

## **Securing EU Growth from Services**

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### **Abstract**

This paper explores the untapped EU growth that could result from the better functioning of services markets and aims to bridge the gap between the EU policy debate, which is often framed in generalities about services, and the latest empirical economic analysis on the growth and productivity that might be generated by services markets. The authors find ample scope for further EU economic growth, both from domestic services reforms and from the deepening of the 'single services market'. Domestic and EU-level services reforms are so intertwined economically that, indeed, we may speak of a 'double dividend' and, for the eurozone, of a 'triple dividend'.

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# Contents

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1. Why emphasise EU growth from services?.....	1
2. EU strategies of services reform.....	3
2.1 Towards a single services market.....	3
2.2 Reforms of domestic services markets.....	7
3. Better services performance: What economic research tells us.....	9
3.1 Comparative productivity growth analysis.....	9
3.2 How services reform can support industrial competitiveness.....	11
3.3 On domestic services reforms.....	12
3.4 How the single services market can contribute to EU growth.....	16
4. Conclusion.....	20
References.....	23

## List of Figures and Tables

Figure 1. Sectoral value-added contribution in the EU (% annual growth).....	1
Figure 2. Sectoral employment growth (% annual growth).....	2
Figure 3. Intra-EU27 trade in service, exports in 2008.....	4
Figure 4. Intra-EU27 FDI in service, abroad in 2008.....	5
Figure 5. Domestic reforms due to the Services Directive in Germany.....	8
Figure 6. The ratio of purchased services to output in EU10 and EU15.....	11
Figure 7. Development of aggregate product market regulation since 1998.....	13
Figure 8. Sources of reform in product market regulation by sector.....	14
Figure 9. The impact of non-manufacturing regulation on the manufacturing sector, 2003...15	15
Figure 10. The burden of non-manufacturing regulation on ICT-using and non-ICT using sectors, 2003.....	15
Table 1. Sectoral labour productivity growth in market services, 1980-2005 (average annual percentage points).....	9

# Securing EU Growth from Services

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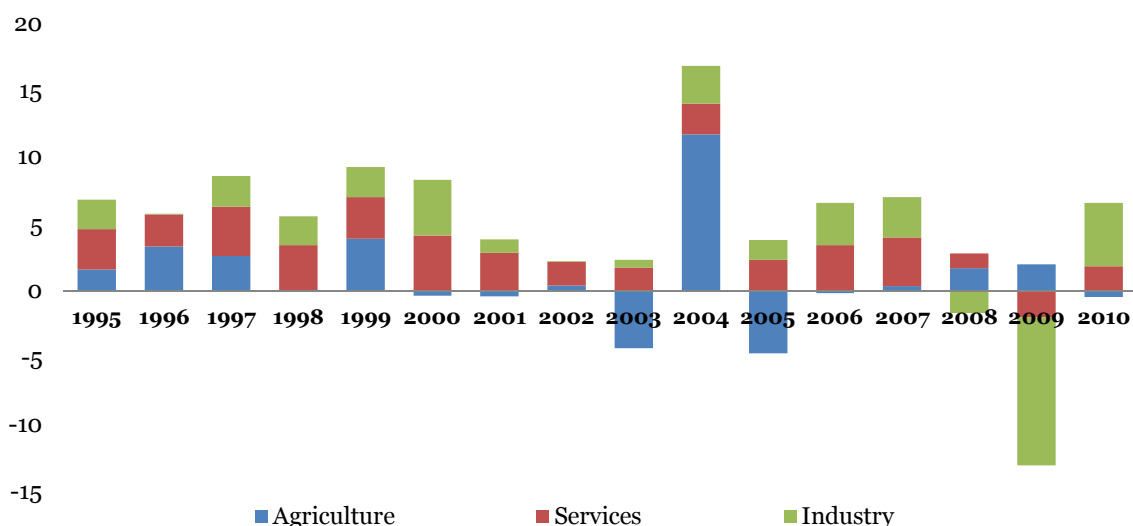
Federica Mustilli and Jacques Pelkmans\*

## 1. Why emphasise EU growth from services?

The European Union (and perhaps even more so the eurozone) is wholly preoccupied with finding sources of economic growth at the moment. With extra public spending ruled out, private spending at best stagnant, almost no increase expected in labour and capital and little scope for a significant increase in R&D, the call for the better functioning of services markets in Europe grows louder all the time. More often than not, however, the suggestion of 'securing growth from services' remains exceedingly general. It begs the question whether and how better functioning of the services markets could lead to higher growth in the EU. Indeed, it seems that when referring to services many EU leaders and observers blend 'assertion' with 'hope' in their attempts to send out a positive message in the crisis. This paper attempts to bridge the gap between the EU policy debate, which is often framed in generalities on services markets, and state-of-the-art empirical economic analysis on growth and productivity that better functioning services markets can boost growth in the Union.<sup>1</sup>

Service activities have mattered for EU growth for many years now, as Figure 1 makes clear. During 13 of the 16 years depicted, the contribution of services to annual EU growth in terms of value added is greater than that of industry. Services markets have also consistently generated job growth in the EU, as shown in Figure 2. It is therefore of utmost importance to

Figure 1. Sectoral value-added contribution in the EU (% annual growth)



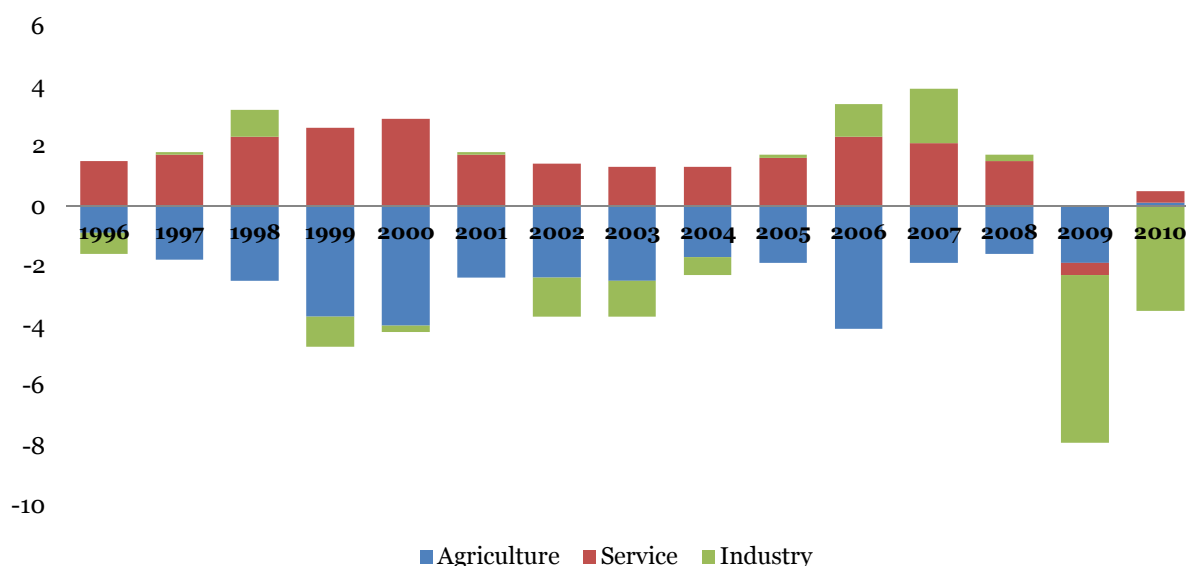
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<sup>1</sup> The authors have benefited from their participation in SERVICEGAP, an FP7 project funded by the European Commission, analysing the growth and productivity effects from the internationalisation of services with firm-level data.

Source: World Bank, World Development Indicators (2012).

the EU economy to move the better functioning of services markets centre stage. We shall bring together empirical economic evidence about today's large, untapped EU growth potential, which could be within reach once better policies and regulation are pursued at EU and national levels.

Figure 2. Sectoral employment growth (% annual growth)



Source: Eurostat (2012).

The economic understanding of the (good and bad) functioning of services markets has improved markedly in recent years. Similarly, empirical knowledge about regulation and anti-competitive structures of various services markets in EU member states, and about the numerous and complex barriers within the EU internal services market has drastically improved. And the grand experiment of the horizontal services Directive 2006/123 (initially known as the Bolkestein Directive) has turned out to be a blessing in disguise due to the intense domestic screening of services laws by member states, the 2010 mutual-evaluation exercise between member states and the active follow-up by the European Commission ever since. This recent empirical literature is helpful in making the case for better functioning national services markets and the proper functioning of the single market for services as a boon to higher EU economic growth.

Section 2 of this report summarises the EU policy dimension in two complementary ways: the internal services market and the EU aspects of domestic reform of services markets. Section 3 surveys the main empirical findings of recent economic research, providing a more robust economic underpinning of both services' reform strategies. After first recalling the economic debate on the gap between the US and the EU in productivity growth (see section 3.1), which widened suddenly after 1995 and is (largely) attributed to differences in services performance, we briefly address the importance of better functioning of services markets for European industry and its global value chains that are so critical for competitiveness (section 3.2). In sections 3.3 and 3.4, the economic potential of, respectively, domestic services reforms and the EU single services market are discussed. Particularly striking is the interdependence in economic terms between the deepening of the EU internal services market and national reforms of services markets. Moreover, there is also a link with the better functioning of the

monetary union. Section 4 draws policy conclusions for both the EU and national services markets.

