

Product market reforms in the euro area

Structural reforms aimed at increasing competition and reducing distortions in euro area goods and services markets are likely to have substantial economic benefits and lower the adjustment costs associated with economic shocks. Considerable progress has been made with regard to the integration of euro area product markets and the opening-up of previously sheltered economic sectors. Furthermore, the use of national state aid in the euro area has been significantly reduced. However, much progress remains to be made in all areas of product market reform covered in this article. Against this background, the ECB attaches the utmost importance to the continuation and acceleration of the structural reform process in euro area goods and services markets.

I Introduction

Structural reforms in product markets (covering both goods and services) have two main aims. First, they aim to intensify the level of competition in the economy. This can be done by increasing the integration of euro area goods and services markets and by deregulating previously sheltered economic sectors. Second, product market reforms aim to reduce potentially harmful distortions caused by different forms of government intervention such as an overly generous use of state aid.

Increased competition and fewer distortions in product markets are likely to have considerable economic benefits, such as downward price effects and improved longer-term employment and growth prospects, as a result of increased competitiveness. Furthermore, well-defined reforms in goods and services markets can increase the flexibility of the economy at large and thereby

lower the adjustment costs associated with economic shocks.

This article starts by providing a general overview of the economic benefits of product market reforms. Since a monetary policy viewpoint is taken, emphasis is given to the impact of product market reforms on prices. In view of the fact that product market reforms are a wide and somewhat heterogeneous topic, touching upon developments and policy changes in a large number of fields, their analysis requires a selective approach. This article therefore focuses on the state of progress in enhancing product market integration in the euro area, opening up network industries and reducing the use of state aid. The article concludes with a description of the procedures for further reforms in euro area goods and services markets.

2 Economic benefits of product market reform

Product market reforms that succeed in increasing competition should lead to cost reductions, lower profit margins and productivity gains as a result of, for example, organisational changes and increased innovation. This in turn is expected to have a temporary downward effect on consumer price inflation. Over time, as industries and consumers adjust to the new, more competitive environment, the initial supply-side effect of lower prices in the affected industries is likely to be accompanied by increased demand for goods and services. The

relative magnitude of the supply and demand effects and their distribution across the different sectors of the economy will determine the overall readjustment of relative prices. This is the main long-term price effect to be expected from increased competition in goods and services markets, since in the long run changes in the overall price level are fundamentally determined by monetary developments.

Previously sheltered sectors of the economy are often characterised by a low level of

labour productivity. Consequently, increased competition in these industries frequently results in initial sector-specific employment losses. Over time, however, sectoral employment generally increases owing to higher demand. Furthermore, as other sectors become more competitive as a result of cheaper inputs, the employment prospects in the economy at large improve and the long-run net employment effects of product market reforms are therefore usually positive. Nevertheless, the necessary reallocation of labour within and between different sectors can be facilitated by appropriate labour market policies, which can also help to increase public acceptance of product market reforms.

The cost reductions and improvements in innovation associated with an increased level of competition in product markets are likely to improve the competitiveness of both the sectors undergoing reform as well as the economy as a whole. It is difficult to assess empirically the economy-wide gains from product market reform, and to date few attempts have been made to analyse the extent to which product market regulations affect macroeconomic outcomes such as employment and growth. However, there is some evidence that policies which foster competition and flexible product markets can yield substantial macroeconomic benefits. Studies by the Organisation for Economic Co-operation and Development (OECD), for example, find a negative relationship between the strictness of product market regulation on the one hand and the employment rate and total factor productivity growth, i.e. the increase in the overall efficiency of the economic process, on the other (see Box I).¹

Whereas the economic benefits outlined above are applicable to all economies, flexible product markets are of particular importance for the euro area. This is due to the fact that countries participating in EMU are no longer able to use country-specific monetary and exchange rate policies to address economic shocks. Hence, the importance of national structural policy measures designed to

improve the flexibility of markets has increased. If product markets were to become more efficient and responsive as a result of structural reforms and price adjustments were to be carried out more swiftly, the adjustment costs associated with economic shocks may become lower. Demand shocks, for example, require relative price adjustments in line with the changed demand pattern, shifts in factors of production within or between sectors, or a combination of all adjustment mechanisms. The necessary adjustments are likely to be easier and faster if product market regulations facilitate the entry and exit of firms, thus allowing for a swift reallocation of economic resources. Reducing the entry costs for companies, for example by lifting regulatory burdens, promotes the creation of firms. The exit of firms that are no longer competitive is facilitated by a reduction in the use of state aid and other policy measures designed to protect the existing market structure. The repercussions of a faster reallocation of resources on unemployment depends, inter alia, on the flexibility of the labour market, which in turn is related to factors such as the employability of the workforce and the sectoral and geographic mobility of labour.

A reduction of structural rigidities in product markets may also facilitate the conduct of the stability-oriented monetary policy of the ECB. First, a more rapid reallocation of factors of production owing to product market reforms is likely to result in a faster adjustment of the economy to shocks, which should be conducive to the mitigation of business cycle developments. Second, the increase in the potential level of output and employment growth – made possible by a more efficient allocation of factors of production owing to lower entry and exit barriers to firms – may help to reduce the degree of price pressures that is associated with a given level of economic activity.

¹ On recent productivity developments in the euro area see the article entitled "New technologies and productivity in the euro area" in the July 2001 issue of the ECB Monthly Bulletin.

