OECD Economic Surveys
EUROPEAN UNION

MARCH 2012

OVERVIEW

This Survey of the European Union is being released together with the Survey of the Euro Area.

Summary

The EU needs to tackle the economic crisis and move to stronger, fairer and cleaner growth. The EU27 economy is in a serious downturn driven by the euro area sovereign debt crisis and on-going weaknesses in the wake of the financial crisis as set out in the *Economic Survey of the Euro Area*. Longer-term prospects are for growth to be weaker than over the past twenty years, influenced by population ageing and sluggish productivity gains. Structural weaknesses in labour and product markets contribute to low productivity and employment, as well as slow growth. Higher growth would help to make current debt levels more sustainable and create more space to deal with social and environmental challenges.

An ambitious programme of structural reforms is needed. Removing policy obstacles to growth requires a broad range of measures to raise productivity and employment rates. The EU has set itself ambitious targets with the Europe 2020 strategy. Many of the necessary reforms require changes in national policies and institutions. EU policy instruments can make a strong contribution to growth by creating the right conditions and incentives to support national reforms. Improving EU and co-ordination of national innovation policies, as well as continued opening of EU markets to trade, would also help support sustainable growth.

Strengthening the Single Market should be at the centre of EU policy action to boost growth. The EU's internal market remains fragmented in terms of trade and financial integration. The main obstacles are market regulations at national level and poor implementation of existing Single Market requirements. The Commission sought to re-launch the Single Market project with the 2011 "Single Market Act" Communication. The twelve key legislative actions it identifies should be passed by the end of 2012 as planned. Greater political commitment is needed to the Single Market project, which would be encouraged by a stronger evidence base and more innovative approaches to decision-making. Implementation of the Single Market, including the Services Directive, should be improved and more actively enforced by the Commission and within countries. The framework conditions for cross-border business should be improved, including by addressing cross-border corporate and indirect tax issues, and stronger implementation of competition policies and consumer protection at the national level. Further integration efforts are required on a sectoral basis for government procurement and the network industries, including through developing cross-border regulators and investment in infrastructure.

Labour market reforms would create more and better jobs. Large differences in labour market outcomes across EU countries suggest that performance could be improved. High unemployment, particularly among young people, and low labour mobility coexist with skill and labour shortages in other regions. Internal migration within the EU can help to meet labour market shortages. However, mobility is hindered by barriers stemming from restrictive domestic labour market and pension policies, and by weak enforcement and implementation of legal rights under the Single Market. The recognition of professional qualifications across the EU should be further developed and the access to public sector jobs improved. Reforms at national level to pension systems and housing policies, which would be beneficial in their own right, are an opportunity to tackle disincentives to worker mobility.

EU migration policy needs to be further developed to better respond to shortages of workers. With demographic changes underway, most EU countries expect growing shortages of skilled labour or workers in specialised activities. This should be mostly dealt with by making better use of the existing population and providing them with the right skills. The EU should develop policies to ensure that migration responds more directly to labour market needs. The Blue Card should be used effectively to make it more attractive to high-skilled workers.

Assessment and recommendations

The EU needs to tackle the economic crisis and reach a stronger sustainable growth path

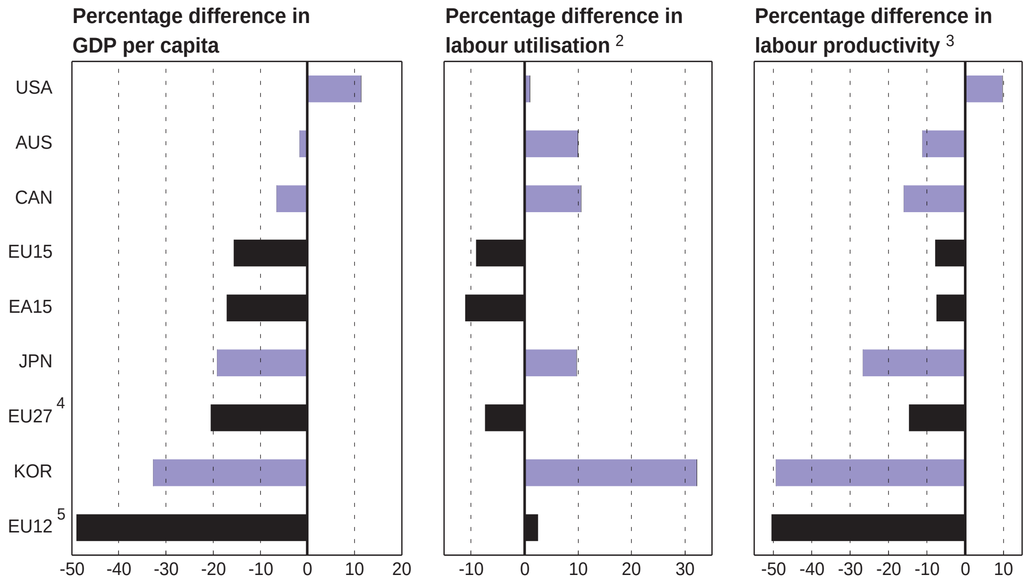
1. The EU economy is in a serious downturn as the protracted sovereign debt crisis has lowered confidence, against the background of underlying economic, financial and fiscal weaknesses and imbalances. The economy will contract in the short run, but longer-term growth prospects are also dim. The origins of the crisis lie in inadequate financial oversight, insufficiently prudent and disciplined fiscal policy, and weaknesses in structural policies during the upswing of the credit cycle that gave rise to serious imbalances. Weaknesses in the design of regulatory, labour market and a range of other policies have impaired growth and labour market performance, while hindering necessary economic adjustments.

2. The crisis has left many countries with weak banking systems, poor public finances and high rates of unemployment. In the euro area, there is a need to rebalance activity after the build-up of excessive imbalances over the past decade, as described in the *Economic Survey of the Euro Area*. The ensuing crisis in the euro area could have a significant negative impact on the European economy as a whole, through close trade linkages and the financial system. These effects are having a dampening effect on growth in the United Kingdom, where the recovery is also subdued due to continued fiscal and financial retrenchment, while Sweden is growing only moderately. Despite strong linkages to the euro area, central and Eastern European countries (EU12) are likely to maintain stronger growth on average than the EU15 economies but some continue to face large fiscal deficits and financial fragilities, as well as high unemployment. The crisis in the euro area must be resolved as pre-condition to returning to growth as set out in the *Economic Survey of the Euro Area*: severe financial vulnerabilities and fiscal weaknesses must be reduced in many euro area countries, which requires an adequate response to the crisis, rebalancing of overall demand and supportive monetary policy settings.

