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**REFORMS TO OPEN SHELTERED SECTORS TO COMPETITION IN SWITZERLAND**

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## ABSTRACT/RESUME

### Reforms to open sheltered sectors to competition in Switzerland

Measures to make the regulation of product markets more conducive to competition play a prominent role in the government's "growth package" of measures to stimulate economic growth which are in the process of being implemented. This paper discusses these measures and suggests further improvements. Notwithstanding significant reforms in recent years, competition law and its enforcement are still weaker than in other OECD countries. Scope for making regulation of product markets more competition-friendly is large in the network industries. While sector-specific regulators have been introduced, their independence needs to be strengthened. The reform of the electricity supply law provides the main building block opening the industry to competition, but vertical separation requirements of the electricity grid from electricity generation and trading activities need to be strengthened. In telecommunications, restrictions in access of competitors to the local loop limit the scope for lowering prices and improving quality of service in broadband connections. Measures still need to be taken to prevent discrimination against market entrants in the railway passenger services market and much scope exists to widen competition in postal services. Progress in lowering the degree of protection in the proposed legislation on agricultural policy 2007-11 is modest. Trade barriers can also be lowered for manufactured goods through the adoption of the Cassis de Dijon principle.

*JEL codes:* K21, K 23, L16, L40, L43, L51, L53, O52, Q3.

*Key words:* Switzerland, competition, productivity and growth, competition law, regulatory policies, network industries, privatization, agriculture.

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### Réformes pour ouvrir à la concurrence les secteurs abrités en Suisse

Les mesures visant à rendre la réglementation des marchés de produits plus propice à la concurrence occupent une place de premier plan dans le « programme de croissance » destiné à stimuler l'expansion économique, dont la mise en œuvre a commencé. Le présent chapitre examine les mesures figurant dans ce programme et propose de nouvelles améliorations. Malgré les importantes réformes opérées ces dernières années, la Suisse est encore à la traîne des autres pays de l'OCDE du point de vue du droit de la concurrence et de son application. Beaucoup reste à faire dans les industries de réseau pour rendre la réglementation des marchés de produits plus favorable à la concurrence. Des autorités de régulation sectorielles ont été mises en place mais elles ont besoin d'une plus grande indépendance. La réforme de la législation relative à la fourniture d'électricité jette les bases de l'ouverture de ce secteur à la concurrence, mais séparation verticale plus stricte est nécessaire entre le réseau de transport et les activités de production et de commercialisation. Dans le secteur des télécommunications, les restrictions d'accès des concurrents à la boucle locale limitent les possibilités de baisse des prix et d'amélioration de la qualité du service dans le haut débit. Il y a encore des mesures à prendre afin d'éviter la discrimination à l'encontre des entrants sur le marché des services de transport ferroviaire de passagers et beaucoup reste à faire pour élargir la concurrence dans les services postaux. La législation sur la politique agricole proposée pour la période 2007-11 ne marque qu'un léger progrès en matière de réduction de la protection. L'adoption du principe « Cassis de Dijon » pourrait aussi contribuer à abaisser les obstacles au commerce des produits manufacturés.

*Classification JEL :* K21, K 23, L16, L40, L43, L51, L53, O52, Q3.

*Mots-clés :* Suisse, concurrence, productivité et croissance, droit de la concurrence, politiques de régulation, industries de réseau, privatisation, agriculture.

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## REFORMS TO OPEN SHELTERED SECTORS TO COMPETITION IN SWITZERLAND

By Andrés Fuentes<sup>1</sup>

Reforms in product market regulation can make a significant contribution to raising productivity growth and lowering high prices in sectors of the Swiss economy where exposure to international competition is limited, both through improving regulation applying across all sectors of the economy – such as competition law – as well as through sector-specific regulation, notably in the network industries. Removing sector-specific barriers to competition would have benefits beyond the sectors concerned, through the reallocation of resources and the lowering of the costs of intermediate goods and services. Furthermore, more intense competition can generate dynamic gains through more innovation, especially in countries and sectors which are close to the technological edge as is the case in Switzerland in a number of manufacturing industries. Empirical evidence suggests that, over an eight-year period, business-sector labour productivity growth in most OECD countries could be boosted by at least 0.4 percentage point through improved regulation of network industries, with potentially significantly larger impacts for countries with – like Switzerland - a relatively restrictive regulatory stance (Conway *et al.*, 2006). Opening agriculture up to more competition could also increase productivity gains and competition in retailing – a sector with heavy weight in the economy. Indeed, profit margins appear to be relatively large in Switzerland in this sector.

### Recent reform in competition law and competition law enforcement needs to be followed up

A competition law amendment, which came fully into force in April 2005, has considerably strengthened the scope for fighting collusive behaviour by introducing direct sanctions for hard-core cartels and for abuse of dominant market position, as well as instituting a leniency programme and more wide-ranging investigative powers for the competition law enforcement agency (the Competition Commission, *ComCo*). *ComCo* has also been given new responsibilities in enforcing the Domestic Market Act, in force since July 2006, which requires cantons to remove barriers to the flow of services across cantonal borders (see the 2005 *Economic Survey*).<sup>2</sup>

These changes have been reflected in competition law enforcement, with *ComCo* imposing its first direct sanction on an airport operator for abuse of a dominant market position. *ComCo* has also investigated excessive termination charges in mobile networks and predatory pricing for ADSL services by the incumbent operator as well as collusive behaviour in public construction procurement and has taken action against recommended price schedules in professional services, such as lawyers' services. However, no investigations of breaches of the Domestic Market Act have yet been concluded, although *ComCo* expects that such investigations will be necessary.

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1. Senior economist in the Economics Department. This paper was originally prepared for the OECD's 2007 Economic Survey of Switzerland under the responsibility of the Economic and Development Review Committee. The author is grateful for the valuable comments received on earlier drafts of this text from Val Koromzay and Peter Jarrett in the Economics Department of the OECD, as well as for discussions with officials from the Swiss government on competition issues. Special thanks go to Françoise Correia of the OECD Economics Department for statistical assistance.
  2. The Domestic Market Act has adopted the "origin principle" in the trade of services across cantonal borders, whereby firms or individuals complying with all legal prerequisites to offer services in one canton may offer the same services also in other cantons without requiring an additional permission.

The scope for improvement in competition law and enforcement remains significant. Competition law still requires proof of abuse for action to be taken against hard-core cartels in some cases, slowing down decision-making. The prohibition principle should be applied to all hard-core cartels. Moreover, representatives of the employers' association, trade unions and farmers continue to be appointed to *ComCo*, which compromises its independence. Staffing levels remain modest. The increase in its staff in 2006 was limited to about half the increase considered necessary initially to allow *ComCo* to fulfil its new wider role. Moreover, reforms in sector-specific regulatory frameworks would go a long way in facilitating *ComCo*'s task in detecting non-competitive practices. For example, opaque public procurement rules and the absence of an *ex ante* regulatory framework in telecommunications bind substantial staff resources. Reforms in these policy areas, as detailed below, would therefore also have benefits for the effectiveness of general competition law enforcement.

