Services and the Single Market

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Abstract The single market programme of the EU covers services as one of the four fundamental freedoms. While the legislative effort has been impressive and positive results evident in areas such as mobile telephony and low cost air transport, the impact on many services has been weak as yet. This holds in particular true for a group of services that share specific characteristics such as the overriding importance of quality, the existence of asymmetric information and the need to produce in a tailor-made way. The combination of these characteristics and trends such as globalisation, the usage of ICT and enlargement, calls for a fresh view on the functioning of the single market. An effective future single market is based on a bottom up approach, integrating single market policies with other policies, starting from the functioning of national markets and being less uniform in nature.

Keywords single market · services · European union

JEL Classification F55 · H77 · L80 · L88

1 Introduction

The single market for services represents the most ambitious attempt to date to promote international economic integration for services. There are international agreements that also seek to promote such integration such as the original US–Canada Free Trade Agreement now superseded by NAFTA and the General Agreement on Trade in Services (GATS) covered by Bernard Hoekman in this issue. However, none of these agreements can be compared in

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range or depth to the programme that underpins the single market for services. The single market can therefore be taken as a ‘laboratory’ for the possibility of market integration in this field. It can tell much about the fundamental requirements for such integration and about the obstacles that must be surmounted by economic actors for integration to proceed.

Two aspects in particular distinguish the single market from standard international agreements on services. First the single market also covers factor movements. Free movement of both labour and capital prove important for integration of markets in services. Second, the EU has legislative powers that enable it to address the regulatory obstacles that constitute the main barrier to integration directly and simultaneously across the twenty-seven Member States. These two aspects imply that the single market cannot easily be transposed other parts of the world. Nevertheless, these special conditions do imply that if services can not be integrated cross-border within the European Union, they are unlikely to do so elsewhere.

It follows that is important to assess the functioning of the single market, and in particular for services. The added value of our paper is first and foremost that it adds to better understanding how the single market for services actually functions. The difficulty of analysing this question, which appears to be straightforward, is that it has many facets and requires sometimes non-standard tools and thinking.

First, the data often used to assess performance need to be interpreted with great care. This has to do with the endemic poor quality of service data, but also with the fact that for instance trade data provide a misleading picture of the tradability of services, and tradability of services in turn does not tell the full story of how the single market functions.

Second, most analyses are still based on goods market logic, while services differ in a significant way from goods. This paper builds on Rubalcaba (2007) and analyses the impact of key characteristics of services for the functioning of the single market.

Third, the service sector is often analysed by focusing on cross-border provision, as this special issue demonstrates as well. Our paper looks at the different pillars (free movement of labour, right of establishment, and cross-border provision of services) and recognizes important links and possible substitution between the various modes of single market operation.

Fourth, the performance of the single market is not static, but is instead influenced by ongoing trends such as enlargement and ICT. Our paper analyses the impact of these various trends on the way the single market functions.

Once we understand how the single market functions, we can evaluate whether or not changes to the single market programme are needed. The added value of our paper is that it combines the above elements to make such an evaluation. The paper comes to the conclusion that the logical policy consequence for the single market is that it needs to be repositioned from a uniform top-down legal construct to a flexible economically based bottom-up one.

2 The single market for services

This section analyses what the single market for services means, what can be said about the performance of the single market for services and which difficulties one finds on its way to make a clear assessment on this.

It has become conventional to state that the single market is working by and large fine for goods, but that services are where the weaknesses lie (OECD 2005a). Because services represent the bulk of the economy so the argument goes, the failing of the single market is essentially the failure to adequately cover services. The Services Directive was intended to address this issue and to the extent that the final compromise does sufficiently open service markets to competition, the single market will be complete at least as far as its main elements are concerned.

Like most conventional wisdoms, there is an element of truth in this, but it is by no means the whole truth. The conventional definition of services indicates that they represent over 70% of GDP, which rises to nearly 80% if public utilities and construction are included. However, this figure is somewhat misleading, since many of these services remain outside the scope of the single market¹ either because they are either non-economic in the sense of the Treaty of Rome or because they have been explicitly excluded from current legislation. Services that could be covered by the single market (including utilities and construction) make up around 57% of GDP, which is still considerable.

More to the point, it is hazardous to make generalisations about services. Indeed counter examples can be found for any generalisation because services are heterogeneous and almost defy description. No single characteristic, for instance intangibility or storability or the simultaneity of production and consumption, is capable of defining services. Rather there is a continuum between goods and services with goods that are quasi-services because their value stems from intangibles (for instance compact disks) or services that are quasi goods because they are storable and reproducible (for instance software). What constitutes a good or service is ultimately an issue of convention. Some of the important issues for services, such as asymmetric information, also occur for certain goods and their particular relevance to services is more concerned with intensity and pervasiveness than with the issue per se.

It is not true that services are always labour intensive. Many services are labour intensive but others are very capital intensive, such as telecommunications, energy or transportation. Nor is it true that services are low productive ones (Fig. 1)². Overall, labour productivity in market services is higher than that for the economy as a whole or for manufacturing industry³. Very high labour productivity is observed both in the capital intensive services and in many high level labour intensive ones such as professional services. Nor is it true that services differ from goods by their degree of regulation. While many services are highly regulated through differing methods (qualifications, sector specific regulators) some are not (management consultancy). Nor has the single market passed services by. The single market has already had a significant effect on certain services which have been the subject of extensive liberalisation, especially telecommunications and air transport (European Commission 2005a).

The tradability of services is a subject of some dispute. The standard way is to look at those services that are currently traded. According to the 2000 EU input–output tables compiled by the IPTS based on products rather than sectors, the ratio of exports to total uses for services is below that of the whole economy and well below that for manufactured products (Table 1)⁴. However, even at a very aggregated level, the category ‘wholesale and retail trade, repair services, hotel and restaurant services and transport’ is substantially traded with approximately the same proportion exported as that of “products of agriculture, forestry, fisheries and aquaculture”, which are undeniably both tradable and traded. For a more detailed level than is available from the input-output tables, it is necessary to match the available data for trade in services with that for production. This is a somewhat hazardous business with rather little detail either for trade from the balance of payments statistics or for production from either the enterprise surveys or the national accounts. In addition, concordance between the two sources is complicated by the use of categories in

¹ With the exception of certain basic provisions such as non-discrimination.

² For an overview of measurement issues relating to productivity in UK market services see Crespi et al (2006). A more detailed examination of these issues for the USA is provided by Triplett and Bosworth (2004).

³ Labour productivity for non-market services can not be reliably established. For an extensive discussion of measurement of productivity for non-market services see the Atkinson Review: Final Report (2005).

⁴ For the EU as a whole, intra-EU trade is part of domestic production. However, since the purpose here is to indicate the extent to which services can be traded cross-border, total trade (intra + extra EU) is used here to calculate the ratio.

Source: EU-KLEMS data base

Fig. 1 Labour productivity per hour, EU-25 2004

the balance of payments data such as ‘travel’ that affect many different production sectors. Nevertheless, it is clear that at a disaggregated level some services are very heavily traded (air and maritime transport, Table 2). However, many services including construction and more surprisingly communications and financial services have been little traded, at least until recently. Clearly, if services cannot be traded across borders the potential for economic integration under the single market will be severely limited.