3. Even before the crisis, economic performance in most EU countries was weaker than in the best-performing OECD countries in terms of GDP per capita and underlying growth was fairly weak (Figure 1). Indeed, the income gap for the EU21 (OECD EU members) *vis-a-vis* the best performers has widened slightly over the past decade. This weak growth performance is partly the result of population ageing and diminishing gains from rising female participation. However, unfavourable policy settings in labour and product markets have also contributed. This is particularly true in countries with very poor growth performance, such as Italy and Portugal, which grew at an average annual rate of just 0.3% over the past decade. By contrast, some central and Eastern European countries with sound policies have managed to achieve vigorous catch-up growth (Figure 2). Overall, growth in Europe is anticipated to slow over the coming decades under current policies: potential growth is projected at an annual rate below 2%. The main driver of the growth slowdown is the ageing of the population, both in EU15 and EU12 countries, which would lead to an overall reduction in the working-age population in the absence of major pension reform or large immigration flows. Labour productivity is difficult to predict but there are downside risks to projections which extrapolate forward recent growth rates, notably if the trend slowdown over past decades continues as discussed in the *Economic Survey of the Euro Area*.

Figure 1. **Sources of real income differences**

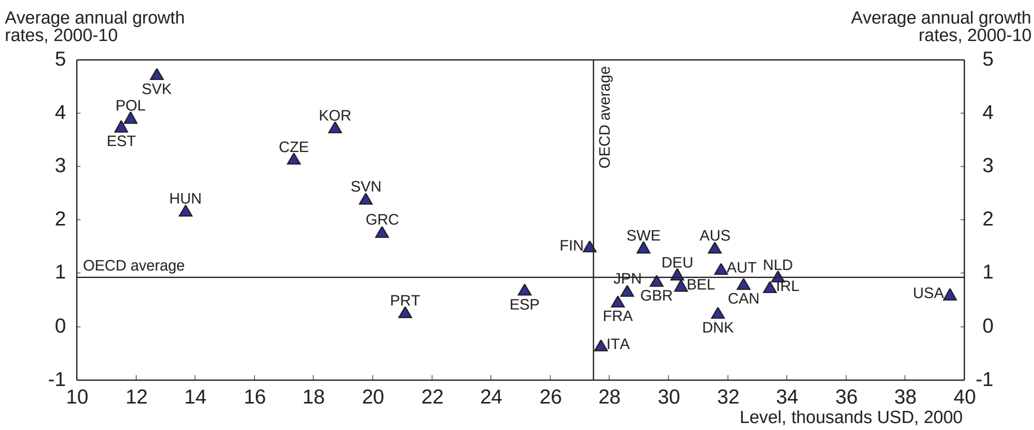
Relative to benchmark[1], 2010 data



1. Benchmark is the simple average of the highest 17 OECD countries in terms of PPP-based GDP per capita. The population of Luxembourg is augmented by cross-border workers and Norway GDP refers to the mainland.
2. Labour utilisation is measured as total number of hours worked per capita.
3. Labour productivity is measured as GDP per hour worked.
4. EU27 refers to the 21 countries that are OECD members.
5. EU12 refers to the 6 countries that are OECD members.

Source: OECD (2011), *Productivity Database.*

Figure 2. **Convergence in GDP per capita**[1]



1. At constant prices and constant 2005 PPPs.

Source: OECD, *National Accounts Database.*

4. An ambitious programme of structural reforms is needed to achieve a sustainable improvement in growth prospects. This could help to restore confidence in the near term and, over time, improve the sustainability of public and private finances as well as substantially raising long-term living standards. Some countries have especially strong structural problems to overcome and the necessary reforms there would help to tackle the underlying causes of economic and financial imbalances. An important factor for future growth will be the ability of EU countries to reap the benefits of globalisation. This depends on the good functioning of labour and product markets, the innovation framework and the

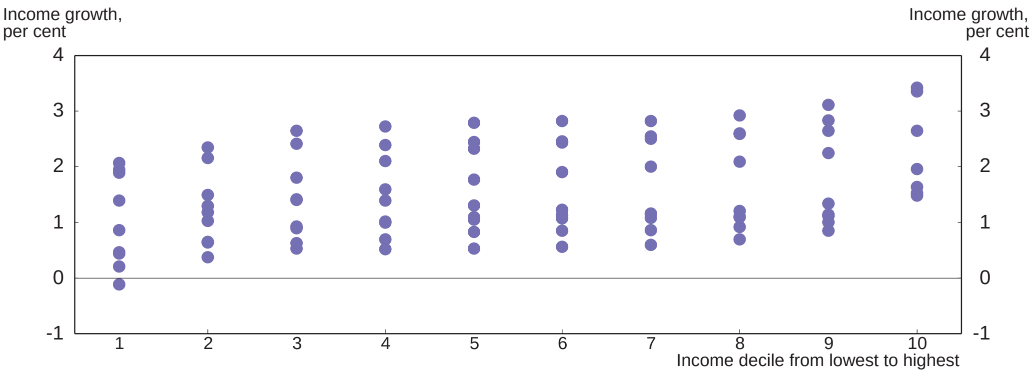
education system, and a fair sharing of the costs and benefits of globalisation. The need to adapt to sustain growth is likely to increase as emerging countries move up the value chain and become more likely to compete directly with a wider range of products currently produced in European economies.

The new growth model should support a fairer and greener economy

5. Growth and a better functioning of the EU economy are needed to meet major social challenges. The weak growth performance in the EU has been accompanied by growing social problems and rising inequality. This reflects in part high unemployment, the development of dual labour markets and detachment from the labour market of vulnerable workers, such as young people with little work experience, older workers or those with low skill levels. The redistribution of wealth as the result of developments in financial markets also contributed to the increase. Inequality in the EU as a whole has risen because income convergence among EU countries has not offset growing income inequality within countries (Fredriksen, 2012). The richest tenth of the population in most EU countries has been capturing a growing share of national income over time, while those in the lower half of income distribution have tended to gain less. Many Europeans have seen only very slow growth in real incomes over recent decades (Figure 3). Higher growth would create space to make current social systems more sustainable, while better functioning markets would help to address some of the underlying causes of joblessness and falling real incomes. Boosting the accumulation of human capital and making educational outcome less dependent on social background, as well as improving the labour market by reducing dualism and facilitating integration of women, immigrants, older and young workers, are among the set of policies that would both increase GDP per capita in the long run and reduce income inequality (Koske *et al.*, 2012).

Figure 3. **Inequality and income growth**[1]

Average annual change between mid-1980s and mid-2000s



1. Dots correspond to observations for Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Sweden and the United Kingdom.

