

- The **Lisbon European Council of March 2000** marked a decisive change in the way EU economic policy is devised; away from legislation and uniformity, and towards the more flexible ‘open method of coordination’.
- This new approach began in 1997 at **Luxembourg**, with agreement to combine collective Employment Guidelines with National Employment Action Plans. After further refinement under subsequent EU Presidencies, and culminating in the ‘**Lisbon process**’, regular high level review of reform policies by EU leaders emerged as a corner-stone of EU economic policy-making.
- Lisbon set the ambitious objective that the EU “*become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs, and greater social cohesion*”.
- The **strategic route map to this ten year goal** spans employment, innovation, social policy and the Single Market. It offers a range of targets, structural indicators, and opportunities and obligations to exchange opinions and experience through peer-review and benchmarking. Two years down the road, Member States have made some progress. To reach their destination, however, they are going to have to travel further and faster.

INTRODUCTION

“Lisbon was a success because it showed that Europe was ready for change. Globalisation of the economy and the appearance of new technologies have transformed the world... The EU has to be at the forefront of this new order and act as a world leader, striving towards a dynamic and competitive Europe that is confident of its potential.” (Programme of the Spanish Presidency of the EU)¹

Lisbon: a decisive change in economic policy making

3.1 The Lisbon European Council in March 2000 was devoted to economic reform and marked a decisive change in European economic policy-making. Heads of State and Government set out their strategic goal for the EU in 2010: “*to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion*”.

3.2 The Lisbon route-map encompasses innovation, the Single Market, employment and social policy (Table 3.1). The agreement represented the culmination of three years of work on a new economic and social policy framework which recognised that, despite the significant progress already highlighted in Chapter 2 above, further reforms were necessary to deliver faster growth, higher productivity, and increased employment across the EU.

¹ “More Europe”: Programme of the Spanish Presidency of the EU 1-1/30-6-2002’, www.ue2002.es/principal.asp?opcion=3&idioma=ingles

Table 3.1: Lisbon's strategic goals

Innovation	Economic Reform for Single Market	Employment	Modern Social Agenda
<ul style="list-style-type: none"> • Legal framework for E-Commerce in 2000 • Fully liberalised and competitive telecoms market in 2001 • Internet access for all schools in 2001 • Community-wide patent in 2001 • Government procurement and access to basic public services on-line by 2003 • Better quality of EU regulation 	<ul style="list-style-type: none"> • Faster liberalisation of gas, electricity and transport • EIB to channel € 1bn of venture capital support to SMEs • Reduction in state aid • Small Firms Charter by 2000 • Strategy for removal of barriers to services in 2000 • Implementation of Risk Capital Action Plan by 2003 • Implementation of Financial Services Action Plan by 2005 	<ul style="list-style-type: none"> • Increase EU employment rate by 2010 to 70 per cent overall and 60 per cent for women • Europe-wide data base on jobs and training • Benchmark provision of lifelong learning • Award for companies that invest in employees • More effective Employment Guidelines (Luxembourg process) • Increased per capita investment in human resource 	<ul style="list-style-type: none"> • National action plans to combat social exclusion • Halve, by 2010, the number of 18-24 year olds excluded from the labour market • Report on sustainability of pensions in EU • Set a benchmark for improved childcare

3.3 The **new policy framework**, overseen by the European Council and supported by the Commission, tilts the balance away from the traditional reliance on intervention and regulation, and towards a lighter approach intended to foster enterprise, innovation and competition. Rather than seeking to standardise or harmonise policies at an EU level, it uses, where possible and appropriate, peer review and national benchmarking to develop and promulgate best practice. The Government, recognising the UK's interdependence with other EU economies, and in close cooperation with its European partners, has been at the forefront of developing this approach.

Annual stock-taking of progress on reform 3.4 The result is that **economic reform has become an established feature of the post-Lisbon landscape**. The European Council meets on an annual basis to discuss progress to date and forthcoming priorities, drawing in the process on contributions from the European Commission and the Council of Ministers, as well as from each individual Member State. The next opportunity for Heads of State and Government to undertake such an assessment is under the Spanish Presidency at **Barcelona, 15-16 March 2002**.

Box 3.1: The road to Lisbon: developing the new agenda for economic reform

The first important step towards a changed approach to economic reform came during Luxembourg's EU Presidency in 1997. In November of that year, at a special meeting of the European Council aimed at 'getting Europe back to work', EU leaders launched an initiative on labour market reform. This '**Luxembourg process**' entailed agreed **Employment Guidelines**, and the drawing up by each Member State of **National Employment Action Plans** outlining how these Guidelines would be met. Despite its basis in the Treaty, the process rests on peer review and on the exchange of information, ideas and experience; for the EU in 1997, a whole new way of doing business.

The following year, economic reform was a key theme of the UK's EU Presidency. The Cardiff European Council endorsed the lighter procedural touch, agreeing that Member States and the European Commission would produce short end-year reports on progress in product and capital market reform (the '**Cardiff process**'). This new approach to policy-making was extended and refined under the subsequent Austrian, German (the '**Cologne process**' of macroeconomic dialogue) and Finnish Presidencies of 1998 and 1999.

HOW LISBON WORKS: THE NEW POLICY AGENDA

3.5 A new policy framework requires a new policy process, led in the case of Lisbon by Member States in the European Council, and implemented by the Council of the European Union, the European Commission and the European Parliament. The annual spring European Council plays, as we have already noted, a central role in maintaining momentum and setting priorities.

The open method of coordination 3.6 Lisbon marked a recognition not only that all EU economies needed to undertake further structural reforms, but also that the traditional Community method, which had served the EU well in the construction first of a Customs Union and then of a Single Market, would not always be appropriate to this challenge. The construction of a Single Market had inevitably entailed (and in the case of Financial Services and other areas where a true EU market remains incomplete, continues to entail) a raft of Community legislation. In the bulk of other areas covered by Lisbon, however, national reforms tailored by, and designed to fit, individual Member States' circumstances will be more appropriate and effective.

3.7 This open approach to policy making demands **regular and rigorous peer reviews** to assess reforms dispassionately; forums designed to facilitate the **sharing of best practice**; and **effective communication** between individual national governments and with EU institutions. More specifically, it entails²:

- agreement on **guidelines** at an EU level, combined with specific timetables for achieving short, medium and long term goals;
- the publication of appropriate quantitative and qualitative **indicators** and benchmarks, taking into account best practice elsewhere in the world;

²Presidency Conclusions – Lisbon, 23 and 24 March 2000.

<http://ue.eu.int/Newsroom/LoadDoc.asp?BID=76&DID=60917&LANG=I>

- the translation of EU guidelines into national and regional policy via **specific targets and measures**, taking into account national and regional differences; and
- **periodic monitoring, evaluation and peer review**; continuous mutual learning, as in the Cardiff and Luxembourg processes.

The coordination of reforms

3.8 Non-binding recommendations for economic reform are coordinated by ECOFIN, through the Broad Economic Policy Guidelines or BEPGs (Box 3.2). ECOFIN also incorporates contributions from other Councils with responsibility for specific policy areas, eg. the Employment and Social Policy Council. The BEPGs are supported by analysis of agreed performance indicators, and by more detailed processes of peer review (some of which will have been carried out by other Councils). They encapsulate the new policy approach: macroeconomic stability coupled with microeconomic reform targeted at increased employment and productivity.

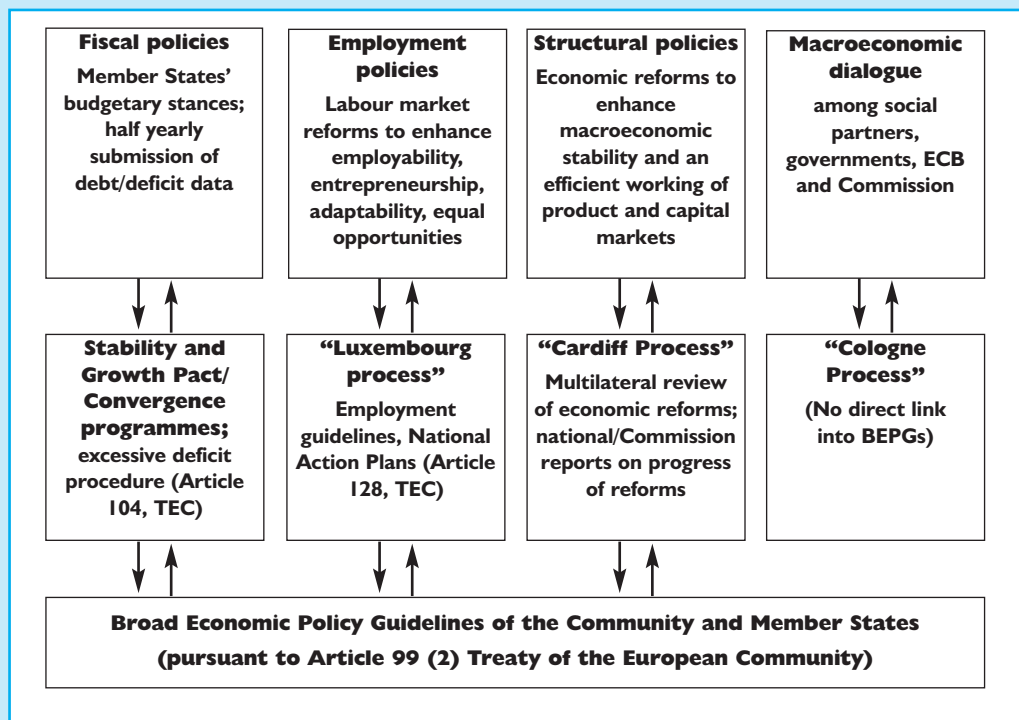
3.9 Even in those areas in which new Community-level legislation is required to complete, maintain and strengthen the Single Market, the Government believes that, consistent with the Lisbon approach, this legislation should be no more prescriptive for Member States than it needs to be. It should also avoid excessive harmonisation in favour of promoting the role of **mutual recognition** in constructing a true Single Market.

