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REPORT FROM THE COMMISSION

ECONOMIC AND STRUCTURAL REFORM IN THE EU

(CARDIFF II)

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REPORT ON ECONOMIC AND STRUCTURAL REFORM IN THE EU

Executive Summary

At the Cardiff European Council in June 1998, Europe's leaders underlined the important contribution of structural and economic reform in the fight against unemployment. In this report, the European Commission presents a broad-ranging analysis of recent progress in this area and priorities for the future. This so-called "Cardiff II" report follows an earlier document on the functioning of product and capital markets published on 20 January 1999 ("Cardiff I") and also draws on Member States progress reports and national action plans on employment. The aim is to contribute to the preparation of the broad economic policy guidelines which will be agreed at the European Council in June and to feed into discussions on the new Employment Pact proposed by the German Presidency.

The central message of the report is that structural reform is essential to foster employment and growth in Europe. Many reforms have already been undertaken in all Member States but their implementation across fields and countries varies considerably. This diversity reflects the different economic and political situations in Member State, but it also points to the need for intensified cooperation of economic policies at European level.

The other main message is the importance of taking due account of the interaction between the various aspects of structural reform and macroeconomic policies. In particular, Member States should make every effort to achieve :

- Coherence between reforms of different markets. Goods markets are generally well integrated, but lack of capital market integration hinders the creation of new enterprises and jobs due to constraints on risk capital, especially for SMEs. Further improvement in the integration of goods markets also needs to be accompanied by better functioning labour markets providing adequate skills and incentives to take up new job opportunities.

- Coherence between reforms of product markets. Integration of goods markets needs to go hand-in-hand with further liberalisation of service sectors. Further integration of product markets should not be accompanied by increases in state aids which reduce competition in such markets.

- Coherence between reform of labour markets and public finances. Increased efforts to prevent long-term unemployment through early use of active labour market policies must be accompanied by reductions in the incentives to remain in benefit schemes. Reforms should also make sure that the unemployed are not simply transferred from assistance to other benefits schemes.

By improving the functioning of markets, structural reforms permit a more accommodating macroeconomic policy thanks to reduced inflationary pressures. Improved and sustainable public finances also improve the capacity of budgetary policy to stabilise economic activity across the business cycle. At the same time, however, tax reform (especially much-needed reductions in the taxation of labour) must be mindful of further necessary budget consolidation.

Economic and structural reform contributes to job creation

Structural reform increases the EU's job-creating potential and is therefore fundamental to the task of reducing the high levels of structural unemployment. It will achieve this by enhancing the EU's competitiveness and sustainable long-run economic growth rate, as well as its ability to deal with globalisation and technological change.

Structural reform, in conjunction with a sound macro-economic policy, is also essential to the success of Economic and Monetary Union; by improving the operation of markets, macroeconomic policy will not be left to bear the burden of market adjustment in the face of shocks alone. Indeed, by removing supply-side bottlenecks, structural reform will allow the EU to run a more accommodating macroeconomic policy.

Awareness of these virtues has led to widespread implementation of reforms throughout the EU. Thanks to the Single Market Programme, today's European product markets work much better than they did in the 1970s. Establishing the euro will improve the operation of capital and financial markets. Labour markets and welfare systems are being reformed. Nonetheless, individual Member States' progress in developing these reforms is very variable. As a result, employment and innovation in some sectors, especially services, is disappointing.

This Report details many structural reforms already undertaken. It finds that implementation of reforms remains uneven across fields and across Member States. In general, progress is relatively satisfactory in goods and capital markets, but less so for services and labour markets. In addition, countries which have made most progress in product markets also seem to have advanced most in capital and labour markets. Nonetheless, labour productivity, employment and GDP per capita are all significantly higher in the US than in the EU, indicating that structural deficiencies continue to be important across the Union.

The Single Market has improved the functioning of product markets, although problems remain in public procurement, standards, and state aids.

Thanks to the Single Market Programme, EU product markets are relatively integrated and function quite well. Nevertheless, remaining price differences between Member States, and between the EU and the US, suggest that room remains for improvement, especially in service sectors and public procurement markets. Some goods sectors also seem relatively segmented - particularly pharmaceuticals, chemicals, food and motor vehicles. Factors accounting for the persistence of price dispersion include taxation, regulatory barriers and inefficiencies in distribution and network industries.

Introducing the euro will sharpen price transparency and competition, which will squeeze price dispersion in EU markets. This process will be further strenghened by progress with the Single Market Programme (SMP) and strict application of competition policy rules by the EU and at the level of Member States. As highlighted by the Commission's recent report on the operation of EU goods, services and capital markets ("Cardiff I" – see below), some Member States have relatively poor record in transposition of single market measures and this must be rectified; beyond that, market developments must be monitored in order to identify problem areas and ensure effective enforcement of Single Market rules. Already, two problem areas stand out: the opening-up of public procurement, and differing Member State technical standards. Concerning competition policy, increased competitive pressure following introduction of the euro and deepening of the Single Market may stimulate demands for State aids. These must be resisted by stricter control of State aids, otherwise the positive effects of market liberalisation may be offset by market distortions created by government support for selected sectors. The Commission will maintain a strict application of Community state aid rules but the Member States should make a concerted effort to reduce the level of aids, especially ad hoc and sectoral aids.

Regulatory reforms to lower prices for consumers and burdens for business

The EU's product and capital markets operate within regulatory frameworks. Regulatory reform to optimise these frameworks is another cornerstone of efforts to improve the functioning of product and capital markets. Regulatory reform consists of improving the quality of regulations, and may or may not involve deregulation. Between EU countries and between sectors, the progress of regulatory reform varies widely. Done properly, however, experiences in Member States and other OECD countries show that it can significantly improve the functioning of targeted sectors. Member State records vary considerably, but broadly speaking, liberalisation is most advanced in telecommunications (causing prices to fall), road haulage and non-reserved postal services. Some progress has also been achieved in energy sectors, the regulation of retail distribution (land use and opening hours) and regulations relating to business start-ups (which mainly affect SMEs). Liberalisation in railways and water, on the other hand, is virtually non-existent. One lesson from the experience of liberalisation is that the public will accept it more if its positive impact on price and quality is quickly experienced by consumers and industrial users. Establishing effective, independent regulatory bodies is essential for this to happen.

The SMP and the introduction of the euro will accelerate the emergence of an integrated European financial market. However, differences in national regulations and tax regimes prevent deeper capital markets and constrain expansion of risk capital for SMEs and R&D

Integrating capital markets properly depends on free and substantive cross-border provision of financial services and cross-border movement of capital. The Cardiff I Report finds that there has been good progress in both areas but, nevertheless, differences in national regulatory environments and fiscal regimes continue to fragment EU capital markets. By offering the prospect of a large, single capital market, introduction of the euro creates a strong incentive to remove these remaining barriers. To which end the Commission and the Member States have created a High Level Group on Financial Services which will submit a report to the June 1999 Ecofin Council identifying the political priorities for developing more liquid and efficient EU capital markets. Deeper and better functioning risk capital markets would facilitate SME expansion and promote R&D and innovation.

Reforms of labour markets are under way. But inadequate investment in human capital and incentives to create and take up jobs still hamper job creation

Low employment rates and high and persistent levels of structural unemployment suggest that, in addition to the remaining problems in product and capital markets highlighted above, labour markets function relatively poorly in the EU. However, closer examination suggest that the problem differs a great deal between Member States, between regions within Member States, and between categories of labour. These differences also suggest a number of lessons: (1) differences between Member States indicate that countries which have undertaken comprehensive structural reforms, rather than scattered measures, have been able to improve their employment performance; (2) differences in regional unemployment in several countries highlight the need to account for regional productivity differences in collective bargaining; and (3) the particularly high incidence of unemployment among certain categories of labour (low-skilled, females, youngsters) reflects the high cost of specific labour categories (in particular unskilled workers), the inadequacy of skills, recruitment patterns and *de facto* discrimination.

To tackle these problems, the Employment Guidelines foresee structural reforms in four areas: employability, entrepreneurship, adaptability and equal opportunities. Efforts by Member States to implement the whole of set of Guidelines are monitored and analysed in the annual Joint Employment Report. The Vienna European Council called on Member States to define policies and specify deadlines and quantified targets in their National Action Plans for employment. The present Report concentrates on reforms of tax/benefit systems and regulation.

Member States have not just started the process of structural labour market reforms. Most are making great efforts to switch employment policies towards a more preventive approach involving early use of active labour market policies as requested by the Employment Guidelines. Many Member States have also introduced targeted measures designed to increase the demand for unskilled labour, often in the context of reforms of tax and benefit systems aimed at reducing labour costs. Several tax and benefit reforms designed to provide incentives for unemployed or inactive persons to seek and take up work or training opportunities have also been implemented. What seems to be lacking, however, is coherence between the different measures. This confirms the need, as foreseen in the 1999 Employment Guidelines, to review and adapt the tax and benefit systems to ensure that they actively support employability and job creation. These reforms, should be viewed, as recommended in the Broad Economic Policy Guidelines, in relation to labour market regulations.

An intense budgetary consolidation effort has taken place with the Maastricht objectives. However, pressure on welfare spending, high tax levels and inadequate tax co-ordination jeopardise the sustainability of government finances and the efficiency of the Single Market

Effort is still required to ensure the sustainability of on-going budgetary consolidation and stability of the euro. Tax systems in the EU face three challenges. First, taxation levels tend to be high compared with the US or Japan, although there are important differences across Member States. High tax burdens are associated with a high provision of public services and generous redistribution mechanisms, which are generally desirable, but they also tend to reduce economic incentive and efficiency.

Second, the structure of EU tax systems tends to impose a particularly heavy burden on labour, but again there are significant differences between Member States. Third, the efficiency of tax systems requires a higher degree of co-ordination between national tax systems to better ensure the smooth functioning of the Single Market. In addition, it reinforces the burden of taxation on labour, since capital is more easily able to move towards EU countries with low tax rates.

As a result of the budgetary consolidation associated with the Maastricht objectives, the tax burden has stopped increasing in nearly all Member States and currently stands well below historical peak levels in half of the cases. At the same time, a number of Member States have implemented important tax reforms designed to simplify the system, broaden the tax base and reduce the taxation on labour. Scope for further reform, in particular in favour of labour, remains ample. But reform is also politically intricate since it involves either lowering both taxation and government expenditure so as to maintain budgetary discipline and price stability, or shifting some of the tax burden to other tax bases. Finally, as noted by the Cardiff I Report, the higher economic integration associated with EMU implies greater interaction between national tax systems. In this context, while recognising that tax competition between countries can be healthy, Member States should strive to co-ordinate their tax systems so as to eliminate harmful competition which could endanger the functioning of the internal market and the provision of desirable public services. They should also adopt legislation designed to achieve an origin-based VAT system, to remove all remaining obstacles to cross-border integration of product markets and to allow a real single market for financial services.

Reforms of public finances concern not only public revenues, but also public expenditures. Here the main challenge relates to the welfare state, which bears heavy pressures as a result of fundamental demographic changes. Most Member States have already undertaken reforms to improve the incentive structure of their pension systems and their health care systems, but further action is required in order to manage future demographic pressures. Whilst public expenditure needs to be better controlled in most countries, it is paramount to preserve public investment, both in human capital and infrastructure.

A Introduction

Structural reforms have an important role to play in fostering economic growth and employment, since they help ensure sustainable long-run growth, reinforce competitiveness and increase the job-content of growth. This growing awareness has led to the implementation of reforms throughout the EU. Indeed, the 1970s' image of Europe hampered by widespread structural rigidities does no longer correspond to reality. Low employment rates and persistent high unemployment, together with higher price levels in the EU than in the US, point, however, to the need for continued reform efforts. So does the fact that reform efforts have been uneven across fields and Member States.

Globalisation and technological developments bring structural changes, which can be more or less painful depending on the economies capacity to create new business opportunities and on people's ability and readiness to shift jobs. Adequate regulations and institutions, including a well-functioning welfare state, are required to smooth the adjustment. Structural reforms also contribute to a balanced policy mix between macroeconomic and microeconomic policies in EMU, by reducing the burden on macroeconomic policies in the event of shocks and by enhancing their effectiveness in sustaining growth and stabilising the cycle.

To reap the full benefits of structural reforms a comprehensive and coherent approach, that addresses the interests of consumers and producers, is necessary to take account of the interlinkage between the different markets and areas. Thus reforms in the goods and capital markets have to be accompanied by more reform efforts in service and labour markets to produce welfare and jobs. Within the different markets reform efforts have to be coherent. State aids should not replace technical barriers in goods markets. Neither should early retirement benefits or other passive measures replace unemployment benefits for the unemployed.

Co-ordination at the EU and EMU level will enhance the success of reform efforts. The Cardiff European Council, asked for closer monitoring on and co-ordination of economic reform. This report identifies structural problems and reviews different policy solutions, taking into account existing policy recommendations in the structural areas. It brings together and builds on a number of EU initiatives in the area of structural reforms. Namely: the process of monitoring of the functioning of the Single Market; the EU employment strategy and the surveillance of product and capital market reforms, also established in Cardiff (Cardiff I and national reports). It deals with areas where there are clear Community competencies, areas where competencies are shared between the union and the Member States and, finally, areas where the responsibility lies at the national level. The report should form a basis for Ministers' discussion of the structural reforms deemed appropriate/necessary to foster growth and employment and to ensure a smooth functioning of the EMU.