Source: OECD, *Income Distribution and Poverty Database.*

6. Achieving sustainable growth requires management of the environmental consequences, although this challenge also creates opportunities to build a new growth model as set out in the OECD Green Growth Strategy (OECD, 2011c). These issues form an integral part of the EU 2020 strategy, which includes the "20-20-20" objectives to reduce greenhouse gas emissions, increase the share of renewables and increase energy efficiency. The EU has developed a comprehensive agenda on resource efficiency, a green economy and sustainable development. The EU has taken an important leadership role in international efforts to combat climate change by pressing for all countries to negotiate a legally-binding agreement under the UN Framework Convention on Climate Change (UNFCCC, 2011). Furthermore, the creation of EU Emissions Trading System (ETS) in 2005 was a major step. The functioning of the ETS is being improved and extended, as recommended in the 2009 *Economic Survey of the European Union* (OECD, 2009a): free allocations of permits have been reduced and the ETS is being extended to air transport in 2012 and to the petrochemicals, ammonia and aluminium industries and additional gases from 2013. The European Union is well on track to meet its target of a 20% reduction in emissions by 2020 relative to 1990, which has been assisted by the sharp drop in emissions due to the

weak economy. As a result, ETS carbon prices have been depressed in recent years and there was a further sharp fall during 2011. While this partly reflects success in reducing emissions, it is important that the resulting over-supply of allowances does not unnecessarily reduce incentives to invest in reducing emissions and improving energy efficiency. Measures could be taken to reduce the supply of allowances, such as a percentage reduction or set-aside of Phase III allowances. There should be a further strong move away from giving allowances for free. Overall, meeting emissions reduction targets and securing energy security goals in a cost-effective way and without compromising growth remain a challenge given the multiple mechanisms and targets involved in the EU. Policy targets should be better prioritised. If demanding targets are to be met, it is essential that cost-effective policy mixes are used. Further efforts are needed to tax emissions from all non-ETS sources appropriately, reduce tariffs on imported biofuels and to ensure that the 10% renewable transport fuel target is met in an efficient way (OECD, 2009a). All options for technology choice should be kept open during the transition phase to a long-term sustainable energy system and policies should be technology-neutral (OECD, 2012b).

The Europe 2020 strategy sets out ambitious EU reform targets, but will they be achieved?

7. An ambitious programme of structural reforms would contribute to higher sustainable growth prospects, as well as achieving key social and green objectives. The Europe 2020 strategy, adopted in 2010, responds to this challenge by setting out five high-level policy objectives at the EU level (Table 1) with a system of corresponding national goals. The objectives of Europe 2020 strategy are set so as to support economic recovery in the near term, and boost growth and job creation in the medium term. This strategy of identifying long-term structural reform goals, while recognising their contribution to exiting from the crisis, is similar to the role of structural reforms in the OECD *Strategic Response* to the financial crisis (OECD, 2009b). Country-specific recommendations are issued by the Council in the context of the European Semester to reach the overarching Europe 2020 strategy's goal of smart, sustainable and inclusive growth. These are highly correlated with the five policy priorities set out in the OECD *Going for Growth* exercises (OECD, 2011b) and OECD *Economic Surveys* of individual countries.

Table 1. **Europe 2020 objectives for a smart, sustainable and inclusive growth**

	2000	2010	2020 target
Population aged 20-64 employed	67%	69%	75%
Share of GDP invested in R&D	1.9%	2%	3%
Education:			
Share of early leavers from education and training	17.6%	14.1%	10%
Share of tertiary educational for age group 30-34	22.4%	33.6%	40%
Climate change and energy:			
Greenhouse gas emissions relative to 1990	91%	83%	80%
Share of renewable in gross final energy consumption	9%[1]	11.7%	20%
20 million reduction in number of people at risk of poverty	124 million[2]	116 million	96 million

1. 2006.
2. 2005.

Source: Eurostat.

8. For the Europe 2020 strategy to succeed, the EU needs to improve on its mixed track record of achieving European objectives through changes in national structural policy settings. The Europe 2020 strategy is the successor to the renewed Lisbon Strategy for growth and jobs (2005-10). Although it led to some reforms that might not otherwise have been achieved, the Lisbon Strategy fell well short of reaching its objective of making Europe "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" (Presidency Conclusions, Lisbon European Council, 23-24 March 2000). The main problem is that most of the policy instruments to achieve the EU objectives are in areas of national competence, making it hard at the EU level to ensure that the necessary reforms are undertaken. The EU has historically not been able to achieve either sufficient national ownership of the EU objectives nor has the peer-review process provided sufficient pressure for domestic policymakers to act. Under the Lisbon

Strategy, various approaches were tried, including both a broad and a narrow set of objectives, but neither was able to deliver fully on them.

9. The key question is whether the Europe 2020 will be any more effective than the Lisbon Strategy, despite relying on the same basic design and institutional architecture. Ownership may be higher because of the focus on a limited set of specific EU-level objectives and because countries set their own national targets in these areas. Moreover, the Europe 2020 strategy includes targeted and precise policy recommendations to national authorities, against which implementation can be monitored. Peer pressure could be stronger than in the past to the extent that peer reviews of structural policies are now linked through the EU Semester process to other high-profile policies on budgetary and economic stability. Furthermore, surveillance of structural policies in the context of macroeconomic imbalances has been significantly reinforced as described in the *Economic Survey of the Euro Area*. A euro area country could even in principle be required to undertake structural policy measures in the context of the new Macroeconomic Imbalances Procedure, which is backed by financial sanctions. However, it remains to be seen how effectively these mechanisms will be enforced, notably with respect to structural policies. So far, the experience with the first European Semester in 2011 has been positive in that the Commission made more precise recommendations with more clearly articulated deadlines for policy action than in the past, making it more difficult for countries to avoid taking action. In addition, the difference between the Council recommendations and those proposed by the Commission was quite narrow and smaller than in the past, perhaps indicating a lower collective tolerance to inaction on structural reforms by other countries in the wake of the crisis and higher awareness of spillovers. It will be important during the second round of the EU Semester and with new economic governance measures in place for the Commission and Council to follow through effectively on the recommendations made in 2011, if the new regime is to establish a strong reputation. It is not encouraging as a signal of commitment to the Europe 2020 strategy that the sum of national objectives, even if these were met, would not reach the EU-wide targets in all areas (European Council Conclusions, 23-24 June 2011).

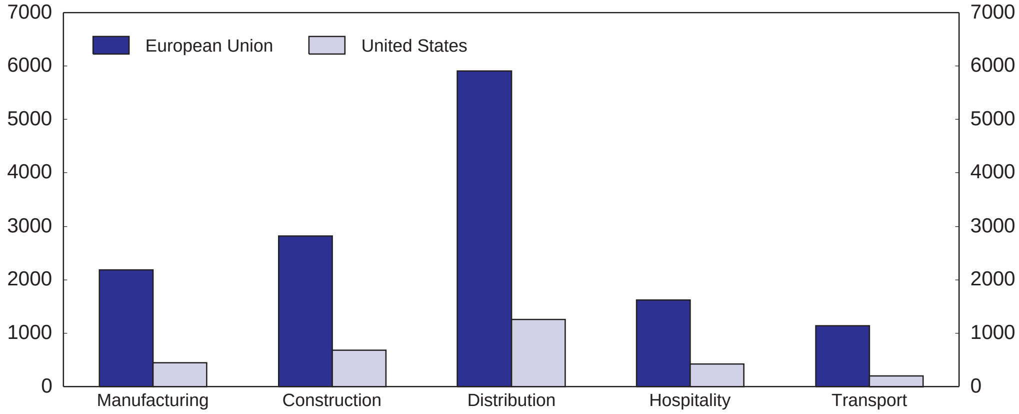
The completion of the Single Market is a strong EU-level tool to boost growth

10. One of the European Union's strongest tools to boost growth is the binding instruments and *communautaire* approach that underpin the Single Market project. These cover major responsibilities to foster internal competition and trade in goods, services and capital market integration (Chapter 1) and labour mobility (Chapter 2). Completing the Single Market using these instruments could have a substantial impact on boosting growth by increasing competition and the scale of economic activities in Europe. This potential is recognised in the Commission's 2011 "Single Market Act" (SMA) Communication, setting out twelve key legislative actions to boost growth. This should be implemented with a high level of political commitment within the Europe 2020 Strategy.