### **Technical barriers to trade can still be lowered**

Barriers to trade result from administrative and technical regulations deviating from those of trading partners. With EU countries supplying about 80% of Swiss imports, removing such barriers *vis-à-vis* EU countries would have particularly large benefits. In recognising this, the government has opened the public consultation process on a draft law, in which it proposes unilaterally to apply the so-called *Cassis de Dijon* principle (which has been adopted by EU countries), whereby products fulfilling product-specific technical requirements in the country of origin are accepted by the importing country, for those in which such requirements are not already harmonised. The draft law foresees exemptions from this principle in a narrowly defined range of goods, mostly to impose stricter environmental and health standards. However, pressures against limiting exemptions only to a few goods may be significant. The government has delayed the timetable of adoption in view of numerous requests for exemptions. The principle of "*Cassis de Dijon*" should be applied with as narrow a list of exemptions as possible.

Scope remains for reducing the prices of imported goods by allowing parallel imports of products patented in Switzerland. At present, producers of goods patented in Switzerland can in general prevent imports of the same good marketed abroad, although on a case-by-case basis *ComCo* has powers to intervene if import restrictions based on intellectual property rights amount to an illicit vertical agreement or an abuse of a dominant market position. The government renewed its rejection of the principle of "international and regional exhaustion" – which would allow imports world-wide or from EU countries, respectively – in April 2007. Adoption of the principle of "international exhaustion" would have the largest impact on pharmaceuticals, lowering their prices in Switzerland by between 8 and 18%, according to government estimates, while the impact on research and development is likely to be limited, given the small size of the Swiss market relative to world markets and the availability of patent protection in other major markets. Moreover, reimbursement of pharmaceuticals by health insurance systems throughout OECD countries provides a strong boost to their sales, possibly beyond the level at which marginal benefits and marginal costs are equalised, further suggesting that aligning Swiss prices of pharmaceuticals with world prices would not unduly harm research incentives. Prices for reimbursement by health insurers in Switzerland are administered and changes in reimbursement rules have contributed to moderate insurance spending in pharmaceuticals in 2006. However, administered prices remain considerably higher than in other European countries, although this difference is, in part, due to larger regulated retail margins. Further efforts to more effectively align Swiss reimbursement prices on those of some other industrialised nations are underway (see also OECD, 2007c). Nonetheless the government is of the opinion that modification of patent protection along the lines suggested above would give a deleterious signal for the research effort of the industry.

## The scope to intensify competition in network industries is still large

Over the last decade, regulatory reform in network industries has been substantial across OECD countries. Many countries have established independent, sector-specific regulators in telecommunications, energy, and, in some countries, the railways, with significant powers to ensure new entrants have access to networks (including *ex ante* regulation), allowing competition to develop. Postal services have also increasingly been opened to competition. These reforms have in many countries been accompanied by privatisation of incumbent enterprises. For example, regulation that is conducive to competition in telecommunications has contributed to falling prices for telecommunications services (*e.g.* Hoj *et al.*, 2007) and to productivity gains in electricity generation (see, for example, Hunt, 2002). Some empirical evidence also suggests that sequential reforms in the railway industry have improved efficiency (Friebel *et al.*, 2004), although there is no consensus yet as to what extent vertical separation should be pursued in this industry and how network access is best regulated (OECD, 2006b). Full opening of postal services in Sweden, introduced in 1993, has been assessed to have made a positive contribution to economic growth (Trinkner and Jaag, 2007, and references therein). Moreover, a competition-friendly stance of regulatory policies in network industries entails productivity gains in sectors using outputs of such industries as intermediate inputs. Indeed, empirical evidence suggests that the regulatory stance in network industries has a substantial impact on the degree to which economies are able to catch up with the productivity performance of the technologically leading country across all sectors of the economy (Conway *et al.*, 2006<sup>3</sup>).

The pace of reform in this policy area has been relatively slow in Switzerland. While sector-specific regulators have been introduced for the telecommunications, the postal services and the railways, and a regulator for the electricity sector will take up its functions in 2008, their independence from the government is generally relatively weak. The terms of office of senior regulatory appointees are typically limited to four years, and reappointments are possible (OECD, 2006a), limiting their independence. The powers of the regulators are less well developed than in other OECD countries, making it more difficult to prevent market incumbents from using their market power to restrict entry. For example, the postal regulator *PostReg* cannot fine companies for breaches of regulatory decisions, and its decisions concerning price regulation have to be approved by the Department of Energy, Transport, the Environment and Communications (DETEC). The new electricity market regulator's powers to prevent non-price discrimination are also limited in some respects, which interacts adversely with ample incentives and scope for discrimination against market entrants by vertically integrated operators, given the limited separation requirements imposed on the industry (see below). For example, no rules are in place limiting the reasons for which network operators can cancel contracts with market entrants wishing to use the network for trading or retailing activities, while the staffing levels of the regulator are modest in international comparison (OECD, 2006a).

Strengthening the independence and providing sufficient powers for network regulators can help ensure that potential market entrants perceive regulation to be neutral and predictable, facilitating their entry and making it more credible. This in turn, will discipline price-setting behaviour by incumbents. The independence of sectoral regulators should be strengthened. The terms of office of senior staff in the regulatory authorities should be lengthened and the possibility of reappointment removed. Sector regulators should have powers to fine market participants breaching their regulatory decisions, and government departments should not be able to intervene in those decisions.

Government ownership in network industries is still substantial (Box 1), with adverse effects on competition and efficiency. *First*, government ownership gives rise to perceptions of conflicts of interest.

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3. This study investigates the impact of a synthetic indicator of regulation in telecommunications, energy, railways, postal services, air and road transport.

On the one hand, the government needs to make sure that the framework conditions are in place to ensure a level playing field between incumbents and market entrants. On the other hand, access of private-sector enterprises to the network may reduce the profits of the state-owned incumbents. For example, such conflicts of interest arise from the cantonal ownership of electricity generation assets, as cantons are responsible for granting permission for the construction of new power plants. *Second*, privatisation – notably of the electricity generation assets owned by cantons and municipalities – can in some cases be useful to achieve a more effective vertical separation of network activities from others in which competition can be established (see below). *Third*, as public enterprises are likely to be less guided by the profit motive than their privately owned counterparts, efficiency of service provision may be compromised. Moreover, because publicly owned enterprises are more likely to be willing to use profits from monopoly lines of business to provide services in competitive market segments at prices below marginal cost, this can result in prices which poorly reflect costs in both market segments. The government should privatise its stakes in network industries, notably the incumbents in postal and telecommunications services. Sub-national governments should be encouraged to privatise their stakes in potentially competitive market segments of the electricity sector, notably in generation.

