains in efficiency. As a result, per capita GDP in these countries is expected to grow rapidly, albeit a full catch-up is likely to span several decades. With domestic price levels rising on account of the Balassa-Samuelson effect, relative prices of imported goods and services will fall

^{1.} The medium-term baseline scenario (see Table 4) has been extended to 2010 for this exercise. Source: OECD.

Table 10. European Union accession countries: key indicators

	Pop	ulation	GDP ¹			
				EU15 = 100		
	Million	Relative size ²	Relative size ²	Per capita	Relative price level	
Cyprus Czech Republic Estonia	0.8 10.3 1.4	0.2 2.3 0.3	0.1 1.5 0.1	67 59 39	85 45 49	
Hungary Latvia Lithuania	10.2 2.4 3.5	2.3 0.5 0.8	1.3 0.2 0.3	52 33 38	46 47 43	
Malta Poland Slovak Republic Slovenia	0.4 38.6 5.4 2.0	0.1 8.5 1.2 0.4	3.8 0.6 0.3	40 47 72	 56 39 65	
Total accession countries EU15	74.8 377.9	16.5 83.5	8.2 91.8	46 100	51 100	
Enlarged EU	452.7	100.0	100.0	91	96	

^{1.} GDP in purchasing power parities. The area totals exclude Malta.

Source: European Commisson/Eurostat and OECD.

with income increasing; the import content of demand is likely to increase in concert. Meanwhile trends towards international specialisation should bolster the economic growth potential of the accession countries, the European Union and the euro area alike.

^{2.} Enlarged EU = 100.

II. Fiscal policy challenges

With monetary policy centralised, fiscal policy in the euro area has been tightly co-ordinated at the central EU level since the advent of the single currency. The co-ordination framework is anchored in the 3 per cent of GDP upper limit for fiscal deficits and the requirement to reduce public debt to below 60 per cent of GDP at a satisfactory pace enshrined in the Treaty and a requirement to move towards and maintain fiscal positions in balance or in surplus over a mediumterm horizon. The latter is stipulated in the Stability and Growth Pact and aims to "protect" the 3 per cent threshold against gross fiscal policy mistakes, create room for fiscal stabilisation and help preparing for the cost of ageing. These fiscal objectives have been largely met by most smaller euro area countries and Spain, but three countries, Germany, France and Portugal, are currently subject to Excessive Deficit Procedures (EDPs) for breaching the 3 per cent of GDP threshold. The three largest euro area countries, constituting 70 per cent of the area's GDP, have failed to move towards medium-term balanced budget positions and are now constrained to embark on a rapid fiscal correction. This may seem counter productive against the backdrop of substantial cyclical slack but is crucial nonetheless. Sticking to the medium-term fiscal consolidation path is necessary, not only to preserve the credibility of the policy framework, but also to secure room for manoeuvre in future downturns and prepare for the age-related spending pressures. The question arises whether the current situation could - and should - have been prevented, and to what extent flaws in the fiscal co-ordination framework rather than teething problems are at the root of the problem.

Fiscal targets were again largely undershot

The Stability Programmes presented by the euro area member countries on the eve of the 2001 downturn foresaw that the general government deficit for the area as a whole would fall to 0.3 per cent of GDP by 2002 and disappear altogether by 2003. The outcome was instead a deficit of 2.3 per cent of GDP in 2002 amid considerably weaker economic conditions. While not alarmingly high by historical standards in view of the unexpected downturn, this implied a failure to fulfil the initial targets. As it was judged impossible to rectify the situation quickly in view of the poor growth prospects, the achievement of a balanced budget was put

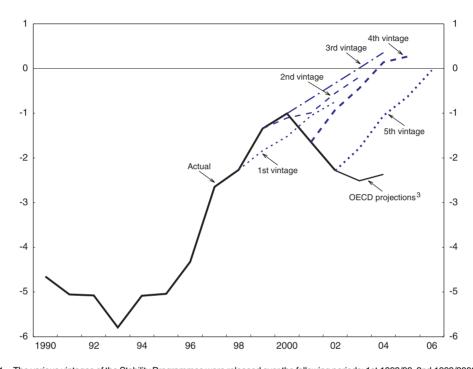


Figure 24. **Moving targets**¹
General government balance in the euro area as a per cent of GDP²

- The various vintages of the Stability Programmes were released over the following periods: 1st 1998/99, 2nd 1999/2000, 3rd 2000/01, 4th 2001/02, 5th 2002/03.
- 2. Excluding UMTS licence proceeds.
- 3. OECD Economic Outlook, No. 73.

Source: European Commission/Eurostat and OECD.

off by three years – from 2003 to 2006 – in several countries (Figure 24). In fact, the outturn is likely to be worse, as the Programmes are built on economic projections that again err on the optimistic side. The latest projections embodied in OECD Economic Outlook No. 73 indicate a further deterioration in the fiscal deficit from 2.3 per cent of GDP in 2002 to around 2½ per cent in 2003 and 2004 in the absence of corrective measures (Table 11). This contrasts sharply with the projected improvement in deficit positions to 1.7 and 1 per cent of GDP in 2003 and 2004, respectively, included in the latest Programmes (Annex I, Table A7).

These aggregate developments mask divergences in fiscal outcomes among the euro area countries (Figure 25). By far the largest deficits in 2002 have been recorded in the three major countries – Germany, France and Italy – and Portugal. The

in per cent of GDP (or potential GDP)								
	1997	1998	1999	2000	2001	2002	Projections ¹	
_	.,,,	1770	1,,,,	2000	2001		2003	2004
Financial balances ²								
Net lending	-2.6	-2.3	-1.3	-1.0	-1.6	-2.3	-2.5	-2.4
Net primary balance	2.0	2.1	2.5	2.6	1.9	1.0	0.7	0.8
Cyclically-adjusted balance ³	-1.8	-1.8	-1.2	-1.5	-1.8	-1.9	-1.6	-1.6
Primary cyclically-adjusted								
balance ³	2.8	2.6	2.7	2.2	1.7	1.4	1.6	1.5
Gross saving	-1.6	-0.8	0.3	0.6	0.1	-0.8	-1.0	-0.8
Government gross debt4	74.9	73.7	72.7	70.3	69.3	69.2	70.0	70.1
Spending and revenue								
Total primary expenditure ²	45.7	45.0	45.1	44.6	44.8	45.1	45.4	45.0
Debt interest payments	4.7	4.4	3.8	3.6	3.5	3.3	3.2	3.2
UMTS licence proceeds	0.0	0.0	0.0	1.1	0.0	0.0	0.0	0.0
Total revenue	46.9	46.5	47.1	46.7	46.1	45.6	45.5	45.3

Table 11. **Euro area fiscal indicators**In percent of GDP (or potential GDP)

Source: OECD.

major three also reported the largest slippage against their earlier Programmes both for 2001 and 2002, although some smaller countries have shown major downward revisions of initially expected surpluses (Luxembourg, Ireland). Portugal breached the 3 per cent threshold enshrined in the Maastricht Treaty in 2001, and Germany and France have done so in 2002, while Italy approached the danger zone. All other countries, while posting weakening fiscal positions from those envisaged in earlier Programmes as well, stayed comfortably below the 3 per cent limit in 2002 notwithstanding a weakening cyclical position of their economies.

Portugal has been under a so-called Excessive Deficit Procedure (EDP) since October 2002. Its deficit reached 4.1 per cent of GDP in 2001. The Council judged that the breach did not result from "an unusual event outside the control of the country or a severe economic downturn". Portugal took decisive corrective action already after the Commission issued a recommendation for an "Early Warning" under the standard procedures of the Pact in early 2002 (which was not endorsed by the Council). The corrective actions included spending freezes, a VAT rate increase and a tax amnesty. Portugal looks to have met its commitments in 2002,

^{1.} OECD Economic Outlook, No. 73.

^{2.} Excluding UMTS licence proceeds.

^{3.} The cyclically-adjusted primary balance excludes debt interest payments. The change in this balance over time aims to gauge the impact of discretionary action on fiscal positions, but covers a broader set of factors, including the impact of erratic movements of specific taxes, variations in take-up of social benefits other than unemployment insurance and unintentional over or underspending.

^{4.} Maastricht definition.

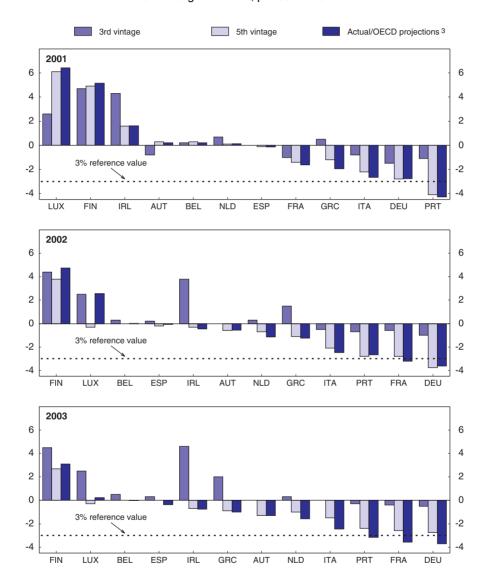


Figure 25. **Fiscal balances**¹
General government, per cent of GDP²

- The third and fifth vintages of the Stability and Convergence Programmes were released over the periods 2000/01 and 2002/03 respectively.
- 2. Excluding UMTS licence proceeds.
- 3. OECD Economic Outlook, No. 73.

Source: European Commission/Eurostat and OECD.

but the OECD projections foresee a deficit of 3.2 per cent of GDP in 2003, which would prolong the excessive deficit procedure.³⁵

In January 2003 the Council decided that *Germany* was in an excessive deficit position as its general government deficit was found to have reached 3.6 per cent of GDP in 2002. The Council Recommendation stipulates that the German authorities should "implement with resolve" their budgetary plans for 2003, which aim at reducing the general government deficit to 2¾ per cent of GDP in 2003 based on projected GDP growth of 1½ per cent. If growth is weaker than 1½ per cent, however, no additional restraint will be demanded. But in any event it needed to take measures totalling I per cent of GDP not later than May 2003. However, part of the government's consolidation package, which includes a tax amnesty to induce repatriation of savings transferred abroad, has still to be legislated. The OECD projections incorporated in OECD *Economic Outlook* No. 73 suggest that, on the basis of legislation enacted to date, the deficit would stay above 3 per cent of GDP in 2003 and 2004.³⁶

In January 2003 the Council issued an Early Warning against France as its deficit clearly moved into the danger zone (2.8 per cent of GDP in 2002 according to its latest Stability Programme). The Council recommended to France not to breach the 3 per cent threshold in 2003 and pursue a reduction of the cyclically-adjusted deficit by at least 0.5 per cent of GDP as of 2003 and in subsequent years so as to reach a position close to balance or in surplus in 2006. In March 2003 it appeared that France had breached the reference value of 3 per cent of GDP in 2002. On 2 April 2003 the Commission launched an Excessive Deficit Procedure for France after the general government deficit reported by France and subsequently revised by Eurostat was estimated to have reached 3.1 per cent of GDP in 2002. In its recommendation to the Council the European Commission notes that the breach does not result from "an unusual event outside the control of the French government" or from "a severe economic downturn" as defined in the Treaty. In early-June the Ecofin Council adopted a recommendation to the French authorities to end the excessive deficit situation as soon as possible but by 2004 at the latest, and to implement measures towards reducing the cyclically-adjusted deficit by the amount necessary to achieve this objective.

Italy, although not in breach of the 3 per cent limit, is clearly also exposed. The general government deficit reached 2.3 per cent in 2002 and, according to the Stability Programme, it would fall to 1.5 per cent of GDP in 2003. However, this largely reflects a number of one-off measures, including the sale of assets through securitisation as well as various tax amnesties and other settlement schemes. Moreover, as stipulated in the Council Opinion on the latest Stability Programme adopted in January 2003, the projected deficit reduction is based on an economic growth assumption that appears optimistic. In its Opinion, the Council recommended

to Italy that measures of a transitory nature, including securitisation be considered as a means to accelerate the reduction of public debt and not as a substitute for corrective action on the deficit.

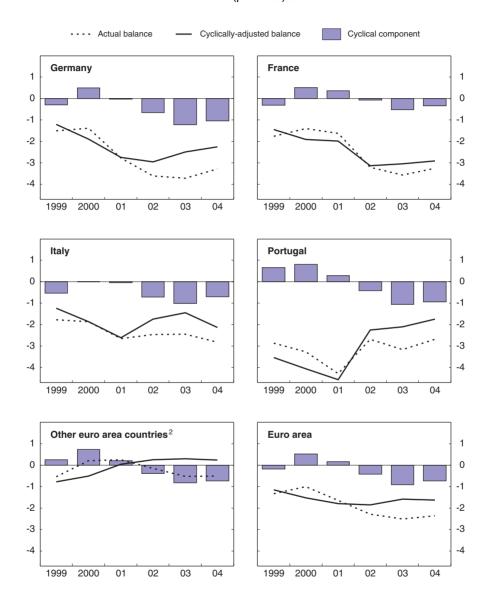
What went wrong

An inspection of the development of cyclically-adjusted fiscal positions since the inception of the single currency in 1999 is revealing. It shows that the current fiscal problems are largely rooted in a fiscal easing that was initiated at the peak of the economic cycle in 2000 and which had knock-on effects also in 2001 and 2002 (Figure 26). Admittedly, the cycle explains part of the observed build-up in deficits, but it does not explain all of it and the differences between countries are again striking. When Portugal breached the 3 per cent limit in 2001, the cyclical position of the economy in fact still had a positive impact on the budget balance. Germany and France would in theory have respected the 3 per cent reference value in 2002 if it were not for the business cycle, but it would have been a close call. In Italy one-off measures reduce the cyclically-adjusted deficit but this may not be sustainable. The root cause of the problem is thus that the three major countries and Portugal failed to comply with the commitments of the Stability and Growth Pact through not moving towards and then staying close to fiscal balance in cyclically-adjusted terms. This is in contrast with the behaviour of other smaller countries where balances have consistently been close-to-balance or in surplus in cyclically-adjusted terms, with the recorded (and projected) deficits fully attributable to cyclical developments.

Given these developments there has thus been significant fiscal stimulus in the area over the 2000-02 period along with the significant impact of automatic stabilisers as the economy slowed down since 2001 (Table 12). After correction for interest payments, which had fallen following the convergence of interest rates over the whole maturity spectrum to the low levels prevailing in Germany with the adoption of the single currency, the fiscal easing over 2000-02 totalled almost 1¼ per cent of potential GDP. It reflected cuts in taxation, amounting to around 1½ per cent of potential GDP, partly offset by cuts in primary expenditure (excluding debt interest payments), averaging around ¼ per cent of potential GDP. As shown in Table 13, the bulk of this fiscal stimulus stemmed from the three major economies.

From the outset the Stability and Growth Pact has been subject to criticism concerning its asymmetric nature – its constraints would bite in downswings but not in upswings – and weak enforcement mechanisms. The experience of the first four years of EMU lends some support to this criticism. The prospect of joining EMU may have temporarily raised the incentives to comply as fiscal sacrifices were politically rewarded. But after the "carrot" of EMU entry was eaten and the "stick" of exclusion was lost, the incentives for compliance with the rules were

Figure 26. **Fiscal policy indicators**Per cent of (potential) GDP¹



Actual balance excludes UMTS licence proceeds and is in per cent of GDP, cyclically-adjusted balance is in per cent of potential GDP and the cyclical component is the difference between the two.

^{2.} Weighted average of the following countries: Austria, Belgium, Finland, Greece, Ireland, Netherlands and Spain. Source: OECD (2002f).

Table 12. **Decomposing the fiscal stance**Change in percentage points of potential GDP¹

·	1997	1998	1999	2000	2001	2002	Projec	ctions ²
	1997	1996	1999	2000	2001	2002	2003	2004
Cyclically-adjusted current revenues of which:	0.2	-0.3	0.6	-0.3	-0.6	-0.6	-0.1	-0.2
Direct taxes on business	0.2	-0.2	0.2	0.1	-0.2	-0.3	0.0	0.1
Direct taxes on households	0.0	0.5	0.1	0.1	-0.1	-0.2	-0.2	-0.1
Indirect taxes	0.2	0.6	0.3	-0.2	-0.3	0.0	0.1	0.0
Social security contributions	0.0	-1.1	0.0	-0.2	-0.2	-0.1	0.1	-0.1
Cyclically-adjusted current expenditures	-0.9	-0.7	-0.2	0.1	-0.5	-0.2	-0.4	-0.2
Net debt interest payments	-0.5	-0.3	-0.5	-0.2	-0.2	-0.2	-0.1	0.0
Net capital outlays	-0.4	0.4	0.2	-1.1	1.2	-0.3	0.0	0.0
of which: UMTS licence proceeds	0.0	0.0	0.0	-1.1	1.1	0.0	0.0	0.0
Cyclically-adjusted primary balance ³	1.0	-0.3	0.1	-0.5	-0.4	-0.3	0.1	-0.1
Cyclically-adjusted balance	1.5	0.0	0.6	-0.4	-0.3	-0.1	0.3	0.0

^{1.} Weighted euro area aggregate excluding Luxembourg.

Source: OECD.

Table 13. The fiscal stance across countries Change in the cyclically-adjusted primary general government balance, in per cent of potential GDP^1

	1997	1998	1999	2000	2001	2002	Projec	ctions ²
	1997	1996	1999	2000	2001	2002	2003	2004
France	1.0	-0.3	0.3	-0.5	0.0	-1.1	0.2	0.2
Germany	0.7	0.3	0.3	-0.9	-1.0	-0.2	0.6	0.4
Italy	2.1	-1.4	-0.3	-0.7	-0.9	0.2	-0.4	-1.0
Major EMU countries ³	1.2	-0.3	0.2	-0.7	-0.7	-0.4	0.2	-0.1
Austria	1.6	-1.0	-0.2	0.2	2.5	-0.6	-0.6	0.1
Belgium	0.0	0.7	-1.0	-0.4	0.8	0.1	-0.1	-0.3
Finland	-0.1	1.5	0.2	2.7	-0.8	-0.4	-1.4	-0.8
Greece	0.7	1.5	-0.1	-0.8	-1.2	-0.4	-0.1	-0.1
Ireland	0.2	0.7	-2.1	1.1	-3.5	-2.1	0.5	-0.1
Netherlands	0.2	-0.4	0.5	0.1	-1.0	0.2	0.1	-0.4
Portugal	-0.3	-0.8	-0.1	-0.5	-0.6	2.1	0.1	0.3
Spain	0.8	-0.5	0.4	-0.5	0.7	0.2	-0.2	-0.1
Smaller EMU countries ³	0.5	-0.1	0.0	-0.1	0.1	0.1	-0.2	-0.1
Euro area ³	1.0	-0.3	0.1	-0.5	-0.4	-0.3	0.1	-0.1
Memorandum item: Cyclically-adjusted total								
balance ⁴	1.5	0.0	0.6	-0.4	-0.3	-0.1	0.3	0.0

^{1.} Excluding UMTS licence proceeds. See footnote 3 of Table 13.

Source: OECD.

^{2.} OECD Economic Outlook, No. 73.

^{3.} See footnote 3 on Table 13.

^{2.} OECD Economic Outlook, No. 73.

^{3.} Weighted averages, excluding Luxembourg.

^{4.} Including net interest payments.

weakened by the exclusive focus on nominal balances in the implementation of the Stability and Growth Pact during the early years of EMU. This focus allowed the cyclical tax windfalls to be spent even though this implied a deterioration of the cyclically-adjusted fiscal position.³⁷ Experiences to date may raise concerns whether the combination of peer pressure and the prospect of sanctions may be too weak to act as a powerful counterbalancing force. Apparently, some countries reverted to a deficit bias once in EMU and fiscal behaviour again became increasingly influenced by domestic political considerations (Box 6). In addition, the three major euro area countries, in particular Germany and Italy, have had a weaker growth performance than most smaller ones. Over the period 1999-2002 the former group grew on average by 1¾ per cent per year and the latter one by 3 per cent – both in actual and potential terms. This obviously made it more challenging for the larger countries to comply with the fiscal commitments stemming from the Stability and Growth Pact.

What should be done

This initial experience of the EMU suggests that peer pressure in committees and the European Council on countries to move to a close-to-balance or surplus position and to maintain this over the cycle worked reasonably well for the majority of euro area countries, but has not been powerful enough for some countries that failed to achieve their medium term targets. Moreover, as the lag between the breach of the deficit limit and the voting of sanctions can span several years, countries are encouraged to "buy time" as they run into fiscal problems.³⁸

This raises the question as to whether there may be scope for other mechanisms to discipline fiscal policy going forward. A long-term solution to remove deficit bias would be to ensure that financial markets act as a disciplining factor, *e.g.* by internalising the costs of unsustainable deficit positions in sovereign risk premiums. The experience so far suggests that financial market concerns over fiscal sustainability issues – barring acute crisis situations – have been weak. Sovereign risk premiums on government bonds are very small, notwithstanding the observed divergence in fiscal behaviour across euro area countries (Box 7). As mentioned above, investors apparently consider that fiscal imbalances against the requirements stemming from the Stability and Growth Pact are temporary and that the sustainability of public finances is not put in question.

One route that has been explored by some observers to make financial markets bite more is to use regulatory measures as a lever, for example by implementing a public rating system to complement the private rating agencies. However, there are risks attached to this strategy, as regulatory failure may prove worse than market failure. Moreover, it would not tackle the root of the problem, which is the lack of mobility of production factors across borders within the area as this implies that countries remain in strong control of their tax bases. The upshot is

Box 6. Is the political business cycle still alive in EMU?

From the outset there has been a concern that the Stability and Growth Pact would fail to provide strong mechanisms to prevent politically-motivated fiscal policies. The experience of the first four years of EMU lends support to this criticism. Overall, unlike the experience in the run-up to EMU, fiscal policies have had an expansionary bias and this may be related to a bunching of general elections. Closer fiscal surveillance may help detect early such behaviour, but it is unlikely to curb the incentives to run politically-motivated fiscal policies when elections approach.

The literature on politically-motivated fiscal policies (see *inter alia* Persson and Tabellini, 2002a and 2002b, Milesi-Ferretti *et al.*, 2002) predicts that uncertainty about the electoral outcome and a polarisation of views induce governments to undertake short-sighted fiscal policies. Most models predict tax cuts before elections while the implications for spending are less clear-cut. Electoral systems also shape fiscal behaviour. Specifically, majoritarian systems induce greater fiscal activism focussed on targeted programmes to shift votes in marginal districts while proportional systems lead to an increase of broad-based programmes.

Empirical work has found some, but not unequivocal, support for these predictions. As concerns EMU, the experience has been too short to draw strong conclusions. However, since there has been a bunching of general elections (both as part of the regular electoral cycle or early elections prompted by political crises) towards the end of the period 1999-2002, the political business cycle may help explain fiscal outcomes.

Recent empirical work (Buti and van den Noord, 2003) indeed suggests that fiscal policy in euro area countries has systematically been eased in election years or in the year preceding the elections. The prediction in the literature that politically-motivated fiscal easing initially focuses on tax cuts rather than expenditure hikes is broadly confirmed by the results (Table 14). Indeed, whereas in non-election years there has been a small bias towards tax increases, there has been a clear tendency towards tax cuts in the years preceding regular elections (or in years when elections were unexpectedly advanced by a political crisis). One way to interpret this finding is that in "normal" years governments build up a "war chest" through tax increases, and then go into the elections with subsequent tax cuts. The pattern for discretionary expenditure is less clear-cut, but on average expenditure hikes have been larger in regular election years than in other years. In any event, fiscal buffers were too small in some countries, with the result that fiscal positions approached or exceeded the 3 per cent of GDP deficit ceiling as soon as the economy slowed down.

that greater cross-border factor mobility would not only contribute to greater economic efficiency (Chapter I) but also prompt stronger financial market incentives for fiscal discipline. Obviously, for "fiscal competition" to have these favourable allocation effects, it needs to be fair, *i.e.* based on competition on public provision

	Non-election years	Pre or early election years	Regular election years
Discretionary fiscal easing (+) or tightening (–)	-0.02	0.85	0.59
of which due to discretionary change in: Expenditure	0.22	0.39	0.68
Revenues	0.23	-0.46	0.08

Table 14. **Fiscal policy stances at different stages of the election cycle**Per cent of trend GDP, unweighted averages

levels and their cost rather than on actions to capture mobile tax bases. While fiscal competition exists within the euro area and the European Union at large, with regulation to ensure that this competition is fair, it is by itself not powerful enough to impose sufficient fiscal discipline.

The Commission has acknowledged that the implementation of the Pact via peer pressure should be strengthened. In its view, a way to encourage compliance with the rules is to bring in a greater dose of "economics" into their implementation. The Commission has issued a set of proposals to the Council to change the implementation of the rules without changing their thrust (Box 8). This led to an Ecofin Council report to the European Council, which endorsed it in its Spring meeting on 20-21 March 2003. The report underscored that policy co-ordination should pay attention not only to macroeconomic developments and the surveillance of budgetary policies, but also to member states' structural policies in labour, product and services markets as well as to cost and price trends. Concerning budgetary policies, the report supports the following principles:

- Rather than interpreting the "close-to-balance or surplus" rule as an "end point" for the Stability Programmes (which consistently shifts out in time with every new vintage of Programmes), the rule should apply in cyclically-adjusted terms each year. Countries that do not yet comply with this requirement will be committed to a time-path (i.e. at least a 0.5 per cent of GDP decline in the cyclically-adjusted deficit per year).
- Pro-cyclical budgetary policies should be avoided, especially when growth conditions are favourable.
- Greater attention should be paid to long-term sustainability of public finances
- The Excessive Deficit Procedure should contribute to ensuring a satisfactory pace of debt reduction.

Box 7. Financial markets and fiscal discipline

The Treaty forbids member governments to seek direct financing by the central bank (ECB or national) or privileged access to financial institutions (Articles 101 and 102). The Treaty also establishes a non-bail out clause (Article 103) by which every member country is liable for its own government commitments. These arrangements are similar to those in *e.g.* the United States. However, unlike states in the United States, member states in the euro area enjoy full autonomy to raise taxes and their tax bases are relatively immobile across borders. This feature may explain why yield spreads across member states are small as compared with the United States. It suggests that incentives stemming from financial markets to maintain sound public finances are relatively weak in the euro area. This has been one of the rationales for establishing fiscal rules.

The launch of the euro was preceded by convergence in euro-area bond yields to historical lows. The elimination of exchange rate risk was a main driving factor, but the existence of fiscal rules and their surveillance are likely to have contributed by reducing the default risk premiums. This is reflected in the convergence of credit rating to the highest level, which are now AA or higher in all euro area member states except Greece whose local currency long-term debt rating is currently A (according to Fitch Rating). Remaining yield spreads are very small and largely explained by differences in issuing practices and liquidity, with smaller issuing member states typically concentrating on a few maturities. The bond market reaction to the recent breaches of the SGP has been strikingly muted. Apparently, market analysts perceive the current departure from fiscal discipline as defined by the SGP as temporary, suggesting that the credibility of the Pact has not suffered.

What are possible regulatory and administrative measures to reinforce financial market pressure complementing or replacing peer pressure mechanisms as an instrument for enforcing budgetary discipline? A number of theoretical possibilities have been aired (European Commission, 2003d):

- Using capital adequacy ratios. The transposition of the Basle II accord into the new EU Capital Adequacy Directive provides an opportunity to impose a rule that the bonds of a government which is under an Excessive Deficit Procedure would carry a higher risk weighting.
- Exclusion from joint-issuance for government bonds. Joint issuance of government debt has been suggested as a way to remove differences in issuance techniques and instruments between national issuers that remain a source of market fragmentation (see the special chapter in last year's Economic Survey). A country in breach of the SGP could be excluded from joint issuance and its bonds would than carry a higher liquidity premia.
- Restrictions on the use of government bonds as collateral in the Eurosystem's credit operations.
 Government bonds of countries in breach of the SGP would cease to be eligible as collateral in the Eurosystem's credit operations.

Box 7. Financial markets and fiscal discipline (cont.)

However, there are several drawbacks linked to these measures which are therefore not considered for implementation by the relevant authorities. Aside frompractical implementation problems, they risk distorting the working of capital markets and hampering the integration of the euro area financial markets. Moreover, the holders of the government bonds concerned would suffer a wealth loss that may not be justified by the underlying solvency situation. A better strategy might be to improve the quality of budgetary statistics – including the reporting of contingent liabilities – and their surveillance by the EU authorities to support the assessment by market analysts. For example, there are obvious weaknesses in the budgetary statistics associated with the reporting of securitisation and capital injections, which prompted the ECOFIN Council to endorse a Commission proposal for a Code of Best Practice (European Commission, 2002l).

The Commission's proposals aim to improve the implementation of the rules, considering that the rules themselves are worth preserving, not least because of fear over the credibility loss that might occur in case of a major overhaul. It understandably takes the view that the benefits of sound fiscal policy in individual countries extend to the whole area and therefore needs protection at the central EU level. Moreover, as argued in the previous Economic Survey, most aspects of the current framework meet the standards of proper rules-based fiscal policy put forward in the literature, and the new Commission proposals may go some way in improving them further:

- The rules are simple and allow for flexibility in their implementation.
- They rely on automatic stabilisers as opposed to discretionary action for short-run stabilisation purposes, with discretionary action focusing on longer-term structural objectives.
- The rules are embedded in an overarching framework of structural reform to ensure sustainable economic growth i.e. the Broad Economic Policy Guidelines.
- The rules are increasingly supported by strict transparency rules, consisting of generally accepted accounting conventions, timely and regular reporting requirements and a rolling multi-year budgetary process.
- Governments are subject to financial sanctions for non-compliance with the rules, with waivers granted only in case of explicitly defined exceptional circumstances.

Box 8. The Commission's proposals to improve the implementation of the Stability and Growth Pact

In a Communication issued on 27 November 2002 the European Commission (2002m) has made proposals to the Council and the European Parliament to strengthen the co-ordination of budgetary policies within the framework of the Stability and Growth Pact (SGP). It acknowledges that budgetary consolidation has ground to a halt since 1999. Several member states failed to complete the transition to the close to balance or in surplus requirement of the Pact and some showed very little progress to reduce debt levels towards 60 per cent of GDP.

