

Chapter 1

The European Market for Services: Patchwork

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In Europe services markets are predominantly nationally oriented. In spite of the proclaimed free movement of services in the European treaty, foreign entry to national services markets is a cumbersome exercise or even an insurmountable hurdle. Cross-border trade in services remains low, albeit foreign direct investment is surging. The breakdown of capital controls, explicit ban on foreign discrimination and deregulation in national services markets, among others with respect to market entry, have contributed to the rise of FDI. However, current regulation procedures and country differences in regulation still hamper the full integration of services markets. Recent EU initiatives such as the Services Directive, action plan for financial services, and plans to integrate energy markets help to lower the market barriers. However, it will take many more initiatives before the free movement of services is realized and the economic benefits of a large market scale and a more competitive environment can be harvested.

Introduction¹

Since January 2007, 27 countries form the European Union (EU), covering nearly the whole of Europe. This constitutes a market of about 500 million consumers, if national markets are integrated. One of the corner stones of the EU is the free movement of goods, services, capital, and labor. For goods the 500 million consumer market seems to be reality, but for services it is utopia. 27 Member States have implemented their own systems of regulating services; they regulate market entry, competition, quality and sometimes even prices. For some services, the degree of regulation isolates these markets from the rest of the world. In these services sectors cross-border trade and for-

¹ A substantial part of this chapter is based on joint work with my colleague Henk Kox. Comments by Jacob Funk Kirkegaard are highly appreciated. I want to thank Nico van Leeuwen for assistance with the data.

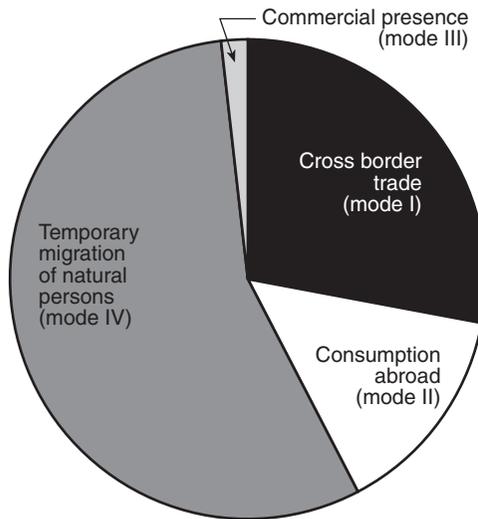
ign direct investment are hardly possible. These are extremes, most notably in the case of network services. For most sectors national regulatory systems do not isolate markets, but fragment them in 27 different markets per services sector.

If there is a European market for services it resembles patchwork, and Europeans need a lot of needles and thread to sew them together. The European treaty aims for the free movement of services, but this statement still expresses more ambition than reality. The basic idea of this chapter is to underpin the metaphor of the patchwork, and to discuss (recent) developments to integrate services markets. Although the European market for services is patchwork, the quilts are much more uniform than for the global market for services. In that respect Europe's efforts to integrate national services markets are an experiment to be applauded, and from which others could learn — such as the WTO with regard to the General Agreement on Trade in Services (GATS), and the EU and U.S. with respect to a transatlantic services market.

The fragmentation of European services industries does not represent a status quo situation. Cross-border trade and foreign direct investment in services are increasing. Section two presents recent trends. Some underlying causes for the increased interwovenness between services markets include deregulation of services industries and increased competition in many European countries. Section three presents recent patterns with regard to product market regulation in services using OECD indicators. These patterns clearly reflect deregulation policies.

Although less regulation promotes competition and even foreign competition, differences in country-specific regulation also hamper trade in services. Section four underscores the importance of reducing these differences in regulation. Section five describes some of the recent initiatives by the European Commission to integrate national services markets. The focus is on the Services Directive, but also some other initiatives for financial services, retail distribution and energy markets are discussed briefly. Section six discusses the prospects of further integrating national services markets in order to make the quilts more uniform.

Figure 1.1 Shares of Types of International Transactions in World Services Trade



Source: Karsenty (2000).

1. Trends in Services Trade

Only a small fraction of services products, such as standard software packages, can be stored and shipped in boxes like traditional merchandise exports. In most other cases—think of vacations or hairdressers—it is difficult to separate production and consumption of the service in time and space. As a consequence, either the producer or the consumer must go abroad for an international transaction to take place. The producer can set up a production unit abroad or can have himself represented by an employee sent abroad on a temporary basis. While exporting and production abroad are optional supply forms for manufacturing firms, in some services industries the only feasible way to supply a foreign market is establishing a local subsidiary.² The GATS treaty therefore identifies four modes of international services supply, as shown in Figure 1.1.³ The figure shows that international services deliveries through commercial presence abroad is the dominant sup-

² Sampson, G and R. Snape, "Identifying the issues in trade in services," *The World Economy*, vol. 8, 1985, pp. 171-181.

³ White (2007) illustrates these four modes with some examples.

ply form (57 percent). This differs per services sector. Kirkegaard⁴ argues that foreign commercial presence is eight to nine times as important as cross-border trade in computer and IT related services for the U.S. Also in financial services foreign commercial presence is much more important than cross-border trade.

Cross-Border Trade (and Consumption Abroad)

In the period 1985 to 2001, EU cross-border trade in goods and services increased on average by about 8.4 percent per year. In 1985, the EU-15⁵ countries exported about \$173 billion in services—the equivalent of a quarter of EU goods exports. In 2001 the value of services trade increased to \$633 billion, but still only 28 percent of EU goods exports.

Traditionally two services sectors, transport and travel, are responsible for the largest share in international services trade. In 2004, both sub-sectors accounted for half of total EU-25 exports in services. This held despite the fact that exports in transport grew less than total services exports in the EU,⁶ as is shown in Table 2.1. External EU-25 services exports totalled about \$450 billion in 2004, while the U.S. exported \$381 billion in services in 2005.⁷

In recent decades, trade in business services has rocketed, recording annual growth of 15 percent since 1985.⁸ Exports have also surged for computer and information services, royalties, other business services, financial services, insurance, and communication services.⁹ The main subcategories with other business services are merchandising services, legal, accountancy and management services, architectural and engi-

⁴ Kirkegaard, J.F., 2007, “Offshoring, Outsourcing and Production Relocations—Labor Market effects in The OECD and Developing Asia, *Singapore Economic Review*, forthcoming.

⁵ The data only cover the 15 members of the EU before May 2004.

