Beside the point?

The economics of the Services Directive

December 2005

Contents

Beside the point? the economics of the Services Directive

Introduction

The Services Directive has proved one the more controversial proposals from the European Commission in recent years. Trade union and others have voiced their concerns that the Directive will undermine employment standards and threaten public services.

The economic case for and against the Directive has featured much less in the public debate. In this assessment we look at the claims being made and how they stack up against the evidence.

Our view is that the economic case for the Directive in its current form has not been made. It is disproportionate to the problem it is trying to address.

Our key conclusion is that Europe does not have a general economic problem with excessive product market regulation[1] that is the central justification for the Directive.

The specific issues that remain should be addressed through more targeted and appropriate solutions through sector agreements, harmonization of qualifications and standards, and action at national level.

Why the Commission says we need a Directive and why now

The central economic justification for the Services Directive is the completion of the Single Market. The Commission and others argue that while much has been done to promote free trade in goods through removal of trade barriers and market liberalisation, more needs to be done to ensure free trade in services.

However, much of the current impetus for such a measure comes from the failure of Europe to meet the economic growth and employment targets agreed at the Lisbon Summit and the overall ambition to make Europe the most competitive economy in the world by 2010.

The Commission's 2002 report to the Council and Parliament asserts: "*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*

[1] This term covers both tangible and intangible products, and thus both 'goods' and 'services'.

the functioning of the Internal Market for services in the near future". (*The State of the Internal Market for Services*, COM (2002) 441 final).

This theme was picked up by the high level Kok Commission in their report to the Council in 2004 on how to reinvigorate the Lisbon Strategy. Kok recommended *"The European parliament and the Council should agree on legislation to remove obstacles to the free movement of services by end of 2005"(Facing the Challenge,* November 2004*).*

The Commission's 2002 report to the Council and Parliament set out at length why nothing short of a Directive could possibly meet the problem. The Commission rejected all of the following approaches:

- *Status quo* was unacceptable if the Lisbon targets were to be met;
- *Voluntary unilateral action* by States seen as too slow and likely to lead to a fragmented approach;
- *Infringement proceedings* by the Commission would be too slow, costly and time consuming and unlikely to achieve the strategic objectives;
- *Sectoral instruments* (such as already applied in financial services) would be unworkable given the number of sectors and the horizontal nature of some barriers across sectors;
- *Horizontal Recommendation* could operate like the Directive, but as it would be non- binding member States could ignore it; it would be complex to implement, and would take considerable time to negotiate.

The Commission concluded that only a horizontal Directive would offer legal certainty without imposing complex rules and be effective within the timescale envisaged by Lisbon.

Economic impact of the Directive – the Commission's case

The European Commission argues that the Directive would increase competition and drive down prices and encourage innovation and productivity, resulting in an overall increase in employment. The Directive attempts to achieve this aim through two routes:

- *Increasing trade in services* between Member States. This would increase measured exports and imports of services between members States (intra EU trade);
- *Permanent establishment* of service providers in other EU States. This would not show up in the trade statistics but in increased capital flows between member States, especially through Foreign Direct Investment (FDI).

Some of the economic arguments deployed by the Commission to support the introduction of the Directive are as follows:

- All EU economies are shifting jobs and output towards services, which in most States approach 70 per cent of total employment. All the net increase in jobs over the past decade across Europe has come from services;

- Between 1992 and 2002 the internal market is estimated to have increased European GDP by 1.8 percentage points and created 2.5 million net jobs, so extension of the internal market to services could have equally significant gains;
- SMEs in particular are held back by barriers to trade and competition, inhibiting growth and innovation and the ability of SMES to innovate and engage in trade;
- Productivity growth in services in Europe has lagged behind productivity growth in services in the US, and Europe has been less advanced in introducing new technologies in consumer service industries;
- Although services account for about 56 per cent of EU GDP, they account for only 20 per cent of total trade within the EU, a share the Commission thinks is too low. Similarly, intra-EU service sector FDI is also thought to be too low;
- The growth of intra-EU services trade has slowed in recent years, with most recent figures (for 2003) showing a small fall, suggesting the internal market process has stalled;
- Price differences for similar services in different EU States are significant and much wider than for goods.

