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DEEPENING SERVICES MARKET INTEGRATION - A Critical Assessment

Jacques Pelkmans*

Abstract: *The greatest asset of the European Union is undoubtedly its internal market. However, the internal market is not completed: it suffers from a giant hole with respect to many services. The present contribution addresses the status of services in the internal market and, in particular, the horizontal liberalisation (or, the lack of it) of services outside the two large sectors which greatly deepened market integration (6 modes of transport and 3 financial services markets). Because a horizontal perspective on services in the EU is still little understood, it is briefly summarized what services really are and how their regulatory logic in the internal market can help to classify them. The (strong) economic case for deepening services market integration is built on recent empirical economic analysis as well as simulation. This is followed by a discussion, with flowchart, of the Bolkestein draft directive, against the backdrop of the frustrating lack of, or at best, selective progress on services for decades. A survey of economic impact studies of the draft directive is provided, too, underpinning its importance even when the infamous origin principle is taken out. Some light is subsequently shed on the tumultuous politicisation of the services debate. Emphasis is laid on the socio-economic context (which, it is submitted, sharpened the discussion at times into polarisation) and a series of other factors such as the diversity of the national regulatory frameworks of services and the labour employed, the complexity of the draft directive, the potentially radical nature of the origin principle (especially for those not aware of the case law of the ECJ), the dominant role of the EP and the opportunism of leading national politicians.*

Finally, directive 2006/123 meanwhile in force is explained and briefly assessed. Apart from the conspicuous manifestation of 'Angst' in drafting the directive, the (de) merits are set out. The conclusion is that a badly drafted directive with excessive emphasis on exclusions and derogations, and which lacks a driving principle, nevertheless comprises several functional obligations in general (e.g single window, administrative cooperation in dedicated networks, etc.), significant advantages for free establishment (which imply equally significant economic gains) and a firm discipline for (or prohibition of) bad practices with respect to temporary provision of services.

1. Introduction

The greatest asset of the European Union is undoubtedly its internal market. Nevertheless, the internal market is not, as many people believe, almost completed. It is not correct to suggest that the remaining issues for the internal market are just technical, politically and economically of minor importance and too trivial to expect political leaders to develop credible strategies for, with all the political energy and exposure that this would imply. Quite the contrary, the internal market suffers from a giant hole which has been ignored for far too long. The internal market is indeed

* **Professor Jacques Pelkmans** - *Jan Tinbergen Chair for European Economics, College of Europe, Bruges & Chair "Business & Europe" at Vlerick School of Management, Leuven / Gent*

developed and 'deep' in goods, capital and codified technology (except the EU patent). However, there is in fact no such thing as a European labour market and the 'free movement of workers' is crafted in such a way that it remains a "residual" issue for national labour markets[1] . Yet, few analysts would expect a genuinely integrated internal market for labour to come about in the longer run, even if free movement were given more chance by removing discrimination and obstacles. The giant hole can be found with respect to services. The conglomerate of economic (and non-economic) activities called 'services' generates some 70 % of the Union's GDP but there is neither a wide nor a deep internal market for services. The EU is now paying a (low growth) price for this failure, in particular in the EU-15 countries. Even so, the Union remains profoundly ambivalent about firm initiatives towards 'completion' of the internal services market, that is, widening its scope and deepening its meaning for business and consumers.

The present contribution will address the status of services in European integration, the economic and regulatory meaning of the severely truncated internal market for services after the adoption of the services directive in December 2006, some of the 'framed' or genuine misunderstandings during the debate on the 'Bolkestein draft directive' on horizontal liberalization of services in the internal market and, finally, the way forward in the medium-run. Section 2 will discuss what services really are, what the regulatory logic is, how services can be usefully classified such that the internal market aspects can be readily understood and, with the help of this classification, what (broadly) was covered by the draft Bolkestein draft directive and what not. Section 3 makes the economic case for a firm and wide-ranging initiative on deepening the internal market for services. Section 4 sketches the Bolkestein draft, in the light of the frustrating lack of, or at best selective, progress on services for decades, followed by a summary of economic impact studies. Section 6 provides an insight in the politicization of the services debate, without any claim of trying to be more than selective. Section 7 summarizes the directive as finally adopted and attempts to interpret its meaning. Section 8 concludes with a few recommendations.

2. About services and their regulatory logic[2]

Imagine, the reader would first attempt to answer the question 'what services are, exactly'. Some would say, presumably, that services are all economic activities which fall outside agro & fisheries and outside manufacturing and mining. Such a negative definition suggests that it is a left-over category and tells us nothing about the common economic characteristics of these activities. Other readers might recall the famous definition that services cannot 'drop on your feet'. One might also note that the GATS (WTO) distinguishes four modes of delivery of services (not very different from the EC treaty), without however, defining services themselves. In economic terms, services are credence or experience goods, usually (but not always) for simultaneous consumption when produced, intangible and unsuitable for e.g. tariff duties (though not for taxation) and highly differentiated. In the EC treaty services can be temporary (subject to free movement)

[1] See Pelkmans, 2006, pp. 178 187 and pp. 203 - 206 for why this is so and further detail.
[2] This section draws in part from Pelkmans, 2006, pp. 125 - 132 and Pelkmans, 2007-a.

and permanent (subject to the right of establishment). The temporary services can be pure cross-border, or, the consumer crosses the border to enjoy the service, or, the producer crosses the intra-EU border(s) to deliver the service (frequently, with temporary [so-called 'posted'] workers performing the actual work). All these elements cannot be missed if one wishes to understand the internal market for services but they are anything but sufficient.

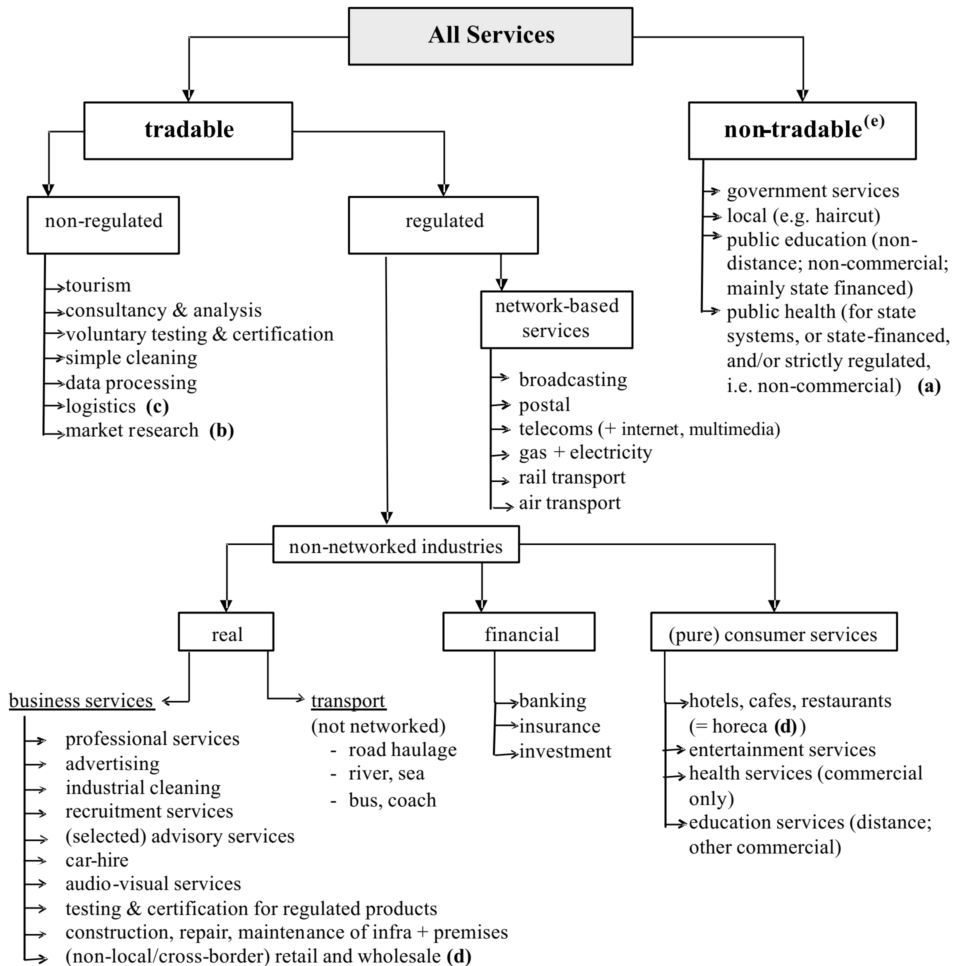
A better appreciation can be obtained if one converts the statistical classification of services into a schema based on the relevant properties for the internal market regime. Doing this carefully can prevent serious misunderstandings, which played a disproportionate role in the debate on the Bolkestein draft directive, while facilitating a better 'reading' of the Commission proposal. Of course, this is critical for economic analysis, too. A fairly comprehensive overview is provided in Figure 1 (Pelkmans, 2006, p. 127). What is required is to apply the internal market 'regulatory' logic to services categories. In order to do this properly, one has to go through five consecutive steps, as follows. First, distinguish economic from non-economic (e.g social) services; only economic services fall under the internal market. Second, distinguish B2B from B2C services, the reason being that consumer protection can be justified in the latter case, and, in turn, this might lead to cumbersome harmonisation issues (which should not normally apply to B2B!). Third, distinguish tradable from non-tradable services; if non-tradable, free movement is irrelevant, though the right of establishment still applies. Fourth, if tradable, are services regulated or non-regulated?[3] Fifth, if regulated, are services network-based or non-networked, as this is treated quite differently in the treaty.

Assuming services to be only 'economic' (although there are some issues of interpretation hidden in the 'untradable' category), Figure 1 incorporates all the answers to these questions. Many examples of services are mentioned so as to help the reader identify what could be at stake, without ever claiming the Figure to be exhaustive. A few remarks may illustrate how to use the Figure for the internal market debate. The tradable/non-regulated category is of huge economic importance to the EU, yet, was hardly or not discussed in the Bolkestein debate. To give just one example, the voluntary testing & certification sector represents an important economic activity for quality control and third party certification for many reasons. In actual practice, in testing houses and certification bodies, the work is often closely related to compulsory conformity assessment (e.g. under the EU New Approach), a regulated but highly competitive business. Non-regulated is a broad characterization, it is even possible that no Member State has ever regulated or restricted any of these activities; it might also mean that self-regulatory practices (e.g in voluntary testing & certification) or broader horizontal rules (e.g. privacy laws and data processing) do cause some problems in the internal market. In any event, the internal market should be allowed to work here and it matters little or not at all whether the origin principle (see below) applies or not. Plain free movement (and truly unhindered establishment) as well as competition policy should do.

The non-tradable category is a complicated mixed bag, many services of which are non-economic (including most

[3] The term 'non-regulated' should not be taken too literal. Thus, tourism is hardly regulated. Even so, the EU has minimum fire prevention regulation for tourists and other travellers. If regulation is light and exceptional, one should not expect regulatory barriers between Member States to be of great importance.

Figure 1
Services in the Internal Market
[trade or 'establishment'; services may be B2B or B2C]



Note: The examples mentioned in the various categories are illustrations for the reader; these lists are not exhaustive.

a) patients can of course move across borders and EU case-law exists about who pays what for hospital and non-hospital care;

b) unregulated, other than laws on privacy (partly EU);

c) unregulated, other than transport itself (which is regulated);

d) retail and wholesale and horeca are almost entirely domestic; however, to a limited extent there might be 'establishment' in other EU countries;

e) non-tradable, commercial services, might still exploit the right to establishment across intra-EU borders.

government services, of course). However, a small percentage of certain subsectors might not be so clearly 'non-economic', and at times also become potentially 'tradable'. This has led to sensitive problems of drawing clear demarcations (be it by the European Court of Justice or in EC directives to come) between non-economic and (sufficiently) market-based. Lack of clarity or resistance against the discretion of EU bodies to decide such demarcations caused turmoil in the EP and the Council, if not in many Member States, primarily illustrated by the sectors of health and education. In particular, the health sector has a complicated position in the internal market. The organisation and financing of healthcare and social protection systems is a clear responsibility of the Member States under public health provisions (art. 152, EC). Nevertheless, aspects of these systems or their effects may be influenced, perhaps even eroded, by activities or mobilities under the internal market. The mobility of patients over intra-EU frontiers seeking medical services abroad has been the subject of many recent ECJ cases, protecting in essence the right of the patient to exploit free movement. The (competitive) internal market for (life or health) insurance might come in conflict with the financing of social insurance based on solidarity. The price-setting of medicines as a part of different national public health reimbursement systems sits uneasily with free movement of medicines, especially parallel imports from low-price Member States. At the same time, health services are clearly for remuneration and, as such, cannot be regarded as 'non-economic' in most instances. The demarcation in (higher) education is somewhat easier but the trend to go for higher student fee + tuition in more and more EU countries may eventually create fuzziness, too. Some non-tradable are economic, yet truly local (e.g. the haircut or the bulk of retail shops) and thus irrelevant for the internal services market. However, supermarkets, hypermarkets, branded shop-chains and wholesale activities might well be potentially or actually active on a cross-border basis due to establishment.

Many services are regulated as is clear from Figure 1. Network-based services fall under art. 86, EC and have become subject to special regimes combining liberalisation, regulation and competition policy (see Pelkmans, 2001, for a survey of all 7 sectors specified). The confusion caused by the first Bolkestein draft was that some of these sectors were placed under a derogation and other ones not, thereby inevitably prompting the suspicion that the draft proposal amounted to a further liberalisation through the backdoor of horizontal liberalisation rather than sector-specific. The non-networked sectors are subdivided into real versus financial, as well as pure consumer services. The real ones include the dynamic class of business services, with some subsectors nevertheless remaining quite resistant to cross-border competitive exposure (e.g. professional services, with often anti-competitive self-regulation; also, repair and maintenance of larger infrastructure and premises, including e.g. railways infra) or subject to sensitive local rules (e.g. advertising). Cross-border retail & wholesale belong to the cases where the 'economic needs' test was still required in no less than 7 Member States in 2002, a major violation of the economic freedoms in the treaty. Non-networked transport, road haulage above all, is long liberalised and regulated under a separate chapter in the treaty and hence falls outside horizontal services liberalisation. The same goes for the three financial sectors, ever

since EC-1992 and even more after the successful Financial Services Action Plan, completed in 2005. This leaves the pure consumer services which do fall under the first Commission proposal, but entail some demarcations issues.

A simple fact worth reflecting on after studying Figure 1 in the light of the Bolkestein draft, is that the current services trade over intra-EU borders (a mere 20 % of intra-EU goods trade) is largely made up of activities of the very sectors *not* falling under the Bolkestein draft ! One should think of tourism and some other 'non-regulated' services (true, they fall under the draft but as non-regulated, the impact is minimal), the three financial services, the transport sector (with road haulage dominating all) and the network sectors. The consternation about the non-economic (and often local, too) services was about socio-politically sensitive demarcation, hardly or not about expected impact of economic significance. Apparently, the remaining sectors, for which the Bolkestein draft was designed, have so far hardly generated cross-border services trade! And when the Commission at long last suggested they should be subjected to the internal market in earnest, the sensitivities came out in the open for the first time in 45 years.

3. The economic case for a major EU services initiative

In the EU-27 nearly 70 % of GDP is generated by services activities: almost 72 % in the EU-15 and over 60 % (and rising) in the new Member States. Thus, even if EU agriculture and industry together would exhibit steady technical progress and better management and would permanently come up with new products, it is bound to have only a limited effect on overall economic growth and employment, merely because of their small and slowly decreasing share in overall activity. Insofar as services are inputs of the production and delivery of such products as indeed is increasingly the case - it will be essential to the competitiveness of European industry and the agro-sector that such business services are themselves dynamic and competitive, stimulated by an internal market which facilitates entry, innovation and variety. Where services are directly consumed by individuals or constitute inputs for other services, and these inputs are not necessarily local, the impetus for greater dynamism can be strengthened by opening up these markets to actual or potential cross-border competition from the entire Union. In the internal market for goods, these statements have long been accepted as elementary and a balanced combination of market forces, economic freedoms, competition policy and appropriate regulation ensures its effective functioning. When it comes to services, and despite a very similar obligation in the treaty, such convictions are less widespread or even selectively denied. Policy makers and analysts, when making the case, have to row against a tide of anxieties and suspicions. It seems that many service suppliers in the EU have become so accustomed to operate in a sheltered environment that liberalization is a priori regarded as a threat.

A few basic facts and results from economic research underline the urgency of addressing the performance of services in the EU:

i Annual growth rates of value added (in constant 1995 prices) between 1979 and 2003 (EU-15) amounted to 4.2 % for *business services*, against 2,2 % for manufacturing, 2,3 % for distributive trades, 2,4 % for

transport and 2,5 % for finance (source: Kox & Rubalcaba, 2007). The shining performance is explained by the close link with the Europeanisation of manufacturing (services following goods), by the trend forced by fiercer competition in the internal goods market to go back to 'core business' (thereby often divesting internal services and thus boosting the statistical growth in business services) and by a relatively high share of knowledge-intensive services in the category of business services. Nevertheless, cross-border business services are often unnecessarily costly due to cumbersome obligations and entry barriers, greatly discouraging SMEs to enter cross-border activities, even though these SMEs are dominating services in their home markets. B2C services across intra-EU borders are small (apart from tourism) and there is little evidence of growth except internet sales.

ii Services in Europe may not be dynamic enough, as is often held, but they are by no means stagnant. Thus, when focusing on all new firms created in the EU-15 in e.g. the year 2000, the European Commission (2003) found that new entrants in services added up to 65 % of all firms on average. It is also crucial to realize that the share of SMEs in services is extremely high and far higher indeed than in manufacturing. This characteristic makes it the more important that access to other EU countries should not be discouraged by extra burdens of protectionism because such features have a disproportional negative effect on SMEs.

iii What matters for the internal market are 'tradable services', that is, they can be traded across intra-EU borders. Taking into account the diversity of the services sector in the respective Member States, the non-tradable sector (e.g. government services, local ones, be they for profit or non-profit) can range from 20 % to over 30 % of GDP. In other words, services potentially tradable in the internal market could amount to some 40 % or more of GDP which is much higher than the actual intra-EU trade in goods today. In sharp contrast, the actual services trade in the EU hoovers around one-fifth of intra-EU goods trade! Knowing the many cumbersome restrictions in the internal market for services (European Commission, 2002), it is hard to escape the conclusion that EU countries could greatly boost intra-EU services trade by opening up radically towards each other. How far one could expect this boost to go, is difficult to know because goods and services are not fully comparable. Services are based on trust and well-established relationships because they are so-called 'credence' or 'experience' goods, unlike most tangible goods which can be characterized as 'search' goods and hence easier to verify. Therefore, proximity to customers is crucial for most services and, therefore, local establishment, rather than distant trade, is the preferred mode of delivery or market access. New

technologies have changed that somewhat, but there is no doubt that the potential share of services trade cannot be mechanically derived by a comparison with goods. Indeed, any overall study of the internal market for services must provide reliable data on local production of services by establishments from other EU countries, besides intra-EU trade. This is difficult because many services establishments are so small that they are not caught by cross-border FDI data.

iv There are other indicators pointing to a serious under-exploitation of the internal market for services. Two examples. Kox, Lejour & Montizaan, 2005, construct a trade-openness index for EU countries and find services trade openness to be low, with very low indices for relatively big countries such as France, Germany and Spain. Turning to establishment, data on services generated by foreign establishments are scarce; what data there is (based on OECD FATS data) shows for e.g. 2002 that the share of their employment in overall services employment in the relevant country never exceeds 20 % and is as low as 5,6 % in France, 2,9 % in Germany and 5,1 % in Italy. Employment shares in foreign establishments in manufacturing are higher than the ones for services in every EU country and the gap is never smaller than one-third, often more than half. When observing these discrepancies, one should not forget that precisely in services the mode of establishment is far more attractive, if not imperative, for durable presence in the market than for goods. What this implies is that one should expect services to have higher, not lower, shares than manufacturing, so the contrasting facts of today are worrying.

v In the last few years, analysts have drawn attention to high growth rates of selected services in the US, compared to the EU, as the main explanation of the transatlantic growth gap between the mid-1990s and (say) 2005. For example, in Van Ark (2004), aggregate labour productivity growth of the US and the EU-15 are decomposed by sectors for the period 1995 - 2002. He finds that 4 of the 5 sectors with the highest labour productivity growth are services: retail (except that of motor vehicles), wholesale trade, financial intermediation and activities auxiliary to financial intermediation. Of the 8-years average of 2.46 %, these 4 services sectors explain 1.16 %. In the EU, by contrast, the 4 sectors make up a mere 0.16 %-point of the 8-years EU-15 average of 1.64 %. These findings would seem to suggest that the regulatory environment for services and/or restrictions to exploit the internal services market seem to hinder a more or less similar development of such sectors in the Union. This would seem to be consistent with the results of the wide-ranging OECD work on the impact of restrictive regulations (including market entry and cross-border access) for the period up to 2003 inclusive (Conway, Janod &

Nicoletti, 2005). Restrictions and lack of rivalry might also be a major reason why ICT-usage in services is falling ever more behind that in the US (see e.g. Denis, McMorrow, Roeger & Veugelers, 2005).

Careful consideration of these points underpins a strong economic case to exploit the potential opportunities a well-functioning internal market for services would offer. As the well-known Commission (2002) report on the barriers in the internal services market amply demonstrated, this requires a wide-ranging horizontal initiative, possibly accompanied by selected sectoral areas.

4. The Bolkestein draft directive

Understanding the proposal for horizontal services liberalization[4] requires at least three steps: grasping the treaty sections on services, appreciating the massive recent case law (so large because the EU institutions failed to take services serious for far too long) and taking a careful look at the draft text. When doing this, one must realize from the start that services are labour intensive which implies that especially services trade (practically always a temporary movement over intra-EU borders) is bound to be closely associated with labour aspects, in sharp contrast with goods trade. Building on earlier case law, the Posted Workers directive 96/71 states that temporary provision of services in another Member State by posted workers performing the actual work is, or can be made, subject to host country control for crucial aspects such as minimum wages and e.g. days of vacation, but not for social charges (as these charges can be imposed by the state of origin, given that the service in the other country is a temporary one). Thus, although directive 96/71 might seem to belong to labour market regulation, in fact it is part and parcel of the acquis of the internal market for services.

The present article will not go into detail about the legal (de)merits of the Bolkestein draft and the finally adopted directive 2006/123.[5] A mere sketch of the approaches should do for our purpose.

4.1 The treaty on services

The treaty text has never been changed in the successive revisions of the Rome treaty. The free movement of services would seem to be a broad, horizontal obligation but there are (1) significant 'carve-outs' in separate articles or chapters in the treaty, such as the six modes of transport, financial services (banking, insurance and investment services) and the seven network industries (see Figure 1), besides (2) considerable scope for derogations (e.g. art. 46, EC). The right of establishment seems to benefit from obligations of close cooperation and removal of administrative obstacles (art. 44, EC) - an area where the Commission (2002) report demonstrated serious failure of compliance by Member States - , yet, is weakened by open derogations (e.g. art.s 45 and 46, EC) and the capture of EU bodies by the professions in the elaboration of the 'mutual recognition' of diploma's under art. 47, EC, until the early 1990s, if not longer. What essentially happened about free movement since the transition period of 12 years was over (i.e. 1970), amounted to a slow but steady intensification of the role of the ECJ

[4] *COM (2004) 2 of 13 January 2004, Proposal for a directive on services in the internal market.*
[5] *See, for instance, Do (2006), House of Lords (2005/6), de Witte (2007) and Micossi (2006).*

in the absence of serious horizontal action by the three Brussels institutions and, since 1985, an emphasis on the sectoral approach in transport and financial services, accompanied since the late 1980s by a gradual opening up of the seven network markets. In terms of Figure 1, this leaves the non(lightly)- regulated services, business services other than the sectorally ones mentioned above and pure consumer services. The Bolkestein draft (in so far as free movement is concerned) is no more than a belated attempt to tackle horizontal services liberalisation, shown to be riddled with barriers and discrimination. The right of establishment in services turned out to be legally less difficult in principle, given the acceptance of host country control for incoming companies and individuals, but in actual practice turned out to be biased against non-locals in many subtle and less subtle ways. Moreover, in not tackling obvious violations of EC law (such as the 'economic needs test') and not harmonizing almost anything (whilst the so-called 'mutual recognition' directives for the professions were little more than attempts of 'maximum harmonization' so as to prevent non-local professionals to enter), the regulatory heterogeneity inside the internal market caused national markets to be so distinct that no single services markets would ever emerge. This raises costs and reduces the competitiveness of European business using these services as inputs. Once a new approach to diploma recognition had been initiated, building on directives 1999/42 and 2001/19, it was time to tackle the obstacles to a free exercise of the right of establishment once and for all. This was the other major aim of the Bolkestein draft directive.