As indicated by J. Bradford Jensen in this issue, it is possible that trade data provide a misleading picture of the tradability of services. Jensen and Kletzer (2006) use the geographic concentration of service activities within the USA to identify which service activities are traded domestically. On this basis they find that a third of services are tradable as against two-

Table 1 Trade by product category, EU-27 2000: Exports as percent of total uses

	Percent
Products of agriculture, forestry, fisheries and aquaculture	12.7
Products from mining and quarrying, manufactured products and energy products	33.3
Services and Construction	6.0
Construction work	0.6
Wholesale and retail trade, repair services, hotel and restaurant services, transport	12.4
Financial intermediation services, real estate, renting and business services	5.5
Other services	7.7
Total economy	15.2

Source: IPTS Input–Output Tables for EU-27

Table 2 Cross border trade as percent production value by sector, EU-25 2004

Sector	Percent
Construction	1.2
Transport via railways	9.3
Freight transport by road	13.3
Transport via pipelines	55.2
Sea and coastal water transport	99.8
Inland water transport	8.8
Air transport	46.5
Supporting and auxiliary transport activities; activities of travel agencies	8.1
Post and courier activities	4.5
Telecommunications	4.4
Financial intermediation	7.6
Renting of machinery and equipment without operator and of personal and household goods	6.3
Computer and related activities	16.4
Research and development	55.0
Legal, accounting, book-keeping and auditing activities; tax consultancy; market research and public opinion polling; business and management consultancy; holdings	7.5
Architectural and engineering activities and related technical consultancy; technical testing and analysis	11.7
Advertising	12.3
Total services and construction	6.3
Total economy	15.2

Source: Eurostat International Trade in Services, Annual detailed enterprise statistics on services and EU KLEMS data base

fifths for the economy as a whole. Their estimates find more workers in tradable professional and business service industries than in tradable manufacturing industries. Workers in tradable sectors have higher skills and significantly higher wages than those in non-tradable activities.

In practice both the data on trade and the work of Jensen and Kletzer relates to the three forms of direct cross-border trade in services (consumer moving to the point of production, producer moving to the point of consumption, direct cross border provision of a service). Since the single market definition of trade in services also includes trade by permanent establishment, in theory all services are tradable in one form or another under the single market. The issue is not therefore whether the single market is relevant for services but the relative importance of cross-border provision and right of establishment in single market legislation.

The potential for cross-border provision is still considered high. In Kox and Lejour (2005) simulations for the EU show that if countries make more use of mutual recognition, bilateral trade in commercial services among EU countries could increase by 30% to 60%. On specific examples the European Commission (2005c) mentions that in accountancy national regulations mean that a firm looking to do business in another Member State faces, on average, business costs 23% higher than a domestic competitor. Eliminating such barriers would boost productivity, thus increasing wages throughout the EU economy by an average 0.4% and employment 0.3%.

Given the high degree of uncertainty concerning the actual and potential degree of market integration in services, other more qualitative information can supplement the existing data. The best way to obtain this information is to descend to the level of the individual service (sector or market), to analyse at that level the obstacles to integration (whether regulatory, economic or cultural) and the practical possibilities to remove these barriers to doing business. Very few studies look at individual services in this way. Although not designed with this in mind, the numerous national studies by the McKinsey Global Institute

come closest to this purpose. Country studies cover Sweden (2006), Portugal (2003), France and Germany (2002), Poland (2000), UK (1998), The Netherlands (1997) (McKinsey Global Institute). In addition they look on a disaggregated basis at certain goods producing sectors, facilitating comparisons across sectors of the economy. They conclude that lack of competition is always an important factor in poor performance but that lack of competition takes many different forms according to the sector and—to a lesser extent—the country concerned.

Information on the functioning of the single market for services cannot be obtained by only looking at the traditional sources of data or literature reviews. It is for this reason that we have complemented traditional sources with practical evidence. During the first half of 2007, the European Commission, in cooperation with McKinsey, organised practitioner workshops on liberal professions (pharmacies and legal services), construction, health services and retail distribution and e-commerce that provided further qualitative information on the functioning of markets for services.

2.1 Characteristics of services

Markets for services are highly diverse across services, within services and between countries so that making generalisations about them can be hazardous. Indeed no generalisation will fit every service. Instead, certain services that are relatively little traded share many common features that are of great importance for their efficient functioning and which in turn explain why they are little traded. For goods the main tariff barriers have long since been eliminated and the main non-tariff barriers concern the physical characteristics of products that are subject to objective evaluation and inspection. On the contrary, the main barriers in services concern the functioning of domestic markets with regard to competition and stem either from regulations or from the specific characteristics of individual markets. The way in which these characteristics combine with the remaining barriers determine to a large extent the economic performance of services. In addition, the weight of services in the economy and their strong inter-linkages with the rest of the economy mean that service sectors and markets also determine to a large extent overall economic performance. This section will begin therefore with the key characteristics of services for the functioning of the single market before examining some of the remaining barriers and their impact on economic performance. We build on Rubalcaba (2007), who also provides characteristics of services but without explicitly linking it to single market performance.

Despite the fact that these characteristics are not new, few papers establish an explicit link between the characteristics and the functioning of the single market. One important characteristic of services that is commonly but not universally found is the *bespoke* nature of the activity. When each service needs to be tailored to an individual case, the capacity for standardising responses and making productivity gains in this way is low. Services as diverse as construction, professional services and health usually require a great deal of customisation for individual clients or patients. Even for retail, the service component often implies face to face contact that requires the content to be adjusted in function of the client⁵. Standardisation of service facilitates their reproduction and diffusion, for instance through franchising. Bespoke provision can be expected to slow down this process and hinder integration.

Issues of *asymmetric information* are rife although by no means confined to services. The supplier of the service has greater knowledge than the customer both about the nature of the service supplied and the ability of the provider to supply the service. As a result, the customer has to rely on the regulator, for instance through the requirement that the provider

⁵ For a further examination of services divided into contact and intermediation categories, see Haskel (2007).

be in possession of a recognised qualification, on word of mouth or on experience in the past with the same or other providers. In any case he or she is in a position of relative weakness. The often technical nature of the information means that the consumer of the service may have limited ability to assimilate important aspects of the transaction. In the arguable extreme case of construction, inability to judge quality *ex ante* may lead to competition on the basis of price alone, even though for the customer quality may be a more important purchase criterion.

Many services have potentially long-lasting consequences or deficiencies that will only show up after the service has been provided. *Quality is an overriding consideration* but one that is difficult to measure or to monitor. Does it mean that the patient survives, that the building does not fall down, that the enterprise does not go bankrupt? Or does it mean something much more complex and nuanced?

With quality difficult to measure, particularly *ex ante*, the traditional way that regulators have strived to assure quality for many services is through limiting entry by the requirement that the provider be in possession of a recognised relevant *qualification*. In the course of a working life, knowledge acquired for an initial qualification will become out of date in the absence of a system to continuously upgrade skills. Qualifications are in any case an imperfect measure of the competence of a supplier to provide a certain service, which begs the question of who is to define and monitor competence? Even competence is not necessarily a good predictor of outcomes, although it is obviously a necessary condition for good quality provision.

Because it is easier to assess the provider than the service itself, most systems of accreditation are based on the procedures which a supplier applies rather than on judging outcomes. However, when assessing the quality of information provided on-line on health, the Picker Institute (2006) found that for the medical information sources they examined there was only a weak, non-significant correlation between providers who scored high on the content of their materials and those who scored high on their development process. The more sophisticated the service the greater the likelihood of such a divorce between process oriented controls and outcomes.

All of these problems of how to assess quality appear more difficult when dealing with *cross-border provision* of services, where information available is weaker and systems of national regulation and organisation of services unfamiliar. Without adequate systems of assessing quality, it will however be extremely difficult to make progress on either productivity improvements or stimulating cross-border purchases.

The specific characteristics of services make issues of *trust* between the service provider and the user important. This can take different forms. For instance, for electronic commerce issues of trust relate to the security of the payment system used to make a financial transaction, on the use of personal data, that the product (good or service) will be as specified and arrive in good condition, that warranties will be honoured and so forth. For professional and health services trust concerns the degree to which the recipient believes that the provider has his or hers best interest at stake, that the provider is independent of outside influences and is working to the highest ethical and professional standards.

Allied to issues of quality and trust are those of *redress*. Consumers and patients want to be sure that if something goes wrong that they would have access to redress. Neither consumers nor SMEs want to engage in long and expensive litigation whose outcome is uncertain. They desire that procedures for dispute resolution should be simple, rapid and effective.