## 2. EU strategies for services reform

The liberalisation of services is a latecomer to the process of European integration. And strategies were highly selective at first. The belated and slow deepening and widening of an EU services strategy can be explained by such factors as the priority given to the single EEC market for goods, the initial (often powerful) resistance by national vested interests, social and political sensitivities with respect to certain services (either because of their labour-intensity, the strategic nature of network industries or the public/universal service obligations of the latter), a lack of (economic) understanding of services, the extremely wide range of service types and the economic nature of services (most services are not easily 'tradable' across borders, and the kind of market failures involved generate complex regulatory issues). Finally, there is the problem of two-level government, with 'domestic' services remaining under national regulatory autonomy. The relevant articles of the Treaty on the Functioning of the European Union (TFEU) have remained very general and unchanged for 55 years.

Moreover, in some services markets (e.g. freight rail, gas and electricity, road transport, air traffic control), the notion of a single market in services has to include a strategic and long-run approach to infrastructure investments, which introduces yet another two-level governance problem. The following stylised discussion of today's EU services strategy distinguishes two 'tracks', which at were at first separate but recently have become increasingly interrelated: the single EU market for services and the domestic (reforms of) services markets, the latter being either in compliance with EU obligations or simply as domestic reform initiatives.

### 2.1 Towards a single market for services

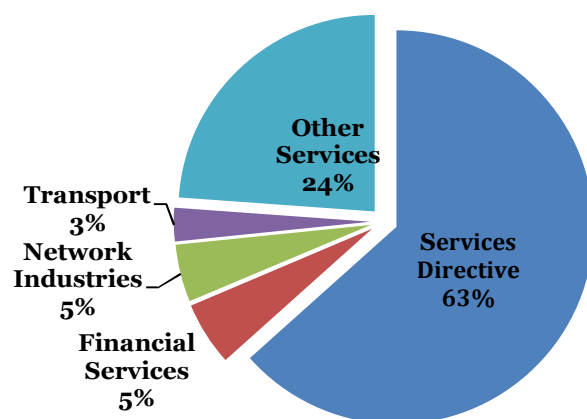
After ignoring EU services markets for decades, despite free movement and the right of establishment enshrined in the Rome Treaty, selective moves towards an internal services market were first made under the EC 1992 programme for financial services and the six modes of transport, if we discount highly restrictive forms of 'mutual recognition' (of diplomas) in selected professional services. In the 1990s this was gradually broadened, via EU policies as well as case law, to horizontal services, culminating in the 2006/123 horizontal services Directive, and to network industries (broadcasting, postal, gas and electricity, telecoms, and the networked air and rail transport sectors). Professional services markets were also subjected to pressures to function better. At the same time, more attention was paid at EU level to the impact of better functioning of services markets on the competitiveness of European industry – whether EU-wide or nationally. With the arrival of the euro at the beginning of 1999, it became increasingly clear that shock absorption and permanent adjustment processes also depend on well-functioning services markets.

Finally, the EU now seems to have accepted the inevitable logic of a single services market. With services now making up the largest share of economic activity (more than 70% of GDP), the economic importance of a single market for services cannot be overestimated. Yet, as far as the authors are aware, no credible estimate of its potential seems to have been published so far. The EU's role in accomplishing a single services market consists of a combination of cross-border intra-EU liberalisation, EU regulation (when market failures so require) and EU competition policy, complemented where possible by mutual recognition. Given the huge variety of services (and the market failures involved in them), this is a complicated exercise. The complexity is further increased by omissions in the treaty, notably about independent EU regulatory agencies in the case of some network industries and in banking, and the deep resistance by holders of highly specific national powers to transfer such competences to the EU level, such as air traffic control or spectrum for telecoms or broadcasting.

It is useful, at this level of generality, to sketch out the panorama of market services for the single market, distinguishing three categories.

A first, large category of services falls under the horizontal services Directive. Many such services are not tightly regulated, but some subsectors are, and they do not have 'sectoral' regimes at EU level.<sup>2</sup> Altogether, their value added in the EU amounts to more than 45% of GDP. A second category comprises four groups of service sectors that are EU-regulated to different degrees, namely, professional services, financial and transport services and network industries. Of course, professional services overlap to some extent with the regulated professions under the services Directive. The professions referred to here are lawyers, accountants, architects, veterinarians, medical doctors, paramedical professions, pharmacists and the like. A combination of EU diploma-recognition regimes and selective EU sector-specific requirements (e.g. for auditing, etc.) have created a blend of EU and national regulation, now also influenced by the services Directive 2006/123. This group of four (more or less) EU-regulated services generate some 20% of EU GDP, with network industries accounting for some 4.7% of EU GDP, financial services almost 6%, transport 3.1% and professional services some 6%.<sup>3</sup> Despite all the recent attention surrounding the services Directive, this second category of services is of great economic importance in any EU services strategy. Today's intra-EU cross-border services trade is dominated by the services that fall under the services Directive (see Figure 3), but this is not the case for the establishment of services providers in other EU member states via foreign direct investment (FDI).

Figure 3. Intra-EU27 trade in services, exports in 2008



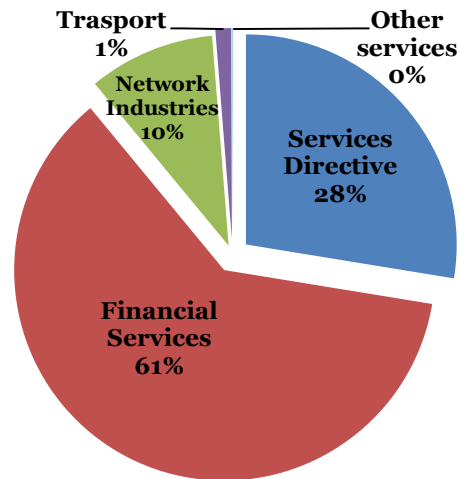
<sup>2</sup> The main sectors are the regulated professions (note, regulated nationally but with a degree of EU mutual recognition), craftsmen, business-related services, distributive trades, tourism services, leisure services, construction services, installation & equipment maintenance, information services, accommodation & food services, training & education for profit, rental and leasing, real estate, testing & certification and commercial household support services.

<sup>3</sup> The contribution of professional services to EU GDP is hard to calculate. It has been suggested that professional services are a subset of 'business services' (11.7% of EU GDP), falling under the services Directive 2006/123. However, this is only partially the case. The 2007 European Commission "Handbook on the Implementation of the Directive" (p. 10) speaks of "most" regulated professions and adds "business-related services", a category employed by Eurostat. The Directive itself, in recital 33, does mention "business services" and sums up a range of professional services, but it is far from exhaustive. Eurostat defines "business services" as NACE K72 and NACE K74.1 - 74.5: all of these activities fall under the services Directive, including the professional services specified in these NACE categories. The professional services *not* falling under the services Directive would include all medical professions, paramedical professions, veterinarians, pharmacists, notaries, interpreters and several others. The present authors suggest that professions under the services Directive contribute 4% to EU GDP and those falling outside it some 2%; hence the 6% in the text.

Source: Eurostat (2012).

As Figure 4 shows, cross-border intra-EU FDI in services is dominated by financial services providers (61%) and network industries (10%) and not at all by activities under the Services Directive.

Figure 4. Intra-EU27 FDI in services, abroad in 2008



Source: Eurostat (2012).

A third category comprises several 'special' services activities, which are hard to classify and currently addressed at EU level in an *ad hoc* fashion.<sup>4</sup>

One should be careful when interpreting simple one-liners about the economic importance of services liberalisation in the EU. Thus, the European Commission's reiteration that the economic activity generated by services falling under the horizontal services directive is more than 40% of EU GDP does not mean that all or many of these services providers are potentially interested, or even capable, of entering cross-border activities in a systematic fashion - far from it. A similar one-liner one often hears is that the EU has 23 million SMEs and most of them are in services. This says very little indeed about potential. Even in the internal market for goods, companies exploiting the internal market are really 'the happy few'.<sup>5</sup> In services, barriers are more numerous than in goods and not always transparent, tradability is low and selective, whilst establishment is not going to be an easy decision for

<sup>4</sup> They include temporary cross-border services provision, often more lightly or not regulated except host-country control for wages under the Posted Workers Directive 96/71; medical services to patients from other EU countries under Directive 2011/24; gambling (where case law has grown but no EU rules exist as yet); taxis & ambulance services and private security services (taken out of the Bolkestein Directive, with no solution found so far).

<sup>5</sup> See Ottaviano & Mayer (2008), for a survey, based on firm-level data, on how few companies actually participate in a few EU countries, let alone in many EU countries, in the EU single market. This work only focuses on intra-EU trade, not FDI which is quite important for services given the low/zero tradability of many services. The successful, competitive companies actively exploiting the internal market perhaps number tens of thousands, the broader group of 'partial' participants (serving or importing from only one or a few EU countries) amounting to a few hundred thousand at most.

most SMEs. The potential for SMEs exploiting the single services market is therefore far from clear.<sup>6</sup>

Estimating the potential for growth for the four categories of sectorally regulated services hinges on a proper understanding of the accomplishments (in cross-border intra-EU liberalisation, harmonisation where relevant and competition policy) with a view to realise a single market. To illustrate the complexity of the system in **financial markets**, for instance, the third EU regime (realised under the Financial Services Action Plan of 2000-2006) was accompanied by rapid European financial market integration. It was first estimated that this could add 1% to EU GDP (Giannetti et al., 2002); perhaps more in the longer run. However, this assumed that market failures in financial markets had been effectively addressed. The current financial crisis (begun barely two years after the revisions of the banking and capital requirements directives in June 2006) has revealed that prudential rules and supervision did not protect the European economy against market failures as previously supposed and had not addressed the related problem of financial stability. The fourth EU financial markets regime, largely now in place (except for some crucial items such as a credible EU bank resolution regime, with EU funds and an EU-wide deposit insurance regime; also, financial supervision is not truly centralised where it matters most) is probably better able to price risks and pre-empt prudential and systemic risks from getting out of hand, but of course this comes at a cost. What the potential economic growth will be under the fourth regime once the EU is out of the crisis is exceedingly hard to 'guesstimate'.