The case law of the last two decades and especially the last few years (Hatzopoulos & Do, 2006 for a survey) has become a major driver of selected liberalisation, but it suffers from the lack of an overall regulatory framework based on politically agreed guidelines, adopted with the political legitimacy of the EU legislature. The ECJ is understandably afraid of substituting political for judicial decisions and therefore often falls back on generally worded derogations, which it subsequently tries to discipline with principles such as proportionality and a duty for national authorities to take into account the measures already taken by the country of origin (a soft kind of mutual recognition, subject to much legal debate).

4.2 Case-law and the origin principle

The case law on the free movement of services has gradually become similar to that for goods, with a delay of a decade or so. Of course, this applies to the principles, not to the specific details.[6] This interpretation has helped the integration of the services market to move forward.

As with goods, there is first the distinction between discriminatory and non-discriminatory barriers. Discrimination on account of the provider's nationality[7] or the provider's Member State of establishment is prohibited, but broad derogations under Art. 46 are possible. For non-discriminatory restrictions, it would seem that the case law on goods (that is, Art. 28) has inspired the jurisprudence on services, too. In the Säger case[8] and later, there is an analogy with the

[6] *An extremely detailed survey of ECJ case-law on services is published by the Commission (DG Internal Market) as Guide to Case Law, Freedom to provide services, 2001. The text above only highlights a few basic principles.*

[7] *Services provisions cannot be reserved for nationals only, except when the derogations in Art. 46 make this restriction indispensable (but the Court assesses this carefully, see further).*

[8] *Case C-76/90, ruling 1991.*

Dassonville case[9]: restrictions 'liable to prohibit or otherwise impede' cross-border services of the 'temporary' type are not allowed. This economic approach covers those measures affecting the ability to provide, those increasing the cost of the relevant service (a very wide-ranging prohibition, like in Dassonville), and those discouraging its provision. Interestingly, it also explicitly protects consumers who are prevented from receiving the services of their choice.

It is then a small step to introduce the analogy with Cassis de Dijon. A Member State cannot normally prohibit the provision, in its own territory, of a service lawfully provided in another Member State, even if the conditions in which it is provided are different in the country where the service provider is established. This looks like mutual recognition. But is it mutual recognition? The case-law for regulated goods makes this dependent on the *equivalence of the objectives* under derogations (like on safety, health, environment and consumer protection) in the origin and destination countries. If equivalent in objectives, the differences in specific details in the laws of the Member State(s) of origin, and of destination are irrelevant for free movement, in other words, the derogations no longer apply. However, if 'equivalence' is *not* specifically mentioned, and therefore does not matter, one often denotes the Cassis-de-Dijon quote (above) as the *origin principle*[10]. What matters is whether the derogations are disciplined (i.e. limited): equivalence of objectives, versus a weaker or no discipline. If and in so far as the discipline is weaker or absent, the origin principle in combination with these 'undisciplined' derogations leaves *more* discretion to Member States. However, exactly for that reason, 'equivalence' (hence, mutual recognition) would give more certainty to firms and Member States *and help free movement more*. The case-law on services is not entirely clear on the distinction. It is crucial to understand why.

The ECJ has been faced with many cases, because, especially in service sectors, for possible market failures not clearly specified in the treaty (thus, other than transport, finance and the professions), the EU legislator has long failed to engage in (minimum) harmonisation. Without guidance from what Council and EP wanted to regulate, the ECJ was forced to stress a fairly radical free movement approach, but also prudently permit very wide and many derogations in fairly general wording. Rather than a consistent and straightforward application of the origin principle, which might have undermined much regulation in destination countries, the ECJ could do no more than 'wait' until the EU legislator determined what the proper limits of the derogations should be. The EU legislator took up this challenge in a few remarkable directives where the origin principle is explicitly the basis of free movement (e.g. the TV-without frontiers directive and the e-commerce directive 2000/31) but refrained from doing so more generally for services. It is only after the discovery of many obstacles to service trade and establishment in 2002, that the Commission was finally in the position to propose horizontal services legislation.

In analogy to Art. 30, the wide derogations of Art. 46 and a host of related

[9] *Case 8/74, in [1974] ECR 837*

[10] *See Pelkmans, 2007-c, for a flowchart juxtaposing mutual recognition and the origin principle (in goods markets)*

other objectives[11] legally need not be incompatible with free movement of services. To verify whether this is so, national regulations have to pass three tests. The first one is the justification test, that is, overriding reasons related to the public interest. But this is restrictively interpreted (indeed, like Art. 30). Thus, economic aims or administrative convenience do not qualify. Second, there is a kind of home country control test. Statutory conditions (if equivalent), already satisfied in the home country, cannot be duplicated by the host country, and the supervisory authority of the host country must take into account supervision and verifications in the home country[12]. Finally, there is the proportionality test: the restrictions should be indispensable and least restrictive (that is, no less restrictive means should be available).[13]

4.3 Horizontal liberalisation logic of services[14]

The combination of a highly conditional 'free' movement of services, a lack of treaty specifications on how to actually accomplish the process of horizontal liberalisation (that is, outside sectoral liberalisation), and extensive ECJ case law compelled to employ broadly formulated derogations (in the form of principles, much more than 'rules') given the failure of the EU legislator to engage in clear harmonisation, did not augur well for the completion of the internal services market. It is only once a 'services strategy' had been agreed in 2000, in the framework of the Lisbon goals to make the EU perform economically far better, that decisive improvements of the functioning of the single market of services could become a serious priority for the EU legislator. Given the tremendous specificity of services and the complicated ECJ case law, the regulatory design of the legislation matters a lot. In particular, what combination of liberalisation, prohibitions of types of national measures, harmonisation for aspects which the ECJ placed under 'derogations' (and the limits of them) as well as cooperation between the Member States for purposes of home-country measures and in avoiding red tape hindering free establishment, is desirable? How could that combination be optimal in balancing the great need to finally liberalize and the justified minimum regulatory protection in the public interest? Figure 2 provides the regulatory logic of the so-called services draft directive[15] which has been widely misunderstood.

As noted before, but too often forgotten, services liberalisation in the EU is always about free movement *and* free establishment. Moreover, it solely applies to economic services, hence not to non-economic services of a social or cultural nature, or, indeed, to publicly financed and/or (non-commercially) regulated services such as (most) public health and public education. Figure 2 is relatively clear about free establishment, the right-hand

[11] The Court has referred to all the essential requirements specified in the old Art. 36 as, in principle, applicable to services, too, as well as to some other ones (which it calls 'mandatory') e.g. 'coherence in the tax system' (C 204/90, Bachmann; ruling 1992). See the Commission survey of 2001 (in footnote 6).

[12] In goods there is an analogy with the Court's principle that identical testing should not be duplicated.

[13] This is a drastic simplification of the case-law. See Hatzopoulos & Do, 2006, for an extensive legal survey.

[14] The following draws, in part, from Pelkmans, 2006.

[15] COM (2004) 2 of 13 January 2004, Proposal for a Directive on services in the internal market, informally known as the Bolkestein draft directive. It leaves out some special issues such as the possible interference of the draft directive with international private law, and the choice (in labour or consumer contracts) of the applicable national law (e.g. Rome I, etc..)

side. Whilst a number of overly restrictive or unreasonable measures or requirements of Member States, or regional authorities, should be unambiguously forbidden (the 3rd arrow), positive measures include conscious administrative simplification like one-stop-shopping for licenses or other red-tape (where Member States should act in the common EU interest which they evidently did not, thus far) and cooperation between authorities in different jurisdictions for quickly retrieving the proper information, and some degree of harmonisation of criteria for licensing and procedures. Given the existing uncertainty for a myriad of services, a screening process of national laws in EU working groups should provide all necessary information about further simplification or abolition of red tape, or, in exceptional cases perhaps harmonisation.

The problem of free movement is a good deal more complicated and the sensitivities are not to be underestimated. If one ignores sectoral liberalisation, dealt with under special regimes in the EU, the starting point of horizontal liberalisation is to ask what core principle ought to be applied over the range of services sectors: mutual recognition or the origin principle. What they have in common is the idea that, except for derogations, a Member State cannot normally prohibit the provision, in its own territory, of a service lawfully provided in another Member State, even if the conditions in which it is provided are different from those in the country of destination. Where the two principles differ is that the origin principle stops right there, whereas mutual recognition (at least, if inspired by the tradition in goods markets) adds a qualification for the derogations: if the objectives behind the derogation(s) are 'equivalent', free movement still applies. There are two certain ways to determine whether objectives are 'equivalent': the ECJ case law and (minimum) harmonisation, focussed on goals only. The upshot is that the origin principle may override some of the worst, protectionist rules for services that cannot be justified, but otherwise will merely invite a litany of derogations, the limits of which are hard to foresee and for which only generally worded disciplines, like necessity and proportionality, will be available. This is indeed what happened with the draft services directive of 2004. In Art.16 the origin principle is defined: "Member States shall ensure that providers are subject only to the national provisions of their Member State of origin which fall under the coordinated field". Wisely, this is first followed by a list of what in any event is prohibited for Member States. But, as Figure 2 shows, the economic meaning of the origin principle is hard to determine in the light of many derogations.

The discipline of the derogations is mentioned in the box left/below the derogations and comprises, inter alia, the criterion whether or not the 'interest is already protected by the rules of the State where the service provider is established'[16]. The difference between the origin principle and mutual recognition vanishes if this quote of the case law is interpreted to mean that the objectives of the relevant laws of the two countries are 'equivalent' (what the ECJ calls 'interests .. already protected'). But that is clearly not the case, the meaning is a more limited one. (see e.g. Hatzopoulos, 2007). Four types of derogations are indicated in Figure 2.

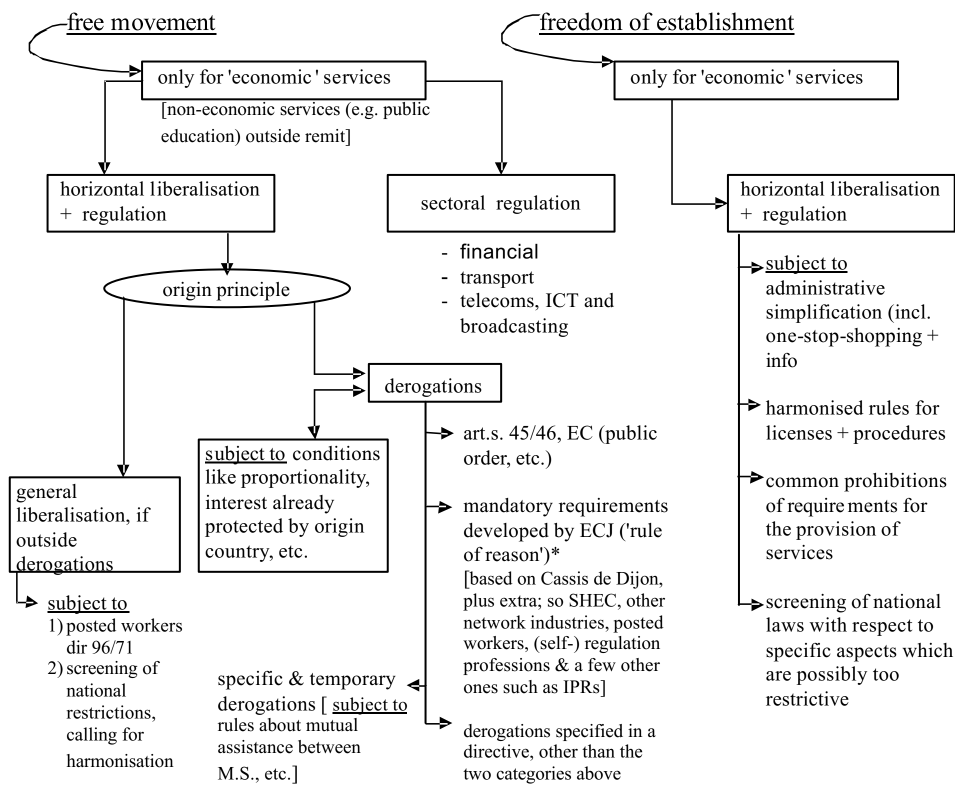
Apart from treaty derogations, which are simply given, two types of derogations

[16] *Quoted from the Guiot case C-272/94, in [1996] ECR-I-1905 par. 13; see Commission survey, 2001, as in footnote 6, p. 116. Similar, in the Saeger case C-76/90 [1991] ECR I 4221 par.15, Commission survey, op. cit. p. 119, etc.*

are identified (permanent, and temporary and highly specific ones, in the articles immediately following art. 16) which are typically 'regulatory'. They express the preferences of the legislature when protecting the regulatory autonomy of the Member States against the working of the origin principle. It is here that one serious weakness of the Bolkestein draft can be found: once the E.P. became the central body for the drafting of the revised version, a long queue of lobbies emerged, all pleading for 'their' derogation.

A fourth type of derogations are the so-called mandatory requirements, based on the 'rule of reason' applied by the ECJ. This group prompted major controversies about the services draft. It one takes the view (with the Commission at that point) that the origin principle can only be derogated by

Figure 2
The regulatory logic of services liberalisation



Note that, if structural assistance between Member States and some further harmonisation is dealt with, the ECJ is likely to significantly reduce the number and scope of derogations, regarded as 'mandatory requirements'.
SHEC = safety, health, environment & consumer protection
IPRs= intellectual property rights

the treaty itself (and not by case-law under the rule-of-reason) and by explicit derogations in the directive, this group of derogations would no longer apply or only in so far as there is a direct treaty basis. The argument behind this radical stance is probably that several such derogations are very generally formulated, as noted before, and have provided excessive discretion to Member States to protect their services sectors. The responses are predictable: one induces an understandable groundswell of opposition, or, an explicit re-insertion into the directive. In addition, by assuming a complicated position on network industries (some excluded, other not but possibly derogated) and insisting on the health sector (with all the new case-law and other complexity) the debate about derogations went out of control.

Once free movement, based on the origin principle, is not reduced or blocked by the derogations, general liberalisation applies (left, bottom). However, since service provision is labour intensive and, in some sectors like construction and construction-related professions (painters, plumbers, electricians) and simple 'horeca' labour services, heavily dependent on labour costs, the posted workers directive 96/71 governs any contracts under this general liberalisation. The consternation around the posted-workers directive in the services debate is almost certainly due to adverse 'political framing'. The Bolkestein draft is not ambiguous about it. The reasons for the nervousness and emotional debates probably lie elsewhere (see section 6). It is also crucial to realize that the 'Polish plumber' is a highly misleading slogan, since the draft directive was either applying the posted workers directive or irrelevant to the accusations (cf. section 6).

5. Economic impact, with and without the origin principle

Since 2003 new EU proposals for legislation have to be subject to Regulatory Impact Assessment (=RIA).[17] One would expect the RIA of the Bolkestein draft to comprise a survey of the relevant economic impact studies available and/or the results of a targeted impact study commissioned for RIA purposes. Even though the RIA of 'Bolkestein' serves the purpose of analytical clarification and also helps the reader to appreciate the choice between several options for the EU services market, it fails to provide a survey of genuine impact studies and does not provide even proxy quantifications of the economic impact. It is of critical importance to understand, why. By the end of 2003 (when the RIA was concluded), quantitative studies were simply not available. In analytical economics, services had long been stepmotherly treated [18] and in international economics the absence of modeling work was conspicuous. One amongst several reasons consisted in the tremendous complexity of barriers to entry and to market access; a related reason was that regulatory barriers (not, tariffs) had to be assessed as to their price and non-price effects, which is extremely difficult; yet another reason consisted in the lack of reliable data for all the barriers to services trade and FDI for all the Member States, the result of decades of neglect by the EU of the internal market of

[17] *Commission Staff Paper, Extended Impact assessment of the proposal for a directive on services in the internal market, SEC (2004) 21 of 13 Jan. 2004*

[18] *It is not exaggerated to consider services as the cinderella of the EU internal market, also in economic analysis. In textbooks on EU economic integration, matters are hardly any better as even a cursory look at Balassa (1961), Hansen & Nielsen (1997), El-Agraa (2001), Hitiris (2003), and Baldwin & Wyplosz (2005) will confirm.*

services! Given all those reasons, the Commission was simply not in the position to 'guesstimate' the economic impact. The lack of quantified 'guesstimates' in the RIA did not help, of course, to facilitate a smooth passage of the draft through the EU legislator, that is, the EP and the Council.

During the policy debate in the EU legislator two studies became available which, in different methodological ways, produced some rough estimates. Economists from the CPB (Kox, Lejour & Montizaan, 2004) found an ingenious method to arrive at rough (minimum) estimates by utilizing the extremely detailed OECD data base of regulation and studying the differences in legislation in every bilateral relation between two EU countries as cost-increasing barriers to cross-border service providers. The underlying idea is that regulatory heterogeneity in such bilateral relations is costly in and by itself, but these costs quickly multiply once more bilateral relations are exploited by service providers interested in trade in the internal market. This is so because for every new country market, the exporter incurs fixed costs of entry and information, which can only be absorbed with a considerable export volume. The authors used a gravity model to show the empirical effects of heterogeneity in services rules in the internal market and subsequently attempted to assess the economic impact of lowering that heterogeneity because of the Bolkestein draft. They estimate an increase of intra-EU services trade of 15 % - 30 %, but in a later refinement a range up to 60 %. In a slightly different fashion, they also estimated the impact of freer establishment due to the draft proposal, expecting an increase of 20 % - 35 %. Also, the EU GDP would increase between 0.3 % and 0.6 %, assuming a faithful implementation.

The other team studying the economic impact was Copenhagen Economics (2005), on request of the Commission. Their approach is closer to what conventional economics would suggest: an attempt to identify the barriers which distort or prevent services trade in the internal market, convert them into so-called 'tariff-equivalents', amalgamate them in a barrier index and see how the index would change with the Bolkestein draft. The index change is related to efficiency improvements and cost reductions of services companies. The empirical effects are then found by applying this on a data base of 275 000 firms of all possible services sectors. The macro-economic impact is derived from the Copenhagen CGE model for trade and investment. The overall effect on economic welfare in the EU amounts to EUR 37 billion, besides a growth in jobs of 600 000.

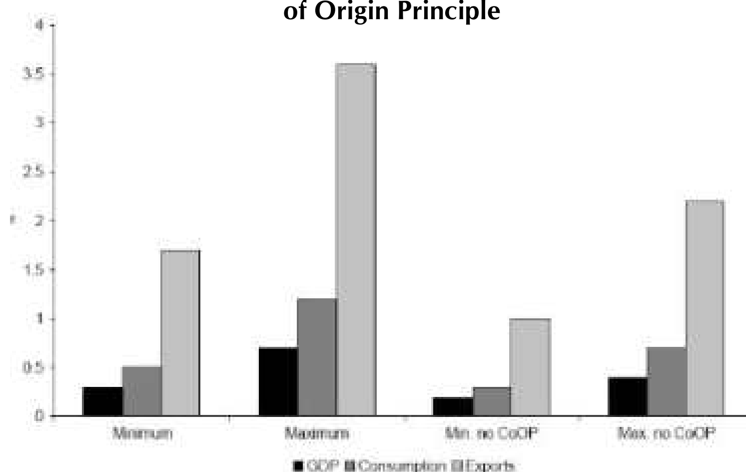
This short contribution is not the place to discuss the merits and technicalities of the two studies. For such a sweeping horizontal directive, all one can say is that the two estimates are not that far apart and distinctly positive. It is interesting to note that most of the gains result from the 'free establishment' part of the directive which is consistent with the general notion that services delivery is more naturally done via direct presence in the local market. One should also not forget, when reading these estimates, that a number of leading services sectors do not fall under horizontal liberalisation and hence are not part of these numbers. Furthermore, the sectors derogated in the draft directive have been left out. In follow-up studies, both centres have attempted to isolate the effect of the origin principle (i.e. trade alone) because it was so controversial in the debate. In de Bruijn, Kox & Lejour, 2006, the origin

principle is found to generate one-third of the welfare gains - the overall results with and without the origin principle are depicted in Figure 2. Copenhagen Economics come to a mere 10 %. These findings confirm that much of the political heat on the origin principle completely disregarded that the *establishment* part of the directive (which has largely survived the radical amendments in the EP) is the true source of benefits. The removal of the origin principle in the adopted services directive 2006/ 123/EC[19] is almost certainly detrimental to the erstwhile expected impact on intra-EU trade, but this does not mean that the adopted directive would not signify considerable progress in economic terms.

Few other impact studies would seem to have been made. But perhaps it is interesting to mention the PriceWaterhouse Coopers (2005) collection of 38 business case studies of companies anticipating the services directive because its approach is so different from that of economic modelling. The larger services companies typically regard all Member States as separate markets for many reasons, only some of which result from policies or laws affected by the Bolkestein draft. When seeking establishment, companies know beforehand that this is an expensive route and policy-related barrier removal (as in the services directive) would not so easily affect, in a decisive way, the economics of establishing an office or new company.

The study suggests that up to 40 % of the barriers to establishment would be addressed by the directive. As to services trade, the low costs of this mode of delivery and the absence of almost any fixed or sunk costs make it ideal for SMEs.[20] Again, there is not so much support in their cases that the directive (then still the draft with the origin principle) would make a major difference as many other barriers, including culture, language, etc., would be more important in the final analysis.

Figure 3: Macroeconomic effects of Services Directive with and without the Country of Origin Principle



Source: de Bruyn,. Kox & Lejour, 2006

[19] *Dir. 2006/123/EC of 12 Dec. 2006, on services in the internal market, in OJ EU L 376/36 of 27 Dec. 2006*

[20] *Note that this assertion contradicts the empirical approach of the work of Kox & Lejour (op. cit.) and co-authors, unless one applies an extremely sweeping version of the origin principle (without derogations, etc.).*

6. Understanding a tumultuous politicisation

The political economy of the process of amending and adopting the services directive 2006/123 is as fascinating as it is complex. Politicisation was more wide-spread and intense than in the case of almost any directive ever before. But that had not been foreseen by most political actors. In 2000 a strategy for a deeper and wider internal market for services was unanimously accepted by all Member States as a crucial element of the Lisbon strategy. In 2002 the Commission showed in great detail how numerous, costly and, at times, prohibitive, barriers and red tape had prevailed in the badly functioning internal market for services and the Council urged the Commission to come up with a horizontal proposal to tackle them. It was only in the course of 2004 and more vigorously during 2005 that an unusually hectic process of politicization unfolded.

In trying to shed some light on the politicisation, at times derailing into polarization, one has to begin by recognizing the somewhat unfortunate socio-economic context of the process. In addition, a host of other factors can be discussed including a range of distinct vested interests (a result of the great diversity among Member States in regulating and/or protecting services or practices of actors in certain services sectors), the complexity of the draft directive and the resulting stream of misunderstandings and false alarms, the potentially radical nature of the origin principle (easy to turn into a caricature, given the complexity of the directive and the subtleties of the ECJ case law), the dominant role of the European Parliament (given the paralysis in the Council for more than a year) and the opportunism of leading politicians including prime ministers in the light of domestic pressures at home. Considering all these factors, and the fierce debates in public opinion in many countries, sometimes linked to the presumed (de) merits of the 2003 draft Constitutional treaty, one might find it amazing that the EP did succeed in passing a text at all which has largely survived the second reading for Commission and Council.

