This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.
Summary

- Main findings
- Key recommendations
Main findings

**Raising inclusive long-term growth.** The EU economies, including those most heavily hit by the crisis, appear to be turning the corner after many years of low and uneven growth. However, low productivity growth, while partly due to the recession, has deep structural causes: high tax burdens, rigid labour laws, barriers to competition, and slow innovation dynamics. Inequality has grown since the 1980s, and high unemployment is hurting the most vulnerable, weakening public support for the EU project. Significant structural reforms have been implemented in some European countries in response to the crisis, but deeper reforms in more countries would raise growth on a sustainable basis. EU institutional and regulatory reforms, complemented by national policies, can enhance inclusive and sustainable growth. The EU 2020 strategy, the European Semester and the Horizon 2020 initiative have been designed to support growth and innovation, but have not succeeded noticeably so far. National ownership has been weak, significant hurdles remain for innovative firms, and regulatory costs of both EU and national origin are large. Social, employment and environmental impacts of reforms are not systematically assessed and spill-overs are not fully incorporated in the European Semester process and in adjustment programmes.

**Reinvigorating the Single Market.** Implicit barriers between EU countries restrict the circulation of goods, services, people and capital. The heterogeneity of rule settings across EU countries and high national barriers, especially in the more protected service sectors, make it hard to adapt to each national regulation. Unnecessary restrictions on foreign direct investment remain in place. Lack of portable pension rights and of national recognition of professional qualifications weakens labour mobility. Physical networks between countries are hampered by deficient infrastructure, and lack of harmonised regulations. Finally, there is room to lower external barriers to trade, which would enhance competitive forces, boost productivity and encourage innovation.

**Towards a low carbon economy.** Progress towards a low-carbon economy in Europe should remain a priority going forward. The European Union Emission Trading System (ETS), a pioneering market to curb greenhouse gas emissions, has in the crisis been characterised by depressed carbon prices which fail to provide the financial incentives for adaptation and innovation to reduce carbon emissions. Lack of legally binding longer-term targets, narrow coverage of the ETS and some expensive subsidy programmes have undermined the economic effectiveness of climate change policy. Finally, the electricity infrastructure is not well adapted to support the change in energy mix needed to meet long-term carbon emissions targets.
Key recommendations

Raising inclusive long-term growth

- Enhance the EU Semester process by focusing more on spill-over effects, strengthening the underpinning analysis, systematically assessing employment, social and environmental impacts of reforms. Continue to address structural imbalances, and better co-ordinate communication with EU member states.

- Reinforce the EU Impact Assessment system and the new EU Regulatory Fitness (REFIT) programme to improve the design of policies and reduce burdens for firms and national public administrations.

- Implement the EU Horizon 2020 framework programme for research and innovation to simplify procedures, and bridge a gap between research institutions and the private market.

Reinvigorating the Single Market

- Improve the implementation of the Services Directive, in particular by eliminating unjustified and disproportionate restrictions to the cross-border provision of services and to the establishment of businesses.

- In network sectors that require regulation, further strengthen co-operation between national regulators, with a view to moving towards cross-border regulators.

- Deepen the internal energy market through further development of energy interconnections.

- Move forward with the adoption of the proposed directives on free movement of workers and on acquisition and preservation of supplementary pension rights. Take measures to eliminate double taxation of pensions, develop automatic qualification recognition, and eliminate disproportionate national barriers related to regulated professions.

- Continue the intensive engagement in multilateral trade negotiations, move forward with a trade agreement with the United States to reduce non-tariff barriers, while continuing to negotiate trade agreements with other partners.

Towards a low carbon economy

- Strengthen the EU Emission Trading Scheme (ETS) by adopting an ambitious 2030 target accompanied by a tight ETS allowance cap. In this context, the renewable energy target and subsidy schemes should avoid creating distortions within the Single Market.

- Make sure that each sector is either subject to CO₂ taxation (for example, under the planned Energy Taxation Directive) or participates in the ETS, as appropriate.

- Encourage ownership unbundling of generation, supply and network activities within vertically-integrated electricity utilities, and streamline permit procedures to support electricity grids investment.
Assessment and recommendations

- Fostering economic recovery
- Reinvigorating the Single Market to boost growth and employment
- Towards a low carbon economy
More than five years after the onset of the global economic and financial crisis, growth is beginning to pick up in EU economies. Systemic risks have been reduced, large external and internal imbalances have receded, and most of the vulnerable countries are gradually regaining competitiveness via wage adjustment and significant structural reforms. Still, low confidence, weak private sector balance sheets and fiscal consolidation, necessitated by the high debt levels, weigh on demand. Unemployment rates stand at double-digits in several countries, and in most are more than twice as high for the young. Inflation is very low in many countries, and deflation risks have risen. The impact of supportive monetary policy on demand is weakened by financial fragmentation. Credit is restrained by weak bank balance sheets, high exposure to sovereign debt and, in the vulnerable countries, high interest rates driven by high perceived risks. These factors have been undermining confidence in the European project (Figure 1).

The challenge for policy is to reinforce the recovery, get people back to work and create a basis for sustainable growth. While the largest part of the required fiscal consolidation has been achieved, in most EU countries strong fiscal positions will need to be maintained for many years to bring debt down. Priority should be given to repairing financial sector balance sheets and recapitalising banks, where needed, in order to restore credit growth and support demand. Fragmentation can be reduced and confidence boosted by further progressing towards banking union in Europe. Expansionary monetary policy will need to support demand for some time. At the same time, higher priority needs to be given to structural reforms to boost more even adjustment and rebalancing, competitiveness, and
the growth potential. This could be facilitated by continued reinforcement and implementation of EU wide fiscal and structural governance.

The 2014 Economic Survey of the Euro Area and the 2014 Economic Survey of the European Union discuss these challenges from different perspectives: the former mainly focusses on financial sector reform and fiscal and monetary policies, and the latter on structural reform surveillance at the EU level.

Fostering economic recovery

The EU exited from recession in the second quarter 2013, following six quarters of declining GDP. Some central European countries (such as Latvia, Lithuania and Romania), Luxembourg, Sweden and the United Kingdom have enjoyed relatively strong growth. In the euro area, confidence has improved against the backdrop of the Outright Monetary Transactions (OMT) programme, progress in fiscal consolidation, structural reforms and external rebalancing and steps forward in reforming EU banking supervision. In vulnerable countries, both long-term government bond spreads against Germany and credit default swaps have declined from their peak levels in summer 2012 (Figure 2), and bank deposits have stopped falling or have picked up again (Figure 3). However, sizable differences remain, especially on the labour market, which usually lags behind recovery: the unemployment rate in Germany is at a record low of about 5%, but exceeds 25% in Spain and Greece. In the vast majority of countries, unemployment among the young is at least twice the overall rate. In the euro area, risks of deflation or a protracted period of very low inflation remain as the large degree of economic slack has put persistent downward pressure on inflation, which is well below the ECB’s quantitative definition of price stability (HICP inflation just below 2%).