In its Communication the Commission stresses that the implementation of the Pact's rule of budget positions "close to balance or in surplus" has met a number of difficulties. Specifically:

- The political ownership of the Pact by member states has eroded over time.
- It proved difficult to formulate and commit countries to fiscal objectives that are properly corrected for the business cycle according to a common methodology.
- Difficulties with the collection and interpretation of fiscal statistics led to undue recognition lags.
- Some countries failed to consolidate their budgets when the cyclical conditions to do so (1999 and 2000) were very favourable.
- The preventive procedures of the Pact proved ineffective in dealing with fiscal slippage.
- The communication to the press, markets and public of the benefits of adhering to the Pact could be improved.

In the face of these difficulties, the Commission has proposed the following measures:

- Establish budgetary objectives that take account of the economic cycle. The principle tool for assessing underlying budget positions shall be the common methodology to measure cyclically-adjusted budget balances which has been agreed by member states and the Commission (European Commission, 2002n). However, other measures that have a temporary impact on the budget balance should also be taken into account to assess the underlying budget balance.
- Establish as a general principle that countries whose underlying budget position is not "close-to-balance or in surplus" should improve their underlying budget position by at least 0.5 per cent of GDP each year until the "close-to-balance or surplus" requirement of the SGP has been reached. If growth conditions are favourable a more ambitious improvement should be envisaged.
- Once "close-to-balance or in surplus" is attained in underlying terms, ensure that automatic stabilisers always operate symmetrically over the cycle. Unwarranted loosening of fiscal policies in good times should be enforced effectively.

Box 8. The Commission's proposals to improve the implementation of the Stability and Growth Pact (cont.)

- Envisage a small temporary deviation from the "close-to-balance or surplus" rule in underlying terms if that produces clear economic benefits in terms of growth and employment, provided that public finances are on a sound footing. Specifically, debt should be well below 60 per cent and an adequate safety margin to avoid breaching the 3 per cent reference value should be maintained.
- Attach greater weight to government debt to GDP ratios in the budgetary surveillance process. The debt criterion of the excessive deficit procedure included in the Treaty, which stipulates that an excessive deficit procedure should be launched if the debt level fails to approach the 60 per cent reference at a "satisfactory pace", should be enforced.*
- * Article 104(2) of the Treaty states that "The Commission shall monitor the development of the budgetary situation and of the stock of debt in member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following criteria (...) whether the ratio of government debt to gross domestic product exceeds a reference value (60 per cent of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace."

The fiscal co-ordination framework is built around the notion that automatic stabilisers ought to operate freely within the constraints imposed by the 3 per cent Maastricht reference value in order to smooth fluctuations in economic activity. This aim is based on the notion that, with the loss of monetary policy autonomy for individual EMU members, budgetary policy needs to play a more significant role in smoothing the impact of country specific shocks. Aside from their stabilising impact, the reliance on the operation of automatic stabilisers has, as noted, a number of additional advantages. They respond to the cycle in a timely fashion since no recognition, decision or implementation lags are involved, unlike discretionary policies. Moreover, they respond symmetrically to downturns and upturns, and thus carry little risk of deficit bias over time. Unlike discretionary fiscal policy, automatic stabilisers operate without ad hoc adjustments in taxation and spending programmes that have potentially counterproductive effects on income distribution and allocational efficiency.

There are also risks involved in using automatic stabilisers. There is a risk that governments treat changes in budget positions that have structural roots as if they were the result of automatic stabilisers, or *vice versa*. This is to misjudge the

underlying fiscal situation and may lead to inappropriate policies and unsustainable debt positions. Moreover, automatic fiscal stabilisation is often created by mechanisms that allow workers and businesses affected by changing economic circumstances to delay their adjustment to change. Such mechanisms include the functioning of social security systems, labour market institutions and many parts of tax systems whose effects on incentives have been analysed in detail in the various OECD Jobs Strategy publications. These systems therefore need to be designed to ensure that the incentives to which they give rise are consistent with flexible labour and product markets that heighten the economy's ability to adapt well to change.

While it is sometimes claimed that structural reforms in the pursuit of greater economic efficiency and flexibility may reduce the effectiveness of automatic stabilisers, this need not always be true (Buti *et al.*, 2002). In particular, reforms that aim at tackling the work disincentives stemming from tax and benefit systems may act as a lever on the ability of automatic stabilisers to cushion the impact of shocks, including supply shocks (*e.g.* productivity or oil price shocks). Structural reforms that enhance the economy's capacity to absorb shocks flexibly may make it less prone to inflation, thereby reducing the risk of conflicts with the monetary policy goal of price stability.

The basic strategy towards co-ordinating fiscal policy in the euro area to limit free-riding opportunities and the associated externalities in a monetary union is thus sound. In any event, sticking to balanced budgets as a guiding principle is necessary to take out insurance against the ageing-related spending pressures, while pushing ahead with sorely needed pension and health care reform.

The Commission's proposals to make the rules "more intelligent" are helpful in bolstering this strategy, even if the enhanced flexibility comes at the expense of simplicity. But the refined framework will only work if governments exercise "ownership" over this framework, as its enforcement will continue to rely on "auto-arbitration" and peer pressure. The EU authorities should insist on the enforcement of the current Excessive Deficit Procedures to maintain the credibility of the rules. Breaches of the 3 per cent rule are the legacy of past behaviour and could have been avoided. The price of pursuing fiscal tightening in the present economic slowdown to rectify insufficient adjustment in the past is worth paying as it would bolster the credibility of the macroeconomic policy framework.

III. Monetary management

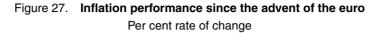
The previous *Survey* concluded that the Eurosystem's record to date had been satisfactory overall, and developments since then broadly confirm this assessment.⁴¹ The Eurosystem readily weathered the financial stress in the immediate aftermath of the 11 September terrorist attacks in 2001 and managed the introduction of cash euros on 1 January 2002 very smoothly. The changeover led to price increases, mostly in the services sector, and to consumer perceptions of high inflation, but this effect was of limited magnitude and of a one-off nature. As the economic recovery stalled and geopolitical uncertainty heightened from the second half of 2002, monetary policy was eased.

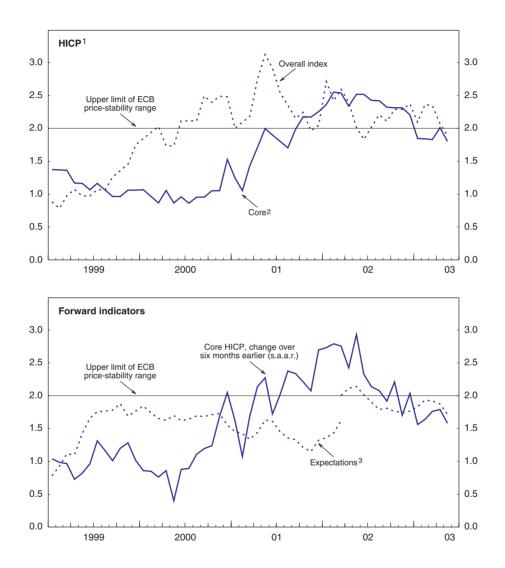
While the framework appears to be robust overall, the challenges facing monetary policy at the current juncture are severe. As discussed in Chapter I, downward risks to the projection of a modest recovery are present. The slack in the economy may thus increase and inflation may soon taper off. With recent indicators indeed pointing in this direction the ECB has cut interest rates further in the spring of 2003, as embodied in the OECD projection.

Inflation is coming down

The ECB defines price stability – which the Treaty set as its prime policy goal – as the annual rate of change in the harmonised index of consumer prices (HICP) staying below 2 per cent over the medium term. ⁴² It has stressed, however, that occasional failure to keep inflation below 2 per cent is unavoidable given the transmission lags of monetary policy and the need to avoid unnecessary volatility in economic activity.

HICP inflation has exceeded the 2 per cent mark – for three out of four years of the Eurosystem's existence (Figure 27, upper panel) – but this partly reflects a rather unusual series of adverse price shocks (animal diseases, poor weather, oil price hikes and currency depreciation). The ECB has emphasised the transitory character of these price shocks. But it has repeatedly warned that real wage resistance against such shocks embedded in wage formation systems risked producing second round effects on wage and price inflation. Perhaps reflecting such effects, core inflation (measured by HICP excluding energy, food, beverages





- 1. Harmonised index of consumer prices. Percentage change over same period of previous year.
- 2. Core HICP is the overall index excluding energy, food, alcohol and tobacco.
- 3. Break-even inflation rate between the nominal yield of French government bonds and the real yield of French index-linked bonds. Up to March 2002, government bonds linked to the French consumer price index with a maturity up to 2009; from March 2002, government bonds linked to the euro area HICP with a maturity up to 2012. Source: European Commission/Eurostat and Agence France Trésor.

and tobacco) has breached the 2 per cent mark since mid-2001. However, it has come down to 2 per cent in the first quarter of this year.⁴³ Although it picked up again in April, higher frequency measures of core inflation suggest that it is still decelerating (Figure 27, lower panel). Moreover, "headline" HICP inflation finally came down to 1.9 per cent in May 2003.

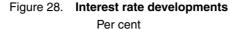
The policy stance

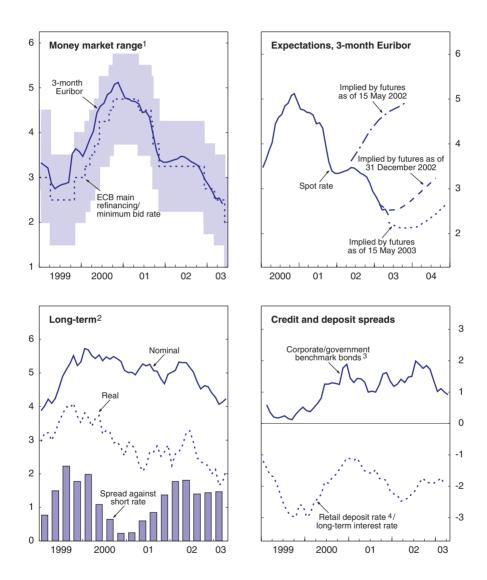
Interest end exchange rate developments

Since the euro area economy slowed down in early 2001, the Eurosystem has cut its minimum bid rate of the refinancing operations by 275 basis points in total, from 4¾ to 2 per cent (Figure 28). This took place in two bouts, one at the early stage of the downturn in 2001 and a second one more recently, as inflation fears receded amid evidence that the incipient recovery was faltering:

- In May 2001 a first 25 basis-point cut in the policy rate, from 4¾ to 4½ per cent, was implemented. This was followed in August by another 25 points cut to 4¼ per cent. The terrorist attacks on 11 September 2001 prompted two further 50 points cuts, in September and November, to 3¼ per cent.
- As adverse confidence effects after the September 11 attack were quickly reversed, and the economy showed signs of a brisk recovery from contraction in the fourth quarter of 2001, the Eurosystem kept its policy rate on hold at 3¼ per cent. Markets also expected the easing cycle to be over and were by early 2002 en Figure 28, upper-right panel).
- The situation changed completely after the summer of 2002, when most forward indicators were foreshadowing a more protracted slowdown in economic activity than initially expected, prompted *inter alia* by heightened geopolitical uncertainty and a deepening bear market for stocks. In view of concerns over sustained wage growth, it was not until December 2002 that the Eurosystem implemented a first rate cut, of 50 basis points, to 2¾ per cent. With the inflation outlook easing as the euro exchange rate continued to appreciate, it was followed by a 25 basis point cut in March, to 2½ per cent and a further 50 basis point cut in June, to 2 per cent.

Monetary policy has thus eased considerably with the onset of the downturn in 2001. Money market rates have moved in concert with policy rates all along, and long rates have started to come down since mid-2002 as the recovery faltered. The latter have fallen by over 100 basis points to 4 per cent by February 2003, although they have rebounded by some 25 basis points since. As a result, the slope of the yield curve became progressively steeper in 2001 and has stayed





- 1. The boundaries of the shaded "corridor" correspond to the ECB's standing lending and deposit facility rates.
- 2. 10-year government bond rates. The real interest rate is deflated by HICP inflation over the last 12 months.
- 3. Lehman euro Baa and 10-year government benchmark bond yield.
- 4. Agreed maturity up to one year.

Source: ECB, Datastream, Euronext/Liffe and OECD.

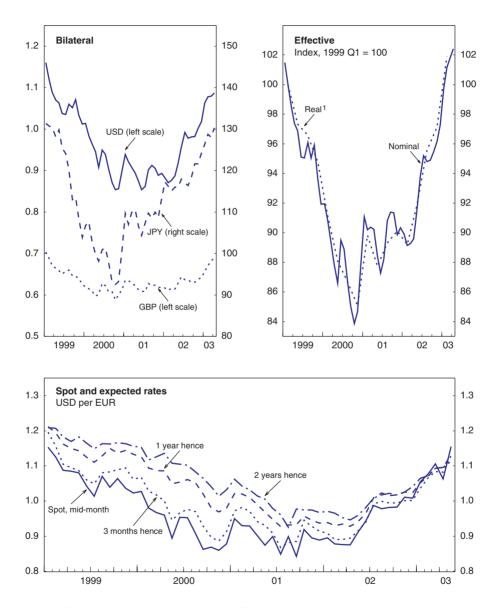
sharply upward sloping since (Figure 28, lower left panel). Real long-term interest rates, as measured by the ten-year government bond yield deflated by the average HICP inflation rate over the past twelve months, increased in the first half of 2002 – not surprising in view of expectations that economic activity would rebound briskly – but are now also on a firm downward trend.

The euro exchange has strongly appreciated since the beginning of 2002 (Figure 29). In the first two years since its adoption, the euro lost 21 per cent of its value against the dollar, which coincided with large net capital outflows related to portfolio investment and foreign direct investment abroad. This tendency extends to a broad range of currencies and therefore affected fully also the effective exchange rate of the euro, which fell by 15 per cent over the same period. Market observers generally considered the exchange rate to be below its equilibrium exchange rate. This was confirmed by the OECD's estimate of the euro's equilibrium exchange rate quoted in previous Surveus, although this suggested a smaller misalignment than some other studies had concluded, of the order of 10 to 15 per cent against the US dollar. Expectations in financial markets of a rebound in the external value of the euro within one or two years have ultimately materialised, with the rate climbing from a USD 0.83 trough late-October 2000 to close to USD 1.19 in late-May 2003. Moreover, in effective terms the euro exchange rate has fully recovered its initial loss. The reversal of net capital outflows, spurred by the unsettling of stock markets, has been a main driver of this development. This has had certain repercussions for monetary aggregates.

Money and credit growth

After initially expanding at a rate near the ECB's "reference value" of 4½ per cent in 1999 and 2000, the closely watched broad money aggregate M3 has been growing at a rate of 7 to 9 per cent per annum since 2001 (Table 15). Currency in circulation and overnight deposits - the narrowest money aggregate (M1) accelerated to almost 10 per cent in 2002. Specifically, euro area residents replenished their stocks of currency at the expense of, inter alia, short-term deposits, following the introduction of the cash euro, with the low level of interest rates also playing an important role. Such rapid growth in M3 may, in principle, give rise to concerns over a build-up of a monetary overhang and inflation pressure, but the ECB has consistently downplayed this risk. It has stressed that the rising uncertainty in financial markets, following the collapse of the stock market, along with low interest rates led to a shift into liquid risk-free assets that are comprised in the broad money aggregate. This "excess liquidity" is not interpreted as a desire by agents to spend more in the short term, but rather as a desire to "hoard" money in low-risk instruments until uncertainty diminishes. In any event, in the current environment of weak economic growth the likelihood of excess liquidity translating into inflationary pressures is considered small.

Figure 29. **Exchange rate developments**Units of foreign currency per euro



^{1.} Nominal effective rates corrected for cross-country differences in unit labour costs (manufacturing sector). Source: Consensus Economics and OECD.

Table 15. **Monetary aggregates and their counterparts**End of period, percentage growth¹

	Level, January 1999 (billion EUR)	1999	2000	2001	2002	2003 Q1 ²
M1 ³	1 802.7	10.5	5.2	5.4	9.8	11.7
M2 ⁴	3 922.5	5.4	3.6	6.4	6.6	7.9
M3 ⁵	4 438.8	5.6	4.1	7.9	6.9	7.9
Contributions to M3 growth from:						
Credit to the private sector	5 703.5	13.6	14.0	9.4	6.4	6.4
Credit to general government	2 036.0	0.7	-2.8	0.0	0.7	0.7
Net external assets	324.5	-4.5	-3.0	-0.2	3.0	4.2
Longer-term financial						
liabilities ⁶	-2 575.8	-3.7	-1.8	-1.9	-2.7	-2.5
Other net liabilities ⁷	-1 029.0	0.0	-1.5	0.4	-0.5	-1.1

- 1. Seasonally adjusted data for M1, M2 and M3 only, so the contributions may not add up exactly to the total.
- 2. Data for March, annual rate.
- 3. Currency in circulation and overnight deposits.
- 4. M1 and other short-term deposits.
- 5. M2 and marketable instruments (repurchase agreements, money market fund shares and units of euro area residents, money market paper, debt securities with an original maturity of up to two years).
- 6. Excluding capital and reserves of monetary and financial institutions (MFIs).
- 7. Including capital and reserves of MFIs.

Source: ECB, Monthly Bulletin and OECD.

This explanation is broadly corroborated by developments in the main counterparts of M3, but needs to be qualified to some extent. Credit to the private sector sharply decelerated in 2001 and 2002 due to the economic slowdown and less favourable lending conditions as the value of collateral dropped and lenders turned more risk averse. However, its negative impact on monetary aggregates was more than offset by two other developments. First, net credit to the general government sector had a large negative impact on money creation in 2000, as massive UMTS proceeds had boosted receipts by governments. The return to "normal" thereafter, together with weaker fiscal positions as the economy slowed down, resulted in a sharp acceleration in growth of credit to the general government sector in 2001 and 2002. Second, large net capital outflows in 1999 and 2000 have been reversed since as investors repatriated capital in the wake of the stock market crash. This capital largely ended up in liquid financial assets held locally by residents in the area, contributing to strong growth in M3.

While the slowdown in credit to the private sector in the past two years is striking, it masks strongly diverging trends. On the one hand, the pace of expansion of outstanding loans taken up by non-financial corporations has slowed down considerably since 2001 (Figure 30, upper panels). This may have reflected, to some extent, a tightening of credit conditions related to the deterioration of firms'

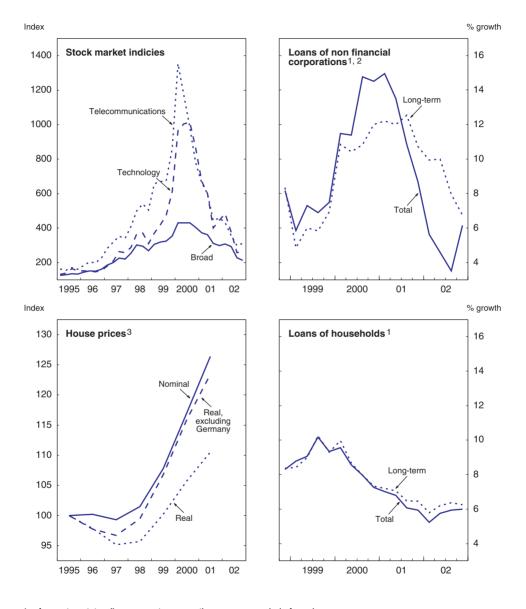


Figure 30. Asset prices and debt

- 1. Amounts outstanding, percentage growth over same period of previous year.
- 2. Including non profit institutions serving households.
- Weighted average excluding Austria, Greece, Luxembourg and Portugal. Real prices are deflated using the consumer price index.

Source: ECB, Monthly Bulletin, Bank for International Settlements (using national data) and OECD.

balance sheets after the unwinding of the stock market bubble. It may have adversely affected both the demand for credit (due to the decline in the value of collateral) and its supply (as high-risk credit dried up due to risk aversion and balance sheet strains of banks). However, there is no evidence of a generalised credit squeeze. On the other hand, loans to households have been buoyed by demand for mortgage loans as property prices have been on a sharp upward trend since 1998, except in Germany (Figure 30, lower panels). It suggests that, consistent with findings in the empirical literature (Boone and Girouard, 2002) negative wealth effects from the stock market slump have been more than outweighed by wealth effects associated with the property booms ongoing in most euro area countries. However, in some smaller euro area countries, where equity holdings by households are more common (either directly or via intermediates such as life insurers and pension providers), these wealth effects may be more pronounced (Bertaut, 2002).

Looking ahead, prudence is called for and further developments need to be closely monitored. The unsettling of stock markets can have longer lasting effects if expectations on future earnings growth priced into stock values at the peak of the cycle indeed prove to have been exaggerated (Mishkin and White, 2001). Equity prices may thus have moved closer to their fundamental values, and balance sheet problems may need significant time to fully unwind.⁴⁴

Low policy rates are appropriate

Monetary policy has eased considerably with the onset of the downturn in 2001 and interest rates are at a historical low. Moreover, Taylor-rule yardsticks for evaluating the policy stance suggest that short-term interest rates have consistently been around1 percentage point below the level consistent with a neutral stance since 2001 (Figure 31, left panel). However, the appreciation of the euro has increasingly acted as a drag on economic activity. The monetary conditions index, which combines information on the real short-term interest and effective exchange rates, has been on an upward trend since the start 2002, although it is still below its level at the advent of the single currency (Figure 31, right panel). It needs to be stressed though that the index is a rather crude measure. 45

In any event, the sharp appreciation of the currency will eventually contribute to a fall in the inflation rate (see Chapter I), both through lower import prices and via its impact on economic activity. The persistent overshooting of the price stability objective of inflation below 2 per cent over the medium term has limited the room for manoeuvre for a more aggressive easing of monetary policy to date, not least because, given its short existence and need to consolidate hardwon credibility, the ECB understandably errs on the side of caution. Nevertheless, the further reduction in key ECB interest rates in June is warranted as the medium term outlook for price stability in the euro area has improved. With downside risks

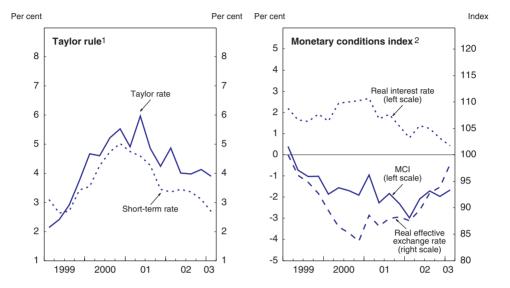


Figure 31. Monetary policy stance

- 1. The Taylor rule computes the amount whereby interest rates should be raised above (reduced below) their equilibrium level if either inflation rises above (falls below) its target or the output gap turns positive (negative) in order to maintain a neutral policy stance. The weights attached to inflation and the gap are 1.5 and 0.5, respectively. The price stability target is for inflation of 1.5 per cent and the assumed equilibrium interest rate is 3.5 per cent.
- Weights used in the calculation of the monetary conditions index are 1 for the real interest rate and 0.15 for the real effective exchange rate.

Source: OECD.

to the outlook predominating, the OECD projection assumes policy-determined interest rates to stay on hold until evidence of the recovery is firm by mid-2004. The ECB will need to continue monitoring closely all factors relevant for the assessment of risks to price stability and act if necessary.

The policy framework revisited

In May 2003 the ECB published the results of the evaluation of its monetary policy strategy. 46 This includes a reassessment of the "first pillar" including the role of the reference value for the growth of the money aggregates as well as a clarification of the price stability objective. Specifically, the analysis of money aggregates is to be focussed on long-term price developments and aimed to "cross-check" the findings stemming from the analysis of short-term economic developments. While the review reiterated the quantitative definition of price stability – inflation as measured by an increase in the HICP staying below 2 per cent

over the medium run – it highlighted that this means that the ECB would aim to keep the inflation rate close to 2 per cent over the medium term, as arguably has been its strategy all along. This decision is based on a reassessment of the trade-off between the cost of inflation and the risks of deflation. It also aims to ensure a safety margin against a possible (downward) measurement bias in the HICP and the implied risk of deflation in individual countries in the face of inflation differentials across countries. The review is welcome as it addresses some of the main concerns over the monetary policy framework that have been debated by observers since the inception of the single currency. The sections below elaborate these concerns and how the review deals with them

The role of monetary analysis

In order to assess the risks to price stability over the medium run, the policy framework of the Eurosystem assigns a prominent role to the monitoring of growth in broad money. This so-called monetary analysis includes a medium-term "reference value" for the annual growth rate of M3. It has been reviewed on an annual basis by the Governing Council and has served as a benchmark against which M3 developments have been assessed by the ECB. The reference value has been set at $4\frac{1}{2}$ per cent, based on a trend rate of growth of potential GDP between 2 and $2\frac{1}{2}$ per cent and a medium-term decline in M3 income velocity of $\frac{1}{2}$ to 1 per cent – implicitly leaving room for an increase in the overall price level of 1 to 2 per cent per annum.

As noted, M3 growth has overshot the 4½ per cent threshold for three out of four years of the Eurosystem's existence. At the beginning of Stage Three of EMU, deviations of M3 growth from the reference value were treated as a matter of concern. However, as growth in M3 became distorted by the impact of portfolio shifts, the ECB's communications underscored that the monitoring of deviations from the reference value are only one element of a comprehensive strategy, and focused increasingly on credit growth and other counterparts of broad money growth.

The usefulness of the reference value for M3 depends crucially on the validity of the assumption of a stable long-run relationship between money demand and nominal output. In several policy and research documents (ECB, 2001a, Masuch *et al.*, 2001, Brand *et al.*, 2002 and Bruggeman *et al.*, 2003) the ECB has demonstrated the stability of the money demand equation and the importance of money growth as a predictor of inflation in the past, paying tribute to Friedman's statement that over the longer run "inflation is always and everywhere a monetary phenomenon". However, the empirical evidence for this relationship is difficult to establish for the euro area as time-series analysis is unavoidably dominated by observations for the pre-EMU period. The Institut für Weltwirtschaft (2002), for example, suggests that a structural break in the money demand equation for the euro area

occurred in 1999, although others (Brand and Cassola, 2000, Calza et al., 2001 and Bruggeman et al., 2003) do not find evidence of such a break.

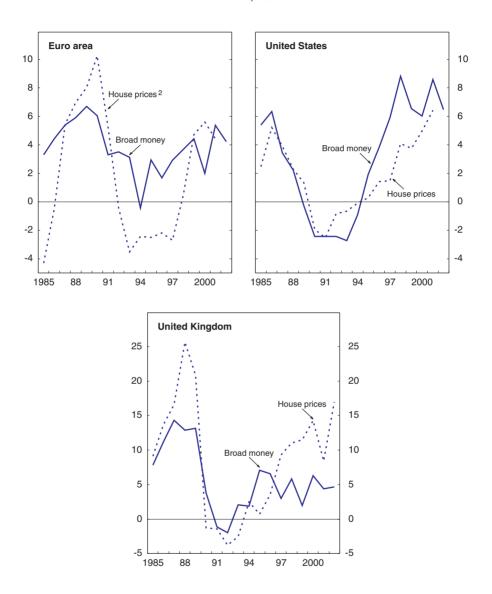
Indeed, in a low inflation environment the link between money growth and inflation may be looser than commonly acknowledged (De Grauwe, 2002). A "velocity shock" associated with a portfolio shift into low-risk financial assets, as occurred recently, is unlikely to boost short-run demand and inflation.⁴⁷ The excess liquidity may be converted into real assets such as property, and prices may be bid up in those markets, but this is unlikely to lead to excess demand for goods and services as it might do in high-inflation environments, as has been underscored by the ECB in its communications.⁴⁸ Figure 32 indeed portrays a striking correlation between money growth and property price developments, even though the direction of causality is likely to be in both directions since wealth effects associated with property runs in turn may affect the demand for money.⁴⁹ In any event, the ensuing wealth effects may contribute to excess demand and inflation pressure, but only with a considerable lag (Begg et al., 2002 and Nelson, 2002). This suggests that high-frequency measures of money growth should not be considered as a relevant indicator of future inflation pressure, whereas the real money gap (the deviation of the observed real money stock from some historical benchmark) may be interpreted that way. 50 The review of the policy strategy acknowledges this and appropriately focuses the monetary pillar on assessing longer-term inflation risks.

In a low-inflation regime, asset cycles may thus become an important driver of the business cycle (Goodhart, 2002). In the Bretton-Woods system downturns were normally caused by inflationary excess demand pressure, which led to sharp corrective increases in interest rates as countries had difficulties to maintain the pegged exchange rates. However, since the 1990s business cycles have increasingly been spurred by asset cycles, notably in property and equity markets, akin to the situation prevailing before the Second World War. In this environment busts in equity and property markets are triggered by over-investment in equipment and real estate and the two are probably linked.⁵¹ Moreover, with asset prices becoming increasingly correlated internationally, the associated wealth effects on consumption become an important transmission vehicle of the international business cycle (IMF, 2002a). This has the potential to amplify cyclical swings in economic activity and provides a strong rationale for a two-pronged monetary policy strategy with a focus on real economic and financial market developments on the one hand and monetary developments on the other hand, as adopted by the ECB.

Meanwhile, several observers have issued warnings that this should not be developed into a strategy of "asset price targeting", even though views as to what extent the monetary authorities should respond to asset price developments are somewhat divergent. ⁵² A pessimistic view is that monetary policy that pre-empts

Figure 32. House prices and money growth

Per cent, real¹



^{1.} Real prices are deflated using consumer price indices.

Source: OECD, Main Economic Indicators; United Kingdom, ODPM Housing Statistics, House prices; Bank for International Settlements (using national data) and OECD.

^{2.} Weighted average excluding Austria, Greece, Luxembourg and Portugal.

asset cycles will always act too late, *i.e.* be pro-cyclical, because of recognition lags (Goodfriend, 2002). Others have suggested that central banks should react to asset prices in the normal course of policy making to reduce output volatility associated with asset price bubbles (Cecchetti *et al.*, 2002 and Reinhart, 2002). However, some have argued that they should do so only in so far as changes in asset prices signal changes in expected inflation (Bernanke and Gertler, 1999) and to the extent asset prices are misaligned with market fundamentals.⁵³ Interestingly, members of the Governing Council of the ECB have not excluded the possibility of gearing its policy decisions in part toward stemming asset bubbles.⁵⁴

In sum, the case for a two-pronged strategy (real economic and financial oriented on the one hand and money oriented on the other hand) of monetary policy has a strong rationale. The ECB's policy-framework review suggests that monetary analysis should serve the purpose of a cross-check of the short-tem economic indicators from a medium to long-term perspective and to monitor trend money and credit growth in order to identify the build-up of financial balances. This re-orientation away from commenting on high frequency M3 growth numbers in every policy statement is welcome as it makes the considerations behind the monetary policy decisions more transparent.⁵⁵

Taking out insurance against deflation risk

Alerted by developments in Japan, observers have pointed to the possibility that deflation risks may have risen at the current juncture (see *e.g.* Ahearne *et al.*, 2002). At low inflation rates, nominal interest rates are normally close to the zero bound. This constrains the amount by which central banks can cut real interest rates, and hence they will be less able to counteract the effect of a large deflationary shock. A large enough shock could push the economy into a deflationary spiral, where inflation becomes substantially negative and real interest rates rise. While there is some evidence that inflation targets significantly below 2 per cent in the euro area could be risky (Hunt and Laxton, 2003), confidence in the euro area's monetary policy framework has remained solid and the risk of expectations of price declines becoming entrenched (a prerequisite for deflation) can be considered small (Ullersma, 2002). Moreover, safeguards in the financial sphere are probably sufficient to prevent financial distress to an extent where this would prompt deflation.

