



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 07.12.2001
COM(2001) 736 final

REPORT FROM THE COMMISSION

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

**{SEC(2001)1993}
{SEC(2001)1998}**

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1. INTRODUCTION

This fourth annual Commission report on the functioning of product and capital markets has been prepared in the light of the long term objectives defined at the March 2000 Lisbon European Council and by the conclusions of the Stockholm European Council. It also integrates the conclusions of the Internal Market Council of 12 March 2001 and the Broad Economic Policy Guidelines. It builds on the Commission's priorities as defined in the Synthesis Report it submitted to the Stockholm European Council and in the Commission's Communication to the October 2001 informal European Council at Gent (COM (2001) 611) on the likely economic impact of the 11 September events. This report's conclusions and results will feed into the updating of the Internal Market Strategy, the future Broad Economic Policy Guidelines and the preparation of the March 2002 Barcelona European Council via the Commission's next Synthesis report (to be presented early next year). Three important new developments have also had an influence on this report.

1. There are new, powerful reasons to strengthen the process of economic reform. Economic reform and the Lisbon strategy were launched at a time of healthy economic expansion, but the positive economic outlook is now fading. Maintaining the political determination to implement reform measures would help bolster confidence in European and world markets, a sentiment those markets currently lack. Reforms may be key to the European economy's ability to withstand future shocks, but knowing where reforms should be targeted and how far they should go requires a good market flexibility monitoring mechanism, especially as regards prices as market adjustment mechanisms. With this in mind and following the Internal Market Council conclusions, a more detailed analysis of retail prices in the Internal Market is presented in this report.
2. The Göteborg European Council has completed the range of long term objectives defined at Lisbon in March 2000 by adding sustainable development to innovation, employment, entrepreneurship and social cohesion. Some attention was already paid to environmental dimensions of market performance in last year's Cardiff report. Then in June 2001, the Internal Market Council adopted conclusions integrating environmental objectives in Internal Market policies as requested by the Spring 1998 European Council. Additional efforts, declare the Göteborg conclusions, are needed to make the Internal Market contribute actively to sustainable development. The report puts forward suggestions for three new lines of action and presents indicators as suggested by the Internal Market Council conclusions.
3. In a declaration attached to its conclusions, the Nice European Council suggested that, in the context of the Cardiff process for monitoring product and capital markets, the Commission should carry out a horizontal evaluation of services of general economic interest. Previous reports have already covered these services, but not in the detailed way that they are treated this year. The evaluation can be found in a dedicated annex.

The fundamentals of the European economy remain strong, but dented confidence in the world economy is taking its toll on economic prospects world-wide. Under the circumstances, the temptation is to put off economic reform. It is true, after all, as the Commission's Synthesis report showed, that EU economic reform has already made progress. Recent months

saw the attainment of some more objectives (e.g. the political agreement reached for the further opening of postal services). However, many more structural changes are still needed if we are all to benefit from highly flexible product and capital markets. If political determination to pursue reform falters now, the competitiveness objectives established at Lisbon will slip out of our reach.

This report follows the structure of objectives defined for the Internal Market strategy. The next section examines how well goods and services markets are functioning from the citizens' perspective. Then it goes on to present relevant developments in goods, services, capital and public procurement markets. After that, the impact of market functioning on business and entrepreneurship is considered.

2. IMPROVING THE QUALITY OF CITIZENS' LIVES: CONSUMER AND ENVIRONMENTAL ISSUES

Citizens are the most important beneficiaries of the Internal Market; that is the Commission's view, and that is the theme chosen to run through the preparation of this report – from the extended analysis of retail prices through sections on retail financial services and on sustainable development to the annex on services of general economic interest.

2.1. There is evidence suggesting that price convergence is slowing down...

Integrated product markets – the essential condition for competitive markets – are a must if European citizens are to benefit from the Internal Market. Not only that, they also make the European economy more resilient to external shocks.

Price convergence is a good indicator of market integration. It is therefore a concern that after some years of clear price convergence, 1999 saw relatively little change. This process seems to have slowed down in the second half of the nineties¹ (see graph 1). Since 1998, price dispersion has remained stable with only small changes registered. But it should be noted that the methodology behind the indicator changed in 1999 making difficult a comparison between 1998 and 1999 figures. More time monitoring prices are therefore needed to be able to say whether a significant change is occurring. Furthermore, as a structural indicator, it is the long term trend of price variation that is important to reach definitive conclusions, (not a single year's results).

Nonetheless, the 1999 figures and the forecast for 2000 seem to confirm the slowdown of price convergence observed in recent years. The accession of Sweden, Austria and Finland, all of them countries with high retail prices, was followed by a process of retail price convergence across the EU15 that started to run out of steam towards the end of the decade.

More detailed analysis shows that the evolution of price variation in the 1990s has been markedly different in different sectors. For example, from 1990 to 1998 the prices of foodstuffs ("oils and fats", meat, bread and cereals) converged significantly across the Community. Meanwhile, other sectors such as tobacco or fuel and some service sectors such as transport services and construction registered little price convergence, sometimes even price divergence (see table 1 and box 1).

¹ As in previous years, price dispersion is measured by the coefficient of variation, which measures the deviation around the average European price. It was 14.55% in 1999 and 14.40% in 1998.

The retail prices of supermarket products vary a lot...

The prices of supermarket products (i.e. food, personal care products and washing and cleaning products) converged in the 1990s. This is one conclusion of a study to monitor and analyse supermarket product prices carried out by the Commission (see box 2)², complementing its study on retail prices for fresh food and consumer electronic products, results of which were presented in the May 2001 Internal Market Scoreboard. Nonetheless, significant supermarket product price differences remain, and this report looks at these in detail with the ultimate goal of benchmarking price differences across the EU. In particular, it will become possible to decompose retail price variation across countries in a way that identifies factors responsible for those variations³. That in turn will help identify what economic reform measures are needed to further integration and improve the operation of retail product markets, all for the benefit of consumers.

The price dispersion of “pan-European” supermarket products (supermarket products sold throughout Europe) remains relatively large in the Internal Market. Retail prices across the EU can be up to 40% above or below the European average (see table 2). The average price difference is around 30%. Concrete examples, perhaps, make the point. A cola drink bought in a Danish supermarket can cost almost twice as it would in a German supermarket. Branded mineral water can be over 300% more expensive in Sweden than in France (see tables 2 & 3).

“Pan European” products are generally more expensive but vary less in price than similar national brand products or similar national or multinational brands not present in a majority of Member States – referred to as “generics” in the data-base (see tables 3 and 4). Whenever “generics” are more expensive, the price difference is relatively small.

Differentiated goods often vary more in price than homogeneous goods, but not always...

Similar branded goods genuinely differentiated to meet different segments of the market, or differentiated by heavy advertising (e.g. shampoo), vary much more in price than homogeneous goods such as sugar or butter (see table 5) – as expected. More surprising is the degree of price variation across the EU for some very homogeneous goods such as flour and some frozen vegetables.

Benchmarking price dispersion - price dispersion across EU countries exceeds interregional prices differences...

Price dispersion inside every Member State is always lower than price differences across countries for the same products. Generally, prices inside Member States vary 5% around the national average; across the EU, prices vary 20% or more.