⁶ This was in particular due to the modest growth in ‘other transport’ (mainly road transport).

⁷ See White, L.J., “Reducing barriers to Services Trade: The U.S. Case,” in this volume.

⁸ Note that this growth rate is biased by a net increase in trade of about 80 percent in 1992 due to a change in the statistical classification system. Without this break in the data, the growth rates would be about five percentage points lower.

⁹ OECD, *OECD Statistics on International Trade in Services; Partner Country Data and Summary Analysis* (Paris, 2003).

Table 1.1 EU Exports in Services, 2004

	Value in billion U.S. dollars	Percent share in total exports	Percent of intra-EU exports to world exports	Percent value growth intra-EU exports 1985-2001
Total services	1064.0	100.0	57.7	10.5
Transport	230.1	21.6	50.2	8.2
Sea transport	101.6	9.6	39.6	10.3
Air transport	77.9	7.3	48.9	13.8
Other transport	50.6	4.8	73.5	3.5
Travel	276.2	26.0	69.8	11.1
Communication services	25.2	2.4	69.1	14.8
Construction	22.4	2.1	47.3	11.2
Insurance	35.7	3.4	56.0	15.3
Financial intermediation	71.3	6.7	55.7	16.9
Computer and information	56.4	5.3	61.2	NA
Royalties and license fees	41.9	4.0	42.5	14.6
Other business services	258.8	24.3	54.2	15.2
Personal services	13.5	1.3	54.1	10.8
Government services	21.7	2.0	48.4	6.4

Source: OECD (2006) and own calculations.

neering services, R&D and intra-firm services. Trade in government services and in personal services is relatively unimportant.

On average 58 percent of all EU-25 services exports is destined for other EU countries. The average is higher for travel, communication services, computer and information services and other transport. It is low for such sectors as construction, air transport, sea transport, government services, and royalties and license fees.¹⁰ A large part of government services relates to defense material, which is often demanded by countries outside the EU.

¹⁰ Royalties and license fees is not really a sub-sector; it consists of transactions related to patents, and copyrights.

Table 1.2 Trade Orientation for Various EU countries, 2001

	France	Germany	Italy	NL	Spain	UK
Transport and communication	20.4	17.7	9.2	70.8	13.1	20.2
Financial intermediation and insurance	3.2	7.8	2.2	4.0	6.4	52.6
Other business services	5.8	5.3	7.4	20.8	10.7	15.8
Personal services	3.1	0.4	1.3	4.1	2.4	3.4
Government services	0.5	3.7	0.9	3.2	1.0	5.2
Total services	5.3	6.1	5.2	13.1	7.5	7.7
Total goods	21.8	27.5	21.2	48.3	22.1	21.0

Source: OECD, fn 9; OECD, *Structural Analytical database* (Paris, 2003); own calculations. Trade orientation is defined as value of exports divided by value added times 100. Data in the last two rows are from Eurostat, *Structural Indicators; Economic Reform; Trade integration of Goods and Services* (2006), and reflect the average of exports and imports divided by GDP.

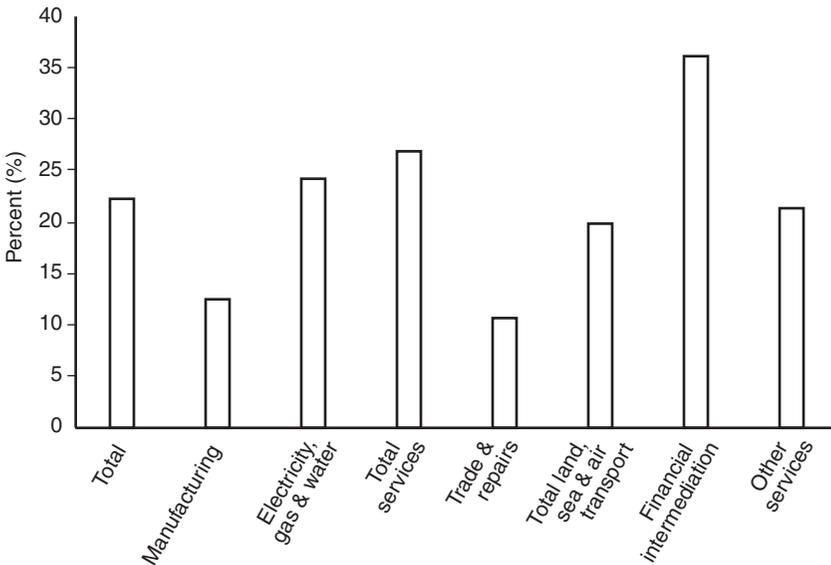
Trade Orientation

To what extent are EU services sectors oriented towards foreign trade? In some services sectors cross-border trade is more important than in others. The differences in their openness to cross-border trade can be due to the nature of the service or to regulatory barriers.

For a trade-orientation indicator we use the value of exports by a services sector divided by value added in that sector.¹¹ This trade-orientation indicator shows the ‘tradability’ of services products in specific sectors. Table 1.2 presents the results. In business services, the picture is mixed. The Netherlands, the UK and to a smaller extent Spain have a strong trade orientation in this sector, whereas markets in France, Germany and Italy appear to be rather inward-oriented.

Table two also shows that exports in transport and communication are relatively high in all EU countries. Only in the UK is openness in finance higher than in transport and communication. That reflects the special position of the UK as a financial center. Its trade orientation is higher than that of the financial services sector in other EU countries.

¹¹ Note that this indicator only indicates the degree of internationalization with respect to exports. In principle the home market could be closed for imports, although in practice this situation does not occur very often. If home markets are closed to foreign competition, firms are often not very competitive, which restrains their export possibilities.

Figure 1.2 Average Annual Growth FDI Stocks in EU15 between 1995-2003

Source: Eurostat (2006).

Overall, however, the tradability of goods is much higher than that tradability of commercial services—except for transport services.

The Role of FDI in Services

Services trade only reflects the internationalization of cross-border trade and consumers crossing the border (modes I and II), according to balance of payment data. It misses the degree of internationalization by foreign establishments in services markets (mode III). Data on sales of foreign establishments in services are rather scarce and incomplete. An indicator for foreign presence in a country is the foreign capital stock. Figure 1.2 presents the average annual growth of the FDI stocks in the EU15 between 1995 and 2003 for various economic sectors.¹² The figure shows that the FDI stock in services grew much faster than in manufacturing, in particular due to growth in financial intermediation. FDI also grew faster in such sectors as transport,

¹² For transport the data are between 1995 and 2002.

other services (mainly other business services) and network industries like electricity, gas and water than in manufacturing.