Box 3.2: The Broad Economic Policy Guidelines

The Broad Economic Policy Guidelines (BEPGs) encapsulate the open method of coordination. Formulated by ECOFIN, they draw widely on the contributions of the Commission, the priorities agreed by the annual spring European Council on economic reform, and the contributions of other Councils concerned with particular policy areas. Through the BEPGs, Member States and the Commission can monitor EU and national progress across a range of performance objectives:

- growth and stability;
- fiscal consolidation;
- improved quality and sustainability of public finances;
- appropriate wage developments;
- a knowledge-driven economy;
- efficient product markets;
- broader and deeper capital markets;
- invigorated labour markets; and
- sustainable development.

How the BEPGs work: the co-ordination of economic policies in the EU³



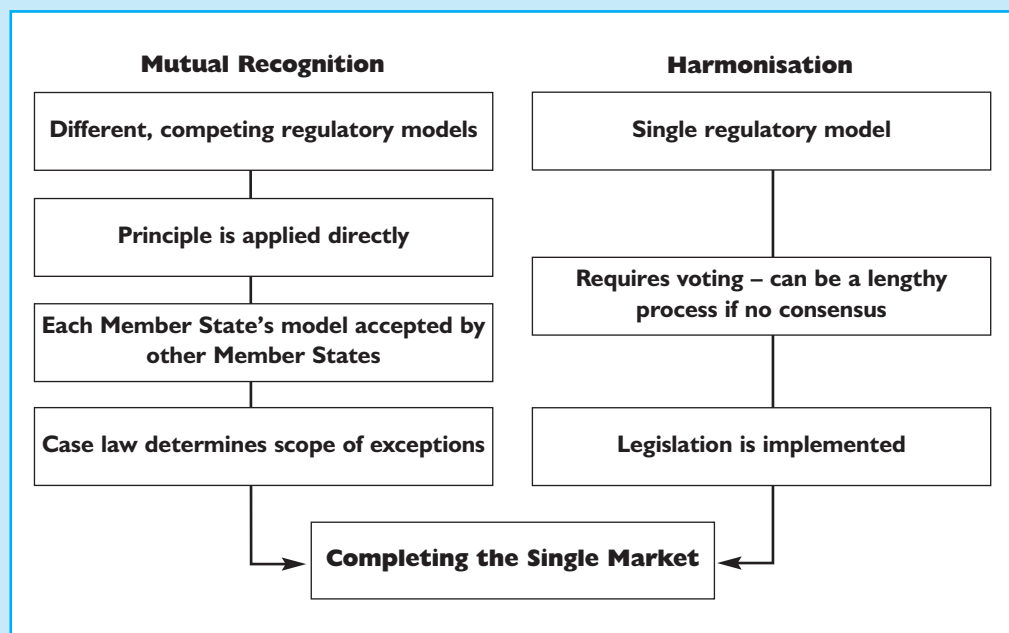
Source: European Commission, DG-ECFIN.

Overall progress on microeconomic reform is assessed against the ECOFIN structural indicators as agreed at the Nice European Council of December 2000.

³ Within EMU, there is also informal coordination at the Eurogroup between the independent monetary authority (the ECB) and decentralised but coordinated fiscal authorities.

Box 3.3: Mutual Recognition: different solutions to common problems

Mutual recognition asserts that goods and services provided lawfully in one Member State must also be lawful in any other Member State; a principle upheld in a landmark European Court of Justice judgement – the “Cassis de Dijon” case of 1978. It respects differences in legal frameworks or circumstances, and recognises that different solutions may be a more efficient means of tackling a common problem than harmonisation. Member States may only act against the principle of mutual recognition in very limited circumstances involving “overriding requirements of general public importance”, for example: public health, protection of consumers or the environment. Any measures taken by Member States must be both necessary and proportionate. As the diagram shows, mutual recognition and harmonisation can each lead, via different but entirely compatible routes, to completion of the European Single Market.



A broader application of mutual recognition

3.10 Since Lisbon, in the field of financial services legislation, Baron Lamfalussy has recommended a style of legislating (explained further in Chapter 6) based on **framework principles** agreed at the political level. This approach could, in the Government’s view, greatly improve the quality of legislation and speed up the construction of a proper Single Market. The Government believes that the Lamfalussy model could have wider application in other comparable fields.

3.11 The Government likewise believes that the mutual recognition model, which has generally served the EU well in building a functioning Single Market in industrial goods, needs to be taken further in services markets, where progress has been more patchy. The **1985 EU White Paper**, *Completing the Single Market*, proposed that the Community should rely as much as possible on the principle of mutual recognition, confining further regulation to essential objectives and requirements. The aim should remain that of ensuring that the provider of services faces only a single set of rules when selling throughout the EU. As a matter of both economic principle and regulatory practice, mutual recognition of established practices recognised by the provider’s home state authorities is far preferable to time-consuming and unnecessary attempts to achieve complete harmonisation of rules across 15 (and soon to be many more) Member States.

3.12 What mutual recognition does require is high levels of trust between national regulators, sustained by full and transparent exchange of information and agreement on the core standards national regimes need to embody. This inevitably means some scope for regulatory competition between different regimes, but the Government does not accept that mutual recognition must invariably lead to detrimental regulatory competition and a **'race to the bottom'**. Advanced economies such as EU Member States have a vested interest in establishing and preserving a reputation for regulatory rigour and legal efficiency among corporate and institutional investors. Competition between governments keen to attract and retain investment is more likely to encourage a raising than a lowering of standards. In economic terms, the continuing presence of some regulatory competition, coupled with Lisbon-type processes to benchmark and peer review Member State regulatory regimes, will lead to better outcomes for the EU as a whole than would a single harmonised regulatory model.

TAKING DECISIONS AT THE APPROPRIATE LEVEL: TAX POLICY

3.13 The same essential principles underpin the UK's approach to EU taxation. The Government's approach can be encapsulated as 'competition where possible, coordination where necessary', and rests on three foundations:

- first, **taxation is a matter for Member States**, in keeping with the principle of subsidiarity;
- second, tax reform should **promote wider economic reform** and not create additional barriers to trade; and
- third, the economic priority for Europe is **reform to promote growth, prosperity, jobs and social inclusion**. Any proposals on tax must be, and must be seen to be, consistent with this agenda.

Unnecessary tax harmonisation

3.14 In practice, this means that **the UK Government opposes unnecessary tax harmonisation** which would constrain Member States' economic success. It does not accept that tax harmonisation is an inevitable consequence of EMU. EMU does not require, either in principle or practice, the harmonisation of direct taxation. US experience shows that a monetary union can function effectively while maintaining independence on tax rates and tax takes. It also demonstrates that 'harmful' tax competition between states and regions is best tackled by improving the flow of information between tax authorities, not by harmonising the rates.

3.15 It is important not to confuse the case which might be made for better and more intense communication over the appropriate policy mix between the single monetary authority and the multiple fiscal authorities inside EMU, with the case for more harmonisation at EU level of specific individual taxes. In practice, the two might well point in opposite directions. In the absence of national monetary autonomy, and in the likely absence of the degree of internal labour mobility experienced in the US, those Member States inside a monetary union might need fewer rather than more constraints on variations in their individual tax rates and bases.

3.16 The Government does not accept that there is an inevitable path leading from monetary, via fiscal, to political union. On the contrary, it believes that Lisbon and Feira (at which the EU agreed to the UK's proposal as the way forward on the savings tax issue – see paragraph 3.19) marked a decisive break with a centralising and harmonising approach to EU economic integration. These Councils also saw widespread recognition that a much less centralised and prescriptive approach, reliant on peer review and the exchange of information, marked the road the EU should take to tackle structural reform.

Fair tax competition 3.17 **Fair tax competition** recognises that Member States have different preferences on the level of social provision and the size of the public sector and, accordingly, on required tax takes and types of tax. Fair tax competition, unlike harmonisation, allows governments to reflect national preferences concerning the role, structure and aims of taxation.