These arguments reflect the conventional wisdom within the OECD that any reduction in regulation must produce a significant increase in growth and jobs. A recent study suggested that a radical reduction in domestic regulation within the EU could increase EU15 GDP per capita by 2.8 percentage points, mainly through increased trade (*The Benefits of Liberalising product markets and Reducing barriers to International Trade and Investment (OECD EDWP No 432, May 2005).*

However, so far more specific studies to quantify the potential impact of the Directive on jobs and economic growth have been few and far between.

One study produced by the Netherlands Bureau for Economic Policy Analysis in 2004 based on theoretical simulations of the impact of the Services Directive suggested that trade in services might increase by between 15 to 30 per cent and the stock of FDI in services might increase by between 20 and 35 per cent. (*The Free Movement of Services within the EU*, Kox et al, CPB report No 69, October 2004).

However, the study rather undermines its own conclusions by admitting that only one third of all FDI flows would be affected by the Directive and noting that *"some might be tempted to conclude that the proposed EU measures are rather irrelevant" (p49).*

Copenhagen Economics published a more detailed "official" study for the Commission in early 2005. This estimated that consumption would increase by about 0.6 per cent of European GDP or about 37 billion euros, with a net job generation impact of 600,000. The study said this would come about both through an increase in trade and higher FDI, through more service firms permanently establishing themselves in other economies (*Economic Assessment of the Barriers to the Internal Market for Services*, Copenhagen Economics, January 2005).

Our assessment

These are clearly important and powerful arguments. With 20 million unemployed across the EU any measure that promises to deliver the ambitions set out at Lisbon through significant increases in growth and jobs and addresses the EU's weakness in innovation and productivity has to be taken seriously.

More trade in services within Europe should stimulate both employment and GDP growth. There is much to be said for advancing a range of policies to help encourage trade, especially in higher value added services.

Intra-EU trade enhancing measures would include increasing the share of GDP that Europe devotes to R&D towards US levels, creating as many world class educational institutions as possible, building cooperative links between universities and business, encouraging investment in highly advanced communication infrastructures, and developing bigger and more sophisticated venture capital markets.

This should be matched by measures to improve productivity and employment growth in all domestic service industries through measures to encourage investment in skills and new technologies and adoption of high performance management and workplace organisation practice.

Protectionist and unjustified discriminatory practices undoubtedly exist in some areas in some economies. These need to be confronted. Where barriers do appear to be creating a genuine problem in a particular area, specific measures to address the issue may be appropriate.

But this approach must be balanced by recognition that regulations can also confer economic benefits and that all governments have legitimate economic and social reasons for controlling some forms of activity.

We are not convinced the Directive will offer the economic benefits claimed. Nor are we convinced that a Directive as proposed by the Commission was required to address those areas where there may be a case to address unreasonable or discriminatory barriers to trade and investment within the EU.

The evidence on which we base our assessment is set out below.

Competitiveness in world markets

The Lisbon Strategy calls for Europe to be the most competitive economy in the world by 2010. The Commission argues the Services Directive is essential to achieving that goal.

If we apply the straightforward measure of competitiveness as how well European firms are doing in global markets, the results are encouraging. Europe is the biggest provider of services in the world economy and between 1997 and 2003 that share went up. In 2003 Europe secured nearly 26 per cent of world trade in services, significantly ahead of the United States at just over 20 per cent.

The alleged competitive "threat" from firms based in China and India is now used to justify almost any policy measure, including the Services Directive. And it is true that both China and India increased their share of world markets for services, up from a combined total of 3.5 per cent in 1997 to just over 5 per cent in 2003.

However, the share of trade accounted for by other Asian economies has fallen even more. World trade in services in 2003 was even more dominated by Europe and the US than it was in 1997.

GLOBAL SHARES OF TRADE IN SERVICES 1997-2003

Share of world trade in services	1997	2003	Change
EU15	24.0%	25.8%	+1.8
United States	19.6%	20.2%	+0.6
China/India	3.5%	5.1%	+1.6
Other Asian*	17.1%	13.9%	-3.2
Other economies	35.8%	35.0%	-0.8

Note: Other Asian is Japan, S. Korea, Singapore, Thailand, Malaysia. Other economies include Canada, Australia, Switzerland, Norway, Russia, and Mexico.
Source: EU Commission, *EU International Trade in Services* 2005.

It is not self-evident from these figures that Europe has a problem competing in world markets in services. Indeed, in internationally traded services, arguably Europe is already the most competitive economy in the world.