About two thirds of the FDI stocks in the EU are directed to services sectors.¹³ Given the differences in FDI growth rates, the contribution of services will increase. UNCTAD¹⁴ offers five underlying reasons for increased FDI in services sectors: the rising share of services in value added; the externalization of services of independent providers; the growing services intensity in the production of goods; the deregulation of services markets; and the liberalization of FDI policies. Moreover, greater competitive forces in services markets have led to market-seeking behavior abroad. Section 3 focuses on one of these arguments: the role of deregulation in services markets.

Activities of foreign services multinationals tend to be spread quite unevenly over domestic services industries in the EU. Kox *et al.*¹⁵ illustrate this using the concept of “FDI inflow intensities,” i.e. the share of a particular sector in total services FDI inflows to the sector’s share of domestic services production. This indicator would total 1.0 if a services sector attracts a share of FDI inflows that corresponds with its share in domestic production. Table 1.3 indicates that services sectors such as retail and wholesale trade, tourism and transport account for far fewer FDI inflows than their corresponding share of domestic services production.

In the UK, the Netherlands and Spain other business services attracts a relatively low share of direct investment compared to the sector’s size; the opposite holds for France and Germany. Communication gets relatively strong attention from foreign investors, which may well be due to deregulation that took place in the late 1990s, combined with the auctions for mobile phone licenses. Except in the Netherlands, financial intermediation attracts a relatively large amount of FDI.

¹³ UNCTAD, *World Investment Report 2006* (Geneva, 2006). The relatively small difference in FDI stock growth rates between total services and total already reflects the importance of FDI in services in the total economy. The growth rate in manufacturing is much lower. It has a sizable but no large impact on the total growth rate, reflecting the shrinking importance of manufacturing.

¹⁴ UNCTAD, *World Investment Report 2004* (Geneva, 2004).

¹⁵ Kox, H.L.M., A.M. Lejour, R. Montizaan, *The Free Movement of Services within Europe*, CPB Document 69, 2004.

Table 1.3 FDI inflow intensity: sectoral share of total service-FDI inflows divided by the sector's share of total domestic services production, selected countries, 1998-2000^a

	Germany	France	UK	Spain ^c	NL	U.S. ^b
Retail and wholesale trade	0.1	-0.4 ^e	0.5	0.3	0.5	1.3
Other business services	1.9	1.5	0.4	1.9	0.2 ^d	0.4
Travel	0.0	0.1	0.2	0.1	0.2	1.0
Communication	1.2	0.8	6.4	4.3	3.0	-1.3
Transport services	0.0	0.2	0.0	0.1	0.1	0.6
Financial intermediation	1.1	4.5	2.6	0.7	7.9	4.1
Insurance (incl. auxiliary services)	-0.1	0.5	1.0	0.0	1.2	3.0
Unweighted average	0.6	1.0	1.6	1.1	1.9	1.3

a. services sector shares in total domestic services production are for the year 1999, except for Germany (1998). **b.** U.S. FDI inflow data refer to 1998. **c.** For Spain, production data for real estate and business services, and for tourism and other services refer to 1998, while data on communication, financial intermediation, and insurance refer to 1997. **d.** This does not count the FDI inflows in financial holding companies. **e.** The negative value reflects a net FDI outflow (disinvestment).

Source: Kox *et al.*, fn 15.

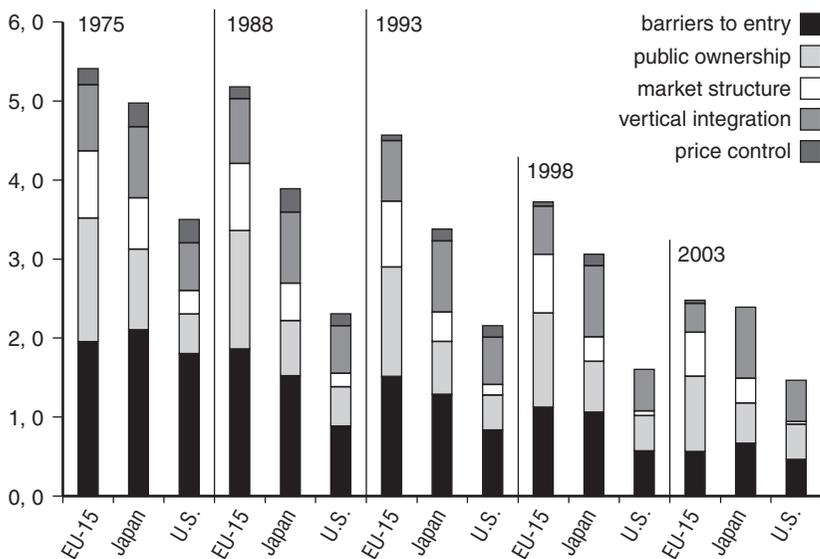
2. Regulation of Services Markets

Regulation is important in services markets. One reason is the need to provide universal services in energy and telecom sectors and to regulate the role of monopolies. A second reason is tied to asymmetries in information and the necessity to ensure quality for users. Quite often these regulations hamper competition because they deter market entry of domestic and foreign firms, restrict the behavior of firms and sometimes regulate prices.

Faini *et al.*¹⁶ are quite pessimistic regarding market reforms in energy and telecom sectors and retail and professional services in Europe. They stress the need for more reform to increase competition and consequently productivity and innovation. However, most European countries have deregulated many services sectors since the 1980s, albeit at different speeds. This section presents recent trends in regulating services markets.

¹⁶Faini R., J. Haskel, G. Barba Navaretti, C. Scarpa, and C. Wey, "Contrasting Europe's Decline: Do Product Market Reforms Help?", paper presented at Breugle seminar, 2005.