Nevertheless, there are a few products for which prices inside a Member State, in whichever Member State has the widest domestic price variation vary as much as they do across the whole EU (see table 2). However, even for these products, the dispersion of prices in whichever Member State has the second-highest dispersion of domestic prices is always much

² This is part of a long-term project by several Commission services (DG Internal Market, Health and Consumer Protection and the Statistical Office) with additional objectives other than measuring price convergence.

³ For a discussion on factors that could explain price variation see European Economy Supplement A, No 7 July 2001.

lower than the EU level of price dispersion. In other words, for the products included in this sample, the EU Market is clearly less integrated than national markets.

Are some countries always more expensive than the rest?

None of the 14 Member States included in the study is always above or below the European average price. However, table 3 and graph 2 show that some countries (e.g. Spain and Germany) are relatively cheap whilst Sweden, Finland and Denmark are relatively expensive. A more precise analysis (see box 3) confirms that these countries tend to have above EU average prices while Spain and Germany, amongst others, have prices of supermarket products below EU average. But this does not systematically occur for all products. This is consistent with the May 2001 Scoreboard results for consumer electronics and fresh food. Including indirect taxation changes the ordering of countries by price level a little, but not much.

“Geographic” or country-specific factors do not explain much of the remaining prices variation

This lack of systematic price deviations for all products across countries suggests that “economic” factors and not “geographic or country-specific” variables play a predominant role in explaining price differences. “Economic” factors would include industry or even product-specific differences in manufacturer or distribution concentration, firm behaviour, or regulatory differences with special impact on some product categories. Country specific factors such as transport costs, income differences, different consumption patterns or differences in wages or local input prices are not responsible for much of the price dispersion. Even in combination, no more than about 21% of all cross-country price variation. Income differentials on their own certainly do not explain satisfactorily why prices differ. High income level countries such as Germany do have some low retail prices whilst low-income level countries such as Greece or Portugal do not have particularly low retail price levels.

Although country-specific factors do not affect prices in a systematic way they may still affect the price level of individual products⁴. For instance, national legislation on the composition of processed food has an impact on very specific products only. Since not all the products in the sample have the same advertising intensity, national regulations on advertising do not affect all products in the sample in the same way. Also regulation on franchising, shop opening hours, recycling requirements etc. might affect products differently

In other words, “geographic factors” are not good at explaining price dispersion for supermarket products. Therefore, “economic factors” are the likely explanatory variables of intra-EU dispersion in retail prices for supermarket products. This is equally true for price dispersion at the national level. Price dispersion may be higher across countries in the EU than across Member State regions but economic, not “geographic”, factors explain both inter-regional and cross-country price dispersion (see box 3).

Market concentration varies a lot across countries...

Market concentration ratios for the top 3 household product brands vary a lot across countries. Higher concentration is to be expected in smaller national markets (as graph 3 shows), but is not always true. The top three brands of surface cleaners account for 87% of the Danish market, 86% of the French market but just 33% of the Spanish market. These differences

⁴ The data set is not detailed enough to check this hypothesis.

change significantly from sector to sector within each country. For instance, Germany has a relatively high concentration ratio for crisps and a relatively low ratio for pasta. Local competition conditions may explain a great deal of these differences. However, the relationship between market power of producers and the price level in supermarkets is not straightforward. Looking at the simple correlation between market power and price there seems to be no clear pattern. Concentration in retailing, distribution channels, the regulatory environment, the distribution of bargaining power between distributors and manufacturers and rivalry at the manufacturer and distribution levels, are all factors having an impact on retail prices, and therefore, it is not possible to establish a simple direct relationship between prices of supermarket products and manufacturers' concentration.⁵

Member States have different retail distribution structures, and this could help explain cross-country price differences...

Each Member State has more or less competition in its distribution sector and differing regulatory environments affecting the structure of distribution – these are important local conditions having an impact on prices. There is considerable variation in prices for different outlet types. That variation is not the same for all products and across countries but hypermarkets and discounters show prices 5% lower than supermarkets on average. Countries having a high proportion of supermarkets in the distribution system tend to have higher prices. (See graph 4).

Squeezing retail price dispersion needs a more competitive, efficient retail distribution system. Competition in the retail distribution sector puts pressure on distribution margins, so retail prices and their dispersion tend to fall. More efficient, competitive retail distribution systems would therefore result in lower prices in European markets. As graph 5 shows, significant price differences between different outlet types suggest the existence of significant gains to be made from more efficient distribution in countries with higher price levels.

In summary...

Aggregate price data seem to show a deceleration in price convergence for private consumption recently. Markets for consumer goods sold in supermarkets have become increasingly integrated since 1990, narrowing the EU-wide dispersion of their prices; nonetheless, some residual price dispersion across the Internal Market remains. Economic and sector-specific factors seem to explain that residual price variation, better than country-specific factors. Hence, economic reform and competition measures seem best to eliminate residual price dispersion in these markets.⁶

2.2. Internal Market plus and environmental protection: a formula for improving citizens' quality of life and sustainable development

At Lisbon, the EU made a political commitment to economic and social renewal. The Göteborg European Council added an environmental dimension to this with its strategy for sustainable development. The Internal Market, Consumer Affairs and Tourism Council's contribution to the Göteborg European Council was its strategy for the integration of

⁵ The effects of market power in different parts of the retail chain on retail prices are analysed in a paper by two Swedish economists, see "Food prices and market structure in Sweden" by M. Asplund and R. Friberg, SSEE/EFI Working Paper 318.

⁶ The recent Green Paper on Consumer Protection (COM(2001)531) sets out some options to increase competition in business-to-consumer and retail markets.

sustainable development and environmental protection with Internal Market policies. Made in response to a request from the Helsinki European Council, the strategy aims to integrate environmental objectives with the free trade of goods and services inside the Internal Market. Developing an Internal Market with high levels of environmental protection as well as a high degree of social cohesion and economic growth is the goal.

The Internal Market Council defined a number of indicators which can help monitor implementation of its strategy. As the strategy has only just been defined, it is useful to report on the recent evolution and current state of play of the indicators. This can provide a baseline for future monitoring.

Indicators can be grouped in two categories. First, some indicators show to what extent market outcomes, self-regulation and market mechanisms take environmental considerations into account. They are important because if firms and markets are improving their environmental performance, there is less need for public policy interventions and regulations with environmental aims. Secondly, policy indicators measure public policy involvement in economic activities to achieve environmental objectives and possible conflicts between policy objectives.

Markets and firms are improving their environmental performance rapidly, but public policy interventions to ensure sustainable development objectives are still clearly needed...

Market outcomes reflect increasing industry awareness about environmental issues. For various reasons, European firms are taking measures both conducive to market performances and increasingly consistent with sustainable development. The number of ISO 14000 certificates – privately granted certifications of sound environmental management and enterprise performance - granted to European firms in 2000 was four times higher than the average for the 1996 – 1998 period (see table 6A). The performance of British, Swedish and Danish firms in this regard is remarkable. However, the numbers of new eco-label certificates granted is very low. The number of certificates granted for eco-management and audit-schemes (EMAS) shows promising growth but it is still very low, especially in some countries (see table 6A).

