REPORT FROM THE COMMISSION

Economic Reform: Report on the functioning of Community product and capital markets
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INTRODUCTION

This is the Commission’s third Report on the Functioning of Product and Capital Markets. It responds to the request made by Heads of State and Government at the Spring 1998 Cardiff European Council. The Lisbon and Santa Maria de Feira European Councils subsequently confirmed the Cardiff process of economic reform as one of the three mutually-reinforcing pillars of the Lisbon economic and social agenda, together with the macroeconomic strategy and the employment and social policies.

Economic reforms in product and capital markets are key to achieving the objectives of growth, competitiveness, full employment and transition to the knowledge-based economy defined at the Lisbon European Council. They are needed to improve the efficiency of our economy and the performance of our markets: this is essential if we are to expand the EU’s economic potential in terms of business and employment opportunities, potential output, consumer satisfaction and living standards for our citizens.

Product and capital market reforms did not start at Cardiff or Lisbon. Similarly, labour market reforms, innovation and social cohesion have been the subject of consideration by European policy for some time now. However, there is no doubt that the Lisbon European Council gave them all a new, richer tone and importance, and they now constitute a credible reform strategy with far-reaching objectives. Success in implementing that strategy will be determinant for the future of Europe.

The process of economic reform initiated at Cardiff is proving effective …

There is now general agreement on the need for structural reforms in Europe, both at national and Community levels. Member States’ own national reports, submitted in November, demonstrate how much progress they are making with economic reform domestically.

Economic reform has been pushed to the top of Europe’s political agenda. The Conclusions of the Lisbon and Santa Maria de Feira European Councils show this by presenting a comprehensive micro-economic strategy of policies with ambitious competitiveness and structural change objectives.

As a result, important policy initiatives have already been taken to change Europe’s regulatory environment in ways that conform with certain fundamental principles - to establish a more dynamic business environment, to embrace the new knowledge-based economy and, at all times, to be sensitive to the priorities of Europeans. Such initiatives include the strategy for removing remaining barriers to trade in services, regulatory simplification, and the opening up of network industries to more competition. All are examples of policy initiatives with roots in the conclusions of previous Cardiff reports.

European micro-economic policy co-ordination has been improved because the key components, at both national and Community level, are now covered by the same monitoring scheme. As a result, competition policy, enterprise policy, and specific policies for the
network industries, as well as other Internal Market policies, are being improved and made more consistent with employment and education reforms.

A report moulded by the Lisbon Conclusions and the objectives of the Strategy for the Internal Market …

Already the subject of successive reviews and improvements, this year’s process has benefited from the new, simpler, more open and decentralised method of co-ordination established at Lisbon based on guidelines for the Union with short, medium and long term objectives and precise timetables. Those European guidelines will be translated into national and regional policies establishing specific objectives and adopting measures that take into account national and regional specificities. Quantitative indicators¹ and other elements useful for evaluating our success in meeting the economic objectives of the Lisbon European Council are provided in this report. These can be used to help draw up the new Broad Economic Policy Guidelines and contribute to the preparatory work for the special Spring Stockholm European Council. They can also help assess implementation of last year’s BEPG.

A number of sectors and policy areas failing to realise their full potential to make consumers better off or to improve firms’ competitiveness were identified at the European Council; actions called for by Lisbon to correct these failings were, in particular, reform of the services sector, legislative and regulatory simplification, and the Implementation of the Financial Services Action Plan. Extra attention is paid to them in this report. But other areas mentioned in the Lisbon Conclusions are also examined, including public procurement, services of general interest and state aid, with possible new actions suggested.

To improve the continuous assessment of the Community’s markets, this year’s report adopts the structure of the Internal Market Strategy with its four strategic objectives – “improving the quality of life of citizens, enhancing the efficiency of capital and product markets, improving the business environment and exploiting the achievements of the Internal Market in a changing world”. This should make for a more effective framework to assess and improve the Internal Market based on the Strategy as called for by the Lisbon European Council.

Consumers and citizens: this year’s special topic …

The European Council at Santa Maria de Feira emphasised the importance of consumers and citizens to the process of transforming Europe. Their influence must be decisive in establishing policy and pushing forward reforms. It is for their benefit above all that the Lisbon European Council set the EU the goal of becoming “the most competitive and economic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”. The Internal Market is key to achieving that goal, just as it is, and has always been, a key means to the end of improving the standard and quality of life of citizens. It provides the economic value added of the Union and must involve a constant search for the best environment to maximise economic benefits. At the same time, the Internal Market guarantees specific rights for its citizens and must be constantly seeking to ensure and strengthen the enforcement of those rights. In this way, economic reform puts citizens at the heart of the Internal Market.

¹ This report presents indicators suitable for the objectives of the Cardiff process. In terms of the EPC report to the ECOFIN Council of 7 November 2000, they can be considered as type 3 indicators. They are not necessarily the same as type 1 indicators used in the Synthesis Report or type 2 indicators, used in the BEPG. See also the Communication COM (2000)594 on Structural Indicators.
The role of consumers and citizens in the process of economic reform being this year’s special topic, issues which are part of the Internal Market Strategy’s operational objectives to improve citizens’ quality of life are examined in depth.