Many services are characterised by a *strong interaction between labour and product markets*. Self employment is high and a worker may move between employed and self-employment status with relative ease so that it is not always possible to distinguish clearly aspects that relate to product and labour markets. Another form of interaction is between working hours and shop opening hours where the different forms of regulation may in practice be incompatible. Attracting and retaining skilled staff is particularly important and

the key to improving productivity but the prevalence of underground or black markets for labour undermines the incentive to train and to maintain skills in several service sectors.

Now that we have identified some of the key characteristics of many services, the next step is to see how these characteristics impede growth.

2.2 Barriers to growth of services

Market fragmentation for services is significant. Market fragmentation can be the result of regulation (OECD 2000, 2001a, b, 2005b, c). Restrictions on the location of sales of over the counter medicines, ownership restrictions on pharmacies or the provision of legal services, zoning laws prohibiting out-of-town shopping are examples. Fragmentation can also result from market conditions. The residential construction market suffers from the large number of small jobs that are required to repair and maintain buildings; in retail consumers may prefer to shop for certain items in small scale, ‘boutique’ type establishments. Issues of confidence and trust also act as a barrier to take up of services. Again, the barrier created is much greater for cross-border purchases where previous experience with the provider, word of mouth and knowledge of local regulation and ways of doing business will be much less than for the local domestic market.

As indicated above, overall cross-border purchases of services remain underdeveloped and intra-EU trade remains only a portion of that (Table 3). Overall, intra-EU trade in

Table 3 Intra-EU trade in services as percent total trade EU-25 2004

	Intra-EU exports as percent total	Intra-EU imports as percent total	Intra-EU exports+ imports as percent total
Services	57.7	60.1	58.8
Construction	47.2	57.6	51.8
Transport	50.2	54.7	52.4
Sea transport	39.6	45.6	42.4
Air transport	48.9	50.0	49.4
Rail transport	69.5	77.0	73.0
Road transport	78.3	79.9	79.1
Inland waterway	82.3	90.7	87.5
Pipeline transport	50.0	69.7	58.5
Travel	69.9	64.2	67.0
Communications	69.0	67.0	68.0
Financial intermediation	55.7	62.0	58.1
Financial intermediation, except insurance and pension funding	55.6	62.6	58.0
Insurance and pension funding, except compulsory social security	55.9	61.3	58.3
Other business activities	54.2	62.4	58.3
Renting of machinery and equipment	56.4	68.0	63.1
Computer and related activities	61.2	64.2	62.2
Research and development	45.4	55.4	50.7
Legal, technical and advertising	53.4	60.9	57.0
Other business activities, nec	58.6	62.8	60.6
Recreational, cultural and sporting activities	54.1	52.2	53.1

Source: Eurostat EU International Trade in Services

services represents 59% of total trade with extra-EU trade exceeding intra trade overall only for sea and air transport⁶. These relatively low figures (transport excepted) mean that markets are organised on a national basis and consumers in particular are reluctant to venture beyond national borders, even when there are relatively few restrictions and some advantages for them to do so—as with e-commerce. Local cross border markets are the areas where cross-border provision appears to have most potential as well as being most developed. The total population of local cross-border regions covered by the EU's Interreg IIIA programme is 172.5 million inhabitants (or 35.2% of EU-27) with a combined GDP of €3.4 billion (or 31.9% of EU-27). In their own right, such regions represent a huge potential for cross-border provision of services.

The studies by the McKinsey Global Institute confirm that there are very large differences in outcomes within the same sectors and that poor productivity is not inevitable. For example, in health, for each station on the London underground travelling east from Westminster life expectancy declines by almost a full year. Devising appropriate incentive structures in many cases can lead to major improvements in performance. However, such structures need to be careful to avoid perverse results. Targeting hospital waiting times for patients can lead to neglect of other important dimensions of health such as infections within the establishment.

Europe suffers from the low growth of new entrants rather than from a dearth of start ups (Fig. 2, OECD 2002).⁷ When dealing with market services, low growth is reflected in the “missing middle” (Table 4). Micro-enterprises of less than ten persons represent more than three-quarters of the total for all sectors and for more than 90% of the total for all the market service sectors. However, for manufacturing, public utilities and transport and communication, the share in turnover, value added and (to a lesser extent) employment tends to rise with firm size. For other market services however the size category of firms with 50 to 249 persons employed is much weaker. In other words, a dualistic structure with a number of large firms and many small firms but few medium sized ones appears to dominate.

Threshold effects such as regulation on employment that make it much more burdensome to take on additional labour, or the need to take on professional managers once a firm reaches a certain size seem to hold back firms from expanding. In turn this would seem to indicate that the incentive for firms to grow beyond a certain size is insufficient to overcome the additional expense and problems that such growth would entail. Thus between the established large firms, often international in outlook and practice, and the small firms that have no desire to grow there is a category of potentially high growth firms that at present is not performing well. It is this category of firms that the single market could have been expected to impact most positively by removing barriers to their expansion.

Many barriers of both a regulatory and non-regulatory nature still exist to the integration of markets for services within Europe. Many of these barriers stem from national and local conditions that are holding back the development of services domestically as well as internationally. In this sense, the single market reveals problems with the functioning of existing markets for services rather than specific problems for cross-border provision.

Because the markets for services remain overwhelmingly national and even local, the effect of the single market on services is most profound through its impact on the functioning of national markets. For example the distance selling Directive and e-commerce Directives as well as general consumer protection measures that also apply to this area act

⁶ Within the EU of course exports should equal imports apart from reporting errors.

⁷ The OECD data would appear to overstate the growth of US firms relative to European ones since American start ups employ less people than those in Europe.

Fig. 2 Net employment gains among surviving firms at different lifetimes, 1990s (net gains as a ratio of initial employment)

within national markets as well as for sales cross-border. Measures to open telecommunications, rail freight and postal services all have a profound effect on the development of e-commerce providers, irrespective of whether their customers are located in the same country or in another Member State. In other sectors, where European regulation has addressed primarily issues relating to the cross-border provision of services, the impact of the single market has undoubtedly been less than expected. For example, standardisation has affected construction products rather than the service itself. Legal services and pharmacies remain essentially regulated or self-regulated on a national basis with for example the directive on recognition of qualifications playing a supporting role. So far the impact of EU regulation on national systems of health has been minimal, reflecting national responsibility for this area.

It is clear that the different modes of opening up markets for services have had quite different effects on national markets. Free movement of labour, both skilled and unskilled, has undoubtedly contributed to the development of service markets in Europe. Right of establishment is the most common way to penetrate markets for services and is also the preferred mode of both enterprises and public authorities. The small share of cross-border provision means that its direct impact is limited but indirectly it can affect the functioning of national markets. These issues are developed in the following section.

3 The different methods of provision of services within the single market

The three principal ways in which the single market has affected the functioning of markets for services are through the free movement of labour, right of establishment, and cross-

Table 4 Share of different size classes for main economic variables by sector, EU-25 2003%

Size class (number of persons employed)	Manufacturing	Electricity, gas and water supply	Transport, storage and communication	Building and construction	Wholesale and retail trade	Hotels and restaurants	Real estate, renting and business activities
Number of enterprises							
1–9	79.2	71.2	94.9	91.2	93.2	91.4	94.6
10–49	16.4	15.9	7.3	7.9	6	7.8	4.2
50–249	3.6	7.6	1.2	0.8	0.6	0.6	0.8
250 and over	0.8	3.7	0.3	0.1	0.1	0.1	0.2
Turnover or gross premiums written							
1–9	6.8	6.5	13.3	31	25	41.9	35.6
10–49	13.2	5.4	14.5	29.7	24.8	25	19.9
50–249	20.7	15.8	13.8	18.4	20.4	11.2	18.6
250 and over	59	73.1	58.9	20.9	29.8	21.6	25.6
Value added at factor cost							
1–9	7.3	5	11	33.5	28.5	38.1	33.5
10–49	15.7	4.7	11.6	31.8	25.2	25.9	19.4
50–249	22.3	12.3	10.8	17.3	16.7	12.6	17.9
250 and over	55	76.9	66.7	17.4	29.6	23.3	28.9
Number of persons employed							
1–9	13.8	2.5	18.7	43	40.5	46	34.4
10–49	20.8	5.5	14.5	30.6	21.1	25.6	17.4
50–249	24.2	14.4	12.3	14.9	12	10	16.3
250 and over	41.1	81.1	54.5	11.5	26.4	18.2	31.6

Source: Eurostat Summary Indicators: employment size classes for EU25 (all Nace activities)

border provision. (Freedom of movement of capital is necessary for right of establishment to function properly, but liberalisation of capital movements has been achieved so that this no longer constitutes a barrier.) This section shows that fundamental freedoms under the Single Market work out differently for services than for manufacturing and their relative importance differs as well.