Unfair tax competition 3.18 **Unfair tax competition** stands in sharp contrast to this; tackling unfair tax practices, in and beyond the EU, is an important Government priority. Unfair tax competition is not about one Member State adopting a lower general rate of tax than another. Under international agreements this is neither unfair nor harmful. A measure might, however, be potentially harmful if it provides for a significantly lower tax rate than that which generally applies in a Member State, for example through tax breaks limited to particular regions or sectors. (This approach has parallels with policy on state aids, outlined elsewhere in this paper.) Tax systems should not discriminate between similar companies engaged in similar lines of business. The UK strongly supports steps to promote **the roll-back of anti-competitive discriminatory practices**.

3.19 Evidence of discrimination in, or abuse of, tax systems often prompts calls for tax harmonisation within the EU. Instead of pressing on with unnecessary and undesirable harmonisation, the EU needs to make a concerted effort to tackle ‘unfair’ tax practices, promote fair tax competition, and fight tax abuse and evasion directly. The UK’s proposals to counter tax evasion on EU cross-border savings, for example, therefore centred on the automatic exchange of information rather than an unnecessary harmonisation of withholding tax which would have undermined the rights of national governments concerning taxation of residents. The UK does, however, recognise that a higher degree of coordination within the EU may be necessary to achieve wider objectives in some areas; hence its support in principle for a framework for energy taxation throughout the EU.

LISBON: ALREADY DELIVERING ON ITS COMMITMENTS

A good start 3.20 As is readily shown by the EU’s structural indicators and highlighted in a range of dossiers, the new policy framework has already taken forward reforms in the two years since Lisbon, including the Stockholm European Council in March 2002 under the Swedish Presidency of the EU. These have been across the range of priorities: some of the most notable are summarised in Table 3.2.

Table 3.2 What has been achieved since Lisbon and Stockholm

Innovation	Economic Reform for Single Market	Employment	Modern Social Agenda
✓EIB to channel € 1 bn of venture capital support to SMEs	✓Further postal services liberalisation in 2001	✓Five million new jobs since Lisbon	✓Social inclusion programme and indicators
✓Fully liberalised and competitive telecoms markets in 2001	✓State aids register and scoreboard by July 2001	✓Implement mobility action plan	✓National action plans to combat social exclusion
✓Rules for e-invoicing	✓Strategy for removal of barriers to services in 2000	✓High-level task force on skills and mobility	✓Report on sustainability of pensions in EU
✓European innovation scoreboard			
✓Regulatory framework for radio spectrum and broadband			✓ Sustainable development action plan June 2001
✓Small Firms Charter by 2000			

WHAT NEXT?

Maintaining the Lisbon momentum

3.21 The evidence shows that the EU has made **substantial progress since the establishment of the Single Market**, while raising living standards for its citizens. Comparison with its largest trading and investment partner, the US, illustrates just how much more on productivity and employment remains to be done.

3.22 The **Lisbon European Council** has responded to this challenge with a comprehensive ten year programme intended to tackle the EU's remaining economic weaknesses while preserving and enhancing its social cohesion. The Government strongly believes in and supports these aims: economic prosperity must go hand in hand with social justice, and the best safeguard against social exclusion is a job. Furthermore, economic and social reform can help promote sustainable development, ensuring a better quality of life for both current and future generations.

3.23 The UK is fully engaged in the new processes of **open coordination** in EU economic policy-making, and is committed to playing a leading role in Europe's reform debate. In the remainder of this White Paper we focus on those key areas – the factors influencing productivity, and the causes of low employment and social injustice – which are central to realising the Lisbon objectives.

3.24 In the near term, and especially at Barcelona, particular attention should be paid to those issues on which action has been promised, but movement is not yet apparent. To cite the succinct comment of Internal Markets Commissioner, Frits Bolkestein: *“Member States are strong on rhetoric, weak on actions. There's much poetry but precious little motion.”*⁴

3.25 A key theme running through this White Paper **is that reform of Europe's product, capital and labour markets can and should – and must – benefit all sections of society and raise living standards**. The Government believes that, as outlined at Lisbon, this is possible. It also believes that, with concerted effort from Member States and the encouragement of EU institutions, it is realistic.

⁴ Institute of Economic Affairs conference, London 19 November 2001.

- Competition drives **strong and efficient growth**, whether of the overall economy or the individual firm. It stimulates cost reduction and innovation, and it ensures that the benefits of these are passed onto consumers in the form of lower prices, increased quality and/or greater choice.
- **Strong competition needs also to be fair**; level playing fields require expert attention and monitoring. The Commission should be supported in its efforts to pursue a strong, pro-active, independent and economically rigorous competition policy, and Member States should be similarly ambitious with respect to national competition policy.
- **Effective state aid** is essential to a competitive and prosperous economy. However, less and better state aid is required if it is to be effective: eliminating that which undermines competition, targeting aid to improve the efficiency of the Single Market, and ensuring the state aid regime operates effectively.
- **Too much of the EU economy remains protected from vigorous competition.** Extending and completing the Single Market remains a key priority; in particular in agriculture, to deliver sustainable rural development and meet consumer demands on food safety, choice and the environment; in services, to deliver the potential for greater trade and productivity; in aviation, to remove the pervasive influence of governments and normalise and liberalise the treatment of this sector; and in energy.
- The **Single Market programme**, domestic reforms, and the gradual replacement of state-owned monopolies by non-protected, private companies have done much to enhance EU competition, and **Spain's priorities for Barcelona** (especially with regard to the single energy market, and transport and communication) provide further welcome momentum.

INTRODUCTION

“All of the work that we do boils down, in the end, to the ultimate goal of competition policy; fair competition serves the European citizen, the European consumer. This is not an abstract concept, but has tangible effects on each single consumer...” (Mario Monti, Competition Policy Commissioner)¹

Competition; fuelling growth

4.1 Competition drives **efficient and strong growth**, whether at the level of the overall economy or the individual firm². It ensures that the benefits of cost reduction and innovation are passed on to consumers in the form of lower prices, increased quality and/or greater choice. In that small number of sectors that constitute ‘natural’ monopolies, regulation may have to be employed to achieve the same result. Strong and fair competition is by far the preferable alternative from the perspective of consumers, companies and governments alike.

¹ “Content, competition and consumers; innovation and choice”, speech in Stockholm, 11 June 2001.

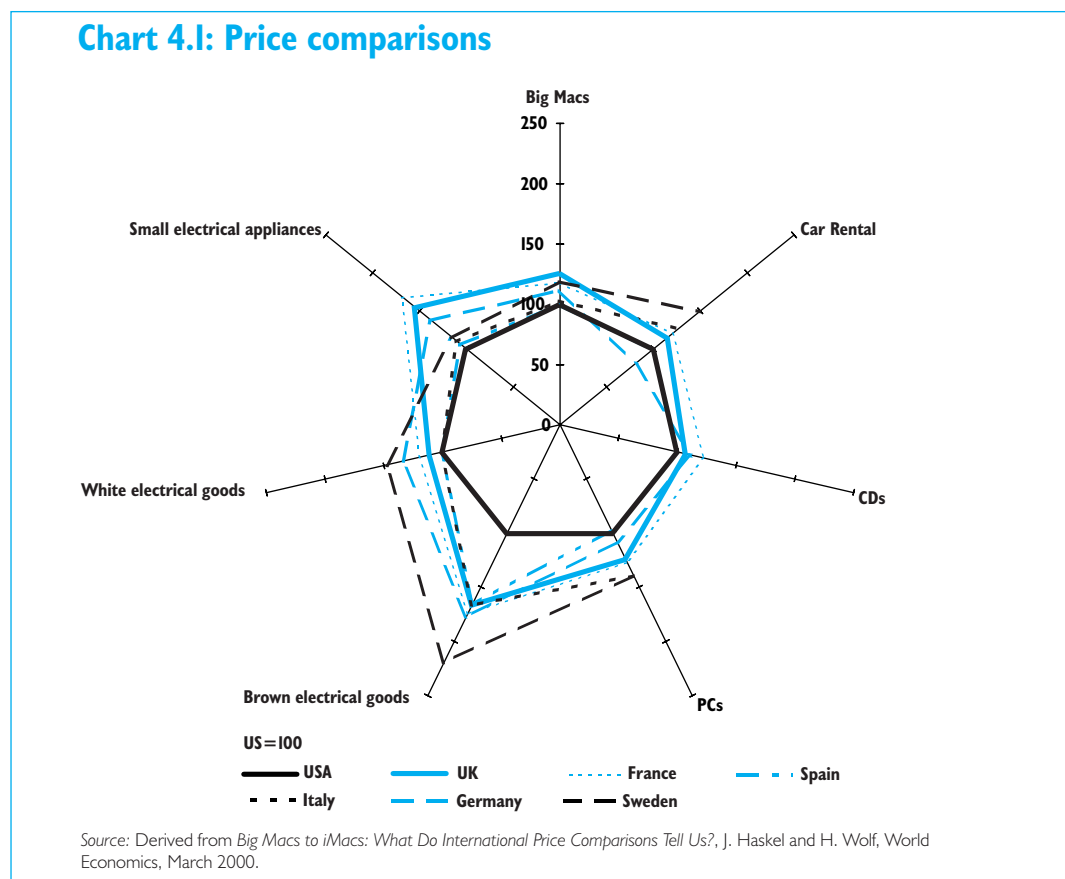
² See for example *Competition and Corporate Performance*, S. Nickell, *Journal of Political Economy* 104(4), 1996 and *Dynamic Count Data models of technological innovation*, Blundell, Griffith and Van Reenen, *The Economic Journal*, 105, March 1995.