B MAIN AREAS OF STRUCTURAL POLICIES

1. IMPROVING THE FUNCTIONING OF PRODUCT (GOODS AND SERVICES) MARKETS

1.1 Evidence on the functioning of product markets

Well-functioning markets are an essential ingredient of a dynamic economy. Progress made towards market integration and the degree of market efficiency, i.e. whether markets respond rapidly and adequately to price impulses, are assessed below by tracking various indicators. As these indicators may be ambiguous and difficult to interpret[1], they are used here in combination.

- As the Cardiff I Report shows, market integration has developed over the period 1993-97: intra-EU trade has continued to grow with Member States increasingly trading in similar products (e.g. cars for cars, rather than cars for coal), possible evidence that their industrial structures are becoming more similar. If so, and helped by the diffusion of information technology, the Member States are likely to become less susceptible to asymmetric economic shocks and their business cycles more synchronised. Furthermore, the process of industrial restructuring is increasingly taking place at the European level, reflected by growing foreign direct investment flows and cross-border merger activity. On the other hand, declines in price dispersion recorded between 1985 and 1993 came to a halt in the more recent period.

- Some Member States are more closely integrated with the rest of the EU than others, in particular, Belgium-Luxembourg, Ireland, the Netherlands and the United Kingdom (see graphs 1.1 and 1.2, plus tables 1.1 and 1.2). Greece, Italy and Austria seem less well integrated. However, this might be due to factors unrelated to markets such as geographical location (Greece), date of accession (Austria) or strikingly different regional industrial structures (Italy).

- Despite increased intra-EU integration, the indicators appear to show that EU product markets are somewhat less efficient than those in the United States. In 1996, the EU's extra-EU trade to GDP ratio, an indicator of its exposure to external competition, was 16% compared to 18.8% for the US, and EU consumer price levels were an average 24% higher than in the US (see annex A). However, many factors may explain the higher price levels in the EU as compared to the US. Differences in indirect tax levels may account for some of this, as consumption taxes drive a 20% wedge between prices paid by consumers and prices received by producers, compared to less than 7% in the US[2]. Other explanations are the EU's generally higher price cost margins (see annex B) and its less efficient and competitive wholesale and retail distribution network.

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[1] For example, firms may engage in M&A activity either to exploit the opportunities of growing market integration or else to try to maintain segmented domestic markets. The data cannot distinguish between the two. Similarly, using price-cost margins as an indicator of market integration is undermined by the fact that market integration and increasing market efficiency should impact on both prices and costs.

[2] The consumption tax wedge is calculated as the ratio of consumption tax revenues to the value of consumption net of taxes. Since implicit consumption tax rates (see table 3.3) are calculated on the basis of the value of consumption including taxes, consumption tax wedges are higher than implicit tax rates.

Exchange rate developments may also affect relative price levels expressed in a common currency.

- Average price levels differ significantly between EU Member States. Price levels are particularly generally high in Denmark, Sweden and Germany and lower in Portugal, Greece and Spain. To some extent, this reflects differences in GDP per capita and indirect tax rates (see table 1.3). Nevertheless, analysis allows identification of countries whose pre-tax price levels are particularly striking even given their standards of living. Early evidence suggests that prices are above expectations in Finland and Sweden and below in Italy and United Kingdom. Various explanations may account for this. The UK's record[3], for example, may partly be due to its openness to international trade or to low price-cost margins. Other countries with relatively low price-cost margins include Belgium and following recent declines, Germany. Sweden's price-cost margins are low as well despite its high price levels. Countries with relatively high price-cost margins are Denmark, France and Italy.

- There are also significant sectoral differences in market efficiency. The most and least efficient sectors are not necessarily the same in all Member States. Analysis of productivity developments in manufacturing sectors (see table 1.4) shows that the EU compares badly to the US in pharmaceuticals, chemicals, food, beverages and tobacco and to a lesser extent in transport equipment, precision instruments, electrical engineering and motor vehicles. In some of these sectors, EU markets are highly segmented due to business strategies, regulation or structural factors such as differences in taste or high transport costs. This market segmentation is often reflected in a high degree of price dispersion between EU Member States (pharmaceuticals, chemicals, beverages, and motor vehicles). Interestingly, taxation rates and price-cost margins in some of these sectors (pharmaceuticals, beverages) are relatively high as well.

- Differences in price levels for manufacturing products between countries also reflect the prices of services used in both the manufacturing and distribution of those products. The relative performance of different services sectors in the various EU Member States has been assessed by comparing their prices or charges. This shows significant differences between the EU Member States. Interesting sectors are wholesale and retail trade (with high prices relative to other services sectors in Denmark, Austria, Sweden and the UK), as well as public administration (with high charges in Belgium, Greece and Luxembourg). The cost of transport and communication is high in Ireland, whilst Germany and the Netherlands have high prices in real estate.

Summing up, three conclusions can be drawn, in line with the Cardiff I Report:

1. Product markets within the EU are relatively well integrated, but some problem areas remain. High levels of price dispersion for some goods and services that mainly supply the public sector suggest that public procurement markets remain relatively poorly integrated. The weaker integration of service markets (by comparison with goods

[3] However, having low prices for a given standard of living does not necessarily imply that the long-term economic prospects are good in all respects. For example, as indicated in the UK report, the UK has a high productivity gap relative to its European partners. In 1995, labour productivity in the UK business sector ranked only 13th amongst 15 Member States. Further analysis is necessary to explain the UK productivity performance. Nevertheless, this is a matter of concern, as highlighted in the UK report on product, services and capital markets.

markets), as highlighted in the Cardiff I Report, is confirmed by the observation that price dispersion in services is double that of goods. Other indications that room for improvement remains in the functioning of EU markets are the large price differences between Member States on the one hand, and between the EU and the US on the other hand.

2. Significant price dispersion within the EU may be attributed to one or more of the following factors – structural (Member States' differences in living standards and tastes, transport costs, etc.), regulatory (consumption and other taxes, non-tariff barriers) and firm strategies (concentration, differentiated products, advertising, etc.). Introduction of the euro, especially by enhancing price transparency, in combination with competition policy should put pressure on firms seeking to segment markets. That leaves regulation and taxation as areas needing further co-ordination efforts .

3. Measures to improve the functioning of EU markets would be the most efficient if targeted first at the less well-integrated countries and at major sectors with segmented markets (as reflected by significant EU-wide price dispersion, high price-cost margins and poor productivity performance relative to the US) - e.g., pharmaceuticals, chemicals, precision instruments, food, and motor vehicles. Similarly, many sectors (telecommunications, transport, energy and distribution) have remained sheltered from international competition until recently and are only now starting to enjoy the benefits of liberalisation.

1.2 Policies aiming at improving the functioning of product markets

The Single Market

The Single Market Action Plan has made a significant contribution to improving the performance of the Single Market since its adoption in June 1997. By the end of December 1998, the fragmentation factor - i.e., the number of directives not yet implemented in one or more Member States - was only 14%, down from 35% in June 1997. Nonetheless, the backlog was not eliminated by 1 January 1999, when the Action Plan came to an end. Non-transposition of directives is worst in telecommunications, public procurement, transport, and intellectual and industrial property. Amongst the Member States, Finland, Denmark and Sweden have the best transposition records, Italy, Portugal and Luxembourg the worst. Some Member States – Austria, Germany and Sweden – have substantially improved their records between November 1997 and December 1998.

As the Cardiff I Report says, all Member States, especially those with a poor transposition record or where progress has been slow (Italy, Portugal, Luxembourg and Ireland) must take measures to rectify the situation. The Cardiff I Report also stresses the need to monitor market developments in order to identify remaining problem areas and ensure effective enforcement of Single Market rules.

Two problem areas stand out: lack of opening-up of public procurement and differences in technical standards between Member States (technical trade barriers continue to hinder an estimated 63% of intra-EU trade). Public purchasing is economically important – equal to an estimated 11 to 12% of EU GDP in 1997 – and often characterised by weak supplier competition. Poor record in transposition of the directives but also local preference and a reluctance to change suppliers explain this situation. For some Member States, improving access to public procurement contracts is a priority. France, for example, intends to accelerate reform in 1999 specifically to improve transparency and openness in public procurement, especially for SMEs. Much more use of electronic commerce is a key plank of their strategy, an approach shared by the UK whose government is committed to purchasing 90% of central government goods electronically by March 2001. However, as indicated in the Cardiff I Report and in a majority of the national progress reports, the efforts to promote greater competition in this field have not yet produced sufficient tangible benefits. Therefore, this is an area to which the Commission will attach special attention in the future reports.

Correct and uniform enforcement of the legislation is also needed, but this is not always happening - the number of infringement proceedings opened by the Commission against Member States for alleged failure to apply Single Market rules continues to grow. Generally, such enforcement problems concern the large Member States. However, amongst the large Member States, the French record is particularly bad, whilst the UK record is particularly good. Amongst the small Member States, Greece and Belgium have the worst records. Beyond legislation, other problems continue to fragment Member State markets including complicated national and local regulations, state aids, difficulties with VAT systems, and deliberate market-segmenting business strategies, especially in the distribution sector, designed to make cross-border market access difficult.

Competition policy

The Single Market has had a strong pro-competitive effect, which will be reinforced by EMU and ongoing technological progress such as electronic commerce. However, a risk exists that companies whose market power is threatened by such developments will attempt to maintain their position through anti-competitive behaviour. Furthermore, increased competitive pressure resulting from monetary union may lead to new demands for state aid to support firms and sectors. Competition policy (including the control of state aid) therefore has an important role to play in safeguarding or enhancing the flexibility of product and service markets.

A number of Member States have recently adopted new competition legislation bringing national law more closely into line with that of the Community (Denmark and the Netherlands in 1997, Germany, Finland and the UK in 1998). In eight Member States[4], the national competition authorities now have powers to enforce Articles 85-86 of the EC Treaty, dealing with agreements between enterprises and abuse of dominant positions. From 2000, the UK competition authority will also have such powers. This arrangement helps streamline enforcement of these articles, as responsibility otherwise falls on national courts or the Commission. Competition law enforcement has also been tightened up in Spain and Sweden, whilst the Austrian government has announced its intention of introducing legislation to create an independent Cartel Office and align Austrian competition law more closely with that of the Community.

Even if the amount of approved State aids has slightly declined since 1990, they remain one of the major sources of distortions within the Single Market. Over the period 1994-1996, total non-agricultural aids represented 1.4% of the Community's GDP (84 billion ECU per year), compared to 1.7% in the period of the previous survey (1992-1994). However, aid levels are still high in Italy (2.1% of GDP) and Germany (1.9%). On the other hand,

[4] Belgium, Germany, Greece, Spain, France, Italy, the Netherlands and Portugal.

Finland, the U.K., Austria and the Netherlands have very low levels of aid (between 0.4% and 0.7% of GDP). Although the trend in state aid shows an encouraging overall decline, aid to the coal industry and rescue and restructuring aid are two areas of particular concern and regional aid needs closer scrutiny.

In particular, the Commission has noted a worrying increase in the amount of aid granted to rescue and restructure firms in difficulty. Excluding aid granted in the context of special measures for the new German Länder[5], the share of such aid in the total increased from 6% in 1992 to 16% in 1996. France, Italy and Spain accounted for more than 80% of this rescue and restructuring aid. As noted in France's report on economic reform, preference should be given to generic measures to improve the ability of firms to adapt and innovate.

The Commission will maintain a strict application of Community state aid rules, but the Member States themselves have to institute more sustained discipline. The exercise of stricter self-discipline might be facilitated by a concerted effort of all Member States to reduce the overall level of aids. As the Cardiff I Report recommends, Member States should set precise objectives and establish a timetable for the reduction of state aids. They should also modify the structure of state aids to redirect them away from ad hoc and sectoral aids towards aids designed to correct market distortions (such as aid in favour of SMEs, R&D).

Market liberalisation and regulatory reforms

Market liberalisation generally accompanies regulatory reforms. An improvement in the regulatory environment does not necessarily mean deregulation and it may also entail re-regulation provided that the new rules are better adapted to the new economic environment. Efforts to simplify and avoid unnecessary regulatory burdens on business have been pursued at the Community level, notably through the SLIM initiative. The Cardiff I Report suggests applying the same methodology to national regulations.

The issue of regulation is particularly important for the network industries (telecommunications, postal services, air-, rail- and urban transport, electricity, gas and water), retail distribution, road freight transport and financial services (this last is discussed in Chapter 2).

Network industries make up 5% of EU GDP and employment, but their economic importance is still greater because the price and quality of their outputs is essential for the growth and competitiveness of European industries, for the operation of the Internal Market and for the European consumers' living standards . This is reflected by the importance attached to this issue in the national country reports and in the Cardiff I Report. The regulatory regime of some of these sectors can also affect the functioning of TENs which are vital for the integration of European product markets.

Due to many factors, including technical change and fiscal constraints, a gradual and differentiated liberalisation process is taking place at the EU level via a wide array of legislative measures designed to open up markets while permitting Member States to take appropriate steps to ensure the fulfilment of universal service obligations. However, the progress of liberalisation varies greatly between countries and sectors. In general,

[5] Aid granted by the Treuhandanstalt and successor organisations.

liberalisation has advanced furthest in the UK and the Nordic countries, where liberalisation in several sectors has preceded the enactment of relevant EU directives. According to the national reports, other countries have made significant progress over the recent period as well – e.g., Germany (in railways and postal services), the Netherlands (in railways), and Spain (in electricity). Within Member States there can also be wide variations between sectors. For example, Spain's new electricity law, adopted in 1997, goes well beyond the requirements of the EU Directive.