Figure 1.3 Regulatory Reform in Energy, Transport and Communications (1975-2003): Breakdown by Regulatory Area



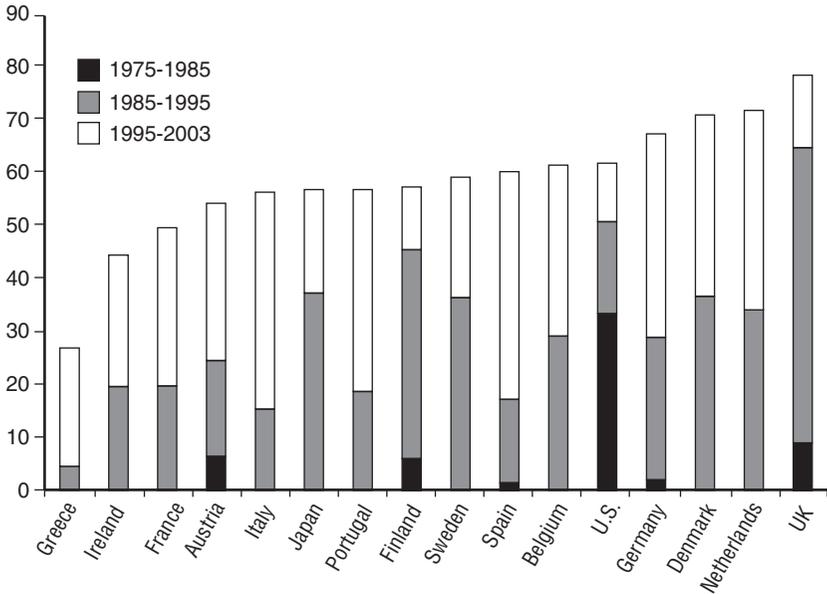
Source: Conway and Nicoletti, fn 17. Simple averages of the regulatory indicators for seven industries: electricity, gas, road freight, railways, air transport, post and telecommunications. Europe is defined as EU-15.

Regulatory Reform in Energy, Transport and Communication

Conway and Nicoletti have recently updated regulatory indices for many services markets.¹⁷ Telecoms and energy cover some of the industries in which anti-competitive regulation has traditionally been relatively strong in OECD countries, because these sectors were traditionally (and partly still are) characterized by natural monopoly segments and network externalities. Moreover, firms have typically been burdened with non-economic objectives (such as universal services obligations). Legal restrictions to entry, widespread public ownership,

¹⁷ Conway, P. and G. Nicoletti, "Product Market Regulation in the Non-manufacturing Sectors of the OECD Countries: Measurement and highlights," *OECD Economics Department Working Papers No. 530*, (Paris, 2006). Although the quality of the OECD indicators is very high, these type of indicators are by definition imperfect, in particular if these are used to indicate their impact on the economy. Moreover, enforcement of regulation is important for the impact on competition. This is not measured by these indicators.

Figure 1.4 The Timing of Reforms in Energy, Transport and Communication



Source: Conway and Nicoletti, fn 17. Simple averages of the regulatory indicators for seven industries: electricity, gas, road freight, railways, air transport, post and telecommunications

and extensive cross-subsidies are common in these markets. Over time, technological advances, the evolution of governance and regulatory techniques, as well as increasing international exposure have made liberalization and privatization increasingly possible. According to these indicators, product market policies have become more market friendly recent decades as is shown by Figure 1.3.

The indicators suggest that regulation in these sectors was restrictive in all OECD countries in the 1970s, though more so in Europe and Japan. Since 1975, regulations have changed in most of the regulatory areas covered by the indicator, but were most pronounced in reducing entry barriers and, to a lesser extent, public ownership. Price controls are also almost completely eliminated. However, market and industry structures remain largely unchanged.

Eurostat data on gas and telecommunication price developments in EU member states show a substantial downward trend.¹⁸ For some countries prices are even halved. This could be due to more competitive market forces, made possible by less restrictive regulation.

Figure 1.4 shows that the United States was the first country to begin reforming product market regulation in the early 1980s. Other countries, such as the United Kingdom, the Nordic European countries and Japan, started reforms a little later. In most other European countries product market reforms accelerated in the mid-1990s.

The cross-country dispersion product market regulation increased in relative terms until the late 1990s. In the EU countries this policy divergence appears to have been more pronounced, despite efforts to harmonize through the Single Market Program. From the beginning of this century, however, regulation in the EU has converged more rapidly than in the past.

As a result of these trends in product market reform, the aggregate product market indicator suggests that English-speaking countries, some small European countries and Germany have energy, transport and communication markets that are more open to competition than the rest of Europe. These services markets are less open to competition in France, Ireland and Greece in particular.

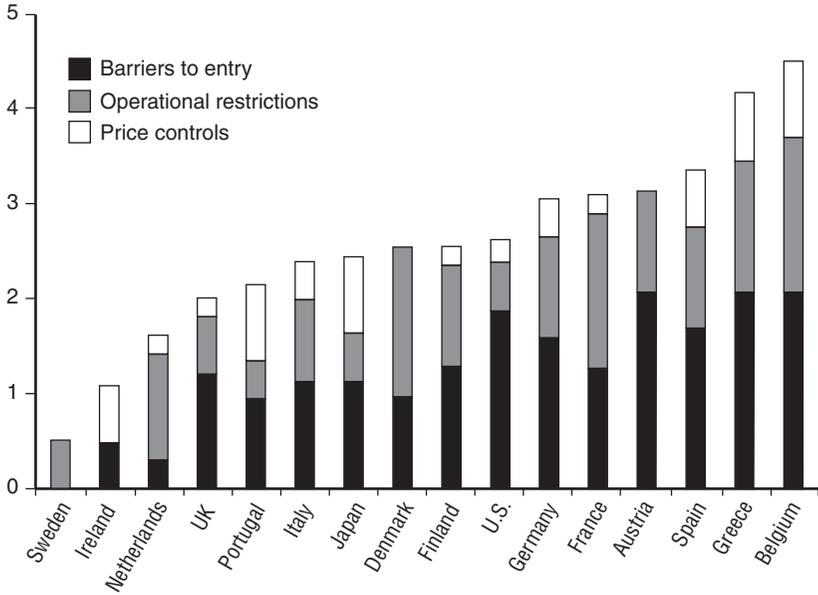
Conway and Nicoletti also conclude that there is considerable variation in the stringency of regulation across industries. In some industries, such as road freight, air transport, and telecommunications, regulation appears to have been completely overhauled. In other industries, such as gas, postal services, and rail transport, regulatory reforms appear to have been minor. The timing of reform has also varied widely across industries, with road freight and airlines being liberalized (and privatized) earlier than other industries and electricity and telecoms being reformed over the past decade.

Regulation in Retail Distribution and Professional Services

In retail distribution and professional services markets are composed of many competing private firms. Hence, competition issues are

¹⁸ Eurostat, "Economy and finance, Balance of payments - International transactions, EU direct investment positions, breakdown by country and economic activity," Luxembourg, 2006.