11. Significant progress has been made towards achieving a Single Market but more remains to be done, especially in services. The potential of a market of 500 million consumers is being held back with many markets remaining organised largely on national lines, where the median market size is less than 10 million. The high degree of integration in goods and services activities through trade and through cross-border companies is a significant achievement, but further progress appears to have stalled over the past decade (Chapter 1). The crisis may have slowed progress further. Trade integration, while higher than between most countries, is lower than within a large federal economy such as the United States and price differences across countries remain high. The fragmented market contributes to keeping average firm size low in Europe (Figure 4). The microeconomic costs of remaining trade and capital market fragmentation are difficult to assess, but there are likely to be substantial costs from the failure to use the full gains of specialisation, the lack of competition and limited consumer choice. Greater integration is needed to boost productivity and avoid excessive macroeconomic imbalances, as argued in the *Economic Survey of the Euro Area*. While there are some inherent barriers to integration in Europe, notably distance, culture and language, policy obstacles to the development of cross-border activity remain a significant problem. Given some of these inherent constraints, EU countries may need to make greater efforts than in federal economies to achieve the same gains from integration.

Figure 4. **Number of enterprises by sector**

Thousands, 2006



Source: OECD, *Structural Business Statistics Database.*

Despite legal progress, implementation at the national level remains deficient

12. The legal framework for an integrated single market has progressed substantially over the past decades. The core legal framework establishes the basic freedom of cross-border movement. Under laws and extensive case law, explicit discrimination in economic transactions by nationality has largely been removed. The EU applies the basic standards necessary to underpin efficient economic activity across a range of areas, such as product safety. EU competition policy and state aid rules help to ensure a level playing field and have been important during the crisis in ensuring that national authorities resisted the temptation to apply protectionist policies.

13. The main policy obstacles to economic integration are now regulations at national level (Chapter 1). Product market regulations in many EU countries remain relatively restrictive by OECD norms, although considerable progress has been made during the past decade. Although not inherently discriminatory by nationality, these restrictive rules are likely to confer an advantage and protection to domestic firms relative to competitors from other EU countries. The diversity of regulations introduces transactions costs for companies looking to develop new business in another EU country. Many aspects of the basic economic institutions of EU countries, such as corporate governance, tax systems, financial oversight and consumer protection, are largely designed and operated at national level. This allows for disparities across countries and can fail to take into account the implications in terms of creating *de facto* obstacles to cross-border activity. Although many large federal economies have some variation across sub-federal levels, the differences across EU states may be greater in some areas, notably product market regulations, taxation and banking supervision, and add to some of the inherent obstacles to developing cross-border activities in Europe.

14. A major problem with the EU Single Market is the chequered implementation of existing requirements. While many national laws and practices have been adapted to comply with EU law, some directives are not even transposed at all into national law in all countries or only poorly, and implementation deadlines are sometimes ignored. Although ultimate responsibility for this failure rests with national authorities, the Commission should be more active in ensuring that possible infringements of EU law are challenged and if necessary pursed through the European Court of Justice, as complaints by individual workers or firms suffer from a collective action problem. The Commission should allocate more resources to identifying and resolving obstacles to integration, including within individual countries. There should be a clear annual report on the implementation of the Single Market for each country, both in a legal and, more importantly, in a practical sense. More rigorous political and economic sanctions could be used for failure to make sufficient progress in opening markets, including loss of access to EU funds. National authorities should also give greater priority to making sure that domestic obstacles to integration are removed. The development of closer co-operation between national regulatory authorities in some sectors, such as network industries, and more effective

EU bodies to facilitate this process could help to overcome co-ordination problems and lack of trust between the competent authorities at national level, so that regulatory decisions are more coherent across countries and support the development of economic activity across borders.

Stronger policy action is needed to deal with remaining barriers to cross-border business

15. As well as improving implementation, stronger policy action is required to tackle remaining barriers to economic integration and realise the potential benefits of integration. Progress continues through a combination of major initiatives and incremental progress as the existing legal framework is applied and developed in practice. The 2007 EU Services Directive is the most recent landmark legislative programme. While this takes important steps to extend existing freedoms in the services area and make this effective on the ground through "one stop" shops for administrative procedures and a mutual screening process for national regulations, the Directive was much less ambitious than the original proposal. At present, it remains too early to assess how effective this measure will be. The 2011 Commission "Single Market Act" Communication sets out twelve "levers" of growth and areas of legislative proposals with the aim that all measures will be passed by the end of 2012 (EC, 2011e). A high level of political commitment will be required to ensure that these important measures are all adopted by that deadline. EU and national leaderships need to be willing to act against protected vested interests and make genuine efforts to encourage progress towards more cross-border activities. To move the Single Market forward more rapidly, a more innovative approach to decision-making could be used to avoid it taking many years to make material progress in some areas. This was discussed more widely at the EU level in the past but little progress has been made in making the decision-making process more reactive. The political commitment to advancing the Single Market from EU governments and the European Parliament could be stronger if the efforts were better directed to clearly identified *ex ante* priorities and if the tangible benefits from proposed integration measures were more clearly presented. More extensive and high profile *ex post* assessment of the gains already achieved would make the case more compelling and help to identify priorities for further action.

16. A more favourable business environment for cross-border trading and investment is needed to deepen economic integration and boost productivity (Chapter 1). There is a need to achieve greater convergence and coherence in the basic features of the business environment across countries, including regulations around corporate governance, product markets and competition. In many respects, the Single Market lags well behind the coherence of institutions found in large federal economies, such as Canada or the United States, although there are also larger linguistic and cultural barriers to cross-border activity in Europe. The current heterogeneous system of cross-border corporate and indirect taxation may raise costs of doing business in other countries and could distort some incentives in terms of trade and investment, although it may also promote some useful forms of competition. Although these are complicated areas, the interaction between the benefits and costs of different approaches towards more common ground on taxation needs to be further considered. The Commission has proposed an optional Common Consolidated Corporate Tax Base scheme, which according to the Commission's analysis would significantly reduce the incentives for profit-shifting. Simplifying the administration of corporate and indirect taxes across countries and ensuring a more similar approach could also significantly lower transaction costs and encourage cross-border activity, notably by small and medium-sized enterprises for which these fixed costs are likely to be a more important barrier.