4.2 A competitive environment is conducive to a more efficient allocation of resources, both within and between firms. Academic literature suggests that this latter effect – the shift of resources away from inefficient firms to more productive and innovative competitors, and especially to new entrants³ – is particularly important. While new entrants are generally less productive at the outset than most incumbents, those which survive quickly improve their performance, raising the overall level of productivity⁴. One of the most important challenges for any competition authority is that to prevent or remove obstacles which might prevent or dissuade new arrivals from entering any market.

4.3 Within the EU, **the Single Market programme** and a succession of **domestic reforms**, where state-owned monopolies have been replaced by non-protected private sector companies, have done much to enhance competition. As shown in Chapter 2, this has brought significant benefits to both EU firms and consumers. Nevertheless, studies indicate that competitive intensity in Europe (and Japan) remains considerably lower than is the case in the US⁵.

The high price of low competition

4.4 Recent evidence is provided by Haskel and Wolf⁶. Chart 4.1, derived from this study, presents a range of price level comparisons with the US. The most striking feature of their work is that **prices across the EU are consistently higher than those in the US**.



³ *Contestable Markets and the Theory of Industry Structure*, W. Baumol, R.D. Willig and J.C. Panzar, 1982 and *Competitive Advantage: Creating and Sustaining Superior Performance*, M. Porter, 1985 for example argue that entry, and the threat of entry, are important determinants of overall competitive pressure in a market.

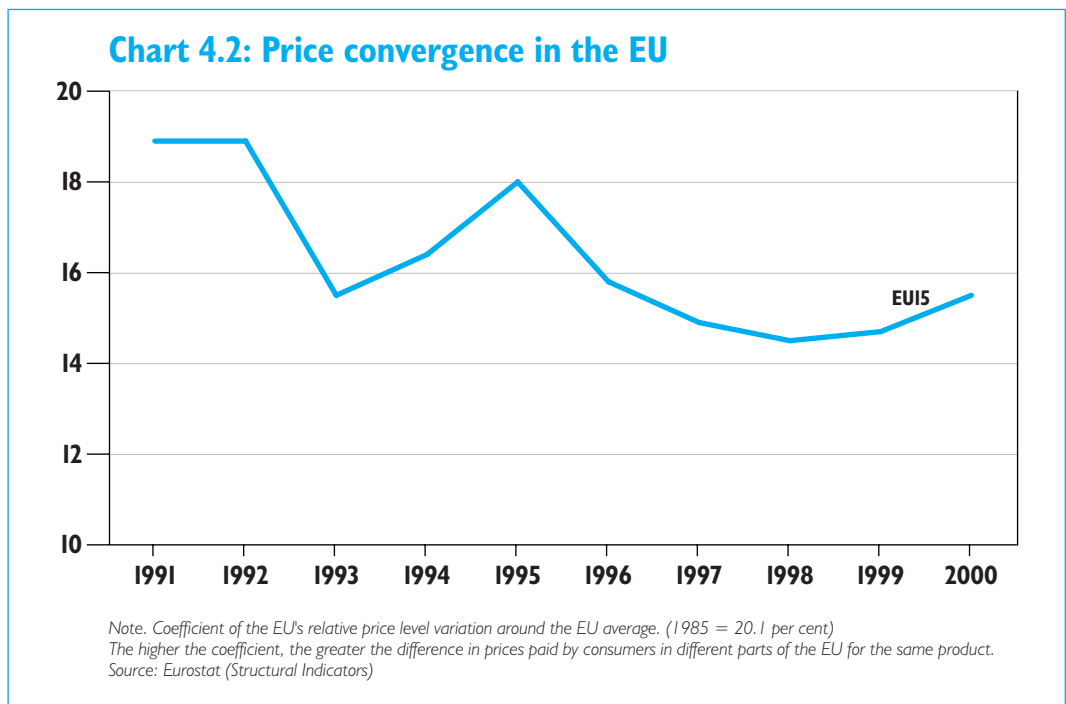
⁴ Evidence from the US comes from *Aggregate Productivity Growth: Lessons from Microeconomic Evidence*, Foster, Haltiwanger and Krizan, NBER, WP 6803, November 1998; in the UK from *Entry, Exit and Establishment Survival in UK Manufacturing*, Disney, Haskel and Heden, Queen Mary, University of London, 2000 and *Productivity in the 1990s: Evidence from British Plants*, Draft Paper, Queen Mary, University of London, Barnes and Haskel, 2000.

⁵ Study by the McKinsey Global Institute, Washington D.C., March 1997.

⁶ *From Big Macs to iMacs: What Do International Price Comparisons Tell Us?* J. Haskel and H. Wolf, World Economics, March 2000.

The Commission confirms the picture **4.5** European Commission surveys⁷ taken during 2000 in the food and electronic consumer goods sectors confirm a picture of weak competitive pressure. Prices of electronic goods differed between Member States by up to 40 per cent, and some food prices were three times higher in some countries than in others. The Commission estimated that, if a selection of electrical goods could be purchased at the cheapest price available anywhere in the EU (which assumes that markets are perfect, and that transport and search costs are absent), **the average consumer saving at an EU level would be around 12 per cent**, ranging at the individual country level from 4 per cent to 20 per cent.

4.6 An increasingly competitive Europe might be assumed to exhibit ever less price divergence within its borders. Chart 4.2 describes the coefficient of variation for private consumption including indirect taxes; the degree of variation, in other words, around the average. While much of the 1990s was indeed characterised by decreasing divergence, this was not true for its entirety. As the decade progressed, the squeeze on differentials appeared to run out of steam.



4.7 A successful single currency within a Single European Market would be of benefit to Europe and to Britain. A successful single currency has the potential to produce greater price transparency, reduced transaction costs and greater competition in both product and financial markets. For the full potential of the Single Market to be realised, Member States need first to remove the remaining legal, administrative, technical and other barriers which hamper Single Market integration, and which prevent Europe from attaining the levels of competition and growth enjoyed by the US.

⁷ Source: *Internal Market Scoreboard*, No. 8, May 2001 (Internal Market Directorate-General, European Commission).

LEVELLING THE PLAYING FIELD: THE POLICY FRAMEWORK

4.8 Strong competition also needs to be fair, maintaining a level playing field requires expert monitoring and attention. An EU aspiring to an innovative, open and competitive economy needs to take particular care over two aspects of the policy framework:

- **competition policy**; ensuring that all markets are open to trade and investment, with no discrimination between new arrivals and incumbents, or overseas and domestic firms; and
- **state aid**; targeting state aid to make markets work more efficiently, and preventing the use of aid to distort or undermine competition.

COMPETITION POLICY: ENSURING DOORS STAY OPEN

Powerhouse Europe, not Fortress Europe

4.9 Vigorous competition is essential for strong and effective markets. **EU competition policy**, at both a national and European level, is based on the premise that markets should be fully open to competition from firms inside and outside the EU. The Government believes that this is best achieved by independent, expert regulators who, using rigorous economic analysis, apply clear rules in a consistent manner.

4.10 The Government has identified a set of principles that it believes underpin any successful competition regime:

- policy should be set and implemented by **strong, proactive and independent competition authorities**;
- all forms of **anti-competitive behaviour** are to be challenged and eradicated;
- there should be a **strong deterrent effect**;
- harmed parties should be able to get **appropriate and adequate redress**;
- governments and competition authorities should **promote international consistency and co-operation**; and
- given its importance to economic performance, **competition policy should receive a high public profile**.

4.11 The UK strongly supports measures aimed at enhancing competition at any level, and recognises the complementarity of reform at an EU and national level. The prohibitions of the UK Competition Act (1998), which came fully into force in March 2000, are consistent with Articles 81 and 82 of the EC Treaty. The DTI White Paper, *Productivity and Enterprise: A World Class Competition Regime*,⁸ outlined reforms to strengthen further the UK's competition regime. These reforms will be implemented in the Enterprise Bill. The UK will continue to pursue its two key aims of opening the UK's domestic markets to competition, and promoting increased liberalisation of European markets in general.

Modernising EU competition policy

4.12 The EU proposals on **modernisation of the competition regime** to rationalise the division of responsibility between national and EU competition authorities can make an important contribution to this agenda. These reforms to the application of Articles 81 and 82 of the Treaty of Rome (which deal with anti-competitive agreements and abuses of a dominant market position) are welcome, for several reasons:

⁸ *Productivity and Enterprise: a World Class Competition Regime*, Department of Trade and Industry, Cm 5233, July 2001

- **decentralisation of enforcement** is consistent with the principle of subsidiarity, and will allow national competition authorities to handle a greater proportion of directly relevant cases;
- the reduced bureaucracy from the abolition of the notification system will allow the **Commission to concentrate on more serious distortions** of competition in the Single Market;
- **greater consistency** for businesses within the Single Market, as Member States apply Community law in all cases affecting inter-state trade; and
- the modernisation process itself, by introducing a more decentralised and economics-based system, should help produce and reinforce a strong **competition culture** across the EU.