Current account imbalances in the euro area have narrowed as, in some countries, the collapse in domestic demand has compressed imports and as better competitiveness has, in some countries, boosted exports (Figures 4 and 5). While business and housing cycles account for about 2 points of GDP of the current account adjustment in deficit countries in 2012 (Ollivaud and Schwellnus, 2013), these countries have undergone significant structural adjustment, suggesting that their current account positions will not return to pre-crisis levels. The current account improvements in vulnerable countries are likely to have contributed to the fall in credit risk premia since the second half of 2012, as external funding needs have fallen. Unit labour costs in these countries have come down substantially, with the notable exception of Italy, but prices have adjusted less than wages, in part reflecting slow product market reforms, which has limited the effect of declining unit labour costs on price competitiveness (Figure 5). Much less rebalancing has occurred in economies with high surpluses, suggesting inefficient levels of saving and investment. A stronger contribution of their domestic demand to growth would smooth overall adjustment in the euro area.

Structural reforms, in part by boosting growth, can put the rebalancing process on a more sustainable footing (e.g. OECD, 2011a; OECD, 2012a). Labour market reforms can help to better align wages to productivity (e.g. reforms of wage-setting frameworks). In deficit countries, structural reforms focusing on strengthening productivity and price and non-price competitiveness, and easing regulations would boost exports. In addition, removing policy distortions that encourage consumption would increase household saving. In surplus countries, measures to create more favourable conditions for investment and
Figure 2. Banking and government risk measures

1. Banking-sector five-year credit default swap rates.
2. Spread between three-month interbank rates (Euribor in the euro area, Libor in the United States) and overnight swap rates.
3. Ten-year sovereign bond yield relative to German yield.

Source: Datastream.

StatLink: http://dx.doi.org/10.1787/888933009824
regulatory reform in service sectors could boost domestic demand and smooth the overall adjustment.

Net international investment positions (NIIPs) of vulnerable countries remain strongly negative, and reducing them will require many years of current account surpluses or large valuation changes. This inevitably slow pace of correction, in turn, might damp further reductions in sovereign risk premia, which appear to be positively correlated with European countries’ NIIPs (Figure 6), especially so for euro area countries with both high external and high government debt (Turner and Spinelli, 2013). This points to the need to implement structural reforms to improve competitiveness and current account balances, and to restore fiscal sustainability.

Economic growth is projected to rise in 2014 and 2015 as confidence improves further, financial market fragmentation declines and fiscal consolidation eases (Table 1). The pace of growth is projected to be strong in some countries outside the euro area, especially...
Figure 5. **Evolution of price competitiveness**

1. The figures shown correspond to unit labour costs of the whole economy relative to unit labour costs in the rest of the euro area.
2. Or latest available data.

Source: OECD, OECD Economic Outlook Database and OECD calculations.

StatLink: [http://dx.doi.org/10.1787/888933009881](http://dx.doi.org/10.1787/888933009881)
Figure 6. **Net international investment position and sovereign risk spread**

Q4 2013 or latest available data

1. Ten-year government bonds over Germany.
2. As a percentage of GDP.
Source: IMF, Balance of Payments Statistics Database; OECD, OECD Economic Outlook Database.

Table 1. **Macroeconomic indicators and projections**

Annual percentage change, volume (2009 prices), EU21

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>Projections²</th>
</tr>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
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<td>GDP</td>
<td>1.7</td>
<td>-0.4</td>
<td>0.1</td>
<td>1.4</td>
</tr>
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<td>Private consumption</td>
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<td>-0.1</td>
<td></td>
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<td>Government consumption</td>
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<td>-0.3</td>
<td>0.4</td>
<td></td>
</tr>
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<td>Gross fixed capital formation</td>
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<td>-3.1</td>
<td>-2.2</td>
<td></td>
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<tr>
<td>Final domestic demand</td>
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<td>-1.1</td>
<td>-0.4</td>
<td></td>
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<tr>
<td>Total domestic demand</td>
<td>0.7</td>
<td>-1.6</td>
<td>-0.4</td>
<td></td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>6.7</td>
<td>2.5</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>4.3</td>
<td>-0.3</td>
<td>0.4</td>
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<td><strong>Other indicators</strong> (growth rates, unless specified)</td>
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<td></td>
<td></td>
<td></td>
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<td>Potential GDP³</td>
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<td>1.0</td>
<td>1.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Output gap⁴</td>
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<td>-2.5</td>
<td>-3.5</td>
<td>-3.4</td>
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<td>Employment</td>
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<td>-0.3</td>
<td>-0.2</td>
<td></td>
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<td>Unemployment rate</td>
<td>9.6</td>
<td>10.4</td>
<td>10.8</td>
<td>11.0</td>
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<td>GDP deflator</td>
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<td>1.4</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td>Consumer price index</td>
<td>3.1</td>
<td>2.6</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Core consumer prices</td>
<td>1.7</td>
<td>1.7</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>Household saving ratio, net⁵</td>
<td>6.5</td>
<td>6.3</td>
<td>6.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Current account balance⁶</td>
<td>0.4</td>
<td>1.0</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td>General government financial balance⁶</td>
<td>-4.5</td>
<td>-4.1</td>
<td>-3.3</td>
<td>-2.6</td>
</tr>
<tr>
<td>Underlying government primary balance⁶</td>
<td>-1.6</td>
<td>-0.5</td>
<td>0.5</td>
<td>0.9</td>
</tr>
<tr>
<td>Gross government debt (Maastricht)⁶</td>
<td>83.4</td>
<td>87.5</td>
<td>89.8</td>
<td>90.7</td>
</tr>
<tr>
<td>General government net debt⁶</td>
<td>55.2</td>
<td>60.6</td>
<td>62.9</td>
<td>64.7</td>
</tr>
<tr>
<td>Three-month money market rate, average</td>
<td>1.6</td>
<td>1.0</td>
<td>0.5</td>
<td>0.4</td>
</tr>
</tbody>
</table>

**Memorandum items**

|                      |      |      |      |              |
| Gross government debt⁶ | 90.8 | 98.8 | 100.8 | 102.1        | 102.1        |

1. EU21 refers to the 21 EU member states that are also members of the OECD.
2. Projections are taken from the OECD Economic Outlook 94.
3. Potential output and the output gap are taken from the OECD Economic Outlook 94.
4. As a percentage of potential GDP.
5. As a percentage of household disposable income.
6. As a percentage of GDP.
Source: OECD, OECD Economic Outlook 94 Database.
Poland and Sweden. The pace will remain moderate in the EU as a whole, however, as tight credit conditions will bear on economic activity for some time, especially in the vulnerable euro area countries. High unemployment and weak income growth are holding back private consumption and investment. Unemployment is projected to stabilise in 2014, starting to decline only in 2015. Inflation might change little in 2014 and 2015, given the large slack. The current account surpluses of Italy, Portugal and Spain are projected to rise further over the next two years.

The risks to these projections have become more balanced but are still on the downside. Downside risks include the uncertain political situation, social tensions and still challenging public finances in many countries which mean that financial market turbulence could flare up again. The vulnerabilities in this respect would be increased by: insufficient progress in establishing institutions and rules to ensure that European banks function effectively; failure to achieve adequate asset quality reviews and stress tests in 2014 and, then, to clean up bank balance sheets; and insufficient progress on structural reforms in both debtor and creditor countries. Deflation risks may intensify if activity continues to be weak. External risks include a still sharper slowdown in emerging market economies, and a tightening of the US monetary stance (the prospect of which already upset markets in May 2013). The upside risk, that the recovery could be stronger than envisaged, could occur if further bold structural reforms are implemented. This could underpin positive feedbacks between confidence, economic growth – in particular investment - and the ability of the banking sector to extend loans.