However, it may still be useful for a central bank to take out extra insurance against deflation if this can be done at a low enough cost. The terms of the trade-off between those costs (associated with a higher inflation target) and the risks of deflation crucially depends on the degree to which modern monetary regimes have mechanisms to counteract the problem of the zero bound to interest rates. Most observers trust such mechanisms are sufficiently robust. Yates (2002), for example, points to the possibility to raise taxes on money holdings to lower

the zero bound, to use open market operations for the purchase of foreign currency denominated assets to prompt a depreciation and to orchestrate fiscal emergency packages.

The policy review's thrust is that the ECB would aim to keep inflation below but close to 2 per cent over the medium term, which has provided further assurance. The ECB has defined price stability - which it is mandated to achieve according to the Maastricht Treaty⁵⁶ – as a year-on-year increase in the HICP below 2 per cent to be maintained over the medium run. From the outset the ECB has underscored that this definition referred only to increases in the price level and some members of the Governing Council have noted that the ECB's comfort zone for inflation is in a range of 1 to 2 per cent rather than in a range of 0 to 2 per cent. It has also pledged to take decisive action to prevent deflation, if needed, and has emphasised that price stability needs to be maintained over the medium term, which can be interpreted as indicating that the 2 per cent upper bound should not be considered as "hard-edged". These announcements have improved the ECB's communication strategy and should help to pre-empt deflation expectations from taking hold. The aim to keep inflation below but close to 2 per cent announced in the context of the review of the policy strategy underscores the ECB's commitment to provide a safety margin against the risks of deflation and is therefore a welcome complement to earlier statements.

Inflation dispersion: an issue for monetary policy?

The review mentions the presence of inflation differentials between countries as an additional rationale for keeping inflation below but close to 2 per cent over the medium term. One of the Maastricht criteria was that countries' inflation rates should converge towards (and not exceed by more than 1½ percentage point) the average of the three lowest-inflation member countries to qualify for entry into the euro area. Inflation dispersion indeed diminished considerably in the 1990s. After 1999 it slightly picked up, but it has not been large by historical standards and is also not out of line with inflation differentials observed among regions in the United States (Figure 33).

Nevertheless, even relatively small inflation differentials that perpetuate over time and become entrenched in expectations may eventually call for painful adjustment processes. Inflation differentials reflect the different economic conditions that countries were facing at the start of EMU. Specifically, Germany is still digesting unification (Buti and Sapir, 2002). Meanwhile "peripheral" countries experienced a positive interest rate shock (as interest rates converged to German levels) and exchange rate shock (to the extent these countries entered the area with a "small country premium" on their exchange rate). The process of monetary unification can be expected to gradually absorb these economic differences, but in the meantime adjustment processes will need to unfold and monetary policy

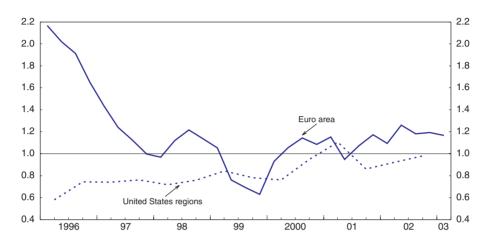


Figure 33. **Inflation dispersion**¹
Per cent

1. Measured by the standard deviation. Source: European Commission/Eurostat, US Bureau of Labour Statistics and OECD.

has little, if any, role to play in this regard. More generally, it will always have to focus on the area as a whole, and seldom fit the requirements of any individual country.

A specific concern remains that the move to very low interest rates may produce asset (housing) bubbles in some countries, especially if tax regimes favour the occurrence of such bubbles. This appears to be the case notably in the smaller countries of the area, and this could explain the persistence of inflation differentials in the area to some extent (Swank *et al.*, 2002). Calculations reported in Annex IV of this Survey appear to confirm this (Table 16). They show that countries that rank high in terms of the amount of tax subsidies available for owner-occupied housing also rank high on volatility of real house prices, as well as on levels of mortgage debt and HICP inflation. In these countries property prices may rise to unsustainable levels and if financial supervision arrangements and prudential standards are not sufficiently robust, financial stability problems may result. This concern has recently prompted the ECB (2003a) to call for increased monitoring of the evolution of households' indebtedness and financial fragility and for strengthening the role of risk assessment procedures.

It is important to make a distinction between short-run (benign) price adjustment mechanisms and longer-term trends in price dispersion. Research by

Ter cent, countries ranked according to the size of the tax advantage								
	Tax advantage ⁱ	Variability of real house prices ²	Mortgage debt as a share of GDP ³	Loan to value ratio	HICP inflation ⁴			
Netherlands	2.03	29	74	112	3.4			
Ireland	0.94	33	30	60-70	4.1			
Spain	0.93	26	32	80	3.0			
Finland	0.90	23	21	75-80	2.2			
Austria	0.56	16	30	60	1.6			
Italy	0.53	16	10		2.3			
Portugal	0.23	4	47	70-80	3.3			
Germany	0.00	10	47	70	1.4			
Belgium	0.00	16	28	80-85	1.9			
France	0.00	11	22		1.5			

Table 16. **Structural features of housing markets and inflation differentials**Per cent, countries ranked according to the size of the tax advantage

Source: BIS, ECB and OECD.

the European Commission (2002o) has shown that about half of the observed inflation dispersion in the period 2000-02 in the euro area is attributable to differences in cyclical positions, with the remainder due to differences in pass-through of the string of adverse price shocks. Inflation differentials should be allowed to absorb misalignments in real exchange rates, and the sooner they unwind, the lower will be the "sacrifice ratio", *i.e.* the amount of economic slack necessary to restore equilibrium in product and labour markets. Otherwise, there is a risk that inflation differentials will persist. Lack of labour market flexibility and wage indexation mechanisms in some countries have meant that real wages do not adjust sufficiently in the face of adverse price shocks. There is some evidence also that differences in product market competition act to sustain inflation differentials (Cavelaars, 2002). As concluded in earlier OECD work (Hoeller *et al.*, 2002), the upshot is that:

- Deeper integration of the euro area economy should be encouraged to spread the impact of shocks more evenly.
- Labour market flexibility and product market competition the topic of the next chapter of this Survey – need to be enhanced to promote relative price and wage adjustment.

Nevertheless, while the less benign sources of inflation differentials need to be removed, inflation differentials are unavoidable to some extent. It is welcome that the clarification of the price stability objective put forward by the ECB's review of the policy strategy takes this into account.

^{1.} Difference between pre-tax and after-tax real mortgage interest rate, 1999 (see Annex IV).

^{2.} Standard deviation, 1970-2001.

^{3. 2001.}

^{4.} Average 1999-2002.

By eliminating the inter-area exchange rate risk and enhancing price transparency the common currency may enhance product market competition and thus add to pressure for labour market reform. More generally, with the option of using the exchange rate to restore competitiveness following an adverse shock no longer available, the need to rely on alternative adjustment mechanisms could raise the political support for bold product and labour market reforms. Once such reform efforts succeed in boosting the economy's potential, growth will accelerate with little risk for inflation.

IV. Policies bearing on product market competition and growth

Competition matters for growth and consumer welfare as it raises the pressure on businesses to allocate and utilise their resources in the best way, while tending to improve the functioning of labour markets. It also pushes enterprises to improve processes and to innovate. Competition may be enhanced by legislation that makes anti-competitive behaviour less likely, by policies that ensure that competitors can enter a market, by separating inherently monopolistic parts of utilities from those that are not and exposing the latter to competition, by eliminating subsidies that do not tackle market failures, and by transparent public procurement rules. In the European Union, competition policy is among the few common policies and aims at ensuring a level playing field in the single market. In addition, member countries have competencies in the competition field and can influence competitive pressures via regulation.

The *first* section of the chapter provides an overview of the links between competition and growth. The *second* reviews the institutional set-up: the split in responsibility between the Commission and national institutions as regards the enforcement of competition legislation, and the important concepts and the framework for handling individual cases. The *third* section highlights the approach to enhance competitive pressures in the network industries. The *fourth* section reviews other areas that are important for competition, such as trade policy. The bite of the policies in place differs across areas and there is considerable room for improvement in some of these. The *last* section sums up and presents a set of recommendations.

Competition enhances potential growth

Over the last decade, the euro area's economic performance has been disappointing. While catching up with the United States' GDP per capita for decades, the convergence process was reversed during the 1990s. Trend labour productivity growth accelerated in the United States, while it slowed in the euro area (Chapter I). Labour productivity growth is to some extent affected by capital deepening and more importantly by technical progress and the speed of diffusion of new technologies and improvements in management.⁵⁹ At the firm level, the

key issues are achieving both an efficient resource allocation and to raise the pace of innovation. The degree of competitive pressure is among the factors, which is decisive for the efforts being put into each of these.

One indicator of competitive pressure is the relative aggregate price level with respect to other countries. After adjusting for differences in living standards, the EU's price level is far below the Japanese, but above the United States price level (Box 9). Furthermore, market power can be gauged by the mark-up of prices over cost. Sauner-Leroy (2003) finds that up to 1993 (i.e. the run-up to the introduction of the single market), mark-ups in manufacturing fell as price effects dominated cost developments. Later, though, mark-ups increased again as falling unit costs

Box 9. **Price dispersion**

The degree of competitive pressure in an industry or a market is reflected in the degree of market power. Price level comparisons across countries, commodities and services can identify where prices are exceptionally high, an indicator of possibly weak competition in domestic markets. The aggregate price level is lower in the euro area than in Japan and also slightly lower than in United States. The euro area price level is close to the US level while GDP per capita is substantially lower (see also Chapter I, Figure 4). Adjusting for differences in GDP per capita, *i.e.* the vertical distance in Figure 34, the Japanese prices are very high while US prices are low compared to prices in the euro area.

The dispersion between the EU countries, though, is still rather high. Several studies have documented price convergence across Europe by reviewing the development of price dispersion over the last decade (Table 17). Overall, price dispersion has fallen over this period, the changes having been biggest in the beginning of the decade. Later, the process appears to have lost steam. ECB (2003b) also find that the degree of inflation dispersion (*i.e.* an indicator of the change in price level dispersion) in the euro area fell strongly from 1990 through 1993, and then subsided gradually towards a low and stable level from the start of EMU in January 1999.

The reduction of dispersion varies depending on the products and services covered. With regard to traded goods, dispersion across member states has fallen towards US levels, but remains higher than within member states. For non tradables, dispersion fell to a much lesser extent, but again this is not at odds with the US experience (although the evolution of US non tradables is highly sensitive to the evolution of housing prices, and as such might not be a good indicator). Thus, the introduction of the Single Market seems to have had an immediate and strong effect on price dispersion in the early 1990s, but it remains higher across borders than within countries, which suggests that there is still room for further reductions as markets become more integrated and competitive pressures increase.

GDP per capita²

Relative price level 1 JPN 140 CHE 120 DEL LUX 100 USA EURO⁶ NLD IΤΔ ESF AUS 80 GRC NZL PRT MEX KOR 60 40

Figure 34. Relative price levels and GDP per capita

1. Purchasing power parities (PPPs) divided by the exchange rate, OECD = 100.

20

15

2. In thousand USD, converted using PPPs.

10

5

Source: OECD.

started dominating price developments. Increasing mark-ups may point to weaker, rather than stronger competition. Additional indicators of the competitive stance are discussed in Annex V.

Economic performance can be stimulated by enhancing product market competition, with effects materialising through a number of channels and interactions with other markets (OECD, 2002f). Such gains may be categorised into one-off efficiency improvements and ongoing gains in productivity. One-off, or static, gains are made through less slack in the use of inputs and better resource allocation in response to competitive pressures. Following regulatory reforms in previously sheltered industries, productivity has often been observed to improve and prices to fall. An important example is the liberalisation of network industries. The

Table 17. Review of literature on price dispersion in Europe

Authors	Period	Scope	Results
European Commission (1996)	1980-93	Price indices for detailed product/service categories collected by Eurostat through regular surveys of final price levels in the 15 EU member states.	Convergence accelerated following the launch of the Internal Market programme.
Dresdner Kleinwort Benson Research, (DKBR, 1999)		Price surveys for EU and US cities, 56 products.	For all but four products, price dispersion is greater in the European Union than in the United States.
Engle and Rogers (2001)		Aggregate CPI for 55 cities across 11 euro area countries.	Border effects have declined over time and can be largely explained by exchange rate fluctuations.
Haskel and Wolf (1999 and 2001)	1998	IKEA products in 25 countries, including 11 EU countries.	Price differences are mostly due to the local level of competition.
DKBR, (2000)	1999-2000		Price dispersion is about twice as high across EU member states than between them.
Financial Times (2000)	November 2000	Cost of living index in 155 cities.	Dispersion of price levels across 15 EU capital cities is 9.8 per cent, whilst it is 7.5 per cent in the euro area and 5.8 per cent in the United States.
European Commission (2001e)		Price Survey on groceries. 68 product categories including branded and non-branded products.	Cross country dispersion is on average four times higher than dispersion inside countries. Large differences in dispersion across countries for different products.
European Commission (2001f)		Comparison of price dispersion in the European Union with that in the United States (1985-99).	Higher price dispersion in the European Union mainly the result of higher price dispersion for tradable products.
European Commission (2001g)		Price surveys of fresh foods and consumer electronics.	Brands and consumer tastes explain up to 40 per cent of the price dispersion for a given product.
OECD Economic Surveys: Euro area 2001	June 1998	Survey of European Consumers' organisation.	The dispersion of prices in the European Union remains on average around 20 to 25 per cent higher across borders than within countries, after taking into account the distance between cities.

Table 17. Review of literature on price dispersion in Europe (cont.)

Authors	Period	Scope	Results
Rogers, Hufbauer and Wada (2001)	1990s	Economist Intelligence Unit for 165 goods and services.	Dispersion of prices in the euro area has declined from 0.12 in 1990 to 0.10 in 1999, but for traded goods from 0.11 to 0.05. There is no evidence of such changes in the United States, but the dispersion for traded goods is just slightly higher in the European Union; for non-tradables it is higher in the United States mainly due to housing prices.
Veugelers, et al. (2001)	1993-97		Price dispersion has declined, but speed depends on the concentration ratio.
European Commission (2002p)		Purchasing power parities of 58 categories of goods and services within private consumption, capital investment, and exports.	Aggregated price levels converged until 1997/98, but dispersion has since stagnated.
Rogers (2002)	1990-2001	Economist Intelligence Unit cost of living index data for 25 European cities and 13 US cities.	The dispersion of traded goods prices in Europe has converged to a level very close to the United States; much of the convergence has taken place in the first half of the nineties.

implication is that in these sectors, regulatory restrictions on competition tend to be accompanied by excess use of inputs. A main reason for a lower effort in these firms is the imperfectly competitive situation where there is less opportunity to compare firm performance, while firm survival is not threatened by inefficient practices (OECD, 2002f).

The dynamic gains caused by intense competition stem from enhanced efforts to innovate and a faster diffusion of innovations. Expenditure on R&D is often used as a crude indicator for innovation. Recent empirical work by the OECD has found a clear positive effect of innovation activity on output by including aggregate R&D intensities as a proxy for innovation effort in pooled cross-country time-series regressions of growth in GDP per capita (Bassanini and Scarpetta, 2001). Other work points to a significant inverse relationship between the strictness of anti-competitive product market regulations and R&D intensity in the business sector (Nicoletti et al., 2001; Bassanini and Ernst, 2002). It also suggests that non-tariff trade barriers

have a negative impact on R&D.⁶⁰ Scarpetta and Tressel (2002) show, within industries, important interactions between product market regulation and the size of the technology gap, *i.e.* the distance to the technological frontier. By including indicators for product market restrictions in cross-country regressions explaining differences of multi-factor productivity at the industry level, they find that a more competition-conducive regulatory framework has a significant positive effect in the long term. According to their estimates, an alignment of the regulatory stance in OECD countries to that of the least regulated countries could reduce the technological gap in most countries. For the large continental European countries, the increases in the total factor productivity level could range from 2 to 6 per cent.

Job creation is stimulated to the extent lower profit margins and corresponding real wage gains reduce structural unemployment, and/or call forth additional labour supply. Furthermore, reduced rent-sharing may reduce labour market segmentation and more elastic product demand may affect wage bargaining – in both cases reducing unemployment. These improvements in the functioning of labour markets are discussed in Chapter I.

Competition legislation is being reformed

The competition policy framework developed under the Treaty of Rome. It aims at "a system ensuring that competition in the internal market is not distorted" (Article 3(g) of the EC Treaty). Articles 81 to 89 deal with competition issues as such and cover antitrust, liberalisation, state aid and international co-operation. These provisions are implemented by *Regulations* issued by the Council and by the Commission, *judgements* by the European Court of First Instance and European Court of Justice, *Notices* issued by the Commission (statements of policy that are not legally binding), and Commission decisions. Article 81(1) prohibits agreements that prevent, restrict or distort competition, such as price fixing or market sharing, and Article 82 prohibits abuses of dominant positions. Both prohibitions apply to practices that may have an appreciable impact on trade between member states. Article 81(3) permits some of the restrictive agreements that fall under 81(1), if they produce sufficient countervailing efficiencies and consumers get a fair share of that benefit. 62

Antitrust cases

Under the current enforcement regime (set up by Regulation No. 17/62), the Commission can take three types of decisions in antitrust cases: *first*, if they do not infringe the prohibition, the Commission may grant "negative clearance" upon receiving notification. *Second*, if an infringement is found, it can impose remedies to bring the infringements to an end and it can impose fines on companies or their associations for past infringements. In 2001, fines were imposed in ten cases. Any arrangement based upon agreements that breaches Article 81(1) is automatically prohibited and legally unenforceable under Article 81(2). Third, under Article 81(3)

an exemption can be granted, if certain criteria are satisfied. For certain types of agreements, "block exemption regulations" are available.⁶³ The block exemption for the automobile distribution and repair network is discussed in Box 10. If there is no block exemption the parties may seek an individual exemption.⁶⁴ At present only the Commission can exercise the power to exempt restrictive agreements. Agriculture is subject to a special regime (Box 12).

The number of new cases based on Articles 81 and 82 fell from around 500 in 1998 to below 300 in 2001. Around 90 per cent of these were closed after informal procedures by way of "comfort letters". The requirement to notify agreements to obtain negative clearance or exemption is regarded as a burden for both businesses and for the Commission which has to examine cases which often do not raise problems but involve a lot of work (EC, 1999a). This workload demands resources that could have been used more gainfully on more important cases. These pressures will increase with the enlargement of the Union in 2004. Following a consultation process, changes to the antitrust enforcement rules were adopted in December 2002.⁶⁵ The core features of this reform are a shift away from the current system of notification and prior authorisation, to a system where Article 81 as a whole is directly applicable.⁶⁶ For the Commission, the elimination of notifications should free up resources. Further, the national competition authorities and the national courts will get the power to apply Article 81 in its entirety, including the exemption contained in Article 81(3). The national competition authorities and the national courts will thus be obliged to take decisions based on European Union law from 2004 when the agreements and practices in question may affect trade between member states.

The Community competition rules apply in parallel to relevant national competition legislation if an agreement affects trade between member states. For example, restrictive agreements between enterprises in one and the same state will have to be examined under the Community competition rules if they restrain imports. If a restrictive practice only affects trade within a member state, only that country's national competition rules apply. This holds for all agreements that have no appreciable effect on trade between states within the Community. With the new Regulation (Regulation No. 1/2003), national competition laws can continue to apply in parallel to the Community competition law, but as regards agreements, the outcome under national law may no longer diverge from that under Community law (obligation of convergence). The success of the reform will to a large degree depend on co-operation and the exchange of information between national competition authorities, and between national competition authorities and the Commission. The new regulation also calls for the establishment of a network of European competition authorities (a network that has already been created and is called European Competition Network (ECN)). Inside this network the cases will be allocated to the best placed authority to act. The Commission will always be able to unilaterally assume jurisdiction over a case, even after a national authority has started its investigation. However, the Treaty's framework on

Box 10. The block exemption for the automobile industry

Block exemption regulations exist for specialisation agreements, R&D co-operation, technology transfer, vertical (supply and distribution) agreements, insurance, liner shipping consortia and air transport. Some of these are or have recently been under review. One of these concerns the EU's block exemption for the automobile industry. The block exemption was introduced in 1985 and updated in 1995. It allowed car producers exclusive distribution networks and had the effect that producers could to a large degree control the pricing of their models across markets. One factor that justified the exemption was that road safety requires good quality repair and maintenance of vehicles with selective and exclusive dealer networks being deemed the best way to ensure this. Such exclusive car dealer networks involve vertical agreements that result in market foreclosure (i.e. denying market access to new entrants) (OECD, 1996). This exemption has contributed to, inter alia:

- Very limited intra-brand competition in the European Union, with only marginal volumes of retail sales across national markets.
- A marked price dispersion for cars: the divergence among pre-tax prices expressed by the standard deviation between national markets was 10.1 per cent in November 2002 (European Commission, 2003e). Price differences for individual models up to 59.5 per cent higher were recorded.
- An industry that operates below the efficient scale: in the European Union, just 300 cars are being sold per outlet and 60 cars per salesperson compared to 800 and 120 in the United States (McKinsey, 2003).

In its Report on the evaluation of the previous block-exemption, the Commission had concluded that the restrictive nature of distribution systems which virtually all car manufacturers established across Europe no longer met the conditions for an automatic and sector wide exemption. The Commission was also concerned that applying the general block exemption governing vertical agreements would not have remedied the competition problems identified in this sector.\(^1\) The Commission's policy towards vertical agreements warrants a stricter approach when, in particular, very weak intra-brand competition is not disciplined by inter-brand competition. Consumers, who spend around 16 per cent of their budget in purchase and maintenance of their cars, do not derive sufficient benefits from an exemption and when distribution is organised along the same patterns virtually by all competing suppliers in a relevant market. These conditions were met in the motor vehicle sector.

A new sector-specific block exemption was thus adopted in July 2002, with stricter provisions than those applied to distribution agreements in other economic sectors. For instance, from October 2003, manufacturers willing to be covered by the block-exemption will no longer be able to operate both exclusivity (i.e. continue to grant sole and protected territories to distributors) and selectivity (i.e. to establish standards for authorised distributors whilst preventing them from selling to unauthorised distributors), but will have to choose one approach. Nor will dealers be prevented from selling or repairing competing makes. Independent repairers

Box 10. The block exemption for the automobile industry (cont.)

must be given access to the technical information, tools and spare parts, which are indispensable to provide safe and reliable repair services to consumers. As of 1 October 2005, virtually all dealers will be free to establish outlets elsewhere in the EU.

It remains to be seen whether the use of a strict block exemption regulation to instil more competition in an industry sector will work. The effects of the new block exemption are yet to materialize and difficult to predict given the transitional period available therein. The ability of the new rules to integrate national markets, to strengthen competition, and to bring about substantial consumer benefits, in particular in the form of lower prices, will be the key to assess their adequacy.

- 1. The general block-exemption on vertical restraints (Block Exemption Regulation No. 2790/1999) applies in the absence of sector specific rules.
- 2. The new Block Exemption Regulation No. 1400/2002 on the motor vehicle sector provides for a transition period until 1 October 2003 for certain provisions and until 1 October 2005 for others. The exemption will not be reviewed before 2010.

anti-competitive agreements (*i.e.* Article 81) was already followed by a majority of member countries, currently 13. The framework on abuse of a dominant position, (*i.e.* Article 82) was followed by 11 member countries.

Merger review

The Commission may block a merger if it creates or strengthens a *dominant position*, thus impeding effective competition in the Union or in a substantial part of it. The concept of dominance is defined by what enables a company to act independently from its competitors and customers, and prevents effective competition on the relevant market. While the competition policy framework has been in place since the 1960s, the regulation concerning merger surveillance was not issued until the end of 1989.⁶⁷ Reasoned decisions are issued in every case, aiming at transparency and legal certainty. The Competition Directorate General (DG Comp) administers merger control through a special unit, the *Merger Task Force*. Since it must meet strict time limits, a surge in merger activity may put the available resources under severe strain. The Commission has blocked 18 of the around 2 100 merger cases it has examined since 1990, approximately the same share as the United States authorities. In December 2001 the Commission presented a Green Paper on possible directions for reform of the merger control system, and a year later a merger control reform

package was adopted. The package consists of a proposal for revision of the Merger Regulation, draft guidelines on the appraisal of horizontal mergers and a series of non-legislative measures intended to improve the decision making process (in the merger, antitrust and state aid fields). Among the changes proposed to the Merger Regulation are the possibility for notification prior to the conclusion of a binding agreement, more time in complex cases (and if remedies are proposed), simplification of the system for referral of cases from the Commission to member state competition authorities (and *vice versa*), and a strengthening of the Commission's fact-finding powers. The latter includes the possibility of imposing higher fines for failure to supply information.

The proposed new Merger Regulation includes a clarification to the longrunning discussion of the substantive standard for merger competition analysis in European Union competition law (European Commission, 2001h and Kühn, 2002). The European Union's concept of "dominance" for scrutiny of mergers differs from the United States' "substantial lessening of competition" doctrine. The draft Regulation seeks to make clear that situations of oligopoly which may give rise to competition problems are covered by the definition of the Regulation. Although this approach differs in text from the test in United States law, the two approaches often produce the same result and the practical consequences will not influence the large majority of mergers (or remedies). The non-legislative measures include a post of Chief Competition Economist in DG Comp with a team (directly below the Commissioner), to strengthen economic analysis as well as the creation of a post of Consumer Liaison officer, also within DG Comp, to focus on consumer issues. In addition, more support staff will be available to the Commission's Hearing Officers. Moreover, so-called advocacy activities, i.e. the promotion of a competitive environment by means of non-enforcement mechanisms such as closer relationships with governmental entities that set economic and regulatory policies and the nurturing of popular support for competition policy, may be established more broadly after the setting up of these functions. An internal system of peer review panels has also been created, to be used in merger, anti-trust and state aid cases. The panels, composed of officials from DG Comp, will be used in complex and high-profile cases to scrutinise the case team's conclusions with a "fresh pair of eyes". Further measures are aimed at strengthening the parties' procedural rights in merger cases, in particular for the merging parties to have access to their file earlier. While the reform package came after the judicial review of cases that received rather strong media attention (Box 11), and some observers saw a strong relationship between these two issues, its contents does not seem to have been affected much since the Green paper a year earlier.

Regarding the analysis of mergers, it has been suggested that the Commission's decisions have relied too much on "qualitative judgements and hunches" (Burnside, 2002; Kühn, 2002 and Box 11).⁶⁸ Thus, the establishment of a separate economic analysis function and of review panels is welcome. The panels will review the views of case handlers during the regular merger review process. The ability of the

Box 11. The judgements of the Court

Two important merger cases

In October 2002, the Court of First Instance ruled on two merger cases that for several reasons should be regarded as very important. In the case of a merger between the two French companies Schneider and Legrand, the Court of First Instance concluded that the Commission's economic analysis was deficient and overturned the decision (however, the Court criticised the analysis of some markets only, not the main French market). In its verdict, the Court noted that it found "several obvious errors, omissions and contradictions in the Commission's economic reasoning" and also "a serious infringement of the rights of the defence, which leads it to annul the prohibition decision."

A few days later, in the case of a merger between Tetra Laval of Sweden and Switzerland and Sidel of France the Court stated that the Commission had failed to prove its "bundling" theory (or portfolio theory, *i.e.* that companies with a large presence in one market can use a merger to become increasingly dominating in a neighbouring market as well). However, the Court also stated that this "decision does not discredit the bundling theory as a whole". That said, the Court judgement included such phrases as "The economic analysis is based on insufficient evidence and some errors of assessment", a very critical tone. The Court's judgements created doubt about current practice and heightened concerns over the need to introduce controls into the framework.*

The "fast track procedure"

In both these cases, the companies were able to go on with their merger processes after the Court had overturned the first decision. That was partly due to the "fast track procedure" which was created with the aim of allowing this possibility, but also due to measures taken by the firms. This was thought to be very significant, as it is the first time European businesses having successfully faced a judicial review process following a merger actually still managed to merge. The fast track thus initially seemed to work very well in these cases. Certainly, the fast track procedure itself is both fast and efficient.

Developments following the judgements by the Court:

- Tetra Laval's attempt to take control of Sidel was originally notified on 18 May 2001. On 13 January 2003, the Commission decided not to oppose the acquisition by Tetra Laval B.V., which belongs to the Swiss-based Tetra Laval Group (Tetra Laval), the owner of the Tetra Pak packaging businesses, of the French packaging company Sidel S.A., subject to compliance with a commitment and other obligations. Following the annulment on 25 October 2002, by the Court of First Instance of the Commission's decision dated 30 October 2001 prohibiting the transaction, the Commission had re-commenced its examination of the proposed operation.
- Following the Court of First Instance's judgement in the Schneider/Legrand case, the Commission re initiated the procedure focusing on France. In order

Box 11. The judgements of the Court (cont.)

to address the competition concerns raised by the Commission for the French markets, Schneider proposed commitments. In November, a French appeals court upheld an earlier ruling that the commitments proposed by Schneider violated an agreement to sell businesses belonging to Legrand only with the approval of its management. Schneider decided to abandon the deal in December 2002 when the Commission opened an in-depth inquiry into the concentration on the basis that the proposed commitments were, in particular taking into account the French judgments, not able to remove the competition concerns for the French markets.