From Lisbon to Stockholm: developing the strategy and implementing policy actions

The main challenge ahead of us is to develop the strategy defined at Lisbon. It is time now to move from blue-print to the practical implementation of the strategy. Significant progress has been made in recent months to develop the necessary instruments; indicators have been selected and the first policy initiatives requested by the European Councils adopted. This report gives an account of developments in the area of product and capital markets. The Commission Synthesis Report addressed to the Stockholm Spring European Council will propose a full account of progress made to date and will provide new ideas on the way forward.

Improving citizens’ quality of life

1. Economic reforms are delivering substantial benefits to consumers …

The conclusions of the March 16, 2000 Internal Market Council stressed a key objective of the Internal Market: delivering a broad range of safe, high quality products to consumers at competitive prices.

Monitoring of the performance of product and capital markets over the last year shows that consumers and citizens in general are reaping increasing economic benefits from the Internal Market. Prices continue to converge, especially in services (see table 5). As a result, the variation of prices in service markets is becoming less marked, and more like the variation of prices in goods markets. In particular, economic reforms are continuing to push down the prices of utilities and network industries in real and nominal terms. Telecommunications have become much cheaper, in spite of tariff re-balancing (see tables 1 & 2). Electricity prices have fallen over 14% in UK (tax included) and 14% in Spain (tax excluded) (see tables 3 & 4). As a result, the annual cost of electricity and telecommunications for a standard “house hold” in Austria was up to 25% less in 1999 than in 1996. In Germany, these savings amounted to € 125 per year and € 105 in France (see box 1).

While prices have been converging in the Internal Market overall (see table 5), prices in the UK and Ireland have moved away from the EU average (see graph 1). Overall convergence also masks the increasing spread in fuel prices due to the diverging path of countries at the extremes of the price distribution. More efforts are needed to assess the impact and nature of price differences (see box 2).

… and do not appear to have threatened the provision of services of general interest …

The performance of services of general interest has become the subject of much attention in recent months, following orientations given by the Lisbon European Council and the Internal Market Council. The Commission issued a Communication on “Services of General Interests in Europe” [COM(2000)580] in September, with the aim of providing greater legal certainty on the application of Internal Market and competition rules in that domain and enhancing the importance of citizens’ interests.

It has been feared that regulatory reform of services of general interest might cause consumer dissatisfaction. It is difficult to draw firm, general conclusions because consumer satisfaction varies across sectors and Member States. However, in the case of mobile telecommunications,
consumer satisfaction seems highest where reform has gone furthest (see graph 2) at least for some aspects. Universal service obligations must be maintained in order to ensure the universal provision of certain services of general interest at affordable prices; in practice, this has not been an obstacle to the opening up to competition of these markets.

2. Only high levels of environmental, health and consumer protection will improve Europe’s market performance and the quality of citizens’ lives …

The March 16, 2000 Internal Market Council conclusions indicated that high levels of consumer protection and consumer confidence are needed for a well functioning Internal Market. This requires market transparency, reliable information and effective enforcement and redress procedures. However, this is not always enough to guarantee health and safety. Such is the background to the White Paper on Food Safety, now entering its implementation phase, involving a series of key actions to avoid future market or regulatory failures that endanger public health. In a broader context, the ongoing exercise on producer liability will suggest new lines for policy action, taking into account the economic impact of any such action on enterprises.

Growing environmental concerns amongst citizens and the objective of sustainable development require a reinforced, symbiotic integration of environmental policy and economic reforms inside the Internal Market. This integration can fruitfully be achieved by increasing the use of market-based instruments to achieve environmental objectives. A wider use of environmental taxes, differentiated according to environmental impacts and compatible with Internal Market rules, could improve economic performance by making market prices reflect the true costs of activities (at EU level, environmental taxes accounted for 6.7% of total tax revenue in 1997 only - see table 8). The use of other economic instruments such as tradable emission permits would achieve the same objective. Public procurement rules allow for environmental considerations to be taken into account; proposed directives further clarify this possibility. New lines of action proposed in Communication [COM(1999)263] on the Environment and the Internal Market still need to be developed. This is necessary to integrate fully the objective of sustainable development with the process of economic reform.

3. On-going economic reforms in the financial services sector are specifically designed to take consumers’ and citizens’ interests into account …

Structural reforms in retail financial services have a direct, significant impact on consumers. The Financial Services Action Plan clearly reflects this. The proposed Pension Funds directive could be a valuable new instrument for the benefit of consumers and citizens; it would make moving to work in other Member States much cheaper by allowing cross-border pension plans and making supplementary pension plans more attractive and less costly. However, today’s situation as regards cross-border credit transfers is worrying. Progress has been made since last year, but charges for such transfers are still unacceptably high (see table 9).

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2 COM(2000) 275 on the coordination of procedures for the award of public supply contracts, public service contracts and public works contracts and COM(2000) 276 co-ordinating the procurement process of entities operating in the water, energy and transport sectors.

