Economic Survey
of the European Union, 2007

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

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

- **Pushing ahead with the internal market.** A vibrant internal market is central to Europe’s long-term prosperity. The services directive will help achieve this, but it is only a step towards liberalisation and integration. A major effort is needed to eliminate the remaining barriers to trade. Quicker and cheaper remedies for individuals would help knock down some of the remaining obstacles. In financial services, wholesale markets are fairly well integrated, but market segmentation in retail banking and the investment fund industry needs to be reduced. The internal market needs to be supported by better regulation, strong enforcement of competition rules and less and better-targeted state aid.
• **Opening up network industries to competition.** Inefficient network industries raise costs for consumers and other firms. Greater competition is needed in electricity, gas, telecoms, transport, ports and postal services. In energy markets, the network needs to be effectively separated from the generation and supply activities and national markets should be linked together better to create regional or pan-European energy markets. The EU’s recent *Energy Policy for Europe* is an important step in the right direction.

• **Removing barriers to labour mobility.** A mobile workforce can be an economic safety valve and can make firms more productive and innovative by bringing new skills and ideas. Mobility could be improved by making pensions more portable, improving the recognition of qualifications and removing restrictions on workers from the new member states.

• **Making regional cohesion policy more effective.** Regional funding has to focus on projects that can spark sustainable growth. Recent reforms go in this direction but they could be even more focussed. More of the funding should be tied to results so that resources get reallocated to projects where the payoffs are highest.

• **Europe’s global role.** The EU is one of the key trade players. Trade barriers on manufactured goods are already relatively low, except for certain processed food products, while liberalisation of internal market in services will also provide new opportunities for service providers from outside the EU. The EU’s policies will influence, together with those of the other main trade powers, whether the Doha trade round succeeds or whether world trade will splinter into regional agreements. Farm subsidies should be reduced and market access improved. Reforms to the Common Agricultural Policy have made it less distorting but the reforms would be even more effective if all support were de-linked from production. The commitment to cut greenhouse gas emissions by 20% is welcome. This goal should be achieved through market mechanisms as far as this is feasible.
It is fifty years since the Treaty of Rome was signed. The treaty created the European Economic Community, set the goal of ever closer union among the peoples of Europe and laid down the “four freedoms” where goods, services, people and capital could move freely among the member countries. The results have been impressive. It has brought prosperity, the single market for goods among 500 million consumers works fairly well, and there has been good progress in reshaping network industries and financial markets. The Union has grown from 6 to 27 countries, 13 of which now share a single currency. The EU now has a larger GDP than the United States, it is the world’s biggest exporter, and European companies are among the global leaders in most industries.

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

Yet, the European project has faced important challenges during the past few years. The constitutional treaty was not endorsed by some member states, the debate around the services directive was difficult and protection of domestic companies remains a problem. While some countries have learned that liberalisation works, others are lagging behind. The process of harmonising laws across member states is proving harder, partly because the low hanging fruit has gone but also because the policy agenda is colliding with differences over economic and social objectives and the best way to achieve them. At the same time, the EU is facing the challenges of technological change, globalisation, population ageing and climate change.

Figure 1.
EARLY REFORMERS HAVE BEEN REWARDED WITH A STRONGER PRODUCTIVITY PICKUP
Change in labour productivity growth, per cent per annum relative to OECD average

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

Source: OECD, Product Market Regulation database and OECD calculations.
Globalisation is a great opportunity for adaptable economies but punishes rigid ones. Ageing populations will weigh on medium-term growth prospects and put Europe’s health and pension systems, some of which are financially unsustainable in the long term, under pressure.

Further structural reforms are needed to cope with these challenges. While economic prospects are improving, there is no room for complacency. Average incomes in the EU15 are almost a third lower than in the best performing OECD countries and more than a third of the working-age population remains inactive. The employment rate has risen, but it remains below the EU’s target of 70%, and nearly half of the unemployed have been out of work for at least a year. The need for reform is also highlighted by differences within Europe itself. Some countries have performed very well, both in terms of productivity and job growth. The challenge is for Europe’s laggards to learn from its best performers. The potential gains in terms of higher incomes are large, especially for the countries furthest behind the frontier. And as some European countries have shown, economic reform and stronger growth do not necessarily come at the cost of a country’s social goals. With well-designed tax and benefit policies, a dynamic business environment can be combined with high levels of equity and social inclusion. In this context, the Lisbon Strategy for Growth and Jobs provides a comprehensive framework that focuses on both community and member state structural reform measures. Member states commit to and implement national reform programmes within common policy orientations agreed and monitored at the EU level, thus reinforcing policy co-ordination across the EU.