In **professional services**, the Commission has proposed a useful simplification (e.g. with an EU-wide professional card system) but, for a true single market, much more will be necessary, such as a drastic reduction (indeed, a proper justification) of nationally 'regulated' professions based on market failures or indispensable national properties, and other ways to enhance competition via entry and/or imports. This is as yet uncharted territory and the pro-competitive gains are therefore unknown. It is still true that markets for professional services exhibit anti-competitive characteristics (see e.g. Bottini & Molmar, 2010 on high mark-ups) but to what extent this is due to market failures that are hard to overcome fully (e.g. extreme asymmetries of information) and/or anti-competitive regulation is not so easy to determine.

In **network industries**, much liberalisation so far has been 'national' (although based on EU rules and EU competition principles) but a single market still seems a long way away,<sup>7</sup> except in air transport and broadcasting (although fragmentation based on languages remains extremely strong). In transport, the internal market is basically accomplished (apart from rail) but the 2011 White Paper [COM(2011) 144] (European Commission, 2011) shows that the growth potential ought to be assessed in a much wider framework of radical cuts of CO<sub>2</sub> emissions and huge investment in infrastructure. In gas and electricity, formidable investment in (cross-border and other) infrastructure over many years is a prerequisite of a

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<sup>6</sup> In comparing the EU SME population with that of the US, there seems to be a 'missing middle' of larger European SMEs in four sectors: distribution, hotels/restaurants, transport & communication and business services (we thank Peter Smith for this observation). See also Kox (2012), emphasising the dominance of micro-enterprises in EU business services, which are sub-scale and incapable of exploiting the single market, and section 3.2.

<sup>7</sup> It is beyond the scope of this paper to discuss this issue in any detail. For an analysis of the failure to develop a single eComms market, see Pelkmans & Renda (2011); for the shortcomings of the third gas and electricity package of 2009 in realising a single market, see Kapff & Pelkmans (2010); in rail freight, enormous (corridor) infrastructure and interoperability issues combine with unfulfilled intermodal investment needs, divergent infra-user fees and too weak EU directives, see e.g. the Single EU Railway Area in COM (2010) 474 and the follow-up in the Council and EP (EurActiv, 6 July 2012).



well-functioning EU energy services market. For telecoms, nowadays called electronic communications (basically, transport of bits, also for broadcasting or internet audio-visual services), European infrastructure shortcomings are also formidable e.g. in broadband investments for very fast internet and spectrum allocation. In freight rail the (10) European corridors can only fulfil the badly-needed potential of radically lower costs and greater reliability if major and often complex investments in new track, marshalling yards, signalling, intermodal terminals, etc. are effectively undertaken. Thus, the growth potential in some network industries is not merely a question of liberalising services across intra-EU borders, but just as much the combination of cross-border intra-EU liberalisation, the promotion of competitive markets and huge and sustained infrastructural investments over a considerable period. It goes without saying that this renders an economic estimate of the gains from these segments of the single market more difficult and somewhat arbitrary. Even if the European Commission (2007) were right in claiming that the proposed third electricity package (adopted in 2009 although in a less ambitious framework) could add 0.6% of EU GDP based on price convergence by market coupling (see Zachmann, 2010 on this point, however), this does not take account of the probable GDP boost arising from huge investment in power stations and interconnectors over two decades. Similarly, the expected array of new services and innovation prompted by advanced broadband hinges on the widespread availability of broadband throughout the EU internal market, including in less densely populated areas.

Finally, estimating the growth potential of temporary cross-border services provision (and their pro-competitive impact) has not even yet begun because of severe data problems and the fact that many barriers to these activities were only significantly reduced after 2006. A rough proxy of this activity's importance before the crisis can be given<sup>8</sup> if one considers that some 1 million workers were 'posted' annually in the period 2007-09. This would be a mix of workers from new member states (one-third) and EU-15 workers. For the 10 Central and Eastern European EU countries, the remittances from posted workers amount to some 1.3% of GDP (80% of all their remittances). The posted workers from the EU-15 have, on average, a higher-skill profile and are twice as numerous, so it is possible that their wage income from posting is as high as (say) 0.5% of EU-15 GDP. The total turnover of temporary cross-border services must be higher as it includes other costs and profits.

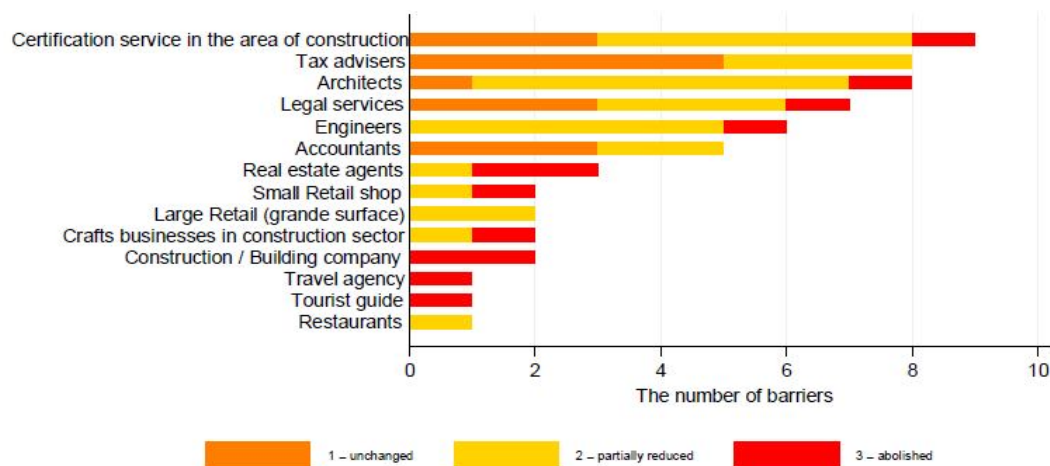
## 2.2 Reforms of domestic services markets

The performance of domestic services markets is, of course, also crucial for European economic growth. However, this is traditionally regarded as a matter falling under national regulatory autonomy. Given subsidiarity tests, the EU level should not encroach upon domestic autonomy unless there is an explicit, well-justified case (see e.g. Pelkmans, 2005) and if EU tools fall under the treaty category of 'shared powers'. But does it make sense in a deeply integrated European economy to draw strict boundaries between 'domestic services regimes' and the 'EU regime for cross-border service activities', not least because establishment in another EU country is always possible (and happens frequently) for market services? For non-market services (e.g. social services), pure government services and services predominantly financed by national or regional governments (say, basic health and educational services, or public radio/TV), this distinction seems fine. Market services,

<sup>8</sup> European Commission (2012), *Employment and social developments in Europe*, November, pp. 257-259 and pp. 277-278. Note that seasonal work in tourism, horticulture and agriculture is not included here. Also, some high-skilled temporary cross-border services (e.g. management consulting; technical & engineering advice) are not likely to be caught by the (social) registration under the posted workers Directive. The same applies to single-person firms providing cross-border temporary services.

however, are in principle part and parcel of the internal market (that is, exposed to competition when serving other national markets or by imported services) and the question is whether that is sufficient reason for the EU level to be actively involved. Taking the notion of a single services market seriously, EU involvement can only be *highly intrusive* for domestic services regimes. As has been demonstrated by the screening and ‘mutual evaluation’ of national reforms in services during the implementation of the horizontal services Directive, the removal of intra-EU barriers critically depends on the abolition or reform of *domestic* services regulation. After all, barriers in the internal services market are ‘behind-the-(intra-EU)-border’ measures, not frontier measures. Nevertheless, a considerable amount of domestic regulation can stay in place or represents a difficult trade-off, depending on the justification. Figure 5 on the removal or reduction of access barriers to the German market for services illustrates this very well.

Figure 5. Domestic reforms due to the Services Directive in Germany



Source: Monteagudo et al. (2012, Annex).

Besides this fundamental issue of intertwined domestic and ‘EU-relevant’ regulation, there are two other reasons that prompted increasing EU involvement in domestic services regimes, with a view to promoting growth and smoother adjustment. First, services reform is frequently talked about today but, in fact, much of it pre-dated the so-called ‘Cardiff process’ that was set up in the run-up to the 2000 Lisbon process and beyond. It is based on what is now Art. 121, TFEU about “(national) economic policy as a matter of common concern” via policy coordination and multilateral surveillance of the implementation of recommendations or guidelines. This is about mutual persuasion, based on analysis, and peer pressure, for the common good (such as higher EU growth). In 2000 the Cardiff report<sup>9</sup> concludes:

Further efforts are required to promote stronger competition in service sectors such as retail trade and professional services. This is especially true for those services not covered by Single Market legislation. For example, reducing legal entry and exit barriers can improve the quality and efficiency of these more sheltered markets.