3 COM (2000) 507 on the coordination of laws, regulations and administrative provisions relating to the activities of institutions for occupational retirement provisions.
4. Summarising, consumers could get even more from economic reform …

… if information and market transparency were improved. This is particularly true in markets where there is serious informational uncertainty (e.g. mobile telephone tariffs, product quality). Also when consumers’ rights cannot be considered “common knowledge” (air passenger transport was an example of this until the recent wide diffusion of the charter of passengers’ rights).

… if specific actions were taken to dismantle barriers while maintaining high levels of consumer protection in areas requiring direct policy intervention. Such might be the case for cross-border credit transfers. Actions are already underway in other areas, such as food safety.

… if competition policy were made more active at the national level. This could eliminate some of the remaining sizeable differences in relative prices across countries (table 5). Domestic mergers need to be controlled if high levels of competition are to be maintained in national markets. Decentralising the application of articles 81 and 82 of the Treaty could have a very positive impact on competition in national markets.

… if communication channels between consumers and public authorities were improved and efficient complaint, redress and enforcement mechanisms developed. Best practice in this area should be established. The Dialogue with citizens should facilitate this task at the Community level. In particularly sensitive areas such as financial services or e-commerce, special attention should be paid to consumers and citizens’ issues, but without increasing the administrative burden on business.

… if the effectiveness and utility of environmental regulations and universal service provisions were regularly re-examined. As time passes, such regulations and provisions need to evolve in line with market developments. Regular updating and pruning would avoid wasteful regulatory burdens. In addition, environmental and economic reforms need to be better integrated. Increasing use of market instruments for environmental policy purposes is helpful to the integration of policies designed to improve the environment with policies designed to improve overall market performances. Regulatory reform in environmentally sensitive areas such as transport and energy will need close monitoring.

A political corollary …

Economic reform is changing governance in the EU, providing a new economic environment in which citizens and consumers play a much more prominent role than in the past. As developing economic reforms cut into the number and dimension of economic activities protected from competition, the number of opportunities open to private initiative in the new European economy grows. This gives citizens an increasingly leading role as economic actors, whilst simultaneous improvements to market performance benefit them as consumers.

The public sector’s role is also evolving as a result of economic reform. It is opening up to competition an increasing number of areas where citizens’ initiatives used not to be welcome or allowed. This is positive, as public authorities are not necessarily well-equipped to be directly involved, still less solely responsible in the many areas that they used to reserve to themselves.

Economic reform calls for increased public policy attention to be paid to certain tasks. Citizens and consumers must have improved, more efficient protection. Regulations and legislation need to be developed and then tested, both for their benefits as well as for the costs
they result in. A permanent effort is needed to review the legislative and regulatory framework striving for simplification, effectiveness and efficiency. Consumers must also be kept well-informed about their rights. Efficient and inexpensive information mechanisms are needed. There are a host of regulatory governance issues that need to be taken care of as a result of economic reform.

**PROMOTING INTEGRATION AND COMPETITION TO MAKE EU MARKETS MORE EFFICIENT**

Pushing on with economic reforms designed to integrate EU markets was a key element of the Lisbon strategy to make the EU “the most competitive and dynamic knowledge-based economy in the world”. This section focuses attention on market performance in service industries, including services of general interest, in goods markets, in financial markets, in public procurement, as well as on the evolution of state aid.

**I. The increasing importance of integrating the EU’s service industries**

The Lisbon European Council conclusions specifically highlight the importance of the services sector, calling for the development of a strategy, before the end of 2000, to eliminate remaining barriers to intra-EU trade in services. This is justified by the economic importance of the services sector and the sector’s poor performance relative to the USA: if the EU’s employment rate in services equalled the US record, Europe would have 36 million more jobs.

Even if socio-cultural and distance-related barriers seem to affect service providers, various regulatory barriers continue to limit EU service sectors to national boundaries, at least in the business service sector (see graph 8). A survey of business service providers involved in cross-border business (see box 4 in annex) found that over 47% of firms providing business services to other EU countries realise 10% or less of their turnover in EU markets other than their home base. Constraints include the need to obtain local registration, be represented by a local agent or have a specific legal form, and the costs of setting up a local operation with its associated administrative and legal procedures (see table 11).

*The revolution in information technology means that these problems must be tackled urgently*

Many service providers no longer need to be situated physically close to their customers. This is challenging traditional service market structures in Europe, potentially making service markets much more competitive even when markets remain segmented by regulations. Completing the internal market for services in the EU would intensify the degree of competition in services in general and provide the conditions for European businesses to compete more effectively on world markets; doing nothing is not an option if the Lisbon European Council’s proclaimed objective is to be realised.