3.1 Free movement of labour

The main area where the single market has had an impact on services is through labour mobility between Member States, facilitated by EU legislation on freedom to move and to establish and on the mutual recognition of qualifications. That this possibility is both known and appreciated can be judged from a Eurobarometer survey in 2005 (Eurobarometer 2005). When asked about what the EU represents for them, 53% of citizens replied 'freedom to travel and work in the EU' ahead of the Euro (44%) and peace (36%). Although overall labour mobility in Europe is low, quite significant movement has taken place in a number of sectors, e.g. for health services and construction. Labour migration has been especially significant from the new Member States to those of the EU-15 that opened up their labour markets to migrants.

Overall, the impact of mobility has been positive, overwhelmingly so for the recipient countries (UK 2007, European Commission 2005b, 2006; DIW 2003). Workers fill gaps in the labour market, support the provision of public services in areas such as public transport, health and education, are young, without dependants and working full time. The potential for migration can be seen from those countries that fully opened their markets to labour migration from new Member States in 2004 (UK, Ireland and Sweden). In Ireland, some 330,000 new member nationals obtained personal public service numbers—required to work or claim benefits—between May 2004 and February 2007. More Poles than Irish applied for these personal numbers in 2006. Between May 2004 and June 2007, the UK received 683,000 applications for worker status from the eight former centrally planned economies that acceded in 2004. Of these nearly all were accepted. The leading sectors for registered workers were both services: administration, business and management (37%) and hospitality and catering (19%; Fig. 3).

Migrants too have benefited. The Eurobarometer survey found that not only did Europeans in general have a positive view of the benefits of long distance mobility but that for the large majority of long-distance movers the experience was positive. Almost half of them (46%) declared that no aspect of their life had deteriorated after their move, 25% saw their job situation improve along with money (22%) and housing conditions (37%).

For those countries sending labour the situation is more nuanced. Where there is an excess of labour out-migration helps to re-establish equilibrium on the labour market and remittances can provide a significant source of income. Out migration can also create shortages of key personnel, particularly in areas such as health for which long periods of training are required. Ultimately, convergence in overall economic conditions will be decisive in ensuring that mobility meets genuine shortfalls and surpluses within the Union to the benefit of all.

The effect of the so-called posted workers directive, which deals with workers present on a temporary basis while they are working on a project in another Member State, appears to have been less than that of EU regulations on the free movement of labour. Even though it covers the basic needs of the market in terms of permitting cross-border provision of services its effectiveness suffers from problems of compliance and enforcement of the

Source: Border & Immigration Agency Accession Monitoring Report A8 Countries May 2004-June 2007

Fig. 3 Sectors in which registered workers are employed

directive by Member States in particular through the imposition of excessive administrative requirements. However, the main obstacle with posted workers is that they are dependent on the ability of firms to provide services cross-border which at present remains very circumscribed.

There can be strong substitutability in services between labour migration and provision of services. Working in a salaried position to get to know a country and its language can be a prelude to setting up there. In this sense, labour mobility and right of establishment are complements rather than substitutes.

3.2 Right of establishment

Because most services remain national and even local in character, establishment represents an obvious way in which to penetrate a market. Where a local presence is required on a continuous basis, it may be the only way. It should not be surprising therefore that foreign direct investment has proved a particularly important means of market integration for services. The share of utilities, construction and services in intra EU-15 foreign direct investment increased from 62% in 1995 to 82% in 2004 (Fig. 4). It is clear that financial services, business services and more recently telecommunications have been driving this increase accounting for 72% of all intra EU-25 FDI in 2004 (Table 5). While the majority of FDI is directed outside the EU for raw materials, utilities, construction, water and air transport and computer services, intra EU FDI dominates for most services. Trade and distribution, land transport, telecommunications, financial services and other business activities all see intra-EU shares in FDI of three fifths or more. The greater the need for a

Source: Eurostat

Fig. 4 Share of utilities, construction and services in intra EU-15 FDI

local presence, the more investment is concentrated on the single market. More recent data on mergers and acquisitions for 2006 also demonstrates an increasing focus on investment on services within the EU (European Commission 2007).

Public authorities appear particularly at ease with right of establishment since it enables them to maintain control of the activity through their national regulatory regimes. The effects on national and local employment are also likely to be reduced since national rules continue to apply. New entry for firms originating outside the home market can have an appreciable effect on the functioning of national or local markets. Examples are Vodafone and Orange for mobile telecommunications and the emergence of a Scandinavian market for retail banking. Single market rules have facilitated such entry on national markets of other Member States.

Nevertheless, entry through establishment should not be seen as a panacea for opening up the markets for services. It could even happen that market integration through establishment reinforces the dual nature of service market and limits the potential of high growth firms. This would come about if right of establishment was used essentially by very small and very large firms to the detriment of the most dynamic firms in the middle. Small firms are likely to be set up by new entrants that initially come as labour migrants. Large firms establish to cover a domestic market more conveniently than from their home base and have the means to cope with multiple administrative and legal systems. The companies that are likely to lose most by being forced to establish are the smaller and middle sized companies that cannot justify the overheads that such establishment would entail and whose main selling point is the flexibility with which they can undertake a task.

Table 5 Foreign direct investment by sector of activity EU-25

	2001 (%)	2002 (%)	2003 (%)	2004 (%)	% Intra
Total	100.0	100.0	100.0	100.0	62.3
Agriculture and fishing	0.0	0.0	0.0	0.0	43.4
Mining and quarrying	1.4	1.2	1.8	2.1	41.1
Manufacturing	17.0	16.4	15.8	15.2	56.7
Utilities, Construction and services	81.7	82.4	81.1	81.4	65.1
Electricity, gas and water	1.9	1.7	1.6	1.0	42.7
Construction	0.3	0.3	0.3	0.3	40.8
Total services	79.5	80.4	79.3	80.0	65.7
Trade and repairs	4.8	5.0	5.1	4.9	67.2
Hotels and restaurants	0.5	1.0	0.9	0.9	76.0
Land transport	0.2	0.2	0.2	0.2	62.8
Water transport	0.2	0.1	0.2	0.1	43.0
Air transport	0.1	0.1	0.2	0.3	47.9
Total land, sea and air transport	0.5	0.4	0.5	0.6	50.6
Telecommunications	10.0	8.3	8.3	7.8	74.7
Financial intermediation	40.2	43.2	43.2	43.9	62.0
Real estate and business activities	21.6	20.3	19.8	20.0	72.5
Real estate	2.6	1.4	1.6	1.4	69.2
Computer activities	1.5	1.4	0.4	0.3	35.4
Research and development	0.0	0.1	0.2	0.2	67.1
Other business activities	17.1	16.9	17.4	17.9	74.7
Other services	1.3	1.7	1.0	1.2	52.8

Source: Eurostat EU Foreign Direct Investments

3.3 Cross-border provision of services

As indicated by the trade data cited above, cross-border provision is currently very much a minor characteristic of service provision. There are both structural and regulatory barriers that reinforce each other. Nevertheless, by providing an alternative to existing channels, by promoting price transparency and through the possibilities opened up to compare how countries differ in the type and quality of service provided, cross-border provision may still have an impact on national systems of service out of all proportion to its relative importance in terms of sales.