Progress has been made since then but this is uneven among member states. In the Commission’s Product Market Review 2010-2011, one reads however that the very same concern articulated in 2000 is still prominent for services, which

would therefore do well to review ... specifically entry and exit conditions... to encourage entrepreneurship (European Commission 2010b, p. 3).

<sup>9</sup> EU Economic Policy Committee (2000), Second annual report on structural reforms – 2000, Brussels, 13 March, EPC/ECFIN/241/00, p. 4.

In the Review, a modelling exercise suggests that structural reforms in EU countries (which of course include also labour market reforms) would push the expected EU annual trend growth of 1½% by 2020 to 2.2% (p. 2), which is significant.

The second other EU (or rather: eurozone) reason to promote domestic services reform is the proper functioning of the monetary union. The purpose here is to achieve relatively low-cost and rapid absorption of (especially idiosyncratic) shocks, which minimises the cumulative loss of growth from such shocks. We shall return to this point in the conclusions.

### 3. Better services performance: What economic research tells us

#### 3.1 Comparative productivity growth analysis

Low growth in the productivity of services in EU member states, both comparatively (e.g. with the US) and absolutely, is certainly a principal reason for the better functioning of services markets via reforms to have been advocated repeatedly. Since 1995, EU productivity growth in services has fallen to a low annual average precisely when that of the US increased sharply. Many economic scholars were intrigued by this trend change, after decades of EU catch-up. Empirical analysis quickly detected that productivity growth differentials, in just a few services sectors, were the main cause of the trend change. This empirical economic analysis has been much refined since. Table 1 shows the average annual labour productivity growth disparities in all market services (annually 1% for the EU versus 3% for the US over 10 years since 1995, in contrast to productivity growth over 1980-95) and the two sectors responsible for it (distribution, wholesale and retail; and business services).

Table 1. Sectoral labour productivity growth in market services, 1980-2005  
(average annual percentage points)

	EU		USA	
	1980-1995	1995-2005	1980-1995	1995-2005
Market Service Labour Productivity	1.4	1	1.5	3
Distribution Services contribution	1.1	0.7	1.2	1.5
Financial Services Contribution	0.2	0.4	0.2	0.5
Business Service Contribution	0	-0.1	-0.1	0.7
Personal Service Contribution	-0.1	-0.1	0.2	0.2
Contribution from labour reallocation	0.1	0	0	0

Sources: Timmer et al. (2010), based on EU KLEMS database.

According to Timmer et al. (2010), whilst the US was experiencing acceleration since the mid-1990s, caused by a combination of an increase in investment for ICT-using sectors and a subsequent productivity growth in market services, the EU witnessed a strong slowdown in multifactor productivity, mainly in trade, finance and business services.

The US-EU productivity growth gap, which still persists, notwithstanding the effect of the financial turmoil,<sup>10</sup> has mainly been driven by the ICT sector inducing an increase in capital deepening and total factor productivity growth in the US. In contrast, the EU suffered a persistent lag caused by various rigidities and hindrances that prevented an effective exploitation of the potential of ICT, especially on the business user side. Detailed empirical economic research at firm-level clarifies how ICT may boost growth. Van Reenen et al. (2010)

<sup>10</sup> During the period 2007-09, the US performance reversed the usual pro-cyclical pattern that can be observed in productivity growth trends. According to Timmer et al. (2010), while the EU has shown a slowdown of -0.7% in productivity growth, the US experienced an increase of 1.6% in the same period.

find that disparities in ICT-driven productivity growth between countries are largely explained by i) labour market and services regulation restrictiveness, and ii) skills and organisational capital inside firms – essentially people management and decentralisation of decision-making and responsibilities. The authors stress that the ICT productivity effect they detect is reduced by 45% if labour regulations are strict and by 16% if services regulation is strict. There is little doubt that, on the whole, labour market regulation in continental Europe is much stricter than in the US, with the UK and Ireland in intermediate positions. This is broadly reflected in the findings of Van Reenen et al (2010). People management inside enterprises is also influenced by labour laws and collective agreements: if the latter are relatively strict, ICT-driven productivity growth will be lower. Also, decentralised structures show a strong interaction with ICT: with decentralisation, the impact of ICT investment is one-third higher.<sup>11</sup> The authors also establish that multinational firms use ICT much more than domestic firms – a finding that is crucial for the economic assessment of the establishment section of the services Directive (having removed a range of significant barriers to FDI in services such as the ‘economic needs’ test, etc.). We return to this point in section 3.4. It should be noted that, although without firm-level data and sophisticated econometrics, Barrios & Burgelman (2008) find that, in the EU and comparing the EU with the US, ICT investment and its related growth impact are significantly lower in countries with rigid, heavily regulated credit, services and labour markets. They speak about an ICT deterrence effect of strict regulation.

Brynjolfsson (2011), based on his groundbreaking work on the intra-firm and market dynamics of ICT-driven innovation, holds that there are three ways in which ICT raises productivity growth: by enhancing ICT equipment itself (e.g. faster computers), by catalysing organisational change and, above all, by transforming the innovation process itself. Although the latter is not unique to services, in (some) services sectors it may engender disruptive effects that are truly ‘Schumpeterian’.<sup>12</sup> There would seem to be no obvious reason why the first way should be different for US and EU companies, since upgraded ICT equipment is usually immediately available worldwide. The second way (catalysing intra-firm organisational change) has been found to be more problematic in Europe than in the US (Van Reenen et al., 2010; Brynjolfsson, 2011; European Commission, 2003). That ICT alters the innovation process itself – the third way – and renders it faster and more disruptive is a crucial insight and certain service sectors (logistics, retail, wholesale, postal services, advertising, etc.) are profoundly affected.<sup>13</sup>

A number of other ICT issues may also help to explain disparities in US-EU productivity growth in recent years. We shall discuss some internal market questions in section 3.4. In addition, broadband investments, relatively low R&D in ICT in Europe, the lack of leading ICT firms in Europe<sup>14</sup> and demand-side aspects such as e-Inclusion all play a role<sup>15</sup> and affect the link between ICT services and economic growth.

<sup>11</sup> Even when controlling for ‘fixed effects’ econometrically.

<sup>12</sup> Meaning the dynamic type of competition characterised by ‘creative destruction’, rather than pro-competitive activities in a market where services or goods and their production methods are all given.

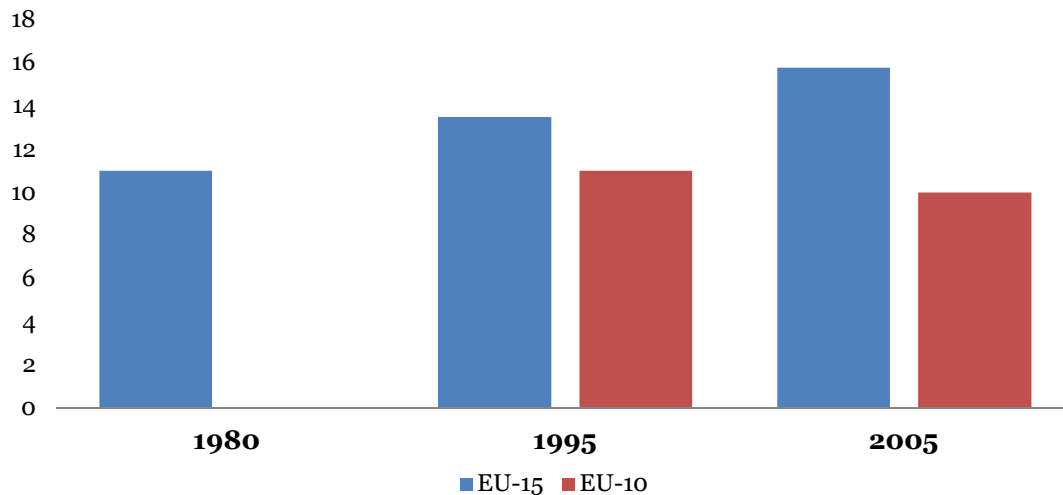
<sup>13</sup> Brynjolfsson (2011) sees a sequence of four mutually reinforcing innovative activities: improved and faster measurement of market activity in real time, faster and cheaper business experimentation (internet firms can do this), the swift sharing of new insights and the rapid replication of new services or processes, reaching all outlets without exceptional efforts. Altogether, this may engender Schumpeterian competition, leading new entrants to challenge incumbents in many services markets.

<sup>14</sup> Veugelers (2012) shows that the EU lacks leading platform-providers who can capture the value in the “new ICT eco-system”. Besides the absence of ICT clusters and the lack of an entrepreneurial

### 3.2 How services reform can support industrial competitiveness

A complementary stream of the economic literature on services focuses on the interaction between manufacturing and services. Manufacturing companies are increasingly including services both on the output (in particular, maintenance and repair service, business advisory services, sales services, pre- and after-sales services) and the input side (through services purchased, both domestically and internationally). As shown in Figure 6, the ratio of purchased services in manufacturing increased steadily in the EU15 from 1980 to 2005.

Figure 6. The ratio of purchased services to output in EU10 and EU15



Note: Indicator is defined as the share of purchased services compared to manufacturing output.

Source: Falk et al. (2011).