In response to the Lisbon request, the Commission is preparing a strategy to eliminate barriers to services. Its goal is to promote the internal market as the natural domestic market for all service providers in the EU, but especially SMEs, as well as consumers, by allowing services to move as freely across borders as within a Member State and by making cross-border shopping as attractive to consumers as domestic shopping. The Commission will present proposals to this end in 2001 and 2002 as follow-up to the strategy. All service sectors should be covered, which means replacing the current piecemeal or sectoral approach with a truly comprehensive approach. The strategy will stress the need to apply the fundamental freedoms of the Treaty, and make use of mutual recognition and the proportionality test to strip away
unjustified and conflicting national layers of regulation. Where necessary, it may also bring forward harmonisation to remove barriers. The regulatory environment covering services should be made flexible enough to keep pace with changes in information technology, and care must be taken to ensure coherence with other Community policies, especially competition policy.

2. Manufactured product markets are generally well-integrated

Cross-border trade in manufactures is outpacing the growth of GNP, and foreign direct investment continues to be an important engine for integration.

_Nevertheless, in non-harmonised sectors, technical barriers to intra-EU trade may remain a problem, especially in certain markets…_

The number of cases of alleged breakdowns of the principle of mutual recognition in the food sector is relatively high (see tables 14 & 15). A lot of these may be explained by the sheer variety of products in the sector and by intense government control of trade flows in response to legitimate consumer demands for enhanced food safety standards. Nonetheless, it is necessary to ensure that exceptions to the application of the mutual recognition principle are duly justified. The sensitivity of trade in the sector on the one hand, and its economic importance on the other, calls for careful policy attention seeking satisfactory solutions.

In the harmonised area, new evidence raises some concerns about the impact of legislative transition periods on the efficiency of the New Approach to overcoming technical barriers. Respondents to a survey on the medical devices sector clearly felt that it has become much easier to supply multiple Member States’ markets, but that an internal market for medical devices remains incomplete (see table 16). This demonstrates the need to back up New Approach directives with ratified harmonised standards and a restrictive approach to the introduction of long transition periods in the directives. They might be used in certain cases to blunt the trade impact of the New Approach.

3. European firms and citizens have paid, and are still paying, a high price for the relatively low degree of integration in financial services markets

Regulatory changes introduced in recent years, the development of common infrastructures and the Euro have rapidly integrated the non-secured money market as well as swap and derivatives markets. This has revealed the cost that was being paid for keeping nationally fragmented markets. Liquidity has been redistributed throughout the Euro-zone, enhancing cross-border activity and reducing price differentials.

… more needs to be done to promote integration …

Not all markets are, however, as integrated as the non-secured money market. The apparent lack of integration in the other markets is reflected in the strong domestic bias of portfolios. In order for investors and companies to be able to reap the full benefits of the strong growth of those markets, some changes are becoming urgent, namely:

- **The establishment of Pan-European clearing and settlement systems.** This would put cross-border intra-European and domestic transactions on a more equal footing and allow for considerable cost-efficiencies. The absence of such a system amongst European stock exchanges partially explains the relatively low degree of foreign participation in domestic stock exchanges.
• **Eliminating unnecessary restrictions on institutional investors.** Institutional investors’ importance in managing financial assets around the world is growing: they offer consumers the possibility of more diversified portfolios and pool savings for investment. The European market for institutional investors, however, remains rather fragmented and its development dictated by national legislation. As a result, it is still only about half as large as the US market (see graph 13). New measures are being taken and existing ones adapted to promote a truly Single Market for Institutional Investors: the Commission’s recent proposal on funded pension schemes aims to develop a pan-European market, now worth €2,300 bn but expected to grow to €3,500 bn by 2005, mainly because of the ageing European population. Other measures include the amendment of two proposals in the important area of investment funds (a market worth €2,930 bn); those would extend both the range of assets and the geographical area (through the introduction of a Single European Passport) in which investment funds can invest.

• **Investors have an increasing need for reliable financial information.** In pan-European private bond markets, the scale and frequency of the issues (see table 17) have increased and the search for higher yields has opened up the market for companies below investment (BBB) grade. The number of European companies that have an internationally comparable rating or report financial statements in accordance with IAS standards, to date remains rather low when compared to the US. The availability of internationally comparable information, however, would enhance the security and accessibility of these markets. The Commission has already issued a communication for listed companies to report in accordance with IAS standards⁴.

• **The Regulatory framework needs to be reshaped to meet the requirements of the present financial framework.** The internationalisation of markets, the increased number of retail participants, the growing market share of below-BBB-grade companies, the changed attitude toward risk, the greater importance of the stock market and the possibly higher volatility call for an update of the regulatory framework, as stated in last year’s Cardiff report.

The FSAP Implementation Report has identified new key priorities and policy actions. The Interim Report by the Lamfalussy group on “The regulation of European Securities Markets” endorses those priorities and suggests that further political efforts should be made to speed up the process in order not to fall behind market developments. The implementation of FSAP measures thus is urgent.

4. **Progress has been made in making public procurement markets more transparent**

The need to make public procurement markets work better was implicit in two conclusions of the Lisbon European Council – the call for work on updating public procurement rules to be completed, with particular emphasis on easing market access for SMEs, and the call for progress on spreading e-government. Successfully increasing the actual economic impact of efficient and competitive public procurement markets is particularly important given current efforts to improve the quality and sustainability of public finances.