**Growth in the European Union (EU) remains weak and non-inclusive**

Seen from a longer-term perspective, growth and productivity performance in the EU has been disappointing, despite the potential gains from a unified European market. Since 2000, total labour productivity per worker grew, in trend, by 0.8% a year, as against 1.2% in the OECD on average. Differences within the EU are also large (Figure 7). In countries with high productivity levels, unlocking new sources of productivity growth is getting harder. Southern European countries that were lagging behind in 2000 have failed to catch up. The recession has also set back EU economies. The structural unemployment

![Figure 7. Low and uneven productivity growth](http://dx.doi.org/10.1787/888933009919)
rate rose by more than 1 per cent in the EU between 2007 and 2013 (Figure 8), and convergence also appears to have stalled in some Central European EU countries. Growth has failed to reduce income inequalities in the EU since the 1990s. Much of this reflects inequality within countries (Figure 9), but the situation has been worsened recently by falling incomes in some low-income countries (Bonesmo Fredriksen, 2012). All these factors have contributed to weakening support for the European Union as citizens perceive fewer benefits from it.

**Figure 8.** Structural unemployment in the EU is high and growing
Non-accelerating inflation rate of unemployment

![Graph showing structural unemployment in the EU](http://dx.doi.org/10.1787/888933009938)

**Figure 9.** Inequality is increasing in some EU countries
Gini coefficient of household disposable income, total population

![Graph showing inequality in some EU countries](http://dx.doi.org/10.1787/888933009957)

1. The reference year differs across countries. For mid-1980s, it refers to 1985 or nearest available year. As for late 2000s, it refers to 2010 or 2009.


If structural reforms do not proceed further, growth is expected to remain modest over the longer term (Table 2). Because of ageing, employment growth, which had been roughly 1% per year before the crisis, will fall towards zero, and dependency ratios will rise steadily (Figure 10). Migration flows and regular increases in the effective retirement age, as countries complete substantial pension reforms, will most likely do little more than
stabilise employment in the coming years (OECD, 2013a and b). Against the background of weak innovation, labour productivity growth may prove only moderate. Achieving the 60% target of government debt with such low growth prospects will require maintaining fiscal surpluses for an extended period of time, which will be a major policy challenge, as discussed in the 2014 Economic Survey of the Euro Area.

Risks to the long-term growth scenario may be mostly on the downside. Financial disruptions are still likely unless fragilities within the euro area are permanently fixed. Over time, the structure of European economies will be challenged by the rising Asian economies and other emerging markets, technological change and environmental problems. Flexibility to adapt to change will be fundamental in facing these challenges, but so far Europe has been slow to tackle structural rigidities with bold policies at the national or the EU level (Figure 11). This would also help to boost competitiveness and improve structural current account balances.

The Europe 2020 strategy to boost growth

The long-term inclusive growth challenge has been recognised by EU countries and the Commission. The Europe 2020 Strategy aims at delivering “smart”, “sustainable” and “inclusive” growth. It contains ambitious targets in key policy areas: employment, education,
research and development (R&D) spending, greenhouse gas (GHG) emissions and poverty reduction (Table 3). Seven flagship initiatives have been set up to reach them in the following areas: the digital agenda, innovation, youth mobility, resource efficiency, industrial policy, new skills and jobs, and a European platform against poverty. The Europe 2020 Strategy is better focused and more binding than the Lisbon strategy, for which major targets were missed (EC, 2010a).

Table 3. **EU 2020 targets**

<table>
<thead>
<tr>
<th></th>
<th>2012 actual</th>
<th>2020 target</th>
<th>Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment rate</td>
<td>68.5</td>
<td>75</td>
<td>% of population aged 20-64</td>
</tr>
<tr>
<td>Gross domestic expenditure on R&amp;D</td>
<td>2.06</td>
<td>3</td>
<td>% of GDP</td>
</tr>
<tr>
<td>Greenhouse gas emissions</td>
<td>83.0(^1)</td>
<td>80</td>
<td>Index 1990 = 100</td>
</tr>
<tr>
<td>Share of renewable energy in gross final energy consumption</td>
<td>13.0(^1)</td>
<td>20</td>
<td>Per cent</td>
</tr>
<tr>
<td>Primary energy consumption</td>
<td>1.583(^3)</td>
<td>1.474</td>
<td>Million tonnes of oil equivalent</td>
</tr>
<tr>
<td>Early leavers from education and training</td>
<td>12.8</td>
<td>10</td>
<td>% of population aged 18-24</td>
</tr>
<tr>
<td>Tertiary educational attainment</td>
<td>35.8</td>
<td>40</td>
<td>% of population aged 30-34</td>
</tr>
<tr>
<td>People at risk of poverty</td>
<td>123</td>
<td>96</td>
<td>Million</td>
</tr>
</tbody>
</table>

1. 2011.  
Source: Eurostat.

Implementation of the strategy is monitored by the yearly European Semester process, in which country-specific recommendations are endorsed by the European Council, based on the Commission’s analysis and recommendations. The specific reforms identified in the European Semester are welcome and are broadly similar to the OECD’s Going for Growth recommendations (OECD 2013b, Table 4). The reforms cover a broad range of policies on productivity and growth: product and labour market reforms, taxation, openness, research, innovation and education, improving business conditions, competition, enhancing flexibility, and raising the quality and use of factors of production.

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Although it is still early in the process and significant progress has been made, reform has been too slow so far in several countries and most countries are lagging behind many of the 2020 targets, in part because of the strains imposed by the crisis. The employment rate of the 20-64 year old population is stabilising at 68.5%, well below the 75% target and poverty rates have increased recently. R&D spending is still fluctuating just above 2% of GDP, short of the 3% target. The economic crisis has helped reduce GHG emission to 83% of
the 1990 reference level, not far from the 80% target, but economic recovery could reverse some of the recent gain. Almost all country-specific recommendations (CSRs) are partially implemented, in some cases to a large extent, although there has been no implementation in a few cases (EC, 2013a).

**Stronger co-ordination, quantification of benefits and attention to inclusiveness can help implementation**

Implementation of economic reforms can be improved by strengthening the current "soft" co-ordination in the European Semester process. According to OECD analysis (OECD, 2010a), reform implementation and results require strong united leadership, an electoral mandate and effective and timely communication underpinned by solid research. Spillover effects of policies have received little attention in the European Semester (Hallerberg et al., 2012) and each national administration tends to focus on its own country's recommendations. Greater focus on spillovers would strengthen peer interest and hence peer pressure. In particular, many reforms that boost domestic growth, such as easing regulations, can also benefit other EU countries, including by reducing implicit trade barriers within the Single Market.

National and EU actors can also increase national support and ownership of the European Semester's recommendations by strengthening the underpinning analysis of the growth, employment and equity impacts of policies, deepening the dialogue with social partners, taking into account national political priorities and better co-ordinating communication with EU member states. The recent appointment of European Semester Officers by the Commission in the EU member states can help in this regard.