From the interlinkage between the two sectors,<sup>16</sup> one should expect a trend growth of services jobs in manufacturing (Falk et al., 2011). One might explore two possible ways through which this interdependence can boost domestic growth, that is, by identifying the trend increase of services occupations in manufacturing over time and by analysing how the share of services purchased is linked to the export competitiveness of EU businesses.

As for the first channel, Falk & Jarocinska (2010) and Falk & Peng (2011), taking advantage of a large firm-level data set for 18 EU member states, find a positive relationship between the employment share of services occupations and the output share of producer services in

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culture, she points to venture capital, fragmented IPR regimes and the lack of a digital single market (see section 3.4) as culprits.

<sup>15</sup> The demand side in the EU may be below potential due to insufficient e-Inclusion, that is, segments of the population (one-third) having no computer linked to the internet and/or no skills to use it. For SMEs, e-Inclusion can be below potential because of the lack of e-skills at various levels of ICT ambition. In Guerrieri & Bentivegna (2011) it is shown that better e-Inclusion leads to a positive effect on EU GDP via higher TFP (total factor productivity).

<sup>16</sup> Many consumer services, according to Peter Smith, including health and social services, constitute a significant segment of services with relatively few inputs from manufacturing and vice versa. Indeed, some of these sectors barely participate in the internal market as they are local or 'domestic' and often funded by government policies or public procurement. In Pelkmans et al. (2008) it is empirically shown that the trend increase in prices of these services over time is higher than for other services. This could be due to a lack of competition, whether domestic or European, and/or 'Baumol's law', which holds that a rise of salaries in jobs that have not experienced an increase of labour productivity often follows from a rise in salaries in other jobs which did experience labour productivity growth.

manufacturing. They show that the increasing demand of a particular service linked to the production of a specific good stimulates the firm to acquire the knowledge required to produce that service in-house. This implies that the increase in the output share of services explains an average 13% increase in the share of service occupations.

The second channel is the effect of services imported or purchased domestically on the export performance of the manufacturing industry. Data show that this channel counts more in countries where KIBS (knowledge-intensive business services)<sup>17</sup> account for a significant part of the services purchased. Wolfmayr (2011), in her contribution to SERVICEGAP, shows that the more services are purchased by the firm, the higher the share of goods exported. Upon closer inspection, it turns out that the link holds when services are imported and not when purchased domestically. This strongly suggests that cross-border *services* trade (presumably, mainly in the internal EU services market, given proximity constraints) exerts a positive impact on the competitiveness of industrial firms.

If this empirical relation turns out to be robust, it means that an important element of EU industrial and competitiveness policy is to further liberalise the EU single services market and stimulate domestic services reforms as well. The latter should bring about more effective rivalry, which should help some domestic services suppliers to compete directly with services imports for their use as inputs in manufacturing.

Kox (2012) zooms in on the largest cluster of services inputs, namely, business services. He shows that the productivity of EU business services has stagnated for years and finds that this is largely due to weak competitive pressures at home and low degrees of openness for imports (confirming Wolfmayr, 2011, for trade). Greater market selection would require fiercer competitive rivalry, but this is often hindered by rigidities or protective regulation or labour market restrictions. The first effect of such selection would be a shift from less productive to more productive firms; the second effect consists of fewer very small service suppliers, which are clearly suboptimal in size, and more room for larger suppliers. Kox simulates two 'reforms', combining different combinations of greater openness and lower regulatory costs. The gains in total efficiency can reach 7% and 4.5%, respectively. This implies that the 'knock-on' effects for industry would thereby become more favourable for the competitiveness of European manufacturers.

### 3.3 On domestic services reforms

The economic literature suggests that part of the growth that can be generated by service sectors finds its origin in domestic reform efforts, whether the result of the implementation of the 2006 services Directive (as noted, this must imply some domestic reform) or national attempts to reduce restrictiveness of services markets at home, possibly complemented by greater flexibility in national labour markets. Here we focus on domestic services reforms illustrated by the OECD regulatory restrictiveness indicators called PMRs.<sup>18</sup>

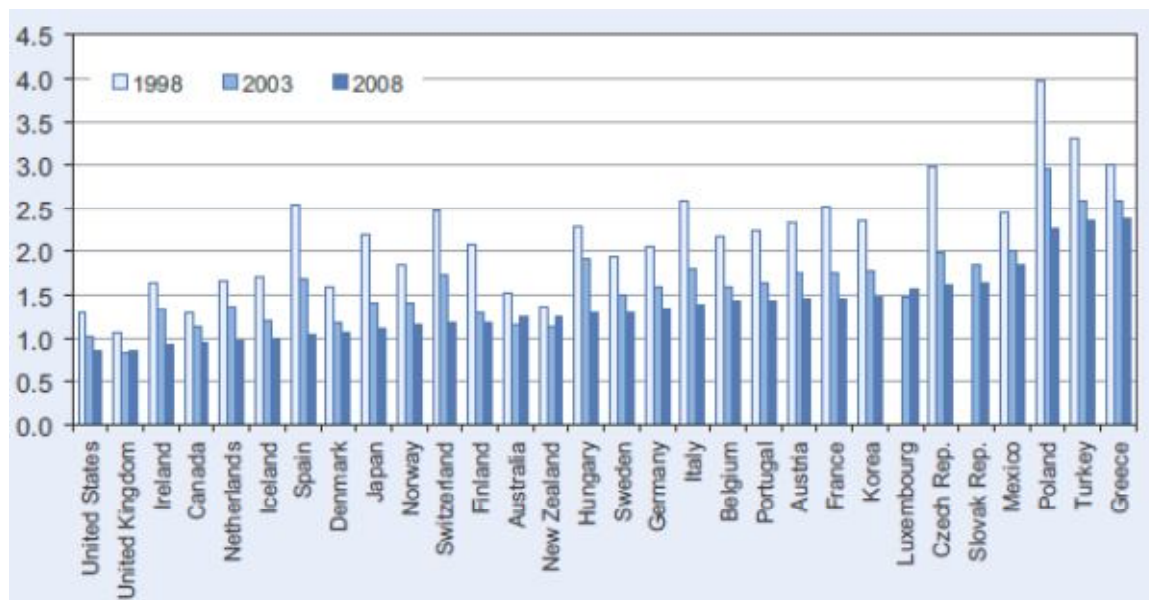
<sup>17</sup> KIBS is not well defined across the literature. However, according to the European Competitiveness Report (2011), KIBS can be identified through the following NACE categories: *Computer and related services* (NACE 72), *Research and Development* (NACE 73) and *Other business services* (NACE 74). The last category includes a large variety of sub-sectors. Indeed, from 74.1 to 74.8, NACE 74 includes *legal, accounting, book-keeping and auditing activities; tax consultancy; market research and public opinion polling; business and management consultancy; holdings, architectural and engineering activities and related technical consultancy, advertising, labour recruitment and provision of personnel, investigation and security activities, industrial cleaning, miscellaneous business activities not elsewhere classified* (photographic activities, secretarial and translation activities)

<sup>18</sup> The OECD PMRs (product market restrictiveness indicators) cannot be explained here, given the space constraints. See Nicoletti & Scarpetta (2003) and Woelfl et al. (2009) for the methodology as well

The OECD work focuses on the better economic functioning of markets by zooming in on the restrictive effects of state control, trade and investment barriers and barriers to entrepreneurship, while ignoring regulation of health, safety, environment and consumer protection (the 'non-economic' functioning of markets). However, in services, asymmetries of information lead to many instances and intensities of regulation some of which are included for purposes of consumer/investor protection and better economic market functioning (e.g. professionals, financial regulation). Also network industries usually require a combination of regulation (and indeed a regulator) and competition policy for purposes of better market functioning. The question in these two types of markets is whether and to what extent such needed regulation can be least-restrictive, thereby allowing market forces to work more freely and hence stimulate growth. Arnold et al. (2011) provide persuasive empirical evidence that countries with low PMRs have experienced higher productivity growth.

The restrictiveness of services market regulation in EU countries has gone down over time as shown by Figures 7 and 8.<sup>19</sup>

Figure 7. Development of aggregate product market regulation since 1998



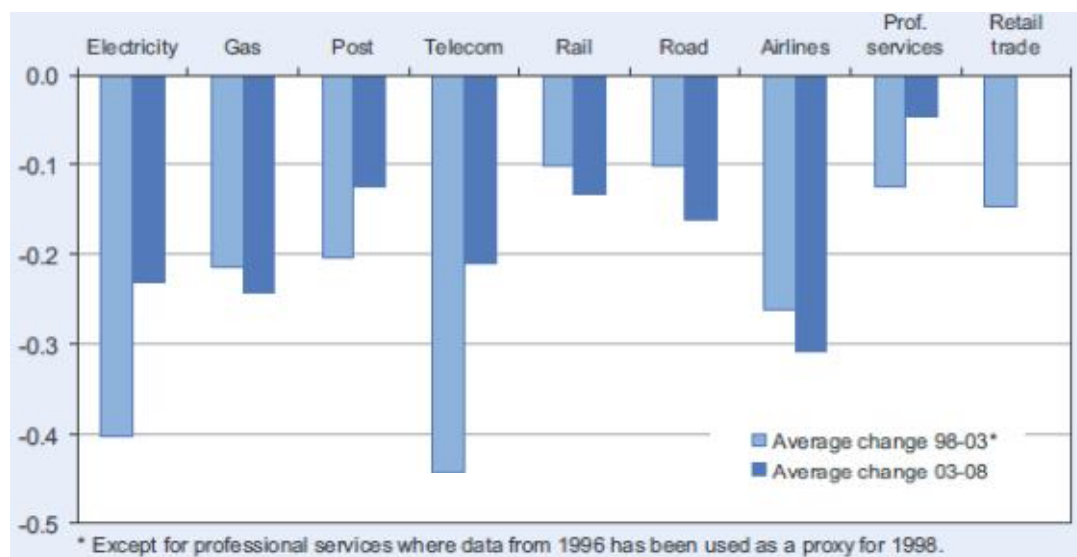
Note: Index scale of 0-6 from least to most restrictive.