17. Several other reforms areas would enhance cross-border activities. More emphasis on competition policy at the national level, including ensuring that the potential of the Single Market to boost competitive pressures is fully used, would also help create better conditions for the development of cross-border activities. More effective and consistent consumer protection across countries would improve consumer confidence when buying in another country and would help boost cross-border sales. The improvement of overall framework conditions in the Single Market should be complemented by sector-specific measures, where there remain particular obstacles to developing cross-border activities. Significant barriers remain in sectors including government procurement, energy, telecommunications, transport and postal services. Specific measures are required in each sector, such as simplifying tendering procedures for government procurement and full ownership unbundling in power generation and transmission. The "Digital Agenda for Europe" strategy, proposed by the Commission in May 2010, would provide a coherent legal framework for the integration of economies online, including a pan-

European licensing for online rights management, strengthening EU data protection rights of consumers, updating the e-Signature directive, and ensuring interoperability of secure e-authentication systems.

18. Integration of the financial system has advanced well in some areas but remains patchy so far in others, reflecting among other factors the lack of unified cross-border banking and financial supervision. While considerable progress appeared to have been made in terms of cross-border activity in the run-up to the crisis, some of this appears to have been unsustainable and driven by unstable economic developments and allowed by weak regulatory oversight (Barnes *et al.*, 2010). The EU financial architecture has been substantially over-hauled following the financial crisis across a wide range of areas. In addition to strengthening financial regulation, significant efforts have been made to achieve more consistent regulation across countries and to improve supervision of cross-border financial activities. New European Supervisory Authorities (ESAs) have been created in banking, securities markets and insurance to strengthen microprudential oversight of cross-border institutions, and colleges of national supervisors are required for all large cross-border institutions. The European Systemic Risk Board (ESRB) has been created to oversee macroprudential risks. However, there could be advantages to a more co-ordinated approach to the supervision for large cross-border institutions, for example in managing prudential risks from cross-border flows from large foreign banks to small countries. This issue will be considered again at the EU level in 2013. At the same time, a wide range of different legal requirements, such as different property laws, tax systems and consumer protection laws (as discussed above) may pose barriers to the development of cross-border retail financial institutions. As discussed in the *Economic Survey of the Euro Area*, the new Single Rule Book approach being set out in legislation currently under consideration will support a better managed form of financial integration by reducing the scope of national discretion. This will help to ensure that the Single Market develops further and on a more sustainable basis. The Single Rule Book approach should nevertheless allow some flexibility to the national authorities to impose stricter requirements in limited and duly justified cases, in the context of a macro-prudential regime to foster greater financial stability and address systemic risk. This use of national discretion should not weaken the gains from a large EU financial market, create negative spillovers within the Single Market, nor create additional risks in the underlying stability of the financial system in Europe as a whole.

Box 1. **Main recommendations for strengthening the Single Market**

- Produce a step change in the political priority to encouraging economic integration through the Single Market. Passing the proposals in the "Single Market Act" Communication by the end of 2012 would be an important step.

- Improve the implementation, enforcement and follow-up of Single Market rules at national level, including through more rigorous enforcement by the Commission. There should be an annual country-specific report on the state of the Single Market with clear indicators and recommendations.

- Improve the elaboration of Single Market policies through a stronger evidence-base to prioritise and motivate reforms.

- Further enhance the framework conditions for doing business across borders and setting up in another country, including through effective competition and consumer protection policies at EU and national level.

- Make further progress with the sectoral approach to market integration by fully implementing the Services Directive and measures aimed at boosting competition in services, and further efforts on network industries, including closer co-operation among regulators and investment in cross-border infrastructure.

Europe needs to innovate more and better

19. Innovation is essential to supporting long-term growth. Europe continues to lag behind the United States in terms of innovation performance, while some emerging countries are rapidly increasing their capabilities in innovation-related higher education and research. Too few businesses are created in new technologies and services, while new enterprises face difficulties in accessing capital and gaining market share. Although the number of new firms created in Europe is comparable to that in the United States, these firms grow by much less than firms in other parts of the world (OECD, 2009a). Academic research in Europe is not enough connected to business activities (EIB, 2009). A key contribution of policy to supporting innovation on the demand side is in creating appropriate framework conditions, in terms of fostering competitive markets, a skilled and adaptable workforce, a financial system that is prepared to support risk-taking, and a tax system that leads to good incentives for innovation. These include a competitive and integrated Single Market in products and working towards EU capital markets that are deep and able to finance innovative projects (OECD, 2009a).

20. Nevertheless, policies to stimulate innovation, especially on the supply side should also play an important role as recognised in the OECD *Innovation Strategy* (OECD, 2010). Although innovation policies remain largely at national level, the EU is pursuing an ambitious agenda and its Innovation Strategy sets out a broad set of actions to ensure that ideas are translated into innovative goods and services that create growth and jobs. In 2011, the Commission proposed a substantial reorientation of EU support for innovation as part of the "Innovation Union" and with a single strategic framework, Horizon 2020, to fund spending. These would lead to wide-ranging changes in innovation policy, its implementation and monitoring, and the interplay between these policies and other closely related areas such as support for small and medium-sized enterprises (SMEs), regional policy and the Single Market (OECD, 2009a). The largely national system of patents at present creates high costs for firms wanting to seek and enforce patent protection across the EU, reducing innovation incentives. An EU-wide system of patents and patent litigation is needed (OECD, 2009a) and is progressively taking shape (Chapter 1).

Box 2. **Main recommendations on innovation**

- Pursue the introduction of a unitary patent protection and a unified patent court to reduce the costs of patenting in Europe.
- Simplify the cost of research grant applications to the Commission, consider synergies between the existing schemes for funding for innovation and ensure that all national research grants are open to all EU-based researchers. Improve ties between academia and the private sector.

Further progress in trade liberalisation and agriculture would boost growth and raise living standards

21. The growth of trade between the EU and the rest of the world has weakened since the crisis and there is a risk of rising protectionist pressures and growth consequences. During the crisis, the EU has largely maintained the overall openness and transparency of its trade and international investment policies. Policy intervention has mainly focused on the financial sector, although other sectors, notably automobiles, construction and tourism, received support within the context of the EU state aid rules. To promote further trade integration, efforts should be stepped up to advance the Doha round to strengthen the multilateral system. The EU played a significant role in the renegotiation of the plurilateral Government Procurement Agreement (GPA) in the WTO concluded in December 2011.

