



“Better Policies” Series

ECONOMIC CHALLENGES AND
POLICY RECOMMENDATIONS FOR
THE EURO AREA

FEBRUARY 2014



OECD “Better Policies” Series

The Organisation for Economic Co-operation and Development (OECD) aims to promote better policies for better lives by providing a forum in which governments gather to share experiences and seek solutions to common problems. We work with our 34 members, key partners and over 100 countries to better understand what drives economic, social and environmental change in order to foster the well-being of people around the world. The OECD Better Policies Series provides an overview of the key challenges faced by individual countries and our main policy recommendations to address them. Drawing on the OECD’s expertise in comparing country experiences and identifying best practices, the Better Policies Series tailor the OECD’s policy advice to the specific and timely priorities of member and partner countries, focusing on how governments can make reform happen.

Economic challenges and policy recommendations for the euro area

February 2014

Table of contents

Foreword	2
1. Introduction.....	3
2. Macroeconomic Challenges: Financial and Fiscal Repairs	5
Macroeconomic conditions are improving but fragilities remain	5
Financial sector reform is not yet complete.....	8
Going forward, key priorities for further reform include:.....	13
Completing fiscal adjustment while improving its quality	15
3. Boosting Growth and Job-Creation through Structural Reform	18
Employment and productivity performance in Europe is highly uneven.....	18
Structural reform to boost output and employment	21
The crisis has accelerated reform in the most vulnerable countries	21
There is much scope for further reform in all countries	24
Fostering innovative and dynamic firms.....	27
Enhancing skills	29
Reducing barriers to product, capital and labour mobility in the EU	31
Bibliography	34

Foreword

The euro area is beginning to show the much-awaited signs of recovery. Area-wide efforts to strengthen the public finances and the institutional underpinnings of the monetary union are sowing the seeds of vigorous, inclusive growth. But comprehensive structural reforms are needed to enhance productivity and restore competitiveness and to pave the way for enterprise development and job creation in the years to come.

Much has been achieved by the southern countries that have been worst hit by the crisis over the last five years. Courageous steps have been taken to enhance competitiveness and tackle the build-up of debt and external imbalances that occurred in the run-up to the crisis. But challenges remain in those countries and elsewhere in the euro area to further narrow intra-area imbalances in a durable manner, and to strengthen the recovery throughout the region. In particular, there is much scope for further pro-competition reforms in some core euro area countries, where the impetus for reform has not been as strong as in the south after the crisis.

Ambitious reforms to secure lasting structural adjustment in the euro area need to be supported by sound macroeconomic policies and financial sector repair. Fiscal consolidation must continue as planned, while allowing the multipliers to operate and preserving much needed public investment in education, infrastructure, innovation and other key growth-enhancing programmes. It is also essential to strengthen the euro area banks and put in place a well-functioning banking union so that lending and effective financial intermediation can resume in support of the recovery.

This document presents a diagnosis of the pending structural reform agenda as well as of other policy actions that hold much potential for boosting growth and jobs in the euro area. For example, on the basis of OECD simulations, moving to best practice in product and labour market reform can have a substantial positive impact on growth: simulations indicate that the gains in aggregate output in the euro area could amount to some 6% over about a decade. Labour market reforms will also help tackle high joblessness (especially among the youth) over the medium term.

The OECD stands ready to support the euro area and individual EU member states in pursuing their reform agenda.



Angel Gurría
Secretary-General, OECD

1. Introduction

Following a major crisis that has caused wide-spread unemployment in many countries, a certain degree of optimism is returning to the euro area. GDP growth in the region is slow but positive, signaling the exit from the recession. Financial market conditions are also showing signs of improvement and foreign investors are returning to the battered markets of countries such as Ireland, Portugal and Spain.

In the past five years, the European authorities have taken significant measures to address the fiscal, financial and external imbalances that had widened in the run-up to the crisis, and to strengthen the region's fiscal and financial institutions. These efforts are finally beginning to pay off. For the area as a whole, the government debt-GDP ratio is stabilising, although at levels that are much too high in many countries, with Greece (172%), Italy (133%), Portugal (129%) and Ireland (125%), in particular, still having a long way to go to lower debt to comfortable levels.¹ The euro area has also embarked on a process of banking union that, if successfully completed, will strengthen financial stability and will potentially reduce vulnerabilities.

Despite the gradually improving situation, the near-term outlook for growth is still subdued and uncertain, and unemployment - at 12% on average in the euro area - remains too high, while youth unemployment is stuck at over 50% in countries such as Greece and Spain. To address this situation, the euro area needs to continue policy reform efforts that will support the recovery, promote competitiveness, and boost job creation. Such reforms will also help restrain the build-up of unsustainable current account deficits in the future and contribute to closer integration among euro area members.

The pace of structural reform accelerated in the countries worst hit by the crisis, notably Greece, Ireland, Portugal and Spain, focused mainly on labour markets and some product markets. These reforms have contributed to reducing the unit labour cost gap that opened up with Germany and other northern countries since the establishment of the euro. The much-needed current account rebalancing progressed in the course of 2013, with the Southern countries all approaching balanced positions. Yet this achievement is also to a large extent the result of austerity measures and low demand. It might partially vanish once growth returns in earnest, unless the reform process continues.

Furthermore, pro-competition reforms have yet to be extended to much of the services sector. Barriers to competition in these countries generally remain above the OECD average, despite recent reforms. Other euro area countries also need to step up their reform efforts. For instance, after Italy and Spain, France and Germany have the highest barriers to competition in services in the euro area. Further pro-competition reforms could help achieve rapid job and productivity gains in sectors such as retail, trade and professional services.

¹ Debt levels as of the third quarter 2013, Maastricht definition.

Simulations suggest that reforms to product market regulations would have a substantial positive impact on growth: the gains in aggregate output in the euro area could amount to some 6% within the next decade.² Labour market reforms will also help tackle high joblessness (especially among the youth) over the medium term.

Boosting long-term productivity, competitiveness and job creation therefore requires continuing policy action on structural reform, both at the national and European levels, addressing both labour and product markets. All European countries, including those less hard-hit by the adverse effects of the crisis, need to continue to push forward this agenda, together with policy efforts to strengthen investment in human capital, enterprise formation and innovation.

Such reforms need to be complemented with sound macroeconomic policies and financial sector repair, supporting a sustainable and balanced recovery. Persisting financial vulnerabilities have to be addressed through further financial reforms and prevention, notably the establishment of a comprehensive banking union which includes a common efficient resolution mechanism and appropriate fiscal backstops. Consolidation efforts to bring down debt-to-GDP ratios over the medium-term also need to continue, but they must be designed in a way that preserves vital public investment and other growth-friendly programmes, that provides the impetus for getting the jobless back to work, and that mitigates inequalities. Support from the European Central Bank will also be essential to avoid downside risks and in particular further downward pressure on inflation.

² See OECD (2013a) for details.

2. Macroeconomic Challenges: Financial and Fiscal Repairs

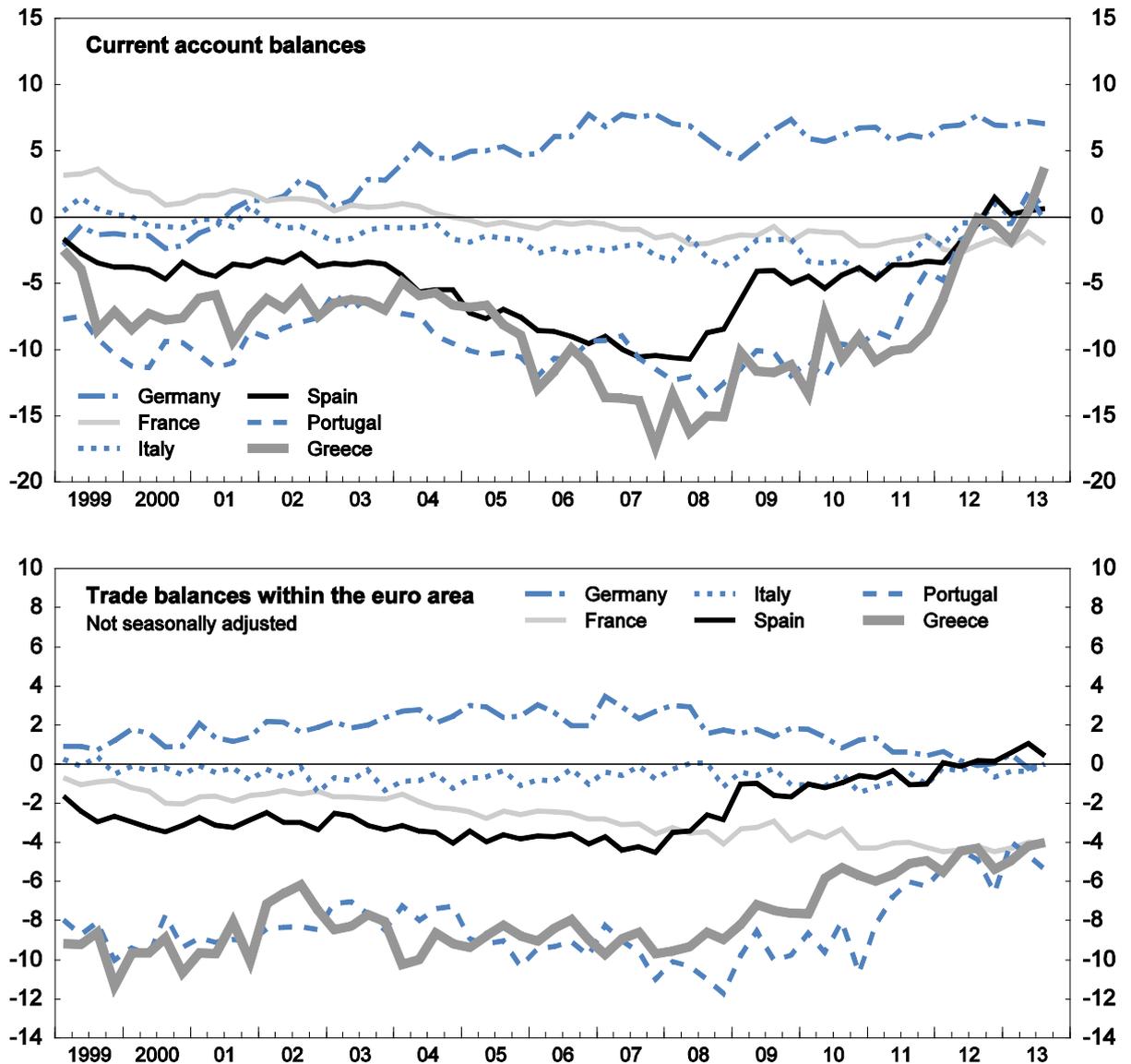
Macroeconomic conditions are improving but fragilities remain

The euro area exited from recession in 2013. Nevertheless, economic growth this year and next is likely to be sluggish and highly uneven across countries. Unemployment remains high, notably among the young and in the peripheral countries. An increasing part of this unemployment risks becoming structural and leaving a permanent scar on economies and societies. Increasing social fatigue with further fiscal austerity and, to a lesser extent, structural reform is a major risk to future growth performance.

Current account imbalances in the euro area have narrowed, especially in deficit countries as the sharp contraction in domestic demand has compressed imports, and gains in competitiveness have, in some countries, boosted exports (Figure 1). Current account rebalancing has been most phenomenal in Greece, Portugal and Spain, which have moved from deficits of around 10% or more just before the crisis to small surpluses by the end of 2013. Unit labour costs in these countries have come down substantially (Figure 2).