Estimating and disseminating the benefits of structural reforms can help improve their acceptability and implementation in EU member states. OECD research shows that structural reforms can offset permanent GDP losses from the crisis (Bouis and Duval, 2011), and a broad package of reforms could raise GDP per capita by some 20 to 25% on the long run vis-à-vis a baseline scenario with no reforms (Barnes et al., 2013; OECD, 2013a). The largest gains can be obtained by improving human capital, and by increasing work incentives by reducing the tax wedge on labour (Figure 12) and lowering replacement rates.

**Figure 12. Higher tax wedge on labour\(^1\) is correlated with less working activity**

*Single person without children, 2012*

1. As a percentage of total labour compensation.
2. Per working-age population.


StatLink \(\text{http://dx.doi.org/10.1787/888933010014}\)
for unemployment insurance (Table 5). The 10 EU countries farthest away from best practice would gain even more, about 30% on average (OECD, 2013a).

<table>
<thead>
<tr>
<th>Labour market policies</th>
<th>After 10 years</th>
<th>Steady state</th>
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<tbody>
<tr>
<td>Average replacement rate</td>
<td>1.5</td>
<td>2.2</td>
</tr>
<tr>
<td>Employment protection legislation (EPL)</td>
<td>0.3</td>
<td>0.6</td>
</tr>
<tr>
<td>Maternity leave weeks</td>
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<tr>
<td>Childcare benefits</td>
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<td>0</td>
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<tr>
<td>Childcare support</td>
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<td>0</td>
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<tr>
<td>Standard retirement age</td>
<td>0.9</td>
<td>1.7</td>
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<tr>
<td>Implicit tax on continued work</td>
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<td>0.1</td>
</tr>
<tr>
<td>Average weekly normal hours and overtime</td>
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</tr>
<tr>
<td>Taxation</td>
<td>2.3</td>
<td>3.5</td>
</tr>
<tr>
<td>Average tax wedge</td>
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<td>2.1</td>
</tr>
<tr>
<td>Marginal tax</td>
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<td>0.5</td>
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<tr>
<td>Share of consumption and property taxes</td>
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<td>0.7</td>
</tr>
<tr>
<td>Product market regulation</td>
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<tr>
<td>Gas</td>
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<td>Electricity</td>
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<td>R&amp;D direct subsidies</td>
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<tr>
<td>Human capital</td>
<td>0.6</td>
<td>11.6</td>
</tr>
<tr>
<td>PISA score</td>
<td>0.3</td>
<td>5.1</td>
</tr>
<tr>
<td>Average years of schooling (15-24 cohort)</td>
<td>0.3</td>
<td>6.5</td>
</tr>
</tbody>
</table>

1. Policy indicators are changed by 10% of their most recent available values in each country in the direction of increasing GDP. For example, unemployment benefit replacement rates and the product market regulation indices are reduced by 10% of their most recent values. These shocks tend to be much bigger than most reforms carried out in the OECD area over the past decade (except in the area of product market regulation), though some individual OECD countries have implemented more ambitious reforms.


Ultimately, structural policy reforms will be acceptable, and therefore sustainable, only if they address issues such as inclusiveness, environmental concerns and other aspects of well-being, as measured in How’s Life (OECD, 2013c). These issues require country-specific analysis, as well-being outcomes are quite dispersed across EU countries (Figure 13). Also, the crisis has adversely affected well-being. For example, a recent survey reported that between 2007 and 2012, subjective life satisfaction declined by more than 20% in Greece, 12% in Spain, and 10% in Italy, although it increased moderately in Germany and Sweden (OECD, 2013c).
Increasing human capital and bringing more people into the labour market would enhance growth inclusiveness, reduce income disparities and hence raise well-being. Win-win policies that increase growth while preserving social cohesion can be identified (OECD, 2012b) and reforms can be sequenced to minimise social impact (OECD, 2013b). Where reforms involve trade-offs, additional policies that directly aim at reducing inequalities, for example by cushioning the impact on most vulnerable groups, or ensuring long-term sustainability are needed, as policies recommended in the 2013 OECD Economic Survey of Greece (OECD, 2013d) for instance. Employment, social and environmental impacts of reforms should be systematically assessed in the European Semester process and in adjustment programmes, so as to favour win-win policies and to add further corrective policies when needed.

Inclusive growth and dealing with the social costs of the crisis would benefit from more attention to policies dealing with high unemployment in the European Semester process. The European Council initiatives adopted in June 2013 to address youth unemployment are welcome, but their impact is likely to be marginal in the near future. The flagship initiative, the Youth Guarantee, is a commitment to provide a good quality offer (e.g. job or training) to all young people. Its implementation will take time (EC, 2013b), and it may deliver little results unless complementary actions on the labour-demand side boost job offerings. Lowering high structural unemployment calls for comprehensive

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Figure 13. **Well-being outcomes**

1. Each well-being dimension is measured by one to three indicators from the OECD Better Life indicator set. Normalised indicators are averaged with equal weights. Indicators are normalised to range between 10 (best) and 0 according to the following formula: ([indicator value – worst value]/[best value – worst value]) * 10.


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labour market policy reforms, as recommended in Going for Growth (OECD, 2013b) and in the European Semester’s country-specific recommendations.

Once appropriate job incentives are in place, strengthening active labour market, training and social policies is essential to raising inclusive employment, especially in the current context of depressed demand and economic change. In particular, less-skilled workers, including those hit by international competition, need training to adapt to the new economic environment. Training schemes are numerous, widely heterogeneous and complex. A comprehensive evaluation of each scheme can help to identify best practices, such as appropriate guidance to the less-educated individuals and quality controls as recommended in the Skills Strategy (OECD, 2012d). In countries with high long-term unemployment rates, reforms in active labour market and training policies are particularly important to avoid long-term losses in skills.

Reducing regulatory burdens can strengthen productivity

Regulation of both EU and national origin may have benefits but also unnecessary costs. This Survey discusses how to reduce EU-origin regulatory burdens, while measures to reduce those of national origins are discussed in country specific OECD Economic Surveys. EU rules may align or replace national legislation, thus bringing about a reduction in the cost of doing business across the Single Market, as discussed in the Single Market Chapter.

However, Europeans perceive a rise in regulation of their societies (OECD, 2009). The complexity of institutional structures and the range of players, regulators, implementers and enforcers of regulation, all contribute to this. Estimates by national authorities suggest that EU-origin regulations account for 40-50% of the total administrative burden imposed on firms (OECD, 2009). In some cases, such as food labelling, very detailed EU-rules raise firms’ costs. In addition, complex EU governance raises administrative demands on national administrations (Schout and Jordan, 2008).

Over the last decade, the EU has launched a number of initiatives to improve the quality of legislation, such as an Impact Assessment system for new Commission proposals, the EU Administrative Burden Reduction (ABR) initiative, and the Regulatory Fitness Performance Programme (REFIT). The objective of the ABR was to cut the EU-origin administrative burden on businesses by removing unnecessary reporting requirements. According to the Commission, the proposed 25% reductions in burdens covered by the initiative have been adopted by the European Parliament and the Council, equivalent to EUR 31 billion in potential annual savings for businesses (EC, 2012a). However, many measures remain to be implemented at the national level. The Commission is in the process of extending this effort through the REFIT programme (EC, 2013d). In particular, in this programme the Commission’s consultation of small and medium enterprises (SMEs) has already identified simplification measures (EC, 2013c); they should be considered by policy makers.