Liberalisation is most advanced in the telecommunications, road haulage and non-reserved postal services. In air transport progress has been made as well, but bilateral "open skies" agreements and the system of slot allocation pose important obstacles to competition. By contrast, liberalisation is only starting in the energy sectors and very much slower in the water and railway sectors. Evidence provided in the Commission's Fourth Report on Implementation of the Telecommunications Regulatory Package[6], as well as in the national reports shows a link between liberalisation and lower prices. For example, countries such as Germany, France, Finland, the Netherlands and the United Kingdom reported falls in telecom prices following liberalisation. In the electricity sector, price reductions occurred in Germany, Spain, Finland and the United Kingdom and in regional transport in Denmark and Sweden.

However, changes brought about by competition can sometimes imply short-term adjustment costs (job losses). These adjustment costs pose three major policy challenges:

1. Acceptance of the liberalisation process will be greater if its positive effects in terms of prices, choice, quality and universality of services are clearly identified. Therefore, as the Cardiff I Report says, the Member states should ensure that these benefits are transmitted to industrial users and consumers without delay. Effective and independent regulatory authorities are therefore essential. However, in many Member States the regulatory authorities have been set up only recently and have yet to develop adequate expertise. In some sectors (e.g. railways, electricity and gas) many Member States have not yet established regulatory authorities

2. In some cases, workable competition within the market is difficult or impossible to achieve, e.g. the management of infrastructure, which constitutes a natural monopoly. In such cases, it may nevertheless be possible to achieve efficiency gains by instituting competition <u>for</u> the market, i.e. by awarding contracts or licences for the provision of the services in question on the basis of a public tendering procedure. This approach has been followed with various degrees of success in the field of local and regional passenger transport in Denmark, Sweden and the UK.

3. Many services provided by the network industries have come to be regarded as essential public services which should be widely available at "affordable" prices and with assured quality. As the free operation of the market may not always meet these requirements, Member States may impose universal service obligations. The definition of these obligations, their financing and the selection of the enterprises charged with carrying them out should not create unnecessary distortions of the market or impede the process of integration.

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[6] COM(1998)594 of 25 November 1998.

Retail distribution in Europe is another sector subject to a number of types of regulation that could impede efficiency and contribute to higher price levels. Apart from labour market regulations, these include restrictions on land use and opening hours. The importance of these restrictions varies widely between Member States. In the Netherlands there are very few 'Hypermarkten', mainly due to land-use planning regulations. In most Member States, local authorities are the main decision-making bodies in the field of land-use planning, but some countries (Belgium, Germany, France, and Portugal) also impose restrictions at the national level. Special problems may arise when the authorities are subject to strong pressure from small traders to block the establishment of large shops. Opening hours are still subject to significant restrictions in Germany, Austria, Portugal and Finland, although in Germany and Austria, the restrictions have been relaxed over the last two years. Germany plans to review the situation in the middle of 1999. A wide-ranging liberalisation of the retail sector is being implemented in Italy.

Finally, in the road freight transport sector, Greece and Italy still apply price controls on domestic road freight transport.

SMEs and entrepreneurship

SMEs account for between 60 % (the Netherlands) and 80 % (Italy) of employment in the EU[7]. SMEs are also the major drivers of net job creation as entrepreneurs start up new enterprises and small enterprises grow. However, as less than half of SMEs survive beyond five years, they also account for a large part of gross job losses.

In recent years, governments have become increasingly aware of obstacles hindering SMEs from exploiting their full job creating potential. The main obstacles have been identified as lack of access to capital (see Chapter 2) and administrative burdens. The result is less job creation, and reduced competitive and innovative pressures on markets. The USA seems to set better conditions for job creation especially by SMEs. The average number of procedures, for example, to establish a company in Europe is 11, against 6 in the USA.

Many Member States are well aware of these difficulties and have undertaken programmes and measures to improve the conditions for SMEs, including simplification of legislation, especially relating to start-ups (Germany, France, Sweden, Denmark), small size thresholds for administrative burdens (Netherlands), consulting procedures (Denmark), etc. In addition, some Member States have lightened tax burdens on SMEs (France, Spain) and there are a number of schemes for providing guarantees or subsidised loans. At the Community level measures have been undertaken as well. The BEST report and the related Commission Action Plan[8] recently came up with recommendations on how to improve the regulatory environment on the European level and the Business Test Panel has been established to assess the compliance costs and administrative burdens linked with new legislative proposals.

R&D and innovation

Europe lags behind both the USA and Japan in terms of innovative capacity. R&D intensity in the EU was 1.9 % of GDP in 1996, against 2.6 % in USA and 2.8 % (1995) in Japan.

[7] European Observatory for SME, Annual Report 1997.

[8] "Promoting entrepreneurship and competitiveness", COM (1998) 550 of 30/9/1998.

The level of R&D expenditure by European companies is 1.2 % of GDP, against 1.8 % for American firms and 2 % (1995) for the Japanese[9]. Within Europe, Sweden has the highest level of R&D expenditure (3.5 %) followed by a group of countries with shares around 2 % (Denmark, France, Finland, Germany, the Netherlands and the UK). Another group can be identified around 1.5 % (Austria, Belgium and Ireland). Finally, Italy, Greece, Spain and Portugal have percentages of R&D expenditures equal to or below 1 %.

R&D expenditure tends to be concentrated in high-technology sectors like aerospace, computers, electronics, chemicals, pharmaceuticals and motor vehicles. However, only 13% of EU exports are high-tech products, around half the share in Japan or the USA. Furthermore, the EU trade balance in high-tech products has been worsening in recent years. Though the EU performs relatively well in scientific research (NSE graduation rates, PhD awards, publications, etc.) this does not translate into technological and economic performance. For example, only 48 % of patents applied for in the European Patent Office stem from European industry. There is thus a scope for improving the EU patent system. Similarly, the EU is lagging behind the USA regarding the development of commercially relevant innovation and their diffusion.

The importance of R&D and innovation has long been recognised by the Commission. In this respect, the first Action Plan for Innovation[10] and the 5th Framework Programme for research, technological developments and demonstration activities[11] are the main policy instruments of the EU. However, according to reports on economic reforms, several Member States have also taken measures to promote R&D and innovation. Spain has identified a need to strengthen R&D and innovation and has introduced new tax incentives and other measures to promote industrial innovation. In France, the high costs of patents and an unsatisfactory venture capital market have been identified as barriers and a new act on the exploitation of research will soon be introduced. In the UK, SMEs' R&D record is poor, so the Government is considering new measures to tighten relations between SMEs and centres for higher education. Austria has put aside 1 billion ATS (revenue from privatisation) to increase R&D spending and co-operation between science and business.

2. FINANCIAL MARKETS

2.1 *Progress in financial integration*

Monetary union has come, at a time of increased competition in the financial field as a result of the completion of the Internal Market, continuing deregulation of financial markets in general, and rapid technological progress. As a result of the interaction of these processes, there will be an acceleration in the emergence of an integrated European financial market. This market should be more liquid, mature and efficient than existing national markets.

Key features of financial markets in the EU include the following:

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[9] Second European Report on S & T indicators, Key Figures, May 1998.

[10] First Action Plan for Innovation in Europe, ISBN 92-827-9111-4.

[11] 5th Framework Programme of the European Community for Research, Technological Developments and Demonstration Activities (1998-2000)", Decision of the European Parliament and Council (22.12.98).

- Viewed as a single set of markets, the value of EU bonds, equities, and bank loans in European capital markets totalled more than $27 trillion at the end of 1995. That compared to $23 trillion in the US capital markets, and $16 trillion in Japan. At the same time, domestic equity markets are relatively small. In 1996 the combined domestic market capitalisation of all 15 EU equity markets was around US$ 3.5 trillion, compared to well over US$ 6.5 trillion for the New York and NASDAQ markets. Following the introduction of the euro, EU equity markets will profit from a wider investor base and a larger, more efficient market.

- Although the integration of financial markets is advanced, obstacles to further integration remain. These barriers have been identified in the Commission Communication "Financial services: a framework for action" (COM(1998) 625 Final) and were discussed in the Cardiff I Report. They include differences in the interpretation and implementation of (EU) financial market legislation; the absence of harmonisation measures in some areas such as pension funds; differences in national fiscal regimes; and technical barriers, for example in the field of payment systems. Given the importance of financial services in the EU economy (some 6% of EU GDP and for 2.5% of EU employment - substantially higher in the UK), it is essential that these barriers to integration be removed.

- Badly functioning financial markets impact especially on SMEs. SMEs are very dependent on banks and tend to pay higher interest rates than larger enterprises. In 1996, for example, the share of financial debt was 37% in SMEs against 28% in large enterprises[12]. Yet, SMEs have much less bargaining power with banks. New and rapidly growing firms may also face credit rationing due to lack of collateral. SMEs often do not have access to stock exchanges or other regulated markets for capital. Private equity and venture capital markets for SMEs are in most Member States quite small and insignificant. This, in combination with substantial minimum capital requirements – particularly high in Austria and Germany – may hinder the creation of new firms.

These observations lead to the following conclusions:

1. More integrated capital and credit markets should greatly enhance the capacity of Member States to respond to shocks in EMU. Capital markets help in smoothing shocks by facilitating adjustment via the cross ownership of productive assets and through lending and borrowing on national credit markets.

2. The need to remove the remaining obstacles to financial markets, including a better access of SMEs to risk capital, is clearly acknowledged, and a series of actions at national and EU level are underway as described below.

3. The removal of currency risk, which the introduction of the euro entails, means that institutional investors are no longer limited to domestic markets, but can seek out the opportunities provided by the increased depth and liquidity of the whole euro-denominated market. Nevertheless, quantitative restrictions remain on the type of asset in which investments can be made. These both distort the structure of

12 European Commission, BACH-database.

institutional investor portfolios and reduce competition in the single financial market.

2. 2 *The EU response*

As recalled in the Cardiff I report, three key developments in 1998 have the aim of ensuring further integration of European financial markets. First, as mentioned above, the Commission's Communication identified the key remaining barriers to the integration of financial markets and actions for dealing with them. Second, in response to the Communication, Ministers of Finance agreed to create a temporary high level group, to be chaired by the Commission, which will submit a report to the ECOFIN Council in June 1999 identifying the political priorities for the completion of the single market in the area of wholesale and retail financial services. Thirdly, the Commission published a Communication on "Risk Capital: a key to job creation in the EU" (SEC (98) 552) and proposed an Action Plan of measures necessary to facilitate the development of a European risk capital market.

As to specific measures, the EU has created the Eurotech Capital scheme to promote the provision of venture capital for cross-border high-technology projects undertaken by SMEs and has recently launched a number of new venture capital initiatives. A new start up equity financing scheme has been launched by EIF.

2.3 *National reforms are taking off*

Legal/regulatory framework

The legal and the regulatory framework in Member States is undergoing major changes. In some cases, these changes are broad reaching in scope as in the UK, with the establishment of a single statutory regulator, the Financial Services Authority and the enactment of the Financial Services and Markets Bill, and in France where a proposed law on savings and financial security should improve the organisation and operation of supervision in the financial sector. Improving the overall efficiency and competitiveness of the financial sector is also the aim of the Third Financial Market Promotion Law in Germany (amending laws on stock exchanges and securities, on investment companies, and on equity investment companies), and of the Capital markets law in Spain. Other reforms are more specific in nature, aiming, for example, to improve the efficiency of mutual funds by increasing the scope of their investment activities (Spain), or to improve the funding of investments in the public interest by amending rules governing interest on private savings ("livret A" in France).

Stock markets

The stock exchanges of euro area Member States switched to quoting all listed securities in euro at the beginning of 1999. Broader ranging structural reforms have been underway for some time with the aim of making markets more competitive and accessible to a wider range of users. These reforms have taken the form, for example of transforming stock exchanges from public institutions into private corporations (Italy and Austria), and the integration of futures and derivatives exchanges with the major stock exchange (Austria and Belgium). Co-operation among stock exchanges with the aim, for example, of sharing technology, has also been important (for example, the Vienna and Frankfurt exchanges). More broadly, the agreement among nine European stock exchanges (London, Frankfurt, Paris, Amsterdam, Brussels, Madrid, Milan, Stockholm and, outside the EU, Zurich) to work together on establishing the basis for a pan-European equity market, is a significant development. The creation of a network of "New Markets" for young expanding firms has been an important development in Germany, France, Belgium, the Netherlands, and most recently in Italy. This network will expand in 1999 to include Sweden and Denmark. Other developments which are facilitating the access of SMEs to capital markets include the Alternative Investment Market (AIM) in the UK and the European-wide EASDAQ.

Venture capital and access of small businesses to financing

In the recent past a variety of initiatives have begun in the Member States to facilitate financing for SMEs and for start ups. In some cases these are specific financing programmes or funds (in Austria, "seed-financing", a Business Angels Initiative, a "High Tech Venture Fund", and a "Young Entrepreneur Assistance Programme"); while in others the legal framework has been made more favourable: in Spain new regulations allow venture capital providers greater flexibility in investment decisions, and changes in the regulation of Reciprocal Guarantee Companies make the system more accessible to business. The government also intends to facilitate the securitisation of loans to companies by providing guarantees which should be of particular benefit to small companies.