Public policy intervention is indispensable to achieve sustainable development objectives. Policy indicators show Member States to be increasingly active in pursuing environmental objectives. Regulation and State aid are the most frequently used policy instruments. State aid expenditure on energy saving and environmental objectives has generally increased in the EU even as total aid has fallen. Such aid is sizeable in Germany, but especially so in the Netherlands and Denmark. The number of EC directives with an environmental component has grown continuously in the last ten years. Other policy instruments more compatible with market mechanisms are less frequently used. For instance, environmental taxes play a relatively secondary role, only accounting for 5,2% of total tax revenues in 1999, below the average level for the 1995-98 period (see table 6B).

The growing number of environmental directives has been followed by many more actions against infringements of environmental directives in 2000 compared with previous years, although Member States' overall transposition deficits remain relatively stable (see table 6B again).

The increasing awareness of environmental objectives has not notably impeded the functioning of the Internal Market. The number of national standards notified under directive EC 98/34 laying down a procedure for the provision of information in the field of technical

standards and regulations has grown considerably in recent years, but the number of environmental standards notified remains relatively stable. The number of registered infringements of Internal Market directives due to environmental, safety or packaging reasons has remained low and stable over the last five years (see table 6B).

An Internal Market working for sustainable development...

Ensuring the compatibility of environmental objectives is not enough. The Internal Market can make an active contribution to sustainable development. Future actions which could make the Internal Market contribute more to sustainable development include:

- Market instruments for the trading of emission allowances, which have not yet been introduced at the Community level. Despite their advantages in terms of economic and environmental efficiency, tradable emission allowances are not used at the EU level. The Community framework offers clear advantages for minimising possible co-ordination problems with international emission trading. Introducing such instruments could help the Union achieve its environmental commitments, as well as reduce the overall cost of cutting down emission levels. The Commission has recently adopted a draft directive on emission trading COM(2001) 581.

- Private market instruments, developed to eliminate market failures related to environmental liabilities. The Commission has issued a White Paper on environmental liability (COM(2000) 66) with proposals to foster the application of the “polluter pays” principle. The development of financial instruments such as insurance for environmental liabilities on a voluntary basis could help eliminate some market failures without public policy intervention. The present market in environmental impairment liability insurance is rather limited and tends to be handled by specialist insurers. Progressive market-driven expansion of this market segment would benefit the environment and the Internal Market. The Commission is currently considering a proposal on environmental liability that will pave the way for development of these instruments.

- Integrated impact assessment. In the context of better quality regulation and simplification, the Commission has presented proposals to the Laeken European Council to “ensure that all major policy proposals include a sustainability assessment covering their potential economic, social and environmental consequences”. Extending such practices would ensure maximum co-ordination in the development and implementation of Internal Market and sustainable development policies.

2.3. Integrating retail financial markets

Last year’s report singled out cross-border transfers as one area of major Internal Market concern for citizens. The Commission has continued to monitor cross-border credit transfer charges closely. Average charges for a €100 euros intra-EU credit transfer remain high (see graph 6). Such charges are simply incompatible with a smoothly functioning, fully integrated Monetary Union. Even more surprising is their evolution. Although the average European charge has fallen 5,8%, there have been significant increases in some Member States and the reduction over a 7 year period is relatively small (see graph 7).

Other types of cross-border payments too seem subject to widely varying but relatively expensive charges (see table 7). With euro bills and coins about to be introduced, the Commission has proposed a regulation (COM(2001) 439) establishing the principle that there should be equality of charges for domestic payments and cross-border payments in euros.

Despite repeated calls for bank charges on cross-border payments to be cut, market developments have not gone far nor fast enough to ensure a well functioning single payments area in the Internal Market.

This draft regulation⁷, is just part of the Financial Services Action Plan (FSAP), a comprehensive programme to create a fully integrated Internal Market in Retail Financial Services by 2005. The Plan itself is based on the creation of an adequate legal framework, reinforcement of consumer confidence and the guarantee of financial stability - essential pillars if consumers are to reap the full benefits of the Internal Market. However, the importance and benefits of these objectives go beyond the boundaries of financial service markets. Financial services can also oil the wheels of trade in goods and services by reducing the retail cost of cross-border commercial operations. In other words, forging an Internal Market in retail financial services will produce a double dividend: consumers and small business will not only benefit from a more reliable, efficient payment system but also from extended trading opportunities and increased competition thanks to lowered financial costs of trade.

3. MAKING PRODUCT AND CAPITAL MARKETS MORE EFFICIENT

The Internal Market Council has concluded that “product and capital markets will only deliver their full potential benefits when they are completely integrated and function efficiently...” And to ensure that integration, it has also concluded that “regular and systematic ... analysis of the structural developments affecting the competitiveness of markets, is important to ensure that citizens benefit from economic reform.” This section highlights some of the most recent, important developments in product market integration as revealed by the monitoring of trade flows and developments in capital markets and financial services markets. The slowdown of economic growth makes structural reform all the more important, because it will help minimise the adverse effects of that slowdown and bring the moment of economic rebound forward.

3.1. Trends in goods and service markets: Internal Market trade integration in manufactures is proceeding well, with positive impacts on Member States’ domestic economies...

Almost ten years on from the creation of the internal market, trade is steadily integrating Member State markets. Cross-border manufacturing trade inside the EU-15 is growing faster than GDP (see graph 8), subjecting Member State markets to competitive pressures, offering consumers greater choice and lower prices.

Monitoring the evolution of imports is especially important, as they increase competition on national markets. Furthermore, imports enable a Member State to acquire better technology available elsewhere, raising domestic productivity. In the UK, a 1% rise in intra-industry import volumes is estimated to raise the level of technical progress by 0.31%⁸. So how open

⁷ Recent progress in the Directive for the distance selling of financial services is another very significant step forward for the creating of this Integrated Internal Market for retail financial services.

⁸ Hubert, F. and Pain, N. (2000) Inward investment and technical progress in the United Kingdom manufacturing sector, NIESR, London. Technical progress is here defined as increases in labour productivity not due to scale effects or industrial structure effects. The study does not take into account an important source of productivity gains often although not necessarily associated with FDI - the transmission of technical knowledge due to skilled labour force mobility. The importance of this

to imports are the Member States? Graph 9 shows the importance of imports to Member States relative to the size of their domestic economies: at one extreme comes Belgium-Luxembourg with imports equivalent to about 50% of GDP; at the other is Italy with imports roughly equal to 15% of GDP. Since 1995, imports by Member States, whether from other Member States or from the rest of the world, have generally grown in importance – up 4% points relative to GDP (see graph 10). However, whereas the increase in import importance has been over 12% points in Belgium-Luxembourg and almost 11% points in the Netherlands, the UK, Denmark and Italy have barely registered any change. Indeed, the importance to the UK and Denmark of imports from the EU has slipped slightly.

All Member States apart from Greece have increased the value of their intra-EU exports since 1995. In part, this is because Greece has redirected exports away from Member State markets and towards candidate countries' markets (see graph 11) – above all, Bulgaria. This makes sense geographically and shows that Greece has been able to benefit significantly from the Europe Agreements signed between the EU and the candidate countries. Enlargement, when it comes, will further intensify this process.

Foreign direct investment has a very positive impact on economic performance...