Figure 1.5 Regulation in Retail Distribution in 2003



Source: Conway and Nicoletti, fn 17.

inherently different than in energy, transport and communications, where public legal monopolies have not been uncommon. Regulatory policies in retail distribution and professional services are based on either consumer protection or urban planning motivations or both. Being essentially country-specific, they have led to a wide dispersion of regulatory approaches, each being insulated by the low tradability of professional and retail trade services. Trade, technological developments and other global factors have less impact in these sectors. Reform trends have been less pronounced than in energy, transport and communication.

Retail Distribution

Despite its generally fragmented market structure, the retail sector is often subject to numerous regulations that weaken competition. Conway and Nicoletti observe large differences in the indicator of retail regulation across OECD countries, suggesting very different

policy approaches (Figure 1.5).¹⁹ In addition, the large cross-country variation in retail regulation appears to have changed little between 1998 and 2003, implying little evidence of recent policy convergence in this sector. Operational restrictions and barriers to entry are the most common forms of regulation in retail distribution. Barriers to entry definitively hamper also market access of foreign providers, and operational restrictions are often also discriminatory, because the regulations often require companies to behave differently than in their home country.

Professional Services

Conway and Nicoletti²⁰ argue that regulation in the professional services often limits competition by restricting entry, allowing for price fixing, granting exclusive rights to perform particular services, and restricting advertising and business structures. These regulations are claimed to be in the interest of consumers because they improve quality of services and overcome information asymmetries. In practice, however, there is little empirical evidence that indicates a positive impact on consumer welfare, as Faini also concludes.²¹

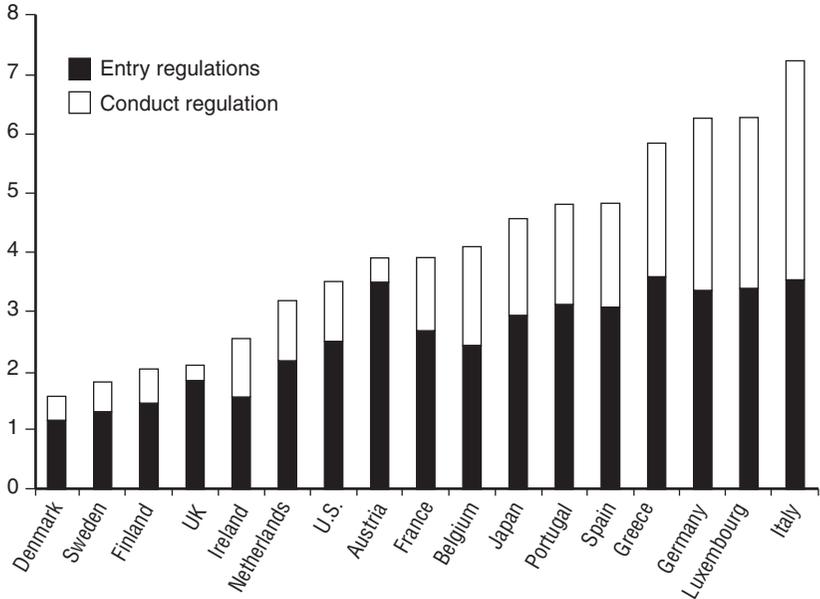
The indicators of regulation in professional services (Figure 1.6) suggest that in Denmark, Sweden, Finland, UK, Ireland, and the Netherlands barriers to entry into professional services are less strict compared to other EU countries and Japan, while differences among restrictive countries mostly reflect differences in conduct regulation – that is restrictions on price setting, advertising, form of business, and inter-professional cooperation. On average entry regulation is more prominent than conduct regulation. In some countries conduct regulation is nearly absent. If the lack of conduct regulation does not affect the quality of the delivered services in these countries, it could also be eliminated in other countries.

For foreign competition in professional services it could be helpful that in 2005 the European Commission embarked upon a reform of

¹⁹ Conway and Nicoletti, *op. cit.*

²⁰ Conway and Nicoletti, *op. cit.*

²¹ Faini, *et. al.*, *op. cit.*

Figure 1.6 Regulation of Professional Services in 2003

Source: Conway and Nicoletti, fn 17.

the system for the recognition of professional qualifications.²² This will help to make labor markets more flexible, further liberalize the provision of services by encouraging more automatic recognition of qualifications, and simplify administrative procedures for those qualifications which are not automatically recognized.

Regulatory indicators for retail distribution and professional services are only available for the years 1998 and 2003. It is thus not possible to analyse regulatory reform over a longer period, as we did for telecoms and energy. The indicators suggest that entry barriers are relatively important. Conway *et al.* conclude that in recent years most European countries have not made much progress in lowering entry barriers according to the product market regulation indicators.²³

²² European Commission, *Directive 2005/36/EC of the European Parliament and of the Council of 7 September 2005 on the recognition of professional qualifications* (Brussels, 2005).

²³ Conway, P., V. Janod and G. Nicoletti, "Product Market Regulation in OECD Countries: 1998 to 2003," *OECD Economics Department Working Papers No. 419* (Paris, 2005).

These entry barriers not only hamper competition in national services markets, they hamper integrating these markets into European services markets.

The analysis of regulation in the sectors energy transport, communication, retail and professional services show that, by and large, regulation has decreased over the past few decades in most EU countries. This is helpful for integrating national services markets because regulatory systems are fragmenting the services markets. However, many barriers are still in place, in particular regarding market entry in retail distribution and professional services and public ownership in energy, telecommunication and transport markets. These barriers also hamper expansion of foreign services providers. Although the analysis above does not cover all services sectors and not all EU countries (such as many business services and the new EU countries), we have no indication that this analysis is not representative for Europe's other services markets.

4. National Regulatory Obstacles for the Internal Market

Section three concluded that market-reform policies reduced the degree of regulation in many services markets in Europe, but regulation did not disappear. We will not discuss the need for regulation, but focus here on the consequences of national regulation for integrating services markets. Many such (market-entry) regulations for services providers affect fixed costs of services firms (see the box below).

The fact that national services markets are regulated is not in itself an important barrier to international services trade. Kox and Lejour illustrate this with a thought experiment.²⁴ Suppose that all countries have the same type of regulation, for instance, a qualification requirement for providers producing a particular service product. Since qualification costs are mainly fixed costs, it would cost an exporting firm a one-off effort in its home country to comply with the qualification criteria. Once it incurred these fixed costs, it could allow the firm to reap economies of scale by expanding its market into additional EU member states.