The new legislative framework is expected to increase already high levels of transparency in public procurement markets, making them more competitive (see table 18 and graph 15). The economic impact of the new proposed directives could be increased by implementing

practical measures to facilitate cross-border entry in public procurement markets (see graph 16). State-of-the-art technologies could help increase the economic impact of competition in public procurement markets by providing easier access to more firms, especially SMEs, from more countries. Given the potential cross-border effects, spreading the use of new information technologies may require action at the Community level but, fully respecting the subsidiarity principle, national alternatives should be explored first. The legislative framework includes a variety of provisions to encourage the use of new technologies in procurement.

5. Thanks to regulatory reforms, certain progress has been made in the market performance of utilities and network industries

Prices are falling, quality is getting better and efficiency is advancing. Introducing competition has spurred innovation and organisational changes, leading to improved productivity in many of these sectors. Therefore, there is no reason to delay further the opening up to competition of postal, energy, transport and communications, provided that consumers’ interests are taken fully into account. In this process, the Commission will maintain its step by step approach based on evaluation of reform and consultation with the various parties concerned, including consumers, as stated in the Communication on Services of General Interest. This requires a more intensive use of evaluation tools to assess the operation, performance and competitiveness of services of general interest so that regulation can be adapted in line with technological change (which increases the cross-border possibilities of providing services within the Internal Market), new consumer needs and new public interest demands.

Further liberalisation should take careful account of the lessons drawn from recent experience of reforms. In particular, the regulatory framework needs to be well-designed. In utility industries such as gas and electricity and railways, substantial up-front fixed costs limit the scope for competition, creating a serious risk of market failure. In airports, for example, the accumulation of slots by dominant incumbent airlines may be limiting reductions in air fares (see tables 19 and 20). Such risks require careful redefinition of the regulatory framework.

Accelerating merger and acquisition activity in the last two years has substantially concentrated the network industries, and the impact of this on competition must be carefully monitored. Much of this activity has been purely domestic, which may be a matter of serious concern, because increased market concentration can dampen the positive economic impact from opening these sectors to competition. In the energy sector, now entering a decisive phase in the process of opening to competition, the value of domestic deals in 1999 was double the figure for 1995 (see graphs 17 & 18).

Economic reform in the energy, postal services and transport sectors is accelerating as requested by the Lisbon European Council. To that end, the Commission submitted proposals in May for the postal sector [COM(2000)319]. Market developments are making the further opening to competition in postal services crucial. The current directive foresees opening up just 3% of USPs revenues yet, despite that one Member State has not transposed it completely and four others are facing infringement procedures for non-conformity, a highly unsatisfactory situation. A further opening of 20% by 2003, as foreseen by the new proposed directive, is a reasonable and prudent objective. The Commission submitted proposals in July for public services in public transport [COM (2000) 7] and will submit new proposals shortly for the further opening of energy and transport markets.
To be made more efficient, EU markets for network industries should be further integrated, particularly in the energy sector as last year’s report emphasised, in spite of the undoubted difficulties. Railway reforms should also continue integration, despite the technical difficulties. In other sectors where technical difficulties are not an obstacle, further integration should definitely be pushed. In mobile telecommunications, for example, differences in international roaming charges are not consistent with a fully integrated market and competitive market behaviour.

6. Reducing the distortionary impact of State aid

State aid are generally continuing to decline (see graph 19). For the EU as a whole, aid to manufacturing fell from 2.3% of GDP to 2.0% between 1997 and 1998. Preliminary figures for 1999 seem to confirm that the declining trend in overall levels of State aid in the EU granted to the manufacturing sector has continued. Nevertheless, the incidence of sectoral aid, the most distorting of all aids, remains too high (see graph 21), although it also appears that the share of aid granted to particular manufacturing sectors fell in 1999. However, although overall “ad hoc” sectoral aids, perhaps the worst type of sectoral aid, have fallen dramatically, they have increased sharply for financial services – up threefold since 1993 (see graph 24). Clearly, aid to financial services needs careful monitoring, and Member States should try to control this upward trend.

The overall evolution of State Aid may be positive, but there are good reasons to improve monitoring of their distortionary effects and assessments of their impacts. The introduction of a state aid scoreboard and register by the Commission may be useful instruments for that purpose. Evidence seems to show that countries with high aid levels also have levels of administrative regulation, so that already distorted markets are made even further distorted (see graph 25). This is an important point which deserves further attention. For the process of economic reform, it is essential to know if we are confronted with Member States that accumulate both regulations and subsidies, or whether different Member States use different policy instruments having an impact on markets. More in-depth analysis of the combined impact of state aid and regulatory burden is therefore essential to identify the areas and countries where economic reforms are most urgently needed.

PROMOTING ENTREPRENEURSHIP

Since the beginning of the 1990s, Europe’s catch up with the USA in terms of living standards has been interrupted and the competitiveness gap is growing wider now. This was recently indicated by the Commission [SEC(2000)1823]. For decades, the EU has been catching up its main competitors, but that trend has now come to an end and seems even to have reversed. Europe must fundamentally improve its ability to create, innovate and change. The main problem seems to be a lack of dynamism and flexibility, a ponderous reaction to structural change: excessive time is lost before necessary changes are introduced and fully exploited.