Foreign direct investment (FDI) flows also integrate markets, contributing to the Lisbon objectives of enhanced economic performance in manufacturing and services. For instance, in the UK, foreign-owned manufacturing firms are estimated to produce about 10-40% more per worker than domestically-owned firms, and enjoy a 5¼% total factor productivity advantage. They account for about a third of total UK business R&D, up from a sixth ten years ago. A 1% rise in intra-industry inward investment raises technical progress by 0.82%⁹ (i.e., increasing FDI has more technological impact than increasing imports). However, the positive economic impact of FDI inflows seems to vary according to the source of FDI - North American establishments in the UK have around 36% higher labour productivity than British-owned ones, EU-owned ones have labour productivity around 22% higher.

Intra-EU FDI flows have been accelerating geometrically, but they are concentrated in just a few Member States...

Flows of FDI inside the EU have grown rapidly, especially flows of intra-EU FDI (see graph 12). Indeed, intra-EU FDI flows have grown much, much faster than manufacturing trade, EU GDP or FDI inflows from the rest of the world. Given the effectiveness of FDI inflows, this is good news for the growth prospects of the EU economy. However, the potential positive impact is going to be very concentrated: inflows of foreign investment from all sources are around 8% or more of GDP in Belgium-Luxembourg, Ireland and Sweden (see graph 13), but less than 2% of GDP in eight Member States. But what makes the attractions of individual Member States so apparently very different in the eyes of foreign investors (both inside and outside the EU)? State aids, tax incentives, the business environment and the depth of structural reform are all plausible explanations, but there is a need for further investigation.

Technical barriers to trade: European standards and better application of the principle of mutual recognition are the key to intensifying market integration by trade...

additional channel of productivity gains enhances the urgency of policy reforms underway to facilitate the free movement of skilled labour.

⁹

op. cit.

Amongst the Internal Market Council conclusions of 12 March, 2001, designed to ensure that citizens and consumers derive the benefits of economic reforms, is one that says “the elimination of remaining technical barriers to trade should be pursued more vigorously, including by making more effective use of European standardisation and through more effective application of the mutual recognition principle... Significant further progress is required in following up the Council’s Resolution on standardisation, in particular through concrete measures to complete the legal framework for a properly functioning internal market in the construction products sector.” The following three subsections report on recent relevant Commission activity and offer some estimates of the economic gains that might result.

Ensuring that European standardisation organisations are fully open, transparent and responsive to market forces...

In the Commission’s view¹⁰, good standards making is assured by standardisation agreements being adopted by recognised independent standards organisations. That view is justified by two particular principles underlying the way those organisations develop standards. First, market needs drive the choice and development of most of the fast increasing number of standards. Why else would market players cover 90% of the costs of standardisation? Second, standards are developed openly and voluntarily, emerging out of the consensus of all interested parties – which means, as far as possible, all stakeholders (producers, users, consumers,...).

The Commission restricts its role to maintaining an open, impartial standardisation infrastructure. Interested stakeholders whose resources are so limited (e.g., consumers, health and safety experts, SMEs) that they would probably not normally participate in standardisation activities are provided with financial help. Similar help may supplement efforts to “green” the standardisation process.

Standards organisations face stiff challenges...

Standards must meet market needs and be developed quickly. Speediness poses a stiff challenge to standards organisations with their very open attitude to all stakeholders (which, unsurprisingly, makes it more difficult to reach a consensus). Private consortia and fora have sprouted in areas where standards organisations have not been fast enough. As reported in the November 2001 Scoreboard, CEN, one of the European Standards Organisations (ESOs), now takes 8 years to draft and obtain consensus on a European standard compared to 4.5 years in 1995. ESOs have tried to meet this challenge in two main ways. First, by improving their performance (by using more information technology and by benchmarking best practices). National Standards Organisations (NSOs) are doing the same, sometimes with Commission financial support. Second, by developing a wider range of deliverables, e.g. Workshop Agreements. However, these new deliverables are not always fully supported at national level. Regular information exchanges should improve the situation.

With their collections of standards growing more alike and ICT making it easy to distribute those standards, even across frontiers, NSOs’ business environment is becoming increasingly competitive. This is putting pressure on their finances. This in turn, puts ESOs’ finances under pressure too as they heavily rely on NSO’s ability to organise the participation of

¹⁰ Report from the Commission to the Council and the European Parliament on the Actions taken following the resolutions on European standardisation adopted by the Council and the European Parliament in 1999 COM (2001) 527.

industry experts in their work (93% of CEN's estimated €700 million costs in 2000 were funded by industry contributions). The situation is growing acute.

One achievement notched up by the ESOs is that more than 80% of standardisation now takes place at the European or international level, as compared to 80% at the national level only 15 years ago. Still, the time taken to arrive at a European standard handicaps work to eliminate technical barriers to trade between Member States; this should be a matter of concern to which particular attention is now paid.

... but progress in standardisation is still being made...

Despite the challenges, standardisation is nearing completion in a number of sectors – weighing instruments, gas appliances, and simple pressure vessels. Meanwhile, after years of deadlock, agreement has finally been reached on the first harmonised standards for construction products – including standards for cement, structural bearing, and lifting plants. More standards should be agreed in the years to come. This should start to open up new, larger markets and increase competition in the sector. Where progress is not made, the Commission will stop financial support. Given the growing financial problems of NSOs, that threat could be a very powerful lever for the Commission.

There are still benefits to be reaped from better application of the principle of mutual recognition...

Mutual recognition (MRP) should apply to products for which no full Community harmonisation applies inside the EU and to products where Member States broadly agree that national regulations can be assumed to offer an equivalent level of protection. Despite only 21% of industrial production or 7% of GDP inside the EU being covered by mutual recognition¹¹, nonetheless problems encountered with the principle's application are having an economically significant impact.

For policy purposes it is interesting to get an idea of the order of magnitude of the maximum potential trade gains that could be expected from the perfect application of the mutual recognition principle in a perfectly integrated Internal Market. Estimates suggest that the value of trade inside the EU in products covered by mutual recognition could, at most, be up to 45% less than it should be (see box 5). That amounts to approximately 1.8% of EU GDP, slightly less than Denmark's entire GDP and slightly more than Finland's. Of course, differences between trade in a perfect internal market and today's real internal market are not just down to failures of mutual recognition. There are a host of other factors other than lack of mutual recognition that cross-border trade has to overcome (e.g., first mover advantage, industrial base, distribution of skills, language, geography, ...). Successfully ensuring the perfect operation of mutual recognition to products inside the EU will not raise, according to these estimates, EU trade by more than 1.8% of GDP. Nevertheless, this figure should be considered as an upper-bound estimate.

Problems with the principle of mutual recognition mainly arise from a limited number of markets, and are mainly the result of uncertainty about the scope and potential of the principle ...