While the fast track judicial process as such is efficient and follows strict time limits and companies should be able to restart their merger processes if the Court overturns the first decision, these cases suggest that other issues may arise and bog down the companies' merger process even following a successful appeal. The merging companies may not have gained much from faster judicial process. This is an issue separate from the fast track procedure itself. Based on this recent experience, an assessment should be made of the usefulness of the Court spending its given resources on choosing and pursuing special cases, rather than pursuing an effective and expeditious judicial control in all cases. The assessment should take into account that, as EU legislation is based on case-law, some social gains may be present anyway. Given the Court's limited resources, that procedure can only be used in cases where there is a genuine and pressing need for the Court to come to a decision speedily. Adequate resources should be made available to ensure that all cases that require expedited review run faster and smoother.

review panels and other measures designed to increase checks and balances during the control process to make the decision process more effective should be assessed.

The enforcement of competition law

The enforcement of competition law could be strengthened by refining the use of instruments that already have proven their role. In particular:

- The Commission has been active in cracking down on hard core cartels. In 2001, a record year for the Commission's anti-cartel programme, ten

^{*} Further, while the Commission thus received its second and third negative judgement by the Court in the space of one working week, the first notable case was in June 2002 with the overturning of the decision to prohibit the proposed merger between Airtours and First Choice.

Table 18. Average value of imposed sanctions relative to the turnover in affected industries

Decided in 2002 by the European Commission

Case	Ratio in %: final amount of the fine/ total world-wide turnover	100% immunity granted to one undertaking	
Industrial gas	5.11	No	
Plasterboards	3.43	No	
Reinforcing bars for concrete	3.33	No	
Speciality graphite	2.51	Yes	
Austrian banks	0.87	No	
Methionine	0.53	Yes	
Fine art auction houses	0.30	Yes	
Food flavour enhancers	0.12	Yes	
Methylglucamine	0.05	Yes	

Source: European Commission.

large cartels were prosecuted and fines totalling EUR 1 836 million were imposed. ⁶⁹ In general, financial penalties of 0 to 5 per cent of turnover in individual industries have been imposed (Table 18). For individual businesses, fines have been much higher. However, fines based on realistic assumptions about the level of unjustified gains, detection and punishment might have to be very high, but the extent of unjustified gains is hard to evaluate and the risk of detection and punishment is also far from clear. This makes the optimal level of fines hard to assess. However, recent work by the OECD (2003d) suggests that fines imposed on anti-competitive conduct usually falls short of levels that would result from applying economic models of deterrence, *i.e.* approximately three times the level of unjustified gains from the unlawful cartel. ⁷⁰ Over time the fines imposed on cartels have been getting bigger, and have reached a level similar to those imposed in the United States. While the sanctions are already high, their deterrence effect should be assessed.

- Leniency programmes that provide for reduced sanctions for companies that co-operate with the investigators may be helpful in breaking up hard-core cartels, and the level of sanctions that may be imposed is a strong determinant of their effectiveness (OECD, 2002g). Such programmes may also provide incentives for individuals to co-operate, due to the possibility of leniency from individual sanctions rather than sanctions imposed on enterprises only. While a leniency programme exists in the Union, the availability of pressing charges against individuals is not a Community-wide tool.⁷¹ The leniency programme for corporate offenders now has all the features for an effective programme in place.

- But because the Community's jurisdiction does not extend to individuals (including criminal penalties), some tools are not available. Further strengthening of the leniency programme could go in the direction of increasing co-operation with jurisdictions that have these tools.
- National law determines the conditions for private suits. Some common aspects of national judicial processes may discourage private actions in competition cases. The difficulties include the need to prove causation and damage in some detail. There are two main advantages of private actions: those who are harmed and sue get the compensation they deserve and it draws private resources into the enforcement process (DTI, 2001). In the United States, for example, 90 per cent of competition cases are private actions, while the number is negligible in the member states. This allows the United States authorities to focus on more important cases, leaving less significant cases to be pursued privately. Strengthening deterrence and enforcement by facilitating private actions will require action by the individual member states, but could be supported by the Union. Especially, greater transparency and predictability could be established concerning the availability and rapidity of remedies, and about the calculation of damage relief. However, the legal framework has to be well-balanced in order to avoid strategic use of private suits by competitors.
- Moreover, the approach to competition issues should be more systematic. The enforcement agenda is partly explained by the rather stable historical experience and the distribution of complaints. In addition, DG Comp has undertaken initiatives such as in the industries undergoing deregulation. Enhanced knowledge of the welfare effects of measures in different markets would also help. Even rather simple applied general equilibrium models could provide important information regarding such effects. Some national authorities, *e.g.* Denmark, have already integrated this approach into their planning framework (Konkurrencestyrelsen, 2000).⁷² Recently, the Commission has started a study that will evaluate the various tools in this area.
- Services only count for 20 per cent of cross-border trade in the Union, less than it did a decade ago (European Commission, 2003a). Business sector services contribute close to 49 per cent of total value added in the euro area, behind the United States at 55 per cent and much more than manufacturing at 20 per cent. However, local suppliers of services are often able to deter entry. The internal market in business services remains segmented, particularly services covered by widely divergent national regulations, such as accountancy, auditing and technical testing. European Commission (2001i) estimates that eliminating barriers to

cross-border trade in business services alone – they represent only a third of all services – would increase EU-wide GDP by up to 4.2 per cent. Community action to implement a single market in services (Chapter I), especially at the national level should be strengthened and supported by competition policy.

Competition enforcement in OECD countries is now typically entrusted to independent institutions, to insulate individual decisions from political and budgetary interference and capture by interest groups. 73 The European Commission considers the situation to be different at the Community level, however, as the EC Treaties give the Commission a legitimacy as a "supranational" institution invested with ensuring compliance with Community law as an impartial arbiter independent from the member States' governments. While the Commission is indeed an independent institution, it is not clear that the pressures that arise on enforcement agencies in other jurisdictions could not also arise at the Community level. Such pressures include the influence of other policies, advanced by other parts of the Commission, on competition enforcement initiatives. It is worth noting in this context that, competition enforcement decisions are taken by the vote of the entire Commission. However, also separate agencies can be obliged to take account of other objectives depending on the rules of substance. It is, moreover, not always clear whether the competition authority expresses views as independent adviser or those of the college of Commissioners.

Systems of administrative adjudication, whether based on separate agencies or not, which combines the functions of investigation, accusation, decision-making, and sanctioning, have also been criticised for lacking checks and balances. Kühn (2002) suggests that the Commission process, *inter alia*, results in a "self-confirming bias" in merger analysis. This issue may also be made more acute to the extent that expense and delay could discourage appeals to the courts. As regards the Commission, recent developments at DG Comp, such as strengthening the Hearing Officer and introducing review panels and a Chief Economist post, address the risk of "self-confirming bias". And at least in "fast track" cases, judicial oversight has become a more realistic possibility at the Court of First Instance level. On balance, the Commission considers that there are no grounds for considering the devolution of some aspects of enforcement to a separate institution.

State aid by member countries is under Community surveillance

Contrary to other jurisdictions, the Community has rules on state aid as a central plank of its competition policy framework (Articles 86-89 of the EC Treaty). Member state authorities may not grant state aid that distorts competition in the Union by favouring certain undertakings or sectors unless such aid is notified to the Commission and found to meet the conditions (these are spelled out in Article 87 of the EC Treaty). Such aid can, *inter alia*, take the form of grants, interest and tax relief,

state guarantee or holding, or provision of goods and services on preferential terms. Under the rules on state aids, the member states must notify the Commission if they intend to grant aid. The Commission will investigate and grant clearance or commence proceedings that finally grant or refuse clearance. At present, the Commission evaluates about 1000 notifications on state subsidies a year, while the Court of First Instance receives between 50 and 60 cases per year and the average time for it to decide a case is a couple of years.⁷⁴ The state aid provisions apply not only to member state governments but also to local authorities and other public sector bodies. The Commission also has the power to order the repayment of illegal aid already granted. However, the EC Treaty (Article 87) allows exceptions where the proposed aid schemes may have a beneficial impact for the Union as a whole.⁷⁵

Reported state aid has declined by a quarter between 1997 and 2000, to I per cent of EU GDP. In 2001 the euro area member states granted more than EUR 71 billion in state aid (within the EU, the total amount exceeded EUR 86 billion). However, twelve out of the fifteen member states reduced national state aid between 1997 and 2001. Of the total national state aid, the sectors comprising agriculture, fisheries and transport received 59 per cent, with transport receiving the largest share. 77 While aid levels fell significantly in the manufacturing, coal and service sectors, the amount of aid to the railway sector increased substantially in 2001. The latest figures also show that in 2001 there were around 1 000 state aid cases registered by the Commission. Around 44 per cent were in the manufacturing and service sectors, 38 per cent in agriculture, 10 per cent in fisheries and 8 per cent in transport and energy. They also show that of all the final decisions taken by the Commission, only 7 per cent were negative ones. Beside the reduction there has also been a re-orientation of state aid following the Councils in Stockholm and Barcelona, with policy focusing increasingly on reducing state aid and reorienting it towards horizontal objectives of common interest, such as support for R&D, SMEs or the environment. However, there is currently little effort to evaluate the effectiveness of aid and its economic impact, except for the Commission's assessment of the potential effect on competition.⁷⁸ Countries with a high level of state aid should try harder to reduce them. Figure 35 illustrates the relationship between national state aid and GDP per capita. Further, the numbers presented in the Commission's scoreboard do not include subsidies provided by the Community, such as the huge transfers to the agriculture sector and transfers by the structural funds. These transfers are not counted as state aid under community rules. The structural fund regulations require that all support for revenue earnings must comply with the same rules as state aid. The scoreboard thus does not fully capture the actual level of state resources that potentially distort competition by favouring the production of certain goods (Box 12). Midelfart-Knarvik and Overman (2002) show that while states and regions in the European Union are becoming more specialised, national subsidies to industry appear to have little effect for either good or ill and their effectiveness at attracting economic activity and

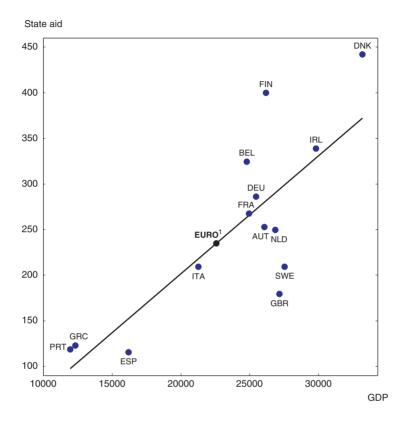


Figure 35. **State aid and GDP** EUR per capita, 2001

1. Excluding Luxembourg. Source: European Commission and OECD.

employment is limited. European Structural Funds, by contrast, are found to have an effect on the location of industry, notably by attracting industries that are intensive in research and development. However, this effect has mostly countered states' comparative advantage by encouraging R&D-intensive industries to locate in countries and regions that have low endowments of skilled labour.

Regulatory policy

Following European Union-wide liberalisation efforts, national authorities have gradually restructured "network activities" – those industries where a high-fixed

Box 12. Agriculture: a sector with its own competition framework

In the agricultural sector, Article 34 of the Treaty sets out, *inter alia* that individual agricultural markets need to be organised with common rules on competition depending on the product. The rules are set out in Regulation 26/62. Moreover, state aid for this sector is large. In 2002, total agricultural support in the Union is estimated at EUR 112 billion, equal to 1.3 per cent of GDP (OECD, 2003e). The Community is not alone in subsidising farming and in fact the total support per farmer is slightly lower than in the United States (Table 19).

Subsidies are both provided by the Community and member states. A part of these subsidies boost production, make it necessary to shelter production in the Union from foreign competition and to subsidise exports of the food surplus. As a sizeable share of subsidies is still linked to production, it benefits big farmers more and as it is accompanied by trade barriers, it reduces imports also from poorer countries despite the fact that the European Union has abolished all import duties from Least Developed Countries (LDCs) under the "Everything But Arms Initiative". Moreover, it traps resources in a low productivity sector, while consumers pay high prices for food. The price incentives under the existing system of production support also produce negative environmental effects by rewarding intensification and expansion (Beaufoy, 2000). Soil erosion is a potential problem in cases where vegetation is removed. In regions with scarce income alternatives various types of agricultural production have been expanded. This may have been a consequence of price incentives under past European agriculture policy. Due to the erratic rainfall pattern in these regions production has been intensified through drip irrigation. On these intensified plantations the vegetative cover has been removed in order to allow modern tilling practices not appropriate for the ecological conditions. These practices have in turn contributed to soil erosion. However, a significant part of the land affected by erosion is non irrigated grassland and to a lesser extent areas of permanent crops (OECD, 2001c). Further, the intensive production brings problems of water pollution in many countries from fertiliser, pesticide and livestock manure run-off. However, the 1992 and the AGENDA 2000 reforms have led to a shift from price support towards direct payments with favourable effects on consumers, on trade and on the intensity of production. In addition, legislation to limit the livestock density and/or to reduce problems of manure has been introduced at the Community and at member state level. Recent reforms have made production subsidies conditional on the development of good farming practices, which should further contribute to improving environmental outcomes.

In January 2003, the Commission presented further proposals to reform the Common Agricultural Policy (CAP) to the Council, with the aim of reaching agreement by the end of the Greek Presidency (June 2003). Main features of the proposals are the further "de-coupling" and "cross-compliance", i.e. a single farm payment independent of production linked "to respect for environmental, food safety, occupational safety and countryside stewardship", the reduction of direct payments according to farm size and the establishment of a stronger rural

Box 12. Agriculture: a sector with its own competition framework (cont.)

development policy. In addition, reforms in some specific markets are proposed (Commission press release DN: IP/03/99 of 22/01/2003). However, a number of agricultural markets (including sugar, olive oil and others) are not yet covered by policy proposals.

Community spending on the first pillar of the CAP (market support and direct aids) will only increase by 1 per cent annually in nominal terms based on the 2006 actual spending level to reach EUR 48 billion in 2013 for the EU 25 (EU 15 plus 10 accession countries) following the agreement at the Brussels European Council in October 2002. While it seems probable that farmers in existing member states may have to accept small reductions in their subsidy payments after 2007, the agreement does not include a commitment to limit expenditure on rural development measures, giving further potential room for spending growth. The Council gave the Commission a mandate to negotiate successfully the Doha round of global trade liberalisation talks, which are due to be concluded at the end of 2004

Public support of certain industries may be well-founded if it internalises positive external effects. At the margin, the support should equal the value of the external effect, and if the external effects are separate from production, the result is "de coupling". However, supporting an individual industry will usually be inferior to more general support, as distortionary effects are lower. At least some of the goals in the reformed CAP, such as the protection and development of rural livelihood, could be attained by more general measures aimed at all industries in rural regions. For example, rural development in the Union mainly focuses on farmers' incomes. As measured by the OECD Producer Support Estimate, the European Union has reduced the share of producer support arising from its most production and trade distorting policies from 96 per cent in 1986-88 to 69 per cent in 2000-02. The recent reform will lead to further substantial decoupling of support from production, but the options each of the EU member countries will choose are not yet clear, and there is flexibility in implementing the agreement across the EU member countries. It seems that arable crops may show the biggest degree of decoupling, except for the sugar sector which is to be reformed next year. The reform requires compliance under "good farming practice" in order to be eligible for the single farm payment laid down in 38 regulations addressing environmental, animal health and welfare and food safety requirements.²

^{1.} However, not all aspects of business behaviour in the agriculture sector are covered by the exceptions. In April, the Commission fined six French farmers' associations a total of EUR 16.7 million for fixing beef prices following the mad-cow crisis in 2001.

^{2.} The key elements of the reformed CAP are a single farm payment for EU farmers, independent from production; limited coupled elements may be maintained to avoid abandonment of production. This payment will be linked to the respect of environmental, food, safety, animal, and plant health animal welfare standards, as well as the requirement to keep farmland in good agricultural and environmental condition ("cross compliance"). Further, a strengthened rural development policy with more EU money, new measures to

Box 12. Agriculture: A sector with its own competition framework (cont.)

1. promote the environment, quality and animal welfare and to help farmers to meet EU production standards in 2005, direct payments for bigger farms to finance the new rural development policy will be reduced ("modulation") and a mechanism for financial discipline to ensure that the farm budget fixed until 2013 is not overshot introduced. Some further revisions to the market policy of the CAP are asymmetric price cuts in the milk sector, reduction of the monthly increments in the cereals sector by half while the current intervention price will be maintained, and reforms in the rice, durum wheat, nuts, starch potatoes and dried fodder sectors.

Table 19. Total support estimate (TSE) in agriculture

	Level in 2002 ¹ million EUR	In % of GDP		In EUR	
		1986-88 average	20021	Per capita	Per farmer ²
European Union	112 564	2.7	1.3	323	19 000
Australia	1 736	0.8	0.4	89	5 000
Canada	6 334	1.7	0.8	204	16 000
Japan	59 087	2.3	1.4	464	28 000
United States	95 785	1.4	0.9	336	41 000

^{1.} Provisional data.

cost infrastructure is needed. Where feasible, network industries have been or are in are the process of being opened up to competition. For example, the local loop in telecommunications, electricity and gas transmission and distribution, and rail track, are all characterised by large fixed costs which give rise to a natural monopoly which must be handled by the design of pro-competitive regulatory mechanisms. Liberalisation and state intervention fall under the Article 86 in the competition chapter of the Treaty (and also Article 31). For two decades, European Union policies have promoted a continuing sequence of favourable supply shocks stemming from these industries. In general, performance results in these sectors indicate that the benefits from competition and incentives from structural separation outweigh any loss in efficiency due to foregone economies of scope (OECD, 2001d). However, while regulatory reform trends over the past two decades increased the reliance on

^{2.} In full-time equivalents. Source: OECD (2003e).

market mechanisms, regulations continue to hinder and distort market forces in many sectors with detrimental effects on economic performance while not always achieving their objectives. This section reviews regulations and reforms in a selected group of network industries: electricity, gas, railways, post and telecommunications.

The network industries

Electricity and gas

The 1996 Electricity Directive laid down the minimum market opening to be achieved in every member state. In the gas sector, a Community directive was adopted in 1998 (98/30/EC) requiring a minimum market opening from 2000, increasing to 33 per cent by 2008. The member states are free to open up a larger share of their market and almost all member states have chosen to do so (Table 20). The Commission then proposed in December 2002 to reform the Electricity and Gas Directives to improve access to transmission, increase cross-border capacity, and fully open the electricity and gas markets. These extensions include open markets to all business consumers by July 2004 and to households by July 2007. In addition legal separation between producers and transport network managers will be compulsory by July 2004, and legal separation between producers and managers of distribution networks will be compulsory in July 2007. Merger activity in the energy sector continued in 2002, and the main area of concentration took place in the generation and supply of electricity and in the trading business. No full, in-depth investigation was undertaken into electricity mergers during 2002 (European Commission, 2003f).

The trend is towards unbundling of generation and retail activities from transmission, while separation of ownership of the transmission grid already applies in five member states. Still, the incumbents are dominating in most member states (Figure 36). At the distribution level unbundling is still very limited, and the existing requirements are only for legal unbundling and not for vertical disintegration. Moreover, cross-country and regional market segmentation persists. The low level of integration is reflected in intra-Community trade in electricity, which still represents only 8 per cent of electricity production. Thus there is no internal electricity market. New players should be welcomed as they could introduce interconnection between the existing markets, and allow arbitrage between the different markets. Integrated markets do exist and they deliver low prices. The UK was a forerunner with regard to using the market in the electricity sector. The Nord-Pool, which comprises Denmark, Finland, Norway and Sweden, is currently regarded as the blueprint for a pro-competitive market organisation (IEA, 2001).80 The European authorities should take steps to learn from these arrangements and facilitate further cross-border markets. New lines should be constructed across

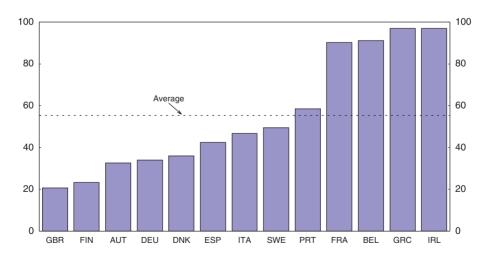
	Ela	atri aitr	,	Coo	
	Electricity		Gas		
	Degree of market opening ¹ (2002, %)	Year of full opening to competition (declared)	Degree of market opening ¹ (2002, %)	Year of full opening to competition (declared)	
Austria	100	2001	100	2002	
Belgium Finland	52 100	2003/07 1997	59 Derogation	2003/06	
France Germany	30 100	 1999	20 100	2000	
Greece	34		Derogation		
Ireland	40	2005	82	2005	
Italy	45	Industry 2004	96	2003	
Luxembourg	57	Derogation	72		
Netherlands	63	2004	60	2004	
Portugal	45	2003	Derogation		
Spain	55	2003	79	2003	
Denmark	90	2003	35	2004	
Sweden	100	1998	47	2006	
United Kingdom	100	1998	100	1998	

Table 20. Liberalisation of electricity and gas markets

Source: European Commission (2002q).

Figure 36. Market share of the largest generator in the electricity market

Per cent of total generation, 2000



Source: European Commission/Eurostat.

^{1.} Theoretical percentage of demand opened to competition.

borders with limited interconnection, preferably by allowing private players to reap the transitory gains from price differences in the currently separate markets. After 1993, electricity prices for end-users in OECD Europe (as measured by the OECD index of energy prices) began to slide downwards, and continued to decline through 2000. However, in 2001 average real electricity price increased by 2.9 per cent (IEA, 2002). Electricity customers in the UK market are benefiting from the fourth lowest prices in the EU, and a typical domestic customer in the UK pays around 27 per cent less than in Germany, around 19 per cent less than Italy and 11 per cent less than French customers (EA, 2003). In the industrial market, prices under contract also represent good value for the customer as UK prices are down 6 per cent on last year (at 3.72 pence per kilowatt hour, compared with 6.37 pence in Italy, the most expensive in Europe). Similarly, Swedish and Finnish electricity prices derived from the NordPool exchange are systematically among the lowest prices in the Union (INRA, 2002).

Gas prices in the European Union have mostly been rather stable over the last decade, but rose from 1999 to 2001 by around 30 per cent for households and by more than twice that for industrial users. As for electricity, competition in the gas sector has been affected by incumbents' strong position in the gas distribution network. Long-term import contracts have also favoured the incumbent operators. Further, given the importance of storability for gas, ownership of and the availability of long-term contracts for storage facilities has reduced new entrants' access. Thus, downstream competition has been restricted and competition has not been effective. To reduce cross-subsidisation and increase transparency, separate accounts now must be kept for the natural gas transmission, distribution and storage activities, and consolidated accounts for non-gas activities. Still, this accounting separation should be replaced by complete ownership unbundling of horizontally and vertically integrated companies to create pro-competitive market structures. Further, the widespread public ownership should be reduced and divestitures and restrictions on cross-holdings considered. In the gas sector, there is still a long way to go at the national level before activities open to competition are separated from the operation of the network infrastructure and access conditions to essential facilities set in a way that does not bar entry.

The application of competition law contributes to the energy market liberalisation process by ensuring that state measures which prevent the creation of a common market are not replaced by measures taken by market operators. In the antitrust sector, the Commission focuses on aspects of supply competition and network issues. As regards gas supply competition, a main case in 2002 was the settlement of the GFU case on joint marketing of Norwegian gas through a gas negotiation committee (GFU). Further, in the Synergen case the incumbent Irish electricity producer ESB undertook to make electricity available by means of auctions or direct sales. As regards network access, the Commission carried out a number of investigations, most of which have not yet

been concluded. The investigation of the UK-Belgium gas inter-connector was concluded after it became clear that the companies concerned had taken or would take certain measures in the near future facilitating third party access (European Commission, 2003f).

Railways and postal services

While production has grown slightly (but fallen slightly as a share of all transport), employment in the railway sector has fallen strongly over the last decade, and by more than in the United States and Japan.⁸¹ Since 1991, steps like requirements for a budget and a system of accounts, separate from those of the state have been taken, along with separate accounting for railway infrastructure (i.e. track and related equipment) and the operation of transport services. A soft version of rights of access for rail transport operators in other member states was introduced, (i.e. for international groupings and international combined transport services, but not for passenger and freight transport generally) to open up the Community markets. In 1995 common rules for allocation of railway infrastructure capacity were introduced through an Infrastructure Manager and guiding principles for the charging of fees for infrastructure. However, the stated European Union aims of "revitalising railways" (European Commission, 2001j) must be set against a starting point that was the result of subsidisation and inefficient resource use, and as such cannot serve as a reference point. Thus, while there is plenty of scope for making the railway industry more effective, a return to old levels of traffic and employment in all its parts is certainly not feasible.

2001 brought the "Rail Infrastructure Package", three directives to be implemented in national legislation by March 2003 followed by a "Second Railway Package" of proposals in January 2002 intended to speed up the opening of rail freight markets and the improvement of inter-operability by several further measures. These steps go in the right direction but progress is slow. Several countries had not adopted the necessary rules or set up bodies qualified to issue the safety certificates and allocate train paths by the first railway infrastructure package's date of entry into force. This state of affairs was already pointed out in the Implementation Report some time ago. Further, steps that have been taken for freight transport should also be implemented for passenger transport. The European Commission announced in 2003 that it intends to publish proposals for market opening for international rail passenger services. The Commission in 2002 also continued with antitrust proceedings against the rail companies Ferrovie dello Stato (FS) and Deutsche Bahn (DB). Both cases concern discriminatory and exclusionary behaviour by the incumbents towards a new entrant. The Commission opened formal proceedings in 2001 (European Commission, 2003f).

Horizontal integration of networks with other European countries would boost the railways' competitiveness compared with other transport forms. For

instance, the technical specifications, including such items as type and strength of power, track gauge and train command and control systems for interoperability are being elaborated and implemented for upgraded and new rail lines. However, all member states need to adhere to this process for real progress to take place. The lack of inter-operability makes interconnection hard and also hampers rail transport on medium and long distances where its advantages should be greatest. Individual systems should be dimensioned according to the common and not to the national markets. Moreover, the economic incentives to exploit all economies of scale and scope from interconnection are much higher for a vertically disintegrated network owner than for an integrated firm. Work by the OECD (OECD, 2001e) suggests that gains from improved interoperability based on vertical separation more than outweigh the cost of increased co-ordination in western Europe with its small, open and traffic-intensive economies.

Postal services in the European Union are estimated to handle 135 billion items per year, generating a turnover of about EUR 80 billion or about 1.4 per cent of GDP. About two-thirds of this turnover is generated by mail services and the remainder by parcels and express services, which are competitive. Overall, postal services are estimated to employ directly approximately 1.7 million people of whom 1.3 million are employed by the universal service postal operators. Since 1997, a very gradual process has been leading towards more open markets in member countries. The latest step was the adoption of the New Postal Directive in June 2002, which liberalises (from January 2003) the delivery of letters weighing more than 100 g (or costing more than three times the price of a standard letter) and all outgoing cross-border mail (except for member countries that prefer not to), to be followed three years later for letters weighing more than 50 g (or costing more than two and a half times the price of a standard letter). Far in the future, the new Directive sets I January 2009 as a possible date for the creation of an internal market for postal services, but this will require later confirmation (or can be changed) by co-decision procedure. These measures have safeguarded the universal postal service in the member states, according to an evaluation of the 1997 Directive (European Commission, 2002r) that especially notes that the effort this far has contributed to "a safe, gradual and controlled opening of the postal market at a time of rapid market development". However, to let consumers benefit from competition, the authorities should rather speed up the opening of these services as already has been done partly in Sweden and the Netherlands. In the meantime, increasing investment in incumbents and the practice of signing long-term public service contracts with partly liberalised operators should be discouraged. At a minimum, governments should withdraw from the parts of universal postal service providers that show no public service properties. Cost-effective solutions to public service obligations should be established, for instance, by contracting out to the most efficient bidders.

Telecommunications

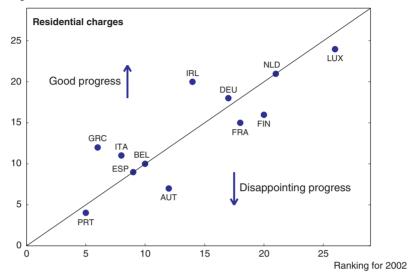
With the opening of telecommunications markets in most member states from January 1998, a long process was completed. In the following years. new services have appeared in the telecommunication markets, quality has improved and the prices of many services have been falling. Mobile communications and internet services are growing strongly, as companies compete with each other with new offers and packages, cheaper second phone lines, as well as new pricing formulae. In all member states, National Regulatory Authorities for telecommunications have been established. They have been given a range of tasks by the European Union regulatory framework and their national governments: they grant new mobile and fixed network licences; approve interconnection prices and agreements; police retail prices and prices charged to customers for changing operators; and deal with the allocation of numbers to new market players.84 In July 2002, the Commission established the European Regulators Group for Electronic Communications Networks and Services. National competition authorities are also scrutinising the telecommunication markets. The main recent development in the telecommunication field is the adoption of a new regulatory framework, to come into force in July 2003.85 The new framework aims at reducing the regulatory burden by limiting the imposition of ex ante obligations to situations where there is no effective competition and simplifying the conditions for obtaining general authorisation. The national regulators assess the market power on the markets where ex ante regulation is warranted, in accordance with the Commission Guidelines (European Commission, 2002s). For those operators deemed to have significant market power, a concept that is aligned to the notion of dominance under competition law, at least one regulatory obligation must be imposed. Differing from the general competition framework, the measures that can be imposed are wider.

Telecommunication prices for household and business services declined over the last decade in most EU countries, indicating greater competition. Telecommunication prices for a basket of household services in previously lagging countries, such as Germany (OECD, 2002h), are now comparable with those in the earliest opened markets in Europe, like the UK, Scandinavia and the Netherlands. On the other hand, business prices based on the OECD basket of telephone charges and measured in a common currency in six of the euro area member countries (and seven of the EU member states) have not come down to the OECD average (OECD, 2003f). In Figure 37, these baskets of telephone charges are adjusted for Purchasing Power Parities and the OECD member countries are ranked. Both the positions and changes from 2000 to 2002 for the euro area members suggest divergent developments among these countries. Regarding residential telephony prices, five euro area countries have moved towards a lower position in the rankings while four have moved towards a better position. For

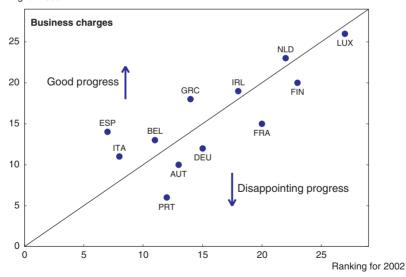
Figure 37. Telephone charges in OECD countries

Rankings of OECD basket of telephone charges in descending order (highest price = 1)1

Ranking for 2000



Ranking for 2000



^{1.} Ranking for 29 OECD countries excluding Slovakia. Charges are adjusted using current purchasing power parities. Source: OECD.