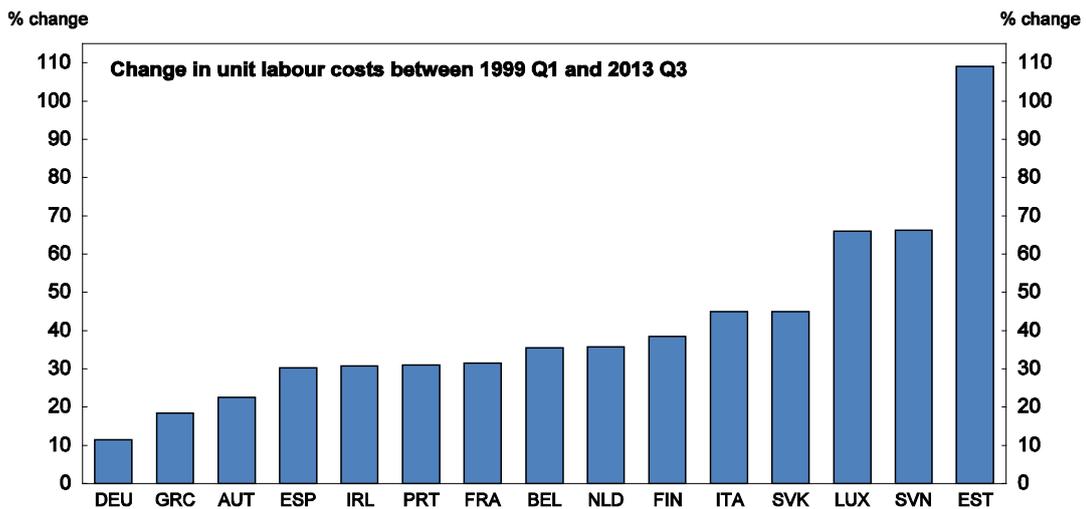
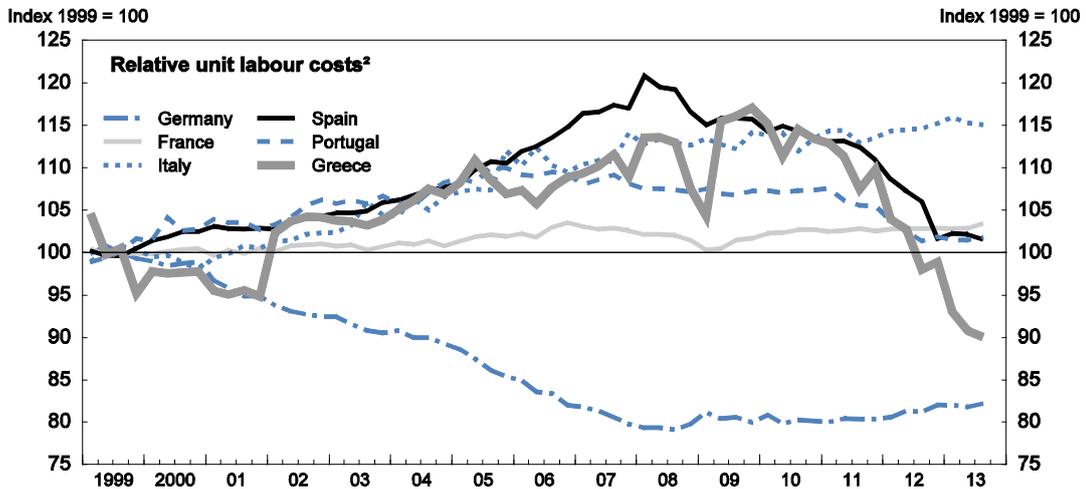
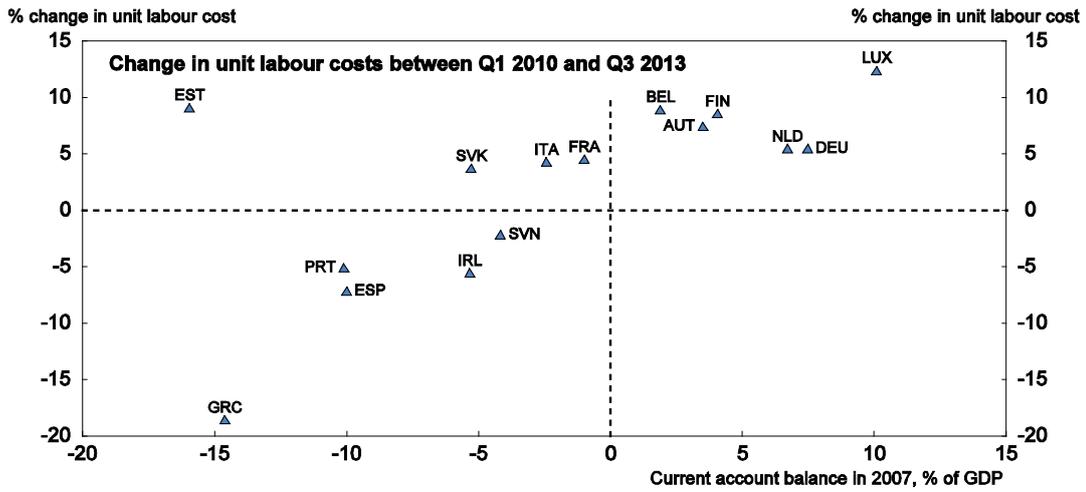
However, the dispersion in unit labour costs between deficit and surplus countries is still higher than prior to the monetary union and prices have adjusted less than wages, in part reflecting slow product market reforms. In some countries, lower unit labour costs need to translate better into export price adjustments to improve external competitiveness. The asymmetric adjustment in current accounts is associated with an increase of the overall current account surplus of the euro area to 2 ½ per cent of GDP.

Figure 1. Current account and trade imbalances
As a percentage of GDP



Source: OECD, OECD Economic Outlook database and Eurostat.

Figure 2. Evolution of unit labour costs¹



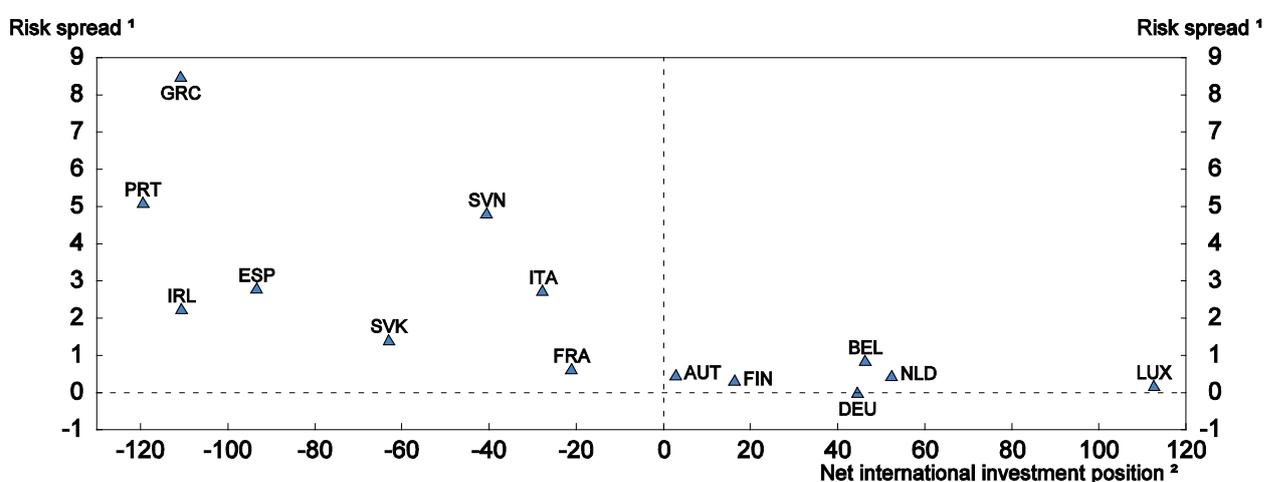
1. Total economy.
2. Unit labour costs of the whole economy relative to unit labour costs in the rest of the euro area.

Source: OECD, OECD Economic Outlook database.

More is needed to narrow imbalances within the euro area in a more symmetric fashion and reduce sovereign risk spreads. Net international investment positions of vulnerable countries remain strongly negative, at levels over 100% of GDP in Greece, Ireland and Portugal and over 90% in Spain (Figure 3). Reducing external indebtedness will require many years of current account surpluses or large valuation changes.

Reforms in surplus countries as described in Section 3 could also boost domestic private and public investment, thus contributing to overall growth. Product market reforms to enhance competitive pressures and entry into sheltered sectors, such as professional services and network industries are a promising means to enhance domestic investment prospects. Similarly, improving the framework conditions for innovation can contribute to higher productivity and potential growth, while at the same time reducing structurally high current account surpluses.

Figure 3. Net international investment position and sovereign risk spread
Q3 2013 or latest available data



1. Ten-year government bonds over Germany.

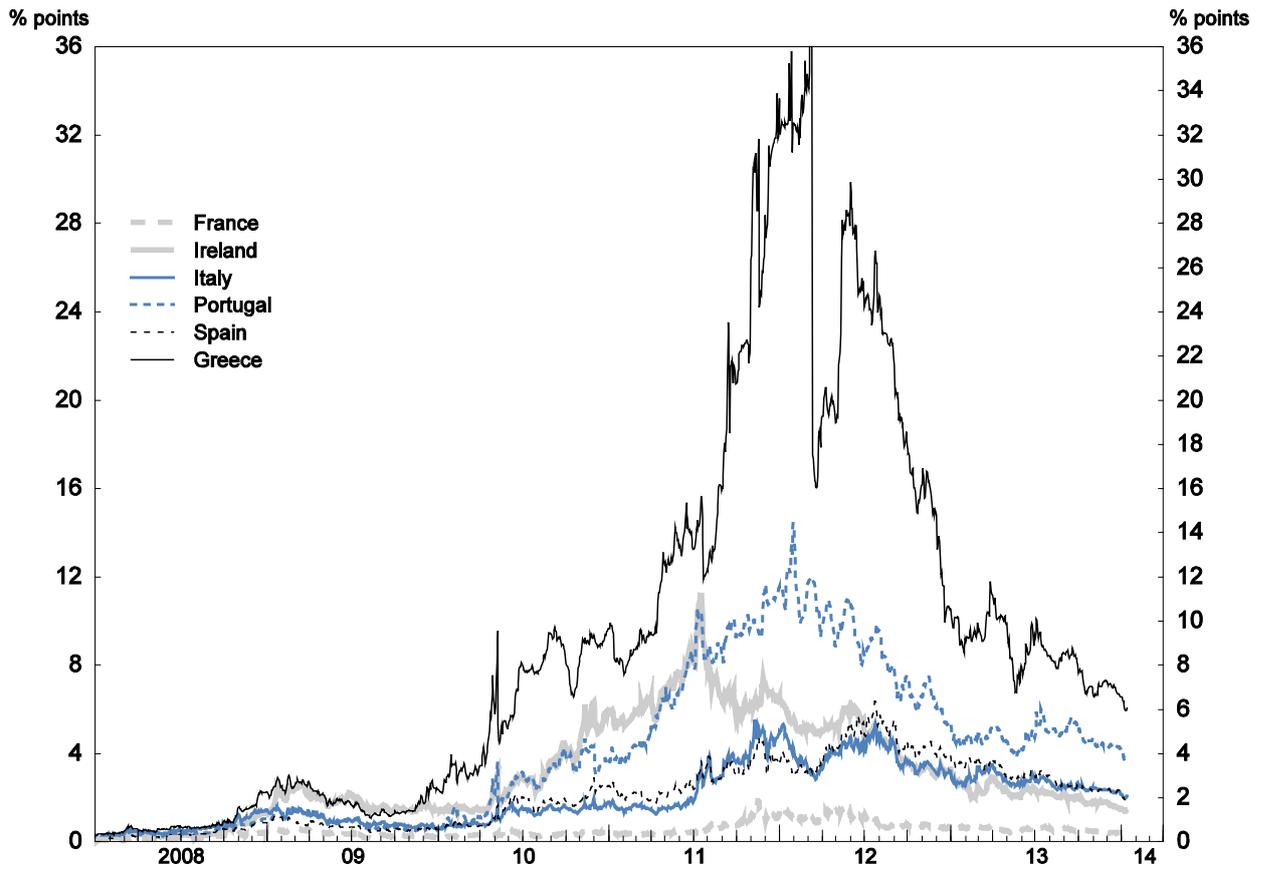
2. As a percentage of GDP.

Source: IMF, *Balance of Payments Statistics database*; OECD, *OECD Economic Outlook database*.

Financial sector reform is not yet complete

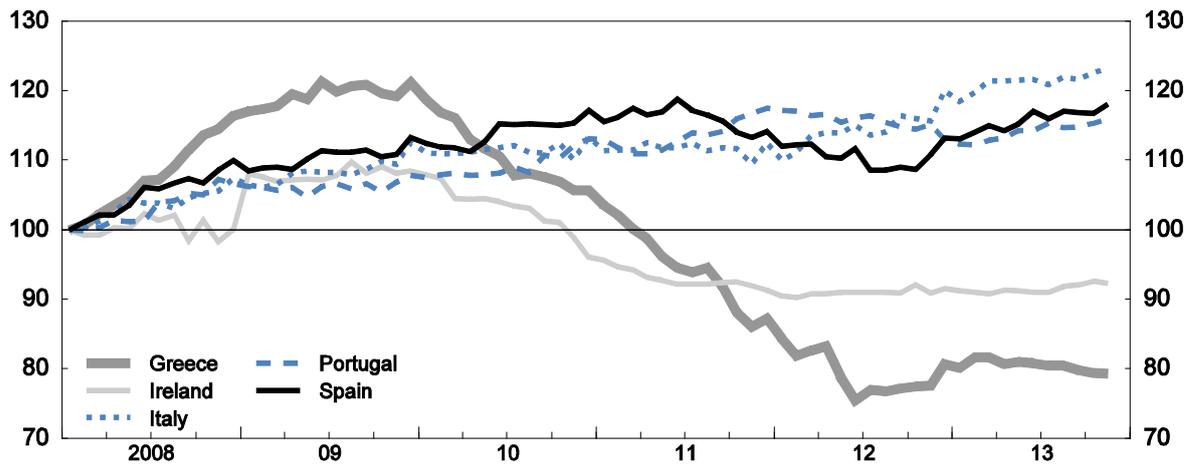
Financial tensions have eased in the euro area, and financial fragmentation has receded. In vulnerable countries, both long-term government bond spreads *vis-a-vis* Germany and credit default swaps have declined substantially from their peak levels in summer 2012 (Figure 4). Bank deposits have stopped falling or have started to increase again (Figure 5). The ECB's OMT announcement, progress in external rebalancing and restoring competitiveness, fiscal consolidation and steps forward in reforming the EU banking system have all contributed to improved risk perceptions.