Problems with mutual recognition occur mainly for certain types of foodstuffs, construction products, vehicles excluded from the EC type approval, financial services and professional

¹¹ The single market review, subseries III, volume 1: Technical barriers to trade

qualifications. The Commission is trying to identify better what exactly are the main problems; that way, it will be able to take measures to improve the situation. To that end it held a number of round tables in November 2000 and September 2001 to discuss the issue with economic operators and Member State officials. A clear conclusion of the discussions was the significant degree of uncertainty felt by both economic operators and Member State officials about the scope and potential of mutual recognition. Many economic operators expressed the view that, given a choice between adapting their products to conform to national technical specifications or arguing that mutual recognition should apply, they tend to prefer the former option. It may be costly, but it is less risky if the Member State of destination blindly sticks to its national technical rules without having regard to level of protection offered by the product. Furthermore, some economic operators consider that adapting products saves time compared to the burdensome process of convincing a reluctant national administration or, exceptionally, judicial process, saving time being a virtue when bringing a product to market. In any case, adapting to national technical specifications is less significant for mass-produced products, and not significant for tailor-made products. The problem mainly arises for SMEs, whose production runs may not be long enough to make the cost of adapting to national technical specifications insignificant, or for products whose shelf-life is very limited (especially technology products). The uncertainty felt by national administrators, for their part, made them often too cautious, therefore reluctant to apply mutual recognition except in cases where there is no doubt at all.

In construction products, the first standards have just been adopted – these might finally unblock cross-border trade...

The Construction Products Directive was passed in 1989 (Council Directive 89/106), but it took until April 1, 2001 for the first harmonised construction product standard, covering cement, to come into effect. Since that date, common cement can be “CE” marked and can, theoretically, be traded freely across borders without conformity testing. Cement has since been followed by the adoption of a raft of standards covering geo-textiles, fire-fighting equipment and insulation products.

By making cross-border trade easier, the introduction of standards in construction products might lead to a big expansion of their trade within the EU. There certainly is evidence that trade in construction products has been constrained in the past. Graph 14 shows that trade in construction products within the Community has grown more slowly than manufacturing trade inside the Community. This is true in general, but also for cement and insulation products, both product groups where standards have just been introduced. Furthermore, there really is remarkably little intra-EU trade in portland cement. On average, an EU industry the size of the cement industry should record trade flows between Member States four times larger than the flows it actually records. In other words, there is very little cross-border trade in cement - most Member States’ production is for domestic consumption. Transport costs probably contribute to this situation, but further work will be done to examine how much.

If teething problems with the new regulatory environment can be resolved...

Unfortunately, trade data is not sufficiently up-to-date to be able to spot any possible trade impact from the introduction of the cement standard. However, there is reason for concern about the trade impact; the European Construction Industry Federation asserts that the way various Member States are reacting to the changed regulatory environment is actually making cross-border trade harder than it used to be, at least for products now subject to harmonised standards. As Member States continue to have the right to set their own regulatory levels of protection for works (engineering and construction services), they are not obliged to accept

CE marked products – works incorporating products, even products covered by standards, must still conform to the Member States' own national regulations on works. So, progress on standards in construction products may still not unblock cross-border trade. This leads to clear conclusions. First, the Commission will have to monitor the situation closely in case further action is needed. Secondly, contesting product restrictions must go hand in hand with the contesting of related service restrictions.

In service sectors, targeted actions are in the pipeline to eliminate cross-border market barriers...

The Internal Market Council concluded in March 2001 that “improving the internal market in services is a crucial strategic challenge for the Community. Competition should be reinforced in services sectors, supported by the removal of barriers to cross-border trade and market entry...”. The Commission launched the Services Strategy in January 2001¹². Under the Strategy, the Commission has accelerated work during 2001 to resolve problems in specific areas (e.g., recognition of qualifications and sales promotions); it has also carried out a survey to identify persistent barriers to cross-frontier movement of services. The results of that survey plus written responses from interested parties as well as Member States are being analysed now and will be presented next year. In 2002, the Commission will set a precise timetable for Member States to dismantle specific barriers identified, present non-legislative supporting measures (e.g. codes of conduct) and propose harmonised rules for service provision where strictly necessary. The aforementioned green paper on consumer protection identifies options for harmonisation in some of these areas.

Different market services, different market performances...

Of course, not all EU service sectors' performances are equally poor. A recent survey¹³ carried out for the Commission of eight business service subsectors found that both suppliers and consumers considered the subsector accountancy and audit, and the subsector technical testing non-competitive. Providers of tax services, personnel recruitment and engineering-related consultancy, by contrast, were considered by consumers and suppliers alike to be competitive.

The findings for accountancy and audit may perhaps be because competition on national markets is weak with little cross-border trade. Certainly, the fact that accountancy services are covered by a multitude of diverging national rules and regulations lends itself to market fragmentation. As the sector is rather large, with over 260,000 employees in Italy and France alone, successful actions to reduce market fragmentation may produce significant effects. Furthermore, the removal of such Internal Market barriers could enormously benefit not just the sector itself but also all companies obliged to use these services as inputs thanks to the resulting cut in costs. Technical testing, like accountancy and audit, is also subject to low levels of cross-border trade suggesting, perhaps, the presence of significant Internal Market barriers that again result in reduced levels of competition. Conversely, the relatively positive opinion expressed by survey respondents about labour recruitment may reflect that it is an extremely large, concentrated sub-sector with around half of its 1 million employees based in the UK alone. This concentration implies that cross-border trade is probably quite significant. The sector has grown fast over the last twenty years, thanks to developments such as labour

¹² Set out in a Communication from the Commission entitled “An Internal Market strategy for services”, COM(2000) 888.

¹³ CSES, “Study on obstacles to trade in business services” for the European Commission (2001).

market deregulation, out-sourcing of selection and recruitment, and a general trend towards increasing labour market flexibility. It is estimated that 1.8 million people are working on a temporary basis across the EU, accounting for about 1.5% of total employment.

The prices of services inside the EU have been more stable than overall prices, but their trend has been the same. The increase was only 1 percentage point, from 1.9 percent in June 1999 to 2.9 % in May 2001, compared with an increase by 2.1 percentage points in the overall index over the same period. However, the general trend masks rather different trends in two service sectors: communication services, whose prices are still declining at a reasonable rate and package holidays and accommodation, where prices have increased fastest and with the largest deviation.

Eliminating cross-border barriers to trade in services could have a significant impact...

Various pieces of evidence show why the Council highlighted the crucial strategic challenge posed by the EU's services sectors. The Commission has provided evidence¹⁴ of the importance of services to employment creation in the EU. Regional data shows that services have been by far the most important engine of employment growth throughout the Community in the late 1990s. (Box 6)

Using a survey on business services carried out for the Commission (see box 6), it can be estimated that eliminating barriers to cross-border trade in business services would increase current EU GDP by between 1.1% and 4.2%. However, as business services represent only a third of all services, the impact of integrating all EU service markets could be even larger.

On the other hand, that would only be the initial impact of eliminating trade barriers. If services could be freely traded across borders, a second important economic impact would also result – free trade would open up the possibility to service suppliers of reorganising and restructuring their production capacity in a more rational way, no longer constrained by national frontiers, with the advantages for efficiency and competitiveness that that would generate. So, there is no doubt that substantial economic gains are to be had from creating an internal market for services.

3.2. Capital and financial service markets are reflecting the deterioration of general business conditions...

Financial markets have been leading indicators of the change in business cycle conditions. For instance, stock market capitalisation of domestic firms fell 3,8% in 2000 compared to the previous year. Even before the tragic events of September, euro-zone stock market capitalisation had fallen 19% between January and August 2001 (17,6% for EU 15).