#### Box 1. Government ownership in network industries

Government ownership is substantial in all network industries:

- The government retains a share of 58.4% in the telecommunications incumbent *Swisscom*. The Federation is bound by law to retain a share of at least 50% in the incumbent.
- The postal services incumbent *La Poste Suisse* is fully government-owned.
- The main railways operators – cantonal railway companies and the Federal Railways company – are fully government-owned.
- The electricity sector is characterised by a high degree of government ownership at all stages of the value added chain. Most electricity generation and transmission is in the hands of companies fully or majority-owned by cantons and municipalities. Electricity distribution and retailing companies are largely owned by municipalities.

#### *The new regulatory framework for the electricity market marks a significant step towards competition*

Electricity prices remain above average in the OECD, notwithstanding the abundance of low-cost hydroelectric as well as nuclear power, which have made Swiss electricity prices less sensitive than elsewhere to increases in oil and gas prices in recent years. Prices are particularly high for small and medium-sized enterprises with little bargaining power in the market (OECD, 2006a). The regulatory framework has thus far not supported competition. Enforcement of the rights of competing suppliers to gain access to the networks of incumbents has had to rely on provisions against abuse of dominance in general competition law. This framework has allowed only large business customers to choose suppliers. Retail service to small customers is subject to universal service obligations, obliging suppliers to provide electricity at regulated prices.

Reforming the regulatory framework of the electricity industry has ranked high in the government's strategy to strengthen long-term economic growth prospects. After the first attempt to introduce a sector-specific regulatory framework in 2002 failed in a referendum, a new regulatory framework was approved by parliament and will come into force in October 2008. It provides for the creation of an independent, sector-specific regulator, rules on vertical separation of network activities from those in which competition is possible, notably electricity generation, wholesale and retail trade. The new legislation gives all large business customers the legal right to choose their electricity supplier from the outset, while households and small businesses will be given such choice in 2013.

The new energy regulation framework constitutes a major step forward, introducing the major institutional arrangements for competition in electricity generation and for electricity trading. Indeed, experience across OECD countries shows that an effective regulatory framework is needed to achieve sustained competition following liberalisation in electricity markets. Economic benefits have proven most significant in electricity generation, whereas electricity retailing activities appear to have offered limited scope for cost reduction and quality improvements.

Scope still exists, however, to improve the regulation of network access prices. The legislation foresees rate-of-return regulation, which sets prices according to *ex post* observed costs, until 2013. Price-cap regulation may be adopted thereafter, whereby price caps would be set for several years in advance. Price-cap regulation provides better incentives to save costs, and experience with price cap regulation in the United Kingdom, for example suggests that cost savings can be significant. Price cap regulation should be introduced as soon as possible. However, price-cap regulation involves a trade-off between static and dynamic efficiency, as a longer price cap improves incentives to reduce costs but generates efficiency losses through more pronounced deviations of prices from marginal cost. The trade-off can be improved through benchmark-regulation, according to which regulated prices are set on the basis of costs of other network operators, allowing separation of regulated prices from each operator's own costs (see Weyman-Jones *et al.*, 2006 for a description of benchmark regulation practices). Moreover, owing to this disconnect, benchmark regulation avoids incentives to misreport costs (Shleifer, 1985), which can impair price cap regulation. A combination of price cap and benchmark regulation is used in Germany. In Switzerland, owing to the large number of regional and local network operators, the scope for benchmark regulation is large. Benchmark regulation should be introduced in the regulation of network access prices.

### ***Vertical separation rules need to be strengthened***

Effective rules concerning vertical separation are critical for sustained competition in electricity markets to occur. This is especially true in Switzerland, where the ownership structure in the industry is characterised by a high degree of vertical integration, which gives network owners incentives to discriminate against competitors wishing to gain access to their networks (see Box 2). Moreover, the legislation has opted for a light regulatory regime, with modest staffing levels and restricted powers to intervene. Such a light regulatory framework requires that incentives and scope for incumbents to discriminate against competitors be limited through stringent vertical separation requirements, thereby alleviating the need for the regulator to intervene.

#### **Box 2. The Swiss electricity market**

The electricity generation market is characterised by a high degree of concentration with a group of five incumbent companies (the *Überlandwerke*) controlling 80% of electricity generation. International interconnection is ample, creating scope for foreign electricity generators to compete on the Swiss market. However, the emergence of competition from foreign suppliers still depends on effective rules to prevent discrimination resulting from vertical integration (see Box 3 below). Vertical integration is also strong, with the *Überlandwerke* owning the Swiss transmission network. The *Überlandwerke* also own stakes in local electricity utilities and are active in electricity retailing. Of the five *Überlandwerke*, three are fully owned by cantons and municipalities, one is majority-owned by a canton and one has majority private ownership. The electricity distribution network is owned by a multitude of local electricity utilities mostly owned by municipalities (see OECD, 2003 and 2006 for detailed descriptions of the market structure).

The new regulatory framework requires legal, managerial and accounting separation of electricity generation from transmission operations as well as accounting separation of retail trading from distribution. In order to put managerial separation of electricity transmission from generation into practice a transmission systems operator was set up (Box 3).

### Box 3. Vertical separation of electricity generation and transmission

A new corporation, *Swissgrid*, was set up in 2006 to manage electricity transmission network operations. The five *Überlandwerke* own the electricity transmission network as well as *Swissgrid*. They are expected to transfer their transmission assets to *Swissgrid* by 2012, retaining commensurate shares in it. Since the *Überlandwerke* are owned mostly by the cantons *Swissgrid* is largely in public ownership. The *Überlandwerke* are represented on the board of *Swissgrid*, although they are required not to intervene in its operations, and members of its board are not allowed to hold managerial positions in the *Überlandwerke*. However, as a corporation *Swissgrid* would need to act in the interests of its owners, whose profits would benefit from discrimination against new market entrants. *Swissgrid's* board also includes representatives of the cantons that own significant stakes in electricity generation, further weakening its independence.

Two models have emerged in OECD countries to achieve ownership separation between electricity generation and transmission operations (IEA, 2001). According to the first model, transmission system operators own the transmission network but are not allowed to own electricity generation assets (practiced in the United Kingdom and the Nordic countries, for example). According to the second model, ownership of generation and transmission assets remains integrated, but the transmission system operator has no ownership ties with the integrated companies owning electricity generation and transmission assets. This model has for example been followed by some states in the United States. The first model is preferable, as unifying transmission system operations with transmission asset ownership helps ensure that efficient decisions are taken with respect to investment decisions concerning the transmission network. The second option may, however, be preferred if ownership separation of transmission and generation assets is judged to be too difficult to achieve.

In the current Swiss context, implementing the preferred model of vertical separation of electricity generation from transmission would require the *Überlandwerke* to divest electricity generation assets. This step would ensure that incentives to discriminate against competing electricity generators would be eliminated, while transmission asset ownership and transmission operations would be unified. The preponderance of public ownership in the *Überlandwerke* might make this option politically viable, although it would require the co-operation of cantons and municipalities, which are fully autonomous in this respect. Alternatively, the *Überlandwerke* could retain ownership of their electricity generation assets. In this case, in order to ensure incentives to discriminate against market entrants are avoided, *Swissgrid* should not be owned by the *Überlandwerke*. In either case, cantons should be allowed to be involved in *Swissgrid* only if they divest their generation assets.