Figure 4. Sovereign bond spreads¹ have fallen



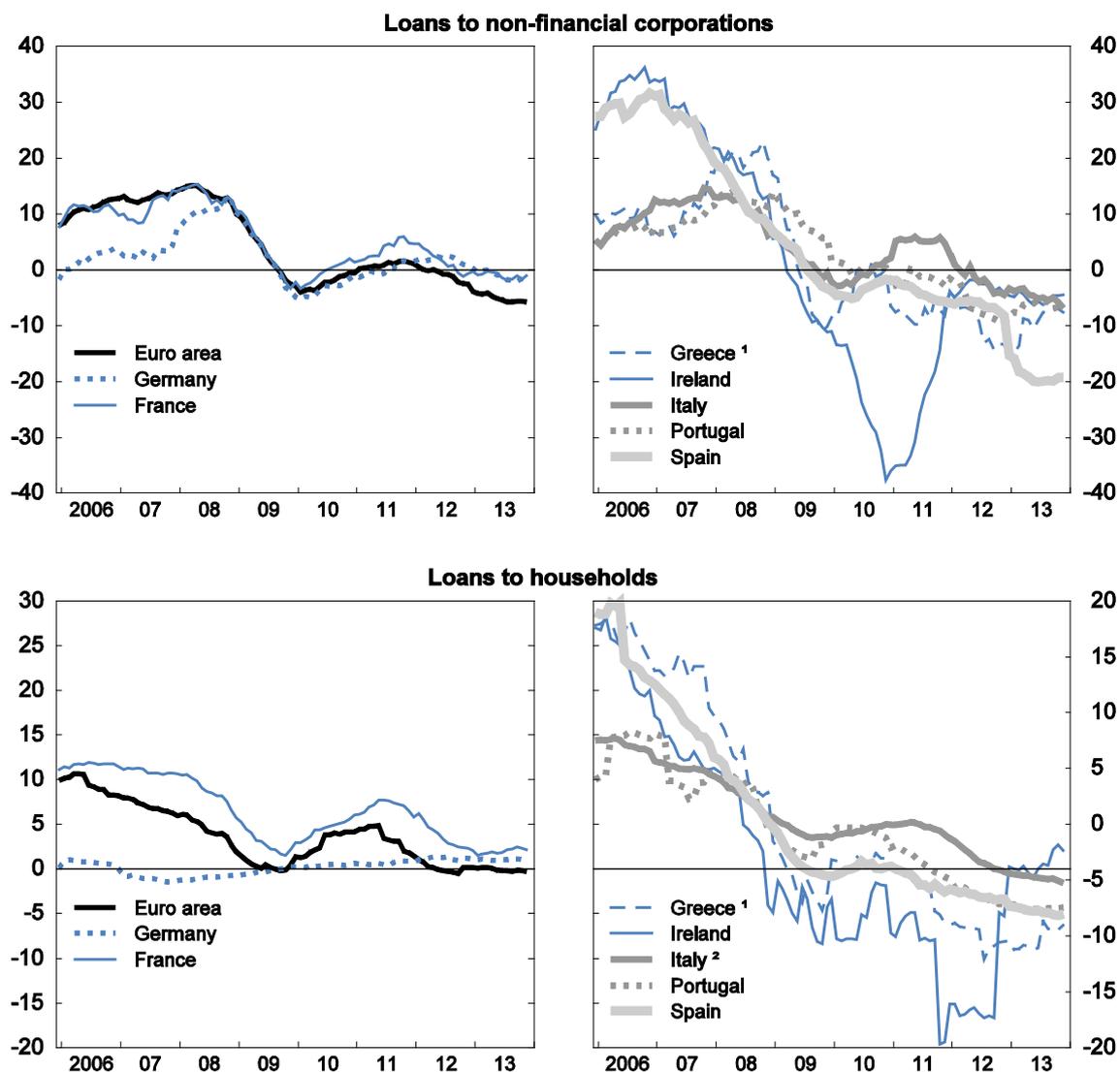
1. Ten-year sovereign bond yield relative to German yield.
Source: Datastream.

Figure 5. Bank deposits¹ have bottomed out
Index January 2008 = 100



1. Non-financial corporations and household deposits in monetary financial institutions (MFIs).
Source: European Central Bank.

Figure 6. Growth of bank credit to the private sector
Loans by monetary financial institutions (MFIs), year-on-year percentage change



1. Adjusted for a break in series in June 2010 due to the inclusion of non-traded corporate bonds and exclusion of loans to sole proprietors from this date.

2. Corrected for securitisation.

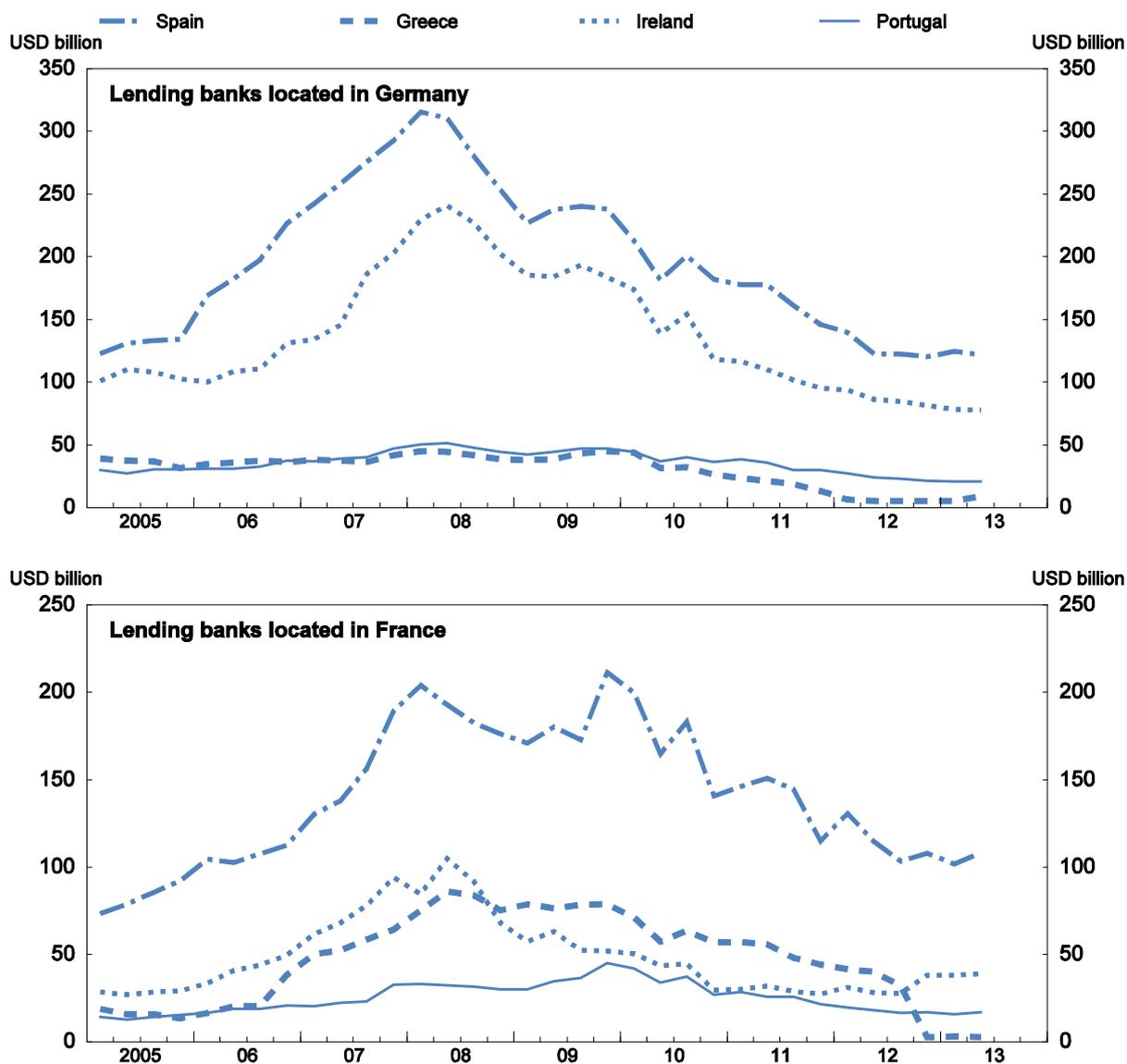
Source: Banca d'Italia and Datastream.

Credit continues to shrink, however, and lending conditions remain tight, notably in vulnerable countries, affecting small and medium sized enterprises in particular (Figure 6). Cross-border supply of bank credit to vulnerable countries has declined during the crisis (Figure 7), while much of the credit supplied by domestic banks continues to be financed via liquidity assistance by the European System of Central Banks.

Rising non-performing loans and weak bank capitalisation are the main factors impeding credit growth. The rise in non-performing loans, especially in the deficit countries, is potentially preventing a reallocation of credit to new activities (Figure 8). High and rising non-performing loans also weigh on inter-bank funding and the provision of private sector capital to banks, both by domestic lenders and via cross-border capital flows.

In contrast to the United States, Europe has been slow to deal with the banking sector weaknesses that were revealed by the crisis. As early as 2008, the United States implemented the Troubled Assets Relief Program (TARP) to purchase banks' bad assets, with an assessment of the adequacy of banks' capital following in 2009 under the Supervisory Capital Assessment Program (SCAP). This quick and decisive action explains at least in part the stronger growth in the United States.

Figure 7. Cross-border credit provided by banks¹ of German and French owners

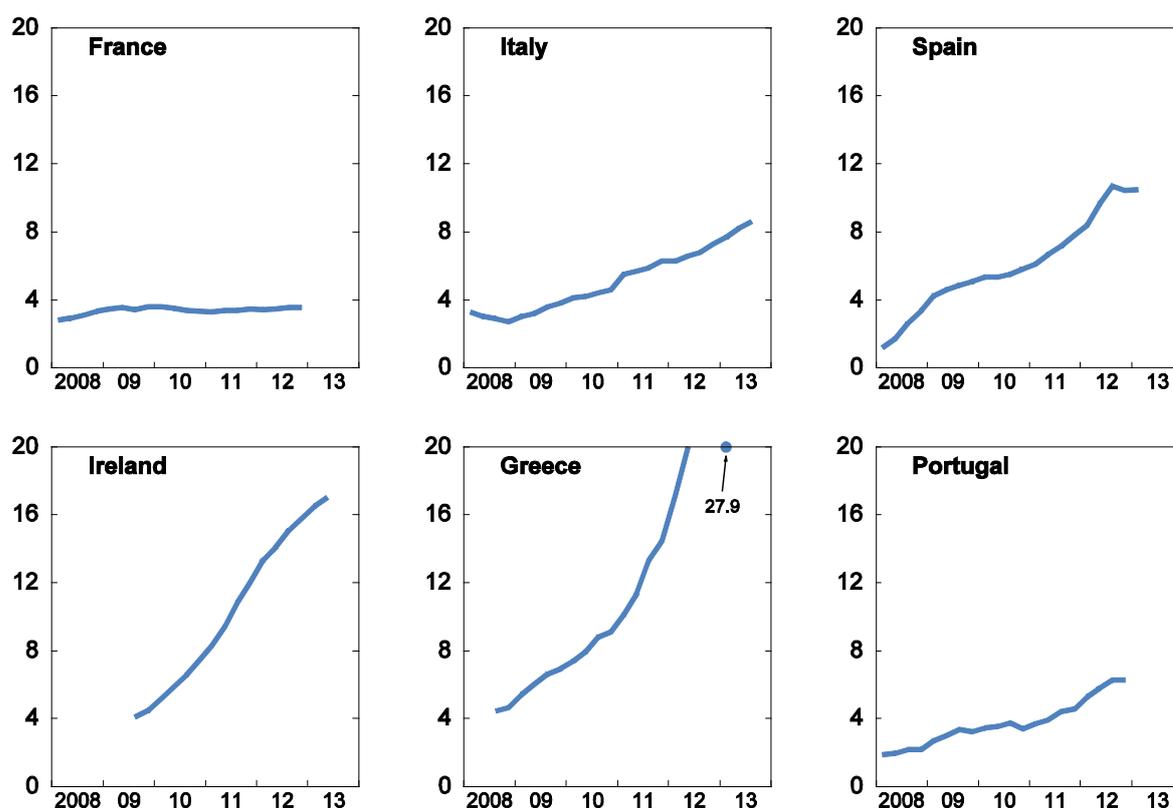


1. Lending banks are owned by stakeholders in Germany and France, respectively.

Source: Bank for International Settlements.

While improving macroeconomic conditions might sustain credit growth, the volume of non-performing loans could be significantly higher than those identified, as past bank regulation and stress tests failed to reveal balance sheet conditions fully. Banks are raising capital as the asset quality review and stress tests draw closer.

Figure 8. Banks' non-performing loans¹
As a percentage of total assets



1. Cross-country comparisons of non-performing loans are complicated by differences in definition.
Source: IMF, *Financial Soundness Indicators database*; national central banks.

EU legislation requires banks to raise capital and liquidity ratios gradually towards Basel III provisions. However, under Basel III, banks are allowed to use internal models to determine the risk weights, and there is considerable heterogeneity across bank models. Also, sovereign bonds of OECD countries still receive a zero risk weight.

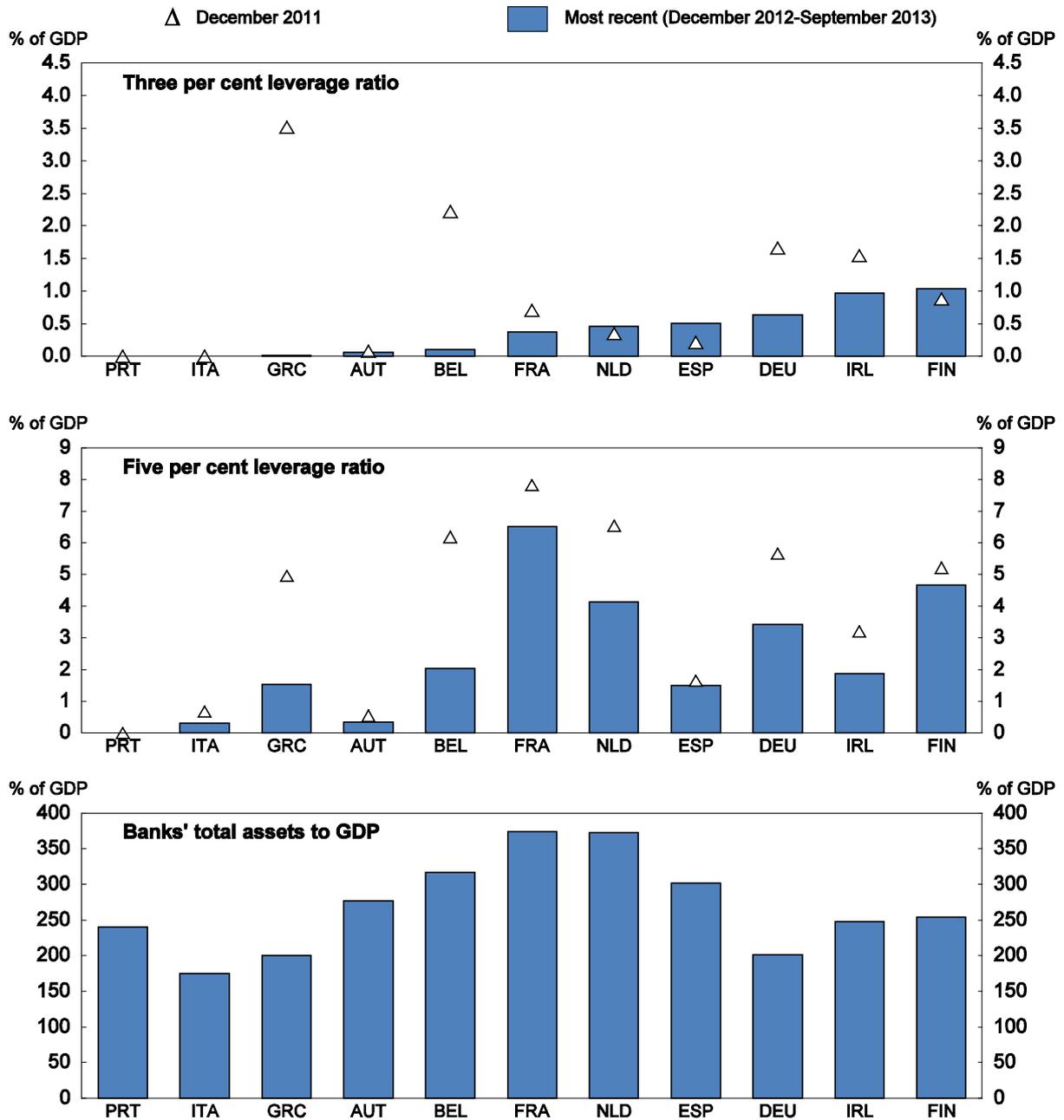
OECD analysis shows that leverage ratios are a good measure of risk-absorbing capacity, suggesting that they can be a useful complement to risk-weighted capital ratios. There are however different views about an appropriate level of the leverage ratio. Estimated capital needs for banks to reach a core Tier-1 leverage ratio of 3% of total assets as required under the EU Capital Adequacy Directive have declined over the last two years and are below 1% of GDP (Figure 9). On the other hand, if a higher leverage ratio requirement was to be applied, at 5% of total assets, the capital shortfall would be substantial in a few countries, especially those with the largest banks in relation to the size of the economy.