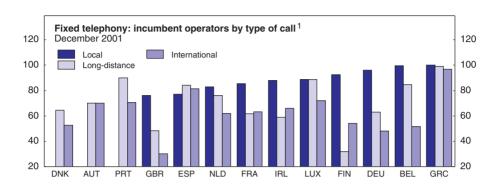
business prices, the euro area countries are split evenly among those moving downwards and upwards. The early European Union wide price developments reflected improvements in fixed-line telephony that to a large degree were brought about by regulatory measures, but the stalling of price declines may reflect that the market is characterised by an inherent risk of abuse of dominant position (OECD, 2002h). As Figure 38 shows the incumbent operators still enjoy overwhelmingly dominant shares in fixed telephony, with market shares between 80 and 100 per cent for local calls in most countries and 50 per cent for long distance and international calls. The market structure for mobile services is also dominated by a few companies, and the incumbents, or incumbents' subsidiaries, now seem to have managed to slow the market share losses they suffered in earlier years (Figure 38). Recent steps towards increasing competition in the latest physical stage of delivery, which are crucial to reduce the market power of the incumbent that arises from control of the local loop, have not been very successful with less than 900 000 lines unbundled.

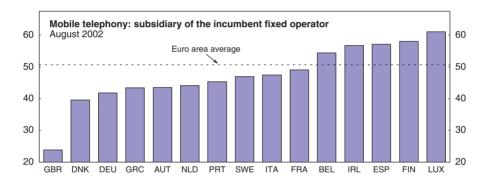
The large price differences between countries suggest that further regulatory efforts are clearly needed. ⁸⁷ The establishment of competing networks would erode these dominant market positions, thus ensuring a competitive market structure, as would more cross-border supply. This reinforces the need for ensuring development of Universal Mobile Telephone System (UMTS), or 3G, networks, whose data-transmission capabilities combined with their portability element make them potentially close substitutes to the existing fixed line and mobile phone networks. Still, the new UMTS licences illustrate the lack of European integration, as they follow national markets rather than the pan-European market. In that sense, the lack of a common licence illustrates the need for more integration.

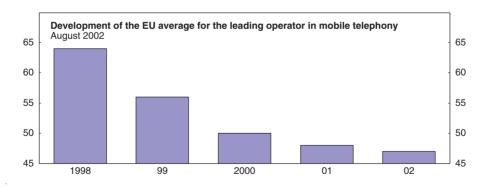
"Necessary" public services?

Concerns have been raised that liberalisation may have detrimental impacts on public service. The limited energy liberalisation measures in France were accompanied by an agreement that the Commission would prepare a report on whether new legislation should protect essential services, or whether market opening should be prevented from interfering with the provision of essential services in their current form. Indeed, liberalising the provision of public goods has to be accompanied by appropriate measures to deal with equity objectives. However, the authorities should separate issues concerning public service obligations from the mode of delivery. The optimal mode of delivery will change along with technology and changing market structures. The sequencing of liberalisation and regulatory reform may alone ensure that liberalised markets deliver on important public service obligations. Rather than sticking with old modes, action should continuously be taken to improve delivery, and to bring it in line with best practice.

Figure 38. **Telecommunications market shares**Per cent







Estimates of outgoing minutes. Due to national differences in practices and measurements these numbers are not fully comparable. For details see Chart 12 of the document referenced below.
 Source: European Commission, 2002t.

Regulators

A key problem in securing competition in network industries is to ensure unrestricted access at commercial or non-discriminatory charges, requiring regulation capable of adapting to market developments. This implies market surveillance, and either sector-specific regulators or combined regulators and competition law authorities (such as in the Netherlands). Nonetheless, the ultimate goal is to move away from regulators and closer to competition law enforcement in the sectors open to competition. While the regulators and competition authorities share the methodologies of analysing markets – see for example the "2003 Regulatory Framework" in telecommunications – their relationship is complex in practice. The rules aim at avoiding overlap and to distribute powers for different situations. Regulatory authorities have *ex ante* responsibility for evaluating structural factors in non-competitive markets and impose appropriate structural remedies, while the competition authorities have power to decide infringements on competition law in this sector (which can also imply structural remedies, but *ex post*).

Indeed, the liberalisation of network industries has created new issues that should be reflected in the institutional architecture:

- As regulators must operate according to national law, regulators are by necessity local in nature. For the time being, also the relationship between the sector-specific authorities and the government varies across sectors and countries. Nevertheless, EC legislation requires operational separation and independence of action by national regulatory authorities. However, to create and sustain a common market, the practices and routines must develop coherently. The demands put on networking between national regulators become very important. The new regulatory framework creates procedures for co-operation between national regulatory authorities themselves, between these authorities and the Commission and between the national regulatory and competition authorities. All of these have extended their work into Community-wide networks, which still lack evaluation procedures. To avoid a self-enforcing growth of regulatory authorities, strict rules for continuous re-evaluation of regulatory needs should be introduced.
- A fundamental practical issue is the need for a clear institutional design specifying the responsibilities of the multiple players. The number of actors in most jurisdictions, especially in the regulatory field is expanding rapidly. Also, the resource allocation differs strongly between individual countries. The question of whether a regulator should analyse competition issues that competition authorities handle in other sectors, such as deciding in whether a player holds "significant market power", i.e. a dominant position, or whether they should be left to the competition

authorities has not been given enough weight, when deciding on the institutional set-ups up to now. While the regulator will have the detailed technical insight and thus is well qualified in these matters, the general authority is more trained in analysing competition issues and has a broader supporting structure. Co-operation may produce good results, as national competition authorities and regulators can utilise each other's comparative advantage but its demands will raise cost and practical issues.

Other policies to promote competition and growth

Deregulation, whether pursued by member countries or inspired by European Union-wide initiatives has progressed. At the same time, subsidies to a large number of sectors have declined, the agricultural sector being an important exception. While regulatory reform has increased the reliance on market mechanisms, regulations continue to hinder and distort market forces in many sectors with detrimental effects on economic performance. Jean and Nicoletti (2002) find that labour market rents in the form of wage premia are relatively higher where regulations restrict competition most and that product market competition tends to curb wage differentials. Calculated as an average of the available euro area countries, wage premia are comparable to the United States in most manufacturing industries. However, outside manufacturing, wage premia tend to be higher than in the United States wholesale and retail trade, hotels and restaurants, and sale and repair of motor vehicles sectors. Individual estimates are only available for seven euro area countries, however (Annex V). Concerning services, the financial sector, retail distribution, the airline industry and port services are discussed in Chapter I. The Community has common policies in some of these areas, but in others the subsidiarity principle means that both goals and policies are set at the member country or local level.

The external trade regime influences concentration and competitive pressures

Concentration indicators and indicators of openness to trade can identify areas where product market competition is potentially weak. Compared to the United States, concentration ratios in the euro area are higher in most sectors (Annex V). Veugelers *et al.* (2001) find that concentration in manufacturing has declined slightly in the European Union since the introduction of the Single Market. Further, the study finds productivity growth to be lower in industries where concentration and price dispersion are higher. Outside manufacturing, concentration levels are high in the utilities sectors, which also signal potential problems with competition (Annex V). The market presence of foreign firms or openness to international trade also affects concentration.⁸⁸ The import penetration rate varies considerably across euro area countries, the average level in manufacturing being

	latest year of data available.			
	Euro area ²	United States	Japan	
Total manufacturing	17.1	20.0	9.2	
High R&D Segmented Fragmented	22.7 19.2	28.0 23.2	9.4 8.8	
Low R&D Segmented Fragmented	11.6 11.8	11.0 15.1	8.8 9.8	

Table 21. **Import penetration**Imports as a percentage of the sum of production and imports,
latest year of data available in the sum of production and imports,

Source: OECD, STAN and ITS databases, April 2003; and OECD calculations.

29 per cent when intra-area trade is included. However, for the area as a whole the ratio is much lower at 17 per cent (Table 21). While that is somewhat below the comparable ratio of 20 per cent in the United States, it is clearly above the 9 per cent observed in Japan. Thus, the numbers confirm that the common market has boosted trade between the member countries while the effect of the extra-border regime on trade is comparable to that of the United States. At the industry level, import penetration would appear to be lower in the low-R&D sectors, whether segmented or not. However, measured against the United States the segmented low-R&D sectors are roughly at the same level, and only a few sectors (wearing apparel, and leather, leather products and footwear) have lower import penetration (Annex V). Overall, this indicator does not suggest areas of potential weakness with product market competition in the euro area, but on the basis of the economy-wide indicators, weak competition is easier to identify at the level of individual countries than in aggregate data and it is difficult to establish general patterns. This probably reflects the fact that the "relevant market" is still the local level, reflecting the relatively high degree of market segmentation that still exists. Forthcoming Economic Surveys of euro area countries will throw more light on these issues.

The gains from removing trade protection, even unilaterally, are sizeable. The conclusion of the Uruguay round continued the reduction in average bound Most Favoured Nation (MFN) tariff rates in the OECD area but the average level of rates remains different across countries and trading blocks:

 The level of tariff protection is slightly higher in the European Union than in Japan and the United States: simple average bound duties for all products is 4.1 per cent, and for non-agricultural products only 3.9 per cent, whilst the averages for MFN statutory applied duties for agricultural and

^{1. 2000} for the euro area and Japan, 2001 for the United States.

Excluding intra-zone imports; using 1999 data for Portugal, and excluding Ireland and Luxembourg.

non agricultural products stand at respectively 4.4 and 4.3 per cent. However, these averages take only the *ad valorem* part of the import duties into account, and, hence, neglect specific tariffs, which are frequently used on agricultural and food products. When converting specific duties to *ad valorem* equivalents, the simple average of bound tariffs on major agricultural commodities in the European Union amounted to 60 per cent in 2000, compared with 28 per cent in the United States and 191 per cent in Japan (OECD, 2002i). However, EU tariffs can only be properly analysed if the effect of preferential access for developing and least developed countries is taken into account. A total of 142 developing countries benefits from the EU's GSP scheme whilst 49 LDCs benefit from duty and quota-free access in the European Union.

- Non-tariff barriers (NTBs) span measures to control import prices and/or volumes.⁸⁹ Although "tariffication" of some NTBs, such as quantitative restrictions, has taken place in some sectors, notably agriculture, non-tariff measures may have become relatively more important as tariffs have been reduced over time for most products. As is the case with other developed countries, complaints of partners tend to focus on technical standards perceived as strict, or SPS measures perceived as onerous.

Limits on parallel imports may weaken domestic competition in branded goods. As such, the emergence of the common market itself raised competition as national rules granting the right to block imports between member states were largely abolished. However, while Community law protects parallel trade between member states, parallel imports of branded goods from third countries into the European Union can, as a general rule, be impeded through the use of trade mark law. However, where such restrictions have an impact on the competitive market structure in the European Union, they might be incompatible with Community competition rules. This is an area where the three main jurisdictions, Japan, the United States and the European Union, have different policies. In the European Union, trademark laws may in principle be used to prevent parallel importing from third countries into the European Union while the possibility of parallel trade between member states is rightly considered to be vital for the functioning of the internal market. This approach ignores the effect of competitive pressure brought about by parallel imports from the rest of the world on the efficiency of the single market

Nagarajan (1999) found that the potential welfare gains for the European Union from a comprehensive trade round comprising market access and trade facilitation could amount to a welfare improvement of as much as 1½ per cent. On the basis of specific assumptions, Messerlin (2001) estimates that the cost of protection by the Union comes close to seven per cent of European Union-wide

GDP.⁹⁰ This underscores the importance of current international trade negotiations to capture potential welfare gains. Trade Ministers will review progress at the next global trade summit in September 2003, taking up, among other things, two controversial issues: a proposed international investment agreement and proposals for multilateral rules on competition policy. The European Union's approach includes the establishment of a basic multilateral framework agreement on competition law and policy, including agreements on core principles for national legislative frameworks, provisions for combating hard core cartels and modalities for international co-operation between national competition authorities. This would be complemented by technical assistance programmes. As suggested in the previous *Survey*, this round represents an opportunity for the Union to use the measures included in the Financial Services Action Plan to form the basis for European Union proposals and pre-commitments in the on-going set of General Agreement on Trade in Services (GATS) negotiations.

Introducing competition in public procurement

Government procurement is a substantial part of the economy. The Commission has published procurement indicators starting in 1993 to measure market trends and the impact of public procurement policies. They show that total public procurement in the Community fell slightly as a share of GDP since the mid-1990s but is still above 16 per cent of GDP, varying from 12 per cent in Greece to 21 per cent in the Netherlands. Procurement is subject to significant barriers and restrictions, and there is as yet no hard evidence that large savings have been made through the internal market. Applying the estimates of possible savings from the Cecchini Report (European Commission, 1988) to the current level of procurement, the potential from greater transparency and increased openness of public contracts would reduce the Community-wide government deficit by 4 per cent of GDP.

Preferential procurement practices, such as outright exclusion of competing firms, choice based on preferential price margins, domestic content requirements or simply opaque bidding and tendering procedures, result in increased profits and in shifting profits to local or national firms. The reactions from the Commission to hinder preferential practices consist of requiring notifications followed by "reasoned opinions" in case of suspected infringements. If there is no satisfactory response, the Commission must refer the member state to the European Court of Justice as a next step. He assed on the available statistics, only 15 per cent of the value of total procurement, equal to 2½ per cent of GDP, is advertised throughout the Community (Figure 39). While rising since 1995, this ratio is still very low and does suggest non-transparent and discriminatory bidding procedures. The dispersion between countries is big, with Greece advertising 35 per cent while Germany is at a low 6 per cent. Finally, the share of imports for public contracts

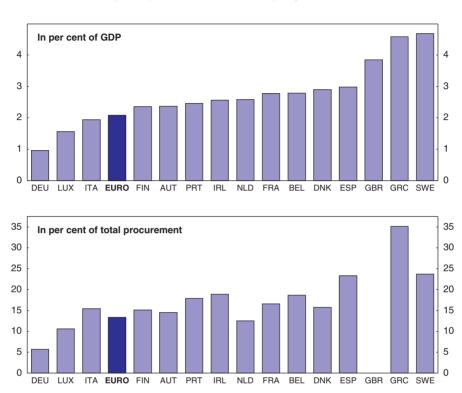


Figure 39. **Published public procurement**Value of public procurement which is openly advertised, 1 2001

1. Public procurement published in the Official Journal. Source: European Commission/Eurostat.

remains very modest: for direct cross-frontier business, they rose from 1.4 per cent in 1987 to 3 per cent in 1995; and for purchases made through importers or local subsidiaries, they increased from 4 per cent of the total contract value in 1987 to 7 per cent in 1995.

Public procurement is governed by the "Government Procurement Framework", consisting of six directives. The directives require the entities to publish both tender and award notices in the Official Journal. The most visible effect of the Directives has thus been a major increase in the transparency of contract award procedures. Proposals to simplify and modernise these have been made, but they are not yet adopted. As the current framework consists of a

cumbersome set of rules, the new proposals should be adopted quickly. However, one should be careful about introducing new goals, such as the proposals for integrating environmental and social considerations into public procurement. European institutions have recognised the importance of information and communication technologies (ICT) for public procurement and the potential benefits from introducing such systems. However, electronic public procurement has a long way to go. A simplified electronic system, as operated in private markets, appears incompatible with the existing legal, auditing and policy frameworks. Continued efforts to increase the use of ICT in public procurement could achieve cost savings, especially regarding transaction costs. However, better and more uniform information is a key to make cost savings in procurement on both the demand and supply side. Purely practical efforts aimed at training for public employees both in their obligations with regard to and in procedures for procurement should be increased. The Commission should also start a programme for standardisation of procurement processes and contracts, to simplify the task of good procurement for the individuals involved. The issues involved are the same in all jurisdictions of the Community, and the correct administrative level for initiating such efforts is the centralised one.

Changes are taking place in the financial markets

Euro area financial market integration was the special topic of the previous Survey, and the changes that are taking place as a result of market pressure and from the measures in the Financial Services Action Plan (FSAP) were reviewed there (Annex III). From a competition point of view, market integration should increase competitive forces. 95 However, the backbone of the equity and other securities markets, the clearing and settlement industry, has been lagging the dismantling of financial borders. The sources can be found, inter alia, in national differences in technical requirements and market practices; in national differences in taxation; in issues relating to legal certainty; and in the existence of large incumbent players. The Giovannini Group (2001) has suggested a number of measures to reduce the differences in requirements and practices and thus increase legal certainty. Some of these, such as the framework for collateral, are FSAP proposals that are adopted and will be implemented by the member states in the coming months. The questions related to taxation are still open. Further, the Group has recently proposed alternative arrangements allowing for improved cross-border clearing and settlement arrangements (Giovannini Group, 2003). The competition authorities should play a stronger role in this area, working towards ensuring that competition concerns are integrated into proposals by vetting them.

European business finance is still dominated by bank finance. In addition, in some states a close connection between governments and banks has raised

concerns related to state aid, resource allocation within the banking industry and political influence on business decisions. In 2002, the French government reduced its ownership in the main French banks. Explicit German government guaranties to local banks will be ended by 2005, while similar guaranties are being dismantled in other countries. This development towards less public intervention and better pricing of risk will reduce distortions to competition and lead to a better allocation of resources. In 2002 the Commission adopted two antitrust decisions relevant to the financial markets, the first giving a conditional exemption to Visa International's multilateral interchange fee (for cross-border payment transactions) and the second fining eight Austrian banks for their participation in a wide-ranging price cartel (European Commission, 2003f).

As highlighted in the previous Survey, the restructuring in European banking has over the years resulted in a falling overall numbers of banks, but not in a similar reduction in branches suggesting that branches may serve as a deterrent to entry. Neven and Röller (1999) investigated corporate and household loan markets in Europe and found significant collusive cartel-like conduct in these markets. One measure for competition pressure in banking is entry of new banks. Table 22 shows that new banking licences are fewer in the Community than in the United States and in a number of other OECD member countries outside EU, suggesting that competitive pressures may be higher in these countries. Recent empirical United States studies have pointed to a link between bank competition and entry rates among small and medium-sized businesses. Moreover, empirical work confirms that less competition in the credit market lowers the incentive to finance new-comers (Cetorelli, 2002). Banking market structure and competition may thus have heterogeneous effects across firms within an industry. The competition authorities should play a stronger role in this area, adding competitive pressure in banking, thereby supporting the

Table 22. **Entry into banking**New bank charters¹

	Number of banks —	Entry (per cent of existing banks)			
		Domestic	Foreign	Total	
Euro area	7 046	2.9	1.6	4.5	
Australia	51	13.7	37.3	51.0	
Canada	55	1.8	10.9	12.7	
Japan	294	4.8	7.5	12.2	
New Zealand	17	0.0	47.1	47.1	
United States	10 500	9.5	0.0	9.5	

^{1.} Latest year available 1998 or 1999.

Source: World Bank Research, Bank Regulation and Supervision database (Barth et al., 2001) and OECD.

development of new businesses and be represented alongside the solidity arguments often raised by the financial sector supervisors.

Scope for further action

Making the common market work better by an active competition policy and liberalisation has been high on the policy agenda for a long time. The new goal – agreed three years ago at the Lisbon European Council – of turning the Union into the most competitive and dynamic economy in the world by 2010, makes this an even more important task. Community-wide competition policy performs well in many areas. However, further reform efforts should focus on three groups of issues: *i*) sharpening the toolkit; *ii*) improving the planning and ensuring that social gains actually emerge; and *iii*) aligning national and common interests. This section puts forward a number of suggestions for policy action under these headings; Box 13 provides a synopsis.

Several instruments in the competition policy toolkit could be strengthened. In summary:

- The European competition authorities have been active in cracking down on agreements and hard-core cartels, with high sanctions being imposed. These sanctions may, however, still be too modest in relation to the unjustified gains. Their deterrent effect should be assessed.
- The introduction of leniency vis-à-vis "whistle blowers" has added greatly to the Commission's effectiveness in the area of competition policy. However, there are tools in leniency programmes elsewhere that are not available.
 The options for making the leniency programme even more attractive should be explored, especially those concerning closer co-operation with member states
- In other jurisdictions, the role of private suits is far more developed and reduces the work-load of the authorities. The Community authorities should encourage its use, to free up resources from investigating the less important cases. However, this requires a well-balanced legal framework to avoid strategic use of private suits to hamper competition by competitors.
- The Commission has been criticised for being judge, jury and prosecutor in one. The recent strengthening of the Hearing Officer may remedy the issue to some extent. Further, the non-legislative measures announced recently to improve the decision making process will strengthen internal measures by introducing a unit for economic analysis and peer review panels. The ability of the review panels and other measures designed to increase checks and balances during the control

Box 13. **Synopsis of recommendations**

Sharpen the toolkit

Several competition enforcement instruments could be sharpened:

- While the level of fines is already high, their deterrent effect should be assessed.
- Options for making the leniency programme even more attractive should be explored.
- Strengthen the possibilities for private suits in a well-balanced legal framework that avoids their strategic use by competitors.
- Assess the effectiveness of recent reforms that aim at improving checks and balances
- Assess the need to raise resources to bring all cases that require expedited review to a faster conclusion in the Court of First Instance

Allocate scarce resources better within the competition policy set-up

A long-term focus in planning and resource allocation should be introduced:

- Community action to implement a single market in services should be strengthened and supported by competition policy, especially at the national level.
- Initiate a systematic approach that utilises tools that capture total social gains when choosing areas for prioritisation.
- Strengthen the scrutiny of subsidies related to agriculture to reduce the heavy welfare losses.

Align national and common interests

A better balance should be struck between national interests and the common good based on the general acceptance that market integration cannot be achieved without free cross border ownership and trade in goods and services:

- Allow further reductions in incumbents' role in the network industries (electricity, gas, railways and telecommunications). The Commission should continue to disclose information on policies that support the incumbents' competitive positions.
- Transcend the national border approach in some important network industries, and aim for cross-border markets and exchanges.
- Cross border co operation between national competition authorities, national sector-specific regulators and the Community authorities is very important. However, the growth of national regulatory institutions should be kept in check so as not to overextend these co operation networks, and regular scrutiny of the institutional set-up is necessary to avoid strengthening national markets at the expense of the common market.

Box 13. **Synopsis of recommendations** (cont.)

- Promote competitive tendering by local and national authorities by modernising and simplifying public procurement rules. Avoid complications from adopting multiple goals.
- Adopt a liberal approach in the ongoing trade negotiations to capture a sizeable share of the gains from liberalisation, and assess the gains from unilateral measures. The competitive pressure brought about by parallel imports from the rest of the world is beneficial, and ways to tackle this issue should be explored.

process to make the decision process more effective should be assessed.

- The experience from the few cases that have been through the recently introduced fast track procedure for judicial review suggests that the procedure fulfils its task: it is both efficient and expedient. However, the outcome thus far is that mergers still may get bogged down. One should assess the need to raise resources to bring all cases that require accelerated review to a faster conclusion.

The enforcement agenda is partly explained by the rather stable historical experience and the distribution of complaints. In addition, DG Comp has undertaken initiatives, for instance, in the industries undergoing deregulation. Measures should be taken to facilitate a long-term focus in planning and resource allocation, by taking into account the following issues:

- Community action to implement a single market in services should be strengthened and supported by competition policy, especially at the national level. Especially with regard to the cross-border supply of services, competition policy is important, as local suppliers still are often able to deter entry. Also, in addition to the swift implementation of the Financial Services Action Plan, the competition authorities should be given a larger role in the development of the common financial services market.
- More generally, the priority setting for competition enforcement should be driven to a greater extent by economy-wide welfare losses associated with adverse competition practices. This would require the use of a broader range of analytical instruments. The Commission is currently studying this issue.

- While having been reduced, there is certainly still scope for reducing state aid further. Its distortive effects undermine national comparative advantage. This need is already recognised by the European Council, which in Barcelona in 2002 stated that less and better aid is a key part of effective competition. A particular problem is related to agriculture, the most heavily subsidised sector in the Union, which leads to heavy welfare losses.
- Further steps are needed to reduce the cost of public procurement, as local authorities often restrict procurement to local providers and only a small share of all contracts are advertised across the Union.

Competition policy is complemented by, and partly overlapping with, the regulation of newly liberalised network industries. Despite the European Union's commendable efforts in this area, competitive conditions in these sectors are undermined by dominant incumbents. Price declines stemming from liberalisation of network industries have become smaller, while new entrants no longer seem to gain market share from the incumbents in some markets. However, the dispersion in prices and the price level differences with the United States suggest that the full scope for efficiency gains has not yet been fully exploited:

- The tendency to act too slowly in liberalising the network industries and over-regulating other sectors should be counteracted. The incumbents typically deter market entry through business practices that are seen as "regular" (e.g. rationing access to common storage facilities in the gas industry for newcomers). For European Union policies to promote a continuing sequence of favourable supply shocks stemming from these industries, careful separation of integrated utilities to limit the risk of network owners controlling entry at other stages of production should be required, to reduce the market power of incumbents and to speed up the process in the lagging industries. Furthermore, the focus on establishing common markets rather than national ones should be strengthened.
- Regulators in the network industries are getting tasks related to those of the competition authorities. This is increasing the number of contact points, especially the number of networks, and will over time start to strain the system. There should be a clearer division of tasks where the Commission's responsibility for competition policy should be very clear. Also, these institutions should be scrutinised regularly to make sure they are needed and that their present form is optimal, especially to guard against conservation of national markets at the expense of the common market.

To support growth, other measures should also be taken. Despite having a rather liberal trade regime, the remaining gains from trade liberalisation could be sizeable. Further liberalisation would enable the Union to capture a sizeable share of these, and should be pursued in the current international trade negotiations. And while parallel imports are the rule for the internal market, the technical-

ities of trademark law that hinder parallel imports from third countries weakens domestic competition in branded goods. The competitive pressure brought about by parallel imports from the rest of the world on the efficiency of the single market is beneficial, and the rules should be amended. Finally, as the long-term gains from an active competition policy are usually not immediately apparent, while the short-term costs are, an important task for the Commission services is to make these gains more visible and to divert the debate away from short-term issues dominated by transition costs.

Notes

- 1. The 1988 Cecchini Report suggested that the completion of the internal market would raise GDP by around 4.5 per cent, by lowering prices by 7 per cent, and by eliminating the remaining barriers to internal trade, increased competition and industrial restructuring (European Commission, 1998).
- 2. There is empirical micro-level evidence that the SMP has had positive effects. Notaro (2002) finds a positive impact of the SMP on industrial productivity, while Allen *et al.* (1998) found that the SMP boosted intra-EU trade, and more importantly that it enhanced competition as measured by lower price-cost margins. Similarly, Bottasso and Sembellini (2001) found that following the SMP, firms' market power decreased significantly. Midelfart-Knarvik and Overman (2002) argue that states and regions are becoming more specialised within the EU, following industrial reallocation, though this process is slow. Moreover, the liberalisation of network industries has provided an impetus to growth, while several studies find large effects from implementing the Financial Services Action Plan (Annex III), some of which have accrued already.
- 3. It should also be noted that when new trade partners emerge, this trade ratio may decline despite intra-area integration still proceeding.
- 4. The ratio of manufacture to service trade flows generally ranges between 3 and 15 for most countries, but in some cases, like Portugal or Ireland, trade in manufacturing is even 15 to 30 times higher. In addition, the overwhelming majority of firms still purchase business services from domestic rather than other EU sources. For example, in business services, the value of sales to other EU member states accounts for between 1 and 10 per cent of overall turnover.
- 5. Very often, temporary posting of workers requires numerous administrative procedures, involving the costs of translating certain employment documents into the language of the host country, or the obligation to apply for a residence permit beyond a certain period, generally three months.
- 6. Indeed, the multiplicity and duplication of authorisations has been often reported as a problem (European Commission, 1999b). For example, one interviewed person stated that "one had to be a collector of licenses" to set up a bakery business in a country, as the requisite authorisations varied depending on the types of products and activities of one and the same bakery.
- 7. "Gold plating" usually occurs when a Directive provides for minimum harmonisation or where the Treaties contain an explicit legal base for stricter national measures. Quite frequently, this induces member states to transpose Directives with rules attached that are stricter than those provided for by the Directive itself.
- 8. The main purpose of the SLIM initiative is to review existing internal market legislation with a view to improving overall quality, facilitating better implementation and reducing

- red tape. The IPM initiative (established in 2001) collects feedback from stakeholders on Commission policies and initiatives. The SOLVIT network (established in 2002) aims at improving enforcement by resolving conflicts between two parties in two member states on an informal basis.
- Under the Distance Selling Regime, a supplier in one member state is required to account for VAT under the destination principle when a sale to customers in another member state exceeds a certain threshold.
- 10. Lannoo and Levin (2002) report that the cost of compliance with the tax rules amounts to about 2 to 4 per cent of total corporate tax revenues raised, *i.e.* between EUR 4.3 and 8.6 billion for the Union as a whole. See also Journard and Kongsrud (2003) on distortions and harmful practices in the United States, Canada and Germany.
- 11. The factors included in the formula might include such items as the sales, employment and capital of the company in each jurisdiction.
- 12. In the manufacturing sector, the R&D gap is partly the result of sectoral differences, the high-tech sector being much larger in the United States, and the number of small and medium-sized enterprises smaller. In the service sector, however, the difference is largely due to a higher R&D intensity in the United States.
- 13. This estimate is based on an equation involving business R&D only.
- 14. Whilst the ratio between NASDAQ's capitalisation and NYSE capitalisation was as high as 55 per cent in 2000, and still reached nearly 20 per cent in 2002, the equivalent ratio for France (Nouveau Marché versus Premier Marché) was a bit less than 1.5 per cent in 2000. At the same time the German Neuer Market closed down, having recorded a massive decline in the index and little IPO activity.
- 15. CESIFO (2002) reports that whilst in the United States the best researchers get substantially higher pay and research funding, with less teaching loads, in most European countries the system makes little distinction between excellent and average researchers, with identical wages and research conditions for all.
- 16. The European Round Table of Industrialists (ERT) argues that too many obstacles are preventing researchers from crossing borders and moving between public and private R&D (Financial Times, 2002).
- 17. The Sixth Framework Programme reinforces financial support for mobile researchers, for example, via the Marie Curie Actions (MCAs). MCA helps young and more experienced researchers to research in another member state, by providing project grants and grants for conferences and training. MCA benefits from greater funding under the 6th Framework Programme, which has increased by over 50 per cent compared with the 5th Framework Programme.
- 18. Besides setting up the Community Patent Court, another step is necessary for Community Patents to become a reality: the 1973 Munich Convention has to be revised to allow the European Patent Office to issue Community Patents.
- 19. Regions with unemployment rates that were either very high or very low relative to the EU average in the eighties tend to stay that way, but many regions with intermediate initial unemployment rates have seen their rates either rise markedly or fall markedly over the last cycle (Overman and Puga, 2002).
- 20. Moreover, whereas part-time is a choice for around 80 per cent of the employees, fixed-term contracts are not the choice of 80 per cent of them (European Commission, 2001d).