The superficial explanation is the political deal between the Christian Democrats and the Social Democrats in the EP, under heavy German pressure, and the subsequent deal between France, Germany and (after a kind of U-turn) the UK in the Council. But this begs the questions why these risky deals were made. This would require a detailed political analysis which this contribution cannot possibly provide. Nevertheless, it is good to remember a few reasons which have helped to bolster the determination of the EU legislature to tackle the services liberalization and not back out. Such reasons include, inter alia, the firmness in the EP not to budge again for excessive pressures from aggressive social interests [following the retreat by the EP on the draft harbour directive, in the presence of shocking violence in Strassbourg by radical elements in the labour unions], the importance of acting in the preponderant area of services in the internal market which was recognized throughout the debates, the strong sentiment that Central European workers and SMEs perceived a great opportunity in the internal market for the first time since their countries had become EU members (and many MEPs feared to be seen as blocking such an initiative) and the low credibility of the Lisbon process with its lack of domestic 'political ownership' in most Member States[21] compared to the hard law of the internal market which had to be

shown to be effective in giving much greater scope for dynamism, trade and establisment.

The socio-economic context in the beginning of 2004 (when the Commission tabled the draft) was unfortunate in several aspects. The EU was divided in a number of countries with healthy economic growth (8 candidate countries, about to enter by May of 2004, and Ireland), a group with reasonable economic performance but modest or lacklustre growth (a number of smaller countries and the UK) and three large countries with relatively high unemployment for a long time already and little to no growth : Italy, France and Germany. Anxieties in the latter three countries and some other ones about the Eastern enlargement, globalisation (and the feared relocation of companies as a consequence of both, exacerbated by low corporate tax rates in the candidate countries), inflows of illegal low-wage workers, the reform on pensions and in labour markets, outsourcing by multinationals and the alleged constraints or pro-cyclical effects imposed by the Stability & Growth Pact on national budgets created a climate of suspicion and deep resistance against initiatives driven by "more market". Against the backdrop of pressure to allow greater flexibility in European labour markets, to pursue other reforms, to further liberalize network industries and to do significant trade concessions in the WTO Doha Round which could only mean 'more globalisation' - and suspected job losses to China and India -, while EU leaders began to stress the goal of competitiveness (seemingly without much interest in the social dimension), labour unions and certain political parties began to accuse "Brussels" of following a 'neo-liberal agenda'. When, in this setting, the Bolkestein draft was published, some hardliners would seem to have opted for a 'nuclear strategy' against a perceived radicalisation of the already objectionable 'neo-liberal agenda'. Whereas in ordinary circumstances such hardliners would have remained isolated and without much influence, the socio-economic context in these three countries (and perhaps Belgium as well) rendered a favourable resonance in other circles much easier. The negative political framing of the 'Frankenstein directive' was ideological but anxieties could be exemplified by selected illustrations of possible consequences which raised serious concerns in many very different groupings in a great many countries. To a considerable degree, the socio-economic context in which the Bolkestein draft was discussed began to substitute the actual substance of the text.

Moreover, the timing was unfortunate, too. 2004 was the year of the first Eastern enlargement and a permanent debate was raging in the EU-15 about the impact of the free movement of workers and the wisdom of having or foregoing temporary restrictions of the inflows of workers from the new Member States. Now that push was coming to shove, most Member States opted for restrictions, thereby confirming the fears of many workers in the Western part of the Union. It does not take much fantasy to appreciate that such a climate was not conducive for a good landing of the draft services directive in which the 'free movement of services' section attempted to facilitate the temporary provision of services by workers from Central Europe ! The ill-understood origin principle was read, more often than not, as

[21] *See Kok et al., 2004. One should add that the EP also plays no role in the Lisbon process. Here was a major chance to show that its role as a legislature did matter.*

meaning that the wages and non-wage conditions from Central Europe would then apply to these 'posted workers', even if this was flatly wrong in 22 out of 25 countries. No matter how emphatic Commissioner Bolkestein repeated that the posted workers directive 96/71 imposes host country control (for minimum wages and several other conditions), a widespread disbelief lingered. This disbelief was partly due to the strong objections from Germany, Sweden and Denmark where collective agreements rather than minimum wage legislation prevailed, circumstances which were regarded as an open invitation to set up circumventive (but legal) constructions to avoid paying such local wages. In other countries, the lingering disbelief was fed by the observation of other evasive constructions or plain illegality which rendered host country control a paper tiger without much practical effect. Inside labour unions prospective losers such as low-skilled workers or semi-skilled workers in a few sectors bound to be hit (e.g. construction, repairs, hotels, restaurants, horticulture) began to receive the benefit of the doubt and a groundswell of protest emerged against the draft directive on account of labour issues. Thus, in addition to the context dominating the substance, the labour issues began to overwhelm the hard core of issues for which the directive had been drafted: the liberalisation of cross-border services.

Thus, to say that rent seekers were the main reason for opposition to the draft directive is too simple, even if there is clear evidence that rent seeking manifested itself in the many requests for derogations (from the liberal professions to taxies !) and, possibly, in the fierce resistance against the combination of the draft services directive and the posted Workers directive in the countries not having general minimum wage legislation (first of all, Sweden and Denmark, and in a less general way, Germany). The latter issue turns around the practical impact of service providers from (say) new Member States, which could be daughters of German or Swedish companies, offering temporary services at wages far below the collective agreements in these three countries and not hindered by wage floors in the law.[22] The obvious remedy to enact a minimum wage legislation is fiercely resisted by the labour unions in these countries for reasons that look like a combination of local ideology ('the government or politics should stay out of industrial relations') and all-too-cosy closed shop practices. Respecting diversity among Member States would imply here that the internal market for (temporary) services would not be under the conditional and moderate host-country control of the Posted Workers directive 96/71 but under absolute host country control entirely dictated by the social partners in such countries. Such an extreme view would be defended as a 'right of social partners to make collective agreements', but would fragment the internal market for temporary services as any advantages of workers from the new Member States are totally removed. Incidentally, it would also apply to the 'free' movement of workers: the 'free' movement would be throttled as host country control reduces the demand for workers from the new Member States to a trickle (see Pelkmans, 2006, p. 198 for a graphical economic analysis).

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[22] *See for the case of Germany, the examples and analysis in Nicolaidis & Schmidt (2007). For Sweden, the issue became acute just before the Bolkestein draft was tabled in the Laval case (case C-341/05). See http://curia.europa.eu and Press release no. 36/07 and the links to Advocate General Mengozzi's view, on 23rd May 2007. See also Pelkmans, 2007 b.*

The labour issues, however, also played a role in many countries which do have minimum wage legislation. By way of illustration, it is insightful to zoom in on the completely misconstrued debate in e.g. France on the 'Polish plumber'. In sharp contrast to the framing in French politics, this Polish plumber (if working as an employee in temporary services under the draft text) would have been obliged to be paid the French minimum wage plus adherence to several other non-wage conditions like health & safety and vacation days, for example (this follows from the Posted Workers directive). If the Polish plumber would provide temporary services as an independent, he does not need the draft directive because there is no change from a long tradition of concluding a service contract, the implicit hourly wage of which is 'free'. In other words, the situation from before Bolkestein in this respect remains unchanged. If the Polish plumber comes to France or any Member State (other than the three mentioned above) as a worker contracted by a French building firm, again host country control applies. If he comes illegally, obviously, the directive is of no use, it is up to the national authorities to enforce the law. These four options for the Polish plumber are exhaustive, there is no other option Nothing in these four options constitutes a new threat to French workers ! But this inference is the exact opposite of an avalanche of assertions in the French media at the time. A detached analytical approach of the draft directive is of little use if politicization takes on such ominous forms[23].

One may also study the positioning of individual countries. Nearly a dozen governments, sometimes the Prime Ministers personally, shifted from a generally favourable view to staunch opposition or 'Bolkestein bashing' without details. This was prompted by complex and varying drifts in domestic politics. However, in Western Europe it is too easily forgotten that the new Member States as well as countries such as the UK, the Netherlands and Spain remained in favour of an only marginally amended version of the directive until the French/German/British compromise was hammered out in May 2006. It should also be telling to many readers that in the Netherlands the social partners in the Socio-Economic Council (SER, 2005 ; see also Pelkmans & van Kessel, 2007) *unanimously* agreed to an amended version of the directive (with an analytical report going into almost every conceivable detail and dismissing a lot of the framing) with the origin principle being upheld! Nobody can seriously argue that the Dutch SER would not wish to balance carefully the social dimension with the desirable and long overdue services liberalisation in the internal market. Had the EP adopted this version, all the serious objections would have been dealt with appropriately and the internal market for services would nevertheless have been pushed forward much more than today. Finally, in several countries the services directive became mixed up with the domestic political campaigns about the constitutional treaty. In France, this went so far that numerous French voters came to

[23] *It is not the purpose of this contribution to survey the entire debate of the directive. Thus, the sensitivities about a sectoral approach for health (see infra), the more precise demarcations of services of general economic from non-economic interests, the idea of a separate directive on the former (an older idea which resurfaced in the services debate) and the turbulence about the origin principle, the option of mutual recognition and the final 'solution' for art. 16 as well as other questions are not treated here. For art. 16, see section 7 (supra).*

believe that the constitutional treaty was another example of being too liberal (whereas, in fact, the status quo was purposely kept in socio-economic affairs, already in the Convention, and a few marginal amendments are best regarded as going the other way e.g. art. III-122).

7. The services directive in force

In December 2006 the EU legislator passed the new services directive[24] in second reading, a text which differed rather drastically from the initial draft text. Indeed, the new version had been amended in such a far-reaching way that the text should have been subjected to a second regulatory impact assessment (=RIA), as the 'better regulation' rules and the inter-institutional agreement prescribe. There was every reason to do so, after the polarization and incredible confusion, which characterized the debate for almost two years, had clearly caused serious problems of drafting and coherence whilst raising pertinent queries about impact and effectiveness. However, none of the three EU institutions involved dared to propose a new regulatory impact assessment. The reasons are purely political. The leading arguments (which were, of course, never formally expressed) can be paraphrased as "better pass a truncated directive first" and " in the present political climate, a new regulatory impact assessment could be regarded as a political postponement rather than an analytical exercise, hence, the RIA could become tainted". The upshot is that a piece of bad regulation was adopted, even if the directive represents welcome progress in some respects.

Two properties of directive 2006/123 on Services in the Internal Market immediately catch the eye: it is a directive of "Angst" and the value-added of the free movement section has been truncated significantly. Before relating the directive now in force[25] to Figure 2, it is worth illustrating how the "Angst" has overwhelmed the (re)drafters of the directive. There are no less than 118 considerations in the preamble (!) which is already most unusual[26] but a long series of them is about what does not fall within the scope or is derogated. Fortunately, consideration no. 33 has survived the hectic process of amending texts because it is the only concrete indication of what services do fall under the directive. It is perhaps good to mention this list explicitly : business services such as management consultancy, certification and testing, facilities management, advertising, recruitment services and those of commercial agents ; mixed B2B and B2C services such as legal or fiscal advice, real estate services, construction, architect services, distributive trades, organizing trade fairs, car rental and travel agencies ; consumer services such as tourism, leisure services, sports centres, amusement parks and certain services for the elderly (except when derogated). A comparison with Figure 1 shows that this coverage is still interesting.

Also at the outset of the directive's text, "Angst" dominates. It is peculiar to find that lengthy articles 1 and 2 as well as art. 3 are entirely devoted to the specification of what does not fall within the scope of the directive, what the directive is not about and what other EC law overrides the provisions of the directive (e.g. the posted workers

[24] Directive 2006/123 in OJ EC L 376 of 27 Dec. 2006 on Services in the internal market.

[25] Although the directive is formally in force since 28 Dec. 2006, the Member States have until 28 Dec. 2009 for bringing into force the laws, regulations and administrative provisions necessary to comply (art. 41 / 1).

[26] See Hatzopoulos (2007) for similar observations.

directive and the TV without frontiers directive). Art. 1 reiterates that the directive is not about the liberalisation of 'services of general economic interest' (art. 86, EC) nor about privatization (which is a curious and totally superfluous remark because the EU has no competence whatsoever with respect to such matters of ownership [art. 295, EC]). Other curious specifications include that it is not about state aids which fall under competition rules (why this remark?), not about media pluralism and related matters, nor about criminal law, nor about labour law or social security. Art. 1.7 does matter : the directive does not 'affect the right to negotiate, conclude and enforce collective agreements and take industrial action ', a direct reference to the Laval case in the ECJ and more generally to the three countries relying on collective agreements only. Art. 2 narrows the scope and lists 12 areas not falling within the scope. Some are sectoral acquis and hence not surprising (e.g. transport [where consideration no. 21 specifies that taxis and ambulances are defined as transport], financial services, electronic communications), one is sectoral but with an unclear acquis, hence understandable (healthcare), some are obvious because not economic (services of general interest and social services) whereas the rest consists of the outcome of strong lobbying for derogations (temporary work agencies [with a few Member States long favouring extremely restrictive provisions], audiovisual services, gambling, private security services and notary services). One might hope that, except for gambling, sectoral liberalisation is given priority by the Commission for these latter derogations.

The broader functional provisions of the directive (simplification obligations for Member states, single windows, right to information, and facilitation by electronic means) have survived, with finer amendments which are too detailed for present purposes. Clearly, these are useful if well implemented. In terms of Figure 2, the section on the freedom of establishment has largely remained the same. What is important is the disciplining of licenses and other authorisations (a true curse in some countries) in art.s 9 13 as well as the list of prohibited requirements in art. 14 (or those subject to evaluation, in art. 15), including the infamous 'economic needs test'. There can be little doubt that, on this count alone, the directive was worth passing. Different simulations (see section 5, infra) show that the larger part of the economic gains can be expected to come from the freedom of establishment, not least because that is the natural route to deliver many services, as noted before. In this perspective, much of the polarization on the origin principle was more symbolic than crucial for a boost to EU economic growth, except for selected sectors.

Figure 2 shows that the free movement section in the draft is far more complicated, not to speak of its proper reading (against the backdrop of sizeable ECJ case law). Even if these complications would seem to be for a lesser economic gain (than establishment), the debates were ferocious and accompanied by several demonstrations. The directive now in force has removed the rigorous (though intricate) logic of Figure 2. The regulatory logic of Bolkestein was centred on the origin principle, decorated with all kinds of disciplines and derogations. Directive 2006/123 does not comprise the origin principle anymore, even if much of the rest of the edifice has remained more or less in place. Instead, art. 16 now reiterates the existing free movement of services provisions in two complementary sentences

as follows: "Member States shall respect the right of providers to provide services in a Member State other than in which they are established. The Member State in which the service is provided shall ensure free access to and free exercise of a service activity within its territory". These sentences add nothing to a treaty text which is 50 years old by now. They are followed by the explicit listing of three elementary principles of EC law : non-discrimination, necessity and proportionality, which, again, seem superfluous (quite apart from lengthy texts in the Pre-amble on these very principles). Art. 16/2 is interesting as it comprises a 'black list' of 7 practices which are henceforth forbidden[27] and will be a relief to many SMEs crossing borders to provide temporary services. Collective agreements are protected in art. 16/3 'in accordance with Community law', which renders the (forthcoming) ruling on the Laval case even more crucial than before. Art. 17 adds a list of extra derogations (on top of art. 2) including network industries (postal, electricity, gas, water and waste) and a series of more special cases (including e.g. mandatory notary services, certain intellectual property rights and, once again, the posted workers directive 96/71, etc.). One can raise serious questions about these derogations, now that the origin principle has disappeared. Given that art. 16 is merely restating free movement of services, the derogations imposed by the EU legislature cannot alter the authoritative interpretation of EC law by the ECJ. As Hatzopoulos (2007, p. 34) puts it "Toutes ces 'exceptions' portant sur les principes etablis par la jurisprudence de la Cour sont source d' insecurite juridique et risquent de créer des tensions entre le legislateur et le juge communautaire..". Former ECJ judge Edwards (2006) goes further and laments "[I]f political institutions no longer feel bound by the case law on the Four Freedoms, for how long will there be 'common market law' for us to review ?". His conclusion is for the "... Parliament to work within the bounds of that interpretation, unless and until the Treaty itself is amended by those who have the power to amend it".

On a positive note, these central articles are followed by a range of provisions which are to be applauded. Art.s 19 23 are protecting the recipients of services in various ways by outlawing special licenses, by assistance, by information obligations and other aspects of services quality. Art.s 28 and following stipulate details about far-reaching administrative cooperation. Although some such administrative cooperation is already specified in the treaty (!), it is the organisation and detail, helped by dedicated networks and electronic means, and actively stimulated by direct Commission involvement that raises hope for effectiveness. Finally, since this horizontal directive is mainly about liberalisation, it is good to mention that two other types of provisions might augment the value of the directive over time. First, Member States will enter an extensive screening exercise and will have to report on it (art. 39/ 1), so that joint evaluation will be possible on the harder cases. A standstill provision is included, too (art. 15/6). Second, there are several options to harmonize. One is that the Commission is held to report by the end of 2010, with additional initiatives 'where appropriate'. Another is given by the so-called "rendez-vous" clause of art. 41 which is to review the

[27] *E.g. a Member State cannot require establishment when only free movement is at stake, cannot impose a license or registration requirements unless covered by the directive, cannot impose bans on activity or special contracts, cannot ask for service-specific rather than general identity documents, etc.*

working of art. 16 ; it might also lead to amendments. Third, now that so much has been pushed outside the directive, one should not neglect what happens in sectoral initiatives, the principal one in the short run being healthcare.

8. Conclusions

Decades after the absence of detail in the (horizontal) services provisions in the treaty needed to be addressed, the EU has finally enacted a directive, be it after exhausting debates and much talking at cross-purposes. The economic case for going this route is firm and will only become more important over time. The outcome of the legislative process in the form of directive 2006/ 123 can be assessed, in short, as follows. In terms of 'better regulation', the directive is something like a regulatory failure : its coherence has suffered a blow compared to the draft, the dominance of 'Angst' has prompted a text full of negatives and curious, superfluous statements and the status of the derogations is unclear at best (and, possibly, go against case law !) now that art. 16 is no longer about the origin principle. But the harvest in terms of concrete provisions which do matter, is fortunately a lot more positive than the often hectic debates in the EP would seem to have suggested. The most important gain is that the freedom of establishment has effectively been liberalized and relieved (e.g. by the black list) from a range of national practices going against letter and/or spirit of the internal market. Other provisons about establishment are also to be applauded as they should help hesitant and uninformed SMEs. The economic gains from establishment in services are bigger than those from free movement, even with the origin principle, let alone 'without'.

The free movement of services as formulated in art. 16 represents nothing else than the status quo. However, even when accepting the derogations and exclusions on face value, useful additional features nevertheless do add value. One may refer to a black list also here (art 16/2), more credible structures for administrative cooperation and extensive protection for the recipients of services. Furthermore, Member States go into a screening exercise and a possible route for future harmonisation has been indicated.

In the medium-run, one should expect several draft directives of a sectoral nature e.g. on healthcare. Also, the repetitive derogations and exclusions of network industries in the text, of course, do not mean that the combined liberalization and regulation of the network sectors will be stopped or weakened. They will simply remain sectoral as has been the case for almost two decades now. It is true, the absolute form of host-country control, driven by collective agreements, is likely to prevail, but with the rapid convergence of wages between East and West in the EU, its impact will soon become less important. With the 'rendez vous' clause, the services debate will come back on the table in 2011. One cardinal difference will be that the EU and many services players will have become better accustomed to the language, case law, harmonisation and implications of the internal market of services. Also, Member States (and regional governments) will at long last have undertaken a systematic screening of their own laws and decrees and presumably - cleansed them from all kinds of cosy specifications protecting vested interests rather than the broader public interest in an EU context. Economically, the crucial position of services will be better understood and, one

suspects, analyzed. The EU should therefore expect another decade of gradual further liberalisation and modest harmonisation in the internal market of services after the 'rendez-vous' which will further reduce the costs of lost opportunities caused by the "Angst" in the EU institutions in 2005 and 2006.

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REAL CONVERGENCE AND INTEGRATION

Aurel Iancu[*]

Abstract. *The study*[**] *is based on the critical observations that competitive market forces alone are not able to assure convergence with the developed countries. These observations are grounded on the results of the computation of the marginal rate of return to capital (which contradict the neoclassical model hypotheses), as well as on the real process of polarisation of the economic activities, taking place worldwide and in accordance with the law of competition. Unlike those who trust the perfect competitive market virtues, the EU's economic policy is realistic as it is based on the harmonisation of the market forces with an economic policy based on the principle of cohesion, which supports, by means of economic levers, the less developed regions and member countries. This paper deals with the evolution of the EU cohesion funds, as well as with the results of convergence.*

Key words: *Neoclassical model, marginal rate of return on capital, polarisation, convergence, divergence, cohesion, cohesion funds, structural funds, variation coefficient.*

JEL: *F02, F15, O57, P37*

Economists wonder if real economy convergence can actually be achieved only in a competitive market according to the neoclassical models. In this respect, extensive studies and models have been completed. Considering the way the determinants and trends of real convergence are approached, the studies and models may be divided into three categories:

- The first one views real convergence as a natural process, based exclusively on the market forces, in accordance with which the convergence process is surer and faster as the market is larger, more functional, less distorted.

- The second one denies that, in the present competitive market, there is an actual real convergence between the poor and the rich countries, but accepts the existence of the tendency of polarisation or deepening of the divergences and inequalities between the centre and the periphery.

- The third one considers that real convergence is necessary and possible in a competitive market, provided that economic policies are implemented to compensate for the negative effects of the inequalities or divergences, until the economic systems reach maturity or the so-called critical mass to support the self-sufficiency of the real convergence process.

Further, we make some critical comments and present some arguments in support of the alternatives that are closer to the real needs and opportunities the Romanian economy to achieve convergence with the EU real economy.

[*] ***Aurel Iancu*** *is a Member of the Romanian Academy, Senior researcher within the National Institute for Economic Research, with a long experience in European and national research programmes, coordinator of PhD programmes in economic science.*

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1. Convergence through the functional competitive market forces

The first way to perceive real convergence exclusively by the market forces is the neoclassical growth theory. Assuming that the economic outcome (GDP per capita) is ensured by the contribution of several production factors (capital, labour, natural resources, technological progress), the neoclassical model advances the fundamental hypothesis that growth depends on the features of the rate of return on capital, which generally tends to decrease in relation to the economic growth. For a certain increase in capital, the outcome increase is less than proportional. More exactly, at the same saving (investment) rate, the marginal rate of return on capital decreases, so that poor countries, with a low amount of capital per capita, attain higher rates of return to capital than those of rich countries, with a considerably higher amount of capital per capita.

According to the neoclassical model, the higher rate of return on capital achieved by the poor countries/regions as against the rich countries/regions (if the other conditions are comparable) ensure the long-term convergent economic growth. This postulate is explained by many authors (based on the Solow's model) taking into account the assumption of equal saving rates (accumulation), population/employed population growth, capital depreciation, technological progress, etc. for all categories of countries. This is the only way that all countries, on different initial development levels, may reach the convergence or equilibrium state by economic growth rates higher in the poor countries than in the rich ones.

According to the neoclassical school, many economists consider that the competition intensification by the establishment and enlargement of the European internal market and integration would have a positive impact and offer opportunities to the countries and regions for diminishing the development and per capita income disparities in order to achieve real convergence. Only action on a larger scale of the competitive internal market forces in the EU, free of any interventionist (protectionist) policy, could guarantee the real convergence of the EU countries and regions.