Box I

Links between the strictness of product market regulation, employment and productivity growth

The OECD International Regulation Database (IRD) provides a broad overview of the strictness of product market regulation in OECD member countries. The database contains more than 1,100 observations per country, referring mostly to 1998. The main sources of information for the database are the responses of OECD member countries to an ad hoc questionnaire developed by OECD staff as well as publicly available information.

On the basis of the economy-wide and sector-specific information contained in the database, it is possible to construct summary indicators of product market regulation. These are measures designed to express the stringency of the overall regulatory environment in different countries, from least to most restrictive (using a scale of 0 to 6, with 0 being the least and 6 the most restrictive regulatory environment).¹

Chart A: Product market regulation and employment rates

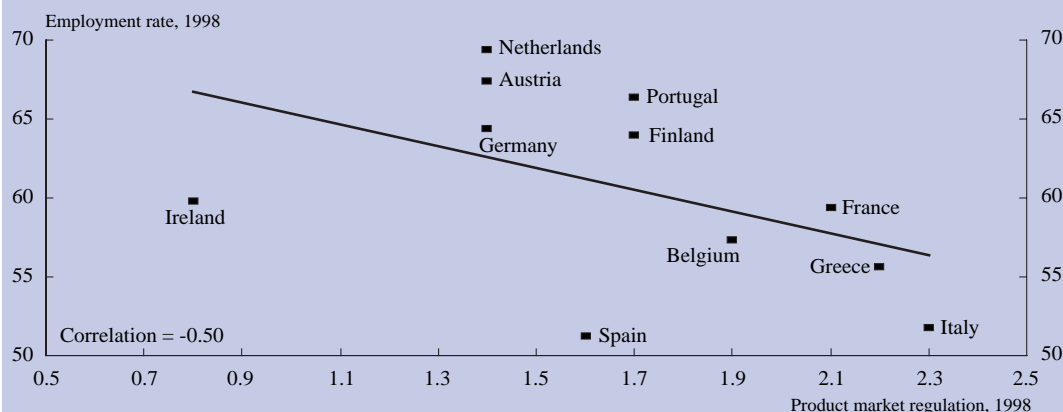
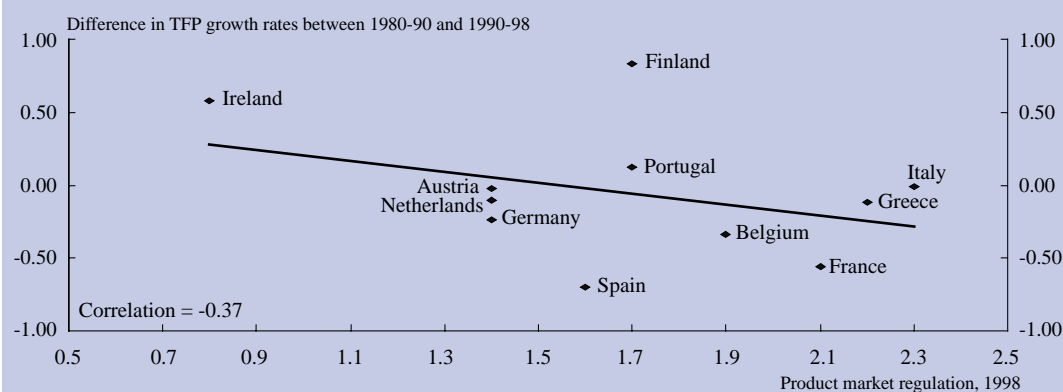


Chart B: Product market regulation and total factor productivity



Source: OECD.

Charts A and B plot the summary indicators for product market regulation for 11 euro area countries (the indicator is not available for Luxembourg) against two macroeconomic indicators: first, the employment rates (as a percentage of the workforce) in 1998 and, second, the difference between the average growth rate of total factor productivity (TFP) during the period from 1980 to 1990 and the average TFP growth rate during the period from 1990 to 1998.

¹ A more detailed description of the database and the summary indicators can be found in G. Nicoletti, "Regulation in Services: OECD Patterns and Economic Implications", OECD Economics Department, Working Paper No. 287, Paris, 2001.

The figures illustrate that in 1998, the reference year for the database, there appeared to be substantial differences between the euro area countries in the strictness of the overall regulatory environment for product markets. Furthermore, the charts tentatively indicate a negative correlation between the strictness of product market regulations on the one hand and the macroeconomic performance of a country in terms of employment rates and TFP growth (i.e. the increase in the overall efficiency of the economic process) on the other.

It should be kept in mind that summary indicators of product market integration are subject to a number of substantial caveats, such as the imperfect international comparability of many forms of product market regulation. Furthermore, the IRD refers only to 1998. Recent regulatory reforms are therefore not taken into account. Notwithstanding these shortcomings, analyses along the lines provided above allow some tentative conclusions to be made on the link between the strictness of product market regulation and macroeconomic performance.

3 Enhancing product market integration in the euro area

The creation of a single market for goods and services has advanced the integration of product markets throughout the EU and hence the euro area considerably. Since product market integration and the resulting increase in competition can be expected to have exerted downward pressure on traded goods and services prices, the decline in price dispersion for most categories of goods and services across the EU Member States during the period from 1995 to 1999 is an important indicator of progress in product market integration. Fuel and power prices were the only exceptions to the general declining trend. However, the cross-border retail trade in fuel and power products still remains limited (see Table I).