Other actions are broader in nature. In Ireland, 75% of the recommendations of Task Force on Small Business on tackling problems such as raising capital, rewarding risk and reducing administrative burdens have been fully or partially implemented. The Small Business and Services Forum will complete a review of these recommendations in the light of the changing environment in which business operates by early 1999. In Spain an SME Observatory has been set up to study how red tape for SMEs might be reduced and access to external finance improved. Finally, as barriers to exit inhibit risk taking, some Member States (France, the Netherlands) are also planning to review bankruptcy regulations to make failure less punitive for entrepreneurs.

Corporate governance

The Risk Capital Action Plan has also recognised that good corporate governance is essential for stimulating the development of capital markets. Again Member States have undertaken a variety of actions. In Italy reforms to the regulatory framework in 1998 substantially modified the system of corporate governance, particularly in the fields of minority shareholders' protection and the contestability of control of listed companies. In France the Company Law Act will be reformed in 1999 to improve the transparency of companies vis-à-vis their shareholders, particularly minority shareholder. Provisions for compulsory administration or liquidation proceedings which can be lengthy and inefficient will also be reviewed in 1999. In Belgium a flexible approach has been adopted, relying on self-regulation and the pressure of financial markets themselves rather than on the legal or regulatory framework. Three voluntary codes on principles of corporate governance were published at the beginning of 1998 by the Belgian Stock Exchange, the Belgian Federation of Enterprises, and the Banking and Finance Commission.

3. LABOUR MARKETS

3.1 *High structural unemployment, but a strongly diversified picture*

Twenty years ago the EU employment rate matched that in the US. By 1997 it was 14 percentage points lower, at 60.5% compared with 74% in the US. Over the period 1985-97, the employment rate remained virtually unchanged overall, while in the US (and Japan) they increased significantly. Unemployment in the EU averaged 10.6% of the labour force in 1997, only slightly lower than the peak rate in 1994 and over twice the rate in the US (4.9%). Whereas the rate in the US has fallen steadily since the early 1980s, apart from during the recession of 1990-92, the rate in the EU has shown an upward trend since the mid-1970s[13].

As shown in tables 3.1 and 3.2, and graph 3.1, these aggregate figures, however, conceal a highly diversified scenario. In summary:

- There are considerable differences among Member States. Austria, Denmark, Sweden and the UK have employment rates of about 70% and above, compared to around 50% or below in Italy and Spain. Within the euro area large differences exist between Member States. Whilst unemployment remains high, though on a decreasing path, in Spain (over 20%) and is 12-13% in Italy, France and Finland, it has decreased substantially in countries like the Netherlands and Ireland. Outside the euro area, unemployment is low in DK and the UK, but it remains relatively high in Sweden.

- Within a number of countries, there exist striking regional differences: in Italy, Germany, Spain, Belgium and Finland, situations of relatively low unemployment in certain regions co-exist with very high unemployment in other parts of the country.

- An analysis of employment rates by age group shows where the differences between the EU and the US lie. While employment rates for prime age males (25-54) are very similar to the US, employment rates for young people (15-24), for prime age women and for older people (55-64), especially men, are much lower in Europe than in the US. However, the unemployment rate for EU prime age males (8.1% in 1997) is significantly above the US level. Unemployment is particularly high for the case of these disadvantaged categories of labour. A hard core of long term, hard to place unemployed is mainly composed of females, low skilled, youngsters and older workers.

- As a share of total working age population, EU employment amounted in 1997 to 3.1 % in agriculture, 18.2 % in industry and 39.2 % in services. For the US, the corresponding figures are 2.0 %, 17.7 % and 54.2%. Future increases in the overall EU employment rate will depend on an expansion of jobs in services for which there is considerable potential.

These observations indicate the following:

1. The vast array of differences across countries, compared to the increasing homogeneity in the business cycle, especially in the euro zone, suggests that the

[13] Employment in Europe 1998, p.9

rise in unemployment is not a simple effect of inappropriate aggregate demand management.

2. Countries such as the UK, Denmark, Netherlands, Ireland and, more recently, Spain, have undertaken a more integrated approach to structural reforms, rather than scattered measures. As to labour market reforms, in the Netherlands, Ireland and Spain, these reforms were introduced in agreement with the social partners. Although important problems remain in those countries, the reform package, together with high growth of GDP in the past years, has contributed to reduce structural unemployment.

3. The difference in regional unemployment in several countries, apart from highlighting the importance of regional and cohesion policies, also points to the need to take into account the highly differentiated levels of productivity and, more generally, economic development, into their collective bargaining.

3.2 *The EU response*

As laid out in the Broad Economic Policy Guidelines and confirmed in the EU employment strategy, tackling unemployment requires a sound, stability-oriented macroeconomic framework coupled with structural reforms. As an *ex ante* application of the new Employment Title of the Amsterdam Treaty, a co-operative effort in overhauling Europe's employment systems was put in place in the Jobs Summit in Luxembourg in November 1997. The process was further strengthened by the Vienna European Council in December 1998 which stated that employment policy has to be embedded in a comprehensive approach encompassing macroeconomic policies directed towards growth and stability, economic reform promoting competitiveness, and the Employment Guidelines. It mentioned that the surveillance of the implementation of the Guidelines – to be carried out via the Joint Employment Report - is an essential element of the Luxembourg process, which needs to be reinforced. It invited the Commission to present a communication on mainstreaming employment policies at Community level.

The Employment Guidelines represents an integrated strategy organised under the four headings of employability, entrepreneurship, adaptability and equal opportunities. Whilst it is still too early for a thorough evaluation, the Luxembourg process has helped to focus the political attention on the employment challenge and has acted as a catalyst for a co-operative efforts in fostering structural reforms in the Member States. The European Employment Pact put forward by the German Presidency aims at strengthening further the EU strategy and making it more compelling.

3.3 *Responses by national governments and social partners*

EU Member States are not starting from scratch in the process of structural reform. In many areas, important progress has been accomplished. Social partners have played a vital role in the reform process. However, a lot remains to be done, as pointed out by the European Council in Vienna which asked Member States, in order to support the commitments in the NAPs, to define policies and set themselves additional quantified targets and deadlines at national level. This includes promoting equal opportunities, making progress in lifelong learning, exploiting the potential of the service sector, creating a better business climate, examining tax-benefit systems, supporting the participation of older workers, and promoting the inclusion of disadvantaged groups.

The Commission intends to take up these points with Member States and monitor progress in the context of the submission of Member States' National Action Plans for 1999. As a contribution to this work the present report concentrates on tax-benefit systems, including the reduction of labour costs for the low-skilled.

Reforms of tax and benefit systems

The need to reform tax and benefit systems to tackle the problem of high structural unemployment has long been part of the EU political agenda and are taken up in both the 1998 Broad Economic Policy Guidelines and the 1999 Employment Guidelines. Progress in most countries in implementing taxation reforms is still gradual. Considerations of revenue loss have prevented many Member States from implementing taxation reforms to foster job creation more vigorously.

Europe's social protection systems need to adapt to meet existing demand and respond to new needs, changing circumstances and the increasing pressure to contain costs. At the same time they should strengthen economic growth and job creation, and shift towards a more active policy designed to get people into employment rather than merely transferring income to them when they are not working.

Such reforms are under way throughout the EU, with the emphasis on curbing expenditure growth and dependency on social protection. Eligibility criteria have been tightened, with stricter definitions of availability for work and tougher sanctions on those refusing to take up a job (or a training course). The duration of benefits and/or replacement ratios have been reduced in an attempt to curb alleged work disincentives. In-work benefits to top up low wages have been modified to minimise the risk of 'poverty traps'. Action to curb high marginal effective tax rates has been taken in several countries. Lower marginal taxes, by affecting wage setting, may also have positive effects on labour demand.

A number of targeted measures to reduce labour costs for the low-skilled have been put in place to increase the demand for low-skilled labour. In many cases, these measures were implemented in the context of reforms of tax and benefit systems aiming at reducing marginal effective tax rates. Whilst reductions in non-wage labour costs may be useful, it is important that they are complemented by effective active labour market policies to improve human capital. Furthermore, agreements between the social partners and labour and product market reforms are important to prevent reductions in non-wage labour costs simply being offset, as so often in the past, by increases in profits or direct wages.

Work organisation and working time flexibility

A radical approach to innovation in the workplace is paramount to adapt to industrial change. This is obviously a matter mainly for social partners. As pointed out by an Expert Group on the Evolution of Labour Law in Europe (the Madrid Group), collective agreements are gaining ground as an instrument for finding a balance between different interests in working life, and collective bargaining, though in the midst of reorganisation, is highly adaptive.

An important aspect of organisation innovation is working time flexibility. In most Member States working time flexibility is still relatively low, whereas regulations and collective agreements often allow more flexibility than is actually utilised. In addition, recently, Austria and Spain undertook significant steps to liberalise working hours, but also in France, Italy, Finland and Greece regulations restricting unusual working hours were eased during the nineties. In Belgium, Spain and France it became possible for the social partners to agree on the annualisation of working hours. In Austria it became possible to exchange overtime with time off. Besides, in countries like Germany or Portugal, enterprises and social partners increasingly use the flexibility offered in existing legislation.

Reducing the weekly working time has been a prominent feature for European policy makers. If well designed, these working time reductions can lead to a redistribution of work towards the unemployed, as some company examples show. This, however, requires several, often difficult-to-meet conditions, among others cost neutrality or the availability of suitable replacements from the stock of unemployed. Across the board working time reductions not agreed with the social partners are likely to be counter-productive as they risk increasing unemployment, in the short run, and be inconsistent with preparing for the ageing of the population, in the longer run. Removing obstacles to voluntary part-time work or allowing social partners to bargain the appropriate working time at the company or branch level, as in the Netherlands (over 35% of part-time workers on total employment), Denmark and Sweden (between 20 and 30%) may help fostering employment opportunities.

Reforms of employment protection legislation

An employment-friendly regulatory framework is important to foster structural change and respond to economic shocks. The key issue for workers, management, the social partners and policy makers alike is to strike the right balance between *flexibility and security*. Italy, Spain or Portugal are traditionally seen to have the strictest *Employment Protection Legislation* (EPL) among the Member States, whereas it is generally considered that EPL is least strict in the UK and Denmark. In some low-protection countries, including Denmark, however, employment protection clauses are embodied in collective agreements. Recent reforms in the area EPL have been undertaken by the Netherlands, Portugal and Spain. In Spain, in particular, the approach of liberalisation "at the margin" which had aggravated the segmentation of the labour market between permanent and temporary workers in the 1980s, has been reversed with the agreement of the social partners. In a number of countries (notably Italy), job-security requirements have been eased in the context of policy packages aimed at tackling regional unemployment. Whilst most of the recent changes go in the direction of making job-security provisions more flexible, in some countries, such as France, EPL became tighter during the nineties, and in Germany the new coalition government is planning to reverse a recent law facilitating dismissals especially for SMEs.

Whilst strict EPL should not be singled out as causing the high European unemployment, adequate job-security provisions combining flexibility and security at work are important for increasing employment and adjusting to shocks. Further EPL reforms in countries with strict regulations would reduce labour market segmentation. To achieve the right balance between flexibility and security, the Employment Guidelines invite social partners to negotiate at all appropriate levels agreements to modernise the organisation of work, including flexible working arrangements, with the aim of making undertakings productive and competitive. Public authorities should provide the enabling framework for this.

4. PUBLIC FINANCES

Both the size and the structure of public expenditures and taxation have an important impact on economic efficiency. As shown in tables 4.1 to 4.3, the broad picture of public finances in the EU is the following:

- The size of the public sector in the EU is large compared with the US or Japan. In 1998, total government expenditures amounted to 48% of EU GDP, which compares with 34% in the US and 38% in Japan. Accordingly, the tax revenue, as a per cent of GDP in the EU (43%) was at least 12 percentage points higher than in the US (31%) and in Japan (28%). However, EU averages conceal wide differences across Member States. The size of public sector within the EU ranges from a maximum of 62% of the GDP in Sweden to a minimum of 31% in Ireland.

- A distinguishing feature of EU countries is the size of the welfare state. Current transfers to households (which include pensions, health care and unemployment and other benefits) amount to almost 20% of the GDP in the EU, and it is above this figure in the euro zone, compared with 14% in the US and 16% in Japan. In some Member States (B, F, L, NL) this indicator of social protection amounts to 23-24% of the GDP, while in others (GR, E, IRL, P, UK) the shares are as low as 12-17%.

- All in all, there is a quite significant correlation between levels of welfare spending and the degree of economic development. Apart from the UK, the lowest levels of social protection in the EU are found in the cohesion countries. It should also be borne in mind that the differences in the level of spending on welfare services in industrial countries are much more limited when both public and private spending are taken into account. For instance, the difference in total welfare spending between the two countries at the opposite end of the spectrum, Sweden and the US, is reduced to some 7 points of GDP (35% of the GDP in Sweden and 28% in the US).

- Whilst EU countries have widely different tax structures, a common element, with few exceptions, is the high tax burden on labour - and especially on low-skilled workers - which has been steadily growing in line with social protection expenditures. Consumption and corporate taxes differ widely in the EU, and so do taxes on interest income, in particular withholding taxes, resulting in discriminatory treatment in favour of non-residents.

- During the budgetary retrenchment of the 1990s, Member States opted for discretionary expenditure-based retrenchments, and five countries (Denmark, Germany, Spain, Ireland, and The Netherlands) simultaneously reduced the tax burden between 1993/94 and 1997. In a number of countries, public investment bore a disproportionate share of spending cuts. Some of this reduction was due to sales of capital assets and to a shift towards the private financing and operation of public infrastructure investments.