Source: OECD, Product Market Regulation Database, reproduced in "The Revised OECD Indicator of PMR", CESifo DICE Report, autumn 2010, p. 35.

as Arnold et al. (2011); for a critical discussion of PMRs when applied to EU countries, see Pelkmans (2010). It should be noted that, although the early stage of PMRs (mid- and late 1990s) focused both on goods and services markets, the revised PMRs (since 2006) largely measure services markets regulation.

<sup>19</sup> We have used graphs from the CESifo Dice Report because the resolution in the original ones from Woelfl et al. (2009) is too low. Although they use the same database, Figure 8 gives a somewhat lower reform effort in telecoms than Woelfl et al. (2009); still, the overall conclusion in the text is clearly supported.

Figure 8. Sources of reform in product market regulation by sector



Note: Index scale of 0-6 from least to most restrictive.

Source: OECD, Product Market Regulation Database, reproduced in "The Revised OECD Indicator of PMR", CESifo DICE Report, autumn 2010, p. 35

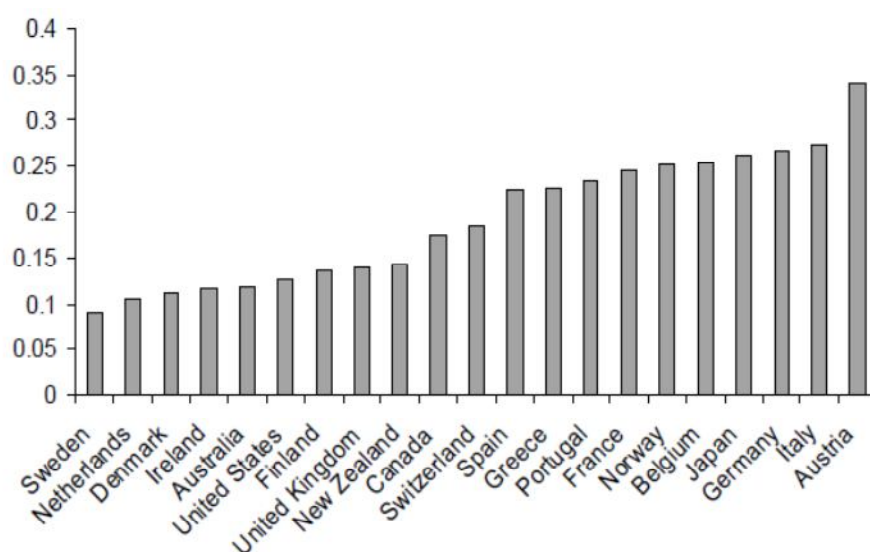
However, there is little doubt that a further stimulus of effective competition in several of these markets can still be accomplished. Restrictive services regulation beyond what it takes to address market failures has no public interest justification - merely hinders better market performance. This is first of all a domestic problem in many EU member states, but, at the same time, it also has repercussions for the internal services market, because unjustified regulation implies barriers to cross-border services exchange or via establishment of service firms by non-domestic EU firms. Moreover, when manufacturing firms want (or have) to use services as input into their production or value-chains, competitive services sectors will obviously benefit industry too. With the help of PMRs, Conway & Nicoletti (2006) have calculated 'knock-on' effects from (restrictive) services markets to industry.

Figure 9 shows that, given different levels of restrictiveness between EU member states' services markets, a relatively high knock-on effect can become a drag on the competitiveness of industrial enterprises in the more regulated countries. As long as reforms ensure that market failures are not re-introduced or taken too lightly, pro-competitive reforms in services markets would therefore boost the competitiveness of industry.

It should be noted that Barone & Cingano (2011) reach very similar conclusions, highlighting the negative indirect effects of anti-competitive regulation on downstream industries using services as inputs. Barone & Cingano find that too restrictive service regulation has a significant negative effect on the growth rate of value-added, productivity and exports of service-dependent industries (with energy supply services and professional services as leading examples).



Figure 9. The impact of non-manufacturing regulation on the manufacturing sector, 2003

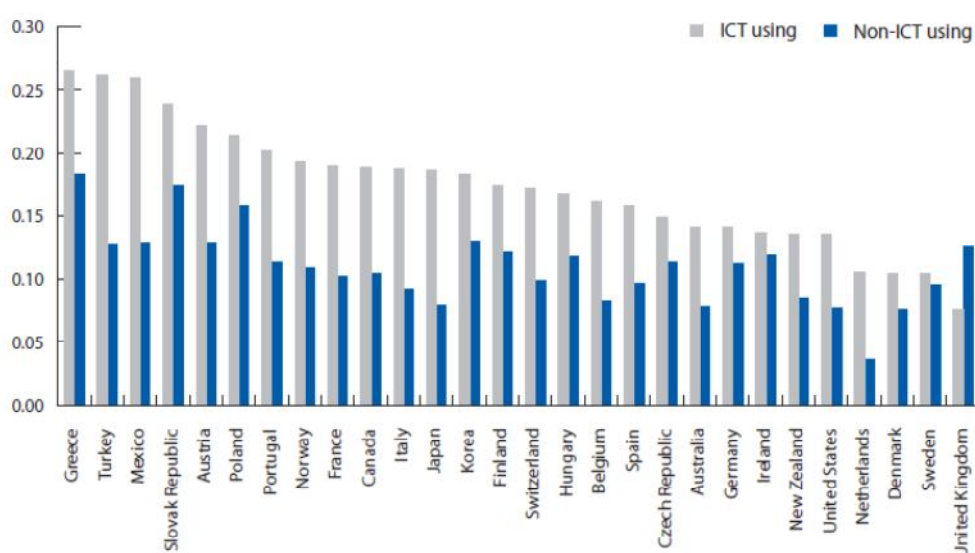


Note: Scale normalised to 0-1 from least to most restrictive of competition.

Source: Conway & Nicoletti (2006).

But this knock-on effect differs not only between countries; sectoral differences matter too. Figure 10 shows that, in 2003, it is larger in all countries (except the UK) for ICT-using sectors than for non-ICT using sectors. Nevertheless, in this respect, countries differ considerably as well, implying that there is likely to be room for regulatory reform in services, which would engender a positive impact on productivity via more competitive intermediate ICT-service input in ICT-using industries, which in turn, would strengthen industrial competitiveness. As shown above, ICT-related activities are crucial for boosting overall productivity growth.

Figure 10. The burden of non-manufacturing regulation on ICT-using and non-ICT using sectors, 2003



Note: Scale normalised to 0-1 from least to most burdensome. According to the authors, the figure shows the regulation impact indicator, which reflects the burden of anti-competitive regulation in non-manufacturing sectors on industries that use the output of these sectors as intermediate inputs into the production process.

Source: Arnold et al. (2011).

Focusing on domestic services regulation of OECD countries, Arnold et al. (2011) study the link between product market regulations, resource allocation and productivity growth with the help of OECD restrictiveness. Lower regulatory burdens tend to facilitate a reallocation of resources to the highest productivity firms. A regulation not properly designed to ensure proper market functioning can, for instance, hinder innovation and impede efficient and effective market entry. The negative effect of anti-competitive regulation on productivity growth can be transmitted through two different channels. First, Arnold, et al. (2011) show that the stronger the ability of countries to absorb new technology or innovation, the greater is the negative effect of anti-competitive regulation on productivity. This result would seem to apply especially to EU15 countries or at least to most of them. The channel can be analyzed both at industry-level where, as for ICT services, inappropriate regulation can slow down productivity growth precisely where it is most promising, and at firm-level where the degree of regulatory heterogeneity amongst EU countries can negatively affect productivity growth by the discouragingly high fixed costs of entry for no less than 27 national markets. The second channel originates from so-called 'market selection', competitive market pressures promoting resources reallocation from less to more efficient firms, which is a significant source of growth. However, anti-competitive regulation is likely to protect incumbents or inefficient practices and thereby throttle re-allocation processes. Such regulations can negatively affect the willingness of incumbents to promote innovations whilst discouraging new entrants (only large new entrants are capable of overcoming such negative incentives).

One might get an idea of the range of possible labour productivity improvements if domestic services reforms in all EU countries could be simulated to go all the way to the least restrictive, best-practice examples in the OECD for all sectors. Of course, this is perhaps somewhat academic since no OECD country has the best-practice regime in every sector. Based on a variant of the Aghion-Howitt (dynamic) growth model and making use of the 'knock-on' effects in Figures 8 and 9, Arnold et al. (2009) arrive at changes in labour productivity (after 10 years) between 7% (Spain) or 8% (the Netherlands, Finland and Denmark) up to as high as 14% (Belgium and the Czech Republic) and even 19% for Poland and Hungary; France would enjoy 10% and Italy 12%. Only Sweden and the UK would not benefit - apparently they are at the least-restrictive level already. Even if this exercise is a radical simulation, it does show that the domestic services reform potential in the EU is still quite large.