Reform of EU merger policy 4.13 **EU merger policy** is also currently under review. The Commission has exclusive competence over all merger cases passing certain thresholds. After a month's initial scrutiny, it can clear a transaction or launch a second-phase, four month investigation. The Commission issued **a Green Paper** at the end of 2001 which raised a number of topics for discussion, including:

- the nature of the competition test against which mergers are assessed. The EU currently asks whether a merger would be likely to “create or strengthen a dominant position as a result of which effective competition would be significantly impeded”, but is seeking views on the alternative “substantial lessening of competition” criterion used in the US and Australia and set to be introduced in the UK;
- proposals to simplify and make more predictable the system of referral to a national competition authority, where a case raises particular problems in a Member State;
- more flexible time-scales, allowing companies to ‘stop the clock’ when considering commitments to address competition concerns identified by the Commission;
- the possibility of automatic Community competence over merger cases subject to filings with at least three national competition authorities, whatever their size;
- potential improvements to checks and balances within the merger review system; and
- the possibility of introducing filing fees for EC merger cases.

4.14 The UK welcomes the Commission's initiative in launching this debate, and will strongly support any steps which enhance the transparency, consistency, simplicity and effectiveness of competition policy at an EU and Member State level. The UK looks forward to continuing to work closely and constructively with the European Commission to ensure the best possible results at both domestic and EU levels.

Box 4.1: Cars block exemption

Pre-tax prices across the EU vary considerably for the same model with the same specification of new car, and by more than 70 per cent for some models⁹. The empirical evidence in numerous studies¹⁰ suggests that taxes, exchange rates, dealer margins and right-hand drive surcharges explain only a fraction of these price differentials. The ability to distribute cars selectively and exclusively appears to give manufacturers significant power over their captive dealers, allowing manufacturers to segment the Single Market along national lines and price discriminate to extract the consumer surplus and maintain profit margins, despite the chronic over-capacity in the industry.

The cars block exemption is an exemption from Article 81 for the car industry, allowing it to selectively and exclusively distribute cars, ostensibly to facilitate expert maintenance and after-sales service of new cars. The European Commission has reviewed the present system to determine how well it is functioning. Its report, issued in November 2000, concluded that the scheme has not achieved the objectives intended when it was renewed in 1995. On 5 February 2002, it produced formal draft proposals for reform.

The proposals are designed to increase competition and bring tangible benefits to European consumers in both vehicle sales and servicing. This should make cross-border purchases significantly easier and lead to greater price competition between dealers. Commission President Romano Prodi, commenting on the draft proposals, said that “The Commission is putting car buyers first” The new regulation will come into force on 1 October 2002, with a transition period of one year.

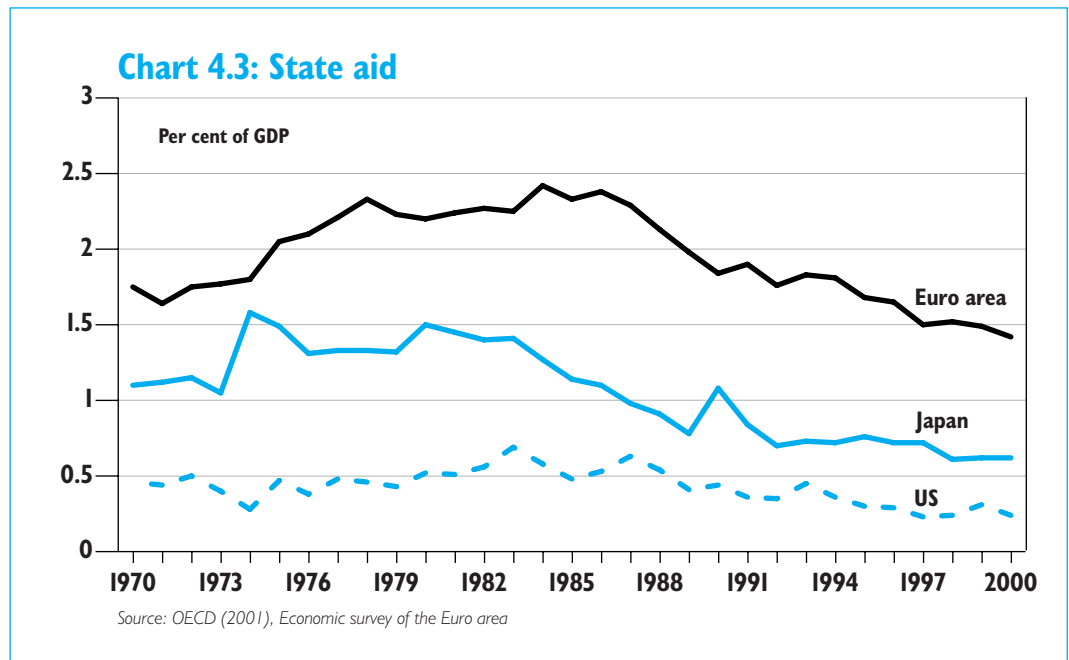
⁹ DG Competition report on car price differentials within the EU at 1 November 2001, http://europe.eu.int/comm/competition/car_sector

¹⁰ A good overview can be found in *Car price differentials in the European Union: an economic analysis*, H. Degryse and F. Verboven, 2000, paper prepared for the Competition Directorate-General of the European Commission.

STATE AID: LESS AID, BETTER AID

4.15 A strong and effective state aid regime is central to a competitive and prosperous economy. In a European context this implies a need for imaginative and constructive reform, both to reduce state aid in total and to ensure the more effective delivery of the Lisbon and Stockholm objectives. **The key aim must be less aid, but better aid.**

4.16 State aid levels have come down since the mid-1980s, but at over 1 per cent of EU GDP (or €90 billion per year) remain high. The EU average aid level is double that of Japan, and four times that of the US. UK state aid levels are among the lowest in the EU – at around half the EU average – hence the euro area average is a little higher than that for the EU as a whole (Chart 4.3).



State aid as a problem... **4.17** Inappropriately directed state aid, whether due to political failure (e.g. the excessive influence of vested interests) or institutional failure (e.g. inadequate enforcement mechanisms) **undermines competition, fairness and efficiency**. Within the EU, the narrow pursuit of national objectives at the expense of other Member States can result in collectively wasteful “beggar-thy-neighbour” policies.

...and a solution **4.18** This does not, however, mean that state aid is inherently undesirable. There is a clear role for **well-targeted state aid** in promoting structural reform, productivity and the operation of the Single Market. Governments may wish to intervene in the face of market or information failures, or where significant externalities are attached to particular transactions (i.e. costs or benefits not captured in the market price). They may also wish to pursue dynamic efficiency, seeking the best sequence of outcomes over time, rather than the best possible at that particular point in time.

4.19 Among the most obvious issues not taken directly into account by markets, are considerations of equity or other **social objectives**. State aid is, as a general rule, not the best policy for addressing social objectives, but it may on occasions be appropriate. For example, there is an important role for state aid in supporting public service obligations in network industries (e.g. energy, transport etc).

Less and better state aid **4.20** The **European Commission** has refined and improved its state aid regime in recent years. It has developed clear, rational principles, including strict rules on aid to traditional established industries, and more permissive rules for addressing possible market failures (e.g. in R&D and environmental protection). Post-Lisbon, there is both an increased need for and increased momentum towards further reform, reflected in ongoing efforts to reorient a declining volume of state aid towards horizontal rather than sectoral or ad hoc objectives.

4.21 The UK bases its state aid reform agenda on three core principles:

- **tighter control** of state aid which undermines competition and efficiency;
- a greater focus on aid which **promotes structural reform**, productivity and the operation of the Single Market; and
- a more **effective operation** of the state aid regime.

Six steps to better state aid 4.22 In the light of these objectives, and building on the good progress being made by the Commission, the Government is keen to pursue the following:

- **more extensive use of the concept of market failure** to determine the appropriateness or otherwise of state aid;
- **introduction of new guidelines** where there is an economic argument for government intervention, and greater use of economic criteria to review or reform existing guidelines;
- increasing the effectiveness of both existing and proposed state aid **by making greater use of economic evaluation techniques** and indicators of aid effectiveness at a Member State level;
- **more transparent and accessible legislation and state aid processes**, reinforcing the strong, independent and pro-active stance of the Competition Directorate; and more and better information about national state aid to encourage peer review and greater third party involvement;
- **streamlined Commission procedures**, to increase predictability and focus Commission (and Member State) resources where most needed, including through improved communications between the Commission and Member States, firmer and shorter deadlines, better case tracking systems and more use of block exemptions and safe harbours; and
- **a more aggressive Commission stance on non-notified and incompatible aid**, taking into account recovery, associated penalties and greater use of third party complaints.

OPENING MARKETS IN PRIORITY SECTORS

4.23 From a competition perspective there are a number of specific sectors on the Lisbon reform agenda which the Government believes warrant particular EU attention, both at Barcelona and beyond. The summary list below begins, however, with the sector often notable by its absence from the European reform agenda: agriculture.