Cross-border provision covers the situation in which neither the service provider nor the client move (comparable to trade in goods), where the client moves to the provider on a temporary basis and where the provider moves to the client also on a temporary basis (otherwise entry takes place by establishment). All three modes are practised although not to the same degree. Direct cross-border provision is the least frequently encountered. Technology does however provide possibilities that did not previously exist for such provision. For instance radiologists abroad can now interpret patients' data transmitted electronically.

Electronic commerce is probably the most significant form of direct cross border provision of a service that has been encouraged by technology. Even so, e-commerce remains overwhelmingly national in focus with just under three-quarters of sales to the own country of the supplier and a further 15% to other EU countries and only 8% to the rest of the world (Table 6). Sales to other EU countries are slightly higher for the euro area at 17% perhaps denoting the expected effect of greater price transparency and ease of payment within monetary union. As would be expected, the share of sales to own country show a quite substantial country size bias with larger countries more reliant on the home market.

Table 6 Internet sales over the last calendar year as a percentage of total turnover

	Business to business/ government	Business to customer	Business to own country	Business to other EU countries	Business to rest of the world
EU-27	78	19	74	15	8
EU-25	78	19	74	15	8
EU-15	78	20	74	15	8
Euro area	75	22	72	17	6
Belgium	79	21	60	32	7
Bulgaria	44	56	62	23	15
Czech Republic	83	17	58	33	9
Denmark	90	10	52	20	28
Germany	79	21	77	18	5
Estonia	—	—	—	—	—
Ireland	—	—	—	—	—
Greece	68	32	78	19	4
Spain	88	12	84	10	6
France	—	—	—	—	—
Italy	82	18	83	10	7
Cyprus	44	56	19	49	32
Latvia	60	40	89	5	6
Lithuania	86	14	75	16	9
Luxembourg	—	—	—	—	—
Hungary	95	5	51	36	13
Malta	—	—	—	—	—
Austria	72	28	71	24	5
Poland	81	19	88	8	4
Portugal	—	9	—	:	—
Romania	59	40	95	3	1
Slovenia	93	—	77	11	—
Slovakia	25	34	63	28	10
Finland	88	12	—	—	—
Sweden	84	15	67	23	9
United Kingdom	83	17	82	9	9
Iceland	60	38	67	17	7
Norway	71	29	84	13	2

Source: Eurostat Annual Survey of ICT usage and e-commerce. All, without financial sector (ten employed persons or more)

However, a number of smaller countries also demonstrate a very substantial home bias (Greece, Latvia, Lithuania, Slovenia and Norway) so that country size alone can not account for the high share of sales within the domestic market.

Temporary movement of the client to the provider of the service is perhaps the most common form of cross-border provision of service. Patient mobility whereby a patient seeks treatment abroad is the usual form of cross-border provision of health services although medical practitioners do also practise on a temporary basis in other countries (for instance to perform an operation). Cross-border shopping has a long history both in border regions and by tourists further afield. With the removal of border restrictions within the EU, there are few obstacles to cross-border retail activity.

For high level business services such as management consultancy or investment banking, it is more usual for the producer to travel to the client to provide services on a

temporary basis. The fact that these services are supplied on an ad hoc rather than continuous basis and the need for face to face contact means that this is the preferred mode of supply. Where a continuous service or intensive local presence is required establishment is preferred, often through international networks where professional services are concerned, such as the accountancy profession.

Summarizing, the single market has had a significant impact on the functioning of national markets for services but not always in the way that was expected. Potential undoubtedly exists for the single market to act as a catalyst for change in services that would benefit both users and producers of services and contribute to improving the overall performance of the European economy in terms of growth and jobs. However, progress is likely to be slower than expected and requires very many changes to the way in which individual markets function for the effect to be cumulative.

4 Drivers of change for the single market for services

The characteristics of services explain to a large extent the difficulties of integration, but that does not mean that the single market as a policy construct needs to be changed: the characteristics have always been there.⁸ This section argues that the world has changed in three crucial dimensions, and that taken together these trends do imply a need for a fresh approach to the single market.

4.1 New economy

Sapir et al. (2004) charted the fundamental way in which the economy has changed over the last thirty years and why many of the policies that were so successful in the post-war period no longer generate results in a way that they once did. The single market programme was conceived as a response to Eurosclerosis and was an early attempt to come to grips with that problem. However, the economic reasoning behind the initial programme was still largely based on an industrial economy with economies of scale in the manufacture of standardised products seen as one of the key benefits of the single market. An economy based on intangibles, on the rapid flow of information rather than materials and on innovation requires a different approach to the one required for an industrial economy. Selection and adjustment become more important than economies of scale and learning curve effects of mass production in commercial success. As a result vertical integration decreases and the importance of new entry, inter-firm mobility and competition on non-price factors increases. In turn this raises the requirement for and returns to job mobility and adaptability both between and within firms.

In such an economy the role of services is crucial. As less intensive users of material resources, services lead the way on intangibles. They provide key inputs for the rest of the economy (financial services, network industries, business services). Services are an integral part of the information economy with software complementing hardware and producing the information that flows over the internet. Services also enhance the necessary flexibility by providing the necessary outlet for displaced workers from sectors hit by restructuring and increased competition on world markets. Finally, many services have relatively low capital intensity and, where regulation allows, low barriers to entry. This sustains economic dynamism and the re-allocation of resources towards new and growing activities.

⁸ For a recent overview of challenges to the single market see Delgado (2007).

Van Ark et al. (2003) and Van Ark (2005) attempted to measure the contribution of the “new economy” to labour productivity and employment growth in the EU and the USA. The relative contribution of an individual sector to overall growth depends on a combination of the share of that sector and its rate of growth. ICT producing industries saw accelerating productivity on both sides of the Atlantic, but faster in the USA where the sector is also considerably larger. Compared to the USA, the EU demonstrated two major weaknesses, both concentrated in services. ICT using industries witnessed a big improvement in productivity in the USA, concentrated in a number of services (securities, wholesale and retail trade), which was not matched in Europe. While both ICT producing and using industries showed strong employment growth on both sides of the Atlantic, the difference in employment growth in the “non-ICT” service sector remained strongly in favour of the USA. It appears therefore that the boost to growth by the “new economy” was both greater and occurred in a more balanced way in the USA than in Europe and that the differing performance of services can account for most this.

Corrado et al. (2006) have a second, and broader, take on the role of the “new economy” which can be derived from examining the role of intangible capital and economic growth. This measure, is much closer in concept to that of the knowledge economy. They found that in 1999 that total business investment in intangibles was approximately one trillion dollars, roughly the same as investment in tangible capital at that time⁹. Because most intangibles are counted as intermediate consumption rather than final demand, they do not figure in the calculation of GDP. Counting software as an investment in the US national accounts in the mid-nineties increased the measured growth rate by 0.25%. The magnitude of the 1999 estimates suggests that uncounted intangibles have an appreciable effect on the level of GDP, as well as on the rate of investment and level of productivity. The authors found that the portion of growth explained by intangibles between 1995 and 2003 goes from 0% (by definition) to 27% when intangibles are included. Moreover, intangibles moved up to parity with tangible capital in importance as a source of growth. Overall, the study provides impressive evidence for the broader impact of the “knowledge economy” compared to the narrower “information economy”.

Compared with the previous industrial era, the contribution to radical innovation, often the product of new entrants and start ups, has increased. Overall, new firm creation in Europe is comparable to that in the USA as are the number of firms that exit economic activity. However, the growth profile is very different, with much faster growth in the USA of the minority of start ups that have real growth potential.