There are different views about an appropriate level of the leverage ratio. The EU Capital Adequacy Directive requests banks to have a non-binding leverage ratio of 3%. A minimum 5% leverage ratio is used as a benchmark for well-capitalised banks by the US Federal Deposit Insurance Corporation, although differences in accounting standards make this ratio not fully compatible with Europe due to the treatment of derivatives. A ratio of 5% for the eight largest banking groups and 6% for subsidiaries has recently been proposed as a regulatory minimum in the United States. Major US banks have a ratio in excess of these GAAP minimums, totalling on average some 5% on an IFRS basis. OECD work found a core Tier 1 ratio versus total IFRS assets (without netting) of 5% to be the most correlated to measures of bank safety (Blundell-Wignall and Roulet, 2012). Considerably higher leverage ratios than 5% have been suggested by others to force shareholders instead of taxpayers to absorb losses.

Going forward, key priorities for further reform include:

- Ensuring that the bank balance sheet risk assessments, asset quality reviews and stress tests scheduled for 2014 lead to a consistent overall assessment of banks' balance sheets that serve as a critical base for decisions about bank resolution or recapitalisation.
- Adopting a single efficient resolution mechanism, building on the proposal by the Council and ensuring that it is operative after the bank asset quality reviews and stress tests are carried out.
- Ensuring that banks can be restructured and recapitalised along common standards where needed and that bail-in conditions are clear in all countries before the bail-in provisions of the Bank Recovery and Resolution Directive apply in 2016.
- While resolution mechanisms are important, prevention is better. Thus, moving towards separation of high risk activities of universal banks (particularly with respect proprietary activities) should rank high on the policy agenda. Such business model reforms should be consistent with regions outside of Europe.
- Ensuring that a sufficiently capitalised Resolution Fund is available, with funding arrangements accounting for cross-border banking and financing needs recuperated by risk-based contributions of the banking sector. Complementing the Resolution Fund by a common fiscal backstop.
- Gradually phasing out zero-risk weighting of government bonds in bank capital ratios, limiting bank exposure to the debt of a single sovereign, and considering the consequences of adjusting capital adequacy rules to include a higher leverage ratio.

Figure 9. Banks' total assets and capital needed to reach a 3% or 5% leverage ratio¹
Per cent of GDP



1. Capital denotes core Tier 1 capital. The leverage ratio refers to 3% or 5% of total assets. Data are adjusted to reflect the International Financial Reporting Standards.

Source: OECD calculations.

Completing fiscal adjustment while improving its quality

In the short-term, most euro area countries need to persevere in their planned consolidation efforts, but the automatic stabilisers should be allowed to play fully if growth disappoints. In this context of continued efforts, as economic slack in the euro area is projected to diminish only slowly and inflation to remain well below the ECB's medium-term objective, it is appropriate to sustain monetary policy support.

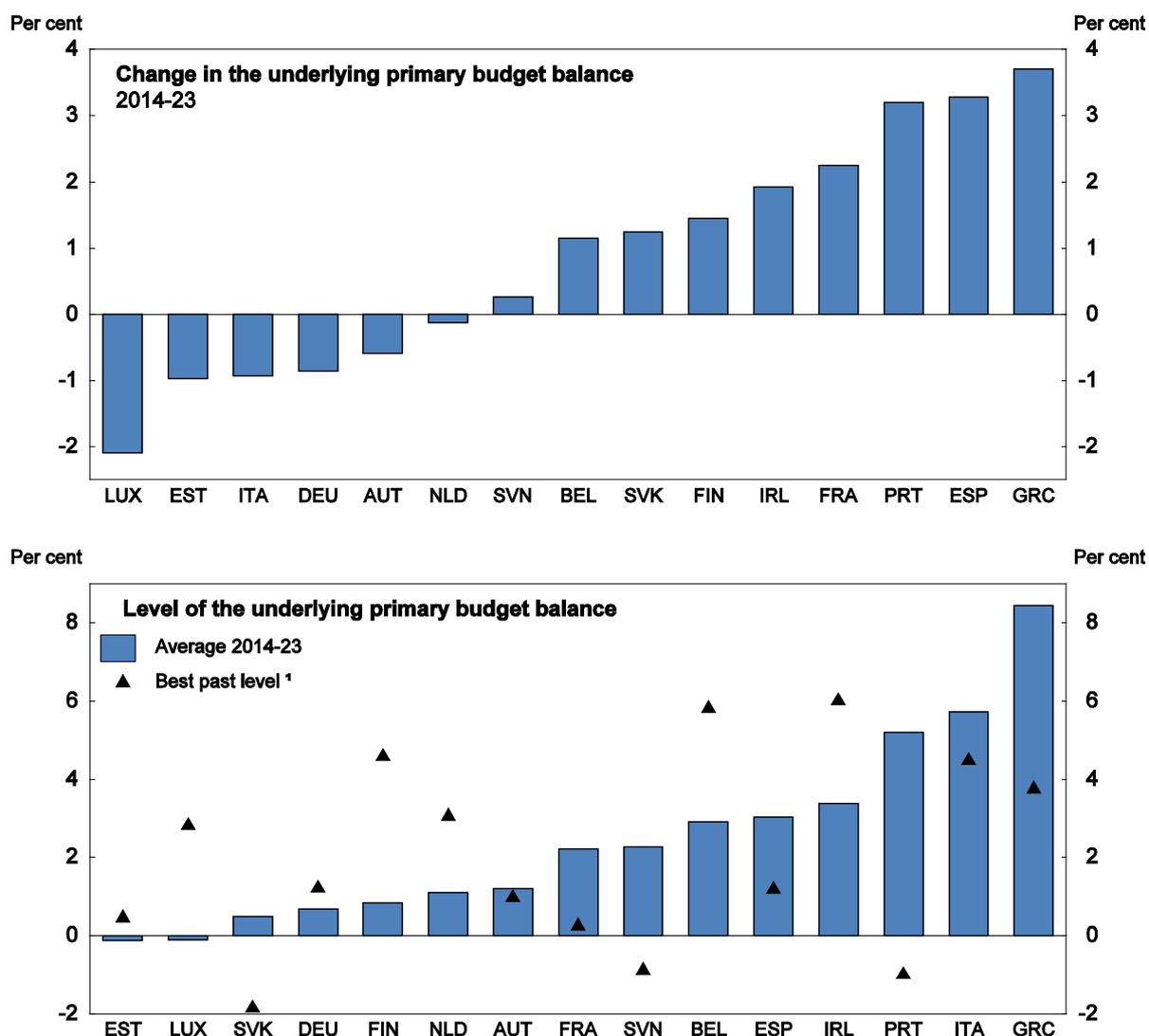
Within the revised EU fiscal governance framework, budgetary policies of euro area countries in the coming years will be subject to a set of rules, with the rule that binds differing by country and year. This includes, in particular:

- The country-specific Medium-term Objective (MTO) provides the principal medium-term anchor of a structural deficit of 1 or 0.5% of GDP (with the amount depending on the level and sustainability of government debt). The MTOs are to be reached by reducing structural deficits by at least 0.5% of GDP annually.
- The Excessive Deficit Procedure (EDP) stipulates that the headline fiscal deficit is to be reduced below 3% of GDP.
- The debt convergence rule requires that the gap between actual debt and the 60% of GDP is to be reduced by 1/20 annually, on average. For countries that are currently in the Excessive Deficit Procedure (EDP), the rule will start applying after a transition phase of 3 years after closure of the EDP.

The required amount of fiscal consolidation needed to meet these various fiscal rules under a stylised set of assumptions about medium-term growth and interest rates are given in Figure 10. For example, for Spain the consolidation requirement between 2014 and 2023 is estimated to total 3% of GDP. Due to differences in output gap estimates, automatic stabilisers and fiscal one-offs, the assessment of structural balances may differ from the official estimates of the EU Commission.

Moreover, the Six Pack stipulates that evaluation of progress towards and respect of the MTO is subject to general government expenditures (net of spending financed via discretionary revenue increases; interest payment, unemployment insurance and EU matching payments) growing less than a medium-term rate of potential GDP growth until the MTO is attained.

Figure 10. Consolidation needed under EU fiscal rules
Per cent of potential GDP



1. Best past level refers to the average largest level of the underlying primary balance in any five-year period between 1990 and 2009 (subject to data availability).

Source: OECD, *OECD Economic Outlook 94 database* and OECD calculations.

For seven out of the 15 OECD Euro area economies, the required improvement in the underlying primary balance under the fiscal rules from 2014 onwards until 2023 is less than 1% of potential GDP, and a slight fiscal loosening is indicated for some (Figure 10, top panel). However, France, Greece, Ireland, Portugal, and Spain would have to strengthen their underlying fiscal position by between 2 and 4% of GDP.

In any event, maintaining budget balances at levels needed to meet fiscal rules could prove challenging in several countries. In Greece, Italy, and Portugal – partly because of high debt levels – the rules imply maintaining an average underlying primary surplus of more than 5% of GDP over the 10-year period. Belgium, France, Slovenia and Spain would need to have an average underlying primary surplus of 2% of GDP or more. With the exception of Belgium and Ireland, these countries have never had such high underlying primary surpluses in any 5-year period between 1987 and 2009 (Figure 10, bottom panel). Future fiscal burdens associated with population ageing makes the task even more challenging.

The composition of fiscal consolidation can and should be adjusted to support growth and complement employment-enhancing structural reform. In particular:

- Raising the effective retirement age to reflect gains in life expectancy can augment long-term potential output growth by supporting labour utilisation. Progress has been made in many Euro area countries, including through the phasing out of early retirement schemes, but this remains a key priority especially in Austria, Belgium, Finland, Luxembourg and Slovenia.
- Reforming the education and health care systems should rank high on the policy agenda as there is scope for large consolidation gains without compromising equity or service quality. For instance, a recent update of the analysis points to potentially sizeable efficiency gains in primary and secondary education in Austria, Belgium, Germany, Italy and Luxembourg.³ In health care, potentially large efficiency gains have been identified in Finland, Greece, Ireland and the Netherlands.⁴
- On the revenue side, cutting certain tax expenditures can increase both equity and economic growth and should be given high priority. Many tax reliefs – including tax breaks for health and child care, education, owner-occupied housing and various saving schemes – often benefit mostly those in higher tax brackets, might be costly in achieving certain policy targets, and distort growth and investment. This is notably the case in France, Italy, Luxembourg and Portugal.⁵ There is also potential to further reduce tax expenditures in Ireland and the Netherlands (especially regarding the tax deductibility of mortgage interest payments).⁶

³ See Sutherland *et al.* (2007) and Hagemann (2012).

⁴ See (Joumard *et al.*, 2010).

⁵ See OECD (2013b) for France, OECD (2013c) for Italy, OECD (2012c) for Luxembourg and OECD, (2013d) for Portugal.

⁶ See OECD (2013e) for Ireland and OECD (2012d) for the Netherlands.

