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STRUCTURAL REFORMS AND THE BENEFITS OF THE ENLARGED EU INTERNAL MARKET: MUCH ACHIEVED AND MUCH TO DO

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by
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Abstract/Résumé

Structural reforms and the benefits of the enlarged EU internal market: Much achieved and much to do

High expectations surrounded the two waves of eastward EU enlargement in 2004 and 2007, with the extension of the EU Internal Market being expected to deliver a substantial boost to economic growth in new and old member States alike. Indeed, considerable progress has been made, with existing evidence pointing to increased trade and FDI flows, enhanced east-west migration and a more stable macroeconomic environment. However, completion of the internal market is progressing at an uneven pace, and comparatively less progress can be seen in services industries, which provide over two-thirds of jobs and value added in the economy. Empirical estimates suggest that competition and trade-enhancing reforms in services industries could generate substantial productivity improvements across EU member economies. Over a period of 10 years, the predicted increase in labour productivity resulting from a bold reform package is around 10% for the average EU country, and new member States stand to gain even more. In addition to service-sector reform, priorities towards a more integrated EU internal market should include removing remaining barriers to labour mobility, improving transport infrastructure, mutual recognition of qualifications, and enhanced market integration of network industries. Finally, a more explicit use of benchmarking may help to enhance the momentum of future internal market reforms.

JEL Codes: D24 ; E23 ; F15 ; K23 ; L11 ; L51
Keywords: economic growth; integration; productivity; structural reform; regulation

Beaucoup a été fait, mais beaucoup reste à faire : Les réformes structurelles et les avantages du marché intérieur élargi de l'UE

On attendait beaucoup des deux vagues d'élargissement de l'UE à l'est en 2004 et 2007, et le développement du marché intérieur de l'UE devait grandement dynamiser la croissance économique dans les nouveaux et dans les anciens États membres. Effectivement, d'énormes progrès ont été accomplis, les données actuelles indiquant une intensification des échanges et des flux d'IDE, un renforcement des migrations est-ouest et un environnement macroéconomique plus stable. Mais l'achèvement du marché intérieur progresse à un rythme inégal et on a comparativement moins avancé dans les activités de services, qui représentent plus des deux tiers des emplois et de la valeur ajoutée dans l'économie. Les simulations effectuées à partir d'un modèle empirique montrent que des réformes qui amélioreraient la concurrence et renforceraient les échanges dans les activités de services pourraient se traduire par des gains substantiels de productivité dans les États membres de l'UE. Sur une période de dix ans, la croissance prédite de la productivité du travail qui résulterait d'un ambitieux programme de réformes est de l'ordre de 10 % pour le pays moyen de l'UE, et les nouveaux États membres tireraient encore davantage profit de ces réformes. De plus, les priorités de la réforme structurelle en vue d'un marché intérieur de l'UE plus intégré devraient être les suivantes : l'élimination des obstacles qui subsistent à la mobilité des travailleurs, l'amélioration des infrastructures de transport, la reconnaissance mutuelle des qualifications et une intégration plus étroite des marchés dans les industries de réseau. Enfin, une utilisation plus explicite de l'évaluation comparative pourrait contribuer à accélérer les réformes futures concernant le marché intérieur.

Classification JEL : D24 ; E23 ; F15 ; K23 ; L11 ; L51
Mots clés : croissance économique ; intégration ; productivité ; réforme structurelle ; réglementation

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STRUCTURAL REFORMS AND THE BENEFITS OF THE ENLARGED EU INTERNAL MARKET: MUCH ACHIEVED AND MUCH TO DO[1]

by Jens Arnold, Peter Höller, Margaret Morgan and Andreas Wörgötter

Enlargement was expected to have economic benefits…

1. In the run-up to EU enlargement towards the east and south-east in 2004 and 2007 many studies predicted a considerable boost to growth for both the new and existing EU members.[2] In general, a higher growth effect was expected from the integration of more advanced economies, reflecting the more dynamic nature of integration along the lines of the new trade and growth theory[3], as opposed to the more static integration gains among economies with diverse factor endowments[4]. The inclusion of more similar economies also raised the prospect of a more rapid enlargement of the euro area. Although there was no consensus in the literature about the right speed with which to adopt the euro[5], only 5 years after the biggest enlargement of the European Union, 4 out of 10 new member countries have joined the euro area.

2. Structural reforms play a crucial role in reaping the full benefits of this integration. The observation that enlargement with more similar economies is likely to generate particularly large benefits underlines the double dividend of growth-enhancing structural reforms. Such reforms help speed up real

1. This paper was presented by Andrew Dean, Director of the Country Studies Branch of the OECD Economics Department, in the Workshop "EU Internal Market" at the Conference on "EU Enlargement - 5 Years After" on 2 March 2009. Valuable comments and suggestions on earlier versions from Robert Ford, Andrew Dean and Giuseppe Nicoletti are gratefully acknowledged. Drafting inputs were received from Sven Blöndal (Going for Growth) and Bill Tompson (Political Economy of Structural Reforms). The final responsibility remains with the authors. This contribution was financed by a voluntary contribution from the Czech Republic. Many thanks for the excellent co-operation during the preparation and execution of this project go to Jan Hebnar, Branislav Gal, Pavlina Zakova, Marek Mora, Karel Dyba and Hana Heidlerova.

2. Breuss (2001) predicts considerable effects for the new member countries and small effects for the old member countries. Most benefits would accrue to Germany, Austria and Italy, while net effects on GDP were estimated to become negative for Denmark, Spain and Portugal. These results were derived from a global macro model (Oxford Economic Forecasting) and explicitly include trade, factor movements, product market reforms, and budgetary costs as channels for benefits and costs of enlargement. Breuss (2007) estimates the enlargement impact to be about 20 times bigger for Bulgaria and Romania than for the old member States as well as the 10 new member States that joined in 2004.

3. According to Baldwin (1992), the dynamic impact of trade integration is typically much larger than the mere static integration effect.

4. See for instance Findlay (1995).

5. See Backé (2004), who provides an overview of possible euro adoption strategies ranging from immediate unilateral euro adoption to late entry after the conclusion of real and nominal convergence.

convergence and strengthen the potential integration effects. In this respect, a homogeneous regulatory environment, which the completion of the EU internal market is intended to bring about, is already an important catalyst for dynamic integration effects, because it is likely to affect the investment rate and innovation, thus boosting productivity. The need for further reforms to complete the internal market is underscored by the presumption that the productivity boost in the wake of enlargement will prove to be by far the largest contributor to the positive growth effects of enlargement.

3. This productivity boost, however, will only happen if the corresponding structural reforms sharpen competitive pressures in product markets, in particular by reducing entry barriers in network industries and liberalising services markets. Therefore, making enlargement a success was, and is, not only an issue for the new member countries, but concerns also the willingness and openness of incumbent member countries to reform.

