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The EU's Single Market: At Your Service?

Line Vogt

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By Line Vogt

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Abstract

While the single market has largely been achieved for the EU market for goods, the services sector has lagged behind. This has resulted in sluggish activity, low productivity growth, high prices, that show a wide dispersion and relatively high inflation in this sector. Both the OECD product market regulation study and the European Commission study on internal market barriers conclude that there are large barriers to trade between the EU countries. Since two-thirds of total output in the EU comes from the services sector it is crucial for the EU to pursue reforms of this sector. The proposed Directive on services in the internal market, also called the services directive, will be a helpful tool towards establishing a single market for services if it is implemented as proposed. The European citizens will gain from large welfare effects associated with the convergence of prices towards the best performers and faster trend economic growth. A watering down of the directive will however reduce the beneficial effects and should be avoided.

This Working Paper expands on material presented in the 2005 OECD Economic Survey of the Euro Area (www.oecd.org/eco/surveys/eu).

JEL Codes: F15; F16; F22; F36; G2; L5; L8; L9

Key words: European Union; services directive; financial sector; transport; telecommunications; product market regulation.

* * * * *

Résumé

A l'inverse des biens, pour lesquels le marché unique est aujourd'hui devenu une réalité, l'avancée vers un marché unique des services marque le pas. Du fait de ce retard, ce secteur connaît une activité hésitante, une faible croissance de la productivité, des prix élevés (qui sont de surcroît très différents d'un pays à l'autre) et une relativement forte inflation. Les études réalisées par l'OCDE sur la réglementation des marchés de produits et par la Commission européenne sur les entraves au marché intérieur concluent de conserve à la présence de puissants obstacles au commerce de services entre pays de l'Union européenne. Dans la mesure où les services constituent les deux tiers de la production dans l'Union européenne, il est capital pour l'Union européenne de poursuivre les réformes dans ce secteur. Le projet de directive sur les services dans le marché intérieur, plus communément appelée directive services, constituera un outil précieux pour progresser vers la mise en place d'un marché unique des services, à condition qu'elle soit mise en œuvre en l'état. Les citoyens de l'Union européenne y gagneront une plus forte croissance économique et de considérables gains de bien-être grâce à la convergence des prix vers les niveaux qui sont ceux des pays les plus performants. Toute édulcoration de la directive en réduirait les avantages et devrait être évitée.

Ce Document de travail prolonge des travaux réalisés pour l'Etude économique de l'OCDE de la zone euro, 2005 (www.oecd.org/eco/etudes/ue).

Classification JEL : F15 ; F16 ; F22 ; F36 ; G2 ; L5 ; L8 ; L9

Mots clés : Union européenne ; directive sur les service ; marché français ; transport ; télécommunications ; réglementations des marchés de produits

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THE EU'S SINGLE MARKET: AT YOUR SERVICE?

Line Vogt¹

1. Introduction

1. The services sector is by far the largest sector of economic activity in the euro area. In 2003 it accounted for 58% of business sector value added, 68% of total employment and two-thirds of total output. Services are found in all areas of the economy ranging from public administration, retail and tourism to financial intermediation and are increasingly linked to the manufacturing industry. Car manufacturers are for example more and more frequently selling financing services alongside vehicles and industrial companies are increasingly using services as production inputs. Moreover, services are important for job creation since the services sector has been steadily recruiting over the last three decades while the workforce has been shrinking in manufacturing and farming.

2. Because of its size, growth and its integration with other parts of the economy, the services sector has a considerable impact on the EU economy and a well functioning services sector is crucial to foster economic growth. Against this backdrop this paper takes stock of the integration of services within the single market. The main finding is that the services sector has lagged behind other sectors when it comes to creating a single market in the European Union. Indeed, with respect to the objective, set out in the Internal Market Strategy for Services, “to make the provision of services between member states as easy as within a member state”, the European Commission states that the internal market for services is far from being a reality (EC, 2002). In the early stage, the Internal Market Programme focussed on eliminating non-tariff barriers to trade and investment by legislative means and mutual recognition of national regulations. Barriers to trade in goods have largely been removed, but barriers to the integration of services are still important. Removing these barriers would raise the euro area's growth potential – indeed enhance the benefits from EMU – and heighten its resilience to shocks. Deep integration of services markets would provide opportunities for outsourcing and scale economies, and consumers would benefit from lower prices and improved quality of services, while new job opportunities would arise.

3. In the following this paper will assess the economic situation of the services sector and take stock of the main impediments to an integrated services market. Based on this assessment the European Commission's policies concerning the services sector will be evaluated by looking at the proposed services directive and the implementation of policies for areas that are not covered by the services directive, namely finance, transport and telecommunications.

2. Services are underdeveloped

4. Notwithstanding its large share, the size of the euro area services sector is still below the OECD average. The United States and the United Kingdom, for example, currently have a services sector employment share close to 80% of overall employment (**Table 1**). While the share of services has increased, there is still considerably scope for further increases (**Figure 1**). The fact that net job creation typically stems from services sectors (**Figure 2**) suggests that it is desirable to remove obstacles to the expansion of the services sector. With its high unemployment rate, expanding the services sector may indeed be highly beneficial for the euro area.

5. Not only is the services sector share in the euro area lagging that in other parts of the OECD, but also the dispersion among the euro area countries is large and the gaps are becoming wider. In 2003 almost 78% of employment in the Netherlands was in the services sector while less than 60% in Portugal. This may indicate that member countries are exploiting comparative advantages, but it may also suggest that the single market in services is not working well. Poor economic growth in the euro area's services sector compared to other countries such as United States, United Kingdom, Canada and Australia (**Table 1**) indeed indicates a large potential for improvement.

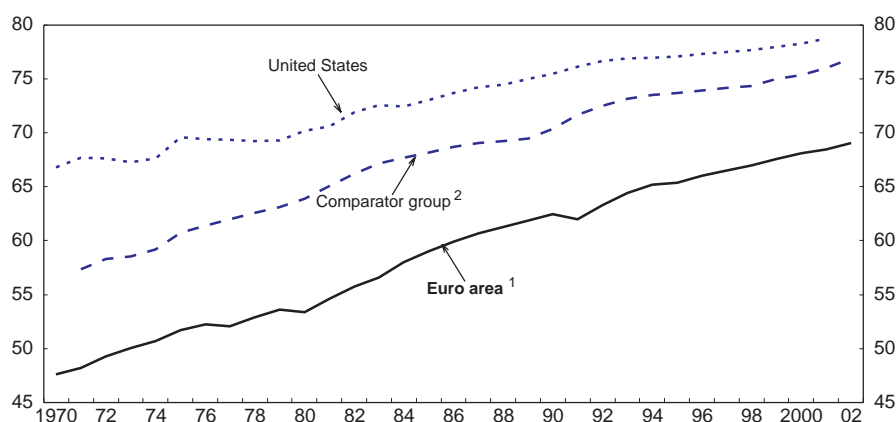
Table 1. The role of services in OECD economies

	GDP in the service sector			Employment in services		
	Share in total GDP		Annual average growth rate	Share in total employment		Annual average growth rate
	1995	2003 ¹		1995	2003 ¹	
Austria	60.2	60.4	0.8	57.8	63.2	1.6
Belgium	66.0	68.6	2.7	72.7	76.0	1.7
Finland	56.4	58.5	3.2	64.9	68.7	2.4
France	65.3	67.9	2.1	70.9	73.9	2.0
Germany	62.5	65.3	0.3	64.3	70.4	1.4
Greece	62.6	64.5	5.3	55.9	60.9	1.6
Ireland	48.5	50.0	11.4	61.1	65.8	5.4
Italy	62.8	66.4	4.4	63.0	66.5	1.9
Luxembourg	83.7	92.7	6.5	70.6	77.2	5.1
Netherlands	63.9	67.5	3.4	74.2	77.7	2.5
Portugal	59.4	63.0	4.8	56.6	59.7	2.8
Spain	63.7	63.9	4.7	64.0	65.3	2.8
Australia	62.5	64.7	4.9	72.8	74.2	1.9
Canada	62.4	60.7	3.6	74.2	76.5	2.3
United Kingdom	62.1	68.6	7.3	76.6	80.6	1.7
United States	66.5	71.5	6.6	77.1	81.1	1.9
Euro area	63.2	65.6	2.4	65.2	68.3	2.2
OECD	64.8	66.4	2.0	68.1	71.4	2.1

1. Or latest available year.

Source: OECD, *National Accounts*.