The free movement of the production factors among the European countries and regions, especially through capital market integration and FDI, is an important way to achieve real convergence.

The less developed countries and regions are characterized by capital scarcity and low saving capability, due to the low income per capita. This means that those territorial entities offer opportunities for development and attract available capital from the countries rich in capital, whose companies are eager to penetrate a large safe and profitable market. After the accession, the capital inflows as investments increased. Among them, the foreign direct investments became the most important means of attracting various intangible resources, such as technology, know-how, expertise, managerial experience, etc. Foreign direct investments have clearer advantages, if compared with financial investments. But their presence in a country or region is dependent on the following requirements: a) sufficient infrastructure of high quality; b) low transaction costs (similar to those in agglomerated areas); c) abundant and cheap local resources (their low cost may compensate for the additional transaction cost, due to the scarce infrastructure); d) possibility to make horizontal investments

based on scale economies, showing a significant dispersion of the production units among countries and regions, as close to the potential clients as possible.

To make the markets of the new EU countries perfectly compatible and competitive, the European Commission implements a systematic policy for the elimination of the non-competitive elements from the market by banning state aid, protectionist actions and other elements that may cause distortions of the single market and national markets.

Moreover, it is quite obvious that many economic reform measures taken by the CEE countries as well as the implementation of the Community acquis and the institutional improvement are aimed at creating a functional competitive market within every national economy and the Community market.

Some economists and international financial institutions still believe that an enlarged and functional market as well as the profound economic integration require the existence of strong mechanisms that automatically lead to real convergence, without any policy in support of such convergence. The implementation of such policies means, in their opinion, many other distortions of the market.

It is quite obvious that such opinions are expressed by the supporters of the neoclassical model, as they think that only the market forces free of any intervention may set in motion efficiently the mechanisms that enable the poor countries to recover the delays by higher growth rates than those of developed countries.

Although the reasoning based on the hypothesis of decreasing rate of return and the hypothesis of perfect competition is logically correct, facts contradict such opinions. On the one hand, poor countries lack the necessary economic, scientific, technological and financial power to cope with competition, which explains, to some extent, the reverse trend, that is widening the gap (divergence) between the poor and the rich countries, and not diminishing it. On the other hand, one should not ignore the overall natural trend of clustering or polarisation of the economic activities at different (national, regional or sub-regional) levels, which might become a major obstacle to convergence.

2. The neoclassical model shortcomings and new approaches

The empirical research done in the last two decades to check the validity of the neoclassical model of convergent growth has not been as relevant as expected. To clarify this crucial problem, we intend to check the veracity of the assumption concerning the existence of decreasing rate of return on capital, illustrated by the existence or non-existence of the correlation between the marginal rate of return of the physical capital (the rate of return of investment in physical capital) and the country's development level (GDP per capita). Consequently we consider the following two indicators:

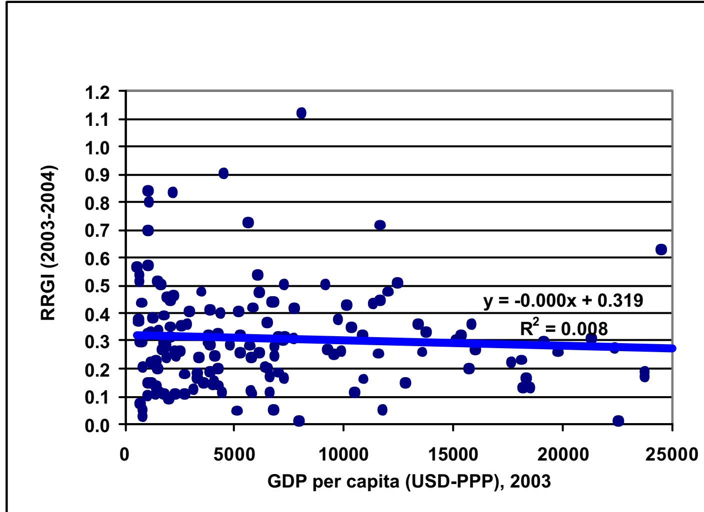
(i) *Rate of return of gross investment in capital (RGI)* based on the ratio:

$$\text{RGI} = \frac{\Delta\ \text{GDP per capita, representing the GDP per capita growth in 2004, as against the previous year (2003) expressed in PPP - USD}}{\text{The amount of gross investment in capital per capita in 2003}}$$

(ii) *Per capita Gross Domestic Product expressed in PPP-USD in 2003*.

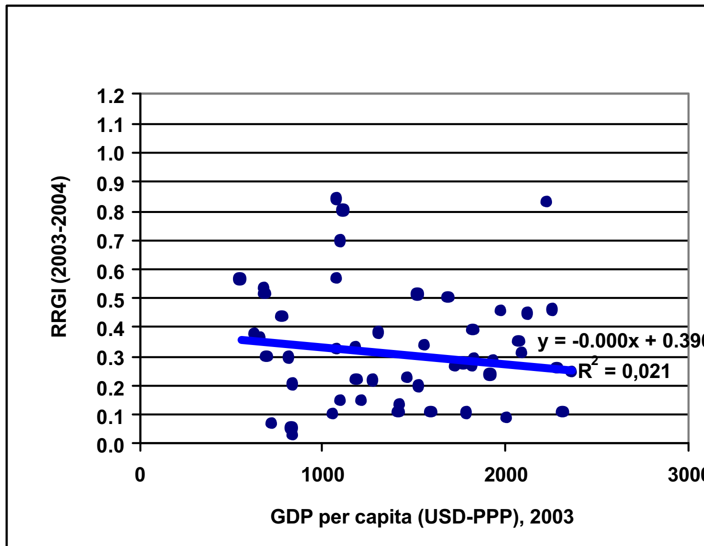
Computing these two indicators, on a total number of 180 countries and a number of groups of countries at different development level, including the group of the 24 EU member countries, and correlating the rate of return with the GDP

per capita, the results are presented in the graphs in Figures 1-6, in which we noted: on the horizontal, the GDP/capita in 2003 and on the vertical, the rate of return of gross investment, for each of the two alternative computations.



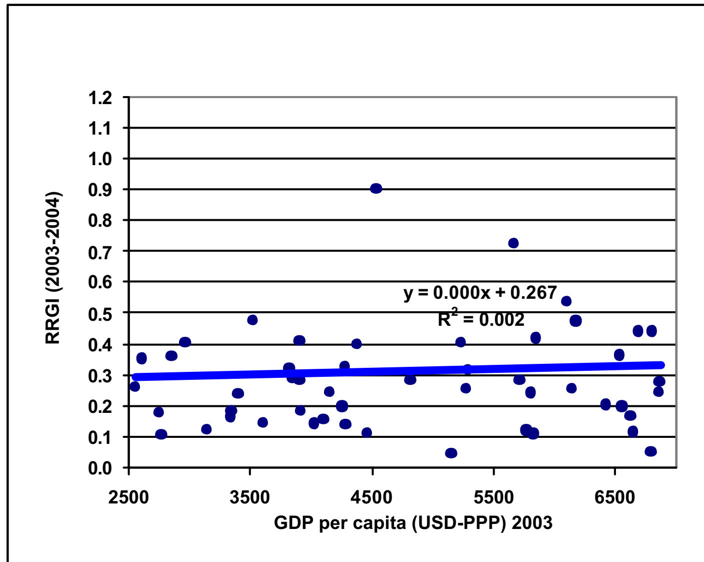
Source: Based on UN statistical data.

Figure 1. The rate of return to the gross investment (RRGI) by the development level of the economies



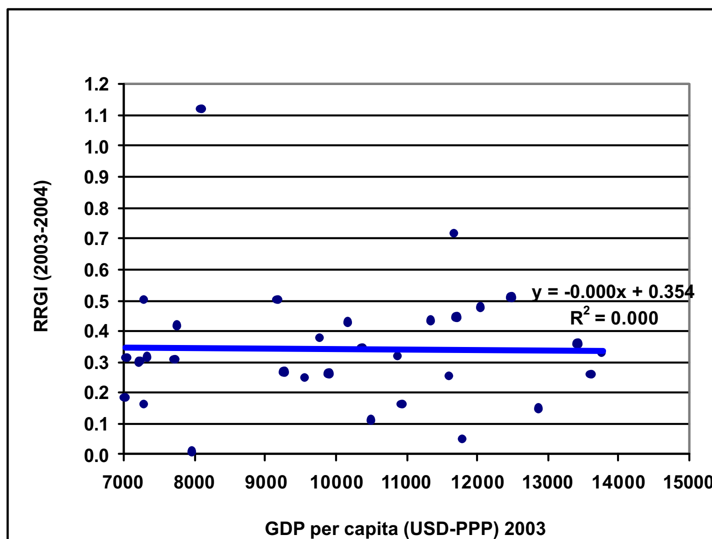
Source: Based on UN statistical data.

Figure 2. The rate of return to the gross investment (RRGI) of the countries with a GDP per capita of 550-2500 USD-PPP



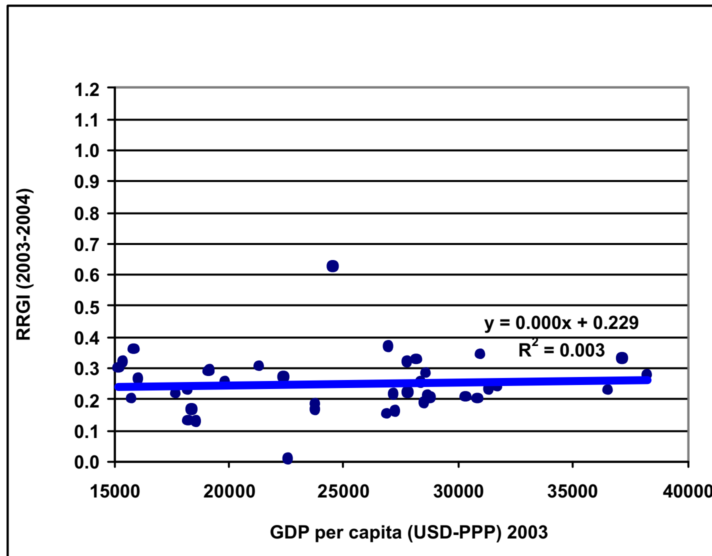
Source: Based on UN statistical data.

Figure 3. The rate of return to the gross investment (RRGI) of the countries with a GDP per capita of 2501-7000 USD-PPP



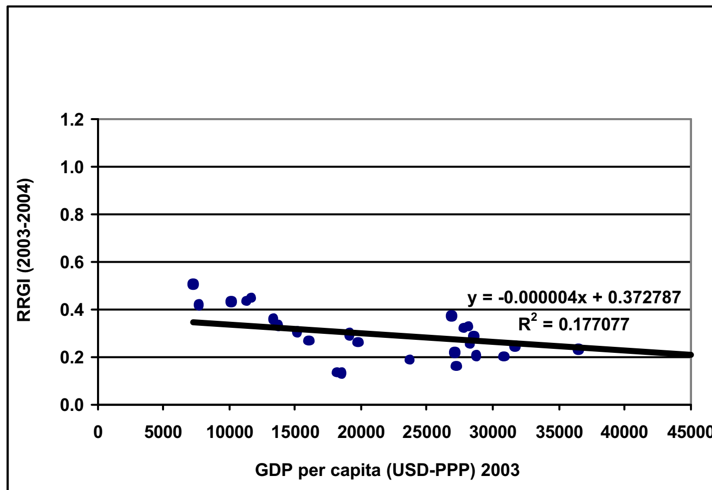
Source: Based on UN statistical data.

Figure 4. The rate of return to the gross investment (RRGI) of the countries with a GDP per capita of 7001-15000 USD-PPP



Source: Based on UN statistical data.

Figure 5. The rate of return to the gross investment (RRGI) of the countries with a GDP per capita of 15001- 40000 USD-PPP



Source: Based on UN statistical data.

Figure 6. The rate of return to the gross investment (RRGI) of the EU member countries

The graphic presentation in fig. 1-5 do not show any downward trends of the marginal rate of return to capital. The trends are rather constant. The slight downward trend in the EU countries (fig. 6) could be explained by the cohesion policy of the EU.

The existence of the increasing or constant rate of return means, according to the neoclassical model, a condition towards divergence or widening the gap among countries. Some clarifications and explicit analyses (beyond the restrictive postulates required by this type of too simplified a model) concerning the definition of the production factors and the interpretation of the economic mechanism closer to reality, as a same of convergence or divergence, are brought by the endogenous theory.

Dividing the capital factor into the three components physical capital, human capital and stock of knowledge and considering that these components do not come from outside, but represent accumulations after the input within the system, we may identify which factors have additional effects in relation to the input, in what proportion and, finally, which category of countries stimulate the factors through the allocated inputs and which factors produce the greatest results.

Rejecting the old hypothesis concerning the decreasing rate of return on capital and other unverifiable constraints, the new theory concentrates on types of models able to include the effects caused within the system by major production factors human capital, productive knowledge stock, etc. as well as types of models able to determine the real causes and mechanisms of the long-term disparities (using the cross-section analysis or long time series), by correlating the growth rate of the production and the per capita income on the national or/and regional level with economic, social and political variables which become either the engine or the brake of growth.

The new theory of convergence is based on the operational character of the effects of the intangible factors (including the economic policy factors). These effects (called "spillovers") spill over the economy in a special way, that is, over other entities, than their direct producers. The effects exceed the input necessary for their production or their remuneration amount.

Usually, the intangible factors (knowledge, professional abilities or skills, information, innovation, know-how, etc.) are embodied in tangible production factors, and their outputs are spilled over. Spillovers may occur during the investment in physical capital (Arrow, 1962), in human capital (Lucas, 1988) or in both types of investment (Romer, 1986). According to Romer, if the spillovers are strong, the private marginal product of the physical and human capital may stay permanently above the discount rate (Romer, 1986; Thirlwall, 2001). Growth may be supported by continuous accumulation (investment), which generates positive spillovers (Grossman and Helpman, 1994), associated with the formation of the human capital (education and training or qualification) and with the Research, development and innovation (RD&I), thus preventing the diminution of the rate of return to capital or the increase in the capital-output ratio.

3. Divergence and polarisation Lasting effects of the competitive market forces

The empirical research for testing the validity of the neoclassical model has demonstrated that, in most cases, neither the hypothesis concerning the decreasing rate of return to capital, nor the real convergence

between the poor and the rich countries (regions) is confirmed. It is impossible to explain the international discrepancy in the present development level only by making reference to the initial difference in factor endowment (Thirlwall, 2001). What actually counts is stimulating the development of the new factors (human capital and knowledge stock) and their increasing contribution to economic growth, detecting possible obstacles to growth in the poor countries and, finally, testing whether the mechanisms causing the inequality between the developed countries and the poor ones may last or not.

The theoretical contribution made by Perroux, Myrdal, Prebisch, etc. has changed the way of explaining real convergence and decisively influenced the direction of the economic policy for the European construction, beginning with the drafting of the Rome Treaty[1]. Although not always analytically rigorous, the new economic notions included in the scientific circuit, such as attraction poles, clusters, centre-periphery, flows of complementary factors, positive spillovers, etc., have broadened the horizon of the debates and the understanding of the processes taking place in the real economy, and the research area concerning the economic policy.

The above notions and the concept of *circular cumulative cause* of the economic processes help us explain the increasing international difference in the development level as against the similar initial conditions[2]. The movement of capital, the human capital and labour migration, the goods and services exchange perpetuate and even worsen international and regional development inequalities. By means of the free trade mechanisms (i.e., free of tariff and non-tariff barriers), the less developed countries, which lack the human capital and the scientific and technological capability, have to specialize in the production of mostly primary goods characterized by an inelastic or almost inelastic demand in relation to price and income.

What causes the increasing inequality between countries is the tendency of interregional and international polarisation (agglomeration), especially in the context of the economic and monetary integration. As there are no barriers to the movement of goods, services and production factors, some countries and regions form strong poles of attraction and cause imbalances between countries showing important differences in the income per capita. The developed countries and regions endowed with factors become poles of attraction that absorb increasing amounts of high quality labour and capital from the less developed countries.

Even if during the accession process the countries make major efforts to support the economic and institutional reforms and attempts to achieve a stable development equilibrium, in real life there is a natural trend with an universal character towards the polarisation of the processes, which in turn causes the broadening of the gap between the development levels of the countries and regions. Myrdal claims that the economic and social forces alike tend towards equilibrium and that the economic theory hypotheses according to which disequilibrium situations tend towards equilibrium are false (Myrdal, 1957; Thirlwall, 2001). If it were not true, then how could one explain the international differences in the standard of living? Unable to answer this question, Myrdal replaces the

[1] *Jacques Pelkmans, Integrare europeană. Metode şi analiza economică (Romanian translation of European. Integration. Methods and Economic Analysis), European Institute of Romania, Bucharest, 2003.*
[2] *M.G. Myrdal, Economic Theory and Underdeveloped Regions, Duckworth, London, 1956.*

stable equilibrium hypothesis with what he calls the circular cumulative causation hypothesis or, briefly speaking, the cumulative causation hypothesis. This hypothesis helps us explain why the international and interregional differences in the development level may persist and increase in time.

Myrdal's hypothesis is based on a multiplier-accelerator mechanism, which causes the income to rise at higher rates in the so-called favoured - more developed - countries and regions, which are endowed with modern infrastructure, gain scientific and technological ascendancy and enjoy physical and human capital inflows, as well as scientific and technological inflows; consequently, they become more attractive for their capital and labour than the less developed areas. The free trade in goods and services and the full freedom of movement of the production factors among countries and regions showing great differences in the development level causes increasing polarisation: on the one hand, countries and regions that become richer, enjoy a significant economic growth and show attractiveness to the high-skilled production factors and, on the other hand, countries and regions characterized by stagnation and economic decline, obsolete and non-attractive infrastructure, decreasing income and taxation levels, that is, limited demand for goods and services.

Under these circumstances, there cannot be any economic convergence. The approaches and analyses initiated by Myrdal, Prebisch, Seers, etc. have led to an influent trend, based on the concept of divergence, which points out the process of polarisation and the divergence between the centre and the periphery.

This trend of thought brings influence to bear upon the following levels: 1) the practical one, reflected in the European construction projects by the adoption of some tools of the European economic policy; 2) the analytical one, strongly reflected in two directions: a) re-thinking the construction and interpretation of economic growth, by returning to the economic and social realities (it concerns the development of endogenous models and the econometric testing); b) new approaches to the geographic (regional) economy, taking into account real processes, such as: regional disparities, development agglomerations or poles, role of infrastructure, transaction costs.

4. Cohesion - An important tool in support of the real convergence within the EU

The chance that the poor national economies advance towards convergence within an enlarged and highly competitive single market is illusory. There are some mechanisms that rather stimulate divergence. But there are some other ones that may produce positive effects on the long-term convergence processes, although their success is rather uncertain in the absence of economic policies to support them and to prevent the negative effects. Among the most important mechanisms mentioned by Pelkmans and pointed out by us, one may find the following: 1) the intraindustrial specialisation of the less developed countries on parts of products and operations, in accordance with the comparative advantage principle, for the capitalisation of the available national (local) resources at small costs; 2) the integration of the less developed countries into the EU makes them more attractive to foreign capital, and, first, to foreign direct investments, initially within the existing

economic clusters and then extended gradually to the periphery territories, along with the infrastructure extension; 3) the strengthening of the competition to which the products, services, factors and companies from the less developed countries are exposed as the countries accede to the EU, which eliminates the non-competitive local activities and causes dramatic social problems, while such activities are taken over by viable competitive companies; 4) the integration into a large single market in accordance with the Community acquis eliminates the distortions and the obstacles to development, but does not always stimulate the development of the poor countries and regions.

The impact of the integration on economic growth, in the absence of cohesion policies, does not ensure that the poor countries will reach higher GDP per capita growth rates than the more developed countries, to enable convergence. Unlocking convergence mechanisms by cohesion policies has become one of the EU's major objectives.

When the Rome Treaty stipulated that "the harmonious development of the economic activities" and "the continuous and balanced expansion" are the first two economic objectives, both the structural divergence and the difference in income per capita between the backward and the advanced members of the Common Market were taken into consideration. To achieve the real convergence in both cases, the Treaty was based implicitly and exclusively on the market mechanisms.

Considering the scarcity of market mechanisms for the recovery of the poor countries and regions, the EU has gradually gained tasks concerning cohesion and solidarity in order to facilitate real convergence by improving the economic performance. The adoption of the cohesion principle was mostly determined by the accession of the countries with a GDP per capita much below the EU average (Greece, Portugal and the CEE countries). The cohesion principle, applied by means of specific tools, is largely used to diminish the disparities in the GDP per capita between countries and regions by improving their performance.

The most important step taken to adopt the principles of cohesion and harmonious development was the explicit inclusion of three economic objectives concerning convergence in the Maastricht Treaty: (1) harmonious and sustainable development of the economic activities; (2) high level of convergence of the economic performance; (3) economic and social cohesion and solidarity of the member states. The objectives (concerning the real convergence of the economic performance through cohesion) were included in the Amsterdam Treaty, with some formal modifications. To apply the above-mentioned principle, two important categories of EU funds were created: structural funds and cohesion funds.

The structural funds are mostly directed to the EU regions with a GDP per capita below 75% of the EU average. The funds are provided: to support the development of the infrastructure in the backward regions; to develop human resources, mainly by training; to enable the private sector development.

The cohesion fund provides support for the EU member countries (with a GDP per capita under 90% of the EU-15 average) to meet the requirements for the European Single Market and the transition to the EMU. Until 2006, cohesion funds were granted to Greece, Ireland, Portugal and Spain.

Afterwards, between 2004 and 2006 the countries which joined the EU in 2004 received the total amount of 8.495 billion euros, out of which Poland received almost half[3]. In 2007, Romania and Bulgaria joined the countries receiving cohesion funds. These funds are used to finance directly individual projects on transport infrastructure and environment, provided that they are clearly identified[4].

The amount provided for the Cohesion Fund increased at a fast pace (see Table 1).

The most important transfers to the cohesion countries (in 1989-1999) were the following: Greece received an amount equivalent to 3.5% of the GDP, Portugal 3.3%, Ireland 2.4% and Spain 1.5%[5].

In 2007-2013, the resources allocated to the cohesion policy (received by the countries with a GDP per capita below 90% of the EU-27 average) will amount to 336.1 billion euros, that is, one-third of the EU total budget and about 4% of the EU GDP. To these resources one should add the structural funds (competitiveness for growth and employment) of 132.77 billion

Table 1 - Evolution of the Cohesion Fund, 1975-2013

Year	Mil. ECU/euro	Share in EU budget, %
1975	257 (ECU)	4.8
1981	1 540 (ECU)	7.3
1987	3 311 (ECU)	9.1
1992	18 557 (ECU)	25.0
1998	33 461 (ECU)	37.0
2002 (incl. pre-accession assistance)	34 615 (euros)	35.0
2006 UE-25*)	38 791 (euros)	32.0
2013 UE-27*)	50 960 (euros)	32.0

*) Excluding the European Agricultural Guidance and Guarantee Fund and Financial Instrument for Fisheries Guidance, but including the Solidarity Fund.
Source: Helen Wallace, William Wallace and Mark A. Pollack, Elaborarea politicilor în Uniunea Europeană (translation into Romanian of the Policy-making of EU), Ediţia a cincea, Institutul European din România, 2005, p. 205.

[3] In 2000-2006, until the accession to the EU, the applicant countries benefited by special lead-up programmes, such as: PHARE assistance for the economic restructuring (lead-up to the participation in the Structural Funds); ISPA a tool for the structural pre-accession policy (lead-up to the Cohesion Fund); SAPARD the special pre-accession programme for agriculture and rural development (lead-up to the European Agricultural Orientation and Guarantee Fund. The ten countries which acceded to the EU in 2004 benefited by the Structural Fund and Cohesion Fund in 2004, and Romania and Bulgaria, which acceded to the EU in 2007, joined the assistance programmes in 2007.