21. Commission's Action Plan for skills and mobility (European Commission, 2002i). Occupational mobility refers to the movement of workers between jobs and sectors, whether within or between member states.

- 22. This is part of a larger package proposed by the Commission to streamline and simplify policy co-ordination. The Commission proposed to review the implementation of product, financial and labour market reforms in January by issuing the "Implementation Package" that gathers the BEPGs, the Joint Employment Report and the Implementation Report on the Internal Market Strategy. The "Spring Report" on the other hand will be the input of the Commission to the Spring European Council, highlighting the main issues and priorities for the Union. The output of the discussion of the Spring Meeting will be the "Guideline Package", which will define and present proposals for action in the various policy areas highlighted as priorities by the Council. This document will be composed of the BEPGs, the Employment Guidelines and the Employment Recommendations. Objectives and priorities will be defined and reviewed every three years, with the implementation of the corresponding policy actions being assessed annually.
- 23. For comparison, the European Commission ran a simulation based on a hypothesis of 3 per cent GDP growth between 2001 and 2010. According to these simulations, to achieve the 70 per cent employment target in 2010, the EU annual employment growth should be 1.1 per cent per year, whereas total employment growth between 1992 and 2001 was 0.7 per cent for the EU as a whole (European Commission, 2001d).
- 24. In the medium-term scenario, unemployment is projected to reach 7.6 per cent by 2008, declining by 0.2 percentage point on average per annum. Extrapolating the decline until 2010 brings the unemployment rate down to 7.2 per cent.
- 25. Data (not including Denmark, Finland, Ireland and Sweden) for 2001 show that the presence of a child of less than six years old decreases the employment rate of women by 12 percentage points below the EU average, whereas the male employment rate rises by 9 percentage points above average (European Commission, 2002g).
- 26. The targets set in Barcelona for child care are that at least 90 per cent of children between three years old and the mandatory school age and at least 33 per cent of children under three years old by 2010 be provided with public child care. OECD (2002b) suggests that the provision of care and education for young children is a necessary condition for ensuring the equal access of women to the labour market. In addition, early development is seen as the foundation of lifelong learning.
- 27. The literature provides mixed evidence on the effectiveness of ALMPs. Job Search Assistance seems to be effective when associated with the regular placement function of the PES, because it speeds the return to work whilst avoiding the risk of reducing the incentive to take up a regular job (Martin and Grubb, 2001). Matching training with job experience in the private sector provides participants with the opportunity to show their competence to prospective employers. (Raaum and Torp; 2002, Brodaty, et al., 2001, van Ours, 2001 and Kluve et al., 1999). Subsidy schemes and job creation in the public sector do not perform well and are costly (Kluve and Schmidt, 2002; Morgan and Mourougane, 2002). Young people appear to be the population most difficult to assist (Jensen, 1999 and Larsson, 2000).
- 28. For more detail on PES reforms see OECD (2000b).
- 29. See PricewaterhouseCoopers (2002), which describes a survey of 400 businesses in eight European countries and 10 000 individuals in ten European countries.

- 30. A draft Directive for achieving a Single Market for occupational pension funds has been adopted by the Council and is under reading by the European Parliament. The Commission has also published a Communication on "The Elimination of tax obstacles to the cross-border provision of occupational pensions" (European Commission, 2001k).
- 31. The situation is slightly more complex regarding small and medium-sized enterprises (SMEs). In all countries, there exist threshold for the number of employees under which different rules on hiring costs or dismissals apply. For some countries, SME employees are more protected, in others flexibility for employers is higher (European Commission, 2002u).
- 32. The IMF (2003) estimates that the long-run effects of reforming labour and product markets in the euro area to the US level of regulation would raise GDP by 10 per cent.
- 33. According to Nicoletti *et al.* (2001), if both the labour and product markets were as flexible as the United States or the three best performers in the euro area, then the employment rate would rise by 10 percentage points. Such a rise in a decade is unprecedented. Even assuming that only half of this increase is coming from reduced unemployment, this means a 5 percentage point fall. For example, in Ireland, the country where the structural unemployment rate decreased most rapidly in Europe over the last thirty years, the reduction was only 4 percentage points between 1997 and 2002 or more than 8 percentage points between 1992 and 2002. For the whole euro area, this rate fell by ½ of a percentage point between the 1995 peak and 2002. This is why the simulation is not based on a sharper improvement in labour market performance. The model being linear, it is easy to calculate what would happen should reforms be deeper.
- 34. With the signing of the Treaty of Accession in Athens on 16 April 2003 the Union is set to expand from 15 to 25 member states, with Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia expected to join in a historic "big bang" on 1 May 2004. Bulgaria and Rumania target entry to the European Union for 2007, while accession negotiations between member states and Turkey will be launched at the European Council meeting in December 2004 if, on the basis of a report and a recommendation by the Commission, the European Council decides that Turkey fulfils the political criteria set at the Copenhagen European Council of June 2003.
- 35. The deficit in 2002 is estimated by the government at 2.6 per cent of GDP. This estimate has been revised up to 2.7 per cent of GDP after a review of the accounts by Eurostat. The official target for 2003 is for a deficit of 2.4 per cent of GDP, but the latest projections by the European Commission are for a deficit exceeding 3 per cent of GDP.
- 36. This projection does not incorporate the Steuervergünstigungsabbaugesetz which was not enacted when the projection was finalised. According to Article 104 of the Treaty and Council Regulation (European Commission) No. 1467/97, when a country whose deficit is found to be excessive (in this case on 21 January 2003), the Council makes recommendations to the country concerned and establishes a deadline to take corrective actions within four months at most. It should complete the correction of the excessive deficit in the year following identification (*i.e.* in 2004). If, after a progressive notice procedure, the country fails to comply with the Council's decisions, the Council can move to impose sanctions.
- 37. Bruno and Portier (2002) report OECD-wide empirical evidence that cyclical tax windfalls are systematically handed out in the form of tax cuts or expenditure hikes.
- 38. For example in case of an excessive deficit procedure the Ecofin Council decides on an excessive deficit, based on a qualified majority of 62 out of 87 votes. After that a

country in breach has four months to take measures. If the country is found not to have taken effective measures, a qualified majority, without the country concerned allowed to vote can demand that the country take measures for the deficit reduction which is judged necessary by the Council to remedy the situation. If the country fails to comply with such demand, a qualified majority may call for sanctions, including a deposit of up to 0.5 per cent of GDP. In case the excessive deficit has not been resolved within two years of requiring the deposit, then the deposit will be converted into a penalty.

- 39. However, Van den Noord (2000) reports asymmetries in a few cases where adverse debt dynamics have been very pronounced in the 1990s, notably in countries that had high debt levels from the outset (Italy and Belgium).
- 40. While this is a well-known feature of fiscal policy, the following quote from Solow (2002) makes the point very nicely: "Maybe prolonged imbalances between aggregate supply and demand so occur in market economies, and maybe appropriately tuned fiscal policy could help to relieve them. But maybe also democratic politics is simply incapable of making the appropriate fiscal-policy adjustments in time to do much good. (...) Whenever discretionary fiscal policy rises to the top of the political agenda, special interests come out of the woodwork. Every tax change, every increase or decrease in public spending is caught over by the potential winners and losers, their lobbyists and elected representatives. The final outcome may often be distributionally and allocationally, and even macroeconomically, perverse. In any case it is bound to be delayed, and possibly dangerous on that account. (...) Note that this is not some kind of minor flaw in the system; it is the system."
- 41. "Eurosystem" is the term used to refer to the European Central Bank (ECB) and the national central banks (NCBs) of the EU member countries that have adopted the euro. The European System of Central Banks (ESCB) is composed of the ECB and the NCBs of all 15 member states.
- 42. The ECB President's Testimony before the Committee in Economic and Monetary Affairs of the European Parliament on 12 September 2001 (www.ecb.int/key/01/sp010912.htm) notes that the 2 per cent upper limit was put forward by ECOFIN when it adopted the Broad Economic Policy Guidelines in July 1995. It also stipulates that low but positive inflation below 2 per cent should be tolerated in view of a measurement bias in the HICP index.
- 43. The ECB does not gear its policy decisions towards this or any other measure of underlying inflation, but it considers measures of core inflation as useful to identify longer-term price trends and the nature and sources of the forces driving headline price dynamics. See ECB (2001b).
- 44. There are historical examples where stock markets crashed because credit to stock investors was abruptly tightened even though the market fundamentals were sound. Under these conditions markets have shown to quickly rebound (McGratten and Prescott, 2001).
- 45. The monetary conditions index (MCI) attempts to provide and aggregate measure of changes in short-term in interest rates and exchange rates weighted by heir relative impact on economic activity. Aside from potential technical pitfalls associated with the MCI, it is particularly important to note that its information content may be blurred dependent on the shock that produces a movement in the MCI. If for example an appreciation of the currency results from a favourable demand shock, the MCI would suggest a "tightening" of monetary conditions which might be used as an argument to cut interest rates, which would work out pro-cyclically (see ECB, 2002a, Box 3).

- 46. The review was made public in a press release on 8 May 2003, which was included also in the Monthly Bulletin of the same month, see ECB (2003c).
- 47. Kontolemis (2002) finds that virtually all of the "monetary overhang" is explained by the drop in asset prices.
- 48. See for example the ECB's Monthly Bulletin of November 2001 (ECB, 2001c): "The strong growth in M3 thus seems to reflect mainly portfolio shifts of private investors from shares and other longer-term financial assets included in M3. These shifts should only have a temporary effect on M3 growth". See also the Monthly Bulletin of October 2002 (ECB, 2002b): "However, given the current economic environment, the Governing Council does not see the risk of this translating into inflationary pressure in the near future"
- 49. Hofmann (2001) provides econometric evidence that property prices affect the demand for credit (wealth effects) and supply of credit (creditworthiness effect) which mechanically boosts the money stock. Fase and Winder (1998) demonstrate that wealth has a substantial impact on demand for broad money.
- 50. Gerlach and Svensson (2002) have argued that the real money gap should receive a similar status as the output gap as an inflation predictor. Trecroci and Vega (2002) find that the real money gap has a significant impact on inflation five to six quarters ahead.
- 51. Borio and Lowe (2002) find evidence that the peak in equity prices typically leads by one to two years the peak in real estate prices, with the bubble in residential property markets normally the last to burst.
- 52. An exception is Bryan *et al.* (2002), who propose to go as far as incorporating asset prices in the central bank's inflation objective function. They base this on a view that the appropriate price index should capture not only the current cost of living but also the value of claims on future consumption.
- 53. Meltzer (2002) defines an "irrational bubble" as "a rapid upward price movement based on exaggerated beliefs about the potentials of a new technology or organisation structure to generate earnings, followed by a collapse."
- 54. Issing (2003) argues that "recently arguments have been forwarded that the uncertainty related to the identification of an asset price bubble is not fundamentally different from the uncertainty surrounding other variables, in which the central bank bases its policy decisions. (...) I would therefore not completely disregard the possibility that situations of financial instability can be approximately identified in a relevant time horizon and that this information should find its way into policy decisions."
- 55. See Begg *et al.* (2002), who state that the past practice of "having to devote half of the first column of page 1 of each 2-page Monthly Bulletin Executive Summary to explaining away yet another set of perverse M3 indicators undermines the ECB's credibility with market participants."
- 56. According to Article 105 of the Maastricht Treaty: "The primary objective of the ECB shall be to maintain price stability. Without prejudice to price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in article 2 of the Treaty." Article 2 stipulates that the general economic policies of the Community are: "To promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of economic performance, a high level of employment and social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among member States."

57. The so-called Balassa-Samuelsson effect played a role in some of the smaller countries that entered EMU with low per capita GDP, notably Portugal and Greece (IMF, 2002b). More generally, smaller countries are more prone to such effects than larger ones due to their greater openness (Duarte and Wolman, 2002).

- 58. Econometric research suggests the common component in euro area inflation is indeed increasing (Fase, 2002).
- 59. In addition, the quality and composition of inputs are important, but hard to measure and not taken into account in the Chapter I calculations.
- 60. Other recent research has found a hump-shaped relationship, *i.e.* indicating that neither high concentration ratios nor perfect competition are the most conducive to innovation (Aghion *et al.*, 2002). This evidence suggests that, beyond a certain point, market power may tend to reduce the incentive to adopt and develop new technologies.
- 61. The Commission investigates cases following complaints by interested parties, such as member states or competitors, consumer groups or customers of companies involved, or on its own initiative. The enforcement set-up, originating in the 1960s, is concentrated in the Commission's Competition Directorate General (DG Comp). DG Comp employs about 610 persons, complemented by resources from other parts of the Commission. However, any final Commission Decision on an alleged infringement of EC competition law is made by the college of Commissioners as a whole and not just DG Comp or the Commissioner for Competition.
- 62. In contrast, Article 82, which prohibits abuse of dominance by any undertaking, is without such exceptions.
- 63. The block exemption regulations specify conditions under which certain types of agreements are exempted from the prohibition on restrictive agreements laid down in Article 81(1). When an agreement fulfils the conditions set out in a block exemption regulation, individual notification of that agreement to the Commission is not necessary to ensure that the agreement is valid and enforceable.
- 64. Agreements should not be regarded as infringing the prohibition of Article 81(1) if they are of minor importance (the *de minimis* principle). Since the end of 2001 the *de minimis* principle is based on a market share ceiling of 10 per cent for horizontal agreements and 15 per cent for vertical agreements (but the agreements cannot include certain hard-core restrictions, such as price fixing). Such agreements are considered incapable of affecting competition within the Common market.
- 65. Council Regulation (European Commission) No. 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty will replace Regulation 17/62 when it comes into force in May 2004. Until then, Regulation 17/62 remains in force.
- 66. Making Article 81 in its entirety directly applicable will have the result that restrictive agreements are *ab initio* null and void if they do not fulfil the conditions for compatibility under Article 81(3) and, *vice versa*, are valid *ab initio* without requiring a Commission decision authorising such agreements if they fulfil those conditions.
- 67. The existing merger regulation consists of rules under Council Regulation 4064/89, as amended by Regulation 1310/97 and Commission implementing Regulation 447/98 of 1 March 1998.
- 68. See Kühn (2002) for a critical discussion of the recent use of leverage and foreclosure arguments.

- 69. The highest price-fixing fine is the EUR 900 million imposed on makers of vitamins in 2001. The fine can never go beyond 10 per cent of a company's world-wide turnover (Article 5(2) of Regulation No 7). Fines are not set with reference to a company's turnover, however, but take into account the gravity of the infringement, its duration and any aggravating or mitigating circumstances. Where an infringement involves several companies (e.g. cartels), it might be necessary in some cases to apply weightings to the basic amounts determined on the basis of the gravity to take account of the specific weight and the real impact of the offending conduct of each company on competition. This in particular where there is considerable disparity between the sizes of the companies committing infringements of the same type. As the basis for the comparison of the relative importance of a company in the market concerned, the Commission uses in general the product's turnover in the last year of the infringement.
- 70. A recent survey of the financial sanctions imposed on 10 hard-core cartels in the OECD area shows that they ranged from 3 to 189 per cent of the estimated harm done, and in only four cases was it clear that the fines exceeded the illegal gains (OECD, 2002g).
- 71. There are currently six member states that foresee criminal law penalties for this sort of infringement (with a possibility for company executives to serve prison or being imposed individual fines). These are Germany (up to 5 years), Austria (up to 3 years for bid-rigging only), France (4 years), Ireland (2 years), and the United Kingdom. In Greece, the criminal liability of corporate executives does not entail prison, but individual fines. Recent work by the OECD has shown that such sanctions are used very seldom. Only Germany has imposed sanctions on natural persons among the EU countries recently (OECD, 2003d).
- 72. As an example, calculations with the Danish general equilibrium model MobiDK showed that distortions caused by recommended prices in retail distribution raised prices by 2 to 10 per cent above the competitive level. It also resulted in distortions in other sectors with total welfare effects of around DKK 1 000 (EUR 135) per household. The Danish authorities took action in this area.
- 73. However, in several EU countries, the ultimate decision making authority in merger cases lies with the government and not the competition agency. In France and Spain, the government decides, and may or may not consult the independent tribunal, while in Ireland, UK, Germany, Greece, Ireland, Netherlands and Italy government reserves some power to intervene in merger decisions in exceptional cases.
- 74. The expansion of the Union in 2004 (Chapter I) will result in a sizeable increase in the number of such cases.
- 75. This is defined as aid having a social character, granted to individual consumers: aid to make good the damage caused by natural disasters or exceptional occurrences; aid designed to promote the economic development of underdeveloped areas (regarded as particularly backward in accordance with Community criteria); aid that promotes the implementation of an important project of common European interest or to remedy a serious disturbance in the economy of a member state; aid to facilitate the development of certain activities or areas, or promote culture and heritage conservation.
- 76. The EU Scoreboard on State aid with updated statistics on State aid was published on April 30, 2003 by European Commission, DG Comp.
- 77. It should be noted that the definition of state aid also comprises measures to alleviate CO2 taxes and reclassification of certain fiscal advantages to state aid.
- 78. The Commission encourages member states to undertake rigorous evaluations of the economic impact of aid and is carrying out a pilot study on this subject.

79. Under the designation of "services of general economic interest", these are allowed under the Treaty either to enable the undertakings responsible for such services to perform their tasks, or on the basis of public health and safety. The Single Act and the Maastricht Treaty added economic and social cohesion, consumer protection, and trans-European networks to this list. In these markets, liberalisation is an ongoing process.

- 80. Nordpool production consists of 55 per cent hydroelectric power, 24 per cent nuclear, 20 per cent fossil-fuel while the rest is based on renewables. Over 90 per cent of Denmark's electricity comes from conventional thermal plants and combined heating and power (CHP) facilities, in addition to some renewables such as wind power. Up to 2000, only parts of Denmark were integrated into NordPool. Sweden and Finland use hydroelectric power (40 per cent), nuclear (40 per cent) and fossil-fuel-powered generation plants. Electric power production in Norway is almost 100 per cent hydropower (NordPool, 2003). For comparison, electricity production in Austria is based 29 per cent on fossil fuel and 71 on hydroelectric and other power (Eurostat, 2003).
- 81. In the European Union, employment in the main railways fell from 1.3 million in 1990 to 766 800 in 2000. In comparison, in the United States it fell from 216 400 to 168 400 and in Japan from 193 800 to 172 200 over the same period (European Commission, 2002v).
- 82. Due to technical, administrative and legislative barriers, trains lose most of the travel time at boundaries. The average speed of international rail freight haulage is only 18 km/hour (European Commission, 2001j).
- 83. A vertically disintegrated network owner maximises revenues from (regulated) user fees and therefore has an incentive to get a maximum number of trains on his network. In a vertically integrated firm such a strategy would cost market shares to the in-house transport service branch and joint profit maximisation would account for the trade-off between the market share of own transport services and revenues from third-party access.
- 84. While national regulators' powers are generally adequate, the Belgian regulator is clearly understaffed (OECD, 2002j), questions have been raised about the regulator's effectiveness in Germany (OECD, 2002h), while there are some shortcomings in the Netherlands and Finland.
- 85. The New Framework comprises five Directives, plus Recommendations and Guidelines.
- 86. This generally accepted "basket" methodology takes into account both fixed and usage charges (OECD, 2003f).
- 87. In November 2002, the Commission decided that concerns relating to high prices and issues of possible discrimination in the leased line sector were now being adequately addressed, and closed the antitrust inquiry it had launched in 1999. As a part, the Competition Directorate-General had opened five investigations into possible excessive prices and/or discriminatory behaviour in the provision of leased lines in Belgium, Italy, Greece, Portugal and Spain during 2000. Two years later, the Commission found a considerable decrease in leased line prices across the EU.A second important outcome was the proactive stance on the part of national regulatory authorities regarding the provision of leased lines and pricing for such lines. Given the evidence of significant improvements in the competitive situation in Belgium and Italy, the Commission closed its investigations regarding those member States. The Spanish case may also be closed while the situation in Portugal and Greece is to be closely monitored (European Commission, 2003f).
- 88. Penetration rates may also reflect industry-specific characteristics unfavourable to international trade, e.g. high transport costs or the presence of highly competitive

- domestic firms. However, what matters most for market forces may not only be actual competition in the market but also potential market entry.
- 89. The "core NTBs" include various price control measures and quantitative restrictions such as import bans, non-automatic licensing or export restraints.
- 90. The results of this study have been debated, in particular as regards an upward bias in the way of measuring the level of protection (generally using tariff rates without taking into account preferential rates and assuming that anti-dumping tariffs apply to all external suppliers rather than only to he country concerned) and, moreover, an upward bias in estimating the costs of this protection (taking into account exclusively the negative impact on consumers and omitting positive effects on producers and public revenues). See also "Économie internationale" (2002).
- 91. For the OECD area, the ratio of total procurement (consumption and investment expenditure) for all levels of government is close to 20 per cent of GDP (Audet, 2002). Of these, one third is potentially open to international trade. Procurement by sub-central government is larger than procurement by central government by about two to three times.
- 92. As the EU's indicators for procurement include procurement by public utilities (whether public or privately owned), they are not directly comparable to the OECD indicators.
- 93. Assessing the potential savings in public expenditure by removing all barriers, the Cecchini Report on the cost of non-Europe (European Commission, 1988) estimated that savings of around ECU 22 billion could be made.
- 94. The Commission has recently referred France, Portugal, Spain and Germany to the European Court of Justice concerning, respectively, French legislation on public procurement for major construction projects; Portugal's failure to implement correctly the Directive on remedies for tenderers who think they have been unfairly treated; Spain's failure to ensure the rules are applied properly for the procurement of health services; and two cases in Germany where waste management contracts were awarded without EU-wide tendering. The EU executive has also sent formal requests to Ireland, Italy and Finland to change their practices. It says that this is because public procurement contracts have been awarded in ways that do not comply with the EU Treaty and/or with the Public Procurement Directives. On average, procurement infringement proceedings have been started against 12 countries each year since 1996.
- 95. As pointed out in the previous *Survey*, for consumers, a so basic cross-border service as transferring money from one country to another has been much more expensive than transferring money within a country. A survey commissioned by the Commission (IEIC, 2001) show total costs for international transfers were up to three times as high from some countries as from others. In response to the lack of progress in reducing the costs of cross-border payments, cross-border transfer fees have been regulated.

Glossary of acronyms

ALMP Active labour market policy
BEPG Broad economic policy guidelines
CAP Common agricultural policy

DG Directorate general

DG Comp Directorate general for competition

EC European Community

ECA European competition authorities
ECB European Central Bank

ECOFIN Economic and Financial Affairs Council

EDP Excessive deficit procedure
EES European employment strategy
EMU Economic and Monetary Union
EPL Employment protection legislation

EU European Union

EUR Euro

FSAP Financial services action plan

g Gram

GATS General Agreement on Trade in Services

GDP Gross domestic product

HICP Harmonised index of consumer prices
ICT Information and communication technology

IPM Interactive policy making

M3 Broad money

MFN Most favoured nation
MRP Mutual recognition principle
NCB National central bank
NRA National regulatory authority

NTB Non-tariff barrier

PES Public employment services
PPP Purchasing power parity
PWD Posting of workers directive
R&D Research and development
S&T Science and technology
SGP Stability and growth pact

SLIM Simpler legislation for the internal market

SMP Single market programme

SOLVIT Internal market problem solving network

UK United Kingdom

UMTS Universal mobile telephone system

US United States
USD United States dollar

USPTO United States Patent and Trademark Office

VAT Value added tax
WTD Working time directive

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Annex I

Annex I **Supporting statistics**

Table A1. **Labour market transitions** By contract status, in per cent of total, 1997-98

	Transitions into:					
	Inactivity	Unemployment	Permanent jobs	Temporary jobs		
Transitions out of:						
Permanent jobs						
Total	3.24	2.28	91.72	2.76		
Men	2.63	2.40	92.52	2.45		
Women	4.09	2.11	90.62	3.18		
Young	5.36	4.39	82.04	8.21		
Older	12.05	3.70	82.36	1.90		
Low skilled	4.26	2.74	89.36	3.63		
High skilled	2.80	1.70	92.98	2.52		
Temporary jobs						
Total	7.32	13.23	35.66	43.79		
Men	5.07	12.75	36.68	45.50		
Women	10.14	13.83	34.39	41.65		
Young	12.04	14.90	31.16	41.90		
Older	12.35	14.95	35.53	37.16		
Low skilled	7.20	16.23	30.37	46.20		
High skilled	9.36	8.37	38.63	43.65		
Unemployment						
Total	18.52	55.37	11.30	14.81		
Men	13.83	55.75	13.54	16.88		
Women	26.62	54.96	8.86	12.57		
Young	16.85	53.35	9.44	20.36		
Older	31.55	62.04	3.56	2.85		
Low skilled	20.15	58.60	7.86	13.39		
High skilled	17.56	41.67	15.73	25.04		
Inactivity						
Total	93.45	2.64	2.23	1.68		
Men	89.37	3.21	4.22	3.20		
Women	91.27	3.28	3.33	2.13		
Young	81.24	7.82	4.92	6.02		
Older	97.82	1.17	0.76	0.25		
Low skilled	95.96	1.77	1.30	0.97		
High skilled	84.28	4.60	6.32	4.80		

Source: European Commission (2002e).

Luxembourg Netherlands

Portugal Spain

	Inc	dicators of cha	nge since 199	90		
	Unemp		(Early) retirement systems			
	Unemployment insurance (unemployment assistance) in months	Gross replacement rates (UI), ² per cent	Tighter work availability ³	Tighter benefit eligibility ⁴	Increase in retirement age ⁵	Stronger disincentives ⁶
Austria	5-12 (unlimited)	43-36	=	+	+	+
Belgium	No limit (none)	=	+	=	+	+
Finland	23 (unlimited)	54-61	+	+	+	+
France	4-60 (unlimited)	57-53	=	+	=	+
Germany	6-32 (unlimited)	40-38	+	=	=	+
Greece	5-15 (none)	=	=	=	=	+
Ireland	15 (unlimited)	41-32	=	=	=	=
Italy	6-9 (none)	15-33	+	=	_	+/-

Table A2. Benefit systems in the euro area

=

80-70

127 (none)

6-60 (24)

12-30 (6-15)

4-24 (6)

^{1. + (-)} indicates an increase (decrease) in the respective indicator and = means that no changes have been enacted.

UI refers to unemployment insurance benefits. Figures refer to gross replacement rates in the first months of joblessness for unemployed persons with a dependent spouse. In countries with no UI, the figures refer to guaranteed income schemes. Changes refer to the 1990s.

^{3.} Includes tighter requirements for being available for work when offered a job.

^{4.} Includes, for example, tighter eligibility requirements for certain groups of people and/or an increased contribution duration.

^{5.} Includes increases in retirement and early retirement ages.

^{6.} Includes, for example, less favourable taxation of pension benefits, a reduction in pension benefit eligibility for certain groups of workers, and a lengthening of the contribution period before receiving pension benefit entitlements.

^{7.} This can be prolonged for a maximum of 12 additional months under certain conditions. There is an upper limit to the unemployment insurance benefit of 2.5 times the legal (gross) minimum wage.

Source: ECB (2002).

Annex I

Table A3. Childcare and elderly care: data and targets set in 2002 National Action Programmes

	-t-t-t	-11.1	
	Childcare indicator ¹	Elderly care indicator ²	Targets set in 2002 NAP
Austria	Children in day-care facilities, 2000/01: 0-1 years 0.3% 1-2 years 6.1% 2-3 years 16.3% 3-4 years 57.9% 4-5 years 86.4% 5-6 years 90.1%		
Belgium	Children under 3 years, 2001: Flemish community31.4% French community 23.8%	Persons over 75 years living in specialised institutions, 2001: French community 14.7% Brussels region 15.9%	
Finland	Coverage of public childcare, 2001: 0-5 years 42.7% 6 years 63.8% 7 years 10.1% ⁴		
France			+32 000 places by 2004; +10 000 places outside school hours for children 3-16 years old.
Germany	Places available for children, 1998: 0-3 years 7% 3-6.5 years 89.5% 6-10 years 12.6% ⁴		No target set in the NAP. ³
Greece	Number of childcare establishments, 2002: 0-6 years 4 392 Number of children covered: 162 008	Number of elderly care establishments, 2002: 714	Detailed targets for children and elderly.
Italy	Children cared for, 1998: 0-2 years 6.3% 3-5 years 4.5% 6-10 years 4% 11-13 years 1.2% Children cared for at least a few times a week, 1998: 0-2 years 57.5% 3-5 years 54.8%	Persons over 65 living in specialised institutions, 1999: 1.34%	
Ireland	6-10 years 49.7% ⁴ 11-13 years 37.2% ⁴		2001 target confirmed: increasing childcare places
Luxembourg	Childcare places, 2001: 1 975		30% by 2003. 17% proportion of children 0-3 years old +3 000 places in school by 2004.
Netherlands	Children cared for, 2001: 0-3 years 25% 4-12 years 8% ⁴		+33 000 childcare places by end 2002.

Table A3. Childcare and elderly care: data and targets set in 2002

National Action Programmes (cont.)

	Childcare indicator ¹	Elderly care indicator ²	Targets set in 2002 NAP
Portugal			2001 data are confirmed: Pre-school education for all children under 5 years by 2006. 75% coverage for 3-4 years old (including 1 800 new classrooms). 100 000 children up to 3 years will be received in day nurseries.
Spain	Children cared for, 2000/01: 0-2 years 8.6% 3-5 years 92.4%	Number of persons over 65 receiving help at home, 1999: 112 797 Number of places in specialised institutions: 208 513	15% coverage for 0-2 years old and 94% for 3 years old.
Denmark	Children cared for, 2001: 0-2 years 68% 3-5 years 93% 6-9 years 79%		
Sweden	Children cared for, 2001: 1-5 years77% 6-9 years68% ⁴ 10-12 years 8% ⁴	Persons over 65 receiving care and assistance, 2001: 18% – at home 9.4% – special institutions 8.6%	
United Kingdon	n		+2 million children cared by 2006. Establishing children's centres in the most disadvantaged areas, so that by March 2006 at least 650 000 will have access to centres' early education, childcare and family support services.