Figure 1. Employment in services
As a share of total employment

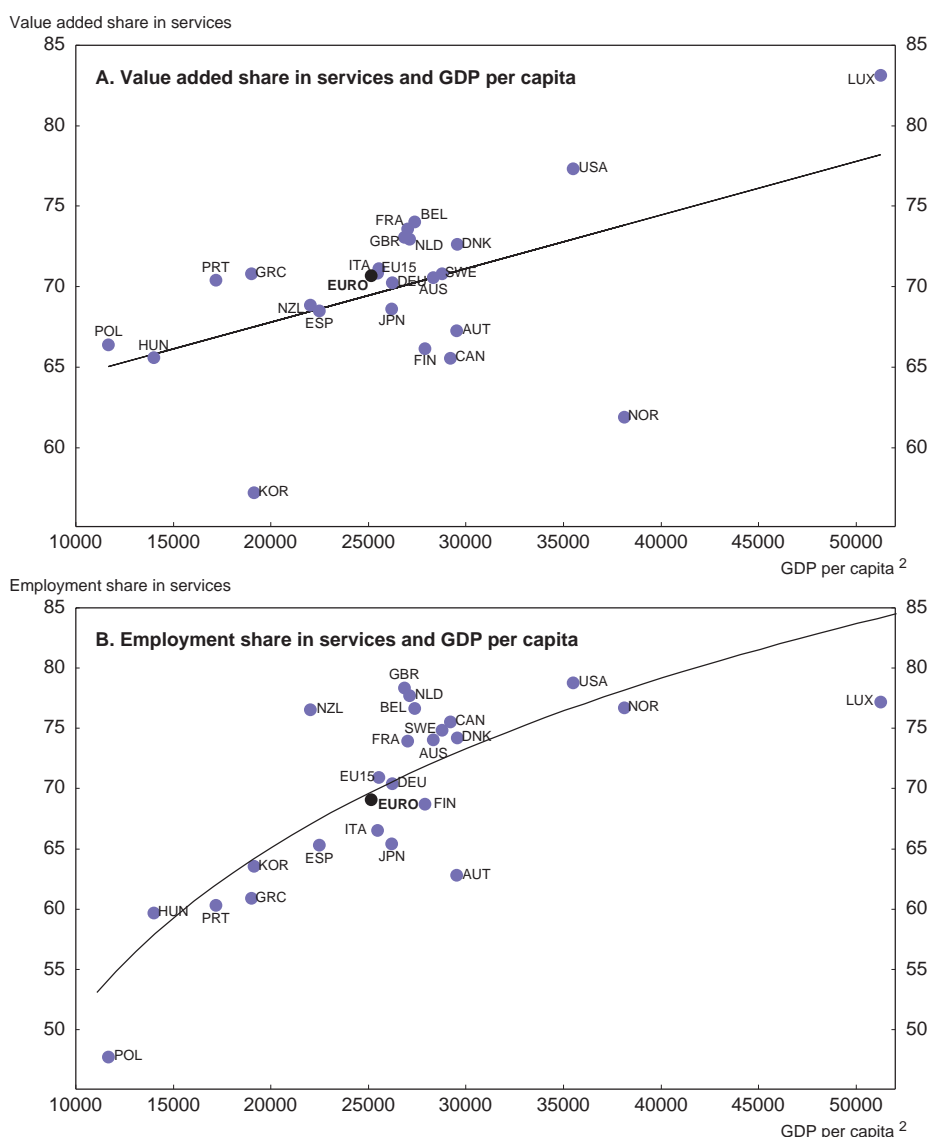


1. Excluding Ireland.

2. Includes Australia, Canada, Denmark, New Zealand, Sweden and United Kingdom.

Source: OECD, STAN database.

Figure 2. Size of the service sector
2003¹



1. Or latest available year.

2. Real GDP per capita in 2000 PPPs.

Source: OECD, National Accounts, Labour Force Statistics and STAN database.

6. Productivity growth in the services sector is markedly lower in the euro area than in other industrialised economies. In the business services sector as a whole, productivity growth in the euro area was only 0.3% per annum from 1995 to 2003, which is considerably less than for the United States with 2.8%, United Kingdom with 2.1% or Australia with 2.6%. For the EU15 the percentage was slightly higher at 0.7% during the same period (Table 2). Especially France, Luxembourg and Spain score poorly on services sector productivity growth. Some parts of the services sector are standing out. While developments in the retail and wholesale market have played an important role in boosting productivity growth in many countries, including the United States and the Scandinavian countries, the euro area is lagging behind. Box 1 highlights possible explanations for the differences in performance, including the role of ICT and the “big box” phenomenon. Moreover, the euro area experienced relatively poor

productivity growth in finance and insurance and restaurants and hotels. Post and telecommunication, for which the euro area shows a very high productivity growth, is an exception, where benefits from reforms have become apparent. Some of the differences in productivity growth may however be due to measurement differences and to the greater use of hedonics in the United States which may overestimate growth compared with Europe (**Box 1**).

Box 1. Productivity growth in the wholesale and retail trade sector in the EU and the US

Several explanations for the euro area's comparatively poor productivity performance in this sector have been put forward. First, the role of ICT as a source of productivity growth is often highlighted, since the retailing sector has been transformed from a low-technology sector to one of the most intensive users of information and communication technologies. Barcodes, scanners, and electronic replenishment capabilities, along with complementary organisational adjustments, have transformed the sector and have boosted productivity growth. However, the pace of organisational change and technology adoption in the distributive trade sector in Europe has been slow (Timmer *et al.*, 2004).

Second, the "big box" phenomenon, exemplified most notably by the emergence of Wal-Mart, is often seen as an engine of productivity growth in US-retailing. In this area the differences between Europe and the United States are large. While the United States has allowed the establishment of large hypermarkets outside cities, European countries often obstruct the establishment and the expansion of large retail outlets ("big-boxes") by tight regulations, as they aim to protect small specialised retail outlets in city centers. Some European countries have even introduced a direct ban on new large shopping centres (e.g. Denmark and France). Regulations on shop opening hours and in some cases price setting regulations pose additional restrictions in several countries, despite some deregulation in recent years. Restrictions on price setting have, for example, recently been recognised to push up prices on some brand-name products by up to 13% in France. Regulations holding back the development of retail trade are particularly stringent in Austria and France (Kongsrud and Wanner, 2005).

Third, the rapid US growth may in part be due to differences in measurement that allow in the US case quality improvements in manufacturing to spill over into measured productivity in the retail sector. A 2003 computer is four times as powerful as in 1993, as gauged by a hedonic price regression that includes speed, memory, and additional attributes. In the hypothetical case of the retail sector exclusively selling computers, and assuming that the number of computers sold per retailer is constant, the US methodology would register an annual productivity growth rate for retailing of 13.9% (Gordon, 2004). Timmer *et al.* (2004) analyse to what extent the US retail trade productivity growth advantage is real or due to such measurement issues. They find that differences are small. But due to the greater use of hedonics in the United States and a bigger share of ICT goods sales, real trade output is overestimated compared with Europe, but more so in wholesaling than in retailing. If the contributions from the growth of real sales of ICT-related trade categories for the period 1995-2002 are excluded, output growth in the US would be reduced by about 0.8 percentage point annually in retailing and about 1.5 percentage point in wholesaling. However, their main conclusion is that even after correcting for possible upward biases, US productivity growth in the trade sector since the mid 1990s remains well above the European one.

7. Service trade flows within the internal market are still relatively small in comparison with manufacturing trade. Balance of payments statistics show that service exports still represent only a very modest one-fifth of total intra-EU trade. But trade flows recorded in balance of payment statistics do not include services supplied through foreign affiliates. Accounting for this, Karsenty (2000) estimates services at about 40% of total trade, the rest being trade in goods, a figure which still remains low in comparison with the large output share. Most exports are found in travel and tourism which is mostly driven by natural endowments rather than by the regulatory environment. Intra-EU trade in personal services is small. In business services, the picture is more mixed among the EU countries. The Netherlands, the United Kingdom and to a smaller extent Spain have a strong trade orientation in this sector, whereas the market for business services in France, Germany and Italy appears to be rather inward-oriented. This pattern is likely to be correlated with the regulatory environment (CPB, 2004a).

Table 2. Labour productivity growth by activity
Average annual percentage changes, 1995-2003¹