4. The growth effects of enlargement were expected to come from a variety of channels:

- More intense trade relationships, in particular an increase of intra-industry trade, allowing a better utilisation of economies of scale in a larger market, as well as meeting consumers' preferences for product differentiation. Fidrmuc (2008) provides a summary of the theoretical arguments as well as an empirical investigation of why intra-industry trade is an important mechanism towards more synchronised business cycles and higher expected gains from a single currency area.

- New investment opportunities for the capital-rich old members. Djankov and Hoekman (1996) argue that the strong expansion of exports from former Communist countries to the EU was not a mere re-orientation of trade from the east to the west, but involved considerable industrial restructuring. This view also suggests that the integration of new member countries is an extended process, although one that was already under way long before enlargement.

- New employment opportunities in the more advanced old EU member economies for the labour-rich new members. In a Heckscher-Ohlin world factor mobility and trade flows are substitutes. However, while expectations about the total flow of east-west migrants covered quite a wide margin,[6] it was generally accepted that migrants from new member States would help to overcome skills bottlenecks and provide some breathing time to adjust to the long-term demographic trends in the old member countries. Overall, the labour market impact of migration was considered to be modest while welfare implications were seen to be positive in the long run. In the short run, however, lower wages and higher unemployment in old member countries were seen to be necessary to absorb the influx of additional labour.[7]

- Institutional reforms in the new member countries, which would make the overall regulatory environment more growth-friendly. Basic market reforms in post-communist countries, such as a stronger rule of law, privatisations, market-determined wages and prices and independent and

6. Bauer and Zimmermann (1999) mention that estimates vary between 5 and 50 million people.

7. In theory an increase in labour supply will be absorbed only at lower wages, everything else equal. However, eventually the capital stock will adjust, thus increasing labour demand and wages. In addition, most studies assume a positive integration effect, which will also shift the labour demand schedule to the right. Estimates making such long-run equilibrium assumptions, like Heijdra *et al.* (2002), Boeri and Brücker (2001) and Hofer and Huber (2003), therefore come to the conclusion that long term benefits are not limited to migrants.

price-stability oriented central banks, marked the end of transition.[8] Following the successful introduction of these reforms, a more lengthy and difficult phase of reforming product and labour markets (including regulatory reform of network industries and the financial sector) began.[9] Enlargement gains were rightly seen to depend on the ability to re-allocate resources, reduce monopoly power and rents and challenge the positions of less efficient incumbents. Adopting the *acquis communautaire* in the course of becoming an EU member was certainly seen as a large step forward concerning legal standards, but the need for further reforms as well as effective implementation was seen as critical to reaping the gains from enlargement.

- Further progress with reforms in existing member countries. The discussion in the run-up to enlargement was in part shaped by concerns about the readiness of these countries for enlargement. Some argued that, first, integration among old members should deepen further, and only then could the success of enlargement be assured. While this discussion was overtaken by events, it nevertheless remains true that enlargement gains depend on the openness to reform of both new and existing member countries.[10]

- Better access to financial markets for rapidly growing and catching up countries. The higher growth expected to flow from enlargement would have to be partly financed with foreign capital. The resulting investment and technology transfer was seen to be an important mechanism for the realisation of enlargement gains.

- Consequent enlargement of the euro area. The benefits of an optimal currency area increase with its size.[11] A positive economic impact was also expected to come from enlargement of the euro area with those new member countries which were able to fulfil the Maastricht criteria for participating in the European Monetary Union. Four years after enlargement, already four of the smaller new member (Slovenia in 2007[12], Malta and Cyprus in 2008 and Slovakia in 2009[13]) managed to fulfil the entry criteria for joining the euro area and enjoy the elimination of

---

8. While Svejnar (2002) finds that the progress of transition varied widely from east to west he concludes that the "end of transition" is likely to be marked by accession to the European Union.

9. Van de Mortel (2002) develops an institutional approach to transition processes, which can be filled with the "Progress in Transition" indicators from the EBRD to classify countries according to their position in the three stages of transition: *1)* willingness to reform; *2)* legal (formal) reform of institutions; and *3)* harmonisation of formal and informal institutions. Not surprisingly, new member States have entered the third stage of reforms around the time of accession. Aidis and Sauka (2005) apply this approach to the issue of barriers to SME development and find that with increasing progress in transition, SME issues become less fundamental and move towards more "practical" areas like human resource availability (labour supply) and skill formation (training).

10. This also includes the issue of reform of European institutions as such. Steunenberg (2001) draws the link between enlargement and issues like voting rights.

11. "The fact is there are strong arguments for making currency areas large and these dominate the case for making them small." Howard R. Vane and Chris Mulhearn (2006), "Interview with Bob Mundell", *Journal of Economic Perspectives*, Vol. 20, No. 4, Fall 2006, pp. 89–110.

12. See Weyerstrass and Neck (2008) for estimating the impact of euro adoption in Slovenia. The temporary positive growth effects are leading to a permanent level effect, which is mainly coming from a reduction of interest rate spreads due to more competition in financial services.

13. Hüfner and Koske (2008) provide an analysis of the policy challenges associated with euro adoption in the Slovak Republic.

exchange rate risk for their economies.[14] Joining the euro area was certainly not considered as urgent at the time of EU entry as it might appear now, and this lack of urgency and some reluctance to give up independent monetary policy may have contributed to a slowdown of efforts to fulfil the Maastricht criteria and tackle associated fiscal reforms.

… and these benefits have been realised …

5. The European Commission undertook a major study in 2006 to assess economic performance following enlargement and compare it with expectations.[15] The study found that enlargement was a win-win situation and that the positive expectations had not been disappointed. Trade relations have intensified, FDI activities soared, and migrants from the new member States have filled vacancies and removed labour-market bottlenecks in old member countries. The overall macroeconomic environment has become more stable, the inflation-growth trade-off has become more favourable and, after a long period of contraction marking the transition from central planning, employment and the labour market conditions started to improve. The following paragraphs take stock of a range of indicators reflecting the overall economic impact of enlargement on individual existing and new EU member countries.

… although less uniformly than expected.

6. When attempting to evaluate the growth effects of enlargement, it is important to acknowledge that a simple comparison of GDP growth before and after enlargement could easily be distorted by cyclical developments. Furthermore, considerable integration had already taken place before enlargement. A broad assessment of the role of enlargement for economic activity has to take into account both of these factors. The cyclical distortion can to a large extent be dealt with by comparing pre- and post enlargement developments in terms of potential rather than actual GDP growth. This is illustrated in Table 1.

7. The table indicates that new member countries like the Czech Republic, Poland and the Slovak Republic benefited from a strong increase in trend growth after joining the European Union. Only Hungary experienced a slowdown in estimated trend growth, reflecting not EU membership but rather a serious fiscal crisis. However, most existing member countries could not maintain the high trend growth rates from the period before enlargement (Ireland, Greece, Netherlands, Spain or Austria) or were not able to boost their historically low trend growth rates (Germany and Italy). The decline of trend growth for Portugal[16] is also worrying since the growth of potential was already low, in contrast to Ireland where the deceleration was greater but from a significantly higher pace of growth. Furthermore, Portugal is a country with a large income gap to the EU average and therefore in need of strong and sustained growth in order to catch up.