Impact of the Directive on trade within Europe

The Commission says that the share of services in intra-EU trade is too low given the share of services in GDP. The Commission says services account for only 20 per cent of trade within Europe while they account for 56 per cent of European GDP.

However, the Commission does not explain *why* 20 per cent (or some other figure) is lower or higher than we might expect. The only justification is that regulatory barriers are a significant impediment to trade and therefore the figure is lower than it otherwise might be.

There are several reasons why we would expect the share of services in intra EU trade to be substantially lower than the share of services in GDP.

- Most services cannot be easily traded internationally – they are produced and consumed locally (indeed, this is one of the key arguments for why a Directive is needed to open up domestic service markets to foreign providers of services);
- Comparative advantage still favours trade in manufactured goods in some EU states, notably Germany, which has been highly successful in expanding its world share of trade in manufactured goods;
- Prices of internationally traded services may have been falling faster than the prices of internationally traded goods. So even if the volume of internationally traded services was expanding rapidly, the value of those services in total trade might show no increase;

For example, across Europe prices for communication services have fallen 21 per cent since 1996 while the price of household goods have increased by 11 per cent (EU Harmonised Index of Consumer Prices, July 2005). So the share of services by value in total trade could be static or might fall, even though the volume of services was growing rapidly.

The Kok Commission in particular also emphasised the slowdown in the growth of trade in services within the EU since 2000 and the fact that absolute trade in services had fallen in 2003. This was seen as clear evidence that the internal market process had stalled and the Services Directive was therefore urgently required to restart progress.

This is an odd conclusion. As we show in more detail later, product market regulation across the EU15 fell significantly between 1998 and 2003 to low levels, often comparable to the US. It is hard to see how a process can possibly stall because of structural barriers in a period when across Europe regulatory restrictions to trade and competition have been falling rather than increasing.

A recent OECD paper concluded that for non-manufacturing: "*the reduction in regulatory impediments to product market competition between 1994 and 2004 was somewhat larger in Euro-area than in other OECD countries, to some extent offsetting their stricter initial policy stance. There has been some convergence within the euro-area, with greater deregulation occurring in the most regulated economies*" (OECD Economics Working paper (2005) 25, p 22).

If trade in services within the EU had stalled because of structural barriers, we might expect trade in services within the EU to grow significantly slower than trade in services with the rest of the world. However, since 2000 the reverse has been the case. Comparing 2000 and 2003, trade in services within the EU grew faster than trade in services with economies outside the EU.

A more plausible explanation is that that we are seeing a cyclical response to weak economic growth and lack of consumer demand within the European Union and similar weaker trading conditions in the world economy. The fall in 2003 is hardly surprising given that this was the worst year for growth in Europe for a decade, with Germany virtually in recession and real wages either stagnant or even falling in much of Europe.

TRADE IN SERVICES INSIDE AND OUTSIDE THE EU 2000-2003

Exports (credits) of services	2000	2002	2003	Change 2000-2003
Current prices	Euro bns	Euro bns.	Euro bns.	percentage
Between EU members (intra EU)	371	415	411	+10.8%
EU and rest of world (extra EU)	311	336	331	+6.4%
Total trade in services	681	751	741	+8.8%

Note: figures may not sum due to rounding
Source: *EU International Trade in Services*, EU Commission 2005.

Impact of the Directive on FDI

As noted above, a key objective of the Directive is to open up markets by making it easier for foreign service providers to permanently establish themselves in other EU States. This would show up as an increase in FDI investment within the EU.

The Commission argues that the amount of FDI undertaken by service firms is too low, given their importance in the EU's economy. Again, the Commission does not say why, taking it as self-evident that FDI is too low because barriers to entry in EU service markets are alleged to be significant.

However, according to the Commission's impact assessment paper of 2002, service sector FDI in 2001 was just over 180 billion euros, compared with FDI of just over 50 billion euros undertaken by manufacturing companies.

In other words, service industries were responsible for over 75 per cent of the FDI undertaken by manufacturing and services combined. It is not clear why this is seen as low, given services account for just 56 per cent of European GDP.

Impact of the Directive on innovation

The Commission argues the Directive will encourage innovation through competition and highlights the importance of service firms in innovation, measured as investment in R&D, and in particular highlights the importance of SME high tech firms providing IT services.