ISIC	Sectors	Euro area ²										New												
		EU15 ²		United States	Australia	Canada	Korea	Zealand	Norway	Denmark	Sweden	United Kingdom	Austria	Belgium	Finland	France	Germany	Greece	Italy	Luxembourg	Netherlands	Portugal	Spain	
01-05	Agriculture, hunting, forestry and fishing	2.0	2.3	2.3	5.9	3.4	3.4	9.1	3.6	3.7	3.4	3.4	3.4	3.6	3.7	2.6	2.4	8.9	1.4	4.0	2.7	1.9	4.1	5.2
15-37	Total manufacturing	1.6	1.8	3.7	2.6	2.4	8.9	1.4	4.0	3.7	2.4	8.9	1.4	4.0	3.7	2.6	2.4	8.9	1.4	4.0	2.7	1.7	6.1	1.8
50-55	Wholesale & retail trade, restaurants & hotels	-0.2	0.2	4.5	2.6	2.2	2.7	0.6	-4.5	4.5	2.2	2.7	0.6	-4.5	4.5	2.6	2.7	2.7	0.6	-4.5	2.0	1.3	2.6	1.8
50-52	Wholesale and retail trade	0.6	1.0	4.7	3.0	2.7	3.7	1.3	-2.4	4.7	3.0	2.7	1.3	-2.4	4.7	3.0	2.7	3.7	1.3	-2.4	2.7	1.8	2.7	2.4
55	Restaurants and hotels	-1.9	-1.4	0.1	1.1	0.2	1.6	-2.2	5.2	0.1	1.1	0.2	1.6	-2.2	5.2	0.1	1.1	0.2	1.6	-2.2	5.2	-2.5	1.9	-0.1
60-64	Transport, storage and communication	3.8	3.9	2.3	4.1	2.7	6.8	4.2	5.8	2.3	4.1	2.7	6.8	4.2	5.8	4.1	2.7	6.8	4.2	5.8	3.5	5.1	3.4	4.2
60-63	Transport and storage	..	..	0.6	3.3	2.0	..	..	1.2	0.6	3.3	2.0	..	1.2	0.6	3.3	2.0	..	1.2	0.6	3.3	4.7	1.8	2.0
64	Post and telecommunications	..	..	3.9	5.8	2.3	..	..	6.9	3.9	5.8	2.3	..	6.9	3.9	5.8	2.3	..	6.9	3.9	5.8	6.3	6.5	7.9
65-74	Finance, insurance, real estate & business services	-1.2	-0.8	1.2	1.1	0.2	-0.7	-1.4	7.0	1.2	1.1	0.2	-0.7	-1.4	7.0	1.1	0.2	-0.7	-1.4	7.0	0.2	-0.4	-1.2	1.0
65-67	Finance and insurance	1.3	1.6	5.2	3.2	1.9	5.3	6.3	1.2	5.2	3.2	1.9	5.3	6.3	1.2	3.2	1.9	5.3	6.3	1.2	2.8	2.8	2.0	2.8
70-74	Real estate and business services	-2.4	-1.8	-0.3	0.4	-0.8	-4.0	-3.6	-2.3	-0.3	0.4	-0.8	-4.0	-3.6	-2.3	-0.3	0.4	-0.8	-4.0	-3.6	-2.3	-1.4	-1.9	0.6
50-74	Total business services	0.3	0.7	2.8	2.6	1.6	2.9	0.5	-1.3	2.8	2.6	1.6	2.9	0.5	-1.3	2.6	1.6	2.9	0.5	-1.3	1.3	1.2	1.2	2.1
75-99	Community, social and personal services	-0.1	0.0	-0.1	0.4	0.3	-1.8	0.6	-5.3	-0.1	0.4	0.3	-1.8	0.6	-5.3	-0.1	0.4	0.3	-1.8	0.6	-5.3	0.2	0.5	0.6
10-67, 71-74	Total non-farm business sector	..	..	2.8	2.4	1.7	..	..	0.3	2.8	2.4	1.7	..	0.3	2.8	2.4	1.7	..	0.3	2.8	2.0	2.9	2.9	2.0
01-99	Grand total	0.6	0.9	1.6	2.0	1.4	3.6	0.7	1.7	1.6	2.0	1.4	3.6	0.7	1.7	2.0	1.4	3.6	0.7	1.7	1.4	2.1	2.1	1.7
01-05	Agriculture, hunting, forestry and fishing	6.9	2.8	5.0	3.3	4.8	1.2	2.7	1.4	4.0	3.3	4.8	1.2	2.7	5.0	3.3	4.8	1.2	2.7	1.4	1.9	1.3	2.7	2.7
15-37	Total manufacturing	4.3	3.3	4.0	3.3	1.9	3.7	0.7	2.7	4.0	3.3	1.9	3.7	0.7	4.0	3.3	1.9	3.7	0.7	2.7	1.7	2.5	1.1	1.1
50-55	Wholesale & retail trade, restaurants & hotels	1.5	1.0	2.0	0.1	-0.3	3.2	0.3	2.0	2.0	0.1	-0.3	3.2	0.3	2.0	0.1	-0.3	3.2	0.3	2.0	1.3	0.4	0.4	-0.4
50-52	Wholesale and retail trade	1.8	1.2	2.3	0.3	0.8	3.3	0.8	2.7	2.3	0.3	0.8	3.3	0.8	2.7	0.3	0.8	3.3	0.8	2.7	1.7	0.9	0.9	0.1
55	Restaurants and hotels	0.7	-0.5	0.6	-0.7	-6.3	2.6	-1.5	-1.1	0.6	-0.7	-6.3	2.6	-1.5	-1.1	-0.7	-6.3	2.6	-1.5	-1.1	-1.4	-1.8	-1.8	-1.4
60-64	Transport, storage and communication	2.0	1.4	4.0	3.0	6.9	8.4	2.5	5.2	4.0	3.0	6.9	8.4	2.5	5.2	3.0	6.9	8.4	2.5	5.2	3.5	3.9	3.9	2.0
60-63	Transport and storage	0.3	..	1.7	1.0	2.3	8.1	-0.2	..	1.7	1.0	2.3	8.1	-0.2	..	1.0	2.3	8.1	-0.2	..	0.8	..	..	1.2
64	Post and telecommunications	6.8	..	10.7	7.1	14.5	8.2	10.0	..	10.7	7.1	14.5	8.2	10.0	..	7.1	14.5	8.2	10.0	..	8.9	..	..	6.4
65-74	Finance, insurance, real estate & business services	-0.6	-0.1	-0.2	-1.2	-0.5	-0.8	-1.8	-3.1	-0.2	-1.2	-0.5	-0.8	-1.8	-3.1	-1.2	-0.5	-0.8	-1.8	-3.1	-0.3	3.2	3.2	-1.6
65-67	Finance and insurance	2.2	0.2	7.6	-1.2	3.5	4.7	0.9	-0.5	7.6	-1.2	3.5	4.7	0.9	-0.5	-1.2	3.5	4.7	0.9	-0.5	1.5	13.0	13.0	1.9
70-74	Real estate and business services	-1.8	-0.4	-1.9	-1.4	-1.8	-2.5	-2.6	-5.1	-1.9	-1.4	-1.8	-2.5	-2.6	-5.1	-1.4	-1.8	-2.5	-2.6	-5.1	-0.8	-0.8	-0.8	-2.7
50-74	Total business services	1.2	1.0	1.7	0.0	1.4	2.6	0.0	0.0	1.7	0.0	1.4	2.6	0.0	0.0	0.0	1.4	2.6	0.0	0.0	1.0	2.1	2.1	-0.1
75-99	Community, social and personal services	-1.4	-0.3	-0.2	0.6	0.0	1.4	0.1	-0.7	-0.2	0.6	0.0	1.4	0.1	-0.7	0.6	0.0	1.4	0.1	-0.7	-0.4	0.0	0.0	0.6
10-67, 71-74	Total non-farm business sector	2.4	..	2.5	1.0	1.6	3.8	0.6	1.3	2.5	1.0	1.6	3.8	0.6	1.3	1.0	1.6	3.8	0.6	1.3	1.0	..	..	0.5
01-99	Grand total	1.9	1.1	1.9	0.9	1.4	3.0	0.6	0.7	1.9	0.9	1.4	3.0	0.6	0.7	0.9	1.4	3.0	0.6	0.7	0.6	1.7	1.7	0.5

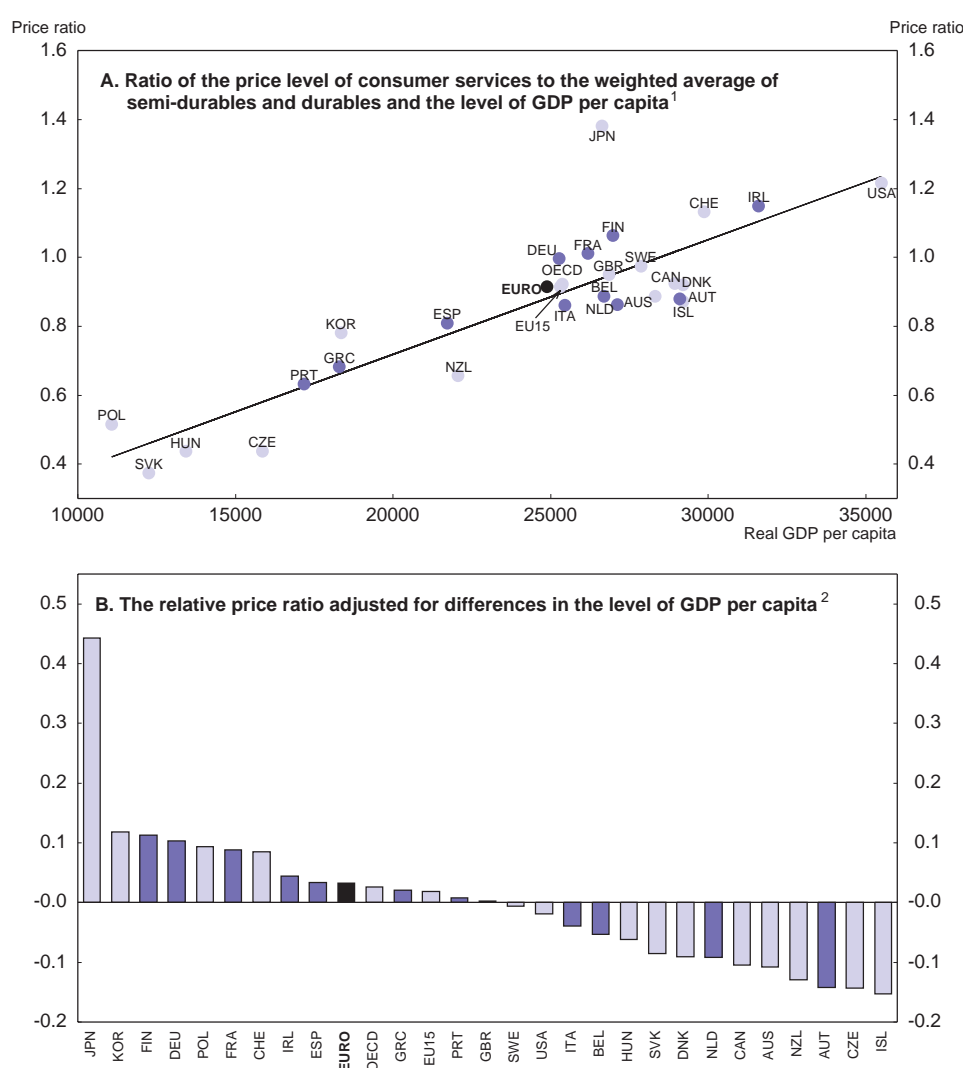
1. Or nearest available year.

2. Excluding Ireland.

Source: OECD, STAN database.

8. There is also a wide dispersion of service price levels within the European Union. In 2003 the highest levels of service prices were found in Ireland, Finland and France, while the lowest were found in Greece and Portugal. Adjusted for cross-differences in per capita GDP, the country ranking changes somewhat, but Finland, Ireland and France along with Germany have still the highest prices (**Figure 3**). This price dispersion shows that the member states, which had a very different starting point regarding service prices, are still in the process of converging towards the best performers in the single market. The physical distance between the member states explains a significant amount of price variation as well as the slow pace of relative price adjustment (Beck and Weber, 2001 and Beck, 2003).