[4] The decision on the financing of each project is taken by the European Commission in agreement with the beneficiary member state. The project management is ensured by the national authority, and the supervision by a monitoring committee.

[5] European Commission, Second Report on Economic and Social Cohesion, 2001.

euros, as well as the funds for the preservation and management of the natural resurses of 404.77 billion euros, of which: 301.06 billion euros for agriculture (market expenditure and direct payment).

Since the main objective is the promotion of the development projects in the backward countries and regions, the structural and cohesion funds are essential operational tools that spread the new poles of attraction in order to extend viable businesses to new areas of the recipient cohesion countries by the development of both the physical (tangible) infrastructure and the intangible one, pertaining to the information, training (qualification), knowledge and innovation fields.

5. Evidence concerning the need for cohesion policies and some assessment of the real convergence

Although the development level of the country's real economy is not a condition for the accession to the EU or a negotiation issue for the accession, the question of catching-up or bridging the gaps between the EU member countries and regions is an important and urgent topic for the economic, scientific and technological strategy of the EU. The issue is important because there are major disparities in the economic development levels of the EU countries and regions. The disparities widened after the accession of the two waves of CEE countries. For example, while in 2000 the ratio of the lowest GDP per capita of a EU-15 member country to the average GDP per capita of the EU-15 was 66%, in 2005, after the accession of the ten countries, the ratio of the lowest GDP per capita to the average GDP per capita of the EU-25 reached 46.6%. After the accession of Romania and Bulgaria, the lowest GDP per capita as against the EU-25 average reached 32%.

The persistence of the disparities and underdevelopment of some EU countries and regions would mean the inconsistency with the very meaning of the European Communities and with the EU strategy, according to which the EU is supposed to become the most important economic and technological power in the world in a predictable period of time, to become the global leader in the economic, scientific, technological and living standard areas. Of course, such a strategy prevents the persistence of disparities and the existence of underdeveloped and poor regions and, also, requires the implementation of policies fully aimed at capitalising the resources of all component countries and regions to achieve their economic and social development. That is why, the EU adopted a firm policy on economic and social cohesion, in order to achieve the real economic convergence of all member countries and regions. From this perspective, it is worth mentioning that all twelve countries of the two accession waves have become cohesion countries, since their GDP per capita has been far below the threshold of 90% of the EU average. Therefore, all these countries satisfy the basic criterion for becoming beneficiaries of the Cohesion Fund for the infrastructure and environment projects. Also, most regions of these countries are eligible for financing from the Structural Funds, since their GDP per capita is below the threshold of 75% of the EU-25 average.

The new member countries have received economic support from the EU since the pre-accession period through special lead-up programmes (PHARE, ISPA, SAPARD, etc.). In the post-accession period, the financial support offered through the

new programmes is more consistent as regards the objectives and implementation mechanisms, as well as the size of the funds allocated from the EU multiannual budget (2007-2013). The question "To what extent did these policies influence the real economy convergence?" is difficult to answer by analytical impact assessments, since these policies have not yet produced effects, due to the relatively short time of application.

The clarifying elements in this matter are the overall results of the influence of all factors of convergent growth in each country, determined by means of different factors (usually, computed on long term), which show either the diminution in the inequalities between the set of analysed economies (the evolution of the index concerning the ratio between the level indicators of the economies, dispersion, Gini index, Theil index, etc.), or the cross-section convergence (β-convergence), or, finally, the convergence of the time series, dynamic distribution, etc.[6]. We confine ourselves in this study to the results of the computation of two of the above indicators, which are equally simple and suggestive

(i) *The index concerning the ratio between the level indicators (GDP per capita)*. Relating the level of the GDP per capita of the countries to the average level of the EU for a certain period, one may find general trend of approximation of the development levels of these countries as against the EU average level in the analysed period. Table 2 contains data on the cohesion countries pertaining to the EU-15 Group (Greece, Spain, Portugal) and the countries that joined the EU in 2004 and 2007.

Table 2: The evolution of the index concerning the ratio of the GDP per capita of the cohesion countries and to the EU-25 average, based on PPP* (1998-2005), percentage

	1998	1999	2000	2001	2002	2003	2004	2005
Greece	70.4	70.7	72.6	73.5	77.2	81.1	81.9	83.0
Spain	88.8	92.5	92.5	93.2	95.3	97.7	97.3	98.3
Portugal	78.2	80.3	80.6	79.8	79.53	72.8	72.2	70.9
Czech R.	65.3	64.9	63.7	64.9	66.5	67.7	70.04	73.07
Estonia	39.1	38.8	40.7	42.3	45.1	48.4	51.1	55.5
Cyprus	79.3	80.3	81.1	83.1	82.3	80.2	82.3	82.5
Latvia	32.9	34.0	35.3	37.0	38.6	41.0	42.7	46.6
Lithuania	38.5	37.2	38.3	40.3	41.9	45.1	47.6	50.9
Hungary	50.8	51.6	52.7	55.7	58.1	59.4	59.9	61.2
Malta	76.5	77.1	77.6	74.0	74.4	72.8	69.1	69.2
Poland	44.7	45.7	46.7	46.2	46.5	47.0	48.9	49.5
Slovakia	46.9	46.8	47.2	48.6	51.1	52	52.9	55.1
Slovenia	71.5	73.9	72.6	74.0	74.4	76	78.9	80.7
Bulgaria	26.2	26.3	26.7	28.3	28.6	29.6	30.4	32.0
Romania	26.5	25.6	25.1	26.5	28.5	28.5	32.1	32.9

* Purchasing Power Parity.
Source: Based on Eurostat data.

[6] *Castro, José Villaverde, "Indicators of Real Economic Convergence. A Primer", United Nations University - Cris E - Working Papers, W-2004/2.*

We have related the GDP per capita of each country to the average GDP per capita, computed for 25 countries, although the official computation for the previous financial years was based on the GDP per capita of the cohesion countries related to the average GDP per capita of the EU-15.

The evolution described by the data presented in Table 2 reveals a general trend of approximation to the average index (denoted by 100%) in all cohesion countries. Of course, the evolution of the indices computed for each country reveals the convergence of the real national economies during the pre-accession and post-accession to the EU.

(ii) *The variation coefficient of the GDP per capita or the σ-convergence.* Frequently used in the economic analysis, the indicator expresses the convergence level as a result of the measurement of the dispersion of the per capita GDP in a group of countries, according to the following formula:

$$\sigma_t = \sqrt{\frac{1}{n}\sum_{i=1}^{n}(X_{it} - \overline{X}_t)^2} \,/\, \overline{X}_t$$

The indicator computation is based on cross-section statistical series (countries), when comparisons in a time sequence are made, and time series (discrete time interval, t and $t + T$), in order to characterize the evolution (trend) of convergence. When the dispersion decreases in a certain period of time (when the value of the variation coefficient diminishes), convergence $\sigma_{t+T} < \sigma_t$ takes place.

To characterize the level and evolution of the real convergence process of the EU national economies, we computed the variation coefficient separately, for two groups of countries, EU-25 and EU-10 (the countries which joined the EU in 2004) and for the two alternatives of the GDP per capita expressed in euros: the purchasing power parity (euros-PPP) and market exchange rate (euros). The series cover the period between 1995-2006.

The results of the computation concerning the evolution of the variation coefficient (ó-convergence) are presented in a numerical form in Table 3, in accordance with above alternatives.

Table 3:The numerical evolution of the σ-convergence (the per capita GDP variation coefficient), EU-25 and EU-10

Years	Calculation based on PPP		Calculation based on exchange rate	
	EU 25	EU 10	EU 25	EU 10
1995	0.44	....	0.71	....
1996	0.43	....	0.68	....
1997	0.42	....	0.65	....
1998	0.41	0.35	0.64	0.81
1999	0.44	0.36	0.66	0.86
2000	0.44	0.34	0.65	0.77
2001	0.42	0.33	0.63	0.67
2002	0.42	0.31	0.63	0.66
2003	0.43	0.28	0.63	0.69
2004	0.43	0.27	0.63	0.64
2005	0.42	0.24	0.62	0.55
2006*	0.42	0.24	0.62	0.51

*Estimated data.
Source: Based on Eurostat data.

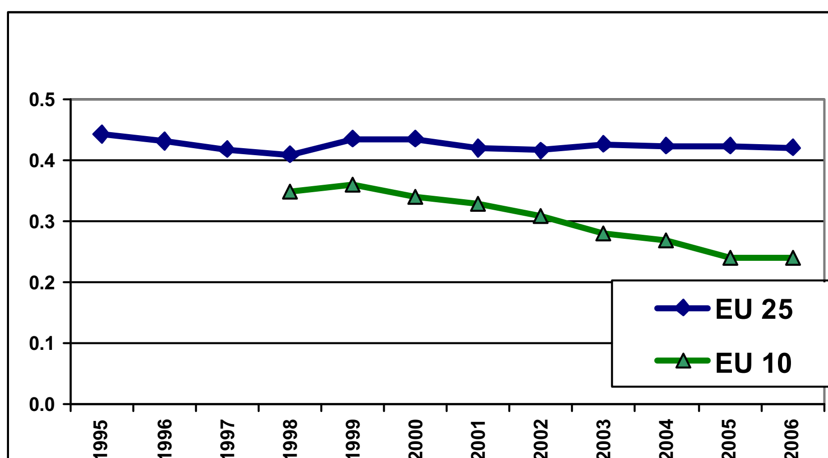
The evolution of the variation coefficients (ó-convergence) computed for the two groups of countries EU-25 and EU-10 and on the basis of the PPP is shown in Figure 3.

From the analysis of the level and tendency of the variation coefficients computed for the above alternatives, we draw the following conclusions:

a) In the case of the ten countries that joined the EU in 2004, the lower level of the variation coefficient means a higher convergence level in relation to the whole of the EU member countries.

b) The downward trend of the variation coefficient for both alternatives (PPP and exchange rate), more discernible with the 10 countries as against all countries, shows a higher rate of real convergence in this group of countries.

c) The variation coefficients based on the market exchange rate in the group of ten countries are higher over two times than those based on the PPP, which means that the difference among the countries of this group in the standard of living is relatively low and, consequently, the convergence level of these countries expressed in real terms is much higher than that expressed in nominal terms.



Source: Based on Eurostat data.

Figure 3. Σ-convergence (variation coefficient) computed on the basis of the per capita GDP (PPP, euro)

CONCLUSIONS

Due to the wide gap between Romania and the developed countries and the complexity of the problem as such, the issue of real convergence should be paid special attention. Moreover, it is worth mentioning that, within the theoretical and empirical research in the field, real convergence is the crucial point of the economic growth and enables the researcher to set the objectives, resources and mechanisms; also, it signals the transition of the countries from the periphery (poor) group to the rich one.

To examine the question of the real convergence from different angles, two classes of models have been designed and used: neoclassical and endogenous. In our study we tried to show the limitations of the neoclassical model and, especially, the failure of the assumption concerning the decreasing rate of return on capital. Finding ourselves in opposition to this kind of model, in this study we present the most important features of the endogenous growth model (and derived models) and its capability to include and/or consider the real convergence (divergence) factors.

The latest empirical research aimed at the validation of various convergence hypotheses proves that there is not and it cannot be an alignment of all countries with an "absolute convergence". What the economic and social reality of the countries and regions confirm is rather the "group convergence", viewed in its dynamics and in relation to the factors of influence acting within the system. Under the present circumstances, the factor that determines the dynamics of the developed countries is knowledge, in its multiple forms. The knowledge factor determines the higher growth rates of the developed countries, if compared to the poor ones.

As pointed out above, market mechanisms are not able to support the convergence process, especially when there is a wider gap in the development level of the countries and regions. On the contrary, the mechanism stimulates, first, the economic clustering, the formation of development poles, which rather cause wider gaps. Considering these natural processes, the European Union tries to correct the shortcomings of the free market laws by the cohesion policy, besides the sectoral policies, with favourable effects on the economic convergence of the less developed countries with the developed ones.

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FROM WASHINGTON CONSENSUS TO LISBON AGENDA: WHAT LESSONS FOR ECONOMIC MODELS IN ROMANIA?

Valentin Cojanu[*]

Abstract: *The path from command to market economics in Romania has been marked by two decisive conceptual clarifications at international scale, from the 1989 Washington Consensus to the 2000 Lisbon Agenda. In both cases, it was about a "how-to" policy list supposedly conducive to better economic performance. Prescriptions from both lists were integrated in national programmes, but doubts still persist as to the configuration of the right policy measures. This material discusses the context and practical implications of the two theoretical models.*

Key words: *economic theory; development; European integration; competitiveness*
JEL: *A11, F02, P47*

Introduction

Romanian authorities and intellectuals of the economics community seem to be on an endless search for economic models to support their reform agenda. No sooner had they left behind the Marxian economics that they had to embark on the so-called *orthodox* or *market economics* and *economics of transition* became a fashionable if ostentatious (Bal 1997: 25) way of thinking about the transition to a market economy in Romania. The path from command to market economics has been marked by two decisive conceptual clarifications at international scale. First, it was in 1989 the manifesto of a group of financial institutions based in Washington which proposed a set of reform policies for Latin American countries, later extended to developing countries as a whole. Second, it was in 1999 the decision of the European Union (EU) to launch a programmatic initiative leading to increased competitiveness for its member countries, currently known as the Lisbon Agenda. Between those very milestones, Romania suffered a radical change in its historical evolution, leaving behind a Communist regime in 1989 and becoming a candidate country for integration into the EU by the end of the decade.

Economists came to realize that the standard precept provide no recipe to smoothly overcome the economic and social difficulties of the transition. The right path to development looks rather like a moving target. It is symptomatic for this intellectual conundrum to see how the sympathy swings between the remarkable achievements of the Scandinavian countries which epitomize a social market economy and the Lisbon Agenda, the European Union's blueprint for becoming "the most competitive and dynamic knowledge-based economy in the world" by 2010, which is praised for its explicit support in emulating the economic liberalism of such competitive economies as the U.S. or Japan.

[*] ***Valentin Cojanu*** *is University Professor at the Academy of Economic Studies, Bucharest.*

It is the message of a need for revamped theoretical arguments in economics which this article attempts to convey. This material comes out with a view to discerning between vagueness and relevance of the economic science that could provide a critical investigation of the economic foundations of contemporary society. The result is based on a discussion of the two theoretical models and consists of a construction which calls into question the tendency of the economic method to try and explain all economic phenomena by using the same catch-all theories and dealing in universal truths.

A decade (1990-2000) of conceptual clarifications and the aftermath

This material concurs with the products of a large variety of schools of thought exemplified *inter alia* by Beaud (1996) and Fullbrook (2004) - which direct their criticism to the way economists try to understand their object of study. The obvious discontent surrounding the methodology of economics has led respectable academic establishments like Harvard University to offer alternative undergraduate courses on economics which discard the classical postulates of rational behaviour and are deemed to suggest "a clearer understanding of the basics of economics" (The Economist 2003). However, this kind of academic initiatives alongside with disparate but systematic research applied in the field of the philosophy of economics and social sciences have not succeeded so far in suggesting a coherent alternative to the dominant methodology based on the deductive and inductive logic. What is usually proposed and so far widely accepted as a credible choice of inquiry rests on a combination of various theories to analyze different economic phenomena and systems plus a mandatory recourse to the historical context.

In spite of the widespread use of mathematics and statistics, empirical studies and economic theory often appear not to live up to the economists' ambitions to provide a consistent body of knowledge. Theoretical reference points become confused in prominent themes of research as the debate elsewhere (Cojanu 2003) reflects it, are severely weakened by the underlying mathematical apparatus (see McCloskey and Ziliak 1996), and supporting arguments are surprisingly put forward by a Nobel laureate and mathematical economist in Stiglitz (2003). The ensuing discussion exemplifies those theoretical ambiguities as these are embodied by the two of the most representative products of the economics community.

The Washington consensus

The year of 1989 transformed the economic history by two defining moments. One is the fall of the Berlin Wall which symbolically marks the turning point from Communism to capitalism in Eastern Europe. The other is represented by the initiative of a so-called group of Washington-based international financial institutions (IFIs) to put forward a paper - the *Washington Consensus* - containing ten policy recommendations believed to provide Latin American countries a way out of the downturn of the 1980s. The circumstantial coincidence made that the latter soon became a guiding policy set to deal also with the unknowns of the transition to a market economy. It was neither the only fitting theoretical construct theories such as supply-side economics, monetarism, or

minimal government enjoyed much respectability nor supposedly the most dominant (see Bal 1997: 25-31), but it is its encompassing coverage of the economic policy dilemmas which ensured it rather a different role, that of a prototypical representation of standard policy prescriptions.

John Williamson (2006) credits himself with the fatherhood of the scheme and confesses that the ten reforms advanced at the core of the *consensus* (see Table 1 at the end of this section) were deliberately proposed "to provide a common set of questions on which the authors of the country papers could focus." It was thus proposed a version of the positive economic theory centred around, basically, macroeconomic discipline, market liberalization, and globalization. The solution was soon embraced by the IFIs for the developing world as a whole, including the evolving transition of the former European communist countries. The evidence of "modest" economic growth in the first targeted region (Latin America), as well as of general "discontent" of global ready-made medicines (Stiglitz 2003) led economists to question whether the policy changes were a mistake and to advance a series of additional policies giving in fact rise to an *augmented* consensus (see Table 1). There are two strands of criticism worth discussing.

There was first admission of guilt on behalf of the proponents in the sense of neglecting crucial circumstantial facts or taking the clarity of concepts for granted relevance for economic problems which more often than not were conducive to unjustifiable misinterpretations. It is somewhat ironic for the pretensions of the standard economics establishment to see its approach mired in allegations of "naïve optimism" of the "experiments set up in ivory towers" (Van Brabant 1998).

There were however some concrete contentious issues such as the objective of "financial liberalization". In Williamson's words, that thinking referred only of domestic liberalization, and did not include capital account liberalization. The IMF policy prescriptions nevertheless included the very latter which allegedly engendered the Asian crisis of 1997 in spite of "persuasive evidence" (Williamson 2006) that inward foreign direct investment, and inward portfolio equity investment, increase growth, but not complete opening including the free inflow and outflow of short-term loans - accelerates growth.

Other issues were simply overlooked. Indifference to issues of income distribution on behalf of both the World Bank and the IMF (Williamson 2006) was replaced by a thoughtful approach to such problems as governance and corruption, or the standards and codes of a properly functioning financial sector. The bleak perspective of recurrent and widespread crises changed the view on macroeconomic policy to a range of policies e.g. counter-cyclical fiscal policies, accumulating a stabilization fund when exports are cyclically strong, avoiding excessive capital inflows when capital is available, and avoiding currency mismatching that paid attention to circumstantial rather than standard evolutions.

Then there was outright dissatisfaction with the apparent inability of standard economics to provide helpful solutions to ongoing economic needs. The fact that it has become associated with several of its prominent exponents makes the case the more so compelling. Dani Rodrik (quoted in Williamson 2006) replaces the mantra of *liberalization* with

that of *institutions*: "what development needs is not a cookbook, nor a description of what advanced countries look like, but, rather, a strategy for kick-starting growth and a series of institutional reforms that will keep a country growing." Stiglitz (2003: 126) goes further and rejects the idealism of a *market* mechanism altogether: *"the consensus policies ... were based on a simplistic version of the market economy, the competitive equilibrium model, in which Adam Smith's invisible hand works, and works perfectly. Because in this model there is no need for government that is, free, unfettered, 'liberal' markets work perfectlythe Washington Consensus policies are sometimes referred to as 'neo-liberal', based on 'market fundamentalism".*

In this context, the pointless debate over shock therapy versus gradualism measures was readily disposed of. It was instead substituted by an ambiguous terminology about *efficient institutional mechanisms*: "It is important to understand that [institutions] do not imply the state's withdrawal from an economic role: rather, the state's role must change to one that will support the market, rather than seeking to replace it." (Williamson 2006)

The Lisbon Agenda

The Lisbon Agenda (LA)'s elusive rationale as an instrument to propel competitive growth within a nascent currency union has been tackled elsewhere (Cojanu et al. 2006) and this section draws only on the point addressed therein as to its strategic liability to exhibit the perennial economics problem of identifying the "right" structural reforms.

The launch of the LA at the 2000 European Council in Lisbon with the view to making Europe an exemplar of competitive performance was preceded by an upsetting revelation: the decline of the EU competitive position vis-à-vis the US, had been a fact that overshadowed the accomplishments of the European integration for decades. The initial formulation was one of great ambitions: the strategy commits Member States to the goal of making the EU "the most competitive and dynamic knowledge-based economy in the world". There were thus defined four pillars of the strategy - "growth", "innovation", "employment" and "social cohesion", and if one translates "sustainable economic growth" into an "environmental dimension" - a decision in fact explicitly made at the 2001 European Council in Göteborg the LA set the EU on a five-pronged competitive track. The LA mid-term review in 2005 apparently refocused the target on a much narrower objective, the strategic goals of "growth" and "employment", but they multiplied at the Community and national levels in ten and three, respectively, distinct dimensions considered to be critical for competitiveness. The "obsessive" character of this quest for competitiveness determinants engendered a continuous redefinition of what is "critical" and resulted in loose interpretations of what LA actually means. Table 1 gathers one of the most representative lists of the LA targets.

The range of possible interpretations of LA targets raises a legitimate question: Does the LA really stand for a guideline to achieve a coherent strategy for competitiveness? The EU administration picked up the goal of creating a "knowledge economy" amidst a world-wide euphoria about the benefits of the "new economy" which was by that time epitomized by the *.com* boom. The tone watered down since and more recent documents (e.g. Commission, 2005) praise the importance of traditional manufacturing industries.

Discussions with Commission officials (quoted in Cojanu et al. 2006), in fact revealed that the initial theoretical underpinning had to rely on common sense and on consensus prescriptions from international organisations, rather than on a set of *ex ante* priorities and a methodology for dealing with the complex nature of competitiveness of an economic zone. One implication becomes obvious and refers to the analytical ambiguity associated with evaluating the "success stories" of countries of commending competitive performance.

This analytical issue could certainly be avoided if the EU's attempt to deal with structural economic liabilities of its member countries paid due attention to parallel international efforts made by such organisations as IMF, OECD, and WTO. Given that all EU countries belong to those institutional arrangements, one may reasonably ask to what extent the LA should not be regarded just as an undertaking in duplicate. What makes indeed the EU Lisbon process different from all those analytical evaluations consists of its goal of embarking at the same time on the misleading task of indicating *the right venue towards competitive upgrading* as well. From an analytical standpoint, this strategy fails on the ground that it gets the observer confused about the existence of any critical determinant of competitiveness, be it "information technology", "employment" or whatever. If one follows two assessments (quoted in Cojanu et al. 2006) of competitive standing of Sweden and Finland between 1999 and 2003, it is disconcerting to find out that their march from bottom to top in the competitive hierarchy of European countries in such a short period of time is explained by the mere refutation of the "ultra liberal Anglo-American" economic model, that is the very one whose success the AL was supposedly conceived to emulate.

To sum up, Table 1 below presents a synoptic view of the theoretical models hitherto discussed. Both were intended from the very beginning to provide a standard way of thinking about economic policies and/or structural reforms and both failed to withstand the challenges of real world competition. The difficult task of making good sense of their prescriptions resides in the multi-faceted perspective on economic policy reforms which hardly be singled out in one however good list. The circumstantial observations of economic facts may require, for example, simultaneous implementations of reformsmarked by simple underliningor step by step measures on an unpredictable pathdouble underlining.