Legal, managerial and accounting separation can be effective in preventing discrimination against market entrants by incumbents if the regulator is able to observe and take action against discriminatory behaviour. However, experience across OECD countries shows that regulators are not able to detect and stop discrimination against competing electricity generators seeking access to the electricity transmission network because the transmission network needs to be actively managed in real time.<sup>4</sup> Therefore, legal, managerial and accounting separation between the transmission system operator and generators is not sufficient. Incentives to discriminate need to be eliminated through ownership separation of electricity generation from transmission operations (see, for example, Hunt, 2002; IEA, 2001). Indeed, without such ownership separation, the potential benefits of the new regulatory framework may well not be realised. Ownership separation between electricity generation and transmission operations should be introduced.

The effectiveness of accounting separation depends on the introduction of cost accounting rules that are adapted to the information needs of the regulator. Indeed, since accounting separation is the only unbundling requirement imposed on distribution networks, it is particularly important that it be effectively

4. For example, to ensure that electricity supply and demand are equalised.

implemented. However, the new legislation does not introduce regulatory cost accounting rules. Cost accounting for company financial accounts is not well adapted for regulatory purposes (OECD, 2006a).

Ownership of stakes in local utilities by the *Überlandwerke* generates risks for the independence of the demand side from the supply side of the market. Local utilities will be in a key position when it comes to putting competition among electricity suppliers into practice, especially in the transition period up to 2013, when households cannot yet freely choose their supplier. The weak vertical separation requirements on the distribution networks would generate further scope for the large incumbent electricity generation companies to discriminate against competitors with an adverse impact on market entry as well as on the scope of foreign electricity generators to compete. In Germany, for example, deepening vertical integration following market liberalisation contributed to weak competition, as reflected in low customer switching rates, and to rising prices (OECD, 2006d). The acquisition of further stakes in electricity distribution networks by the *Überlandwerke* should be prevented.

### ***Lack of competition lowers quality and raises prices in telecommunications services***

Access to broadband is more wide spread in Switzerland than in most OECD countries. To some extent, high broadband penetration is likely to reflect relatively high income levels in Switzerland. Moreover, wide access to cable TV networks, to which almost all Swiss households are connected, provides a platform through which broadband services can be offered without relying on the fixed telephone line network. However, prices for broadband services are high in comparison with other OECD countries, while the speed of data transmission is considerably lower (Figure 1).

While telecommunications markets were opened to competition already in 1998, market entrants have, until recently, not been given access to the unbundled local loop on the telephone network. The absence of regulated access to the local loop allowed *Swisscom*, the incumbent operator that owns the fixed-line telephone network, to retain a market share of almost 100% in the wholesale market for ADSL connections.<sup>5</sup> While competing broadband services can be provided through the cable TV network, scope for competition is limited, as only half of all cable TV connections have been equipped for voice services (Economiesuisse, 2005), and the share of broadband connections provided through cable has fallen to less than a third (Communications Commission, 2006). Moreover, the market for cable TV connections is dominated by one firm, *Cablecom*, limiting competition to, at most, a duopoly. Broadband offers through cable TV have been very similar to *Swisscom*'s ADSL offers in terms of speed and prices (OECD, 2007a). Other broadband technologies are not yet well enough established to offer adequate scope for competition.

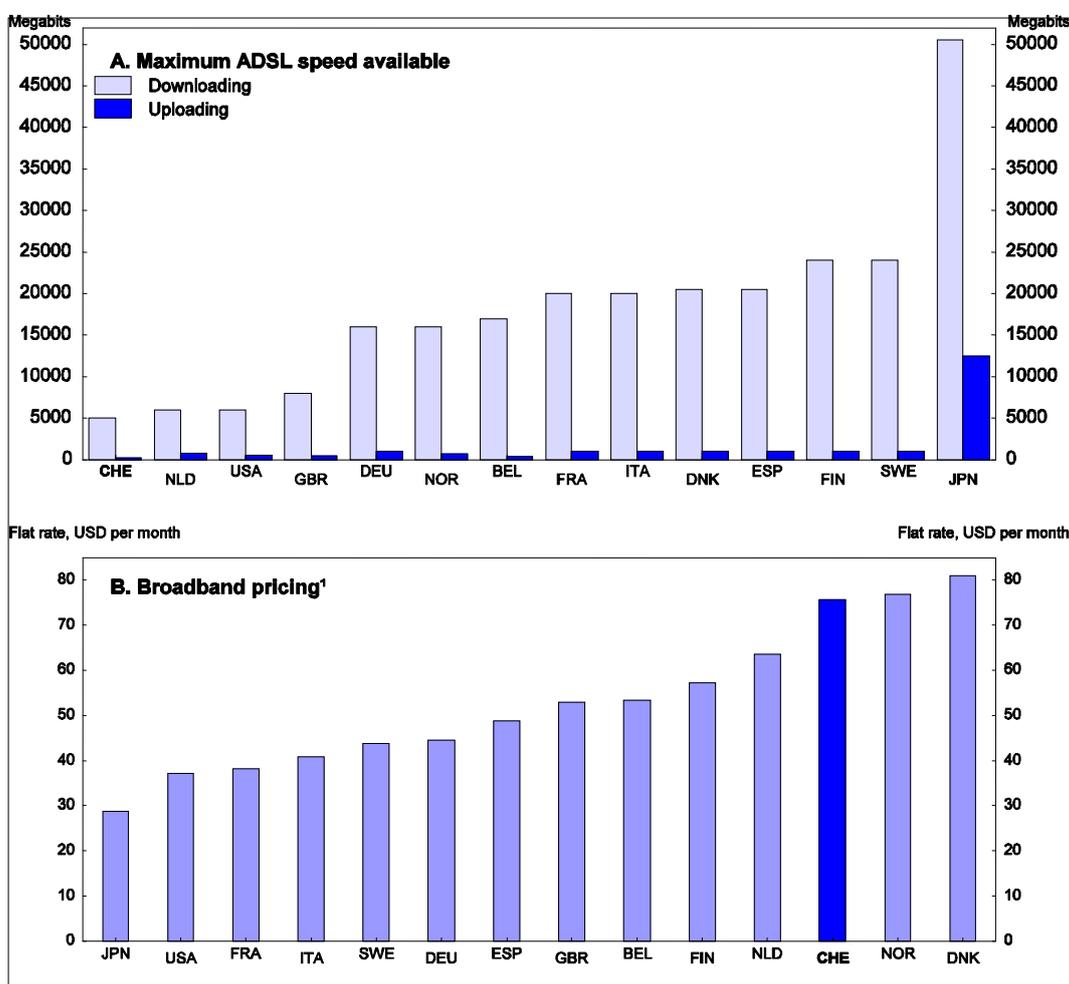
In response to unsatisfactory access for competitors to the local loop, parliament passed legislation granting competitors access to the unbundled local loop as from 1 April 2007. Although these access rights have been granted with considerable delay relative to other OECD countries, they are subject to significant constraints. In particular, limits have been imposed on access modes which require limited investment of competitors in equipment of their own. Line sharing<sup>6</sup> has not been made available, and a time limit of four years has been imposed on bitstream access.<sup>7</sup> Bitstream access and line-sharing have