(a) Agriculture

Reforming the CAP 4.24 One of EU's greatest challenges concerns one of its most basic needs: food production. The **Common Agricultural Policy (CAP)** was designed to meet several aims: a secure supply of food at reasonable prices, market stability, and a satisfactory standard of living for the agricultural community. Based initially on measures to maintain commodity prices above world levels, control production, subsidise exports and restrain imports, CAP legislation now provides for direct payments to farmers and extends to quality standards, rules of origin, labelling and packaging, and plant, animal and public health matters.

Why the CAP doesn't fit 4.25 While few would dispute that the EU's food supply has been secure over recent decades, the **CAP has from any broader perspective been a failure**, and is increasingly so. It has imposed a substantial burden on the EU economy; it has not met changing consumer demands on food safety or the environment; and it has done little to facilitate change and development in rural areas. The reasons for this unsatisfactory outcome are several, and inherent to the CAP's original blueprint:

- **support is still largely directed at the production of specific commodities** such as cereals, beef and dairy products. This gives an incentive to specialise without regard to market requirements for quantity or quality of output;
- **not all support directly benefits farm incomes.** Some is dissipated in administration costs or in stocks of surplus production; some accrues to landowners, in the short run by raising rental rates, and in the longer term through land values. The increased price of land encourages intensified farming and may slow structural reform;
- **policy has constrained competitiveness** in the EU farm and processed food sectors, increasing the export subsidy bill and undermining trade and export promotion schemes;
- **price support has created a vicious circle;** surpluses depress market prices, adding to the cost of the price support scheme; and
- **sustainable development is at best not encouraged, and may be discouraged.** Production subsidies may also foster a focus on particular crops or livestock, high livestock densities, heavy use of agro-chemicals and the cultivation of marginal land; all potentially detrimental to the environment.

The cost to the consumer and taxpayer 4.26 The costs of CAP are considerable. The annual budgetary cost is about €40 billion (nearly half of total EU expenditure), while price supports mean that consumers pay an extra €48 billion on their annual food bill. This represents a subsidy of around €12,500 per farmer per year (an average amount which, in practice, is clearly distributed in a very disproportionate manner). The **distortionary impact** of the transfers from taxpayers and consumers to agricultural producers, equates to an estimated welfare loss of 0.2–0.4 per cent of EU GDP; the equivalent of around £4 billion a year to the UK economy.

The wider costs of CAP 4.27 The cost is not, however, restricted to the EU. The EU is the largest importer of agricultural produce, and the second largest exporter after the US. The CAP depresses world market prices, both by dumping EU surpluses elsewhere and by applying tariffs to imports. The consequences as discussed in Chapter 8, are particularly damaging for developing countries more reliant on agricultural exports.

Reforming the CAP 4.28 The **MacSharry (1992)** and **Agenda 2000**¹¹ reforms attempted to address some of these problems. Price support was reduced, and offsetting compensation payments to farmers were introduced. Agenda 2000 also introduced a CAP ‘second pillar’ providing support for rural development and agri-environment schemes, though this still only accounts for about 10 per cent of CAP expenditure.

4.29 While both MacSharry and Agenda 2000 were steps in the right direction, the Government firmly believes that further reform is necessary to address the problems and ensure both a sustainable future for agriculture and a better deal for consumers. A new framework will need to eliminate the economic losses which the current system generates, protect the environment, and reduce the burden on the taxpayer. EU enlargement makes the case for reform more pressing, while from a broader perspective, reform of CAP could be usefully employed in the battle against world poverty.

¹¹ The Agenda 2000 project aimed to set out a clear vision of the EU’s future and prepare for enlargement. The resulting package of legislation covered four main areas: CAP reform, structural policy reform, the pre-accession instruments and the new financial framework.

EU enlargement 4.30 Although not a pre-condition of **EU enlargement**, the prospect makes reform of the CAP even more necessary. The candidate countries are more economically dependent on agriculture than existing Member States, with agriculture accounting for around 6.5 per cent of gross value added and 20 per cent of employment.

4.31 Against this background, the costs of CAP to consumers are likely to be much more crucial for the candidates than for existing Member States. Not only are prices in candidate countries significantly lower for key commodities such as sugar and milk but the share of income spent on food is much higher than in the EU. Any reduction of food prices through CAP reform would have the greatest impact on the poorest in the candidate countries.

Reducing support 4.32 The Government supports a number of routes to reform. **Direct support payments** should be reduced over time, and payment decoupled from production. This would improve responsiveness of supply to market demand, and encourage producers to focus on adding value rather than maximising subsidies. Removing an incentive for intensive production would also benefit the environment. Some of the savings generated from reduced support should be redirected to agri-environmental and rural development schemes, and to promoting market reform in related areas.

Reducing barriers 4.33 Further price cuts are urgently needed to bring EU prices into line with world levels and open up the EU marketplace. Price support is the most distortionary aspect of the CAP, dragging in its wake production controls, export subsidies and intervention stock-piling. Removing trade barriers would benefit EU consumers and food processors via more competitively priced imports. It would also be of obvious benefit to non-EU exporters newly able to compete in the large EU market.

(b) Services

Opening EU service markets 4.34 Completing the Single Market in the services sector represents one of the EU's major challenges. Services, both private and public sector, equate to nearly three quarters of the EU economy – in the UK, just under £600 billion per annum – but account for only a quarter of total trade flows. Changing technology is, however, increasing the range of services that can be provided at a distance, bringing to light new barriers which potentially limit trade and competition in the EU.

4.35 The Government believes that addressing these barriers would be of **substantial benefit to growth and productivity** across the entire EU economy. While the productivity gap with the US is, for many EU countries, narrower in market services than in manufacturing, it is nevertheless significant, as described above in Chapter 2.

Employment growth in services 4.36 Services have, in recent years, held the key to EU employment growth. Service sector firms tend to be more labour-intensive, and their employees rank among the highest skilled and best paid members of the workforce. Contrary to common perceptions, the service sector has proportionally more highly skilled workers than any other sector of the economy.¹²

4.37 Addressing barriers in services can be even more difficult than in physical goods markets. Different national cultures foster different tastes and expectations, which may be reinforced by national or regional regulatory systems. This leads to variations in standards which, in turn, create uncertainties for consumers accustomed to other arrangements.

¹² See for example *Britain's Productivity Performance 1950-96: An International Perspective*, M. O'Mahony, NIESR, DP 103, 1996

4.38 The ‘intangibility’ of many services naturally means that, for some companies, overseas expansion entails not exporting but:

- establishing a physical presence;
- transferring personnel;
- setting up partnerships; and
- negotiating franchise arrangements.

4.39 Such strategies may be vulnerable to a wider range of complications than is traditional exporting: differing professional standards, for example, or accounting regulations. The difficulty of the task should not, however prevent efforts being made to tackle it; more should be done to remove Single Market barriers in this field.

4.40 Competition could be increased by taking steps to improve the geographical mobility of businesses and workers, or by facilitating the provision of services at a distance through improvements to telecoms and internet access. Particular consideration should be given to:

- **mutual recognition;** valuable in encouraging cross-border service sector competition, especially through the mutual recognition of professional qualifications;
- **encouraging e-commerce;** untying the provision of services from their location, enabling transactions without a physical presence, and opening up markets to import competition; and
- **quality and transparency;** ensuring that consumers have sufficient confidence to take advantage of the opportunities offered by more open markets. Mutual recognition and self-regulation go part of the way, but greater peace of mind may be required from, for example, benchmarking, standardised definitions or certificates.

4.41 Introducing competition into **public services**, and enhancing their efficiency, can represent a particular challenge. The experience of others, and dissemination of best practice, can be exceptionally helpful¹³. Finland, the Netherlands, Sweden and Belgium have all made recent efforts in this field. In Belgium’s case this involved the introduction by the National Employment Office of a scheme, the “Strategic Planning Instrument”, intended to enhance efficiency by introducing cost, unit production and quality goals, and a balanced ‘scorecard’ model to allow the regular monitoring and adjustment of assignments. Strategic goals are set on an annual basis, and large-scale investment in information systems is intended to ensure that the National Employment Office has ready access to reliable and relevant data. Since the introduction of the new approach, significant improvements have been observed in terms of the quality and efficiency of the services offered, which given the nature of those services, is of particular benefit to the entire economy.