8. There are many reasons why the consequences of enlargement on existing member countries need not be uniform. One very powerful mechanism is geographical proximity, which allowed former border countries like Germany, Austria and Italy to reap a large part of the trade-related benefits.

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14. There was considerable discussion about the appropriateness of the Maastricht criteria for catching up economies. See for instance Szapary (2000), who considered the inflation criterion inappropriate because of the Balassa-Samuelson effect on inflation for catching up countries. At the end an "equal treatment" principle was considered to be most appropriate legally as well as economically. Concerning the latter, current euro area adoption criteria emphasise the importance of sufficient convergence (Ecofin, 2000).

15. See European Commission (2006).

16. Heijdra *et al.* (2002) estimate a negative welfare effect of eastern enlargement for Portugal.

Table 1. Potential real GDP, average annual growth in percent

	(I) 1999-2004	(II) 2004-2007	(III) (II)-(I)
Slovak Republic	4.6	6.2	1.6
Czech Republic	3.3	4.9	1.6
Poland	3.3	4.3	1.0
Turkey	4.2	5.2	0.9
Norway	3.0	3.8	0.8
Switzerland	1.8	2.2	0.5
Belgium	2.1	2.2	0.1
United States	2.6	2.6	0.0
Germany	1.3	1.3	0.0
Japan	1.2	1.2	0.0
Finland	3.2	3.1	-0.1
Greece	4.0	3.9	-0.1
Italy	1.2	1.1	-0.1
Sweden	3.1	3.0	-0.2
Mexico	3.0	2.9	-0.2
Denmark	1.8	1.7	-0.2
Austria	2.5	2.3	-0.3
Spain	3.6	3.3	-0.3
United Kingdom	2.7	2.4	-0.4
Korea	4.8	4.4	-0.4
Australia	3.4	3.0	-0.4
Netherlands	2.5	2.1	-0.4
Canada	3.0	2.6	-0.4
France	2.2	1.7	-0.5
New Zealand	3.3	2.8	-0.6
Portugal	2.2	1.4	-0.8
Hungary	4.3	3.4	-0.9
Ireland	6.8	5.2	-1.6

1. Potential output is estimated using a production function approach for all countries except Portugal(the latter is trend real GDP using a Hodrick-Prescott filter).

Source: OECD, *Economic Outlook* No. 84, December 2009.

Moreover, the New Economic Geography" argues that integration can increase diversity by re-enforcing relative economic strengths and weaknesses.[17] Five years after the main wave of enlargement, a certain range of outcomes of EU-integration can be recognized:

- Goods trade integration had already progressed a long way due to the reduction and elimination of tariff barriers. Furthermore, globalisation brought a tremendous increase of world trade. However, new member countries, especially the more advanced ones, maintained the momentum of increased trade integration with the existing member countries, and also with each other. This is particularly the case for the Czech and Slovak Republics, whose economies became deeply integrated into new supply networks of manufacturing conglomerates, for example in the car industry. Further possibilities to reduce non-tariff barriers came from extending the Schengen

17. See Marques (2008) for a Survey of theoretical and empirical integration studies.

Table 2. Goods trade (exports + imports) with the EU27 as percent of total goods trade

	(I)	(II)	(III)
	1999	2007	2007-1999
Czech Republic	81.8	82.7	0.9
Slovakia	81.6	80.4	-1.2
Austria	79.4	75.9	-3.4
Portugal	80.9	75.9	-5.0
Poland	75.7	75.8	0.1
Latvia	76.5	75.7	-0.8
Estonia	78.5	75.1	-3.4
Hungary	77.7	74.2	-3.5
Belgium	75.6	73.6	-2.0
Denmark	72.1	71.6	-0.5
Slovenia	75.7	71.6	-4.2
Romania	70.8	71.4	0.6
France	67.0	66.9	0.0
Lithuania	65.4	66.9	1.5
Ireland	65.5	66.1	0.6
Spain	71.5	66.1	-5.5
Sweden	66.5	65.8	-0.7
Netherlands	70.0	64.9	-5.1
Germany	65.7	64.7	-1.1
Finland	67.0	60.3	-6.8
Greece	69.1	59.5	-9.5
Bulgaria	55.9	59.4	3.5
Italy	64.8	58.5	-6.3
United Kingdom	57.5	56.2	-1.3

Source: Eurostat.

area. Table 2 shows that the share of intra-EU trade differs widely within the EU and that has not changed much after enlargement. This strong heterogeneity suggests that there may still be unexploited mutually beneficial trade opportunities in some member countries.

- While growth and living standards among new members have undoubtedly increased (Table 3), this achievement is not equally sustainable everywhere. Some new member countries used the potential of EU-membership to boost domestic demand and accepted large current account imbalances, while others paid more attention to fostering export capacity. The Czech and Slovak Republics, Hungary, Poland, and Slovenia achieved significant convergence without a deterioration of their current accounts. High growth and current account deterioration was not, of course, confined to the new members, but also occurred in Greece, Ireland and Spain.

- All new EU member countries, except Hungary, managed to increase their growth rates after EU accession. Even Estonia and Romania, which had already enjoyed stunning growth rates in the run-up to accession, further increased growth after accession. Most old member countries have experienced modest gains in terms of economic growth, in particular some former “border”

Table 3. Real GDP *per capita* and current account changes

EU27 = 100, based on euros at purchasing power parity with EU27 and per cent of GDP (current account)

	Real GDP per capita		Change in real GDP per capita	Change in current account
	1999	2007	2007-1999	2007-1999
Estonia	42	68	26	-14
Ireland	126	150	24	-6
Lithuania	39	60	21	-4
Latvia	36	55	19	-15
Slovakia	51	67	17	0
Romania	26	42	16	-10
Greece	83	95	12	-11
Czech Republic	70	80	11	1
Bulgaria	27	37	10	-17
Spain	96	105	9	-7
Hungary	53	63	9	2
Slovenia	81	89	9	-1
Poland	49	53	5	3
United Kingdom	118	119	1	-1
Finland	115	116	1	-2
Netherlands	131	131	0	4
Portugal	78	76	-2	-1
Sweden	125	122	-3	4
Belgium	123	118	-5	-3
France	115	109	-6	-4
Austria	131	124	-7	6
Germany	122	115	-7	9
Denmark	131	120	-11	-1
Italy	118	101	-16	-3

Source: Eurostat.

countries with low growth received a welcome boost. Austria, Denmark and Germany feature prominently in this group. In contrast, some of the existing and poorer member countries have not yet managed to adjust to the new investment locations and cost-effective supplies (see Table 4).

- Many old EU member countries made use of the possibility to delay the free movement of labour from the new member countries, at least for a transition period. However, others have benefited from a large inflow of labour from new member countries.[18]

- While the general mood in old EU member countries is in favour of protecting domestic industry, a few have actively engaged in establishing new supply networks, including by investing in the new member States. Further research should shed light on the split between manufacturing and services investment, as well as the reasons behind the overinvestment in real estate in some countries.