These stylised facts suggest the following:

1. High taxes hamper economic efficiency, growth and, eventually, job creation. High labour taxes are particularly harmful at the low end of the wage scale where they lead to disincentives to create and take up jobs, and increase "black market" activities.

2. As suggested by the BEPGs, the tax pressure, overall and especially on labour, should be reduced in the EU. However, within the EU, large differences in the size of the public sector and the tax burden persist. This would imply: first, that general tax reductions would not seem to be equally called for in all Member States; and, second, that given the need to maintain fiscal discipline, a reduction in the overall tax burden requires cuts in spending. To the extent that governments manage to broaden the tax bases and increase the efficiency of tax systems, tax rates could be reduced while maintaining current tax revenues and expenditures.

3. The insurance principle makes the link between the size of the Welfare State and the tax burden particularly close in the majority of EU countries. Therefore, reducing the tax burden on labour requires reducing expenditures, for instance, through welfare reforms, and/or the shift of taxation onto other tax bases. This has been initiated by some Member States. Nevertheless, the pressures on social spending coming from the ageing of the population and the need to improve the functioning of the Welfare State in relation of the labour market (cfr. Chapter 3) often necessitate reforms of welfare spending.

4. Whilst a certain degree of competition between fiscal systems is natural and helpful, some tax co-ordination within the EU is necessary to avoid harmful tax competition. Such harmful competition can distort the functioning of the Single Market and may further increase the tax burden on the less mobile tax bases, namely labour, thereby aggravating the unemployment problem.

5. The composition of fiscal adjustments is important not only for the durability of budgetary discipline, but also for growth and employment. Indeed, the significant reduction in structural unemployment in the 1990s in Denmark, the Netherlands, Ireland and the UK[14] went hand in hand with a fiscal adjustment package based on reductions in tax burdens and discretionary cuts in spending, though, in line with conclusions of the Council in Vienna, they preserved the levels of public investment.

4.1 *Social protection expenditure and population ageing*

Social protection systems in Europe play a fundamental role in ensuring income redistribution and social cohesion. However, due to demographic and other structural changes, today's societies and economies are radically different from those at the time

[14] The UK, however cannot be judged according to the same parameters as used for continental EU countries. In fact, unlike the rest of the EU, the tax burden had decreased significantly during the 1980s and public investment dropped mainly due to outsourcing and other management choices.

at which modern welfare states were established. Particularly, health care and pensions, which represent two thirds of expenditures on social protection in the EU (see table 4.3 in the statistical annex), will bear much of the pressure driven by population ageing. Increasing awareness of these problems, as well as external pressure to re-establish budgetary discipline, has led to reforms.

This change is quite evident for *pension systems*. Since the mid-eighties most pension schemes have been reformed in order to be able to handle the increasing old-age burden and to become financially sustainable. Major reforms were introduced in Austria, Germany, Italy, France, Greece, Portugal, Sweden, and the United Kingdom. Reforms involve less generous benefit indexation rules, initiatives aimed at increasing real retirement ages, reductions in replacement rates, tightening of eligibility criteria for disability benefits and pension credits for years with limited or zero contributions, curtailing or abolishing public sector employees' special pension benefits, and/or lengthening of contribution periods required for pension eligibility. A number of European countries, such as, for instance, Denmark, The Netherlands, Sweden, Finland or the UK, are operating supplementary funded pensions on a mandatory/contractual basis. In other Member States, albeit less developed, supplementary funding of pensions is being introduced.

In several countries, reforms, by cutting eligibility and transfer ratios[15], have brought the expected increases in the ratio of pension expenditure to GDP firmly below the expected increases of the old-age dependency ratio. Cost containment was just one of the objectives of the reforms, which also aimed at making the system more able to cope with demographic change, more transparent in its distributive effects, and less distortionary in its effects on individuals' choices[16].

Health care systems are also undergoing substantial changes, although the general pattern of reform is less uniform. This is due to substantial differences in the structure of national health care systems and the role of the public sector in the provision and financing of health care. While maintaining the principles of universality and equality in the access to services, expenditure control has been pursued with a wide variety of instruments: tighter hospital budgets, restrictions on the supply of services (i.e., hospital beds, new entrants in medical education, new technologies), restrictions on the reimbursement of drugs (with negative and positive lists and reference price systems), increase in cost-sharing. Several reforms aimed at increasing efficiency in the use of resources and quality of services by modifying incentives at the micro-level: giving patients more choice (Sweden), introducing competition within the public sector and between the public and the private sector (UK), separating the provision and the financing of services (UK), relying more on contracts as an instrument to allocate resources among providers, shifting responsibilities towards regional and local administrative levels (Finland, Italy).

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[15] Respectively, the ratio of the number of pensioners to the number of elderly citizens and the ratio of the average pension to the average wage.

[16] This applies particularly to the recent Italian and Swedish pension reforms, which share the same general objectives and main features.

While some reforms have improved the incentive structure in the pension and health area, demographic pressure, all other things being equal, might push expenditures on social protection up by 6 to 7 percentage points of the GDP until the year 2030[17].

Further reforms would therefore be needed even if a significant increase in employment were to alleviate the pressure. Measures have been proposed to raise the retirement age, to reinforce the insurance aspect of the system, by closely linking pensions and contributions, as well as to, at least, complement pay-as-you-go systems with funded schemes. It is important to assess the elements of reform which may ensure the sustainability of public pension schemes while preserving their basic aspects of solidarity. Budgetary pressure on health care systems may be alleviated, while guaranteeing universality and preserving their quality, by taking advantage of the potentially beneficial effects of market mechanisms on efficiency, and by making consumers more aware of the costs of the services, which would encourage them to restrain their demand.

4.2 Towards efficient and employment-friendly taxation

Tax reforms

Tax systems have an important impact on growth and employment. At the same time, they should generate sufficient revenue for the financing of public expenditure, notably deriving from welfare and social provisions. Hence tax systems have to aim at balancing economic efficiency and social cohesion, whilst contributing to maintenance of budgetary discipline which is at the core of EMU.

As in the case of public expenditure, several countries have implemented important tax reforms in the past several years. In general, such reforms aim at simplifying the tax system, broadening the tax base, reducing taxes on labour and reducing the shadow economy. Sweden, Denmark, Spain, Italy, Portugal and The Netherlands have introduced fundamental reforms in their tax system along these lines.

EU tax co-ordination

Although some degree of tax competition is desirable in order to enhance the efficiency of tax systems, harmful tax competition is a cause for concern, since it may lead to fiscal degradation through the erosion of mobile tax bases, which are transferred to low-tax countries, and the increase of "black market" activities. This could significantly reduce fiscal revenues, thereby leading to a sub-optimal provision of public goods or force a further rise in the tax burden on less mobile bases like labour, which would hamper employment.

As stressed in the Cardiff I report, the persistence of incompatibilities between national tax systems in some areas and of harmful tax competition gives rise to

[17] According to a Commission study (European Economy – Reports and Studies, 3/1996), pensions are expected to grow by 3 to 4 percentage points of GDP by 2030. The study shows that, under the assumption of no further reforms compared to the 1996 institutional setting, pensions could amount to 15-20% of the GDP in Belgium, Finland, France, Germany, Italy, Austria and Luxembourg, and to 10-15% in Denmark, Spain, and Sweden. Only in Ireland, the UK and Portugal expenditures on pensions could remain below 10% of the GDP in 30 years time.

obstacles to trade, and may contribute to the segmentation of the Single Market, hence to a sub-optimal allocation of resources. EU tax policy is better described in terms of tax co-ordination rather than outright tax harmonisation. There are certain areas of taxation which require a high degree of harmonisation, indirect taxation being the most prominent example. Value-added tax and excise duties may directly affect the functioning of the Single Market. Differences as regards the tax bases, as well as the application of normal and reduced VAT rates, result in implicit tax rates that vary between 12% in Spain and 21.2% in Denmark (see table 3.3 in the statistical annex). Although consumption is not highly mobile, cross border sales may be significantly distorted by differences in VAT rates.

Taxation of corporate income and the interest on savings are areas where a certain degree of co-ordination is important and desirable. Corporate taxation across the EU seems to be dominated by a wide array of exemptions and deductions which directly affect the tax bases. Consequently, the differences in terms of effective taxation of corporate income across Member States are larger than the differences between statutory rates. Also comparisons of the interest withholding tax rates show large differences within the EU (table 4.4). The statutory rates for local creditors range from 0 to 40%, while, for foreign creditors, the range goes from 0 to only 25%. Such differences in taxation across Member States could lead to inefficient allocation of financial and physical capital. The *Code of Conduct* and the new Council Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community, as well as the agreement on the need to eliminate withholding taxes on payments of interest and royalties between associated companies, should be regarded as a package of measures to fight against harmful tax competition, and the first concrete result of a comprehensive and co-ordinated approach to tax policies at the Union level.

STATISTICAL ANNEX

(CARDIFF II)

Table 1.1 : Member State share of intra-EU FDI inflows and their importance r[elative] to GDP, 1992-97

	Share of total FDI inflows	Importance of FDI inflows to GDP
Belgium-Luxembourg	13.7%	3.5%
Denmark	1.7%	0.7%
Germany	12.3%	0.4%
Greece	0.6%	0.4%
Spain	7.0%	0.9%
France	12.1%	0.6%
Ireland	2.9%	3.2%
Italy	6.9%	0.4%
Netherlands	16.7%	3.1%
Austria	2.2%	0.7%
Portugal	1.7%	1.2%
Finland	1.0%	0.6%
Sweden	4.9%	1.4%
UK	16.4%	1.0%
EU-15	100.0%	0.8%

Source: Eurostat and Commission services

Table 1.2 : Cross-border mergers and acquisitions involving EU firms. Percentage shares of each Member State, compared to shares of EU GDP, 1995-1998

Member State	Target* (acquired company) %	Bidder** (acquirer) %	GDP as % of EU total (1996)
Belgium	4.4	3.3	3.1
Denmark	3.2	4.7	2.0
Germany	20.8	14.3	27.4
Greece	0.4	0.2	1.4
Spain	5.6	1.7	6.8
France	14.4	14.6	17.8
Ireland	1.3	3.3	0.8
Italy	7.5	3.2	14.1
Luxembourg	0.6	1.0	0.2
Netherlands	7.2	12.4	4.6
Austria	2.2	1.6	2.7
Portugal	1.1	0.4	1.3
Finland	3.8	3.1	1.5
Sweden	4.9	8.1	2.9
United Kingdom	22.6	28.4	13.4
EU	**100**	**100**	**100**

Sources: Acquisitions Monthly and Eurostat

* Takeovers of EU firms, by firms of another Member State or non-EU firms, classified by nationality of the acquired company.

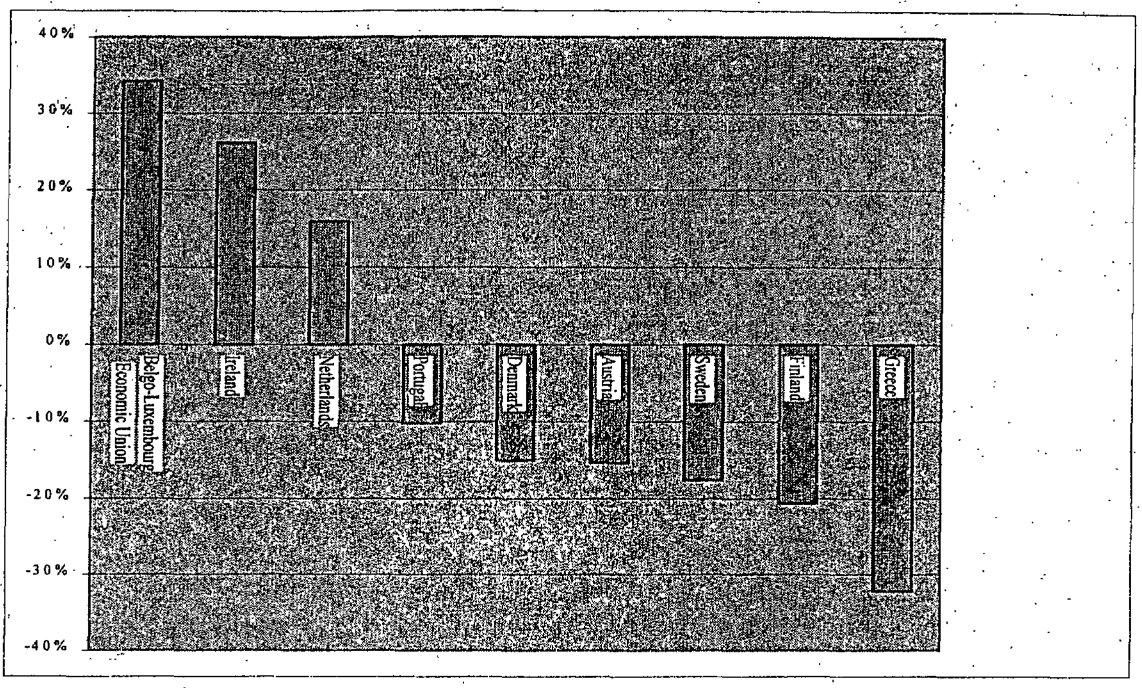
** Takeovers by EU firms, of firms in another Member State or outside the EU, classified by nationality of the acquiring company.