However, most statistics suggest that while the service industries are big users of new technology, the overwhelming majority of investment in R&D is undertaken by manufacturing firms. In the UK for example about 80 per cent of all private sector R&D is carried out by the manufacturing sector, a share that has not greatly changed in a decade.

Moreover, the evidence suggests that IT services is the sector least likely to experience the restrictions and protections the Directive is supposed to sweep away. The evidence on sector specific barriers is set out in more detail below.

So we remain sceptical that the Directive will have much impact on innovation as measured by the share of R&D in GDP. Far more important will be policies to directly stimulate R&D, promote world-class educational institutions, and develop and strengthen university-industry links.

Impact of the Directive on productivity

The past decade has seen productivity growth in the US exceed that in Europe, and much of this is ascribed to productivity growth in services. In particular, the US appears to be more advanced in applying new technology on a large scale in consumer services such as retail.

The Commission believes the Directive would help close some of this gap by encouraging greater productivity among services within the EU.

Studies suggest that most of the growing gap between European service sector productivity and US service sector productivity is due to one sector – retailing. And much of this has come from the so-called "Walmart" effect – the ability to combine big investments in IT with the opening of big stores on greenfield sites.

If this analysis is right, then the Directive is irrelevant to addressing this part of the productivity gap. The gap is driven by productivity growth in big corporations, not the SMEs the Directive is intended to benefit most. Moreover, most of Europe simply does not have the abundance of undeveloped land and low population densities that have made it much easier for large scale US retailers to exploit the "Wal-Mart" effect.

Are barriers to trade a significant break on economic growth?

The Commission's 2002 report to Council and Parliament prepared the way for the Directive by citing at length the barriers that firms might face in the service industries.

The report highlighted some restrictions that on the face of it are hard to defend. A restriction on the employment of chimney sweeps was one of the more unusual, but arguably less relevant. But the Commission also cited laws that restrict the number of opticians per capita of population, requirements that medical laboratories could not inspect samples taken more than 60 kilometres away, and limitations on the number of petrol pumps.

Unfortunately, none of this was quantified. The examples were typically said to exist in one Member State, but no indication was given whether this was, say, Estonia (employment 0.6 million) or Germany (employment 38 million). And much of the detail appears to have derived from complaints made by businesses in response to Commission surveys and consultations. Experience in the UK tells us that the volume of complaints about burdens on business has little connection with the actual importance of the issue when it comes to investment, growth and jobs.

The Copenhagen Study referred to earlier provides a far more rigorous assessment of what and where the actual barriers might be. The study identified two sorts of barriers:

- Rent-creating barriers mean that incumbent firms are protected from both foreign and sometimes domestic competition (for example, by requiring that only a national of that country can carry out particular services). The removal of these barriers would drive down price by increasing competition.
- Cost creating barriers: these barriers include excessive regulatory, legal and administrative requirements that impose an effective tariff barrier on new entrants to the market, especially from other EU States. Their removal would improve efficiency and competitiveness by wasting fewer resources.

The study says that in terms of economic impacts, the second sort of barrier is the more important.

The study was unable to undertake a detailed examination of barriers in all parts of the EU service sector. So it looked in detail at the accountancy profession as a proxy for professional services; at IT services as a proxy for business services; and retail and wholesale services.

The study's results show that while barriers were significant in the professions, there were virtually non-existent in IT services and relatively low in the retail sector.

The various barriers are expressed as a tariff equivalent or additional cost that foreign firms would have to face if they wanted to establish themselves permanently in a foreign domestic market. Foreign firms today are estimated to face the equivalent of a 12 per cent tariff in terms of cost creating barriers in the regulated professions, but only 0.7 per cent in business services and just over 1 per cent in distribution.

The Directive would sharply reduce the tariff for entry into the regulated professions to about 2.5 per cent. Tariffs would also be cut in half for business services and distribution, but because these were small to begin with the change is marginal. This is shown in the table below.

IMPACT OF THE DIRECTIVE ON COST OF ENTRY FOR FOREIGN FIRMS

Cost-creating barriers	Professions	Business Services	Distribution
Before Directive (estimated)	11.8%	0.7%	1.2%
After Directive (estimated)	2.5%	0.4%	0.5%
Change	- 9.3%	-0.3%	-0.7%

Note: all figures tariff equivalent of cost of entry due to cost creating administrative, regulatory and legal barriers.
Source: *Economic Assessment of the Barriers to the Internal Market for Services*, Copenhagen Economics, January 2005, p 18.