Nowhere is this more evident than in services. Take two rather similar innovations in concept, Starbucks coffee in the USA and the Pain Quotidien in Belgium. Both relied on a new business concept, how to supply an existing product in superior form to a market that was looking for higher quality combined with a better environment in which the products could be consumed based around conviviality. The degree of diffusion of the two chains is instructive (Fig. 5). From its origins as a vendor of coffee (beans and ground), Starbucks was taken over in 1987 and converted to a coffee bar chain and opened its first locations outside Seattle in Vancouver and Chicago the same year. By the time of its initial public offering in 1992, Starbucks had grown to 165 outlets. It opened its first outlet outside North America in Tokyo in 1996 and is now present in 30 additional countries with more than 10,800 Starbucks world-wide. Pain Quotidien was founded by Belgian chef Alain Coumont at the end of the 1980s who had decided to bake his own sourdough loaves after his source in Paris failed. Today Pain Quotidien has over 60 branches worldwide, mainly in Belgium,

⁹ Haskel and Marrano (2007) in a similar exercise for the UK arrived at very comparable results.

Fig. 5 Growth of number of stores Starbucks and Pain Quotidien

France in and around New York and Los Angeles but with a nascent franchise in the UK and Turkey and openings in Kuwait, Lebanon and Dubai. Both Starbucks and Pain Quotidien are successful applications of a similar concept, but one is much bigger than the other.

An EU in which economic structures are changing fast implies much greater labour mobility, both geographically and sectorally. As indicated in Section 3, labour mobility plays an important part in international integration for services. Restrictions on mobility therefore hit services particularly hard. Skill bottlenecks at present coincide with high unemployment. Widening wage differentials are a symptom of these bottlenecks. In the past, such differentials did drive mobility, both within countries and between European countries. Wage bargaining systems that effectively set a common wage across different regions and across sectors seriously diminish the incentive for mobility. Experience with successive waves of enlargement has shown that expectations also play a role. Where there is an expectation that national labour conditions are likely to improve, people are more reluctant to move across borders. Achieving greater mobility turns on a wide variety of factors both positive (such as incentives) and negative. Geographical mobility is hindered by the state of the housing market, with affordable property for rent often unavailable, and lack of facilities for child care. For cross-border mobility transferability of pensions, recognition of qualifications as well as linguistic and cultural barriers remain formidable.

Economies of scale still play a role as demonstrated by the introduction of second generation mobile telecommunications where the single European standard certainly enabled firms to exploit such advantages. However, network externalities and accompanying demand side economies of scale along with the trend towards customisation and differentiation will likely become more important than supply side scale economies. Speed to market and innovation have become key factors for ensuring success along with the ability to use technology successfully. These require different skills from those of replying to the undifferentiated demand that characterised the industrial era. Services play an important role both in facilitating and participating in these transitions.

Concluding, the introduction of IT in services both influences the way we look at service markets, and reveals an unfulfilled European potential.

4.2 Enlargement and globalisation

Sverdrup (2005) examines the degree to which enlargement has increased the administrative heterogeneity in the EU based on work by the Kaufmann and Kraay in the World Bank (2003). The World Bank sets out to measure government effectiveness in ten new Member States in terms of the quality of public service provision, the quality of the bureaucracy, the competence of the civil servants, the independence of civil service from political pressures and the credibility of the government's commitment to policies. It also sets out to measure respect for the "Rule of Law" in terms of the extent to which agents have confidence in and abide by the rules of society.

On both government effectiveness and the rule of law, the ten Member States that acceded in 2004 score much lower on average than EU-15. In addition there is less variance between Member States of the EU-15 on these two measures than between the ten new Member States. The two countries that acceded in 2007 score even lower than the EU-10. Sverdrup concludes that this increases the administrative heterogeneity in the EU to such an extent that it is likely to challenge the notion of homogeneous implementation and application of rules and regulations. Whether or not the data warrant this rather extreme conclusion, the regulatory environment that will be necessary to manage the single market of EU-27 will be different from that of the EU-12 under which the bulk of the programme was conceived. The market itself will no longer be 'single' but more diverse, culturally, linguistically, in levels of development and administrative capacity.

Globalisation, particularly the emergence of China and India, changes the context in which the single market operates. Since 1999, EU-25 shares of world trade in goods (excluding intra-EU trade) have been stable at around 19%. For services the share is considerably higher at 26%. In extra-EU trade, the EU remains the leading exporter for both goods and commercial services, the leading importer for commercial services and the second most important importer of goods.

Global financial market integration has progressed rapidly. Cross-border holdings of assets began to increase steadily from the mid-1970s on, with the accumulation of foreign assets accelerating sharply in the 1990s. In global terms, foreign direct investment (FDI) flows rose from 5% of world GDP in 1985 to over 15% by the late 1990s. The most remarkable feature in foreign direct investment in recent years was the acceleration of mergers and acquisitions activity from the mid-1990s, which drove global FDI inflows to a peak in 2000, but FDI flows slumped sharply after the dot-com bubble burst before recovering again.

The figures quoted above, and their stability over time, do not permit any conclusive judgments to be made about the impact of the single market. Nor do they confirm that the EU is unable to compete in a globalised world.

In view of their importance in the knowledge economy, standards, particularly standards for network industries are an important commercial instrument for market development and conquest. Europe has had relatively little success compared with the USA and Japan in imposing proprietary standards on the rest of the world. It has had more success with non-proprietary standards for which the official industry-led standards setting process is well equipped. The ability to develop successfully and have adopted widely such standards could represent an important lever for the EU in a globalised world. However, the ability to develop a standard is not sufficient. It must be done in a time-frame that is compatible with

fast-moving technologies and its adoption in Europe must lead other countries to follow suit. When other countries fail to adopt European standards, producers can be cut off from the markets they wish to serve. The advantage that Europe has over its major competitors resides in the more open standards setting procedure that ensures that third countries will be able to license the relevant patents easily.

Concluding, enlargement implies both a strengthening of the European market (sheer size) and increased diversity. Globalisation implies a shift in focus from an internal orientation (removing barriers for intra-EU trade) to an outside orientation (using the European dimension to compete on the world).

5 Implications for the future single market for services

The combination of the characteristics of services described in Section 2 and the trends described in Section 4 have implications for the way the single market for services functions, or rather, should function. Market models change. The world is changing fast and becomes more diverse. The diversity is biggest of all for services. This section develops four different implications for the single market for services.

5.1 Tailor-made versus general

The central principles governing the internal market for services are set out in the Treaty. This guarantees to EU companies the freedom to establish themselves in other Member States, and the freedom to provide services on the territory of another EU Member State other than the one in which they are established. In the first step towards an internal market for services these general barriers needed to be eliminated. While this process has not been completed (ever new barriers emerge), in the next phase the single market cannot go on in this way.

Today's complex and diverse world precludes one-size-fits-all solutions. The legal rights to establish a business and to move freely within Europe exist. But that alone is not sufficient to let markets function properly. In order for the single market to deliver further concrete benefits, one first needs to verify where the biggest potential for benefits lies and what is preventing these benefits from being realised. For this a results based approach taking a user perspective is needed through market monitoring. This implies analysing specific markets through a bottom up approach involving users, innovators and new entrants, market participants, public authorities and market experts. Such tailor-made solutions could even potentially be different across different Member States. Notice that this implies a rather different approach than the original single market that was based on uniformity.

Market monitoring begins with an in-depth analysis of the available statistical data. It then needs to be complemented with specialised knowledge of a sector, for instance on the nature of specific entry barriers and the type of regulation applied. Such knowledge is required to interpret the results of data analysis and to point up relevant factors that would otherwise be missed. Market monitoring, therefore, implies a combination of rigorous statistical analysis with more qualitative appreciation. The better the initial appreciation the easier will it be to proceed later with in-depth market monitoring.