### 3.4 How the single services market can contribute to EU growth

A second strategy to get long-term growth from services markets is to enhance services exchange amongst the member states, and where possible beyond the single market with third countries, too. However, there is no clear economic distinction between the reforms at domestic level and the deepening and widening of the single services market. This is explained by several unavoidable interdependencies between the national and EU level of reform. First, the implementation of the horizontal services Directive must imply that some national regulation is made less restrictive or is removed, and this of course in a non-discriminatory fashion. Therefore, the practical manifestation of the services directive inside every member state amounts to less or less intrusive/restrictive regulation, whether for domestic or cross-border purposes. In other words, the horizontal services Directive is tantamount to a (selective, but non-negligible) domestic pro-competitive regulatory reform in services markets. The consequence for empirical economic research is immediate: not only will the removal or lowering of services barriers create a more pro-competitive environment by boosting services imports, which would eventually lead to higher efficiency generating economic growth (the traditional economic impact analysis of border obstacles), but the

implementation will also reform the domestic services markets, which is bound to have similar effects on growth via domestic activity, not imports. Because intra-EU cross-border services imports are not, on average, a large share of domestic services turnover, such a domestic reform is likely to engender a larger economic impact than the pure cross-border effect itself.

It is important to see that this interdependence goes beyond cross-border intra-EU services trade and also affects the local services provision by foreign affiliates. Companies undertaking FDI tend to be competitive as their foreign venture usually rests on certain company-specific advantages or higher efficiency. Hence, FATS<sup>20</sup> are likely to benefit from a more competitive services environment created by domestic reforms, induced by the services Directive, but – in addition – there may well be a dynamic effect of inducing additional FDI in services. This is to be expected for two reasons: first, the services Directive has resolutely removed all problematic obstacles to the right of establishment of services companies, and, second, FDI of competitive service providers will be even more attractive due to the implied domestic reforms which give such competitors better opportunities. The presumption that FATS are competitive, and hence capable of benefiting from the new business environment, is supported by the empirical literature on FDI.

Second, insofar as domestic services regulation is justified by market failures, cross-border EU services provision cannot expect such regulation to go away via (say) a horizontal liberalisation directive. However, services exporters in the EU will still have great difficulties developing an EU market strategy, for the simple reason that national services regulation often differs somewhat from EU country to EU country. This is even true for sectors subject to some or perhaps considerable EU regulation (e.g. eComms; gas & electricity; financial services). This ‘regulatory heterogeneity’ can be very costly to business with a European focus – for every country, fixed entry costs will be incurred separately, which will have to be earned back before the investment and entry become profitable. Such recurrent fixed entry costs are extremely discouraging for services SMEs and at the very least not a help for many other providers. Thus, much more than for goods, services export strategies suffer from intra-EU regulatory heterogeneity. The second interdependence consists therefore of the beneficial impact of domestic reforms in services on the single services market whenever such reforms reduce regulatory heterogeneity. Reduced regulatory heterogeneity may be the result of i) the horizontal services Directive, for the simple reason that many domestic rules are abolished or become less intrusive, which must lower regulatory heterogeneity; ii) pro-competitive domestic reforms that go beyond the services Directive (since it is not all-encompassing); and iii) even when domestic regulation is justified, harmonisation at EU level is agreed with a view to lower or eliminate such regulatory variety.

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<sup>20</sup> The European Commission, together with other international bodies, supports the construction of the Foreign Affiliates Statistics (or FATS) database, a comprehensive source of variables for the monitoring of the activities of a foreign-controlled (or controlling) company after its establishment. FATS are, at least theoretically, the response to two main problems: first, they disaggregate data, allowing a better understanding of the effect of trade in services through mode 3 and look closer to the firm dimension. Trade (not only in services) takes place between firms and not between countries. Second, FATS represent a sub-set of the FDI world by including only affiliates controlled by a foreign investor (owning at least the 50% of the shares or voting power). FATS monitors the economic activity of the controlled/controlling establishment through variables (sales/turnover, employment, value added, number of enterprises) referring to the overall operations that concern foreign affiliates’ activities. The statistics are defined at firm-level and subsequently grouped by country and sectors; they are compiled both for foreign affiliates in the compiling economy (*inward* FATS) and for affiliates of the compiling economy (*outward* FATS).

Altogether, we have identified the following possible economic effects of the services Directive: i) the increase in intra-EU services imports, hence, a more competitive environment, as barriers are lowered or removed; ii) the concomitant reform of domestic services regulation insofar as the Directive requires this in order to remove the barriers, hence, a more competitive environment irrespective of (more) imports; iii) the (positive) impact on intra-EU FDI in services (in particular, since restrictions on incoming FDI have been removed by the Directive); iv) the (presumably positive) impact on cross-border FDI induced by the greater market opportunities as a result of the concomitant domestic services reforms; v) the expected leadership in market selection by FATS as they can be assumed to be competitive and are best able to benefit from the more pro-competitive domestic environment in each member state; vi) the benefits from a lowering of regulatory heterogeneity as induced by the Directive; and vii) the benefits from selected harmonisation of national regulation justified by market failures, yet distinct in practical details and requirements.

Economic literature on these various economic impacts is still relative scarce. Early studies on item (i) include Breuss & Badinger (2006) and Badinger et al. (2008). The first study, based on a partial equilibrium approach, finds an increase on the aggregate EU GDP of 0.7%. Using the same approach, Badinger et al (2008) estimated a GDP growth of 1.5%, including as well the effects of decreasing barriers to FDI in services (in fact, they found an increase of 18.9% in inward FDI stocks in selected service sectors). The elimination of the country-of-origin-principle, as was done in the finally legislated services Directive, lowers GDP growth by 0.5% to 1%. Also CopenhagenEconomics (2005a) finds an increase in EU GDP of 0.6% based on the first Bolkestein draft with the origin principle. An update of the study (CopenhagenEconomics, 2005b) concluded that the CoOP (country of origin principle) was good for 7-9% of the trade gains from the Directive. Apart from technical issues of how these estimates have been arrived at, there is the considerable problem of identifying the services barriers which – in those days – was still very difficult indeed. One might employ the OECD PMRs, but these are not defined or meant as ‘barriers’ and their use inside the EU is somewhat problematic anyway (Pelkmans, 2010). That is why the study by Monteagudo et al. (2012) constitutes a major improvement. This Commission study is more firmly based on the identification of intra-EU services barriers (as a result of the ‘mutual evaluation’ exercise between the EU member states), both before the directive and after implementation. Another merit is that it analyses both items (i) and (ii). Using simple restrictiveness indices, the authors arrive at an estimated EU GDP increase of 0.8% (for EU countries, ranging from 0.3% to 1.5%) for the state of implementation in 2011. The implied effects on intra-EU services trade (7%) and FDI in services (4%) are only incorporated as far as short-run competitive effects are concerned; their long-run effects should further augment the overall economic impact. Some 80% of the GDP increment is reaped within five years. These gains are relatively modest for item (i); most of it arises from the benefits of the implied domestic reform of services regulation (item (ii)) as domestic market activity is far larger. Simulated gains would augment with another 0.4% if member states would move to the average EU restrictiveness level but with no less than 1.6% if all EU countries would adopt services regulation no more restrictive than the five least-restrictive EU member states.<sup>21</sup>

On item (iii) Badinger et al. (2008) find a GDP growth of 1.5% and Monteagudo et al. (2012) an increase of FDI inflows of 4%. As far as we know, there is no study separating out the effects on intra-EU FDI in the medium run attracted by the greater market opportunities

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<sup>21</sup> The authors also simulate the economic impact of lower information and transaction costs as achieved with the Points of Single Contact introduced by the Directive in all EU countries. They find a range of 0.13% (now) possibly going up to 0.21% of EU GDP.

inside member states as a result of the domestic services reform implied by the services Directive (item (iv)). The literature on FATS is still scant and none of the contributions so far has addressed item (v). Kox & Lejour (2006) have done groundbreaking work on the impact of the services directive at a time that the identification of intra-EU barriers was still very problematic. That is why they turned to an indirect empirical approach, the effects of lowering regulatory heterogeneity (item (vi)) resulting from the implementation of the Directive. They argue, with some justification, that heterogeneity amounts to fixed entry costs which are specific to each national services market in the EU and sunk. Of course, quite apart from regulatory barriers to imports, these fixed entry qualifications are rather costly and tend to deter entry, certainly when an EU-wide strategy would be considered. The Bolkestein draft directive (with the origin principle still in it) would induce an increase of 30-62% of intra-EU services trade (i.e. some 2-5% of total EU trade) and augment by 18-36% intra-EU FDI in services (Kox & Lejour, 2006), which, in simulations, leads to an increase of (2004) EU GDP of some 0.5-1.5% (Lejour, 2008). The authors also simulate the impact of the full removal of all regulatory heterogeneity, which yields amazing results: intra-EU FDI would increase by 30% and intra-EU (market) services trade would triple!