Figure 3. Relative prices of services and GDP per capita
2003



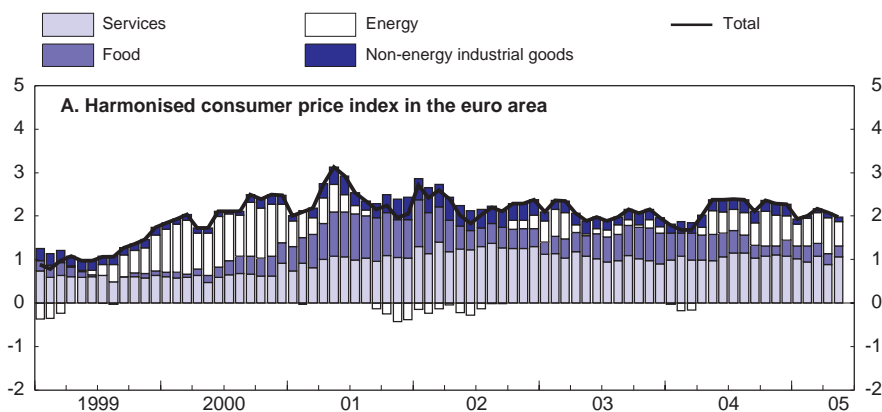
1. Consumer services is a proxy for non-tradable goods and semi-durables and durables are a proxy for tradable goods. The price level of services is based on 2002 data and 2002 PPPs while the GDP per capita is for 2003 on the basis of 2000 PPPs.

2. Measured as the difference in the actual minus the fitted value of the price ratio appearing in panel A.

Source: Eurostat; OECD, *National Accounts and Purchasing Power Parities and Real Expenditures: 2002 Benchmark Year*, 2004 ed.

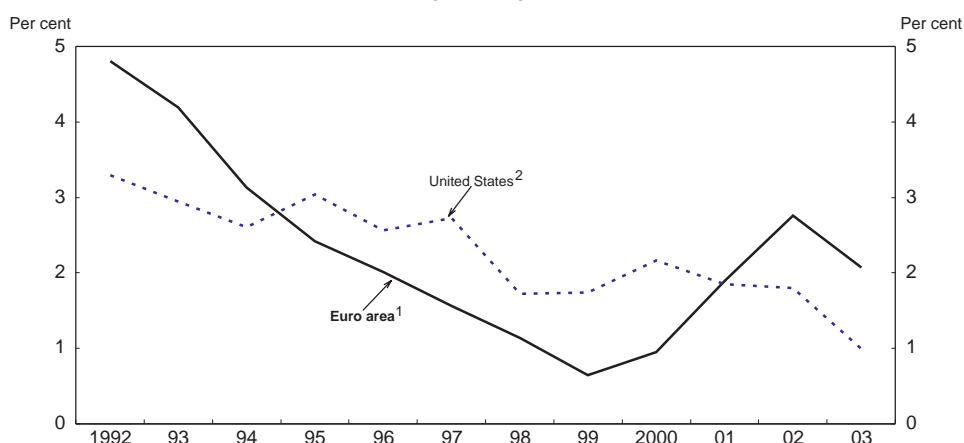
9. The European Commission has found evidence that the high level of inflation persistence can be traced to the service sector (EC, 2004a) (**Figure 4**). Moreover, while service sector inflation has been declining in the United States since 2000, it has been on an upward trend in the euro area (**Figure 5**). This phenomenon is arguably one of the main culprits of the area's inflation persistence and associated weak resilience to shocks compared with other economies – not least because it hampers monetary policy by limiting the scope for reducing interest rates in times of slack. In comparison with the United States, euro area inflation is particularly high in wholesale and retail trade, two sectors where most euro area countries impose stringent regulations (Conway *et al.*, 2005). Some of the increase in service prices in the euro area may be related to the introduction of the cash euro in January 2002, which boosted restaurant prices in all countries in 2002 (Adriani *et al.*, 2004) (**Box 2**). Eurostat, however, although acknowledging a significant increase in restaurant prices in 2002, concluded that the changeover effect cannot be seen as a main factor driving inflation in 2002 (Eurostat, 2003).

Figure 4. Contributions to overall inflation
Year-on-year percentage change



Source: European Commission/Eurostat; US Department of Labor, Bureau of Labor Statistics.

Figure 5. Price developments in market services
Annual percentage changes, GDP deflators



1. ISIC 50-74, average using real business sector services GDP 2000 weights, excluding Ireland.
2. Industry 34 to 67.

Source: US Bureau of Economic Analysis and Eurostat.

Box 2. The euro introduction and restaurant and hotel prices

The public has reportedly viewed the introduction of the euro notes and coins as causing a significant jump in hotel and restaurant prices. According to an investigation by the European Commission, the increase in the overall Harmonized Index of Consumer Prices (HICP) attributable to the introduction of the cash euro was only between 0.12% and 0.29%. Although the aggregate price index saw little or no increase, prices in restaurants and cafes, however, increased strongly in the three months after the euro coins and bills were introduced. In January 2002, the annualised monthly price increase in the restaurant sector was more than 15%. Countries like the Netherlands, Germany, and Finland all registered annualised monthly price increases in their restaurant sectors in January 2002 of more than 20%. This stands in stark contrast with the moderate restaurant price increases observed in the EU countries that did not adopt the euro, the United Kingdom, Denmark, and Sweden. Hobijn, Ravenna and Tambalotti (2004) found that the increase in restaurant prices in the euro area right after the introduction of the euro notes and coins was unprecedented by any recent historical standard, although they consider this not to be unexpected. They claim that the price increase in the euro area restaurant sector is attributable to menu costs prompting suppliers to concentrate their price increases at the time when the euro was introduced.

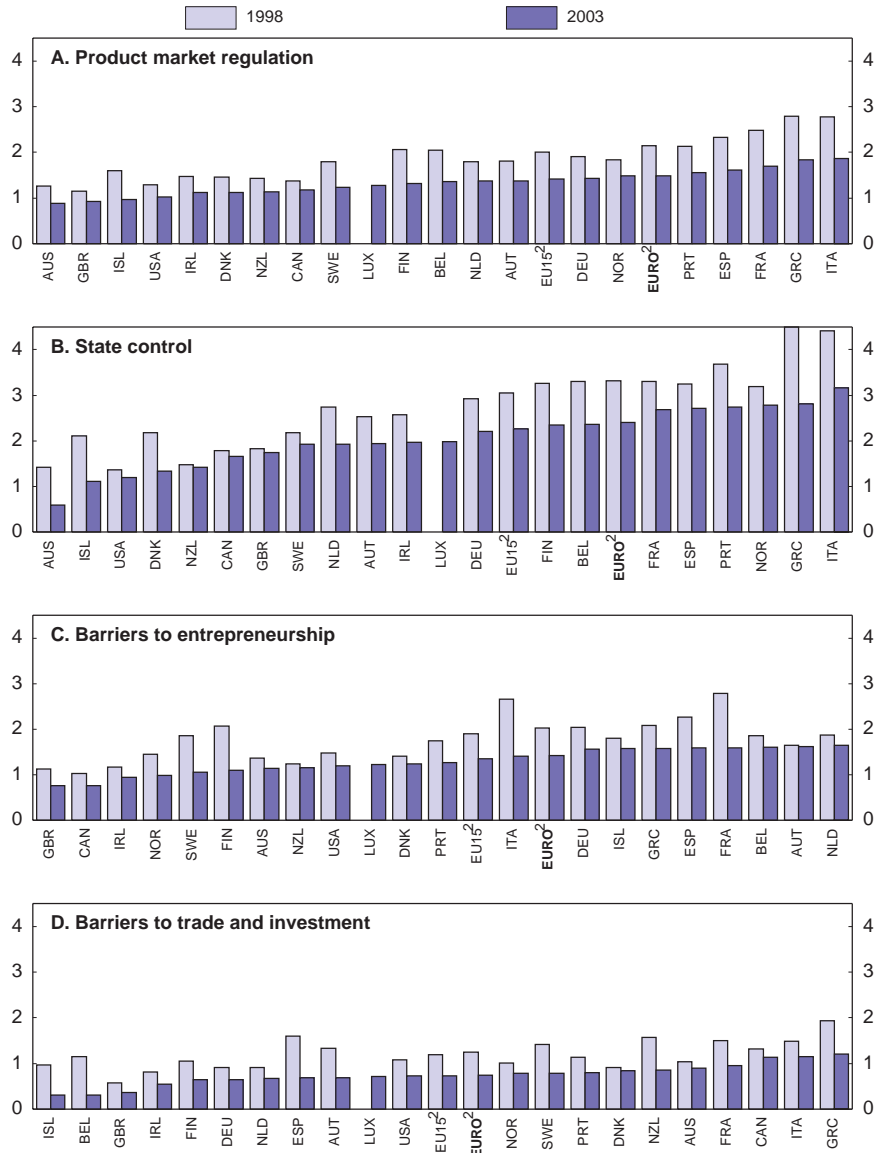
3. Stringent regulations impede the integration of services

10. Services are much more vulnerable to cross-border barriers within the internal market than goods since service delivery often requires the presence of the service provider in the country where the service is delivered. Because of the complex nature of services and the importance of qualifications of the service provider, service businesses are often subject to much more complex rules covering the entire service activity than is the case for goods. Stringent regulations combined with a lack of transparency of the national and local regulations make service exports difficult.

11. In the OECD project on product market regulations, Conway *et al.* (2004) find that product market regulations are heavier in euro area countries than in other OECD countries (**Figures 6 and 7**). Among the euro area countries, Greece, Italy, France, and Portugal were found to be in the group with the most restrictive product market regulations in 1998. These countries recorded however an improvement in overall product market regulation between 1998 and 2003, by reducing state control, in particular by removing price controls in the air transport and telecommunications sectors, and reductions in the extent of direct government control over firms. Only Ireland was in the group of most liberal countries in 1998, together with the United States, the United Kingdom, Canada, Australia and New Zealand. Sweden, Finland, Germany, Belgium, the Netherlands and Spain were estimated to be in the middle group in 1998 with stricter regulations than the abovementioned countries. Countries in the middle group made only small progress between 1998 and 2003 and mainly by reducing the extent of state control by removing price controls and relying less on “command-and-control” regulation.