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5. While competing operators obtained a market share of about a third on the retail market, the absence of local loop unbundling restricted competitors to the incumbent's resale offers, which also remained unregulated.
  6. In line-sharing, the incumbent continues to provide telephony service, while the new entrant delivers high-speed data services over that same local loop.
  7. Bitstream access provides wholesale access to ADSL lines of the incumbent to competitors with some scope for the competitors to influence quality of service. Access refers to the situation where the incumbent

played an important role in many countries in fostering competition for high-speed access to the internet (OECD, 2005). In addition, the narrow definition of access rights will prevent competitors from gaining access to fibre networks, should the incumbent decide to replace copper telephone networks by fibre, as noted by the Communications Commission (*ComCom*, 2006). Moreover, *ComCom* noted that the conditions under which competitors can obtain physical access to local switches (co-location) were not spelled out in a transparent manner (Communications Commission, 2006). While the incumbent published a co-location offer when the new unbundling rules came into force, which introduced transparency, the regulator does not at present have powers to ensure the transparency of access. Legal restrictions on the access of competitors to the local loop should be eliminated. Bitstream access should not be subject to time limitations. Line-sharing should be offered to competing service providers. The regulator should be obliged to ensure co-location on transparent terms.

Figure 1. ADSL speed and prices in international comparison

October 2006



1. Cheapest offer for maximum speed available in Switzerland, or faster.

Source: OECD (2007), *Communication Outlook*, 2007 Edition, OECD, Paris.

installs a high-speed access link to the customer premises and then makes this access link available to third parties.

*Ex post regulation is cementing market power*

Access prices to the local loop remain subject to *ex post* rather than *ex ante* regulation unlike in most OECD countries. In particular, the *ComCom* can impose regulatory remedies only if a market player issues a complaint, in which case the sector regulator has to agree with the Competition Commission that a dominant market position is observed in the relevant market. Since the outcome of this procedure is difficult to predict, *ex post* regulation has increased the degree of uncertainty among potential market entrants and has led to delays with significant welfare losses, especially in this sector, where technological developments occur at a quick pace. The absence of *ex ante* regulation in the provision of access to the fixed-line telephone network is thus likely to mitigate the price and availability benefits that arise from local-loop unbundling. Moreover, the current regime of *ex post* regulation may weaken incentives for regulated firms to reduce costs, as their prices are based on current costs, whereas the use of price caps in *ex ante* regulation for a predetermined period would allow firms to appropriate part of the gains from cost savings.

While call-termination charges have been subject to *ex ante* regulation in many countries for several years on the grounds that each mobile operator's network constitutes a natural monopoly, regulatory remedies against high termination charges were delayed in Switzerland, because it was not in the interest of mobile operators to issue a complaint about other network operators' high termination charges. Costly charges have contributed to relatively high prices in mobile telephony (Figure 2), although the operators agreed to lower termination charges gradually between 2005 and 2009 following an investigation by the Competition Commission. The regime of *ex post* regulation also delayed reductions in interconnection charges in fixed-line telephony (Copenhagen Economics, 2005). Indeed, the case for regulating interconnection *ex ante* is particularly strong in view of the fact that interconnection fosters the development of competing networks, encouraging investment and innovation.<sup>8</sup> *Ex ante* regulation should be introduced for access conditions to the local loop as well as for interconnection charges.

***The planned reform to allow more competition in rail passenger transport needs to be well anchored***

The railways network was first opened to competing service operators in 1999. Some competition has emerged in freight transport, with competitors attaining a market share of 25% in 2007, more than in most other OECD countries. In this market segment competition has been supported by the fact that one private Swiss company owns infrastructure, albeit on a limited scale, which is likely to have strengthened its bargaining position to obtain access to the network of the dominant incumbent.

Decisions concerning network access of competitors are taken by a company (*Trasse Schweiz AG*) mostly owned by the incumbent vertically integrated railway companies,<sup>9</sup> although its decisions are bound by the legal obligation to provide non-discriminatory access, while network access prices are set by the government. Some restrictions remain on the access of foreign firms to the network. Foreign firms can offer domestic freight transport services only if they create a subsidiary in Switzerland, following an agreement with the EU in 2002. Foreign firms need to join with a Swiss partner company in order to offer unlimited cross-border passenger and freight rail transport services.<sup>10</sup> Competition in the market for

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8. Shelanski (2007) emphasises the risks inherent in the use of *ex ante* regulation to correct inefficiencies related to market power but emphasises the need for *ex ante* regulation of interconnection.

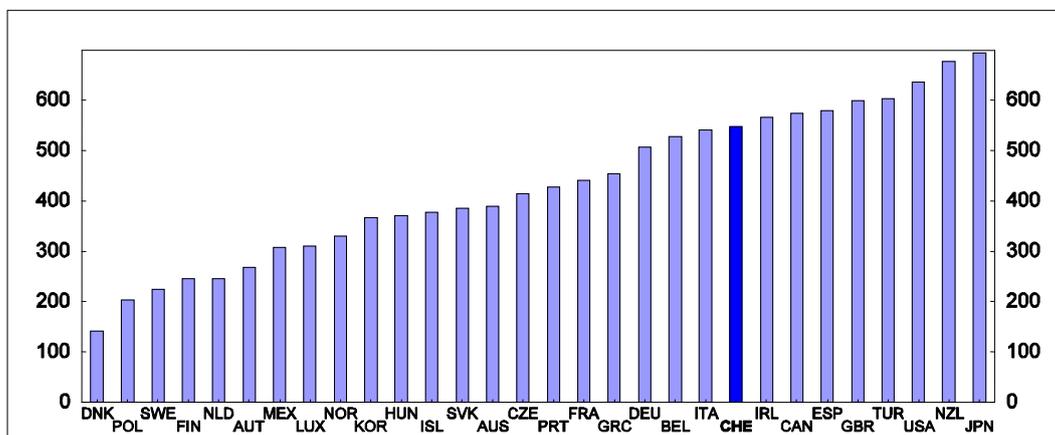
9. Apart from SBB, these include the operator BLS (which co-operates with Deutsche Bahn) and *Südostbahn* (SOB), an operator mostly owned by jurisdictions at all three levels of government. The association of Swiss public transport companies, which does not own network infrastructure, owns 25% of *Trasse Schweiz AG*, as do the other three owners of *Trasse Schweiz AG*.