3. Boosting Growth and Job-Creation through Structural Reform

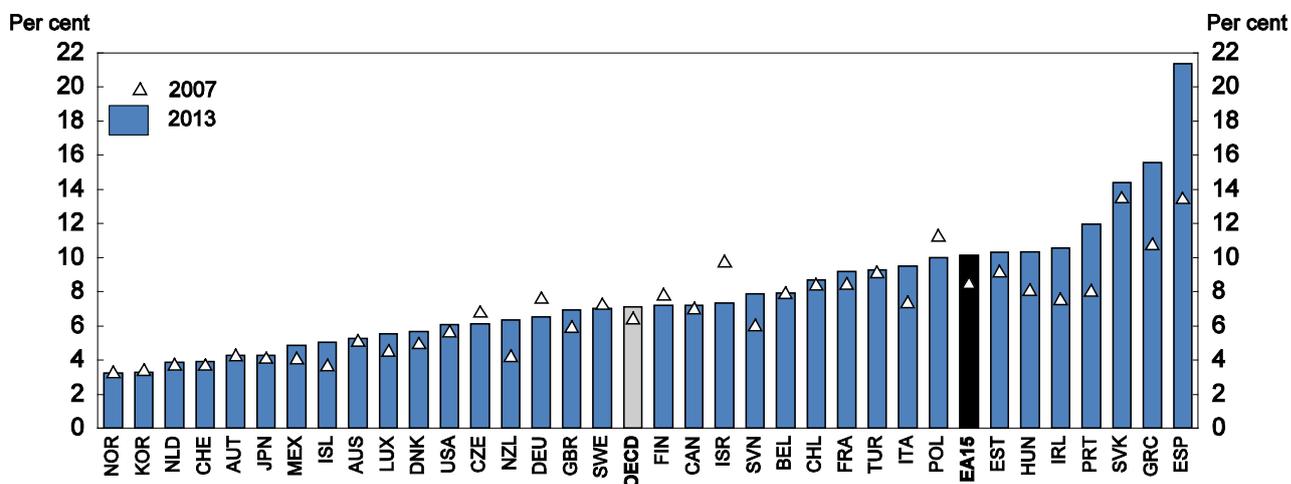
Employment and productivity performance in Europe is highly uneven

The employment crisis in the euro area is evidenced by the high rate of unemployment, which remains at around 12 per cent, with the highest rates observed in Greece and Spain (over 25 per cent). Youth unemployment has reached even more dramatic levels, over 30 per cent in Italy and Portugal, and almost 60 per cent in Greece and Spain.

Structural unemployment in the euro area is also high by OECD standards and has risen over the crisis (Figure 11). Potential growth had slowed prior to the crisis and has fallen further since. In addition, employment performance within Europe is uneven in both areas and the gap between worst and best performers is very large (Figure 12).

Productivity levels vary considerably within the euro area (Figure 13). The speed by which countries with lower productivity levels are catching up is also highly uneven (Figure 14), and OECD projections suggest that even over a long horizon not all low-productivity countries will catch up without significant reform (Figure 15). Such a catch-up is, however, dearly needed also in light of mounting competitive pressures from emerging markets (Figure 16). The export market shares of these countries have increased very rapidly over the recent past, thanks to low unit labour costs and also strong trade links with other fast-growing countries.

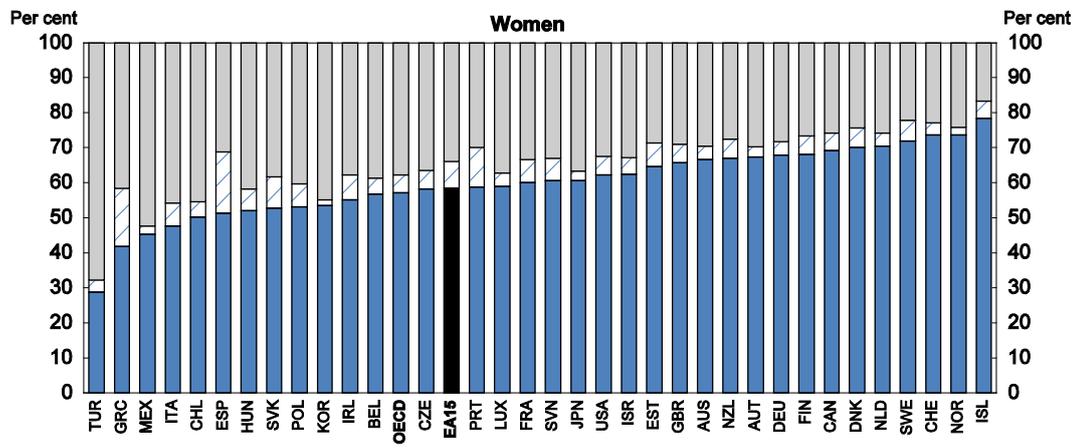
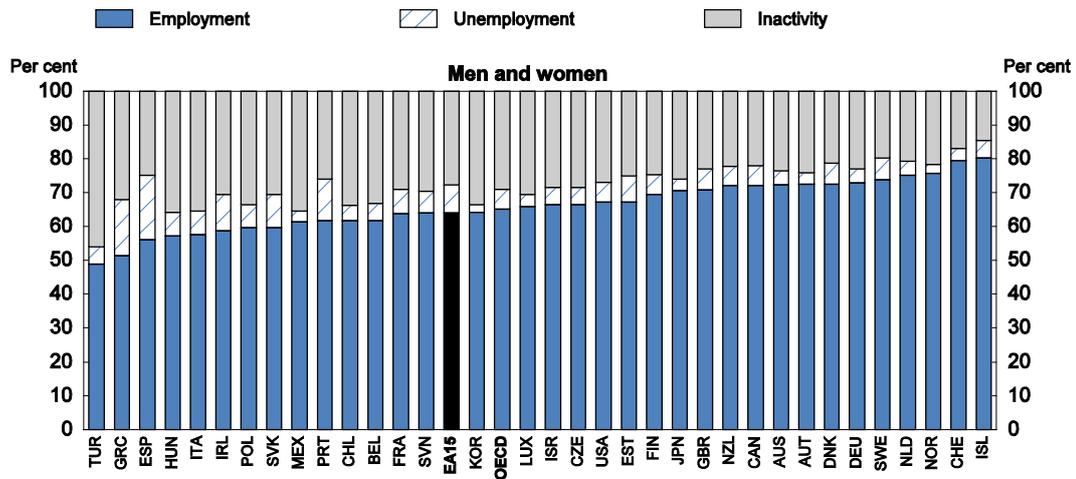
Figure 11. Structural unemployment¹
Non-accelerating inflation rate of unemployment



1. EA15 refers to the 15 countries in the euro area that are members of the OECD.

Source: OECD, *OECD Economic Outlook 94* database.

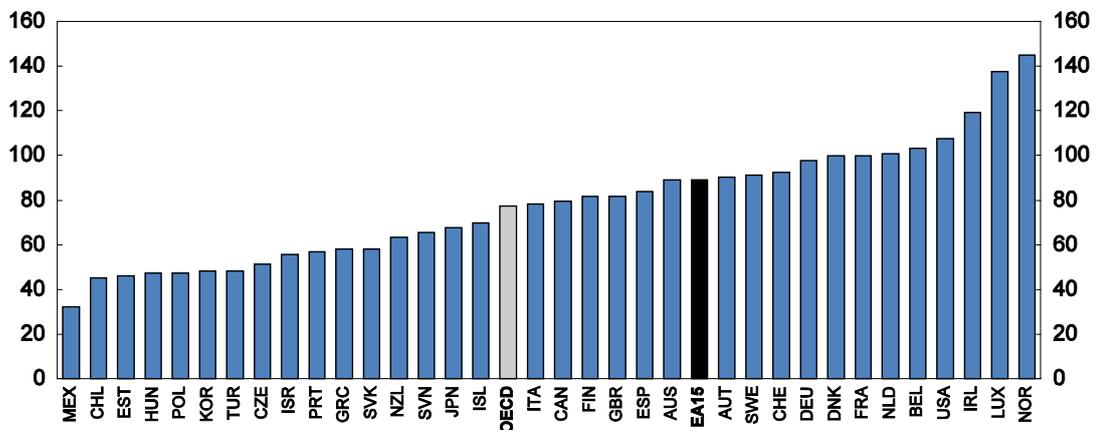
Figure 12. Activity rates¹
2012



1. Working-age population.

Source: OECD, Labour Force Statistics database.

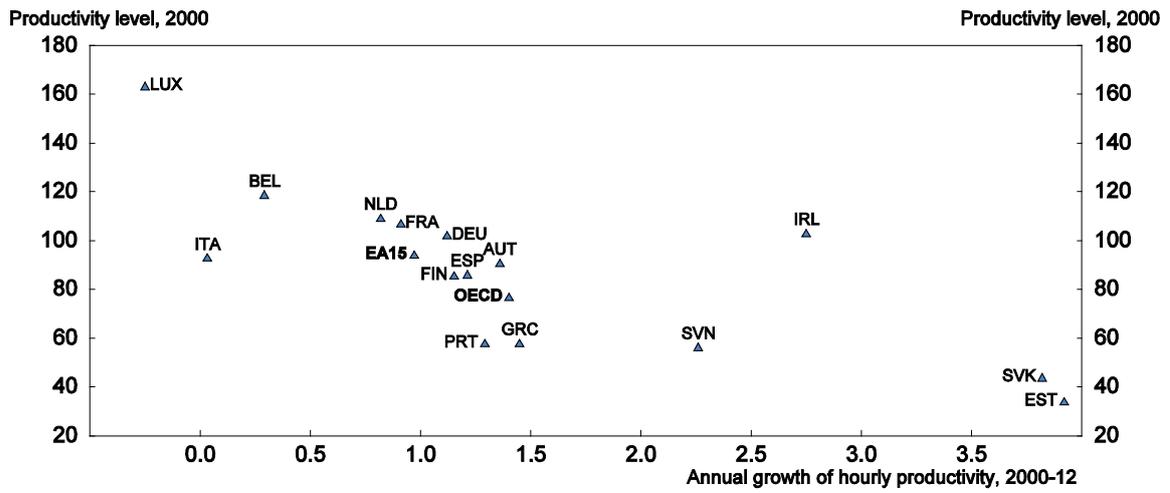
Figure 13. Hourly labour productivity levels¹
Average of upper half of OECD countries = 100, 2012



1. Based on GDP per hour worked.

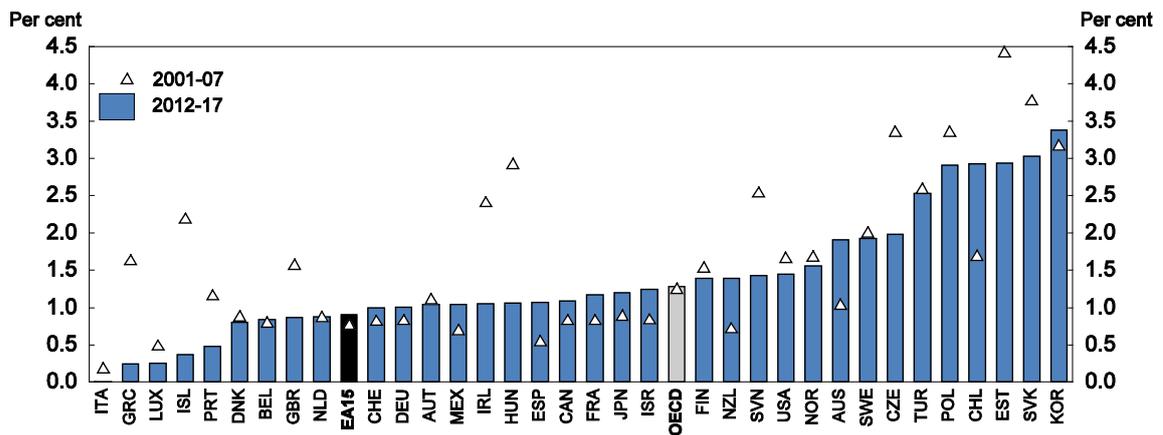
Source: OECD, Productivity database.

Figure 14. Ireland and Eastern European countries are converging faster than southern European countries



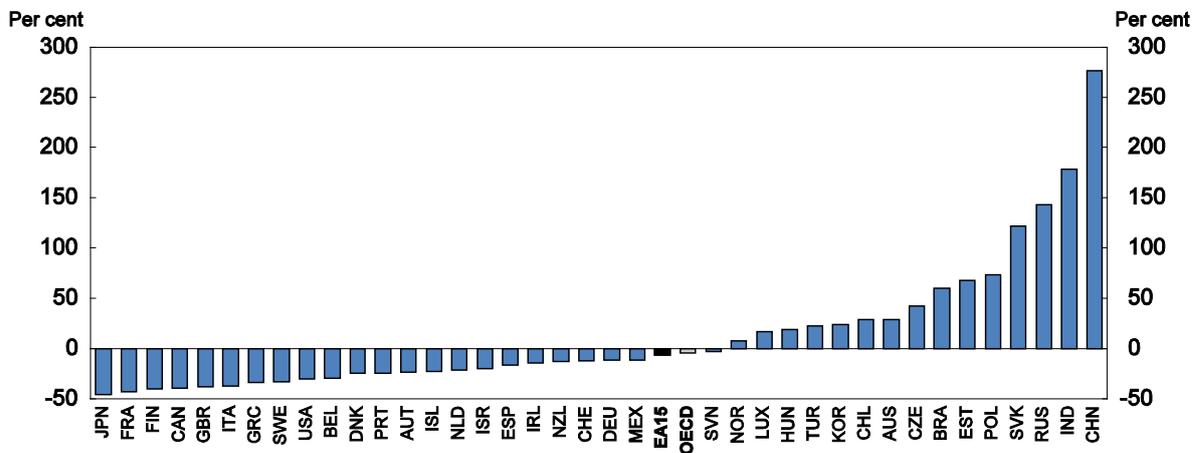
Source: OECD, Productivity database.

Figure 15. Potential labour productivity growth
Annual averages, percentage change



Source: OECD (2013), OECD Economic Outlook 93, OECD Publishing, Table 4.1.

Figure 16. Export market shares
Change between Q1 1999 and Q2 2013

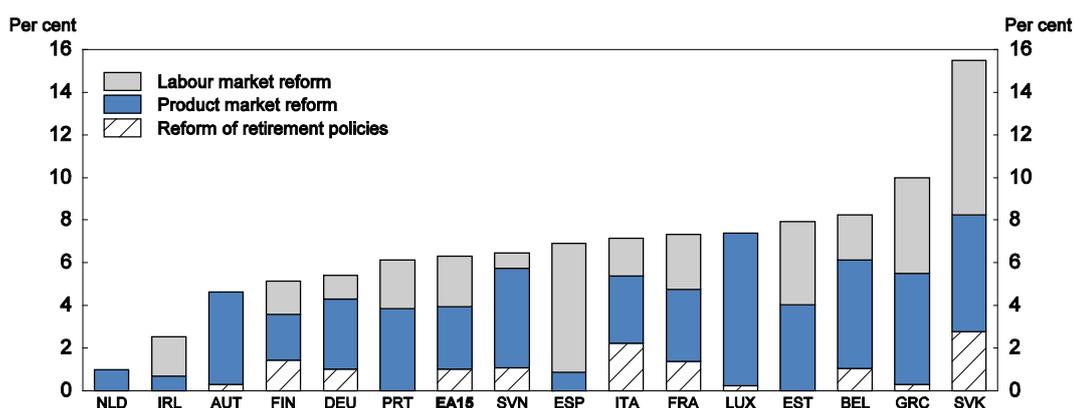


Source: OECD, OECD Economic Outlook 94 database.