12. To take stock of cross-country barriers to service expansion, the European Commission has made a comprehensive inventory of the internal market barriers that inhibits cross country service trade and establishment of service providers (EC, 2002). The Commission discovered that many companies find it difficult - or even impossible - to establish in other member states. There are examples of companies who had found it easier to open a subsidiary in some of the new member states than in the EU15. Most companies still “think national” and often do not consider growth across national borders, even if their services are not specifically designed for the domestic market and could potentially be exported. There is a lack of trust and a natural resistance to deal with habits in other member states and there is still a lack of “thinking European”.

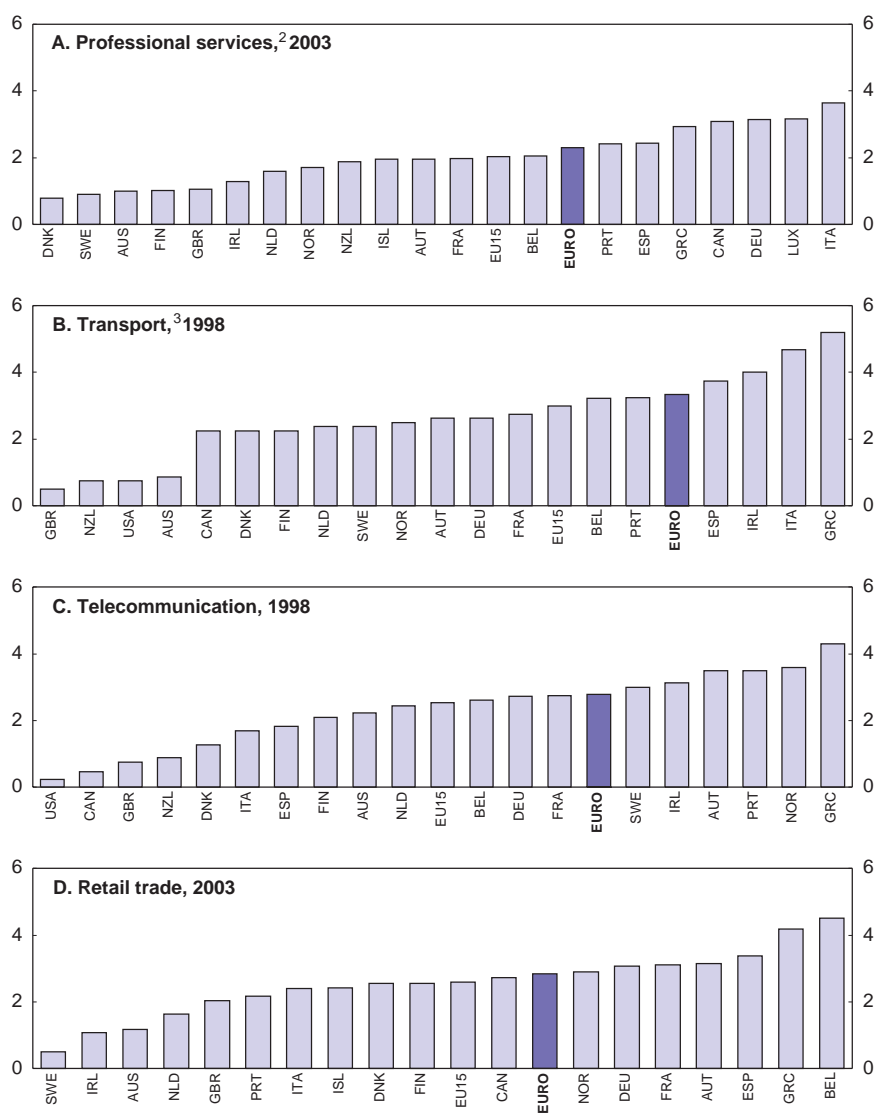
Figure 6. Regulations in 1998 and 2003



1. Index 0-6 scale from least to most restrictive. Countries are sorted by 2003 data.

2. Simple average of individual countries for the euro area and EU15.

Source: OECD, Product Market Regulation database.

Figure 7. Market regulation in some service sectors¹

1. Index 0-6 scale from least to most restrictive.

2. Simple average of indicators for legal work, architectural work, accountancy and engineering.

3. Simple average of air, rail and road transport

Source: OECD, Product Market Regulation database.

13. The report identified a large number of barriers to providing services from establishing a business to distribution, sales and after sales. Quite some regulation is local, which makes it difficult to provide an overview with any precision. Spain has for example a total of more than 700 (national and local) regulations for opening new stores. Numerous examples of problems were given including lack of information on necessary authorisations and planning requirements, qualification requirements, employment law, technical standards for the equipment and material, rules on commercial communications, taxation and contract law. Particular problems occur in areas where there are questions of interpretation of national laws resulting from unclear, inconsistent or unpredictable national jurisprudence. For example, in one member state, seven different local and national licenses are needed to open a hotel or restaurant; while in another a company wishing to open a retail outlet needs a building permit, an environmental permit and a socio-economic permit, as well as having to comply with zoning regulations which can sometimes be highly complex. Transport services are also subject to different requirements in the various member states, particularly as regards the characteristics of the vehicles used, such as lorries and tourist coaches and the diversity of national rail systems which has different gauge widths, different systems for supplying electricity or different maximum axle loads for wagons and locomotives. The most important barriers are listed in **Box 3**.

14. The above suggests that removing and improving regulations is of particular importance to develop the service sector within the context of the single market. Messina (2004) has indeed found evidence that product market regulations have a significant effect on the expansion of service sector employment. Stringent and different regulations in the member states result in considerable costs such as legal assistance, translation and change of business model for companies that engage in cross-country activities. The fact that small and medium-sized enterprises are the main drivers of the services sector makes the situation even more problematic since these companies cannot afford the extra cost it takes to establish abroad. The impossibility of using the same business model in all member states prevents companies from taking advantage of economies of scale and competition is hampered. In the absence of international competition, firms are sheltered from market pressures and have little incentive to innovate. The result may be excess rents to capital or labour, or both, so that profits and/or wages, and ultimately prices, are higher than they would be under competitive conditions.

Box 3. Identified barriers to service trade

- Monopolies in some member states have the effect of preventing the establishment of service providers from other member states in which no such monopoly exists. The monopoly concerned may be one that is entrusted to a specific body (such as postal services or energy utilities), a monopoly on the distribution of certain products or activities reserved exclusively for certain operators.
- Quantitative restrictions on access to service activities, e.g. quotas or numerus-clausus rules governing the number of service providers, rules on maximum surface area, or geographic distance limits between service providers, can place established national operators at an advantage over new entrants. Examples of this can be rules like imposing a limit of 1 optician per 10 000 inhabitants and one driving school per 15 000 inhabitants.
- Territorial restrictions may require authorisation to engage in service activities to a specific region or locality, so that service providers wishing to cover the entire national territory are obliged to become established in several regions. Nationality requirements exist in several member states with respect to shareholders, management and staff of service enterprises and with respect to some regulated professions.
- Residence requirements, particularly those relating to managers of service enterprises, give rise to problems. For example, depending on the particular country, two thirds, one half or at least one of the members of the management board must be resident.
- Some service activities are subject to rules designed to ensure independence and autonomy between different activities, preventing them from being exercised jointly. In one member state, for example, estate agencies are prohibited from engaging in other professional activities such as property management, financial consultancy or cleaning.
- Regulations governing professional qualifications differ. For example, a service provider from a member state with no requirement for a professional diploma wishing to become established in another member state that does have such a requirement will not find it easy to have professional qualifications recognised.
- The different company tax regimes result in obstacles which penalise cross-border establishment of service providers. Although businesses would like to consider the internal market as just one market, numerous problems result from the fact that companies must conform with 15 different fiscal regimes. There is a risk of double taxation and compliance costs increase.
- Price regulations applicable to a certain number of services, whether providing for maximum prices, minimum prices or prices set or recommended by member states or professional bodies are liable to cause problems in the case of cross-border service provision.
- Opening a bank account in the member state in which a particular service is provided is often necessary in order to facilitate payments, but is difficult as it involves making a declaration of residence or of non-residence, which in turn gives rise to tax declarations and causes administrative delays and costs.
- Accounting rules are designed amongst other things to meet tax inspection needs; for this reason, they differ markedly from one member state to another. An enterprise which is active in several member states is therefore obliged to maintain parallel accounting systems while at the same time ensuring consistency in the accounting of the enterprise as a whole.
- The payment and reimbursement of VAT also causes problems. Indeed, the rule according to which services are subject to VAT in the country of establishment of the provider is accompanied by numerous exceptions which give rise to complex situations in the context of cross-border sales. This results in numerous service providers being subject to VAT obligations in member states other than the one in which they are established. Furniture removers, for example, are obliged to deal with the competent authorities in each of the member states in which they offer their services, and ask for a VAT number in each of these member states and settle their affairs according to the different rules.
- More favourable tax treatment for services by local providers is a major hindrance to the provision of services. In some member states, for example, the costs of professional training are tax-deductible only if the courses take place in the particular country concerned. Similarly, life insurance and additional insurance policies, as well as pension fund and investment fund contracts can be offset against tax only if concluded with local insurance companies.
- Difficulties encountered in the context of debt collection are a problem which is exacerbated by long delays of cross-border payments. One particular difficulty relates to the use of debt collection agencies and the protection of creditors' rights in the event of bankruptcy in other member states. An enterprise cannot use its debt collection agency if the latter is not established in other member states: approval formalities for debt collection agencies differ between member states and sometimes even from one region to the next, the provision of legal assistance may be the preserve of the legal professions and the costs of debt collection are not always for the account of the debtor.
- Authorisation for the reimbursement of medical costs incurred in another member state is only granted by national authorities under certain conditions and this may discourage persons insured under social security schemes from turning to service providers established in another member state. Persons who decide for various reasons to travel to another member state to receive medical treatment there, will often not be reimbursed.