Table 1: Target areas of the Washington Consensus and the Lisbon Agenda

The original Washington Consensus	*The augmented Washington Consensus*	*Lisbon Agenda*
♦ Fiscal discipline ♦ Reorientation of public expenditures ♦ Tax reform ♦ Financial liberalization ♦ Unified and competitive exchange rates ♦ Trade liberalization ♦ Openness to FDI ♦ Privatization ♦ Deregulation ♦ Secure property rights	♦ Legal/political reform ♦ Regulatory institutions ♦ Anti-corruption ♦ Labour market flexibility ♦ WTO agreements ♦ Financial codes and standards ♦ "Prudent" capital-account opening ♦ Non-intermediate exchange rate regimes ♦ Social safety nets ♦ Poverty reduction	♦ Single Market ♦ Open and competitive markets inside and outside Europe ♦ European and national regulation ♦ European infrastructure ♦ Research and development ♦ Innovation and sustainable use of resources ♦ European industrial base ♦ Employment and social protection systems ♦ Adaptability of workers and enterprises and the flexibility of labour ♦ Human capital through better education and skills

Sources: Williamson (2006); Commission (2005).

Concluding notes

What are the lessons of this package of good intentions and questionable execution? What could all this mean for competitive development of Romania? The results of scholarly work point to divergent solutions as to the suitability of all-encompassing prescriptions. At least two general principles of action should be observed in line with that conclusion.

First, it should be noted that the recourse to policy reforms should come as a consequence of national initiatives and definition of priorities and not the other way around. Understanding what happens within national or regional economic spaces is not primarily linked to whatever yardsticks of idealized behaviour, but to a familiarity of that environment's development needs.

Second, the governments should be aware that reform is about programmes and priorities which should not take anyway the course suggested by a model. If a proper rationale is to be found, a country should take then benefit from similar initiatives and/or experiment in line with its historical experience. For a practical agenda, this imperative implies reaching a twofold target of counteracting the challenges of both international competition and local needs. The capacity to react is based on such diverse economic mechanisms as absorption of macroeconomic shocks, productive impact of macroeconomic policy, and particular cultural attitudes in production and consumption (propensity to invest and save).

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THE RESTRUCTURING OF ROMANIAN POWER SECTOR AT THE CROSSROADS: COMPETITIVE MARKETS OR NEO-COLBERTISM?

Oana Diaconu, Gheorghe Oprescu, Russell Pittman*

Abstract: *Despite efforts made by European Commission to liberalize electricity markets and foster integration, there are still significant barriers to free competition. Until now, Romania was one of the countries that have been compliant to the European Union's electricity directives, being ahead of several older member states in this area. However, reforms have not started to pay out, suggesting that the model of combining state-owned non-competing generators with private/privatized distributors and suppliers may not be the best model of market deregulation. As a result, Romanian authorities have started to talk about plans to restructure the sector, by re-consolidating the unbundled generation companies and the state-owned distribution companies into one national energy company, aiming to create a national champion, competitive on the regional markets. However, these proposals are based on questionable economics and their adoption will have negative effects on market competition and, thus, on consumers.*

Key words: *electricity sector; liberalization; Romania; European Union*

JEL classification: *L22, L43, L51, L94, P23, Q48*

Two opposite forces are currently shaping the future of electricity sector in Europe. On one side, there is the electricity market liberalization policy that the European Commission has pursued in the last ten years, which aims to create a single, competitive internal electricity market across EU. On the other side, at the national level, there is a growing trend toward an interventionist policy of picking and supporting "national champions" in "strategic" sectors, a policy traditionally advocated by France. (Maicent and Navarro, 2006)

In order to liberalize the markets and foster integration, the policy of European Commission, reflected in the EU Electricity Market Directives of 1996 and 2003, and the more recent Green Paper[1], called for vertical unbundling of transmission and distribution operators, gradual opening of the national markets, better regulation of access networks, independence of national regulators, free entry to generation. According to EU Directive[2] 54/2003 by July 2007 the Member Countries should establish a regulated third party access regime to transmission and distribution

* ***Oana Diaconu*** *and* ***Gheorghe Oprescu*** *are Professors within the Department of Economics and Management Polytechnic University of Bucharest.* ***Russell Pittman*** *is Director of Economic Research and Director of International Technical Assistance Economic Analysis Group - Antitrust Division, U.S. Department of Justice (The views expressed by Mr. Pittman in this article are not those of the U.S. Department of Justice).*

[1] *Green Paper. A European Strategy for Sustainable, Competitive and Secure Energy, COM (2006)105 final, Brusseles, March 8.*

[2] *Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC*

networks; implement the legal separation of supply from transmission and distribution; open the market for all categories of consumers; establish a regulated regime for cross border trade and set up an independent market regulator. (Jamasb and Politt, 2005)

However, the findings of an electricity sector inquiry launched in 2005 pointed out that "the objectives of market opening have not yet been achieved" and that there are still significant barriers to free competition (European Commission, 2007). In order to address this, the Commission has proposed a third legislative package amending and complementing the existing regulation for the electricity and gas market[3]. The package is designed to address the main "structural failings" of European electricity and gas markets:

- High level of concentration and market power due to insufficient unbundling;
- foreclosure of competition by the vertically integrated monopolists which own network infrastructure and discriminate against new entrants;
- lack of transparency in the wholesale energy sectors which discourages new entry;
- Low levels of cross border trades and integration due to: insufficient interconnector capacity, distorted investment incentives that integrated monopolists have and capacity withdrawals by the incumbent national firms that do not want to encourage competition.

Many of these structural failings have been caused by opposition of several EU member states, notably France and Germany, to deeper reforms, in their attempt to protect the interests of their large, national energy giants and by the evasive manner in which some member countries applied the EU directives.

The "third package" has also to be viewed in the larger context of the new EU energy strategy, set out in the Green Paper and the Commission Communication to the Spring European Council concerning the renewed Growth and Jobs strategy, which has three main objectives: the creation of a competitive a efficient energy sector, security of supply and sustainability. A competitive and integrated energy sector, argues the Commission, is essential for achieving the strategic objectives of security of supply and sustainability.

Competitive markets provide the necessary signals for investment which leads to supply security in the most cost efficient manner. Similarly, the creation of a competitive internal market will allow the Union's energy companies to operate in a market of a larger dimension, which will improve their ability to contribute to security of supply. At the same time, market forces oblige European operators to use the most cost effective methods of production, which in the appropriate regulatory environment can benefit sustainability. Consumers will be able to choose between different providers and contract schemes, and could thus reduce their electricity costs and adapt their consumption to market developments. Competitive, cost reflective prices will help encourage energy efficiency, which can

[3] The package, which was introduced on September 19, 2007, includes four documents: a new directive amending Directive 2003/54/EC concerning common rules for the internal market in electricity, a new directive amending Directive 55/2003/EC concerning common rules for the internal market in natural gas, a regulation establishing an Agency for the Cooperation of Energy Regulator, a regulation amending Regulation (EC) No 1228/2003 and a regulation amending Regulation (EC) No 1775/2005.

reduce the dependence on external suppliers and which supports the Union's objective for sustainability and security of supply (European Commission, 2007)

Romania is one of the countries that have been compliant to the European Union directives, being ahead of several older member states in certain areas of electricity sector reform. So far, in all its strategic and policy documents Romania has expressed its commitment to the objective of creating a competitive and integrated European energy market.

The liberalization efforts undertaken have been significant. Over the 1998-2000 period the vertically integrated, state-owned monopoly was divided into five separate state-owned enterprises: one each for nuclear generation (Nuclearelectrica), hydro generation (Hidroelectrica), thermal generation (Termoelectrica), transmission (Transelectrica), and distribution (Electrica). Since then the distribution function has been further divided into eight regional companies, with five of these privatized to foreign buyers (Electrica Oltenia to CEZ, Electrica Moldova to E.ON, and Electrica Muntenia Sud, Electrica Banat and Electrica Dobrogea to Enel). Termoelectrica has been also further horizontally unbundled. The most important entities that were spun off Termoelectrica were the vertically integrated Energy Complexes, Turceni, Rovinary and Craiova, created in 2004 by integrating the brown coal mine previously belonging to the Oltenia National Lignite Company. Together they account for about 25% of electricity production in Romania. An independent regulatory body, ANRE, has been established and the regulatory reform has advanced significantly. The wholesale market is operating since 2000, although its design has been modified in 2005. The Day Ahead Market, a sub-market of the wholesale market has transacted about 7.7% of the national consumption, a relatively high percentage by European standards. The market opening is on going. Since July 2005 all industrial consumers have been eligible to change their supplier and all consumers are legally eligible to choose their suppliers since July 2007. The market structure that resulted from ten years of successive unbundling is promising. In 2006, on this market there were 61 electricity producers, 104 suppliers, 8 distribution operators, 8 million residential consumers and 600,000 industrial consumers.

However, reforms have not started to pay out yet, mainly due to the fact that competition in the generation sector has failed to emerge. The reason is that most of the generators continued to remain state owned and subject to political and administrative interference from the state. Privatization has been always a sensitive political issue. The most viable generators (hydro power plants, the Energy complexes) that could have attracted the interests of private investors have been deemed of strategic importance and withhold from privatization. The thermo power plants that were listed for sale did not attract the investors interest, given their age, outdated technology and significant need for investments. Given the excess capacity and high reserve margins that exist, at least theoretically, in the Romanian power sector there had been no significant green field investments.

In these circumstances, the sector has been plagued by corruption scandals and by the chronic financial problems of some generators. For example, Termoelectrica had accumulated, by 2005, debts of 1.2 billion Euros mostly due to regulated prices below average costs and to

horizontal unbundling measures that left it without its most efficient generation units. Nuclearelectrica has also accumulated debts of 180 million euros. The managers of low cost generators like Hidroelectrica or Rovinari, have granted long term contracts to politically connected energy suppliers, at prices below the market price and sometimes even below costs.

Current scandals in the sector show that - taking horizontal unbundling and sector's liberalization as given - the model of combining state-owned non-competing generators with private/privatized distributors and suppliers is not the best model of market deregulation. The manager of public companies often pursue other objectives than profit maximization (security of generation, lower prices, etc.) and are under strong political control. In such a model, corruption would always be an issue, even if transparency is maximized or the sector is totally de-politicized.

Also, the scandals-that surfaced in a period when the market is progressing fast toward a competitive model- underline the need for a professional and less politically amenable regulator that would lay out more clearly the rules of the game for all the market participants. Political pressures and the fact that most of the staff of the regulatory agency have close ties with the industry[4] - which suggest a certain degree of regulatory collusion - may account for the limited willingness of the regulator to deal more firmly with the sector's issues.

So far the Government has dealt with the financial problems of the sector by providing successive waves of state aid, in the form of public debt write-offs and subsidies for debt repayment towards private creditors, of more than 1 billion Euros. In accordance with the pre-accession procedure, the aids have been authorized by Romania's Competition Council as being compatible with the *acquis communautaire* because they represented compensations to an undertaking operating a service of general economic interest. However, these authorizations decisions raised many question marks about their conformity with the European legislation.[5]

However, after accession, state aids should be notified to and authorized by the European Commission. It is doubtful that the Commission will agree anymore with any new state aid and therefore it becomes crucial for this company that a decision is made about its prospects in the market. It is likely that due to this change in state aids authorization procedures the sector will need to undergo severe adjustments in the near future.

Foreseeing or not some of these issues, in the past two years, the Romanian Government has started to talk about plans to restructure the generation sector in order to render some troubled generators financially viable. The restructuring plans have also been spurred by the very large investments that thermo power plants need to undertake in order to comply with the EU environmental standards.

The solution most seriously considered has been that of re-consolidating the unbundled generation companies by grouping the most viable generators (the hydro plants, the Energy Complexes and

[4] *Most of them come from the industry. ANRE and Hidroelectrica even share the same building*

[5] *As an example, if the undertaking which is to discharge public service obligations is not chosen pursuant to a public procurement procedure, which would allow for the selection of the tenderer capable of providing those services at the least cost to the community (which was not the case for Termoelectrica), then the level of compensation needed must be determined based on an analysis of the costs of a typical undertaking, well run and adequately equipped. Or, in this case, the involved costs were Termoelectrica's costs, probably substantially higher than those of a "typical undertaking" in the sector.*

possibly the nuclear producer, Nuclearelectrica) together with other less efficient thermo generators in 1-3 larger companies. The idea the was to group generators in order to create companies with similar (low) *average* costs and market shares that, was argued, could successfully compete against each other. Implicitly, under this plan, the less efficient thermo generators would be cross subsidized by the more efficient units of the company. The investment needs of the consolidated companies would presumably be financed from the rents accruing to the inframarginal generators.

At the end 2006, the Romanian Ministry of Economy and Commerce signed a contract with the consultant Parsons Brinkerhoff Power (UK) and the Institute for Power Studies and Design (Romania) in order to explore the re-organization of the generation along these lines. A preliminary study of the Institute was submitted to the Government last summer. In the spring of 2007 the consultants submitted five proposals, each with two or three scenarios, of grouping the hydro, nuclear and thermo generators in 3 or more companies based on a set of criteria such as: the market share; levelized costs of the generators and their investment needs in the 2007- 2012 period. According to the study the preferred solution was to create five companies, among which a "strategic" state-owned generator, that would own Nuclearelectrica, RAAN and the two largest hydro power plants in Romania, Portile de Fier I and II (which account together for about 40% of the hydro generation in Romania).

For a while the plans to re-concentrate the industry seem to have been abandoned. An earlier version of the Energy Strategy released by the Government in May 2007 talked about "re-grouping of the generators mainly by natural aggregation as a result of privatization of thermo and hydro power plants"

However, in September 2007, things have taken a surprising and more dramatic turn. Romanian authorities have announced plans to create a national energy company, which would bundle not only most of the energy producers but also the distribution companies that are still state owned, with the intention of creating a strong national champion in the regional markets, following the model of CEZ and ENEL.

If implemented, such measures would represent a big step back for the electricity market reform in Romania and a significant departure from the doctrine of competitive electricity markets to which Romania has subscribed so far. This is a major change of policy that may suddenly render worthless ten years of reform because it would dissipate most of its potential benefits, which derive chiefly from the effects of competition on generators.

The reason why the policy of "national champions" has all of the sudden such an appeal for the Romanian government is yet uncertain. It is possible that Romanian political class has never really been committed to the ideas of competitive energy markets but felt compelled to formally embrace them in order to join the EU, obligations of which now they feel partially relieved. For the Romanian politicians, the energy sector may represent a too important source of rents and a too powerful political instrument to let go. However, it may also be the case that the plans of re-concentrating the sector are genuinely viewed by the government as the only viable solution for electricity sector in the present circumstances. In this case, they are based on flawed economic reasoning. Let's first review some economic fundamentals.

On a liberalized market, the price of electricity is determined by the most expensive source of supply necessary to meet demand. The most expensive source of supply is that with the highest *marginal* cost. This is called marginal cost pricing. On the power market there are usually low marginal costs generators, like nuclear, coal and hydro units, and high marginal cost producers, usually the natural gas-fired-units and other fossil fuel units. The industry marginal cost of electricity production is the horizontal sum of the marginal costs of individual generators on the market. The high marginal cost generators typically operate only during peak periods, when demand is high. In order for them to operate, the price during peak demand periods needs to be high enough to cover their fixed costs (including a normal return). The payments that the marginal generator receives in excess of its variable costs when the market is tight are called scarcity rents. During all periods, the facilities with lower marginal costs - the inframarginal generators - receive a market price in excess of their marginal costs. These excess payments received by low marginal costs generators are called inframarginal rents. Therefore, the inframarginal generators receive both inframarginal and scarcity rents. They are used to cover the fixed costs of the generators and represent a very important signal for their investment decision.[6] Other pricing mechanisms can be devised for the electricity market; however, marginal cost pricing has the advantage that, on competitive markets, is welfare maximizing.

A low marginal cost generator is not necessarily a low average cost generator. The average costs are the sum of average fixed costs and average variable costs of generation. Fixed average costs are accounted mainly by capital costs. They depend, among other things, on how intensive the capacity is utilized, on discount rates and on the expected life of the plant. In terms of levelized costs per kWh[7], combined gas cycle turbines often have lower *average* costs than nuclear or hydro generators. Low marginal cost units like nuclear power plants or even hydro plants have high fixed costs and higher levelized costs per kWh. *The failure to understand the distinction between average and marginal costs fuels some popular misconceptions such as that of "cheap" nuclear and hydro electricity.*[8]

The average costs do not matter on a deregulated energy market, in the sense that they do not influence the market price.[9] They are important only for the magnitude of profits/losses that the generators make. The average cost of the generator has no influence on the marginal costs of the units it owns. *Therefore bundling together generators in order to create companies with similar average costs will not keep electricity prices low.*

The idea that, on a free market, there can be no competition among generators with different average costs which seem to underline the consolidation proposals is rooted either in a misunderstanding of marginal cost pricing or in the mistrust in the efficiency of the wholesale market.

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[6] *Of course, this is a simplified depiction of the manner in which electricity wholesale market operates.*

[7] *The methodology of levelized costs is used in order to compare the different electricity generation options. The levelize cots can be thought of as the tariffs that the owner of a generator would need to receive over the life of the facility in order to cover the construction and operating costs of a generator based on its expected life and capacity factors.*

[8] *The price of hydro power is also artificially lowered by regulatory arrangement that do not reflect the opportunity costs of water used for generation purposes.*

[9] *The situation is different if the retail prices are regulated, consumers being charged a weighted average of the generator costs. See Van Doren and Taylor, 2004.*

On the electricity market the units that cover the peak load had different cost characteristics than those who cover the base load (the former have lower fixed costs and higher marginal costs). The peak load units do not function frequently and cover their fixed costs from scarcity rents when demand is high. In theory, on the long term, a competitive market will make the scarcity rents exactly cover the fixed cost of peak load units. If the scarcity rents are higher than the fixed costs, supplementary peak load capacity will be added. The extra capacity will reduce the prices during peak load and the scarcity rents. If the scarcity rents will fall toward levels lower than fixed costs this would be a signal that there is extra capacity in the system. This capacity will gradually exit the market increasing the prices to the point they cover the fixed costs of peak loaders. The electricity prices and scarcity rents provide essential signals with respect to the optimal capacity mix of base and peak loaders on the market.

However, in practice, marginal costs pricing may not be as successful in guiding the investment decisions and assuring the system reliability as the theory claims. The wholesale electricity markets are affected by a series of imperfections that limit the extent to which prices can convey accurate signals with respect to investments in generating capacity. They may lead to investment cycles - periods of overinvestment in capacity followed by periods of underinvestment, reduced reliability and high price volatility. The most important imperfections are: the limited response to price changes on the demand side[10]; non-price rationing of scarce generating capacity due to reliance on non-market mechanisms; incomplete and illiquid forward markets; too short term contracting due to regulatory opportunism and retail market imperfections (Joskow, 2003). Therefore, a certain degree of skepticism with respect to the efficiency of the wholesale electricity market may be warranted.

Even so, probably the most important flaw of the restructuring plan is that it ignores the effect that a concentrated market structure will have on competition in the generation sector. The plan will result in a market with 2-3 large players with significant market power. This translates in higher prices and inefficient allocation of resources in the generation sector. Or, most economists would agree that the bulk market liberalization in the power sector stems from the effects of competition in the generation sector.

There are two main academic arguments for why electricity market liberalization is worth pursuing. They pertain to the static efficiency of the deregulated market. First, on the supply side, competition provides better incentives to the generators to minimize costs, by choosing the right technology, capacity mix and capital labor intensities, and drives prices toward marginal costs. Second, on the demand side, deregulated prices will better signal to consumer the marginal cost of additional consumption, reducing peak-demand, when generation is more costly, and increasing off-peak demand. As a result, the total costs of producing power will be reduced and the competitive market will pass the savings onto consumers. However, empirical evidence points out that demand is extremely inelastic and therefore the demand side benefits of liberalization are modest. So far, liberalization has scarcely involved the use of real time pricing.

[10] *Most do not perceive the price fluctuations on the wholesale market. Even if the fluctuations were perceived the price elasticity of demand would still be very low.*

However, even if real time pricing was fully implemented, the savings to consumers would be very low. Some estimates place them around 2% of the total cost of delivered power (Stoff, 2002)

The benefits of market deregulation have to be weighted against its costs. The costs stem from increase market complexity and, possibly, less reliability, which gives rise to increased risk premiums[11] and regulatory costs. Or, forgoing the effects of competition in the generation sector would make liberalization a pointless and formal exercise: it would mean forgoing most of the benefits while being saddled with its all, at all negligible, costs.

What is market structure and why is the market structure so important? Market structure is an array of properties that, together with demand, determine the strength of competition on the electricity market. When competition is weak, firms have market power: they can and find profitable to charge prices above the competitive levels. The properties of the market are determined by technology and legislation/regulation and refer to: the number of producers; their relative size; the barriers to entry and exit; the degree of vertical integration; the degree of product differentiation, etc.

Market concentration is an important determinant of market power. It measures the extent to which few firms make most of the industry sales. However, other factors like the price elasticity of demand, the generation technology, the reserve margins in the system, the extent of geographic market are equally important.

One of the overriding conclusions of the empirical literature on electricity market deregulation is that the market structure is crucial for the future development of the liberalized markets (Newbery, 2006; Jamasb and Pollitt, 2005; Joskow, 2003). The experience of other countries shows that embarking upon deregulation while retaining a highly concentrated market structure is a dangerous reform path: it delays the whole process and makes its benefits harder to materialize. Regardless how good the institutional design or the quality of regulation is, they can do little to enhance market efficiency if grafted on uncompetitive market structures that are especially hard to regulate and reform ex-post. One of the main lessons that can be drawn from international experience with electricity market deregulation is that:

„No market design will work well if there is not an adequate number of competitive suppliers of generation service or the market power of dominant firms has not been mitigated in some way (i.e. with regulated forward contracts). There should be a large number of competing suppliers of generation service and deep liquid bilateral forward wholesale markets for physical and financial contracts for power" (Joskow, 2003)

Deregulation in England and Wales Electricity Pool provides an interesting illustration. Up to 1996 the electricity market was highly concentrated, the market price being determined by two big producers. Those two producers were exercising their market power gradually increasing the price-cost margins. In 1996, however, the regulator imposed the two companies to divest 6000 MW of capacity in favor of a third company. Moreover, it conditioned the attempt of the three companies to vertically integrate by additional divestitures. After 2001, the Electricity Pool has been replaced by a different market design: NETA (New

[11] *Although the increased risk premiums would also reduce the bias toward capital intensive generation of regulated utilities.*

Electricity Trading Agreements) based on self-scheduling, voluntary bilateral and day ahead markets, and "pay as you bid" pricing. Meanwhile the de-concentration process in generation sector has accelerated, because of producers' expectations that new entry would significantly erode the high price margins and because of the uncertainty surrounding the remuneration of capacity. Even before NETA was introduced, however, electricity prices dramatically fell due to continuous decreases in market concentration. Newbery (2006) concludes that the experience of England and Wales shows that high prices were mostly a consequence of the concentrated market structure, and not of the market design.

In other countries like Spain and Portugal, the deregulation has been stalled by high concentration in the generation sector, concentration initially encouraged by the Spanish and Portuguese authorities. In fact most of the European national markets remain highly concentrated.

If, on mature markets, the market structure is hard to change ex-post, in Romania, where restructuring is still on going and most generation assets are still public, the Government can still significantly alter it.

The current structure of the Romanian power sector looks promising comparative to that of many other EU members. Romania has fully implemented EU directives and is advanced in its efforts to create a competitive power sector. The concentration in the sector is moderate although Pittman et all (2006) finds that there is scope for market power, especially during the winter season that is the time of peak demand in Romania.[12] The property regime, the inheritance of past regulation which sought to use electricity prices as a tool of social protection, together with political interference in the management of state owned companies have been main obstacles to competition.