18. See the *OECD Employment Outlook* for a description of labour flows between east and west.

Table 4. Real GDP, average annual growth, %

	(I) 1999-2004	(II) 2004-2007	(III) (II)-(I)
Slovak Republic	3.9	8.5	4.6
Latvia	7.5	10.9	3.5
Czech Republic	3.2	6.4	3.1
Poland	3.2	5.5	2.3
Slovenia	3.7	5.7	2.0
Austria	1.8	3.1	1.3
Netherlands	1.7	3.0	1.3
Bulgaria	5.1	6.2	1.1
Lithuania	7.1	8.2	1.1
Finland	3.0	4.1	1.1
Denmark	1.5	2.5	1.0
Germany	1.1	2.1	1.0
Romania	5.3	6.1	0.8
Estonia	7.9	8.6	0.7
Sweden	2.8	3.4	0.6
Belgium	2.0	2.5	0.5
Spain	3.5	3.7	0.2
France	2.1	2.1	0.0
Portugal	1.5	1.4	-0.1
Ireland	6.1	6.0	-0.1
United Kingdom	2.8	2.6	-0.2
Italy	1.5	1.3	-0.2
Greece	4.5	3.8	-0.7
Hungary	4.5	3.0	-1.5

Source: Eurostat.

- While infrastructure investment generally ranks high on the priority list for public expenditure, not much has happened to improve transport infrastructure for east-west traffic. Only few additional highway border crossings have been opened and rail track investment is minimal, although most airports have been renovated since 1989. The issue of how best to overcome the barriers to cross border co-ordination and co-operation needs further exploration, in order to ease the evident bottlenecks of east-west transport infrastructure.

9. Overall, the single market in goods works very well. However, the completion of the internal market in other areas, notably services, is progressing at an uneven pace.[19] While much progress has been made on reducing barriers to goods trade and the mutual recognition of standards and regulations, less progress can be seen for services, network industries, the mutual recognition of qualifications, and public services and public employment. Price level convergence is much lower in the EU than across US states, mainly because of persistent differences in services prices. Some of these differences have a cultural dimension, like the many different languages spoken across the EU area, and will therefore not change very quickly. However, some of the factors contributing to a less than desired functioning of the internal market can be linked to policies. Among these are:

19. See *OECD Economic Survey: European Union* (2009).

- The Lisbon bottom-up process has not addressed some controversial reform issues. While benchmarking can be valuable and is increasingly popular, it is also an agreed *modus vivendi* to avoid explicit rankings.

- Strong border effects persist despite the four freedoms. Harmonisation of product market regulation could increase cross border trade of services within the EU significantly.[20] Liberalisation of the service sectors within and across EU countries is much less advanced than for goods. While the service sector provides over two-thirds of jobs and value added, internal trade in services amounts to only 5% of GDP. An important reason is that regulatory barriers make it hard to provide services across borders. Some laws amount to non-tariff barriers to trade, while differences in regulations across countries make it more difficult to sell services to all European citizens. The main losers from trade barriers are consumers and small and medium-sized firms. Large firms can afford the transaction costs and will have the in-house knowledge of different legal systems. For small firms, however, it will seldom be worthwhile to launch a legal challenge against regulatory barriers in another country.

- Cross border mobility of labour in the EU lags far behind the mobility within the US or Canada. In particular, cross border labour mobility between old and new member States is much lower than what would be expected given income differences and distance.

- Market areas for network industries remain either national or regional, hampering cross-border activities.

Regulatory reform of services and trade is likely to boost labour productivity sizeably

10. Product market regulations, like other regulations, generally address public interest concerns about market failures, including monopoly conditions, externalities and asymmetric information. However, some regulations may drift away from their original public interest aims, resulting in the protection of special interest groups, and regulations (and their implementation) sometimes involve costs that exceed their expected benefits. In addition, technical progress, the evolution of demand and progress in regulatory techniques can render regulations obsolete.

11. Arnold, Nicoletti and Scarpetta (2008) and Conway *et al.* (2006) present empirical evidence of a positive relationship between lighter product market regulation and productivity growth in OECD countries. This section applies the findings of these studies and the new vintage of OECD product market (PMR) indicators to illustrate the potential gains from regulatory reforms in terms of economic performance. The structure of the PMR indicators in shown in Figure 1, and is summarised in Box 1.

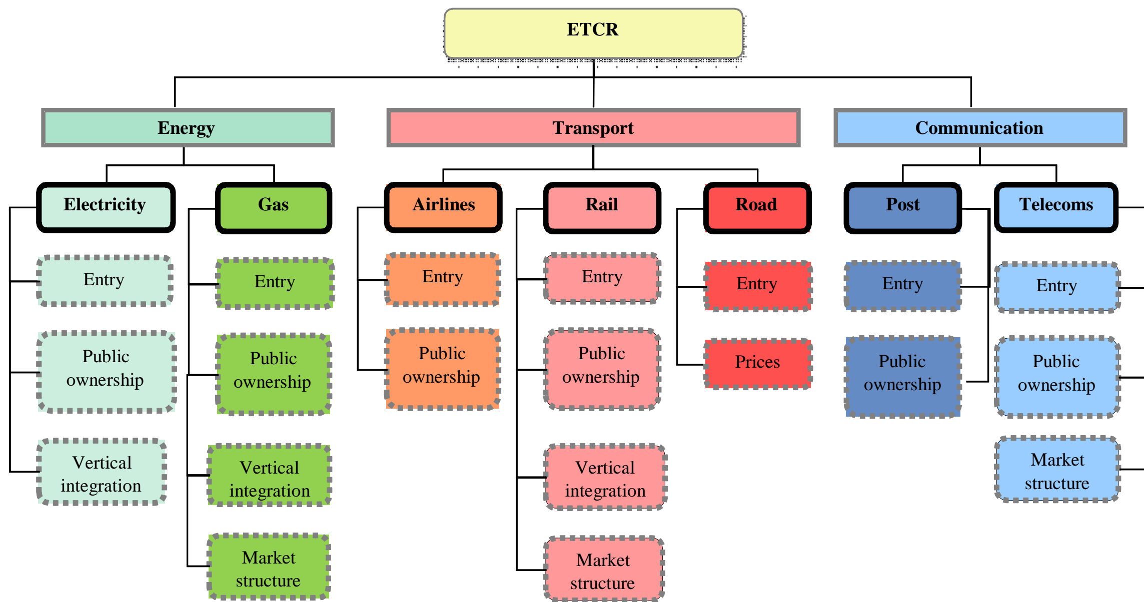
12. The empirical model on which the analysis is based takes into account certain specific conditions in a country – notably differences in industry structures and the distance between industry-specific productivity levels in each country and those in the corresponding industry leader country. In contrast to earlier work, however, the present analysis does not have to rely on the PMR indicator analysis from 2003, but can make full use of the most recent assessment of product market regulation in most OECD member countries (see OECD, 2009d).[21]