4. What are the policy levers?

15. Unleashing market forces in services is key to the Lisbon agenda; hence it is not surprising that the European Commission has been focussing extensively on this issue. The main instrument to that end is the draft *Directive on services in the internal market* (henceforth referred to as the services directive) tabled by the Commission on 13 January 2004.² In the following this paper will highlight the various features of the services directive as well as the policies for sectors that are not covered by the services directive, namely financial services, telecommunications and transport, to take stock of the progress in liberalising the EU services market.

4.1 *The services directive*

16. The services directive builds on EC Treaty Articles 43 and 48, which concern the “freedom of establishment”, and Article 49, which concerns the “freedom to provide services within the Community”. But in practice these principles meet a large number of obstacles. Decisions by the Court of Justice only affect individual infringements of the EC Treaty and one country at a time. The services directive aims at making these work in practice throughout the Union, and not only accessible through case law. The services directive does not cover some sectors such as financial services, transport and telecommunications which are already covered by other Community-instruments and where further Community initiatives are underway (see below). Services performed by the State for no consideration as part of its social, cultural, educational and judicial functions where there is no element of remuneration are also excluded from the scope of the proposed directive. In total, the services covered by the proposal account for around 50% of economic activity in the EU.

17. The directive contains two main elements: 1) freedom to establish a business in another member state and 2) free trade between member states.

4.1.1 *Freedom of establishment*

18. In order to eliminate obstacles to the freedom of establishment, the proposal provides for certain principles which authorization schemes applicable to service activities must respect, the prohibition of certain particular restrictive legal requirements and the obligations to assess the compatibility of certain other legal requirements. The directive contains a black list of regulations that are not compatible with the directive and a grey list with regulations that may not be compatible with the directive (**Box 4**). The services directive also foresees the creation of single contact points by member states and requires member states to ensure that relevant information is easily accessible. This means that a Finnish company which plans to open a store in Italy can contact the Finnish authorities and get an overview of the Italian regulations and all information needed to open the store in Italy. Moreover the directive aims to improve communication between authorities regarding companies that have broken the law, *i.e.* information about doctors who have acted illegally in one country should be passed on to another member states.

Box 4. The “black” and “grey” list of the services directive

Prohibited requirements: the “black list”

Member states shall not subject access to or the exercise of a service activity on their territory to compliance with any of the following requirements:

- Discriminatory measures based on nationality, nationality requirements for providers, staff, shareholders or managing and supervising members or place of the office.
- Prohibition on having an establishment in more than one member state.
- Restrictions on the freedom of a provider to choose between a principal and a secondary establishment.
- A condition of reciprocity with a member state in which the provider already has an establishment.
- A case-by-case application of an economic test making the granting of an authorisation subject to proof of the existence of an economic need or market demand, an assessment of the potential or current economic effects of the activity or an assessment of the suitability of the activity with the economic planning objectives set by the competent authority.
- Direct or indirect involvement of competing operators, including within consultative bodies, in the granting of authorisations or in adoption of other decisions of the competent authorities, with the exception of professional bodies and associations or other organizations acting as the competent authority.
- An obligation to provide or participate in financial guarantees or to take insurance from a service-provider or body established in their authority.
- An obligation to have been entered, for a given period, in the registers held on their territory or to have exercised the activity for a given period on their territory.

Requirements to be evaluated: the “grey list”

Member states shall examine whether their legal system makes access to a service activity or the exercise of it subject to compliance with the following non-discriminatory requirements:

- Quantitative or territorial restrictions.
- Requirements which impose an obligation on a provider to take a specific legal form.
- Requirements which relate to the shareholding of the company.
- Requirements, other than those concerning professional qualifications or provided for in other Community instruments, which reserve access to the service activity in question to particular providers by virtue of the specific nature of the activity.
- A ban on having more than one establishment on the national territory.
- Requirements which stipulate a minimum number of employees.
- Fixed minimum or maximum tariffs.
- Prohibitions and requirements with regard to selling below cost.
- Requirements stipulating that an intermediary provider must give access to certain specific services provided by other service-providers.
- An obligation on the provider to supply other specific services jointly with his/her service.

4.1.2 Freedom of free movement

19. In order to eliminate the obstacles to the free movement of services, the proposal provides for the country of origin principle, meaning that the service provider is subject only to the law of the country in which he is established. It is however important to note that the country of origin principle does not overrule the Posting of Workers Directive (PWD), which states that *temporary workers* abroad are subject to host country provisions with regard to all employment conditions, including minimum wage, holidays, sickness insurance and collective agreements that have been extended to a whole sector (**Box 5**). The country of origin principle is also accompanied by a number of derogations which are general, temporary or applied on a case-by-case basis. There is, amongst others, a general derogation for postal services and distribution of electricity, gas and water and derogations regarding specific requirements applicable in member states where the service is provided linked to the particular characteristics of the place and which are necessary in order to maintain public safety and health provisions or the protection of the environment.

20. The services directive will, however, have major implications for *self-employed workers*. Since they are not covered by the PWD, self-employed workers could supply services cheaply in the host country – indeed perhaps undercut rates in the black economy in that country. They would still have to comply with host country regulations on consumer protection and on safety and health risks, and any workers hired in the host country would be covered by local law. Several high-cost EU-countries view the freedom of self-employed workers to supply services on a temporary basis as a threat to social interests, and this partly explains the reticence in *e.g.* Germany and France.

Box 5. The Posting of Workers Directive

The employment conditions of workers posted by their employer in another country on a temporary basis are regulated by the Posting of Workers Directive (PWD).¹ The PWD requires that posted workers should benefit from similar employment conditions to those applicable to local workers in the host country. More specifically, the working conditions covered by the directive include minimum wages, working time, minimum paid leave, the protection of temporary workers, health and safety standards and anti-discrimination measures. The PWD applies regardless of whether the corresponding rules stem from acts, regulations or administratively extended collective agreements. The administrative simplification provisions enshrined in the services directive have however prompted fears that workers' rights will be eroded and have played an important role in the trade union movement expressing strong reservations about the proposal (European Trade Union Confederation, 2004).

The PWD aims at protecting local workers against the competition of posted workers with lower compensation claims (Davies, 1997). To take one topical example, estimates reported by Meier (2004) show that the German construction sector counted between 100 000 and 200 000 foreign posted workers, whose wages averaged about 30% below their German counterparts, while 300 000 German construction workers were unemployed. As Meier (2004) observes with an analytical model, rising costs in the sectors that are covered by the directive pull down real wages in the rest of the economy, have an ambiguous effect on real wages in the construction sector and are most likely to reduce overall social welfare. The PWD limits the scope for enhancing competition and greater gains that are likely to ensue. Nonetheless, the services directive does not attempt to reform the PWD.

1. The directive 96/71/EC concerning the posting of workers in the framework of the provision of services was adopted on 16 December 1996.

4.1.3 Expected benefits from the services directive

21. With its very wide scope, the services directive can be expected to bring about large employment and welfare gains. The fragmented and diffuse nature of the many obstacles to the free flow of services implies that the impact of the directive is very difficult to quantify. In its impact assessment, the EU Commission (2004b) noted that the creation of a well-functioning internal market for services could result in gains on a scale equivalent to those generated by the Single Market Programme in the field of goods (1.8% increase in GDP and 2.5 million jobs). At the other extreme, a very conservative reckoning by Copenhagen Economics (2005) puts employment and welfare gains at 0.3 and 0.7% respectively. But the Copenhagen Economics figures include static effects only – even though most of the gains from stronger competition are of a dynamic nature – and are thus bound to underestimate the benefits by a wide margin. In particular, the Copenhagen Economics study focuses only on the effects of price convergence and does not account for the labour productivity gains that the directive would entail. The CPB Netherlands Bureau for Economic Policy Analysis (2004b) found firm indications that the proposed services directive will create a substantial increase – up to a third – in cross-border trade and investment, which are currently severely restricted by the heterogeneity of regulations across countries. Guerrieri *et al.* (2005) found that EU output growth can be significantly increased in line with the objectives of the Lisbon agenda if the availability of business services and accumulation of knowledge are enhanced by improving the regulatory environment, deeper integration of the service market and a stronger impact of technology diffusion.

4.1.4 Is there a risk of social dumping?

22. Despite its anticipated benefits, the services directive has met heavy opposition from different parties, in particular the labour unions. Its transversal approach implies eliminating rents in many sectors, including the regulated professions, thereby making it advantageous for a variety of powerful special

interests to coalesce against the proposal. In addition, misunderstandings about the interaction of the proposed services directive with the existing Posting of Workers Directive and scepticism regarding the possibility of enforcing this directive has fuelled fears of social dumping, while others have argued that services, such as health care should be excluded. In public comments the country-of-origin principle has been misinterpreted and the directive has been linked with the issue of movement of persons from the new to the old EU member countries (**Box 6**). Skilful use of these misunderstandings has enabled interest groups to create considerable resentment in public opinion against the proposed directive. In order to address these fears and enhance the public acceptance of the directive the Commission has signalled its willingness to review aspects of the directive.

Box 6. The services directive and the movement of posted workers and the self-employed

The freeing up of the provision of services across borders has raised anxieties in high-cost countries. For example, even though the free movement of workers is covered by other legislation and not by the services directive, fears have been expressed that the services directive would prompt movement of workers from the new to the old EU member countries, not least since the implementation of the directive would coincide with the ending of transitional arrangements restricting migration flows from the new EU member countries.¹ West German wages, for instance, are six times those in Poland, even though in purchasing power parities, differences in real wages are considerably smaller.

Since the services directive does not overrule the Posting of Workers Directive (**Box 5**), posted workers in the old EU member countries would be subject to host country labour market regulations. Hence for posted workers to be able to undercut labour conditions in the host country, one would need to assume that the PWD will prove difficult to enforce. However, even if the PWD is enforced, posted workers will exert a downward pressure on host-country wages. While the services directive is likely to generate substantial economic gains for the Union as a whole, the question thus arises as to whether nationals of high-cost countries would be less well off if the services directive raised cross-border provision via migration.