Table 1.3: 1996 price level indices and standards of living

Member State	Aggregate price levels (including tax, EUR15=100)	Aggregate price levels (excluding tax, EUR15=100)	GDP per capita (PPS)
Belgium	102	100	113
Denmark	123	117	116
Germany	115	115	110
Greece	76	82	68
Spain	83	87	78
France	110	107	104
Ireland	92	93	95
Italy	88	87	104
Luxembourg	110	108	162
Netherlands	104	106	104
Austria	110	108	113
Portugal	68	74	70
Finland	109	108	95
Sweden	123	119	100
UK	86	87	98

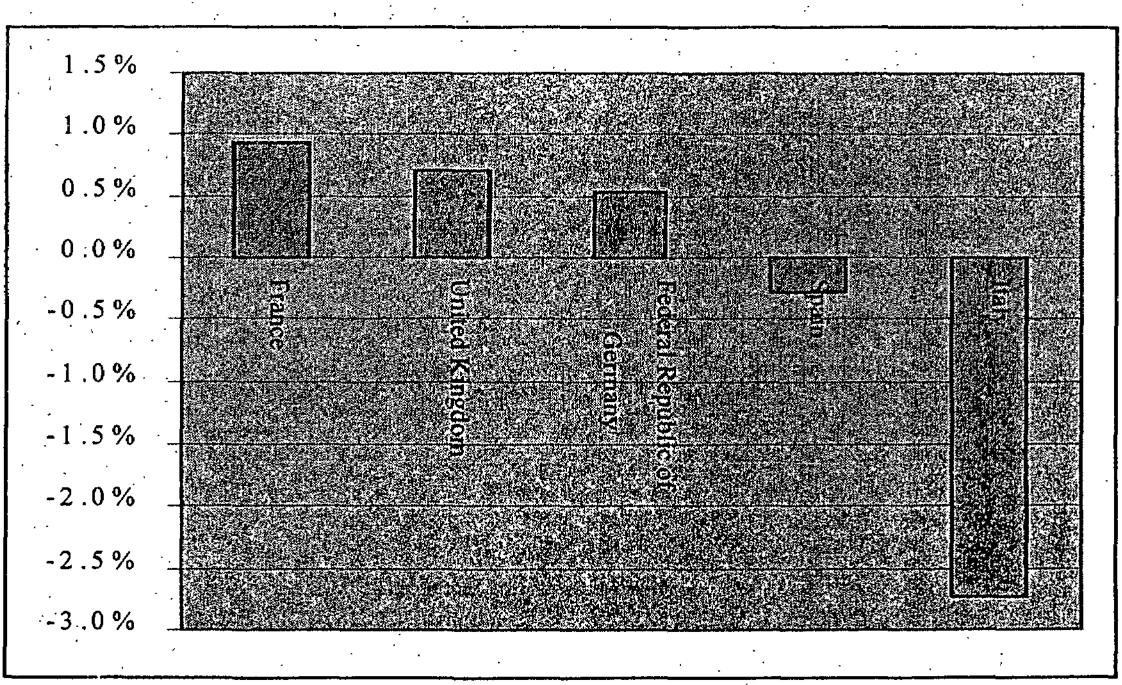
Source: Eurostat, Commission services

Graph 1.1: Small Member States: trade integration within the EU relative to small Member State average, 1992-97 (the difference between each individual small Member State's intra-EU trade to GDP ratio and the weighted average intra-EU trade to GDP ratio for small Member States)



Source: Eurostat and Commission services

Graph 1.2 : Large Member States: trade integration within the EU relative to large Member State average, 1992-97 (the difference between each individual large Member State's intra-EU trade to GDP ratio and the weighted average intra-EU trade to GDP ratio for large Member States)



Source: Eurostat and Commission services. Note that the scale of this figure is different from that of Figure 1.1

Table 1.4: EU productivity and price dispersion in manufacturing sectors (1996)

	Relative productivity (Total manufacturing=100)			Coefficient of price variation
Sector	EU	USA	EU/USA	EU
Pharmaceuticals	165	277	0,60	32,1%
Food, beverages, tobacco	98	131	0,75	15,9%
Chemical industry	162	203	0,80	15,9%
Transport equipment	97	115	0,85	13,1%
Precision instruments	99	114	0,87	8,6%
Electrical engineering	102	118	0,87	10,9%
Motor vehicles	114	125	0,91	15,3%
Office machinery and computers	151	157	0,96	14,2%
Paper and printing	106	94	1,13	16,6%
Mechanical engineering	98	85	1,14	8,3%
Metal articles	83	69	1,21	16,2%
Rubber and plastic	91	73	1,25	11,4%
Shipbuilding	83	55	1,50	11,9%

Source: Eurostat, Commission services

The 'EU' column shows sectoral productivity levels in index form relative to the EU's average manufacturing productivity level (=100); the "USA" column does the same for the USA. The "EU/USA" column divides the EU's relative productivity levels by those of the USA – the result indicates in which sectors the EU is relatively more productive than the USA. The final column simply provides a measure of price dispersion around the EU.

Table 1.5: Relative performance of the EU vis á vis the US and Japan

1996	EU 15	US	JAPAN
Standard of living*	100	148	118
Apparent labour productivity**	100	126	89

* GDP per head at 1990 market prices in purchasing power parities (PPPs). EU 15=100

** GDP per person employed at 1990 market prices in PPPs. EU 15=100

Source: AMECO, DG II

TABLE 3.1 MAIN FEATURES OF THE UNEMPLOYMENT IN THE EU 1997

	UNEMPLOYMENT RATE OF TOTAL LABOUR FORCE (1)	SHARE OF LONG-TERM UNEMPLOYED AMONG ALL UNEMPLOYED (≥12 MONTHS) (2)	UNEMPLOYMENT RATE OF THOSE WITH LOW EDUCATIONAL LEVEL (3)	SHARE OF UNEMPLOYED WITH LOW EDUCATIONAL LEVEL AMONG TOTAL UNEMPLOYED (4)	UNEMPLOYMENT RATE FOR YOUTH (15-24) (5)
Belgium	9.2	60.5	13.4	50.2	21.3
Denmark	5.5	27.2	14.6	37.3	8.1
Germany	10.0	50.1	13.3	26.5	10.7
Greece	9.6	55.7	6.3	37.3	31.0
Spain	20.8	51.8	20.6	62.6	39.2
France	12.4	39.6	14.0	45.1	29.0
Ireland	10.1	57.0	16.4	63.7	15.9
Italy	12.1	66.3	9.1	55.6	33.6
Luxembourg	2.6	34.6	3.8	71.5	7.3
Netherlands	5.2	49.1	7.9	49.4	9.7
Austria	4.4	28.7	5.7	34.7	7.6
Portugal	6.8	55.6	6.2	76.6	14.1
Finland	13.1	29.8	21.6	38.2	35.4
Sweden	9.9	34.2	10.1	31.9	21.9
United Kingdom	7.0	38.6	12.2	55.0	13.6
EURO-Zone	11.6	50.9	N.A.	47.0	23.5
EU-15	10.7	49.0	13.7	47.2	21.2
USA	4.9	8.7	10.0	N.A.	11.3
JAPAN	3.4	21.8	N.A.	N.A.	6.6

(1) Harmonised unemployment rates, *EUROSTAT*
(2) *Labour Force Survey, EUROSTAT.* For USA and Japan, *OECD Employment Outlook 1998*
(3) Educational level lower than upper secondary; persons aged 25 to 64 years-old (1995), *OECD Employment Outlook 1998.*
(4) Educational level lower than upper secondary (lower secondary and less); persons aged 25-59 (1997 2Q), *LFS, EUROSTAT.*
(5) *Labour Force Survey, EUROSTAT.* For USA and Japan, *OECD Employment Outlook 1998*

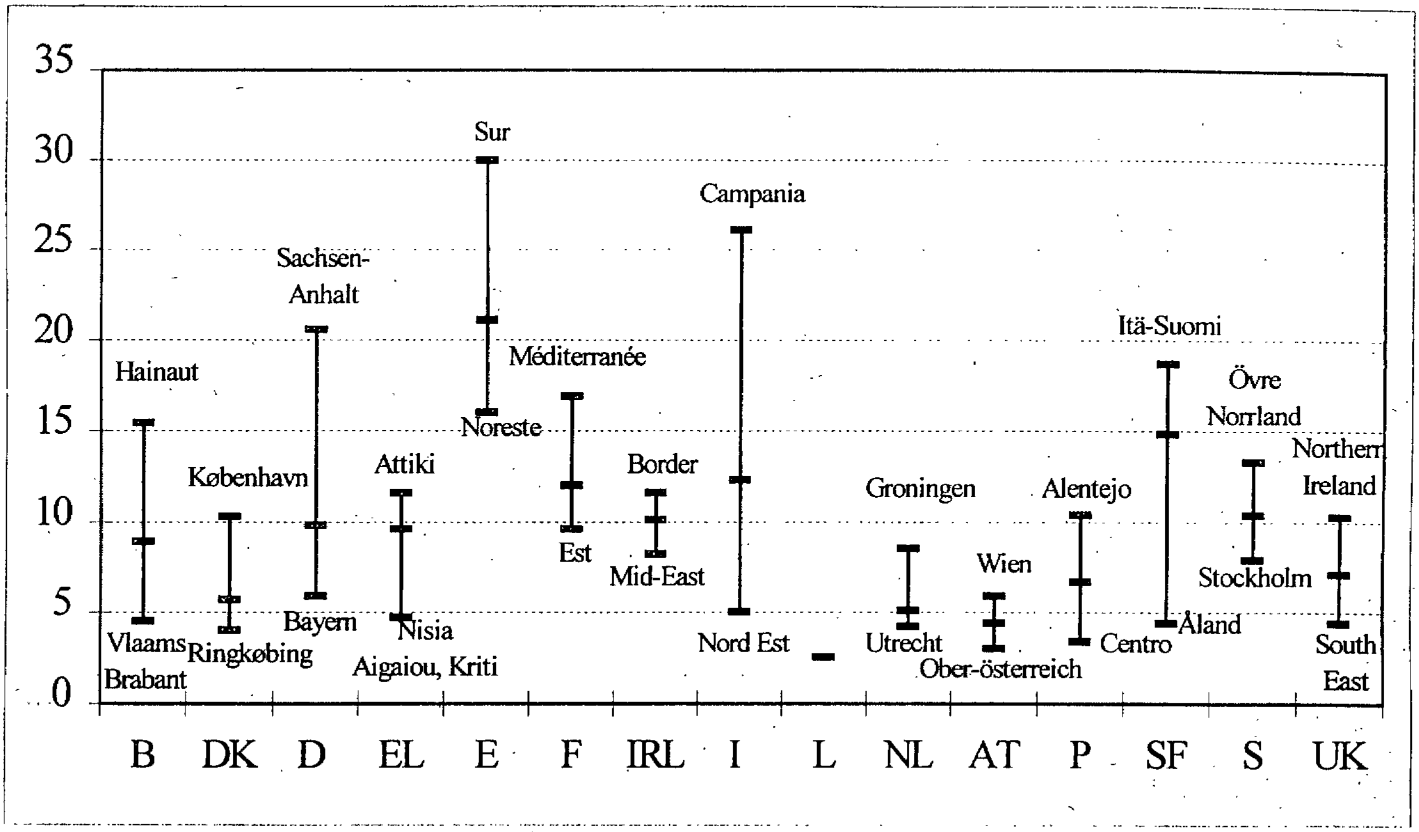
Source: LFS, EUROSTAT; OECD Employment Outlook 1998.

Table 3.2 Employment and Unemployment rates in 1997

Country	Employment		Unemployment	
	Total (1)	Men 25-54 (2)	Total (3)	Men 25-54 (4)
Austria	70.0	93.7	4.4	4.5
Belgium	57.3	86.6	9.2	6.2
Denmark	77.5	90.5	5.5	4.1
Finland	63.9	80.7	13.1	12.3
France	60.1	86.5	12.4	9.6
Germany	61.8	82.4	10.0	8.2
Greece	56.8	90.1	9.6	4.9
Ireland	57.9	82.5	10.1	9.5
Italy	51.3	83.1	12.1	7.5
Luxembourg	58.8	92.5	2.6	1.5
Netherlands	66.7	89.5	5.2	3.6
Portugal	67.6	88.4	6.8	5.0
Spain	48.6	80.1	20.8	13.9
Sweden	69.5	81.8	9.9	9.6
UK	70.8	85.5	7.0	6.7
EU15	60.5	84.5	10.7	8.1
United States	74.0	88.4	4.9	3.7
Japan	74.7	95.3	3.4	2.5

Source: (1) & (2) Employment rates report, European Commission; (3) Harmonised unemployment rates, EUROSTAT; (4) EUROSTAT: US and Japan OECD Employment Outlook, June 1998.