... but there are clear and promising signs of structural changes in financial markets

In this increasingly difficult market context, European firms continued to turn more often to stock markets for funding. The amount of new capital raised by domestic companies in stock markets increased 48,6% in 2000 in the Euro-zone; in the USA with respect to 1999, the increase was much smaller (27%). More significantly, domestic companies newly admitted to European stock markets doubled the amount of capital they raised in 2000 over the previous year. In the USA, such companies only increased new funding by 10%.

¹⁴ Employment in Europe 2001, Recent trends and prospects, Directorate General for Employment (July 2001).

European capital markets are definitely becoming more efficient too. Stock market liquidity increased 86% between 1998 and 2000. The ratio of turnover to market capitalisation has increased from 1.1 in 1999 to 2.1 in 2000.

... and there are encouraging signs of capital market integration ...

Interest rate differentials show that the Euro zone inter-bank market became completely integrated in 1999, a process that started in the mid 90's. Government bond market have also become much more integrated, although small but persistent yield differentials suggest scope remains for further integration¹⁵.

Institutional investors' (pension funds, investment funds and insurance companies) portfolio compositions show progress in capital market integration. In the past, national regulations restricted institutional investors' ability to diversify their portfolios. As a result, their portfolios had a heavy domestic bias, higher risk and gave sub-optimal returns (see graph 15). Now, thanks to Community-driven regulatory changes and the single currency, this is much less the case. Sectoral rather than country diversity may have motivated this diversification, but the result nevertheless is that pension and investment funds' portfolios now have substantially less domestic bias. In March 2001, only 22% of their total assets in equity, money and bond funds were invested in fully domestic funds (excluding Ireland).

How investment funds are composed still varies widely from Member State to Member State. For instance, equity funds are preferred in the UK, bond funds are preferred in Spain, and money funds are preferred in Greece and Sweden. However, as graph 15 shows, there has been an unequivocal reduction in the home bias of equity investment funds.

Pension funds based in countries showing greater capital market integration as reflected by home-bias in the portfolio of institutional investors have also diversified their portfolios most. Domestic equity accounted for 67,6% of EU pension funds' equity assets in 1995. In 1999, this was down to just 60% (see graph 16). However, this broad evolution hides some very startling Member State differences. For instance, in 1995, 100% of Spanish equity assets were domestic and equity had a very small share of total assets. Today, however, equity investments have become more important for pension funds in Spain (as in other Member States), reaching 12% of total assets, yet only 53% of the equity held by pension funds is Spanish. Similar trends have been seen in Portugal, Finland and Sweden.

These structural changes in financial markets have made a significant contribution to economic reform already...

Improved efficiency and increased financial market integration have already paid dividends in the form of lower capital costs. They have also contributed to structural changes in the European economy by facilitating corporate restructuring, mergers and acquisitions, the international expansion of European companies and the radical transformation of some utilities and network industries.

...but there are still more benefits to come from further integration in other market segments.

¹⁵ CSEF "Study to analyse, compare and apply alternative indicators and monitoring methodologies to measure the evolution of capital market integration in the EU" for the Internal Market Directorate General (forthcoming)

Financial integration is not so far clear at the retail level in banking. Bank deposits by non-nationals may have increased slightly between 1997 and 1999, but bank loans to non-nationals actually fell during the same period (see graph 17). Putting euro notes and coins into circulation and introducing the measures foreseen in the Financial Services Action Plan could transform the situation.

Current clearing and settlement systems remain quite fragmented. The economies of scale to gain from integrating clearing systems are potentially large. This, together with the need for risk management standards, demands changes to the current status quo. Prompt policy measures are needed if financial services are to be integrated faster. The sharp increase in the use of collateral for cross-border payments between 1998 and the end of 1999 shows the growing importance of providing a clearing and settlements infrastructure designed for increasingly integrated European financial markets. Several market driven initiatives are already underway to rationalise the securities settlement industry.¹⁶

3.3. Public procurement : markets have become much more transparent in 2000...

The legislative package proposal requested by the Lisbon European Council has been delivered by the Commission and is currently being discussed by the Council. In the meantime, public procurement markets have become increasingly transparent. The percentage of public procurement published in the Official Journal over the total value of public procurement increased 36% in 2000 after relative stagnation in the three previous years (see table 9). The increase was especially significant in Spain, Sweden, the Netherlands, Italy, Austria, Denmark and the UK. However, improvements have not been the same in all countries and as a result, differences in the market transparency of public procurement across Member States have grown.

Registered awards of contracts resulting from cross-border tendering have increased (see graph 18). This might indicate that public procurement markets are opening up to international competition; however, these figures do not capture indirect procurement through affiliates in foreign countries, or through wholesalers, agents and other intermediaries, so it is not possible to draw a clear conclusion. The Commission will collect more reliable information on cross-border figures in the future.

Two recent communications – one on public procurement and environmental issues (COM(2001) 274) and one on public procurement and social affairs (COM(2001) 566) – should improve the environmental and social performance of procurement markets. Meanwhile quick progress is being made with the introduction of new technologies, which should open procurement markets still further.

4. IMPROVING THE BUSINESS ENVIRONMENT: FOSTERING ENTREPRENEURSHIP

Effective competition and entrepreneurship are key to meeting the ambitious competitiveness targets established at the Lisbon European Council. That is a clear message from the Stockholm European Council. Progress towards the Lisbon goals in the area of entrepreneurship and innovation has been assessed in a recent communication (COM (2001)

¹⁶ A group of financial-market participants, under the chairmanship of Alberto Giovannini, which advises the European Commission on financial market issues has prepared a report on EU cross-border clearing and settlement arrangements. The report examines clearing and settlement arrangements for equities, fixed income securities and derivatives.

641 final).¹⁷ It came to the conclusion that the pace of progress has been slower than might have been hoped in March 2000 and warned that Member States' short-term considerations due to the economic slowdown should not further weaken the commitment to substantial reforms.

This following part presents some relevant results on market and policy developments having an impact on the business environment faced by firms in the Internal Market. It focuses mainly on public policies affecting the competitive environment of firms, i.e., state aid, taxation and the regulatory framework. It concludes by summarising recent developments in the financing environment for firms and innovation.

4.1. State aid: Positive developments

The Internal Market Council conclusions of 12 March 2001 requested the Commission to develop and implement new analytical instruments to control state aids. Consequently, in April, the state aid register was made publicly available on the Internet. Then, in July, the Commission published its first state aid scoreboard, which gave a detailed overview of the evolution of different types of state aid.

The latest available figures confirm trends observed over the last four years of the evolution of state aid. Aid to manufacturing fell from 2.6% of manufacturing value added over the period 1995-1997 to 1.9% in 1997-1999. In the meantime, overall aid fell from 1.43% of total GDP to 1.187%.

Lower state aid spending yes, but not necessarily less distortionary spending...