The need to monitor markets applies equally well to manufacturing and network industries as to services. Indeed, the European Commission has already completed sectoral enquiries for energy, retail banking and business insurance which all revealed substantial

defects in the functioning of these markets. The particular importance of market monitoring for services stems from services' major share of the economy, from the very weak existing knowledge base about many services and the prevalence of barriers and anti-competitive practices in these sectors. Since co-ordinated action will be required to remove barriers and open up markets to competition for services (see next section), it is important that the knowledge base for such action should be developed.

Problems with the availability and quality of official statistics on service sectors are both substantial and well-known. Official Statistical Institutes are working to improve the situation but the rate at which changes are made differs from country to country. At the present time, it is still not possible to establish a comprehensive and accurate picture of the state of development of service activities at a sufficiently detailed level. The situation is compounded with regard to developments over time.

For services, annual enterprise based surveys for market services are necessary to provide the necessary micro-based information. The predominance of very small firms in service activity requires that also firms with twenty persons employed or less also be surveyed on a regular basis. Enterprise surveys can also provide a wealth of information, for instance the breakdown of turnover by segment that is of particular importance for market monitoring. Such comprehensive survey based data should become the initial source for market monitoring exercises in the place of the national accounts.

Lack of adequate data means that considerable caution needs to be exercised by users when interpreting results. This applies particularly to data from the national accounts, the only source for comparable cross-sector analysis and within the national accounts to that on productivity. Data on services accounting for two thirds of the economy is either unreliable or unsuitable for productivity analysis in its current state. Although improvements to the quality of official data should be a priority, such data will not be sufficient. Data on markets and their development will need to be collected from private and other sources in order to complement the official data.

Information on the use of services and the satisfaction of users, both SMEs and consumers is also important. Such data is already collected for several infrastructure services of general interest and constitutes a precious complement to other types of data for the single market. European Commission services need to be able to analyse on an on-going base the development of the major market segments for each sector and to be able to identify the major players. It should be mentioned that market analysis is required for several policies, including competition, trade and consumer protection policies in addition to the single market. Market monitoring should be able to respond to needs also for these other policy areas.

5.2 Coordinated market policy versus single market policy

The single market as it was originally conceived was a relatively autonomous policy. Eliminating legal barriers across Europe did not require much cooperation with other policies. However, if a bottom up and more tailor made approach is aimed for, cooperation is needed.

Sapir et al. (2004) already stressed the importance of better coordination between single market policies and other policies. Similarly, the OECD analyzed the gains that can be achieved from coordinating labour market and product market reforms (OECD 2001a, b, 2005a, b, c). In an empirical study, the IMF finds sizeable positive employment effects of deregulation in OECD countries (Berger and Danninger 2005). Reviewing the literature reveals that there are two different ways in which the single market interrelates with other

policies. The first one acknowledges that enhancing competition requires a whole array of policies, of which the single market is just one. The second one deals with the interrelationship with the labour market.

The principal goal of the single market program is to enhance competition. By opening up borders for players of other Member States, entry is facilitated. This enhances competition in those markets that are opened to foreign players and it also rewards efficiency. Successful companies can easier leverage their success into other markets than their domestic one, thereby increasing the incentives to compete and to innovate. There are examples of the single market legislation leading to effective competition, for instance retail banking in Sweden or market entry by low cost airlines (Baily et al. 2006).

However, more often than not, opening up borders alone does not do the trick. This holds in particular true for markets with oligopolistic market structures. Such markets involve vital sectors of the economy, from financial services, transport, energy, retailing, hospital services or the media. These markets are characterized by only a few active firms and entry is often difficult, such that government intervention can be needed to facilitate entry. This will usually require a coordinated effort by regulation, competition policy, and consumer policy. Further complexities ensue because oligopolistic markets are often markets with high levels of investment, which puts extra weight on carefully weighing of costs and benefits of any government intervention.

Take for example the energy market. The sector inquiry launched by the European Commission concluded that there are still a variety of obstacles for an effective internal energy market. Lack of transparency, insufficient market based pricing and inadequate regulatory action at Member State level leads to dependency of entrants on vertically integrated incumbents, such that most incumbents remain dominant on their home markets. Cross-border sales exert little competitive pressure, while integration is hampered by insufficient interconnector capacity and long-term capacity reservations predate the liberalisation. There is also a lack of adequate incentives to invest in additional capacity to eliminate long-established bottlenecks. Such a broad range of problems can surely not be solved with a single policy. The European Commission suggested combining competition law with remedies of a regulatory and structural nature and concluded that it might be unavoidable to fully unbundle the sector to achieve a well functioning common market.

The energy sector is by no means unique in its complexity and its need for single market regulation to interact with other policies. The initiation of detailed studies of the functioning of markets, with an open mind as to the best policy responses, such as the recent sector inquiries by the European Commission are good examples of how to proceed in future.

One of the consequences of market opening is that it prompts or speeds up business restructuring. New services are developed, foreign players enter the market, European standards are applied or innovation leads to a new way of working. These restructurings have implications for the size, the regional allocation and distribution of (un)employment. The success of market opening depends very much on the ability of labour markets to adjust in parallel, with the political willingness to break with traditional labour market institutions that do not cater for modern needs and with the capacity of policy makers to effectively manage transition.

Liberalisation of shop opening hours is a good example. While unsuccessful in Germany and Sweden they have been highly effective in the UK and The Netherlands, apparently without compromising working conditions. The difference between failure and success mainly depended on the ability of labour markets to adapt to the new situation. In the Netherlands, the opening hours provided an opportunity for job creation and flexible working hours so that the government and trade unions agreed on a drastic change in 1996

(OECD 2005a, b, c), while collective bargaining and tight restrictions basically prevented Sweden and Germany to take advantage of the opportunity offered by longer opening hours (McKinsey Global Institute country studies on France and Germany 2002, Baily et al. 2006).

Well functioning labour markets are particularly important for the creation of new activities. With demand uncertain, the ability to rapidly adjust employment levels becomes important. As is well known, the majority of job creation takes place in small and medium sized businesses and in services. SMEs are less able to balance work flows than large companies and therefore require greater flexibility. Many service activities require atypical hours (for instance the twenty-four hour nature of some financial services) or tailoring to when the consumer is available.

Although the employment potential of current changes in economic structures is large it will only materialise with a labour market that enables job creation in new activities. Conversely, what might happen to people who lose their jobs in countries with rigid labour markets? These people are not easily re-employable, either because they have obsolete skills or because they have made use of early retirement or other exit schemes. They perceive there to be no appropriate jobs available for them locally and they are not prepared to move home.

This appears to be the lesson from the OECD country study of Germany, which charts the success of German enterprises in restructuring their activities and gaining competitiveness on which Germany's formidable export resurgence has been built (OECD 2006). However, the job losses associated with restructuring are not compensated by gains in other sectors of the activity so that the net gain to the German economy is diminished. In addition, consumer confidence is undermined as a result of job losses. A McKinsey study of offshoring confirms this picture in more detail (Farrell 2004). While the USA gains \$1.12–1.14 from each dollar spent abroad in offshoring, Germany loses €0.2 from each euro spent abroad, because the value of German labour re-employed is so much less than that of the USA.

Another way labour market and single market policies interact refers to entry by foreign firms and labour mobility. Suppose that one European firm wants to open a subsidiary in another European country, thereby creating a large number of jobs. The firm wants to move some of its staff from the home to the foreign country. Obviously the economic feasibility of such a move would depend on the ease of pension and health transferability and other features that facilitate labour mobility. Javorcik and Spatareanu (2005) use firm level data on new investments in 19 European countries to analyze the impact on a variety of labour market regulations (flexibility of dismissals, length of notice period, severance payments) on FDI. They conclude that a clear positive relationship between flexibility of the labour market and the level of FDI exists and moreover the services sector is more sensitive to labour market regulation than manufacturing.

Single market policies can only be effective if labour markets are sufficiently flexible. But for labour market reform to be successful open market policies should be in place. Labour and product markets are communicating vessels. Successful countries design policies that make vessels communicate, policies that combine flexibility on the labour market with security for the individual affected (protecting the person not the job).