10. In combined road-rail transport service cross-border service can be offered by foreign companies by themselves.

national passenger transport is absent in interurban passenger transport, and competition through tendering of services in regional passenger transport is limited.

Figure 2. **Mobile telephone prices in international comparison**

Yearly expenditure on medium user basket, VAT included, USD, May 2007



Source: OECD, Telecommunication database.

The government has drafted legislation that would align Swiss regulation of the railways industry with its EU equivalent.<sup>11</sup> The new legislation, if passed, will improve network access conditions for market entrants, strengthening the powers of the regulator (see OECD, 2006a for details). Moreover, the tendering of public service obligations for regional passenger services would be encouraged by making it compulsory in cases where benchmarking indicates poor performance. Experience from other OECD countries suggests that tendering of rail passenger transport services can be successful in generating competition and cost-savings if service providers competing with the incumbent can obtain access to rolling stock. Since incumbents typically have an effective monopoly over rolling stock,<sup>12</sup> access requires enforcing non-discriminatory access. Ensuring access of competitors to rolling stock is not part of the regulator's responsibilities. Non-discriminatory access to rolling stock should be ensured. To this end the railways regulator should oblige the incumbent operator to rent out rolling stock with non-discriminatory conditions. An alternative would be to separate ownership of rolling stock from the incumbent services operator, as has been done in the United Kingdom. Moreover, limiting tendering to cases where the costs of the incumbent provider exceed those of other incumbents entails the risk that entry of a company offering service at costs below all incumbents' costs is impeded. Making the tendering of regional passenger services compulsory in all cases should be considered.

Competition resulting from the tendering of regional passenger transport service could also be undermined if the railways incumbent SBB (*Schweizerische Bundesbahnen*), through its infrastructure subsidiary, were to carry out less investment in the rail infrastructure when a service contract is awarded to a competitor. Such concerns arose, for example, in Germany when competitive tendering was introduced (OECD, 2006d). At present, SBB receives a fixed budget to undertake small-scale and maintenance investment at its discretion. This arrangement could generate scope for the incumbent to invest less in

11. A first proposal to introduce such legislation was rejected by Parliament in autumn 2005.

12. Technical requirements on rolling stock differ across countries, and tendered service contracts are relatively short-term, so that market entrants typically need to rent the incumbents' rolling stock. See Hoj *et al.*, (2007). In Switzerland this point is reinforced by the planned exclusion of rolling stock from the *Cassis de Dijon* principle.

railway lines on which competitors have been granted passenger transport services. Measures should be taken to prevent discrimination against competing service operators in investment decisions. To this end, competing service operators should be given a right to propose investment projects. In any case, the costs and benefits of all investment projects should be evaluated independently.

### *Postal services are still largely closed to competition*

As other European countries, Switzerland has engaged in a gradual process of allowing new firms to provide postal services thus far reserved for the incumbent operator *La Poste Suisse*. The range of services in which it retains a legal monopoly is, however, still relatively large, comprising all letters below 100g, which make up the bulk of the letter-posting business. Furthermore in services in which the incumbent is subject to competition – notably parcel delivery – the market share of *La Poste Suisse* is high, exceeding 80%. The incumbent is subject to universal service obligations in the letter business in which it is protected by monopoly as well as in a range of market services in which it is exposed to competition.<sup>13</sup> It is by law not allowed to cross-subsidise services that are not subject to universal service obligations with revenues obtained from services that are subject to universal service obligations, leaving room for cross-subsidisation among such services. Indeed, prices for parcel delivery – which is subject to a universal service obligation but in which market entry of competitors is allowed – are among the lowest in Europe, while prices for some postal services protected by monopoly are relatively high, especially in the market segment of letters below 20g. The weight limit up to which the incumbent's letter delivery business is protected by a legal monopoly is higher than in other European countries, suggesting that competition could be extended to more letter services. The government is considering reforming the relevant regulatory framework.

### *Funding arrangements for universal service obligations need to be reformed*

*La Poste Suisse* can use profits from monopoly services to fund costs resulting from universal service obligations, in particular the costs of maintaining postal outlets in which revenues do not cover costs. It has also been granted a number of cost advantages *vis-à-vis* its competitors. It is subject to less costly border controls and benefits from exemption from the prohibition on lorry transport at night. Moreover, the government provides equity to the Post Office without requiring a return or having profits transferred to the budget. The cost advantages granted to the incumbent for universal service bear little relationship with the costs of each service and lack transparency, making it more difficult to assess whether activities in competitive market segments are cross-subsidised. As a result, competition with market entrants does not take place on a level playing field. Cost advantages of the incumbent operator *vis-à-vis* competitors should be removed. As a step in this direction, the government has announced its intention to require a return from *La Poste Suisse* from 2008 onwards. However, the risk of an implicit subsidy resulting from the provision of capital by the government could most effectively be avoided by privatising of the post office. Such a step could also diminish incentives for cross-subsidisation (see above).

Narrowing the market segment benefiting from monopoly protection raises the question as to how universal service obligations should be financed. In a number of OECD countries – such as Sweden and Finland – universal service obligations in postal services were judged not to impose significant costs on incumbent suppliers (Hoj *et al.*, 2007). The Swedish postal services operator receives subsidies to compensate for additional costs only for universal service obligations in payments services and for selected services in rural areas. *La Poste Suisse* asserts that it is subject to relatively stringent universal service obligations as to the density of its network of post offices which is likely to keep their cost high. Funding

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13. Universal service obligations outside the legal monopoly on domestic letter delivery include foreign letter delivery, parcel delivery, newspaper delivery and payment services.

the costs of universal service obligations through the budget would provide a transparent mechanism to cover their costs.<sup>14</sup> An independent valuation of the net cost should be undertaken.

#### *Employment regulation distorts competition*

*La Poste Suisse* is subject to restrictions on its commercial operations that competitors do not face. For example, it is bound by personnel rules applying to government-sector workers and is subject to the obligation to offer jobs throughout the country. To effectively introduce competition these regulatory burdens on the incumbent need to be lifted.

Market entrants in postal services are required to offer employment contracts on the same terms as those customarily offered on the market. Given the market-dominating position of the incumbent, this rule effectively obliges market entrants to offer the same wages as the incumbent, which may result in the loss of potential benefits from competition in terms of higher employment and lower prices. Even if wages of postal workers may fall if this regulation is liberalised, the purchasing power of wages in other sectors would rise as a result of lower prices for postal services, provided policies are pursued that ensure that the market is effectively open to market entrants. Moreover, imposing employment conditions on competing service providers can reduce incentives for competitors to use new, cost-reducing technologies, for example, if such new technologies reduce training needs for workers or improve job amenities (for example, through increased safety), which would allow competitors to reduce wage costs in the absence of the restrictive regulation on employment conditions that is specific to postal services. Regulation regarding the fixing of pay and working conditions that is specific to the sector should be abolished.