The Lisbon European Council conclusions not only called for cuts in state aids, but also changes in their composition – in particular, increases in the relative weight of horizontal and regional aids at the expense of sectoral aid because the former are considered to distort competition less than the latter (see box 8). In 1999, when the Council made those recommendations, most Member States were already doing one or the other, but only a few were doing both simultaneously. As graph 19 shows, those few were France, Austria, Belgium and, especially, Portugal and Spain. In fact, all Member States with above-EU average state aid spending, including those five, were reducing their state aid levels. The EU's objective of reducing state aid, set by the 2000 Broad Economic Policy guidelines after Lisbon, was therefore being achieved at the time. However, contrary to the objective of changing the composition of state aid to reduce its distortionary impact, sector-specific aid was actually growing increasingly important (see graph 19 and table 10). Note that there was nothing inevitable about that - Denmark and, to a lesser extent, Austria already had state aid levels below the Community average and a far less distortionary structure of aid than was generally true in the EU.

... because some sector-specific aid is resistant to spending cuts...

The persistence of sector-specific aid is due to particular sectors. Some traditional state-aid receiving sectors have faced aid cutbacks, but others – particularly coal and transport - have maintained or even slightly increase their levels of aid, so that sectoral state aids are becoming

¹⁷ The analysis of this communication was based on a series of documents presented by the Commission including the 2001 Competitiveness report (SEC(2001) 1705), the 2001 Innovation Scoreboard (SEC(2001) 1414), the forthcoming Enterprise scoreboard and the 2001 BEST Procedure Report (SEC(2001) 1704).

increasingly concentrated. Apart from those sectors, the pace of sectoral aid reductions in the EU economy as a whole is much more positive. Efforts to cut down aid in the coal and, where possible, transport sectors must be stepped up. Most cuts in state aid spending between 1995 and 1999 came at the expense of regional aid (graph 20).

The best news is the reduction in ad-hoc aid...

Ad hoc aid, which is often one of the most distortionary types of state aid has been dramatically reduced. Total ad hoc aid in 1999 was 10% of 1994 levels. Compared to 1993, state aid to manufacturing in 1999 has fallen by 93%. Declining aid to the new Länder has contributed significantly to this reduction, but significant cuts in aid for restructuring over the last five years have helped too. However, cutting state aids for restructuring is relatively easy in good economic times; the commitment to aid reduction may soon be tested with a downturn in the business cycle.

4.2. Taxation may be producing distortions of business decisions and competition...

EU businesses are presently confronted with a single economic zone in which 15 different company tax systems apply. This generates specific compliance costs, contributes to a lack of transparency and causes losses of economic efficiency. Moreover, the EU companies increasingly no longer define their "home market" as one Member States but rather the whole EU. The resulting structural changes can lead to EU-wide re-organisations, which may be constrained by the need to comply with 15 different tax systems.

An in-depth Commission services study [SEC(2001)1681] on Company Taxation in the Internal Market has analysed how the working of 15 different national tax systems may be producing distortions of business decisions and inefficiencies. The study has identified large differences in the effective rates of company taxation in the EU (see table 11). These differences could impact on economic decisions by both discriminating between domestic, inward-bound and outward-bound investment and influencing the choice of composition of the investment in terms of assets and of sources of finance. The study has also identified a number of fields in which company tax systems may hamper cross-border economic activity in the Internal Market, thus undermining EU companies' international competitiveness.

In order to tackle the existing tax obstacles to the Internal Market, the Commission has proposed a two-track strategy [COM(2001)582] involving both targeted remedial measures and a more longer term comprehensive solution consisting of providing companies with a common consolidated tax base for their EU-wide activities.

4.3. Simplifying the regulatory burden

A recent OECD study has shown that the administrative burden of starting a business is worst for the smallest companies. The Internal Market Council has emphasised that the "administrative and regulatory burdens on businesses, particularly small and medium-sized enterprises (SME), must be further reduced at both Community and national level". The employment performance of such enterprises seems to be most affected by the conditions covering business start-ups. Europe's capacity to improve the quality of regulations and legislation is therefore a vital element in achieving the Lisbon objectives.

At the Community level, several policy measures have been taken. For instance, the fifth phase of SLIM was launched in April (SEC(2001) 575). More comprehensive solutions are underway. The White Paper on Governance (COM(2001) 428) has acknowledged the need

for reducing Community legislation. A Commission Communication An Action Plan to improve Community legislation will be submitted to the Laeken European Council. An Action Plan will then be submitted by June 2002. The Communication It stresses that the improvement of the regulatory environment has to become one of the first political priorities of the European Union. The ultimate objective is to make European companies more competitive; but the immediate and most urgent objective is to facilitate the understanding of Community interventions by European citizens. Only simpler and easier to understand proposals can be more widely accepted by Europeans. This is essential to ensure the capacity of action needed by the Union to confront the political challenges ahead, starting with enlargement. To this end, the action plan will identify identifies about 30 concrete actions, which should be implemented already in 2002. They are intended for the Commission itself, to the European Parliament, the Council and the Member States. The action plan will likely focus on three aspects, proposes three specific objectives. First, the simplification and consolidation of the 'acquis communautaire' by the means of consolidation, codifying, recasting and simplification; secondly, the improvement of the legislative cycle of the acts arising from the Treaty through better preparation and evaluation of proposals for acts, simplification and acceleration of the procedure of adoption of acts, and improving the transposition and application by the Member States and the implementation and the follow-up by the Commission; finally, the development of a new political and administrative culture by setting up a decentralised internal network in the Commission to follow, check the application of this operational programme and the quality of legislation and to promote the most effective practices with the human and financial resources. For more effectiveness, this network should widen in the Council and in the European Parliament and collaborate with corresponding structures in the Member States.¹⁸

It is, however, the national level where regulatory changes are first perceived by companies and new data suggests that there is scope for improvement in many Member States. Recent studies conducted by the Austrian authorities and by the Commission show significant Member State differences in terms of the time and money needed to set up a company. Methodological issues may blur the results for individual Member States, but there is an unquestionable conclusion: starting a business in the EU is substantially harder than in the USA - the Austrian study estimates that, for an identical company, starting-up costs just €171 in the US compared to the EU average of €1,625 (see box 10).

On the other hand, Member State measures to reduce the regulatory burden facing firms and promote entrepreneurship do seem to be having a real impact – less time and money is required to launch a new firm. The 2001 Best Procedure report (SEC (2001) 1704) presents the most successful recent experiences in this field. In presenting its results in March 2002, the Commission's benchmarking exercise on the administration of start-up procedures will provide clear indications on where further progress can be expected in this field, while similar projects under the Best Procedure are addressing other aspects of the whole process of business creation, growth and exit.

4.4. The improving financial environment of recent years must be safeguarded against the deteriorating economic climate...

The **risk capital market** in Europe grew fast in 2000. Data shows that venture capital funds raised far exceeded investments in Europe (see graph 21). A growing share of private equity investments are flowing into seed and start-ups, i.e. young enterprises. These two types of

¹⁸ Action is also needed to improve the regulatory environment in labour markets as pointed out by the 2001 Joint Employment Report, especially as regards the fight against undeclared work.

investments absorbed 19% of private equity investment in 2000 compared to 6.5% in 1996 (see table 12). Growth in total seed and start-up investment was striking, up by nearly 115% at €6.4 billion in 2000. On the funding side, nearly €9 billion of the venture capital raised was expected by fund managers to be directed towards early-stage investments in 2000.

Growth has been shared by all Member States even though important differences persist, reflecting the presence of a fairly fragmented pan-European market. But, despite its growth, the European market is still small compared with that of the US. US early-stage investments amounted to more than total European venture capital investment and more to than 4 times European early-stage investment.