^{1.} Children cared for (other than by the family) as a proportion of all the children of the same age group. Breakdown by: before entry into the non-compulsory pre-school system (during the day); in the non-compulsory or equivalent pre-school system (outside pre-school hours); and in compulsory primary education (outside school hours).

Source: European Commission (2002g) and UK Spending Review 2002, www.hm-treasury.gov.uk/Spending_Review/spend_sr02/report/spend_sr02_repchap01.cfm

^{2.} Dependant elderly men and women (unable to look after themselves on a daily basis) over 75 as a proportion of men and women over 75. Breakdown by: living in specialised institutions; who have help (other than the family) at home; and looked after by the family.

^{3.} However, on 17 April 2002, the German government approved a national sustainability strategy ("Perspectives for Germany. Our Strategy for Sustainable Development"), in which a target was set of 30 per cent for all-day childcare facilities in the Western Länder by 2010. Moreover, the government has announced its intention to spend EUR 4 billion for all-day schools in the next years.

^{4.} Outside school hours.

Annex I

Table A4. Overview of the Action Plan for Skills and Mobility

Actio	n	Responsible body	Deadline
Occi	pational mobility and skills developme	nt	
1	Acquiring key skills.	Member states, Commission.	
2	Maths, science and technology skills,	Member states, Commission, social	By 2006.
_	and careers for scientists.	partners, scientific community.	
3	Raising post-secondary education	Member states, Commission.	By 2010.
	and fewer unqualified.	Marahamatatan Garanianian assial	D 2004
4	Closer links between education and industry, and career guidance.	Member states, Commission, social partners.	By 2004.
5	Lifelong learning and continuing	Member states, social partners.	By 2004.
,	training.	Member states, social partners.	Dy 2004.
6	EU awards.	Commission.	
7	ICT skills definition.	Member states, Commission, social	By 2005.
		partners.	-,
8	Monitoring ICT and e-business skills.	Member states, Commission, social	By 2002.
	C	partners.	•
9	Recognition of non-formal and formal	Member states, Commission, social	By 2003.
	learning.	partners.	
10	Transferability of qualifications.	Member states, social partners.	By 2003.
11	Investment in less advanced regions	Member states, social partners,	By 2003.
		Commission.	
Geo	graphic mobility		
12	Free movement	Member states, European Parliament,	By 2002.
		Council, Commission.	
13	Social security and health insurance	Council, European Parliament,	By 2003 and 2004
	card.	Commission.	
14	Supplementary pensions.	Member states, social partners,	By 2002.
		Council, European Parliament,	
1.5	Dueforeignel accomplished for accordate d	Commission.	D 2002 1 2005
15	Professional recognition for regulated professions.	Member states, Council, European Parliament.	By 2003 and 2005
16	Internal market for services.	Member states, Commission.	
17	Tax-benefits and housing.	Member states.	• •
18	Language skills.	Member states, Commission.	By 2005.
19	More learning in other member states.		Dy 2009.
20	Recognition of educational	Member states, Commission, social	By 2003.
	qualifications.	partners.	•
21	Qualifications in collective agreements.	Social partners.	
22	Immigration policy.	Council, European Parliament,	By 2003.
		Commission.	
Info	rmation and transparency		
23	One-stop mobility information site and	Member states, Commission.	By 2003 and 2005
-	information on qualifications.	,	y
24	European employment services	Member states, Commission.	By 2002 and 2004
	(EURES) integration and classification		
	of occupations.		
25	Mobility information campaign.	Member states, Commission.	By 2003.
Mon	itoring and follow-up		
	chmarking and implementation.	Commission – annual spring report.	
		transport annual opining report.	

		10	1010719		ition of	-	-	_	u.cg.	•					
	AUT	BEL	FIN	FRA	DEU	GRC	IRL	ITA	LUX	NLD	PRT	ESP	DNK	SWE	GBR
Comprehensiveness of strategies															
Compulsory education	Р	P	Α	Α	Α	Р	Р	Α	Р	Α	Р	Р	Α	Α	Α
Formal adult education/	•	•	••	• •	••	•	•	••	•	••	•	•	••	••	••
training	P	P	Α	P	Α	P	Α	P	P	Α	P	P	Α	Α	Α
Workplace/other non-formal/															
recognised prior learning	P	P	Α	Α	Α	P	P	P	P	Α	Р	P	Α	Α	Α
Focus on disadvantaged	В	Б		Б	ъ		В		Б	ъ	ъ	_			ъ
groups Overall investment/funding	P	P	Α	P	P	Α	P	1	P	P	P	P	A	Α	P
schemes	P	P	Α	P	P	P	P	P	P	Α	P	P	Α	Α	Р
Coherence of strategy System development (policy needs, planning, targets, implementation,															
monitoring) Partnership working (social partners, public authorities, learning	P	Р	A	A	P	Р	Р	I+	P	A	P+	Α	A	A	P+
providers, civil society) Cross-cutting aspects (advice/guidance services,	Р	P+	A	P	Α	I+	Α	P	P	Α	P+	P	Α	Α	Α
education/training mobility)	I+	P	Α	Α	P	P	P	P	P	P	P	P	Α	Α	Α

A Adequate: denotes that a particular criterion is given appropriate priority within both the member state's strategy and concrete actions.

P Partial: indicates that some attention is given to the criterion in both the strategy and actions or that it is given appropriate priority in one or the other.

Table A5. **Developing lifelong learning strategies**

Insufficient: refers to when the particular criterion is absent from both the strategy and the actions or is given some attention in one or the other. + Indicates improvements compared to last year.

Letters in **bold** indicate changes compared to last year.

Source: European Commission (2002g).

Notes:

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Table A6. Wage indexation and minimum wages in the euro area

Wage in	dexation	Minimum wages			
Systematic	Belgium, Luxembourg.	Statutory ¹	Belgium, Spain, France, Portugal, Ireland, Netherlands, Luxembourg.		
Conditional indexation (adjustment possible when inflation exceeds a threshold).	Greece, Finland, Italy.	Legal ²	Greece.		
Indexation clauses common in collective agreements. Other	Spain, Netherlands. France (indexation of minimum wage). Portugal (ex post adjustment to surprise inflation in 2000).	Implicit	Germany, Italy, Finland, Austria.		

Statutory refers to the amount of the minimum wage being fixed by law.
 Legal refers to the amount not being fixed by law but through employer/employee agreement. Source: European Commission and OECD.

Table A7. The five vintages of Stability and Convergence Programmes compared

General government balances in per cent of GDP

	Vintage ¹	1999	2000^{2}	2001 ²	2002	2003	2004	2005	2006
Austria	First	-2.0	-1.7	-1.5	-1.4	_	_	_	_
	Second	-2.0	-1.7	-1.5	-1.4	-1.3	-	_	-
	Third	_	-1.4	-0.8	0.0	0.0	0.0		-
	Fourth ³	-	-	0.0	0.0	0.0	0.2	0.5	
	Fifth	_	-	_	-0.6	-1.3	-0.7	-1.5	-1.1
Belgium	First	-1.3	-1.0	-0.7	-0.3		-	-	-
	Second	-1.1	-1.0	-0.5	0.0	0.2	- 0 (_	-
	Third Fourth	_	-0.1 -	0.2 0.0	0.3 0.0	0.5 0.5	0.6 0.6	0.7	_
	Fifth	_	_	U.U —	0.0	0.0	0.3	0.7	-
Finland	First	2.4	2.2	2.1	2.3	-	-	0.7	••
riiiaiiu	Second	3.1	4.7	4.2	4.6	4.7	_	_	_
	Third	J.1 —	4.5	4.7	4.4	4.5	4.9	_	_
	Fourth	_	-	4.8	2.6	2.1	2.6		_
	Fifth	_	_	_	3.8	2.7	2.1	2.6	2.8
France ⁴	First	-2.3	-1.7	-1.2	-0.8	_	_	_	_
	Second	-2.1	-1.7	-1.2	-0.7	-0.3	_	_	_
	Third	-	-1.4	-1.0	-0.6	-0.4	0.2	-	-
	Fourth	_	-	-1.4	-1.4	-1.0	0.0	0.3	-
	Fifth	-	-	-	-2.8	-2.6	-2.0	-1.3	-0.5
Germany	First	-2.0	-2.0	-1.5	-1.0	-	-	-	-
	Second	-1.2	-1.0	-1.5	-1.0	-0.5	-	-	-
	Third	_	-1.0	-1.5	-1.0	-0.5	0.0		-
	Fourth	-	-	-2.7	-2.0	-1.0	0.0	0.0	_
	Fifth	_	-	_	-3.8	-2.8	-1.5	-1.0	0.0
Greece ⁵	First	-2.1	-1.7	-0.8		-	-	-	-
	Second	-1.5 -	-1.2	-0.2	0.2	2.0	2.0	_	_
	Third Fourth	_	-0.8	0.5 0.1	1.5 0.8	2.0 1.0	2.0 1.2		_
	Fifth	_	_	U. I	-1.1	-0.9	-0.4	0.2	0.6
Ireland ⁶	First	1.7	1.4	1.6		-	-	-	-
ileiailu	Second	1.4	1.4	2.5	2.6		_	_	_
	Third	-	4.7	4.3	3.8	4.6		_	_
	Fourth	_	_	1.4	0.7	-0.5	-0.6		_
	Fifth	-	-	-	-0.3	-0.7	-1.2	-1.2	-1.2
Italy	First	-2.0	-1.5	-1.0		_	_	_	_
	Second	-2.0	-1.5	-1.0	-0.6	-0.1	-	-	-
	Third	_	-1.3	-0.8	-0.5	0.0	0.3	-	-
	Fourth	_	-	-1.1	-0.5	0.0	0.0	0.2	-
	Fifth	-	-	-	-2.1	-1.5	-0.6	-0.2	0.1
Luxembourg	First	1.1	1.2	1.3	1.7	-	-	-	-
	Second	2.3	2.5	2.6	2.9	3.1	-	-	-
	Third	-	3.0	2.6	2.5	2.5	2.4	_	_
	Fourth Fifth	_	_	4.1	2.8 -0.3	3.1 -0.3	3.4 -0.7	-0.1	_
NI - 4111 -7				_				-0.1	• •
Netherlands ⁷	First Second	-1.3 -0.6	-0.6	-1.3	-1.1 -1.1	-	_	_	_
	Third	-0.0	1.0	0.7	0.3	0.3	0.3	_	_
	Fourth	_	-	0.7	0.4	0.2	0.5		_
	Fifth	_	_	_	-0.7	-1.0	-0.7	-0.4	0.1
Portugal	First	-2.0	-1.5	-1.2	-0.8	_	_	_	_
	Second	-2.0	-1.5	-1.1	-0.7	-0.3	_	_	_
	Third	-	-1.5	-1.1	-0.7	-0.3	0.0	_	_
	Fourth ⁸	-	-	-2.2	-1.8	-1.0	0.0	0.4	-
	Fifth	_	-	_	-2.8	-2.4	-1.9	-1.1	-0.5

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Table A7. The five vintages of Stability and Convergence Programmes compared (cont.)

General government balances in per cent of GDP

	Vintage ¹	1999	2000^{2}	2001 ²	2002	2003	2004	2005	2006
Spain	First Second	-1.6 -1.3	-1.0 -0.8	-0.4 -0.4	0.1 0.1	0.2	_ _	- -	-
	Third Fourth Fifth	- - -	-0.3 - -	0.0 -0.1 -	0.2 0.0 -0.2	0.3 0.0 0.0	0.3 0.1 0.0	0.2 0.1	- - 0.2
Euro area ⁹	First Second Third	-1.8 -1.5 -	-1.5 -1.1 -0.8	-1.1 -1.0 -0.7	-0.7 -0.6 -0.3	-0.2 0.0	- - 0.4	- - -	- - -
	Fourth Fifth	_	-	0.0	-0.9 -2.2	-0.4 -1.8	0.1 -1.1	-0.6	0.0
Denmark	First Second Third Fourth Fifth	2.5 2.9 – –	2.8 2.1 2.7 -	2.6 2.2 2.8 1.9	2.3 2.6 1.9 2.1	2.5 2.6 2.1 2.2	- 2.7 2.1 2.5	- - 2.1 2.4	- - - - 2.2
Sweden	First Second Third Fourth Fifth	0.3 1.7 - -	1.6 2.1 3.4 –	2.5 2.0 3.5 4.6	2.0 2.0 2.1 1.7	- 2.0 2.2 1.5	- - 2.3 1.6	- - - 2.0	- - - - 2.0
United Kingdom ¹⁰	First Second Third Fourth Fifth	-0.3 0.3 - -	-0.3 0.2 1.1 -	-0.1 0.2 0.6 -0.2	0.2 -0.1 -0.1 -1.1 -1.8	-0.4 -0.9 -1.3 -2.2	- -1.0 -1.1 -1.7	- - - -1.0 -1.6	- - - - -1.6
Other EU countries ⁹	First Second Third Fourth Fifth	0.0 0.7 - -	0.2 0.6 1.5 -	0.5 0.6 1.2 0.0	0.7 0.4 0.4 -0.4 -1.0	- 0.2 -0.2 -0.6 -1.3	- -0.3 -0.4 -0.9	- - - - -0.8	- - - - -0.8
EU ⁹	First Second Third Fourth Fifth	-1.5 -1.0 - -	-1.2 -0.8 -0.3 -	-0.8 -0.7 -0.3 0.0	-0.5 -0.4 -0.2 -0.8 -2.0	-0.1 0.0 -0.5 -1.7	- 0.2 0.0 -1.0	- - - - -0.7	- - - - -0.2

First: 1998/99, second: 1999/2000, third: 2000/01, fourth: 2001/02, fifth: 2002/03. Comparability across programmes is limited by asynchronous shifts from ESA79 to ESA95. In some cases, countries have submitted amendments in the course of the fiscal year.

Source: National Stability and Convergence programmes; European Commission (2002w) and OECD.

^{2.} UMTS licence proceeds are excluded because they are one-off and for the sake of comparability with earlier programmes.

^{3.} The notified surplus for 2001 is likely to be reduced when late tax payments made that year are imputed back to earlier years

^{4.} Favourable scenario. In February 2002, the government published revised projections for the fiscal balance of 1.8-1.9 per cent of GDP in 2002 and 1.7-1.8 per cent in 2003 based on a below-potential growth forecast.

^{5.} Convergence programmes for the first and second vintage, Stability programme thereafter.

^{6.} As of the third programme, payments into public pension funds are included in the surplus.

^{7.} Cautious scenario except for the 2001 projection in the third programme.

^{8.} The notified 2001 deficit is expected to be revised up by 0.4 percentage points as the accounting of taxes and social contributions is aligned with ESA95 requirements and by an additional unspecified amount to reflect capital injections into public corporations.

^{9.} Weighted averages. For the purposes of aggregation, missing observations are dealt with by inter or extra-polation.

^{10.} On a financial year basis (year t stands for FY t/t+1).

Annex II

The mutual recognition principle in practice

Since the mid-1980s, the principle of mutual recognition (MRP) has been widely applied in areas, which have not been subject to EU-wide harmonisation or minimum requirements. Under the principle, a producer who has complied with the requirements of his country of origin has the right to sell in all the other member states. A first evaluation of the principle in 1997 acknowledged the lack of information on the effectiveness of the MRP, the lack of awareness of this principle among businesses and consumers, and the need to provide more regular and thorough evaluations of its impact. This was reiterated in the first report on the MRP. The issues related to its application to trade in goods are quite different from those for services:

- For goods, the MRP applies whenever issues related to standards, testing and certification requirements may affect trade. It is only when the MRP is thought to fail that harmonisation is sought. Among intra-EU imports affected by technical regulation, around a quarter is subject to the MRP. If the MRP does not apply, the Union issues harmonisation directives. In the so-called "old approach" very detailed and technical directives were issued. The complexity of these directives, and the time required for agreement led the Commission to adopt a "new approach", which lays down "essential requirements" and leaves much freedom to producers to decide how to meet them.
- In its second report on mutual recognition, the Commission recognised the effectiveness of the MRP, but noted that it may vary by product category (European Commission, 2002x). For products that pose few safety concerns, the MRP usually works well. On the other hand, the application of mutual recognition for technically complex products, or products which can pose safety or health problems, it operates less well, apparently due to a lack of information, mistrust and misunderstandings by administrations. Also companies admit that they often opt for adapting products to the national rules of the destination country. Thus, in these cases, the case for harmonisation is stronger.
- For services, the Commission acknowledged that the MRP operates much less well, partly because of their specific character (European Commission, 1999c). One of the areas where the MRP has been developed through legislation is that of regulated professions. For regulated professions, three directives apply: one on higher-education diplomas and training of at least three years' duration, another covering other diplomas, certificates and vocational training and a third covering crafts and trades professions. Under these directives, professionals can obtain recognition of title, possibly subject to a test or period of supervised practice covering substantial differences between their competencies and the qualification requirements in the member state in which they wish to practise, while the crafts and trade professions can also obtain unconditional recognition to practise based on certain specified minimum years of practise in another member state. In contrast, doctors, general care nurses, veterinarians, pharmacists, mid-wives and architects are

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covered by specific directives applying an approach of automatic recognition of qualifications fulfilling certain specified minimum training conditions. For lawyers, two directives facilitate services and establishment under home professional title without any examination of the diplomas. Access to professions which are not regulated in a member state is, by definition, not subject to any legal constraints in the form of qualification requirements. In March 2002, the Commission issued a proposal to modernise the Directives on mutual recognition of professional qualifications, including consolidation of existing provisions, liberalisation of conditions for the provision of services between member states and rationalisation of the procedures for the operation of the system of recognition. There is no mutual recognition of business licenses, the banking sector being an important exception.

– Member states may under very strict conditions I override the principle of mutual recognition in the name of the general interest. Member states have tended to apply these conditions in a rather loose manner. The Commission underlines a lack of mechanisms to deal with such problems and devising solutions. However, there is probably scope to avoid dual regimes for service providers: in this respect enforcement of the MRP is probably better than seeking harmonisation at the EU level, although this might prove unavoidable in some cases. Against this background, the European Commission is planning to make a proposal for a directive by the end of 2003 on the free provision of services, which will involve a mixture of mutual recognition, administrative co-operation and, where strictly necessary, targeted harmonisation.

¹ The exact wording may be found in the European Commission's "First Report on the Application of the Principle of Mutual Recognition In Product and Services Markets" (see European Commission (First Report)) and is: "Member States may not waive this principle [mutual recognition] except under very strict conditions, which involve 'overriding requirements of general public importance', in particular public health, protection of consumers or the environment".

Annex III

The financial market environment

The previous *Survey* assessed the current policies and their implementation in the euro area financial markets. While the huge differences once observed across the area are gone, there is still unfinished business. The *Survey* found that there is still room for improvements in the financial market infrastructure, that national and common interests still intertwine and lead to gridlock or costly solutions, while the decision-making set-up and co-ordination processes still do not measure up. The policies issues that were deemed to be most pressing are listed in Box A1. This annex presents recent measures and upcoming action, and discusses the most important developments in the regulation of the financial markets.

The policy framework

The current structure of regulation and supervision across the Community is the result of different administrative, legal and financial approaches across countries. Progress in adopting legislation in the pursuit of an integrated financial market has been slow. As described in last year's *Survey*, the Financial Services Action Plan (FSAP) is the Community's central tool for attaining greater market integration. The FSAP was conceived in the run-up to the Cardiff Council in 1998, and became a policy priority with its adoption as part of the "Cardiff process". It was endorsed by the Cologne European Council in June 1999 and has been reaffirmed by later Councils. The original FSAP contained more than 40 concrete measures, both legislative and non-legislative. To date, most measures have been completed, while others have been redefined and further measures have been added.

Of the eight prioritised measures for adoption in 2002 from the Barcelona Council, five were adopted by the beginning of December 2002. Several more have been adopted in 2003. For the legislative measures, co-decision necessitates adoption by both Council and Parliament. A continuous re-adjustment of the programme following new developments and set-backs has made the number of measures less relevant, as shown by the remaining measures listed in Table A8. Of these issues, several are new as compared to the original FSAP (examples are the proposals for a Follow-up Report of the High Level Group of Company Law Experts, which partly developed in the wake of the Enron scandal in the United States and for continued efforts on Cross-border Clearing and Settlement arrangements following the Giovannini group's work in the field).

Admitting the slow process of adopting legislation, the authorities have taken steps to re-shape the regulatory process by separating first principles from secondary legislation. The new framework for the securities sector was shaped by the Lamfalussy proposals, *i.e.* the Committee of Wise Men (Lamfalussy Report, 2001). The set-up is very similar to the structure of primary and secondary legislation that exists in most countries. The Lamfalussy proposals were endorsed at the Stockholm Council in March 2001.

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Box A1. Synopsis of 2002 EDRC recommendations

An overriding and immediate recommendation is for the European authorities to adhere to the timetable for implementing the proposals in the Financial Services Action Plan by 2005, which were deemed necessary already in 1998. These measures should form the basis for EU proposals and pre commitments in the ongoing set of GATS negotiations. Further efforts should focus on the following issues:

Improve the financial market infrastructure

Common financial markets in the euro area have matured in the areas where the infrastructure is simpler as in the wholesale business or where the public sector is most involved. By contrast, in areas where EU wide public infrastructure is scant, markets remain regional and transaction costs for cross border activity remain high. In order to improve the conditions for financial market integration in this regard, the following policies need to be pursued:

- Entry barriers related to sunk cost of existing market infrastructure should be offset by an effective competition policy. In particular, access to the existing infrastructure should be open to new market entrants, possibly subject to fair fees and licenses to be closely monitored by the EU competition authorities.
- To improve the clearing and settlement infrastructure for securities, the authorities should try to exploit the ECB's experience in cross border transactions such as that stemming from TARGET, which uses similar technologies.
- The authorities should eliminate the remaining obstacles that hamper deep integration. While the markets generate solutions around existing barriers they are often far from optimal from an economic efficiency point of view and costly.

Align national and common interests

National industries' interests often stand in the way of achieving a common financial market. A better balance should be struck between these interests and the common good based on the general acceptance that financial market integration cannot be achieved without free cross border ownership and trade in financial services and products:

- A new Take over Bid Directive should be adopted with priority in order to clarify and establish a legal framework for cross border mergers and acquisitions.
- Domestic policies towards favouring "national champions" should be discouraged. The Commission's task in this regard would be to disclose information on such policies and adopt a policing role.

Box A1. Synopsis of 2002 EDRC recommendations (cont.)

 Consumers and businesses should be given increased scope for raising complaints when their home or prospective host country does not appear to apply the common principles within a reasonable time frame from adoption.

Streamline decision making and co ordination

Progress in adopting legislation in the pursuit of an integrated financial market has been slow, even though steps have been taken to re shape the regulatory process by separating first principles from secondary legislation. The current structure of regulation and supervision is the result of different administrative, legal and financial approaches across countries. The following directions for change should be pursued:

- Scrutinise the current committee structure. There should be continual assessment of existing structures for financial regulation and supervision to ensure that they support the design and implementation of new legislation, the sharing of supervisory information and best practices to attain convergence, and more generally contain threats to financial stability. In this process, transparency and accountability should be aimed for.
- Ensure convergence of practices across the internal market. Facilitation of cross border co operation must be continued to avoid divergent local practices.

The first use of the speeded-up procedures following the Lamfalussy proposals was during the second half of 2002 for the Directive on Market Abuse (see below), which will soon come into force. Others, on prospectuses and investment services, are also just out of the pipeline. These framework directives are adopted in co-decision between the Council and European Parliament (level 1). Secondary legislation (implementing rules) will be adopted by Committees of both Ministry representatives and technical experts (level 2). Supervisory committees will provide input for discussions at level 2 and will stimulate co-ordination between national supervisors (level 3). This committee structure was proposed to be in operation by the end of 2001, but was implemented a year late.

During December 2002, the ECOFIN Council endorsed a report from the Economic and Financial Committee (EFC) on financial regulation, supervision and stability extending the principles from the Lamfalussy framework to the other financial sectors (i.e. banking, insurance, pensions and financial conglomerates). The introduction of a new committee structure in insurance and banking as in securities' markets is a step long overdue. Facilitation of crossborder co-operation must be continued to avoid divergent local practices. However, these committees consist of members with strong national interests and obligations, and they must be kept transparent and use consultation processes continuously. The most critical aspect

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Table A8. Legislative programme for 2003

Proposals scheduled for adoption by Parliament and Council

Take-Over Bid Directive

Modernisation of the Accounting Provisions of the 4th and 7th Company Law Directives (mid 2003 expected)

Transparency Directive (2004 expected)

Investment Services Directive upgrade (early 2004 expected)

Expected Commission proposals

Follow-up Report of the High Level Group of Company Law Experts

Proposal for a 10th Company Law Directive

Proposal for a 14th Company Law Directive

EU Legal Framework for Payments in the Internal Market

Reinsurance Supervision

Clearing and Settlement – follow-up of the Giovannini Group

Remaining key FSAP measures

Review of the capital requirements for financial institutions

Insurance Solvency II

Source: European Commission and OECD.

regarding the outcome of the FSAP is now national implementation. In the past, financial services measures have been among the slowest to be implemented.

Recent reforms

A major difference between the United States and the European Union is the absence in the latter of both common and modern corporate laws and of accounting standards. The ability to evaluate securities, equity and businesses across borders would be facilitated by a common law and standards, opening up, on the one hand, opportunities for dis-intermediation and less expensive trades, and on the other, a larger pool of capital to tap. Recent initiatives address these issues:

- From October 2004, companies operating in more than one member state will get the option of being established as a single company. The European Company (known by its Latin name Societas Europaea, or SE) will let businesses operate governed by one set of rules only, with unified management and reporting systems rather than having to respect different national laws. The European Company statute may offer reduced administrative costs and a legal structure adapted to the internal market as a whole. Still, the directive also includes a number of rules and regulations that may increase cost and hamper its take-up. Especially, the rules for worker involvement seem to go much further than in national legislation generally. As the European Company will not appear for some time, neither the take-up among businesses or the practicality of the rules may be assessed for a while. However, the High Level Group of Company Law Experts is currently working on proposals to extend the Community-wide principle to other companies (private companies, co-operatives, and other forms of enterprise).
- From 2005, all EU companies listed on a regulated market must prepare consolidated accounts in accordance with International Accounting Standards (IAS). Member states will have the option to extend this requirement to unlisted companies. The proposal will help to eliminate barriers to cross-border trading in securities by ensuring that com-

pany accounts are more transparent and can be more easily compared. This should in turn increase market efficiency and reduce the cost of capital. However, the market players are arguing for changes to the proposals on valuation of financial instruments, where especially banks have to comply with accounting rules as well as regulators' requirements in their risk management strategies. The Commission has also launched proposals to modernise the fourth accounting directive (on annual accounts) and the seventh accounting directive (on consolidated accounts) accordingly.

- Over the last decade, proposals on a cross-border Take-over Bid Directive have been presented to Council and Parliament regularly, as current legislation in this area dates back to 1989 and leaves many practical issues unsolved. The proposal was identified as a priority by the 2000 Lisbon European Council in view of its potential benefits in terms of facilitating restructuring and so boosting competition, expected in particular to offer Europeans engaged in take-over bids greater legal certainty and to protect the interests of minority shareholders. In 2000, an amended proposal was introduced. This proposal included a minimum level of harmonisation to increase legal certainty. In July 2001, the Parliament rejected the proposal, mainly based on the argument that the management of targeted companies would be left with no effective possibility for defensive measures - so-called poison pills - to frustrate a bid without consulting their shareholders and also, that the directive did not respect subsidiarity. Following the rejection, the Commission set up a High Level Group of Company Law Experts in September 2001 to assist in the preparation of a new directive and to define new priorities for the future development of company law. The Commission launched a new proposal for a Directive during October 2002, this time outlawing most defences, limits on individual shareholdings and restrictions on the transfer of shares but keeping dual shareholding structures, where some shares have greater voting rights and thus let their holders dominate company decisions. The proposal has again become the object of negotiations as additional goals and issues are being introduced.
- Among the restrictions on running cross-country businesses in the EU, the necessity of operating individual occupational pension funds in each of the countries where the business has a pension plan for its employees is ranked high. One common scheme operating cross-border would make equal treatment of employees easier and reduce the costs of running such pension schemes, but raises complicated tax and supervision issues and is not feasible under current rules.² Attempts to create a common prudential framework for pension funds in the European Union go back to the early 1990s. A directive was proposed by the Commission in October 2000, and the Barcelona Council set the end of 2002 as its deadline (adoption took place in May 2003, and will be followed implementation by member States within 24 months). This Directive aims to enable institutions to accept sponsorship by, and run a pension scheme for, a company located in another member state subject to detailed rules of operation. However, the organisation of pension schemes falls under the subsidiarity principle and is a matter for member states only. The new Directive thus cannot touch a number of substantial issues.
- A Directive on insider dealing and market manipulation (market abuse) was proposed in 2001 and adopted under co-decision in January 2003. This basic framework for the allocation of responsibilities, enforcement and co-operation within the European Union is aimed at professional market participants. The directive was heavily amended late in the process, inter alia due to its effects on a diverse range of professions. Secondary and implementing legislation on the market abuse directive will represent the first use of the speeded-up Lamfalussy procedures.

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- The draft Directive on securities trading and prospectuses was presented in May 2001. The draft updates two earlier pieces of EU legislation (acts from 1989 and 1990), with both the Financial Services Action Plan and the Risk Capital Action Plan listed as a top priority. The proposal should simplify regulatory compliance by establishing common disclosure standards when securities are offered to the public or traded on regulated markets, and forms part of the single passport for issuers. The directive also simplified procedures, including a new language regime. It allows criminal and administrative sanctions, imposes new disclosure obligations on issuers and has extra-territorial application, and will also end stock exchanges' role as approval instances for prospectuses and place it with the home country regulators. The Parliament suggested a number of changes during spring 2002, including exempting businesses with assets lower than EUR 350 million from the new regime. According to the European Commission, this implies that less than one in four businesses across Europe will have to produce their prospectuses in accordance with the common format.³ As the information expansion for these companies through the prospectus directive is small (larger companies are already followed closely by analysts and the financial press), the current suggestions will basically relegate legislation on prospectus content to the national domain and not create a common standard. While the Barcelona Council (March 2002) asked the Council and Parliament to adopt the Directive as early as possible in 2002, final adoption took place in July 2003. However, work on secondary legislation has already been started.