Both the Dutch study referred to earlier and the Copenhagen study set out estimates of potential gains for each Member State. The UK comes out ahead in both studies, mainly because the UK is a significant net exporter of services and it is assumed we will gain from the enhanced export opportunities and FDI the Directive is claimed to deliver.

The comparison of cost-creating barriers suggest the main difference between the UK and other major EU economies is in the regulation of the professions, where the UK is significantly less restrictive. However, the UK has very similar (low) cost creating barriers to France and Germany in retail and IT services. Italy has a slightly higher cost barrier in retail, but the differences are not great.

Another way of putting it would be to say that in business services and distribution, Germany, France and the UK are already relatively open to foreign business and in these sectors the additional impact of the Directive in opening up domestic markets will be limited. As these economies account for a large share of EU GDP and employment, this must cast further doubt on whether the economic impact of the Directive could be as great as some have claimed.

COST BARRIERS TO FOREIGN FIRM ENTRY IN MAJOR EUROPEAN ECONOMIES

Tariff barriers	Professions	Retailing	Business services
UK	7.1%	1.75%	0.7%
France	11.3%	1.1%	0.7%
Germany	12.0%	1.5%	0.7%
Italy	16.2%	2.1%	1.0%

Note: all figures mid point estimates of tariff barrier from cost creating admin, regulatory or legal requirements to foreign firms permanently establishing in domestic markets.
Source: *Economic Assessment of the Barriers to the Internal Market for Services*, Copenhagen Economics, January 2005, p 38.

Most studies on regulatory impacts now draw on OECD indicators of product market regulation. The indicators should be not be used uncritically – they simply record the level of regulation, not whether it is justified or not.

However, they do allow us to assess both the level and trend of regulation in product markets across the OECD.

The latest update by the OECD looks at the period 1998 to 2003. This shows that:

- Barriers to trade and investment fell from relatively low levels in 1998 to even lower levels in 2003 for all EU15 economies;
- Barriers to trade and investment in many European economies are now similar to and in some cases lower than the United States;
- Barriers to entrepreneurship (including administrative burdens on start-ups, transparency of regulation, and barriers to competition) are comparable with or lower than in the US.

The table below summarises two indicators – one shows barriers to trade and investment and the other (taken from the entrepreneurship set of indicators) shows barriers to competition.

The barriers to trade and investment indicator distinguishes between "explicit" barriers to trade and investment and "other" barriers which picks up many of the sorts of practices the Directive is intended to remove. However, the "other barriers" indicator generally gives even lower scores. For example, Italy scores 0.4, France scores 0.3, the UK and the US 0.2. These differences are not significant.

So whether we take the more general or the more specific measure of regulatory burdens and barriers in these two areas, it is hard to argue that Europe today has a major economic disadvantage in either.

BARRIERS TO COMPETITION, TRADE AND INVESTMENT IN 2003 OECD index score: 0 = lowest barriers, 6 = highest barriers

Barriers to Competition	Index score (ranked)	Barriers to trade and investment	Index score (ranked)
Denmark	1.7	Poland	2.4
United States	1.5	Slovak Republic	1.6
France	1.4	Hungary	1.4
Hungary	1.1	Greece	1.2
Austria	0.8	Italy	1.1
Belgium	0.6	France	1.0
Netherlands	0.6	Czech Republic	0.9
Italy	0.6	Denmark	0.8
Sweden	0.6	Portugal	0.8
Greece	0.5	Sweden	0.8
Czech Republic	0.5	Luxembourg	0.7
Portugal	0.5	Austria	0.7
Germany	0.5	Netherlands	0.7
Finland	0.4	Spain	0.7
Spain	0.4	US	0.7
UK	0.4	Germany	0.6
Poland	0.3	Finland	0.6
Slovak Republic	0.3	Ireland	0.5
Ireland	0.3	UK	0.4
Luxembourg	0.1	Belgium	0.3

Note: The OECD indicator on barriers to trade and investment include restrictions on foreign ownership of shares, discriminatory barriers, and regulatory barriers. The OECD indicator on entrepreneurship includes licence and permits systems, the operation and transparency of rules and regulation, administrative burdens on start-ups, sector-specific administrative burdens, legal barriers and anti-trust exemptions.