²⁴Kox, H.L.M. and A.M. Lejour, "Regulatory heterogeneity as obstacle for international services trade," CPB Discussion Paper 49, 2005.

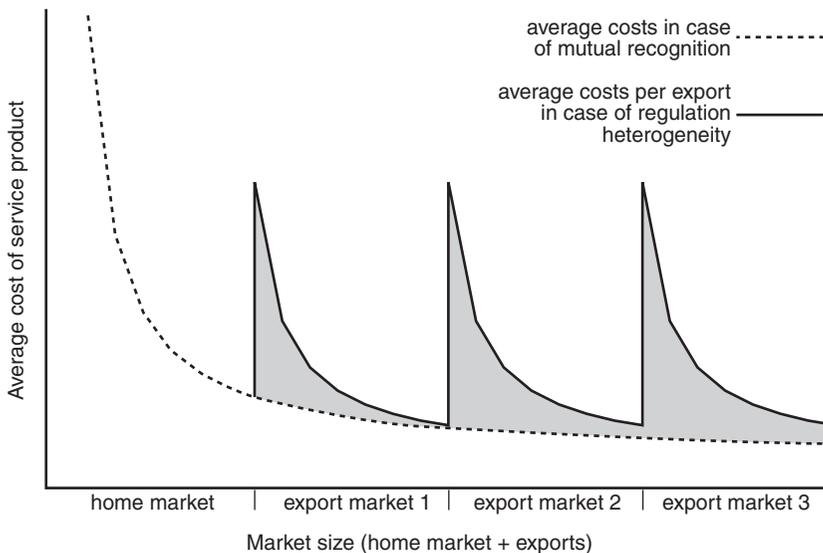
Examples of National Regulations for Services Providers that Affect Fixed Costs

- Firm start-up licenses and associated authorization requirements
- Service-providing personnel must have locally recognized professional qualifications (may necessitate re-qualification)
- Obligatory membership of local professional association
- Owners or managers of service-providing firm must have local residence or nationality
- Firms must have a specific legal form
- Requirement that services providers have nationally recognized liability insurance or professional indemnity insurance
- All services activities in export destination country are fully subject to regular administrative and tax procedures
- Limitations on inter-professional co-operation or on the variety of services provided by one firm (may require unbundling)
- Temporary services personnel from origin country are subject to rules of the social security system of the destination country
- Impediments for material inputs, suppliers and personnel from origin country (necessitates search for new local suppliers)

Source: Kox, H.L.M. and A.M. Lejour, "Regulatory heterogeneity as obstacle for international services trade," CPB Discussion Paper 49, 2005, based on European Commission, *Report from the Commission to the Council and the European Parliament on the State of the Internal Market for Services* (Brussels, 2002).

However, such a uniform system of regulation does not exist in Europe. Countries developed their own systems of regulation rooted in their own culture and institutions. They have often have little confidence in the quality of each other's legal regimes and are reluctant to adapt their own regimes where necessary to facilitate cross-border activities. The result is that each national authority uses its own system of quality safeguards to protect services buyers. This is a great

Figure 1.7 Cost Effect of Regulation Heterogeneity in EU Internal Market (perspective of exporting firm)



nuisance for international trade. Services exporters are confronted with different regulations and requirements, leading to additional costs when firms want to do business in other EU member states. These costs can be a prohibitive barrier for entering export markets.

Kox and Lejour argue further that the fact that these fixed qualification costs are specific for that national market implies that the costs cannot be spread out over production that is destined for other EU markets. The consequence is that the regulation heterogeneity limits intra-European economies of scale.

Figure 1.7 provides a picture of these effects for a services provider who subsequently enters a number of EU export markets. The presence of national qualification requirements gives rise to country-specific fixed transaction costs for the services exporter. Implicitly, the shaded area in Figure 1.7 shows the firm-level cost and efficiency gains that can be attained by a system that allows firms to achieve more economies of scale in dealing with regulation requirements.

Qualification requirements and associated costs for legal and other assistance are mostly independent of firm size. Hence, the market-entry deterring effect will be strongest for small and medium-sized firms. They form the large majority of services providers.

In a survey among a large number of business services firms in the EU, 44 percent of the firms mentioned costs as a “very important” barrier to setting up a local operation in other countries.²⁵ Those firms that were able to estimate the size of the start-up costs estimated them to be on the order of 6 months sales proceeds.²⁶ The European Commission has reached a similar conclusion:

Evidence collected from SMEs and SME-supporting organisations suggests that many SMEs back off after initial inquiries about administrative requirements and procedures because they feel they do not have the necessary resources to deal with the current complexity. Such agencies report that micro enterprises in particular were easily dissuaded from engaging in cross-border activities.²⁷

The heterogeneity in regulatory regimes doesn't only hamper services providers. Regulation heterogeneity suppresses foreign competition and the influx of new products and innovative working methods that foreign services providers can bring. It implicitly restricts the choice possibilities for domestic firms that want to purchase business services. The domestic price of business services will be higher than necessary (compared to the open-borders case). In the case of producer services, it leads to higher input prices for EU-based firms.

5. Current Initiatives to Integrate Services Markets

Section four argued that differences in national regulation negatively affect the internationalization of services providers and thereby contribute to fragmenting European services markets. However, recent developments indicate that the future could at least be a little

²⁵ CSES, *Barriers to international trade in business services—Final Report*, Study commissioned by the European Commission (Brussels: CSES / European Commission, 2001), p. 43.

²⁶ *Ibid.*, p. 191.

²⁷ European Commission, *Report from the Commission to the Council and the European Parliament on the State of the Internal Market for Services* (Brussels, 2002).

bit different. Most European countries try to reform services markets by reducing entry barriers, barriers to competition and eliminating price controls (see section three). At the same time FDI is growing considerably. Moreover, the European Commission has taken initiatives to integrate services markets, and a common services market is also a key element of the EU's Lisbon reform program. These initiatives are of a much more recent date than the Single Market Program.