However, the interpretation of changes in price dispersion is subject to a number of caveats. First, continuing differences in

indirect taxation across the EU Member States contribute to price dispersion. Second, the gradual convergence of productivity and living standards across Member States is likely to exert some limited upward pressure on price developments in non-traded goods and services prices in Member States and regions with relatively low GDP per capita levels (what is known as the Balassa-Samuelson effect). The small inflation differentials resulting from this effect are likely to contribute to a reduction of price level differences between EU Member States and are expected to decline over time.

Despite the clear advances in EU and euro area product market integration, the internal market remains incomplete. One of the reasons for this are deficits in the implementation of Internal Market Directives into Member States' national legislation,

Table I
Price dispersion in the EU for goods and services, 1995-99

(coefficient of variation; VAT included)

	1995	1996	1997	1998	1999	Change 1995-99
Private final consumption	0.18	0.16	0.15	0.14	0.14	-0.04
Non-durable goods	0.15	0.14	0.13	0.12	0.11	-0.04
Durable goods	0.16	0.13	0.12	0.12	0.11	-0.05
Fuel and power	0.18	0.17	0.16	0.18	0.20	0.02
Services	0.17	0.16	0.16	0.13	0.13	-0.04

Source: European Commission, "Economic Reform: Report on the functioning of Community product and capital markets 2000" ("Cardiff report").

which limits the de jure integration of product markets (see Chart 1).

The average share of non-implemented Internal Market Directives in the euro area countries declined from around 6.8% in November 1997 to around 2.7% in May 2001. This is slightly above the corresponding figures for the EU, namely 6.3% (November 1997) and 2.5% (May 2001). Although this decline indicates an improved national transposition record, by May 2001 10.8% of all Internal Market Directives had not yet been transposed in all euro area countries. This figure has remained almost constant over the last two years. The degree of non-transposition differs significantly between the various policy areas. The most problematic areas appear to be transport policy, public procurement and consumer policy. More than 30% of the Internal Market Directives in these fields have not yet been transposed in all euro area countries. Other important areas in which the de jure integration of the internal market remains incomplete are social policy and telecommunications, where the transposition of around 20% of the Directives is still incomplete.

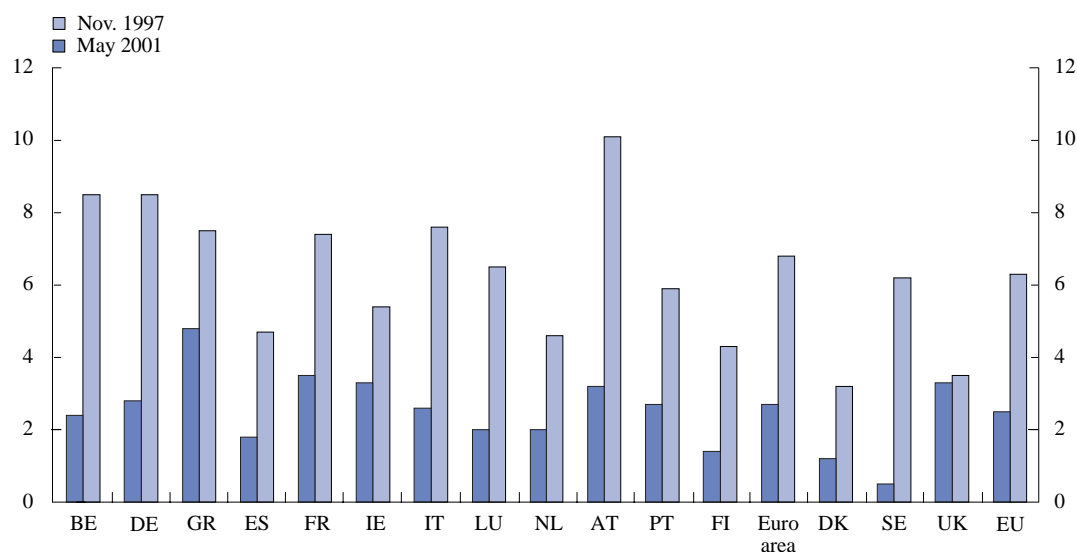
In the 2001 Broad Economic Policy Guidelines (BEPGs) the ECOFIN Council urges the Member States to reduce the internal market transposition deficits to less than 1.5% by spring 2002. Since the economic importance of the different Internal Market Directives varies significantly, a summary measure of the transposition deficit, giving equal weight to all Directives, is of limited use in assessing the economic implications of the transposition deficit. This notwithstanding, a reduction of the deficit to 1.5% would certainly constitute a significant advancement with regard to product market integration and could be expected to contribute to a further increase in competition. However, since the current transposition deficits appear to be caused mainly by backlogs in the national policy-making process, a number of Member States will have to intensify considerably their administrative and political efforts regarding the transposition of EU law in order to meet this target.

Other indicators of progress with regard to product market integration are business surveys designed to identify remaining obstacles for cross-border business activities.

Chart 1

Non-implementation of Internal Market Directives

(as a percentage of the total number of Directives)



Source: European Commission, "Single Market Scoreboard", No. 8, May 2001.

Note: Figures for the euro area and the EU are unweighted averages of the figures for the Member States.