– Along the same lines, a directive on transparency obligations of publicly traded companies was proposed in March 2003. The proposed directive will apply to all companies whose securities are admitted to trading on a regulated market in the EU, such as the wholesale bond markets (inter alia, Eurobond markets). The directive updates and upgrades periodic information requirements for securities issuers, especially related to the introduction of International Accounting Standards (IAS). This is also a framework directive, expected to be adopted in 2004 (two years after the initial timeframe).

Several other initiatives of the same nature are forthcoming. On corporate governance the Commission will issue a communication in May on Company Law and Corporate Governance on the basis of the conclusions of the Report of the High level Group of Company Law Experts (the Winter Group Report). It is expected to cover issues, such as disclosure of companies' corporate governance structures, the role of independent or supervisory directors, and corporate reporting. The plan has to be adopted by the end of 2003. As to the need for reinforcing statutory audit, the Commission's Recommendation on Auditor Independence will be followed by a Communication (envisaged in May) which is expected to introduce a 10-point-plan for actions for reinforcing statutory audit in the EU. Further, the EU legislative framework on auditing will be revisited with a view to introducing, *inter alia*, provisions on auditors' independence and adequate public oversight of the audit profession.

The regulatory side

The issue of financial stability is being monitored both from a business cycle and structural point of view. The sharp decline of the equity market has implied lower profitability and has reduced the level of capital assets in financial firms which restrict the whole sector's room to manoeuvre and expand into new markets, thereby harvesting the gains from the single market and the euro. In June 1999, the Basle Committee on Banking Supervision issued a proposal for a New Capital Adequacy Framework (Basle 2), consisting of three pillars: i) minimum capital requirements (to refine the standardised rules set out in the 1988 Accord); ii) a supervisory review of an institution's internal assessment process and its capital

adequacy; and *iii*) use of disclosure to strengthen market discipline as a complement to supervisory efforts. The Financial Services Action Plan states that following the new Accord, the Community should adopt a version as a directive. However, the Basle Committee's schedule has been extended, and implementation of the new framework is currently planned for end-2006. The Commission is also reviewing the solvency framework in the insurance sector [the Solvency II review (Table A8)]. The intention is to carry out this review based on the same broad principles as Basel II, while finding an approach that is suitable for the insurance sector.

Little competition will result in higher prices and reduced scope of banking services. As shown in last year's Survey, the restructuring in European banking has over the years resulted in falling overall numbers of banks, but not in a similar reduction in branches suggesting that branches may serve as a deterrent for entry. Neven and Röller (1999) consider corporate and household loan markets in Europe and find significant collusive cartel-like conduct collusive behaviour in these markets. One measure for competition pressure in banking is entry of new banks. In Chapter IV it is shown that new banking licences are fewer in the Community than in other OECD countries, suggesting that competitive pressures are higher in the latter countries. Recent empirical studies from the United States have pointed to a link from bank competition to entry rates among small and medium-sized businesses. A bank will face a tradeoff between restricting credit to new entrants while continuing its ongoing relationship with industry incumbents on the one hand, and allowing credit access to new firms thus establishing new and possibly more valuable relationships with them at the expense of the older clients, on the other. Empirical work seem to confirm that the less competitive conditions are in the credit market, the lower is the incentive to finance new-comers (Cetorelli, 2002). Banking market structure and competition may thus have heterogeneous effects across firms within an industry sector. For the Community, low growth of new businesses and low exit among existing ones is a well-known challenge, and the recent work suggests that banks could play a larger role.

Developments in some markets

Closing the gap with the United States in bond market financing is a very slow process. Figure A1 shows that new issuance of euro denominated bonds by corporate issuers, after being rather stable over the first years of the euro and a strong showing in 2001, fell dramatically during the slowdown in summer 2002. Total issuance, where asset backed bonds and public issuance contributes heavily, has been roughly stable since 1999, but was markedly highly the first months of 2003. However, the share of total issuance from the private sector is not increasing. At the same time, roughly a quarter of the annual issuance has a shorter maturity than three years. The implication is that replacement issuance is growing, off-setting part of the total growth.

European business finance is still dominated by bank finance. However, recent studies are suggesting that there is evidence that financial structures such as the mixture of financial markets and intermediaries is not important for explaining differential growth rates across countries (Dolar and Meh, 2002). Countries do not grow faster, and firms' access to finance is not systematically easier in either market or intermediary-based systems, while an important factor is a sound legal system that protects the rights of investors and enforces contracts. This conclusion is consistent with the broad empirical analysis of financial structure and economic growth by Demirgüç-Kunt and Levine (2001): "Through a diverse set of analyses, the answers are surprisingly clear... Overall financial development matters for economic success, but financial structure *per se* does not seem to matter much". This suggests that the European authorities should focus on legal and regulatory reforms that support the functioning of both

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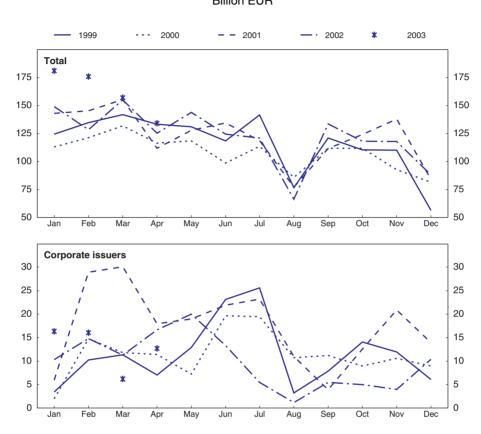


Figure A1. Volume of euro-denominated bonds issued
Billion EUR

Source: European Commission, Monthly Bond Market Note – Developments in the Euro-denominated Bond Markets.

markets and intermediaries, rather than concern themselves with the degree to which their national financial system is market or intermediary-based. Rapid implementation of Directives on the national level is thus very important.

Estimating the gains

The original Cecchini Report argued for a total integration bonus of 4.5 per cent of which financial market integration would contribute one-third (i.e. 1.5 per cent). Since the report was presented, ongoing integration must have eroded the remaining bonus. However, the size of gains up to now may not be that large, as several studies suggest that deep integration is still lacking in some market segments. Based on long-run co-movements in the biggest EU stock markets (UK, France and Germany), Pascual (2003) finds that while French stock market

prices became more closely integrated with UK and German markets up to the mid 1980s, evidence of changes in the degree of financial integration for the UK and German stock markets or continued change for France in the last decade and half are not found. For retail credit bank markets in Europe, Heinemann and Schüler (2002) conclude that these are far away from deep integration. Kleimeier and Sander (2002) find some limited evidence of an integrated retail banking market prior to 1 January 1999, but point to possible structural changes for the corporate lending market after the introduction of the single currency. However, Adam *et al.* (2002) find a distinct lack of integration of short-term corporate loan markets.

Neimke et al. (2002) suggest that the remaining gains could be close to the 1.5 per cent of the Cecchini Report. Two reports published on the behalf of the Commission in late 2002 also suggest that the potential impulse form stronger market integration may be sizeable. A study from London Economics (2002) looks at savings for businesses following a restructuring from bank to bond financing, i.e. a move towards the US model. Large savings would come from reductions on cost of bond finance in combination with an increase in its share, and from competition induced reductions in the cost of bank finance. Further, the study suggests that integration of equity markets will reduce trading cost substantially. These changes would also translate into increased investment, consumption and employment. Over a decade, this could raise the level of GDP by 1.1 per cent. Based on similar ideas of convergence with US financial markets. Giannetti et al. (2002) tries to establish a connection between financial markets development and business growth. This study suggests that European manufacturing industry would grow up to 1 per cent faster if financial markets across the Community developed to US levels. As other sectors of the economy may experience smaller gains, the overall effect could be smaller. While partly overlapping and thus not additive, these two reports underline that financial market integration, and concurrent development towards very efficient levels, in the long run may generate sizeable returns.

Notes

- 1. The Commission presents an up to date summary of progress on the internet.
- 2. The special issues related to occupational pension funds are related to the long time period between the obligations arises (premiums are paid) and the actual pay-out of pensions. This creates *i*) the need for long term overview of such schemes by pension fund supervisors on behalf of members to ensure that funds are not diverted to other purposes; *ii*) the same from tax authorities as taxes on pension premiums are deferred today but are often imposed on the much later pension pay-outs; and *iii*) the possibility that the country giving the tax break in the first place is not the same as the one receiving the tax receipt later, a situation countries have tried to avoid to protect their tax bases.
- 3. Commissioner F. Bolkestein cited in the Financial Times, 14 March 2002.

Annex IV

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Tax incentives and house price volatility: Theory and Evidence

Cycles in owner-occupied housing markets produce swings in household wealth that in turn exacerbate the overall cyclical variation in economic activity. To the extent that housing cycles in the euro area behave asymmetrically, *i.e.* are not synchronised and/or very different in intensity across the monetary union, they also tend to complicate the conduct of monetary policy.

The housing cycle stems from the relatively inelastic supply of housing which, to the extent housing demand varies over time due to changes in economic (income expectations, real interest rates) or other (demographic, preferences) conditions, may result in strong movements in prices.

However, one additional factor that can exacerbate volatility in house prices is the myriad tax incentives governments provide to stimulate house ownership. A tax system that contains generous incentives for house ownership not only results in a higher steady-state level of house prices (and an associated misallocation of resources), but may result also in greater volatility of house prices. Specifically, it means that the tax breaks for owner-occupied housing would act as a destabilising force, to some extent offsetting the automatic stabilising properties that are normally attributed to income taxation. In a monetary union with widely different tax systems this may be one factor behind inflation divergence.

This Annex provides some evidence that this phenomenon is indeed relevant in the euro area. The starting point is a simple theoretical model of the housing market that aims to formalise the link between housing price dynamics and the income tax system. Next, estimates of the marginal effective income tax rates on housing (which are typically negative) are presented and compared across the area.

A simple model for the market for owner-occupied housing

The volatility of house prices results from a combination of price-inelastic supply of newly built dwellings and preferential tax treatment of owner-occupied housing. This can be demonstrated with a relatively simple model developed by Poterba (1984, 1991).

According to this model the demand for owner-occupied housing declines with the purchase price of housing. However, the price sensitivity of demand tends to fall (*i.e.* the slope of the demand curve to increase) with the degree of preferential tax treatment and the expected house price inflation (or capital gain). A fall in the interest rate also produces a reduction in the price sensitivity of demand. This can be shown as follows. The starting point is the assumption that equilibrium in the market for existing owner-occupied houses requires that homeowners, in their role as investors, earn the same return on housing investment as on other assets. This

requires that they equate the marginal value of rental services from owner-occupied housing with the user cost of capital attached to a marginal unit of housing:

(1)
$$R(H) = [r(1-\tau) + \delta - \pi]P_H$$

where R is the marginal value of the rental services per period on owner-occupied homes, r is the nominal interest rate, τ is the marginal effective tax rate on interest income (which in a tax system that taxes net interest income in the same way as other earnings is equal to the marginal income tax rate), δ is the rate of depreciation, P_H is the price of owner-occupied housing and π is the expected rate of house price inflation. The marginal value of the rental services is a negative function of the total housing stock H, hence dR/dH < 0. Therefore equation (1) can be interpreted as the (downward-sloping) demand function for housing.

The supply function relates the total stock of housing to the flow of net construction, which is a function of the ratio of house prices to construction cost (C):

(2)
$$H_t = (1 - \delta)H_{t-1} + \varphi(P_H / C)_t$$

 ϕ is the positive short-run price sensitivity of supply. This sensitivity is typically very small and therefore the short-run supply curve tends to be very steep. However, the long-run price sensitivity is equal to ϕ/δ , which for relatively small values for δ should be considerably larger than the short-run sensitivity.

Figure A2 depicts these relationships and illustrates how price dynamics behave following a positive (permanent) demand shock. The left panel shows what would happen if the tax treatment of housing is less generous (*i.e.* the marginal effective tax rate on net interest income is low). In that case the demand curve is relatively flat. Initially the equilibrium moves along the vertical short-run supply curve S_s from E to A. Eventually supply will expand (S_l is the long-run supply curve) towards the long-run equilibrium B. So, prices first go up and then come down again, but settle at a higher level than prior to the shock.

The right panel depicts the situation when the tax treatment of housing is generous – i.e. τ is large. The demand curve is now steeper because the impact of price increases on demand will be choked off by the tax break. The shock now produces a sharper initial increase in the price level and a sharper subsequent fall than in the left panel. Hence the tax break leads to more volatility in house prices subsequent to a demand shock.

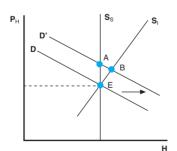
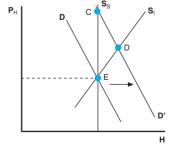


Figure A2. The impact of a demand shock on house prices



Source: OECD.

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A further observation can be made. The real capital cost is assumed to be positive, which should indeed normally be the case. However, if the positive demand shock is very large, households may anticipate future price increases and the expected capital gain π may be large. In that case the user cost of capital may become negative and the slope of the demand curve may turn positive. As a result the short-run equilibrium price is undetermined and the price will keep spiralling up until expectations of further price increases falter, capital costs rise, and boom turns to bust. This situation is akin to a speculative bubble.

The impact of tax breaks on housing cost

Van den Noord (2003) estimates the real financing cost of housing and the tax wedge between the market interest rate and the financing cost of housing investment, to the extent these are affected by the personal income tax system. This study considers the case where housing investment is entirely financed by borrowing. The basic features of personal income tax systems that affect the borrowing cost of housing investment are:1

- Whether the interest payments on mortgages are deductible from taxable income, and
 if so, whether there are limits on the deductible period or the deductible amount.
- Whether tax credits are available.
- Whether the imputed income from owner-occupied housing is taxed.

A related question to examine is whether a modest increase in inflation will lead to negative real financing cost, and hence make housing an extremely attractive investment in some countries, but not in others. If so, this may help explain why inflation divergence among euro area countries will tend to result in divergences in housing demand and property prices and, in turn, in divergent trends in housing wealth.

The results are summarised in Table A9 and Figure A3. From the computations it emerges that the real cost of financing is generally lowest in the smaller euro area economies, except for Greece. The real financing cost was in 1999 below 1 per cent in the Netherlands,

	AUT	BEL	FIN	FRA	DEU	GRC	IRL	ITA	LUX	NLD	PRT	ESP
Deduction or credit Imputed rent (taxed) Interest rate Marginal tax	Yes No 4.68	Yes Yes 4.71	Yes No 4.72	No No 4.62	Yes No 4.49	No Yes 6.31	Yes No 4.77	Yes No 4.73	Yes No 4.67	Yes Yes 4.63	Yes No 4.78	Yes No 4.73
or credit rate	0.50	0.58	0.30		0.53	0.45	0.24	0.19	0.46	0.60	0.30	0.25
Cost of financing Inflation Real cost of financing Tax wedge	4.12 0.51 3.60 -0.56	4.71 1.13 3.58 0.00	3.82 1.31 2.52 -0.90	4.62 0.56 4.05 0.00	4.49 0.64 3.85 0.00	7.88 2.14 5.74 1.58	3.83 2.46 1.37 -0.94	4.20 1.65 2.55 -0.53	3.71 1.02 2.69 -0.96	2.60 2.03 0.57 -2.03	4.55 2.17 2.38 -0.23	3.79 2.23 1.56 -0.93

Table A9. The tax wedge for housing: simulation results

Source: Van den Noord (2003).

Obviously other parts of the tax system, such as wealth tax, property tax, taxation on real estate transactions, VAT, etc. also affect the real financing cost of owner-occupied housing. These are not considered here, but obviously constitute an interesting area for further research.

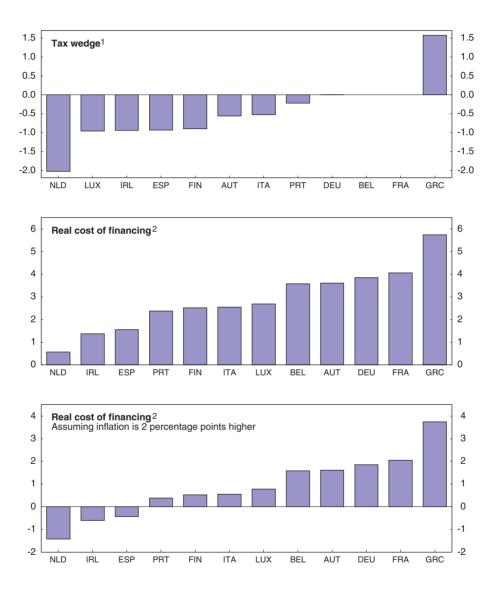


Figure A3. The impact of taxation on housing cost

Per cent

^{4.} Difference between after-tax and pre-tax real interest rate on mortgage loans; 1999 tax rules, interest rates and inflation.

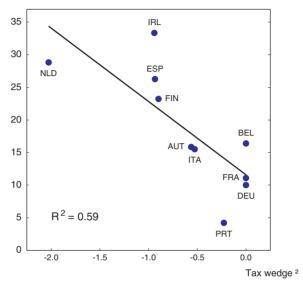
^{5.} Real after tax interest rate on mortgage loans; 1999 tax rules, interest rates and inflation. Source: Van den Noord (2003).

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Figure A4. Correlation between the tax wedge and variability of house prices

Per cent

Variability of real house prices 1



1. Standard deviation, 1970-2001.

2. Difference between after-tax and pre-tax real interest rate on mortgage loans; 1999 tax rules, interest rates and inflation. *Source:* Van den Noord (2003).

between 1 and 2 per cent in Ireland and Spain, and above 2 per cent elsewhere (middle panel). For the tax wedge the following picture emerges (upper panel). It is clearly negative (i.e. the tax system subsidises housing) in the Netherlands, Portugal, Luxembourg, Ireland, Spain, Finland, Austria and Italy but it is (virtually) zero in Germany, Belgium and France. In Greece housing is heavily taxed (which serves to offset loopholes and tax evasion in other parts of the system).

A simulation of a 2 per cent points increase in inflation from their actual 1999 levels (Figure A3, lower panel), shows that the real financing cost of housing becomes negative in three countries: the Netherlands, Ireland and Spain.

The theoretical model suggests that price variability of owner-occupied homes would be largest in countries where the tax breaks for owner-occupied housing are largest. Regressing the marginal effective tax wedges on owner-occupied housing in euro area countries on the variability of house prices (gauged by the standard deviation of the house price index, 1995 = 100, since 1970) confirms this (Figure A4). More than half of the variation in the standard deviation across euro area countries is explained by the tax wedge on housing. The most striking example is the Netherlands, which combines the largest tax breaks with the second largest price variability. There is a middle range containing Ireland, Spain and Finland, and the least prone to price variability with the smallest tax breaks are Austria, Italy, Portugal, Belgium, France and Germany.

Annex V

Indicators of market power

The degree of competitive pressure in an industry or a market is reflected by the degree of market power. At the aggregate level, it can be gauged by international price comparisons. By comparing price levels across countries, commodities and services can be identified where prices are exceptionally high, pointing to weak competition in domestic markets. Figure 34 (Chapter IV) shows that while aggregate price levels vary across the euro area, they are in most cases close to that of the United States, but much lower than in Japan. Some countries diverge strongly, especially Denmark and Sweden with high price levels. Portugal, Greece and Spain diverge on the low side. Adjusting for differences in GDP per capita, i.e. the vertical distance in Figure 34, the euro area is close to the regression line, while the United States is considerably below and Japan above the line.

Furthermore, market power can be gauged by the mark-up of prices over cost. As noted in Chapter IV, Sauner-Leroy (2003) suggests that up to 1993 and before the introduction of the single market, mark-ups in manufacturing fell as price effects dominated. Later, though, mark-ups increased again as falling unit costs started dominating price developments. Notably, the growth in mark-ups in Finland seems to be clearly stronger than in the other euro area countries.

The distribution of gains from market power does not necessarily show up as high mark-ups, but can also dissipate in higher wages. Jean and Nicoletti (2002) find that product market conditions appear to be important determinants for wage *premia* (Table A10). Among the euro area countries for which data is available, wage *premia* are estimated to be comparatively high in Greece, mainly due to relatively high *premia* in fragmented low-R&D industries (*e.g.* food, textiles, apparel and leather). Segmented low-R&D industries (*e.g.* tobacco, coke and petroleum products) provide their workers with relatively high wage *premia* in Austria, Greece and Spain. Outside manufacturing, wage *premia* tend to be notably higher than the international norm in air transport in Italy and in the energy sector (electricity and gas) in Spain. Overall, they find that labour market rents in the form of wage *premia* are relatively higher where regulations restrict competition most and that product market competition tends to curb wage differentials.

Market power may also be detected in indicators of market structure. Thus, concentration indicators and indicators of openness to trade can be helpful in identifying areas where product market competition is weak. Table A11 shows concentration for separate industries, based on fragmentation and R&D effort, and finds relatively high concentration in all clusters in Finland.1

¹ Fragmented market structures are characterised by small firms and low sunk costs and entry barriers. In these industries the number of firms typically grows in line with the size of the market. Segmented market structures on the other hand are characterised by large average firm sizes and significant entry barriers associated with high sunk costs (Oliveira Martins *et al.*, 2002).

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Table A10. Estimated industry wage premia¹

	EURO ²	USA	EURO ²	USA	
MANUFACTURING -					- NON-MANUFACTURING
Fragmented low R&D					Utilities and transport
Textiles	-0.12	-0.09	0.16	0.28	Electricity and gas
Wearing apparel	-0.19	-0.21	0.09	0.13	Water
Leather	-0.21	-0.15	0.00	0.03	Land transport
Wood	-0.07	-0.08	0.16	0.05	Water transport
Pulp and paper	0.04	0.08	0.15	0.11	Air transport
Printing and publishing	0.07	-0.03	-0.05	0.01	Auxiliary transport activities
Non-metallic mineral products	0.01	-0.01	0.07	0.14	Post and communications
Fabricated metal	-0.04	-0.02			
Segmented low R&D					Other
Food and beverages	0.00	-0.07	-0.02	0.13	Construction
Tobacco	0.17	0.26	-0.08	-0.13	Sale, repair of motor
					vehicles
Coke, petroleum products	0.32	0.19	0.01	-0.07	Wholesale trade
Rubber and plastics products	-0.02	-0.02	-0.12	-0.18	Retail trade
Basic metals	0.07	0.10	-0.18	-0.24	Hotels and restaurants
Fragmented high R&D					
Machinery and equipment	0.01	0.08			
Instruments, watches, clocks	-0.01	0.11			
Segmented high R&D					
Chemicals	0.12	0.10			
Office machinery	0.07	0.09			
Electrical machinery	0.02	0.06			
Radio, television	0.06	0.14			
Motor vehicles	-0.01	0.20			
Other transport equipment	0.08	0.21			

Results of first-step regressions. In logarithm, compared to the economy-wide, employment weighted, average
wage. The data concern the period 1994 for France, 1995 for other euro area countries, and 1998 for the United States;
ISIC Rev. 3 classification. The parameters in **bold** are significant at the 10 per cent level. Parameter estimates of an
industry dummy variable in a wage equation where other regressors include employee and employer characteristics.

It is also comparatively high in the fragmented low-R&D industries in Belgium and in both fragmented and segmented high-R&D industries in Sweden. The comparatively higher concentration levels in these cases may signal problems with competition. In non-manufacturing, concentration levels are also very high in the utilities sectors. Of particular note are the concentration levels in Italy in electricity and gas, post and telecommunications that are systematically and substantially higher than in other countries.

The market presence of foreign firms or openness to international trade may also affect the degree of competitive pressure. However, what matter most for market forces may be not only be actual competition in the market but also potential market entry. Penetration rates may also reflect industry-specific characteristics unfavourable to international trade, *e.g.* high transport costs for goods with a low value per ton or the presence of highly competitive domestic firms.

^{2.} Simple average of data available for Austria, Belgium, France, Greece, Ireland, Italy and Spain.

Source: Jean, S. and G. Nicoletti (2002) and OECD (2002k).

Table A11. Hirschman-Herfindahl indices of industry concentration¹
In selected industries

	AUT	BEL	FIN	ITA	EUDO?	SWE	GBR ³	JPN	USA ⁴
	1997	1997	1997	1996	EURO ²	1999	2000	1999	1997
MANUFACTURING -									
Fragmented, low R&D									
Food products	26	31	150	31	59	131	27	2	3
Textiles	88	54	443	7	148	125	19	3	7
Wearing apparel	131	493	341	14	245	244	29	4	9
Leather products	553	2 566	263	22	851	360	134	46	65
Wood products	58	87	167	4	79	76	16	5	4
Paper and pulp products	160	185	352	75	193	218	79	23	14
Publishing and printing	49	40	99	43	58	39	14	18	3
Segmented, low R&D									
Beverages	226	595	2 064	69	738	1 428		40	192
Rubber products	790	745	775	291	650	515		75	
Glass products	440	430	1 154	153	544	675		105	
Basic metals	170	299	739	94	326	352	112	46	29
Non-ferrous metals		1 059	2 372	280	1 237	517		65	
Shipbuilding and repairs	1 707	242	1 422	646	1 004	249		178	
Fragmented, high R&D									
Machinery and equipment	43	96	98	12	62	70	17	8	8
Medical appliances		76	269	31	125	321	43	48	
Other manufacturing	86		178	14	93	233		34	11
Segmented, high R&D									
Coke and petroleum									
products		1 083		1 127	1 105	917		220	76
Chemicals products	207	75	284	44	153	375	44	15	14
Drugs and medicines	490	551	2 175	137	839	2 042		51	
Office and computing									
machinery	792	387		2 208	1 129	367	285	84	18
Electrical machinery	92	209	323	26	163	129	31	22	14
Motor vehicles	476	363	429	238	377	446	90	49	24
Other transport equipment	553	903	753	297	627	663	117	109	
NON-MANUFACTURING									
Electricity and gas	181	889	154	976	550	156			
Post and									
telecommunications	230	608	559	1 957	839	653	106		

^{1.} European countries are based on enterprise data; Japan and the United States are based on establishment data.

Source: OECD (2002k).

The aggregate import penetration rate varies considerably across euro area countries, from a high of above 40 per cent of total demand in Belgium and Ireland. The average level in manufacturing is at 29 per cent when intra area trade is included, but for the area as a whole the ratio is considerably lower at 17 per cent (Table A12). While the extra-border trade measure is somewhat

^{2.} Simple average of data appearing in the table.

^{3.} Food products include beverages; leather products include footwear; medical appliances include optical instruments, watches and clocks.

^{4.} Beverages include tobacco and motor vehicles include other transport equipment.

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Table A12. **Import penetration**Imports as a percentage of the sum of production and imports, latest year of data available ¹

		Eu	ro area ²		
	ISIC Rev.3 code	Total	Excluding intra- zone imports	United States	Japan
Total manufacturing	15-37	29.4	17.1	20.0	9.2
Segmented, high R&D		37.6	22.7	28.0	9.4
Chemicals and chemical products Office, accounting and	24	35.7	18.5	17.0	9.4
computing machinery	30	73.5	65.6	47.2	21.1
Electrical machinery and apparatus, nec ³ Radio, television	31	28.6	18.4	35.2	9.2
and communication equipment	32	47.8	38.7	31.0	10.9
Motor vehicles, trailers and semi-trailers	34	31.1	12.5	31.9	2.8
Fragmented, high R&D Medical, precision and		30.4	19.2	23.2	8.8
optical instruments Machinery and	33	42.0	32.2	17.8	29.9
equipment, nec ³ Furniture; manufacturing,	29	28.4	15.7	20.6	5.2
nec ³	36	27.7	19.5	34.7	8.4
Segmented, low R&D Coke, refined petroleum products and nuclear		23.5	11.6	11.0	8.8
fuel	23	21.8	12.4	17.2	11.4
Basic metals	27	36.3	21.4	19.7	6.6
Rubber and plastic products Food products,	25	24.5	11.0	10.9	2.8
beverages and tobacco	15-16	17.6	7.2	5.9	10.4
Fragmented, low R&D Textiles	17	20.9 31.6	11.8 19.1	15.1 24.6	9.8 29.3
Wearing apparel, dressing and dying of fur Leather, leather products	18	38.8	31.6	50.7	26.3
and footwear	19	36.9	26.0	73.2	50.7
Wood and products of wood and cork	20	19.0	11.6	12.3	23.6
Pulp, paper and paper products	21	28.0	13.5	9.6	4.7
Printing and publishing	22	8.4	3.2	2.4	1.6
Other non-metallic mineral products Fabricated metal products	26	13.5	5.4	12.7	4.0
except machinery and equipment	28	13.5	6.2	8.4	3.1

^{1. 2000} for the euro area and Japan, 2001 for the United States.

Source: OECD, STAN and ITS databases, April 2003; and OECD calculations.

^{2.} Calculated using 1999 data for Portugal, and excluding Ireland and Luxembourg.

^{3.} Nec: not elsewhere classified.

below the comparable ratio of 20 per cent in the United States, it is clearly above the 9 per cent observed in Japan. At the industry level, import penetration would appear to be lower in the low-R&D sectors, whether segmented or not. However, measured against the United States the segmented low-R&D sectors are roughly at the same level, and only a few sectors (wearing apparel, and leather, leather products and footwear) have lower import penetration. Based on more detailed numbers, import penetration would appear to be low in fragmented sectors in Finland and Italy, in low-R&D fragmented sectors in Spain, and in high-R&D fragmented sectors in Germany. Import penetration rates are also comparatively low in segmented low-R&D industries in Spain, and in segmented high-R&D industries in Germany and Italy.

Pulling results together

The indicators presented in this section suggest some areas of potential weakness with product market competition in euro area countries that may undermine their macroeconomic performance. On the basis of the economy-wide indicators on relative price levels and adjusted import penetration, Finland would appear to show signs of weak competition. This assessment is supported by the sectoral-based indicators benchmarked on international averages, where Finland also appears to have weak competition in all sectors except in segmented low-R&D industries. The sectoral indicators also point to potential weaknesses with competition in R&D intensive industries in Germany. Moreover, there are some indications of weak market forces in fragmented low-R&D industr0ies in Italy and in segmented low-R&D industries in Spain. Moreover, concentration is high in most utility industries.

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