20. See OECD (2008b).

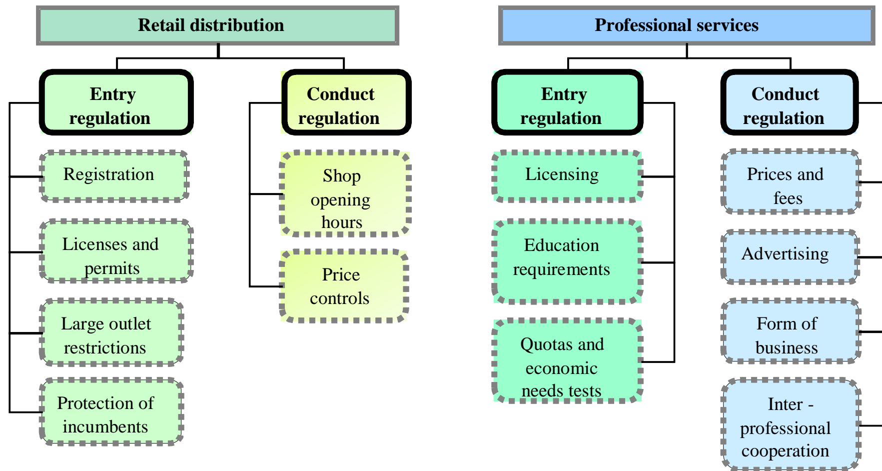
21. This approach is in line with Ilzkovitz *et al.* (2008) who identify four obstacles to a better working of the internal market: regulation, integration, competition and innovation. Problems are in particular identified in the areas of competition and innovation, thereby also shedding some light on the disappointing productivity performance of European economies.

Figure 1. The tree structure of the PMR indicators

Panel A. The indicators for regulation in networks sectors (ECTR)



Panel B: The indicators for regulation in retail trade and professional services



Box 1. The model used for the simulations

The simulation presented here evaluates the labour productivity impact of a hypothetical regulatory reform in non-manufacturing sectors, on the basis of the empirical model of labour productivity in Conway *et al.* (2006), which is based on the theoretical work of Aghion and Howitt (2006). The model is estimated on industry-level panel data for 20 sectors across 20 OECD countries. Given the dynamic nature of the model the adjustment of productivity to policy reforms is gradual. The impact is calculated over a time period of 10 years after the reform.

The simulations proceed in two steps. First, the simulated policy changes are defined at the level of sector-specific regulation indicators for each non-manufacturing sector. These changes in service sector regulation measures are translated into the corresponding knock-on effects for each sector of the economy, including manufacturing sectors, on the basis of input-output relationships between different sectors of the economy. This approach captures the idea that a sector that relies relatively heavily on inputs from a given non-manufacturing sector is likely to be affected relatively strongly by changes in that non-manufacturing sector. These knock-on effects are measured by the indicators that are referred to as regulation impact indicators in Conway *et al.* (2006).

In a second step, the impact of this reform on labour productivity growth is simulated for each sector of the economy using a dynamic empirical model. More precisely, an estimate of the reform impact is obtained by comparing the model predictions on labour productivity outcomes both with and without the hypothetical regulatory reform. In the empirical model labour productivity growth in a given sector and country depends on its ability to keep pace with the growth of the same sector in the country with the highest sector-specific level of labour productivity (the productivity leader) by either innovating or taking advantage of technology transfers. The prospects of catching up with the productivity leader are affected by the policy environment in follower countries. In particular, Aghion and Griffith (2005) stress the role played by institutions that promote (or hinder) firm rivalry and/or entry of new firms in raising (or curbing) incentives to enhance productivity. In the model presented here, these institutions are proxied by the OECD indicators of anti--competitive regulations described above.

There is growing evidence on the particular role of industries that are intensive in the use of information and communication technologies (ICT) for productivity growth, and to some extent the recent disparities in productivity growth across OECD countries reflect differing degrees of adaptability across countries to recent technology shocks in ICT (Triplett and Bosworth, 2004; OECD, 2003b; Van Ark *et al.*, 2002). To allow for this particular role of ICT-intensive sectors, the model distinguishes between the effect of regulation on ICT-intensive and non-ICT intensive sectors. Indeed, the empirical findings obtained in the estimations suggest that there is a stronger effect of regulation in ICT-intensive sectors.

The labour productivity effects of the simulated regulatory reform are calculated for each sector separately, and then aggregated to a weighted average at the economy-level. The estimation equation used in the empirical model is the following:

$$\Delta \ln LP_{ijt} = \delta\,(\Delta \ln LP_{ijt}^{leader}) + \sigma\, prodgap_{ijt-1} + \gamma_1\, PMR_{ijt}^{ict} + \gamma_2\, PMR_{ijt}^{non\text{-}ict} + \alpha\,(PMR_{ijt-1} * prodgap_{ijt-1})$$

$$+ \text{country/industry dummies} + \text{time dummies} + \varepsilon_{ijt} \qquad \text{with } \varepsilon \sim N(0,\Sigma).$$

In this equation, the indices i, j and t denote countries, industries and years, respectively; LP denotes labour productivity; prodgap is the 'productivity gap' - which is measured as the (log) difference between the level of productivity of a given sector in each country and that of the productivity leader - and PMR is the regulation impact indicator of anticompetitive product market regulation. Fixed effects for each country-industry combination are included so as to account for unobserved time-invariant factors affecting productivity growth in a particular sector or country (e.g. natural endowments or location). Time dummies are also included to control for global productivity shocks in any given year.

13. The latest year covered by the PMR indicators is 2008. They cover both economy-wide regulations (for instance barriers to trade and investment) and industry-specific regulatory policies, and the latter are used in this simulation. These industry-specific indicators comprise two broad groups of sectors:

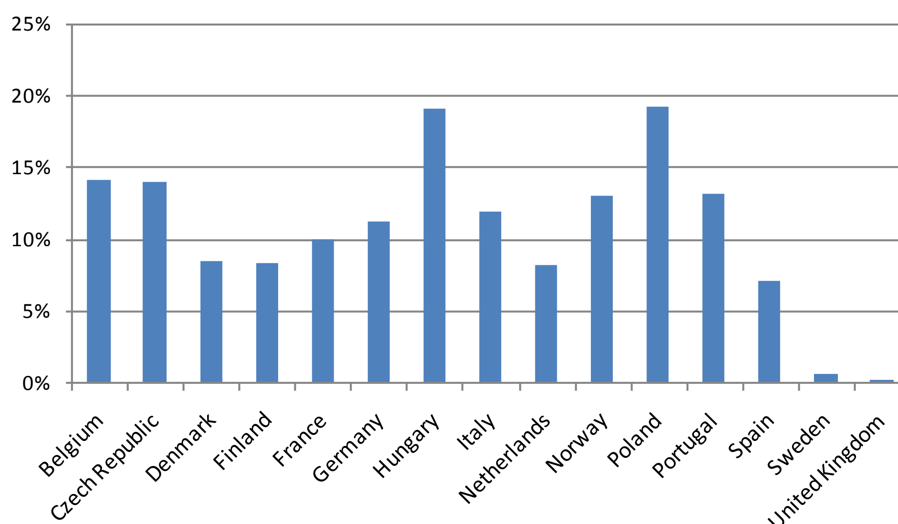
network industries, including energy (electricity and gas), transport (air, rail and road transport) and communication (post and telecommunications); and retail trade and professional services. The simulation accounts for the fact that countries that are more specialised in activities with a higher input content from these sectors have more to gain from pro-competitive services reform. The regulatory domains covered for these sectors are State control, barriers to entry, involvement in business operations, and, in some cases, vertical integration and market structure. Hence, the simulations consider regulations that hamper trade in services and network industries.