Table 2**Remaining obstacles for businesses in the internal market***(as a percentage of interviewed businesses)*

	1999	2000	Change
Additional costs to render products or services compatible with national specifications	37	33	-4
Unusual testing, certification or approval procedures	31	31	0
State aid favouring competitors	29	27	-2
Difficulties related to the VAT system and VAT procedures	27	26	-1
Inappropriate legal appeal mechanisms (breaches of contract)	n.a.	24	n.a.
Discriminatory tax treatment of your operations	17	24	+7
Lack of legal security of cross-border contracts/transactions	17	23	+6
Restrictions on market access; existence of exclusive networks	23	20	-3
Lack of protection against piracy and counterfeiting	18	18	0
Costly financing arrangements for cross-border transactions	18	18	0
Discriminatory practices of awarding authorities in public procurement markets	15	16	+1
Requested rights or licences in hands of local competitors	15	15	0
Difficulties in the temporary posting of staff abroad	8	13	+5
Requirement to establish branch in another Member State	15	13	-2
Other legislative or regulatory obstacles	15	10	-5
Ban to market a product/service legally marketed in another Member State	9	9	0

Source: European Commission, "Single Market Scoreboard, No. 7, November 2000.

Note: The survey is based on 3,240 interviews conducted in 2000 and 3,395 interviews conducted in 1999. The surveys cover large, medium-sized and small firms from the services, distribution, manufacturing and construction sectors.

Such obstacles are illustrative of the extent to which EU product markets are de facto integrated. This concept goes beyond the de jure integration by means of Directives and other legal instruments and also encompasses problems that have not yet been legally addressed or that cannot be legally addressed. The latest available survey conducted for the European Commission, relating to 2000, indicates increasing overall satisfaction of EU businesses with the operation of the internal market. However, notwithstanding this positive overall picture, the surveys show that the range of remaining obstacles for businesses to participate in the internal market is considerable (see Table 2).

Although business surveys are subject to the general caveat that they reflect only the views of a particular group of economic agents, the results indicate that progress with regard to the removal of the remaining obstacles is limited. With regard to some of the most frequently mentioned hurdles, such as the additional costs of complying with national product or service specifications or the use of state aid in favour of competitors, the situation appears to have improved

somewhat. The significance of certain other important obstacles, such as unusual testing, certification or approval procedures or costly financial arrangements for cross-border transactions, however, remains unchanged. Furthermore, a number of problems related to cross-border business activity in the EU, for example discriminatory tax treatment and the lack of legal security for cross-border transactions, even appear to have increased. More generally, the survey results suggest that considerable efforts in a range of policy areas are still required in order to also ensure the de facto completion of the internal market.

The integration of services markets across the EU and hence the euro area is generally less advanced than the integration of goods markets. In fact, the intensity of intra-EU trade in services in relation to the sector's size has declined since the early 1990s. This is in stark contrast with the increase in goods trade, where market integration is more advanced. The lack of competition associated with the insufficient integration of services markets is particularly harmful as the economic significance of services is steadily increasing. Moreover, new information and

communication technologies (ICTs) reduce the need for some services industries to be located close to their customers. Most of the barriers to trade in services appear to be due to national regulations, such as the administrative procedures for setting up subsidiaries in other Member States. The European Commission recently unveiled a two-year strategy to remove bureaucratic obstacles and barriers to cross-border trade in services, which is therefore of considerable economic importance for the euro area and the EU as a whole.

To sum up, over the last decade the integration of euro area product markets has

made great strides forward, but progress remains to be made in a number of important areas. First, remaining deficiencies in the de jure integration of product markets, such as the non-transposition of Internal Market Directives, have to be overcome. Second, further efforts are required to identify and remove technical and administrative hurdles to the operation of the internal market for goods and services which, taken together, have a crucial impact on the level of de facto integration and competition in the internal market. This in turn will have important repercussions on price developments and price dispersion in the euro area.

4 Opening-up of sheltered sectors: regulatory reform in network industries

Many of the recent reforms in euro area goods and services markets focused on regulatory changes in network industries. Until a few years ago, these industries were typically characterised by the existence of one large, vertically integrated and publicly owned incumbent. Arguably the most important reason for this monopolistic market structure is the presence of a bottleneck infrastructure with natural monopoly characteristics. It would be extremely expensive and economically inefficient to install, for example, competing electricity transmission systems or rail networks. Furthermore, in the past governments frequently pursued non-economic objectives related to network industries, such as universal service obligations, equal prices across geographic regions and the security of the supply of essential services. More recently, however, the question emerged as to what extent competition could be introduced in network industries by granting universal access to the bottleneck infrastructure. This requires specific regulations in order to ensure non-discriminatory access for potential competitors under "fair" conditions. Furthermore, regulatory oversight has to ensure that non-economic objectives, such

as universal service obligations, quality standards and the security of supply, are guaranteed. A further common feature of network industries is that they are not only sizeable in their own right, but provide important inputs for a wide range of economic sectors, which further increases their economic importance.²

Significant progress has been made in the liberalisation of the *telecommunications* sector. As from 1 January 1998, free competition in the provision of voice telephony and telecommunications infrastructure was introduced in the EU and by 2001 the last country-specific temporary derogation from the implementation of the relevant EC Directives had expired. Although a number of impediments to the de facto implementation of competition in this sector still need to be resolved, the introduction of competition in this industry is now well advanced. In view of the progress made so far the 2001 BEPGs no longer refer to the telecommunications sector as a priority industry for further regulatory reforms.