In a broader context and apart from the specific scope of application of the services directive, theory suggests that the free movement of people will be advantageous for all countries in the Union. What immigrants earn exceeds the loss in output at home caused by emigration, while what they earn in the old EU countries is normally less than their output. Only the last immigrant receives a wage that equals the immigrant's contribution to national output. Migration will, of course, affect wages. Assuming an aggregate production function with constant returns to scale in the host country, immigration will raise labour supply and reduce the wage rate of occupations that offer similar services as the immigrants. But the national income accruing to nationals in the host country will rise – the so-called immigration surplus (Borjas, 1994) – as the owners of capital and real estate will gain as well as the occupations that are not subject to competition from immigrants.² This model implies that there will be losers in the west, but also that there will be a gain from immigration, with the winners winning more than the losers lose (Sinn, 2004). At the same time, wages will go up in the country of origin as labour gets scarcer. The shrinking in wage differentials over time will reduce incentives to migrate. They will cease to have an effect, when the wage differential equals the migration costs.

While immigration could hurt the wage income of some occupations, immigration also expands the size of the market and could thus lead to economies of scale, while the services directive is likely to generate large efficiency gains. In this case the marginal product of both labour and capital increases, which could increase the size of the immigration surplus substantially and even those occupations subject to pressure from immigration, may not suffer.

Of course, gains from immigration will be smaller, if labour markets do not function well. If real wages fail to adjust in the host country, immigration will lead to higher unemployment. But this is not an argument against the services directive, but in favour of labour market reforms.

In addition, the services directive could trigger an outflow of capital towards the new EU member countries as companies may take advantage of the comparatively low labour cost. If so, the demand for labour in the new member countries would rise and eventually real wages would adjust up to a level where the real wage differential between the new and old member countries would be exactly offset by the migration cost of capital. Meanwhile the demand for labour in the old member states would fall, and unemployment would increase in the absence of labour market reforms.

1. All euro area countries have administrative restrictions on immigration for a seven year period. However, it does not apply to the posting of workers. The Ifo Institute projected that 4 to 5% of the population of the new member countries will emigrate to the old EU countries (Sinn, 2004).

2. Davis and Weinstein (2002) have challenged the notion of a positive immigration surplus. They argue that a large, technologically superior region is likely to experience a terms-of-trade deterioration from immigration, because at initial prices, the production of the immigrants leads to an excess supply in world markets and adjustment occurs through the deterioration in the terms of trade. The better integration of services in Europe is unlikely to lead to strong terms of trade effects, however, and while lower export prices could hurt the income of nationals, the net effect on welfare has also to take into account lower consumer prices for the nationals.

23. Since the proposal leaves unchanged the Posting of Workers Directive the services directive does not open the gates to social dumping. Neither directive prevents member states from supervising companies and workers operating on their territory and member states where the service is provided would continue to enforce working conditions. They can still carry out spot checks, for example on construction sites, and demand all relevant information from the company which has posted workers there (EC, 2005). The unions fear however that the control possibilities will be more limited as they expect a large number of workers to come. Due to the differences in wages, there is a possibility that this may be the case. If so, uncontrolled immigration could reduce the wage income of native labour in the short term. Due to the expansion of the size of the market the directive will however also lead to economies of scale, and since labour supply for the area as a whole is unchanged there will be little direct implication for wages on aggregate. While the adjustment processes may hurt some groups in the short run, it must be kept in mind that it is the EU citizens as a whole that will benefit from the liberalization of the service market as prices fall and jobs are created.

4.1.5 *The state of play*

24. The directive is currently being considered by various EU bodies. In March 2005 the European Council underlined that the internal market for services has to be fully operational, but that the European social model should be preserved. It also stated that the ongoing debate shows that the directive as it is currently drafted does not fully meet these requirements. The directive is currently being discussed in the European Parliament by ten committees, with the Committee on the Internal Market and Consumer Protection as the lead committee. The committee has presented amendments, which propose a substantial narrowing of the scope of the directive and to replace the country of origin by a mutual recognition principle (**Box 7**). The Parliament will have a plenary vote on these amendments in October 2005. Based on the feedback from the Parliament and the Council, it seems likely that the services directive will be revised. It is, however, important that the European Commission resist a heavy watering down of the directive's main provisions in order not to lose the economic benefits.

Box 7. The Gebhardt draft report

The draft services directive has been submitted to the European Parliament for a first reading. This has led to a proposal by MEP Evelyne Gebhardt for an amendment to the Parliamentary Committee on the Internal Market and Consumer Protection.¹ The amendment considerably narrows the scope of the directive. Specifically:

- It exempts “services, which are commercial, but pursue a general interest objective”, which is much broader than “public services”, from the directive. It leaves it to the member countries to define “services of public interest”, but this is understood to not only include health care (including private provision), but also regulated professions and crafts – thus removing most of the potential economic benefits from the directive.
- It drops the “country of origin principle” in favour of a “mutual recognition” clause, but only explicitly applies this to business-to-business services and certain business-to-consumer services, with a very long list of derogations. The rewrite would force the Commission to launch a massive harmonisation operation, which is potentially costly. The Commission would prefer to harmonise regulations on consumer protection only and then apply the country of origin principle, as is the current practice for e-commerce and television broadcasting.
- Among the new features the proposal aims for an improvement in the role of “one-stop shops” and says that the administrative procedures at one-stop shops should be kept to a minimum. At the same time, the one-stop shop should give additional guarantees of the right of the host state to carry out controls and that the one-stop shop should act as the contact both for providers wishing to set up a business in another member state and for those wishing only to supply a service on a temporary basis in another member state.

While the rewrite maintains the freedom of cross-border business establishment for services, the reduced scope of the directive would also affect this principle. Moreover, the impediments to cross-border trade of services due to

these amendments would deprive medium-sized businesses from the possibility to test markets abroad before they decide to establish a foreign subsidiary. This is less of a concern for big companies which can afford to cope with a different regulatory regime in the host country. There is also a more fundamental problem associated with applying the mutual recognition principle, as opposed to the country of origin principle, in the case of services. The mutual recognition principle assumes that the specific service at hand is regulated. However, in practice the service provider rather than the service itself is usually regulated. For example, there often is regulation regarding the standards of certification of skills (diplomas), but not regarding the service itself because service products are often relatively heterogeneous or tailor-made and not well defined. As a result, it will prove very difficult to enforce the mutual recognition principle in practice, whereas the country of origin principle is relatively easy to enforce.

1. European Parliament, *Draft Report on the Proposal for a Directive of the European Parliament and of the Council on Services in the Internal Market*, Committee of the Internal Market and Consumer Protection, provisional, 2004/0001(COD).

4.2 *EU policies for the sectors not covered by the services directive*

4.2.1 *The Financial Services Action Plan*

25. The Financial Services Action Plan (FSAP) is the Community's central tool for fostering financial market integration (**Box 8**). It is due to be fully implemented by end-2005. In the 2002 *OECD Economic Surveys of the euro area*, the implementation of the FSAP was assessed and the OECD recommended further efforts in implementing the FSAP by 2005 in a satisfactory manner (OECD, 2002). Although major progress has been made since then, there are still lacunae and political agreement at the EU level has yet to be reached on three proposed directives relating to cross-border mergers, aspects of company law (including the transfer of headquarters to another EU member state) and capital adequacy requirements for banks and investment firms. Against this background, barriers to achieving the objectives of the FSAP remain and highlight the very real difficulties in harmonising national legislation and legal concepts. Two examples are important.

- The directive on takeover bids was intended to harmonise rules governing the bid procedure and the use of takeover defences, and to protect minority shareholders. While some minimum standards have been set, the directive agreed by the EU Council in November 2003 and passed by the European Parliament the following month went some distance in the opposite direction by allowing member states to opt out of the articles with regard to takeover defences. The general rules require mandatory authorisation of takeover defences by shareholders and the suspension of special defensive rights such as multiple voting shares. However, governments reserve the right not to require companies to apply the new provisions. In that case, a company may opt for an investor friendly regime but can also opt out. It can be argued that the directive focuses too much on multiple voting rights as a barrier to takeovers but is rather silent on other barriers which are practiced widely in Europe, such as voting caps, golden shares or double voting. Such provisions preserve national champions.
- One and a half years after the EU Commission put out its proposal for a directive on cross-border mergers, the EU Council reached a political agreement in November 2004, which was accepted by the Commission. One of the main issues at stake in the Council discussions was the provision on employee participation. It was finally agreed that employee participation in the newly created company will be subject to negotiations based on the model of the European Company Statute. When companies with different degrees of worker representation merge, trade unions can force the merged firm to comply with the higher standards if at least one third of the total number of employees before the merger were covered by a workers' participation scheme.³

Box 8. Individual measures in the Financial Services Action Plan

Strategic objective 1: a single EU wholesale market

1. Upgrade the two Directives on Prospectuses.
2. Update and upgrade the Regular Reporting Requirements.
3. Directive on Insider Dealing and Market Manipulation (market abuse).
4. Communication on and Directive to upgrade the Investment Services Directive (ISD).
5. Communication on Conduct of Business Rules in the ISD (distinction between professional and retail investors).
6. Amend the 4th and 7th Company Law Directives to allow fair value accounting.
7. Communication updating of the EU accounting strategy followed by legislative action.
8. Modernisation of the accounting provisions of the 4th and 7th Company Law Directives.
9. Recommendation on EU auditing practices (quality assurance and auditor independence).
10. Implementation of Settlement Finality Directive.
11. Directive on financial collateral arrangements.
12. Adoption of the proposed Directive on Take Over Bids.
13. Political agreement on the European Company Statute.
14. Review of EU corporate governance practices.
15. Amend the 10th Company Law Directive.
16. 14th Company Law Directive.
17. Commission Communication on Funded Pension Schemes.
18. Adoption of the two Directives on UCITS.
19. Directive on the Prudential Supervision of Supplementary Pension Funds.