14. The indicators show a wide variation in the competition-friendliness of regulatory frameworks. Among European countries, three country groups can be distinguished: Sweden and the United Kingdom have a very competition-friendly regime, while many other European countries cluster around a middle range of the indicator. Finally, outliers in terms of stringency are Belgium, the Czech Republic, Hungary, Norway, Poland, and Portugal. Over time, there has been considerable progress in easing regulations, especially in network industries. Many countries moved to regulated third party access to the network or unbundled the network from production and distribution. In addition, the share of public ownership has come down considerably in many countries. But there is still considerable scope for liberalisation in the services sectors, notably in the eastern European countries.

15. The simulation exercise estimates the effect of aligning the product market indicator for each non-manufacturing sector with international best practice in regulation (Box 1). This is, of course, a very ambitious reform exercise. No single country has the least restrictive regulatory policy in every single sector, so that this simulation would imply a lower average level of regulation (across all sectors) than is currently in place in any single OECD country. The simulation exercise has been undertaken for most EU countries that are OECD members. For a few countries, no response to the product market indicator questionnaire was received, while for some others industry-level data coverage is incomplete.

16. The potential benefits that could accrue from aligning product market regulation to international best practice, in the sense just described, vary substantially: They range from an increase in the level of labour productivity of almost to 20% in Hungary and Poland over ten years, to about 10% for EU member countries like France, Germany, and Italy, to close to zero in the United Kingdom and Sweden (Figure 2). Cross-country differences in the potential benefits from an ambitious reform can be due to differences along three dimensions: how far a country is away from international best practice, in which sectors a country’s regulation is particularly behind and to what extent the country uses inputs from sectors that are over-regulated.

Figure 2. Simulated changes in labour productivity, cumulated over 10 years



Reforms need to be carefully implemented[22]

17. Enlargement has generated considerable potential for positive economic effects in old and new member countries. However, a climate of permanent reform willingness needs to be established in order to reap the benefits of integration in a continually changing world. Moreover, reform dividends are not distributed equally across time, countries and economic sectors. Almost by definition, the impact of reforms to increase the benefits from better integration will be determined by the lagging country. Co-ordination of reforms therefore promises additional dividends, which is an important attraction of the Internal Market project.

18. Reforms can be difficult to adopt and implement because they typically involve substantial up-front redistribution away from incumbents in protected sectors in return for efficiency gains that will fully materialise only over a considerable period.[23] In this sense, the costs of the *status quo* are often hidden — hey are the loss of the future benefits for large numbers of people, while it is typically quite clear who will pay up front for the reform. The losers from reform may therefore be more easily organised than the (future) winners.

Box 2. OECD promotes reforms

OECD economic policy recommendations are provided in three publication series and discussed beforehand by representatives of its member countries. Macroeconomic policy recommendations are published in the twice yearly *Economic Outlook*. While smooth economic development is greatly enhanced by a sound macroeconomic policy framework and such a framework has important repercussions for the efficacy of structural policies, it is not in general discussed with respect to Internal Market Issues.

OECD Economic Surveys are the most general vehicle to bring policy messages to the attention of individual country administrations. They are published for each member country at roughly 18 month intervals (and also for some

22. This section draws on preliminary findings from the OECD project on The Political Economy of Structural Reform.

23. In Rodrik's (1994) terms, such reforms tend to have a high "political cost-benefit ratio": the political costs of a reform are associated with the amount of income redistributed away from loser groups, while the economic benefits are understood in terms of the efficiency gains that it makes possible.

non member countries), and bring together expertise from across the OECD as well as the feedback from all member country administrations. Member countries, as well as a growing number of observers, use the draft *Survey* produced by the Economics Department to share experiences with policies that work and help avoid policies that do not work.

Going for Growth, an annual OECD publication, is based on empirical indicators for economic performance as well as policies. Identifying robust relations between policies and performance, which is a main objective of this exercise, is a never ending challenge, but indispensable to identify policy priorities. Five policy priorities are identified for every country. Specific recommendations will then be provided in *Economic Surveys* of individual countries.

19. However, the experience of OECD countries points to a number of steps that governments can take to overcome barriers to reform. *First*, binding external commitments can help, a fact that underlines the continuing importance of European policies in respect of the Single Market. *Secondly*, reform is easier where the costs of staying with the *status quo* are well understood by stakeholders and the public. This points to the need for comprehensive and transparent explanations of the short- and long-run costs and benefits of reforms, underpinned by solid research. *Thirdly*, reforms in sectors that have already been opened up to competition (whether *via* trade liberalisation or domestic deregulation) often generate reform pressures in sectors on which they rely for inputs and services.[24] *Finally*, individual regulatory reforms tend to be harder to resist when rolled out in the context of a wide-ranging regulatory reform. Such a strategy needs to be based on clear principles, such as competitive neutrality, structural reform of public monopolies, removal of legislative restrictions on competition except where they can clearly be shown to promote the public interest and the establishment of non-discriminatory access regimes for public infrastructure. A broad consensus on such principles can make regulatory privileges harder to defend while creating a presumption in favour of reducing entry barriers and pro-competitive reforms.

Recommendations proposed in OECD Economic Surveys

20. This section summarises the most important recommendations relevant for the good functioning of the EU internal market which have been made in recent *Economic Surveys*.

21. The euro area has grown beyond its founding members. While belonging to an optimal currency area is not a formal criterion for joining the euro area it is nevertheless long-established wisdom that factor mobility, in particular labour mobility, helps to deal with asymmetric shocks within a currency union.[25] Nevertheless some EU members restrict access to their labour markets, reducing the benefits of euro-area membership to the new member countries. A recommendation to ease restrictions on cross-border labour flows was made in the *2007 OECD Economic Survey for Austria* and in the *2007 OECD Economic Survey of the European Union*.

22. The *2007 Economic Survey of the European Union* also picked up another issue regarding labour mobility within the European Union, which is the restricted portability of pension entitlements, in particular occupational pensions. The portability of pension entitlements should also be improved by further reforms to strengthen the actuarial element of the pension system. The harmonisation of income replacement schemes should be accompanied by measures to maintain work incentives.