² A more detailed analysis of the regulatory reform process in the telecommunications, electricity and gas sectors can be found in the ECB publication entitled "Price effects of regulatory reform in selected network industries", March 2001.

The network industries mentioned in the 2001 BEPGs, namely energy (electricity and gas), postal services, air transport and railways, are currently in very different stages of the regulatory reform process. However, the introduction of competition in all these sectors, with the exception of the air transport industry, is less advanced than in the telecommunications industry. Taken together, the products and services produced in network industries have a share of slightly less than 5% of the overall euro area Harmonised Index for Consumer Prices (HICP). The economic implications of the regulatory reform process in these industries are of importance with regard to price developments and therefore with regard to monetary policy.

Turning first to *energy markets*, the EC Electricity Market Directive (96/92/EC) had to be transposed into national legislation by 19 February 1999. The Directive called for an initial liberalisation of at least 25% of the national electricity markets, a share which is due to increase to one-third of these markets by 2003. The EC Gas Directive (98/30/EC) had to be transposed into national legislation by 10 August 2000. The Directive called for an initial liberalisation of at least 20% of the national gas markets, a share that is due to increase to one-third of these markets by 2008.

Most euro area countries envisage either opening up a larger share of their electricity and gas markets to competition than stipulated by the relevant EC Directives or fully liberalising their energy markets. At the current juncture, around 60% of the euro area electricity market and 39% of the euro area gas market are open to competition. On the basis of member countries' intentions in 2001, the share of the euro area electricity market that will be open to competition will increase to no more than around 70% by 2008, with most of the additional opening-up of the market due to take place by 2004. The share of the euro area gas market to be opened up to competition is set to increase to 54% by 2008.

As illustrated in Box 2 recent developments in the HICP sub-indices for telephone and telefax services and electricity, in relation to the overall euro area HICP, indicate that regulatory reforms have had a moderating impact on euro area price developments in these two sectors. Consumer prices for gas in the euro area do not appear to have been influenced by the partial introduction of competition as yet. However, this is not unexpected, since the first steps towards regulatory reform in this sector were only taken recently.

With regard to the level of competition, the *postal sector* is divided into two parts. Parcel and express services operate in a broadly competitive environment, whereas the delivery of letters is highly regulated in most Member States. With effect from February 1999 the Postal Directive (97/67/EC) opened up about 3% of the regulated national postal services markets to competition. In 2000 the European Commission proposed to open up an additional 20% of these markets by 2003, with a view to a further opening-up of the market by 2007. However, at the time of publication, the EU Council of Telecommunications Ministers had not yet reached a political agreement on these proposals.

Whereas progress at the EU level remains limited, the experience of the few Member States that have liberalised their postal markets beyond the minimum requirements of the Postal Directive appears to have been broadly positive. Increased competition has led to substantial price reductions in the parcel post, bulk and direct mail markets, which has resulted mainly in direct benefits for producers. Pioneers of postal liberalisation have not experienced problems in the provision of universal services, even in remote areas with low population density.

The provision of *air transport services* within the EU was gradually opened up, culminating in April 1997 in the introduction of cabotage, i.e. the right of a Member State carrier to operate a route within the territory of

Box 2

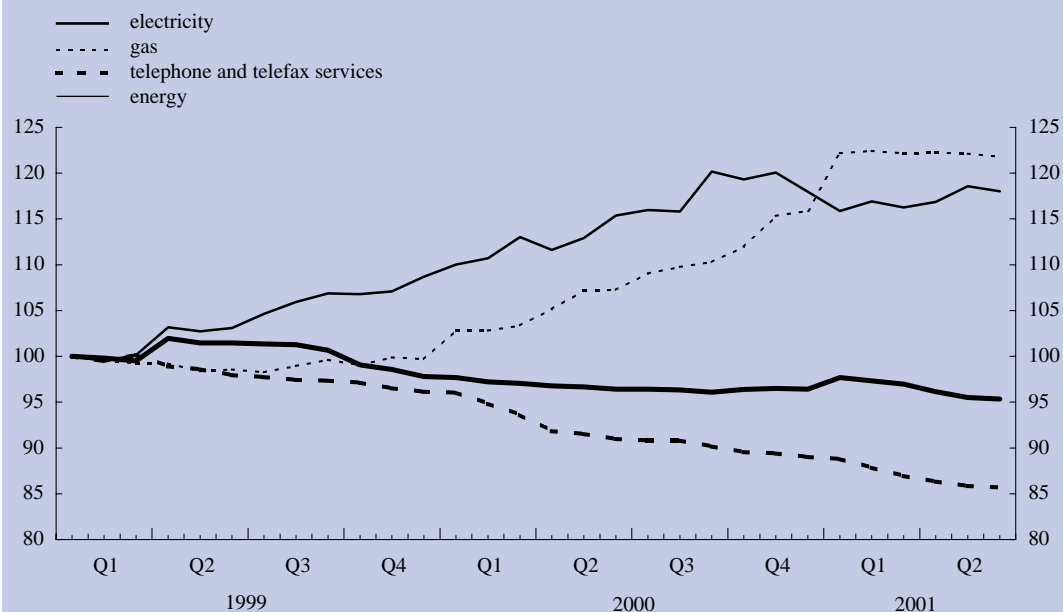
Consumer price developments in selected network industries

As from 1 January 1998 free competition in the provision of voice telephony and telecommunications infrastructure was introduced in most EU Member States. Furthermore, the transposition of the EC Electricity Market Directive into national law resulted in a partial opening-up of the electricity market as from February 1999, with the partial opening-up of the gas market following in August 2000. These regulatory reforms are expected to result in a higher level of competition in these industries and downward pressure on consumer prices.