#### *Regulation of prices can be improved*

All services in which *La Poste Suisse* has a legally guaranteed monopoly are subject to price regulation. However, since market entry for competitors may be difficult in some market segments in which market entry is allowed by law, for example, because of increasing returns to scale, the current scope of price regulation may be too narrow. Therefore, all services in which the incumbent has a dominant market position should require regulatory intervention. Moreover, the practice of limiting price regulation to requests for price increases by the incumbent leaves some scope to improve consumer welfare unexploited. Indeed, if productivity growth in the provision of regulated services is stronger than in other sectors of the economy,<sup>15</sup> scope for price reductions would not be utilised, leaving monopoly profits to the incumbent. On the other hand, if potential gains in productivity are relatively small, so that nominal price increases are necessary, the incumbent operator would not have any incentive to reduce costs, given that the regulatory decision is based on actual cost. *Ex ante* price-cap regulation could avoid these shortcomings, by fixing prices several years in advance. Price caps should be used to regulate the prices of those services in which *La Poste Suisse* has a dominant market position. Moreover, an independent body should be charged with the enforcement of price regulation.

#### **Public procurement markets continue to be geographically fragmented**

With public procurement accounting for 9% of GDP and 26% of government expenditure, competition in government procurement is critical for avoiding waste in government spending and can make an important contribution to fostering productivity growth. 80% of goods and services purchased by government are bought by the cantonal and municipal levels, with different procurement rules applying in each canton. Local firms are awarded 90% of all contracts awarded by sub-national administrations,

14. 90% of the population must be able to reach a post office by foot or by public transport.

15. Strictly speaking, if productivity growth is stronger than productivity growth in other sectors plus trend inflation.

suggesting that the fragmentation of procurement law leads to significant protection of local firms. Limiting potential suppliers to local firms also facilitates collusive behaviour. Moreover, 60% of the value of procurement contracts are awarded without a tendering notice or with tendering limited to pre-selected firms deemed to fulfil technical requirements.<sup>16</sup> Accountability in the procurement process is weakened because procuring authorities are not obliged to publish the criteria according to which suppliers are chosen nor to document their procedures in those purchases which are not subjected to public tendering. The Competition Commission is in charge of evaluating competition in public procurement. However, no nation-wide statistical information is available that would allow the benchmarking of costs. Procurement rules across cantons should be harmonised, threshold values for public tendering should be lowered, and the accountability of procurement actions should be improved. Public procurement costs at lower levels of government should be benchmarked.

### Agricultural policy generates high costs for the economy

Policies to protect farming in Switzerland have a high welfare cost. Consumer prices of raw agricultural products are on average about 2 times higher than world prices (OECD, 2006e) and about 65% higher than in EU countries. In addition, very high subsidy payments to agriculture – amounting to 1.3% of GDP or 63% of gross farm receipts – maintain inefficient farming structures and thus generate further welfare losses in their own right. Agricultural subsidies have fallen by 0.5 percentage point of GDP (by 17% in nominal terms) since 2000, and most of the subsidies are disbursed depending on inputs used or output produced, although some shift towards income support has occurred (Table 1).

Table 1. **Agricultural Support Estimations**

	Millions of CHF							
	1999	2000	2001	2002	2003	2004	2005	2006
Producer Support Estimate	7 656	7 439	7 076	7 032	7 032	7 221	6 958	6 280
<i>of which payments based on:</i>								
Commodity outputs	5 045	4 758	4 276	4 570	4 113	4 292	4 013	3 325
<i>of which : Market Price Support</i>	4 784	4 427	3 896	4 206	3 763	3 960	3 683	2 983
Input use	203	213	237	250	220	224	223	226
Area planted/animal numbers, production required	893	920	881	957	977	983	992	998
Historic area planted/animal numbers, production not required	1 163	1 187	1 304	1 316	1 318	1 318	1 320	1 320
<i>Memorandum item:</i>								
Producer support as a percentage of GDP	1.9	1.8	1.6	1.7	1.6	1.6	1.5	1.3

Source : OECD, PSE/CSW database.

The high prices largely reflect the impact of tariff and non-tariff trade barriers. High wages and difficult geographic conditions, which depress productivity, could be seen as further important contributing factors. However, given that agricultural products are internationally tradable, the dismantling of trade barriers would induce farmers to limit agricultural production to those sub-sectors and geographic areas that are viable even if high wages are paid, freeing resources for more productive use, with prices falling to levels observed in other countries. Moreover, the high degree of protection interacts with regulation allowing collusive practices among producers – such as recommended price schedules issued by producers' associations, raising prices further. Indeed, the high level of protection and subsidies results in low productivity levels,<sup>17</sup> relative to manufacturing, in international comparison (Figure 3). While policies have

16. According to an analysis of the Competition Commission (2006) on the basis of data from 1999.

17. Since the productivity comparison is based on nominal value added, the high prices in Switzerland bias the Swiss productivity figures upwards.

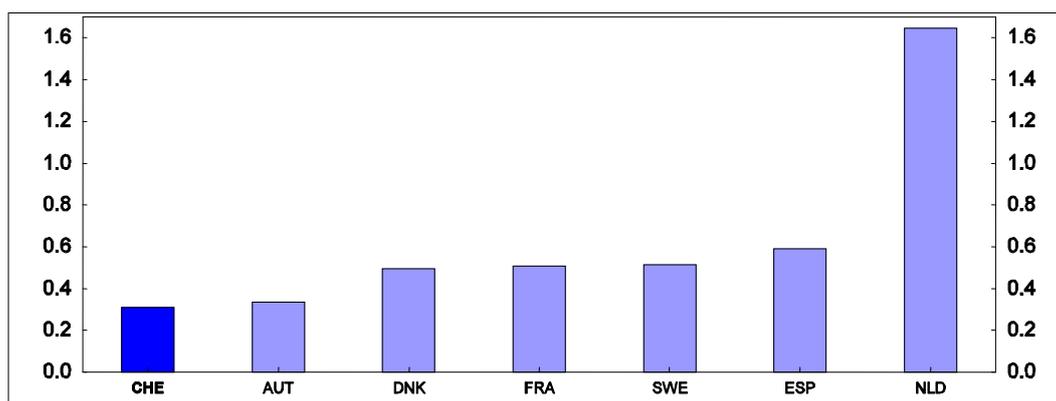
been adopted to shift some subsidy payments towards less distortionary income support, most of the subsidy payments are still linked to the use of inputs, outputs or prices (Table 1 and OECD, 2006e).

### *The pace of reform remains slow*

Legislation passed in June 2007 makes further progress in gradually exposing the agricultural sector to more competition. It foresees further cuts in price support, notably for milk and cereals, the termination of the remaining subsidies for downstream processing industries and of most export subsidies. Nonetheless, the nominal budgetary outlays for subsidies are expected to remain broadly constant until 2011, with some shift from price support to other forms of subsidies, including income support. The expected reductions in the margins between Swiss producer prices and producer prices prevailing in unsubsidised markets are modest. Indeed, the new legislation provides for limited reductions in tariffs and non-tariff protection.<sup>18</sup> To take reform further, the government also intends to propose a free-trade agreement on agricultural products to the EU to be implemented by 2015. It would aim at the removal of tariffs, quotas and other non-tariff trade barriers.