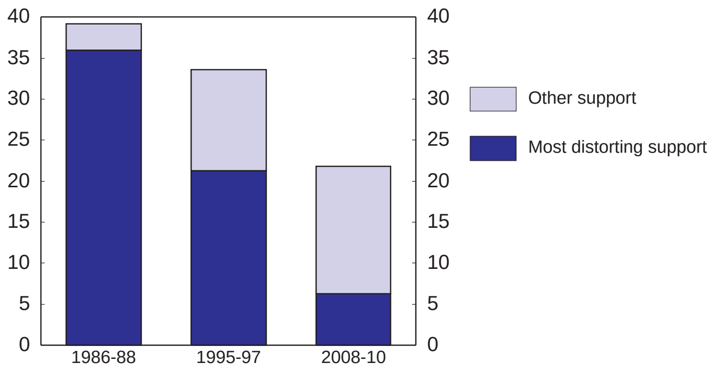
22. The EU's use of the main trade policy instruments has remained largely unchanged in recent years and it remains a user of anti-dumping measures, although 43% of these measures are applied to a single WTO member (China) and their use is less intensive than by some other economies. The EU continues to pursue its policy of comprehensive bilateral free trade agreements, which are second-

best but make some important progress pending a multilateral deal and are designed to contribute to further liberalisation at the multilateral level. The EU has recently signed a free trade agreement with Korea and negotiations are well advanced with Canada. Least developed countries are granted duty- and quota-free access under the Everything But Arms (EBA) initiative in the framework of the EU's Generalised System of Preferences (GSP). Other developing countries benefit from preferences under the overall GSP, and further preferences under GSP+. More flexible rules of origin for products imported under GSP countries were introduced in 2011. The relaxations cover all goods and are particularly significant for products processed in the least developed countries.

23. A significant reduction of trade distorting agricultural support in the EU has already taken place over the past decade through successive reforms, constituting an important contribution of the EU to multilateral trade negotiations. Further reduction in protection of the EU agricultural sector that may result from a successful WTO Doha Round would yield benefits in terms of prices for consumers. This may also impact the productivity of the agricultural sector. The efficiency of the Common Agricultural Policy (CAP) has improved over the past decade as payments have become increasingly decoupled from production (OECD, 2009a; OECD, 2011d; OECD, 2011e). However, imports of agricultural products remain lower than for many other goods. Reforms of the CAP have focused on reducing export subsidies and trade-distorting domestic support, but average MFN agricultural tariffs remain relatively high at 15%. Total support remains considerable in both absolute and relative terms. OECD indicators of support show that market price support represents a declining share of transfers to producers, which has fallen from 87% in 1986 to 15% of transfers in 2010. In the period 2008 to 2010, the level of support to producers was reduced to 22% of gross farm receipts compared to 39% in the period 1986 to 1988. The EU has also reduced the forms of support that most distort production (Figure 5). The level of price distortions has been significantly reduced, while the share of payments granted with no requirement to produce has increased. As payments have become increasingly decoupled from production, the CAP has come closer to being a system for delivering public goods and responding to a set of other rural and environmental objectives. However, efforts should be made to better target support to specific objectives: for example, around three-quarters of CAP funding is allocated to direct income support without any conditions on farm income, while direct payments are only linked through cross-compliance instruments to environmental and other production standards objectives (OECD, 2011a).

Figure 5. **Producer support estimate**

Share of most distorting support in percentage of gross farm receipts[1]



1. Most distorting support: price- and production-linked support measures that increase commodity production the most above the market equilibrium level.

Source: OECD (2011), *PSE/CSE Database.*

24. The combination of high world food prices, which boosts farm earning power, and the need for fiscal consolidation, creates a window of opportunity for reform. Current proposals from the Commission would introduce a new system of direct payments which would change the distribution within and between countries with little impact on production and trade (EC, 2011c; EC, 2010). However, the CAP post-2013 agenda should make efforts to shift the focus away from direct support payments and towards further improving the spending efficiency under CAP and contribute to improving productivity and profitability in the agricultural sector (OECD, 2011a). Single payments remain skewed towards

relatively large and wealthy recipients. Furthermore, despite introducing innovation as a core element of reform and removing production quotas, under the current Commission proposals market deficiencies would remain. Market access to some products will still be restricted by very high quota tariffs, although opportunities exist for lower tariff rates via tariff rate quotas.

Box 3. **Main recommendations on trade and agriculture**

- Continue efforts to secure further multilateral trade liberalisation through the Doha round and, in the absence of agreement, continue to pursue bilateral and regional trade agreements while ensuring that these are trade-creating and supportive of broader trade and development goals.
- Continue to reduce trade barriers and distortions in agriculture in the context of broader trade measures.
- Pursue a far reaching reform of the CAP in the context of the 2014-20 framework to create a stronger link to environmental and productivity objectives. Move further away from unconditional direct income support and market measures.

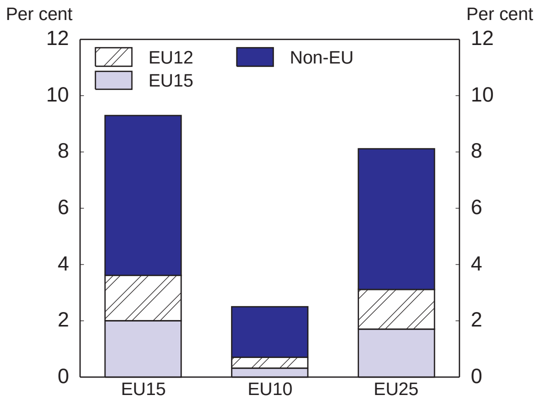
Labour market reforms and removing barriers to intra-EU labour mobility would boost employment, growth and ease adjustments

25. Boosting growth requires removing obstacles to employment. EU labour markets have structural weaknesses that hinder job creation. There are large imbalances of supply and demand of labour between and within countries. Overall employment rates are low due to modest participation rates and persistently high unemployment rates in some countries. Groups with weak attachment to the labour force, such as women, immigrants, older and younger workers are most affected, especially in southern and Eastern Europe. In particular, youth unemployment in the EU rose to an unprecedented 21% in 2011, even though the size of the labour force is beginning to recede due to ageing. Many of the weaknesses in EU labour markets reflect the poor functioning of national labour market institutions, such as excessively strong employment protection legislation, labour market dualism, ineffective wage bargaining, and social protection or taxation systems that weaken incentives to work. The differences in policy settings across countries are reflected in a wide range of labour market performance. Labour market regulations and tax-benefit systems fall largely outside EU competences and require reforms at national level. However, removing obstacles to labour mobility within Europe and achieving a coherent framework for labour migration would help to make the labour market work better and require policy action at the EU level (Chapter 2).

26. Greater mobility between EU countries would help meet imbalances in demand and supply, as well as making it easier for workers and firms to make the right job matches. Labour mobility in the EU remains low: only 3% of working-age EU citizens live in a different EU country (Figure 6). Indeed, migration from outside the EU is much larger than migration within the EU, accounting for around 5% of the working-age population, although this most likely partly reflects larger income differentials. EU enlargement has, however, resulted in a substantial increase in labour migration flows in Europe since 2004, despite many EU15 countries applying transitional restrictions on access to their labour markets. Migrants within Europe are on average substantially younger than the average worker. Moreover, many migrants are over-qualified for their jobs, reflecting among other things difficulties in obtaining recognition of professional qualifications in some areas.

Figure 6. **Share of foreigners[1] in working-age population**

2010 data



1. Foreigners are foreign nationals living in a country.

Source: Eurostat, *Migration Statistics* and *Labour Force Survey*.