23. Labour mobility is additionally hampered, in some countries, by high transaction costs for house purchases, inefficient rental markets and the intrinsic discrimination of social housing systems against outsiders. As the *2007 Economic Survey of the European Union* therefore recommends shifting the tax burden away from taxes such as stamp duty that impose high transaction costs, removing anti-competitive

24. Research and communication play a role here, since it may be up to reformers in the public administration to "educate" the potential winners from regulatory reform about its potential benefits.

25. See Mundell (1961) and Fidrmuc (2008).

regulations in the real estate brokerage sector and providing social housing assistance in ways that do not undercut mobility. Several Economic Surveys have recommended removing tax privileges for owner occupied housing in order to establish a level playing field for the development of an efficient rental market, and phase out rent controls, which tend to benefit insiders against newcomers.

24. As documented above, while the internal market has proven its positive effects in the area of simple goods trade, much remains to be done in the area of network industries. Many service providers are still organised along national or even regional lines, as are regulators. There are still wide variations in electricity prices for industry, for instance, as cross-border trade is underdeveloped and incumbents still hold a large market share in many countries. Consequently network industries are much less integrated than they would be in a unified market. The liberalisation of telecommunications is much further advanced, but mobile phone prices in the Czech Republic, Poland, Slovakia and Hungary are still a multiple of the prices charged in the Nordic countries (*OECD Communications Outlook*, 2007). Estimates by Copenhagen Economics (2006) suggest that liberalisation of the electricity and telecom sectors could lead to large increases in cross-border trade and significant price declines, confirming the need and room to implement further reforms in this area. While network industries have always specific regional characteristics there are some unifying, policy relevant common aspects. Network industries have already been liberalised, but to differing degrees.

- One among the most important points is vertical integration hampers market access by outsiders, while effective unbundling[26] is a forceful mechanism to widen the scope for competition and innovation in network industries. The *2008 Economic Survey for Germany* describes the difficulties regulators face in providing fair access if vertically integrated incumbents own the network, and hence recommends effective unbundling of the network from service provision.[27] Implementing vertical separation becomes difficult once the network is privatised. It is therefore important to explicitly consider the interaction between privatisation and competition policies. A positive example in this respect was the decision by the German government to maintain public ownership of the railtrack and (partly) privatise rail services (*Deutsche Bahn*).

- Another important bottleneck for the better establishment of supra-national network services markets is insufficient infrastructure, in particular cross-border installations. The *2008 Economic Survey for Germany* recommended allowing regulators to require the use of revenues from auctioning (scarce) interconnection capacity be devoted to investment in new capacity.

- Wherever possible, technological opportunities for competition between alternative networks should be encouraged. The diffusion of broadband access has been greatly encouraged by the presence of cable television networks, although their role in Europe (in contrast to Japan and Korea) has been very uneven. As OECD (2003b) states, “Within Europe, the difference in performance levels on offer are also enormous and largely depend on how much competition incumbents face.” OECD (2007c) confirms that this is still true and concludes that “The fastest connections, lowest prices and most innovative services are in areas where there is a range of consumer choices for broadband.

25. Last, but certainly not least, the *2007 Economic Survey of the EU* strongly supports implementation of the EU Services Directive. It will be important that the Services Directive be implemented effectively; that the screening process leads to a significant reduction in barriers to trade; and

26. The term is mentioned 19 times in the 2007 *OECD Economic Survey of the European Union*.

27 . The *Survey* mentions “unbundling” 31 times.

that member countries do not abuse the exceptions and exclusions to the directive. It will be equally important to liberalise the sectors excluded from the services directive.

Recommendations proposed in Going for Growth

26. *Going for Growth* identifies policy priorities in areas of under-performance of outcomes and where policy indicators signal a lack of activity. The United States is used as a benchmark and differences in GDP *per capita* are decomposed into a labour utilisation gap and a productivity gap. The majority of policy priorities are identified in the area of product market regulation.[28]

27. The most broad-ranging recommendations for product market regulation relate to joint European policies tackling barriers to trade remaining in many service sectors. The 2006 Services Directive, which is due to be fully transposed into law in 2009, should ease barriers to cross-border services trade, although some service sectors are exempt and some anti-competitive national laws will be left in place.[29] It is a priority for the European Union to ensure that member States implement the directive and consider common standards where mutual recognition is difficult.

28. Another priority area for European Union member countries is to make further progress on improving the operation of network sectors, where there are considerable efficiency gains still to be realised, especially in energy, ports and postal services. Countries identified as needing further reform in network sectors include Austria, the Czech Republic, Germany, Greece, Hungary, Ireland, Italy and Portugal. In railways, stronger competition is identified as a priority for Austria and Portugal, while in telecommunications further regulatory reforms are a priority for Greece, Hungary, Ireland and Portugal. In some network sectors more competition through greater entry is needed, while in others, privatisation is considered to be the most promising means to improve efficiency.

29. Further reforms in other services sectors, such as retail distribution and professional services, are identified as priorities in many countries. For retail distribution, the priorities typically refer to easing entry for larger stores and/or liberalising opening hours (Austria, Belgium, Denmark, France, Hungary, the Netherlands and Spain). In some cases they cover just the national level but often they also cover the regional or local level, where planning rules can interfere with opening of large outlets. Easing of restrictions in professional services (accounting, architecture, legal and business services) was considered to be a priority in a number of EU countries (Austria, France, Germany, Hungary and Luxembourg).

The benefits of moving ahead fast

30. Structural reforms may take time to pay off, but early movers are likely to reap benefits from reform sooner. Figure 3 illustrates that countries that liberalised early and aggressively have been rewarded with higher labour productivity growth. And reforms in product markets have probably facilitated complementary labour market reforms. This is in line with the empirical findings by Arnold *et al.* (2008) that the slow pace of service sector liberalisation in most continental European countries has undermined productivity growth in sectors that have a strong potential to use information and communication technologies (ICT).[30]

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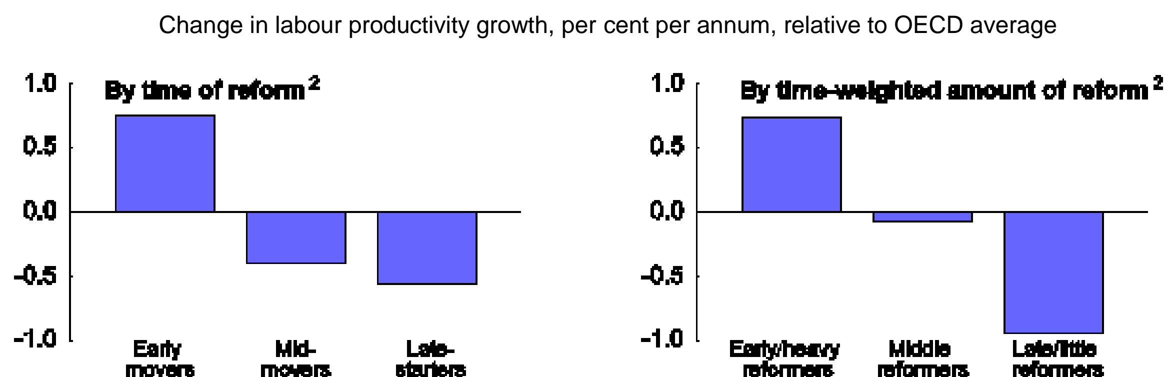
28. The rest of this section is taken from OECD (2009d), *Economic Policy Reforms: Going for Growth*.