The European Union still has a long way to go to create the right business environment, one with a reduced regulatory burden, improved financing conditions, especially for new firms, a modern and simplified fiscal environment and a fertile climate for innovation.
1. **MEMBER STATES HAVE CONTINUED TO IMPROVE THEIR REGULATORY ENVIRONMENTS BUT MORE STILL NEEDS TO BE DONE …**

Significant measures to reduce companies' administrative burden have been introduced. Most concerned electronic access for business to administrative information and requirements, implementation of one-stop shops or single contact points for administrative procedures, and the development of small business support services (see table 21). Better indicators to monitor changes in the regulatory environment are needed.

Nonetheless, recent evidence still highlights how Europe lags behind its main competitors in the costs and procedures associated with business creation (see graph 26 & table 22). Measures already taken by Member States therefore need to be enhanced, and national initiatives should find their place in, and derive synergy from, a coherent Community policy framework.

**A more coherent, better co-ordinated EU-wide approach to simplification is needed …**

This is a request from the Lisbon European Council, considered essential to respond to the new challenges posed by globalisation and rapidly evolving technologies and markets. In response, a Commission strategy to improve the regulatory framework will be adopted in 2001, pulling together, streamlining and building on existing initiatives. An assessment of existing initiatives will be first set out together with an outline of the Commission’s approach. The strategy itself, to be adopted before the end of 2001, will then set out a clear plan of action, drawing, *inter alia*, on the analysis in the forthcoming White Paper on Governance. It will assess the appropriateness of alternative approaches to regulation and new forms of policy co-operation, with a view to promoting new forms of partnership between different levels of governance. It will also emphasise the need to ensure the protection of citizens' rights and interests. The quality and coherence of regulation at Community and national level will also be addressed. Proper regulatory impact assessments will accompany legislative initiatives.

2. **BETTER FINANCING CONDITIONS FOR COMPANIES ARE NEEDED …**

Access to the right type of finance, at the right time, throughout the entire business life is essential to help entrepreneurs translate their ambitions into reality. European SMEs still consider that access to finance is a problem limiting their growth potential.

**Market developments are encouraging …**

The European private equity market (capital provided to companies not listed on the stock exchange, including venture capital and buy-outs) to date has been largely underdeveloped when compared to the US market, highly concentrated in the UK and mainly directed towards buy-outs rather than seed and start-up financing. The existence of a well functioning stock market that encourages initial public offerings is a crucial element in the development of venture capital and thus to be promoted. But things are changing:

- In 1999, investment in private equity increased by 74% (see graph 27) and the capital committed to early-stage (start-up + seed) investments doubled. However, early-stage investments still only represent 27% of total venture capital invested, or about 12% of total European private equity. In 1999, 42% of venture capital was invested in high-tech, of which almost half in the early stages.
• In 1999, an increased amount of venture capital was raised by EU countries other than the UK, contributes to a more balanced market. However, venture capital investment still remains rather low in terms of GDP (below 0,1% of GDP) in Greece, Portugal, Denmark, Austria and Italy.

• In most EU Member States, measures have been taken recently to improve the regulatory and tax environment of start up companies, recognising their importance for the economy and the specific financing problems of these companies. However, care should be taken to ensure that the measures in support of venture capital do not distort competition in the Internal Market.

• The Commission Strategy to stimulate the development of a true venture capital market is embodied in the 1998 Risk Capital Action Plan (RCAP). In this context, it adopted the Progress Report on the RCAP [COM(2000)658], establishing priorities for action to ensure the implementation of the RCAP by the 2003 deadline set by the Special Lisbon European Council. Acknowledging that public funding has a role to play in addressing market failures, the Commission also adopted a document on the review of community financial instruments, proposing measures to improve the coherence of EIB, EIF and other Community funding for risk capital.

These developments are all the more remarkable because they have taken place in a context of falling costs for alternative financing sources. Debt financing conditions have improved substantially as a result of EMU, fiscal consolidation and changes in financial markets (see table 23). The cost of debt has fallen in all countries for which data are available, especially in Spain. The cost of financing has allowed firms to save up to € 55,716 in interest payments per year per million euros borrowed. Cheaper debt financing has allowed firms to improve their financial profitability with respect to 1993 levels. These results confirm effective progress in improving financing conditions as a result of the combined impact of macro and microeconomic policies.

**Businesses need the right environment to innovate …**

Europe’s competitiveness problems are firmly linked to its relatively sluggish and comparatively insufficient capacity to innovate. Besides favourable financing conditions, innovation requires a competitive environment, with no unnecessary regulatory burdens and an appropriate system of economic incentives to encourage firms to innovate. Adopting the Regulation on the Community Patent 5 on the basis of the recent proposal should help achieve this. So should other IPR developments relating to new technologies.