Structural reform to boost output and employment

According to OECD long-term scenarios, if countries were to move to best practice in product and labour market policy settings, aggregate output in the euro area could rise by more than 6% by 2025 (Figure 17). Labour market reforms that reduce the structural unemployment rate would have large effects in a few countries, notably Greece and Spain. Aggregate output could rise by more than 20% in the long term by 2060 (OECD, 2013f), with even larger gains in countries that are the furthest from best practice. The largest gains come from product market reforms, which could raise productivity and GDP in the euro area by about 17%.

Figure 17. Structural reforms raise long-run output¹
Difference in the level of GDP in 2025, per cent



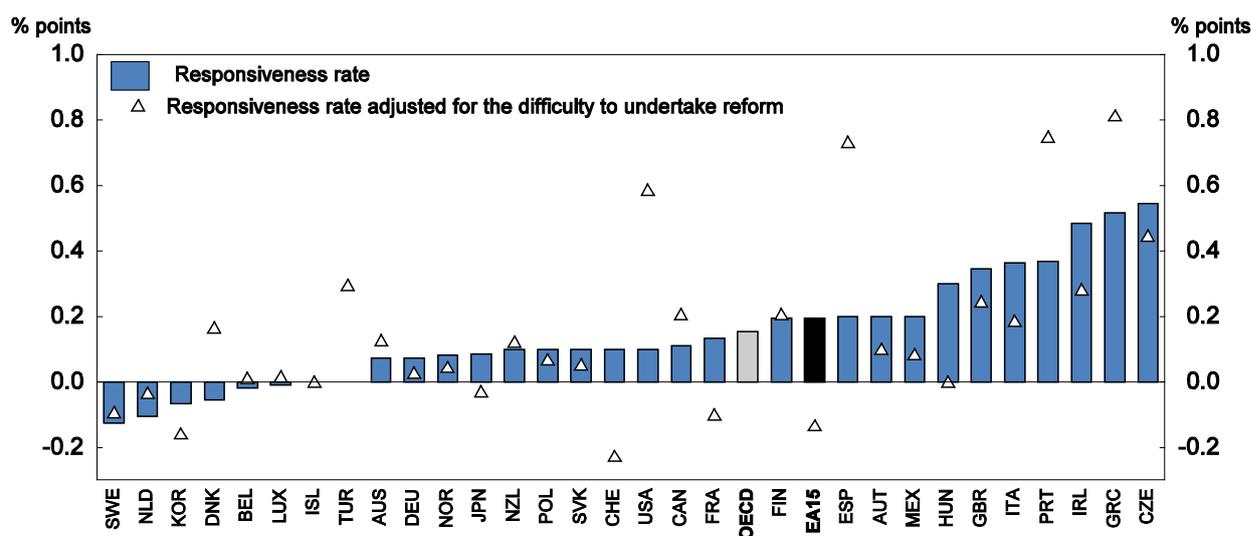
1. The size of each bar shows the effect on GDP of each policy simulated in isolation. The reform of retirement policies assumes that the ratio of working-life to life-expectancy converges towards that of Switzerland. Labour market reforms are assumed to gradually reduce the structural unemployment rate to 5% in all countries where it would otherwise be above this level. Product market reforms move each country's regulations gradually towards best practice.

Source: OECD, *Economic Outlook 93 long-term database*.

The crisis has accelerated reform in the most vulnerable countries

Structural reforms have accelerated over recent years, with the euro area debt crisis acting as a potent catalyst. The southern Euro area countries have been actively reforming to regain price competitiveness and restore fiscal sustainability (Figure 18). In particular, Greece, Portugal and Spain have undertaken fundamental reforms that are very difficult to implement in non-crisis situations.

Figure 18. Change in responsiveness to *Going for Growth* recommendations from 2009-10 to 2011-12¹



1. OECD and Euro area aggregates do not include Chile, Estonia, Israel and Slovenia. The reform responsiveness rate indicator is based on a scoring system in which recommendations set in the previous edition of *Going for Growth* take a value of 1 if “significant” action is taken and 0 if not. The “adjusted” responsiveness rate weighs responsiveness on each individual priority according to the difficulty of undertaking the relevant reform, as measured by the inverse of average responsiveness to priorities in this area in non-crisis circumstances across the OECD or the BRIICS.

Source: OECD (2013), *Economic Policy Reforms 2013: Going for Growth*, OECD Publishing, Figure 1.2.

The reforms that have been undertaken in the Euro area countries cover many areas (Table 1), including taxes, product and labor market policies, education, pensions, public spending and, to a lesser extent, infrastructure:

- In one euro area country out of two, including Greece and Spain, the implicit tax on continued work at older age has been reduced. Several countries implemented tax increases focused on indirect and property taxes to mitigate work disincentives. In Portugal, and to some extent in Greece, the tax system has been simplified and the tax base broadened.
- Labour market reforms have focused on easing regulation and reducing the dualism between temporary and permanent jobs, including by reducing severance pay. Job protection for regular contracts has been eased in Portugal and in Spain. Greece has introduced wide-ranging labour market reforms, and the minimum wage has been reduced by 22%, and by an additional 10% for the young. In Ireland, implementation of conditionality on labour market activation measures has been strengthened.
- Some relaxation of product market regulations also took place, following progress made before the crisis (Figure 19). Several sectors have been deregulated to spur competition in Greece and Portugal, although in both countries significant regulatory barriers to competition remain (OECD, 2013g and h). In Italy, competition authorities have been strengthened and shop opening hours have been liberalised. In Ireland, the water sector has been restructured and end user charges introduced to discourage waste.

Table 1. Countries where reforms have been introduced since 2011¹

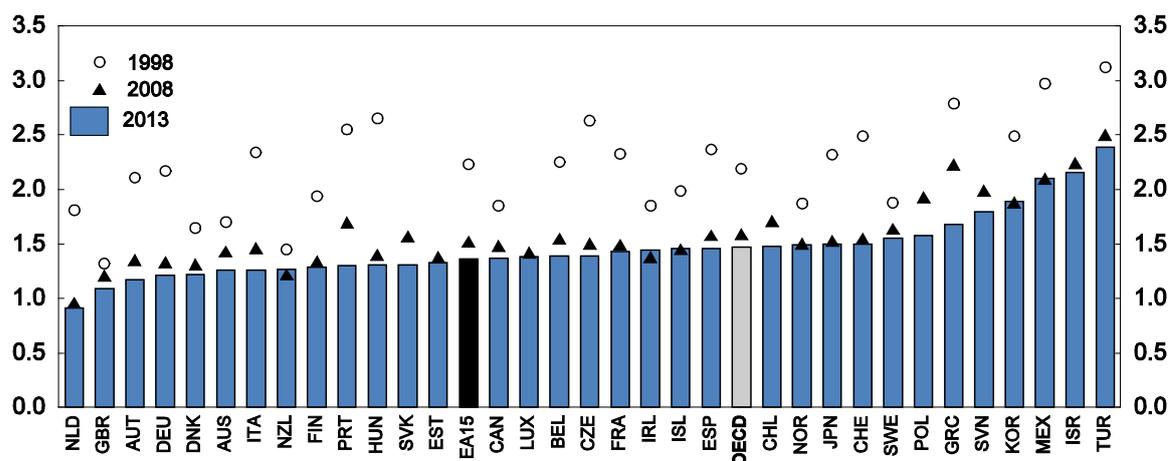
For bolded countries reforms are dropped from the list of priorities

Policy areas	Countries having taken action ¹
Product market regulations	
Strengthen competition in network industries	Austria, Belgium, Estonia, European Union, Germany, Ireland.
Reform/simplify product market regulations	Estonia, Luxembourg, Portugal, Slovakia, Spain
Reduce barriers to competition in the services sector	Austria, Ireland, Luxembourg, Portugal
Reduce regulatory barriers to competition	Greece, Italy, Slovenia, Spain
Strengthen private-sector participation in economic activity	Greece, Ireland, Portugal, Slovenia
Reduce housing market distortions	Netherlands
Labour market regulations	
Reform (disability) benefit schemes	Austria, Luxembourg, Netherlands, Spain
Reform the unemployment insurance scheme	Belgium, Finland, Italy, Netherlands
Reduce/moderate the minimum cost of labour	Greece
Reduce/ease job protection	France, Italy, Netherlands, Portugal, Slovenia, Spain
Reform the wage bargaining system	France, Portugal, Spain
Strengthen policies to support female labour force participation	Slovakia
Improve incentives for (formal) labour force participation	Estonia, Finland, Ireland, Slovakia, Spain
Taxation	
Reform/strengthen the structure of taxation	Austria, Germany, Greece, Italy, Portugal
Reduce implicit taxes on continued work at older ages	Austria, Belgium, Finland, France, Greece, Spain , Luxembourg, Slovenia
Reduce the (average) tax wedge on labour income	Belgium, France, Germany, Italy, Netherlands
Shift toward indirect taxes	Finland, France
Reduce impediments to full-time female participation	Germany
Human capital	
Improve educational efficiency/outcomes/achievement	Austria, Slovakia
Strengthen vocational education and training	Estonia, Portugal, Slovakia, Spain
Strengthen primary education	Greece
Strengthen secondary education	Spain, Greece, Italy, Portugal
Reform tertiary education	Austria, France, Finland , Germany, Greece, Slovakia
Financial regulation	
Improve/streamline financial regulation	EU level.
Other areas	
Reduce producer support to agriculture	
Improve public sector efficiency	Finland, Greece
Strengthen R&D and innovation incentives	Ireland, Slovakia
Improve the quality/provision of infrastructure	Ireland
Reform bankruptcy procedures	Ireland, Estonia

1. This table lists countries where some action has been taken since 2011 in policy reforms identified as priorities in the 2011 and 2013 editions of Going for Growth.

Source: OECD, *Going for Growth 2013 and 2014*.

Figure 19. Product market regulations restricting competition¹
Index scale from 0 (least restrictive) to 6 (most restrictive)



1. The product market regulation (PMR) indicator measures the extent to which policy settings promote or inhibit competition in areas of the product market where competition is viable. The reported indicators for Mexico, Poland and Turkey are based on preliminary estimates as some of the underlying data has not been validated with national authorities. Subsequent data validation may lead to revisions to the indicators for these countries

Source: Koske, I., I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 up-date of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Paper*, forthcoming, OECD Publishing.

There is much scope for further reform in all countries

Even though many Euro area countries have made notable advances on their structural reform agenda, further efforts are needed (Table 2). A key priority is to prevent cyclical unemployment from becoming structural and address the social impact of the crisis. In particular, reducing high labour tax wedges is essential to increase incentives to work, in terms of labour force participation or number of hours supplied (Figure 20) as well as labour demand. OECD policy recommendations often focus on reforms of tax and benefit systems, including recalibration of unemployment benefit and pension schemes, to improve work incentives.

Table 2. Policy priorities for euro area countries - 2013

Policy areas	Current policy priorities ¹
Product market regulations	
Strengthen competition in network industries	Austria, Belgium, European Union, Ireland, Slovakia, Slovenia
Reform/simplify product market regulations	Belgium, Spain, Luxembourg, Portugal
Reduce barriers to competition in the services sector	Austria, Belgium, Finland, Germany, Ireland, Luxembourg, (priority at EU level)
Reduce barriers to foreign ownership/investment/trade	
Reduce regulatory barriers to competition	Austria, France, Greece, Italy, Spain
Strengthen private-sector participation in economic activity	Greece, Italy, Portugal, Slovenia
Reform planning regulations	Luxembourg
Labour market regulations	
Reform (disability) benefit schemes	Austria, Luxembourg, Netherlands
Reform the unemployment insurance scheme	Belgium, Finland, Greece, Netherlands, Portugal, Spain
Reduce restrictions on labour mobility	European Union, Slovakia
Reduce/moderate the minimum cost of labour	France
Reduce/ease job protection	Germany, France, Italy, Spain, Luxembourg, Netherlands, Portugal, Slovenia
Reform the wage bargaining system	Belgium, Spain, Italy, Slovenia
Strengthen policies to support female labour force participation	Ireland, Slovakia
Improve incentives for (formal) labour force participation	Ireland
Taxation	
Reform/strengthen the structure of taxation	Germany, Greece, Italy
Reduce implicit taxes on continued work at older ages	Austria, Belgium, Finland, Luxembourg, Slovenia
Reduce the (average) tax wedge on labour income	Austria, Belgium, Finland, France, Germany, Greece, Italy, Netherlands
Shift toward indirect taxes	Austria, Belgium, Italy
Reduce impediments to full-time female participation	Germany
Human capital	
Improve educational efficiency/outcomes/achievement	Austria, France, Italy, Portugal, Slovakia
Strengthen primary education	Greece
Strengthen secondary education	Spain, Greece, Portugal
Reform tertiary education	Austria, Germany, France, Italy, Portugal, Slovenia
Financial regulation	
Improve/streamline financial regulation	Spain, (priority at EU level)
Other areas	
Reduce producer support to agriculture	(priority at EU level)
Improve public sector efficiency	Finland, Greece, Portugal
Strengthen R&D and innovation incentives	Ireland, Slovakia
Reform bankruptcy procedures	Ireland

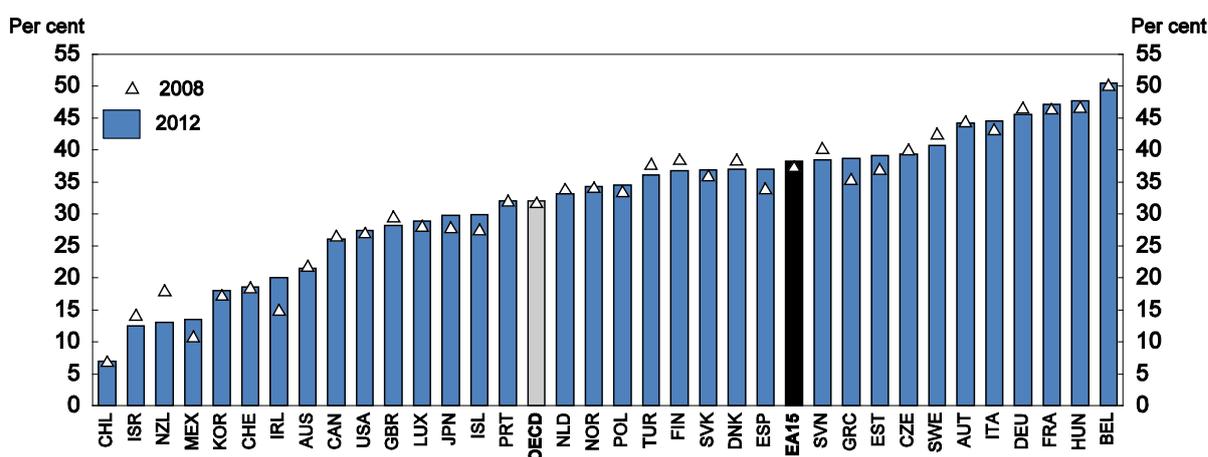
1. These reform priorities were set in 2012 and reported in the 2013 edition of *Going for Growth*.