The global figures for 2000 mask the slowdown that occurred in the latter part of the year, which may affect investment in seed and start-up segments disproportionately. The new climate of uncertainty, if it persists, may lead to industry consolidation. If anything, current difficulties and the wide gap with the US should be an additional stimulus to accelerate completion of the Risk capital action plan (RCAP).

Sectoral analysis of investments reveal that the high-tech sector's share of total investments increased over 50% in the five-year period 1996-2000. The amount invested in high-tech increased by about 70 percent from 1999 to 2000. However, biotechnology's share of investment hardly changed, reaching 2,9 percent in 2000, growing in line with total investment.

Funds are being mobilised due in part to the Risk capital action plan, but now reflection is necessary about the next steps...

Developing **financial intermediaries** capable of meeting the challenges posed by the new economy may be crucial to ensuring the best possible performance of risk capital markets. Business angels can be essential factors in the financial support of start-ups. By funding projects that are generally too small for venture capital institutions, business angels can provide exactly the crucial link between liquid capital and entrepreneurs. They often provide not just money but also valuable business know-how. However, business angels networks are still relatively underdeveloped in most EU Member States compared to the US. Public financial support for start-ups and early stage investments such as that provided by the EIB therefore represent important 'second-best' catalysts by providing initial investment through venture capital funds. Public support measures should concentrate on cases where market failures appear –specially to avert their impact on small enterprises. Those measures will have a more efficient and less distortionary impact on competition if investment risks are shared with private investors and public authorities.

The recent Commission report on the RCAP underlined the importance of entrepreneurship and innovation. The plan's important contribution to the development of risk capital markets and entrepreneurship in general is the mobilising of funds for risk capital and the stimulation of demand for those funds. More dynamic and innovative markets are the necessary complement to foster the development of risk capital markets.

4.5. Innovation: essential for competitiveness and a fundamental objective of economic reform

Innovation, one pillar of the Lisbon strategy, is an area of increasing concern for Community policies. The recent Innovation Scoreboard (SEC(2001) 1414) provides interesting evidence on progress made and on weaknesses in the European system of innovation.

The Internal Market has two main impacts on innovation. First, by making it easier to import capital goods embodying technological change, the Internal Market spurs innovation in Europe, especially in the least technologically advanced Member States. According to a recent Innobarometer survey (Eurobarometer 100, which collects the views of a poll of European managers of companies on their innovation experience and priorities) acquiring high-tech equipment is considered the main source of technological innovation for a large majority (61 %) of European firms (note that the second main source of technological change reported is via co-operation with suppliers and / or customers; as the Internal Market necessarily expands the possible network of contacts with clients and providers, it must contribute to innovation through this channel as well) (see graph 22).

Secondly, the Internal Market contributes to innovation and creativity by providing the necessary enabling regulatory environment – in particular, an efficiently functioning Internal Market for technology and industrial and intellectual property rights. In the Member States with the strongest technological performance, technology acquisition is either direct or takes place via internal or external R&D. Graph 23 shows the relative importance of the market for technology (e.g. contractual R&D plus licence acquisition by EU Member States).

The importance of intellectual and industrial property rights (IPR) protection for innovation is well known. In a competitive world where technology determines market success, legislation to protect IPR has to be adapted to the new competitive environment. Table 13 shows that “time advantage” –i.e., not patenting and keeping the innovation secret in order to benefit from the time advantage of being the first innovator- is the strategy of technological knowledge protection preferred by European firms. The relatively low percentage of firms using patent protection is an indication of the current unsuitability and limitations of patenting in Europe. The Community Patent directive proposal should be adopted as soon as possible. It will make easier and cheaper the use of IPR, thereby increasing the incentives to innovate and facilitating the dissemination of innovation instead of keeping innovations secret, reduce the costs of patenting and diffuse technological progress in Europe especially for SMEs. In the area of copyright, the recently adopted Directive on Copyright and related rights in the Information Society (Directive 2001/29) will have a positive impact on innovation and the business environment. It updates the legal framework of copyright and related rights to respond to the new challenges of technology with a particular emphasis on products and services (both on-line and on physical carriers).

New methods of IPR infringement and the shortening of product life cycles demand faster, more efficient registration procedures to protect IPR. The Commission is determined to ensure the best possible, most suitable framework for EU and global IPR protection.

5. CONCLUSIONS

Recessionary risks put the process of economic reform to its first real test. The Commission has delivered, or is in the process of delivering, proposals for policy measures requested by the Lisbon and Stockholm European Councils. Implementing those measures will in any case take time, especially if resistance to reform is encountered in some areas, but it is more than ever important to stick to the agreed timetables. Now, as 2001 nears its end, the EU’s main assets in confronting possible external shocks are the single currency and the Internal Market. Steps must be taken to ensure the best possible functioning of our economic and monetary union; that is the key to minimising the impact of external shocks. This report has suggested which steps should be the priority.

- Evidence provided in this report and in the May 2001 Internal Market Scoreboard show that goods markets remain insufficiently integrated and competitive; nonetheless, integration has advanced significantly over the last ten years in many sectors. Although intra-EU manufacturing trade continues to grow, sectors such as construction products clearly fall short of optimal market performances. Foreign direct investment has grown rapidly but in a very unevenly distributed way across countries. The causes of this situation should be monitored. Sector specific actions to effectively eliminate trade barriers are needed at the EU level. Improvements to standardisation should play a greater role in the future to render the Internal Market more efficient. So could actions to improve competition at the national level. Distribution clearly needs increased attention.
- Service markets offer the biggest potential gains from further Internal Market integration. Estimates show sizeable potential returns from implementing and enforcing policy measures to be submitted by the Commission next year.
- Integration in financial services and capital markets is progressing, as is the implementation of the FSAP and RCAP; however, market developments call for speedier adoption and implementation of measures. Rapid introduction of reforms will be vital, especially in the area of prudential supervision. Commission proposals to integrate retail financial markets will contribute to the successful introduction of the euro and improve the performance of some segments of those markets. In wholesale financial markets, clearing and settlement systems require changes so as to make them more efficient, particularly for cross border transactions. The financial environment of firms, especially start-ups, has improved substantially in recent years. Those improvements must be consolidated. To achieve these objectives, it is indispensable to make progress faster on the legislative and regulatory front as stated in the Fifth Implementation report of the FSAP and in the implementation initiatives of the Lamfalussy Group.
- Structural measures to improve entrepreneurship are needed to meet the desired competitiveness objectives established at Lisbon last year. This is essential to ensure the European economic and social model's viability in the new knowledge society. These are long term objectives, but action must start now to ensure an efficient regulatory and legislative environment along the lines put forward by the White Paper on Governance. A good place to start would be legislation and mechanisms to protect and enforce industrial and intellectual property rights. The Commission proposal to remove tax obstacles in the Internal Market and pave the way for an EU consolidated tax base will contribute to the international competitiveness of EU business in line with the goal established at the Lisbon European Council.
- Integrating sustainable development objectives in Internal Market policies is underway. Regulatory and sustainability impact assessments and the development of a diversified range of market instruments to achieve environmental policy objectives are the key to ensuring sustainability and an improved quality of life for citizens.