However, the situation could dramatically change if the Government embraces the idea of "consolidating" the industry as a solution to its financial problems, especially if it chooses to create no more than 1-3 generation companies. The "consolidated" entities will have significant market power that will be hard to mitigate through regulation. Bundling together hydro and thermo power plants may give generators additional incentives to restrict production and manipulate the market. Such entities may have incentives to restrict the output of their non-baseload plants in order to earn inframarginal rents on the lower cost capacity. Therefore the re-organization may have long run negative effects on market competition. The Romanian consumers, of which some already face relatively high electricity prices by EU standards[13], will have to deal with even higher prices due to increased price-cost margins.

Even if the electricity sectors of most EU countries are currently dominated by 2-3 (sometimes vertically integrated) producers, it would be a mistake to infer that this is a desirable arrangement that Romania should try to mimic, as some have argued. The package of legislation that the European Commission intends to adopt is directed precisely against this unsatisfactory status quo. The rhetoric of the national champions is fallacious and must be resisted because "national champions" do not benefit the

[12] *Even a market with a sufficiently large number of producers may be insufficiently competitive if only few of the generators can change their production as a result of the price signals. In Romania, during winter, more than 70% of the generation is base load due to cogeneration, which could give significant market power to the peak load producers.*

[13] *This refers to industrial consumers.*

consumers and the economy. They mean less competition, higher prices and less choice for the consumers, distorted investments, less reliable infrastructure and a significant potential for political interference and corruption. To the extent they remained state owned and are poorly managed they may become a significant burden for the state budget and "black hole" for the taxpayers money.

The performances of the state controlled generators in Romania have been poor: the generation costs are high, the technology is outdated and there are serious environmental issues that they need to tackle in the next few years. They have been riddled by financial losses, for which they are not entirely to blame, and by corruption scandals. Competition in the generation sector coupled with better governance and property structure stands to deliver significant efficiency gains in this sector, which, in the longer run can be passed to the consumers. Re-concentrating the sector along the scenarios we described could mean forgoing them.

Conclusions

The future competitiveness of the Romanian electricity sector hinges crucially on how the restructuring process will continue. After joining the EU the Romanian generation sector has come under increase pressures to restructure due to both changes in the state aids authorization procedures, which now limit the ability of the Government to support the loss making generators, and to increased investment needs, partially due to the necessity of complying with the EU environmental standards. The recent proposals of "consolidating" the generation sector aim to address these problems. However, these proposals are based on questionable economics and their adoption may significantly distort competition in the future. This would mean forgoing a good part of the efficiencies gains that the liberalization of the electricity markets may bring.

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SOME CONSIDERATIONS ON ABUSE OF DOMINANT POSITION

Ovidiu Maican*

Abstract: *Article 82 (formerly 86) EC contains four essential elements (an undertaking, a dominant position, an abuse of that position and the abuse must affect trade between member states). The term undertakings is subject to the same broad interpretation as that applied to article 81 (formerly 85) EC and covers the same activities, both public and private.*

The Community interest must be also taken into account. Although it is not clear precisely what this element of article 86 requires, it will clearly curtail the scope of the exception provided under this article.

Although abusive behavior of undertakings in a dominant position is prohibited, it must be recalled that merely being in a strong position is not a problem in itself. It is necessary for major players in a market to be aware of their position because practices which would not fall foul of article 82 (formerly 86) EC, where an undertaking is not dominant, will do so where dominance is established. A refusal to deal by a non-dominant undertaking would not be an abuse within article 82 (formerly 86) EC, but it will be so where the undertaking is dominant.

Keywords: *Concentration of economic power, dominant position, abuse manifestation, forms of the abuse, jurisprudence*

Introduction

A threat to ensuring a free and fair competition is represented by the adverse impact of the concentration of economic power.

Competition and trade among states within (inside) the European Union can be adversely affected not only by "cartels" (agreements between companies, decisions of company associates and concerted practices), but also by "dominant positions", that is by companies situated on quasi-monopoly positions.

For this reason, the control of the powerful economic positions held by those capable of dominating the market was taken into consideration, along with a follow-up on the advantages deriving from such a position.

Definition

Article 82 (formerly 86) EC considers that any action of one or several companies consisting of a dominant position abuse on the Common Market or on a considerable share thereof is incompatible with the Common Market as long as such action can affect trade between the member countries.

The aforementioned article does not define the concept of dominant position abuse. What the laws of the European Community condemn is not the dominant

* ***Ovidiu Maican*** *is a university Lecturer at the Academy of Economic Studies, Department of Law. He holds a PhD in Community Law, a Post-Graduate Degree in Geopolitics and a Master Degree in Drug Trafficking. Fields of expertise: Community Law, Constitutional Law, Business Law.*

position itself but rather the misuse of a dominant position. Therefore, it becomes necessary to distinctly analyze the two components of the dominant position abuse, i.e. dominant position and the abusive application thereof.[1]

The first attempt to elaborate a definition of the concept of dominant position can be found in Art. 66, paragraph 7 of the CECO (CECA) Treaty, which corresponds to Art. 82 (former 86) EC. This text shows that: "If the High Authority considers that public or private companies, which as of right or as of fact, hold or acquire a dominant position on the market of a relevant product placed under its jurisdiction, where such position eludes an actual competition on a significant share of the common market, and if such companies use such position for purposes that are in contradiction with the objectives of this Treaty, then the High Authority will address the appropriate recommendations thereto in order to ensure that such position is not used for such purpose."[2]

A similar definition is the one contained in Art. 22, paragraph 1 of the German Law dated July 27, 1957, which provides: "a company is deemed to hold a dominant position on the market as long as there are no competitors or no notable competitors on such market". The definition was modified in 1973 in the sense that the company holding a dominant position "has a preponderant standing on the market in respect of its competitors".[3]

Other definitions were formulated by the European Commission and the Court of Justice of the European Communities.

In a memorandum dated December 1, 1965, concerning concentrations on the common market, the Commission placed less emphasis on the status of the market and on the lack of pressure exercised by the company, and insisted more on the capacity to exercise an influence on other companies."[4]

The text of the Commission illustrates that "It is mainly all about economic power, i.e. the ability to exercise an important influence on the operation of a market and, in principle, a predictable influence, as far as the dominant company is concerned. Such economic capability of a dominant company influences the economic conduct and decisions of other companies, whether used or not in the manner presented. A company which can defeat other competing companies on the market at its discretion, can already hold a dominant position and can determine, in a decisive manner, the conduct of other companies even though its own share of the market is still relatively unstable."

At a first glance, there is the tendency to oppose two definitions, one based on the market status and company power, the other on the independent nature of the company conduct.

Reference to the strength of the company does not eliminate the necessity to take into consideration the framework of competition on the market. In the Zoja case (JOCE/L no. 299 dated December 31, 1972), the Commission retained as a decisive element the suppluy structure of the ethambuthol market. The situation existing on the market constitutes a clue to the dominant position, not one of its definition elements.

The first decisions and resolutions adopted by the Court used varied wording.[5]

[1] *B. Goldman, A. Lyon-Caen, A: Vogel Droit Commerciel Europeen, Paris, Dalloz, 1994, pg. 411*
[2] *B. Goldman, A. Lyon-Caen, A: Vogel Quoted work, pg. 410*
[3] *B. Goldman, A. Lyon-Caen, A: Vogel Quoted work, pg. 410*
[4] *B. Goldman, A. Lyon-Caen, A: Vogel Quoted work, pg. 410*
[5] *B. Goldman, A. Lyon-Caen, A: Vogel Quoted worj, pg. 412*

In the Sirena resolution dated February 18, 1971, the Court described the concept of dominant position by "taking into consideration the individual existence and position of manufacturers or distributors of similar or substitute products."

In the Continental Can decision dated December 9, 1971 (JOCE no. 7 of January 8, 1972), "global independence of conduct" was used as a definition.

In the United Brands decision dated February 14, 1978, the Court considered that the existence of competition does not rule out the existence of a dominant position, as the latter implies the capacity to act autonomously.

This definition is retained and acknowledged by a more recent resolution, Hoffmann-La Roche dated February 13, 1979. According to such resolution, "The dominant position contemplated herein refers to the status of the economic power held by a company, which confers it the authority to set barriers against the maintenance of an actual competition on the market, thus making possible the existence of an extensively independent conduct in respect of competitors, clients and consumers."[6]

It was still in the Hoffmann-La Roche case that the Court formulated a general definition of the abuse of dominant position, namely "an objective concept regarding the conduct of a company placed in a dominant position, of such nature so as to influence the market structure, and as a result of the presence of that company, the degree of competition is already weakened, having as outcome the creation of obstacles using various means meant to stand in the way of a normal competition of products and services between operators, or in the way of a competition degree already existing on the market, or in the way of the development of such competition."[7]

In order to assess a dominant position, three categories of factors are used.[8]

The structure criteria take into account the organization of the markets, such as company size, market share distribution or conditions of access to markets.

The conduct criteria illustrate the conduct of companies on the market, such as relations with consumers (clients) and price determining.

Conduct criteria show the effects of the company's conduct.

Most often than not, the authorities of the EC use the structure criteria, particularly the market share held by the company at stake. However, the utilization of the structure criteria requires two conditions, namely: non-limitation to market share analysis and also consideration of company dynamics.

The use of structure criteria involves special issues when the term of dominant position is attributed to a company holding monopoly on a certain market. In this case, there are two possibilities. The first is the possibility of a monopoly as of right granted to a private or public company by the public authorities and the second is that of exclusivity resulting from an intellectual property right. In such situations we are not dealing with a dominant position.

The analysis of dominant position misuse implies that the constitutive elements of such misuse be first and foremost taken into consideration. In this respect, we are dealing with conduct abuse and result abuse.[9]

[6] *B. Goldman, A. Lyon-Caen, A: Vogel Quoted work, pg. 412*
[7] *C. Gavalda, G. Parleani Droit des Affaires de l'Union Europeene, Ed. Litec, Paris, 1995, pg. 276*
[8] *B. Goldman, A. Lyon-Caen, A: Vogel Quoted work, pg. 413*
[9] *B. Goldman, A. Lyon-Caen, A: Vogel Quoted work, pg. 422*

Conduct abuse implies an action or lack of action that causes prejudice to the competitors. A dominant position is defined as the power to conduct oneself independently, without regard for the competitors, or the possibility of setting obstacles that stand in the way of an actual competition.

Result abuse implies an action or lack of action that causes prejudice to clients, suppliers or consumers. In this respect, it can be asserted that a concentration operation cannot be deemed an abuse of dominant position if it does not cause direct prejudice to users or suppliers.

Abuse may have effects not only on the dominant market, but also on other markets. The impact on other markets is not subject to sanctions by the laws of the European Community.[10]

In order to assess abuse, a distinction must be made between "normal" and "abnormal" competition of the dominating company.

"Normal" competition means that the company is not prohibited to defend its interests and that it must manifest a moderated aggressiveness. In this sense, the courts of the EC showed that "the existence of a dominant position does not deprive the company placed in such position of defending its own interests exposed to possible threat... such company has the possibility, to a reasonable extent, to take the actions it deems fit in order to defend its own interests."[11]

Normally, a company holding a dominant position seeks to develop and attract new clients. In this respect, it can practice cost and price reduction.

"Abnormal" competition clashes with the particular responsibility of a dominant company. It can practice high or discriminatory prices in order to eliminate its competitors from the market; it can set up barriers in the way of access on certain markets. A dominant company has the obligation to treat all clients equally and without discrimination.

The abuse of dominant position materializes in:[12]

- Directly or indirectly imposing inequitable sale or purchase prices, or other unfair commercial conditions;
- Restricting production, sale market or technical developments to the detriment of their beneficiaries;
- Applying different conditions to equivalent transactions concluded with other commercial partners and placing them in positions of commercial disadvantage;
- Determining that agreements be signed subject to conditions of acceptance by the other party of certain additional obligations which, by nature or according to commercial practice, are not related to the object of such agreements.

As an introductory consideration, it must be ascertained that abuse of dominant position has been more frequently encountered at EC level, thus generating the reaction of EC institutions.

Abuse of dominant position represents an anti-competition and unilateral activity, distinguishing itself from the situations regulated by Article 81 (formerly 85) EC, which are bilateral or multilateral activities.[13]

The provisions of Article 82 (formerly 86) EC equally apply to both private and public sector (if the respective

[10] *C. Gavalda, G. Parleani Quoted work, pg. 277*
[11] *C. Gavalda, G. Parleani Quoted work, pg. 278*
[12] *Octavian Manolache Legal regime of competition in EC law, Ed. All, 1997, pg. 132*
[13] *Octavian Manolache Quoted work, pg. 133*

structures act in their commercial capacity), as well as to all economic sectors in a uniform manner, the agricultural sector included. There are exceptions to the application thereof, namely coal and steel, and also the defense sector.

According to the practice of the Court of Justice, articles 81 (formerly 85) EC and 82 (formerly 86) EC aim to achieve the same scope at different levels, i.e. maintain competition on the common market. Thus, the limitation of competition, prohibited if it is the result of the conduct provided by Art. 81 (formerly 85) EC, does not become permissible by the mere fact that such conduct is the result of the influence of a dominating position and generates the merger of the companies concerned.

First of all, we also need to evidence the fact that, should one or several companies hold a dominant position at the level of the EC market, this shall not automatically lead to the attributing of abusive practices. Occasionally, a dominant position is the consequence of an activity equally profitable for the companies and the beneficiaries, an activity carried out over the years through high quality product and service supply that meets the requirements of consumers.

The practice of the Court also shows that, upon ascertaining the fact that a company holds a dominant position, it shall not constitute in itself an accusation, this meaning that, notwithstanding the reasons for the dominant position, the company concerned has a particular responsibility whereby it does not allow its conduct to affect the actual undistorted competition. As the jurisprudence of the Court would have it, the mere creation of a dominant position by granting an exclusive right, as such is defined under Art. 86 (formerly 90) EC paragraph 1, is not incompatible with the provisions of Article 82 (formerly 86) EC.

A member state comes in conflict with the regulations of Articles 81 (formerly 85) EC and 82 (formerly 86) EC only if, by merely exercising an exclusive right, it cannot avoid misusing such dominant position.

In a material case, it was shown that the provisions of Art. 5, 86 and 90 of the Treaty do not prevent the national laws from reserving retail sale of tobacco manufactured products to distributors who were authorized by the state. This is true to the extent that the company holding the exclusive rights and issuer of the operation licenses for retail traders does not misuse (particularly to the disadvantage of consumers) the dominant position it enjoys on the market in terms of the distribution of such merchandise.

In the same way, it was also shown that a company holding a dominant position is entitled to defend and gain market shares, provided that the company maintains itself within the limits of a normal competitive conduct and of a lawful competition. However, Art. 82 (formerly 86) EC prohibits only the conducts of a dominating company that aim to eliminate a competitor, thus strengthening its position by resorting to means other than those pertaining to competition in its essence.

The provisions of Article 82 (formerly 86) EC are directly applicable, and the reality of such fact is confirmed also by the dispositions of Article 1 of Regulation no. 17/62, which prohibits abuse of dominant position, no prior decision being required for this purpose.

Furthermore, the Court practice specifies that the interdictions provided by Article 82 (formerly 86), in relation with the provisions of Art. 86(formerly 90) EC grant the concerned parties rights which must be

safeguarded by the national courts of law. The national courts of law can admit actions for damages or actions whereby certain resolutions provide payment of fines (penalties).

Art. 82 (formerly 86) EC prohibits in all cases the misuse of dominant position, even if such misuse is encouraged by a national regulation.

The court resolved that in order to evaluate the compatibility of national measure effective implementation or preservation with the provisions of Art. 86 combined with Art. 3 lett. f of the Treaty (currently Art. 3 lett. g) and paragraph 2 of Art. 5 of the same Treaty, when, through such measure, the prices established by the manufacturers or importers must be accepted upon sale of the merchandise to a consumer, it is necessary to determine whether such act of effective implementation or preservation is advantageous for trade carried out among states, taking into consideration the barriers that may be generated as a result of the nature of tax covenants to which the merchandise is subject, but without taking into account any abuse of dominant position that such covenants may encourage.

The Court of Justice also considered that the company which holds a dominant position on the market of raw materials exploits this position when, in order to reserve the raw material for its own production of derivate products, it refuses to deliver the raw materials to a client (who is also a manufacturer of derivate products), with the purpose of eliminating any competition from the client.

A dominant position is not condemnable in itself. What should be condemned is the misuse of a dominant position. There can be no exemption, and no notification obligation constrains the companies, but there may be a request for negative attestation. We find here concepts similar to those that prevail in the national law.

The list of abuse types is presented in Art. 82 (ex 86) EC, similar to that presented in Art. 81 (ex 85) EC, both having an enunciative nature.

Forms of the Abuse of Dominant Power

a) Abuse consisting in "directly or indirectly imposing purchase or sale prices or other inequitable conditions" (Art. 82, ex. 86, letter a, EC).[14]

This practice concerns the imposing of low prices (lower than costs) in order to eliminate weaker competition. The term "price" also comprises elements correlated to reduction according to quantity, bonuses, discounts according to cash payment etc. Abuse can mean (as in the General Motors case) "charging an exaggerated price as compared to the economic value of the performance rendered, such measure having as result the halting of analog imports". Therefore, a price is deemed exaggerated if the proportion between such price and the economic value of the service rendered is not reasonable and if the company holding a dominant position "used means by which it obtained advantages and transactions that would not have been obtained in circumstances of a workable and efficient competition". A situation of abuse is the one in which a company imposes on an airline company the application of very high or very low fees, as well as a unique price per one line.

In the United Brands resolution, the Court showed the difficulties in defining

[14] *Gerard Druesne Droit Material et politiques de la Commmunaute europeene, PUF, 1991, pg. 194*

prices inequitably increased. The Commission stressed the fact that, in respect of the Danish, German and Dutch clients, the sale prices were exaggerated, a 15 per cent reduction of such prices being required. The decision, deemed insufficient, was annulled by the Court.[15]

The Court used two criteria in estimating to what extent the price was exaggerated, namely the excessive disproportion between the actual cost borne and the actual price charged, as well as the comparison between competing products.

The use of the first criterion implies two difficulties (the comparison between a company placed in a dominant position and another company bearing competition pressure, as well as payment of intellectual property rights).

The comparison between competing products is also difficult to make due to their different characteristics.[16]

b) Abuse consisting in "limiting the creation of outlets or the technical development to the disadvantage of consumers" (Art. 82 ex 86,letter b, EC)[17]

Unlike Article 81 (ex 85) EC, there is no reference to production control, technical progress or technological development, which are supposed to be exercised by companies connected to one another on covenant basis, or by company associates. There is no reference to investments.[18]

The compiling difficulties derive from the fact that the abuse of dominant position is not the result of a covenant. The freedom of action of a company is not restricted if it holds a dominant position.

We are dealing with the refusal to sell and the attempts to keep clients by means of exclusive procurement undertakings combined or not with reductions, for the sake of loyalty. In the Suiker Unie case, the Court ascertained that it misused its dominant position in relation with a refinery, forcing "negotiators to channel their exports to determined consignees or destinations and to impose such restrictions on their clientele", thus limiting the outlets and the buyers of the negotiators. In the Hoffman-La Roche case, the Court noted the illegal nature of an exclusive procurement clause, inserted at the buyers' request, as such covenants are not based on "economic performance justifying such advantage, but rather they tend to drive the buyers away or reduce options with respect to procurement sources and block the access of other manufacturers to the market.".

The "inequitable sale prices" contemplated by Art. 82 (ex86) EC can be "prices abusively reduced" (Court of Justice, decision dated July 3, 1991, Akzo Chemie case). There are abuses of dominant position occurring on markets that differ from the securities market and there are massive and prolonged price cuts. The Court confirmed its jurisprudence in the Tetra Pak case on November 14, 1996.[19]

The Court of Justice, in its resolution dated February 13, 1979 (the Hoffmann-La Roche case) showed that the concept of abusive utilization is an objective concept which views the conduct of a company in dominant position, meant to influence the structure of the market or the extent of competition (already low) and which have

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[15] *B. Goldman, A. Lyon-Caen, A:Vogel Quoted work pg. 421*
[16] *B. Goldman, A. Lyon-Caen, A:Vogel Quoted work. pg. 428*
[17] *Gerard Druesne, Quoted work, pg. 186*
[18] *B. Goldman, A. Lyon-Caen, A:Vogel Quoted work, pg. 429*
[19] *Alain Guedj Praqtique du droit de la concurrence national et communautaire, LITEC 2000, pg. 78*

as effect the act of preventing (by resorting to means other than those governing a regular competition of products or services, based on the performance of economic operators) the maintenance of the competition extent still existing on the market or the development of such competition.[20]

As such, Article 82 (formerly 86) EC prohibits a dominant company to eliminate a competitor and thus strengthen its positions by resorting to methods other than those illustrating fair competition. From this standpoint, the competition of prices cannot, however, be considered legitimate. Prices lower than the average of variable costs (i.e. prices varying according to product quantities), by which a dominant company seeks to eliminate a competitor, must be considered as abusive. A dominant company has no interest whatsoever in practicing such prices unless the purpose is to eliminate competitors, in pursuit of power, and then reveal its prices, obtaining gains from its monopoly status since each sale generates a loss, and learn information on the total of fixed costs (i.e.. the costs that remain unaltered whatever the product quantities) and at least part of the variable costs related to the unit manufactures. In fact, prices lower than the average of the total costs, which include fixed costs and variable costs, but higher than the average of variable costs, must be deemed abusive if they are established as part of a plan aiming to eliminate a competitor. Such prices can, in fact, determine the elimination from the market of companies that may be as efficient as the dominant company but which, due to less financial capabilities, are not able to stand up to the competition."

c) Abuses consisting in "application, in relation with commercial partners, of unequal conditions for equal performance, thus generating a disadvantage in competition" (Art. 82, formerly 86, letter c, EC)[21]

It refers to discriminatory conditions imposed, i.e. application of discriminatory prices which affect one client more than they affect another client, for the same performance. In its decision dated June 2, 1971, the Commission condemned the German company GEMA for the fact that it requested importers of magnetic tape recorders and magnetoscopes a bigger royalty than the one owed by the German manufacturers, without admitting the grounds according to which the control cost was much more important in the first case than in the second. In the GVL case, the Court of Justice considered the refusal of this company to offer its services to certain persons, because of their nationality or residence, to be a discriminatory treatment and therefore an abuse.[22]

The merits of the United Brands case allowed the Court to elaborate specifications regarding performance equivalence. United Brands applied a different sale price every week, depending on the member country involved or on the clients.

In order to defend itself against the discrimination indictment, the company responded that, in the absence of a unique banana market, it had to take into consideration the various variable situations regarding clients. The conclusion of the Court was simple, in the sense that within the market United Brands was the supplier, while the various re-sellers represented the

[20] *Louis Vogel Droit de la concurrence et concentration economique, Ed. Economica, 1988, pg. 139*
[21] *Gerard Druesne Quoted work, pg. 187*
[22] *B. Goldman, A. Lyon-Caen, A:Vogel Quoted work. pg. 428*

demand, and the prices practiced by the dominant company needed to be assessed at the level of the entire market and not at the level of each individual market where the resellers were in turn suppliers.[23]

d) Abuse consisting in "subordinating the signing of agreements to supplementary performance which, by nature or according to commercial practice, are not related in any way to such agreements" (Art. 82, formerly 86, letter d, EC)[24]

The misuse of dominant position consists, in this situation, in subordinating the signing of an agreement to the acceptance by clients of other products and services that are not related in any way to the object of such agreement. Therefore, it refers to the act of preventing a company from expanding by using the advantages conferred to it as a result of the control exercised on certain products, thus forcing the client to buy another product manufactured by the company but competing with the products offered by other manufacturers.

The abuse situations can be differentiated in two categories, anti-competition abuses and exploiting abuses.

Anti-competition abuses (which affect current or potential competitors) take the form of blocking measures meant to eliminate new competitors from the market of the dominant company, as well as measures whereby prejudices are caused to the current competitors (prices reduced in an unfair manner, refusal to do business with a competitor).