Source: *Product Market Regulation in OECD Countries 1998-2003*, ECO/WKP No. 419 (2005) 6, April 2005 (tables 22 and 23).

The Country of Origin principle

The most controversial element in the proposed Services Directive is the “Country of Origin Principle” (sometimes abbreviated as CoOP). The Commission saw this as a key element in the Services Directive, allowing firms to provide services on a temporary basis in another Member State according to the regulatory requirements of their home Member State, rather having to comply with the regulations of the Member State where the service is being provided.

However, the European trade union movement and many others have expressed strong opposition to this measure, arguing it would undermine regulatory standards and basic employment protections.

The UK Government’s Department of Trade and Industry (DTI) has commissioned Copenhagen Economics to try and separate out the impact of the CoOP from other features of the Directive. The findings suggest that at current levels of trade, the CoOP principle will deliver no more than 10 per cent of overall benefits. The report says: *"The provisions relating to the Country of Origin Principle account for around 10 per cent of the total welfare gains from the Services Directive (The Economic Impact of the Country of Origin Principle in the Proposed Services Directive, Copenhagen Economies, p5).* The CoOP provision in particular would have very little impact on the claimed job gains from the Services Directive, primarily because the claimed economic benefits would come mainly through higher productivity and lower prices.

The study notes that if trade in services increased, for example, as a result of changed firm behavior due to the Directive or some other change in the EU economy, the benefits from the CoOP would also be greater. However, the study suggests trade would have to increase by between 5 and 10 times before CoOP could offer strong economy wide effects. The study also notes that such dramatic increases are not likely: "*the magnitude of the direct price and cost impacts of existing barriers to service provision do not provide any indication to suggest that the CoOP will lead to a radical shift in the average firms' production and market behaviour*". Thus the evidence from this study suggests that it is unrealistic to expect significant economic benefits from the CoOP.

The study was not intended to isolate other features of the Directive, but the researchers believe it sheds light on what may be more important within the Directive. The study notes that Article 29 on the regulated professions is likely to have a particular economic importance, as might some aspects of Article 15 on price setting. The study concludes by saying that: *"some articles in the proposed Directive are likely to be economically more significant than others".*

We draw two conclusions from this study. Firstly, the vast majority of claimed economic benefits, especially the gains in jobs, are independent of the Country of Origin Principle. Secondly, it further questions the need for a wide-ranging Directive as opposed to the more targeted measures set out in Article 29 on professional services.

What do firms feel are the real barriers to trade?

Many firms across Europe replied to the Commission consultation on potential and actual barriers to trade in services. The Commission clearly sees such views as very important in justifying the current Services Directive.

However, a more recent in-depth study of 38 UK firms by PriceWaterhouse Coopers (PwC) for the DTI suggests that regulatory barriers are not a major impediment to either establishment or cross-border provision of services. The study focused on firms that had either recently established or provided services without establishment to at least one of six other member States.

In terms of establishment, the study concluded that: "*overall, the barriers which appeared to have the most impact on the case study firms in terms of* *their willingness to establish in new EU markets and their success in doing so were natural ones, such as business culture and language"* (Impact of the proposed EU Directive on Services in the Internal Market: case studies of UK businesses, final report, August 2005, PwC, para 13, p4).

In other words, the economics of establishment are driven by factors such as language, culture and economies of scale for which the Directive is irrelevant. The study concluded: *"policy related barriers, whether covered by the Services Directive or not, were rarely seen as changing the economics of establishing an office. While often costly and time consuming, they tended to be seen as irritants, rather than the key factor in decision-making and/or success."*

The study also found that a barrier to establishment was the need to be assured there were sufficient economies of scale to make overseas establishment worthwhile. Firms faced significant start up costs in terms of leasing new offices, hiring staff, and developing client bases and contacts and these high-fixed start up costs could only be justified if the firm was confident a sufficient market existed. The study noted that "*overseas offices needed critical mass to be profitable and this was often difficult for smaller firms" (paragraph 10, p4).* As a result, smaller firms were far more likely to see provision of services without establishment as a far more cheaper and flexible way of developing business with the rest of the EU.

In terms of cross-border provision of services without establishment, the study found that "*case study firms reported encountering few barriers to the provision of services within the EU which would be reduced by the Services Directive…Natural barriers, particularly those related to culture, were the most significant barriers faced by firms seeking to provide services elsewhere in the EU; in some cases, these issues had been strong enough to prevent firms providing services successfully*".