Graph 3.1 Regional unemployment rates in Member States, 1997 (minimum, average and maximum in %)



Source: EUROSTAT, Regio database

Note: NUTS 1 regions except for B, NL, AT, P, SF, S (NUTS 2), DK, IRL (NUTS 3), L (national)

TABLE 3.3	IMPLICIT TAX RATES ON LABOUR AND CAPITAL (%) (1996)				
	IMPLICIT TAX RATE ON EMPLOYED LABOUR (1)	**TAXES ON LOW- SKILLED WORKERS (2)**	**IMPLICIT TAX RATE ON CONSUMPTION (3)**	**TOTAL TAX WEDGE (4)**	**IMPLICIT TAX RATE ON OTHER FACTORS (5)**
Belgium	44.8	50.5	13.7	48.2	38.6
Denmark	47.1	41.3	21.2	54.2	35.8
Germany	43.3	46.5	13.7	45.6	36.1
Greece	44.9	34.9	16.6	34.5	9.7
Spain	38.3	34.4	12.3	37.4	24.0
France	44.9	44.3	14.6	51.1	47.6
Ireland	29.1	26.5	18.9	36.6	21.4
Italy	50.1	48.3	13.4	45.4	33.1
Luxembourg	30.2	29.1	17.9	44.8	49.8
Netherlands	46.7	39.3	15.4	48.4	37.0
Portugal	42.0	30.6	15.9	34.2	18.0
UK	27.3	26.8	14.6	33.1	36.8
Austria	45.8	37.4	15.6	49.9	38.9
Finland	55.3	45.3	19.0	55.6	24.1
Sweden	57.6	48.6	16.1	56.3	47.4
EURO-Zone*	44.8	44.2	14.1	46.4	35.6
EU-15	42.6	41.8	14.4	44.8	35.6
USA	23.2	29.2	5.5	27.9	45.3
Japan	24.7	18.4	5.1	27.1	52.3

* EURO-Zone includes 11 countries: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, Austria and Finland.

(1) The ratio of taxes directly borne by the employed labour to the total compensation of employees. Employed labour taxes include: social security contributions paid the employers and the employees, the taxes on payroll and workforce, and personal income tax on employed labour.
(2) Tax benefit of singles with no children (wage level 67% of APW). Employees' and employers' SSC and personal income tax less transfer payments (% of gross labour costs: gross wage earnings plus employer's SSC).
(3) The ratio of consumption taxes to the after-tax value of consumption
(4) The tax wedge includes all taxes borne by labour (social security contributions and personal taxes on labour income) plus the part of consumption taxes paid when spending labour income. The tax wedge is the difference between the producer wage and the consumer wage as a percentage of the former.
(5) Social security contributions and other taxes paid by the self-employed, plus taxes on capital income expressed as a percentage of the capital income (total operating surplus).

Source: EUROSTAT and DG XXI (Structures of taxation systems in the EU), DG II, OECD The Tax/Benefit position of employees, 1997.

Table 3.4 **Net Replacement Rates of Unemployment Benefits in 1995**

COUNTRY	NET REPLACEMENT RATES			
	2/3 of APW		APW	
	1st month	60th month	1st month	60th month
Belgium	79	86	61	58
Denmark	93	82	70	74
Germany	74	85	72	66
Greece¹)	N.A.	N.A.	57	N.A.
Spain	72	49	74	35
France	86	57	76	46
Ireland	60	60	49	49
Italy	41	7	42	5
Luxembourg	87	84	87	66
Netherlands	87	92	79	71
Austria	65	62	63	61
Portugal	88	3	78	2
Finland	87	95	75	81
Sweden	80	109	78	82
UK	81	85	61	64

Note: The summary measures of net replacement rates and tax rates have been calculated as a simple average of the rates for three family types (single person, couple without children and couple with two children. The net replacement rate for the 60th month of unemployment includes the possible topping-up of social assistance but the 1st month's rate not.

¹) The Greek net replacement rate is from the study of the Central Planning Bureau for 1993.

Source: OECD 1998, Benefit Systems and work Incentives

TABLE 4.1 STRUCTURES OF CURRENT EXPENDITURES IN THE EU (% GDP) (1998)

	TOTAL EXPENDITURE (1)	PUBLIC INVESTMENT (2)	TOTAL CURRENT EXPENDITURES (3)	CURRENT TRANSFERS TO HOUSEHOLDS (4)	PUBLIC CONSUMPTION (5)
Belgium	51.1	1.5	49.0	24.0	14.0
Denmark	57.6	1.6	55.9	19.2	26.8
Germany	47.5	1.8	44.7	18.8	19.2
Greece	41.5	3.6	39.8	15.6	14.5
Spain	42.9	3.0	39.2	15.0	15.8
France	54.1	2.8	51.1	23.4	19.3
Ireland	31.6	2.5	29.6	12.1	12.4
Italy	49.9	2.3	46.6	20.0	16.2
Luxembourg	44.5	5.0	39.5	23.4	13.1
Netherlands	48.3	2.5	45.9	24.1	14.1
Portugal	42.8	4.1	39.4	16.6	18.6
UK	41.3	1.2	39.8	16.3	18.5
Austria	51.5	2.0	47.9	21.2	18.9
Finland	52.2	2.7	49.7	19.9	20.6
Sweden	61.8	2.5	60.2	21.8	25.8
EURO-Zone*	49.1	2.3	46.1	20.2	17.8
EU-15	48.2	2.1	45.6	19.5	18.2
USA	34.1	1.6	33.2	13.7	15.3
Japan	38.6	6.4	30.4	15.7	10.0

* EURO-Zone includes 11 countries: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, Austria and Finland.
(1) Nominal total expenditure as a percentage of gross domestic product at market prices (includes (2) and (3))
(2) Gross fixed capital formation as a percentage of gross domestic product at market prices (included in (1))
(3) Total current expenditure as a percentage of gross domestic product at market prices (included in (1) and including (4) & (5))
(4) Current transfers to households as a percentage of gross domestic product at market prices (included in (3))
(5) Government consumption (national DEFs) as a percentage of gross domestic product at market prices (included in (3))

Source: AMECO

TABLE 4.2	THE STRUCTURE OF THE TAX BURDEN (% GDP) (1998)				
	TOTAL CURRENT RECEIPTS (1)	TAX BURDEN (2)	SOCIAL SECURITY CONTRIBUTIONS (3)	DIRECT TAXES (4)	INDIRECT TAXES (5)
Belgium	49.7	48.3	17.1	18.4	12.9
Denmark	58.8	52.4	2.7	30.7	18.9
Germany	44.8	42.2	19.6	10.0	12.6
Greece	39.0	34.8	12.6	8.0	14.2
Spain	40.8	36.9	13.9	11.5	11.4
France	51.3	47.6	19.3	12.6	15.7
Ireland	33.7	32.3	4.0	14.0	14.3
Italy	47.2	42.9	12.7	14.6	15.5
Luxembourg	46.8	42.5	11.5	14.0	17.0
Netherlands	47.0	44.2	18.1	12.6	13.6
Portugal	40.4	36.5	11.8	10.5	14.2
UK	41.4	38.6	7.7	16.7	14.2
Austria	49.3	46.5	17.0	13.7	15.8
Finland	52.9	46.5	13.4	18.7	14.5
Sweden	62.7	54.3	15.3	22.7	16.3
EURO-Zone*	46.7	43.4	17.0	12.4	14.0
EU-15	46.4	43.0	15.1	13.7	14.2
USA	35.4	31.5	9.4	15.1	7.0
Japan	33.0	28.9	11.1	9.5	8.4

* EURO-Zone includes 11 countries: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, Austria and Finland.

(1) Total current receipts as a percentage of gross domestic product at market prices (includes (2))
(2) Tax burden as a percentage of gross domestic product at market prices (includes (3), (4) and (5))
(3) Social security contributions as a percentage of gross domestic product at market prices (included in (2))
(4) Current taxes on income and wealth as a percentage of gross domestic product at market prices (included in (2))
(5) Taxes linked to imports and production as a percentage of gross domestic product at market prices (included in (2))

Source: AMECO.

TABLE 4.3	THE STRUCTURE OF SOCIAL PROTECTION IN THE EU (% GDP) (1993-1996)				
	EXPENDITURES ON SOCIAL PROTECTION (1)	**PENSIONS (2)**	**HEALTH (3)**	**UNEMPLOYMENT (4)**	**INVALIDITY (5)**
Belgium	27.4	8.6	7.1	3.9	1.8
Denmark	33.3	12.6	6.0	5.3	3.4
Germany	28.3	11.3	8.6	2.8	2.0
Greece	19.6	8.3	5.2	1.0	1.7
Spain	21.9	8.7	6.4	3.6	1.7
France	29.1	10.6	8.4	2.5	1.7
Ireland	19.1	4.0	6.6	3.3	0.9
Italy	24.1	12.9	5.4	0.5	1.8
Luxembourg	24.2	7.4	6.0	0.7	3.2
Netherlands	30.6	9.8	8.9	3.0	4.7
Portugal	18.5	6.3	6.2	1.0	2.5
UK	27.0	9.2	6.9	1.8	3.1
Austria	28.5	10.8	7.3	1.6	2.2
Finland	32.9	9.4	7.0	4.9	4.9
Sweden	36.1	12.6	7.9	4.0	4.2
EURO-Zone*	27.1	10.8	7.6	2.4	2.1
EU-15	27.4	10.7	7.4	2.4	2.3
USA	N.A.	N.A.	N.A.	N.A.	N.A.
Japan	N.A.	N.A.	N.A.	N.A.	N.A.

* EURO-Zone includes 11 countries: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, Austria and Finland.

(1) General government spending on social protection measures as a percentage of GDP at market prices (includes (2), (3), (4) & (5))
(2) General government spending on pensions as a percentage of GDP at market prices (included in (1))
(3) General government spending on health as a percentage of GDP at market prices (included in (1))
(4) General government spending on unemployment as a percentage of GDP at market prices (included in (1))
(5) General government spending on invalidity as a percentage of GDP at market prices (included in (1))

Source: ESSPROS.

TABLE 4.4 CORPORATE AND INTEREST TAXES (1998)

	STATUTORY CORPORATE TAX RATES	WITHHOLDING TAX ON INTEREST (RESIDENTS)	WITHHOLDING TAX ON INTEREST (NON-RESIDENTS)
Belgium	39	15	15
Denmark	34	0	0
Germany	30-45	30-35	0
Greece	35-40	20	40
Spain	25-35	25	25
France	33.33	0	0
Ireland	25-32	24	24
Italy	37	27	0
Luxembourg	20-30	0	0
Netherlands	35-36	0	0
Portugal	34	15-20	20
UK	31	20	N.A.
Austria	34	20	0
Finland	28	0-28	0
Sweden	28	0	0
EURO-Zone*	N.A.	N.A.	N.A.
EU-15	N.A.	N.A.	N.A.
USA	15-35	0	N.A.
Japan	27-37.5	N.A.	15-20

* EURO-Zone includes 11 countries: Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, Austria and Finland.

<u>Notes on statutory corporate taxes and withholding taxes on interest:</u>

BELGIUM: The standard corporate tax rate is 39%. If less than BEF 13 million, 28% to 41%.
FINLAND: 0% withholding tax paid to non-resident or resident companies; 28% paid to resident individuals.
FRANCE: The effective corporate income tax rate, including the 10% surtax, is 36,66%. From 1997, the corporate income tax rate for SME's that capitalise tax results is 19% (25% of profits). From 1997-2000, companies exceeding FF 50 million turnover pay an additional 15% surtax (effective 41,66%). This will be progressively phase out in 2000.
GERMANY: 45% for resident companies' undistributed profits and 30% for distributed profits (branches of foreign companies pay 42%). Local taxes can increase the total 50% (generous allowances make effective rates much lower. Withholding tax is 30% on interest paid by domestic banks or 35% (over-the-counter trade, which can be refunded) a solidarity surcharge of 5,5% put rates at 31,65% and 37,625% respectively.
GREECE: Corporate tax is 35% for listed non-financial companies and 40% for the rest. Interest on loans is subject to a 40% withholding tax, if paid to a non-resident, and 20%, if paid to a resident company. Loans granted by foreign banks and industrial firms to Greek companies are exempt from tax on interest.
IRELAND: The standard rate is 32% but the first IP 50,000 of a company's taxable income is subject to a 25% rate. Income tax of 24% is withheld on interest payments to both local and foreign creditors made after April 1997; however, tax treaties reduce the withholding tax to zero for most of the countries.
ITALY: Corporations are taxed at 37% but from 1998, a lower rate applies for non-distributed profits. A new regional tax of 4-5% on business value added (IRAP) is being introduced. Withholding tax is 27% on interest from bank accounts. From July 1998, non-residents are exempt from withholding tax.
LUXEMBOURG: Rates for corporate income tax vary from 20% to 30%, depending on the income level. There are also a 4% tax surcharge for an unemployed fund and a municipal business tax of 9,1% as an average. Favourable investment allowances and tax holidays for new investors reduce the effective tax burden.
NETHERLANDS. The corporate income tax is 35% (together with local taxes). For companies with profits of up to NLG 100,000 the rate is 36%.
PORTUGAL: The general rate in many municipalities put the effective corporate tax in 37,4% (local surcharges of 10% of the base tax). Withholding tax is between 15% (on interest from ordinary loans and credit facilities) and of 20% (on interest from bank deposits and all bonds). For no residents is 20% from non-exempt bonds and other interest payments
SPAIN: 25% for non-resident corporations (capital gains are taxed at 35%) and 35% for resident corporations. If the creditor is a resident in a EU country that is not on Spain's tax-haven list the withholding tax is zero (only Luxembourg is included in this list).
UNITED KINGDOM: Corporation tax for companies with profits under GBP 300,000 is 25% for the years ending March 31st 1997, 21% for the two years ending March 31st 1999 and 20% from April 1st 1999. Interest payments to non-residents may be subject to reduced or zero withholding tax under tax treaties.
UNITED STATES: Companies pay 15% on the first US$ 50,000 of taxable income, 25% on the next US$ 25,000, 34% on the next US$ 9,925,000 and 35% on the remainder, plus a 5% surcharge on income between US$ 100,000 and US$ 335,000, and a 3% surcharge on income between US$ 15 million and US$ 18,333,333. There is no withholding tax on interest paid to US companies and other remittances are governed by the treaties.
JAPAN: Corporate rates go from 27% to 37,5% There is a regional tax and a municipal tax of 5% and 12,3% respectively, and an enterprise tax of 12% on profits The withholding tax on interest to non-residents is 15% (20% for interest on loans).