The chart below shows recent developments in the HICP sub-indices for telephone and telefax services, electricity and gas relative to changes in the overall euro area HICP for the period from 1999 to 2001. The chart also contains the HICP sub-index for energy, which provides a useful benchmark for the assessment of changes in the electricity and gas indices.

HICP sub-indices relative to the overall HICP for the euro area

(index January 1999 = 100; monthly data)



Source: Eurostat.

With regard to the HICP sub-index for telephone and telefax services, a marked downward trend compared with the overall HICP is discernible throughout the period under review. The electricity sub-index also shows a downward trend, although the decline is much weaker than that for the telephone and telefax services sub-index. However, in view of the strong increase of the overall sub-index for energy during most of the period from 1999 to 2001, mainly on account of the rise in oil prices, the decline in electricity prices in relation to the overall HICP is remarkable. The HICP sub-index for gas follows the developments of the overall energy index closely, although with a considerable time lag. This is due to the link between oil and gas prices. Given that the liberalisation of the European gas markets is still in its early stages, it cannot be expected that the HICP sub-index for gas will already reflect progress in regulatory reform.

Overall, the chart indicates that the introduction of competition in network industries is likely to result in downward price effects in the industries concerned. However, it is important to keep in mind that such reforms are only one of the factors determining relative price developments in these industries. Other important elements include technological progress (in the case of telecommunications) and tax changes and energy price variations (in the case of electricity and gas).

Table 3**Average changes in air traffic fares between euro area capitals, 1997-2000¹⁾***(unweighted average of fare changes in the euro area countries as a percentage)*

	Business fare	Economy fare	Promotion fare
One carrier	+23.2 (11)	-15.5 (11)	-6.5 (11)
Two carriers	+14.1 (10)	-16.4 (11)	-2.7 (11)
Three carriers	+7.7 (7)	-7.9 (7) [-17.8 (6)] ²⁾	-5.4 (8)
Four carriers	-14.5 (2)	+13.3 (3) [-23.5 (2)] ²⁾	-11.8 (4)

Sources: European Commission, "Economic Reform: Report on the functioning of Community product and capital markets 2000" ("Cardiff report") and ECB calculations.

- 1) The figures in brackets indicate the number of euro area countries for which the category is applicable. For example, in all euro area countries (except Finland, where no data are available) at least one carrier offered business fare services. However, only two countries had four carriers offering business fare services.
- 2) Figures in square brackets exclude one euro area country with highly atypical price developments.

another Member State. The liberalisation of the industry appears to have contributed to the dynamic development of air transport services, resulting in a considerable increase in the number of carriers, routes and employees. The national airlines' market share of domestic and international routes within the EU declined as part of the industry's restructuring process, although the previous "flag carriers" remain the dominant service providers.

The extent to which regulatory reforms in air transport services resulted in downward price effects is strongly related to the number of operators serving the route and hence the level of competition (see Table 3). More specifically, economy and promotion fares tended to fall, whereas prices for business fares increased in most euro area countries. Since economy and promotion fares compete not only with the fares of other operators serving the same route but also with fares for indirect flights and charter services, the level of competition in this market segment tends to be higher than in the business segment.

A report by the European Commission published in 1999 on changes in the European airline industry found that the share of routes with more than two competitors had increased since the start of the liberalisation process. However, in 1997, the reference

year of the study, more than 90% of EU air routes were still monopolistic or duopolistic. While this is partly due to the limited market volume on many routes, air transport competition is also limited by infrastructure bottlenecks, notably the scarcity of available slots at major airports. According to current rules established carriers will not normally lose their take-off and landing slots however little they actually use them. Although a Council Regulation adopted in October 1993 (Regulation EEC 95/93) stipulates that 50% of unused or newly created slots must be set aside for newcomers to the market, the availability of peak-time slots at congested airports has not increased substantially. Against this background the European Commission is expected to come up with new proposals in order to reform the allocation procedures for take-off and landing slots. Furthermore, the European Commission has taken the initiative to remove further infrastructure bottlenecks that reduce the level of competition in the air transport industry, in particular the overloaded air space due to the lack of an integrated EU air traffic control system.

Regulatory reforms in the EU rail transport industry are still in the early stages. However, a conciliatory agreement reached between the European Council and the European Parliament in November 2000 brought about some progress by calling for, inter alia:

- a gradual opening-up of the European rail freight network to all licensed rail operators. Seven years after the entry into force of the Council Directive operators will have access to the whole rail network for international rail freight transport;
- the separation of essential functions of the railway industry, such as infrastructure management and rail services;
- the establishment of an independent regulator in each Member State; and
- a reduction of the technical barriers between the different national rail networks.

Furthermore, the European Commission intends to present a second package of measures on the opening-up of domestic rail freight and passenger markets no later than December 2001. These measures are likely to foster productivity in the rail transport

industry and contribute to lower prices for rail services depending on the extent to which they will result in a reduction of the regulatory burden for rail transport and an increased level of de facto competition.