EU member states can further increase EU-origin regulatory burdens through the domestic legal acts needed to transpose directives into national law. These are estimated to be about a third of the burdens (EC, 2012b). The REFIT programme aims to identify these burdens and corresponding simplification measures. Consistent with subsidiarity and proportionality principles, actions can be taken at the EU level to counteract excessive practices. First, in certain policy areas a limited number of directives may be replaced by EU regulations, which do not require national transposition (EC, 2006). Second, directives can
be drafted in a more effective way to reduce room for interpretation, and undue loopholes. Third, EU level institutions need to communicate to explain to people cases where national authorities added unnecessary burdens. Democratic oversight cannot function when voters do not know at which level each decision is taken.

REFIT focuses on the burdens attached to existing legal acts through their revision and repeal. It has also lead to the withdrawal of proposals and to the decision not to take forward certain initiatives. The Impact Assessment System covers the flow of new Commission proposals (Figure 14). To manage the clear risk that the overall stock of EU legislation is still getting increasingly complex, the European Parliament and Council should also systematically assess the impacts of any substantial amendments to Commission proposals. In addition, administrative burdens can be further reduced by deeper reforms that involve changes in policy design, as discussed in OECD (2010b).

**Figure 14. Generation of legal acts**

![Generation of legal acts](image)

1. The rise of the number of acts in 1995 reflects a high number of international trade regulations. Source: EUR-Lex (Official Journal of the European Union on line).

Beyond those imposed on firms, EU procedures also generate burdens for national administrations. While it is essential that national administrations that know local specificities and implementation issues are involved in designing and implementing EU procedures, national public resources are needed, and this cost is proportionally heavier for the smaller EU countries. Care should be taken, and data made available, to ensure that these costs are assessed for both new and existing legislation. As there is a clear interaction between firm-level and national-level costs of regulation, it is appropriate that REFIT covers both.

**EU Cohesion Policy can support EU 2020 targets and the recovery**

EU Cohesion Policy, which funds projects to diminish regional economic and social disparities, is being reformed. This reform seeks to ensure that EU funding is better targeted to attain the Europe 2020 goals for growth and employment and to streamline procedures, in line with recommendations of the last Survey (OECD, 2012c). Analysis indicates that in the past funds have not often been well targeted to growth-enhancing
investment and procedures have been administratively cumbersome (LSE Enterprise, 2011; OECD, 2012e).

To encourage better targeting, “Partnership Agreements” are agreed between the Commission and EU member states. They specify countries’ economic objectives (out of a menu of 11, reflecting “Europe 2020” priorities), targets to be reached by the end of the programme period, performance indicators and milestones, and governments’ commitments for action. Certain conditions have to be met prior to the disbursement of funds (e.g. the proper functioning of public procurement systems), and 6% of funding conditional upon performance, to be evaluated in a mid-term review. The Commission can request Partnership Agreements to support the implementation of Council recommendations. Failing to take remedial actions may lead to suspension of funding. However, verification of compliance with commitments and associated decisions about continued funding could prove difficult and give rise to disputes. It is obviously too early to assess this wide-ranging reform, but much will depend on the transparency and clarity of the partnership contracts, as otherwise procedures risk becoming too burdensome and evaluation may be compromised.

Developing the knowledge-based economy can boost productivity

Knowledge-based capital (KBC) – assets that lack physical embodiment, such as computerised information, innovative property and economic competencies – is essential to allow firms to compete in new technology sectors. It is influenced by education, R&D, ease of resource allocation, patenting, and bankruptcy law.

KBC can be boosted by better education and training policies. Graduation rates in tertiary education vary widely across countries (Figure 15), and there is scope for increasing them in some countries. While the EU 2020 target encourages raising graduation rates, the Commission should assess education quality, potentially making use of the labour market achievements of graduates and of OECD data on skills (Programme for the International Assessment of Adult Competencies).

Figure 15. Graduation rates in tertiary education

Sum of age-specific graduation rates and programme destination, 2011

1. Tertiary-type A programmes are largely theory-based. Tertiary-type B programmes are typically shorter and focus on practical, technical or occupational skills.


StatLink  http://dx.doi.org/10.1787/888933010071
Another lever for KBC is innovation. At 2% of GDP, EU R&D spending is below that in Japan or the United States. In Italy, Portugal and Spain, business R&D spending is particularly low (Figure 16). By contrast, in a few countries in the EU such as Sweden, Germany and Finland, businesses spend more in R&D activities and reap the benefits in terms of patents (Figure 16).

Figure 16. Business outlays for research and development (R&D) and patents per capita

At the EU level, the Horizon 2020 framework programme for research and innovation will foster EU innovation policy and simplify its implementation by setting a single set of rules and by combining all research and innovation funding in a single strategic framework. It will be co-ordinated with closely related areas such as support for SMEs. It also aims at strengthening co-operation between private firms and public research entities, which is important to generate marketable innovation (Andrews and Criscuolo, 2013). Implementation is the key to achieving genuine simplification and efficient co-operation between private and public sectors. Public support to innovation can enhance private R&D, but this is not always the case (Westmore, 2013). The public funding design has to be sensitive to market signals. For example, grants could be structured to require firms to match in some proportion the support received. Countries that lag behind could also develop refundable R&D tax incentives to meet the needs of young firms that have not yet made profits (Andrews and Criscuolo, 2013).

Apart from direct support, investment in KBC appears to be related to good bankruptcy law, flexible product market, early stage venture capital and strong patent rights (Figure 17). Bankruptcy laws vary across EU countries, pointing to possible gains from adopting best practices, which could be encouraged by the EU, perhaps through directives or guidelines. In addition, acute financing constraints for young innovative firms lacking a track record to signal their “ability or bankability” can be eased by venture capitalists.
Lower labour market protection, taxation on corporate income and capital gains, well-functioning secondary stock market, and public co-investment funds can help attract them (Andrews and Criscuolo, 2013). The Unitary Patent in the EU, planned for 2014, is an important step to simplify patenting procedures and reduce costs.
Reinvigorating the Single Market to boost growth and employment

Internal barriers still impede the Single Market

Completing a genuine Single Market in the EU can deliver large gains (OECD, 2011b). According to the Commission, the Single Market generated an extra 2.8 million jobs in the EU and an additional 2% in GDP from 1992 to 2008 (EC, 2012c). However, much more can be done as the EU economy is still fragmented (Braconier and Pisu, 2013; Figure 18).

Figure 18. Trade between EU member states

Country specific border effects

1. The border effect is a measure of the reduction of trade due to a border. For instance, in Estonia trade within the country is almost 15 times larger than trade across the border, everything else (e.g. road distance) equal. For further detail on the estimation, see Source.


http://dx.doi.org/10.1787/888933010128
size of firms in the EU relative to the United States, as shown in the last Survey (OECD, 2012c), is an indicator of the costs of fragmentation and lost opportunities in exploiting economies of scale. The positive correlation between the size of firms in terms of number of employees and their productivity in the manufacturing sector suggests that the largest firms are more productive (Figure 19).