Figure 3. **Relative labour productivity level in agriculture in selected countries**

Nominal value added per hour worked relative to manufacturing,  
2003 or latest available year<sup>1</sup>



1. Per full-time worker equivalent for Austria, France and Spain; 2004 for Switzerland, 2002 for France.

Source: OECD, STAN database.

Slow progress in lowering the protection given to farming in Switzerland will continue to entail a large burden for the government budget and high prices for consumers. The favourable conditions in the Swiss labour market at present would provide a favourable backdrop for accelerating the withdrawal of protection to the sector. A free trade agreement on agricultural goods with the European Union would generate large welfare benefits resulting from a considerable reduction of consumer prices. It would accelerate structural change, with farming revenues estimated to decline significantly as a result, according to federal government estimates. However, the welfare gains resulting from lower consumer prices could to some extent be offset by the wedge that would be driven between the import prices of agricultural products imported from EU countries and non-EU countries, where the costs of producing agricultural goods is in many cases lower than in both Switzerland and the EU. For example, the elimination of trade

18. Animal feed tariffs are to be lowered. This measure will, however, raise effective protection of meat products.

barriers *vis-à-vis* EU countries could lead to a substitution away from agricultural imports from low-cost countries in favour of imports from EU countries where costs might be higher.<sup>19</sup>

### ***Impediments to structural change need to be removed***

Prospects for reductions in trade protection which may result from the envisaged free trade agreement with the EU or from progress in multilateral trade negotiations, to which Switzerland is fully committed, make the removal of barriers to structural change in agriculture especially important, as such barriers could strengthen calls for increased subsidies to offset the impact of lower trade barriers on farming income. A number of provisions in the regulation of agricultural land slow down structural change. Current inheritance rules for agricultural land and fixed assets stipulate that an heir wishing to maintain a farming business is given preference over other heirs and can compensate them for relinquishing their share of the inheritance on the basis of a valuation of land and fixed assets below the market price. Moreover, price controls on agricultural land prevent farmers from selling land at market prices. The inheritance provisions bias heirs' decisions towards remaining in the farming business, locking in resources in non-viable farming in the long term. Price controls on agricultural land have a similar lock-in effect on resources. In addition, both the inheritance provisions and the price controls lead to wealth loss among farming households, aggravating income losses which may result from the downsizing of agricultural production.

In the recently approved legislation, the scope for the special inheritance rules concerning farming land were reduced by raising the employment threshold above which these rules apply from 0.75 to 1 full-time worker. The price controls on agricultural land were relaxed. Impediments to structural change in land law should be removed. In particular, inheritance rules favouring the passing on of farms between generations should be abolished and price controls ended. Structural change could also be facilitated by accelerating the replacement of subsidies linked to production activities by direct income support and by tying income support to individual incumbent farmers, rather than farming businesses, so as to avoid subsidies biasing decisions by the heirs of farms towards maintaining non-viable operations.

#### **Box 4. Recommendations to make regulation of product markets more conducive to competition**

##### **Improve the enforcement of general competition law and of sector-specific regulation**

- The prohibition principle should be applied to all hard-core cartels. The independence of *ComCo* should be ensured by excluding members that represent economic interests. Its resources should be raised.
- The independence of sector regulators should be strengthened. The terms of office of senior staff in regulators should be lengthened and the possibility of reappointment removed. All sector regulators should have powers to fine market participants breaching its regulatory decisions. Government departments should not be able to intervene in regulatory decisions.
- The federal government-owned stakes in network industries, notably in the incumbents in postal and telecommunications services, should be privatised. Sub-national governments should privatise their stakes in potentially competitive market segments of the electricity sector, notably in generation.

##### **Remove geographic barriers to competition within Switzerland and internationally**

- Procurement rules across cantons should be harmonised, threshold values for public tendering lowered and the accountability of procurement actions improved. Public procurement costs at lower levels of government should be benchmarked.

19. At present, such welfare losses would be modest, as Switzerland imports few agricultural goods from non-EU countries, in part reflecting EU subsidies for its agricultural exports. The welfare loss would consist of foregone tariff revenues.

- The Internal Market Act should be enforced.
- The “*Cassis de Dijon*” principle should be applied with as narrow a list of exemptions as possible.

#### **Follow up on the reform of the regulatory framework for the electricity industry**

- Vertical separation requirements need to be improved. Ownership separation between electricity generation and transmission operations should be introduced. The acquisition of further stakes in electricity distribution networks by the *Überlandwerke* should be prevented. Regulatory cost accounting should be introduced.
- The powers of the electricity market regulator to prevent non-price discrimination should be strengthened, notably by setting rules limiting network operators’ scope to cancel network access contracts and by raising its staff level.
- Price caps and benchmark regulation for the determination of network access prices should be introduced as soon as possible.

#### **Continue improving the regulatory framework in the telecommunications industry**

- Legal restrictions on the access of competitors to the local loop should be eliminated. Bitstream access should not be subject to time limitations. Line-sharing should be offered to competing service providers. The regulator should be obliged to ensure collocation on transparent terms.
- *Ex ante* regulation should be introduced for access conditions to the local loop as well as for interconnection charges.

#### **Take measures to prevent discrimination against market entrants in the railways industry**

- Making the tendering of regional passenger services compulsory should be considered.
- Non-discriminatory access to rolling stock should be ensured. To this end the railways regulator should oblige the incumbent operator to rent out rolling stock with non-discriminatory conditions.
- Competing service operators should be given a right to propose investment projects. Investment decisions should be based on an assessment of costs and benefits that is independent from the incumbent.

#### **Create the conditions for sustained competition in postal services**

- The net cost of universal service obligations should be assessed independently from the incumbent. If necessary, costs from universal service obligations should be funded through the budget.
- A level playing field for competition between incumbent and market entrants should be created. Restrictive personnel rules applying to the incumbent, such as the obligation to offer jobs throughout the country, should be lifted. Administrative privileges for the incumbent should be eliminated.
- Regulation regarding the fixing of pay and working conditions that is specific to the sector should be abolished as part of a strategy to open the market to competition.
- All services in which *La Poste Suisse* has a dominant market position should be subject to price regulation by an independent regulator. Price caps should be used to regulate the prices of these services.

#### **Accelerate reform in agriculture**

- Impediments to structural change in land law should be removed. In particular, inheritance rules favouring the passing on of farms between generations should be abolished and price controls ended.
- The replacement of subsidies linked to production activities by direct income support should be accelerated and income support be tied to individual incumbent farmers, rather than farming businesses.
- Collusive actions among agricultural producers, such as recommended price schedules, should be eliminated.

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