27. Europe's linguistic and cultural diversity constitute an obstacle to labour mobility that is hard to avoid. But, there remain many administrative obstacles to mobility in the EU and legal rights under the Single Market are often not implemented in national laws or effectively enforced. Furthermore, the cost of migration for individuals is increased by policy-induced barriers to mobility, such as the loss of pension entitlements, differences in national regulations of professional qualifications, inaccessibility of some public sector jobs and housing market frictions. For pensions, people moving jobs between, and often even within, EU countries may lose part of the value of their existing rights. Indeed, long vesting periods can mean that no entitlement is received for shorter periods of work. Also, EU nationals often cannot contribute adequately to *occupational and supplementary pension schemes in their home countries while working in another EU country.* Efforts to promote pension mobility are hampered by the diversity of systems and the weak funding positions of many public and private schemes after the crisis, which could be further complicated if more workers could withdraw existing contributions. However, steps can be taken to improve the portability of public and private pension entitlements to avoid losses in pension value when moving between countries, including through shorter vesting periods and allowing workers to contribute for some time to schemes in a home country while working abroad. There remain risks of double taxation for pensioners and discriminatory treatment of cross-border transfers of pension capital, which should be removed.

28. Difficulties linked to the efficiency of professional recognition procedures reduce incentives to move. Automatic recognition applies only to seven out of more than 800 professions. However, mutual recognition is now at the heart of ensuring recognition in other professions, which allows professionals to obtain the recognition of their qualifications. At the same time, it gives some leeway to countries to ensure that the qualifications correspond to national requirements. Between 2007 and 2010 and for all professions, more than 90% of professionals requesting the recognition of their qualifications in another country received a positive decision, although the number of applications was only around 25 000 per year on average. In contradiction to existing EU legislation and ECJ rulings, EU nationals or other citizens are often excluded explicitly or implicitly from public sector jobs. Workers trying to get a job in the public sector face problems with the recognition of professional experience and seniority, recognition of professional qualifications, and disproportionate language requirements. Large housing transaction costs, particularly in some continental and southern European countries, make it harder for owner-occupiers to move to other countries, while other housing rigidities can also make it hard for renters, who tend to be young, to move. Better information about job vacancies in other countries or regions would facilitate migration. Information sharing should be improved, mainly through co-operation between national employment agencies and by upgrading the EURES system. Removing these obstacles would help workers to find jobs and make it easier for firms to recruit from outside their locality, both within the same country and elsewhere in Europe.

An EU-level immigration policy could ease skill shortages due to demographic changes

29. Immigration from outside the EU has a larger impact on labour markets in European countries than migration within the EU. Twenty-seven million foreign-born immigrants live in the European Union. Most of them live in the EU15 countries, although good growth performance is turning some EU10 countries into destinations for non-EU immigrants even if overall numbers still remain low. Although net inward migration rates are positive for most EU countries, emigration rates from European countries are substantial in some cases, particularly for high-skilled workers. For Ireland, Italy or the United Kingdom, the outflows of their own high-skilled citizens broadly cancel out the inflow of skilled workers.

30. With demographic changes underway, most EU countries expect growing shortages of skilled labour or workers in specialised activities. In principle, labour market shortages should be reduced mainly through increasing labour participation and the employment rates of women, young and older workers and immigrants already living in the country. In addition, education and training should be improved to make sure that they match skills requirements by employers. Policies at the EU level should be developed to ensure that migration responds more directly to labour shortages, particularly for specific types of high-skilled workers. Managing labour flows at the EU level is important to attracting high-skilled migrants because of the sensitivity of their choice of location to obstacles such as the still fragmented nature of EU labour markets. The recent Blue Card – an EU-wide work permit, allowing high-skilled non-EU citizens to work and live in the EU – should be used effectively in order to make it more attractive to high-skilled workers.

Box 4. **Main recommendations on mobility and immigration**

- Improve portability of public and private pension entitlements to avoid losses in pension value when moving between countries. Pension reforms should be designed with a view to facilitating movements both between employers and across borders. As proposed by the Commission*, a vesting period of no more than one year across the EU should be ensured when t*ransferring into pension schemes across borders. *Allow workers to pay into occupational and supplementary pension schemes in their home countries while working in another EU country.*
- Eliminate double taxation of cross-border pension benefits and discriminatory taxation of cross-border transfers of pension capital.
- Develop recognition mechanisms aiming to ensure more automaticity in the recognition of professional qualifications.
- Open public sector employment as far as possible to all EU citizens in national laws and procedures. Public sector employment practices should facilitate labour mobility, including through recognition of seniority and qualifications acquired in other countries.
- Pursue a reform of EURES enabling greater European mobility, and enhancing placement and matching between labour supply and demand. The EURES network and portal should be upgraded, and co-operation and information-sharing between national employment services should be improved.
- Policies at the EU level need to be developed to ensure that migration responds to labour needs, such as expected shortfalls in labour supply and skill shortages.
- Use the Blue Card scheme effectively to make it more attractive to high-skilled workers.

Regional policy can contribute more to growth

31. EU cohesion policy has contributed to raising economic performance in regions by promoting economic convergence and helping to reduce disparities in living standards. The objectives of EU regional policy have moved increasingly from providing transfers to poorer regions to supporting endogenous growth with a primary focus on small and medium enterprises (SMEs), the environment, innovation, infrastructure and R&D. Achieving these objectives with a budget of less than 0.5% of EU GDP is difficult, although cohesion funds can amount to a much greater share of GDP in some of the poorer recipient regions and are one of the main sources of investment in some cases during the fiscal consolidation efforts. The record of EU cohesion policy so far is somewhat mixed: regional disparities have been falling at the EU27 level since 2000 (EC, 2011d), but not all lagging regions have been able to boost their performance. The challenge is to get the maximum benefit from the available funds by making sure countries focus on activities that support productive investment and growth. Achieving this has been a long standing problem. Currently, further concrete reforms are being debated for the next financial framework (EC, 2011a). Previous trends to decentralise the management of cohesion funds may get reversed, by attaching conditionality requirements to the use of cohesion funds - supported by more and better indicators of policy impact – and reducing the freedom of EU countries and regions to decide where to spend funds. *Ex ante* conditions, based on previous project performance, could target the key weaknesses in implementation that have often led to ineffective use of funds in the past. Administrative burdens associated with cohesion funds for countries and regions should be further lowered (OECD, 2007).

Box 5. **Main recommendation on regional policy**

- Attach *ex ante* conditions to the use of cohesion funds without creating an additional layer of bureaucracy. These should target the key weaknesses in past implementation.
- Further lower administrative burdens associated with cohesion funds for countries and regions.

Bibliography

Barnes, S., P. Lane and A. Radziwill (2010), “Minimising Risks from Imbalances in European Banking”, *OECD Economics Department Working Papers*, No. 828, OECD publishing, Paris.

EC (European Commission) (2010), “The CAP towards 2020: Meeting the Food, Natural Resources and Territorial Challenges of the Future”, Communication from the Commission, COM(2010) 672, Brussels.