Source: OECD (*Going for Growth database*).

In addition, despite reforms in many countries, there remains much scope to re-balance employment protection to reduce dualism between highly protected segments of the labour market and unstable marginal jobs (Figure 21). The phasing of these reforms is however important. For example, lowering unemployment benefits in times of high unemployment and sluggish growth risks a significant loss of income, which would undermine aggregate demand and exacerbate already widening inequalities. Moreover, public acceptance of further reforms will be undermined if they are not accompanied by broad-based measures in other areas.

There is a particular need to beef up and redesign active labour market, training and social policies to cushion the impact of job losses adequately in the short term and to facilitate the return to work and reduce unemployment before it becomes entrenched. Targeted measures are also needed for some groups, such as the increasing number of young people not in employment, education or training (NEET). Less skilled workers, including those hit by international competition, need training to adapt to the new environment. In many euro area countries, training schemes vary widely in quality and sometimes lack focus on job opportunities. A comprehensive evaluation of each scheme can help to identify best practices, such as appropriate guidance to the less-educated individuals and quality controls as recommended in the *Skills Strategy* (OECD, 2012e).

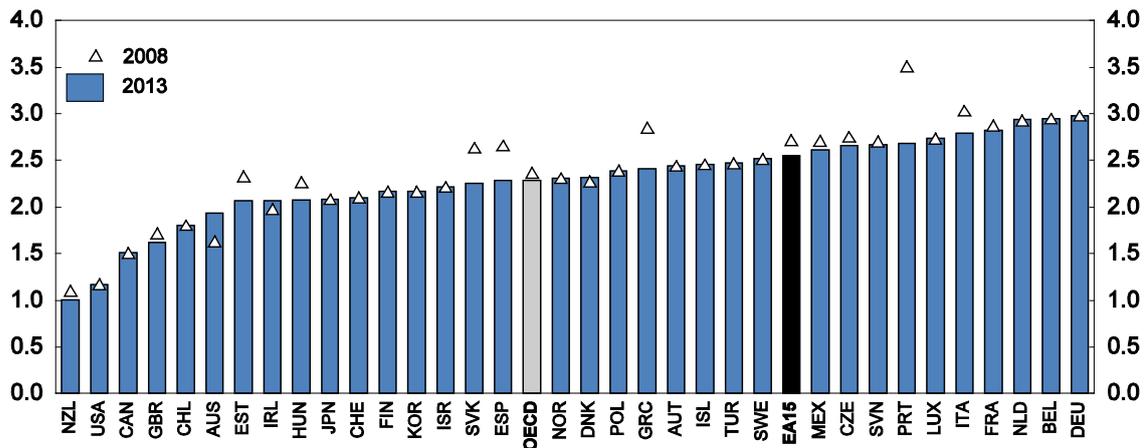
Figure 20. Average tax wedge on labour¹
Single person at 67% of average worker earnings, no child



1. As a percentage of total labour compensation.

Source: OECD, *Taxing Wages database*.

Figure 21. Employment protection is relatively high in the euro area
Index scale from 0 (least restrictive) to 6 (most restrictive)



Source: OECD, *Employment Protection Legislation database*.

There has been less progress on the reform agenda in surplus countries. Measures to create more favourable conditions for investment in these countries would not only support medium-term growth but also help ensure that the ongoing rebalancing persists once cyclical conditions improve. This is essential to achieve more balanced growth in the euro area as a whole.

There remains ample scope to support potential growth and productivity with competition-friendly reforms in product markets to simplify regulations, reduce barriers to market entry, strengthen private-sector participation in economic activity, and reform the governance of state-owned enterprises. Most recommended reforms are sector-specific, focusing on regulatory entry barriers in potentially competitive segments of network industries and competition-enhancing reform in the services sector. For instance, removing unnecessary licensing requirements, suppressing excessive regulations in the retail sector, and reducing education requirements for setting up a business could generate considerable positive output and employment effects in the economy overall.

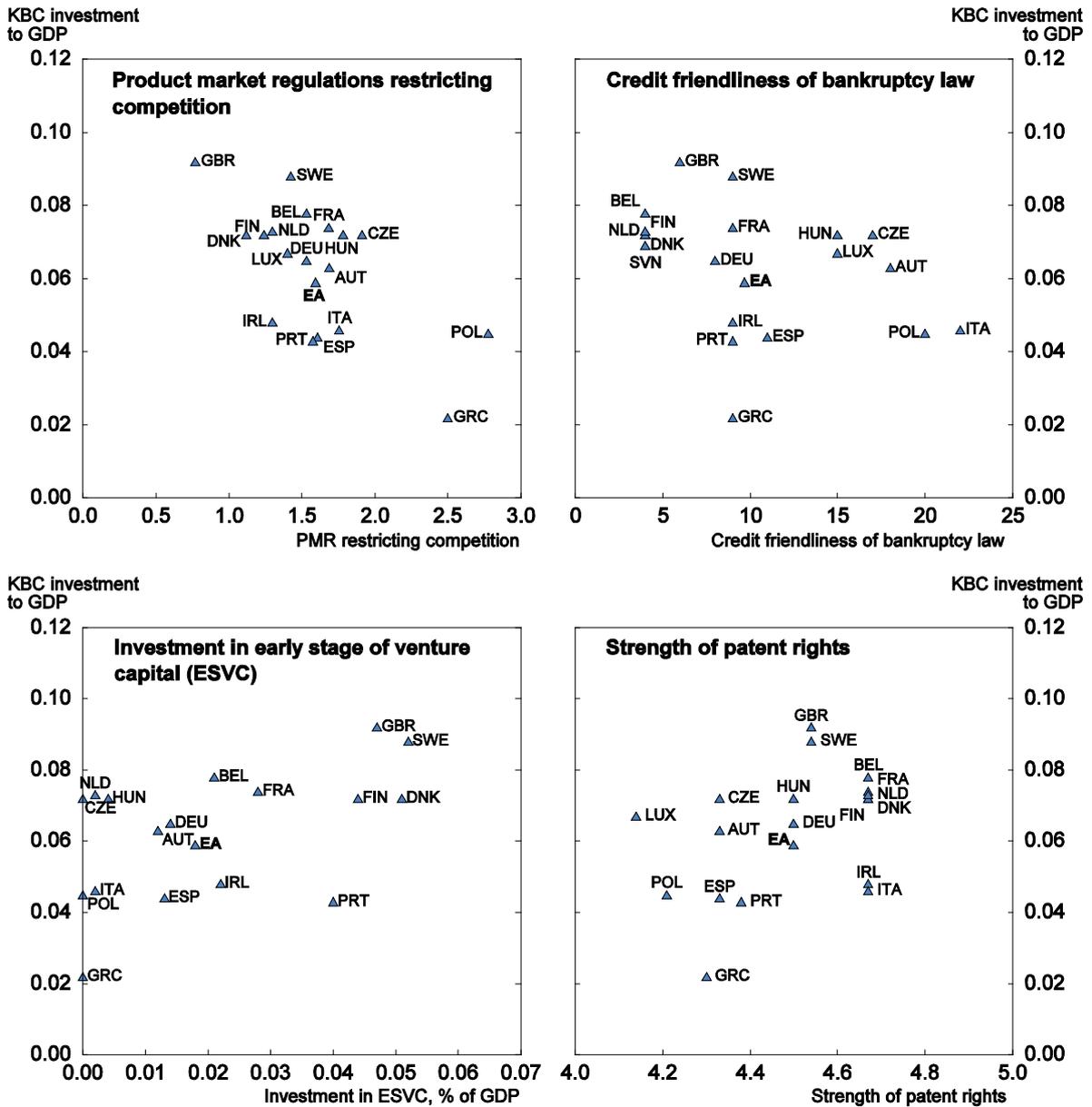
Fostering innovative and dynamic firms

Flexible labour and product markets favour faster reallocation of resources from low to high productivity activities. They help firms that innovate most to attract capital and labour and support the accumulation of knowledge-based capital (KBC) which has become an essential asset to compete in new technology sectors (Figure 22). Patenting also tends to foster KBC accumulation, and the EU Single Patent is an important step towards more efficient patenting. It would be desirable that Italy and Spain join this scheme as soon as possible.

At the national level, it is also essential to reduce patent litigation costs, move towards bankruptcy laws that do not overly penalise failure, develop R&D tax incentives that meet the needs of young firms, and strengthen co-operation between private firms and public research entities. Greater labour market flexibility, a lower tax burden on corporate income and capital gains, well-functioning secondary stock markets, and public co-investment funds can also help attract venture capitalists.

Overall, innovation policies that can bear fruit only in the long run have so far been given lower priority by countries than they deserve. Business R&D spending is especially low in Italy, Portugal and Spain (Figure 22). By contrast, enterprises in Finland and Germany, which have higher productivity levels, spend more on research and development.

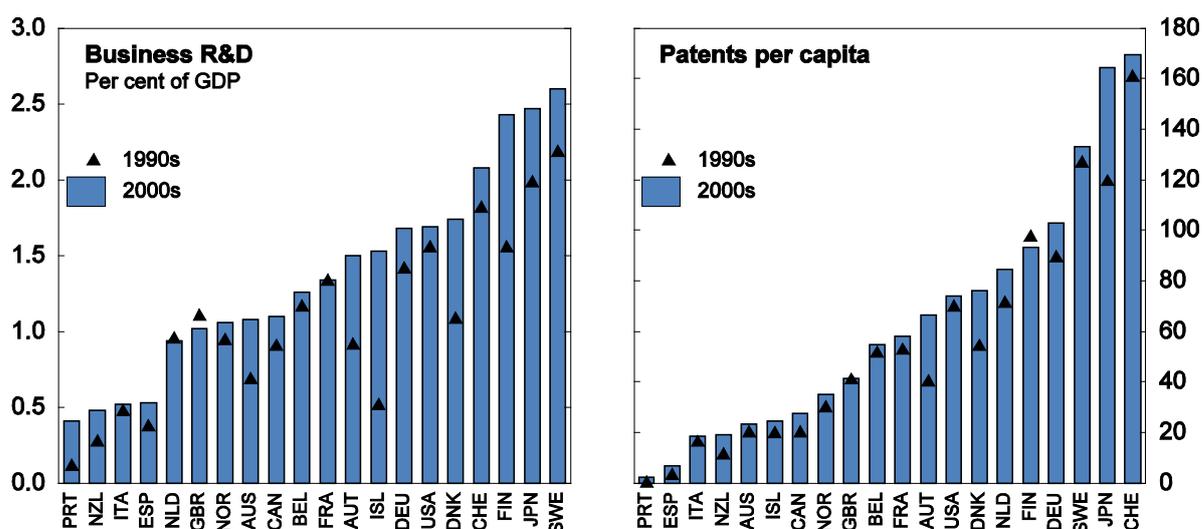
Figure 22. Investment in knowledge-based capital (KBC) and selected public policies¹
2005



1. Intangible investment to GDP is measured in 2005, while the policy indicators refer to either 2003 (PMR and bankruptcy law) or 2005 (patent rights and early stage of venture capital).

Source: OECD calculations based on intangible capital estimates from Corrado *et al.*, (2012), "Intangible Capital and Growth in Advanced Economies: Measurement Methods and Comparative Results", *IZA Discussion Papers 6733*, Institute for the Study of Labor; and policy indicators from the OECD (PMR, EPL), World Bank (Bankruptcy Law), and Park, W. (2008), "International Patent Protection: 1960-2005", *Research Policy 37*, Elsevier, www.sciencedirect.com.

Figure 23. Business outlays for research and development (R&D) and patents per capita¹



1. The patent measure is based on triadic patents, which refer to a series of patents for the one invention filed at the European Patent Office, the United States Patent and Trademark Office and the Japanese Patent Office.

Source: Andrews, D. and C. Criscuolo (2013), "Knowledge-based Capital, Innovation and Resource Allocation", *OECD Economics Department Working Papers*, No. 1046, OECD Publishing.