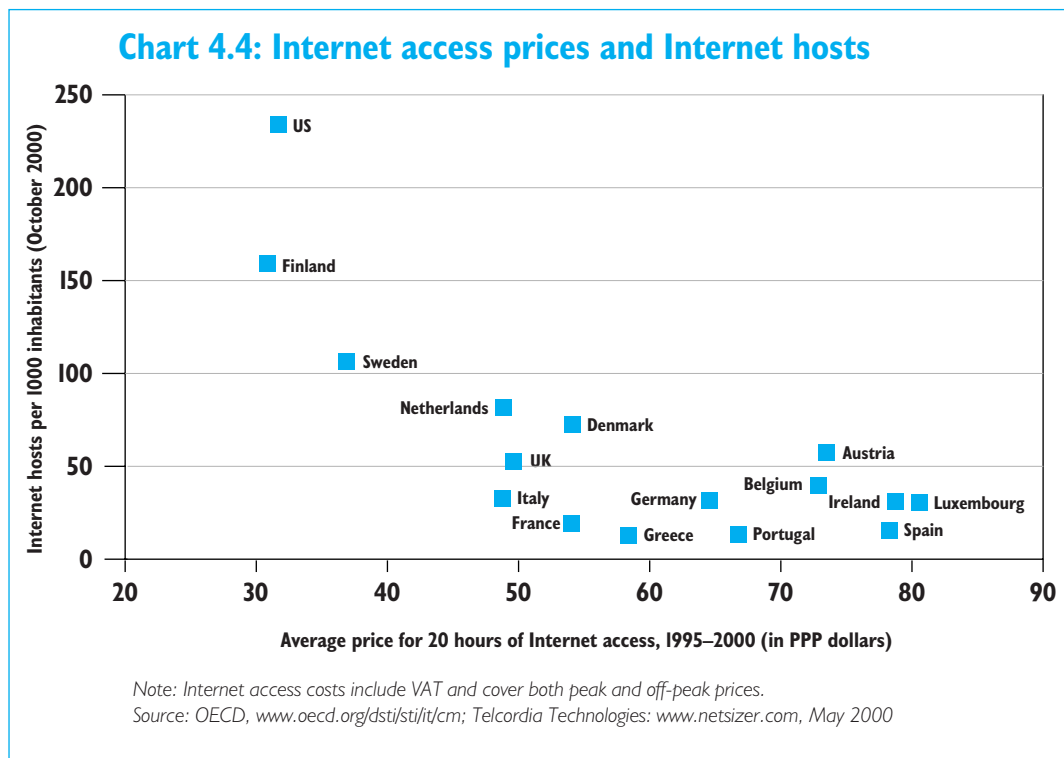
(c) Communications

The communications revolution **4.42** Becoming the leading knowledge-based economy in the world, as aspired to at Lisbon, is a considerable task. It requires the communications industry to invest in the infrastructure to bring new technologies to the doorsteps of consumer and businesses (the networks of cables operated by telecoms and cable companies, satellite services and the third generation of mobile communications) and to demonstrate the benefits of these technologies to potential users.

¹³ For further examples, see the *EPC Annual Report on Structural Reforms 2001*, ECFIN/EPC/171/01-EN

4.43 New technologies delivered through these networks have already brought significant new opportunities to residential consumers and to businesses. The Internet is the prime example. More is promised as new technologies come on stream and become widely available at affordable prices as competition bites. And while there are differing views on the exact extent and routes through which it has acted, there is gathering evidence that the pervasive take-up and use of ICT (Information and Communication Technologies) in homes and business in the US (as well as some EU Member States) has brought productivity gains both in the ICT sector and the wider economy.

4.44 Evidence suggests, however, that the EU has not yet matched the performance of the US in the communications revolution. Chart 4.4 illustrates just one example of this.



What needs to be done

4.45 The telecoms industry needs to be looked at in a European and global, context. While the interconnection of different networks has long enabled communication across national borders, the recent period has seen consolidation of ownership against a background of strong competition and effective regulation. The result has been falling prices and increased choice.

4.46 Open markets will increase consumer choice, lower prices and extend access to these technologies more widely across society. So going forward the priorities should be vigorous promotion of competition across the EU; acceptance of the principle that outcomes on availability and take-up are market based; consistent and accurate benchmarking of performance and understanding of the underlying reasons behind variations in performance.

The challenge of broadband **4.47** This approach should encourage competitive pressure on prices and provide incentives to innovate and introduce new technologies. Broadband, for example, is likely to be a key technology in the future providing higher speed communications and innovative applications but take-up is currently limited (for example, the UK, France and Germany had 0.4, 0.7 and 1.4 broadband subscribers respectively for every 100 of population at end 2001). This presents the ICT industry with a challenge: delivering investment in the networks and selling the benefits of broadband to those who could potentially benefit.

4.48 The Government agrees with the Commission's view, expressed in its Communication to the Spring European Council in Barcelona, that decisions on broadband networks are a matter for the market, but that public authorities can promote competition and ensure a level playing field (for example, through the application of the recently agreed new rules for telecommunications). The Government believes that, in the long run, competition will be the best way of developing and maintaining a sustainable broadband market, and that the promotion of competition should be the focus of broadband policy. Government can also have a role on the demand side; for example, through the procurement and use of ICT for the delivery of public services. This is consistent with UK's domestic strategy for broadband, set out in the *UK online annual report 2001*.¹⁴

4.49 Experience to date is that liberalisation and competition deliver the best results. The Government is concerned to avoid inappropriate intervention, and regards the market as the best mechanism for identifying successful and desirable technologies. It will continue to make this case in discussions with EU partners, arguing that greater competition to produce lower prices and wider access is best achieved through liberalised, open and independently regulated markets.

Getting the regulatory framework right **4.50** In this context, progress on the new regulatory framework for communications has been one of the most significant achievements of economic reform since Lisbon. **The Government welcomes agreement on the legislation reflecting the conclusions of the 1999 Communications Review**, which updates and streamlines the regulatory framework throughout the EU. It believes that the challenge now is to implement the new regime on time as effectively as possible.

4.51 It welcomes, in particular, the acknowledgement of the detailed and unique knowledge of local markets held by National Regulatory Authorities. At the same time, however, the Government agrees that some coordination is desirable in the interests of a single EU telecoms market, hence the importance of a consistent regulatory framework across the EU. The Commission has an important and instrumental role to play in this.

4.52 The Government also wants to see progress on **the full implementation of the E-Commerce Directive**. Creating this legal framework would improve certainty for EU businesses, allowing them to take full advantage of the opportunities offered by e-commerce. It should also ensure that regulation is more responsive to increased competition and rapid market change. The Government is already actively consulting on how this might be done.

Spectrum allocation **4.53** **Radio spectrum** is a major asset of growing importance to the communications industry¹⁵, and a raw ingredient for a wide range of services such as mobile telephony and radio communications for emergency services. In the interests of market efficiency, the Government believes that licence auctions are an effective means of arriving at an efficient initial allocation of radio spectrum, and welcomes the fact that the new Directives will allow for the continuing auction of spectrum licences.

¹⁴ *UK online annual report 2001*, www.e-envoy.gov.uk/ukonline/champions/anrep_menu.htm

¹⁵ Estimated to be worth £20 billion to the UK economy in the year 2000 (see *The Economic Impact of Radio*, a Radiocommunications Agency Study, February 2001, www.radio.gov.uk)

4.54 Trading licences allow the rights to be redistributed to those who value them most highly. The Government therefore fully supports the new regulatory framework for communications in that it **permits the trading of rights** to use radio spectrum. The Government has already announced its intention to consult on the practical implementation of trading once EU law has been amended, and to incorporate the necessary powers in the proposed Communications Bill.

4.55 The Government will fully consider the scope for further action on spectrum management as part of its consideration of the findings of Professor Martin Cave's independent review of spectrum management¹⁶, due to be published shortly.

(d) Aviation

The benefits of a single aviation market

4.56 The EU's progress in the aviation sector represents an excellent example of the benefits which the Single Market brings to consumers' daily lives. The European Commission's 1999 report "*The European airline industry: from Single Market to worldwide challenges*" showed that, as a result of deregulation:

- **EU air travel prices have fallen significantly.** As noted in Chapter 2; over the period 1993–1998 business fares were on average 10 per cent lower than before deregulation. Full economy fares were down 17 per cent and promotional fares fell by 24 per cent.
- **competition between airlines has increased.** The number of routes with more than two operators trebled over the same period; and
- **New competitors have entered the market.** As a direct result of liberalisation, new 'no-frills' airlines such as easyJet, Go and Ryanair have rapidly established a strong market presence, especially in the UK.

Aviation – the challenge ahead

4.57 The UK Government's aviation policy is founded on the principles of liberalisation and normalisation. As with other sectors, the Government is committed to ensuring that regulation is effective and well-focused, that competition policy is vigorously applied, and that market distortions are minimised. Consistent with this, it is pursuing a market-based response to the problems currently facing the Community's airline industry. In practical terms, this means:

- working with our European partners to **minimise distortions to the internal Single Market**. The Government supported Commission guidelines limiting airline compensation following the terrorist actions of 11 September to the exceptional impact of the closure of airspace;
- **tackling temporary market failure**; stepping in quickly and decisively to provide third-party war and terrorist cover, while being committed to withdrawal as a properly functioning market is restored;
- working towards a revised European Regulation that enables market mechanisms to be used to allocate scarce capacity at airports. The existing rules for **allocating take-off and landing slots** inhibit competition at Europe's busiest airports, such as Heathrow;
- taking a lead in pressing for **regulatory barriers** to structural reform to be dismantled; and
- supporting the Commission's efforts to create **a Single European Sky** and improve the efficiency of the European Air Traffic Management system.

¹⁶ Radio Spectrum Management review, <http://www.spectrumreview.radio.gov.uk/>

4.58 Although the internal aviation market is liberalised, **air services between Europe and many third countries remain protected by bilateral agreements**, and foreign ownership of airlines is restricted by these agreements and by national legislation. EU airlines are responding to the increased global uncertainty by restructuring their businesses, but progress towards consolidation is held back by these regulations, to the detriment of passengers.