Summing up, the introduction of competition in network industries can result in considerable downward price effects and other general economic benefits, such as improved longer-term employment and growth prospects. However, an appropriate regulatory framework which ensures non-discriminatory access to the bottleneck infrastructure is indispensable in order to create de facto competition in these sectors. In other words, the “quality” of the regulatory framework has a considerable impact on the extent to which potential price falls due to regulatory reforms in network industries will be achieved.

5 Reducing distortions: the use of national state aid in the euro area

The control of state aid is an important element of EU competition policy and a reduction of the use of state aid is a frequently reiterated demand in discussions on product market reforms in the euro area. The underlying rationale for limiting state aid is the assumption that subsidies often reduce aggregate economic welfare by weakening the incentives for firms to improve their efficiency and by enabling the less efficient to survive or even expand at the expense of the more efficient. Furthermore, state aid has to be financed by means of general taxes, which increases the overall importance of the state in the economy and aggravates the distortions caused by state aid. Finally, state aid may distort intra-EU trade, which in turn may lead to intra-EU friction and retaliatory measures, thereby endangering the benefits of the internal market.

Assessments of the economic repercussions of state aid have to differentiate between the main categories of state aid, namely *sector-specific aid*, *region-specific aid* and general or *horizontal state aid*. Sector-specific aid affects

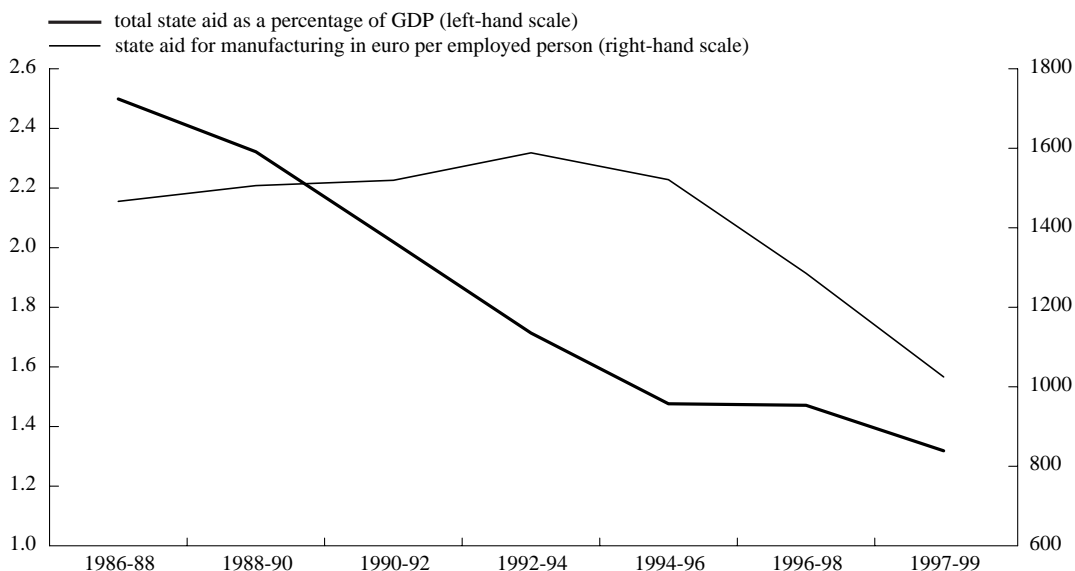
the sectoral structure of the economy and has the strongest distortive effects on the allocation of resources. Horizontal state aid such as financial support for research and development investments is available for all sectors of the economy. However, public subsidies for particular economic activities such as research and development tend to be asymmetrically distributed across different industries. Horizontal state aid is therefore also likely to lead to distortions of the allocation of resources, although these are likely to be less pronounced than in the case of sector-specific aid. The implications of region-specific aid are likely to fall between those of the other two categories, depending on, inter alia, the relative economic importance of the supported regions and the sectoral structure of the region concerned.

The overall use of national state aid in the euro area nearly halved during the period from 1986 to 1999, but it is still at a sizeable level of around 1.3% of GDP (see Chart 2). Developments with regard to national state

Chart 2

Overall national state aid and state aid for manufacturing in the euro area

(three-year averages of overall state aid as a percentage of euro area GDP and state aid for manufacturing in the euro area in euro per employee)



Sources: European Commission, "Surveys on State aid" (various issues), and ECB calculations.

aid for the manufacturing sector are somewhat different. Expressed in euro per industrial employee national state aid for manufacturing rose slightly until the period from 1992 to 1994 and fell gradually in the period thereafter. Financial support provided within the framework of the EU's Common Agricultural Policy (CAP) and the EU's regional policy is not included in these figures. This is due to the CAP's exclusive focus on agriculture and to the fact that a large share of the financial assistance provided through the EU's regional policy does not directly benefit private enterprises.

Over the period from 1986 to 1999 the relative importance of horizontal state aid for the manufacturing sector as a share of

total national state aid for manufacturing remained relatively stable at around 40%. The share of region-specific state aid to industry increased over time, mainly at the expense of sector-specific state aid for industry. The latter declined gradually from 23.5% during the period from 1986 to 1988 to 9.1% during the period from 1997 to 1999.

In sum, there have been significant reductions in national subsidies to enterprises in the euro area, particularly during the 1990s, but overall state aid remains considerable. Furthermore, particular efforts are needed to reduce the share of the most distortive form of state aid, namely sector-specific public support to enterprises.