**… and face the challenges of the New Economy.**

The development of the New Economy presents consumers and small businesses with unprecedented opportunities - cost savings, new and more flexible work organisation, improved processes and new, expanding markets. Exploding B2B e-commerce is outpacing growth in B2C e-commerce, the latter being well below its potential level, if the US is any guide. For SMEs, B2B will speed up processes, improve quality and ensure better service. This should encourage innovation.

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The relative share of B2B vs. B2C is expected to increase from 80% in 2000 to 90% in 2003. B2C penetration is just 0.2% of retail sales in Europe compared with 0.7% in the US.

The challenge is for SMEs to move beyond the learning phase and put their awareness of e-commerce into practice. For policy makers, the real challenge is to equip SMEs for competition on global electronic exchanges. As far as B2C is concerned, regulatory complexity seems to be hampering its development and must therefore be addressed. For “business to consumers”, the challenge is to increase consumer confidence in e-commerce.

Since last year, several EU level initiatives have been taken to address these challenges including the launch of the eEurope initiative and the eEurope 2002 Action Plan, as well as adoption by the Commission of a legislative package to strengthen competition in the EU’s electronic communications markets and adapt existing regulations to the requirements of the Information Society. A regulation has been proposed on full local loop unbundling that will help further reduce the cost of Internet access. Beyond that, final adoption by the European Parliament of the Electronic Commerce Legal Framework Directive brings Information Society service providers within the Internal Market.

Progress has to be made in modernising and simplifying the fiscal environment.

The current VAT arrangements have a number of shortcomings: they are complicated, susceptible to fraud and out of date. Businesses are confronted with difficulties linked with VAT obligations in different Member States. There is a patent need to improve the VAT system in order to bring it up to date and ensure it encourages legitimate commercial transactions within the Internal Market, reducing the scope for fraud. In its communication presenting a new VAT strategy the Commission has proposed a viable strategy focusing on four main objectives: simplification and modernisation of existing rules, more uniform application of the present arrangements and closer administrative cooperation. Initial results of this new approach are very encouraging.

In conclusion, fostering entrepreneurship requires the attention of policy makers even more than ever, …

Especially as globalisation and rapidly evolving technologies and markets pose new and complex challenges to both regulators and enterprises. Priority actions should focus on:

- Encouraging the creation and growth of small businesses at national level by rapid transition towards E-administration. The basic objective must be to maximise use of information technology to lighten the administrative burden. Businesses should also be allowed to use digital signatures in dealing with the public administration.

- Launching and implementing co-ordinated action to improve the EU’s regulatory framework. This programme should assess different options to regulations and promote a more systematic analysis of the overall impact of new regulations. Simplifying the existing regulatory framework should also be a key priority. The Commission will present its strategy in 2001.

- Ensuring a high level of coherence and co-ordination between national and Community efforts to improve the regulatory framework, mainly by ensuring the correct

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6 Com (2000) 348 of 7 June 2000 “A strategy to improve the operation of the VAT system within the context of the Internal Market”.
enforcement of Community law. This might be one of the main tasks to accomplish in the governance exercise from an economic point of view.

- **Facilitating faster access to finance for smaller enterprises**, notably by developing a true venture capital market. The directives on the prudential supervision of supplementary pension funds, UCITS, prospectuses and EU Accounting Strategy communication are important to this goal. Expanding the capacity of guarantee schemes at all levels could also make it much easier for SMEs to access finance.

- **Accelerating Europe’s transformation into an Information society**, so that consumers can be as confident shopping on-line as off-line and so that SMEs fully grasp all its opportunities. This implies the timely implementation of the eEurope Action Plan, including the e-commerce Directive. It also means greater coherence among all initiatives which may impact on e-commerce, particularly the discussions by stakeholders on jurisdiction, taxation, and cybercrime. Sectoral initiatives should also be checked for coherence, as should the implementation of a European Research Area. Adequate protection of intellectual property rights is also essential to ensure a climate conducive to innovation and creativity, which makes it crucial to adopt the draft Directive on Copyright and related rights in the Information Society, as well as the Community Patent.

**DEVELOPING THE EXTERNAL DIMENSION OF ECONOMIC REFORMS**

The EU is a major player in international trade and economic relations, so the Lisbon Council’s ambitious goal for European competitiveness necessarily has external consequences. Internal Community reform will have international economic impacts, and reforms by the international community will impact economically on the Community. It therefore makes sense for the Community to actively participate in the reshaping of global regulatory changes; that will ensure that international regulatory changes fit better and are synchronised with EU internal economic reforms, helping improve the Community’s international competitiveness.

This is especially important in the case of the initiatives to complete the Internal Market for services and integrate European financial service markets. That initiative underpins the importance to the EU of taking an active part in preparing the framework for the General Agreement on Trade in Services negotiations. It also underlines the importance of current negotiations with the USA on developing Mutual Recognition Agreements in some professional services and insurance. The Internal Market is a good model for economic reform that could be used to foster international trade and investment in certain economic areas.