5.3 Regulations versus directives

The inflexibility of the existing 'acquis' (total body of EU law accumulated thus far) in face of globalisation and changing technology is a major potential problem for the future unless new, more rapid decision making procedures can be adopted. Enlargement requires an

acceptance both of more diversity and regulation that is easier to apply. From the beginning, the single market programme suffered from a tension between the stated aim of mutual recognition and the practice of harmonisation. The essential requirements doctrine was honoured more in the breach than in the execution and the process of political bargaining that preceded the adoption and transposition of directives led rather to harmonisation on the basis of the most regulated Member State than on that of the least. It could be argued that this was the price to pay for the high rate of adoption of single market proposals, particularly in the first phase between 1985 and 1992.

According to the OECD, in the past members of the EU were not distinguished among its members for the rapidity with which they liberalised their product markets, labour markets or financial systems (OECD 2005a, b, c). Ambler and Boyfield (2005) question even the efficiency of the Community method to achieve reforms, characterised as it has been by long adoption periods for directives, the need for transposition, delays in implementation and numerous derogations. They point out that Directives require Member States to legislate at least to the level set out by the Directive. If Member States legislate to exactly the same level, then the Directive may as well be a Regulation. According to them, either a matter requires harmonised EU legislation (in which case it should be addressed in a Regulation) or does not (in which case it should be left to Member States).

Another drawback of the Community method is the difficulty of modifying past compromises. It makes it difficult to rapidly change the rules of the game when a preceding approach is revealed as inadequate. The inflexibility of the existing *acquis* in face of globalisation and changing technology is a major potential problem for the future unless new, more rapid decision making procedures can be adopted. With the accumulation of single market legislation the disadvantage becomes cumulative (Aghion et al. 2006).

These problems will be magnified in an EU of 27 by the relatively underdeveloped administrative capacity of several new Member States to apply complex regulations and the increased difficulty in reaching agreement on new measures in an EU that has doubled its membership since 1995. Moreover, as the single market extends to public services, public procurement and the freedom to provide services, it starts to affect national social, regulatory and cultural models in ways that were not always originally envisaged. There is a latent opposition between the need for deep integration to achieve a single set of homogeneous rules of the game and a fragmented European space characterised by national idiosyncrasies and heterogeneous preferences (Aghion et al. 2006).

It follows that a single market that is predominantly based on Directives needs to be replaced by a single market that relies more on Regulations instead of Directives and non-regulatory policies.

5.4 National markets versus European markets

Given the nature of services discussed in Section 2, markets for services are overwhelmingly national, and in many cases local. The single market will therefore impact the development of services in large part through its effect on the functioning of national markets. EU regulation, for instance in the consumer field, is already having a significant impact on the functioning of certain national markets for services such as e-commerce. In other areas, the impact is much less. From the point of view of the user, the source of a regulation, European, national or local is immaterial. He or she expects the three to work together in a seamless fashion for the benefit of the user.

In view of the fact that most regulation of services will remain national, at least for the foreseeable future, the manner in which different regulatory levels interact is of prime

importance for the functioning of the single market. This goes beyond national authorities taking ownership for the single market, whose legislation they in any case apply along with their own. Up until now, the two major instruments for integration have been harmonisation around a common European standard and mutual recognition. In turn, mutual recognition has been seen as leading to competition between systems while harmonisation has been seen as a quasi-federal solution.

Given the fragmentation, the complexity and the difficulty of regulating many services, the achievement of a high degree of European harmonisation for many services is in any case illusory. Competition between systems is also unlikely to lead to market integration since many barriers to cross-border provision will remain. In addition to harmonisation and mutual recognition therefore a means to ensure that incompatible national systems of regulation do not stifle the development of services needs to be found. One solution could lie in a form of regulatory convergence around a common understanding of the purpose and best way to regulate in individual cases based on intensive contact between regulators and the diffusion of best practice. In addition to EU action, such convergence might lead to a dense web of multilateral and bilateral agreements between like minded countries coming to complement efforts at EU level to set basic or framework legislation in a given area.

6 Conclusion: tomorrow's single market for services

The single market programme has yielded substantial benefits. Yet there remains an equally substantial untapped potential. Benefits have not always reached consumers. International comparisons are insightful but do not reveal in which way the untapped potential can be released.

To release this potential, one cannot continue as before. The previous sections showed that the context in which the single market operates has changed. The intangible based economy, enlargement and globalisation question the effectiveness of continuing on the same basis. The areas within services that the single market programme has successfully addressed tend to be the least contentious and most obvious ones. Deep integration leads the single market into areas that are more complex and less amenable to simple and uniform solutions. In addition a social and cultural dimension often characterises these new areas. As a result, difficult political choices are needed but not easy to achieve.

One typical response in the literature is to look to the deficiencies of the single market programme itself. It is often said that the single market remains "incomplete". This is frequently seen in terms of either the absence of adequate legislation or if there is legislation, its imperfect transposition and enforcement. In the first category would come issues relating to the robustness of the compromise agreed over the Services Directive and the legislative gaps that arguably remain in sectors such as retail financial services, pharmaceuticals, and the defence industry (where the EU's competence is restricted). In the second category might come problems of enforcement and regulatory inadequacy across the EU in sectors such as wholesale financial services and the network industries, such as energy, posts and railways. For instance, one might want to analyse why EU-driven liberalisation appears to have been "more complete" in a sector such as telecoms, but much less so in energy, so far at least.

Despite the usefulness of continuing to reduce barriers, the single market can never be "complete". This is true not only in the obvious sense that markets are dynamic not static. But it is also the case that in the real world there are many factors that will ensure a permanence of diversity and legitimate non-tariff barriers within the single market as a result of such factors as differences of language, culture, consumer preference and the costs of doing business.

This paper concluded that for the single market in services to be effective in the future it needs to be based on in-depth knowledge of the different sectors. The energy market in Poland is more similar to the Spanish energy market than the Polish beverages market. Trade and entry takes place across borders in a sector, and it is easier to integrate single market policies with other policies at the sectoral level. Such integration is necessary since the single market is only one policy lever to enhance efficiency in markets, and different instruments at different policy levels need to be used in a coherent way.

A mix of both horizontal and sectorally specific instruments will continue to be required to manage the single market. Where barriers to integration stem from the specific nature of a sector, for instance prudential requirements for financial services, the main thrust of action for the single market remains sectorally focused. Where barriers to integration stem from more generic types of impediment, for instance professional qualifications, horizontal instruments will prove more effective. Whatever the instrument, their effectiveness will be worked out market by market and it is this sense that the single market will need to be based on a bottom up approach. In each case, the appropriate mix of instruments needs to be applied to remove the barriers that effectively impede integration for a given market.

To cater for increased differentiation, the new single market also needs to be less based on uniform Directives than in the past. Finally, the single market for services should take into account that most services market will remain mainly national or local in character. Further development of the single market for services is essential, but becomes effective mainly through its impact on existing markets.

The preceding examination of the conditions for a successful single market for services has wider implications. Labour mobility and permanent presence are very important for service markets and can be both complements and substitutes for cross border trade. Therefore, it is not possible to take a separate approach to market opening than for factor movements. Since immigration is a very sensitive subject, particularly from less developed to more developed parts of the world, progress on liberalisation of services at world level is likely to be slow. Regional agreements may need to be implemented first.

Furthermore, we concluded that opening up services markets implies addressing issues of trust. This implies both a strong regulatory environment and a high degree of mutual understanding between the regulators of different countries. This can only be built from the bottom up through regular contact and exchange of information on a long term base. The need for such practices is inherent when dealing with deep, 'positive' integration in place of the 'negative' integration that has dominated the liberalisation of trade in goods. International integration for services is therefore likely to take longer and remain less complete than that for goods for the foreseeable future.

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