29. Services trade is underdeveloped in the European Union. See OECD (2008d) *Economic Policy Reforms: Going for Growth*, Part II, Chapter 7 on International Trade in Services and Domestic Regulation.

30. Arnold *et al.* (2008) make the case that relatively strict anti-competitive regulation in continental Europe, at a crucial moment when a new general-purpose technology appeared, slowed down the adoption of new ICT technologies and had negative longer term implications for productivity growth.

Figure 3. Early reforms have paid off

Change in labour productivity growth, per cent per annum, relative to OECD average



2. Labour productivity growth from 2000-05 minus productivity growth in 1970-80.

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

Source: OECD, *Product Market Regulation* Database and OECD calculations.

31. An important point to note in this context is that eliminating anti-competitive regulations has a direct and indirect effect on productivity growth. First, easing restrictive regulations boosts productivity growth in ICT-producing and using sectors, *e.g.* the sectors that have driven the recent surge in productivity in the US and some other countries. Second, catching up to best practice is much easier in countries where regulation promotes competition than it is in poorly regulated ones. As countries or sectors with a low productivity level have the largest potential for catch up, the reform dividend of abolishing inappropriate regulations is largest in the countries with the widest productivity gaps. In other words, the benefit from reforming poor regulation increases the further a country is away from the world productivity frontier.

Conclusion

32. The 2004 and 2007 enlargement of the EU provided the expected win-win situation. Trade relations intensified, FDI activities soared, and many migrants from the new member States filled vacancies and removed bottlenecks in the old member States. The overall macroeconomic environment became more stable, the inflation/growth trade-off became more favourable and labour markets improved significantly for the first time since the iron curtain was removed.

33. However, completion of the internal market is progressing at an uneven pace. While much progress has been made in cross-border trade in goods and mutual recognition of standards, comparatively less progress can be seen in services industries and in the mutual recognition of qualifications. Although the service sector provides over two-thirds of jobs and value added in the economy, intra-EU trade in services still amounts to only 5% of EU GDP, and continues to be hampered by regulatory heterogeneity and explicit regulatory barriers to cross-border service provision. Cross-border labour mobility between old and new member States is also low, due to numerous obstacles hindering the free flow of labour within the European Union. In this context, effective implementation of the Services Directive should lead to a significant reduction in barriers to trade in services. It will however, be equally important to liberalise the sectors excluded from the services directive.

34. The potential benefits that could result from aligning market regulation to internal market best practice and from reducing anti-competitive product market regulations are large, although they also vary

substantially across countries. In the end, while it is the new member countries that should expect the greatest benefits from product market reforms, the potential gains for some of the old members are also sizeable, and should be sufficient reason for them to press forward with their own reform efforts. The main losers from trade barriers are consumers and small and medium-sized firms. Large firms also pay high costs, but can afford the burden of higher cross-border barriers and can develop, or purchase, the knowledge needed to navigate disparate legal and regulatory systems.

35. Eliminating inappropriate regulations can raise the productivity performance of an economy in many ways. It can influence the productivity of existing firms by improving incentives to invest and adopt the leading technologies available in the market and innovate. It can lower entry costs, intensifying competitive pressure and fostering the reallocation of resources across sectors and, within each sector, across firms with different productivity levels. To the extent that greater competitive pressure lowers prices, this effect can generate trickle-down effects into downstream sectors by reducing the costs of intermediate inputs, particularly in services industries where import competition is limited. Improved regulation can also have differential effects across industries and firms depending on specific technological and market factors as well as on their position relative to frontier production techniques. Better regulation will make it easier to achieve a resource allocation that maximises productivity in a static and dynamic context. In other words it is an essential component to benefitting fully from globalisation and the completion of the internal market.

36. This study suggests that the internal market would function more efficiently if the policies that shape it would more directly address controversial reform issues. While benchmarking has become more and more popular and has strong benefits, it is nevertheless an agreed *modus vivendi* to avoid rankings. Productivity developments show a marked dispersion across EU countries; countries that liberalised early and aggressively have been rewarded with higher GDP *per capita* growth. Partly as a result of this cumulated experience, member States are becoming increasingly aware that holding back on reforms is costly. Over-regulated product markets and incomplete integration are important reasons for slow productivity growth in the EU's services sectors and - given the ever increasing role of services in a knowledge economy - for the economy as a whole. Weak competition contributes to weaknesses in innovative capacity, thus undermining productivity growth. Poor labour market performance also plays a role, especially *via* increasing skill mismatches while low levels of education among entrepreneurs may handicap the adjustment to globalisation.

37. In terms of policy, the changes to the regulatory environment and competitive conditions should be high on the priority list: there are many countries, including the eastern European countries in which regulatory policy falls well short of best, or even good, practice. This can and should be changed. Illustrative simulations - presented in this report - show that regulatory reforms can have a significant payoff in terms of economic growth: For the EU as a whole, labour productivity could be nearly 10% higher after ten years if reforms were undertaken in the areas covered by OECD product market regulation indicators.

38. It would therefore be useful to bring the ongoing screening process of identifying discriminatory regulation in EU member administrations, including lower levels of government, together with the findings of the OECD PMR exercise. This would be an excellent opportunity to use the identified link between economic performance and policies, measured with a comprehensive set of policy indicators, in order to push for a new and agreed reform effort to improve the functioning of the Internal Market. Such a reform could activate silent productivity reserves, thereby also strengthening the global competitiveness of European economies.

39. Some areas emerge from both the analysis of the OECD as well as the Lisbon process in the EU as clear priorities for such accelerated action:

- Labour mobility is a complementary factor for integration. Services, in particular, cannot be provided freely as long as administrative barriers differentiate between workers from different members of the EU. Further obstacles are provided by the incomplete portability of pension entitlements as well as inefficient housing markets.

- Incumbents which own distribution networks provide persistent obstacles for new suppliers in network industries. Enforcing effective unbundling can provide a significant boost for competition.

- Deeper integration between old and new EU members could be facilitated by better co-ordination and co-operation concerning the expansion of cross border infrastructure.

- Finally, swift implementation of the services directive could add to the significant benefits of a Europe without barriers.

40. The current crisis is a challenge not only for the European Union, but for the world economy as a whole. Experience in OECD countries shows that a crisis is also an opportunity to undertake major reforms, because during a downturn it is more evident that refusing to change has a high cost. OECD is joining the coalition of policy makers with a forward looking commitment for openness and further regulatory reform. Although macroeconomic developments dominate policy concerns for the moment, OECD products such as *Going for Growth* and the country *Economic Surveys* provide strong arguments for pressing ahead with reform, including by widening the scope for competition. Exploiting the potential of the internal market with effective reforms will be a key requirement for in sustaining economic growth over the medium term.

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