**Figure 19. Productivity is higher in large firms**

Value added in thousand EUR; manufacturing sector; 2011

Fully reaping the benefits from liberalised trade and investment requires low barriers to the re-allocation of resources and flourishing innovation. Stringent domestic regulation reduces potential productivity gains from import competition substantially (Ben Yahmed and Dougherty, 2012), which tends to favour firms close to the technology frontier. The growth and employment benefits from trade integration can be realised sooner with flexible labour markets (Kambourov, 2009), which is an issue in most EU countries (Figure 20). Retail trade regulation also affects the benefits reaped by consumers and signals for reallocation by preventing prices from adjusting fully.

**Figure 20. Employment protection is relatively high in the EU**

Index scale from 0 (least restrictive) to 6 (most restrictive)
A package of policies to encourage economic integration through the Single Market has been identified in the Commission’s “Single Market Act” and “Single Market Act II”, and in the Monti report (Monti, 2010). These measures are a step change in the political priority of the Single Market, as discussed in the last Survey (OECD, 2012c), and can be further strengthened to fully tackle remaining barriers at their roots. For instance, a broad reform package that would align PMR indicators to the average of the top half of the best performers and would cut heterogeneity by one fifth, could increase trade intensity within the EU by more than 10% (Fournier et al., 2014).

Heterogeneity of rules and practices creates administrative costs and informational barriers to trade (Kox and Lejour, 2005; Fournier et al., 2014) and to investment, including FDI (Kalemli-Ozcan et al., 2014). Efficiency gains can be reaped from better harmonisation of regulations. In particular, in network sectors that are still regulated on a national basis (e.g. telecommunication, energy), efficiency gains can be achieved by making regulations more compatible and by the merger of regulators. The expertise of a unified regulator can also be stronger. The disadvantages of European wide regulation are likely to be lower than advantages, as regulators mainly handle technical issues, and as firms in network sectors are rather large and hence can better deal with language and cultural barriers. Cooperation between national regulators should be further strengthened, with a view to move towards cross-border regulators.

Tax-related administrative burdens also increase heterogeneity and costs for companies. They should also be harmonised and simplified while allowing national government to set tax rates that reflect national preferences. In addition, goods transported between EU seaports are still subject to the same custom formalities as goods from outside the EU. Concern about custom duty fraud can be addressed by new technologies (e.g. satellite observation), and formalities can be simplified, as shown by the “Blue Belt” Pilot project (EMSA, 2012). Product market regulations (PMR) in Europe remain restrictive despite recent reforms, maintaining impediments to the Single Market. The PMR indicator shows that between 2008 and 2013 gains in the EU as a whole have been very small, although they have been significant in a few countries (Figure 21). In addition, rule changes mainly reflect national policy choices, so heterogeneity hardly changed. The Commission could make more use of the link between national regulations and trade to analyse gains from regulatory reforms.

The 2013 PMR indicator also shows no improvement in the regulatory burden of services, and even deterioration in some countries despite the Services Directive (Figure 22). The Services Directive aims at removing discriminatory, unjustified and disproportionate national requirements on service providers, clarifies the requirements to ensure freedom of establishment, adopts the “silence is consent” rule and creates Points of Single Contact to streamline administrative formalities. However, firms that operate in different countries still have to comply with different sets of regulation reducing competition from foreign providers, especially from foreign SMEs. The Services Directive does not cover some sectors that are covered by other legal acts (e.g. telecommunication, energy, financial services), or public procurement. Foreigners still face implicit barriers, and the direct cross-border share of procurement is lower than 5%. The directives adopted
on February 2014 to reform public procurement will streamline procedures, including by establishing a European e-invoicing standard.

A more ambitious implementation of the Services Directive alone could generate an additional 0.6%-2.6% of GDP in the long run (Monteagudo et al., 2012). The Services Directive can be strengthened by eliminating unjustified or disproportionate restrictions to the cross-border provision of services and to the establishment of businesses. For example,
there are still too many restrictions on the right of establishment and on the freedom to provide services. The recent peer review on the implementation of the Services Directive (EC, 2013e) identifies in particular restrictions on the right of establishment and room for progress in the implementation of the Points of Single Contact.

FDI can be an important source of productivity gains, yet remaining FDI restrictions and product market regulations impede it (Nicoletti et al., 2003; Kalemli-Ozcan et al., 2014). In catching-up countries, lower productivity firms can achieve large productivity gains if they benefit from the expertise of foreign owners, if regulations do not impede the necessary restructuring. Stringent product market regulations have caused foreign investors to select highly productive firms (Kalemli-Ozcan et al., 2014). A few FDI restrictions remain in some sectors (e.g. media, real estates, transports). The Commission should consider an initiative to further reduce FDI barriers such as equity restrictions, approval requirements and other operational restrictions. FDI flows would also benefit from more efficient bankruptcy laws and civil justice systems. The latter is widely heterogeneous across EU member states (OECD, 2013e). Implementing minimum standards on statistics on civil justice would help.

National level enforcement of EU rules can also create heterogeneities in practice (Pelkmans and Correira de Brito, 2012). The SOLVIT network was created in 2002 to settle cross-border disputes informally. Fostering the visibility and the capacity of this network may be necessary to fully reap the benefits.

The proposed directive on free movement of workers would rightly require EU member states to take concrete action to guarantee a more effective and homogeneous application of EU law. In this context, its adoption (foreseen for April 2014) would implicate the existence of at least one body in every member state to provide assistance and information to EU workers and their family members on their EU rights. Adoption of the Directive on Acquisition and Preservation of Supplementary Pension Rights, also foreseen for April 2014, would be a substantial step forward. Reforms could be more ambitious, however, by eliminating double taxation of pensions, developing automatic qualification recognition and eliminating disproportionate national barriers related to regulated professions, as discussed in the last Survey (OECD, 2012c).

The digital economy is opening up new opportunities for the Single Market

The digital economy is expanding rapidly, opening growth and employment opportunities. However, polls indicate a lack of trust among consumers in cross-border e-commerce, calling for more effective data protection security measures, as envisaged in the Digital Agenda for Europe (EC, 2010b). Privacy protections need to be implemented in a manner that enables the benefits derivable from the use of personal data. In addition, access to markets is essential with consumers having difficulties making informed choices due to inadequate information disclosures and facing limitations in purchasing some products across borders. These obstacles, however, might be mitigated by the correct transposition of the Consumer Rights Directive, adopted in 2011. The authorities need to be able to prevent network or platform providers from abusing market power, to ensure a level playing field. This issue is addressed by the “Connected Continent” package, although the
European Data Protection Supervisor (EDPS, 2013) considers that providers would still be given large rights to manage Internet traffic. As digital activities can easily move across countries (OECD, 2008), regulation would be more effective at the EU level rather than at the country level.