Another major external challenge with an impact on the Community’s economic reform process is enlargement to the East. The Commission adopted on 8th November its Enlargement Strategy paper and reported in detail on progress towards accession by each candidate country. The candidate countries continue to have important holes in their adoption and effective implementation of Internal Market legislation, so work remains to be done. Nonetheless, thanks to the Association Agreements, trade and investment integration with candidate countries is growing fast in a trading framework free, on the Community-side, of tariff barriers and quantitative restrictions. Trade analysis shows that different candidate countries’ exports have different product compositions. In particular, the extent to which they are exporting products whose standards are harmonised at the Community-level varies. This is an issue which needs to be explored. It may have significant consequences for the pace of future trade integration by different candidate countries; it could also add to the task of
implementing fundamental principles of Internal Market trade, notably mutual recognition (see box 5 & graphs 33 & 34).

Accession implies adopting the Community acquis and Community practices. The Cardiff process of economic reform has created a new culture of self-assessment of change at the microeconomic level that has proven very useful. Candidate countries could benefit from the application of self-assessment mechanisms to monitor the adoption of Internal Market rules and practices.

CONCLUSIONS

1. **CITIZENS MUST DRIVE ECONOMIC REFORM**

Reforms are needed to give Europe a modern, dynamic economy. Setting priorities for the reform agenda should fully involve civil society, both consumers and entrepreneurs. Reform will not work if citizens relinquish the initiative. Public authorities must attend to citizens’ priorities, ensuring that they can enforce their rights and preventing market failures detrimental to citizens’ interests. This means providing better information and ensuring greater market transparency. It also means implementing efficient legal and regulatory frameworks designed to provide effective safety and consumer protection. Last, but not least, it means installing sound and efficient redress mechanisms and access to justice. These are all indispensable instruments to maintain the momentum of economic reforms. What public authorities must not do is try to limit change by introducing unnecessary regulations or keeping obsolete ones in place. This is essential to guarantee that economic reform makes European citizens economically better off.

2. **EUROPE MUST CREATE A DYNAMIC, FRIENDLY ENVIRONMENT FOR ENTREPRENEURSHIP TO FACILITATE TRANSITION TO THE KNOWLEDGE BASED ECONOMY**

The Internal Market for services must be made to work as well as the Internal Market for goods. But today’s greatest challenge facing the Internal Market is creating the conditions essential to develop a more dynamic entrepreneurial spirit in Europe. Only this will succeed in accelerating the adoption of new technologies, renovate the industrial and economic tissue of our economy, and facilitate the transition to a knowledge-based economy. The simplification of regulation and legislation will be a key element of that process; however, it will also be essential to co-ordinate different policies at EU and Member States level.

3. **IN PURSUIT OF THE LISBON OBJECTIVES, PROGRESS HAS BEEN MADE IN THE PROCESS OF ECONOMIC REFORM**

Member States have made significant progress in setting reform processes in motion which, in some cases, can be considered unprecedented. At the Community level, detailed major policy initiatives are being developed and implemented. Substantial progress has been made in financial services, but market developments demand accelerated implementation of some measures. The strategy for the service sector will soon be submitted to the Council and the EP. The initiative for the simplification of legislation and regulation will be adopted by the Commission in the first half of 2001. Member States should continue in their efforts to find national solutions to economic reform needs with national dimensions. Attention should be paid to the co-ordination of economic reforms at Member States level: we should avoid “two
speeds” in the reform process which may hinder the good functioning of the Internal Market as a whole.

4. **Reforms must be continued, deepened and accelerated**

They must **continue** because they are part of **long term strategy** for growth, employment and competitiveness. Economic reforms often have some short term effects that citizens can readily observe such as falling prices, but their main benefits will come in the longer term. Countries like the USA, where reforms started several years ago, are only now harvesting the results.

Economic reforms must be **deepened** because the European economy is still too **rigid**, hampering overall economic performance. The evolution of the exchange rate of the € vis-à-vis the US$ is due to a large extent to the superior results of the US economy in terms of competitiveness and market performance. Only a determined, renewed endorsement and implementation of the Lisbon agenda will send out a credible signal of our commitment to improve the competitiveness of the European economy. This will reassure international markets and investors about our determination and strengthen the euro in world markets.

Speeding up economic reforms may require fast-track procedures, as the Lamfalussy group recently suggested for the financial services sector. Standard procedures\(^7\), without a political impulse to speed up the introduction of reforms, risk sluggish policy response, and we cannot risk falling behind market developments.

As the European Council has suggested, we also have to **accelerate** our reform process or **else miss the extra macro-economic growth potential offered by new technologies**. When old problems such as oil shocks and raw materials shortages reappear, the formula for long-term growth based on new technologies, innovation and economic reforms appears clearer than ever before. New technologies are a new high octane fuel available for developed economies, but they require a finely tuned, flexible economy to make the best out of them. More innovation in a dynamic regulatory environment yields the highest return in terms of competitiveness, employment and growth. This is the logic of Lisbon.

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\(^7\) The average delay between the date of a Commission proposal and the official date of transposition is more than four years. This estimate is based on 198 basic internal Market directives between 1985 and 2000 and does not take into account further delays due to late transposition by some Member States.