4.59 Dismantling this obsolete structure will involve the Commission and other Member States securing third country agreement not to revoke bilateral traffic rights in response to changes in ownership and control. It will also require agreement within Europe not to revoke bilateral traffic rights in response to similar changes affecting third party airlines.

Third country liberalisation **4.60** Such market-based reforms and the removal, where possible, of ownership and control restrictions, will not change the industry overnight. The global web of bilateral air service agreements governing air transport will take many years to break down. A ‘normalised’ aviation industry represents, however, a valuable prize, and one which the UK is committed to pursuing.

(e) Postal Services

The EU postal services market **4.61** EU postal services handle an estimated 135 billion items per year, generating a turnover of around €80bn or 1.4 per cent of EU GDP. Two thirds of this turnover is generated by mail services, many of which are not subject to competition; the remainder comes from parcel and express services, which are in contrast already competitive¹⁷. In the United Kingdom alone, Consignia handles over 20 billion letters per year, or around 80 million per working day¹⁸.

Reserved Services **4.62** Many Member States maintain ‘**reserved sector**’ in which only the national postal company may operate. The extent of reservation varies across the EU, subject to the maximum limits set in the 1997 Postal Service Directive. Very few Member States have abolished their reserved areas and fully opened up their postal markets. Drawing on experience of opening other markets, the Government believes that with the appropriate regulatory framework to ensure the provision of the universal service, further moves to open the market in this sector promises similar substantive benefits.

Introducing competition in the EU **4.63** The **1997 Postal Services Directive** provides for a continuation of gradual and controlled market opening. In May 2000 the Commission came forward with proposals to further reduce the price/weight thresholds of services that may be reserved in order to maintain the universal service. At the Telecommunications Council of December 2001, Member States agreed by a large qualified majority to reduce those thresholds to:

- 100 grams/3 times the basic weight tariff by 2003;
- 50 grams/2.5 times the basic weight tariff by 2006, and
- abolition or some other step in 2009, subject to further agreement by member States following a review and report by the Commission on the impact on the universal service.

4.64 **The UK fully supports all efforts at market-opening compatible with the maintenance of a universal service at a uniform tariff.** It has already introduced significant reforms of its own postal services, including the establishment of a new pro-competition regime and postal regulator (PostComm), and greater commercial freedom for Consignia. These developments mark a step-change, encouraging competition in the postal sector which furthers the interests of consumers while ensuring the provision of the universal service.

¹⁷ Source: European Commission, http://europa.eu.int/comm/internal_market/en/postal/general/index.htm

¹⁸ Source: Consignia.

(f) Energy

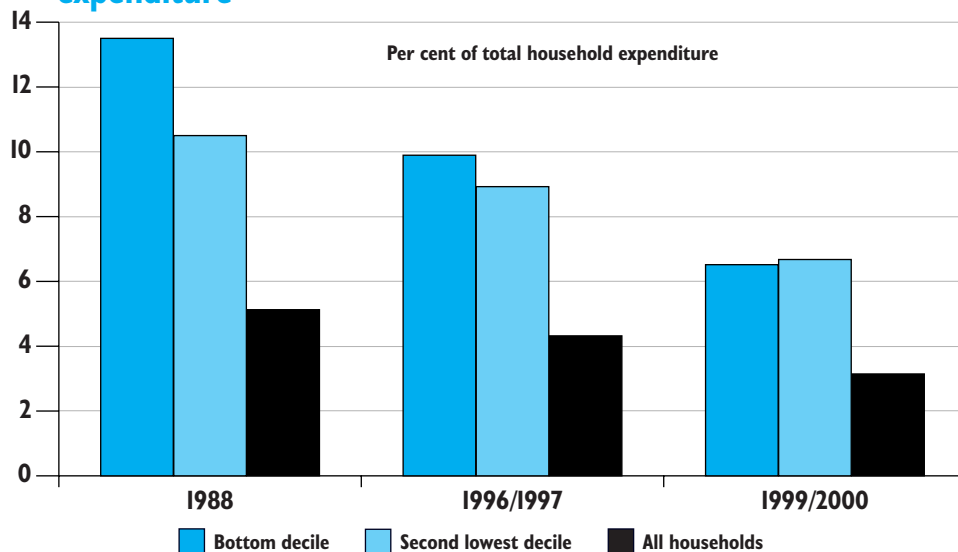
4.65 The energy sector is an important part of the EU economy, and a basic requirement for everyday life. It amounts to around 3 to 4 per cent of GDP, is a key input to other industries' production, and accounts for a disproportionate share of spending by low-income households. At present, 69 per cent of the EU's electricity market has formally been liberalised, and 79 per cent of gas¹⁹. The scope for further reform is obvious, with lower prices through greater competition likely to benefit lower income households the most, thereby alleviating fuel poverty. Box 4.2 illustrates the extent to which fuel poverty has been reduced in the UK over recent years by liberalisation; tackling such poverty has been, and is, an important part of the Government's energy policy.

4.66 The Commission has already put forward proposals amending the existing electricity and gas Directives in the directions described above, and requiring **full market opening in both electricity and gas by 2005**. The Government believes that these proposals should be agreed as soon as possible, and remains fully committed to the Lisbon mandate of accelerated liberalisation. It urges a fully operational internal market in these sectors, and agreement to an early date for **the full opening of both electricity and gas markets**.

Box 4.2: Fuel Poverty

'Fuel poverty' is a term characterising those households which need to devote more than 10 per cent of their income to ensure adequate heat and energy provision. As Chart 4.5 shows, UK energy price cuts following liberalisation have proved disproportionately beneficial for such households, freeing up a greater share of their income to be used elsewhere. It is estimated that between 1996 and 2000, the number of English households in fuel poverty fell by around a third (the number declining by half a million in 1999-2000 alone). Fuel consumption has in the meantime risen by approximately 8 per cent, suggesting that this trend did not reflect simply a fall in demand.

Chart 4.5: The share of fuel and power in household expenditure



¹⁹ First Report on the implementation of the internal electricity and gas market, European Commission Staff Working Paper,

4.67 The Government believes that all EU Member states should liberalise and integrate their energy markets if the benefits of a true Single Market are to be realised, and welcomes the Spanish Presidency's focus on this issue. Specifically, they must ensure:

- an **independent regulator** or oversight body to ensure non-discriminatory treatment of all competitors, and to safeguard the interests of consumers;
- the **legal separation of production/supply** and transmission/distribution in all markets;
- **access to the infrastructure network**, and clear transparent charging, within non-discriminatory regimes; and
- **sufficient interconnection and clarity of rules** at a trans-boundary level, to prevent the emergence of bottlenecks which might interfere with trade.

**Reforms being
taken forward**

4.68 An example of an EU Member State which has seen significant recent liberalisation in this sector, is Spain. The government adopted legislation in 1999 to eliminate legal barriers to competition in energy, over and above the requirements of corresponding EU Directives. Liberalisation was accompanied by the privatisation of state-owned companies and the establishment of an independent regulatory authority. Limits were placed on the expansion of dominant operators in electric power and liquid gas (for example, electricity groups with more than 40 per cent market share could not add new capacity for five years). Furthermore, management influence across sectors was constrained, to reduce the risk of coordination between operators. No person or legal entity may sit on the Board of Directors of more than one dominant company in network industries, and any company or group owning more than 3 per cent of more than one operator in the same sector, may only exercise their voting rights on the excess over 3 per cent in one such company.

THE WAY FORWARD TO THE LISBON GOALS

Box 4.3: Priorities for action

Vigorous competition between firms is essential to promote strong and effective markets. EU policy on **competition** and **state aid** are central to Member States' efforts to strengthen competition, stimulate innovation and enterprise, and reap the full benefits of market liberalisation across the EU. Competition policy should:

- be strong, pro-active, independent, economically rigorous and high-profile;
- have a strong deterrent effect, and allow harmed parties adequate redress; and
- promote international consistency and cooperation.

The Government welcomes the Commission's initiatives on modernisation of the EU competition regime and merger reform, and supports all efforts to enhance the transparency, consistency, simplicity and effectiveness of competition policy at an EU or Member State level. Similar rigour and effectiveness should be applied in policy on state aid, including:

- greater use of the concept of market failure, and of economic criteria and evaluation techniques in general;
- more transparent and accessible legislation, and streamlined procedures; and
- a more aggressive Commission stance on non-notified and incompatible aid.

While a focus on specific sectors should not be allowed to detract from the broader aim of exposing the EU as whole to greater internal and external competition, there are clearly some areas where progress would be more welcome, and is more urgent, than others. Substantial benefits stand to be realised from further competition-boosting reforms in some sectors, notably:

- **agriculture**, through reform of the CAP;
- **services**, through urgently seeking ways to complete the Single Market, building on the principle of mutual recognition;
- **telecommunications**, by moving further in delivering the knowledge-based economy to the whole of society through enhanced competition;
- **aviation**, extending liberalisation beyond the EU; and
- **electricity and gas markets**, further opening up to benefit poorer households in particular.