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

**How important is the single market?**

The single market has delivered major benefits for EU citizens. It has given consumers access to a wider range of goods and services and has helped the business sector become more competitive. The stronger competition that it has brought about has lowered prices and lifted innovation, entrepreneurship and growth. But while the internal market process is moving forward, progress has slowed down recently. The lion's share of the improvement in trade, investment and price convergence occurred in the 1990s, with less progress since then. A fresh impetus is needed. With this in mind, the Commission will publish a wide-ranging review of the single market in the second half of 2007. A competitive and dynamic internal market is necessary to foster prosperity and help achieve the objectives of the Lisbon strategy for growth and jobs. It is also important for the smooth functioning of the euro area.
The service sector is the main area that requires further progress in the internal market. Service markets are segmented, with trade among member countries amounting to less than 5% of GDP. This contributes to low productivity growth in the sector. The services directive will help by providing more legal certainty, reducing administrative barriers and boosting co-operation among member states. Certain entry barriers such as market demand tests are now outlawed (albeit with escape clauses) and the mutual screening process, where all national legislation must be vetted to see whether it meets the single market principles, should help chisel away some of the other barriers.

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

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

Network industries are another priority. The sectors that have been liberalised the most, such as air transport and telecoms, have delivered substantial payoffs in terms of lower prices and better service for consumers and other firms alike. However, substantial barriers to competition remain in place. Further market opening is needed in electricity, gas, telecoms, transport, ports and postal services, while respecting universal services obligations. The potential welfare gains from network reform are estimated to be 1½ to 2% of GDP at least.
Energy markets need to be linked together more tightly and opened up to competition. This would lower prices for consumers and make energy supplies more secure. The gas and electricity directives adopted in 2003 contained some important measures – for example, all customers will be free to choose their supplier by July this year – but they have not been implemented well by member states. An EC competition inquiry recently found serious malfunctions in energy markets. Vertically integrated energy giants can treat competitors unfairly and shut out potential entrants. Market concentration is high, with dominant firms often able to control wholesale prices. Competition from imports is weak because cross-border interconnections do not have enough capacity and the available links are not used efficiently or are tied up through historical contracts. Capacity is not expanding quickly enough because the financial incentives to do so are weak and the rules and responsibilities surrounding cross-border issues are unclear. Other problems include state ownership, which can distort competition, and wholesale markets that do not work well due to poor system information and a lack of transparency.

- The priority should be to create integrated EU-wide or regional markets. The Nordic market provides a good role model. Achieving this will at least require greater co-operation among system operators, and possibly moving away from national operators towards cross-border ones. The reliance on national regulators will have to change, especially on issues affecting cross-border trade as existing co-operation is insufficient. The recent agreement by the European Council on the need to establish an independent mechanism for national regulators to co-operate and take decisions on important cross-border issues is a useful first step.

- Separating the network, generation and supply activities of vertically integrated firms is needed to prevent abuse of power and create a level playing field for competition. The Commission recognised this in its Energy Policy Review when it proposed two options – full ownership unbundling or independent system operators (but where the network assets may remain owned by the incumbent). While both options would go a long way towards boosting competition, OECD experience, as reviewed by the International Energy Agency and supported by the Commission’s review, has shown that full ownership unbundling is more effective. The European Council recently agreed on the need for effective separation of supply and production activities from network operations (unbundling) based on independently run and adequately regulated network operation systems, but did not require ownership unbundling.

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

The review of the single market must do more than just fill in the holes. In order to reduce the regulatory burden, red tape needs to be cut and the Commission’s recent initiative supported by the European Council is welcome. New interventions need to be well chosen and effective, while having minimum cost. The Commission in conjunction with member states should push ahead with its Better Regulation agenda, but it could go further by insisting on impact assessments for all proposals across all EU institutions (including substantive amendments by the Council or Parliament) and ensuring that the new independent Impact Assessment Board contributes to high-quality assessments by the Commission. According to the principle of subsidiarity, the community should intervene only where there is a clear case for action at the pan-European level. Regulation is not always the best option. When the community does regulate, it should opt for flexible rather than prescriptive rules – taking a lead from the successful Lamfalussy process in financial markets.