According to the Commission, investment in high speed communication networks is too low (EC, 2012c). In response, the Commission helps infrastructure project funding by extending guarantees. Investment shortages also suggest a lack of competition in some markets to spur new investment. In France, for example, record levels investment reflects the introduction of increased competition particularly in the broadband market. Further deployment can also be facilitated by encouraging cross-utility reuse of infrastructure (EC, 2012c), but not from any diminution in competition. This is the main objective of the proposed regulation on measures to reduce the cost of deploying high speed electronic communication infrastructure (EC, 2013f).

**The Single Market can be strengthened with openness to the rest of the world**

Trade agreements would open opportunities to broaden the scope of the Single Market. Multilateral trade agreements would be the best way to reducing trade barriers, but progress has become very slow: the Doha round started in 2001 and reached a first agreement on trade facilitation only in December 2013. Plurilateral agreements, provided that they are open and cover a critical mass of world trade, are a useful tool to address trade barriers among a range of WTO members in certain sectors and can serve as building blocks for multilateralism. Examples in which the EU is involved include the negotiations on an Information Technology Agreement, Trade in Services Agreement and the recently-launched Environmental Goods initiative. Finally, free trade agreements (FTA), notably with the United States and Japan, are another key way for EU firms to realise benefits of globalisation of value chains across the world. In particular, a trade agreement with the United States would be a major step with large potential gains (OECD, 2005). Beyond the cut of remaining tariff barriers, this negotiation is an opportunity to reduce non-tariff barriers by removing unnecessary costs and delays for trade, for example by introducing mutual recognition of standards and procedures. It could become a building block for future multilateral initiatives.

Simultaneously, the EU should continue its efforts with other counterparts, with an emphasis on trade agreements with partners that have a strong political will to reach an agreement, are able to deliver high standards of trade liberalisation, have a large potential for gains, on grounds of size, different specialisations, large trade barriers, or because the partner’s rapid growth creates major business opportunities. To avoid trade diversion costs, the agreements should cover substantially all trade (and investment) between the countries. While such outcomes are typically best achieved through multilateral or bilateral trade liberalisation initiatives by fostering the integration of firms in global value chains, preliminary results by Miroudot et al. (2013) indicate that further trade opening by countries to the rest of the world can under certain circumstances also yield significant productivity gains.
ASSESSMENT AND RECOMMENDATIONS

Recommendations to reinvigorate the Single Market

Key recommendations

● Improve the implementation of the Services Directive, in particular by eliminating unjustified and disproportionate restrictions to the cross-border provision of services and to the establishment of businesses.

● In network sectors that require regulation, further strengthen co-operation between national regulators, with a view to moving towards cross-border regulators.

● Deepen the internal energy market through further development of energy interconnections.

● Move forward with the adoption of the proposed directives on free movement of workers and on acquisition and preservation of supplementary pension rights. Take measures to eliminate double taxation of pensions, develop automatic qualification recognition, and eliminate disproportionate national barriers related to regulated professions.

● Continue the intensive engagement in multilateral trade negotiations, move forward with a trade agreement with the United States to reduce non-tariff barriers, while continuing to negotiate trade agreements with other partners.

Further recommendations

● To encourage FDI, consider an initiative to further reduce equity restrictions, approval requirements and other operational restrictions.

● Identify areas where the heterogeneity of regulations and tax-related procedures can be further reduced and strengthen efforts to enforce the EU law at the national level.

● Build a regulatory framework for the digital economy by establishing technical and legal security and privacy standards, enabling authorities to prevent dominant providers from undertaking practices that abuse market power in the provision of Internet services.

Towards a low carbon economy

Combatting climate change

World GHG emissions are estimated to increase by another 50% by 2050, under current policy, primarily driven by energy use (OECD, 2012f). Curbing global emissions beyond 2020 would require a rapidly increasing global carbon price to an estimated EUR 250 per ton of CO₂ in 2050 (OECD, 2012f). The EU has pioneered a carbon market, the European Union Emissions Trading Scheme (hereafter, ETS) to achieve its 2020 GHG emissions target, a 20% reduction in EU greenhouse gas emissions from 1990 levels. The system covers nearly 50% of total EU emissions (EC, 2013g). The ETS tightening between the first (2005-2007) and the second (2008-2012) trading periods has reduced emissions by roughly 4% (Abrell et al., 2011). These gains are uneven across sectors, suggesting the ETS succeeded in favouring emission reduction in sectors with the lowest marginal abatement costs (Abrell et al., 2011).

Climate change mitigation would be best achieved within a multilateral treaty to ensure a level playing field, as a global carbon price would substantially reduce the cost of action (Dellink et al., 2013). The EU is taking part in the Clean Development Mechanism in
developing countries to earn certified emission reduction, and is also considering linking the ETS with similar markets.

In the EU, the emission target is not ambitious enough to address the climate change challenge. Lower economic activity than had been expected when the targets were set has opened up an opportunity to make greater progress. In the wake of the 2008 global crisis, the ETS allowance price fell to below EUR 5 per ton of carbon dioxide emitted (Figure 23). Since then, a surplus of emission allowances has developed (EC, 2012d). The recent “back-loading” initiative to postpone auctioning of allowances only partially resolves this issue, as revealed by the absence of substantial price change. This depressed price weakens the incentive to develop cleaner technologies and, along with increased coal exports from the US connected to shale gas, coal-powered electricity generation is on the rise in Germany. In addition, an unstable carbon price represents an uncertainty cost that can impede development of low-carbon technologies.

The ETS currently suffers from lack of credibility that long-term targets will be achieved, which reduces incentive to invest in abatement. This may be reflected in the currently low price of ETS allowances. The planned decline in the supply of pollution allowances under current policies is below emission expectations (Figure 24). If the long-term credibility of the system were higher, this expected mismatch between supply and demand should generate an upward pressure on prices. Credibility can be undermined by political uncertainties (Brunner et al., 2011). The current low price of the ETS makes it look ineffective, encouraging national policy makers to increase national level incentives to reduce carbon emissions. These policies, by depressing the demand for allowances, further depress allowances prices. This could develop into a vicious circle (Zachmann, 2013), in which the emission reduction process would not be efficient anymore. This lack of credibility should be decisively tackled by setting an ambitious 2030 emission target, and by adjusting the ETS emission cap accordingly.

The exclusion of several sectors (e.g. road transport, agriculture) from the ETS, as well as the different level of energy taxation applied in different sectors, raises the prospect that

![Figure 23. The EU emission allowances price has collapsed](http://dx.doi.org/10.1787/888933010223)
marginal emissions reduction costs will vary sharply between sectors, which would raise the overall costs of emissions reductions. Harmonisation of carbon price might be achieved by introducing a CO₂ component in energy taxation that would reflect as much as possible the ETS price, and by making sure that each sector and operator is either subject to CO₂ taxation or participates in the ETS, as appropriate. Keeping carbon prices aligned will be challenging. Road transport and fuel emission in the agriculture sector can be included in the ETS by making fuel suppliers responsible for surrendering CO₂ permits but would need to take into account different practices in EU member states. ETS coverage has been extended to domestic and international aviation, but with the creation of a dual market: other emitters cannot use the aviation allowance. Such sector specific arrangements are inefficient and should be suppressed.