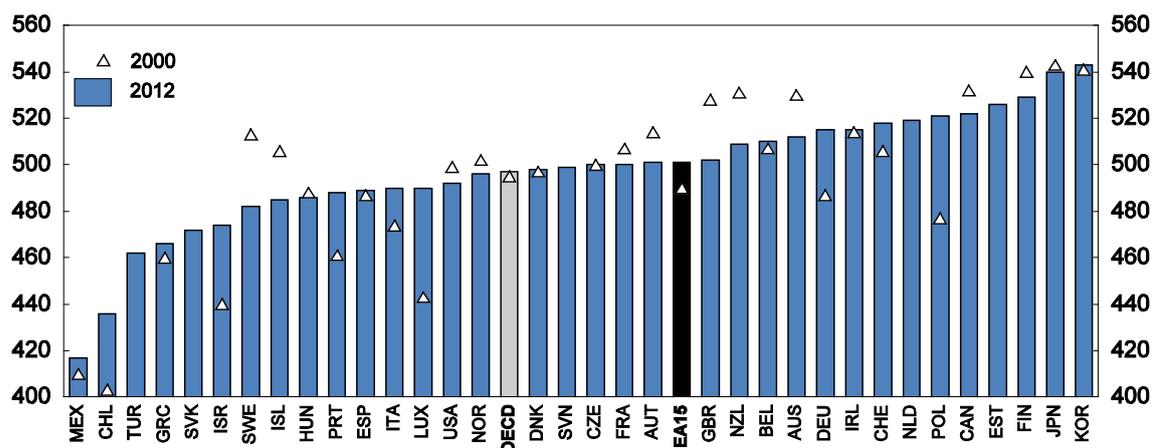
Enhancing skills

High levels of education and skills are crucial to generate productivity growth and employment in today's world. The ICT revolution of the late 20th century has considerably increased the importance of equipping workers with the right skills. Globalisation has further reinforced this trend. Upgrading skills is particularly important for countries that are catching up or that have failed to do so in the past.

This is the case of some of the southern EU countries, which are lagging behind in terms of educational achievement at the age of 15 (Figure 24). OECD analysis indicates that moving to best practice in the OECD area could generate large efficiency gains in secondary education outcomes, although such gains might take several years to materialise fully.⁷ The OECD Survey of Adult Skills reveals that adult numeracy and literacy skills also vary widely across countries, with the room for improvement particularly large in several Euro area countries (Figure 25). The Survey also shows that actual skill levels often differ markedly from what formal education qualifications suggest, implying that the quality of the education system is a key success factor.

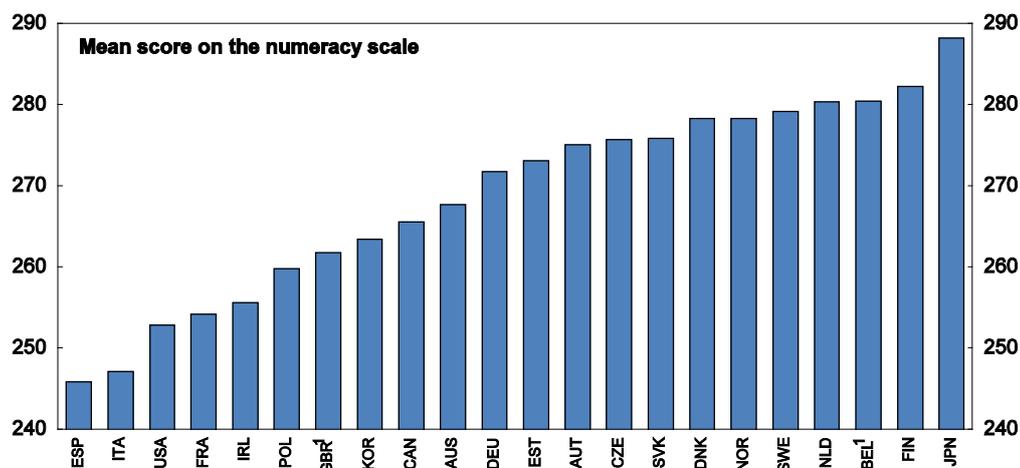
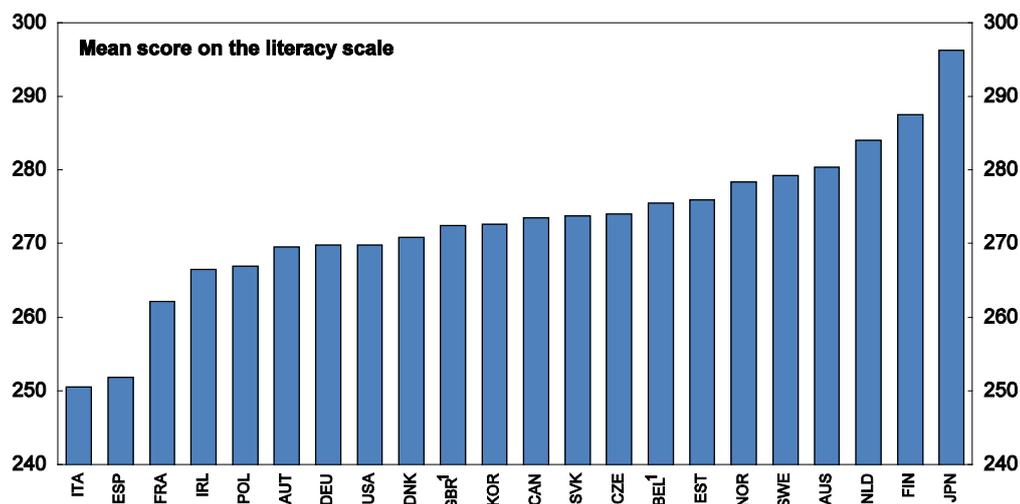
⁷ See Sutherland *et al.* (2007).

Figure 24. Educational achievement
Average of PISA score in mathematics, reading and science



Source: OECD (2013), *PISA 2012 Results in Focus: What 15-year-olds Know and What They Can Do With What They Know, Overview*.

Figure 25. Literacy and numeracy proficiency among adults

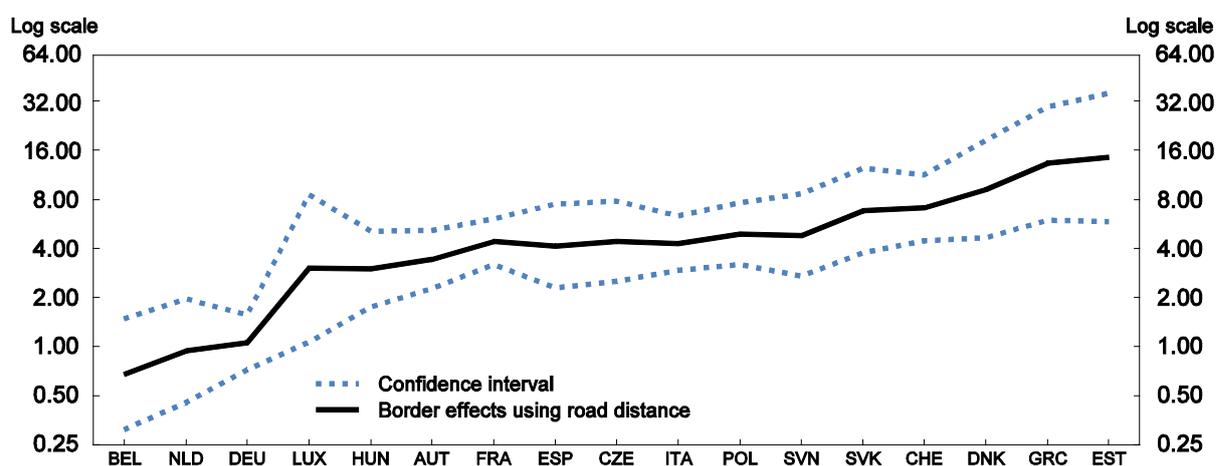


Source: *Survey of Adult Skills (PIAAC) (2012)*

Reducing barriers to product, capital and labour mobility in the EU

A range of measures still restrict trade between European countries (Figure 26). Unnecessary heterogeneity of rules and practices creates administrative costs and informational barriers, reducing trade, labour and FDI flows. This calls for determined efforts to further develop the EU single market by reducing unnecessary heterogeneity of rules.

Figure 26. Trade between EU member states
Country-specific border effects¹



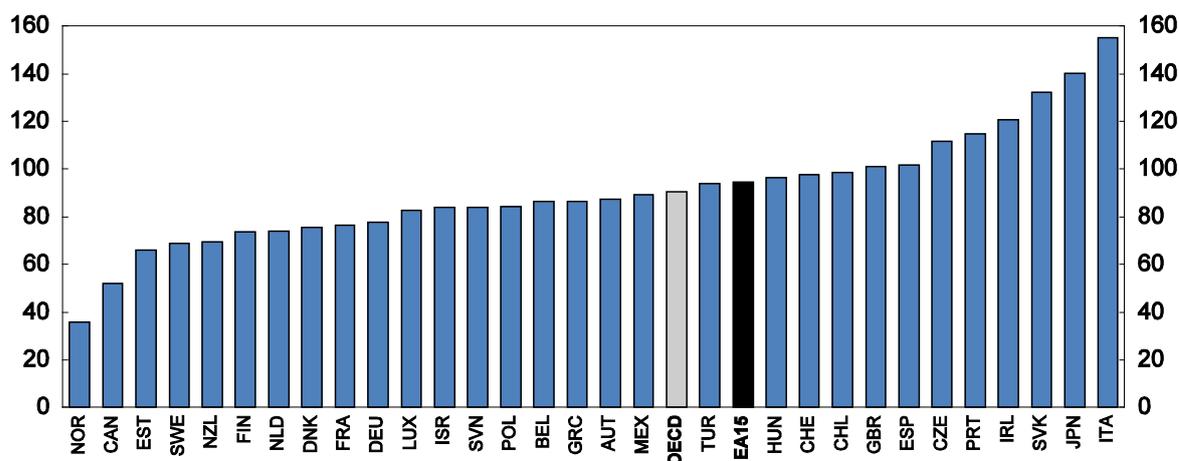
1. The border effect is a measure of the reduction of trade due to a border. For instance, in Estonia trade within the country is almost 15 times larger than trade across the border, everything else (*e.g.* road distance) equal. For further detail on the estimation, see *Source*.

Source: Braconier, H. and M. Pisu (2013), "Road Connectivity and the Border Effect: Evidence from Europe", *OECD Economics Department Working Papers*, No. 1073, OECD Publishing.

Trade is also hampered by a number of national barriers, which need to be reduced. In particular:

- Goods transported between EU seaports are still subject to the same customs formalities as goods exported outside the EU. Although this reflects concerns about customs duty fraud, ways need to be found to remove such formalities.
- Rail passenger and freight service markets should be opened to international competition to raise efficiency and hence decrease transport costs.
- Network industries that require pro-competition regulation (*e.g.* telecommunication, energy) are still regulated on a national basis, which is causing inefficiencies. Co-operation between national regulators should be further strengthened with a view to moving towards harmonisation or even cross-border regulators.
- Despite progress, interconnectedness of national electricity networks is incomplete, as is illustrated by the price gaps between neighboring countries such as France and Italy (Figure 27). This calls for moving forward towards ownership unbundling of generation, supply and network activities, and for the streamlining of permit procedures where possible.

Figure 27. Electricity prices for industry
EUR per thousand kilowatt hours before taxes, 2012¹

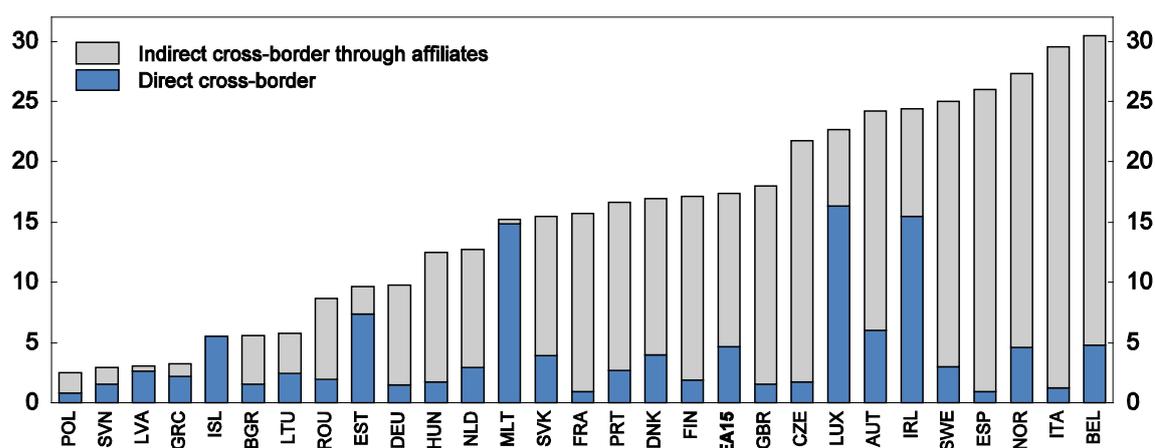


1. Or latest available data.

Source: IEA, *Energy prices database*.

It is also desirable to extend the achievements made by the Services Directive, which aims to remove discriminatory, unjustified and disproportionate national requirements on service providers; clarifies the requirements to ensure freedom of establishment; adopts the “silence is consent” rule; and creates Points of Single Contact. Firms that operate in different countries still have to comply with different sets of regulation reducing competition from foreign providers, especially from foreign SMEs. Also, not all services sectors are covered by the Services Directive. The regulatory burden that damps cross-border service trade can be further reduced. There are still too many restrictions on the right of establishment and there is room for progress in the implementation of the Points of Single Contact. In practice, foreigners still face implicit barriers in national procurement processes that hinder competition and raise costs (Figure 28).

Figure 28. Cross-border government procurement
As a percentage of the number of awards, average 2007-09



Source: European Commission (2011), *Cross-Border Procurement above EU Thresholds*, Final Report, DG Internal Market and Services, March.

Last, the digital economy is expanding rapidly, opening opportunities for growth and employment. However, polls indicate a lack of trust among consumers in using the internet for shopping, calling for data protection rules and minimum technical and legal security standards. Privacy protection demands need to be implemented, and in a manner that enables the benefits derivable from the use of personal data. Moreover, authorities need to be able to prevent network or platform providers from abusing market power, to ensure a level playing field. As digital activities can easily move across countries, regulation would be more effective at the EU level rather than at the country level.

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