The Single Market Program focused mainly on the integration of goods markets. Services markets were not totally neglected, but for many commercial services single market policies lagged behind. Section two argued that cross-border trade in services has grown about the same speed as trade in goods, but given the rising share of services in GDP, the international market for services has opened more slowly than for goods. In identifying the role of the single market for various sectors, Nahuis demonstrated that for many services the internal market did not increase cross-border trade substantially, whereas the the internal market did stimulate trade for most goods sectors.²⁸ Lejour and de Paiva Verheijden (2007) show that services trade between the provinces of Canada is about twice as large as between the EU member states (measured as share of services value added).²⁹ An EC questionnaire of EC among services providers on the barriers to internationalization gives convincing anecdotic evidence to the statistical evidence mentioned above.³⁰

This section discusses some of the recent Commission initiatives to integrate services markets. We concentrate on the highly-debated Services Directive, integration of financial markets, retail and wholesale markets and network industries.

The Services Directive

In 2004 the European Commission proposed the Services Directive in order to slash regulatory barriers between national services markets.

²⁸Nahuis, R., "One size fits all? Accession to the internal market, an industry-level assessment of EU enlargement," *Journal of Policy Modelling*, vol. 26, 2004, pp. 571-586.

²⁹Lejour, A.M., and J-W. de Paiva Verheijden, "The Tradability of Services within Canada and the European Union," *Service Industries Journal*, forthcoming, 2007.

³⁰European Commission, *Report from the Commission to the Council and the European Parliament on the State of the Internal Market for Services* (Brussels, 2002).

Several studies indicate that bilateral trade and foreign direct investment in services could be boosted substantially. Kox and Lejour approach the issue by quantifying the market-entry costs of country-specific regulations, accounting for differences in product-market regulations between each EU country pair.³¹ The degree of bilateral policy heterogeneity between countries is used as a proxy for sunken export costs; it may differ between each pair of countries. Applied in gravity equations for bilateral services trade in the EU, regulatory heterogeneity in policy areas like competition and trade regulation appears to have a robustly negative trade impact.

Kox and Lejour subsequently estimate in considerable detail the extent to which the Directive would affect bilateral policy heterogeneity. Intra-EU FDI in services could increase by 18 to 36 percent. In particular less heterogeneity in barriers to competition and a lower level of FDI restrictions would facilitate greater foreign direct investment. The Services Directive does not eliminate all heterogeneity in barriers to competition; some FDI restrictions in destination countries will remain in place. If all this heterogeneity in regulation would be eliminated, services FDI could increase by about 130 percent in Europe on average.

With respect to cross border trade, the heterogeneity in barriers to competition and explicit barriers to trade and investment hamper further market integration. The Services Directive would increase bilateral services trade within the EU by 30 to 62 percent, which is two to five percent of total EU trade. A complete elimination of heterogeneous barriers would nearly triple intra-EU commercial services trade.

These numbers are stunning and we acknowledge that these are out-of-sample predictions. However, these numbers underpin the relevance of regulation and differences in regulation as barrier for international transactions in services.

In order to estimate the macro-economic importance of the Services Directive, De Bruijn *et al.* have fed the estimated trade impacts (not the FDI effects) into an applied general equilibrium model

³¹ Using country-wise data on some 200 different items in product-market regulations from the OECD International Regulation database. The indicator is decomposed into five different areas of product-market regulation. See Kox, H.L.M. and A.M. Lejour, "The effect of the Services Directive on intra-EU trade and FDI," *Revue Economique*, vol. 57 (4), 2006, pp. 747-769.

WorldScan. They conclude that European consumption could increase on average by 0.5 to 1.2 percent.³² If the effects of more FDI are added (derived from Lejour *et al.*)³³ consumption could increase by 0.5 to 1.5 percent. The limited openness of commercial services for trade and foreign investment explains why these macro-economic effects are relatively modest. However, expressed in terms of 2004 European GDP, the measures would total 35 to 95 billion euros. This still ignores the productivity and innovation impacts resulting from greater trade and FDI.

Copenhagen Economics also analyzed the EU proposals with an applied general-equilibrium model.³⁴ Their model also accounts for FDI effects. According to their simulation results, overall consumption in the European Union would increase by 0.6 per cent due to the Services Directive. This is somewhat smaller than the results reported by CPB.

Financial Services

Financial integration in Europe has proceeded quickly. The introduction of the euro was an important landmark. It underpinned and stimulated integration of euro-derivative markets, equity and bond markets. In banking, however, integration proceeded less well. Some banks from different countries merged, but the efforts by ABN/AMRO to acquire a bank in Italy were seriously hampered in 2006. Moreover, the European Central Bank ECB has stressed that dispersion of national retail interest rates is also caused by differences in consumer protection rules, differing tax treatment, structural differences in the banking sector and the level of technology and competition in the national financial sectors.³⁵ The European Commission formulated proposals to address some of these issues. Ilzkovitz *et al.* point out that further efforts might be necessary in order to reduce the costs

³² Bruijn, de R., H. Kox and A. Lejour, "The trade-induced effects of the Services Directive and the country-of-origin principle," *Working Paper 44*, ENEPRI (Brussels, 2006).

³³ Lejour, A.M., H. Rojas-Romagosa, and G. Verweij, "Opening up Services Markets within Europe: Modelling Foreign Establishments," *CPB Discussion Paper*, 2007.

³⁴ Copenhagen Economics, *Economic Assessment of the Barriers to the Internal Market in Services*, commissioned by the European Commission, 2005: www.copenhageneconomics.com.

³⁵ European Central Bank, "Differences in MFI interest rates across euro area countries," Statistics Publication, September 2006.

of cross-border clearing and settlement transaction, for which the costs are far higher than for domestic transactions.³⁶

It is hard to assess the costs and benefits of financial integration. The London School of Economics estimated that GDP might increase by 1.1 percent in the long run caused by higher investment and private consumption and higher employment by integrating equity and bonds markets. The costs of capital are reduced by 0.5 percent points.³⁷ This study (as well as others) however, does not deal explicitly with the integration of the banking sector.

Retail and Wholesale Services

Between 1994 and 2003 the average contribution of wholesale and retail trade to total productivity growth was 27 and 26 percent respectively in the U.S. and only 10 and seven percent respectively in Europe. Moreover, productivity growth in the U.S. was on average much higher than in the EU. McGuckin *et al.* explain the difference in performance by the early start of using ICT in the U.S. and the remaining regulatory obstacles within and between European countries.³⁸ The major obstacles to productivity growth are store opening hours, land usage restrictions (in particular on large stores) and labor laws. Land usage rules hamper entry and exit of firms and reduce the possibilities to economies of scale by larger firms. Dhyne *et al.* argue that the competitive pressure of larger retailers, like Wal-Mart, also stimulated other stores to improve technological and organisational structures.³⁹ These results suggest that regulatory reforms of land usage and opening hours could increase productivity growth in Europe. It has to be noted, however, that land usage laws are more rel-

³⁶ Ilzkovitz, F., A. Dierx, V. Kovacs and N. Sousa, "Steps towards a deeper economic integration: the Internal Market in the 21st century A contribution to the Single Market Review," *DG EcFin Economic Papers*, 271 (Brussels, 2007).