EC (2011a), “Conclusions from the High Level Meeting on the Future of Cohesion Policy”, Budapest, 31 March – 1 April.

EC (2011b), “Europe 2020 Flagship Initiative Innovation Union Communication”, COM(2010) 546, Brussels.

EC (2011c), Legal proposals on CAP Reforms are available at: http://ec.europa.eu/agriculture/cap-post-2013/legal-proposals/index_en.htm.

EC (2011d), “Investing in Europe’s future”, *Fifth Report on Economic, Social and Territorial Cohesion*, DG for Regional Policy, Brussels.

EC (2011e), *Single Market Act. Twelve Levers to Boost Growth and Strengthen Confidence: Working Together to Create New Growth*, Communication from the Commission, COM(2011) 206, April, Brussels.

European Investment Bank (EIB) (2009), "R&D and the Financing of Innovation in Europe Financing Innovative Firms", *EIB Papers*, Vol. 14, No. 2.

Fredriksen, K. (2012), "Income Inequality in the European Union", *OECD Economic Department Working Papers*, forthcoming, OECD publishing, Paris.

Koske, I., J.-M. Fournier and I. Wanner (2012), "Less Income Inequality and more Growth – Are they Compatible? Part 2: The Distribution of Labour Income", *OECD Economics Department Working Papers,* No. 925, OECD publishing, Paris.

OECD (2007), *OECD Economic Surveys: European Union*, OECD publishing, Paris.

OECD (2009a), *OECD Economic Surveys: European Union*, OECD publishing, Paris.

OECD (2009b), *OECD Strategic Response to the Financial and Economic Crisis: Contributions to the Global Effort*, OECD publishing, Paris.

OECD (2010), *The OECD Innovation Strategy: Getting A Head Start for Tomorrow*, OECD publishing, Paris.

OECD (2011a), Communication on CAP post 2013, available at: *http://www.oecd.org/dataoecd/22/30/48937654.pdf.*

OECD (2011b), *Going for Growth*, OECD publishing, Paris.

OECD (2011c), *Towards Green Growth,* OECD publishing, Paris.

OECD (2011d), *Agricultural Policy Monitoring and Evaluation: OECD Countries and Emerging Economies*, OECD publishing, Paris.

OECD (2011e), *Evaluation of Agricultural Policy Reforms in the European Union*, OECD publishing, Paris.

OECD (2012a), *Economic Surveys: Euro Area*, OECD publishing, Paris, forthcoming.

OECD (2012b), *Environmental Outlook to 2050*, OECD publishing, Paris, forthcoming.

UNFCCC (2011), *Establishment of an Ad Hoc Working Group on the Durban Platform for Enhanced Action, http://unfccc.int/files/meetings/durban_nov_2011/decisions/application/pdf/cop17_durbanplatform.pdf.*

Chapter summaries

Chapter 1. A Single Market for Europe

The creation of a more integrated Single Market is one of the EU's main policy levers to boost growth and job creation. Despite major progress with integration of EU goods and services markets over the past decades in terms of cross-border trade, it remains lower than within the United States. In recent years, trade has increased mainly from central and Eastern Europe, while intra-EU15 cross-border economic activity has stalled and some of the progress of financial integration over the past decade now appears to have been unsustainable.

The remaining fragmentation of the Single Market prevents Europe from fulfilling its full growth potential and important gains in terms of scale and competition. Product market regulations at national level and their diversity are key obstacles to a more effective Single Market. Many of the institutions and regulations that govern and facilitate integration among EU countries are still organised on national lines. While enormous progress has been made over past decades in building the Single Market, including the landmark Services Directive, weak implementation of the framework has undermined its effects on growth.

A step change is required in the priority devoted to achieving a true Single Market in Europe. This should include better identification and more rapid adoption of policies required to make markets more integrated, as well as better implementation and stronger enforcement of Single Market requirements. Product market regulations at national level should be more friendly to cross-border activities. The Single Market needs more effective basic economic institutions for cross-border activity in areas such as taxation, competition policy and patent protection. Specific measures are needed to ensure that there is more cross-border competition and integration in some sectors, particularly network industries such as telecommunication, energy and transport.

Chapter 2. Mobility and migration in Europe

There are large differences in labour market performances in EU countries, resulting in part from different policy settings. High unemployment, particularly among young people, and low labour mobility within and between countries coexist with skill and labour shortages in some countries and regions. This reflects weaknesses in national labour market policies, such as high costs of exit and entry, training mismatches or disincentives to participation, and also barriers to labour mobility. Well performing labour markets are important for facilitating adjustment to shocks, especially in the monetary union, allocating resources to best uses, and in dealing with potential labour market shortages related to ageing.

Mobility within the EU can in principle help to fill labour market shortages, but the cost of moving for individuals is increased by policy-induced barriers to mobility such as the loss of pension entitlements, lack of recognition of qualifications, inaccessibility of some public sector jobs and housing market frictions. To achieve better functioning EU labour markets, labour market institutions should be improved and obstacles to mobility reduced.

With demographic changes underway, most EU countries expect growing shortages of skilled labour. In principle, this should be addressed through increasing labour participation and employment rates of female, young and older workers and migrants already living in the country, and making sure that training and education match skill requirements by employers. Nevertheless, policies at the EU level should be developed to ensure that migration responds more directly to specific labour market needs particularly for high-skilled workers.

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

The economic situation and policies of European Union were reviewed by the Committee on 14 February 2012. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 7 March 2012.

This Survey of the European Union has been prepared back-to-back with the Survey of the Euro area, which was discussed and approved on the same days as this document. The Surveys are being released together.

The Secretariat's draft report was prepared for the Committee by Sebastian Barnes, Charlotte Moeser and Jon Pareliussen under the supervision of Piritta Sorsa. Research and editorial assistance was provided by Isabelle Duong.

The previous Survey of the European Union was issued in September 2009.

Further information

For further information regarding this overview, please contact:

Piritta Sorsa, e-mail: piritta.sorsa@oecd.org; tel.: +33 1 45 24 82 99; or
Sebastian Barnes, e-mail: sebastian.barnes@oecd.org; tel.: +33 1 45 24 94 21; or
Charlotte Moeser, e-mail: charlotte.moeser@oecd.org; tel.: +33 1 45 24 87 57.

See also *http://www.oecd.org/eco/surveys/European Union*.

How to obtain this book

This survey can be purchased from our online bookshop: *www.oecd.org/bookshop*.

OECD publications and statistical databases are also available via our online library: *www.oecdilibrary.org*.

Related reading

OECD Economic Surveys: *OECD Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at *www.oecd.org/bookshop*.

OECD Economic Outlook: More information about this publication can be found on the OECD's website at *www.oecd.org/eco/Economic_Outlook*.

Economic Policy Reforms: Going for Growth: More information about this publication can be found on the OECD's website at *www.oecd.org/economics/goingforgrowth*.

Additional Information: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's website at *www.oecd.org/eco*.

Economics Department Working Papers: *www.oecd.org/eco/workingpapers*

OECD work on European Union: *www.oecd.org/European Union*