Strategic objective 2: open and secure retail markets

20. Political agreement on proposal for a Directive on the Distance Marketing of Financial Services.
21. Commission Communication on clear and comprehensive information for purchasers.
22. Recommendation to support best practice in respect of information provision (mortgage credit).
23. Commission report on differences between national arrangements relating to consumer-business transactions.
24. Interpretative Communication on the freedom to provide services and the general good in insurance.
25. Proposal for amendment of Insurance Intermediaries Directive.
26. Commission Communication on a single market for payments.
27. Commission Action Plan to prevent fraud and counterfeiting in payment systems issue.
28. Commission Communication on an e-commerce policy for financial services.

Strategic objective 3 : state-of-the-art prudential rules and supervision

29. Adopt the proposed Directive on the Reorganisation and Winding-up of Insurance Undertakings.
30. Adopt the proposed Directive on the Winding-up and Liquidation of Banks.
31. Adopt the proposal for an Electronic Money Directive.
32. Amendment to the Money Laundering Directive.
33. Commission Recommendation on disclosure of financial instruments.
34. Amend the Directives Governing the Capital Framework for Banks and Investment Firms (Basel 2).
35. Amend the solvency margin requirements in the Insurance Directives.
36. Amendment of the Insurance Directives and the ISD to permit information exchange with third countries.
37. Adopt a Directive on Prudential Rules for Financial Conglomerates.
38. Commission Decision for a Securities Committee and a Committee of Securities Regulators.

General objective: wider conditions for an optimal single financial market

39. Adopt a Directive for ensuring taxation of interest income from cross-border investment of savings.
40. Implementation of the December 1997 Code of Conduct on business taxation.
41. Review of taxation of financial service products.
42. Commission initiative on taxation of cross-border occupational pensions.

Source: OECD (2002).

26. Since the transposition of legislation agreed under the FSAP into national legislation is still incomplete, its impact on integration is only beginning to be felt. Based on quantitative measures, the ECB (2004) finds that, five years after the introduction of the euro, the level of integration achieved in the different segments of the European wholesale capital market has remained heterogeneous. They conclude that integration has progressed faster and more deeply in market segments where product specification has been defined on a market-wide basis, where the rules applying to transactions and the practices followed by market participants have been harmonised across the area, and where a common infrastructure exists. At this juncture, the key issue is to achieve fast and consistent implementation of the directives at the national level consistent with earlier commitments of full implementation by 2005 so as to reap the benefits from integration. The Lamfalussy arrangements, which have established committees of supervisors in charge of monitoring the consistent transposition of EU financial regulation, will play a key role in this respect. Meanwhile, retail markets have remained segmented, with retail banking merger activity mainly taking place within countries rather than cross-border. Recent initiatives at EU Council and Commission level, however will hopefully take away barriers to cross-border consolidation. Initiatives to integrate mortgage markets have so far been piecemeal. In its financial services policy for 2005-2010, the European Commission will propose carefully-targeted measures to improve the functioning of markets for retail financial services, including mortgage markets.

4.2.2 *Transport*

27. In September 2001, the Commission proposed in a white paper “European transport policy for 2010: Time to decide” to bring substantial improvements in the transport sector by developing a modern, sustainable transport system by 2010. In the white paper the Commission suggests about 60 measures to make overall transport efficient, of high-quality, and safe and at the same time, to shift the balance between modes of transport by revitalizing the railways, promoting sea and inland waterway transport, controlling the growth in air transport, and developing inter-modality by combining road-rail, sea-rail or rail-air transport (WTO, 2004).

28. While good policy intentions have focused on part of the transport sectors, precious little decisive action has taken place. EU efforts to create an integrated market for transport services give a central role to the *railways* sector. As a first step towards instilling competition, the first railways package, passed in March 2001, established the principle of vertical unbundling between transport providers, infrastructure operators and regulators.⁴ It is still not fully implemented as it has not been transposed by Germany and Greece. A second railways package passed in April 2004 provides that freight services – including cabotage – will be fully competitive as from 1 January 2007.⁵ The Commission took a further step in March 2004 with the third railways package which proposes the opening up of international passenger services as from 2010.⁶ The proposal is still under discussion in the EU Council.

29. The *air transport* sector remains fragmented despite the adoption of the “single European sky” in 2004. Contrary to what its name may suggest, the regulation of 10 March 2004 laying down the framework for the creation of the single European sky does not create a single European airspace but authorises the cross-border provision of traffic control services, for which the primary responsibility remains with member countries, and reinforces co-operation among national regulators (Van Houtte, 2004). In practical terms, this means that, under the single European sky, a flight from Rome to Brussels still has to deal with nine different control centres. Furthermore, a string of bilateral “open sky” agreements between member states and third countries contain provisions that advantage the airlines of the signatory countries relative to operators from other EU countries. The EU Commission entered into negotiations with the United States on an accord that would supersede existing bilateral treaties but, after six negotiating sessions between October 2003 and June 2004, no agreement was reached.

30. In *road transport*, the goal of promoting congestion charging, which was laid down by the EU Commission in its 2001 white paper, is still remote. The current situation in which tolls are often absent or loosely related to external costs is associated with large welfare costs because of the economic losses from congestion and of the environmental damage from emissions (European Commission, 2001). Congestion charging could thus bring considerable benefits. Nevertheless, the directive proposed by the Commission in July 2003 as a first step in this direction, which aimed at introducing toll fees based on economic and environmental costs for lorries, is still in limbo.

31. Progress towards a competitive market for transport services has proved even more difficult in the area of *ports*. The EU Commission presented a directive on market access to port services in February 2001.⁷ An important provision was to end the monopoly of port authority workers on the loading and unloading of ships. Despite a 25 year delay before exposing incumbents to competition, the proposal has met with strong opposition from trade unions and was ultimately rejected by the European Parliament in November 2003. Meanwhile, the Commission has tabled another liberalisation package in late 2004.

4.2.3 *Telecommunications*

32. In 1999, the Commission launched a major review of the sector. The review resulted in the adoption of a new regulatory framework in March 2002; the new framework entered into force in July 2003. The new framework for telecommunications aims at establishing a harmonised regime across member states, promoting more competitive markets and technology-neutral regulation, and guaranteeing basic consumer interests. Other legislative instruments of the new regime include: the Radio Spectrum Decision, which establishes principles and procedures for the development and implementation of an internal and external EU radio spectrum policy, the Commission Competition Directive, which consolidates the legal measures that have liberalised the telecommunications sector over the years, the Commission guidelines on market analysis and the assessment of operators with significant market power, which set out a common methodology and principles for the national regulatory authorities charged with these tasks and the Commission recommendation on relevant markets, which defines a list of 18 relevant electronic communications markets to be examined (WTO, 2004).

33. Three years after its adoption, the implementation of the new regulatory framework for electronic communications is still incomplete and the implementation gap is wide in the euro area as Belgium, Germany, Greece, France, Luxembourg and the Netherlands are not complying with the directive.

5. **Concluding remarks**

34. A decade after the envisaged completion of the internal market, there is still a considerable gap between the vision of an integrated economy and the reality as experienced by European citizens and European service providers. There are many barriers that hinder the expansion of services and amounts to a considerable drag on the economy and its potential for growth, competitiveness and job creation. It is clear that the goal set by the Lisbon Council to make the European economy the most competitive in the world cannot be met unless sweeping changes are made to remove barriers to cross-border services.

35. Stringent regulations have resulted in low productivity, higher costs and prices, misallocation of resources, lack of innovation and poor service quality and in the end it is the EU citizens who pay the price for an ineffective service sector. Easing of regulations will play an important role in boosting economic growth in services by increasing the potential for specialisation and economies of scale by improving the competitive environment. Given the key role of services, this in turn will affect the performance of the entire economy.

36. The potential gains from the integration of services markets fall into two broad categories:
- *Welfare effects associated with the convergence of prices towards the best performers.* The wide dispersion of services prices in the euro area countries is an indication that a large scope for efficiency gains is being left unexploited.
 - *Faster trend economic growth.* Growth of labour productivity in the services sector in the euro area has been poor in international comparison. The productivity growth gap is particularly marked for business sector services where market conditions are most likely to weigh on measured efficiency. The integration of services markets would spur trend growth by realising economies of scale, better exploiting comparative advantages and improving the allocation of resources at large.
37. In this context, the initiative to implement the services directive is indeed very welcome. The scope of the directive is promising, but the parliamentary amendments indicate a great risk that the directive may be watered down. Such watering down will hamper integration and delay the achievement of a single services market and should be avoided. Moreover, implementation of the Financial Services Action Plan, the transport plan and the telecoms package has been slow and in addition the large public sector is kept outside the services directive regardless of the fact that some parts are public in one country and private in others. In any case, adoption of the services directive is an important first step towards a single service market becoming reality.

NOTES

1. Seconded to the Economics Department by the Ministry of Finance of Norway. This paper expands on work undertaken in preparation for the 2005 *OECD Economic Survey of the Euro Area* (OECD, 2005), but does not necessarily reflect the views of the Organisation or its member countries.
2. Commission proposal COM (2004)2.
3. This provision applies when the higher standards covered more than a third of the workforce prior to the merger.
4. Directives 2001/12/EC, 2001/13/EC and 2001/14/EC, all of 26 February 2001. In those countries, that have unbundled, the separation of infrastructure and operation of passenger services has led to still unresolved conflicting incentives that threaten to undermine investment and service quality.
5. Directives 2004/49/EC, 2004/50/EC, and 2004/51/EC, all of 30 April 2004.
6. Commission proposals COM(2004)139, COM(2004)140, COM(2004)142, COM(2004)143 and COM(2004)144, all of 3 March 2004.
7. Commission proposal COM(2001)35 of 13 February 2001.

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