Exploiting abuses consist in imposing excessive prices, selling merchandise on the condition that other merchandise less demanded on the market is purchased (sometimes at a lower price), imposing different prices in different geographical areas (when such differences in prices cannot be grounded on cost differences).

The English clause can also be considered an abuse of dominant position. By means of the English clause, buyers have the obligation under contractual clause, to inform the seller of the most favorable offer made to them by the competitors. Thus, it will become very easy for the seller to identify its rival and to obtain highly valuable information for putting together a market strategy.[25]

If a company placed on a dominant position requests the buyers or obtains, on agreement basis, the consent of such buyers to notify them with respect to the competitors' offers, this shall constitute a deepening of the severe nature of dominant position abusive use (buyers have an evident commercial interest of not disclosing the competitors' offers and they are free to procure their supplies from the competitors of that company in case the latter does not adjust its prices to such favorable offers).

In case of companies that enjoy exclusive rights granted by a member state (therefore holding a dominant position), it is considered that such companies resort to practices of dominant position abuse (opposing Art. 82 ex 86, EC) if they request payment for unsolicited service, invoice disproportional prices, refuse to use modern technology or grant price reductions to certain users, simultaneously compensating such reductions by increasing prices on the invoices of other users.

In practice, it was shown that we are dealing with a dominant position abuse if a

[23] *B. Goldman, A. Lyon-Caen, A:Vogel Quoted work. pg. 428*
[24] *Gerard Druesne Quoted work, pg. 197*
[25] *Octavian Manolache, Quoted work, pg. 137*

company imposes on those purchasing its machinery the obligation to procure raw materials for such machinery from it or from suppliers designated by it.

When a company placed in a dominant position directly or indirectly forces its clients under an exclusive procurement obligation, this shall constitute an abuse since the clients are deprived of the possibility to choose their procurement source, while other traders are refused access to the market. Whether such a sale is consistent with the commercial practice or not is irrelevant, because a commercial practice accepted in normal circumstances on a competitive market cannot be accepted on a market where competition is already limited.

On the other hand, it was shown that, although it is acceptable for a company placed in a dominant position to sell at loss, it is unacceptable in case of eliminatory sales.

Although the EC competition law admits that a company placed in a dominant position is entitled to take reasonable steps in order to protect its trade interests, still, actions actually aimed to strengthen and misuse the dominant position are prohibited. Art. 82 (formerly 86) EC particularly prohibits a company placed in a dominant position to eliminate a competitor by practicing price competition, as such is not included in the range of quality-based competition.

From a classical approach, the provisions of Article 82 (formerly 86) EC were applied solely to practices that produced effects on the market conditions and were meant to cause prejudices to beneficiaries or commercial partners, i.e. solely in terms of conduct on the market and not conduct causing changes in the competition structure of the market.

The Court of Justice did not adopt this distinction showing that at stake was solely the issue of whether the term "abuse" comprises only practices of companies that affect the market directly and cause prejudice to production and sales (for buyers or sellers), or it comprises also changes in the structure of a company leading to the hindering of competition on a substantial share of the Common Market. The distinction between measures referring to the company structure and practices that affect the market is not definite.

Examples from EC jurisprudence (Microsoft case)

The most recent and eloquent example of dominant position abuse is the case of the American company Microsoft.

After five years of investigation, the European Commission reached the conclusion that Microsoft violated the European laws on competition (Art. 82 formerly 86 EC), by coming close to a monopoly situation on the market of PC operating systems, media systems and servers.

The investigation began in 1998 following a complaint filed by a company also of American origin, Sun Microsystems.

Pursuant to the decision of the Commission dated March 24, 2004, the Commission ordered the American corporation Microsoft to disclose, within a 120 days' term, the interfaces needed by the competitors to operate with the Windows system. At the same time, within, and not later than, 90 days, Microsoft had the obligation to provide PC manufacturers with a version of the Windows OS (without Windows Media Player). Finally it was forced to pay a fine of 497 million Euros.

Microsoft misused its power on the market by intentionally restricting

interoperability between Windows PCs and non-Microsoft servers, as well as by connecting Windows Media Player, a program confronted by competition, with the Windows operating system.

This illegal conduct allowed Microsoft to acquire a dominant position on the servers market and significantly reduced competition on the media players market.

Such abuse caused prejudice to the competition climate and to consumers, who found themselves faced with less options and higher prices.

Microsoft filed an action for annulment against the decision of the Commission with the Court of First Instance on June 7, 2004 (case T-201/04, JOCE 179/36 dated July 10, 2004).

First of all, the petitioner claimed that the Commission committed an error in invoking Art. 82 (formerly 86) EC. In the petitioner's opinion, the conditions imposed by the EC court on a company placed in a dominant position, to obtain a license for its own intellectual properties are not met in the case at stake. The technology for which license procurement was required is not indispensable in obtaining interoperability with Microsoft PC operating systems, and the refusal to provide the technology could not have prevented the appearance of new products on secondary markets or the elimination of competition on secondary markets.

Microsoft showed that within the European Economic Area no license for the development of the software had ever been applied for. The petitioner pointed out the Commission's failure to fulfill the obligations imposed by the World Trade Organization under the TRIPS (Trade Related Aspects of Intellectual Property) Agreement when the present case was subject to the provisions of Art. 82 (ex 86) EC. Secondly, the petitioner invoked error on part of the Commission when it invoked violation of Art. 82 (ex 86) EC, owed to the fact that it considered the availability of Microsoft's own PC systems conditioned by (related to) the concurrent purchase of the Windows Media Player system.

According to Microsoft, the ECJ decision is based on theoretical speculation whereby the distribution of media functionality under Windows can lead, in the future, to a situation in which suppliers and manufacturers of software would encode their products in Windows Media format. It is further shown that the theory is in contradiction with the decision of the Commission in the AOL/Time Warner concentration case.

The petitioner claims that the decision does not meet the conditions required in order to have a case of violation of Art. 82 (formerly 86) EC, particularly of letter d of the article. It is pointed out that Windows and its media functionality are not two distinct products.

Finally, the petitioner claimed the disproportionate nature of the sanctions (compensations, measures) imposed on it, as well as the excessive amount of the fine enforced.

In spite of all the above, Microsoft paid the fine to the Commission on June 29, 2004.

On June 25, 2004, the American company requested the suspension of the measures ordered by the Commission and the application of transitory measures, on the grounds that such measures could cause serious and irreparable (irreversible) damages. Following the petition, the Commission informed the president of the Court of First Instance that it has no intention to enforce the measures until the application for suspension is not settled.

On December 22, 2004, the president of the EC instance dismissed the application for suspension filed by Microsoft. Subsequently, due to the fact that Microsoft did not observe the decision issued by the Commission in 2004 and pursuant to another decision of this Community Instance dated November 10, 2005 (called the decision of “Article 24 (1) because it was adopted by virtue of the provisions of Art. 24 (1) of Regulation no. 1/2003), the Commission established the obligation of regular penalty payments for failure to observe the 2004 decision. A new decision, C (2006) 3143, dated July 12, set such penalties to the amount of 280.5 million Euros for the period December 16, 2005 June 20, 2006.

The American company filed an action for the annulment of the latter decision with the Court of First Instance on October 2, 2006 (the T-271/06-JOCE no. 294 case, dated December 2, 2006). In the first place, the petitioner showed that the Commission did not provide it with clear information and instructions on the manner in which the 2004 decision should be observed. In the second place, it claimed that the EC institution did not present the standards to be followed by the petitioner in order to ensure the interoperability provided by the 2004 decision. In the third place, the Commission did not hear the petitioner prior to adopting the decision. In the fourth place, the petitioner considers that its rights have been violated by the Commission, due to the fact that it was refused access to the file, as well as to the communication between the Commission and its experts.

Finally, it is pointed out that the penalty amounts are excessive and disproportionate, and that the complexity of the obligations imposed on it was not taken into account, nor was the good-faith of the petitioner, manifested in observing the prior decisions of the Commission.

Up to the present day, none of the actions on the roll of the Court of First Instance has been concluded, which demonstrates the complexity of the case, as well as certain negative aspects of the Commission's actions, all of which are developing on the background of the economic and commercial conflict between the USA and the European Union.

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CROSS-BORDER ROMANIAN STUDENTS MOBILITY IN A COMPARATIVE PERSPECTIVE

Andreea Vass*

Abstract: *Strategic management and greater policy coherence of Romania's human resources is needed taking into account the interlinkages between demographic, education, labour market and migration flows changes. We focus in this paper on the high need of strengthening incentives for circular and repetitive migration of Romanian students. They represent the most relevant pool of the future-be skilled labour force. Overviewing the realities, it may come to no surprise that Romania has less higher education graduates than in EU. Nor that the expenses for the higher education represent nearly the same amount per capita as in the other EU countries, when adjusted with GDP. Nor that, according to international university rankings, Romanian universities score one of the lowest performance in Europe. Above all, today we risk that our best students migrate to western higher education schools without returning to their home country. A deep analysis of this phenomenon reveals an even harsher reality: the propensity of Romanian students to study abroad is even lower than in other neighbouring countries.*

Key words: *international students' migration flows, education policy, university performance, brain drain*

JEL: *F22, I23, H52, O15*

INTRODUCTION

It may come to no surprise to anyone that Romania has too few higher education graduates. Nor that the expenses for the higher education represent nearly the same amount per capita as in the other EU-25 countries, when adjusted with the GDP. Nor that, according to international university rankings, the Romanian universities score one of the lowest performance in Europe. Furthermore, we risk today that our best students migrate to western higher education schools without returning to their home country. A careful analysis of this phenomenon reveals an even harsher reality: the Romanian students are in no rush to study abroad. Their propensity to international mobility is lower than those of the neighbouring countries. Furthermore, according to World Bank estimates, a merely 12% of all returning Romanians come back with a university degree, which places us a far behind Bulgaria or other Eastern European countries (Mansoor, Quillin, 2007).

The brain drain is, however, a present phenomenon and it is not too difficult to explain it. *On the one hand*, abroad, gifted young people find themselves in an environment that guarantees high-quality education and internationally recognized degrees. *On the other hand*, such students may be offered good financial

* ***Andreea Vass*** *is a science scholar at the Romanian Academy's Institute of National Economy. In the last three years she was an adviser at the Department of Social and Economic Policies within the Presidential Administration.*

incentives and, for the most competent among them, the opportunity to advance their career within universities, research institutes or multinational companies. It goes without saying that the receiving country draws great benefits by capitalizing on these foreign talents. If they do not return to their home countries, such countries lose a potential of added value that could help their societies' development. Such added value could be significantly greater than the one created by the rest of the population that does not have access to higher education.

KEY POINTS ON INTERNATIONAL STUDENTS' MOBILITY

- **10 countries attract over 75% of world's brain drain** from the 2.6 million students who study in a foreign university.
- **2% of European students undertake their studies in another European country.** In 2004, 16,000 Romanian students, approximately 2.4% of the total Romanian students, were out of the country studying in a European university. We have to keep in mind, however, that the total Romanian student population is significantly smaller compared to other European countries.
- **Romania has too few students and university graduates.** 1 out of 10 Romanians aged over 25 - which is half the European average and one third of the American one - has post-secondary studies.
- **Too few Romanians study in a foreign university:** a little over 1 out of 1000 Romanians, which is 3 times less than Bulgaria.
- **Very few foreigners come to study in our country.** We have 9500 foreign students in public universities and 500 in private schools; half of foreign students in Romania are coming from the Republic of Moldova. However, 1% of all international students choose the Czech Republic or Hungary.
- **No Romanian authority takes any interest in the 23,000 Romanian students who have left the country to study abroad for at least one year (out of which 16,000 study in European countries).** No one seems to want to know what their qualifications are, in what field, how many of them come back or how well integrated they are in the Romanian society. They could make a difference for Romania's scientific and technological progress.
- **World Bank estimates that only 12% of returning Romanians have obtained a university degree abroad.**
- **Stubborn ignorance and complacency come at a great cost** - these estimations are based on OCDE and EUROSTAT statistics, as neither the Ministry of Education, Research and Youth (MERY) nor the National Institute of Statistics (NIS), nor anyone else in this country for that matter, know exactly how many Romanian students study abroad.
- This matter deserves to be dealt with separately as **a key point in Romania's post-accession strategy** emphasizing the need to get as much support as possible in order to:
  -Facilitate Romanian students' access to foreign higher education institutes;
  -Capitalize on Romanian students' foreign university education upon their return home.

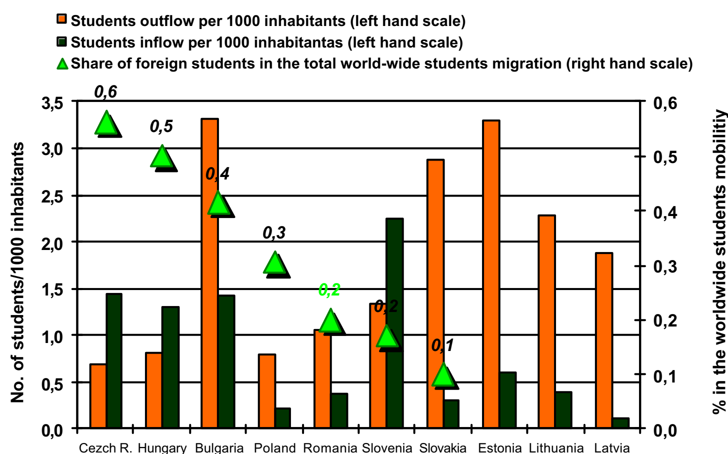
10 COUNTRIES ATTRACT OVER 75% OF WORLD'S BRAIN DRAIN

Some might say it is an easy lesson to learn. Yet even developed countries have come to assimilate it relatively late and to various degrees. Over one fifth of the 2.6 million international students worldwide are in the **United States** (22%, on a descending trend compared to previous years). This percentage remains unmatched even by adding up the next two countries' brain drain ratios: the **United Kingdom** and **Germany** (11% and 10% respectively). If we add in **France**'s capacity to attract intelligence (9%), **Australia**'s, **Canada**'s, **Japan**'s (4% to 6%), **Russian Federation**'s, **Belgium**'s and **Spain**'s (between 1% and 3%), we come to the conclusion that these 10 countries' high-performance knowledge centres attract over 75% of all migrating brains. Remarkably, there are 17 American universities among the first 20 ranked by the *Shanghai Top 500 World Universities*.

Direct **academia investments** explain, for the biggest part, the differences in higher education quality. In its turn, performance thus achieved prompts yearly growth of funds allocated to higher education in most countries. However, there are different strategies when it comes to the role of public funds versus private funds in supporting higher education. In Korea, USA or Japan for instance, private investments are greater than public ones. In Austria, Germany, Denmark or Norway private funds play a minor role; what is more, in these countries private resources are used mostly to support pre-school education and significantly less for higher education purposes.

Nevertheless, the **percentage of international students per university** reconfigures the above ranking. Thus, **Australia**, **Switzerland**, **Austria**, **New Zealand**, **Belgium**, the **United Kingdom**, **Germany** and **France** have over 10% of foreign students in their total number of higher education students according to the latest OCDE statistics. Lately, this ranking includes the **Czech Republic** with 4% (more than USA 3.5%), and **Hungary** with 3% of international students.

Figure 1. Students mobility in the Central and East European countries, 2004



Source: Calculations based on OECD Statistics, April 2007

2% OF EUROPEAN STUDENTS STUDY IN ANOTHER EUROPEAN COUNTRY

With the Bologna Process, the European Union aims to create a European Higher Education Area which should promote intellectual, cultural and social values together with political and economical dimensions. Students and professors play a central role in this project. EU programs revolve around them providing a large framework of interdisciplinary and region-based cooperation. Results have already started to appear. According to EUROSTAT estimates, in UE-27 the number of young people who study in another European country grows annually by approximately 5%. Up to now, however, this growth has paralleled the general growth in the number of students, which means that the percentage of internationals has remained relatively constant - approximately 2% of the total number of students. The **Cypriots** and the **Luxembourgers** have been of course the most mobile students given the few local universities. Over 10% of **Maltese** students have studied as well in another European country. They are followed by the **Greeks**, the **Irish**, the **Slovaks**, and the **Bulgarians** who are **significantly more mobile than the rest of the Europeans** (6% to 8%). At the other end, the **Polish and the British are the least inclined to study abroad.**

Similarly, **Romanians are in no rush to study in a European higher education school.** If 10 years ago their number was significantly larger than the number of Bulgarian students abroad, today the Romanian students in a European university barely reaches 80% of the number of Bulgarians. Therefore, although our population is more than twice as big, the number of Bulgarian young people in a European university is bigger than ours by about 4500 students. Moreover, when it comes to registered international students in Romanian universities, we have about 1500 such students less than Bulgaria.

Between 1998 and 2004 Bulgarian students' **mobility multiplication rate** of 4 matched the Slovaks', though indeed bigger than the rate of the new member states: 3 for Romanian students, 2.5 for the Czech and the Polish, and 1.5 for Hungarian students.

HOW MUCH DOES IT COST TO STUDY ABROAD?

In 2004, out of approximately **23,000 Romanians studying abroad**, about 20% were attending universities in **France**, 18% in **Germany**, 14% in **USA**, 13% in **Hungary**, 7% in **Canada**, 5% in **Italy**, 3% in the **United Kingdom**, 2% in **Spain**, **Switzerland**, **Austria**, **Belgium** respectively. Their mobility has been supported mostly through scholarship programs, subsidies and to an insignificant extent through loans. Private funding was very low as well, but it is rapidly becoming a viable source of financial support.

According to the **average annual tuition fees in public colleges and universities** (in US dollars at the purchasing power parity exchange rate, source: OCDE), we can identify at least 6 groups of countries with their corresponding tuition fees:

a. **Countries without tuition fees**: Czech Republic, Denmark, Finland, Island, Norway, Slovakia, Sweden;
b. **150 - 1000 USD**: France, Hungary, Turkey; less than 500 USD: Belgium, Austria, Italy, Portugal, Spain, Switzerland;
c. **1000 - 2000 USD**: United Kingdom, Holland (note: in these countries

there are only private higher education institutions where students get enrolled through government programs);

d. **2000 - 3000 USD**: New Zealand, Israel;
e. **3000 - 4000 USD**: Canada, Chile, Australia, Japan, Korea;
f. **Over 4500 USD**: USA.

In most of these countries the higher tuition fees for international students have ceased to apply to Romanians after Romania's accession to the EU.

1% OF INTERNATIONAL STUDENTS CHOOSE THE CZECH REPUBLIC OR HUNGARY

The Czech Republic or Hungary has achieved remarkable results through their better quality of higher education systems. Czech universities attract annually 15,000 foreign students, while Hungarian universities about 13,000. This means that 1 out of 100 international students choose a university in one of these two countries. If we take into account European students' mobility solely the ratio becomes 4 students in 100. **Thus, the Czech Republic imports twice as much intelligence as it exports annually**, while **Hungary 60% more**. **Bulgaria** followed by **Poland** is the next in line to attract international students to Central and Eastern Europe.

These countries have higher education institutions present in the Shanghai Top 500, that have succeeded in meeting the high quality education needs of young people from countries like Slovakia, Romania, Ukraine, Serbia and Montenegro, Israel etc. Romania is not mentioned by this ranking. In addition, Romania does not have open universities platforms, with worldwide exposure, that may play a central role in student promotion, such as the American University in Bulgaria, the Central-European University in Hungary, Jagello University in Poland or Carol University in the Czech Republic.

A LITTLE MORE THAN 1 OUT OF 1000 ROMANIANS STUDY ABROAD

Many question the methodology used by the Shanghai ranking. It is nevertheless difficult to argue with the following statistics that plainly show that:

- Romania has **few higher education graduates** - 1 in 10 Romanians aged over 25, which is half the European average and one third of the American average;
- **Few Romanians leave to study abroad** - a little over 1 in 1000 Romanians, which is 3 times less than Bulgaria;
- **Few international students choose Romania to do their studies** - 1600 from EU-25, about 4500 from the Republic of Moldova, and the rest up to 9500 students from countries like: Israel, Tunisia, Greece, Ukraine, India, Serbia and Montenegro, Albania or Bulgaria.

Romanian students' access to the European Higher Education Area will certainly open new prospects of a solid high education network based on mobility, flexibility, high-quality education and significantly reduced tuition fees that apply beginning this year.

Who cares? There is a huge lack of interest towards students who wish to study abroad or those who have a degree from a prestigious foreign university. It is both the fault of Romanian authorities as much as ours, the general public, who choose to focus instead on the latest gossip on politicians.

Information campaigns on high education programs are insufficient. PLOTEUS is a portal supported by the European Commission. It helps students, parents, career counsellors, professors, those who look for employment during their studies, to find information. But even this is not informative enough. The National Office for Foreign Scholarships is the MERY counterpart. They do not provide however detailed presentations of different European education systems. We do not have access to a reliable data base on continuing professional training opportunities available in the European Union.

Despite years of European exchange and scholarship programs and institutional support - Erasmus, Socrates, Tempus, GRUNDTVIG, Transversal, Jean Monet etc. there is still a lack of straightforward information booklets on European travel requirements, living expenses, tuition fees, accommodation, legislation and other useful information for potential applicants. University program transparency is not encouraged nor rigorously applied in the Romanian public area. Yet, neither the objective and efficient selection criteria have found their way into the Romanian educational environment as they should have. Under these circumstances, the right of the Romanian public to freedom of movement can only be guaranteed by providing the necessary information.

No one is interested to know what happens to students who leave the country to study abroad. For instance, why aren't we capable to set up a Romanian Students Centre in the Parisian *Cité universitaire* and in all the other major university centres? We are lucky indeed to have passed the Iorga law that helped buy the buildings where the *Accademia di Romania di Roma* and the *Istituto romeno di cultura e ricerca umanistica-Venezia* in Venice are located today. For the rest of it, one can only grieve for the fate of the Romanian scholarship student who finds herself or himself without any institutional support and usually becomes a mere entity at the mercy of chaotic circumstances.

No one is interested to know what happens to Romanians who hold undergraduate or graduate degrees from prestigious universities. How many of the 23,000 Romanian students abroad return home? Who cares enough to keep a quantitative and qualitative record of the fields they specialize in and of the extent to which these talents are put to good use? Does anyone ever make use of these young people's expertise? I cannot help thinking of the *40 percent unfilled university positions* that we precariously fill today with young PhD-track students whom we do not pay enough but rather rotate or by aggressively piling up teaching hours.

CONCLUSIONS

The serious absence of reliable statistical data on the volume, type, destination, impact and trends related to education being delivered across borders is discussed. This article argues that the lack of solid information on program and provider mobility creates an undesirable environment of speculation, confusion and often misinformation, which lead to a lower propensity of Romanian students to study abroad. After all, if we want to lure Romanian graduates back home in order to strengthen the Romanian educational and economic system we should start by monitoring them. Please note that our forecasts are based on OCDE statistics for international student mobility and on EUROSTAT statistics for the European

context. And that is because neither the MERY nor the NIS can offer precise information on this topic. Under the circumstances a classification by field of study or education levels would be evidently too much to ask. And yet we incessantly grieve over our brains' exodus. We keep complaining about the severe lack of experts in various fields. In reality, we choose to stubbornly and foolishly ignore those who could make a difference.

Policy debate about how to manage highly-skilled migration in general, students in particular is missing in Romania. The Government rationale for undertaking a commitment to opening up of student migration and to monitor their performance stands at least on three pillars. First, we must assume that international student mobility has moved from unorganised or self-organised study abroad to a variety of mobility forms organised within national, regional and international programmes. Second, the ways that push and pull factors influence student mobility are based on stimulating motivations in pursuit of academic and professional growth, economic benefit, individual internationalisation, and enhanced social status. Third, student migration has become an issue of economic competitiveness, like attracting best talent, wealth creation and brain drain.

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Rien ne se crée sans les hommes. Rien ne dure sans les institutions.

Jean Monnet

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