³⁷ London School of Economics, 2002, "Quantification of the Macroeconomic Impact of Integration of EU Financial Markets, http://europa.eu.int/comm/internal_market/en/finances/mobil/overview/summary-londonecon_en.pdf.

³⁸ McGuckin, R., H. Spiegelman, B. van Ark, "Can Europe match U.S. Productivity Performance? Perspectives on a Global Economy," *Conference Board Research report R-1358-05-RR*, 2005.

³⁹ Dhyne, E., L.J. Alvarez, H. Bihan, G. Veronese, D. Dias, J. Hoffmann, N. Jonker, P. Lünne-mann, F. Rumlér, J. Vilmunen, "Price Changes in the Euro-area and the US: Some Facts from Individual Consumer Price Data," *Journal of Economic Perspectives*, vol. 20, 2006, pp. 171-192.

evant in Europe. Land is scarcer because of the higher population density in Europe. Differences in taste could also hinder the development of standardized large retailers all over Europe.

Network Industries

Section three showed that many countries have reformed their network industries, and tried to open up these industries to more competition. Initiatives of the European Commission have been helpful regarding reform efforts. However, the level of regulation within Europe is very uneven. The separation of vertically-integrated monopolies (often state-owned) sometimes meets fierce resistance because of vested interests and the fear that public interests are not taken sufficiently into account in liberalized network industries. It is necessary to introduce competition, however, which could finally lead to higher productivity and lower prices. The expansion of interconnections between national networks could at least reduce the physical barriers for foreign competition.

Dynamic Effects

Most of the estimates on the effects of integration of European services markets only mention trade and investment effects or the static efficiency effects. Assessments of the dynamic effects are lacking because economists do not fully understand the mechanisms to measure them and data are nearly not available. However, Faini *et al.*, Ilzkovitz *et al.*, and Kox and Lejour⁴⁰ conclude that the prime economic gains come from more market entry. Improved market access will subsequently stimulate competitive selection and productivity growth. Competitive selection will lift average productivity, bolster the role of SME firms in exports, intensify knowledge spillovers, and strengthen innovation by incumbent firms. Moreover, increased FDI in liberalized services markets will also increase average productivity. This can be expected to be beneficial for the number of available services varieties, for services quality, and for the price of services.

⁴⁰Op.cit; Kox, H.L.M. en A.M. Lejour, "Dynamic effects of European services liberalisation: more to be gained," in *Global Challenges for Europe*, Report by the Secretariat of the Economic Council, PART 1, Prime Minister's Office Publications 18/2006, pp. 313-142, <http://www.vnk.fi/hankkeet/talousneuvosto/tyo-kokoukset/globalisaatioselvitys-9-2006/en.jsp>.

The literature on the relation between trade openness and income growth may offer some additional evidence regarding the size of the dynamic effects. The empirical relationship between openness and income is subject to debate. Some influential papers estimate that 1 percentage point more trade openness causes income to grow by 0.6 percent in the short term, and 1.1 percent when also long-term effects are counted.⁴¹ Applying the latter estimate, the 2004 Services Directive could increase European GDP by two to five percent. These long-run effects incorporate the effects of extra competition, productivity spillovers, extra innovation and productivity growth. Nicoletti and Scarpetta estimate that entry liberalization in services towards the OECD average could boost productivity growth by 0.1 to 0.2 percent in some European countries.⁴²

6. Prospects for Further Integration of Europe's Services Markets

In 2007, the European Union reviews its Single Market policies. Ilzkovitz *et al.*⁴³ state that the Single Market opened up perspectives to restore the confidence of European business and improve the performance of European companies through the formation of a better integrated and more competitive and innovative market place. The removal of barriers was intended to create an integrated market in which producers and consumers could reap the benefits of economies of scale. Moreover, fiercer competition was expected to result in efficiency gains and to stimulate innovation and the dynamic efficiency of the EU economy.

It is clear that the markets for goods are further integrated, but the EU has not yet taken the path towards a more dynamic and innovative economy. Comparisons with the United States show substantial gaps in growth rates in several services sectors. A higher level of regulation in Europe and the fragmented services markets explain a substantial part of these differences. The higher level of regulation in Europe and the differences in regulation which also hamper internationalization

⁴¹ Frankel, J., and A. Rose, "An estimate of the effect of common currencies on trade and income," *Quarterly Journal of Economics* 117(2), 2002, pp. 437-466.

⁴² Nicoletti, G. and S. Scarpetta, "Regulation, Productivity and growth: OECD evidence," *OECD Economic Department Working paper no. 347* (Paris, 2003).

⁴³ Op. cit.

require renewed single market policies for services markets if Europe wants to harvest the benefits of integrated services markets. After the laborious battle over the Services Directive this proposal will probably not meet much enthusiasm. Moreover, the horizontal approach of the Services Directive has to be abandoned, because more tailor-made proposals for market integration by services sector are needed. Such an initiative asks for a separate Directorate-General (DG) on the Internal Market for Services instead of the current DG on Internal Market and Services.

This analysis has demonstrated that many services markets have scope for further integration. Examples are retail and wholesale, network industries, financial services, and many business services. The Services Directive is a good start for business services, in particular the one shop idea to fulfill all administrative inquiries for foreign firms. From the OECD indicators we know that many entry barriers remain. Eliminating these barriers would also stimulate foreign entry and introduce extra competition. The fierce debate over the Services Directive also showed that the acceptance of foreign regulation of imported services without domestic control is in many cases not acceptable at this moment. The alternative could be more detailed proposals on specific regulatory burdens to integrate national markets for each services market. This requires greater efforts. We have to accept that the low-hanging fruit is already harvested. Services markets by their nature are harder to regulate, but deregulation may be the only way to a more dynamic and innovative services economy. The large size of the U.S. market and fewer regulatory barriers are important causes for America's faster growing markets. It seems to be worthwhile to pursue further integration in order to try to grasp the large welfare effects possible by extra competition and effects on productivity and innovation. If not all EU member states are interested, enhanced cooperation between some member states could set the stage, although large scale markets are needed to generate larger economic effects.

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