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

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

The euro and the Financial Services Action Plan have contributed to greater integration of financial markets. Indeed, Europe has overtaken the United States in some segments of global markets. Capital flows are
largely unimpeded and most wholesale markets are well integrated. There has been less progress at the retail level. Retail banking – and mortgage markets especially – are mainly national. Cross-border mergers of financial institutions can be complex due to government guarantees, ownership arrangements, tax issues and resistance by supervisors, although the Commission has improved the rules in this area by limiting supervisors’ discretion. Approval for selling products across borders can be lengthy because they must be tailor-made to cater for national laws on investor and customer protection. In mortgage markets, one option would be to go for full mutual recognition (which implies that the judicial process of the lender’s country would apply) since well-informed customers should be able to decide which product is best for them. However, since consumer safeguards are highly valued in some countries, another way forward may be harmonisation of the most important protections and mutual recognition for the rest. Fragmented payments infrastructure has also been holding back a pan-European banking market, and the industry will need to work quickly to ensure that the Single Euro Payments Area (SEPA) is up and running on time in 2010. In this respect, the recent agreement by Council and the Parliament on the legal underpinnings of SEPA will help.

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

Trade barriers on manufactured goods, except for some processed food products, are relatively low and the liberalisation of the internal market in services will also open this market further to non-EU suppliers. The European Union grants extensive preferential access to less developed and African countries, and is a lead donor of aid for trade. The Union is an active member of the WTO and its first stated priority is to maintain the strength of the multilateral system of trading rules. The EU should continue to take a leadership role in the Doha round of trade negotiations by acting together with the other main trade partners to reduce farm subsidies and open up its markets. While support to EU farmers has declined slightly over the past five years and has become less production distorting by moving away from market price support, it remains above the average for the rest of the OECD and well above the most free-trading countries.
From the focus of the economic effects of agricultural policy, as is the case for many countries, further reform is desirable because of the economic benefits resulting for Europeans. However, the common agricultural policy (CAP) has many objectives, including competitiveness of food production, protection of the environment, maintenance of the population in rural areas and underpinning farm incomes. But it has some negative side-effects. While imports from the poorest countries have been liberalised, import tariffs continue to reduce export opportunities for other countries. Consumers pay more for certain types of food, and it traps resources in a low productivity sector. There are many factors that contribute to more intensive farming, and to the extent that the CAP also encourages intensification it can cause environmental harm – although the CAP also includes policies that aim to mitigate the adverse environmental consequences.

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

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

The EU has been a global leader in policies to tackle climate change. Its unilateral commitment to cut its greenhouse gas emissions by at least 20% by 2020 is welcome. Market mechanisms should be used as much as possible to make sure these goals are achieved with the lowest cost. The EU’s emissions trading scheme is a good example even though it had problems during its pilot phase. These problems are being addressed, especially through tighter allocation of permits, but it would also help if allocation methodologies and cap setting were harmonised and if permits were auctioned rather than given away. Options to link with trading schemes in other countries should also be envisaged.

Is regional policy achieving its goals?

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

Is the European workforce mobile enough?

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

Most of the policy obstacles have been removed. The main exceptions are the transitional restrictions on migrants from the new member states. Around half of EU15 countries now give free access to workers from the ten countries that joined in 2004, but only two of them have fully opened their doors to workers from Bulgaria and Romania. Most of the new member states have granted free access. So far, enlargement has not led to the flood of migrants that was initially feared. While the overall level of migration has been rather modest, the inflow to some countries has been higher than expected, due mostly to their strong labour markets and the fact that they did not impose restrictions. These countries have benefited through better job matching, a reduction in structural unemployment and the easing of labour shortages. Countries that still have restrictions should reconsider their decision, but if they are retained, they should use that time to reform their employment policies as the payoff for migrants and the host country is maximised in flexible job markets. Labour mobility could also be enhanced by improving the transferability of occupational pensions. The Commission has been trying for many years to promote pension portability, and has proposed another directive on the issue. The Commission and member states should also continue to improve the recognition of qualifications, eliminate barriers in the regulated professions, reduce transaction costs on house sales and ensure that measures that provide housing for the poor are implemented in a way that does not undercut mobility.

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

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