Source: E.I.U Country Tax Regulations.

Price dispersion

At the most aggregate level (including both private and public consumption as well as capital investments), EU price dispersion has come down from 20.1% in 1985[18] to 16.3% in 1996. However, figures at this level of aggregation do not necessarily reflect developments in specific markets (see Table A.3.1).

The 3.8% decline in GDP price dispersion since 1985 results from a 6.0% decline in price dispersion for private consumption, which was offset by a 1.8% rise in price dispersion for government consumption (reflecting rising wage difference between Member States) and 0.7% rise for capital investments. This seems to imply that market integration has concentrated in markets for consumer products, and that other markets (including public procurement) have been less affected. There is evidence that import penetration ratios for public procurement sectors in the Member States are consistently lower than penetration ratios in the non-public sphere[19]. Nevertheless, with a price dispersion of 13.5% capital good markets remain more integrated than market for consumer goods (15.9%). The former figure actually reflects a relatively high price dispersion in construction (22.0%) and a low price dispersion for machinery and equipment (7.7%). The Single Market Review[20] had already identified the construction sector as one of the least integrated economic sectors, also because trade intensity in the sector is relatively low. Nevertheless, the degree of price dispersion in construction has come down from its 1993 high of 23.6%.

At the level of individual product headings even larger differences in price dispersion[21] exist. Price dispersion tends to be high for small-item products like potatoes (42%), beer[22] (41%), tea (34%), and flowers and plants (32%), which have a relatively low price elasticity of demand. For other product headings, the high level of price dispersion reflects the prevalence of regulated prices in certain sectors: services of general practitioners (44%) and specialists (43%), natural gas (41%), medicines (34%). In general, price dispersion in services is larger than price dispersion in manufactured products, especially homogeneous items such as fruit juice and underwear, or large-ticket items including washing machines, dishwashers and other household appliances (all 11%).

In order to assess the degree of dispersion of price levels between EU Member States, the price dispersion in a large integrated market like the United States would be the ideal benchmark. However, no comprehensive statistics exists that permit a comparison of prices between US regions or states. Nevertheless, the American Chamber of Commerce Researchers Association (ACCRA) collects information on relative prices levels in US cities for a select number of consumer goods and services. A comparison of these data with information about EU prices at the basic heading level

18 Sources OECD, Eurostat

19 'Public procurement', Vol. 3, N° 3, The Single Market Review (1996)

20 "Economic evaluation of the internal market", European Economy, N° 4, 1996.

21 Aggregation tends to lead to a reduction in the coefficient of price variation. Caution should therefore be exercised when comparing price dispersion at the aggregate level with the level of price dispersion for specific product headings.

22 Substantial differences in excise tax rates between Member States help explain the relatively high levels of price dispersion for alcoholic beverages and tobacco products.

showed that on average the dispersion of prices (including taxes) in the EU was 40% above that in the US. For a subset of items typically found in grocery stores, the degree of EU price dispersion was more than twice as high as in the United States. Further EU market integration might be able to reduce this, along with general price levels (as preliminary OECD data estimates that on average EU consumer prices in 1996 were 24% higher than their US equivalents).

We may therefore conclude that while the Single Market Programme has had an important effect on price dispersion, there is nevertheless considerable scope for further price convergence. The greater degree of price transparency, lower transaction costs and the elimination of exchange-rate risk in the Economic and Monetary Union should contribute to such a development.

Table 2.1: Price dispersion in the EU

Year	Aggregate price levels	Private consumption	Government final consumption	Construction	Machinery and equipment
1985	20.1%	21.9%	25.4%	19.2%	9.1%
1990	19.4%	21.4%	24.7%	19.3%	6.0%
1991	17.5%	18.9%	n.a.	22.2%	6.2%
1992	17.1%	18.2%	23.5%	21.0%	7.6%
1993	16.2%	15.9%	25.9%	23.6%	6.7%
1994	17.1%	16.4%	26.1%	23.0%	8.5%
1996	16.3%	15.9%	27.2%	22.0%	7.7%

Source: Eurostat, Commission services

Table 2.2: 1996 price level indices (EUR15=100)

Country	Aggregate price levels	Private consumption	Government final consumption	Construction	Machinery and equipment
Belgium	102	103	104	106	91
Denmark	123	126	119	130	114
Germany	115	112	135	125	106
Greece	76	81	59	69	102
Spain	83	83	80	88	88
France	110	113	113	99	102
Ireland	92	94	84	83	102
Italy	88	87	89	85	95
Luxembourg	110	101	154	120	99
Netherlands	104	103	104	120	95
Austria	110	109	116	113	99
Portugal	68	74	45	65	101
Finland	109	117	104	81	116
Sweden	123	127	122	127	109
UK	86	88	82	74	95
USA	85	80	106	86	85

Source: Eurostat, Commission services, OECD

Price-Cost Margins in Manufacturing

Introduction

Imperfect competition in the goods market will in general lead to welfare losses. Demand side losses arise because market imperfections allow firms to earn monopoly rents by charging prices to their customers which are too high, given the marginal cost of producing the goods or services that are offered. Possession of market power also puts less pressure on firms to choose the best available production method and use resources efficiently. This leads to high production costs and puts additional pressure on prices. Barriers to enter certain markets are a primary factor leading to the appearance of market imperfections. Therefore one important objective of the single market programme (SMP) consisted of increasing the degree of competition by removing administrative barriers such as, for example, technical standards and limited access to public procurement. It was estimated that this program would be likely to affect a sizeable fraction of EU industries[23]. Thus, at least for some of the identified sectors one can expect a decline in price cost margins and a more efficient use of resources in recent years.

This appendix presents estimation results the evolution of price-cost margins in the manufacturing sector, looking especially at whether price cost margins have declined in those sectors which should be most affected by the SMP. Of course the decline in mark-ups is not necessarily limited to those sectors. Other factors such as increased trade with emerging economies, for example, may also have affected the degree of competition in recent years. In order to be able to better discriminate between a general reduction in monopoly rents and a reduction caused by the SMP, the mark-up estimates for EU countries/sectors, for which time series of sufficient quality are available, are compared to the corresponding US industries. A previous OECD study[24] finds that average mark-up estimates for US industries over the period 1970-92 are often at the lower end when compared to other OECD economies. The US results can therefore also serve as a benchmark for assessing the progress that has been made within the EU in recent years.

In interpreting these results it must be pointed out that mark-up estimates do not necessarily provide completely unambiguous guidance for judging the performance of an industry in a particular country. They must therefore be seen in relation to other indicators of sectoral performance. There are two economic circumstances in particular which call for a cautious interpretation, namely, rent sharing and innovation rents. In the presence of rent sharing between workers and firms, mark-ups will generally be underestimated, because only those rents which accrue to the company are captured by the estimation procedure. Also, a decline/increase of mark-ups should not necessarily be interpreted as an improvement/decline in economic performance of that particular sector. An increase in mark-ups could be the consequence of producing higher quality products or some other technological advantage not matched by competitors which allows the corresponding sector to reap

[23] 40 out of 120 industrial sectors were identified as being most affected by the internal market.

[24] See Oliveira Martins, J., S. Scarpetta and D. Pilat (1997). Mark-up pricing, Market Structure and the Business Cycle. OECD Economic Studies, 27.

an innovation rent. Conversely, a decline in mark-ups could indicate a lack of innovative activity in a particular sector, increasing the exposure to foreign low cost competition.

Box: Methodology and Data

The empirical analysis follows closely the study conducted by the OECD, with the following modifications. First, the end of the estimation period is extended from 1992 to 1995. Second, unlike in the earlier OECD study which was mostly concerned with the estimation of an average mark-up over the entire sample period (1970-92), this study also looks whether statistically significant breaks in the level of mark-ups have occurred in 1986 or after. Finally, in order not to confuse structural breaks from business cycle fluctuations, the estimates also control for the impact of sectoral output gaps on mark-ups. The reported results only give the trend change in mark-ups.

The primary data sources are the OECD ISDB and STAN data bases. ISDB provides time series information at the 2-digit level, while STAN gives data for selected 3-digit manufacturing industries. Unfortunately, data at the required detail are generally only available for the US, the four largest EU countries plus Belgium, Denmark and Sweden. The analysis proceeds as follows. First, results for 2-digit manufacturing sectors are given. In a second step, estimates at the 3-digit level for those sectors which have been classified as being affected by the SMP are presented.

Empirical Results:

Table B.1 presents regression results for the 2-digit manufacturing industries in large and small EU countries and the US[25]. The following general picture emerges from these regressions. Price-cost margins in the large EU countries are generally estimated to be somewhat greater than in smaller EU economies and they also generally exceed those in the US, especially before 1986. Within the large EU economies, mark-ups seem to be lowest in the UK. There exists a tendency for mark-ups to have fallen significantly in some industries in the larger EU economies, especially in basic metal industries and in manufacture of fabricated metal products, indicating that SMP has been effective. The effects are different across countries and not uniform across the 3-digit industries. The results in the table also indicate some convergence of mark-ups within the EU

The sectors manufacture of wood and wood products, paper, printing and publishing and basic metal industries have been classified as being hardly affected by the SMP. Together, they currently employ about 19% of all workers in the manufacturing sector in the seven EU countries. Generally no significant change in mark-ups occurred in these sectors; there are, however some exceptions. In the wood industry, a significant mark-up increase occurred in France and a decline in Sweden. In paper and publishing, a decline in mark-ups occurred in both West-Germany and Sweden. In basic metal industries a pronounced decline in price cost margins occurred in Italy and Germany. Italy used to have the highest mark-ups before 1986.

[25] Only significant changes up to the 10% level of significance are reported.

Within the food sector, the chemical industry and in the sector non metallic minerals, which employ about 26% of all manufacturing workers, SMP effects can be expected in some sub-sectors, namely in the sectors beverages, pharmaceutical products and non metallic minerals. As can be seen from the table, these effects do, however, generally not show up at the 2 digit level[26].

Industries producing consumer goods, especially textiles, but also other consumer goods like jewellery or toys, which are summarised in the table under the heading other manufacturing industries and most fabricated metal industries (investment goods sectors) have been identified as industries exhibiting non-tariff barriers before 1986. Together these sectors comprise about 55% of total manufacturing employment. A decline in mark-ups in the textile sector cannot be observed, price-cost margins even increased in Italy and Sweden. The sector fabricated metal products, (including machinery and equipment) includes the bulk of public procurement sectors, industries operating in regulated markets with high non-tariff barriers and/or sectors with technical, administrative and fiscal barriers. Especially in this sector one should therefore expect a decline in price-cost margins. In fact, as can be seen from the table, in three large EU countries (no data are available for the UK) a significant decline of mark-ups can actually be observed in recent years. Price-cost margins did not go down in Belgium and Sweden (no data are available for Denmark). Notice, however, that the smaller countries already had relatively low mark-ups. For the sector other manufacturing industries, a decline in mark-ups can be observed for Germany, Italy and Belgium, while mark-ups in the UK increased, although starting from a lower level.

[26] There is no decline in price-cost margins for beverages. For pharmaceuticals we observe a significant decline of price-cost margins in Belgium (-4.2 percentage points from 1988-95) and France (-2.5 from 1988-95). Mark-ups in the sector industrial chemicals declined as well in some countries, namely by –2.25 percentage points in France, by -2.9 percentage points in the UK and by -0.3 percentage points in Belgium over the same time period.

Table B.1: Mark-up Estimates (1970-95)

Sector	Large EU-Countries								Small EU-Countries							
	DE		FR		IT		UK		BE		DK		SW		US	
	before 86	94*	before 86	95	before 86	95	before 86	95	before 86	95	before 86	95	before 86	95	before 86	95
FOOD	11	11	10	13	8	11	0	0	10	10	9	9	4	16	7	7
TEXTILES	9	9	9	9	8	12	5	5	9	9	10	9	7	12	6	6
WOOD, WOOD PRODUCTS	9	9	11	17	NA	NA	NA	NA	NA	NA	NA	NA	10	6	10	10
PAPER, PRINTING PUBLISHING	14	10	10	10	NA	NA	7	7	6	6	7	7	17	10	12	9
CHEMICALS	10	10	11	11	12	12	10	10	9	9	11	11	14	14	12	17
NON-METALLIC MINERALS	17	17	17	17	17	17	6	6	16	16	17	17	2	11	13	7
BASIC METAL INDUSTRY	9	4	9	9	14	8	3	3	4	4	2	2	4	4	9	9
FABRICATED METAL PRODUCTS	13	12	11	7	13	10	NA	NA	9	9	NA	NA	4	4	11	11
OTHER MAN. INDUSTRIES	17	14	NA	NA	12	7	6	10	10	0	14	14	NA	NA	9	9

For each country, the first column gives the mark-up in % before 1986 and the second column gives the mark-up in the year 1995.
For West Germany, data only available until 1994.

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