Impact of the Directive on SMEs

The Commission's arguments give a lot of weight to the restrictions faced by SMEs, and this is a sector the Commission feels will benefit most. The Commission notes that US firms are on average bigger than EU firms and that US small firms appear to grow faster, on average, than European small firms.

However, if Europe were to fully replicate the US internal market we would expect the number of SMEs in Europe to rapidly shrink. The US is a big firm economy where economies of scale matter. It has a lower share of employment in SMEs than Europe and one of the lowest self-employment rates in the OECD.

The PwC study quoted above confirms that cross-border provision of services can be a more viable option than establishment to enable smaller firms to export services to other Member States. However, as noted above, the study makes it clear that the main barriers faced by smaller firms (and others) to cross-border provision of services are cultural barriers, which the Services Directive would not address. This does not substantiate the claims that the Directive will bring significant benefits to SMEs.

The benefits of regulation

As we noted earlier, much of the conventional economic analysis assumes all regulation is bad and therefore less of it is inherently a good thing and will result in higher growth and more jobs. This is a one-sided view that fails to take into account the potential benefits of regulation. Setting high and consistent standards can encourage competition on the basis of innovation and productivity, rather than cost-cutting and poor quality provision. Moreover, restrictions can have a good economic and social reason for them, for example, most governments tightly control gambling activity and set tough requirements for firms engaged in services with significant environmental, legal or public health implications.

Conclusions

The economic case for the Directive has not been made. It is disproportionate to the problem it is trying to address. The claimed wider economic impacts are overstated.

Moreover, the time and effort spent on the Directive in its current form has been a distraction from progressing more targeted measures to encourage trade and investment and in following up the constructive ideas in the Kok Commission report on developing an EU wide "knowledge economy."

The key points from our assessment are:

- The EU as a whole is already the world's most competitive economy in internationally traded services;
- The internal market process has not stalled. The slowdown in trade in services since 2000 is because of macro-economic factors;
- Product market regulation has fallen significantly in all EU economies have the past five years, and today is at low levels;
- In most of the areas the Directive is trying to address overall regulatory severity is at or close to that of the US;
- The significant cost barriers to foreign entry in domestic services are primarily among the business professions: barriers are very low in retail and almost non-existent in business services;
- Almost all the claimed economic gains, especially jobs, can be delivered without the Country of Origin Principle;
- The Directive is irrelevant to the real barriers to establishment of service

providers – the "natural" barriers of language and culture and the need for economies of scale in overseas markets before establishment becomes profitable;

- The potential benefits – both economic and social – of regulation and restriction have not been taken into account.

Europe no longer has a general problem with excessive product market regulation. The specific issues that remain should be addressed through less sweeping solution through sector agreements, harmonization of qualifications and standards, and action at national level.

Bibliography

Copenhagen Economics Jan 2005 *Economic Assessment of the Barriers to the Internal Market for Services*

Copenhagen Economics Oct 2005 *The Economic Impact of the Country of Origin Principle in the Proposed Services Directive* Final Report

European Commission 30.07.2002 *Report from the Commission to the Council and the European Parliament on The State of the Internal Market for Services* COM (2002) 441 final

European Commission 2005 *European Union International Trade in Services Analytical aspects*

EU Harmonised Price Index of Consumer Prices July 2005

Kok Nov 2004 *Facing the Challenge The Lisbon strategy for growth and employment* Report from the High Level Group chaired by Wim Kok

Kox et al Oct 2004 *The Free Movement of Services within the EU* CPB report no 69

OECD May 2005 *The Benefits of Liberalising Product Markets and Reducing Barriers to International Trade and Investment* OECD EDWP No 432

OECD 2005 *Economics Working Paper* (2005) 25

OECD April 2005 *Product Market Regulation in OECD Countries: 1998-2003* Economics Department Working Papers 419

PriceWaterhouse Coopers August 2005 *Impact of the proposed EU Directive on Services in the Internal Market: case studies of UK businesses* Final Report for Department of Trade and Industry

Trades Union Congress
Congress House
Great Russell Street
London WC1B 3LS

www.tuc.org.uk

contact:
Ian Brinkley
020 7467 1205
ibrinkley@tuc.org.uk

Janet Williamson
020 7467 1305
jwilliamson@tuc.org.uk