Subsidies that favour CO₂ emission reduction are widely heterogeneous across countries and technologies (OECD, 2013g; Figure 25), creating distortions within the Single Market in favour of options that maximise subsidies. For instance, subsidies for solar panels in Germany are much higher than in Greece: this does not reflect solar energy potentials. Research subsidies are justified to stimulate R&D and to correct for market failures that pricing alone cannot address (Acemoglu et al., 2012). Reforms of inefficient energy subsidies can be achieved through an overhaul of the state-aid guidelines for renewable energy subsidies.

Likewise, the renewable energy target can be justified by the need to spark R&D on the issue, but the target should be set to avoid imposing sharply different marginal costs of emissions reductions, compared to the ETS. In the same vein, the systematic assessment of the environmental impact of policies to support bio fuels, including indirect land use change as proposed by the Commission (EC, 2012e), is welcome. This approach is likely to prove less costly than setting quotas on types of biofuels.

In addition, remaining inefficient fossil fuel subsidies (see OECD, 2013g, for an inventory) should be gradually suppressed, as they work directly against the carbon emissions reduction goal. However, the higher energy prices that might result could be regressive and increase energy poverty, straining existing social safety nets. The
authorities will need to monitor the situation carefully and strengthen their social safety nets as needed.

Improving environmental outcomes require taking into account all externalities, including not only GHG emissions, but also air pollution, noise, congestion, land use, etc. Ultimately, prices adjusted for externalities should be equalised, which is notably not the case with fuels such as diesel and petrol (Figure 26). For this purpose, a price has to be set on each externality (e.g. congestion charges). This would also be more efficient than the current use of emission standards.

**Figure 25. Effective carbon prices in selected countries**

2010 EUR per tonne of CO₂ abated\(^1\)

1. The dotted lines indicate the minimum and maximum price range.
2. Single weighted average for Denmark and average of weighted averages for the others.


StatLink http://dx.doi.org/10.1787/888933010261

**Figure 26. Diesel and petrol prices adjusted for externalities\(^1\)**

EUR/tonne of CO₂, 2012 Q4

1. The implicit carbon price for diesel and gasoline in the transport sector is obtained by subtracting the external costs of negative externalities from the carbon price implied by excise tax. The external cost contains air pollution, noise, accidents and congestion. The implied carbon price is computed by converting the excise tax per litre to a tax per tonne of CO₂ after deducting the estimated cost of a range of externalities associated with burning fuel.

Source: OECD calculations.

StatLink http://dx.doi.org/10.1787/888933010280
**Investing in electricity grids and interconnections**

Commission estimates point to considerable investment needs for grids by 2020 (EUR 140 billion for electricity and EUR 70 billion for gas; EC, 2011). Renewable energy growth can only occur with additional electrical grid infrastructure, with a special focus on interconnection of national networks. Some areas in the EU, like the Iberian Peninsula, still have only limited connections to European electricity and gas networks. Price differences between neighbouring countries reveal important network bottlenecks (Figure 27). Vertically-integrated national incumbents with large market shares in home countries have a strong interest in stifling investment in interconnection capacity to protect their own national markets. Ownership unbundling of generation, supply and network activities within vertically-integrated electricity utilities is needed, in the states where they are not realised so far, to address conflicts of interest. Permit procedures should be streamlined where possible. In addition, the Commission should continue its efforts to promote smart grids by developing binding network codes and guidelines. The regulation on Guidelines for trans-European energy infrastructure is in force since May 2013, including Projects of Common Interest (PCI).

**Figure 27. Electricity prices for industry**

EUR per thousand kilowatt hours before taxes, 2012

A sound assessment of energy infrastructure needs requires switching from national assessment of needs to EU-wide assessment. Unfortunately, as discussed in Black (2013), the co-ordination of national policies in the energy field is hampered by the perceived divergence of national interests. National decisions taken independently have led to over-investment in production capacities, illustrated by levels of spare production capacities. As each country is making conservative and hence low assumptions of the evolution of production capacities of its neighbours, it can overestimate capacity investment needs.

**Aligning the Common Agricultural Policy (CAP) with environmental goals**

As payments have become increasingly decoupled from production, the CAP has come closer to being a system for delivering public goods and supporting various rural and environmental objectives. The CAP agreement reached on June 2013 moves in the right
direction by distributing payments in a fairer way, by better targeting to active farmers, by phasing out of existing restrictions of production volumes, and by further supporting green practices and innovation, in line with recommendations in OECD (2011c). However, more decisive reforms should be considered as the efficiency of the agricultural sector remains very low in some part of the EU, especially in new EU member states such as Poland or Slovenia (Figure 28).

Figure 28. **The agricultural sector efficiency is low in several EU countries**

Value added per employed person,\(^1\) EUR thousand, 2011\(^2\)

CAP subsidies represent two fifths of the value added of the EU agricultural sector, and such large scale support allows inefficient farms to postpone restructuring. The last agreement reduces the overall level of agricultural support, but real per capita support will remain almost unchanged. EU initiatives to encourage efficiency enhancing investments only partly offset this drawback. For instance, although the Common Agricultural Policy has fostered the modernisation of large farms in Poland, it has had little impact on small farms’ restructuring there (OECD, 2010c). In addition, these initiatives generate cumbersome procedures. Efficiency gains would be better encouraged by a significant reduction of agricultural subsidies, with the aim to provide payments on the basis of the provision of common goods only. Ultimately, a sharp reduction of resources allocated to the agricultural sector would allow reallocating EU budget resources towards innovation policies in other sectors with higher growth potential.
Recommendations on climate change

Key recommendations

- Strengthen the EU Emission Trading Scheme (ETS) by adopting an ambitious 2030 target accompanied by a tight ETS allowance cap. In this context, the renewable energy target and subsidy schemes should avoid creating distortions within the Single Market.
- Make sure that each sector is either subject to CO₂ taxation (for example, under the planned Energy Taxation Directive) or participates in the ETS, as appropriate.
- Encourage ownership unbundling of generation, supply and network activities within vertically-integrated electricity utilities, and streamline permit procedures to support electricity grids investment.

Further recommendations

- Eliminate remaining inefficient fossil fuel subsidies.
- Further reform the CAP to create a stronger link with environmental and productivity objectives. Move further away from unconditional direct income support and market measures.

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Chapter summary

Chapter 1. Reinvigorating the EU Single Market

The EU Single Market remains fragmented by complex and heterogeneous rules at the EU and national levels affecting trade, capital, including foreign direct investment, and labour mobility. Further development of the Single Market and removing barriers to external trade would bring substantial growth and employment gains by enhancing resource allocation in Europe, by generating economies of scale and by strengthening competition and hence incentives to innovate. Reforming regulation and other implicit barriers can also yield a double dividend: it would stimulate cross-border activities and support the necessary reallocation process within countries. Such reallocation can cause hardships, especially for the less-skilled workers who may not be able to compete. To deal with such problems, it is important to enhance active labour market policies and training. The Single Market would also benefit from better networks between countries that can be supported by a well-targeted infrastructure policy. New digital networks can be promoted by an appropriate regulatory framework to strengthen confidence and to promote fair competition. Regarding external trade, the first-best solution is clearly multilateral trade negotiations, but short of that external trade and investment barriers can be reduced with Free Trade Agreement negotiations with the United States and other partners.
This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

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