Item (vii) is about the benefits of selected harmonisation of national services regulation, even when justified. Harmonisation is not necessarily a 'good' thing, in particular not when countries attach value to diversity based on distinct national preferences, in sharp contrast to mere heterogeneity in procedural or technical details grown out of forgotten legislative origins whilst the respective national laws serve equivalent objectives. In the presence of such diversity, harmonisation would result in welfare losses for countries cherishing deeply felt preferences. However, in goods markets, the EU has found out over time that equivalence of objectives is the routine, and exceptions with deeply felt preferences are rare (e.g. GMOs for some countries). It is thus reasonable to expect that selected harmonisation would help to bring down regulatory heterogeneity and benefit the EU at large. Two types of studies have emerged in this respect. One category comprises sectoral or specific case studies where much of the heterogeneity seems purely a relic of the past, but adjustment to a common solution (and its initial costs) are not easily accepted. Box 1 provides a battery of examples raising costs in the EU single market.

*Box 1. Pointless regulatory heterogeneity in the single services market*

Regulatory autonomy of member states can lead to extra costs and waste, also in services, if national regulations and procedures do not differ on grounds of truly distinct preferences. There may simply be turf fights or an unwillingness to cede power or to compromise on long-standing practices. In banking supervision, there used to be some 150 exceptions to EU rules and it is only because of the deep financial crisis that the pursuit of a common rule book has now become acceptable. In telecoms, the European Commission has complained for years about inconsistencies in the application of EU rules due to national regulatory autonomy. This is often linked to disparities in the degree of competition in national telecoms markets. ECORYS et al. (2010), found that if best-practice competition would be EU-wide in this respect, EU GDP might increase with up to 0.44%. In e-commerce, the differences in e-Identification and e-Authorisation are notorious and efforts in overcoming these in the EU Digital Agenda have only just begun. In rail, infrastructure user fees differ enormously between member states, far more than can ever be justified by cost differentials. For rail freight services, this matters a lot because rail freight is only economical (in most instances) on EU corridors crossing several countries. In air transport services, the absurdity of maintaining nearly 50 areas of traffic control is still not fully solved despite the Single European Sky.

A new study by CopenhagenEconomics (2012) of ten problem cases in the single market lists the following for services: i) fragmented data protection rules hindering the provision of European digital services; ii) private copying levies differ substantially between member states hindering the EU market for digital devices and media services; iii) in renewable energy services, national subsidy schemes differ a great deal, distorting the single market; iv) in railway services, different national approval regimes of the EU signalling and train control system (ERMIS) create barriers for foreign suppliers and services; v) significant (de facto national) derogations in SEPA, the EU single payments system, water down the benefits of SEPA; and vi) direct sellers are confronted with differing sales laws of the member states.

Another (small) category relates to more general quantifications or simulations. Somewhat extreme simulations, as quoted above, seem to indicate that voluntary harmonisation can pay off, even if selective. Thus, Nordås & Kox (2009) find that their bilateral heterogeneity indicator (for services) has a large and negative impact on bilateral FDI stocks. Quite suggestive is their result that the effect of being a member of the EU disappears when regulatory heterogeneity is explicitly included in the regression on regulation and FDI. The authors show that a limited reduction of regulatory heterogeneity in the OECD already yields substantial increases in incoming FDI. These exercises suggest that the horizontal services directive, which avoids harmonisation, might selectively be followed up with voluntary harmonisation to the benefit of all.<sup>22</sup>

A special case is the Digital Single Market, linked to a broader Agenda of what the Commission calls 'performance targets' on broadband access, cross-border intra-EU e-Commerce, e-Inclusion, R&D in ICT and public services under e-Government. The Digital Single Market assumes a much broader view than merely the (deep) fragmentation of the market for digital services, due to differences in data protection or (no) pan-European licensing for online rights management or (the lack of) an EU online dispute resolution system for e-Commerce or a range of issues with respect to ICT interoperability standards. It is also about the demand side (e-skills or e-Inclusion), specific ICT application on a large scale (e.g. smart grids, digitisation of the cinema, rail passenger services, etc.) and active promotion of performance 'benchmarks'. By explicitly linking network issues, demand, supply, R&D, the creation of content and single market issues, it is hoped to maximise the economic and social potential of ICT in the EU. In such a context, it becomes more difficult and perhaps inappropriate to try to isolate pure cross-border 'barriers' to digital services and the economic impact of their removal or common regulation. Before the Commission's Digital Agenda was published (European Commission, 2010a), CopenhagenEconomics (2010) claimed that a single EU digital market might generate no less than 4% additional EU GDP. Since this refers to an amalgam of measures and effects, it is bound to overlap to a considerable degree with several of the elements discussed above.

#### 4. Conclusions

Since the mid-1990s, both EU member states and the EU level itself have realised ever more that services markets in Europe were underperforming, to the detriment of medium and long-run economic growth. For EU countries, empirical evidence about the trend reduction of the restrictiveness of services regulation over this period is clear and convincing. As we

<sup>22</sup> A more informal but telling result which supports the gains from reducing regulatory heterogeneity, can be found in the European Business Test Panel (2009), in which thousands of SMEs participated. The co-existence of different rules in EU member states is strongly resisted by the companies. No less than 50% of the firms in the sample would start trading across intra-EU borders if regulations were the same.

have shown, the potential for further reforms in domestic services markets is nonetheless considerable and indications are that such reforms would yield substantial productivity increases. At EU level, the horizontal service Directive has been enacted and implemented with special efforts, including the screening of thousands of national and regional laws and the 'mutual evaluation' amongst member states. Moreover, in other domains such as network industries, professional services and financial services, progress has been made. Nevertheless, there is not yet a single services market. The empirical economic literature suggests that the further pursuit of the single services market is likely to generate additional economic growth.

Our main conclusions are presented below.

*i. Domestic and EU-level services reforms tend to be economically intertwined.* This is true, by definition, if one looks at national implementation simply as a way for member states to comply with the liberalisation under the services Directive. However, it is also true from the perspective of the overarching common objective of fostering EU growth (say, under Art. 121, TFEU). This implies deep domestic services reforms resulting in more competitive and better-functioning services markets everywhere, which are quintessential and far more important for EU growth than exposure to e.g. cross-border intra-EU services trade.

*ii. More competitive services markets matter for the competitiveness of European industry,* including firms' advantages in EU companies' global value chains. Indeed, the 'knock-on' effects from services (as inputs to industry) can be effectively mitigated by allowing market selection induced by greater competitive pressures in business services. This will often result in a somewhat larger firm size and less inefficiency.

*iii. EU and domestic services reforms (and to some extent, labour reforms as well) are one among several factors needed to better exploit ICT in EU user industries and user services sectors.* This is especially linked to the swift introduction of new ICT-driven business models, flexible, yet effective intra-firm organisation and radically new patterns of ICT-related innovation.

*iv. Simulations of domestic reforms bringing EU countries' regulatory restrictiveness to best-practice levels (without affecting the solution to market failures) show very substantial productivity improvements for many countries.*

*v. The gains from realizing a fully-fledged EU internal market for services (that is, much beyond the horizontal services directive) are still not fully understood.* In financial services, no new estimates seem available yet, whilst in network industries there are only some ad hoc attempts (pointing to fairly substantial gains); in professional services no reliable estimates are available. In all three, there is no such thing as a genuine single market, which is suggestive of considerable further gains; the manifold economic gains from the services Directive are beginning to be understood only now and the medium- as well as longer-run gains are almost certainly adding up to several percentage points of EU GDP, if not more. Adding to the long-neglected benefits of less regulatory heterogeneity in services, gains are much higher still.

*vi. Reaping the gains from better functioning services markets is not always just a matter of greater competition,* engendered by pro-competitive reforms, possibly helped by selective harmonisation at EU level. In several network industries, it requires considerable infrastructural investments (gas, electricity, rail, internet) over longer periods throughout the Union. A unique case is the digital single market, coupled with a much broader Digital Agenda where various supply and demand issues, R&D in ICT, harmonisation questions, interoperability standards, benchmarking of performance and e-government are brought together to leverage digital services in Europe.

Altogether, one can speak of a 'double-dividend' strategy: what member states are expected to do in terms of reforms (whether due to the Lisbon process or recommendations under Art. 121, TFEU or in the European Semester or in the light of enlightened *self-interest*) also serves the broader goal of EU economic growth, whereas the EU pursuit of the single market in services not only serves this goal (as this report shows) but, in turn, helps directly the national reform efforts as well. Both will indirectly be helpful for the competitiveness of European industrial firms, too.

One can go one step further for the eurozone which may enjoy a 'triple dividend', because promoting domestic services reform helps the proper functioning of monetary union. A well functioning monetary union must have a smooth and swiftly working adjustment mechanism. More precisely, one would like to see relatively low-cost and rapid absorption of (especially idiosyncratic) shocks which minimises the cumulative loss of growth from such shocks. This is crucial for a monetary union because it needs to have alternative adjustment channels as nominal exchange rate changes are no longer available. Services reform would best go hand-in-hand with labour market reforms as they are complementary and can also reinforce each other (because services are very labour intensive). In Pelkmans et al. (2008), a theoretical survey is complemented by an empirical economic analysis of national services market reforms that are 'lubricating' the adjustment processes in the euro area.<sup>23</sup> In fact, one can speak of a 'triple dividend' because this lubrication comes on top of the double dividend discussed above. Since the euro is a common good to the euro countries, one can justify a more binding approach for these domestic reforms than on the basis of Art. 121, TFEU. A fortiori, this holds for euro countries having received rescue funds for their sovereign debt, as they have a duty to improve their competitiveness and restore growth so as to be able to pay back these funds and rectify their debt exposures.

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<sup>23</sup> The empirical results show clear differentiations between eurozone countries and between sectors at the one-digit level (e.g. in price stickiness).



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