6 Procedures for further product market reforms in the euro area

Articles 98 and 99 (1) of the Treaty establishing the European Community (the "Treaty") require EU Member States to regard their economic policies as a matter of common concern and to co-ordinate them in the context of the BEPGs. This also applies

to the co-ordination of product market reforms in the EU and the euro area.

The responsibility for product market reforms in the euro area rests to a large extent with the Member States, although the

European Community also plays an important role in many areas related to product market reform. In its role as guardian of the Treaty, the European Commission initiates legal action against the delayed implementation of Internal Market Directives by Member States or blocks state aid that is not compatible with the relevant articles of the Treaty. With regard to the introduction of competition in previously sheltered sectors of the economy, the allocation of responsibilities depends on the industry-specific situation. In the telecommunications sector, for example, the legal provisions for opening up the market are largely in place. It is now primarily up to the regulatory authorities of the Member States to safeguard and further increase the de facto level of competition in this market. Moreover, the European Commission retains an important role in monitoring the process and may initiate changes to the existing legal framework if further measures are required to increase competition. In network industries that are not yet fully open to competition (energy, postal services, air transport and railways) Member States can decide to exceed the binding minimum opening requirements (if any) set by the Council of Ministers. Furthermore, it would be up to the Member States to undertake additional product market reforms in policy areas in which they retain the exclusive policy-making competence. These are product market areas that are not subject to an explicit EU policy and that do not conflict with horizontal EU policy objectives such as the completion of the internal market.

Turning to the current procedures for implementing product market reforms, the Cardiff European Council in June 1998 called for a reinforced monitoring of structural reforms in the EU, which initiated what is known as the "Cardiff process". As part of the Cardiff process Member States present national reports on reforms concerning the functioning of product and capital markets and the European Commission prepares a report on the functioning of Community product and capital markets (i.e. the "Cardiff Report"). Furthermore, the Economic Policy

Committee (EPC), comprised of delegates from the Member States, the European Commission and the ECB, conducts an annual in-depth peer review of economic reforms in Member States. This process complements the assessment provided in the Commission's Cardiff Report and results in the EPC's *Annual Report on Structural Reforms*. The latter report focuses on the situation in the EU Member States and covers a somewhat broader range of issues than the Cardiff Report. Both reports feed into the BEPGs, which are the key instrument for economic policy co-ordination in the EU, including the reform of product markets. Furthermore, the BEPGs serve as a point of reference for the ex post policy assessment partly conducted by the European Commission and published in its *Report on the Implementation of the BEPG*. The monitoring of structural reforms in the Cardiff process is implemented by a "light procedure". Unlike the Stability and Growth Pact for fiscal policies, the Cardiff process does not foresee sanctions in the case of non-compliance. Instead, the instruments used in this procedure are peer pressure and an extensive reporting, monitoring and evaluation system, as well as the identification of best practices, i.e. successful initiatives undertaken in one Member State that might also be applied in others.

At its summit in Lisbon in March 2000 the European Council further emphasised the need for progress in product market reform as a key condition for the EU to achieve its strategic goal "to become the most competitive and dynamic knowledge-based economy in the world". Furthermore, it was decided that the annual spring meetings of the European Council should define, inter alia, mandates concerning structural reforms and ensure that the Member States and the Community institutions follow them up. The first such meeting took place at the Stockholm European Council in March 2001. The number of concrete decisions taken concerning product market reforms was limited. Shortly before the Council meeting, the European Commission proposed that Member States should fully liberalise their

electricity and gas markets by 2005 at the latest. The European Council generally welcomed the opening-up of these markets, but no precise timetables were adopted. The “open sky” initiative, which aims to alleviate existing air transport capacity bottlenecks in the EU by integrating the national air control systems, was delayed.

This notwithstanding, the European Council agreed on a comprehensive list of follow-up

activities in order to maintain and further enhance the momentum of reform initiated in Lisbon. These activities are reflected in the BEPGs priority areas for product market reform. The next follow-up meeting to Lisbon, scheduled for spring 2002, will provide a further opportunity to assess the current pace of product market reform in the euro area and the EU.

7 Concluding remarks

Structural reforms in euro area product markets aim to increase the level of competition in the economy and to reduce potentially harmful distortions. This in turn should result in considerable economic benefits such as downward price effects and improved longer-term employment and growth prospects. Furthermore, well-defined reforms in goods and services markets can reduce the adjustment costs of changes in economic circumstances.

The integration of euro area product markets and, more recently, the introduction of competition in previously sheltered economic sectors has advanced considerably, but there are a number of important issues which remain to be addressed. There is also a need for a further reduction in the levels of state aid in general and sector-specific state aid in particular. Against this background, the ECB strongly welcomes the increasing political importance that is given to further progress

in product market reform and encourages the competent policy-makers in this field to build upon the momentum generated at the Lisbon European Council in March 2000.

The ECB attaches the utmost importance to product market reforms in the euro area and will continue to monitor and analyse closely the ongoing developments in this field for two main reasons. First, in order to be able to assess the timing and magnitude of the downward price effects that these reforms are likely to bring about. Second, in order to detect any further economic effects that reforms in goods and services markets may trigger. Furthermore, the ECB will contribute to the ongoing work on goods and services market reform through its participation in the EPC and other competent Community bodies as well as through further analyses of the economic implications of product market reform.